Why ESG matters... ...and how it affects you.

The world is changing. ESG is moving to the top of (most) world leaders’ agendas. What does this mean for pension fund investors?

CIO QUARTERLY UPDATE
Implications of market activity from Q3

DOES YOUR MANAGER CARE ABOUT ESG?
3 steps to understand your manager’s approach

INVESTMENT COMMITTEE UPDATES
Decisions made by the IC in 7 client areas

HOW TO ASSESS ESG IN ABSOLUTE RETURNS
CIO approach to ESG risk in portfolios
Welcome to Asset Class

Welcome to the latest edition of Asset Class. In addition to the usual market and Investment Committee updates, this quarter we focus on Environmental, Social and Governance (ESG) factors.

Whilst the concept of Responsible Investing has been around for several decades, it has yet to become a mainstream investment approach. Many pension funds and consultants still treat ESG as a separate activity: Responsible Investing concepts are not yet part of day to day conversation. So this quarter, Asset Class focuses on the best ways to help our clients understand their exposure to ESG risks and opportunities.

CIO Philip Rose and Head of Manager Research, Pete Drewienkiewicz, have taken a fresh look at assessing whether your managers are engaged with ESG. And whether it actually affects your investments.

If you’d like to discuss any of the articles, please contact your usual Redington consultant, or the Manager Research Team. We’d love to hear from you.

Honor Fell

PHILIP ROSE
CIO –
Strategy & Risk

As Redington’s CIO, Philip is responsible for signing off on the strategic investment process and ensuring that all risk management advice is of the greatest benefit to clients. Philip has over 20 years experience of structuring solutions for pension funds and insurance companies.

PETE DREWIE N-KIEWICZ
Head of Manager Research

Pete’s team is responsible for the research, selection and monitoring of fund managers across traditional and non-traditional assets, working closely with the consulting and ALM teams to ensure recommendations are in-line with clients objectives.
CIO MARKET UPDATE

Chief Investment Officer Philip Rose reviews the market highlights from the last 3 months.

Q3 was a positive environment for risk assets across both market and systematic risk factors. Volatility remained low on both a realised and implied basis as markets continue to shrug off geopolitical concerns.

Redington’s View: The front page of the newspaper may not be a good investment process. Consider your investment objectives and how you can best achieve them, rather than trying to react to every news story.

While the rhetoric from the Bank of England became distinctly more hawkish over the quarter, interest rates only moved marginally, with small rises in both nominal and real yields over the quarter.

RedView: The Bank of England has been wrong before on interest rates, but may not be wrong in the future. However, as shown in the US this year, rising short rates do not necessarily mean rising long rates.

Equities, bonds and commodities all performed well - albeit with modest positive returns.

RedView: Risk assets continue to deliver positive returns. Forecasting whether any individual risk factor will deliver positive over short, medium or long time periods remains challenging. There are often better ideas to spend your time on.

Equity value, equity momentum, equity quality and trend rose. At the same time, equity low volatility and FX carry both fell.

RedView: A low volatility environment does not always mean a long/short strategy (such as long/short equity low vol) will perform well. Correspondingly, a high volatility environment does not imply it will perform badly.

Credit performed well across both investment grade and high yield, with US long dated investment grade being the strongest performer. The excess returns in the chart below show the returns due to credit, with both interest rate risk and FX risk hedged out for investment grade credit and FX hedged out only for high yield credit.

RedView: While credit returns remain positive, they have declined from previous quarters. Clients may find that reliance on credit only may be an inefficient or insufficient way of meeting their required return target.
Redington’s mission is to help 100 million people become financially secure. This long-term ambition requires both a sustainable financial and social system. In addition to engagement, an integrated risk management approach is needed. We believe this includes managing Environmental, Social and Governance (ESG) factors. ESG will have a meaningful impact on long-term risk-adjusted returns.

Signatories to the Principles for Responsible Investment (PRI) continue to climb. Assets classified by UKSIF as being responsibly managed also tick up year on year. The latest PLSA Stewardship Survey of UK pension funds reported that 93% said ESG factors were material to financial performance.

Academic research into the financial materiality of ESG factors is also increasing. There is a growing acceptance that ESG data may lead to a more complete understanding of a company. Understanding ESG factors allows investors to take a more accurate view of corporate valuation or credit risk. Meta studies which collate the results of multiple related studies have shown either a neutral or positive relationship between ESG factors and financial performance.

