Wealth Management
Dominion Securities

ESG manager due diligence guide

Investment manager due diligence is a core competency at RBC Wealth Management. The firm's Global Manager Research (GMR) team is based worldwide and performs numerous onsite due diligence meetings throughout the U.S., the UK, Europe, and Canada in support of multiple investment platforms. GMR has become increasingly aware of the growing influence of environmental, social, and governance (ESG) factors within investment decisions. As ESG investing has grown, GMR has observed a growing segmentation of what ESG investing means to different managers, and it's become more difficult to uniformly evaluate managers who utilize ESG investing and integration.

As such, we have augmented our due diligence process to more effectively evaluate the proliferation of managers who claim to integrate ESG factors into their investment processes. In Part 1 of this guide, we define ESG integration. Part 2 lays out GMR's due diligence process. Finally, Part 3 describes how the process has evolved to segment managers for easier comparison.

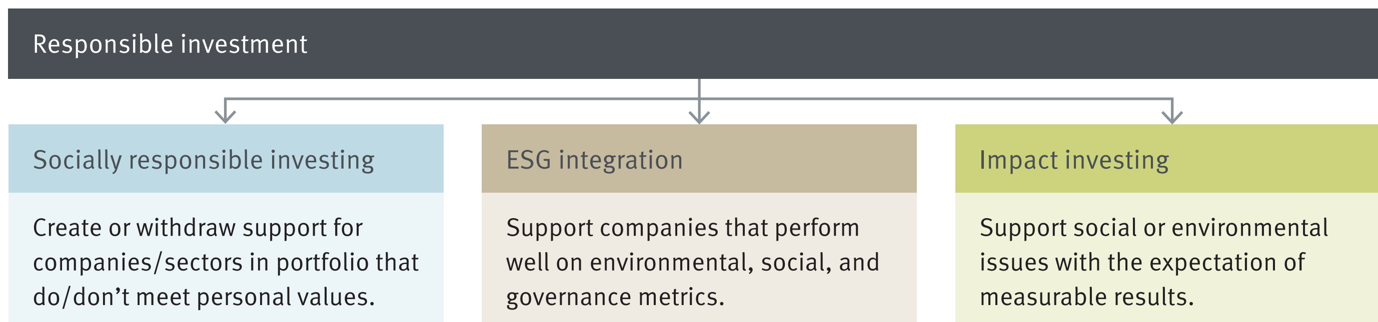
As we have developed our method of due diligence, we have identified a segmentation of the ways investment managers are applying ESG data to their portfolios. Informally, this may be called the "ESGness" of a portfolio. We believe there is a "spectrum of ESG integration." We acknowledge that a particular manager's investment process is a viable strategy, but each requires slight variations in our due diligence in order for us to make an effective ESG evaluation and comparison. Our aim is that investors can incorporate this information into their own evaluations of investment managers and portfolio construction.

Part 1: ESG definition and growth

RBC Wealth Management defines "responsible investing" as strategies that look at factors beyond traditional risk and return metrics when constructing a portfolio. These strategies use ESG data in their investment decision-making in a number of different ways, defined in more detail here.

The investment management industry has experienced significant growth in the area of ESG integration. Through GMR's numerous meetings with investment managers, we noticed a significant increase in the number of investment firms implementing responsible investing guidelines. As more and more asset managers formalize their policies around responsible investing, particularly ESG investing, manager due diligence must evolve to evaluate a manager's skill at integrating ESG factors into the investment process.

Furthermore, as responsible investing has grown, so too has the potential for "greenwashing." Greenwashing is when a manager or company makes unsubstantiated claims regarding the integration of ESG into their



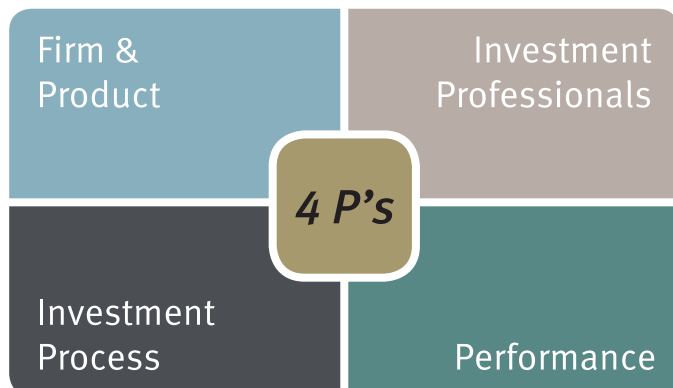
firm or investment process. As investor interest in this area continues to grow, so does the potential for greenwashing, furthering the imperative for thorough due diligence.

