Global Asset Management

RESPONSIBLE INVESTING: THE EVOLUTION OF OWNERSHIP

2017 RBC Global Asset Management
Responsible Investing Survey
Executive Summary

Introduction

Within the investment community, responsible investing, in one form or another, has been in practice for over 30 years. Early on, the concept had no universal definition, but typically meant aligning an investment portfolio with a moral or ethical belief system – which could be effected simply by excluding companies that were not compatible with the investor's beliefs.

Today, responsible investing has evolved considerably in its sophistication and range of approaches. As illustrated in the sidebar, responsible investing can include ESG integration, engagement and socially responsible approaches, which can be further broken down by a variety of strategies including impact, screening and other themes.

In addition, a discussion about responsible investing can also include related topics such as a company's corporate citizenship, philanthropy or efforts to increase diversity.

While responsible investing has moved into the mainstream, and the rate of adoption of responsible investing strategies has accelerated, it remains a topic defined by starkly different views and opinions. Indeed, consensus on key responsible investing issues is the exception. Many investors believe strongly that incorporating ESG factors in the investment process can mitigate risk and add value; however, others remain unconvinced of the value that an ESG approach offers. Adoption of ESG investing appears to be growing; indeed, a significant number of institutions plan to increase (or establish) allocations to strategies that incorporate ESG factors in the near term. However, others seek better data about the ESG performance of companies before they will incorporate ESG factors into their investment process. There also appears to be broad disagreement about the appropriate role of shareholders, industry and/or regulators when it comes to improving reporting on ESG activities. Attitudes toward many aspects of responsible investing are remarkably different in Europe than they are in North America.

These are among the key conclusions drawn from RBC Global Asset Management's (RBC GAM) 2017 survey of institutional asset owners and investment consultants within Canada, Europe and the US. The survey reveals some of the questions and concerns that persist among institutions, including whether a divestment or engagement approach is best when attempting to influence corporate behavior. It also highlights possible reasons as to why the US has been slower than other regions to integrate ESG factors in investment processes.

RESPONSIBLE INVESTING DEFINED

ESG Integration

Inclusion of environmental, social and governance (ESG) factors as a component of fundamental analysis to identify potential sources of alpha or risk reduction

Socially Responsible Investing

Impact Investing
Allocating funds to earn a financial return alongside measurable social and environmental impact

Positive Screening
Using ESG measurements to select specific companies or sectors

Negative Screening
Using ESG measurements to exclude specific companies or sectors

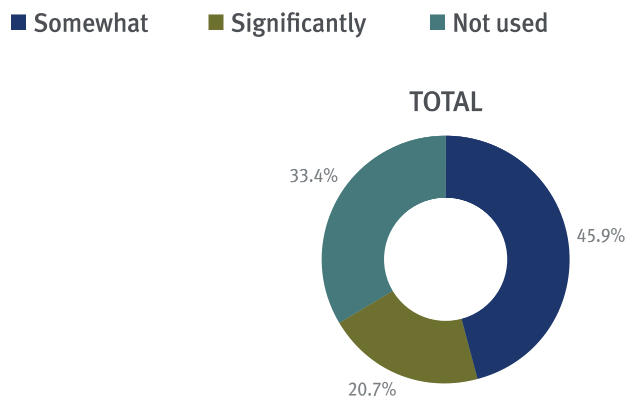
Sustainability Themed
Building portfolios that only include investments that meet specific ESG criteria

Engagement

Seeking to influence corporate behavior through direct engagement, shareholder proposals, and proxy voting

Still a question of returns

Exhibit 1: To what extent are ESG principles used as part of your investment approach and decision making?



67%

of respondents said they use ESG principles as part of their investment approach and decision making.

As ESG analysis has become more sophisticated and technical, it has become more widely recognized as a tool that asset managers can use to add value and mitigate risk. Over the years, as more institutional funds have flowed into ESG-focused strategies, ESG integration has become more of a core component of fundamental analysis. More and more, asset managers – either at the individual portfolio manager level or firm-wide – are formally integrating ESG analysis into their investment process, as they believe it will have a material impact on investment risk and/or returns. However, the pursuit of responsible investment strategies (including ESG integration) is ultimately driven in large part by asset owners.

