



Principles
for Responsible
Investment

An investor initiative in partnership with
UNEP FI and the UN Global Compact



Responsible investment in passive management strategies

Case studies and guidance

January 2011



UNEP **Finance Initiative**
Innovative financing for sustainability

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The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The six Principles are:

- 1** We will incorporate ESG issues into investment analysis and decision-making processes.
- 2** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- 3** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- 4** We will promote acceptance and implementation of the Principles within the investment industry.
- 5** We will work together to enhance our effectiveness in implementing the Principles.
- 6** We will each report on our activities and progress towards implementing the Principles.

Contributions

The PRI Secretariat is grateful to the following people for their contributions to this report:

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Introduction

James Gifford, Executive Director, PRI



The following report presents eight case studies that demonstrate how asset owners and investment manager signatories are meeting the challenge of responsible investment within passive management strategies for equities.

Passive management is an important strategy for many investors. It is defined by the PRI (in its Reporting & Assessment survey) as an investment strategy that aims to replicate broad capital market benchmarks (for this reason passively managed funds are also referred to as indexed or tracker funds).¹ There are many funds within the PRI signatory body that have large indexed holdings and find the Principles consistent with their fiduciary duty and goals of delivering long term returns to their clients. The [PRI Report on Progress 2010](#)² found that approximately 17% of signatories' total assets were held passively in 2009, and that each investor signatory typically holds passive funds (based on their median value) worth US\$ 1.9 bn, up 31% from the previous year.²

This publication has been created to help clarify how signatories can implement the relevant Principles in this important part of their portfolios. Through a brief overview and a series of case studies, this report takes a snapshot of how responsible investment within passive management is currently interpreted. It also provides some initial ideas for how investors can develop their own approaches to this challenge.

“...this report takes a snapshot of how 'passive responsible investment' is currently interpreted.”

Readers of this document may also be interested in the PRI's recent [report on Universal Ownership](#).³ Many passive investors are also considered 'Universal Owners', as they have long-term portfolios that represent a slice of the total investment market. Due to broad diversification, these investors have a clear financial interest in the long-term health of the economy as a whole, not just in individual companies. So cross-market, long-term responsible investment activities such as promoting corporate action on climate change, addressing corruption and enhancing ESG disclosure are especially relevant for them. This is a theme explored in more detail in the Universal Owner report and serves as a useful companion to this document.

We are grateful to all the signatories and partners who contributed to this report and we hope it provides an insight as to how several PRI signatories are currently seeking to implement the PRI in their passively-managed assets.

James Gifford
Executive Director, PRI

1. Enhanced passive mandates that seek to add value over an index should be considered actively managed assets according to the 2010 PRI Reporting & Assessment tool user manual.

2. P. 7 PRI Report on Progress 2010

The six Principles for Responsible Investment were drafted in a UN-convened process by a group of institutional asset owners, supported by a multi-stakeholder group of experts. During the process, it was made clear by the drafting group that passive management is consistent with the Principles, primarily through voting and company engagement, both independent and collaborative. Currently, this means that passive managers' responsibilities are largely exercised through active ownership activities (Principle 2). There are also an increasing variety of indices being designed that integrate ESG factors into index design and management and these may become more widespread over time.

In passive investment, as with many areas of responsible investment, the most appropriate way to put the Principles into practice for each institution depends on the nature of the financial instruments being used and circumstances of the individual investor. Importantly, the different structures of passive investments – for example, whether assets are managed in a separate account versus a pooled or co-mingled fund – make a difference to the tools investors have at their disposal when it comes to implementing the Principles.

How do passive managers put Principle 2 into practice?

Research undertaken for this publication indicated the core importance of active ownership to a responsible passive management strategy. Passive managers can exercise voting rights on behalf of their clients in domestic and international markets. Additionally, as several case studies in this report indicate, asset owners can retain and implement their own voting and engagement rights or delegate these to a third party, service provider.

Many passive managers also have engagement programmes focused on dialogue with investee companies on ESG issues. This can also involve

engaging collaboratively with other investors. Due to the size of many passive portfolios, active ownership is a powerful tool to ensure that companies, from which they cannot divest, are well managed and report on relevant ESG issues. Where passive managers do not wish to engage on a one-to-one basis with investee companies, they can engage in sector or market-level initiatives such as the Extractive Industries Transparency Initiative or Carbon Disclosure Project. PRI signatories can also benefit from the PRI Engagement Clearinghouse, which provides a central global collaborative forum for investors on a range of issues, allowing signatories to pool their resources and influence and achieve greater impact with their engagements.

In particular, signatories reported that passive investors can help strengthen the corporate governance practices of investee companies through exercising voting rights. Many signatories argued that improved corporate governance can help investors build confidence and trust in companies, reduce investment risk and contribute towards greater stability in the financial market.

