AUSTRALASIAN FUND MANAGER ESG PRACTICES

A survey of the most ESG ambitious Global Equity funds

CEFGroup Report

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Contents

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Note: The results presented in this report are generated from Mr. McLean's Master of Finance thesis, in collaboration with Morningstar, MyFiduciary, and Saturn Advice. A deeper analysis of the survey and the managers' actual portfolio holdings is available in a CEFGroup working paper at **ResearchGate** and **SSRN**.

KEY TAKEAWAYS

- Fund managers' engagement in responsible investing is largely driven by the expected value (performance expectations and investor demand), rather than values (making a positive difference in the world), especially for managers from the United States.
- The top three responsible investment approaches are: ESG integration, negative screening, and engagement/active ownership.
- Smaller funds tend to rely more on external ESG providers, while larger funds use raw ESG data, as they have the resources to process this data.
- U.S. funds focus on environmental themes, while Australasian based funds' priorities are more spread across the environmental, social, and governance themes.
- ESG named funds are more climate focused whereas non-ESG named funds focus more on governance and corporate behaviour.
- Most of the engagement by fund managers on ESG issues is done through voting and private, rather than public, interactions.
- While the climate change theme is the most important for the respondents and decarbonisation is one of the more important factors in ESG investing, only half of the survey respondents provide portfolio-level Scope 1 & 2 emissions metrics and underreporting of emissions is prevalent. Less than a fifth of funds responded on portfolio-level Scope 1, 2 & 3 emissions metrics.

ABOUT THE SURVEY

Stakeholder demand for socially responsible investment has led to the rise of investment funds adopting responsible investment practices (e.g. ESG integration). The aim of this report is to investigate the ESG policies and strategies of global equity funds available to Australasian investors.

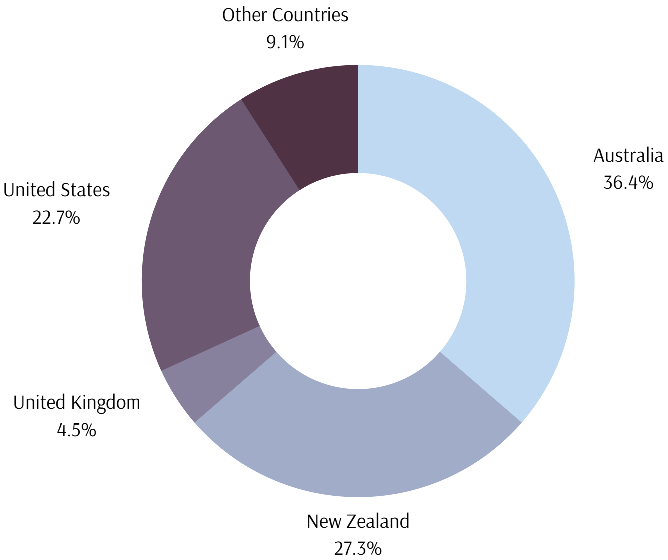
To do this, the research team surveyed asset managers available to Australasian investors to elicit an understanding of how they integrate ESG information practices within the investment decision-making process of their most ESG ambitious global equity funds.

The survey took place from September 2021 to November 2021, and resulted in 44 usable responses.

This project is being carried out by a team of researchers at the University of Otago from the Climate and Energy Finance Group, in partnership with Morningstar, MyFiduciary Ltd, and Saturn Advice.

BASIC STATISTICS

Figure 1: *Location of Headquarters*



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Despite our Australasian investor focus, the responding institutions are diverse with headquarter locations spread among Australia (36.4%), NZ (27.3%), U.S. (22.7%), U.K. (4.5%) and other countries (9.1%). This shows that a large portion of the most ESG ambitious global equity funds available to Australasian investors are managed overseas within larger global asset management entities.

Of the respondents, 79.5% reported that they incorporate ESG considerations into the investment process across all of their funds, while 20.5% reported that they do so across some funds. This may be showing the loose definition of ESG considerations, as some funds believe classical governance practices and traditional exclusions such as tobacco are ESG considerations.

When asked how their institutions build ESG capabilities, the overwhelming majority of respondents indicated that they conduct in-house training (95.5%), with much less emphasis on external training providers (34.1%).

