GIB ASSET MANAGEMENT

ESG: Impacting Impact

Gulf International Bank (UK) Limited
November 2019

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GIB ASSET MANAGEMENT

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GIB (UK) is a London-based international asset management firm. We have been managing institutional assets for over forty years for our clients from our offices in London and New York. We are active in global equities, investment grade and high yield fixed income (including emerging market debt and structured credit) and trade finance.

We strive to align our investment style with the priorities and goals of our clients. By investing with purpose we create the trust necessary to underpin long-term relationships; some of our clients have been doing business with us for over 30 years.

Our objectives:

- To provide a window on the world for our investors
- To challenge conventional thought and status quo
- To institutionalize a responsible investment culture
- To foster economic development through delivery of innovative investment products
- To provide leading analysis and insight to support client investment decisions
- To deliver superior investment performance

GIB (UK) is regulated in the UK by both the Financial Conduct Authority and the Prudential Regulation Authority and is registered as an Investment Advisor in the United States with the Securities and Exchange Commission.

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Contributing Authors

Gregga J Baxter	General Manager
Alan Lehman, CFA	Senior Analyst
New York	+1 212 922 2341 330 Madison Avenue New York, NY 10017

This research benefits from the considerable input of GIB (UK) investment teams in London.

London	+44 207 259 3321 One Knightsbridge London, SW1X 7XS

For more information, contact our sales and marketing team at +44 207 259 3149 or by email:

John Angell	John.Angell@gibam.com
Andrew Houghton	Andrew.Houghton@gibam.com

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Summary

Investment activity can no longer support economic activity that is unsustainable.

Global sustainability is defined by the 17 Strategic Development Goals (SDGs) adopted by all 193 members of the UN General Assembly in 2015. The investment required to meet these goals by 2030 is estimated at $96 trillion. This is roughly equivalent to current Gross World Product (GWP) or current global securities market capitalization.

While sustainable and responsible investing is a current megatrend, in of itself it is not enough to make the necessary impact to achieve the SDGs. The rallying call to investors to employ influence through proxy voting and engagement is vital yet has inherent consequences and challenges.

One repercussion is the response by green- and rainbow-washed investment managers to use an SRI mantra merely to raise assets under management for premium fees. To make the necessary impact the asset owner universe needs to join the *stakeholder* ecosystem and make a real world difference.

The challenge is the sheer weight of dollars ***not*** aligned to SRI principles. These dollars dominate global equity and fixed income indices such that the prospect of achieving the real world SDGs can seem out of reach. Yet the global financial ecosystem has hundreds of touchpoints which, if pulled together, can make global sustainability a reality.

Over a period of twenty years British cycling evolved through the aggregation of marginal gains to become today's global cycling powerhouse. In the same way, the transformation of the financial system requires each component to align with sustainable objectives. When that happens the term sustainable and responsible investing will be redundant and investment and economic activity will be synonymous with sustainability.

Introduction: The Elitist Disconnect

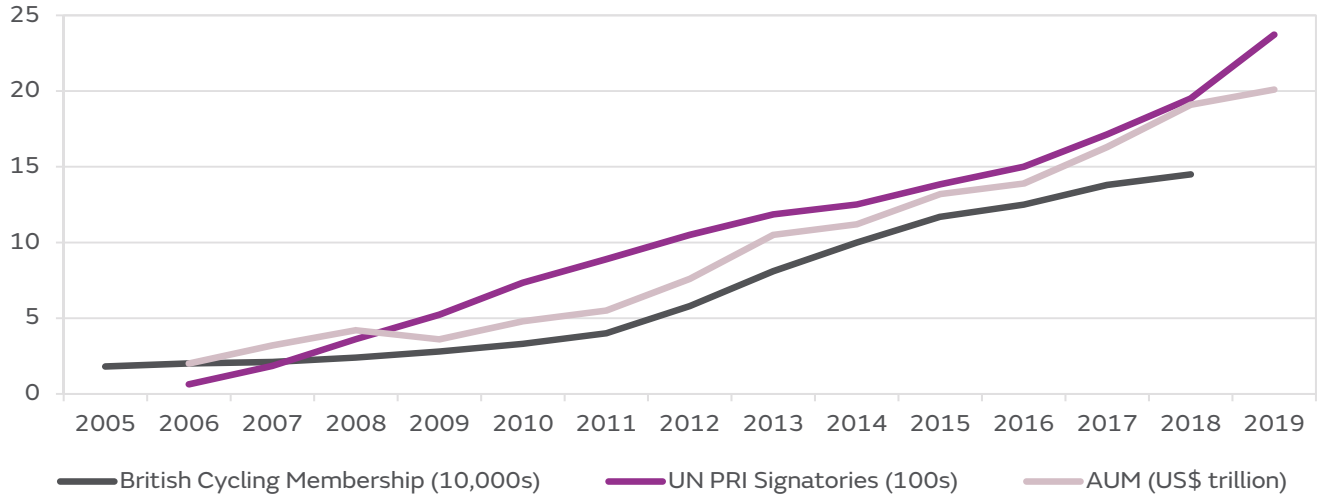
In the late 1800's cycling in Great Britain was ridiculed; the then governing body the National Cyclists' Union (NCU) was ruled by elitists who viewed the bicycle "as a machine of working classes and a strong resistance to racing rapidly emerged from the wealthy ruling classes." The NCU's attitude led to the development of a clandestine cycling organisation (the Road Racing Council [RRC]) which operated races in "dark clothing, no racing numbers and [taking a] 'secret society' approach..."[1]

The British cycling ecosystem was doomed to irrelevance relative to the flourishing international scene where Le Tour de France (initiated in 1903) and Giro d'Italia (1909) were garnering worldwide attention. The first positive step came from a single individual, Percy Stallard – Britain's premier cyclist, at the height of World War II. His advocacy for modern racing was dismissed as a hopeless revolt but he prevailed and the British League of Racing Cyclists (BLRC) was formed. The positive momentum continued until, in 1955, Brian Robinson became the first Briton to win a stage of Le Tour de France.[1]

By 1959 the world governing body (Union Cycliste Internationale) was able to pressure British cycling to unify the NCU and BLRC into a credible body, the British Cycling Federation (BCF). Nonetheless, the BCF languished through the succeeding decades. That all changed in 1997.[1]

This paper is about the impact of sustainable and responsible investing (SRI), not the history of Great Britain nor cycling. Akin to British cycling, SRI has developed a credible ecosystem capable of making an impact – a direct response to the reality *investment activity can no longer support economic activity that is unsustainable.*

Table 1



Source: British Cycling – adapted from annual reports and UN PRI[2]
AUM represents UN PRI Signatories Asset Owners' AUM

1 www.britishcycling.org.uk/search/article/bc-50th-The-Story-behind-British-Cyclings-formation
2 www.unpri.org/Uploads/h/b/r/priglobalgrowth20062019_50545.xlsx

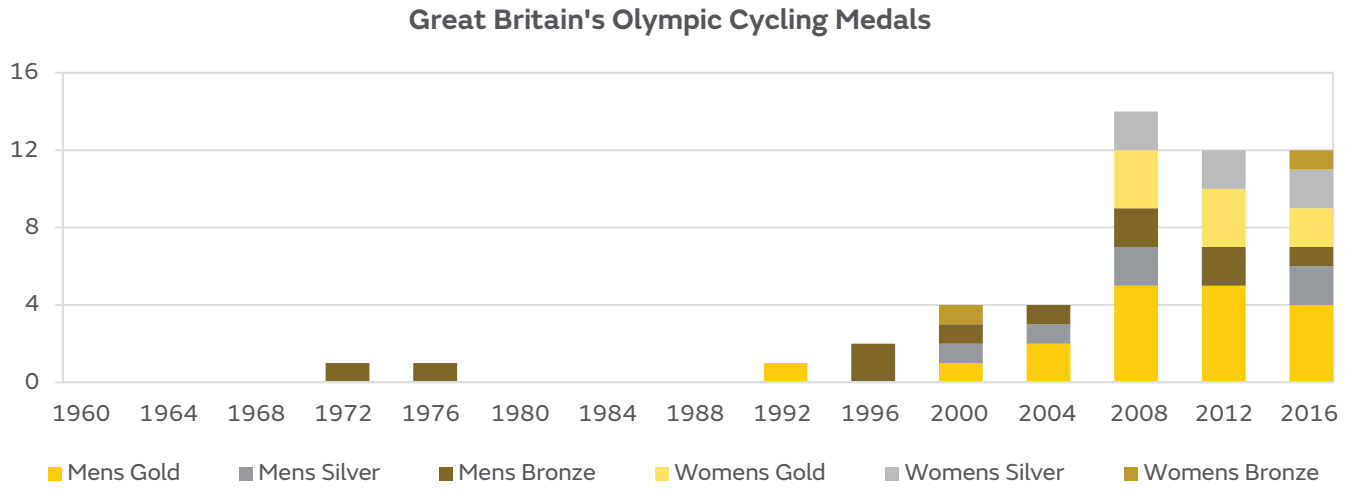
The investment community today has evolved to take responsibility for the effects of their investments. Yet the impact asset owners celebrate raises some questions. In this paper we examine what it means to be impactful, how change is attained and the specific methods investors are using to bring about change.

In 1997 British cycling too resolved to make an impact. To do this BCF hired Peter Keen as its Performance Director. He outlined a turnaround plan and in 1999 BCF was awarded lottery funding for six years. In the 2000 Summer Olympics in Sydney Great Britain won two bronzes, a silver and a gold medal. Yet Britain went from worthy competitors to the pinnacle of domination when they brought in Dave Brailsford.[3]

Brailsford "was relentless[ly] commit[ed] to a strategy that he referred to as 'the aggregation of marginal gains,' which was the philosophy of searching for a tiny margin of improvement in everything you do."[4] Brailsford said, "The whole principle came from the idea that if you broke down everything you could think of that goes into riding a bike, and then improve it by 1 percent, you will get a significant increase when you put them all together."[5]

"Just five years after Brailsford took over, the British Cycling team dominated the road and track cycling events at the 2008 Olympic Games in Beijing, where they won an astounding 60 percent of the gold medals available. Four years later, when the Olympic Games came to London, the Brits raised the bar as they set nine Olympic records and seven world records."[4]

Table 2



Source: Sports-Reference.com[6]

3 www.britishcycling.org.uk/search/article/bc-50th-The-Story-behind-British-Cyclings-formation
4 www.jamesclear.com/marginal-gains
5 www.bbc.com/sport/olympics/19174302
6 www.sports-reference.com/olympics/countries/GBR/summer/CYC/

The SRI Ecosystem: Moving Toward Universal and Mainstream

The SRI ecosystem is no longer the purview of a limited subset of the investment universe proselytizing in isolation. "In spite of growing anti-globalization tensions in many countries, connectedness reached an all-time high in 2017, as the flows of trade, capital, information and people across national borders all intensified significantly for the first time since 2007."[7] Despite political headwinds, a globally connected sustainable investment universe has now evolved to become mainstream. The UN Principles for Responsible Investment (UN PRI) reported that in 2018, 86% of asset owners now "consider ESG/active ownership in the selection and monitoring of external managers" – a 31% rise since 2017.[8] What then does this mean for the financial ecosystem?

The entire rationale for investing has changed. First introduced in 1962, the Friedman doctrine holds that corporations should only be responsible to shareholders.[9] Today, global investors demand a different ideology; one that engenders responsibility to stakeholders, i.e. clients, community, employees, regulators and asset owners (not just shareholders [equity owners][10] but all asset owners, i.e. equity owners, debt owners and financial asset owners).

> We will be active owners and incorporate ESG issues into our ownership policies and practices.
>
> **UN PRI – The Six Principles: Principle #2**

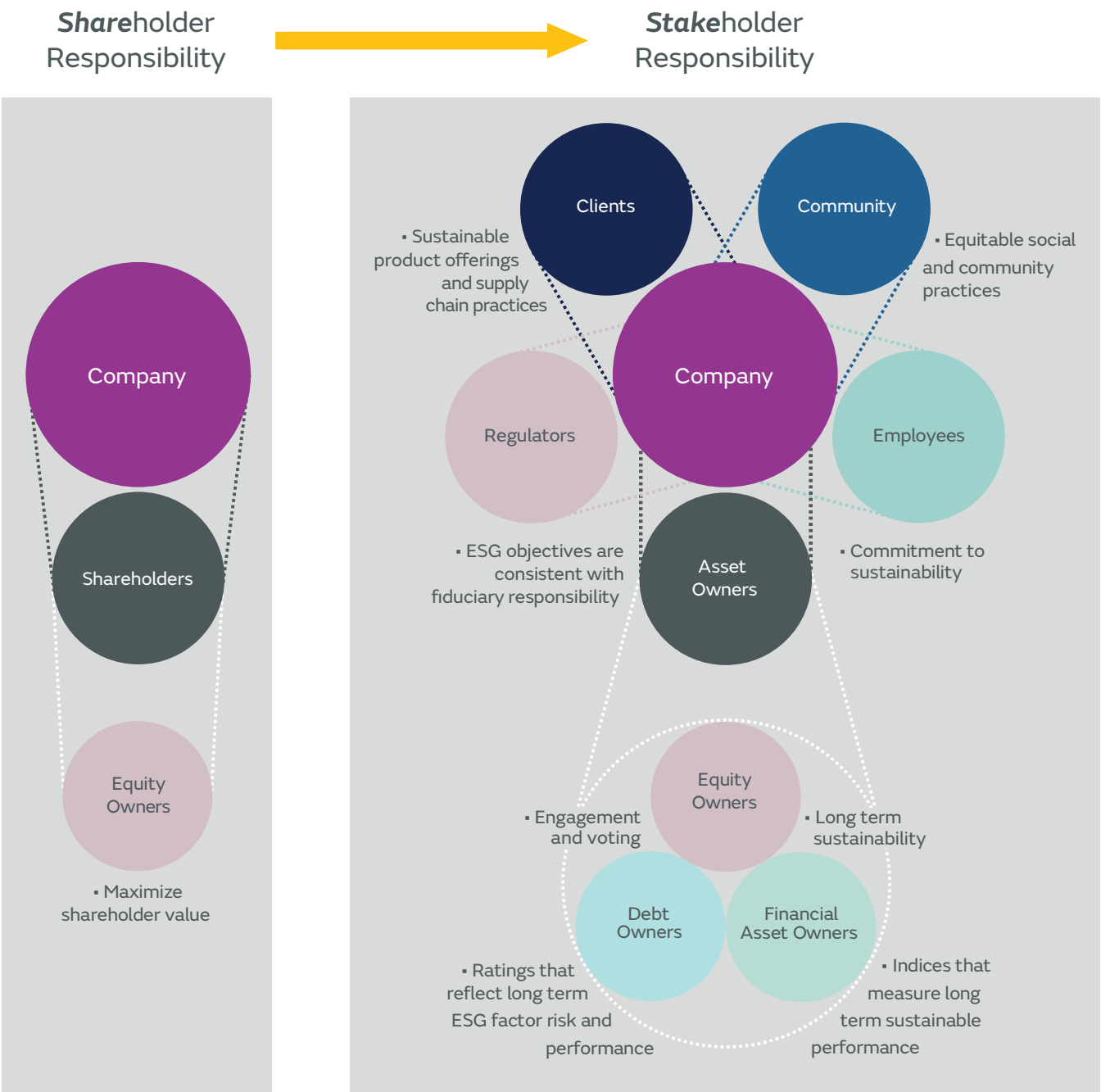
So how do investors promote this broader stakeholder responsibility? By incorporating the real-world impact investment decisions have on traditional risk/return allocation strategies. To do this the UN PRI outlines two major avenues of investor influence used to shape their holistic risk/return/real-world impact allocation: **proxy voting** and **engagement**.

