ESG Institutional Investor Survey

STATE STREET GLOBAL ADVISORS

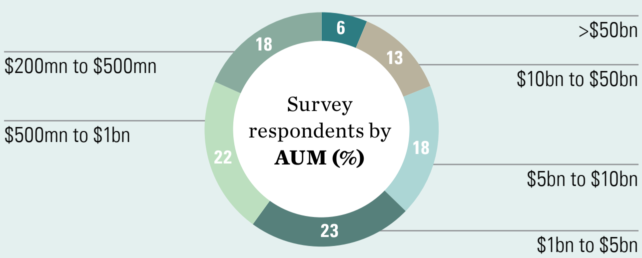
PERFORMING FOR THE FUTURE

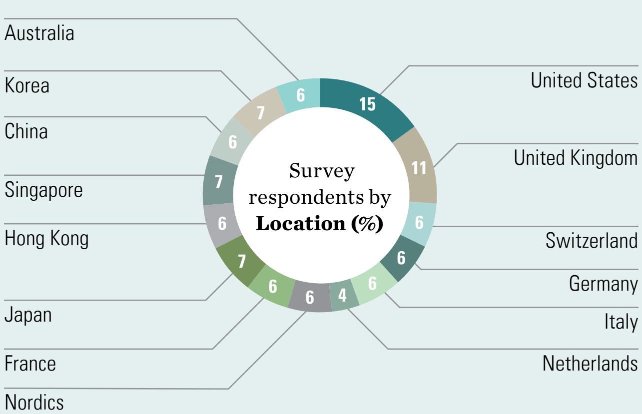
ESG's place in investment portfolios. Today and tomorrow.

Growing interest in environmental, social and governance (ESG) credentials among institutional investors reflects a view that ESG insights and perspectives can address multiple objectives.

In addition to targeting positive social or environmental impacts, ESG criteria are increasingly recognized as material to long-term financial outcomes.

In 2016, ESG investing encompassed $22.9 trillion, or just over a quarter, of the world's professionally managed assets.*





About this study: In December 2016 and January 2017, Longitude Research, in association with State Street Global Advisors (SSGA), surveyed senior executives with asset allocation responsibilities at 475 institutions. They included private and public pension funds, endowments, foundations and official institutions.

The survey was conducted by a combination of telephone interviews and online. The results were analyzed and collated by Longitude Research and supplemented by a series of in-depth interviews.

The survey explored institutional investors' attitudes toward ESG adoption. It sought to gain insights into their strategic approach, asset allocations, performance measures and challenges.

*Source: GSIA. *2016 Global Sustainable Investment Review.*

INTRODUCTION

To gain deeper insights into how investors are implementing ESG in their portfolios and the challenges they face, State Street Global Advisors commissioned a survey of 475 global institutional investors in the United States, Europe and Asia Pacific, including some of the largest pension plans, endowments and foundations. Respondents are directly involved in or influence asset allocation decisions. The findings were supplemented by a series of in-depth interviews with senior institutional investment professionals.

The results confirm that overall adoption of ESG investing is high: the vast majority of investors have some exposure to ESG factors in their portfolios. Furthermore, institutions are highly satisfied with the performance of their ESG investments. Indeed, the extent of satisfaction among those investing in ESG is encouragingly strong.*

Yet, while the survey finds that ESG investments are a feature of many institutional portfolios, the depth of exposure is low for all but a small group of investors, despite long-term performance potential. ESG encompasses only a third of investments on average. We uncovered a range of challenges that can inhibit investors' capacity to embrace ESG investing more fully.

Issues around metrics and a lack of standardized performance measures can lead to confusing and contradictory results and prove particularly concerning.

Other difficulties include the lack of internal capabilities, internal and external stakeholder misalignment with ESG objectives and concerns over costs.

Confronting these challenges demands a multifaceted approach. Given the range of investor experiences and perspectives, there is no such thing as a typical ESG investor: they represent a broad spectrum of knowledge, expectations and goals.

Indeed, our survey identifies three groups of institutional investors along a continuum of ESG adoption:

- **Low adopters (ESG strategies represent less than 25% of their portfolio)**
- **Intermediate adopters (25-50%)**
- **High adopters (over 50%)**

Within each group we see variations in conviction around ESG performance, the prominence they attribute to the various challenges that can limit ESG uptake and their level of momentum toward ESG integration.

Addressing these issues will be critical to enabling more investors to capitalize on the long-term performance characteristics that ESG can offer.

*This view is not a testimonial of satisfaction with our advisory services and should not be interpreted as a statement of experience or an endorsement by a client, but rather an opinion on ESG investing in general. Many of the survey respondents are not clients of SSGA.

KEY FINDINGS

1

ADOPTION DRIVEN BY PERFORMANCE BELIEFS

Broad Uptake

Most institutions (80%) have an ESG component as part of their investment strategies.

Helping Returns

More than two-thirds (68%) say that integration of ESG has significantly improved returns.

Managing Volatility

A large majority (69%) say that pursuing an ESG strategy has helped with managing volatility.

No Compromises

ESG implementation is driven by a no-compromise approach: three-quarters have the same performance expectations for ESG as they do for other investments.

Missing Depth

The depth of ESG exposure within portfolios remains low: only 17% of respondents have more than 50% of assets with exposure to ESG factors, and 44% have less than 25%. A third group has between 25% and 50%.

2

CHALLENGES INHIBIT GREATER ADOPTION

Benchmarking

Benchmarking is seen as one of the greatest challenges. Over half of respondents say that they find it difficult to benchmark performance against peers and that accurate assessment of external ESG managers is an issue.

Terminology

There's internal confusion around what exactly ESG constitutes: three-quarters of respondents say that there is a lack of clarity around ESG terminology in their organizations.

Wider Issues

Concerns around data, performance measures, internal capabilities and costs vary according to current levels of ESG investment exposure and maturity.

3

ESG PATHWAYS ARE EVOLVING

Integration

Integration is on the rise, but full integration of ESG criteria into long-term decision-making is low (just 27% are fully integrated).

Engagement

While most investors (78%) recognize the value of engagement with companies, some may be attempting to do too much with limited internal resources.

Building Partnerships

Many respondents recognize the value of using firms with specialist expertise to help them deploy their ESG strategies. Over half use asset managers with a specialist division.

01 ADOPTION

Moving into the Mainstream

Fact or Fiction? Adoption of ESG strategies is gaining momentum.

Reality The results show that adoption is broad: the vast majority of respondents now have some exposure to ESG strategies. However, the proportion of ESG exposure in portfolios is low on average.

Changing Fast

Institutional investors' attitude toward responsible investing has come a long way in a very short time. While institutions assessing investments have in the past considered ESG factors to some degree, few were considering them explicitly — and most would have placed them firmly in the risks bucket.

Now, developments such as the United Nation's Principles for Responsible Investing* are helping investors to see ESG factors in terms of both opportunity and risk.

Other considerations are also compelling companies to address ESG issues more explicitly. Climate change, media attention around areas such as child labor and working conditions, and the rise of social media as a reporting tool for both good and bad corporate behavior, are driving executives to analyze and measure their investments according to ESG criteria.

Good Principles, Good Business

In turn, many investors believe that effective ESG management improves company performance by helping to identify reputational, operational and financial risks and create commercial opportunities.

"Increasingly, there is a broader appreciation of the idea that good governance translates into better management of areas such as carbon footprint and workforce engagement," explains Lori Heinel, deputy CIO at State Street Global Advisors. "This creates better quality companies that provide better performance over the long term."

