How City of London Investment Management Uses ESG Research

CITY OF LONDON
Investment Management Company Limited

June 2016

Why is ESG Analysis Part of CLIM's Process?

In March 2015 CLIM launched an initiative aimed at understanding better the environmental, social and governance (ESG) characteristics of the underlying closed-end fund (CEF) portfolios. The impetus for this project was a belief that corporations' ESG performance has implications both for financial performance and for business risk. Growing interest in sustainability is a broad social trend and so ESG analysis is emerging as a mainstream tool for investment appraisal. The Global Sustainable Investment Alliance has estimated that the proportion of all assets run according to sustainable criteria rose to 30% in 2014 from 22% in 2012 (source: Financial Times).

Governments increasingly legislate to hold corporations more accountable for the environmental consequences of their activities, to encourage higher health and safety standards and to promote more effective governance. Companies therefore face growing pressure to be seen as responsible corporate citizens and corporates risk severe financial penalties for breaching the associated regulatory obligations.

Historically ESG analysis has been associated with screening only by socially conscious investors but these issues should now interest all investors. From a governance perspective, corporate leadership, executive pay, audits, internal controls and shareholder rights have always been important issues for shareholders. In more recent years high profile industrial disasters, such as BP's Deepwater Horizon oil spill, have highlighted that stewardship of the natural environment is a significant business risk, with a consequent impact on equity valuation. The link between corporate social responsibility and financial performance is less clear cut, though most investors would accept that corporations can strengthen their franchise by more effective management of their stakeholder relationships with employees, suppliers, customers and local communities.

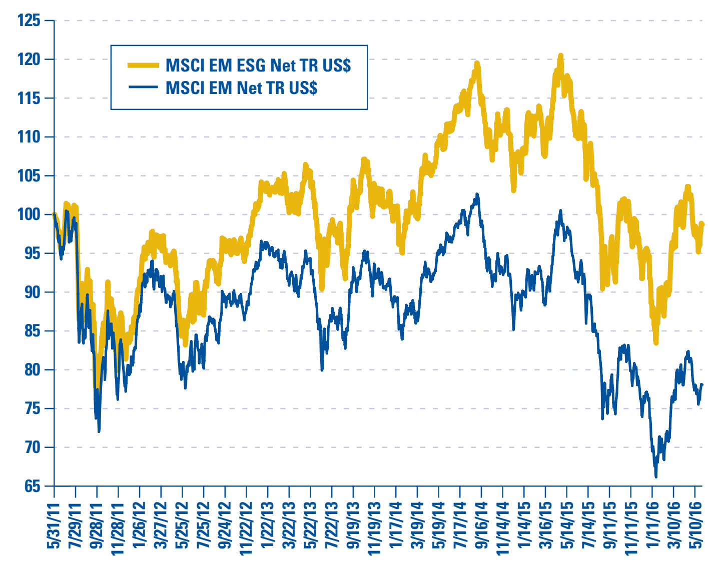
ESG research hence offers insights into the quality of a corporate franchise and management's diligence in meeting its regulatory obligations. CLIM has partnered with Sustainalytics, a leading independent provider of ESG research, to aggregate this information at the portfolio level. This is helping CLIM's research teams to understand better Managers' investment styles and is also presenting a new perspective on portfolio risk.

How Can ESG Research Help CLIM Achieve its Investment Objectives?

CLIM's objective remains to outperform benchmarks primarily by exploiting CEF discount volatility and secondly via active asset allocation. In respect of the underlying CEFs, Manager skill in aggregate, as measured by the total NAV contribution to relative performance, is not expected to significantly impact relative returns for CLIM's clients over an investment cycle. None of this has changed. However, Manager due diligence is an important element of CLIM's research process and Sustainalytic's research is helping CLIM to maintain its competitive advantage in this area.

Some academic research has demonstrated that stocks with higher ESG performance exhibit a lower level of stock specific risk. Other studies also suggest a tendency by sustainable investment strategies to outperform. While the overall body of research is not conclusive on these points, it is notable that the performance of ESG indices, in the short period since they have been launched, has generally been satisfactory versus the 'parent' indices. In emerging markets equities, however, ESG strategies have exhibited relatively strong performance trends.

