For institutional clients only.

Viewpoints

2Q 2021

Welcome to our latest Viewpoints, a quarterly publication presenting candid discussions with industry experts on vital topics. Should you seek additional information on this issue's subject, feel free to contact us. We welcome feedback as we shape content for future issues.

Presented by

Chris Wroblewski, CFA
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Featuring

Nichole Roman-Bhatty
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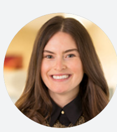
Marquette Associates



Linsey Schoemehl Payne
Managing Partner
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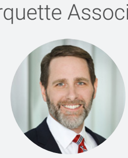

Brian Beargie, CFA
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ESG and Its Place in the Investment Process

Various stakeholders, such as institutional investors, asset owners, employees and the general public, are increasingly demanding better disclosure on environmental, social and governance (ESG) linked risk factors, expecting accountability and corrective actions from today's companies. As the world looks towards a more sustainable future, large asset managers and investment consultants are in a unique position to drive change by adopting a mindset that emphasizes stakeholder influence and advances thinking around the investment risks and opportunities informed by the ESG lens. In a conversation with Linsey Schoemehl Payne, Nichole Roman-Bhatty and Brian Beargie, we discuss timely topics relating to ESG for institutional investors. Furthermore, we explore the methods and considerations for incorporating ESG factors into the fixed income investment process.

Before we start, I want to thank Nichole, Linsey and Brian for their time and willingness to participate in our quarterly Viewpoints publication. Each has extensive experience in the investment industry with a unique perspective on the ESG revolution. I look forward to a provocative discussion and invite our readers to enjoy an ESG-centric conversation with some of the leading voices in the industry. Let us begin by learning more about our ESG specialists.

Nichole Roman-Bhatty is a Managing Partner for Marquette Associates. Nichole has been with the company since 1998 and has 26 years of investment experience. She leads the religious services practice area at Marquette, focusing on non-profit, religious, public and corporate clients. Nichole is a Co-Lead of the sustainable investing group and a member of the firm's endowment & foundation services committee.

Linsey Schoemehl Payne is a Managing Partner for Marquette Associates. Linsey has been with the company since 2016 and has 13 years of investment experience. Linsey is a Co-Lead of the firm's sustainable investing group and a member of the OCIO committee.

Brian Beargie is Co-Head of Global Investment Grade Credit Research at LGIM America. He has been with the firm since 2007 and has 25 years of investment experience. Brian oversees the US Investment Grade Research team while focusing on the energy and taxable municipal sectors.

LGIM America

Linsey, we will start with you. How would you explain the recent surge in interest in sustainable investments and what do you think is driving this demand for integrating ESG factors in the asset allocation process?

Linsey: The COVID-19 pandemic brought to light a slew of sustainability issues. While these environmental and social concerns were nothing new, they were received by a captivated audience, quarantined at home. In light of this newfound awareness by the consumer, investor, etc., the issues themselves now garner greater risk, making ESG integration a critical component of any investment thesis.

ESG, and its place within the investment process, has become a focal point for many investors. However, I have not come across a well-defined, agreed upon definition in the marketplace. Brian, what does ESG mean to you and in what ways, if any, has it changed the risk evaluation process in fixed income?

Brian: ESG means a lot of different things to different people. At LGIM America, we consider ESG along three distinct pillars – Stewardship, Integration and Solutions. Stewardship is being a responsible investor (e.g., actively voting our proxies) to raise global standards for the benefit of all. Solutions is primarily focused on providing ESG products and services to help our clients accomplish their goals as it relates to their own ESG-related objectives. Integration is where I live and breathe. It is taking ESG data and evaluating whether these risks and opportunities are appropriately reflected in the valuations of securities.

Taking the E, S, and G factors in isolation, is any one factor easier or harder to properly evaluate? From a data availability standpoint, which of the three remains the most challenged, and how close or far away are we from having complete datasets and standardized reporting frameworks?