The ESG Imperative

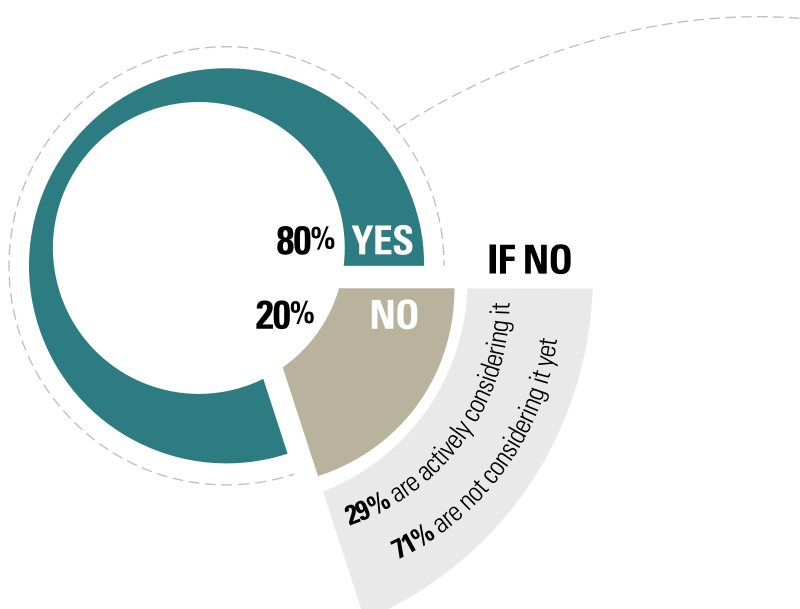
The vast majority (80%) of respondents in our survey say they have some form of ESG strategy within their portfolios. That reflects, perhaps, a diversity of interpretations of ESG; it captures a range of potential styles and tools with which investors can implement their responsible investing objectives.

Most have been investing in ESG strategies for between four and five years, although a quarter have had an ESG component for more than five years.

Among the 20% who do not yet have exposure to ESG strategies, the results reveal an entrenched group of non-adopters (71%) that are not actively considering them.

On the whole, however, there appears to be considerable momentum behind the adoption of ESG investment, which creates among institutions a sense of urgency to keep up with their peers. This urgency is highlighted by Marie Giertz, Chief Economist at Swedish public pension fund Kåpan, who says: "I think the whole financial industry, the fund industry, is moving toward ESG investment. We can't be left behind — we have to follow that trend."

Is ESG a component of your institution's investment strategy?



* See https://www.unpri.org/about

01 ADOPTION

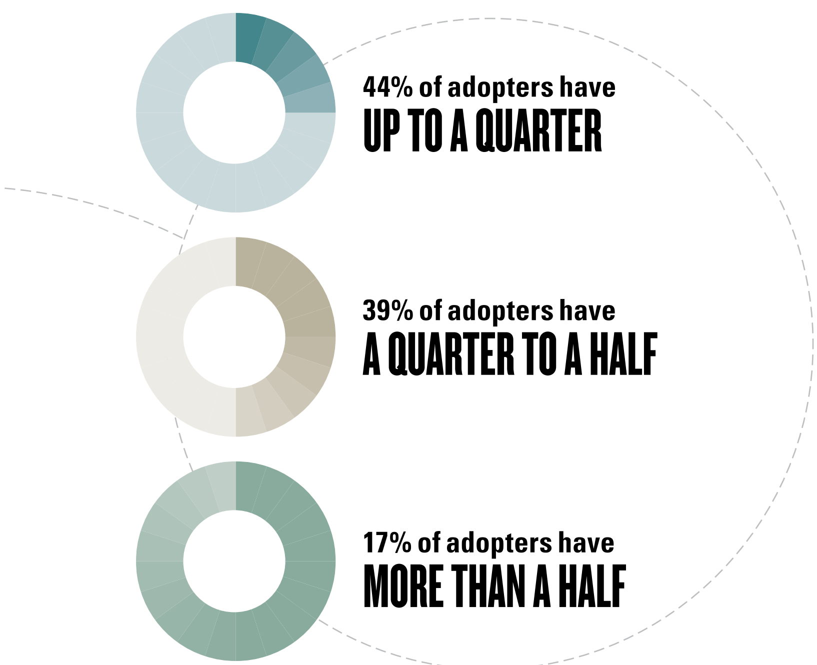
A Range of Exposure

Approaches to ESG come in many guises. Indeed, the range of definitions of ESG can mean that pinpointing the extent of exposure is subject to qualification.

Our survey indicates that despite the broadening reach of ESG investing within the institutional investing arena, the proportion of investors' portfolios that incorporate ESG factors is low — about one-third, on average.

But there are varying degrees of penetration within investment portfolios. Among investors in our survey who have an allocation to ESG investments, 17% indicate that 50% or more of their overall investments have exposure to ESG strategies; an intermediate group of 39% indicate that 25–49% of their portfolios feature exposure to ESG strategies; and 44% of respondents have portfolios with ESG exposure of 1–25%.

What proportion of your overall investments incorporates ESG factors?



US Investors are Making Headway

Our results highlight some key regional differences. Perhaps surprisingly, given the region's longer history of responsible investment, Europe's investors lag their US counterparts in ESG exposure levels.

In the US, 27% of investors incorporate ESG factors in at least half of their investments, while in Europe and Asia Pacific the equivalent figures are just 17% and 15%, respectively.

European and US investors are most likely to have intermediate allocations of between 25% and 49%, while Asia Pacific investors trail with nearly half allocating less than 25% to ESG strategies.

These aggregated regional results no doubt conceal significant variations in adoption at a country level. For example, we might expect countries in Northern Europe to feature higher allocations than the region as a whole.

It appears, however, that US investors, while relative newcomers to ESG, are moving quickly. The growing recognition of ESG as a material input to investment decisions in the US is exemplified by, for example, guidance issued by the Department of Labor in 2015 that enables ERISA-governed pension plans to take ESG considerations into account when investing. Before that, ESG guidance was less clear for fiduciaries.

01 ADOPTION

ESG Investment Approaches

Fact or Fiction? Investors are becoming increasingly sophisticated in their application of ESG strategies.

Reality Asset stewardship is a vital part of ESG approaches, and investors are looking beyond negative screening.

A Range of Approaches

At the most basic level, an ESG policy may be executed through negative screening — strategies that exclude investments from portfolios where they are deemed controversial or they conflict with particular values.

Positive selection strategies, on the other hand, put capital to work directly to target distinct outcomes or impacts in a particular area of focus — such as housing, healthcare, education, resource conservation or gender diversity.

Finally, ESG integration incorporates ESG data directly into the research and security selection process with the aim of improving financial outcomes.

Active Stewardship is Integral

Many investors in our survey are seeking to add value through active stewardship. This involves activities to engage with investee companies across a range of governance and sustainability issues, ultimately to influence ESG practices and focus on long-term value creation.

Among respondents, 73% say that they consider active ownership — in the form of shareholder engagement with companies they own — to be an integral part of their approach to ESG investing. Meanwhile, 71% have some level of engagement with investee companies either directly and/or via their asset manager.

"In an age of rapid technological change, companies increasingly need to articulate their strategies around good corporate governance and areas like talent development, innovation and sustainability. It helps them remain viable and competitive and to maintain credibility among investors."

Rakhi Kumar, Head of ESG Investments and Asset Stewardship, SSGA

Is your institution engaging with portfolio companies as part of a broader ESG strategy?

