

Inspired thinking



PRI: One year on

Introduction

In early July, the UN Principles for Responsible Investment (PRI) held the first annual event for its signatories. Since the PRI's April 2006 launch, its signatory base has grown to over 200 organisations representing \$10 trillion of assets. Having started out with an already impressive \$4 trillion worth of assets supporting the PRI at launch, this substantial and rapid acceleration of support is phenomenal. Members come from all corners of the globe: at the time of writing, asset owner members included government pension schemes in Australia and New Zealand, Canada, South Africa and Thailand, including 15 Brazilian pension funds and nine Korean institutions. Asset managers from several European countries, the US, Brazil, Japan, Australia and South Africa are also represented. Overall, 41% of signatories are European, 25% are North American and 34% from other regions, mostly emerging markets. Many research organisations and service providers have also joined.

The PRI provides those institutions responsible for overseeing and investing the savings of millions of beneficiaries – asset owners and asset managers – with a common framework to guide their approach to taking into account environmental, social and governance (ESG) issues in their investments. It also provides a way for members to learn from one another, to develop best practice and share experience, to join forces to address particular ESG issues and to debate emerging issues. And because the PRI is sponsored by the United Nations Environment Programme (UNEP) and the Global Compact, it also provides a valuable way for investors to interface with the UN and the member companies of the Global Compact, and to tackle important global issues from climate change to child labour together.

Status of implementation after one year: summary of findings

In early 2007, signatories were asked to complete a questionnaire developed by investment consultants Mercer for the PRI secretariat; of those approached, 85% of asset owners and 69% of asset managers – including Insight – did so, representing 75% of total PRI assets. The summary report – PRI Report on Progress 2007 – offers a solid – albeit self-reported – early picture of members' progress towards embracing and implementing the six Principles. This article provides a brief review of progress against each principle as well as some commentary from Insight.

Principle 1: Integrating consideration of ESG issues into investment decision-making

Overall, signatories demonstrate most progress in implementing this Principle (as well as Principle 2). 67% of asset owners and 83% of asset managers claim to have adopted a formal policy on responsible investment. The majority report they have focused on equity assets, but plan to extend integration to private equity, real estate and fixed income in the future. Moreover, more than half of investment managers and 40% of asset owners claim that they already integrate consideration of ESG issues into internal investment decision making processes 'to a large extent'. 22% of asset owners say that they are already considering RI or ESG issues in asset manager selection and 14% of investment consultants say they consider these issues when short-listing managers. However, 18% of asset owners and 12% of asset managers have no policy in this area as yet and did not commit to adopting one in 2007.

Comment

While these findings are encouraging, they do not demonstrate precisely how signatories are integrating ESG factors. There are several different ways this can be done – and one of the strengths of the PRI is that it allows individual asset managers to adopt strategies appropriate to their business models and that meet their clients' needs. However, some approaches are more robust than others. We believe that proper integration of ESG issues – where asset managers incorporate consideration of these issues into their every day investment decisions – will only be achieved by adopting rigorous processes that analysts and fund managers are fully involved in developing and thus supportive of. This can be done using a top-down process, for example, by analysing long-term environmental and social trends and considering whether they are likely to affect particular sectors and stocks, and/or by working bottom-up and assessing companies' ESG performance at a stock level and consistently taking that assessment into account in stock selection. Insight employs both approaches very effectively. We are sceptical that this can be achieved by buying-in standardised analysis of companies' ESG performance which hasn't involved discussions with the companies to fully understand their exposure to ESG issues and their approach to managing them.

It is particularly important that signatories are more transparent about their approach to integration. Moreover, Insight would encourage the PRI to facilitate dialogue between asset owners and asset managers, and between asset managers, so as to build an understanding of the different approaches they employ and their relative effectiveness.