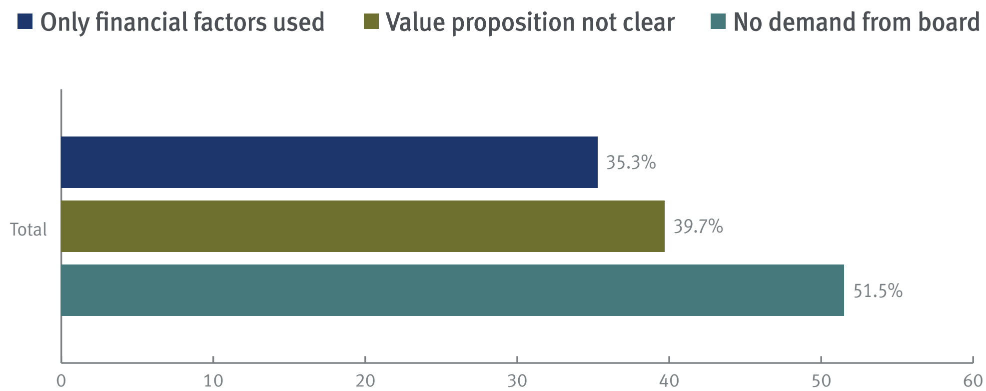
The question of whether pursuing a responsible investment strategy means giving up potential returns has long been a key question, and it remains front and center for many institutional investors. According to RBC GAM's new global survey, when investment consultants were asked what is the most common ESG-related question or concern from their clients, the question, "will returns suffer?" was by far the top answer, with more than three quarters of all respondents across geographies citing it. On the other hand, a majority of respondents believe ESG integration is likely to perform as well or better than strategies that do not incorporate ESG factors. This lack of clarity may explain why a large number of investors – in North America, at least – continue to take a "wait and see" approach to ESG investing.

Today, responsible investing is truly global in scope. Looking in particular at ESG integration, while investors in Europe have been and continue to lead the way, the survey found that the trend continues to gather steam in the US and Canada. When asked specifically about ESG integration, a full 67% of respondents in the US, Canada and Europe said they use ESG principles as part of their investment approach and decision making. By geography, more respondents in Europe (85%) than in Canada (73%) and the US (49%) incorporate ESG analysis.

45%

of European respondents to the RBC survey said they use ESG principles "significantly" in their investment approach and decision making.

Exhibit 2: Top 3 reasons for not incorporating ESG



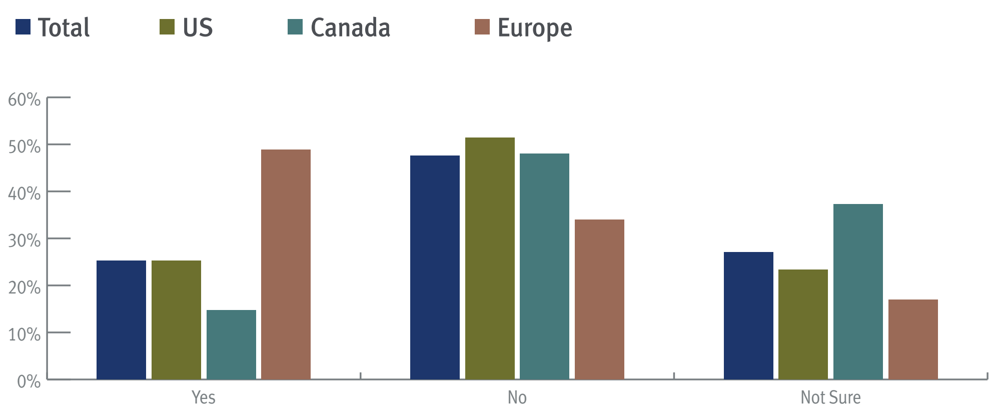
One clear sign that Europe is leading the way in ESG investing is the fact that 45% of European respondents to the RBC GAM survey said they use ESG principles "significantly" in their investment approach and decision making. That compares with 16% in Canada, 12% in the US and 21% overall. Among institutional investors who said they apply ESG principals "somewhat," those in Canada led the way (57%) followed by Europe (40%) and the US (37%). Overall, 46% of respondents said they apply ESG principles somewhat.