Most responding institutions are signatories of the UN Principles for Responsible Investment (UNPRI). In related research with a global sample of fund managers, **Brandon et. al. (2021)** show that active managers signing up to the UNPRI is not necessarily a credible signal of ESG implementation, especially in the U.S., where signing up is associated with lower ESG performance. Clearly, our sample is biased toward the Australasian and ESG ambitious fund context, and this sample is likely to integrate ESG more fully, which is explored through more detailed portfolio holdings analysis in **McLean et al. (2022)**. Interestingly, there is a relatively low membership of climate-related initiatives (e.g. Carbon Disclosure Project), even though, as we show later in this report (**Figure 9**), climate change is the most important ESG sub-theme according to the fund managers.

Figure 2: *Signatories/Memberships*

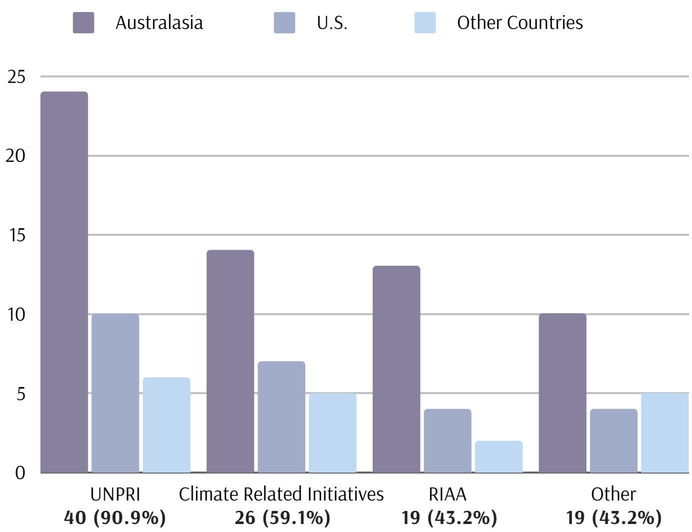
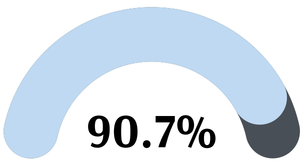
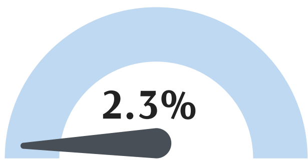


Figure 3: *Actively Managed Funds*



The median assets under management of respondent funds is US$ 340 million and 90.7% are actively managed.

Figure 4: *Female Lead Fund Managers*



Surprisingly, only one respondent indicated that their lead portfolio manager is female, highlighting a significant gender disparity in the fund management industry.

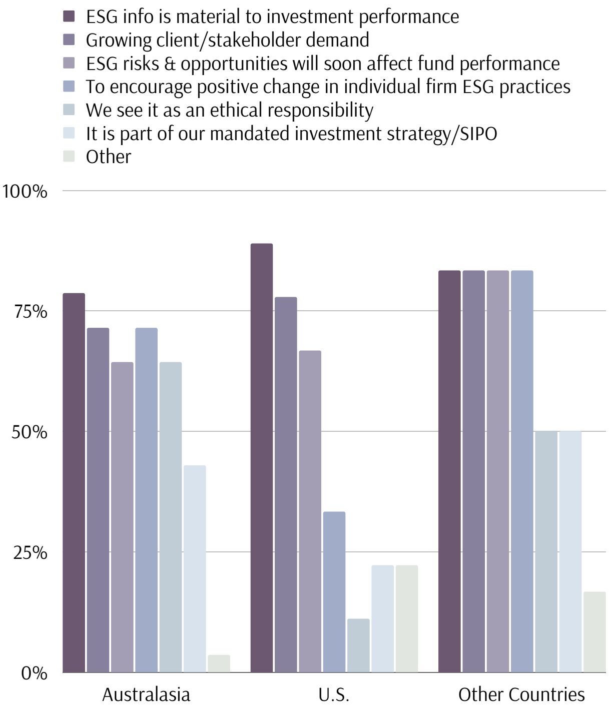
Diversity of company management has become an important sub-theme of the social pillar of ESG. While female fund managers do not underperform their male counterparts, they are drastically underrepresented in the asset management industry (**Aggarwal and Boyson, 2016**; **Niessen-Ruenzi and Ruenzia, 2019**) even in this sample of ESG ambitious funds.