Why do investors choose passive management strategies?

Over the years passive investing has gained increasing prominence in asset allocations. Passive, or index investing, can be attractive as it offers low management costs and provides highly diversified investments. It is an investment strategy that does not rely on manager skill. Instead it relies on delivering market returns so is appropriate for longer term investing where maximum diversification is required.

Usually the constituents of indices are weighted by their market capitalisations in order to reflect the market and provide these market returns. It is important to note that in recent years an increasing number of multi-factor and risk indices have been created that lay out transparent ground rules for how they operate. Therefore, when a passive investor follows such an index they are able to specify precisely how their investment in that index is managed and maintained.

How can passive managers interpret Principle 1?

Principle 1 of the PRI relates to the incorporation of ESG issues into investment decision-making. When the Principles were drafted in 2005/06 it was made clear that passive investors' responsibilities are largely exercised through the active ownership activities outlined in Principle 2.

This view is reflected in the PRI annual Reporting and Assessment survey, in that if a signatory indicates that assets are passively managed, the relevant Principle 1 questions on active management and ESG integration into stock selection disappear from the survey and are not counted. Passive managers can rest assured that the PRI is entirely compatible with their strategy, even if there is no consideration of ESG factors in the portfolio construction process.

It is worth noting that some passive managers are finding ways to incorporate ESG issues into their stock selection processes. Referred to as 'enhanced passive management', these approaches tilt the traditional index using ESG criteria and then use optimisation methods to ensure the portfolio tracks the underlying benchmark. However, there is some debate as to whether these approaches are active or passive management. It is noteworthy that at the time of printing the PRI Assessment survey regards these approaches as active management, although this remains an ongoing debate.³

Another interpretation of how Principle 1 can be implemented in passive management strategies relates to the strategic decision-making level or asset allocation level of the investment process. For example, some signatories have invested in ESG-themed indices based on views of macro ESG trends (note, this type of approach to Principle 1 is also not currently scored in the PRI Assessment). There has also been some discussion of the impacts of climate change on asset allocation decisions. Bringing ESG issues into these macro processes is certainly at early stages, but is likely to increase.

What about the other Principles?

When undertaking active ownership such as voting and engagement, passive managers can certainly implement Principles 3 (encouraging ESG disclosure), 4 (promotion within the investment chain), 5 (collaboration) and 6 (reporting). These Principles are implemented in many of the same ways, whether funds are invested actively or passively, and the PRI provides a comprehensive library of implementation resources.

Conclusion

Many passively managed funds have chosen to sign the PRI and begin implementing the Principles. They recognise that the PRI is consistent with their fiduciary duty and goals of delivering long term returns for their clients and beneficiaries. The Principles have always been intended to be aspirational and not a prescriptive set of rules, and are to be applied as appropriate within each asset class and investment approach.

The case studies below highlight the variety of ways in which passive managers are implementing the PRI.

3. This definition remains under consultation by the PRI Secretariat which invites signatories interested in this area to comment directly.

Environment Agency Active Pension Fund (EAPF)

Exercising ownership rights in pooled passive funds

6

Signatory type: Asset owner

Country: UK

Established: 1989

AUM (at 31/12/09): US\$ 2.40 billion

Approximate percentage of funds under passive management (at 31/12/09): 39%

“ We require all our equity managers to consult with us on all resolutions about environmental governance issues.”

EAPF's approach to ESG issues

We believe that companies managing environmental risks, impacts and opportunities are more financially sustainable in the long term. In our opinion, these companies benefit not only the economy and their owners but also the environment and society. This is reflected in our Environmental Overlay Strategy and Corporate Governance Policy. They are applied across our whole fund.

We invest in many different types of assets: equities, bonds, gilts, property and private equity. For each type, our approach requires us to consider different approaches, constraints, risks, opportunities and potential benefits.

Taking responsibility for passive ownership

We recognise that whilst the use of pooled and indexed products can be cost-effective, it does reduce the range of governance tools open to us. At the same time we believe our role as a responsible investor is even more crucial when you “own” a small piece of all the companies in the index. Our primary tools therefore are engagement and voting.

Using a partnership approach

We have set up a three way partnership with ourselves as the asset owner, our investment manager and a service provider that specialises in international engagement support, in order to undertake engagement and voting for all our passively-managed assets.