Survey respondents who reported that they do not incorporate ESG considerations into their investment approach cited several reasons. The main reason for this decision is an absence of demand from the institution's board of directors or stakeholders. Other common reasons cited include an unclear value proposition; the fact that only financial factors are used in the investment decision making process; and lower return expectations. These responses suggest that many institutions continue to doubt the value proposition of an ESG investment approach.

However, in another indication of the dichotomy of thinking around ESG integration, 37% of all survey respondents who indicated they apply ESG analysis said the approach's value proposition, or higher risk/return profile, was one of the top reasons for employing it. The numbers were similar across regions, with more investors in Europe (49%), citing it than in Canada (35%) or the US (31%). And, unlike those who do not employ ESG considerations, the most common reason given (57%) for incorporating ESG analysis was the fact that multiple factors – not just financial – are used in the investment decision making process, while a board mandate and investment guidelines were cited by 36% and 31% of respondents, respectively.

Walking the talk

Exhibit 3: Do you expect to increase your allocation to ESG managers/strategies over the next year?



25%

of respondents said they planned to increase their allocation to managers that incorporate ESG into their investment management process or ESG-based investment strategies over the next year.

One clear sign that ESG integration continues to gain momentum is that 25% of respondents said they planned to increase their allocation to managers that incorporate ESG into their investment management process or ESG-based investment strategies over the next year. Institutional investors in Europe once again led the way, with nearly 50% saying they planned to increase their allocation to ESG investment strategies during this time. In the US, 25% plan to increase their allocation to ESG strategies in the next year, and in Canada, 15% plan to do so. However, many investors remain on the fence about increasing their allocation over this short period of time; 27% of respondents are not sure whether they will increase their allocation to ESG strategies within the next year. In Canada, 37 % of respondents aren't sure, and in the US the number was 23%.

Similarly, a significant portion of investors appear to be considering an allocation to impact investing – an investment approach that seeks to generate a beneficial societal or environmental impact alongside a financial return.

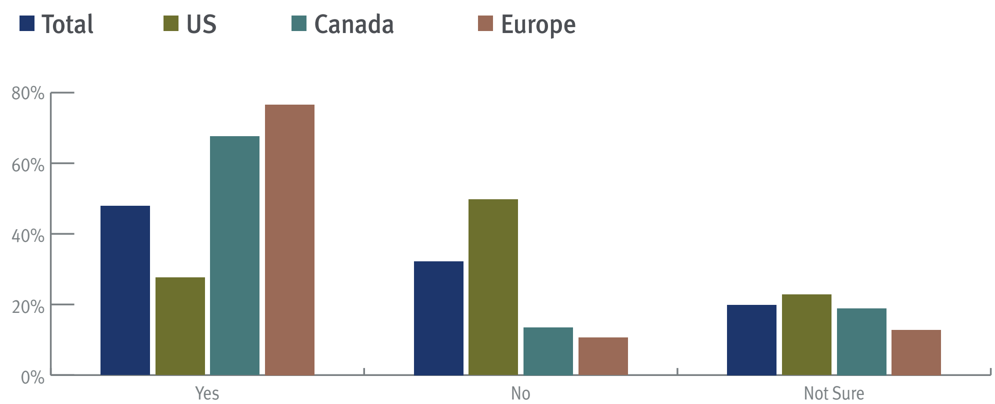
When investors were asked whether they planned to allocate funds to impact investing over the next one-to-five years, 20% of respondents overall said yes. Institutional investors in Europe once again took the lead, as about 40% plan to allocate funds to impact investing over the next five years. About 19% of investors in the US and 13% of investors in Canada plan to do the same. Overall, 43% of respondents said they aren't sure whether they will allocate funds to impact investing over the next five years. In Canada, that number was 52%; in the US nearly 40%, and in Europe about 32%.

Small steps

48%

of respondents said they consider ESG investments to be risk mitigators.

Exhibit 4: Do you consider ESG to be a risk mitigator?



For investors who incorporate ESG factors into their portfolio strategies, the research suggests that while many are taking small steps, a significant portion are going all in. According to the survey, nearly one-fifth (19%) of these respondents said their entire portfolio factors in ESG principles. On average, investors factor in ESG principles in 49% of their portfolios.