Figure 1: 5 Year ESG Performance



Source: Bloomberg

Figure 1 shows that the MSCI EM ESG index outperformed its parent index by over 4% pa in the five years from launch in May

2011. The evidence suggests that ESG analysis does help measure business quality and that superior ESG performance could be a good indicator of long term franchise durability. Certainly, achieving a superior ESG assessment demands robust procedures and controls. Hence, while ESG analysis is not a substitute for rigorous financial analysis, it does highlight management diligence in meeting stakeholder needs.

CLIM's key source of alpha remains exploiting discount volatility. However CLIM's own portfolio construction is enhanced by a thorough understanding of the investment characteristics of the underlying CEF portfolios and ESG research is part of this process. CLIM's Manager due diligence now includes an ESG assessment, giving CLIM a research advantage by providing evidence to challenge portfolio construction from a new perspective.

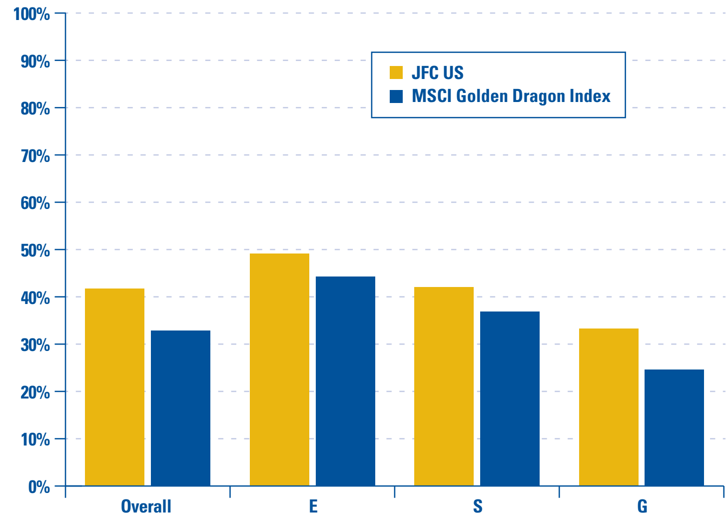
What is CLIM's ESG Research Process?

CLIM does not undertake its own in-house ESG research but has partnered with Sustainalytics, a leading independent ESG research specialist, to assess portfolio ESG characteristics. Sustainalytics scores companies, typically against 60 - 80 relevant indicators that cover preparedness, disclosure, quantitative performance and qualitative performance on each E, S & G theme. Each indicator is weighted to produce an overall ESG score, which can be compared against an appropriate benchmark.

CLIM presently commissions circa 50 portfolio analytics reports each year covering over two thirds of AUM. These reports aggregate the portfolio holdings scores and hence conveniently summarise each CEF ESG characteristics versus its relevant benchmark. The key output is the 4 scores, overall, E, S & G vs benchmark at the portfolio level. In addition to these scores for each security, the report includes an analysis of quintile and sector distributions, the top ten and bottom ten ESG performers and a controversy distribution.

Figure 2 reproduces an extract from the summary page of Sustainalytics' ESG Portfolio Analytics Report on the JPMorgan China Region Fund (JFC), produced in March 2016. JFC is a typical CoL portfolio from an ESG perspective, to the extent that its profile closely resembles the average results. The scores are based on an analysis of 84 securities which account for 87% of the JFC portfolio. The chart shows the overall ESG score is 9% ahead of the benchmark and that the three themes are also all above average E (+5%), S (+5%) and G (+9%). The detail of the report demonstrates that JFC's quality bias results principally from its stock selection in the Information Technology and Financials sector. The report also notes that JFC has no significant overweight positions (>1%) in the lowest performing ESG performers.

Figure 2: JPMorgan China Region Fund Relative ESG Performance*



**Relative performance is calculated as weighted sum of percentilerank.*

Source: City of London Investment Management, Sustainalytics

The strength of this comprehensive process is that it produces clear overall results. The portfolio analytics reports provide a sound basis on which to challenge Managers' specific stock selection decisions and they are shared with Managers as required in order to facilitate constructive dialogue.