Our investment manager handles our funds against a range of passive indices. All but the UK equities are pooled. The funds are:

Asset class	Index
UK equities (segregated)	FTSE All-Share
UK index-linked gilts (pooled)	FTSE UK gilts indexed >5yrs
North American equities (pooled)	FTSE World North America
European equities (pooled)	FTSE World Europe ex UK
Japanese equities (pooled)	FTSE World Japan
Asia Pacific equities (pooled)	FTSE World Asia Pacific ex Japan

Asking managers to vote on environmental issues

We require all our equity managers to consult with us on all resolutions that are about environmental governance issues e.g. climate change disclosures. The majority of these resolutions are brought in the US market and we hold these as a pooled passive fund. In our Investment Management Agreements we insist that we are able to exercise our vote independently from other members of the pooled asset group. The administration to implement this is largely undertaken by the specialist engagement service provider. As currently we only request this for environmental resolutions the task is limited to around 80-90 votes each year. We publish how we voted on these resolutions on our website.

Challenges ahead

To expand the process to cover all votes would have its limitations, not least administrative. There could also be restrictions in certain countries that will not allow pro-rata voting. However we do not believe this goal is beyond the capacity of modern fund management and/or technology.

Currently our investment manager is able to offer the service of pro-rata voting on UK pooled equities but there is growing demand, particularly from smaller funds for this function to be available across all markets. We believe this will be an area of product development in the medium-term as responsible asset owners want to exercise their shareholder rights to ensure their long term interests.

More information:

www.environment-agency.gov.uk 

Fonds de réserve pour les retraites (FRR)

ESG criteria for RFPs and mandates

8

Signatory type: Asset owner

Location: France

Established: 2001

AUM (at 31/12/09): US\$ 47.97 billion

Approximate percentage of funds under passive management (at 31/12/09): 50%

“The mandate requires our passive managers to vote and assist FRR in engaging dialogue with companies.”

FRR's approach to ESG issues

FRR works with approximately 40 asset managers and has allocated more than 50 investment mandates via a tender procedure. We ensure that ESG-related issues play a large part in the recruitment and selection of passive mainstream equity managers by including relevant criteria in both our Request for Proposals (RFPs) and our mandates.

ESG considerations in the selection of passive managers

FRR scores PRI/ESG-related issues in first and second round questionnaires for selecting passive managers, with varying weights applied. In the first-round qualitative questionnaire the weight attributed to these issues varies from 15 to 20 per cent. It is a more delicate task to offer equivalent data for the second-round qualitative questionnaire as ESG-issues are mainstreamed throughout the document. However, the quality of a passive manager's voting process can potentially account for up to 10 per cent. This means that in the case where all other scores are globally equal, the PRI/ESG score can be decisive.

Some of the relevant questions asked in our RFPs for passive managers discuss areas such as voting proxies, risk control and compensation policy in relation to responsible investment. Examples of these questions include:

- What process is used to determine votes (committee, managers, platform, etc)? Do you delegate, partially or totally, the decision-making? Do you think your system will have to be adapted to meet the specific needs of the FRR mandate?
- How do you guarantee that the specific wishes or orientations expressed by your institutional investment clients in terms of proxy voting policy are really complied with when it comes to voting proxies?
- Do you ever submit draft resolutions at shareholder meetings on behalf of your institutional clients?
- Please provide a brief description of your activity of dialogue and engagement with issuers: resources dedicated, preferred themes, number of issuers concerned per year, results obtained, etc.
- In the event there is no dialogue and engagement activity at present, do you plan to set up an in-house system in this area? If so, what is the timeframe?

- What resources could you offer for protecting the image/reputation-risk related to repeated and acknowledged violations of fundamental principles by the companies in which you invest (such as basic conventions of the ILO or UN Global Compact, etc)?
- What quantitative and qualitative indicators have been selected for measuring the performance of managers?
- Are the managers' remuneration policies published internally and/or externally?
- More generally, do you consider that your remuneration policy complies with the recommendations issued by the G20 countries at the Pittsburgh summit of 25 September 2009, and that it reflects a satisfactory balance between the interests of your clients and those of your managers?
- Passive managers must state that they will assist FRR, at the latter's request, by making its resources and skills available as needed, for the purpose of developing its policy of dialogue and engagement with issuers.
- Passive managers must undertake to exercise the voting rights attached to financial instruments exclusively in the interest of FRR, in accordance with its guidelines, and to report back to the FRR on the exercise of these voting rights.
- Passive managers must act on the fact that FRR excludes from its investment universe companies that are involved in the production of anti-personnel mines and cluster bombs and must be willing to personalise the benchmark index should FRR exclude other companies from its investment universe.
- Passive managers must commit to reporting on proxy voting practices quarterly and annually. This includes a table listing the votes themselves, a report containing an explanation of the votes and an analysis of any problems encountered.

ESG considerations in mandates for passive managers

The mandate is the contract that binds FRR and the asset management company. In the case of a passive mandate, FRR requires managers to replicate the risk adjusted return of the benchmark allowing a tracking error of 50 bp. In the introduction to the mandate, reference is made to the PRI and to FRR's responsible investment strategy.