4%

01 ADOPTION

Deeper Integration

Our survey indicates that many investors have moved beyond negative screening and now employ other ESG strategies within a broader approach.

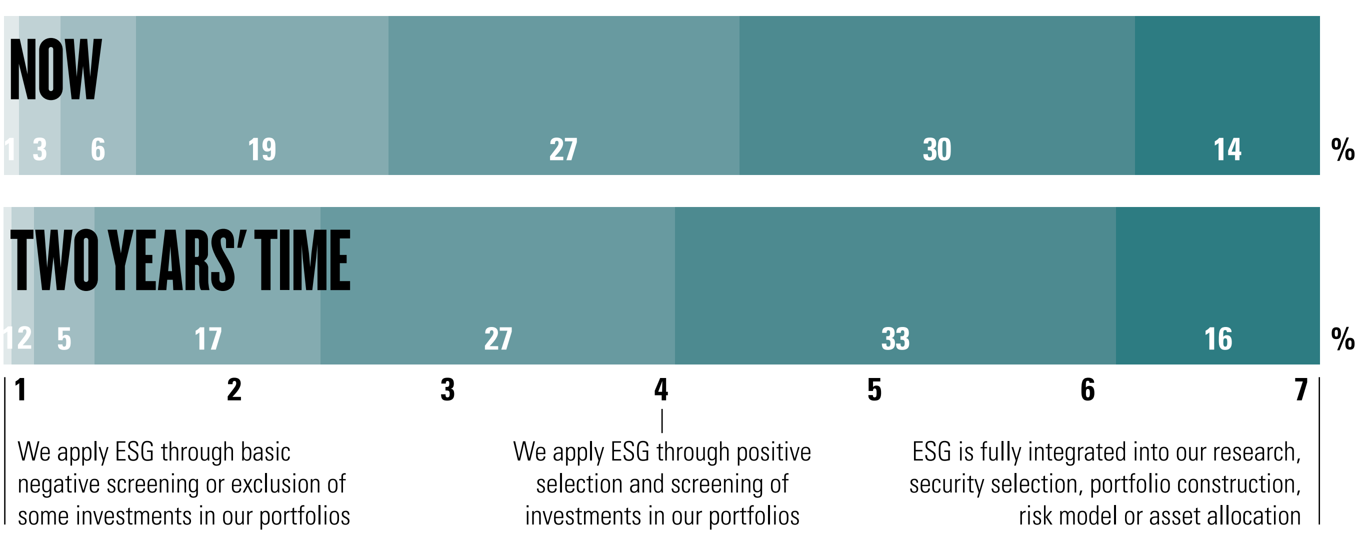
When viewed as a spectrum of potential approaches to ESG investing, 44% indicate a progression toward deeper integration of ESG into research and security selection, including 14% who say that ESG is fully integrated. Many institutions feature positive selection strategies as part of their overall ESG investing program. Very few (4%) cite negative screening only.

It's a complex issue, and simply excluding companies from investment may reduce the potential for improving returns, as Andrew Howard, CIO at Australian pension fund VicSuper, explains: "Overall, negative screening isn't the primary way that we work to achieve our ESG goals," he says.

"You need to engage with companies where you identify issues to get a better outcome," he adds. "As an industry, we have a very strong voice when we work collectively. At present, the only fund-wide exception to that would be tobacco — we don't invest in that, because we can't make a positive contribution through engagement."

Sweden's Kåpan is one fund that is increasing integration. "We do exclude some companies on the basis of ESG risks," says the company's Marie Giertz. "But we also want to step up our engagement with those where we think we can change their direction — that's one of our aims."

Thinking of your current application of ESG, where would you place your institution on a scale of 1 to 7?



02 ACCELERATING ESG

Performance Potential is a Key Motivator

Fact or Fiction? ESG is a means to do good and appeals primarily to mission- or values-based investors.

Reality Investors demonstrate a no-compromise approach when it comes to performance, but ethical and responsible investing criteria are also important drivers of ESG adoption.

Performance is Paramount

Investor attitudes have shifted: ESG is no longer seen simply as a means to do good, but also as a way to address a combination of financial, risk and ethical objectives. The majority (75%) of surveyed investors with ESG strategies expect the same returns from those investments as they do from others.

Meanwhile, about three-quarters of investors in the survey say that risk mitigation is a driver behind their increased interest in ESG. They seek to manage potential reputational impacts of ESG factors on performance.

More than three-quarters also say they are motivated by a belief that ESG credentials play a role in wider financial performance; this is broadly in line with the proportions for other factors such as ethical values and the desire to see positive environmental or social impacts.

Multidimensional Drivers

Chris McKnett, Head of SSGA's Global ESG business group, believes ESG appeals to investors on multiple levels. "One, building the case for dealing with systemic issues such as climate risk," he says. "Two, it provides another important dimension of long-term performance. And three, tomorrow's investors strongly favor products that target specific environmental or social outcomes."

US investors in particular are driven to consider ESG investments based on a belief that they play a key role in broader financial performance — 52% of them, versus 35% in Europe and 31% in Asia Pacific.

Changing Perspectives

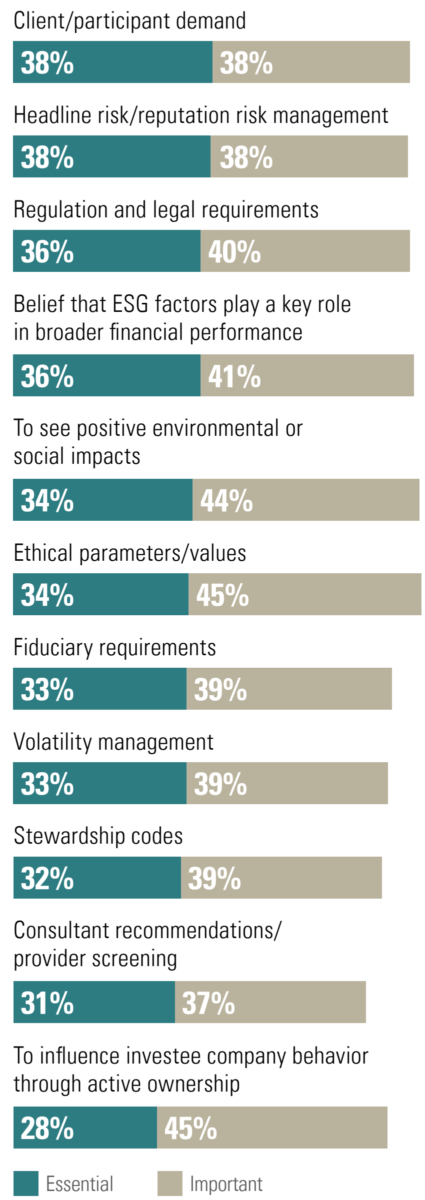
While our survey overwhelmingly demonstrates a recognition of the value of embedding ESG criteria into investment decisions, some investors remain skeptical.

Non-adopters are less convinced about the potential for performance enhancement and can be doubtful that it outweighs the cost of implementing ESG strategies. More than four out of ten say that there is an unclear value proposition.

Chris Ailman, CIO of one of the US's largest pension plans, CalSTRS, believes this is down to a misunderstanding of why ESG investment matters. "There are still investors that push back against ESG because they believe it's about investing for something other than returns," he says. "Yet what matters is not a return today or tomorrow, but a return today, tomorrow and for the next 20 years."

Adopters, and particularly those with higher levels of exposure, seek greater conviction around the value proposition of ESG beyond developed market equities. They have less certainty around the credentials of ESG for emerging markets equities, fixed income, multi-asset class and alternative investments.