RESPONSIBLE INVESTING MOTIVATIONS

Responsible investing is primarily motivated by financial performance and demand from stakeholders and clients, while encouraging positive change and ethical responsibility motivations are far less prevalent. This shows that the shift in the industry is mainly driven by value rather than values motivations, especially for managers from the United States. This highlights the tension between the pressures that investment managers face to maximize returns for clients and truly incorporating ESG risks and opportunities.

While 88.9% of U.S. firms use ESG information because it is material for financial performance, only 11.1% do so because it is their ethical responsibility. In contrast, a greater proportion of non-U.S. firms see responsible investing as an ethical responsibility, highlighting that moral intentions are not independent of headquarter region.

Figure 5: *Responsible Investing Motivations*



RESPONSIBLE INVESTING APPROACHES

Figure 6: *Responsible Investing Approaches*

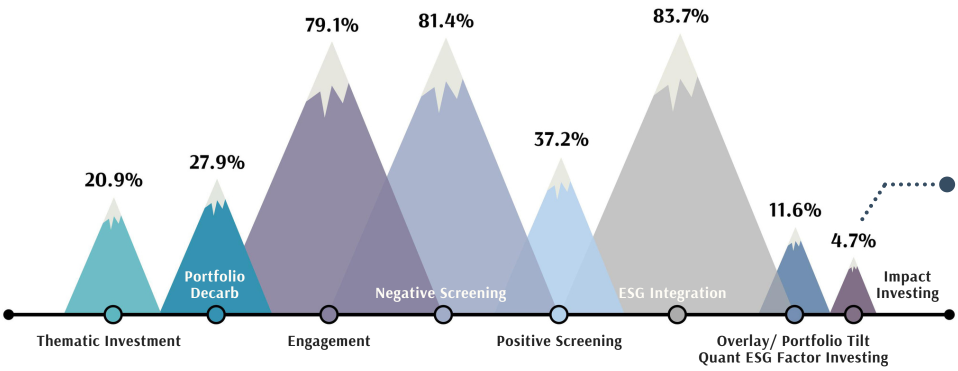


Table 1: *Top three Responsible Investment Approaches Definition* (**RIAA, 2021**)

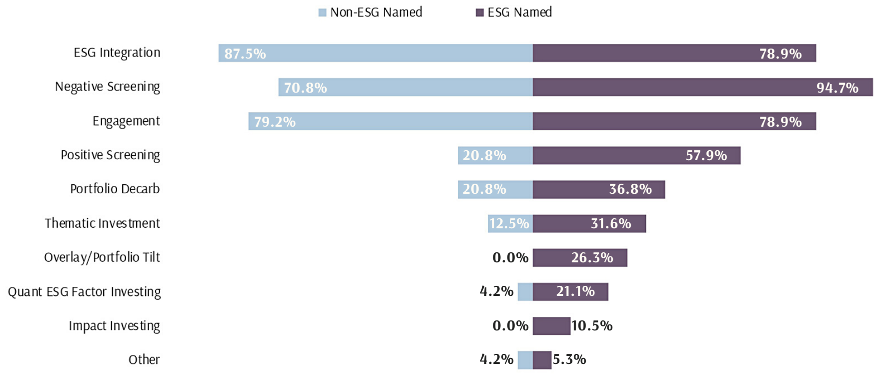
ESG Integration	Negative Screening	Engagement
Explicitly including ESG risks and opportunities into financial analysis and investment decisions based on a systematic process and appropriate research sources.	Excluding certain sectors, companies, countries or issuers based on activities considered not investable due principally to unacceptable downside risk or values misalignment.	Executing shareholder rights and fulfilling fiduciary duties to signal desired corporate behaviours - includes corporate engagement and filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guidelines.