As part of the mandate, passive managers are required to vote and assist FRR in engaging dialogue with companies. Some examples of where ESG considerations are included in the mandate include:

- Passive managers must certify that they have read the foundational texts of FRR, the updated minutes/reports of the Supervisory Board and FRR's responsible investment strategy statement.

More information:

www.fondsdereserve.fr 

Signatory type: Asset owner

Country: Australia

Established: 1987

AUM (at 31/12/09): US\$ 13.24 billion

Approximate percentage of funds under passive management (at 31/12/09): 12%

“HESTA considers engagement by its external fund managers to be of crucial importance regardless of whether they are active or passive managers.”

HESTA's approach to ESG issues

HESTA considers ESG capacity as a key distinguishing feature in passively managed investments. For instance we look for the intelligent undertaking of share voting and engagement with companies and regulators. HESTA has the objective of voting every share owned by the fund, both domestic and overseas. For domestic listed equities, we determine all voting preferences internally on the basis of advice from proxy advisers and also from our external fund managers.

Working with partners

HESTA has allocated substantial resources to both share voting and engagement by professional third party providers. As founding members of the Australian Council of Super Investors (ACSI) and Regnan, we rely on these two bodies to engage on our behalf with Australian companies. For international share voting and company engagement HESTA uses a specialised service provider, as HESTA is not able to resource internally this function.

Engagement as a crucial part of passive management

HESTA also – and this is of central relevance to this case study – considers engagement by its external fund managers to be of crucial importance regardless of whether they are active or passive managers. Passive managers are by their nature ‘universal’ and long term owners.

Therefore, the long term health and viability of the markets and companies in which they invest should be of interest to them. HESTA has not, however, linked performance tracking to an ESG index. We consider this less important than the activities described above – however, we will think about this in the future in the course of ESG planning for each asset class.

Appointing a passive manager with ESG capacity

HESTA approached the appointment of an international listed equities passive mandate through the standard RFP process (which contained specific references to share voting, governance and ESG capacity) followed by a formal interview process. HESTA's first filter was the ability to meet the technical requirements it set for a passive equities manager. In assessing the remaining short listed candidate firms the two key factors that would essentially determine the outcome were: first, cost, and second, engagement and ESG factors. These two factors were to be considered together – HESTA valued the latter component highly but not at unlimited cost.

Remembering that HESTA had centralised international share voting through a specialised engagement service provider, the key factor was not the execution of HESTA's share voting, but the differentiation of firms on how they voted the shares under their control and, particularly, their engagement and broader ESG capabilities.

The key components of this determination, which included an intensive interview process, were as follows:

- A review of all policies such as share voting guidelines and engagement policies. We wanted to be sure that these policies and guidelines were 'good practice' from an ESG point of view, but also that there was sufficient discretion built in to enable a focus on pragmatism and long term value creation.
- HESTA then looked at execution and practice. Were the policies and guidelines meaningfully applied? For example, were all shares voted – if not, why not? Depth and frequency of engagement – was this limited to letter writing or did it extend further? Was engagement prioritised and on what basis? Where discretion existed – was this exercised (in our view) intelligently and thoughtfully or, rather, was it driven by process? We reviewed voting patterns on key issues quantitatively and qualitatively.
- Do they measure performance in share voting and engagement? Did they have an understanding of what 'success' would look like. For engagement in particular, did they track the impact of what they were doing?
- Was the organisational adequately resourced? HESTA wanted to know about the people, systems and processes, capacity for institutional learning, whether external data providers were used, who those providers were and how the data was used in decision-making – and how it was intended to grow these capacities and services over time.
- The final key component might be grouped under the heading of 'strategic thinking'. Most passive equities managers focus on governance, but little on the 'E' or the 'S' in ESG. We looked for the ability to think beyond governance and to consider how social and environmental factors might fit into their strategy, particularly engagement strategy, and plans for future development.

It was an interesting process from which we learned a great deal. It was a combination of quantitative analysis and qualitative assessment as to which firm was the best fit with HESTA. As always, we were helped enormously in this process by the views of other pension funds.

More information:
www.hesta.com.au 

National Pensions Reserve Fund of Ireland

Appointing a specialist engagement and voting overlay provider

12

Signatory type: Asset owner

Country: Ireland

Established: 2001

AUM (at 31/12/09): US\$ 32.1 billion

Approximate percentage of funds under passive management (at 31/12/09): 37%

“Passive management was something that had to be considered as part of our RI strategy.”

NPRF's approach to ESG issues

As an investor in over 2,000 companies worldwide, NPRF believes that ESG issues impact on long-term investment performance. At the time of becoming a signatory to the PRI in 2006, the Fund had an equity exposure of close to 70% with around 40% of this passively managed. Since then the equity allocation has reduced but the proportion passively managed has increased to 60%. This high degree of passive management was something that had to be considered as part of our RI strategy.