What is driving interest in ESG?



02 ACCELERATING ESG

High Levels of Performance Satisfaction

Fact or Fiction? ESG investors tolerate short-term underperformance, provided that other criteria are met.

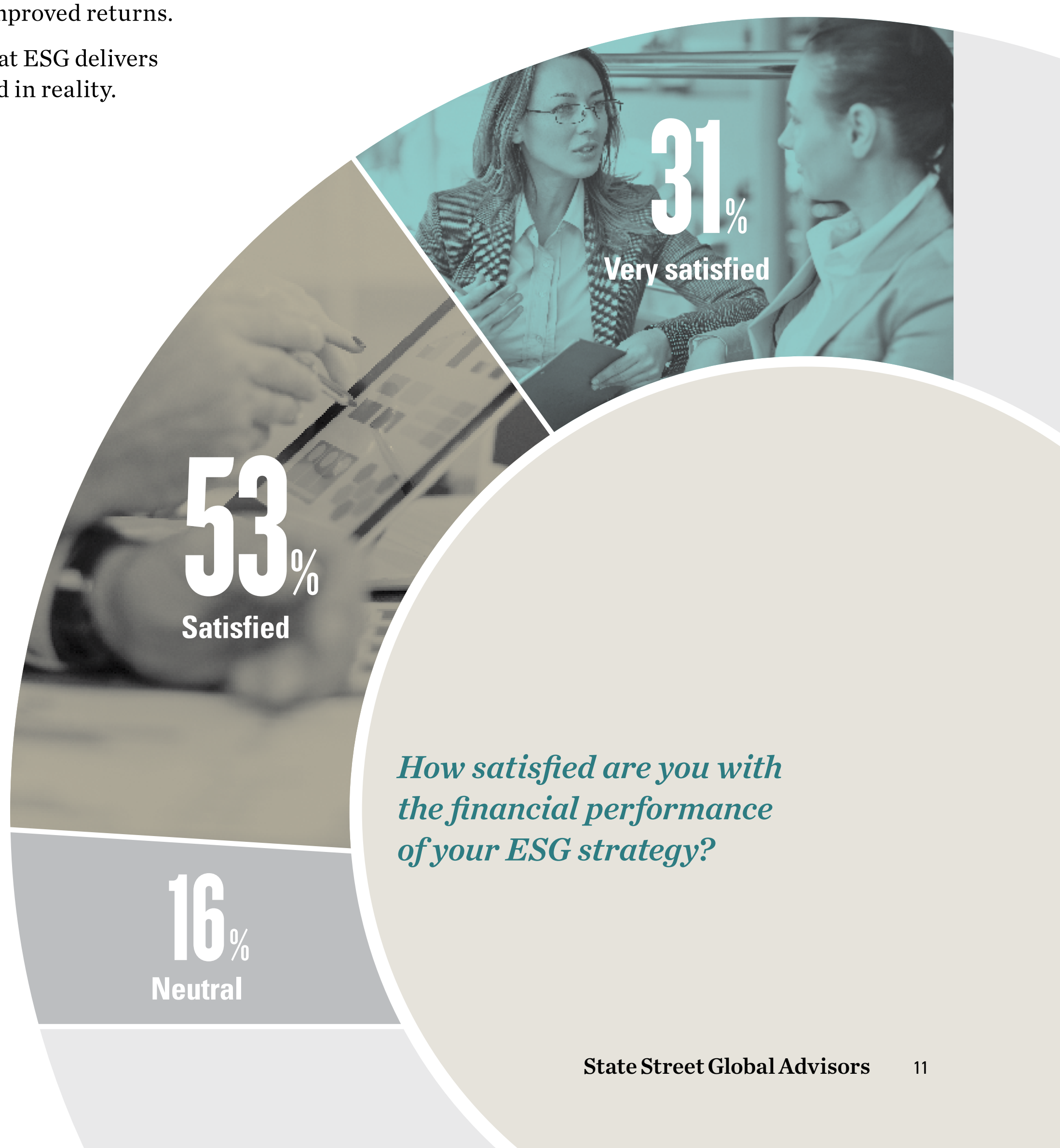
Reality Implementation is driven by a conviction that ESG strategies drive long-term returns.

Delivering on Performance

Investors' belief in the performance benefits of ESG investing is backed up by high levels of satisfaction among adopters. The vast majority (84%) are satisfied with the financial performance of their ESG strategy, including 31% who are very satisfied.*

Satisfaction is highest among those firms that have been pursuing ESG investing for the longest and where ESG is most integrated into decision-making. More than two-thirds (68%) say that integration of ESG into decision-making has significantly improved returns.

This suggests that the perception that ESG delivers good financial performance is rooted in reality.



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02 ACCELERATING ESG

Benchmarking is a Key Barrier

Fact or Fiction? Investors struggle to benchmark ESG strategy performance.

Reality Benchmarking is seen as a key challenge, with over half of respondents saying they find it difficult to benchmark performance against peers and accurate assessment of external ESG managers is an issue.

Finding the Right Tools

While overall satisfaction with the performance of ESG investments appears strong, many investors express concerns about the available data and tools with which to measure that performance.

Perhaps this is to be expected, given the relatively nascent view of ESG as a performance driver and its evolving role in portfolios.

A little more than half agree that they have difficulty benchmarking the performance of their ESG strategy against peers.

Less predictable, however, is the finding that the more deeply ingrained the ESG strategy, the greater the difficulty of measuring its performance. Investors with the most exposure to ESG within their portfolios are more likely to agree that they have difficulty benchmarking their performance (61%) than those with the least exposure (52%).

It may be that this more experienced group has a greater appreciation of the challenges associated with benchmarking than those with lower exposure or more recently established programs.

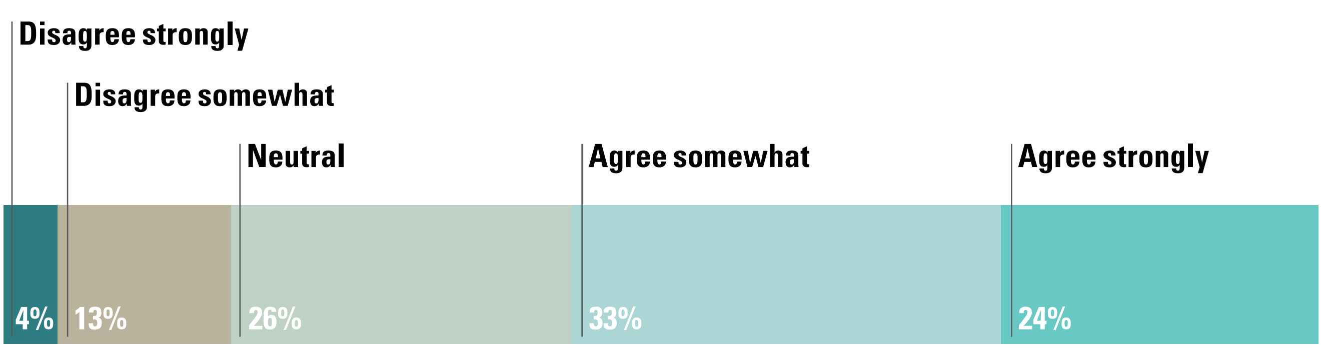
The Benchmark Struggle

Our survey highlights a wide range of performance metrics employed by investors. Nearly half (49%) benchmark against their own past performance; 47% against a common benchmark index; and 46% against peers with comparable portfolios, so the market is clearly some way off determining which type of measure constitutes best practice.