Here the geographic breakout adds interesting color to how much institutional investors are factoring ESG principles into their portfolios. Again, Europe leads, with fully one-third of respondents reporting that their entire portfolio considers ESG factors. In Canada, the portion of respondents who apply ESG factors to their entire portfolio was 16% and in the US it was 13%. Investors in Europe factor ESG principles into, on average, 62% of their portfolio, compared with 57% in Canada and 34% in the US.

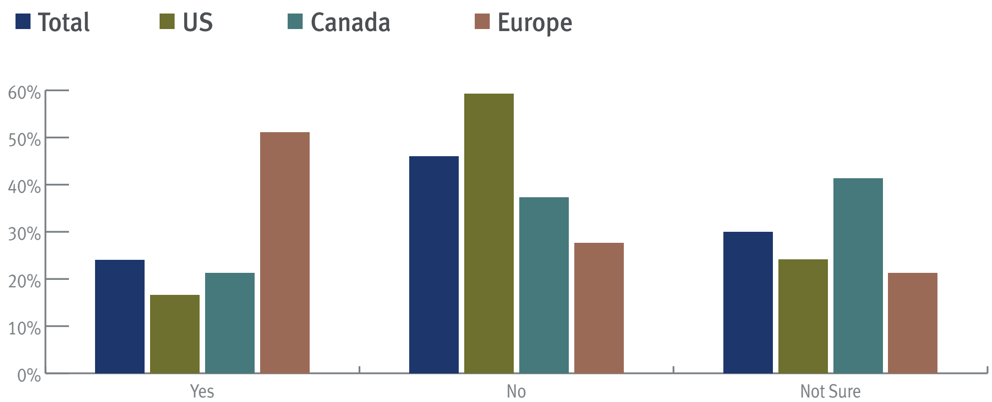
Perhaps not surprisingly, how institutional investors think about ESG integration – as a risk mitigator or alpha source, or how it will perform versus a non-ESG integrated approach – largely follows the same pattern as whether they plan to increase their allocation to managers or strategies that incorporate ESG principles.

For example, overall, a majority of European and Canadian investors view the consideration of ESG factors to be a risk mitigator while in the US a greater percentage do not consider it to be a risk mitigator. When the topic turned to alpha generation, the European investors stood out in their belief that ESG integration can produce alpha. Over 50% of European respondents consider the analysis of ESG factors to be an alpha source, yet overall, only 24% of all respondents share that same belief. Despite this discrepancy, 82% of respondents think that an ESG investment approach will perform as well or better than a non-ESG approach, with only 18% saying an ESG integrated approach would perform worse.

24%

of respondents consider ESG investments to be alpha sources.

Exhibit 5: Do you think of ESG as an alpha source?



In the US, where more than half of respondents do not expect to increase their allocation to ESG strategies this year, 50% do not consider ESG analysis as a risk mitigator, 59% do not think of ESG analysis as an alpha source, and 26% think an ESG approach is not likely to perform as well as a non-ESG approach. This suggests that many US institutional investors remain unconvinced of the value of ESG integration and do not expect it to make a positive contribution to portfolio risk levels or returns.

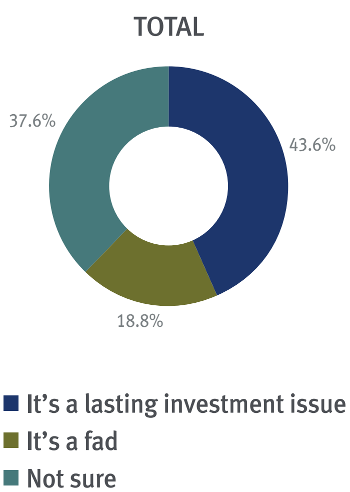
In Europe, on the other hand, where nearly 50% of respondents expect to increase their allocation to ESG strategies within the next year, 77% of respondents consider ESG analysis to be a risk mitigator, 51% see ESG analysis as an alpha source, and 96% think ESG strategies will perform as well or better than non-ESG strategies. Investors in Canada were more mixed, with 68% saying ESG analysis is a risk mitigator but 37% saying ESG analysis is not a source of alpha (41% said they weren't sure), and 91% of respondents saying they expect ESG strategies will perform as well or better than non-ESG strategies. According to the data, Europeans have the most favorable opinion of ESG investing, expecting it to help reduce risk, increase alpha and perform in-line with (or better than) traditional investments. This finding is consistent with the survey data showing greater use of ESG factors in Europe than in either the US or Canada.