5% of respondents indicated that they engage in impact investing, although all of the funds surveyed are global equity funds. The survey respondents may have different interpretations of "impact investing", which CEFGroup defines as below:

- **Impact Investments** are investments made in companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.
- **Company Impact** is the measurable impact that a company has due to its business activities. For example, a company building solar farms is mitigating emissions in the Energy sector.
- **Portfolio/Capital Impact** is the measurable impact an investor has by providing capital to a project or investment. Showing additionality is key for this type of impact, for example, providing capital directly to a solar farm developer (in a primary market transaction), which allows them to build additional renewable generation.
- **Impact Investing in secondary markets** is **hard to measure** as investors are not providing additional capital to the company and the link between secondary market investment decisions and the cost of capital is insignificant (**Berk and Binsbergen, 2021**). Some argue that engagement can have an impact, but this will again be hard to measure unless the fund is a pure activist fund.

The most common responsible investing approaches are fundamental analysis incorporating ESG considerations, negative screening, and engagement/active ownership with companies. This is consistent with **RIAA's 2021 benchmark report**. The proportion of funds adopting portfolio decarbonisation is quite low, although the importance of climate change is by far the highest, see in **Figure 9** below.

Figure 7: *Responsible Investing Approaches - ESG Named vs Non-ESG Named*



A greater variety of responsible investing approaches are adopted by ESG named funds, who also engage in higher levels of screening relative to non-ESG named funds. Non ESG named funds mainly use ESG integration, negative screening and engagement, while ESG named funds use approaches across the responsible investment spectrum.

TYPES OF ESG DATA USED

Respondents more commonly incorporate analysis at the individual firm level rather than at the aggregated sector or country level. U.S. fund managers incorporate each type of ESG data more than managers based in Australasia.

Interestingly, raw data is more commonly used than ESG ratings, which may correspond to the adoption of internal ESG scoring frameworks, alongside growing concerns regarding the divergence of different external ESG ratings (**Berg et. al. 2021**).

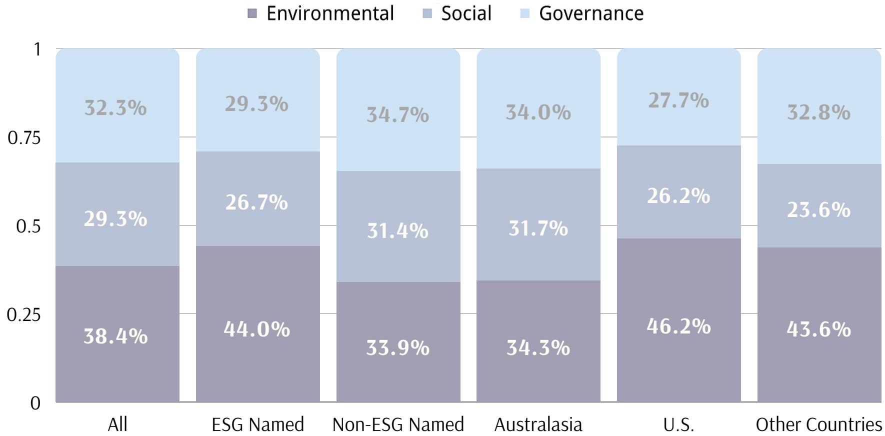
Table 2: *Types of ESG Data Used*

	Analysis at Firm Level	Raw Data e.g. Emissions	Analysis at Sector Level	External ESG Ratings	Analysis at Country Level	Other
All	83.3%	78.6%	69.0%	69.0%	42.9%	23.8%
Larger Funds	85.0%	85.0%	65.0%	50.0%	40.0%	35.0%
Small Funds	81.8%	72.7%	72.7%	86.4%	45.5%	13.6%
ESG Named	77.8%	83.3%	77.8%	66.7%	44.4%	22.2%
Non-ESG Named	87.5%	75.0%	62.5%	70.8%	41.7%	25.0%
Australasia	76.9%	73.1%	57.7%	65.4%	34.6%	23.1%
U.S.	90.0%	90.0%	90.0%	70.0%	40.0%	20.0%
Other Countries	100.0%	83.3%	83.3%	83.3%	83.3%	33.3%

Our comparison of small and large funds highlights a significant difference in the proportion of respondents who use external ESG ratings. While 86% of small funds indicated that they use external ratings, only 48% of large funds selected this option. Alongside this, large funds more commonly incorporate raw ESG data into their analysis alongside financial data. These results are likely driven by the resources that larger funds have available to process raw ESG data, reducing the need to rely on external ratings, relative to smaller funds.

