Aon Investment Research and Insights

An Investor's Guide to Responsible Investment

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Empower Results®

Table of contents

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Aon's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

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Introduction

Responsible Investment is in the headlines.

Globally, investors are beginning to acknowledge that non-financial risks may have a meaningful impact on long-term financial performance.

Companies and investment managers are reacting to increasing demands from investors to understand specific, non-financial aspects of their business by providing more appropriate disclosures.

Many governments around the world increasingly view Responsible Investment as an imperative and are encouraging, guiding, or legislating that investors and companies operating within their borders must be able to deliver on sustainability, climate and social development goals and promises.

Responsible Investment, and more specifically Environmental, Social and Governance (ESG) integration, builds on the premise that robust, long-term sustainable investment returns are dependent on stable, well-functioning and well-governed companies, industries and economies.

While traditionally, consideration of non-financial ESG data has not been included as part of traditional fundamental financial analysis, assessing these non-financial risks can provide financial opportunities.

This area should be of interest to investors hoping to build investment portfolios that are resilient to change and deliver better long-term risk-adjusted returns.

The purpose of this paper is to provide an introduction to Responsible Investment, including the main approaches and the investor landscape.

Defining the purpose of Responsible Investment

One of the challenges around Responsible Investment is the differing views around its purpose, methods and value.

The Investment Leaders Group (ILG) of the Cambridge Institute for Sustainable Leadership – of which Aon is a member – has sought to define this as part of its core mission to help shift the investment chain towards a more sustainable and responsible investment process.

The ILG defines Responsible Investment as having three main drivers:

- Enhanced returns
  Responsible Investment is a means of enhancing returns by incorporating information on longer-term risks faced by companies and economies into the investment decision-making process. Sustainability 'megatrends' such as climate and demographic changes, as well as increasing resource scarcity can provide greater insight into tomorrow's winners and losers.
- Economic imperative
  These same megatrends will disrupt economic prosperity as costs escalate in response to this scarcity, and as socio-economic disparities widen. Unless current trends are reversed, economies will be weakened and subjected to bubbles and economic downturns driven by sustainability issues.
- Service to society
  Investment should be a service to society; a means of tackling social and environmental problems through effective deployment of capital. Investors should seek to invest in a way that is construed as constructive rather than detrimental to sustainability.

The ILG contends that these three perspectives are not mutually exclusive and can be held at the same time. However, a responsible investor may be more strongly influenced by one particular perspective over the other two.

Regardless of your motivations, there is a Responsible Investment approach tailored to your needs.

The universe of investment approaches

Responsible Investment can be viewed as an overarching theme for a number of investment approaches. At Aon, we consider the universe of Responsible Investment to have four main components: ESG Integration, Impact Investing and Socially Responsible Investing (SRI), any of which may be utilised alone or incorporated into a Mission-Related Investing (MRI) approach.

SRI tends to be the area most investors are familiar with, as it is the oldest of the four broad Responsible Investment categories. SRI tends to use a negative selection process; excluding certain sectors or investments from a portfolio based on an individual's or an organisation's value system. On the other hand, Impact Investing typically focuses more on positive investment inclusion criteria rather than negative screening.

Investment approach	Definition	Impact on selection process	Examples
ESG integration	Integrates environmental, social and governance non-financial data into fundamental investment analysis to the extent they are material to investment performance	Positive/negative/neutral	A fund manager who has a clear and systematic process on how financially material ESG factors are identified and incorporated into the decision-making process
Impact Investing	Looking for investments that have a positive investment return as well as a desired social, economic or environmental outcome	Positive	Low-income housing, clean drinking water, clean technology projects, protecting biodiversity
MRI	Placing investments (or avoiding investments) into companies or funds that complement (or are counter to) an investor's mission	Positive or negative	Healthcare, child issues, religious beliefs
SRI	Attempting to screen out investment in stocks, companies or industries based on a set of ethical values	Negative	Private prisons, carbon, coal, fossil fuel, cluster munitions

Investor values

Investor values are most prominent in Impact Investing, MRI and SRI, and can represent a positive or negative input into an investment decision. Some investors negatively exclude companies in the gambling industry – an example of an SRI approach.

