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What Investors are seeking from
Sustainability

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Sustainability in Property

Introduction

What are Investors seeking?

- Drivers behind Investors' socially responsibly investment regimes
- Balancing ideals with performance considerations using ESG

ESG – Environmental, Social and Corporate Governance

- It's not just about Green Buildings or environmentally friendly development
- Active ownership (Beta) and ESG integration for Mercer clients
- Mercer ESG ratings explained
 - Examine some ESG factors
 - Alpha integration in the investment process
 - Mercer ratings and examples from rated strategies

United Nations Principles for Responsible Investment (UNPRI)

- Incorporate ESG issues in investment analysis/decision-making
- Be active owners and incorporate ESG issues into ownership policies and practices
- Seek appropriate disclosure on ESG issues by the entities in which they invest
- Promote acceptance and implementation of the Principles within the investment industry
- Work together to enhance effectiveness in implementing the Principles
- Report on our activities and progress towards implementing the Principles

SRI – ESG

What are Investors seeking?

Much demand from Mercer clients for strategies with focus on these factors. We are incorporating issues in our ratings of funds. Currently 1071 funds are being monitored / rated for ESG

- Fiduciary duty to enhance long term returns
- Keen interest in:
 - Active ownership - *using influence or third party overlay to change corporate behaviour*
 - Themed funds, e.g. Clean energy/tech and Green buildings, social housing
 - Carbon footprints
- Screening:
 - Positive ie. *o/w company stocks that have a positive impact on society*
 - Negative – *exclusion (not just u/w) companies with perceived negative impact, eg. gambling, animal testing, tobacco production*



Active ownership and beta

- Over time, engagement and voting can improve market and portfolio performance.
- Engagement strategies and voting practices that meet the following 3 criteria will increase long-term shareholder value for institutional investors:
 1. active ownership policy is well articulated;
 2. policy is integrated into core manager functions; and
 3. outcomes are reported and evaluated over time

Communicate your philosophies, strategies and performance to investors

What is ESG integration according to Mercer?

- ESG can contribute to (long-term) alpha and beta enhancement
- Not 'value(s)-led' but value based, including risk management and identification of investment opportunities
- Taking a long-term horizon and integrating extra-financial (such as ESG) factors into the core investment process
- Many approaches emerging, Mercer does not prescribe the 'best' approach but rather encourages innovation

ESG Factors

| Environmental factors | Social factors | Governance factors |
|------------------------------------|---|--------------------------------|
| Climate change strategy | Stakeholder relations | Board structure |
| Environmental policy | Working conditions | Independent board directors |
| Sustainability best practice | Supply chain management | Independent board leadership |
| Environmental management practices | Health and safety conditions | Separation of Chairman and CEO |
| Pollution management | Product safety measures | Executive compensation |
| Water supply management | Treatment of customers | Shareowner rights |
| Sustainable transport | Labor relations, including relationship with unions | Accounting quality |
| Waste management | Community impact assessment | Audit quality |
| Clean energy investments | | Board skills |

ESG integration and alpha

Idea Generation

Evidence of market leading capability - identifying and integrating ESG factors into active fund positions as a source of value added.

- integrated approach to ESG factors into **buy/sell decisions**:
 - **skill of team members**, **data sourcing** and the inclusion of ESG factors by the portfolio managers themselves in the **identification of attractive investment opportunities**.

Portfolio Construction

Evidence that the manager integrates ESG driven views into the **active bets** in the portfolio

- taking into account the strength of the conviction and the expected time period upon which the ESG factor is likely to become material.

Implementation

Evidence that the manager has a **long-term investment** horizon

- (as evidenced by portfolio turnover data) to effectively implement ESG views.
 - Also look for evidence of voting and engagement activities as beta enhancement tools

Business Management (Firm-wide Commitment)

Company support at the highest levels.