ESG THEMES WEIGHTING

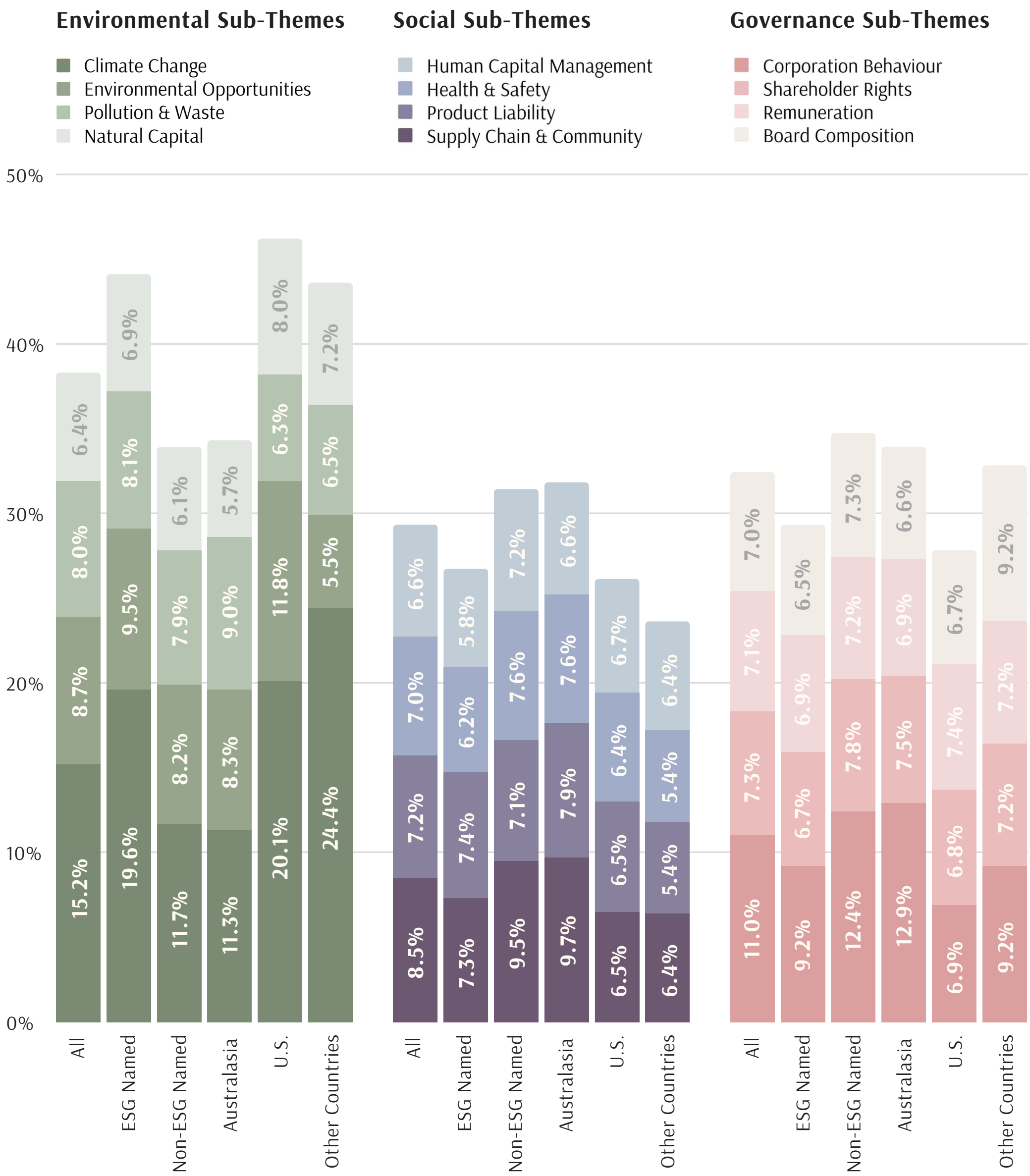
Figure 8: *ESG Themes Weighting*



Within responsible investing, ESG pillars are very broad and encompass many different themes, which may be treated with varying levels of importance within the investment process. We asked respondents to allocate 100 points between environmental, social and governance themes based on the importance that their funds place on them in the investment process.

