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2009 review of the sustainable investment performance of external asset managers

Public summary

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Objectives

This report summarises the outcomes of the fifth annual review of the sustainable investment (SI) approaches used by asset managers in charge of managing Mistra assets.

At the end of 2009 all of Mistra's externally-managed assets (SEK 2.94bn in 11 mandates/funds managed by 8 different asset managers) were invested using some degree of explicit inclusion of environmental, social and governance (ESG) issues[1].

Although most of Mistra's assets have now been managed according to an ESG-inclusive style for a number of years, the understanding of how ESG issues can create or destroy value for investors continues to evolve both at the level of individual companies and other issuers or securities, and in portfolio management. As such the review process represents Mistra's wish to understand the response of its external managers to this evolution.

For most managers this was the fifth time that they had participated in the review. The familiarity of Mistra and onValues with the managers' processes, and of the managers with Mistra's investment objectives, meant that we were able to concentrate on the incremental changes to investment processes and teams from 2008 to 2009, and to revisit areas of concern revealed by previous annual reviews.

As in previous years, the review process included asset managers responding in writing to a short questionnaire and then participating in a telephone conference to clarify open issues. The results of the review were then presented and discussed at a meeting of the Mistra Investment Committee. The focus of the review was on constructive conversations with managers that allow them to share insights and concerns. The process also avoids being prescriptive regarding the integration of ESG issues, rather acknowledging that a diversity of ESG investment styles is both possible and arguably desirable. It was nonetheless made clear both in the written survey and in the teleconferences that Mistra's primary interest in ESG issues relates to their ability to enhance risk-adjusted financial return.

This year, the review included a special focus on the following two topics:

- Asset managers' commitment and efforts to implement institution-wide ESG policies aimed at 'mainstreaming' ESG information across the entire assets under management. Mistra expects this to ultimately have a positive effect on the quality of ESG integration in the mandates/funds it invests in.
- Managers' understanding of the financial risks and opportunities relating to climate change. Managers were asked to comment on their assessment post the Copenhagen Climate Conference.

[1] That is to say that the inclusion of ESG issues is a formal requirement of the asset management agreement or fund strategy

Summary of findings

Efforts to mainstream ESG in the entire assets under management (AuM) of institutions managing Mistra assets

- Overall, we observe a relatively strong move of asset managers towards introducing institution-wide ESG policies
- Five of the eight managers now have group-wide policies to exclude companies based on certain criteria, such as controversial weapons or universal norms across all AuM
- Several managers also have group-wide ESG-inclusive voting policies that apply to all equity investments
- Some of the managers are making an effort to provide ESG data to portfolio managers in view of improving their awareness for ESG and their efforts to integrate ESG in portfolio management
- These efforts are driven by the fact that most managers have signed the UN Principles for Responsible Investment and are therefore committed to gradually consider ESG across the whole institution.

Attribution of risk and return to the ESG-related investment process

As in previous years, in order to isolate the contribution to risk and return arising from the ESG component of the process, we asked the managers to compare the Mistra mandate's performance with a reference portfolio of their choosing, where the reference portfolio could include (in decreasing order of preference):