Conversely, a manager may not market or label a specific firm or fund as "ESG," yet they may employ practices that lead to ESG integration. The lack of clear parameters only reiterates the requirement for comprehensive due diligence, including the identification of different ESG investing and integration approaches. The current investment landscape necessitates further research into who is truly integrating ESG information and who is not. Ultimately, the due diligence process requires analysis into the authenticity of ESG integration into a portfolio.

Part 2: GMR's due diligence process

GMR focuses on four fundamental categories when performing investment manager evaluation: Firm & Product; Investment Professionals; Investment Process; and Performance—aka the "4 P's."

GMR's due diligence process



Source - RBC Wealth Management

In this section we'll also explain the additional steps we've taken to incorporate ESG factors into our 4 P's approach to manager evaluation.

In Part 3 we define how we segment the universe of ESG managers. As we review managers along these 4 P's, we've observed a segmentation of different types of manager philosophy, process, and thus portfolio characteristics. Understanding and assessing managers as they relate to these features matter for helping investors know what they own.

Firm & Product

As mentioned earlier, GMR has seen an increasing number of investment firms formalizing their ESG integration approach. This differs from firm to firm; GMR has identified key indicators that we look for when evaluating a firm's commitment to ESG integration.

First, has the firm signed the UN Principles for Responsible Investment (PRI)? PRI is the largest responsible investing initiative in the world. When asset managers and owners sign on to the PRI they agree to abide by the six Principles.[1] Signatories are assessed annually via a questionnaire and receive a score from "E" to "A+" (with A+ being the highest). The scores are graded on a bell curve, so competition for higher scores is fierce. With all this said, the financial costs of completing the questionnaire can be onerous. Some firms may not be signatories even if they agree with the Principles. However, for many institutional investors, signing the Principles has become required for further investment consideration, so the potential for greenwashing is high.

With that in mind, it is important to dive deeper and not simply look to see if the manager has joined the PRI. It is vital to understand a manager's motivation for introducing ESG into their processes. **Firms that believe ESG is additive invest resources to build out their ESG capabilities.** Best practices include allocating resources into: investment teams (such as dedicated ESG analysts), ESG data, integration tools, and enhanced reporting capabilities. Measured, intentional integration of different data sources should strengthen the investment process instead of diluting it.

Preferred areas of a firm's ESG build-out

- Investment team
- ESG data
- Integration tools
- Reporting capabilities

Additionally, it is key to monitor what products a firm is offering with ESG integration. If they are "adding" ESG consideration to existing products, this warrants

[1] Principles for Responsible Investment (https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment)

examination, as this may change the profiles of these products going forward. Other managers may rebrand and change the mandate of a product to a different benchmark or universe completely. It is important to track changes to help ensure that investor exposure remains consistent with expectations.

Investment Professionals

As we alluded to above, one of the key investments a firm can make while building out its ESG integration is a meaningful ESG team. **GMR prefers to see a team with a strong background in ESG evaluation that is materially integrated into the investment process.** Building a team can take time and significant investment.

Assessing the diversity of a given team is a key part of our due diligence. The "S" within ESG stands for "social"—which underscores firm/team interaction with all stakeholders. We believe it is important to understand a firm's diversity and inclusion policies and practices. Teams who claim that ESG—including diversity and inclusion—is important to them should demonstrate consistency as reflected in their own hiring practices. This could include a diverse investment team, or evidence that they have a plan to improve the diversity of their team going forward.