Just 24% cite non-financial measures, which confirms the focus by investors on the financial performance of ESG strategies.

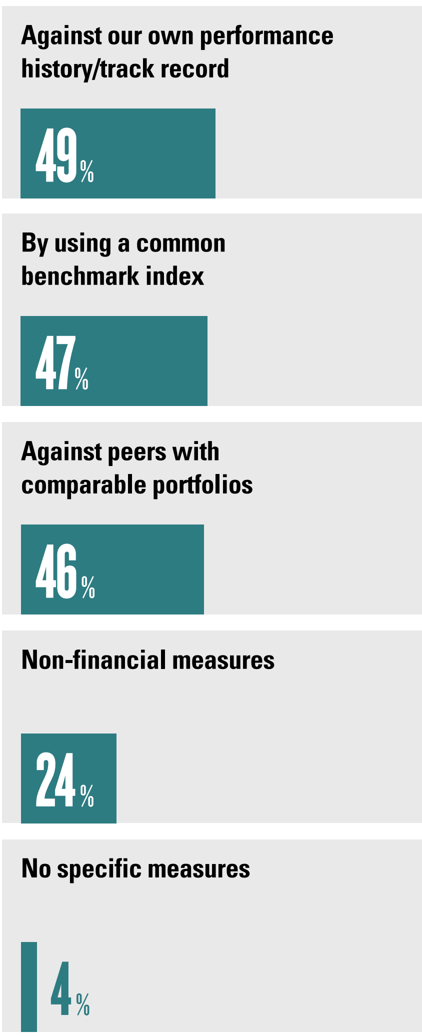
Attempting to assess the performance of specific areas of the portfolio is also problematic. "Often, it's hard to understand quite how accurate some of the measures are at providing us with the full picture," explains Andrew Howard of VicSuper. "Yearly Trucost reports, for example, are valuable in measuring the carbon intensity of our equity portfolio, but only to a point. The information only looks at climate impacts, and doesn't take long-term resilience, the strategic direction of the company in terms of transition and upside exposures into account. It doesn't therefore give you a full indication of a company's carbon risk exposure."

We have difficulty benchmarking our performance against peers



02 ACCELERATING ESG

Which of the following ways does your institution evaluate ESG performance? (Select all that apply)



Not Only Portfolio Performance

Our survey also shows that investors do not only struggle with performance at portfolio level. More than half (56%) say they lack the capability to assess the performance of external managers. This is supported by respondents' comments in interviews: many suggest that disparate sources of information make comparisons highly challenging.

Marie Giertz outlines how this affects Kåpan's efforts at measurement: "We would like our external managers to have an ESG perspective in their investment process, and we have a dialog with them regarding their ESG philosophy. However, without global standards there are some difficulties in interpreting ESG risks as definitions and how to measure and evaluate ESG risks differs among managers and external ESG research firms/teams. But the most important factor for us is that you take ESG into consideration and that you can describe your own process."

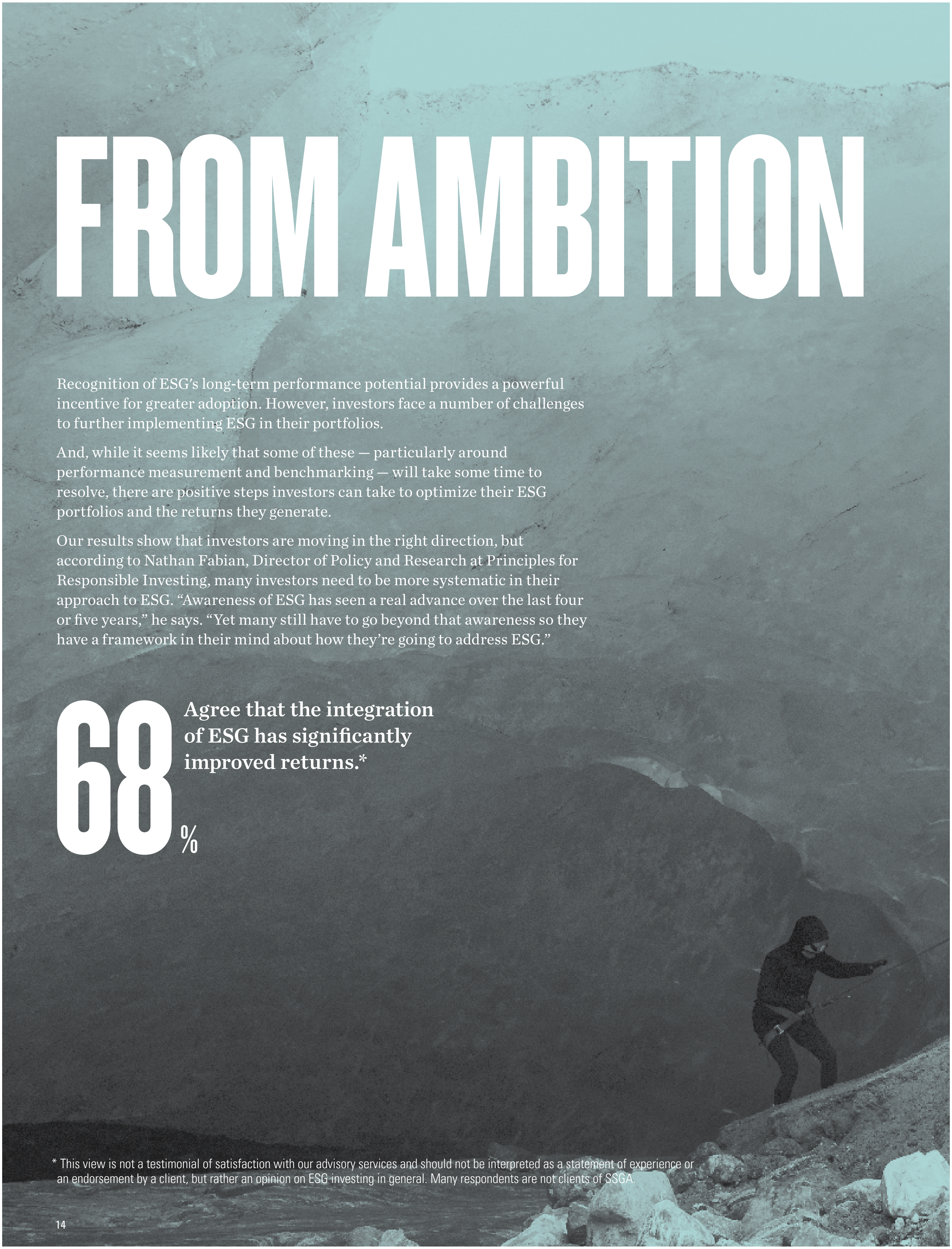
For many investors, the lack of standardized tools for performance measurement means that they often have to use a variety of methods for assessing company ESG performance.

Giertz explains Kåpan's approach: "It's very difficult to evaluate impact and pick out the right stocks from an ESG perspective. A traditional approach looking at different macro and micro components, such as balance sheets, profits and political risks on a country, sector or company level, are still the main focus for us, but we're adding ESG criteria to the investment decisions."

Some Way to Go

So while there is a sense among investors that current difficulties around performance assessment are part of the evolution process for what is a relatively new investment framework, it's clear that the inconsistency of measures leads to a degree of frustration and constitutes a barrier for further adoption of ESG.

"There is a proliferation of different types of ratings and other measures, and we expect that these may give conflicting results," says Annie Bersagel, acting head of responsible investments at Norwegian mutual pension fund and insurance company KLP. "We're currently in a process of disruption that's really necessary in order to clarify how to measure investments on ESG quality. Eventually, the best standard will win, but we're not there yet."