Principle 2: Being active owners, incorporating ESG issues into ownership policies and practices

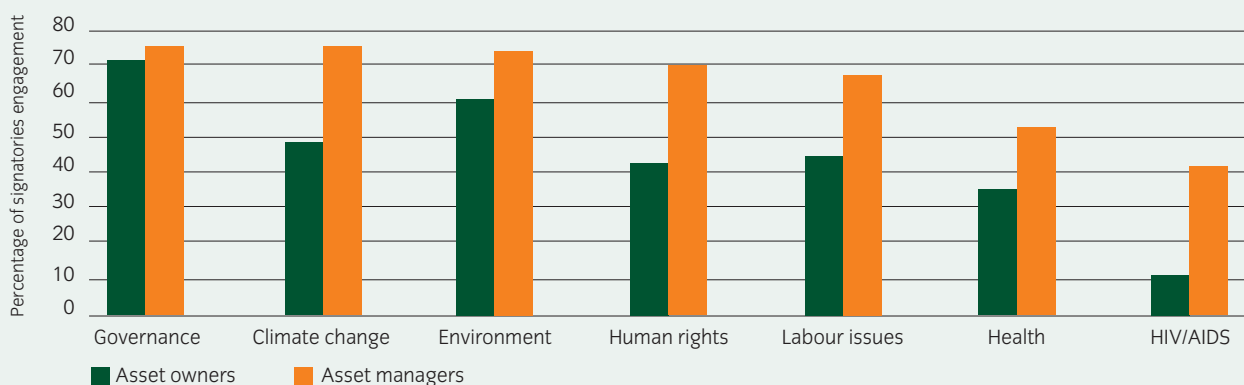
Voting

Commitments to active voting appear to be quite high: 93% of investment managers have a voting policy; 85% vote on behalf of their clients, and 78% claim to be able to execute client-specific voting policies. Asset owners often outsource voting to their managers. Asset managers tend much more than asset owners to disclose their voting policies. Although most investment managers execute votes themselves or work with voting agencies, 20% outsource their voting entirely. However, only 53% of asset managers track voting instructions, and 47% require voting reports; the equivalent proportions for asset owners are 38% and 37%.

Comment

While the majority of signatories claim to be voting actively, a lack of transparency seems to be the main issue. Many asset owners are not yet disclosing their voting policies and many asset managers are not reporting publicly the voting recommendations they were to clients or how they vote on their clients' behalf. Insight has for several years disclosed its voting recommendations on the FTSE350 and provided a commentary on the reasons for our voting decisions. We also provide those clients with a specific interest information on our voting decisions beyond this universe of stocks. We believe offering this level of transparency is a basic and important element in demonstrating active, responsible share ownership. We do not see that this presents any difficulties in relation to commercial confidentiality.

Chart 1: Extent of signatories' engagement on different ESG topics



Engagement

There is quite a high level of engagement among signatories, both on environmental and social issues, and governance issues. Fully 74% of investment managers state that they engage directly with companies, as do 50% of asset owners. Only 18% of asset owners and 12% of asset managers do no engagement at all, with the remainder delegating engagement to their existing fund managers or by using independent engagement overlay service providers.

Chart 1 outlines which issues signatories engaged on most. There is a good mix of environmental and social issues, with governance issues being the most prevalent. Engagement is reportedly primarily stimulated by wanting to understand and encourage companies to address risk factors, to address a theme identified by an investor or in reaction to news or events. 28% of signatories engage on the basis of specific client direction.

In terms of assessing engagement success, 38% of investment managers and 24% of asset owners say they set engagement objectives and have developed sophisticated mechanisms for tracking and measuring this. Nearly half of investment managers (49%) and just over a quarter of asset owners (28%) claim to be able to provide evidence of improvement in performance on an ESG issue by companies with which they engaged.

Comment

Many PRI signatories are clearly convinced of the case for engagement and are already quite active. However, there can be several motivations for engagement. It can simply be to gather information (and thus help to inform investment decisions for some funds), or to build a relationship with a company. We believe that it is vital that it is also intended to improve corporate performance on ESG issues. Fund managers need to be clear about the type of engagement they do and whether it results in the outcomes they set out to achieve.