Preferred ESG Investment Professional characteristics

- Background in ESG research
- Meaningful input into the investment process
- Diverse team
- Portfolio manager understands ESG risks

A key consideration for our GMR analysts is evaluating who are the key decision-makers integrating the data into the research process. This can be difficult to ascertain without direct contact with the investment team and the portfolio manager(s). **Our preference is that the portfolio manager(s) understands the key ESG risks within the portfolio holdings.** They may work with dedicated ESG analysts and/or traditional analysts, but the individual(s) making the final investment decisions should understand the ESG risks present in their portfolio. Every investment portfolio has ESG risk. If the person(s) constructing the portfolio doesn't understand such risk, we believe the potential for greenwashing is high.

Investment Process

To that end, due diligence is, at its core, a search for a repeatable investment process. There are a number of third-party services that evaluate and rank products based on the ESG factors of the stocks or bonds that the manager holds. Many managers may have high scores in these systems without any intention of integrating ESG. **We believe intentional ESG integration is the key to a repeatable investment process**. As such, GMR does not rely solely on any third-party data source to evaluate the integration of ESG data into an investment process. Rather, we seek investment managers with a clearly articulated investment philosophy and process that communicates the investment objectives, approaches, and strategies employed, including how they consider and include ESG data.

Assessing ESG Investment Process integration

- Intentional ESG integration vs. incidental ESG scoring
- Exclusions
- Engagement

In its purest form, ESG investing does not explicitly exclude any names or sectors from investment. However, in practice, many managers choose to exclude certain businesses or sectors from their portfolios. It is important to understand what may be excluded from a portfolio. Many of these exclusions may be done based on a percentage of revenue from an activity that is deemed objectionable. If a manager decides to exclude anything from their portfolio, it is important to understand (1) what they are excluding, and (2) what quantitative criteria is used to make the decision.

Finally, a key component of PRI is active ownership, which is also known as engagement. Engagement is a process where investment managers or firms hold a discussion with portfolio investments regarding ESG issues. Engagement can be as simple as just voting proxy statements; often engagement is a tool investors use to encourage a company to eliminate ESG risks. Now that so many firms have signed the PRI, they are required to disclose their engagement policies and practices. **We believe a high-quality engagement program will target material ESG issues.**

Performance

As with all forms of investing, performance evaluation remains important. However, performance is the most difficult measure to quantify in ESG evaluation. We do not believe that returns need to be sacrificed in order to integrate ESG data into a portfolio. At the same time, it is very difficult to isolate and attribute the impact of ESG integration on portfolio performance. When the data is truly integrated, it is very difficult to separate the impact ESG data has versus other information.

Performance evaluation criteria

- Controversy assessment
- Performance comparison vs. traditional and ESG benchmarks

However, it is still possible to evaluate fund performance qualitatively. To reiterate, we do not believe that a third-party data provider should be the sole means of measuring a portfolio's ESG integration. With that said, third-party ESG scores and controversy research may provide useful insights into the risks held within a given portfolio. **Evaluating portfolio holdings for names with well-documented ESG risks or controversies can help assess performance.**

Second, it is beneficial to compare the performance of an ESG portfolio to both an ESG-screened benchmark as well as a traditional, non-ESG benchmark. In this way we can evaluate if the manager is performing in line with expectations relative to a traditional market. But it is also important to consider how well the manager performs relative to a benchmark that considers ESG risks in its construction. In this way, GMR can determine if the manager is adding value or if ESG factors alone are influencing performance.

Part 3: Qualitative assessment drives ESG spectrum segmentation

As we review managers according to the 4 P's, we've observed a segmentation of different types of manager philosophy, process, and thus portfolio characteristics. Understanding and assessing managers as they relate to these features can help investors know what they own. Additionally, this segmentation aids due diligence efforts as we can compare investment managers to peers with a similar investment style. As such, we have created a "Spectrum of ESG integration"—a methodological foundation in assessing styles of ESG integration.

