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Demystifying ESG and Responsible Investment

Vicki Bakhshi, Director, BMO Global Asset Management

About BMO Global Asset Management

Leadership

- Launched Europe's first social and environmentally screened Fund in 1984. One of the largest Responsible Investment teams in Europe

Global coverage

- Experienced, well resourced, active global equities team (50 in total) with extensive fundamental research capabilities and risk management

In-house expertise

- Dedicated Governance and Sustainable Investment team (15 in total) conducting ESG analysis, proxy voting and engagement

Engagement

- Our GSI team engaged 1,363 companies across 62 countries in 2017

A history of innovation in Responsible Investment...

1984	1987	1998	2000	2006	2007	2010	2012	2014	2016	2018
Launch of Stewardship Growth - first ethical fund in UK	Launch of Stewardship Income & Stewardship North American funds	Stewardship North America becomes Stewardship International fund	Launch of Responsible Engagement Overlay (reo®)	Founding signatory to Principles for Responsible Investment (PRI)	Launch of Ethical Bond fund	Launch of Emerging Markets ESG Strategy	Launch of ESG Risk Tool	Rebranded as Responsible Fund range	Launch of BMO Responsible Global Equity Strategy ESG Profile and Impact Annual Report	Publication of Ireland Roadmap - June 2018 Launch of BMO Responsible Euro Credit Fund

Source: BMO Global Asset Management as at 31.07.2018. ESG = Environmental, Social and Governance. GSI = Governance and Sustainable Investment.

Today's agenda

Setting the context

- What – Defining responsible investment
- Why – Drivers for growth
- How – Options available for investors

How to develop an ESG strategy

- Four-step action plan

Hot topic: Climate change

Defining responsible investment

What is responsible investment?

“Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns”

- *UN Principles for Responsible Investment*



Environmental

- Climate Change
- Water Management
- Pollution



Social

- Labour Standards
- Human Rights
- Health and Safety



Governance

- Executive Pay
- Business Ethics
- Corporate Governance

From niche to mainstream

\$78

trillion assets adopted ESG strategies in 2016⁽¹⁾

25%

increase in global ESG investing in last 2 years⁽²⁾

53%

of total professionally managed assets in Europe use ESG strategies⁽³⁾

Source: (1) Principles for Responsible Investment 2016, (2) Global Sustainable Investment Alliance 2016, (3) Yougov poll 2015.

Why consider responsible investing?



Risk Management

Identification and management of ESG factors
Portfolio and fund manager monitoring



Stakeholder Expectations

Beneficiaries
Public stakeholders



Compliance

Regulatory requirements
Industry standards

ESG = Environmental, Social and Governance.

Risk management – The evidence mounts

University of Oxford (2015) – 88% of published studies find a positive relationship between company-level sustainability practices and operational performance

Bank of America Merrill Lynch (2017) – companies with poor ESG standards have higher volatility in earnings per share than peers

Barclays (2016) – bond issuers with strong corporate governance profiles have experienced fewer credit downgrades

Morgan Stanley (2015) – US sustainable equity mutual funds had equal or higher returns, and equal or lower volatility, than mainstream peers for 64% of the periods studied

“To ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries”

- Fiduciary Duty in the 21st Century: Ireland Roadmap, 2015

ESG = Environmental, Social and Governance.



Stakeholder expectations – What do beneficiaries want?

57%

of UK investors agree that investment managers have a responsibility to ensure that the companies they invest in are managed in a way that is positive for society and the environment⁽¹⁾

40%

would like to be offered a fossil fuel free option⁽²⁾

X2:

Millennials are **twice as likely** to think they have a social responsibility to ensure their pension is invested ethically⁽³⁾

Sustainability matters

58%

want investments to achieve positive social outcome⁽⁴⁾



Source: (1) and (2), Good Money Week Public Polling Report, 2017. http://goodmoneyweek.com/sites/default/files/download/public_polling_report_2017_gmw.pdf. (3), UK Sustainable Investment and Finance Association, 2017. <http://uksif.org/wp-content/uploads/2017/10/Millennials.pdf>. (4) Standard Life Investments. Pixabay.

Compliance – Regulation is on the way

Legislation	Timeline	Requirements
IORP II	Implementation by January 2019	<p>Pension funds are asked to:</p> <ul style="list-style-type: none"> • Publish their position on ESG issues in their Statement of Investment Policy Principles • Consider ESG issues in risk assessments and governance structures • Provide details to prospective members on the above <p>This is on a 'comply or explain' basis</p>
Shareholder Rights Directive: 2017 revision	Implementation by June 2019	<p>Institutional investors and asset managers should develop and disclose a policy on shareholder engagement</p> <p>Also on a 'comply or explain' basis</p>
European Commission Action Plan for Financing Sustainable Growth: First Legislative Package	Proposals published in May 2018	<p>Range of proposals includes:</p> <ul style="list-style-type: none"> • Mandatory disclosure of how ESG issues are integrated into investment decision-making processes, covering institutional investors and asset managers

IORP II = Institutions for Occupational Retirement Provision Directive II. ESG = Environmental, Social and Governance.