However, we also recognise that, despite the growing awareness of ESG factors and implications many investors and asset owners still struggle to define a Responsible Investment policy or to measure exposure to ESG factors. ESG risks are often ‘unseen’ or unmeasured risks which may not be captured in traditional financial analysis and often not explicitly discussed during a traditional manager research meeting. This may be due to timeframe of analysis (short-term modelling may not capture ESG factors which are often long-term in nature) or lack of data (ESG metrics e.g. gender pay gap, carbon footprint have been inadequately reported in the past and although improving are not universally or standardised).

As investors start to look beyond traditional financial metrics and to incorporate ESG metrics the demand for providers of this data increases and the quality of data provided improves. A major sign that ESG is moving to the mainstream can be seen in the spate of acquisition of ESG research and rating companies by major mainstream research providers and investment firms. In July Morningstar took a 40% stake in Sustainalytics, and this was preceded by the acquisition of Trucost by S&P Dow Jones in October last year.

ESG is also of increasing importance as consumers start to change their behaviour: a YouGov poll conducted as part of last autumn’s Good Money Week found that 60% of the British public believe that the financial sector should be able to generate high returns whilst investing responsibly and 69% want a new law requiring financial advisors to ask customers if they’d like to exclude specific sectors of companies. Despite rising consumer expectations, the majority do not wish to pay more: they expect companies and service providers to bear any financial implication of acting sustainably. Brands and companies which do not live up to this expectation should expect to face increased scrutiny in the future: and may face destruction of value as a result. The corollary of this trend is that we expect to see increasing pressure from consumers of financial products to invest in a responsible fashion and to label products accordingly.

In this edition of asset class we shine a spotlight on the work Redington has done to increase focus on ESG issues and the ways in which Responsible Investment practices are formalised across our business.
MANAGER RESEARCH
We updated our 10x10x10 research process to include an ESG advantage in the 10 selection factors we use to assess Preferred Manager. ESG capability is assessed for managers across all the asset classes we cover.

QUARTERLY MANAGER REPORTING
We include the PRI Governance and Strategy assessment for all managers who are signatories. We recently completed a review of ESG data providers and will soon include a more dynamic, fund level score as a standard part of our reporting. We have engaged with all managers on whom we provide quarterly reporting: in our latest review we found that over 80% have a firmwide ESG policy however, fewer than 20% currently produce regular fund-level reporting on ESG factors.

INVESTMENT COMMITTEE
We assess all asset classes on whether it is possible to integrate ESG information into the investment process. Is it possible for an asset manager to engage on ESG issues? Is it possible to report on ESG characteristics? This assessment is fed into our model portfolios. The results are reflected in the client’s strategic asset allocation process.

TRUSTEE EDUCATION
We have developed an ESG education session which we run with clients. This education can simply serve as an introduction to ESG. We can also push further into a Responsible Investment Principle setting exercise.

PORTFOLIO REVIEW
As part of the trustee education session, or on an ongoing basis, we can provide a review of each asset manager’s capabilities. Plus, asset class allowing, we produce a report on the ESG exposure in each portfolio.
THE REDINGTON APPROACH

Redington Investment Principle #1

All investment strategy starts with the clear goals, constraints and objectives of the client, including a defined and agreed risk budget.

Redington champion a twin focus on client objectives and risk budget. This has meant that many clients have increased their allocations to absolute return investments, rather than “traditional” index benchmark investments.

So why has a focus on objectives and risk caused this shift? What does it mean for integrating ESG risk into client portfolios?

CONTEXT

Focus on Objectives
Focusing on objectives pushes investors towards absolute return. Historically, many benchmarks explicitly or implicitly measured performance against their peers. But relatively few of our clients are actually in competition with each other. They may have quite different objectives or risk tolerances.

Focus on Risk
Clients have looked to control risk both through hedging and diversification. Hedging risk such as interest rate and inflation risks requires a significant asset allocation in collateral. This leaves the non-collateral assets to generate returns. This has often meant accessing assets (such as equities) through synthetic means (such as equity futures) rather than direct investments.

Diversification has meant gaining exposure to several factors:
• new market exposures;
• systematic trading strategies;
• manager skill;
• illiquidity premium, some of which can be best accessed using futures or short positions.