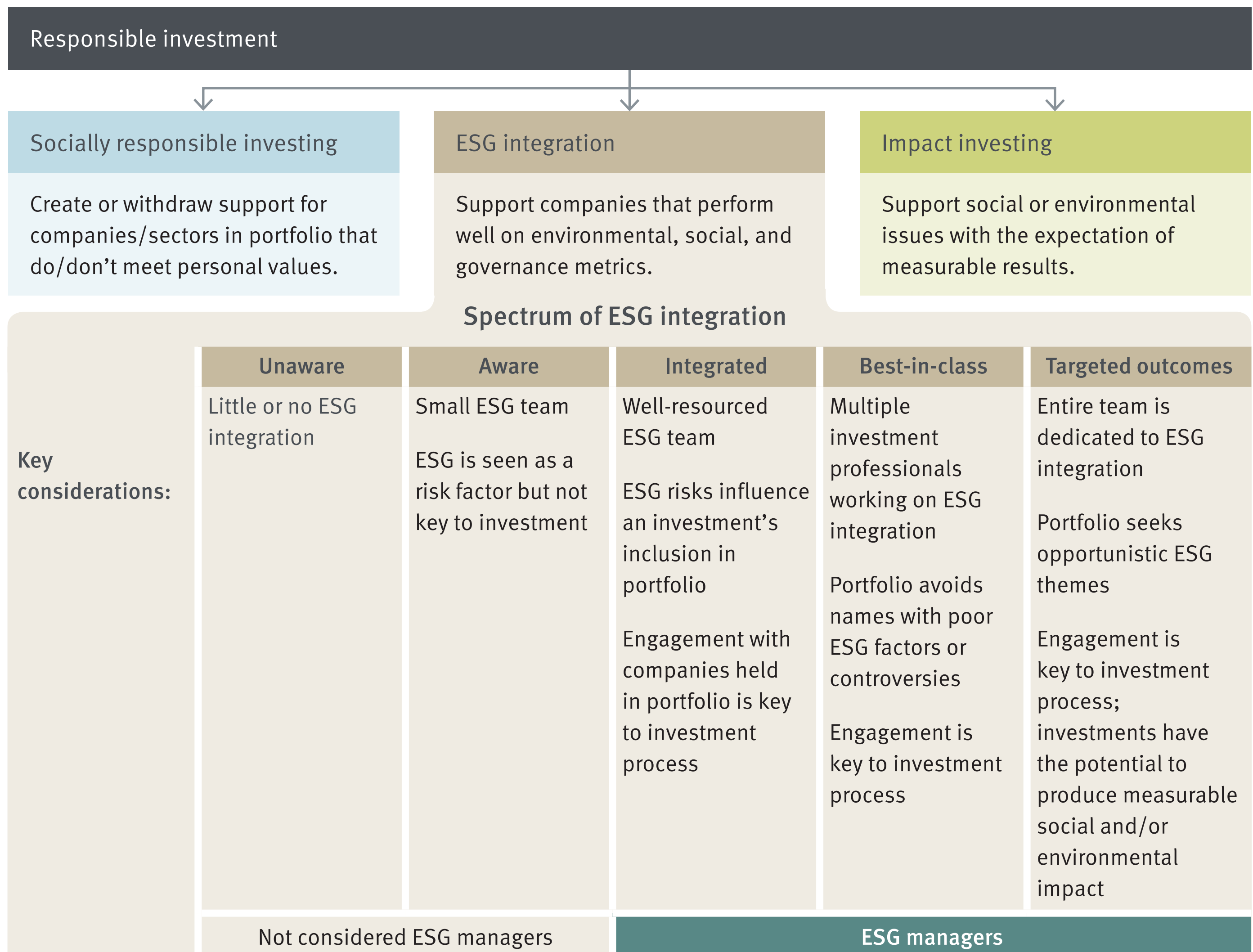
Back in 1992, Morningstar introduced its "Style Box"[2] methodology in response to a similar issue. To compare funds across the entire investable universe was daunting. Morningstar concluded that segmentation of equity funds could be viewed in terms of what is actually in a portfolio. Its original Style Box plotted equity portfolios on a spectrum spanning value, core, and growth investing. Once a manager was classified as a particular style, these managers could be more accurately evaluated.

In the same vein, we believe that it is not enough to only assess a "responsible investing" manager within the three broad categories of socially responsible investing (SRI), ESG integration, or impact investing. Typically, SRI is rules-based, screening out specific investments. Impact investment specifically targets environmental and/or social impact as the primary investment criteria. ESG investing is less standardized and the primary investment criteria generally remains return-seeking. Thus, ESG managers require further granularity.