How to invest – a range of options

Negative screening	ESG integration	Positive screening	Impact investing
<p>Excluding companies from the portfolio on the basis of their products (eg cluster munitions, tobacco) or behaviour (global norms such as UN Global Compact)</p>	<p>Including ESG factors in stock selection and portfolio construction processes</p> <p>Can be applied to active or passive investments, and across asset classes</p>	<p>Selecting best-in-class companies</p> <p>Thematic funds focused on sustainability solutions (eg water, clean tech)</p>	<p>Investments that target both a financial and social / environmental return</p> <p>Sometimes linked to the UN Sustainable Development Goals</p>

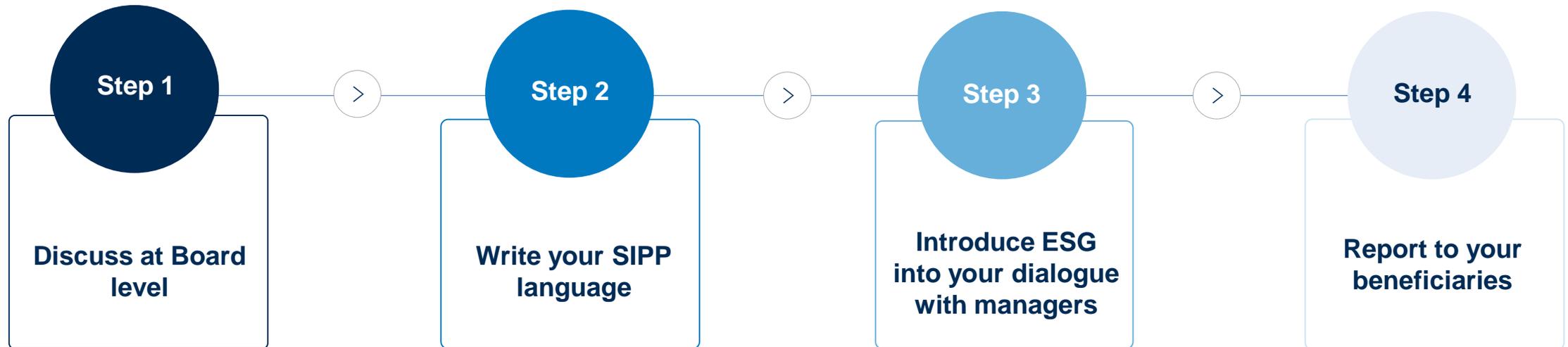


ESG = Environmental, Social and Governance.

Roadmap to developing an RI strategy

How to develop an ESG strategy

A four-step roadmap to action



SIPP = Self Invested Personal Pension. ESG = Environmental, Social and Governance.

Step 1: Board-level discussion

- What are the fundamental beliefs around ESG and how does this fit with the plan's objectives?
- Are there beliefs on specific ESG factors – such as climate change?
- Will the fund attempt to engage with beneficiaries on ESG and if so, how?
- What position does the fund wish to take on stewardship? (voting and engagement)
- What are the internal governance structures on ESG policy development, implementation and review?
- Does the fund wish to consider joining collaborative groups such as the PRI or SIF Ireland?

ESG = Environmental, Social and Governance. PRI = Principles for Responsible Investment. SIF = Social Insurance Fund.

Step 2: Write your SIPP language

Pension fund	SIPP language
Large university fund (USS)	“The trustee... requires its investment managers to integrate all material financial factors, including corporate governance, environmental, social, and ethical considerations, into the decision-making process for all fund investments”.
Local authority (Brunel pool)	“Responsible investment (RI) is central to how Brunel fulfils its fiduciary duty”. Six priority themes: UK policy framework, Climate change, Cost and tax transparency, Human capital and diversity, Supply chain management, Cyber security.
Corporate (Kingfisher)	“The Trustee Board... recognises that because of the need to closely track the index benchmarks, it is not appropriate for the Scheme’s passive manager to take account of social, environmental and governance considerations in the construction of their portfolio. However, the Trustee Board also encourages its passive manager, and its other pooled fund managers, to pursue a policy of engagement with investee companies”.
NEST (Default pension provider)	“Values are a legitimate basis for action - NEST should look to understand our members’ values and look for common ground to inform our responsible investment priorities and action” (Objectives for Responsible Investment).