Almost by definition, a diversified portfolio will not track any one market benchmark. It is much more suited to an absolute return mandate.

INTRO TO FRAMEWORK

Our framework for ESG investment takes into account three considerations;

Identification
Being able to measure ESG risk in the investments you own

Engagement
Working with companies to alter their behaviour

Investment
Integrating ESG into the investment process
This framework has been set up in the context of direct investment in equities and/or credit. It follows a benchmark with either an active or passive mandate.

How can we reconcile this approach with a focus on absolute returns?

**IDENTIFICATION**

For equity and credit benchmarked portfolios this is relatively simple. You can score each company or issuer according to the desired metric and total the results.

For absolute return based strategies this is more challenging for several reasons;
- Exposure may be obtained synthetically via index based contracts;
- A wider range of instruments may be used and there may be short positions as well as long;
- Indices can be viewed as their underlying components;
- Short positions can be netted off and instruments with no “official” score mapped to those that do.

While this is not straightforward, it is possible. It does, however, depend on manager transparency and getting timely data.

**ENGAGEMENT**

Engagement is more challenging when an investor is neither a direct owner or lender. Owning equity futures is unlikely to get you a meeting with even the largest index constituent. One possible engagement route is to invest via a manager that also runs large physical positions where they actively engage with company management. But, this is not engaging directly.

Accepting the trade-off between engagement and managing other risks may be a more realistic approach. Incorporating ESG into asset allocation does not mean putting it above all other risks. Rather, it means placing it in the same framework as other risks, some of which will be hedged out and others retained.

**INVESTMENT**

Incorporating ESG in the investment process is perhaps where there is the widest range of opportunities in the move to absolute return. Freed from benchmarks, managers can manage risks more closely. However, the wider opportunity set many make this more challenging.

Systematic strategies in individual stocks offer the opportunity of incorporating ESG at relatively low costs. They can also take advantage of opportunities to be short rather than long. The data based approach of these strategies means obtaining a longer history for ESG based risk factors more important. Yet the starting point of screening stocks according to set criteria does offer great opportunities.

**CONCLUSION**

It is undoubtedly challenging to measure ESG risks in absolute returns. But we believe it is worth making the effort to understand ESG risks and the implications for all asset classes. We believe that transparency and availability of data will only improve in the future. We can contribute to progress through keeping ESG in the agenda, both as we seek to continually improve our internal processes and in our interactions with our clients, asset managers and the wider industry.
ESG – OUR MANAGER RESEARCH PROCESS
The Manager Research Team consider ESG as a key component of our research process across all asset classes. In some asset classes e.g. Fixed Income we have found that managers aren’t as conversant in the language of Responsible Investment as active equity managers and therefore we often have to dig a little deeper to understand the way in which an asset manager considers ESG risks. In this piece Pete Drewienkiewicz outlines the techniques he uses to get to the bottom of ESG in the manager research process.

You need the 3 E’s – Engagement, Evidence and Evaluation
It may not be clear that a manager does ESG well if they are not used to talking to clients and consultants about the topic. It may be so integrated into their process that it isn’t visible. They might not think of it as something separate. That’s where the ‘3 E’s’ come in...

ENGAGEMENT
Traditionally engagement is viewed as the interaction between an asset manager and the companies they invest in. As consultants we do not have direct engagement with companies. However we do have the opportunity to engage with asset managers on the topic of ESG: to ask them to disclose information; challenge them to think about these topics more deeply; and sometimes even push them to improve their practices.

EVIDENCE
Most people think if a manager is investing responsibly it would be obvious – not necessarily. Engagement with asset managers not only helps us to incrementally add to the global trend towards greater transparency around and better understanding of ESG issues; it also provides us with evidence to support or discredit a manager research thesis. Pulling apart an asset manager’s process and corroborating their statements with our research is a key element of our process.

We want to understand whether an analyst uses ESG data. If so, what are the pitfalls as well as the benefits of each data set? Can a portfolio manager give an example of when ESG factors were assessed during an investment decision? And we want to make multiple touchpoints to ensure that the philosophy and approach is consistent. It’s incumbent on the researcher to dig deeper to find the evidence, rather than the manager.
EVALUATION
Once we have engaged with an asset manager and collected evidence, we need to evaluate what we have learnt. Context is king at this point: not only is best in class ESG integration wildly different across the asset classes we cover; we also see evidence of rapid change and constantly moving goalposts as the best continue to get better and the rest race to keep up. In many asset classes the standards of best practice have not yet been set; this makes ESG one of the areas that we believe it is crucial to have a manager research team able to carry out in depth, high quality manager selection to give our clients the best possible chance to meet their goals.