Digging deeper

43%

of overall respondents said they thought the Fossil Fuel Free movement is a lasting investment issue.

Exhibit 6: Do you believe the Fossil Fuel Free movement is an investment fad or lasting investment issue?

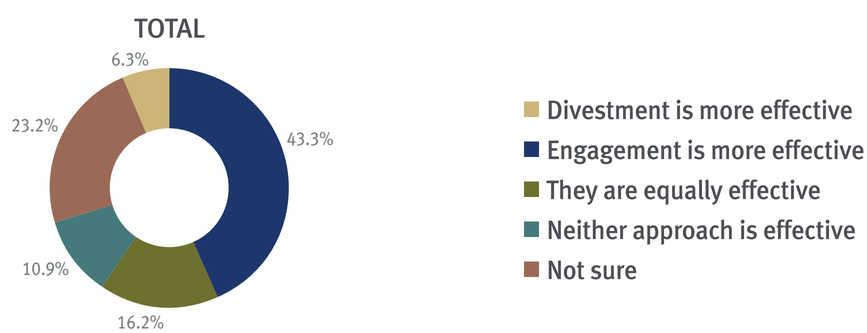


When the question turned to the Fossil Fuel Free movement – broadly the global effort to divest from companies that extract, process or transport fossil fuels – there was wide agreement that it is a lasting investment issue rather than a fad. A plurality of investors (43% overall, 40% in the US, 44% in Canada and 53% in Europe) agree that the movement is a lasting investment issue. Once again, however, a sizable number of respondents (38% overall, 37% in the US, 40% in Canada and 36% in Europe) are not sure.

In the context of the divestment campaign targeting fossil fuels, investors were asked to rank the effectiveness of engagement versus divestment. Interestingly, divestment was found wanting, with just 6% of respondents calling it more effective than engagement. Across the board, engagement was the method deemed most effective. It was cited by 43% of respondents overall, 42% of those in the US, 51% of those in Canada and 38% of those in Europe.

Interestingly, many European respondents (34%) believe that engagement and divestment are equally effective, suggesting a more open-minded view toward divestment. This was not the case in Canada or the US. In fact, a much higher proportion of respondents in the US compared to other regions believe neither approach is effective.

Exhibit 7: In the Fossil Fuel Free context, when thinking about ESG investing, do you consider divestment to be more effective than engagement?

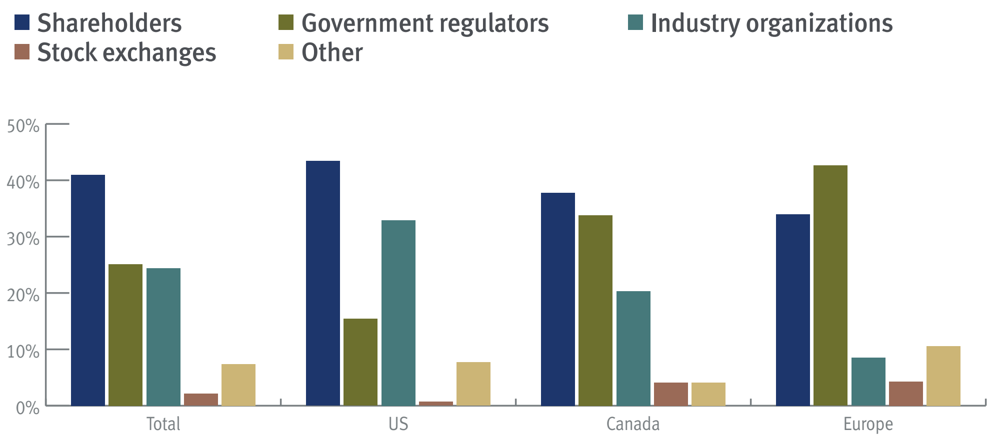


43%

of respondents consider engagement to be more effective than divestment.

Challenges to implementation

Exhibit 8: In your opinion, who should take the lead in influencing companies to provide better ESG-related information?



41%

of respondents said shareholders should take the lead through proxy ballot initiatives.