FROM AMBITION

Recognition of ESG's long-term performance potential provides a powerful incentive for greater adoption. However, investors face a number of challenges to further implementing ESG in their portfolios.

And, while it seems likely that some of these — particularly around performance measurement and benchmarking — will take some time to resolve, there are positive steps investors can take to optimize their ESG portfolios and the returns they generate.

Our results show that investors are moving in the right direction, but according to Nathan Fabian, Director of Policy and Research at Principles for Responsible Investing, many investors need to be more systematic in their approach to ESG. "Awareness of ESG has seen a real advance over the last four or five years," he says. "Yet many still have to go beyond that awareness so they have a framework in their mind about how they're going to address ESG."

68% **Agree that the integration of ESG has significantly improved returns.***

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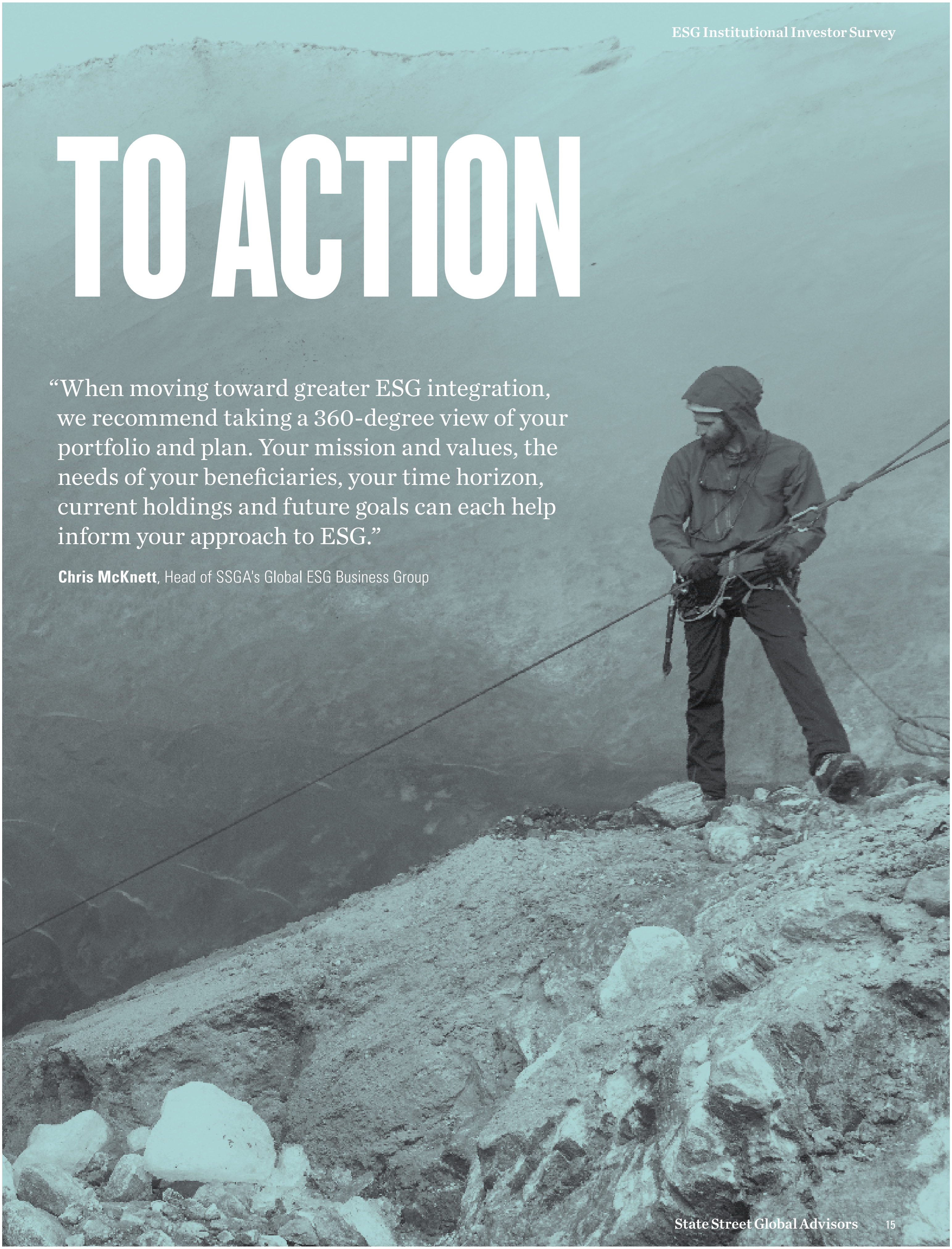


TO ACTION

"When moving toward greater ESG integration, we recommend taking a 360-degree view of your portfolio and plan. Your mission and values, the needs of your beneficiaries, your time horizon, current holdings and future goals can each help inform your approach to ESG."

Chris McKnett, Head of SSGA's Global ESG Business Group

03 FROM AMBITION TO ACTION

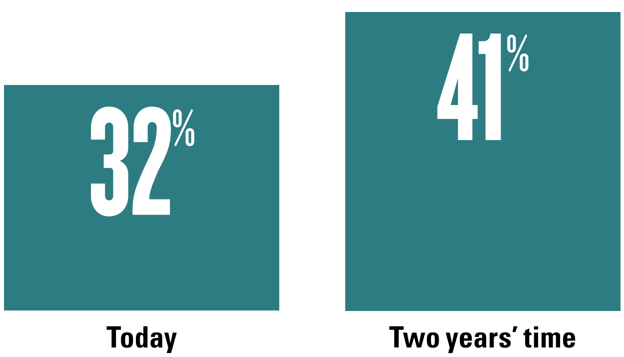
Aim Higher

Further to Go

Despite many surveyed investors expressing satisfaction with the performance benefits of their ESG strategies, overall ESG exposure remains low — on average, only a third of adopters' investments incorporate ESG criteria.

Our results suggest that investors expect that proportion to grow over the next two years — to around 40% of their portfolio. On average, the 'ideal' proportion suggested by investors is only marginally higher.

Proportion of investments incorporating ESG criteria now and in two years



The averages belie the full range of ideals among investors in the survey — some are looking to achieve an exposure of around 70% of their portfolio. But the results do point to a lack of ambition among many institutions. Indeed, some investors envisage an ideal exposure level of just 20%.

ESG exposure could transform these investors' long-term financial results, risk mitigation and exposure to volatility, so they need to become more ambitious and consider increasing their ideal exposure levels.

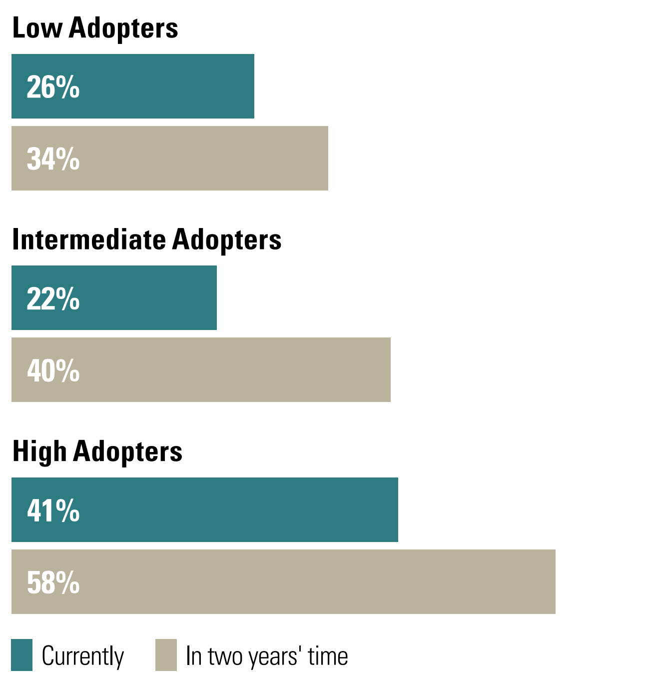
Deeper Integration Required

Embedding ESG into long-term, strategic decision-making requires deeper integration. Around 40% of investors in our survey expect to have fully integrated ESG over the next two years, but momentum varies according to their current levels of overall ESG exposure.

