CITY OF LONDON
Investment Management Company Limited

# Promoting ESG Awareness in Emerging Market Closed-End Funds

**May 2015**

## Background

In early March, CLIM announced an initiative whereby the firm will promote ESG (Environmental, Social and Governance) awareness in emerging market closed end funds (CEFs). CLIM firmly believes that businesses which adopt best practice in their ESG policies will ultimately earn better returns and will use Sustainalytics ESG research as the basis for its work with investment managers.

Historically, Socially Responsible Investing (SRI) principles have entailed applying social screens on portfolio investments in order to avoid companies producing munitions, tobacco, alcohol or other products judged to run counter to specific ethical or moral beliefs. This type of "negative screening," has given way to ESG which focuses on "positive screening" and engagement with companies in an attempt to influence their corporate behavior. CLIM has taken a similar approach with regard to Corporate Governance since 1999, when it began publishing a bi-annual Statement on Corporate Governance and Voting Policy for Closed-End Funds and by actively engaging with Boards of Directors to improve shareholder rights and governance of CEFs. ESG is a natural evolution of this approach and while CLIM cannot screen out securities in the various CEF's according to ESG variables, it can encourage greater transparency from CEF investment managers and the Boards that oversee them. This includes 85% of the securities managed by CLIM on behalf of its clients, including more than 80 CEFs managed by over 40 fund management companies who themselves manage in excess of $12 trillion of assets.

With regard to market performance and ESG, a 2012 review by Deutsche Bank researchers of more than 100 academic studies on sustainable investing had the following to say, "89% of the studies we examined show that companies with high ratings for ESG factors exhibit market-based outperformance, while 85% of the studies show these types of companies exhibit accounting-based outperformance. Here again, the market is showing correlation between financial performance of companies and what it perceives as advantageous ESG strategies, at least over the medium (3-5 years) to long term (5-10 years)." **Sustainable Investing: Establishing Long Term Value and Performance, June 2012, DB Climate Change Advisors.*

## Methodology

The CLIM Research and Corporate Governance teams will use ESG scoring provided by Sustainalytics, an independent ESG research firm, to measure progress on adoption of ESG criteria within each portfolio over annual scoring periods. This project will involve no change to CLIM's investment process. CLIM's intention is to encourage CEF investment managers to be more explicit about how ESG considerations are integrated into their investment processes thereby participating in the expected superior returns emanating from the performance of these securities as ESG factors become more material to total returns.

Sustainalytics' robust analytical framework addresses a broad range of macro-level ESG issues and trends that have a significant impact on each industry and company. The three themes of environment, social and governance are scored according to an analysis of a comprehensive set of core and sector specific metrics that are focused on management preparedness, disclosure, quantitative performance and qualitative performance. An important feature of the analysis is that company scores are determined relative to their industry peers.

## ESG Scoring of Portfolios

A company's overall ESG score is derived from an appropriate weighting of each indicator score. The governance contribution is fixed at 25% of the overall score but environmental and social factors vary between 30 – 45%. Controversy and event assessments, which highlight areas of specific concern relating to ongoing negative developments for each of the three ESG themes, are also a key element of the analysis. The controversy indicators receive a total weight of approximately 40% of the overall score, though this varies slightly per peer group. Significant controversies include a 12 month forward-looking assessment of how an event is expected to develop, whether negative, neutral or positive.

The Controversy indicators are updated fortnightly, while the ESG Rankings are otherwise formally updated annually for each company.

Controversies are rated based on their impact, level of recurrence, degree of exceptionality, level of company's responsibility, company's response to the incident and outstanding risks. The existence of controversies may translate into reputational, legal and financial risks.

All companies are scored in the following 10 controversy areas:

*Environment*

- Operations Incidents
- Environmental Supply Chain Incidents
- Product & Service Incidents

*Social*

- Employee Incidents
- Social Supply Chain Incidents
- Customer Incidents
- Society & Community Incidents

*Governance*

- Business Ethics Incidents
- Governance Incidents
- Public Policy Incidents

Based on the relevancy/importance of the controversy areas to different sectors, the weighting of the 10 individual controversy indicators may vary. Controversies are rated on a hurricane scale of Category 0-5, with Category 5 representing the most severe controversy. The Category ratings correspond to the controversy indicator scores as follows:

| | |
|---|---|
| **Category 0** (no evidence of related controversies) | = 100 |
| **Category 1** | = 99 |
| **Category 2** | = 80 |
| **Category 3** | = 50 |
| **Category 4** | = 20 |
| **Category 5** | = 0 |

Overall portfolio ESG scores are derived from the aggregate of the individual company scores for each of the three themes. These scores, as well as the total ESG score, are compared against scores for the relevant benchmark index and provide a basis for detailed engagement with investment managers.