The portfolio analytics reports provide valuable context for analysing a fund's investment performance. In the event of an unexpectedly low ESG score, CLIM drills down further into the ESG reports for the underlying companies and engages with the Manager for an explanation of the investment case for these securities. CLIM will not routinely raise low ESG scores with Boards but poor investment performance is a matter that will be escalated and if appropriate the ESG score will also be referenced. The ESG score of one such fund prompted a concern that the individual portfolio manager may not have adhered sufficiently closely to the house investment process. Such a reasoned, evidential approach enables CLIM to leverage its influence on Managers via its Board engagement and our influence is disproportionate to the size of our positions.

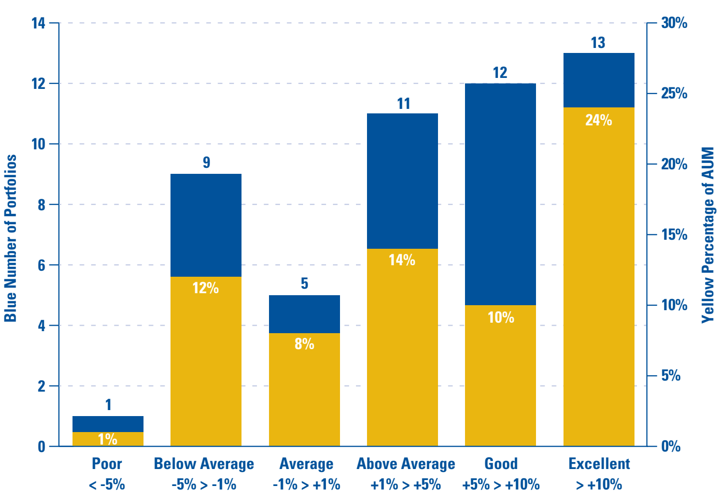
What More Does CLIM do to Engage on ESG Issues?

CLIM is also engaging with the Heads of ESG at investment managers. This is a relatively new role at most firms, a trend that reflects the growing momentum for managers to integrate ESG research more fully into their investment processes. Our engagement helps to establish the extent to which ESG research is fully integrated as opposed being more of a reporting function. The engagement is also helping CLIM to gain internal supporters at investment managers as we encourage CEFs to adopt ESG reporting beyond the brief 'boiler plate' statements that have historically been the norm. This is a key element in our strategy to promote greater transparency on ESG issues.

How Do CLIM Portfolios Score on ESG Issues?

CLIM's ESG research has established that clients' underlying CEF portfolios do tend to be invested in superior quality companies. Fifty one portfolios have been analysed at least once, representing over two thirds of AUM. Sustainalytics research covers on average circa 85% of the portfolio holdings, ranging from 40% for small cap portfolios to 100% for those with a large cap focus. Overall CLIM portfolios score, on a weighted average basis, 6 percentage points ahead of the benchmark. The distribution of the 51 portfolios analysed in the process to date, in figure 3 below, shows the profile of these funds according to their overall ESG rating. The largest block, representing approximately 25% of funds and AUM, have achieved excellent scores. It is also notable that CLIM is invested mostly in funds that score above average.

Figure 3: Overall ESG Percentile Ranking vs Benchmark

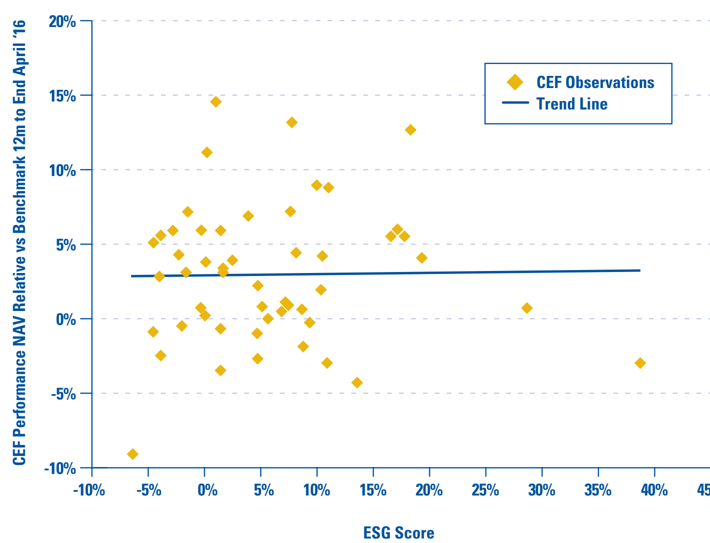


Source: City of London Investment Management, Sustainalytics

How Does CLIM Measure the Effectiveness of its ESG Research?