At Insight, our engagement serves all three purposes, but it is fundamentally intended to improve corporate performance. In order to assess the effectiveness of our engagement activities, we maintain records of who we have spoken to, the objectives of our engagement, the current status of the dialogue, the manner in which corporate performance has changed and the reasons for the change. (For a comprehensive account of our engagement activities, see <http://www.insightinvestment.com/uk/responsibleinvestment/riandcg/riliterature/>).

There is clearly also a good case for greater coordination of engagement between and among asset owners and asset managers to share views and develop a consensus about what the appropriate approach to managing particular issues should be. This would help to ensure that companies receive consistent messages from investors and are rewarded for the right behaviour. The Engagement Clearinghouse set up by the PRI should help to facilitate this.

Principle 3: Encouraging appropriate ESG disclosure

Promoting better reporting is an important element of the PRI. Without good reporting, asset owners and asset managers don't have the basic information they need to begin to assess companies' management of their key risks and impacts – and neither do other stakeholders. Signatories are encouraging better reporting by companies on ESG issues. They are doing this by supporting initiatives like the Carbon Disclosure Project (CDP), the Global Reporting Initiative (GRI) and the Extractive Industries Transparency Initiative (EITI). 54% of asset owners and 85% of asset managers have 'to a small or large extent' asked companies to produce standardised ESG reporting.

Comment

Appropriate disclosure on ESG issues is essential to provide shareholders with the confidence that the risks and opportunities associated with these issues are being managed effectively. Yet, in our experience, the quality and consistency of corporate ESG reporting varies a great deal between sectors as well as between companies. This lack of consistency and rigour makes it extremely difficult to make meaningful comparisons of the performance of companies. This, in turn, limits our ability to assess how performance in those areas may affect the financial performance of companies and, hence, investment returns. Investors can play an important role in the development of clear and consistent guidance for companies about how they should report.

An even more important debate is how (financially) material ESG issues and socially or environmentally important issues should be treated. In our view, it is critical that companies are clear about which, if any, ESG issues are financially material or strategically important to their business. It is these issues, and these alone, that should be included within annual reports and accounts, as they are relevant to shareholders. Companies should explain the basis on which they assess the materiality of ESG issues and the actions they take to manage them. If none is considered

material, this should be stated, with a clear explanation of why that is considered to be the case, and no further commentary need be provided. In terms of wider reporting, companies should also provide appropriate commentary, through annual corporate responsibility reports or similar, or on their website, on all ESG issues as they believe is relevant to their stakeholders.

We are concerned, however, that some investors pressure companies to include discussion of non-material and non-strategic issues in their annual reports to shareholders. This is an area where we would particularly encourage greater investor discussion and coordination.

Principle 4: Promoting the acceptance and implementation of the Principles within the investment industry

Among asset owners, 23% claim to already be including 'to a large extent' PRI-related requirements in requests for proposals from fund managers; 38% do so to a lesser extent, and 23% plan to do so in 2007. This leaves only 15% not planning to take this route at present.

However, there appears to be little use of performance indicators and little evidence of incentive structures to promote ESG integration.

Signatories have also engaged in dialogue to quite a large extent with policymakers to promote responsible investment. 41% of asset managers have done so, as have 28% of asset owners, although 33% of the latter signatory group have not done so at all so far.

Comment

One of the most important drivers for responsible investment will be asset owners' routinely requiring all of their asset managers to embrace the Principles. We hope to see much greater evidence of this in the next few years. This could be strongly facilitated by investment consultants or other parties beginning to formally evaluate the responsible investment capabilities of asset managers. Ideally, asset owners should: i) build into their manager selection process the consideration of managers' capabilities to deliver on the PRI's commitments; ii) consistently and regularly monitor the performance of managers, and; iii) tie a proportion of asset managers' compensation to their performance in this area.

Principle 5: Working together to enhance effectiveness

A large number of signatories take part in a range of ESG-related industry groups and initiatives. In total, they support 57 different initiatives. By far the most strongly supported is the CDP, along with the International Corporate Governance Network (ICGN). They are also gradually beginning to use the PRI Engagement Clearinghouse to alert others to engagement initiatives underway and to recruit others to support.