Impact Investors may wish to identify investment opportunities which help unemployed people in developing countries or boost investment in renewable energy or help develop cures for disease. In all cases, the investor values drive the decision-making process.

ESG investing

ESG investing is fundamentally different from the other approaches mentioned. Instead of being driven by values, investment decisions are still directed by the fundamentals of the company. However, in addition, non-financial ESG factors are also considered to the extent they are material to the company's future financial performance.

Within an ESG approach, material ESG factors are considered alongside fundamentals (financial data) where relevant. An ESG consideration would be considered 'material' to the extent it is believed to impact (positively or negatively) the investment's current or future value.

ESG factors that may be considered material to a company's financial performance could include the following:

- Environmental factors – use of water, alternative energy, climate change mitigation or adaptation, etc.
- Social issues – diversity, working conditions, consumer protection, human rights, education, health, etc.
- Corporate Governance – transparency, disclosures, reporting, incentives, board composition, executive compensation, checks and balances against fraudulent activities, etc.

Responsible Investment encourages investors to look at a firm's ESG policies to determine whether that company has implemented best practices in each of these areas (i.e. whether it is making efforts to maximise corporate responsibility and sustainability).

A changing landscape

Regulatory changes

Key bodies and policymakers have issued stronger guidance for institutional investors to take account of ESG risks. For example, the Pensions Regulator expects the trustees of pension schemes to consider the financial impact of long-term sustainability risks when setting investment strategies. Encouragement from regulators is expected to lead to better outcomes for beneficiaries.

Demographic shift

In the coming decades the millennial generation will begin to inherit wealth transferred over from previous generations. This shift of wealth may have lasting consequences if millennial investment interests diverge away from traditional standards. Studies conducted by BlackRock have shown that 67% of millennials want their investments to reflect both their social and environmental values.

Increasing weight of academic support

In a 2012 Deutsche Bank meta study, "*Sustainable Investing: Establishing Long Term Value & Performance*", eight studies linked strong corporate governance to financial outperformance, while five studies linked environmental factors to outperformance. Although only one study linked non-financial social factors to outperformance, there is a growing body of research that suggests issues like diversity have a material impact on financial performance.

Challenges ahead

Aon believes ESG risks will be significant drivers of future risk and return and so should not be ignored when making investment decisions. However, it is also important to recognise potential challenges to assess subjective inputs for investors.

- Accessibility – Each investor has their own risk and return criteria, so it may prove difficult to provide a 'one size fits all' investment opportunity for different investors.
- Clarity and consistency – It is essential that universal Responsible Investment terminology is adopted in order to alleviate misconceptions and confusion around Responsible Investment funds and products.
- Measurement changes – Responsible Investment promotes long-term sustainable growth. Current methods of reporting performance such as quarterly reports are perhaps insufficient for those with a long-term view, as they are focused on short-term performance. New methods of reporting need to be considered in order to present a complete picture of Responsible Investment-related investments.

What can investors do?

A great place for investors to start is by understanding the risks and exposures already embedded in their portfolio. This will lead to a clearer understanding of investment managers' policies and actions. Scenario testing for example is also a useful tool to understand how broader influences such as climate change may impact future results.

We have set out five possible questions below, which investors could ask their investment managers to begin this process.

1. What is your approach to Responsible Investment and how do you believe that will add value or reduce risk?
2. Are you a signatory to the United Nations Principles for Responsible Investment (UNPRI)?
   - The UNPRI is a set of six principles and signatories should be able to provide their latest transparency or assessment reports. These outline a manager's approach and provide high level assessment from the UNPRI.
3. Do you have resources dedicated to Responsible Investment?
4. How do you incorporate Responsible Investment into your investment decision-making for our portfolio?
5. Are you able to provide examples of how you have incorporated Responsible Investment views into your investment decision-making?

This type of exercise can help investors shape their own Responsible Investment policies and ESG beliefs.

Conclusion

The Responsible Investment landscape is evolving and the pace of change is rapidly accelerating. Regulators are applying pressure on investors globally and investment managers are reacting by launching products and implementing and updating ESG policies.

We believe long-term investors should define their own Responsible Investment beliefs and we suggest talking to your Aon contact to determine how Responsible Investment and ESG considerations can be incorporated into your investment decision-making.

We're here to empower results

For more information visit
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