Conclusion
This is not a box ticking exercise. You need to specifically make managers show you where their strengths and weaknesses lie. When looking for evidence of an ESG advantage it’s harder if they don’t realise they’re good – it may not mean they’re bad. Our job is to ask the right questions; uncover the facts; and finally to set those facts in context.
Risk Adjusted Returns: Q3

Over a 1-year period, Developed Market Equities provided the strongest risk-adjusted returns, as the asset class delivered an excess return of 17.1% with a volatility of 4.6%, resulting in a Sharpe ratio of 3.69. Emerging Market Equities generated the highest excess return (21.4%), but a relatively high volatility (9.6%) meant that the Sharpe ratio of 2.23 was lower than for Developed Market equities. The asset classes that delivered the lowest returns over the 12-month period were UK Government Bonds and Index-Linked Government bonds, which returned -4.1% and -4.3% respectively. Other negative performers over the period were Commodities (-11.0% p.a.) and Macro Hedge Funds (-1.4% p.a.). Although useful for evaluating performance on a short-term basis, please note that one year is a short timeframe over which to assess risk and return characteristics.

Over a 3-year period, European High Yield had the highest risk-adjusted return with a Sharpe ratio of 1.04. Emerging Market Debt (0.93), US Leveraged Loans (0.78), US High Yield (0.78) and UK Index-Linked Government Bonds (0.77) have also exhibited strong risk-adjusted returns over the period. Commodities and Macro Hedge Funds performed poorly, with excess returns of -11.0% p.a. and -1.4% p.a. respectively. Emerging Market Equities displayed the highest volatility of all asset classes shown, at 15.5% p.a.
On a risk-adjusted basis, European High Yield Credit remains the best performer over a 5-year period, with a Sharpe ratio of 1.63. The second-best performing asset class was Developed Market Equities, with Sharpe ratio of 1.07. Emerging Market Equities posted the highest volatility of the assessed asset classes (14.3% p.a.) over a 5-year period, however the low expected return (3.5% p.a.) meant it was one of the worst performers on a risk-adjusted returns basis (with a Sharpe ratio of 0.24). Commodities and Macro Hedge Funds were only two asset classes to deliver a negative excess return, returning -11.0% p.a. and -0.9% p.a. respectively.

Looking at a 10-year period, Index-Linked UK Government Bonds was the strongest performing asset class on a risk-adjusted basis (with a Sharpe ratio of 0.71). In addition, it delivered the highest excess return (6.7% p.a.). This asset class was closely followed by EMD Currency, with an excess return and Sharpe ratio of 6.4% p.a. and 0.70 respectively. Commodities was, again, the weakest performer returning -7.7% p.a. Developed and Emerging Market equities displayed the highest volatility of the asset classes shown, but achieved relatively low returns over the 10-year period, resulting in Sharpe Ratios of 0.20 and 0.02 respectively.
Redington’s Investment Committee meets every week to ensure clients don’t have to. At this committee we discuss changes to key investment strategies. The Investment Committee will flag any developments that require your attention. Here is a roundup of the committee’s activity from July through to September. We continue to look at each client in the context of their own objectives and constraints. Our consultants will be in touch directly if any of these decisions impact you.

**Top IC Updates**

**July - September**

**Clear Goals and Objectives**
1. Buyout Framework
2. DC Pension Objectives
3. DC Model Portfolios
4. Incorporating SCRM into PRMF

**LDI and Overlay Strategies**
1. SONIA LIBOR Modelling
2. Segregated LDI Preferred List

**Liquid Market Strategies**
1. Equity Expected Returns
2. Liquid Markets Model Portfolio Classification
3. Japan Equity Preferred List

**Liquid & Semi Liquid Credit Strategies**
1. Multi-Class Credit Model
2. Liquid Credit Model Portfolio
3. Evidencing Credit Alpha
4. Credit Market Timing
5 ILLIQUID CREDIT STRATEGIES
1. SETTING AN ILLIQUIDITY BUDGET
2. OIC EXPECTED RETURN
3. ILLIQUID CREDIT MODEL PORTFOLIOS WITH ESG