On average, survey respondents place the highest importance on environmental themes within the investment process, followed by governance and social themes. This result may be attributable to the rising awareness surrounding climate change risks and opportunities. It is also likely that the funds place a lower importance on addressing social issues given that they are often more difficult to measure and address. Our regional analysis highlights that on average, funds with Australasian headquarters place equal importance on environmental and governance themes when selecting investments, while funds with U.S. headquarters tend to indicate a higher weighting for environmental themes.

Figure 9: Average ESG Sub-Themes Weighting [1]

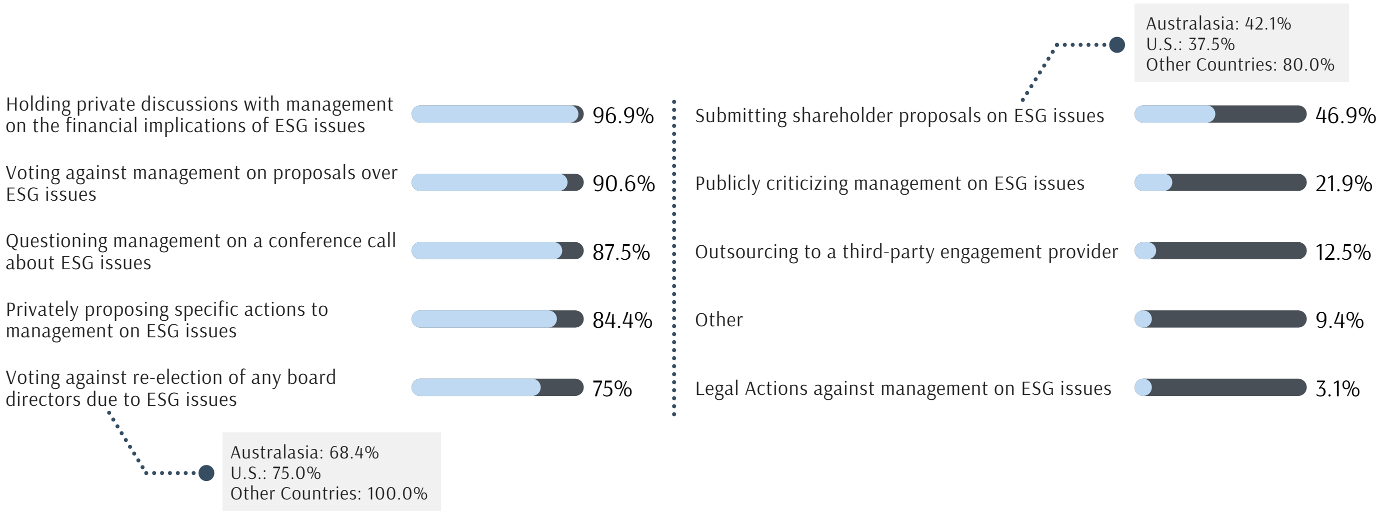


Global equity funds on average place the highest importance on climate change, followed by corporate behaviour, supply chain & community, and environmental opportunities. The least importance tends to be placed on natural capital (including biodiversity) within the investment decision-making process. While funds consider climate change to be the most important sub-theme, it is interesting that few respondents engage in portfolio decarbonisation as a responsible investing approach (as shown in **Figure 6**). Our regional analysis indicates that funds with U.S.-based headquarters rank climate change as the most important sub-theme, followed by environmental opportunities. Given that funds with U.S. headquarters are primarily motivated by financial performance, it is likely that they prioritise environmental themes that have better data, quickly evolving regulations and stronger links to performance. In comparison, funds with Australasian headquarters rank corporate behaviour first, followed by climate change. Not surprisingly, ESG named funds are relatively more climate-focused, while non-ESG named funds are relatively more focused on corporate behaviour.

[1] Using constant sum (point allocation) questions, respondents were asked to allocate 100 points between four environmental sub-themes (climate change, environmental opportunities, pollution & waste, and natural capital), four governance sub-themes (human capital management, health & safety, product liability, and supply chain & community), and four social sub-themes (corporation behaviour, shareholder rights, remuneration, and board composition). The ESG sub-themes weighting for each survey respondent is calculated as: percentage of points allocated to an ESG sub-theme multiplied by the percentage of points allocated to its corresponding ESG theme.