Comment

Some companies and commentators are calling for investors to collaborate more to lessen the duplication of their information-gathering, research and engagement activities. In principle, we support greater investor collaboration, as it should allow investors to send more consistent messages to companies as to the standards of corporate governance and responsibility that are expected and to set common expectations of good practice.

However, it is important that collaborative initiatives are directed towards encouraging real improvement in corporate behaviour and performance, are efficient in terms of the time and resources required, and achieve better outcomes than individual investors would acting alone. We are not convinced that all collaborative initiatives meet these tests at present. We therefore encourage the Clearinghouse to focus on ensuring that the collaborative engagement it facilitates in future meets these tests. However, given the diversity of PRI signatories, they will not always have a uniform view as to the response they would like to see from companies. Religious investors, for example, may want to push companies to do or stop doing particular things with which other non-religious investors may disagree. Thus, a range of different collaborative engagement projects will no doubt emerge, and a fully consistent line from all investors may not always be possible.

Principle 6: Reporting on activities and progress in implementing the PRI

A strong focus of investors' work is to encourage companies in which they invest to disclose sufficient, relevant information on their ESG performance. Equally, PRI supporters have a particular responsibility to ensure that they set an example and provide systematic, clear disclosure on their own activities in this area.

Some are already doing this: the following percentages of signatories claim that they, to a large extent:

	Asset managers	Asset owners
Disclose how they integrate ESG issues into investment processes	52%	42%
Disclose voting records	62%	33%
Systematically report on ESG engagement, results and progress	47%	37%
Use the PRI 'comply or explain' approach	18%	21%

Comment

As responsible investment moves towards the mainstream of investment practice, pressure will build for all players in the industry to be much more transparent about how they deliver it. But better individual disclosure alone will not address the particular challenge faced by pension funds – namely, how to differentiate between those investment managers who are committed to the proper integration of ESG issues and meaningful engagement with companies, and those that simply take a tokenistic or tick-box approach.

We believe this gap could – and should – be filled by the UN PRI by ensuring that the annual summary reports provide more clarity as to each signatory overall performance and providing pension funds with the information they need to differentiate between asset managers. We hope it will focus on encouraging leadership and a ‘race to the top’ – and thus be recognised as an initiative that drives best practice rather than being labelled a talking shop or being seen as an initiatives that promotes compliance and no more.

Our reflections one year on: credibility is key

We are strong supporters of the PRI. As with any initiative, credibility is critical to its success. We believe there are three ways in which the credibility of this nascent but very important initiative can be bolstered and protected.

First, it should consider carefully the basis on which signatories are accepted. In aiming to mainstream responsible investment, it would clearly be tempting for the PRI to accept any and all signatories in an effort to meet its stated target of increasing the number of signatories. However, we believe that signatories should have to demonstrate a minimum level of commitment to responsible investment prior to being able to join. For example, they should be required to have published a responsible investment policy and then perhaps be required to have reached other milestones after one and two years of membership that demonstrate their commitment to continually improving. Setting a minimum standard will protect the reputation of other members and avoid the problem of free riders that similar initiatives have experienced. In addition, there should be a process for identifying and expelling signatories who do not meet the minimum requirements.

A second element critical to securing the PRI's credibility is putting in place a robust auditing process for the annual assessment of signatories' progress. In this first year, the report discussed in this article is based on signatories' own submissions that were not subject to any verification. Insight would strongly support an additional level of independent scrutiny being adopted in this process.

The final and very important element relates to the governance and operation of PRI itself. The large number of signatories the PRI has attracted in a short amount of time demonstrates that it is seen by leading asset owners and asset managers as having the potential to add real value. Although the PRI was initially conceived and developed by a group of pension funds, and has to date been directed by a Board comprising only of asset owners, it now seems appropriate that its governance arrangements should evolve so as to embrace and fully engage its wide signatory base. It is particularly important that the PRI demonstrates that its governance practices are beyond reproach and appropriate to an organisation dedicated to promoting high standards of corporate governance among companies around the world.

November 2007

Produced by the Insight Investor Responsibility Team

Web: http://www.insightinvestment.com/responsibility/investor_responsibility_home.asp

Tel: 020 7321 1162