The UN PRI's Six Principles reflect the reality that investor influence comes from within the investment community, i.e. investment behaviour needs to change in order to deliver sustainable purpose. The starting point of course is to measure sustainable purpose in order to set an investment goal. We measure sustainable purpose as the investment required to meet the 17 SDGs by 2030. In 2014, the United Nations Conference on Trade and Development (UNCTAD) measured that need as $5 to 7 trillion per annum or $96 trillion cumulatively.[11] This amount compares to current global securities market capitalization of US $102 trillion.[12]

7 Steven A. Altman, Pankaj Ghemawat, and Phillip Bastian, "DHL Global Connectedness Index 2018," Deutsche Post DHL, February 2019
8 www.unpri.org/annual-report-2018/how-we-work/the-pri-in-numbers
9 Milton Friedman – Capitalism and Freedom (1962)
10 Set by the Friedman Doctrine
11 unctad.org/en/PublicationChapters/wir2014ch4_en.pdf
12 Defined as the total market capitalization of the MSCI ACWI Index (US $45.7 trillion) plus the Bloomberg Barclays Global Aggregate Index (US $56.4 trillion) as of August 30, 2019. Source Bloomberg

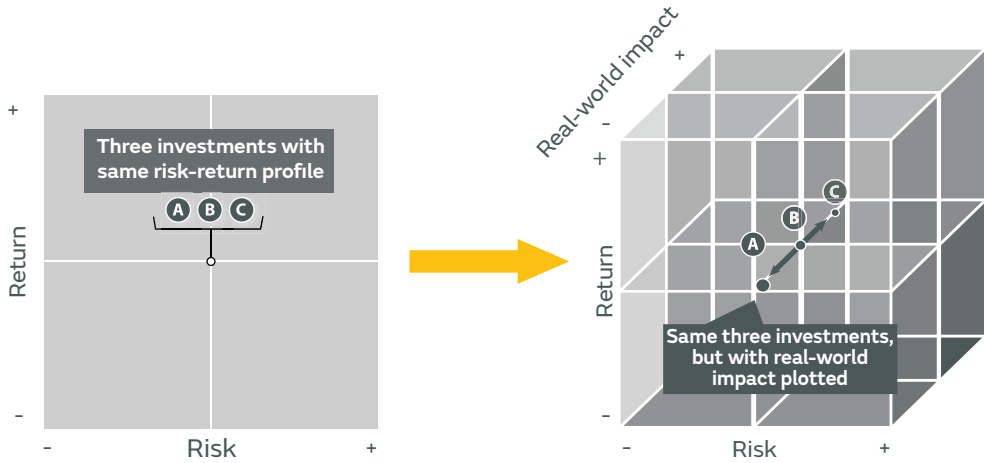
To simplify, by 2030 the total market capitalization will need to ~double (or grow on average ~4.2% per annum) just to satisfy the UNCTAD funding estimates. Compare this to the annual equivalent growth of equities (8.9%) and fixed income (4.2%) since 2003.[13] The 4.2% growth is irrespective of population, civil advancement or sustained growth required to facilitate a functioning global society.

Table 3



13 As defined in footnote 12

Table 4

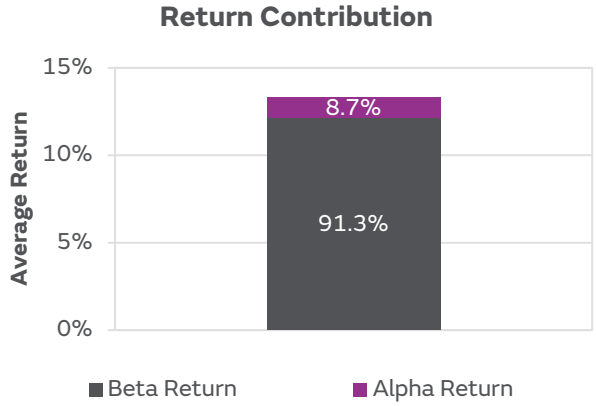


Source: UN PRI

Over the period to 2030 the financing need can be met by increasing the tax rate/GDP percentage by 7.0% or by allocating 5.9% per annum of global securities.[14] The investment need varies enormously from country to country (4-15% according to the IMF)[15] such that at the higher range the incremental tax rate/GDP percentage (or incremental borrowing) needed is simply not attainable.

Investment assets are therefore vital to achieve a sustainable future.

Table 5



Source: Bloomberg and Vanguard. Sampling of Vanguard active funds which outperformed their benchmark. January 1, 2019 through September 30, 2019.

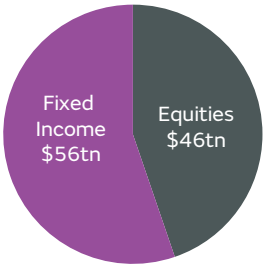
The investment change needed cannot be met by a handful of well-intentioned impact funds or even by a handful of global sovereign wealth funds. Nor can the investment need be generated by active managers given that global alpha equals market beta combined with the tendency of recessions and/or market shocks to wipe out cumulative alpha every decade or so.[16] The need requires contribution from all types of investors (SRI, impact, active, passive, macro, micro, public, private, equity and debt). This does not mean discarding modern portfolio theory but instead globally (and collectively) taking a more holistic view of investor responsibility.

14 7.0% equates to ~$6 trillion/$85.8 trillion GDP (per annum)
5.9% equates to ~$6 trillion/$102.1 trillion global securities market capitalization (per annum)

15 IMF - Fiscal Policy and Development: Human, Social, and Physical Investment for the SDGs – Vitor Gaspar, David Amaglobeli, Mercedes GarciaEscribano, Delphine Prady, and Mauricio Soto (January 2019)

16 In short, Beta = Correlation Asset, Benchmark x (Standard Deviation Asset / Standard Deviation Benchmark) or Beta = Covariance Asset, Benchmark / Variance Benchmark meaning that depending on how an asset performs (using the expected return CAPM model as a proxy, ER = Rf + B x (ERm - Rf), its performance is influenced by the broader market. As asset beta rises the expected return of an investment will also rise due to its positive correlation relationship (with the exception of rare negative beta assets).

Current Market Capitalization



$102tn
2018 market capitalization

2030

$86tn
2018 global GDP

5.9%
growth (pa)

7.0%
growth (pa)

How can we get there?

$12,455
total needed per person

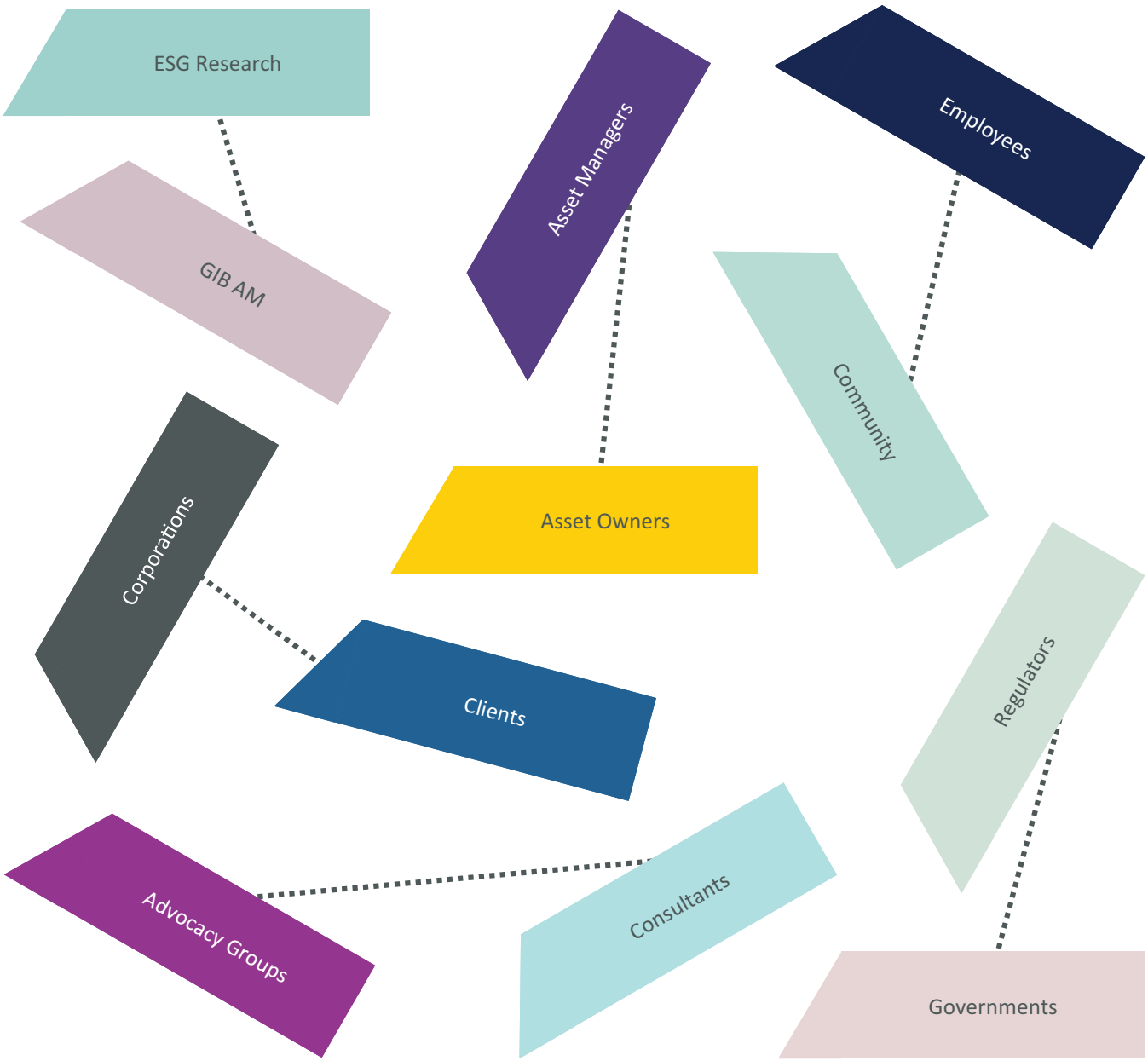
320bn
bicycles purchased

$777
needed per person (pa)

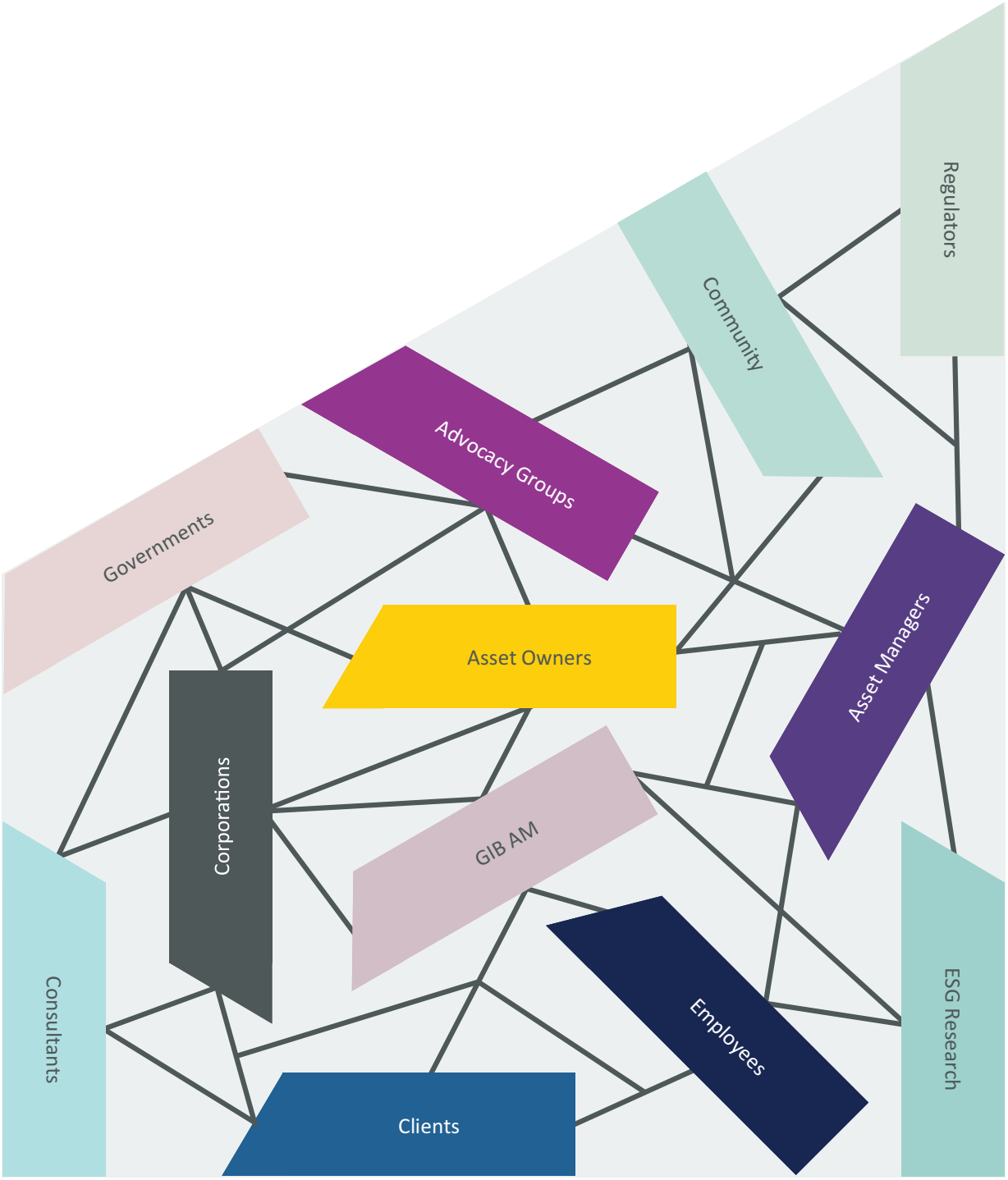
42 bicycles
per person

Source: Bloomberg, Consumer Reports, UNCTAD, World Bank, GIB UK

Current Disorganized Ecosystem With Minimal Collaboration



Desired Ecosystem Where All Stakeholders Interact



The Stakeholder Ecosystem

Each stakeholder has various outlets to influence their ecosystem. In this section we present case studies (presented in alphabetical order) highlighting the ways which they were able to bring about change and make an impact.