To be clear, in assigning a manager as ESG or non-ESG, we are not making an assessment of quality for the manager's investment process. These ESG integration categories are meant to be descriptive not prescriptive. Categorizing managers as value/core/growth, for example, does not concurrently categorize a manager's investing skill. Similarly, our "Spectrum of ESG integration" categories seek to segment a manager primarily for relative comparisons.

As previously noted, greenwashing occurs when a manager or company makes unsubstantiated claims regarding the integration of ESG into their firm or investment processes. Greenwashing can happen in any of these segments. This spectrum is not meant to identify greenwashing; instead, it's intended to delineate the way managers are applying ESG data to their portfolios. Thorough due diligence, which we lay out in Part 2, is required to identify the effectiveness of ESG application.

[2] Morningstar Style Box (http://awgmain.morningstar.com/webhelp/glossary_definitions/mutual_fund/glossary_mf_ce_Equity_Style_Box.html#:~:text=The%20Morningstar%20Style%20Box%E2%84%A2,characteristics%20along%20the%20horizontal%20axis)



Defining the segments

GMR provides analysis and evaluations of a number of different investment managers. Within these assessments, there are several investment strategies that we classify as ESG managers. This means that GMR believes these strategies have a sufficient level of ESG integration to be considered by clients seeking meaningful ESG factors in their portfolios. Using the segmentation outlined above, we are able to delineate and rationalize who we classify as an ESG manager and who we do not. Simply because a manager claims ESG integration does not mean we will classify them as an ESG manager.

Unaware

Most legacy asset managers fall into this classification. They have no real intention of integrating ESG information into their investment processes. They have no-to-minimal investments allocated for dedicated ESG team members or additional resources needed to review ESG data and consider ESG risks. Some asset managers have begun advertising ESG integration because they receive higher scores from third-party evaluation metrics like Morningstar's Sustainability ratings. This designation, however, is incidental as opposed to intentional ESG integration.

Unaware characteristics

- Little or no ESG integration into team or process

Aware characteristics

- Investments in ESG team
- Begin considering ESG factors on currently available products
- ESG primarily seen as a downside risk

Aware

We have seen more and more asset managers considering ESG data within their investment processes. We believe when most asset managers look to include this information, they will move from the "Unaware" to the "Aware" segment. This shift typically requires a company-level commitment to dedicated ESG resources. This could lead to hiring ESG specialists and/or creating an ESG scoring framework—and providing these resources to the firm's portfolio managers.

That said, specific fund managers may "take or leave" the ESG resources at their disposal. We have observed that carving out ESG resources does not necessarily create ESG-specific products but rather is indicative of an intention to integrate ESG into existing products. These managers may produce marketing materials that highlight their "strong" ESG integration; it requires significant due diligence to identify which firms have truly achieved integration versus those that have not. GMR does not classify managers in this segment as ESG managers.

Integrated

"Integrated" is the first segment on the "Spectrum of ESG integration" where we would classify the managers as ESG managers. "Integrated" managers take many of the steps that "Aware" managers do, but take them further. They make significant investments into ESG-dedicated resources, including hiring ESG specialists and/or investing in ESG data available to these teams.

Integrated characteristics

- Significant investment in ESG research
- ESG factors have meaningful impact on inclusion in a portfolio
- Engagement with portfolio holdings is key to investment process

Third-party ESG data is expensive, so when firms invest in numerous sources of information, it is proof of their commitment. These firms typically build an ESG integration framework—and establish a clear link between this framework and the investment portfolios.

Portfolio managers will be able to clearly articulate the ESG considerations regarding the holdings within their portfolios, as well as rationalize each holding with an ESG framework. These managers may still hold names they identify as having high levels of ESG risk; however, they will also be able to express why they believe these risks are acceptable.

Typically, "Integrated" managers will engage with their constituent companies at some level about perceived ESG risks. Engagement may be done via proxy voting or direct conversation. It can have different points of emphasis, but managers often focus their efforts on "bad actors." Many of these managers believe that improving ESG policies and/or disclosure may enhance investment return potential.

Best-in-class characteristics

- Large reliance on ESG team or data
- Portfolios seek to avoid names with poor ESG practices or significant controversies
- Entire industries or sectors with structurally poor ESG factors may be completely removed from consideration

Best-in-class

"Best-in-class" managers likely have invested in and built out a large, firm-wide ESG team. These teams typically need to be large because of the workload a comprehensive ESG analysis requires: company-by-company-level ESG analysis across a broad investable universe. Metrics under the ESG framework are predominantly data that is not captured in traditional financial statements; the time-intensive nature of extracting this information implies the use of capable, dedicated professionals and resources.