CLIM's objective remains to deliver superior relative investment performance for its clients. The ESG initiative does not signal any change from this imperative. ESG research has helped CLIM's research teams gain better insights into Managers' investment styles but what about investment performance? This is a long term project and we do not argue that there should be a strong relationship between short term performance and ESG performance. Nevertheless it is interesting to review the results of our ESG research against one year relative returns for 12m ending April 2016, the period since the initiative was launched. The scatter chart in Figure 4 shows that the line of best fit for all 51 observations is in fact virtually flat.

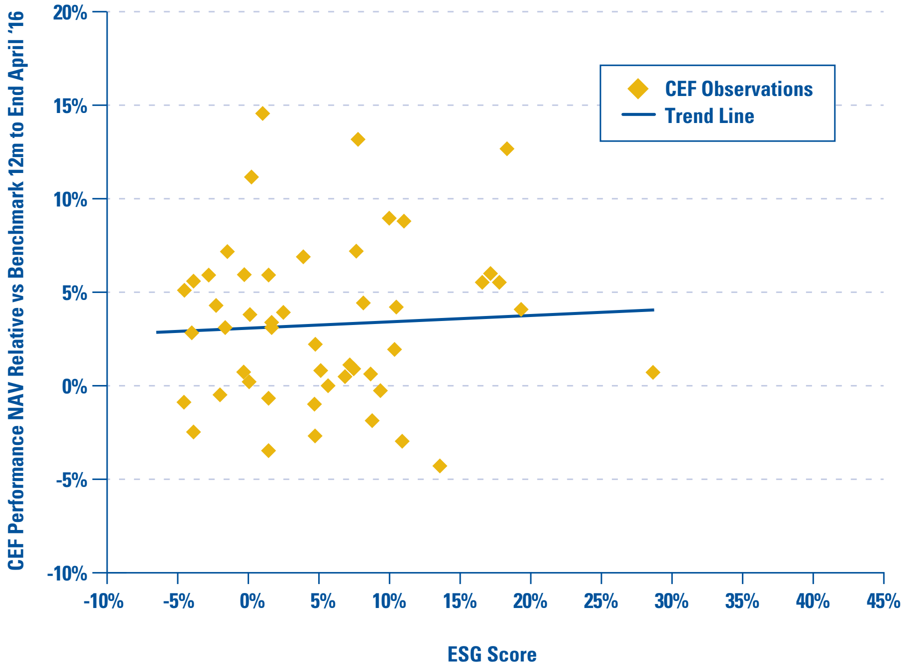
Figure 4: NAV vs ESG Performance All Observations



Source: City of London Investment Management

The statistical significance of the data over this short period is weak but it is CLIM's intention to provide further updates as we continue this process. Excluding the best and worst ESG scores, however, does produce a moderately positive slope as shown in figure 5.

Figure 5: NAV vs ESG Performance (excluding 2 outlying ESG Observations)



Source: City of London Investment Management

CLIM's influence over specific stock selection in each underlying CEF is extremely limited. CLIM's investment process neither excludes specific business activities, such as alcohol and tobacco, nor are Managers encouraged to buy or sell specific stocks. However CLIM does encourage Managers to be more transparent regarding the ESG characteristics of their portfolios, specifically to provide more detailed reporting of voting records and engagement on ESG issues. Progress is being made on transparency but it is incremental and reflects pressure from a number of sources, including CLIM.

CLIM has adopted a relative approach to measuring ESG performance. The methodology does not make a value judgement on a specific industry but it does facilitate comparison of corporations in the same industry. This methodology hence measures the extent to which portfolios holdings are invested in 'best-in-class' companies from an ESG perspective.

Improved ESG disclosure, while not immediately transformational, will in all likelihood make a significant medium term contribution to raising the underlying portfolio ESG performance. A good analogy is the fuel consumption indicator on a car dashboard, which does not directly impact fuel economy but can have a significant indirect effect via its influence on driver behaviour.

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