Client Impact

Sometimes company behaviour is altered in direct response to client demand. Clients are the lifeblood of any organization and without their demand, supply is meaningless. As a result, companies must listen and adapt to their customers, especially in our increasingly competitive global marketplace. Client led change is none the more present than at fast food chain McDonald's.

While McDonald's is among the leaders of sustainability and transparency, their use of plastic straws angered customers. Despite having a clear and transparent plan to combat waste by 2025, the company's transition policy didn't occur fast enough.[17] "Our customers have told us that one of the most important environmental issues in our restaurants is waste and recycling. We agree that we must join together with our customers and crew to tackle this issue..."[18]

Americans use over 500 million straws per day[19], many of which never get reused or recycled.[20] Although plastic straws are insignificant relative to the total waste produced each year, straw use has become symbolic as a small (yet easily achievable) transformation customers and corporations can take to impact sustainability efforts.

SumOfUs is a "community of people from around the world committed to curbing the growing power of corporations. We want to buy from, work for and invest in companies that respect the environment, treat their workers well and respect democracy."[21] Their advocacy platform has garnered nearly 500 thousand signatures to ban single use plastic straws. In addition, several news outlets reported the growing momentum of advocacy against McDonald's use of plastic straws. McDonald's responded citing the direct influence of their customers to alter their practices.

McDonald's UK
@McDonaldsUK

You asked, we listened. Paper straws will be rolling out to all UK restaurants from this September!

3:16am - 15 June 2018

1,130 Retweets 5,595 Likes

308 1.1K 5.6K

17 corporate.mcdonalds.com/corpmcd/scale-for-good/packaging-and-recycling.html
18 McDonalds Schedule 14A (2018)
19 That equates to 1.5 straws per person per day
20 www.nationalgeographic.com/news/2017/04/plastic-straws-ocean-trash-environment/
21 www.sumofus.org/about/

Community Impact

Communities play an important part in directing change as well. Communities have the most at stake because company (governmental) behaviour directly impacts the communities in which companies operate and as a result act as leading advocates for change. Often times they are able to influence directly corporate (governmental) behaviour. This is evident in the case study of Flint, Michigan's water supply scandal.

In 2011 Flint, Michigan was under immense financial pressure. As a result of their financial standing, Flint was unable to raise any more money. "To get around that obstacle, a scheme was concocted to use remediation of a lime sludge pond as the basis for an emergency loan. But most of the loan actually went toward helping to pay for the Karegondi pipeline" – an ill-fated attempt to alleviate the city's dire financial situation.[22] Detailed in a report on the crisis, officials with the Karegondi Water Authority (KWA), Michigan Department of Treasury, Department of Environmental Quality and the emergency managers found a loophole which allowed them to "manipulate bond finance rules" and place their financial interests above the health and well-being of community residents.[23]

Once the financing was secure, Flint's water supply was switched from the Detroit Water and Sewerage Department (DWSD) to the KWA. This would source water from the Flint River, reducing delivery costs. In the spring of 2014 the shift was made from Lake Huron, yet because of governmental officials' financial myopia the transition was made "without applying mandatory corrosion controls" and residents immediately noticed contamination in the new water supply.[24] The DWSD offered to reverse the switch and provide clean, safe water to locals. This proposal was rebuffed by local officials citing concerns over increased costs. At this point, several environmental agencies alerted residents of the severity of contamination, including cancerous material in the water supply.

Locals rose up and filed over a dozen lawsuits against the municipality citing health risks, personal liability of city officials and violation of the Safe Water Drinking Act. In addition, several governmental officials were criminally charged in the catastrophe.[24] In 2017, restitution was paid out by several agencies including the State of Michigan and the EPA.

While unfortunate, this story demonstrates that even though elected officials (either governmental or corporate) are tasked with equitable representation of their constituents they do not always do so. Communities must then stand up and demand action. By using their voice (through public forums, media outlets or direct engagement with elected officials), locals engaged officiants and restored a safe water supply to the residents of Flint.

22 www.aclumich.org/en/news/charges-against-emergency-managers-underscore-folly-shortsightedness-created-flint-water-crisis
23 alumich.org/sites/default/files/Hammer%20MCRC%20Testimony_0.pdf
24 https://www.aclumich.org/en/news/charges-against-emergency-managers-underscore-folly-shortsightedness-created-flint-water-crisis

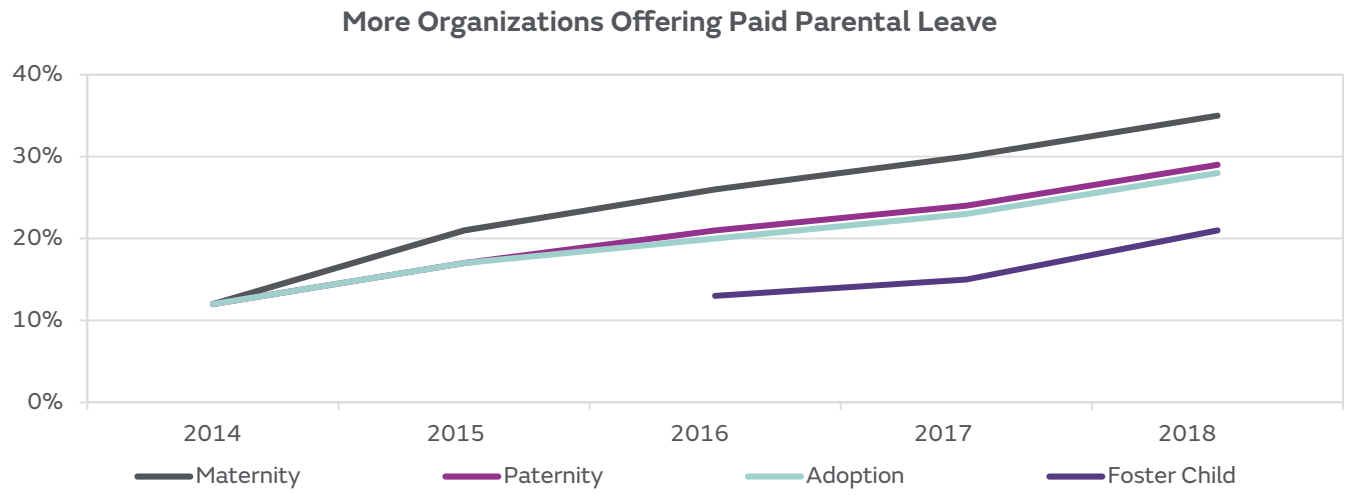
Employee Impact

Company employees are a potent force to enact equitable treatment. Acting as a bridge between companies and clients, communities, regulators and asset owners, employees are well positioned to pre-empt discriminatory behaviour before it becomes pervasive.

In recent years there have been several examples of employees demanding gender neutral policies at such firms as Estée Lauder, CNN, the Transportation Department and JPMorgan Chase (JPMC). In the JPMC case an employee (Derek Rotondo) filed a class action suit citing sex discrimination in JPMC's parental leave policy. At the time, JPMC offered sixteen weeks of leave for primary caregivers and unless Rotondo could prove that his wife was incapable of providing for their new-born he would only be entitled to two weeks leave. Rotondo contended that the policy violated the Civil Rights Act by designating female parents as default primary caregivers. In May 2019 the parties agreed to a settlement and the company agreed to administer their paternity policy in a gender-neutral manner.[25]

Employee engagement and advocacy, not necessarily through litigation, is a powerful change agent and also has the effect of advocating for change at other unrelated parties. As a result, these unrelated companies take note and adjust their policies in response to employee activism.

Table 6



Source: Society for Human Resource Management – 2018 Employee Benefits
Sample of employers surveyed n = 3,106-3,290
Maternity Leave includes coverage by family or parental leave policies, other than what is covered by short-term disability or state law. Paternity, Adoption and Foster Child Leave includes coverage by family or parental leave policies.

25 www.nytimes.com/2019/05/30/business/fathers-parental-leave-jpmorgan-chase.html

Regulatory Impact

Regulation, whether it be mandatory either from governmental agencies (SEC/FCA) or voluntarily from advocacy groups (GRI/CDP) has a storied track record of enacting change. Yet today, the SRI investment community is largely tasked with self-regulation as major governing bodies refrain from implementing ESG regulation.

The role and responsibility of regulators is typically designed to promote trust, honesty and accountability within stakeholder ecosystems. They do this by monitoring and policing ecosystem activity and if stakeholders are found violating regulation the regulator will implement various penalties.

For example, the SEC recently filed an emergency action halting an "alleged fraudulent, ongoing international trading program that has placed at risk more than $125 million of investor funds." According to the complaint the SEC alleges Mediatrix Capital "induced investors to invest by falsely representing that their money would be invested using a highly profitable algorithmic trading strategy that had never experienced an unprofitable month and had returned more than 1,600% since inception." Yet in reality, the trading strategy consistently lost money – "more than $18 million from its trading in 2018 alone."[26]

Turning back to the SRI ecosystem, in Hester Peirce's "Scarlet Letter" speech on ESG matters she commented "...a statement that you are an ESG manager may not require much to back it up. It may be enough to buy an ESG scorecard, hire a proxy advisor, or invest according to an index that incorporates an ESG filter."[27] In this sense, we agree and recent buzz surrounding SRI opens the door to greenwashing but without the regulation in place, who knows how the Mediatrix Capital story would have played out. Regulators are therefore in a position to convert SRI promises into SRI impact. Regulators need to police SRI behaviour and ensure investment advisors[28] are in fact following their self-prescribed policies – something we have not yet seen in practice (see page 45 voting actions of asset managers).

We do see instances of regulatory incentives which could help foster socially responsible behaviours. For instance, in the US the Federal Deposit Insurance Corporation offers retail banks consumer insurance up to $250,000 on their bank deposits.[29] In return, the retail banks must adhere to the Community Reinvestment Act which supports "the credit needs of its entire community, including low- and moderate-income neighbourhoods, consistent with the safe and sound operation of the bank."[30] This program is beneficial to both parties all while supporting socially responsible behaviour.

The implementation of consistent global regulations related to sustainability is particularly challenging given the political headwinds of individual national priorities. However market demand has manifested itself in organizations such as the UN PRI, Task Force on Climate-related Financial Disclosures (TCFD) and Network for Greening the Financial System (NGFS) with memberships from around the world. Such organisations are providing an operable, if not perfect, framework to support the attainment of sustainability goals.

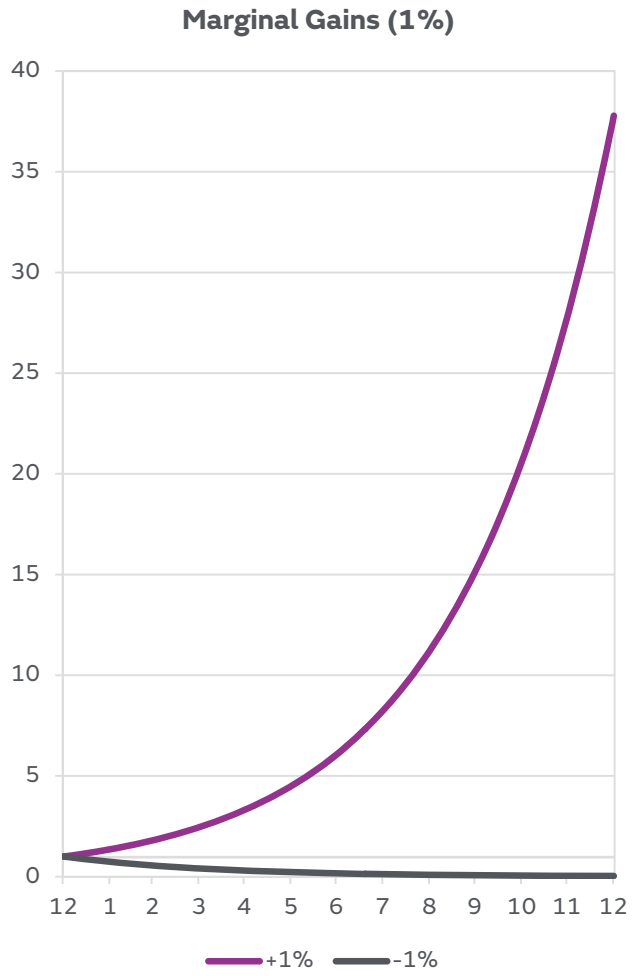
26 www.sec.gov/news/press-release/2019-180
27 www.sec.gov/news/speech/speech-peirce-061819
28 www.sec.gov/fast-answers/answersinvadvhtm.html
29 www.fdic.gov/deposit/deposits/faq.html
30 www.fdic.gov/regulations/laws/rules/2000-6500.html

Stakeholder Incentives and Asset Owner Consequences

Pausing to reflect on the success of Great Britain's cycling team each of these case studies has a common theme – small, actionable and measurable goals. By focusing on what they could control and making marginal gains significant change occurred. Under Brailsford's leadership Great Britain "test[ed] their suits in wind tunnels to see what kind of tiny effect the fabric has on a cyclist's aerodynamics. They paint the floor of their bike truck white so they can spot normally invisible dust that might harm bike maintenance during a race. The team has even brought their own mattresses on the road so that the riders never change their sleeping posture."[31] This attention to controllable improvements led to tremendous success.