Brian: In my opinion, metrics surrounding Governance are most advanced, albeit still very imperfect. Environmental factors are probably the most interesting (and offer the most long-term alpha opportunity) but they depend highly on political factors such as the introduction and implementation of various carbon taxes. The Social component is probably the most difficult to evaluate because it often has to do with a vague concept of a "social license to operate," which often can be linked to a company's reputation. As it stands today, scoring reputation and the social good of products/services is a very highly debated topic. As an industry, we are very far away from complete datasets. It is very difficult to quantify things that are innately qualitative. However, I would say that firms like LGIM America and Marquette maintain a proactive approach in staying ahead of the pack in evaluating publicly available datasets to determine if they have meaningfully predictive value.

From a client perspective, Nichole, can you discuss the most important consideration when it comes to adopting ESG or climate-focused solutions?

Nichole: The most important consideration for clients is measuring the "success" of their sustainable investing strategies. As such, reporting has become a focus for us as consultants. While investment managers have started to produce reporting that captures the impact of their strategies on various sustainability issues, the lack of standardization makes it difficult to compare strategies on an apples-to-apples basis. For example, looking at climate change, which is the area we have seen the most client interest, the measurement of carbon varies across strategies.

The interest in climate focused solutions has accelerated over the past several years and across our client base. One notable change is that we are also seeing differentiation. For example, we have some clients that put water scarcity and preservation as critical and others that want to directly focus on renewable energy. Half of the seventeen United Nations Sustainable Development Goals ("SDGs") are climate solution oriented which allows for customization. Marquette offers customized workshops using the SDGs for clients wanting to better align mission with investments.

> "Data has long been the biggest challenge for ESG adoption and continues to be the case today."
>
> Nichole Roman-Bhatty
> Marquette Associates

Investment managers, asset owners and investment consultants have a role to play in promoting, understanding and educating key stakeholders regarding ESG impact. Linsey, how would you characterize the role you have as an investment consultant in advancing the ESG agenda? Which key stakeholders are most important to engage with? (Investors, regulators, allocators, elected officials, etc.)

Linsey: To some extent, these issues are intertwined with fiduciary duties of prudence and risk management. Relative to companies 40 years ago, which had balance sheets comprised of raw materials and equipment, companies today more heavily rely on intangible assets to comprise their worth. This shift forces investors to take a second look at traditional valuation metrics, which may no longer be capturing the full picture. Incorporating ESG factors into the risk analysis process, often times leveraging materiality frameworks like the Sustainability Accounting Standards Board (SASB), is a way to develop a more holistic assessment of a company's value. On the other end, as sustainable-focused strategies continue to multiply, it's important that we as investment consultants take a proactive role in assessing the quality of these strategies for our clients. To that end, we would argue that regulators play the most important role in advancing the ESG agenda not only from a green-washing prevention perspective but also in terms of disclosures and reporting in order to enhance the client experience and assessment of these strategies.

Given the growth of these types of strategies, I am curious what Marquette's thinking is on the general perception of ESG-related investment vehicles in the marketplace? Is it more impact related or does it stem from a risk-adjusted return perspective?

Linsey: The marketplace seems to fall into two camps – those that have been implementing these types of strategies for decades and those that have not. For the latter, there is still some hesitation around actually putting dollars towards ESG-related investment vehicles. And rightfully so; the market has seen the number of strategies launched within this space skyrocket over the past year, which calls into question the validity of the strategies themselves. Certainly, many do incorporate sound frameworks, but many others are simply examples of "green washing." That being said, the age-old argument that ESG strategies come at the expense of returns seems to be losing steam; if anything, investors are starting to appreciate the risks associated with ignoring sustainability issues.

I think it is fair to say that LGIM America shares your view that the appreciation of these risks, from the investor community, has risen in recent years. Brian, from an integration perspective, how do you incorporate ESG into the fixed income investment process and what is proving to be the biggest obstacle in the design of ESG specific fixed income products?