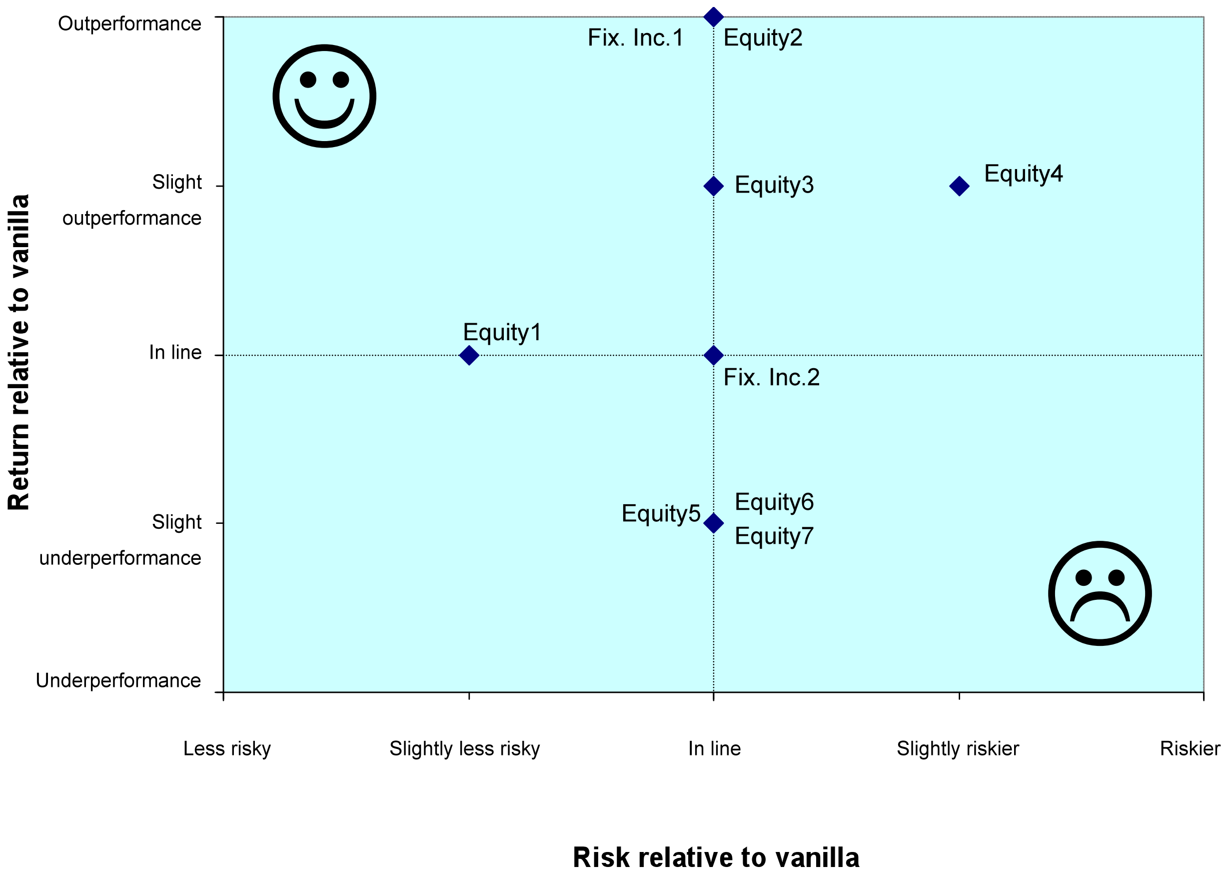
- A closely-related, 'vanilla' strategy that does not include the Sustainable Investment (SI) component but that is otherwise identical to the Mistra mandate
- A model portfolio that simulates the performance of a portfolio without the SI component (i.e. a synthetic version of the above)
- An appropriate broad benchmark (e.g. a mandate that invests in large-cap US equity and that has value characteristics might choose the S&P 500 Value Index as the reference portfolio).

For 2009, this attribution analysis showed the following results:

- Overall, 2009 has been a positive year in terms of the SI component contributing positively or being neutral with regard to financial returns (6 out of 9 mandates), or having only a slight negative impact (3 out of 9 mandates) compared to a 'vanilla' strategy[2]. This in spite of the fact that some of the SI strategies lead to a certain size and value bias that was expected to work less well in upward markets as those observed in 2009.
- In most cases the ESG component does not contribute to higher risk (as measured by standard deviation or tracking error) compared to the reference portfolio. Only in one case we observed ESG adding slightly to risk
- Overall, therefore, it can be said that the ESG component is working quite well. Managers are monitoring it carefully and most of them today use some kind of quantitative analysis to this end.