As an example, ESG-dedicated specialists usually provide an assessment (in the form of a score) for each company under their purview—and relative to a specific sector. The scoring may take the form of rank-ordering companies, from high to low, based on a sector-specific, materially designated ESG criteria set.

"Best-in-class" ESG-dedicated investment practices also necessitate that ESG specialists, in providing assessments, have an impact on investment decision-making. In continuing our example, the ESG specialist, in rank-ordering companies, can effectively eliminate certain names with lower ESG scores or significant levels of controversy from fund-level investment consideration—prior to the portfolio manager's universe screening. This ESG-screened universe is the opportunity set a portfolio manager may pick from. In other words, "Best-in-class" ESG specialists provide analysis enforceable in portfolio construction. They are integrated into the investment process.

In practice, GMR has observed that this structure of ESG specialist integration often results in portfolios that exclude certain industries or sectors with structurally poor ESG factors, such as tobacco, alcohol, firearms, or fossil fuels.

One alternative to having a large ESG specialist/analyst team is to partner with an ESG data provider and use their scores to rank the market. A number of providers of ESG exchange-traded funds have utilized this approach. "Best-in-class" managers will generally engage with the companies they hold in their portfolios in a similar manner to the "Integrated" managers as described above.

Targeted outcomes

The "Targeted outcomes" segment straddles the line between ESG and impact investing. The latter seeks measurable social and/or environmental impact through its investments. Similarly, "Targeted outcomes" managers perform in-depth ESG evaluations and seek to invest in companies with products or services that stand to benefit from environmental and/or social trends.

These portfolios tend to be thematic and may be very concentrated in a small number of sectors and companies. Examples of these themes include: clean energy, water, healthy eating, and health care, to name a few. Engagement with a portfolio's constituent companies is often used as a source of ideas for investment. Many of these themes are nascent or created when a company enters a new industry, and managers need to be in tune to new entrants and their potential for sales and earnings growth as they disrupt industries.

Targeted outcomes characteristics

- Investment team relies on ESG data for idea generation and opportunities
- Portfolios are constructed to take advantage of environmental and/or social themes
- Engagement provides emerging themes or investment ideas

The evolution of due diligence

Investment management is always evolving. New information and techniques will arise and due diligence practices must evolve to monitor them. GMR believes ESG utilization is here to stay. As such, we've adapted our due diligence practices to categorize the ESG market into comparable segments for more apples-to-apples comparison.

Once managers are segmented, we've augmented our due diligence process to evaluate managers on what they are actually doing to implement these practices. In this way, we believe investors can identify the type of ESG manager they want to use and then pick a manager who is adept at investing in that manner. Investors must have confidence that we are making informed evaluations of investment managers. Modern investing continues to evolve. This guide provides a framework that GMR is reviewing the essential information.

Due diligence processes do not assure a profit or protect against loss. Like any type of investing, ESG investing involves risks, including possible loss of principal.

This guide is provided for informational purposes only and does not include any recommendation to purchase a particular security or investment product. Interest rates, market conditions, tax and legal rules and other important factors which will be pertinent to your circumstances and investment decisions are subject to change. Specific investment strategies should be considered relative to the suitability of the products contained therein, your objectives and risk tolerances. The value of investments and any income from them is not guaranteed. Past performance is not indicative of future performance or value, future returns are not guaranteed, and a loss of original capital may occur. For information on any product mentioned in this guide you are advised to consult with your investment advisor prior to investing.

The information contained in this report has been compiled by RBC Dominion Securities Inc.* from sources believed to be reliable, but no representation or warranty, express or implied, is made by RBC Dominion Securities Inc., its affiliates or any other person as to its accuracy, completeness or correctness. Whilst efforts are made to ensure the accuracy and completeness of the information contained in this report at the time of publication, errors and omissions may occur. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ®Registered trademarks of Royal Bank of Canada. Used under licence. ©2020 Royal Bank of Canada. All rights reserved.