SIPP = Self Invested Personal Pension. NEST = National Employment Savings Trust.

Step 3 – Introduce ESG to fund manager monitoring

Question	What to look for
What is your organisation's commitment to ESG?	<ul style="list-style-type: none">• Corporate-level policy or statement on responsible investment• Top-level commitment at CEO / CIO level• Membership of relevant networks (such as UN Principles for Responsible Investment)
What expertise in ESG do you have?	<ul style="list-style-type: none">• Staff with ESG knowledge – either in a dedicated team or embedded in investment teams• Training of investment teams on ESG issues• Access to resources such as data or broker research
How do you integrate ESG factors into your investment processes?	<ul style="list-style-type: none">• Systematic, repeatable process, which is part of core valuation approach not an add-on• Thoughtful approach to use of third-party ESG data – not taking it at face value• Case studies showing where ESG factors have been material to investment analysis, and what decisions were taken as a result
What is your approach to stewardship?	<ul style="list-style-type: none">• Publication of voting and engagement policies, and reporting on outcomes• Extent to which voting decisions are made in-house vs following proxy advisor recommendations• Case studies of engagement, including outcomes achieved

ESG = Environmental, Social and Governance.

ESG in action – Investment analysis

Turnover

Positive: Revenues from sustainable solutions

Negative: Breaches in ethics limit access to future public contracts

ALLIANZ SE-VINK	EUR	FY1	FY2	FY3									
ALV GR	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	
TURNOVER	100,399	119,067	121,867	127,873	134,175	140,213	145,921	151,237	156,098	160,448	164,228	167,365	
		18.6%	2.4%	4.0%	4.9%	4.5%	4.1%	3.6%	3.2%	2.8%	2.4%	1.9%	
EBIT	9,922	10,789	11,028	11,034	12,141	12,688	13,204	13,685	14,125	14,519	14,861	15,147	
EBIT MARGIN	9.9%	9.1%	9.0%	8.6%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	
TAX	(2,245)	(2,842)	(2,906)	(2,907)	(3,199)	(3,343)	(3,479)	(3,606)	(3,722)	(3,820)	(3,916)	(3,991)	
TAX RATE (EBIT)	22.6%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	26.4%	
NOPAT	7,677	7,944	8,122	8,126	8,942	9,344	9,725	10,079	10,403	10,693	10,945	11,156	
NOPAT MARGIN	7.6%	6.7%	6.7%	6.4%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	
INVESTMENT													
D&A	1,204	1,458	1,493	1,566	1,655	1,741	1,825	1,904	1,979	2,048	2,110	2,165	
CAPEX	(1,062)	(1,622)	(1,660)	(1,742)	(1,816)	(1,888)	(1,960)	(2,008)	(2,059)	(2,103)	(2,138)	(2,165)	
CHANGE IN W/C	0	0	0	0	0	0	0	0	0	0	0	0	
TOTAL		(184)	(167)	(176)	(161)	(144)	(125)	(104)	(80)	(55)	(28)	0	
OP CASH FLOW		7,780	7,954	7,951	8,781	9,200	9,600	9,975	10,323	10,638	10,917	11,156	
DISCOUNT FACTOR		1.00	0.93	0.86	0.79	0.73	0.68	0.63	0.58	0.54	0.50	0.46	
		7,780	7,360	6,800	6,955	6,742	6,509	6,258	5,991	5,713	5,424	5,129	
PRESENT VALUE		65,537	69,896										
TERMINAL VALUE		79,063	122,039										
TOTAL VALUE		144,600	191,935										

Capex

Disruptive technologies such as EVs may force changes in R&D strategy

EBITA Margin

Increased costs from rising carbon prices

Fines for environmental breaches

OPERATING ASSUMPTIONS	
REV GROWTH RATE	4.9%
EBIT MARGIN	
DEBT/SALES	
CAPEX/SALES	1.4%
WCAP/SALES	0.0%
TERM. GROWTH RATE	1.5%

WACC ASSUMPTIONS	
10 YEAR BOND YIELD	2.2%
BORROWING SPREAD	2.0%
TAX RATE	26.4%
KD	3.1%
RISK FREE	2.2%
MKT RISK PREMIUM	6.0%
BETA	1.25
KE	9.7%
SPLIT	
EQUITY/TOTAL CAP	76%
DEBT/TOTAL CAP	24%
WACC:	8.1%

WACC

Poor corporate governance feeds into lower quality score

Source: BMO Global Asset Management. For illustrative purposes only.

