ESG PRACTICES FOR PASSIVELY MANAGED EQUITY STRATEGIES

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EXECUTIVE SUMMARY

Mercer’s ESG (environmental, social and governance) ratings have generally been well-integrated into the manager research process for actively managed strategies. However, there continue to be challenges when assessing whether passively managed strategies exercise active ownership and stewardship responsibilities in a meaningful way. Many passive managers have identified their active ownership responsibilities through broader corporate governance and stewardship activities at a centralised firm-wide level.

Given the growing focus by Mercer and the investment industry on the importance of investor stewardship, we have created a framework for assessing passive equity managers to a format that more formally reflects active ownership practices such as voting, engagement, and industry collaboration on ESG issues. Specifically, we highlight the key areas of focus for passive managers and have developed a new ESG-Passive (ESGp) rating scale for passively managed equity strategies. Passive equity managers are long-term shareholders of stocks, therefore the key focus is on exercising ownership rights to generate value through good ESG practices.

Mercer’s clients have broad exposure to passively managed strategies and we have met a number of ‘preferred provider’ passive managers to assess their voting and engagement activities. Given the new ESG rating scale for passive strategies, we have prepared detailed assessments of these passive managers to which Mercer clients are exposed. It should be noted that, unlike ESG integration in active management, these assessments have been undertaken at the firm-wide level and specifically with the central corporate governance teams. More detail is provided below on the difference between ESG ratings for active and passive management.
The new ESG-Passive (ESGp) rating scale will be used to assess and identify clear leaders in ESG and investor stewardship for passive managers. More detailed analysis in the research note provides an assessment on how well firms undertake their stewardship activities such as voting, engagement, industry collaboration and reporting.

**The process will incorporate the assessment of:**

- Voting and engagement process
- Resources and implementation
- ESG integration and internal initiatives
- Industry collaboration and firm-wide commitment

**The following rating scale will apply:**

- **ESGp 1:** The firm is a leader in its active ownership activities, undertaking voting and engagement activities at a global level, rather than at just a regional level. Policies are clearly articulated, and transparent, with the resource and expertise and systems in place to ensure these activities are implemented effectively. Engagement is undertaken in a thoughtful manner and typically done at the company, industry and regulatory level. Voting policies also proactively address environmental and social issues in order for the team to vote effectively and engage with companies (rather than abstaining or focusing only on governance issues). Leading managers will also work closely with other teams on proactively addressing ESG integration across asset classes and have developed (or are working towards) ESG tilted passive strategies (beyond negative screening). Furthermore they will be active participants in collaborative initiatives with other institutional investors on ESG issues such as engaging with regulators and policymakers in order to drive the market forward in areas related to corporate governance, environmental and social standards. These managers will also typically demonstrate strong firm-wide commitment through the organisations in which they participate.
• **ESGp 2**: This rating will typically indicate the manager has made clear efforts to develop a process for its voting and engagement activities, but lags the best practices in some respect (e.g. regionally strong, but working towards developing a global presence; demonstrates some strength in company and industry engagement, but not in engaging with regulatory bodies, etc.). ESG integration may focus on one aspect or another (focus on ESG tilted passive strategies, or on working with the active equity teams within the organisation or with sub-advisors), but not necessarily on both.

• **ESGp 3**: Managers will have some dedicated resources in place and will demonstrate characteristics of the above, but the primary focus is likely to be only on governance aspects of voting and engagement. Voting and engagement will also tend to be at the regional level rather than global. Furthermore, engagements will typically be more reactive than proactive. There may also be more limited reporting and disclosure. The manager may have less internal resources available to implement active ownership to the same degree and might be relying heavily on external resources. They may be more locally focused in their engagement efforts rather than being more globally active.

• **ESGp 4**: Managers will have few resources in place and will demonstrate some characteristics of the above but will not have the same level of disclosure. Voting will typically be outsourced with limited oversight and little or no evidence of engagement. Efforts to address environmental and/or social issues, either within voting or engagement, will be limited or absent.