ENGAGEMENT STRATEGIES

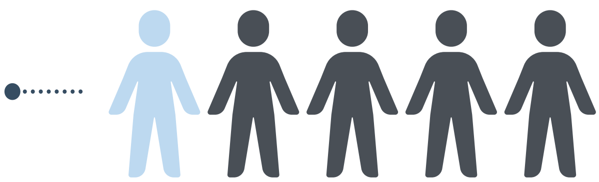
Figure 10: *Engagement Strategies*



Among respondents that actively engage with their portfolio companies (79.1%), the most frequent engagement approach is private discussions with management regarding the financial implications of ESG issues. This is followed by voting against management on proposals over ESG issues at the annual meeting and questioning management on a conference call. While many responding funds indicated that they privately propose specific actions to management, few funds publicly submit shareholder proposals. This supports the interpretation that fund managers prefer private interactions with firms first, and only escalate to public actions once private interventions fail. Alternatively, skeptics may interpret these responses as harder to verify and therefore easier to overstate ESG engagement. This divergence is emphasised in both Australasian and U.S. regions. However, funds with headquarters in other regions, including Europe, more actively submit shareholder proposals and vote against the re-election of the board of directors.

Interestingly, many respondents do not consider proxy voting to be a form of outsourced engagement. 20 respondents indicated that they engage with companies through proxy voting, but only 4 of them chose outsourcing as one of their engagement strategies in an earlier part of the survey.

Figure 11: *Proxy Voting vs Outsourced Engagement*



PORTFOLIO CARBON INTENSITY: REPORTED VS ESTIMATED

Figure 12: *Weighted Average Carbon Intensity - Scope 1 & 2*

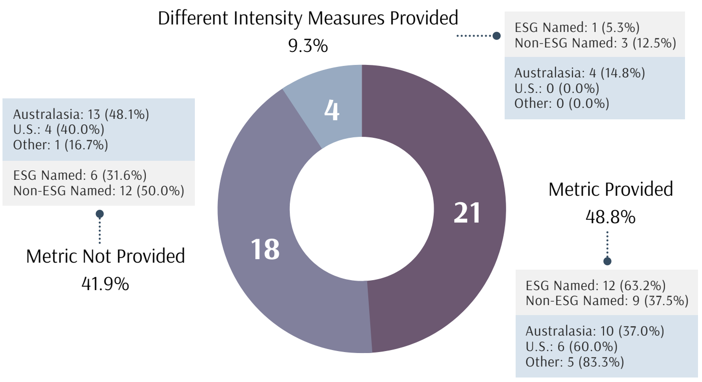
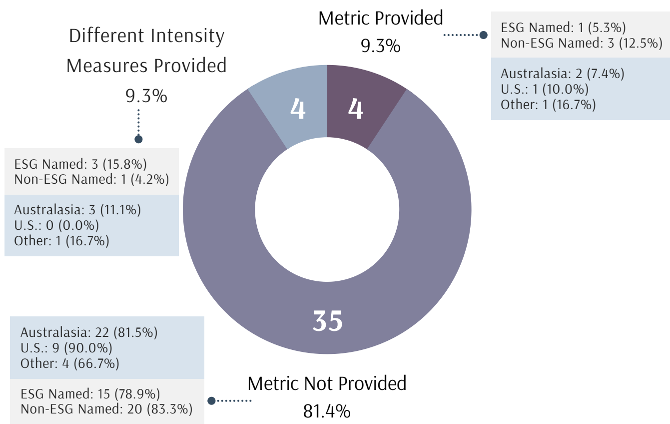


Figure 13: *Weighted Average Carbon Intensity - Scope 1, 2 and 3*



Rising stakeholder demand for climate change awareness coupled with improved data coverage has led many fund managers to measure their portfolio exposure to emissions. As shown in **Figure 12**, nearly half of the global equity funds provide their Scope 1 and 2 emission intensity. The proportion of ESG named funds that provide the metric is significantly higher than non-ESG named funds, reflecting the larger importance placed on climate change themes. Interestingly, some ESG named funds indicated that they do not calculate an emissions intensity metric citing explanations such as “It is not a specific objective of the fund” or “We do not currently have any clients who have requested this information. However, we could calculate this if a client requested”. Across the regions, funds with Australasian headquarter lag behind other funds in our sample with respect to reporting this information.