- The extent to which the business leaders **understand and accept the importance of ESG/SRI** and
 - the extent to which they have committed time, effort and \$\$\$ to integrating this across the investment institution

ESG Ratings for our clients

Mercer ESG Ratings

- ESG 1
 - Assessed as being the ‘leaders’ in integrating ESG and active ownership into their core processes. Full integration across investment process.
- ESG 2
 - ESG factors are part of decision making at the strategy level with some indication that data and research is being taken into account by the fund managers in their valuations. Likely to be a strong level of commitment made at the firm wide level.
- ESG 3
 - Made some initial progress with respect to ESG integration and active ownership.
 - May be quite good at active ownership with evidence of voting and engagement, but not really progressed in terms of thinking about the environment or social issues
- ESG 4
 - Are assessed as having done very little with respect to ESG integration or active ownership.

ESG Ratings for our clients

Examples of ESG Ratings

– ESG1 – Unlisted Diversified Fund

- “The manager has a high focus on sustainability and is a leader in this area. The company is committed to the philosophies of environmental protection and sustainability, describing its approach as being “in its corporate DNA.” The firm has a dedicated Sustainability Manager with 3 to 5 year targets set on each asset. XXXXX’s private equity arm invests globally in research and development for various initiatives such as tidal electricity, de-salination plants and solar energy for green buildings...”

– ESG2 – Listed A-REIT

- “XXXX and its parent company XXXXX are highly aware of ESG issues. The investment process has a tangible connection with ESG as part of the quality scoring within the investment process. There is a genuine deep effort in investigating governance issues as part of the assessment of stocks. In addition the manager subscribes to a corporate guidance specialist and uses these findings as a further guide to governance and related voting. XXXXXX has the services of a specialist SRI group, Regnan, to assist in investigation of topical issues...”

– ESG3 – Listed A-REIT

- “XXXXXXXXXX is a signatory to the United Nations PRI. The tangible influence of an ESG perspective is primarily in terms of voting policy and engagement with corporate management. It is XXXXXX’s policy to vote on all resolutions. There is consideration of the recommendations of third party corporate governance providers (admittedly this advice has not found to always be appropriate). The portfolio managers note that some A- REITs are well developed on the environmental and social front, but this pattern is rare. ***E and S are not part of the stock evaluation process....***”

ESG Ratings for our clients

Examples of ESG Ratings (contd.)

– ESG 2 – Unlisted Development Fund

- XXXXXXXX has a stated policy and process for implementing sustainability principles across project design and development particularly incorporating elements into master planned communities. Further, it has ongoing relationships with two key consultants, XXXX Design – Architects and Town Planners, and XXXXXXXXX – Engineers, to ensure sustainability principles are incorporated into every project development. The environmental sustainable strategies include:
 - Grey water retention, treatment and recycling storm water polishing
 - Reducing building waste during construction
 - Reduction in vehicle dependence and enhanced cycle and pedestrian connections

– ESG 1 – Unlisted Fund

- XXXXXXXX has a high focus on sustainability and is a signatory to the UN Principles of Responsible Investment.
- It actively engages in social programs for communities across Australia and has introduced a Social Investment Program called “XXXXXXX” which it describes as “chequebook philanthropy” and encourages employees and other stakeholders to actively give a day of their annual leave in support of the program.
- Each asset has a Building Sustainable Committee and members label themselves “green zealots.” XXXXx admits that the cost of attracting and retaining tenants is hard to measure at this point but it has a number of initiatives in place supporting ecological footprints, sustainable development and conservation.

Conclusion

A tale of many approaches

- An investor has many choices but peer pressure is building for ESG investment
 - Pure alpha generation strategies such as generating returns from pure trading carbon emission permits or value add refurbishment?
 - Having your cake and eating it too
 - Investing for alpha – returns above a benchmark and
 - Beta – returns in line with some market index?

- Not every stakeholder is on the same page
 - Investor
 - Fund Manager
 - Real estate occupier





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Appendix

Responsible Property Investment (RPI)

A Few Definitions

- Is it RI, SRI or RPI???
- RPI as defined by Pivo and McNamara, (2005:12)
 - “RPI, in a nutshell, means maximizing the positive effects and minimizing the negative effects of property ownership, management and development on society and the natural environment in a way that is consistent with investor goals and fiduciary responsibilities. It requires both an understanding of how cities and buildings relate to these larger issues and knowing how to address them in a financially prudent manner.”
- RI versus Socially Responsible Investment (SRI)
 - Principles for Responsible Investment
 - Responsible Property Investment Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI)

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