Here we remember the importance of continual improvement and compounding. Simple mathematics demonstrates that just a 1 percent improvement each day for one year leads to tremendous gains – 37.8 times better to be exact. "In the beginning, there is basically no difference between making a choice that is 1 percent better or 1 percent worse. (In other words, it won't impact you very much today.) But as time goes on, these small improvements or declines compound and you suddenly find a very big gap between people who make slightly better decisions on a daily basis and those who don't."[32]

Table 7



31 www.theringer.com/nfl/2017/9/12/16293216/atlanta-falcons-thomas-dimitroff-cycling-team-sky
32 www.jamesclear.com/marginal-gains

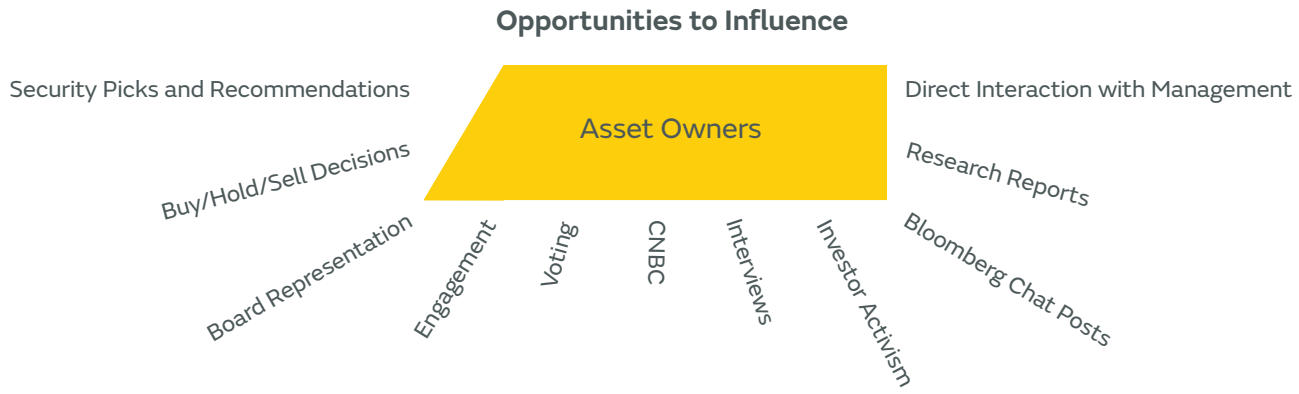
In each of these case studies there are small yet tangible actions stakeholders took to influence company behaviour. As we saw, company behaviour has real consequences on these stakeholders and by using their stature to exert influence has tangible impact. Yet that is typically not the case for asset owners – who are often only effected monetarily and not physically (like we saw in the aforementioned case studies). Yet asset owners have considerably more avenues of potential impact but currently lack the associated consequences, accountability and responsibility observed by other stakeholder relationships.

The flap of a butterfly's wings might ultimately cause a tornado.

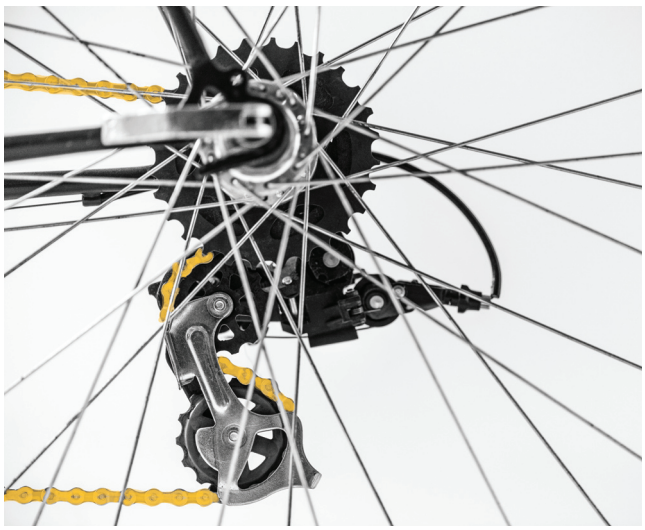
"The Butterfly Effect" attributed to Edward Lorenz (1969)

The Current State of the Asset Owner Universe

In this section we discuss asset owners – in doing so we are referencing investment decision makers, i.e. investment managers (not mutual funds/ETF owners), family offices and in-house managed institutional portfolios which may or may not own the assets themselves but instead act as a manager. Given the aggregate weight of capital at their disposal and its importance to fund sustainability needs, asset owners are important agents for impact. They are afforded multiple opportunities to exert influence.



Active and passive investors are the mechanism to achieve



the SDGs by **2030**

At the core of nearly every investment risk/return decision is market beta. Market beta affects both active and passive managers yet having a non-SRI market beta is the single greatest obstacle to impactful investment. The catalyst required for investor behaviour change will be, among other things, the style being adopted by SRI investors to enact change. In our deeper dive section (page 41) we categorize four different levels of engagement.

Passive ownership (index replication) is set to surpass active investments in 2019 (including sustainably focused funds).[33] Ultimately index tracking managers can be replaced by a machine unless they can demonstrate added value. That added value can come from their stewardship of clients' assets in line with client goals. This can manifest itself in tilts to or from certain exposures, proxy voting policies and engagement with index providers. The latter is key given that index providers ultimately determine what index tracking managers own. As a result, index providers have the greatest influence on asset owner investment discretion. For example, recently, FTSE Russell (the third largest index provider behind S&P Dow Jones and MSCI)[34] announced they "will not include China in its flagship government bond index, citing market liquidity and foreign exchange concerns."[35] As a result, asset managers who track the FTSE World Government Bond Index (WGBI) are now constrained to the universe set forth by FTSE Russell – meaning no Chinese exposure.[36]

Asset owners are increasingly taking the initiative to embed responsible investment principles into indices. Recently a group of asset owners and managers has advocated for the exclusion of controversial weapons from mainstream benchmarks. "Investors tracking big-name benchmarks are all contributing to the financing of companies involved in controversial weapons."[37] "Responsible asset owners do not want their passive investments forced to hold companies operating in violation of international treaties nor for such companies to be included in benchmarks and index-based derivatives."[38]

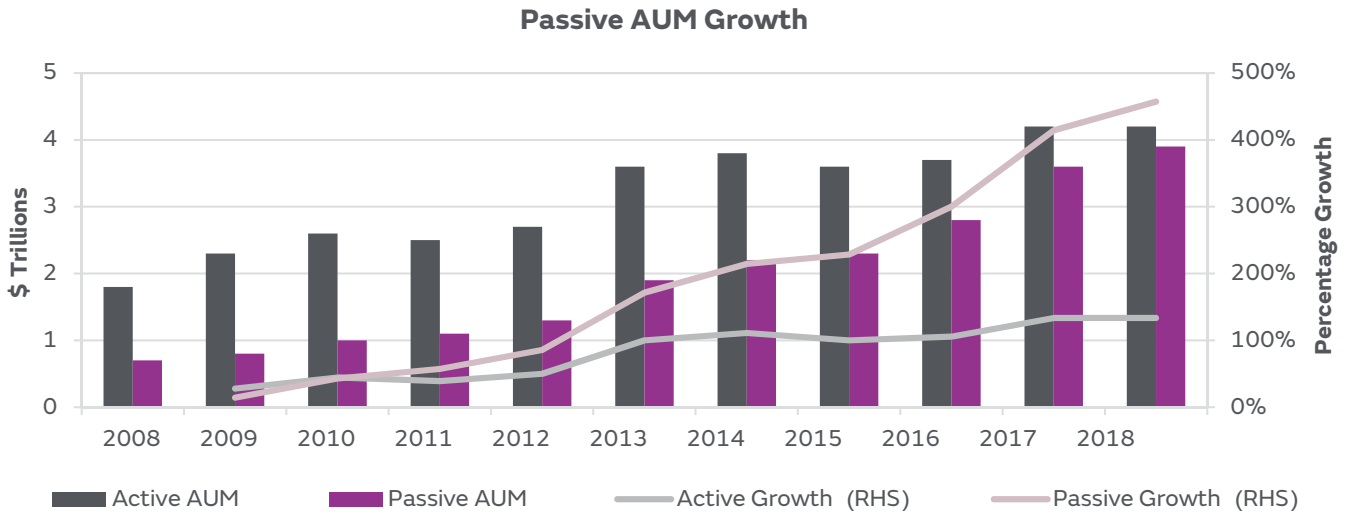
Indexes are often used to establish the universe of securities from which the manager will likely invest

FTSE Russell – Indexes and Benchmarks Made Clear (May 2017)

One of the first SRI indices (the Domini 400 Social Index – now rebranded to the MSCI KLD 400 Social Index) was launched in 1990. That number has grown to over 1,000 today with new indices launched on an almost daily basis.[39] This supports projections of $400 billion of sustainable ETF products in the next ten years by Blackrock and others.[40]

33 www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019
34 www.prnewswire.com/news-releases/global-index-industry-revenues-total-2-7-billion-in-2017----new-burton-taylor-benchmark-study-analyzes-index-industry-trends-and-factors-driving-revenue-growth-300711213.html
35 www.ft.com/content/73806e50-e0c2-11e9-9743-db5a370481bc?shareType=nongift
36 According to Bloomberg there are 19 funds which track the WGBI totaling $37.5 billion AUM.
37 www.ft.com/content/37b86924-464b-3aab-97a8-3023f549965b
38 www.sustainablefinance.ch/upload/cms/user/2017_11_15_SSF_Focus_Controversial_Weapon_Exlusions_E_final.pdf
39 www.ishares.com/us/literature/whitepaper/an-evolution-in-esg-indexing.pdf
40 www.ishares.com/us/education/sustainable-investing/resources

Table 8



Source: Morningstar Inc.
Note: 2018 data as of November 30, 2018 of which active AUM incorporates aspects of passive investment

Index trackers and passive investors (debt and equity) generally have a longer term investment horizon than event-driven active managers. This supports the case for increased allocations to them by asset owners aligned with the 2030 SDGs which generally take years to implement. There are challenges though – for instance, credit rating agencies typically focus on short term default probability for their credit ratings.[41] As credit rating agencies incorporate ESG considerations into their ratings we need to see a shift towards longer dated time horizons for their analysis to be supportive of the SDGs.[42/43] Yet this increase in passive investment, which we expect to surpass Blackrock's projections, will create, in our view, an investment universe where asset allocations, exposure and ex-ante tracking error all incorporate ESG factors into performance and risk measurement. We believe sustainable investing will become the new normal such that the term itself will become redundant.

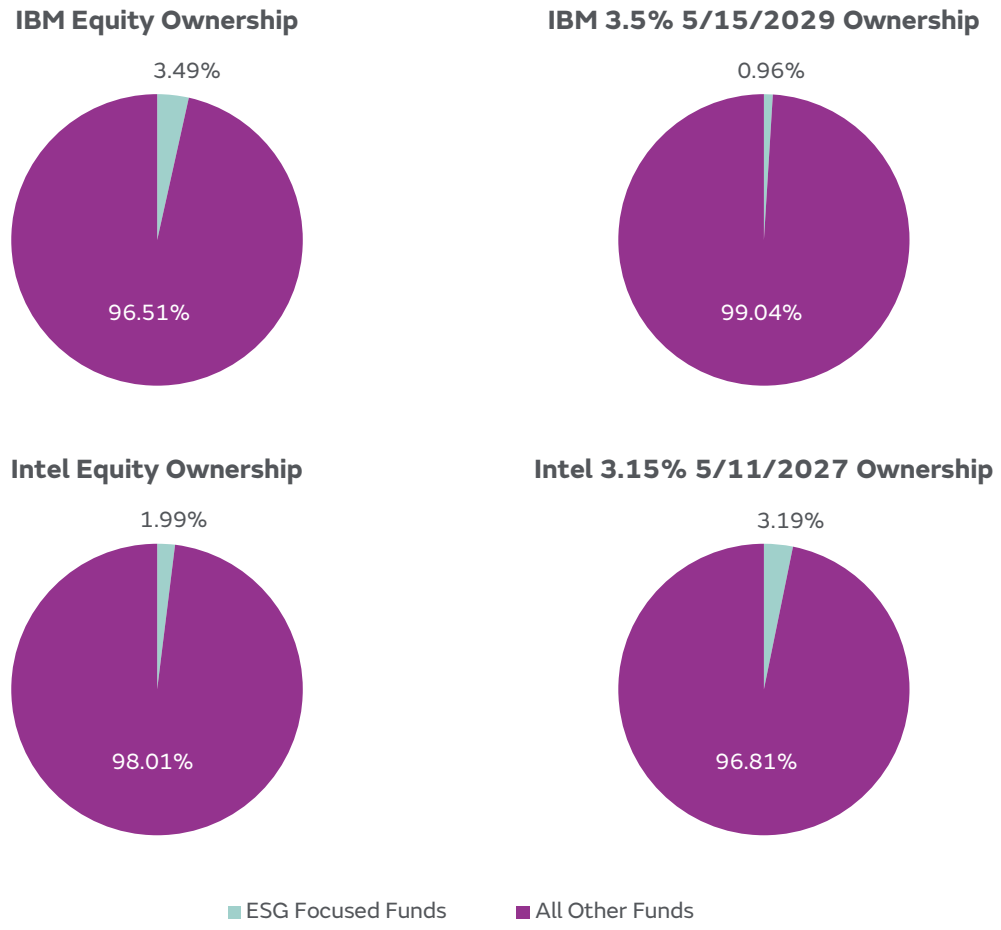
Timeframe matters

Passive investors are vital to achieving the $96 trillion SDG achievement investment need.

The cold reality is that SRI focused asset owners' holdings are almost irrelevant compared to non-SRI investment. As a result, there is increased importance on a transition to SRI linked passive investment. Take for example Intel and IBM – ESG focused funds own less than 3.5% of their equity and debt.[44]

41 www.markadelson.com/pubs/Time_Dimension_of_SP_Credit_Ratings.pdf
42 www.spglobal.com/ratings/en/products-benefits/products/esg-in-credit-ratings
43 ESG Data Indiscretions: A Sanity Check on Practicality – GIB (UK) (September 2018)
44 Sample debt issuance. IBM equity (fixed income) total funds account for 60% (42%) of total outstanding shares monitored by Bloomberg. Intel equity is 71% whereas Intel debt is 37%.

Table 9



Source: Bloomberg
Note: ESG Focused Funds include those with a general attribute of Clean Energy, Climate Change, Environmentally Friendly, ESG, Islamic, Religiously Responsible or Socially Responsible.

Unless and until index providers change index component weighting to incorporate ESG factors, non-SRI passive investors will continue to drown out influence from active SRI investors. Thus benchmark market return (beta) will not generate the requirements for SDG funding. We need a secular shift to SRI beta to make a meaningful impact on our current ecosystem. To demonstrate, according to Morningstar "sustainable-fund flows contributed about 3.5% of overall fund flows in 2018. Their $89 billion in assets under management constituted only about 0.5% of overall AUM."[45]

In this next section we focus on the tools the UN PRI has determined available for socially responsible investment activism – proxy voting and engagement. While important, these tend to focus on publicly traded companies. Later, we identify other avenues the financial ecosystem (not just publicly traded companies) has at its disposal to influence socially responsible behaviour.