6 ILLIQUID MARKET STRATEGIES
1. ILLIQUID MARKET MODEL PORTFOLIOS WITH ESG
2. ILS EXPECTED RETURNS
3. REAL ASSET OPPORTUNITIES

7 ONGOING MONITORING
1. MODEL PORTFOLIO PERFORMANCE CALCULATION
2. CLIENT COMMUNICATION ON REPLACING LIBOR
3. MRT RATINGS
## Redington Investment Principles

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<th>STRATEGY IMPLEMENTATION</th>
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<td>1 All investment strategy starts with the clear goals, objectives &amp; constraints of the client, including a defined and agreed risk budget.</td>
<td>6 For every return above the risk-free rate there is a risk; however some risks offer no or negative expected returns.</td>
<td>11 Risk management needs to be put in place in the good times to have the most effect in the bad times.</td>
<td>16 We accept that our clients may have strong market views but we will encourage them to right-size the risk they take in expressing these views.</td>
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<td>2 The success of an investment strategy is judged by meeting client objectives, not in predicting the direction of the market.</td>
<td>7 Our assumptions where possible are empirically based.</td>
<td>12 Risks still exist if you don’t measure them, but risks can only be controlled if you do measure them.</td>
<td>17 Spend more time on things that will make a difference to goals and objectives and less time on those that won’t.</td>
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<td>3 Investment strategy should be as simple as possible but as complex as necessary to meet client objectives.</td>
<td>8 Using prudent expected return assumptions incorporates a margin of safety leading to better outcomes.</td>
<td>13 Risk management and asset allocation are not an exact science; you need both qualitative and quantitative judgement.</td>
<td>18 Implementation costs (both trading and fund management fees) should be as cheap as possible but not at the expense of compromising client objectives.</td>
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<td>4 Investment strategy only works if it is implemented; a strategy can only be optimal if a client will execute it.</td>
<td>9 Going strategically net short a risk premia should be subject to a much higher hurdle than being long.</td>
<td>14 We accept that making mistakes is inevitable; we commit to acknowledging, correcting and learning from them.</td>
<td>19 Prioritise the “quick wins” first before worrying about how difficult the harder things are.</td>
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<td>5 Manager selection should not drive investment strategy; rather managers should be chosen to fulfill the strategic asset allocation.</td>
<td>10 Illiquidity always increases risk relative to a liquid comparable asset and so needs to offer a higher expected return to be a part of an asset allocation.</td>
<td>15 Diversification adds value over the long-term but cannot be relied upon to protect the portfolio in all adverse conditions.</td>
<td>20 If you don’t understand something, our advice is don’t invest in it.</td>
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**Risk Factor Glossary**

**EQUITY RISK PREMIUM:**
Excess return over cash of Net MSCI world index in USD, scaled to 10% volatility

**TERM PREMIUM:**
Basket of excess return on four 7 to 10-year government bond indices, scaled to 10% volatility

**COMMODITIES:**
Excess return over cash on Bloomberg Commodities Total Return index, scaled to 10% volatility

**EQUITY VALUE:**
Excess return over cash on MSCI World enhanced value index, beta neutralised, scaled to 10% volatility

**EQUITY MOMENTUM:**
Excess return over cash on MSCI World momentum index (M1WOMOM), beta neutralised to Net MSCI World index, scaled to 10% volatility

**EQUITY QUALITY:**
Excess return over cash on MSCI World quality index (M1WOQU), beta neutralised to Net MSCI World index, scaled to 10% volatility

**EQUITY LOW VOLATILITY:**
Excess return over cash on MSCI World min vol index (M00IWO$O), beta neutralised to Net MSCI World index, scaled to 10% volatility

**TREND:**
Excess return over cash on SG trend index, scaled to 10% volatility

**FX CARRY:**
Excess return over cash on Deutsche Bank developed market FX carry index (DBHTG10U), scaled to 10% volatility

**RESPONSIBLE INVESTMENT:**
Focuses on the financial materiality of ESG (environmental, social and governance) factors. Then integrates these factors into firm valuation / credit analysis.

**SOCIALLY RESPONSIBLE INVESTMENT / ETHICAL INVESTMENT:**
Based on moral or religious beliefs. Primarily involves negative screening of portfolios to exclude undesirable characteristics.