[2] For the remaining two mandates/funds, the attribution analysis was not possible

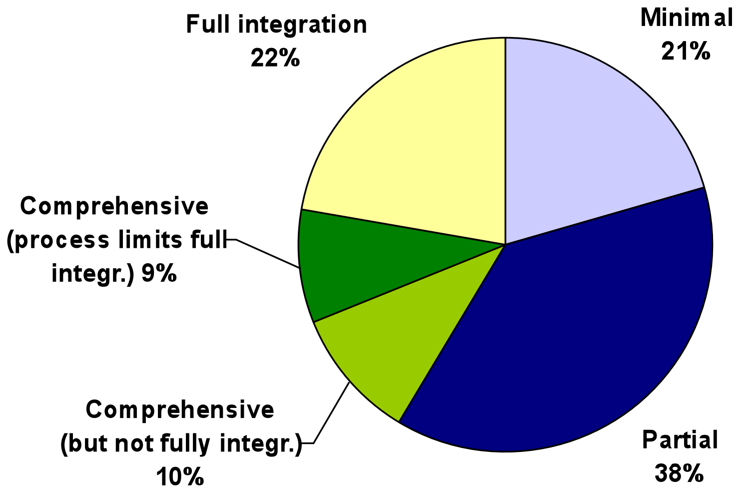
2009 risk and return of Mistra investments relative to 'vanilla' reference portfolios (schematic). Indicated are the seven equity and the two fixed-income mandates/fund investments for which data is available:



Integration of ESG issues into the investment process

- As ever, a major focus of the review was to understand the degree to which Mistra's managers are using ESG information as an additional source of informational advantage in their traditional investment decision-making techniques. In the chart below we present the onValues assessment of the degree to which ESG is integrated into financial analysis in a way that is likely to optimise risk and return over the long term.
- Our qualitative assessment remains almost unchanged. We observe a trend leading to stronger integration in the lowest rated strategies, which we expect will lead to all strategies being rated at least 'Partial' by the end of 2010.
- 59% of the assets receive our lower ratings on integration (minimal / partial), but this is due to the fact that these are mainly fixed-income assets, where full ESG integration is less relevant than in the case of equity. It is understandable that ESG data, which generally focus on issuer selection, are less integrated in these managers' processes, and touch only on the corporate issuers in the portfolio.

Asset share of different ESG integration levels in the Mistra portfolio:



Consideration of climate risks and opportunities in portfolio management

- Most managers have not yet taken a very sophisticated approach toward considering climate risks and opportunities
- They often point to their ESG data providers as those that are/should be dealing with the matter
- All the ESG data providers used for Mistra investments include the management of climate risks and opportunities in their rating processes. This information is used by the asset managers only for stock-picking and not for asset allocation or portfolio management purposes.
- The most sophisticated answers to our question about the investment relevance of climate change post-Copenhagen coincide in their view that:
    - Even if the outcome from Copenhagen is unclear, the secular shift from a high carbon to a low carbon economy is well under way and offers significant opportunities for the long-term oriented investors
    - Short-term outcomes from international negotiations will not have a material impact on this secular trend
    - National and regional developments (regulatory, emission trading and subsidy regimes) are currently much more relevant for investment purposes than developments at the global level
    - How quickly the US will introduce its carbon emission trading system is of high relevance to investment markets
    - Copenhagen having failed to commit states to clear emissions targets makes investments in polluting sectors more uncertain (introduces an element of risk).

Changes to ESG-related processes and teams

- Most investment processes and teams are fairly stable, with changes being of a marginal nature. The managers seem to be avoiding the temptation to change their processes too much. We believe that it is positive that managers have strong conviction in their strategies 'in all weathers' and are thinking of the likelihood of outperformance over the long term, as opposed to reactively changing the process
- Overall, it is positive to see that several managers have maintained and often strengthened their in-house ESG teams. This is a positive sign of long-term commitment.
- The portfolio turnover observed in the Mistra mandates/funds is consistent with the declared investment approaches and with managers' expectations. Where it strongly diverged from expected averages, managers were able to give plausible explanations.

Appendices

Survey sent to external asset managers

Annual review of asset managers' approach to sustainable investment (SI)

Mistra and onValues
December 2009

Goals and process

The goal of the annual review is to monitor the way in which asset managers apply sustainable investment (SI) criteria in managing mandates on behalf of Mistra. As expressed in its Investment Policy, Mistra believes that these criteria should contribute positively both to risk-adjusted financial performance and to a more sustainable development of the economy.