## CLIM Engagement

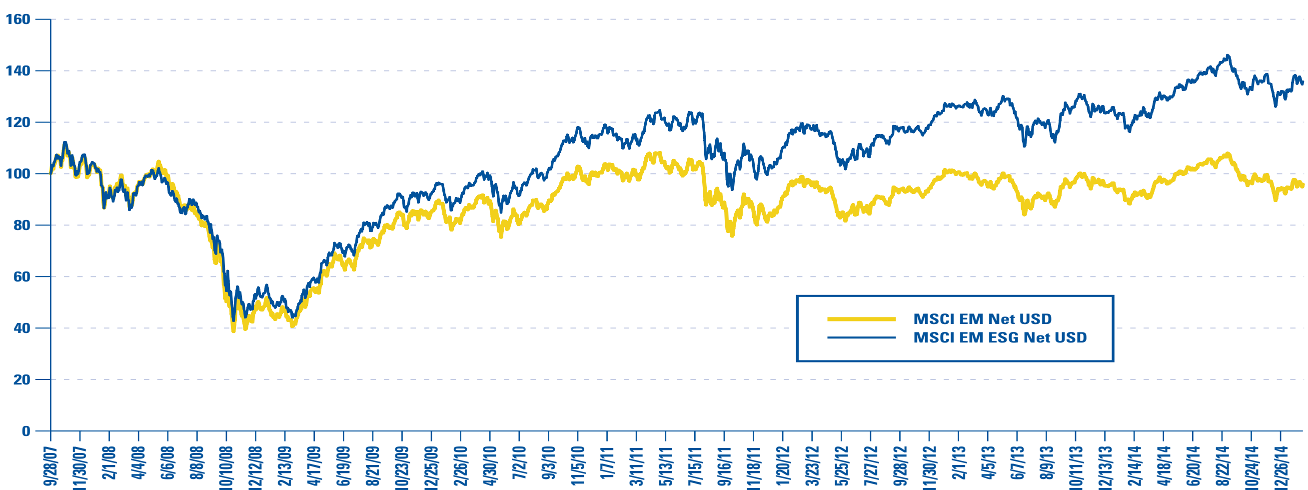
CLIM will engage with CEFs in three ways:

**1. Risk Management** – The manager due diligence process, whereby the CLIM research team verifies that the claims made by managers about their process and philosophy are in fact reflected in their portfolios, is the starting point. In other words, do they do what they say they do? The more information that can be gleaned independently about portfolios, the more effectively the research team can perform this task. The manager's ESG analysis is a valuable additional risk management tool in this work as it assists the research team, for example, to validate the claim generally made by managers that they invest in well governed and well managed companies. CLIM will not be directing investment managers to buy, or not buy, specific stocks – some may make good investment decisions via the purchase of bad companies at cheap prices – as long as they acknowledge this is a risk they are managing. It would be surprising if investment managers said they bought good quality stocks and their portfolios scored poorly. This would be reason for increased Board engagement, especially if investment performance was weak.

**2. Influence** - many managers are significantly increasing the resources devoted to ESG analysis and integrating this work into their existing company research. The CLIM Corporate Governance team is providing impetus to this by encouraging managers, both directly and via Boards, to report more explicitly to shareholders the ESG characteristics of their portfolios. Initial impressions are that no one investment management group has the lead in this area, all are scrambling to build resource, while some are very engaged, others just pay lip service to the approach. In addition, some management groups are just expanding Corporate Governance teams to deal with ESG.

**3. Outcomes and measuring success** – the hope is that CEFs will see increased ESG scores over five years, reflected in improved NAV performance over an investment cycle. When comparing the MSCI EM vs MSCI EM ESG benchmarks from September 2007 to December 2014, (see graph below) the ESG benchmark has outperformed, which while not conclusive, does provide very early indications that ESG considerations can impact investment returns positively in emerging markets.

## MSCI EM vs MSCI EM ESG




*Source: MSCI*

## Initial thoughts

- Based on a very preliminary analysis of initial portfolio reports recently received from Sustainalytics, CLIM portfolios have an above average ESG score, as compared to the MSCI EM index. Early evidence also supports that CEFs have above average scores.
- Closed end fund boards are giving a broadly enthusiastic initial response to this initiative. Managers' response has been more reticent but those with whom we have engaged so far are investigating how to improve their disclosure on ESG issues.
- There is no clear protocol for ESG integration and CEF investment managers are taking different approaches which CoL is better positioned to assess through independent research. The goal is not to prescribe a uniform approach, but to increase awareness of ESG and the risks of not integrating ESG factors in the investment process.
- The ultimate ESG measurement of each portfolio will take into account the score of the relevant benchmark index so as to ensure a consistent comparison.

## Conclusion

The ESG initiative will form part of CLIM's risk management process via the research and corporate governance teams, with no change to investment process. CLIM will engage with CEF investment managers and Boards to raise ESG awareness and will measure progress using ESG scores over multiple time periods. Please stay tuned for periodic updates on this initiative.

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