Ensuring consistent voting by our managers

NPRF's initial assessment of all its equity managers (active / passive, fundamental / quantitative) showed a wide variety of approaches, with some managers being reasonably active in voting across most portfolio holdings and others just voting in their local region or not at all. Most managers outsourced voting to a proxy service provider to varying degrees. Essentially it became clear that NPRF as the asset owner had no consistency of approach and therefore, there was a very real possibility that we could be unintentionally cancelling out votes across similar mandates or not voting at all across others.

Considering engagement for the first time

We also found that while some engagement was taking place that it was generally being done at a basic or ad hoc level by just a small number of managers. At that time the NPRF came under some scrutiny regarding a number of Sudan-related holdings. While both the companies and managers we dealt with at that time were responsive to our requests it was clear that engagement on a larger scale required a depth of expertise and resources that we simply were not geared up for internally.

Developing an active ownership policy

In developing our active ownership policy we first embarked on an education process which involved meeting with and talking to our managers, peer funds and several voting and engagement service providers. We quite quickly made the decision that bringing voting and engagement in-house without significant resources and a dedicated team was not possible and therefore out-sourcing became an obvious choice. As we learned more about the processes involved we also determined that a combined voting and engagement service where voting is used simply as one of the tools of engagement would be the optimal solution for the NPRF.

Appointing an external engagement service provider

In July 2007, the NPRF Commission appointed a specialist engagement and voting overlay provider to execute proxy votes and to engage with companies on ESG issues across our global equity portfolio, approaching a company's ESG performance from a shareholder's perspective and framing its discussions with companies in terms of long-term value creation. Our approach is based on the premise that a company run in the long-term interest of shareholders will need to manage effectively its relationships with employees, suppliers and customers, behave ethically and have regard for the environment and society as a whole and is entirely consistent with the NPRF's commercial investment mandate.

International best practice forms the basis for the NPRF's voting and engagement with companies and the NPRF Commission monitors these activities on an ongoing basis. The NPRF works very closely with the specialist engagement service provider and oversees its activities through regular monitoring and reporting in addition to having significant input into the direction of engagement being undertaken. We found that a significant benefit of appointing a specialist engagement and voting overlay provider was that, because it acts on behalf of a number of other institutional investors, it enabled the pooling of resources to create a stronger and more representative shareholder voice.

Outcomes

At the end of December 2009, the NPRF was an investor in over 2,900 companies worldwide and over the year, NPRF exercised its voting rights at 2,812 shareholder meetings and engaged in-depth with 323 companies on 1,076 topics including environmental, social and governance issues.

Feedback from both our active and passive managers has been very positive since deciding to outsource the responsibility of voting to an external service provider. Managers are still required to ratify the provider's recommendation in blocking markets, unless there is a trading reason not to do so.

More information:

www.nprf.ie 

Signatory type: Asset owner

Country: Australia

Established: 1999

AUM (at 31/12/09): US\$ 6.32 billion

Approximate percentage of funds under passive management (at 31/12/09): 74%

VicSuper's approach to ESG issues

At VicSuper, our investment policy acknowledges the potential for sustainability issues to impact materially investment returns over the medium to long term. VicSuper aims to implement this policy with minimum cost in order to maximise the returns that we pass onto members. VicSuper therefore predominantly uses a passive investment management approach to invest in the major asset classes (equities and fixed interest).

A range of measures to implement Principle 2 in passive investments

VicSuper's focus on delivering value for our members over the long term means that we aim to achieve sustainable investment returns at a low cost, taking into account a broad range of material investment risks and opportunities.

As a primarily passive universal investor, VicSuper maintains investments in a broad selection of companies around the world. VicSuper has an interest in these companies developing successfully sustainable business strategies that enable them to maximise their potential to generate long-term cash flow and create long-term shareholder value. We address sustainability issues in passively managed investments primarily through proxy voting and company engagements (domestic, international and emerging markets), and through collaborative engagement initiatives. We use two specialist engagement service providers based in Australia and the UK to approach Australian and

“ VicSuper defines enhanced passive investment as investments designed to achieve similar risk and return characteristics as an index, that are representative of the index, but that are selected based on their sustainability credentials. ”

international companies on their sustainability risks and opportunities. We undertake our own proxy voting for our Australian listed equity investments, and utilise our UK-based engagement service provider to undertake proxy voting for our international listed equity investments.

VicSuper is also involved in a number of collaborative engagement initiatives that are targeted at industries, markets, regulators, and public policy issues. In addition, we measure and publicly report the carbon footprints for all our passive and enhanced-passive listed equity investments, and a portion of our unlisted equity and property investments.