As responsible investing has become mainstream, many corporations have responded by providing metrics and information that can help investors gauge how the companies are performing in areas such as sustainability, diversity, and overall governance. However, with the wide variety of regulations and reporting requirements, the level of information provided varies from company to company.

Indeed, for investors who employ ESG criteria, a majority across all regions are not satisfied with the level of reporting across every sector in the survey. Who, then, should take the lead in moving industry toward better ESG reporting practices? Shareholders? Government? Industry groups? The responses to this question varied meaningfully across geographies.

The largest group of survey respondents, 41%, said shareholders should take the lead through proxy ballot initiatives. That was the most common response from investors in the US (43%) and Canada (38%) but not in Europe (34%), where 43% of respondents said government regulators should be the driver.

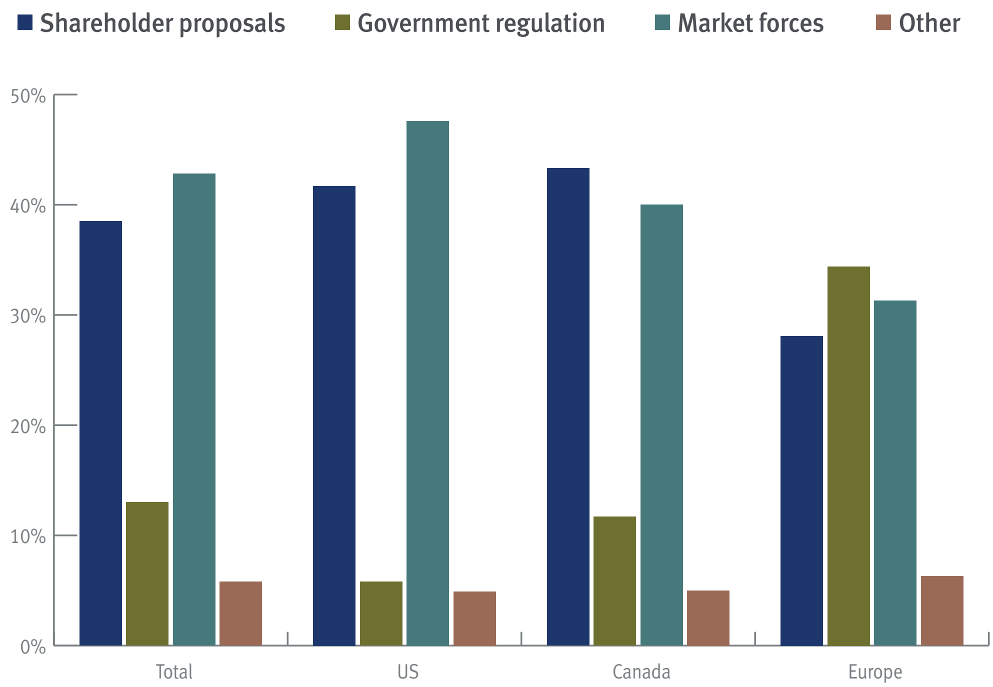
Beyond reporting, investors across the board believe that more sustainable long-term returns would be the metric that would improve most for companies with high-quality ESG practices. Perhaps reflecting their uncertainty towards the benefits of ESG investing, 30% of institutional investors in the US said that none of the suggested metrics – sustainable long-term returns, lower cost of capital, earnings growth or higher returns to shareholders – would improve with better ESG practices.

Gender diversity

43%

of respondents appear happy to let market forces do the work of correcting imbalances.

Exhibit 9: What is your preferred approach to have more gender diversity on corporate boards?