ESG in action – Company engagement

- **Identification of material ESG risk:** The food sector has high exposure to environmental supply chain issues, particularly water. Kerry Group was identified as a company with limited disclosure versus peers
- **Engagement with company:** One-on-one calls between our water expert and Kerry's Sustainability Manager, in which we gave best practice recommendations
- **Progress:**
 - Kerry improved its **water disclosure** by responding to the CDP Water programme for the first time in 2017. We will review how it is scored versus peers
 - Kerry undertook a **supplier risk mapping** exercise in 2016 – we have asked for disclosure of key findings
 - Our engagement also covered **governance**, where the company reduced the number of majority shareholders in line with their holding



Source: BMO Global Asset Management. For illustrative purposes only. This does not constitute a recommendation to buy or sell any particular security.
ESG = Environmental, Social and Governance. CPD = Carbon Disclosure Project.

Step 4 – Beneficiary engagement and reporting

- Consider **engaging beneficiaries** to understand views and preferences
- Disclose **policies and case studies** of investment or company engagement
- **DC schemes:** Consider offering an ESG or ethical option to DC fund participants

8 DECENT WORK AND ECONOMIC GROWTH 

JD Sports

Background

In 2016, an undercover documentary about JD Sports' UK warehouse in Kingsway revealed poor labour practices such as zero hours contracts with below minimum wages, extreme surveillance and security checks, and staff being threatened to be fired for sitting down during long shifts. Due to poor disclosure, our initial assessment showed that JD Sports had poor systems for effectively managing labour risks.

Action

We visited the company's Kingsway distribution centre for a tour of the facility, and met with the CFO and logistics director. Our conversations focused on the monitoring of labour agencies that the company uses, and staff satisfaction at the site.

Our view

Our initial view of inadequate labour management changed during our engagement with the company. We were assured that the company is taking the issue seriously and employs practices to mitigate labour-related risks. Examples include: offering agency staff permanent contracts, enabling career progression, auditing labour agencies, and formal staff feedback procedures. Nevertheless, warehouse operations pose difficult labour-related challenges and companies such as JD Sports need to be more proactive and transparent in their approach.

Liat Piazza, Governance and Sustainable Investment team

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Credicorp

Background

The founding family and main shareholder of Credicorp, Peru's largest financial services group, continues to exert significant influence over the group. This, alongside a board that is almost entirely comprised of former company executives and family representatives, raises concerns linked to board entrenchment and can put the interests of minority shareholders at risk.

Action

Through voting and one-to-one engagement, we expressed our concerns and strongly encouraged a review of board composition to include non-executive directors without previous or existing ties to the company. We welcomed the appointment at the 2017 AGM of an independent, non-executive director (INED) with strong financial sector experience.

Our view

The board would benefit from a more comprehensive review of its current composition. As it stands, we think it runs the risk of 'group-think' tendencies from directors' common views and close involvement in past managerial decisions. This threatens board dynamics and can ultimately hinder its effectiveness. We will continue to engage on this issue.

Juan Salazar, Governance and Sustainable Investment team

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Source: BMO Global Asset Management. For illustrative purposes only. ESG = Environmental, Social and Governance. DC = Defined Contribution.

Hot topics



Climate change: a systemic risk?



“ ”

The combination of the weight of scientific evidence and the dynamics of the financial system suggest that, in the fullness of time, climate change will threaten financial resilience and longer-term prosperity.

Mark Carney
Governor of the Bank of England, 2015

Divestment has gathered pace...

- **Divestment** strategies are in place for over 950 institutions globally, representing over US\$6 trillion
- There are varying **degrees of divestment** depending on the definitions chosen
- A growing number of **pooled funds** offer fossil fuel free options

THE IRISH TIMES

Ireland set to sell off €318 million investments in fossil fuels

New bill will see State become first country in the world to divest from fossil fuel assets

© Thu, Jul 12, 2018, 18:46

Kevin O'Sullivan Environment & Science Editor



The Fossil Fuel Divestment Bill, passed in the Dáil on Thursday, now goes to the Seanad, where it is expected to go through quickly and become law by the end of the year, Deputy Thomas Pringle said.

Source: <https://www.irishtimes.com/news/environment/ireland-set-to-sell-off-318-million-investments-in-fossil-fuels-1.3563114>

...but it is not the only option

- **Risk management** – Focus on how climate risks are integrated into investment decisions
- **Engagement** – Call on investee companies to manage risks better
- **Investment** – Seek out investments in companies providing climate solutions
- **Public policy** – Support collaborative investor efforts
- **Disclosure** – Consider publishing information on how risks are managed, in line with the TCFD



TCFD = Task Force on Climate-related Financial Disclosures.

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Contact us

BMO Global Asset Management (EMEA) – Head Office

Exchange House

Primrose Street

London EC2A 2NY

Tel: +44 (0) 20 7628 8000

Calls may be recorded.

bmogam.com

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