'Enhanced passive investment'

VicSuper defines enhanced passive investment as investments designed to achieve similar risk and return characteristics as an index, that are representative of the index, but that are selected based on their sustainability credentials. Typically these investments only turn over a small portion of their investments every year, generally far less frequently (and therefore far less costly) than most active funds. VicSuper has three investments that fall into this category:

- Carbon Aware International Shares Fund;
- Vanguard Sustainability Leaders Australia Shares Fund; and
- Vanguard Sustainability Leaders International Shares Fund;

Sustainability-specific investments

When initially seeking to integrate sustainability considerations into our investment strategy we were looking for an index-like investment that took sustainability considerations into account (but without making ethical or value judgements), that was relatively low-cost and that was broadly representative of the index (diversified). We felt that investing in a highly active fund would present cost and diversification challenges for VicSuper.

Our first sustainability-specific investments were made in 2000 to the Vanguard Sustainability Leaders Australia Shares Fund and the Vanguard Sustainability Leaders International Shares Fund (formally branded the SAM Sustainable Asset Management Sustainability Leaders Australia and International funds). The investments in these funds are selected on a 'best-of-sector' basis, with every industry sector in the relevant index included, subject to a minimum hurdle performance.

More recently we seeded the Carbon Aware International Shares Fund, managed by Vanguard Investments Australia, which invests in a portfolio of 700 international companies and seeks the investment returns of the MSCI World Developed ex-Australia index, with a collective target of a 50% reduction in greenhouse gas emissions compared to the broad index. The Fund comprises the top 40% of the companies in each industry from an initial list of 1,700 companies, ranked by their carbon footprint relative to industry peers. These companies are then subjected to risk modelling that seeks to create a well-diversified portfolio that is country, industry and size neutral. The annual turnover of the Fund is intended to be less than 10%.

Sustainable approach leads to increased performance

Sustainability investing at VicSuper is beginning to show outperformance over longer time periods. For the eight years to 31 July 2010 VicSuper's Equity Growth Sustainability investment option, which is allocated 100% to equities and consists mainly of enhanced passive investments, was the best performing of VicSuper's seven investment options. Other investment options offered by VicSuper include the Equity Growth option which is 100% allocated to equities including a 20% allocation to sustainability, and a mixture of balanced and conservative options including a 100% cash option.

More information:

www.vicsuper.com.au 

Signatory type: Investment manager

Country: US

Established: 1998

AUM (at 31/12/09): US\$ 627.2 billion

Approximate percentage of funds under passive management (at 31/12/09): 42%

“ We recognise that expectations are evolving and we are working with various engagement specialists to keep abreast of the trends. ”

Northern Trust's approach to ESG issues

Northern Trust Global Investments signed the PRI based on our shared principles and support for the United Nations' approach to responsible investment. We believe the overarching themes of the PRI – transparency, accountability and continuous improvement – align with our own values. The emphasis the Principles place on collective action and idea exchange is an approach that we endorse and believe is critical for widespread acceptance of responsible investment practices.

Additionally, given the complexity of integrating a consistent approach to ESG issues into our core investment practices, we believe it is important to be part of a community working to establish a common language and best practices around these issues. Internally we use the PRI as a framework to formalize and prioritize our responsible investing initiatives.

Index management

As a sophisticated, mainstream institutional index manager we divide our ESG integration efforts into two layers. The first layer is our ability to offer, accommodate and successfully execute client requests for custom index mandates – whether socially screened, alternatively weighted or with proxy voting guidelines to express the views of the asset owner. Northern Trust manages approximately US\$15 billion according to socially screened index mandates.

ESG Integration across the whole portfolio

The second layer of ESG integration would apply the Principles across our asset management franchise. To assist with this goal, Northern Trust has created a governance structure to support business wide ESG initiatives, including a new Head of Corporate Social Responsibility reporting directly to our CEO and a cross-functional Responsible Investing working group. The working group, comprised of senior executives and investment professionals, identified two action items related to index management:

- Review Northern Trust's custom proxy voting policy; and
- Monitor client expectations on engagement/global norms.

Is company management best placed to make decisions on social and environmental proposals?

In proxy voting, Northern Trust's fundamental precept is to ensure that shares are voted in the best interests of clients/beneficiaries and to protect the value of the investment. Our custom proxy voting guidelines outline our position towards common resolutions and highlight our specific stance on corporate governance issues, such as, director independence, board structure and executive compensation.

Our current proxy voting guidelines provide that we generally support the position of a company's board of directors when voting shareholder initiated social and environmental proposals. This position is grounded on the belief that in most cases a company's management group and elected directors are best positioned to make corporate decisions on these sorts of proposals. While this core belief remains unchanged, a number of recent events--including revised SEC interpretations of the rules that control the types of issues a company's management can and cannot exclude from corporate proxy ballots and a proliferation in the types of issues being voted upon--have led us to conclude that a more nuanced approach to these sorts of issues may be in order. We are therefore actively working with our proxy voting vendor to identify specific types of proposals that may merit our support.