This is the fifth annual review of Mistra's external asset managers. The review is an opportunity for you to communicate and discuss with Mistra any changes in the SI aspects of the mandate / fund. Both Mistra and onValues (the external investment consultant that conducts the yearly review) are familiar with the basis of your investment strategy thanks to previous annual reviews. The goal is therefore to discuss any changes in the investment strategy and useful lessons learned from the implementation of the strategy.

Please send **brief** written answers to the following questions (with attachments if required) to Ivo Knoepfel, Managing Director, onValues (knoepfel@onvalues.ch) and to Fredrik Gunnarsson, Administrative Director, Mistra (fredrik.gunnarsson@mistra.org) **by close of business on Friday, 22 January 2010**. Your answers will be used as the basis for a constructive teleconference discussion, which will take place in early February 2010. As in previous years, onValues will present the results of the annual review to the Mistra Investment Committee.

The Mistra Investment Committee and onValues greatly appreciate your commitment to this process.

Questions

All answers should refer to the period 1 January – 31 December 2009 or to the situation at 31 December 2009 (please indicate if this is not the case). If you manage more than one mandate / fund for Mistra please make clear when answers apply to a specific mandate.

1. **Changes in SI commitment and AUM at institution level**
    a. Please indicate how your institution's total AUM in the SI field has evolved in the calendar year 2009.
    b. If possible, break out by asset class and country / region, and by SI style (negative screening, positive screening / best-in-class, integrated, engagement overlay, etc.). If precise data are available at the headline level but not for regions, styles, etc., please give any qualitative commentary you can on the underlying trends (e.g. "Our US negatively-screened funds and mandates saw net outflows.", "Our net growth in new accounts in Sweden was flat. New clients preferred engagement approaches", etc.)
    c. Please include examples of your institution's commitments and efforts aimed at "mainstreaming" the consideration of environmental, social and governance factors in the management of your entire AUM. Have these commitments and efforts been communicated publicly and/or to clients?

2. **Contribution of SI investment process to risk and return**
   a. Please provide data for 2009 for the contribution to risk ***and*** return made by the SI component of your investment process. You might want to compare the performance of your SI strategy with a reference portfolio, such as (in decreasing order of preference):
      i. A closely-related, 'vanilla' strategy that does not include the SI component but that is otherwise identical to the Mistra mandate
      ii. A model portfolio that simulates the performance of a portfolio without the SI component (i.e. a synthetic version of i. above)
      iii. An appropriate broad benchmark (e.g. a mandate that invests in large-cap US equity and that has value characteristics might choose the S&P 500 Value Index as the reference portfolio)
   b. Please comment the contribution to risk *and* return made by the SI component of your investment process. Please indicate reasons for an eventual out- or underperformance of the SI mandate compared to the reference portfolio. What elements of your SI process have worked well, which ones need improvement?
   c. Please highlight the concrete example of a change in the portfolio *based on SI considerations* (inclusion/deletion of a specific position, changes in the weighting of a position) and comment on the expected contribution to portfolio risk and return.

3. **Climate risks and opportunities post-Copenhagen**
   a. Please summarise your assessment of the investment relevance of recent climate policy decisions taken by leading nations in the run-up to or at the Copenhagen climate conference
   b. Describe in detail how climate risks and opportunities are considered in the management of the mandate / fund managed for Mistra (i.e. criteria used, for which industries, criteria included in screening methodologies or integrated in company valuations etc.)
   c. Are you planning any changes in the way climate risks and opportunities are considered in your investment process as a result of the outcomes of the Copenhagen climate conference?

4. **Turnover**
   a. Please indicate the turnover rate of the mandate / fund managed for Mistra. Please calculate turnover as the lesser of annual purchases or annual sales divided by the average net asset value in the past year (in %)
   b. What is your forecast long-term turnover for the mandate / fund?
   c. What was the turnover of the reference portfolio chosen in question 2. above?

5. **Changes to investment process / team in 2009**
   a. Please describe any changes to your investment process, sources of investment research or data (ESG or mainstream research), or team members since the end-2008 review
   b. Please describe any policy changes relating to the use of formal or informal ownership rights since the 2008 review (e.g. changes in the equity voting policy)

6. **Other issues**
   a. Are there any other issues you would like to highlight or questions for Mistra? Please let us know.

Further information

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