Full integration among those with higher exposure (50% and over) will increase more rapidly — from 41% currently, to 58% — than those with lower exposure over the next two years. This may be attributable to greater conviction in the value of ESG investing, stronger internal alignment with ESG strategies and the availability of resources to execute ESG investing.

VicSuper exemplifies this trend, as CIO Andrew Howard outlines: "We are looking to integrate ESG into everything we do, rather than seeing it as a standalone issue. We are working to ensure that our asset consultants and fund managers also take an integrated approach to ESG."

Percentage of asset owners with ESG fully integrated into strategic decision-making



03 FROM AMBITION TO ACTION

Evolve the ESG Culture

56% of adopters say there's a lack of clarity over ESG terminology

Culture is Key

An organization's culture sets the tone for its decision-making and strategy, from influencing what sits at the top of a board's agenda through to the way in which staff prioritize daily activities.

Institutions where ESG strategies have been pursued the longest and constitute a larger part of their portfolios have embedded the consideration of cultural factors more deeply in the organization: 77% of these investors say that all staff are well aligned to ESG investment strategies.

Annie Bersagel explains KLP's view: "We never get pushback from our owners about whether ESG runs counter to fiduciary duty. The ongoing discussions relate rather to where to draw the line on specific cases, as opposed to whether we should have responsible investment guidelines in the first place. It's a very clear strategy — all the way up to the CEO — that responsible investment is a key part of KLP's DNA and our brand."

Among adopters, alignment among many institutions around their ESG strategy appears patchy overall and there is confusion internally about what ESG means in practice. Over half of adopters (56%) say that there is a lack of clarity over ESG terminology within their institutions.

And while alignment with ESG strategies is high among boards (77% say this), senior managers (76%) and investment teams (74%), there is some way to go before all staff are aligned (only about two-thirds).

In a recent State Street study, 30% of institutional investors cited explicit support from senior management as a way to overcome barriers to ESG integration.*

* Source: State Street's Center for Applied Research, *The Investing Enlightenment,* 2017

The Importance of Education

Such gaps are a particular problem among certain groups of decision-makers. Trustees, for example, are pinpointed by Nathan Fabian at Principles for Responsible Investment: "Conviction levels among trustee boards is one of the highest-priority issues," he says. However, he adds that there is a more widespread issue around alignment: "I also think improvements will come from asset owners properly aligning the incentives of their managers with their sustainability objectives."

Education will be an essential ingredient to achieving deeper integration. This will allow change to come from within the organization, according to Fabian. "You've got to bring out the general level of ESG literacy across all staff," he says. "Use ESG information across all your teams, so that there's a basic risk management capacity around ESG."

And this education program should filter down from the top. Chris Ailman at CalSTRS, for instance, sees his role as leading that change. "My goal is for all of my staff, from portfolio managers down to entry-level investment officers, to have a core understanding of what we mean by ESG, how our policies describe it, and how I want to see us integrating it into our investment decisions," he says.

Communicating the Benefits

Our results suggest that institutions could be doing more to communicate the benefits of ESG investment to their ultimate stakeholders: their beneficiaries and clients. Only 27% say that beneficiaries fully understand and are aligned with their ESG strategies, and over a quarter say that these stakeholders are not aligned. It's also an issue among non-adopters. Nearly half (45%) say that limited demand from stakeholders is a major barrier to incorporating ESG.

Michael Wyrsch, CIO at Australian pension fund Vision Super, describes this divide: "The way we view it is that our pension-fund savers have long-term prospects and they want good living standards in retirement, and the way to achieve this is to focus on the sustainability of the companies we invest in. There's no point having an investment that beats the market for nine years and then goes bankrupt."

03 FROM AMBITION TO ACTION

Cooperate to Break Down Barriers

Work with Peers

Overcoming some of the barriers outlined in this report will require investors to make full use of their combined knowledge and economies of scale. Working together to share performance information can help to address the measurement challenge, by enabling the development of benchmarking tools and more standardized reporting metrics. This will not happen overnight, but if investors align to agree best practice and share lessons learned, high-quality standards will emerge more quickly.

Some responses in our study suggest that this is already starting to happen. Kåpan, for example, is looking to its peers for some answers. “I have found it very useful to look at what others are doing, what we are missing and how we should integrate ESG more,” says Marie Giertz.

There may also be an argument for clubbing together on investments to share resources. Nathan Fabian, says that this can yield good results. “I’m finding that funds like to pool together with two, or three, or four others, share expertise, and then go and find investment opportunities,” he explains. “There’s also some commercial advantage that’s coming through in this, which is not an unhealthy thing at all.”

Capacity to Engage

The process of company engagement demands time, knowledge and resources. However, not every institution has capacity to engage directly with all companies on ESG matters. Here, there appears to be some recognition among those with the most ESG exposure that not only is engagement vital to the financial success of ESG investment, but also that to be effective it requires additional resources: just 26% of these investors attempt to engage purely via investee companies themselves.

Some institutions also say that to achieve their desired ESG outcomes they need to be smart about where they deploy resources and financial firepower.

Norway’s KLP adopts a strategic approach to ESG — partly by grouping with other investors to engage on key issues, and partly by focusing on specific areas. “We’re a fairly large investor in the Norwegian market, but not by global standards,” explains Annie Bersagel. “We need to be strategic in the kinds of engagements we target, and put our resources in areas where we think we can make a difference.”

Is engagement done through your asset managers, directly with investee companies, or a combination of the two?

22%
Through our asset managers

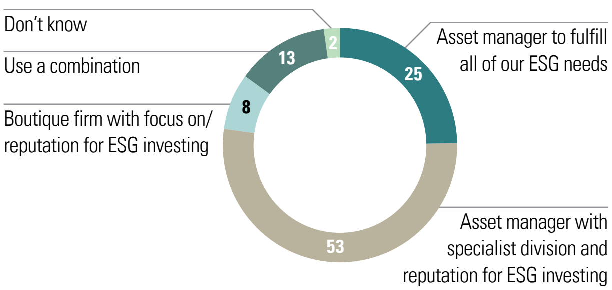
38%
Directly with the investee company

40%
A combination of the two

03 FROM AMBITION TO ACTION

Build ESG Partnerships

Which most accurately describes your approach to selecting an investment manager for your ESG strategy? (Adopters)



Use Specialist Help

As the research highlights, finding the right resources to manage ESG strategies can be a challenge. Accelerating ESG adoption will therefore demand a partnership approach.

Many respondents recognize the value of using firms with specialist expertise to help them deploy their ESG strategies. Over half use asset managers with a specialist division, while a quarter use an asset manager to fulfill all needs. Just 8% use boutiques only, and a further 13% use a combination.

Those without any ESG exposure are thinking along similar lines: asset managers with specialist divisions would also be their top choice for accelerating ESG adoption.