Evolving expectations on engagement

Northern Trust has chosen not to engage with companies other than at voting points, as we believe this is a costly exercise and that such activity extends beyond the services of index management. Inevitably, costs related to engagement would be passed through to clients via the charges we apply and at this point we have not seen regular support of the concept from index clients. Nonetheless, we recognize that expectations are evolving and we are working with various engagement specialists to keep abreast of the trends.

International co-ordination

An important consideration for a leading Global Index Manager with a diverse base of clients in more than 40 countries is the impact of country/regional norms on global index mandates. This is particularly an issue in commingled funds, where multiple clients are invested in the same index strategy. For example, a country might impose a restriction on portfolio holdings, such as Belgium's proposed cluster bomb regulation. Options for index managers include revising the global index mandate to accommodate the client domiciled in the most restrictive country, or customizing investments at the country level. Northern Trust has partnered with index providers to develop index solutions but this is often driven by coordinated client demand.

Ultimately, we intend to establish policies that are transparent and responsive to the evolution of ESG issues. We are dedicated not only to meeting the needs of our clients, but also to giving back to the communities we serve, following sound business practices and ethics and taking a conservation minded approach to protecting the environment.

More information:

www.northerntrust.com 

Signatory type: Investment manager

Country: UK

Established: 1970s'

AUM (at 31/12/09): £315 billion (US\$ 508 billion)

Approximate percentage of funds under passive management (at 31/12/09): 66%

“ We have a very active approach to corporate governance whilst assets are managed on a passive basis in line with the client's benchmark. ”

LGIM's approach to ESG issues

As an institutional investor LGIM has a fiduciary duty to clients to exercise its voting rights responsibly. The right to vote is a basic privilege of share ownership and a fundamental tool used by investors to signal support or dissatisfaction with management actions. This mechanism is one of the valuable methods of promoting good corporate governance in the marketplace and therefore it is vital that shareholders take the opportunity to exercise their voting rights responsibly.

LGIM is a major investor in the UK equity market with typical holdings of over 4% of the FTSE index companies. We undertake extensive engagement with companies on ESG issues which shape the voting decisions. This involves direct meetings with executive directors, chairmen and other non-executive directors to discuss, for example, company performance, board succession and remuneration issues. This ensures that there is a very active approach to corporate governance whilst assets are managed on a passive basis in line with the client's benchmark.

Extension of international voting

Given the growing movement towards international equity portfolios by UK pension funds,⁴ there has been increased demand for LGIM to raise its global corporate governance activity.

The previous approach had been to vote on all UK resolutions and the top 100 North American companies using an international proxy advisors' voting policy. This represented over 50% of the value of the assets in this region.

During 2010, LGIM has voted in four regions which represent approx. 96% of LGIM's developed market equity portfolio – North America, Europe, Japan and Asia Pacific. In addition we recruited two analysts into the corporate governance team taking it to five people. In 2011, LGIM is implementing its own custom voting policy (Enhanced Approach) and in 2012 LGIM is planning to extend direct engagement with international companies (Comprehensive Approach).