45 www.morningstar.com/content/dam/marketing/shared/pdfs/sustainability/Sustainable_Funds_Landscape_2018.pdf?cid=EMQ_

Proxy Voting

To date, sustainability and activism have generated considerable acclaim but the most visible amour-propre lies with proxy voting. Asset owners, managers, advocacy groups and regulators all stress the importance of proxy voting to enact change. Yet the current system of proxy voting is not working the way we want. We present several challenges facing the current state of proxy voting and offer solutions for it to act as an agent of change.

At publicly traded companies, annual meetings serve as a valuable tool to offer asset owners a say in company dealings. This say, via proxy voting, falls into two forms of proposals: **management resolutions** – which are brought forward by the board of directors and typically deal with election of directors, auditor ratification and compensation and **shareholder resolutions** which offer "an opportunity to place certain proposals in a company's proxy materials for a vote at an annual or special meeting of shareholders."[46/47] Yet we see substantial challenges confronting SRI proxy voting enthusiasm: non-SRI passive index investment, regulation and accountability.

Proxy Voting – Passive Index Investment

As discussed prior (see page 24), there is far too much money linked to non-SRI investment. In the proxy voting context, the sheer weight of numbers significantly limits the share ownership behind a proxy vote. Accordingly it is almost impossible for proxy resolutions to receive the necessary support. There is simply too much money tracking non-ESG focused benchmarks.

The Vanguard Group, the world's largest mutual fund provider, is one of the largest equity owners of all public companies. Its ownership of Intel and IBM is ~8% in both cases.[48] Yet Vanguard's SRI-themed funds (with aggregate AUM of $7 billion) own only 0.03% of Intel and zero of IBM.[48] At the same time, Parnassus, the largest manager by AUM ($26 billion) of sustainable-focused funds, owns zero of Intel and a mere 0.11% of IBM.[49]

Sustainable-funds AUM constitute only about 0.5% of overall AUM

Morningstar – Sustainable Funds U.S. Landscape Report (February 2019)

46 www.sec.gov/info/smallbus/secg/rule14a-8i8-secg.htm
47 See Annex (page 42) for further details on proxy resolution support
48 Source: Bloomberg
49 Source: Bloomberg and www.parnassus.com/parnassus-mutual-funds

Table 10

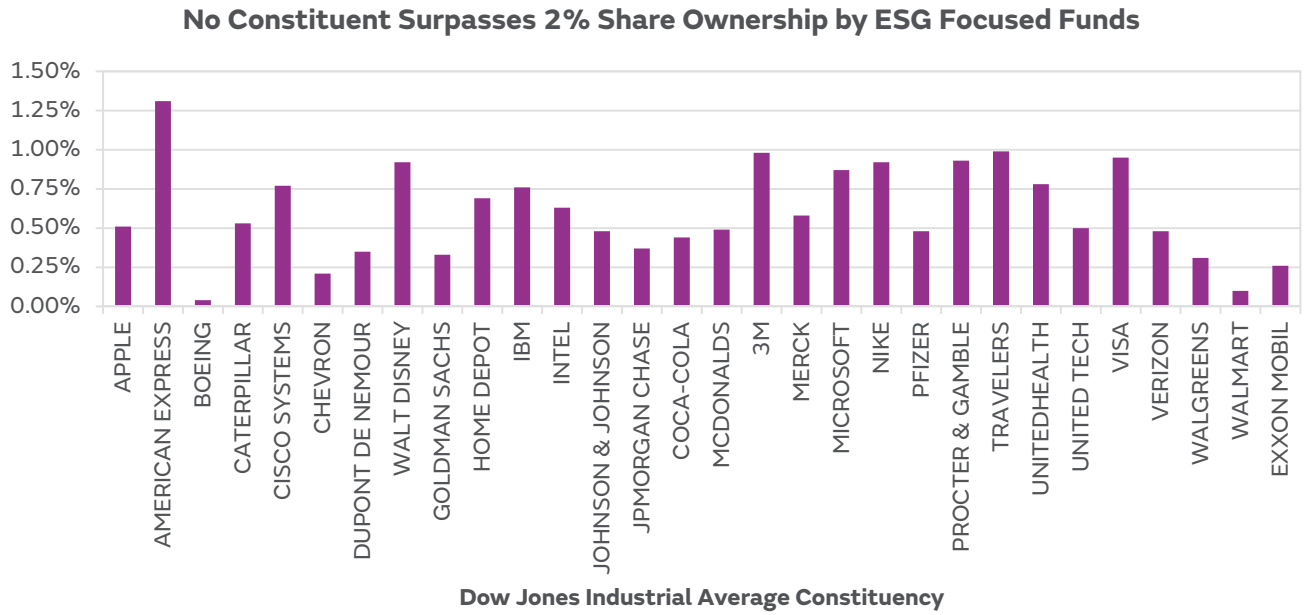
	AUM ($ Billions)	Intel Shares	(%)	IBM Shares	(%)
Vanguard SRI-Themed Funds	6.85	1,487,746	0.03%	19,184	0.00%
All Other Vanguard Funds	5,293.15	359,917,771	8.12%	71,925,971	8.12%
Parnassus Funds	25.73	0	0.00%	1,000,000	0.11%
Total Shares Outstanding		4,430,000,000		885,875,161	
Market Capitalization ($ Billions)		208.70		124.50	

1 As of June 30, 2019
2 This table includes every sustainably focused fund Vanguard and Parnassus offer
Source: Bloomberg, Vanguard and Parnassus

For proxy resolutions to be impactful we must shift the investment landscape toward passive SRI allocation

SRI asset owners will need to engage with index providers to move the needle in favour of SRI proxy resolutions. As global investors such as Japan's GPIF increasingly benchmark to ESG indices, we expect this pressure to reach all index products over time (see page 23 for further support).[50]

Table 11



Source: Bloomberg
Note: ESG Focused Funds include those with a general attribute of Clean Energy, Climate Change, Environmentally Friendly, ESG, Islamic, Religiously Responsible or Socially Responsible.

50 www.pionline.com/searches-and-hires/gpif-request-index-proposals-esg-diversity-benchmarks

Proxy Voting – Regulation

Adding to the current challenge facing proxy voting initiatives is the incongruent nature of global regulatory frameworks wherein significant variances exist between proxy rules across major markets. In the UK for instance shareholder resolutions are more onerous for the proponents – requiring them to meet stricter filing requirements and bear the cost of such resolutions whereas US regulation allows for virtually any shareholder to submit a resolution. The UK system offers several advantages over the US – resolutions are binding and advocates are afforded the opportunity to call special meetings, both of which can lead to improved checks and balances of public companies.

In the US there is a distinction between ordinary shareholder resolutions and contested shareholder resolutions. The former is available to nearly any shareholder, is heard at the target company's expense, cannot relate to board elections or ordinary business matters and is nonbinding regardless of the result. On the other hand, a contested shareholder resolution can relate to board elections or ordinary business but is done so at the shareholder's expense with the possibility of a legally binding outcome. There is no such distinction in the UK.

Reflecting these differences, in the UK more than 90 percent of shareholder resolutions relate to governance and ordinary business while seeing 44 percent pass (binding). Contrary, the US has more shareholder resolutions per company of which 30 percent relate to social and environmental issues but fewer than 20 percent pass (non-binding).[51]

Proxy resolutions are complex with multiple factors at play. SRI investment managers face the challenge of aligning their proxy policies/voting with the goals of the asset owners whose money they manage. This is a topic of current attention with the SEC proposed new Regulation S-K rulemaking regarding ESG factor disclosure.[52] Corporate disclosure requirements have not been updated since the mid-1970s and asset owners believe there is a need for reform. However, the SEC is cautious not to impose these proposed regulations in piecemeal fashion. "The marketplace evolution of sustainability disclosures is ongoing – companies certainly provide more sustainability information than they did ten years ago – and allowing this evolution to continue should provide market participants with a continued opportunity to sort out the types of information they find useful."[53] We agree with the SEC and as an industry are still sorting out issues of materiality relating to ESG issues. William Hinman – Director of Corporate Finance Division at the SEC continued stating that by "adding requirements to the disclosure regime that do not deliver benefits that justify their costs decreases the attractiveness of our public markets." We deem this a fair counterpoint to the acclaim the proposed Modernization of Regulation S-K Items has received.

Sustainability issues are highly complex (as previously discussed in our publications) and it is important to identify correctly what issues and requirements are material for investors to make informed investment decisions. In due course we believe the investment marketplace will standardise and self-regulate via engagement and activism. It is difficult to find a scenario where forceful governmental regulation has unanimously benefited open markets. This is why, as an ecosystem, financial markets must continue to remain engaged on sustainability issues and be supportive of ESG related issues. For change to occur the investment universe must measure sustainability practices. Only then can stakeholders measure and benchmark these practices determining marginal gains (or losses).

However, it is naïve to think that global regulatory framework will harmonize. Despite having specific directives to incorporate ESG issues into financial decision making (IORP II), the European Union members still have varying regulations.[54] Accordingly, stakeholders must adapt and adhere to the best of their abilities.

51 American Business Law Journal – Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom – Bonnie Buchanan, Jeffry Netter, Annette Poulsen and Tina Yang (2012)

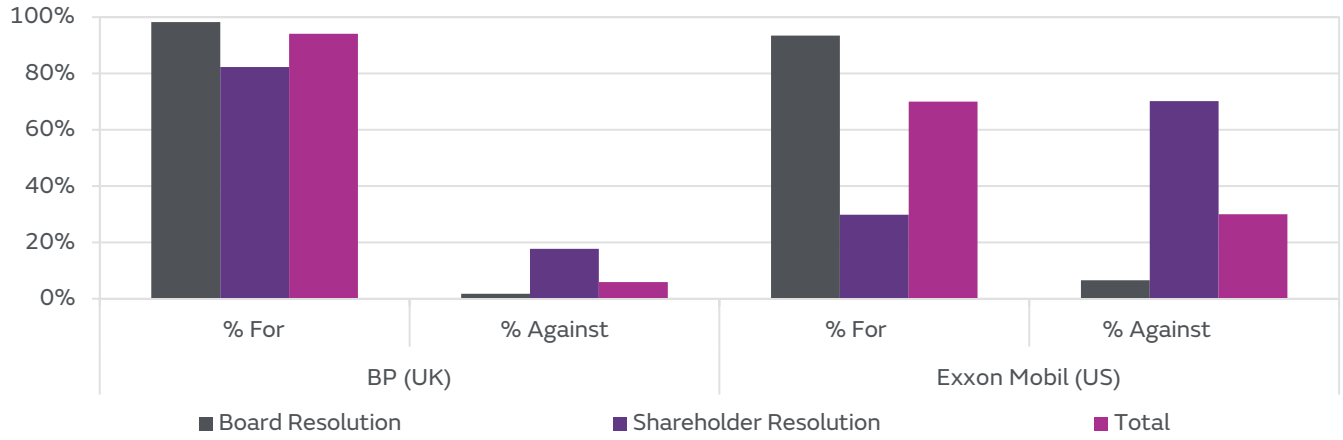
52 www.sec.gov/rules/proposed/2019/33-10668.pdf

53 www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519

54 www.ipe.com/news/regulation/iorp-ii-how-the-eu-directive-has-reshaped-the-pensions-industry/www.ipe.com/news/regulation/iorp-ii-how-the-eu-directive-has-reshaped-the-pensions-industry/10029076.fullarticle

Table 12

Regulatory Differences Influence Proxy Outcomes



Source: British Petroleum Form 6-K May 21, 2019 and Exxon Mobil Form 8-K May 29, 2019

Proxy Voting – Accountability

As ESG AUM continues to grow, asset managers have gone to great lengths to promote SRI and rightfully so. However, flashy marketing and promotional material aside, the only document that matters is the investment fund prospectus. Yet as we saw in our last publication ESG: Playing by the Rules in Portfolio Construction (May 2019) asset managers' investment mandates and responsibilities can be highly qualitative. For example, one fund seeks "to invest in companies with positive performance on Environmental, Social and Governance ("ESG") criteria... [However] no company is perfect in all these areas, but the Adviser makes value judgments in deciding which companies best meet the criteria."[55]

Table 13

Sample Asset Manager Shareholder Resolution Proxy Voting Outcomes

Asset Manager	Management Recommendation Agree	Management Recommendation Oppose	Abstain	Other	No Ownership
A	78.90%	16.20%	1.20%	1.00%	2.70%
B	12.50%	80.60%	2.70%	1.20%	2.90%

N=408
*NO = No Ownership
Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) and two selected sustainability focused asset manager proxy votes. Management recommendation "Agree" is thought of as opposition of ESG policies whereas management recommendation "Oppose" is thought of as support for ESG policies. Further information can be found in the Annex page 42.

55 www.sec.gov/Archives/edgar/data/747546/000119312513060647/d458639d485apos.htm#toc458639_3

Given the ambiguity set forth in fund prospectuses, asset managers can gerrymander their implementation of SRI policies. For example, we examined ten SRI fund managers and reviewed their policy statements. Each fund advocates for fair employment practices. However, when reviewing their proxy voting actions we observed inconsistencies with their voting behaviour. Holy Land Principles advocate for "equal and fair employment practices... without discrimination based on national, racial, ethnic or religious identity."[56] Below are two similar shareholder resolutions from two similar technology companies yet voting practices are quite different.