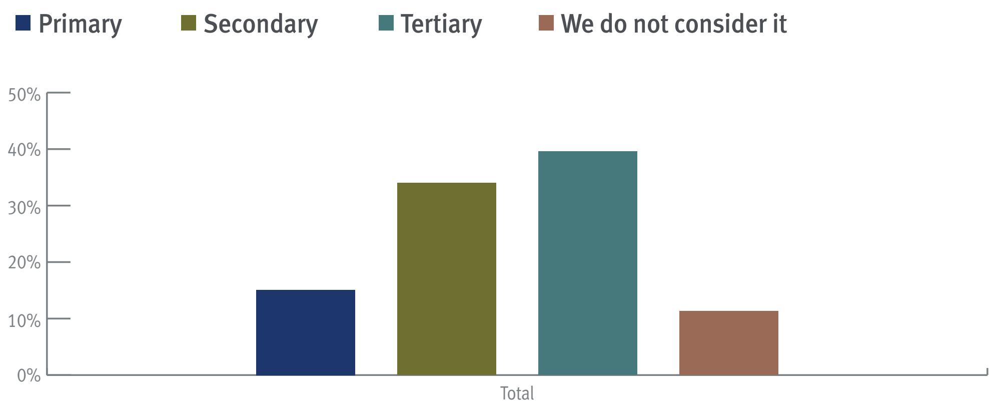


The majority of investors in every region polled said gender diversity on corporate boards is important to their organization, but a plurality (nearly 43% overall) appear happy to let market forces do the work of correcting imbalances. After market forces, shareholder proposals are the second most preferred approach to increasing gender diversity on corporate boards.

In Europe, however, government regulation is the preferred approach, followed by market forces and shareholder proposals. Canadian respondents said shareholder proposals are their first choice, followed by market forces and government regulators. In the regulation-averse US, respondents said market forces are their first choice, followed by shareholder proposals and government regulation.

Consultants' viewpoint

Exhibit 10: To what extent do you/your company consider the asset managers' approach to ESG issues and active ownership/stewardship when advising your clients about the selection of asset managers?



15%

of respondents said an asset manager's approach to ESG and stewardship was a primary criterion in manager selection.

Consultants play an important role in assisting asset owners to review, implement or adjust their investment strategy, determine appropriate portfolio allocations across asset classes and geographies, monitor and report on performance, and to select and evaluate money managers. In this gatekeeper role, consultants have important influence over how institutional investors understand and think about issues such as responsible investing and the use of ESG factors in security analysis.

The most common ESG-related concern or question consultants hear from clients is whether returns will suffer. Beyond returns, the other common questions received by consultants include whether incorporating ESG factors is worth the cost, whether this approach is just a fad and how to measure ESG-related performance.

As gatekeepers, information providers and performance analysts, consultants would appear to be uniquely poised to address the concerns of investors by providing relevant data and research, and by including questions about responsible investing (including the use of ESG factors) in their analysis of a client's existing or prospective asset manager(s).

The survey asked consultants whether, when advising asset owner clients on manager selection, they considered an asset manager's approach to ESG analysis and active ownership as a primary, secondary or tertiary criterion. Fifteen percent said it was a primary criterion while 34% said it was a secondary criterion and 40% said it was a tertiary criterion. The remaining 11% said they do not consider a manager's approach to ESG factors at all.

While no clear pattern emerged when consultants were asked if they or their clients initiated discussions about ESG, most consultants (54%) agreed that ESG factors will become a routine criterion for money manager selection over the next one to three years.

Conclusion

Responsible investing is now well established in institutional investor circles but even so, a marked divergence of views remains, carved largely out of a concern over how well ESG-integrated approaches will perform versus so-called traditional investment approaches. Skepticism on this point appears to be inhibiting a significant portion of institutional investors from adopting an ESG-integrated strategy (at least in some parts of the world).

While this “comfort level” gap remains, the study still showed that many investors plan to increase allocations to ESG strategies over the short term, indicating an increase in the rate of global adoption overall. Adoption rates vary by geography, but in all regions there appears to be a positive trend.

The survey highlighted differences, sometimes significant, in how investors think about and act on responsible investing. In addition, it revealed how consultants’ view on this topic differs from that of investors.

More than anything, the survey showed that more education about various strategies of responsible investment, particularly the value proposition of integrating ESG factors into the investment process, is needed.

Methodology

RBC Global Asset Management (RBC GAM) in partnership with Pensions & Investments developed a survey of 27 questions around the topic of responsible investing.

The survey was distributed during the months of July and August of 2017 to institutional asset owners, consultants, clients, P&I Advisory Panel members, and members of the Pensions & Investments database throughout Canada, Europe and the United States.

Signet Research, Inc. collected and analyzed the results of 434 respondents and determined that the findings from the survey could be accepted as accurate at a 95% confidence level within a sampling tolerance of approximately +/-4.7%.

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