Different markets, bring different challenges

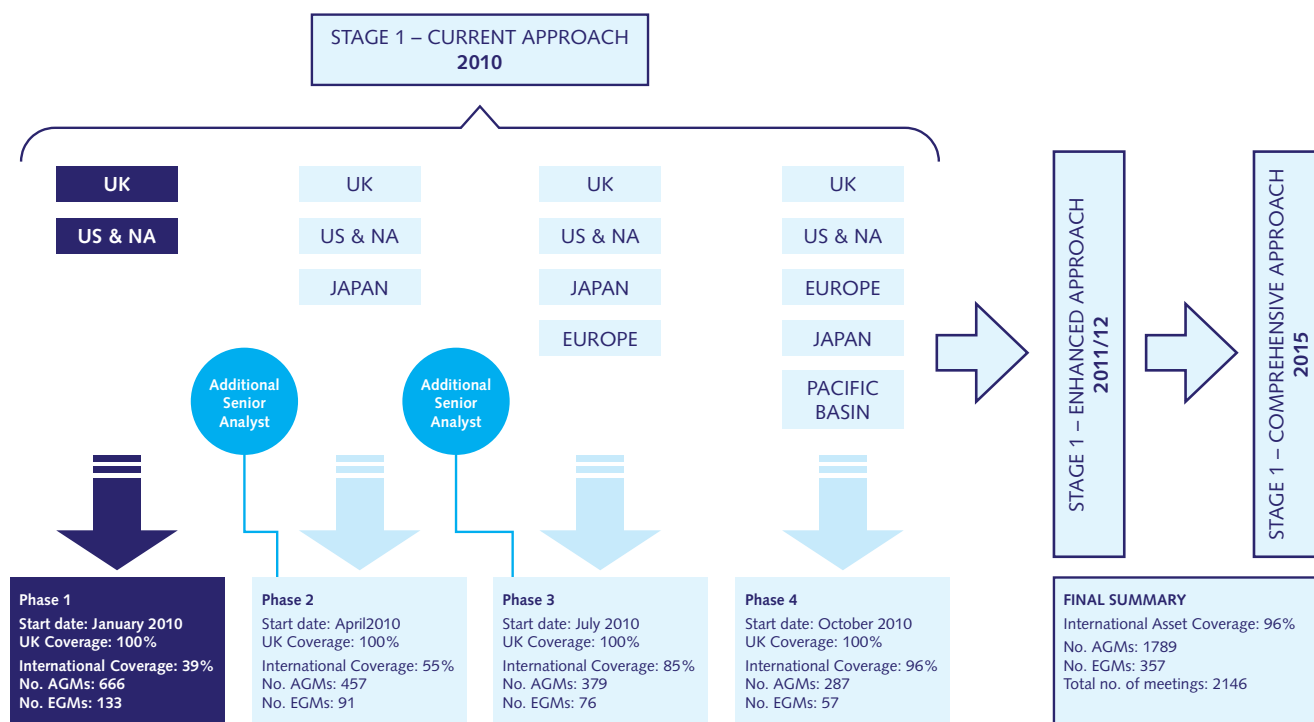
Each market has particular features, such as the concentration of AGMs in Japan. In Europe, share blocking practices in many of the markets mean that we can not vote on shares without compromising the fund managers' ability to undertake transactions. As a result, we can only vote around 60% of the European markets.

The objective of LGIM's voting and engagement policy is to ensure that all of the fund management, voting and engagement activities are considered together to meet client expectations.

4. Asset Management in the UK 2008, The IMA's Seventh Annual Survey, Chart 18: UK Pension Fund Equity Asset Allocation (1999-2008), Investment Management Association (IMA), Pg 39

Name of region	% of total value of equity assets managed
UK	49%
Continental Europe	15%
North America	20%
Japan	6%
Other Pacific Basin	7%
Rest of the World	2%
Total	100%

International Voting Strategy



Signatory type: Asset owner

Country: UK

Established: 2005

AUM (at 31/12/09): US\$ 4.74 billion

Approximate percentage of funds under passive management (at 31/12/09): 11%

Lothian's approach to ESG issues

In 2008, Lothian Pension Fund (the Fund) undertook a review of its investment managers' activity on ESG issues and found its passive managers performed poorly compared to their peers.

Seeking collaboration with peers on ESG issues

Passive investment managers' holdings are dictated by index providers, so the lack of ESG activity, including voting, was particularly concerning. The Fund, with relatively small amounts of assets invested passively, recognised it was unlikely to have any great impact when trying to influence the managers in isolation. Therefore, the Fund's findings were presented to the Local Authority Pension Fund Forum (LAPFF), which represents 49 UK local authority pension funds with combined assets of over £ 75 billion.

LAPFF agreed to pursue the issue and commissioned a specialist ESG research specialist to undertake a comprehensive audit of the largest passive managers in the UK. Fund managers were evaluated and rated across five key responsible investment themes of strategic orientation, engagement, research, proxy voting and transparency. Following the assessment, the Fund recognised a major gap in the coverage of voting and engagement of passive managers. It revealed the apparent lack of strategic approach to ESG, as well as a huge variation of coverage of voting and engagement across global markets.

“ We recognised the Fund was unlikely to have any great impact when trying to influence the managers in isolation... but a relatively small investor can collaborate with like-minded investors to have greater influence in the investment market. ”

The assessment identified:

- The extent of managers' voting was inconsistent across the world and an estimated £ 130 billion of assets were not voted regularly;
- Managers engaged inconsistently with companies and an estimated £ 350 billion of assets were rarely, if ever, engaged; and
- Small cap stocks were rarely engaged, and holdings in emerging markets were typically never engaged.

Outcomes

Representatives of LAPFF and Lothian Pension Fund discussed these findings with a number of passive managers, exploring areas for improvement. Since this engagement, there have been notable changes, including greater levels of voting transparency. While LAPFF's survey is not the only reason for these positive developments, pressure from LAPFF members undoubtedly had an impact. This process has shown how a relatively small investor can collaborate with like-minded investors to have greater influence in the investment market.

More information:
www.lpf.org.uk 

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For more information, or if you would like to contribute a case study, please contact info@unpri.org 

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