Table 14

Sample Asset Manager Shareholder Resolution Proxy Voting Outcomes

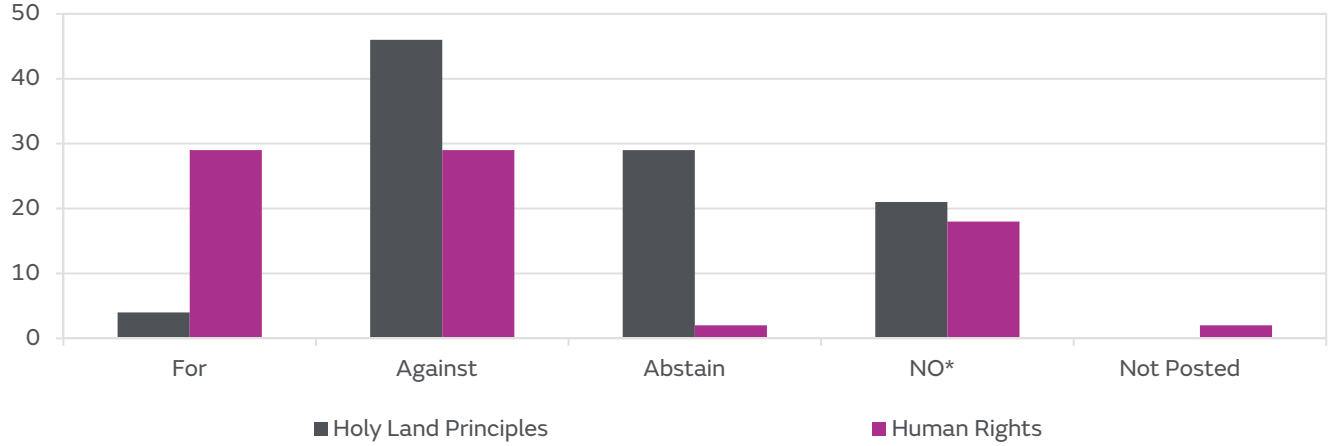
Company	Resolution	For	Against	Abstain	NO*	Total For	Total Against	Total Abstain
Intel	Holy Land Principles	1	4	3	2	3%	79%	18%
IBM	Human Rights	2	6	0	2	5%	91%	5%

*NO = No Ownership

Source: GIB UK – Intel and IBM 8-K Filings (2015) and the ten selected SRI asset manager proxy votes.

Table 15

Sample Shareholder Resolutions Activity (2015-2019)



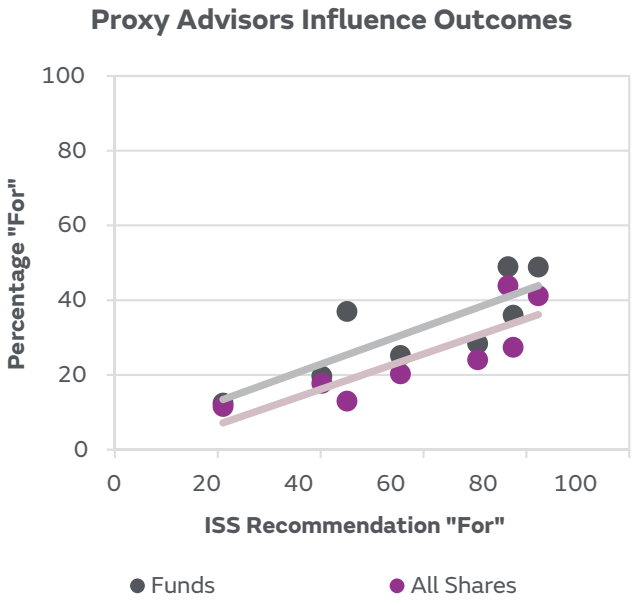
*NO = No Ownership

Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) and the 10 selected sustainability focused asset manager proxy votes.

56 Intel Corp 2015 Schedule 14A

Adding to this challenge is the fact asset managers use third party proxy advisors (such as ISS or Glass Lewis) to administer proxy voting on behalf of managed funds. Asset managers choose themes to support and in turn these proxy solutions firms administer votes depending on the resolutions brought forth. This leads to an industry which is highly influenced by a select few proxy advisors. This has led to a bifurcated proxy marketplace. Some investment advisors support the work of proxy advisors, easing their workload and monitoring and advocating for SRI corporate behaviour. However, there has also been considerable scrutiny on this subindustry. "Proxy advisory firms have been riddled with conflicts of interest, failed to link advice with economic return or company specific information, and lack process and transparency."[57] There is value in each camp – proxy advisors can be supportive of impactful behaviour but must do so in a neutral, customized approach.

Table 16



Source: ICI Research Perspective - Proxy Voting by Registered Investment Companies, 2017 (July 2019)[58]

Engagement

The process of engagement is much more interactive and tangible than proxy voting. At its core, engagement attempts to "encourage companies they invest in to improve their management of ESG issues."[59] This process can be accomplished using a direct approach whereby an asset manager reaches out directly (or indirectly) to the target company or through a pooled engagement (third party) approach essentially delegating engagement responsibility to an advocacy group. Each of these methods is extremely laborious but offers a viable method to attain actionable change. It is much harder for target companies to ignore direct communication by asset managers as opposed to proxy resolutions where the initiatives are very structured and can be rejected by regulators such as the SEC on the grounds of micromanagement.

The challenge then becomes measurement and reporting of company behaviours. While initial engagement is great, in order for asset managers to ensure target companies follow through on their commitments they must demonstrate their change in behaviour. This is highlighted by the increase in sustainability reporting trends since 2010. According to ProxyPreview sustainability reporting resolutions reached a decade high in 2018 (which includes 31 withdrawals – meaning an agreement was reached between advocates and target

57 www.thinkadvisor.com/2019/08/21/secs-new-proxy-voting-guidance-gets-mixed-reviews/

58 Note: Funds represent "the number of US-registered investment companies recording a "For" vote for proposals in a given category, divided by the total number of votes that funds cast." whereas All Shares represents "the number of shares voting "For," divided by the total number of shares voted, including shares owned by shareholders who abstained from the vote." Each dot represents a different topic of shareholder resolutions (aggregate average)

59 www.unpri.org/listed-equity/introductory-guide-to-collaborative-engagement-/482.article

companies). We should expect this trend to decline as more companies agree to publish sustainability reports.[60] For engagement to be meaningful – stakeholders must have reliable and transparent data on the initiatives of target companies sustainability practices. Only then can asset owners determine success (or failure) and properly address the challenges companies face.

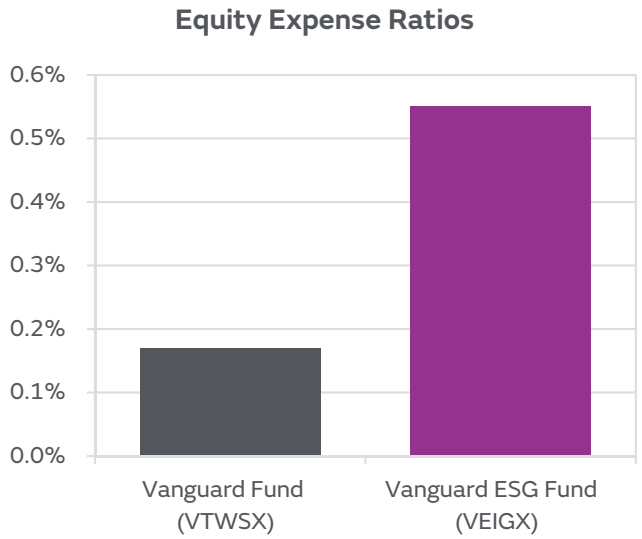
Moving on from UN PRI's activism toolbox (proxy voting and engagement) we outline several additional avenues the financial ecosystem has at its disposal to be impactful.

Fee Disparity

To begin, asset owners entrust their money to managers who uphold the fiduciary responsibility bestowed upon them. Yet one of the biggest threats to positive ESG impact by investors comes from the asset management industry itself. ESG has become a great way to sell new products for a higher fee. For example, the Vanguard Total World Stock Fund (VTWSX) expense ratio is 0.17%.[61] Comparably, their ESG focused fund, the Vanguard Global ESG Select Stock Fund (VEIGX) has an expense ratio of 0.55% a 38bp difference.[62] A similar picture is portrayed when examining fixed income funds.

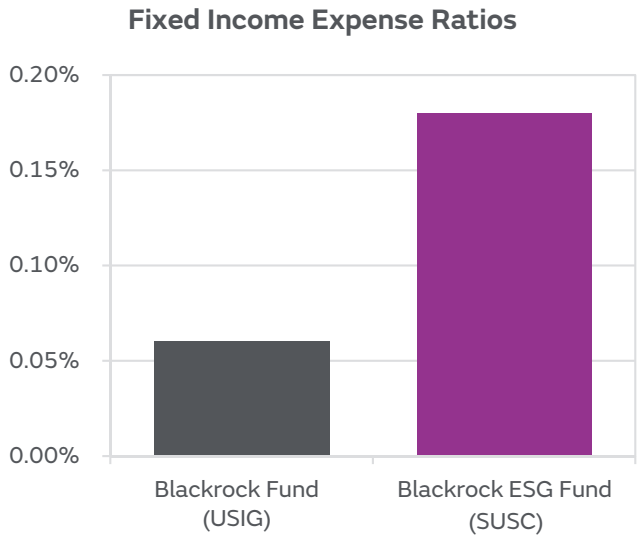
Both EU and US regulators are acting to protect investors against greenwashing but asset managers need to act to protect them from themselves. This requires asset managers to vote proxies in absolute accordance with the ESG principles they describe, act upon engagement they advertise and uphold the principles they stand for in their offering documents lest they be charged with deceit. As more managers walk the talk we can be confident that real impact will come from the combination of engagement with index providers and better proxy voting integrity.

Table 17



Source: Vanguard, Blackrock

Table 18



60 Reference our publication ESG Data Indiscretions: A Sanity Check on Practicality (September 2018) – Page 8
61 investor.vanguard.com/mutual-funds/profile/VTWSX
62 investor.vanguard.com/mutual-funds/profile/VEIGX

Earnings Calls

Company earnings calls present an opportunity for investors to engage management on qualitative topics providing valuable information to market participants. Earnings calls are typically structured with a statement by a senior member of management followed by a Q&A where analysts ask management questions. These calls provide valuable information to asset owners which are not present in traditional reporting mechanisms.[63] Furthermore, these calls offer colour relevant to socially responsible investors which may be financially relevant.

"ESG" mentions during company earnings calls has increased 100%

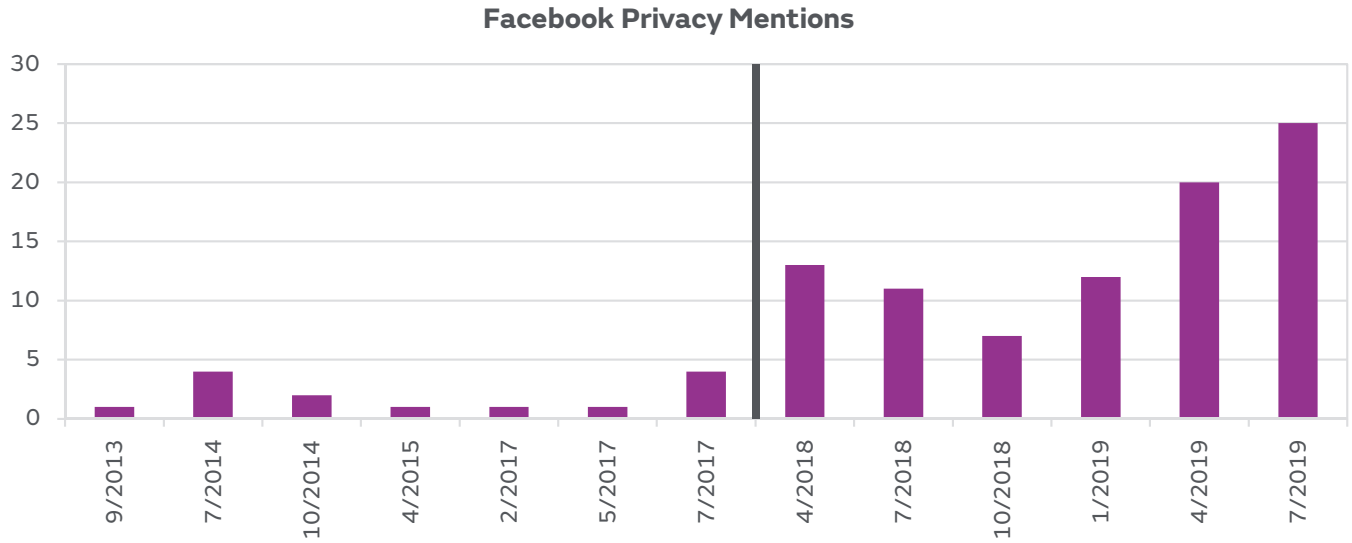
Source: www.esginvesting.co.uk/2019/09/100-increase-in-esg-in-sp-earnings-calls/

Having direct (or indirect) access to target companies holds them accountable for their comments. Unfortunately for Facebook, investor activism did not prevent the 2018 Cambridge Analytica (CA) controversy. Had more investors advocated for privacy regulation and policy perhaps the data of 87 million users would not have been compromised – but there was certainly interest in Facebook's privacy policy prior to 2018.

With more focus on sustainability, analysts are well positioned to confront illicit behaviour and pre-empt detrimental headlines. Yet herein lays the challenge to impact and engagement. As discussed in prior research, ESG data is reactive. It wasn't until The New York Times published their investigation into Facebook and Cambridge Analytica did investors take note. With adequate reporting, Facebook might have offered the necessary information to pre-empt this headline. A transition to a sustainable socially responsible future is not as easy as measuring company inventory. To date, there are very few (if any) metrics ESG advocates can turn to to gain insight into future behaviours. CSR reporting in a thoughtful standardized way can change this and give investors colour on company's future behaviours – leading to a tangible and measurable impact for a sustainable socially responsible future.

63 Norwegian School of Economics Bergen – The Predictive Power of Earnings Conference Calls (Spring 2018)

Table 19



Source: Facebook Earnings Calls
Note: Grey line signifies when the scandal broke, March 2018

Analyst Reports

Another important and highly influential avenue available to promote change lays with sell side research analysts. Examining the constituents within the S&P 500 we observed each company has on average 21 analysts providing a recommendation (buy/hold/sell).[64] This results in ~21 unique opportunities to suggest, question or critique business practices related to sustainability. We observed more than half of analyst recommendations were buy recommendations (52 percent),[65] while only 7 percent were of the sell variety.

While it's difficult to quantify the breadth of analyst research recommendations or the influence they hold on investment decisions we do know that analysts' opinions matter. Examining analysts' recommendations which were downgraded over a two year period we see that market performance of these equities was quite poor all while the average Consensus Rating deteriorated. This is no surprise nor is this exercise demonstrating causality (research analysts too are at the mercy of time – as we discussed in our previous paper ESG Data Indiscretions: A Sanity Check on Practicality "both CRAs and research and data providers exhibit a lag when incorporating new information into their scores/ratings. Neither of which presume to predict future events.")[66] The same can be said of research analysts. Research coverage is a useful tool to assess the quality of an investment and is widely used by others to make informed investment decision.