Priorities Differ

Our results highlight differences, however, between those with and without exposure when it comes to how they choose firms with which to engage.

Among adopters, the key attractions are quality of investor communication and a proactive and visible engagement strategy; track record is third. Fees rank sixth in importance and breadth of products seventh. These investors are clearly investing time and resources into selecting managers that will provide them with the information they need and generate the ESG outcomes they seek.

Those without exposure also rank track record and reputation and quality of investor communications in the top three. The need for competitive fees and costs ranks joint third in their selection criteria, which corresponds with the finding that cost concerns represent a major barrier for this group. The need to convey a convincing value proposition of ESG carries extra weighting among non-adopters.

Engagement strategy ranks lower among non-adopters, who may not fully recognize the potential of active engagement for improving long-term investee company performance.

What factors are most important in selecting a manager for ESG?

Adopters		Non-Adopters
83%	Quality of investor communications	67%
82%	A proactive and visible engagement strategy	63%
81%	Track record and reputation	68%
81%	Their solutions align with our investment strategy	61%
78%	Depth of proprietary research	54%
77%	Competitive fees/costs	65%
76%	They provide dedicated ESG resource and capability	60%
72%	Breadth of products	65%

WHO ARE ESG INVESTORS?

Viewed across three broad ranges of ESG adoption (low, intermediate and high), the survey results reveal patterns across a number of dimensions.

Among groups that have adopted ESG, we observe differences in conviction around performance, the prominence they attribute to the various challenges that can limit ESG uptake and their level of momentum toward ESG integration.

LOW ADOPTERS

PROFILE

These investors have either not yet initiated an ESG investment strategy or have limited exposure to ESG strategies (less than 25% of their portfolio).

While 40% of those with limited exposure have been using ESG investments for two years or less, there is a sizable proportion (60%) that has been investing for longer, including 18% for more than five years.

CHARACTERISTICS

Adoption
The average exposure of investments to ESG factors for low adopters is 13%. The results also identify 20% of investors as having no exposure to ESG factors in their portfolio. Among this group, 71% are not yet considering it.

Integration
Among the low adoption group, 26% of respondents describe the level of their ESG integration into long-term decision-making as full, and only 34% expect this to happen over the next two years.

Engagement
Around 60% of this group currently has an engagement program.

Culture
Just 27% say that investment teams are fully aligned with ESG; 35% say the same of senior management; and 33% say that their board is fully aligned.

Performance
This group is less likely than other groups to believe that ESG has significantly improved returns (66% say this).

CHALLENGES

With little or no exposure to ESG strategies, this group seeks greater conviction around the potential for ESG investing to contribute to long-term performance.

This group is also more likely to cite product availability across a range of asset classes as inhibiting adoption of ESG.

INTERMEDIATE ADOPTERS

This group of investors has embarked on ESG programs with exposures of between 25% and 50% of their investment portfolio.

They have typically been investing in ESG strategies for between two and five years (half of these respondents say this), but 27% of this group have been doing so for more than five years.

Adoption
This group's average exposure to ESG strategies is currently 37%, and their ideal level is just 44% on average.

Integration
Few (22%) have fully integrated ESG into long-term decision-making, but 40% say that they expect full integration across research, security selection, portfolio construction and risk modeling over the next two years.

Engagement
Nearly three-quarters (73%) say they currently engage with companies. Many (43%) do so directly.

Culture
Only two-thirds say that staff are aligned with their ESG strategy, and fewer than four in ten say that the board, senior management and investment teams are fully aligned.

Performance
A little over two-thirds say they have the same expectations for performance for their ESG investments as for their other investments.

Organizational considerations are paramount for these investors. They are more likely to highlight allocation, training and streamlining of resources as crucial for progressing the ESG agenda within their organizations.

HIGH ADOPTERS

These investors have the most mature ESG programs. They cite more than half of their investments as having exposure to ESG strategies, and are most likely to have integrated ESG across research, security selection, portfolio construction and risk modeling. They have typically been investing in ESG strategies for longer than most — half of them for more than five years.

Adoption
These investors are more ambitious about their ESG exposure level, with an ideal level of about 70% of their overall portfolio.

Integration
Momentum is strongest for these investors: they are looking to more rapid, deeper ESG integration into investment strategy. Over half (59%) describe their ESG investment approach as integrated.

Engagement
This group recognizes the importance of engaging with investee companies as part of its ESG approach (81% of the group has an engagement program).

Culture
ESG is more deeply embedded within these investors' organizations. Over half say that all board members, senior management and investment staff are fully aligned, and 77% say that all staff are aligned around ESG strategies.

Performance
Nearly all (91%) say that they expect the same performance from their ESG investments as they do other investments.

Investors with the most exposure to ESG within their portfolios are more likely to agree that they have difficulty benchmarking their performance.

This group seeks more clarity around the credentials of ESG for emerging markets equities, fixed income, multi-asset class and alternative investments.

THE WAY FORWARD

The aspirations and needs of institutional investors around the roles and impact of ESG within their portfolios continue to evolve. Many are seeking a more sustainable approach to investing, one that enables them to address their ethical and responsible investing needs and focuses on long-term value creation.

We believe that the two benefits go hand in hand; the view that high-sustainability companies outperform their peers is gaining broader recognition. Indeed, the survey results confirm that significant interest in ESG is based on a conviction in its potential to improve financial performance, alongside ethical, risk management and fiduciary requirements among others.

Satisfaction among investors with exposure to ESG criteria in their portfolio is high. Yet average exposure, both actual and intended, is low. The capacity or willingness of investors to commit larger proportions of their investments to an ESG lens appears constrained. This comes, therefore, at the expense of harvesting the potential long-term performance benefits that many identify in our survey.

To varying degrees, institutional investors cite a number of challenges or concerns in implementing, or extending the reach of, ESG as part of their broader investment strategy.

Principal among these, is investors need to gauge and measure what can be an uncertain balance of values-based goals with broader risk-adjusted return objectives. The value proposition of ESG needs to be quantified. But ongoing ambiguity around evaluation and the reliability of ESG performance measures creates uncertainty for investors across the adoption spectrum. Meanwhile, the depth of internal capabilities and alignment of stakeholder perspectives also weigh heavily.

Most institutions will struggle to adapt or find solutions to these challenges by themselves. Quality partnerships and ongoing dialog — with both peers and providers — will be crucial to helping more investors to harness the potential of ESG.

Defining ESG

Environmental, social and governance (ESG) investing incorporates an analysis of ESG credentials into the decision to invest — in addition to traditional financial metrics.

It can also encompass efforts by investors to influence the activities of the companies within investment portfolios through voting and engagement, either directly or by an investment manager on the investor's behalf.

EXCLUSIONS

Exclusionary screens seek to align investments with an investor's values or mission. Certain types of investments that may be incompatible with an investor's beliefs are omitted from a portfolio. With this style, values and mission typically carry a greater weight than financial outcomes alone.

INCLUSIONS

Inclusion or positive selection seeks to put capital to work to achieve positive outcomes, both financial and non-financial. Sometimes referred to as impact investing, this style can target a range of focus areas including housing, healthcare, education, resource conservation and gender diversity, among others.

INTEGRATION

Integration seeks to improve financial outcomes by incorporating ESG data into the research and security selection process. In practice, integration is often combined with other styles of ESG investing.

ASSET STEWARDSHIP

Asset stewardship encompasses active engagement with companies across a range of governance and sustainability issues. A combination of guidance and proxy voting aims to ensure invested companies are appropriately focused on longer-term value creation.

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