**Other passively managed asset classes**

In our discussions with some the passive managers listed above, we have noted that there is little activity around active ownership practices for other asset classes that are assigned a ‘PP’ rating such as cash, LDI, and passive fixed income (although in the case of the latter, some managers do look to engage with companies on behalf of both equity and fixed income investors). For the purpose of this paper, our passive ESG ratings will currently only apply to equity strategies. For all other passive asset classes, we will assign an N rating (although we will note where applicable, that we have ESGp ratings for the equity strategies).
BACKGROUND

The importance of stewardship

Given rising expectations around investor stewardship and active ownership, coupled with a growing market share for passive investment strategies, this is an area which we believe should be given much more focus. John Kay’s review on the UK equity market, published in July 2012, focuses on how the investment industry might be encouraged to think and act over a long-term horizon as opposed to simply managing to short-term earnings expectations. He proposed a number of recommendations\(^1\) to address the issue of short-termism and to encourage better stewardship and engagement between portfolio managers and companies. Regulators and industry associations have taken a similar view, introducing “stewardship codes” in a number of regions including the UK, across the EU, Switzerland, South Africa, Singapore, and most recently Japan. We currently provide assessments for some UK clients of the compliance of passive managers with the UK Stewardship Code.

A number of studies have shown that companies with more involved and active shareholders are valued more highly over the long-term. In particular, one study\(^2\) highlighted that firms are likely to be more engaged, and engagements more likely to be successful, if the target firm is concerned about its reputation and if it has higher capacity to implement corporate social responsibility changes. This study showed that after successful engagements, there is some evidence that companies experience improvements in operating performance, profitability, efficiency, and governance.

Passive investors have a clear financial interest in the long-term wellbeing of companies. However, given their inability to take direct action (through buying and selling stocks) as active managers would, and to walk away from companies that underperform, engagement with companies should be a core function for investment firms that manage passive strategies.

The United Nations Principles for Responsible Investment (UN PRI) have further highlighted that as passive investors represent a significant and growing share of the total investment market and have broad diversification, their wider influence can extend to the market as a whole, not only to individual companies.\(^3\) As such, long-term responsible investment activities such as addressing corruption and enhancing ESG disclosure across markets and through industry/regulatory collaboration are especially relevant for these passive investors.

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2. Dimson, Elroy; Karakas, Oguzhan and Li, Xi, “Active Ownership”, December 2012
3. UN PRI, “Responsible Investment in Passive Managed Strategies”, January 2011
Mercer research process and the four-factor consideration in assessing passive managers

The Manager Research team has been assessing passive strategies for a number of years, and has an investment rating scale that reflects the particular nature of these strategies. Passive strategies are currently assigned a ‘Preferred Provider’ or ‘R’ rating, and the Manager Research Ratings guidelines highlight the following:

“Preferred Provider” status is assigned to strategies within product categories for which Mercer does not maintain formal ratings. This indicator normally applies to strategies for which the primary goal is not outperformance of a benchmark – for example, cash, passive and LDI (liability-driven investment) strategies. Strategies assigned a Preferred Provider status will go through the RRC (Rating Review Committee) review process for ratings to be ratified.5

In assessing passive strategies, Mercer’s research focuses on the following: Portfolio Construction; Implementation & Risk Management; Cost & Fees; and Business Management. Given that the primary goal for these strategies is not outperformance over a benchmark, there is limited scope for ESG considerations to be actively integrated at the strategy level. However, voting and engagement activity can take place across all holdings and be driven by a central team or teams.

Difference between ESG in passive versus active strategies

Across actively managed strategies, ESG considerations specifically reflect two key ideas: 1) the extent to which ESG criteria are integrated into the investment decision-making process (i.e. idea generation and portfolio construction), and 2) voting and engagement practices (at the investment strategy level) and how this is reflected in portfolio decisions (i.e. increase, decrease exposure to a company following engagement). When considering passive strategies, two key distinctions must be made. First, the bulk of the focus is specifically on voting and engagement practices. Second, most of the analysis will typically focuses on firm-wide levels of commitment rather than at the investment strategy level (although there can be some variance in how this is implemented across different regions/markets).

We have therefore created a four-factor framework for passive managers in their active ownership activities to focus on the following:

1) voting and engagement process
2) resources and implementation
3) ESG integration and internal initiatives (focus on ESG initiatives within the business)
4) industry collaboration/ firm-wide activities

This is different from the four-factor framework for actively managed strategies, where we look for the following:

1) ESG in idea generation
2) ESG in portfolio construction
3) voting and engagement as it pertains to the specific strategy
4) firm-wide commitment

4 Mercer guidelines to ratings for definition.
5 Manager Research Rating Guidelines for more detail.
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