In order to make these informed decisions the CFA Institute believes that investment analysis "includes the consideration of material ESG information/considerations (ESG factoring) as an important component of a complete... financial analysis for any actively managed fundamental investment portfolio."[67] As an industry, financial intermediaries (sell-side analysts, investment advisors etc.) need to raise the issues of

64 Bloomberg – EQS (August 27, 2019)
65 As a percentage of total coverage by analysts
66 GIB (UK) – ESG Data Indiscretions: A Sanity Check on Practicality (September 2018)
67 Positions on Environmental, Social, and Governance Integration – CFA Institute 2018

Table 20

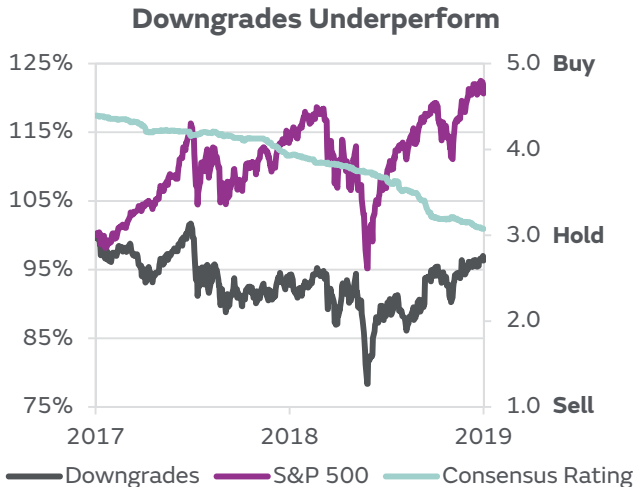
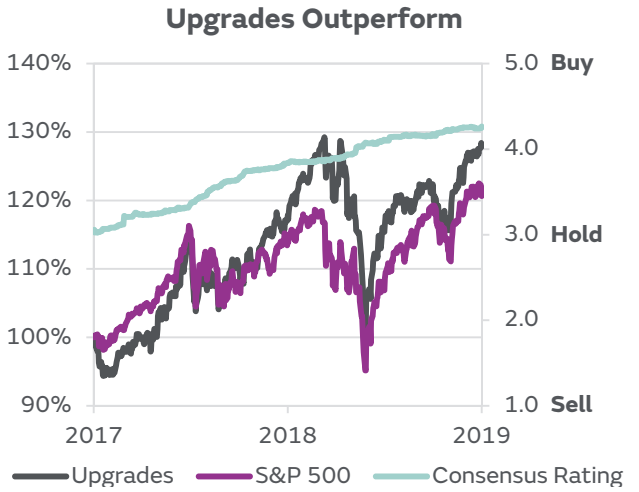


Table 21



Source: Bloomberg
Note: Upgraded/Downgraded Equities consist of the ten companies which exhibited the largest improvement/decline in Consensus Rating July 31, 2017 through July 31, 2019. All exhibited a Consensus Rating improvement/decline of greater than 1.

sustainability and analyst recommendation reports are a fantastic opportunity to raise awareness and leverage their position (as intermediaries between investors and companies) to support marginal gains of sustainably based business practices.

Investment Banking and Advisory

Bankers and advisors also have several indirect ways to make an impact. They are in a position to encourage or require financial counterparties to act in a socially responsible manner. "Financial service providers should integrate ESG considerations in their Know Your Customer (KYC) due diligence processes. This will help banks mitigate reputational risks and reduce credit risks by providing finance to firms with better sustainability and overall management practices."[68] Hermes found that companies with better ESG scores generally had a lower credit risk (using CDS spreads as a proxy).[69] As a result, financial intermediaries are now incorporating ESG data as a means to improve counterparty transparency and assess credit risk. In doing so, we as an industry are well positioned to demand sustainable business practices. Financiers are then afforded the opportunity to elevate the bar – encouraging counterparties to improve their business practices.

Bankers and advisors support financial transactions and interact with counterparties and principals at road shows for M&A and IPO transactions. This affords the opportunity to raise ESG issues to encourage their inclusion in terms and conditions.

For instance, the recent surge in dual class share offerings by many technology IPO's has led to concerns about the governance structure of these firms. Financial intermediaries are well positioned pre-emptively to highlight potential ESG issues before a capital raise or merger occurs. We have started to see pushback (WeWork pulled their IPO) against the trend for dual class share structures as public market sentiment does not welcome these newfound governance structures.

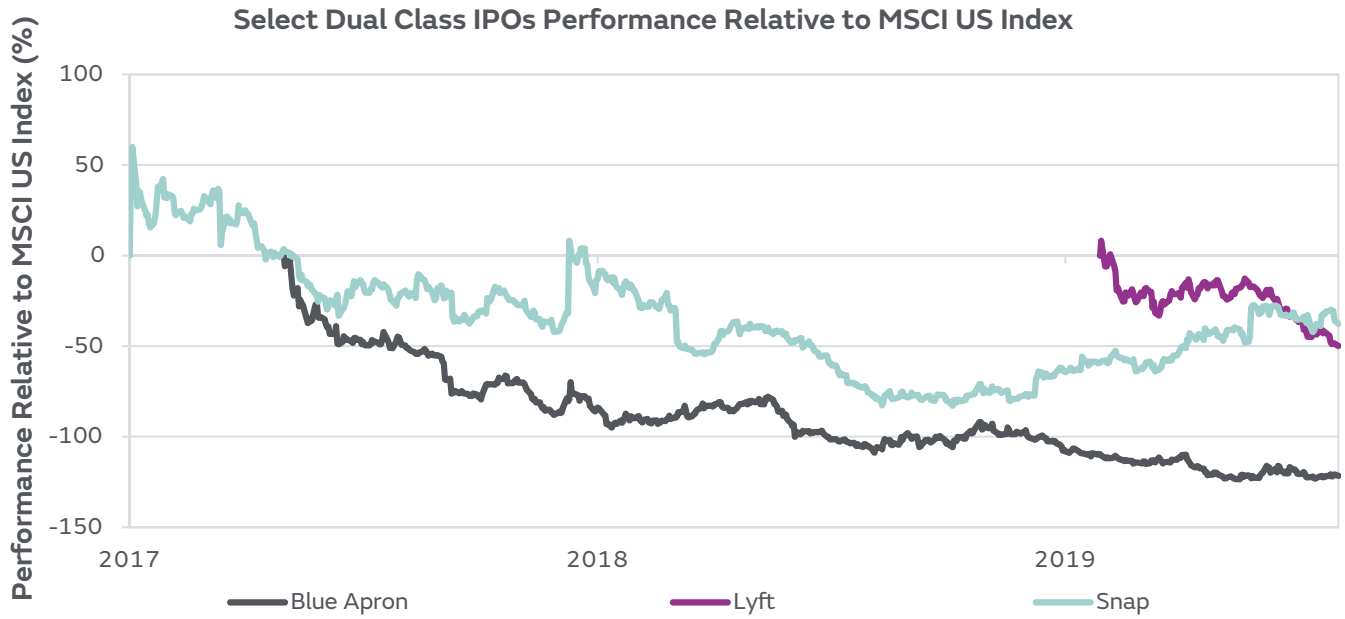
68 www.bsr.org/reports/BSR_The_Sustainable_Supply_Chain_Finance_Opportunity.pdf
69 www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/04/Credit-ESG-Paper-April-2017.pdf

Table 22

Company	IPO Date	Class	Votes	Shares Outstanding	(%)	Equivalent Votes	(%)
Blue Apron	6/28/2017	Class A	1	6,659,066	51%	6,659,066	9%
		Class B	10	6,426,829	**49%**	64,268,290	**91%**
Lyft	3/28/2019	Class A	1	280,041,336	96%	280,041,336	52%
		Class B	20	12,779,709	**4%**	255,594,180	**48%**
Snap	3/1/2017	Class A	0	1,103,779,150	80%	0	0%
		Class B	1	47,581,741	3%	47,581,741	2%
		Class C	10	227,914,380	**17%**	2,279,143,800	**98%**

Source: Bloomberg

Table 23



Source: Bloomberg

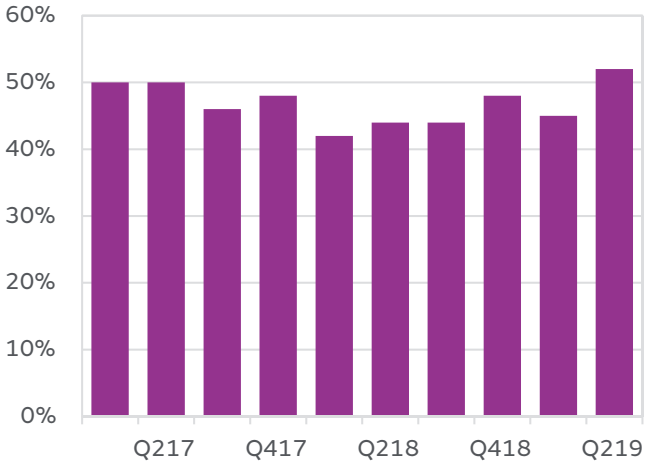
Private Equity

The focus on ESG issues is not limited to public markets either. PwC found that 67% of private equity firms "identified and prioritised SDGs that are relevant to their investments in 2019" compared to only 38% in 2016.[70] For example, the Carlyle Group incorporates ESG into nearly every investment. "Ensuring that our investment process integrates ESG considerations equips us to better identify and monitor the most relevant ESG issues and most significant market trends—reducing risk and creating value."[71]

Private equity is a powerful multiplier to direct investment dollars to the attainment of the SDGs. Typical private equity investments are levered and thus the entire capitalization of private equity owned companies brings influence to bear. In 2019 "private-equity firms contributed 52% to the purchase prices of companies they bought."[72] On this metric the $3.4 trillion in private equity assets can harness an additional $3.1 trillion of debt capital aligned with the principles of the private equity investor. Thus private equity is a significant enabler of fixed income investors funding the SDG goals.

Table 24

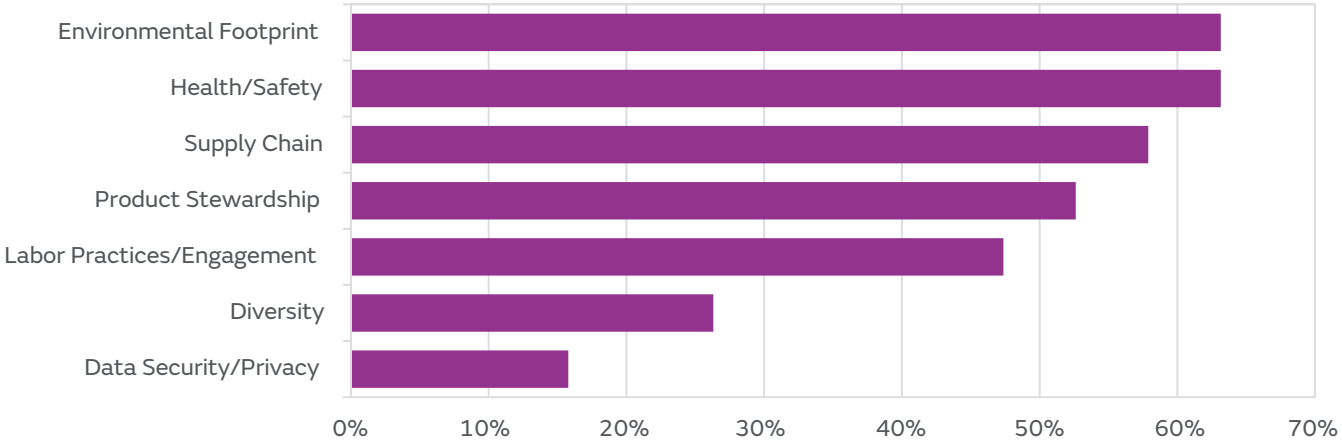
Average Equity Contributions



Source: www.wsj.com/articles/putting-the-equity-back-into-private-equity-11563218832

Table 25

Material KPI Issues Reported by Carlyle Group Investments



Source: The Carlyle Group – Corporate Sustainability Report (2019)

70 www.pwc.com/gx/en/services/sustainability/assets/pwc-private-equity-responsible-investment-survey-2019.pdf
71 www.carlyle.com/sites/default/files/reports/carlyleccr2019.pdf
72 www.wsj.com/articles/putting-the-equity-back-into-private-equity-11563218832

Broad Proactivism

Furthermore, we see the continued onslaught of research, news articles, media and general advocacy of sustainability by financial intermediaries supportive of the ecosystem. Being vocal about impacting company behaviour whether greenwashing or genuine is somewhat irrelevant because clients, asset owners, regulators, employees, communities and corporations will take note. Marginal gains, irrespective of how they are attained, are the end goal and we believe any avenue of advocacy is impactful.

GIB (UK) Observations

For Asset Owners

- Remain cautious of greenwashing by asset managers. Understand how asset managers actually implement ESG/sustainability principles. Hold asset managers to account for their stewardship of your SRI objectives.
- Engage directly with index providers to create custom indices that align with your SRI objectives.
- Be vocal at investor forums to promote awareness of custom indices. Involve consultants and index providers to migrate custom indices to market benchmarks.

For Asset Managers

- Embed a culture of SRI throughout your entire firm such that operating behaviours become consistent with investment objectives. There should not be a siloed approach to ESG/SRI implementation.
- Resist the temptation to relabel a traditional strategy to offset fee compression. Develop methodologies to align security selection, voting and engagement on a consistent and data-based framework.
- Be vocal about your SRI ambitions and intent. Walk the walk to raise additional AUM on the merits of your SRI investment credentials.

For Index and Rating Providers

- Engage with the investment community (asset owners, managers and regulators) to create SRI market benchmarks that are sufficiently broad to accommodate global securities.
- Adjust time horizons to incorporate the longer term risk and opportunity presented by SRI.
- Engage with ESG data providers to promote data consistency across SRI investment criteria.

For Regulators

- Collaborate to establish a practical framework incorporating global disclosure standards to prevent ESG arbitrage across different markets.
- Be rigorous to protect investors/asset owners from greenwashing.
- Encourage quantitative measures to SRI stewardship.

A Deeper Dive

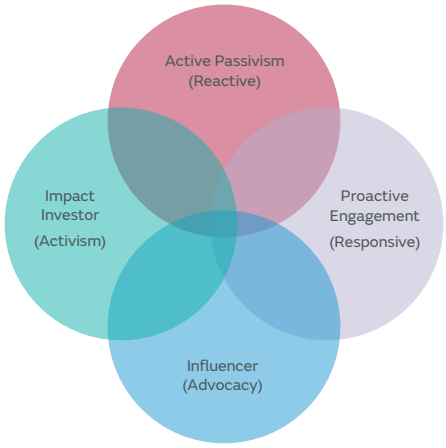
Engagement Classification

For the UN PRI's protagonists to provide tangible results we must outline the key players. We define the first level of engagement as **active passivism**. Asset owners are concerned with company behaviours but take no proactive approach to alter their behaviour – instead they are content with company behaviours only until the company does something with which the active passivist disagrees. This results in a reactive approach to activism. An example would be an owner of the MSCI World ESG Leaders ETF where they ride the wave but do not engage directly.