Brian: We explicitly integrate ESG data into the investment process through a tool called ESG Active View. This tool collates thousands of points of data from both external and internal data providers. Our global network of investment analysts are organized along industry groups that we call Global Research and Engagement Groups ("GREGs"). These groups help set the weights for each ESG data set for each industry. This is modeled off the SASB Materiality Matrix, that Linsey referenced earlier. However, the ESG Active View goes much further by collating and synthesizing this data. This assists our asset class analysts to properly evaluate whether ESG risks and/or opportunities are reflected in asset valuations. We believe the results, although not always perfect, accomplish two very important objectives. First, these datasets can be clear warning signs on topics that may not make it to the top of the newsfeed of our competitors. And second, it can start important debates about the short and long-term risks presented by ESG factors with our portfolio managers.

Looking ahead, what remains the biggest challenge for ESG adoption? Additionally, as we observe climate-oriented investment solutions gaining steam in the market, what is, or, how would you, characterize the next frontier in ESG investing?

Nichole: Data has long been the biggest challenge for ESG adoption and continues to be the case today. It's difficult to provide concrete reporting when the information is not readily available at the issuer level and where it is, it's not standardized. This is especially true around diversity, equity and inclusion, which we believe will be a continued focus for investors. As a result, investors are shifting their focus to diversity of their investment services providers, including consultants.

Another challenge to ESG adoption is the debate within the sustainable investing community about most effective implementation of ESG guidelines. The Fossil Fuel divestment campaign is a good example. Sustainable investing experts are divided on the most effective implementation strategy to combat climate change. Some sustainable investors believe that complete divestment of the most carbon intensive companies is most effective while others believe divestment of the most intensive carbon emitters while initiating shareholder advocacy dialogues with the rest is more impactful. As a result, the underlying investment portfolios of fossil fuel free strategies can differ, making the selection process more complex.

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> Linsey Schoemehl Payne
> Marquette Associates

Brian, staying with the climate theme, in your view, how would you describe the intersection between ESG and the ongoing evolution of best practices in assessing credit risk? How have climate considerations begun influencing that assessment, i.e. physical risks vs transition risks?

Frankly, I do not believe ESG integration has really changed as much as some people think. The real change is the availability of data. As analysts, we thrive on data. It is our lifeblood.

But the real challenge is to separate non-predictive data (i.e., noise) from predictive data. The latter is the most important. Incomplete and inconsistent datasets make testing data difficult, but not impossible. Furthermore, it is every credit research analysts job to get "inside the heads" of the rating agencies to determine how they may incorporate this data into their analysis. Lately, we are spending a lot of time understanding how the rating agencies are thinking about ESG. Like it or not, rating agencies still matter. Over a decade after the financial crisis and the market still hasn't found a better mousetrap to allocate risk than Nationally Recognized Statistical Rating Organizations ("NRSROs"). As for climate, we are using the output of various internal predictive tools to think about topics such as energy transition. At a minimum, it is helping us consider realistic stress test scenarios. As I mentioned before, the various climate pathways are highly dependent on political will, which is very difficult to predict. Nonetheless, it is our responsibility to our clients to make sure we consider these potential outcomes.

While we have discussed the structure of ESG-related investment strategies and how the allocation of capital can be used to progress the ESG agenda, there is another avenue that I understand both our organizations are pursuing. That is engagement or stewardship activities. Linsey, how much importance do you place on these activities? Are there specific issues clients are looking to address through adoption of ESG policies?

Linsey: Engagement is critical, especially with of the rise of passive strategies within equities. In those instances, divestment is not an option and instead the investor relies on the index provider to vote proxies and participate in corporate engagement to drive change. Engagement has also moved the needle on many of these issues, whereas divestment has simply been met by new sources of capital. Part of the reason engagement has succeeded is that performance for "improvers" generally surpasses that of companies already meeting the gold standard on many of these issues. There seems to be an alpha-play with engagement, particularly within less efficient market segments where information is not readily available. Lastly, and probably more obvious, the issues that investors are trying to tackle here are enormous and require significant capital and manpower, particularly around research and development. These large, long-standing companies are oftentimes ripe for leading these efforts and simply need shareholder support to justify the moves. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference. As of March 31, 2021, LGIM America had $241 billion assets under management.

For further information about LGIM America, find us at www.lgima.com

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