Not surprisingly, the majority of respondents do not calculate the Scope 3 emissions intensity of their portfolios (see **Figure 13**), with more than half of the respondents citing data reliability and coverage issues with Scope 3 emissions. The nature of Scope 3 emissions, which result from the activities that are not controlled by the reporting corporate, can lead to double counting, as two or more organisations may account for the same emissions. A higher proportion of ESG named funds (63.2% vs 54.2% for non-ESG named) explained why they do not calculate this intensity measure.

Figure 14: *Stated vs. Estimated Portfolio Carbon Intensity*

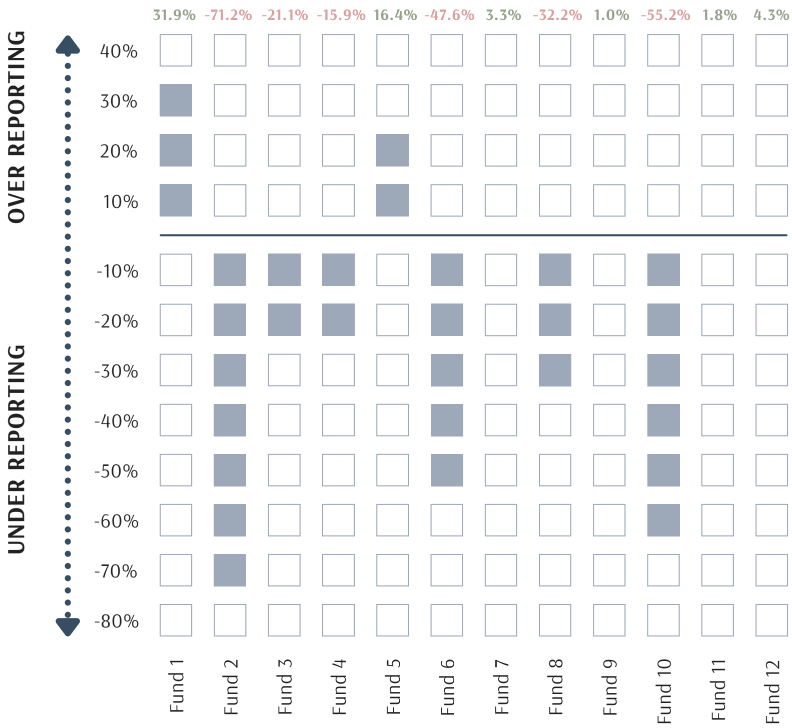


Figure 14 illustrates the percentage difference between stated and our estimated Scope 1 and 2 portfolio carbon intensity of respondents [2]. On average, the (few) funds who provided this metric in the survey are likely underestimating their portfolio’s exposure to carbon-intensive firms. This is attributable to the severe underreporting by a select few respondents. Possible reasons for the higher dispersion could be different methodologies or data sources used in calculating portfolio carbon intensity.

ABOUT CEFGROUP

CEFGroup is one of the leading academic climate and sustainable finance teams in the world. The team embraces interdisciplinarily research and is focused on delivering policy and practitioner relevant research that has impact. As one of a few dedicated climate and sustainable finance research groupings in Australasia and Asia, CEFGroup is strategically placed to support the sustainability transition of the financial industry and broader economy. CEFGroup research is undertaken with international collaborators and has been published in leading international journals.

For more information:
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- **Morningstar**
  Morningstar is a global investment research firm that compiles and analyses fund, stock, and general market data. Morningstar provides an extensive line of internet, software and print-based products for individual investors, financial advisors and institutional clients.
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  MyFiduciary is an independent NZ-owned investment consultant specialising in investment governance. We have broad experience across asset allocation, investment selection and funds management, our clients include charitable trusts, foundations, independent advisers, KiwiSaver Providers, and Māori and iwi organisations.
- **Saturn Advice**
  Saturn Advice is an impartial financial advisory business providing investment and financial planning advice to New Zealanders.

[2] We estimate a fund's portfolio emission intensity using their holdings data, provided by Morningstar as of 30th June 2021, and the reported and estimated Scope 1 and 2 CO2-equivalent emissions data from Refinitiv. The reported emissions data is based on company filings, while estimated emissions is based on Refinitiv's carbon estimate models.

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