The next level is **proactive engagement** where an investor takes a responsive approach to proscribed behaviour. This is different from the active passivist in that an engaged asset owner is actively responsive toward company policy and directly communicate with a company's management. One example would be The Church of England who "ask[ed Exxon Mobil] to set long-term emissions reduction targets aligned with the goals of the Paris Agreement, covering both the company's operational and product emissions. [As a result,] in 2018 Exxon took some important steps forward on climate change that had been requested by the [Church of England], including publishing its fullest-ever climate risk report."[73] This example highlights proactive engagers who have direct engagement with subject companies but are reactive to company behaviour.

The third level is the **influencer** where the asset owner may or may not agree with company policy but is advocating for some form of change. This is different from engagement in that they are not reactive to company behaviour and instead are looking to spearhead their differences. An example would be CalPERS who is a leading advocate for change in the state of California.[74]

Lastly we have the **impact investor** who opposes company behaviour and is taking steps to alter this behaviour. This level of activism is distinct from all other forms in that the asset owner fundamentally advocates for change and is financing alternative solutions. Often times, impact investors do not deal with public companies but instead provide financial support for start-up and early stage ventures. In addition, this group can have aspects of philanthropy in which case they are not necessarily concerned with a financial return – instead they only care about making a fundamental change. While there are many impact investors out there, one example is the Clean Air Fund which was formally launched in September 2019 during the UN Secretary-General's Climate Summit in New York to "focus on funding activities which have both climate mitigation and human health benefits."[75]



73 www.churchofengland.org/sites/default/files/2019-05/Church%20Commissioners%20Annual%20Report%202018.pdf
74 www.calpers.ca.gov/page/about/organization/calpers-story/our-mission-vision
75 www.ccacoalition.org/en/partners/clean-air-fund

The Proxy System

Proxy voting is seen as the most direct form of SRI engagement. Advocacy for proxy voting is positive in that casting a vote is better than not voting at all. However, as the SEC and others look to align investment adviser stated objectives with actual behaviours, it is instructive to examine the proxy system in some detail.

Table 26

Board Resolutions Breakdown

Category (%)	2011	2012	2013	2014	2015	2016	2017
Election of directors	69.1	70.1	70.3	70.0	70.7	71.0	70.2
Auditor ratification	11.2	11.4	11.3	11.2	11.4	11.1	11.0
Compensation	16.1	15.0	14.6	15.3	14.1	13.9	14.8
Other	3.7	3.5	3.8	3.5	3.8	4.0	4.0

Source: Investment Company Institute Research Perspective – Proxy Voting by Registered Investment Companies, 2017 (July 2019)
Note: Columns do not sum to 100% due to rounding

Table 27

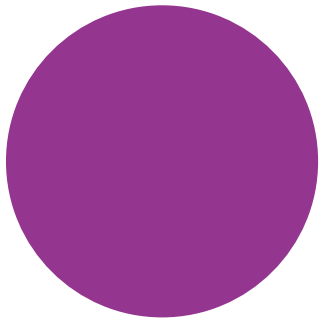
Board Resolutions Support

Category	Average Support	Count
Election of directors	-	-
Auditor ratification	98%	143
Compensation	91%	222
Other	95%	16
Grand Total	**94%**	**381**

Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions. Note we did not review Board of Directors elections in our analysis.

Table 28

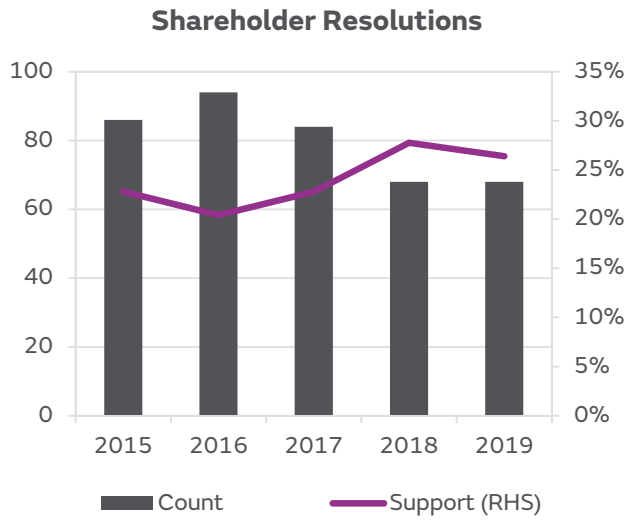
Management Recommendation of Shareholder Resolutions



Yet we need to be careful to draw any significant conclusions from this observation. For instance, shareholders may work with management amicably to agree on a course of action rendering no resolution being heard. The Investment Company Institute found that in 2017, 18% of shareholder resolutions were withdrawn as a result of agreeable resolution.[76]

In spite of these side negotiations shareholder resolutions have gained support when brought to the floor to vote. In our analysis of the DJIA we observed a positive trend of shareholder support despite a decline is actual resolutions being heard. While support is considerably below majority we feel the directional trend is supportive of sustainability initiatives especially with such a high level of withdrawn resolutions due to resolution (18%).[76]

Table 29



Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions.

The majority of shareholder resolutions were related to Social - compensation (13%) and Governance topics - specifically political contributions (15%), independent board chairman (13%), and special meetings (8%). Only 10 shareholder resolutions received more than 50% support (2.5% of total votes heard) and no resolution was supported by management. Again, we iterate the bleakness of data can be misleading as advocacy/resolution often occurs behind closed doors. Furthermore, in the US per SEC Rule 14a-8 there is no obligation by management to act on any of these resolutions.

Of the 400 shareholder resolutions that were brought to a vote, the breakout is as follows:

Table 30

Topic	Count	Support
Environmental	38	18%
Social	123	14%
Governance	239	22%
Grand Total	**400**	**24%**

Note: There were 10 shareholder resolutions withdrawn (2.5%).
Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions.

76 Investment Company Institute Research Perspective – Proxy Voting by Registered Investment Companies, 2017 (July 2019)

Table 31

Shareholder Proposals Receiving More Than 50% Support

Company	Year	Resolution	ESG	Support
DuPont de Nemours	2018	Eliminate Supermajority Vote Requirement	G	71.7%
Cisco Systems	2015	Proxy Access	G	64.7%
Exxon Mobil	2017	Report on Climate Change Policies	E	62.1%
Exxon Mobil	2016	Proxy Access	G	61.9%
McDonald's	2015	Proxy Access	G	61.7%
Walgreens Boots Alliance	2019	Report on Governance Measures Implemented Related to Opioids	S	60.5%
International Business Machines	2017	Proxy Access	G	59.4%
Chevron	2015	Proxy Access	G	55.3%
Procter & Gamble	2017	Repeal Any Amendments to Code of Regulations Adopted After April 8, 2016	G	51.9%
Travelers	2019	Prepare Employment Diversity Report, Including EEOC Data	S	50.9%

Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions

Does the apparent success of these ten resolutions make an impact as measured by the relevant ESG pillar score change? We found no meaningful correlation.

Table 32

Shareholder Proposals Receiving More Than 50% Support ESG Score Change

Company	ESG	Meeting	Pillar Source Prior	PillarSource (6/2019)	Difference
DuPont de Nemours	G	2018	78.9	75.6	-3.3
Cisco Systems	G	2015	93.2	81.4	-11.8
Exxon Mobil Corp	E	2017	63.6	48.4	-15.2
Exxon Mobil Corp	G	2016	28.6	25.0	-3.6
McDonald's Corp	G	2015	55.8	18.8	-37.0
Walgreens Boots Alliance	S	2018	56.1	45.3	-10.8
International Business Machines	G	2017	34.7	71.8	37.0
Chevron	G	2015	23.2	14.5	-8.6
Procter & Gamble	G	2017	45.5	46.2	0.7
Travelers	S	2019	55.8	58.9	3.1
Average			**53.5**	**48.6**	**-4.9**

Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions, Bloomberg, Sustainalytics

We found the same lack of correlation when looking at shareholder resolutions which were withdrawn. However, we note that 40% of withdrawn shareholder resolutions received a commitment or are in discussions. This supports the notion that proxy voting is an important tool for shareholder ESG advocacy.

Table 33

Shareholder Proposals Withdrawn

Company	Topic	ESG	Outcome	Meeting	Pillar Source Prior	PillarSource (6/2019)	Difference
Home Depot	Political Contributions	G	No Vote (Other)	2018	79.5	84.7	5.2
3M	Special Meeting	G	Unknown	2018	92.0	88.6	-3.4
Caterpillar	Compensation	S	Unknown	2018	51.2	42.7	-8.5
American Express	Political Contributions	G	Commitment	2016	45.3	52.3	6.9
Chevron	Climate Change	E	Dialogue	2017	41.4	35.5	-5.9
Procter & Gamble	Holy Land Principles	S	Commitment	2017	31.8	23.1	-8.7
Procter & Gamble	Proxy Access	G	Unknown	2015	55.6	46.2	-9.4
Walmart	Cumulative Voting	G	Unknown	2019	29.4	28.3	-1.1
Walmart	Proxy Access	G	Unknown	2017	33.3	28.3	-5.0
Pfizer	Holy Land Principles	S	Commitment	2017	88.5	63.7	-24.8
Average					**54.8**	**49.3**	**-5.5**

Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions,
Bloomberg, Sustainalytics, Ceres

Are SRI Managers Walking the Talk?

We chose 10 SRI focused asset managers who publicly disclose their proxy voting and observed their voting behaviour from 2015 to 2019. Some asset managers generally agreed with management (regardless of the resolution) while others generally opposed management. The following table reflects all proxy resolutions during this timeframe.

Table 34

Select SRI Asset Managers Voting History (All Resolutions)

Asset Manager	Management Recommendation		Abstain	Other	No Ownership
	Agree	Oppose			
A	**87.3%**	9.0%	0.6%	0.9%	2.2%
B	21.5%	22.9%	0.9%	0.0%	54.6%
C	**54.9%**	44.4%	0.0%	0.8%	0.0%
D	9.6%	8.4%	0.0%	0.8%	81.2%
E	42.7%	**52.1%**	1.4%	0.9%	2.9%
F	**61.6%**	38.3%	0.0%	0.1%	0.0%
G	14.1%	30.0%	1.4%	0.0%	54.5%
H	23.6%	26.5%	0.5%	0.1%	49.3%
I	27.9%	**62.4%**	2.5%	0.9%	6.3%
J	49.6%	44.0%	0.9%	0.9%	4.7%
Total	**39.3%**	**33.8%**	**0.8%**	**0.5%**	**25.6%**

N=789 for an average of 5.3 shareholder resolutions per company per year (excluding board nominations)
Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions and the 10 selected sustainability focused asset manager proxy votes.

We see the same divergence when looking at shareholder resolutions, (of which management advocated against every resolution) and see that some industry players are true advocates for socially responsible behaviour – using ESG shareholder resolutions as a proxy (oppose management) whereas others tend to follow board recommendations. As we discussed prior, it is dangerous to extrapolate trends from these proxy voting results because Asset Manager A could be working closely with management truly advocating change.

Table 35

Select SRI Asset Managers Voting History (Shareholder Resolutions)

	Management Recommendation				
Asset Manager	**Agree**	**Oppose**	**Abstain**	**Other**	**No Ownership**
A	**78.9%**	16.2%	1.2%	1.0%	2.7%
B	2.2%	34.1%	1.7%	0.0%	62.0%
C	27.0%	**72.1%**	0.0%	1.0%	0.0%
D	3.2%	14.7%	0.0%	0.7%	81.4%
E	12.5%	**80.6%**	2.7%	1.2%	2.9%
F	32.8%	**66.9%**	0.0%	0.2%	0.0%
G	4.7%	35.0%	2.7%	0.0%	57.6%
H	20.8%	32.1%	1.0%	0.2%	45.8%
I	7.6%	**79.9%**	4.2%	1.2%	7.1%
J	27.5%	**64.5%**	1.5%	1.2%	5.4%
Total	**39.3%**	**33.8%**	**0.8%**	**0.5%**	**25.6%**

N=789 for an average of 5.3 shareholder resolutions per company per year (excluding board nominations)
Source: GIB UK – Dow Jones Industrial Average Constituent Participants 8-K Filings (2015-2019) sampling of shareholder resolutions and the 10 selected sustainability focused asset manager proxy votes.

Regulation S-K

The Case for the Modernization of Regulation S-K[78]

1. The SEC has clear statutory authority to require disclosure of ESG information, and doing so will promote market efficiency, protect the competitive position of American public companies and the U.S. capital markets, and enhance capital formation;
2. ESG information is material to a broad range of investors today;
3. Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful;
4. Companies' voluntary ESG disclosure is episodic, incomplete, incomparable, and inconsistent, and ESG disclosure in required SEC filings is similarly inadequate;
5. Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure; and
6. Petitions and stakeholder engagement seeking different kinds of ESG information suggest, in aggregate, that it is time for the SEC to regulate in this area.

78 corpgov.law.harvard.edu/2018/10/09/petition-to-sec-for-rulemaking-on-environmental-social-and-governance-esg-disclosure/

What are the Holy Land Principles?

Holy Land Principles[79]

1. Adhere to equal and fair employment practices in hiring, compensation, training, professional education, advancement and governance without discrimination based on national, racial, ethnic or religious identity.
2. Identify underrepresented employee groups and initiate active recruitment efforts to increase the number of underrepresented employees.
3. Develop training programs that will prepare substantial numbers of current minority employees for skilled jobs, including the expansion of existing programs and the creation of new programs to train, upgrade, and improve the skills of minority employees.
4. Maintain a work environment that is respectful of all national, racial, ethnic and religious groups.
5. Ensure that layoff, recall and termination procedures do not favour a particular national, racial, ethnic or religious group.
6. Not make military service a precondition or qualification for employment for any position, other than those positions that specifically require such experience, for the fulfilment of an employee's particular responsibilities.
7. Not accept subsidies, tax incentives or other benefits that lead to the direct advantage of one national, racial, ethnic or religious group over another.
8. Appoint staff to monitor, oversee, set timetables, and publicly report on their progress in implementing the Holy Land Principles.

79 Intel Corp 2015 Schedule 14A

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Notes

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