

ESG Subcommittee Update

Report to the SEC Asset Management Advisory Committee

May 27, 2020

Agenda

- ESG Subcommittee members
- Workstream details
- Overview of in-scope practices
- Workstream report-outs
- Questions for AMAC members
- Next steps

ESG Subcommittee Members

- Michelle Beck, TIAA Financial Solutions
- Jane Carten, Saturna Capital
- Rich Hall, Univ. of Texas/Texas A&M Investment Management Co.
- Jeffrey Ptak, Morningstar Research Services
- Aye Soe, S&P Dow Jones Indices

Workstream details

Workstream	Key Outcomes
Is ESG About Values or Value?	Recommendations regarding whether the focus should be on values, value, or both, and what the implications are for best practices and regulation
Assessing Performance of ESG Strategies	Recommendations for understanding drivers behind risk and returns of ESG funds, as well as ways to measure alignment of financial outcomes with fund's objectives
Proxy Voting in ESG Strategies	Recommendations for approaches to proxy voting for ESG strategies
Issuer Disclosure of ESG Data	Actionable recommendations regarding what guidance or regulation should be provided to issuers with respect to ESG data
What Role Should ESG Rating Systems and Benchmarks Play?	Recommendations for how and whether to suggest or require the use of third party ESG ratings systems and/or benchmarks for those investment portfolios that brand themselves as ESG

There are a variety of practices described by fund managers as ESG

- Considering ESG Practices
- Exclusion: Screening out stocks in one or more categories
- Overweighting stocks in one or more categories
- Incorporating ESG category sentiment metrics into investment decisions
- Investing in line with an ESG benchmark index or rating system
- Proxy voting in alignment with ESG preferences
- Activism with management on ESG preferences
- ESG impact measurement for investments

Examples of ESG focus areas

Environmental

- Use of carbon, Carbon emissions
- Sensitivity to flood, fire, water scarcity
- Need for raw materials
- Biodiversity and land use
- Sustainability practices
 - use of renewable energy
 - LEED certification
 - recycling behavior
 - energy efficiency in manufacturing
 - use of disposable plastics
 - Pollution/waste practices
- Deforestation practices/use of palm oil
- Use of nuclear energy

Social

- Weapons
- Alcohol
- Gambling
- Support for organized labor
- Practices forbidden the Islamic faith, such as debt
- Practices forbidden by the Catholic faith, such as birth control and abortion
- Human rights practices
- Supply chain labor standards
- Consumer protection
- Animal welfare

Governance

- Separation of CEO and board chair roles
- Companies' management or board gender diversity
- Executive compensation
- Employee compensation
- Business ethics
- Tax transparency
- Corruption
- Anti-competitive practices

Is ESG about Values or Value—and what are the implications?

- How ESG should interact with the names rule; is it fundamental, or a strategy
- If ESG is about values, it is about consumer choice
- If ESG is about value, it is about financial metrics
- How should either be disclosed and aligned

What are the considerations in assessing performance of ESG strategies?

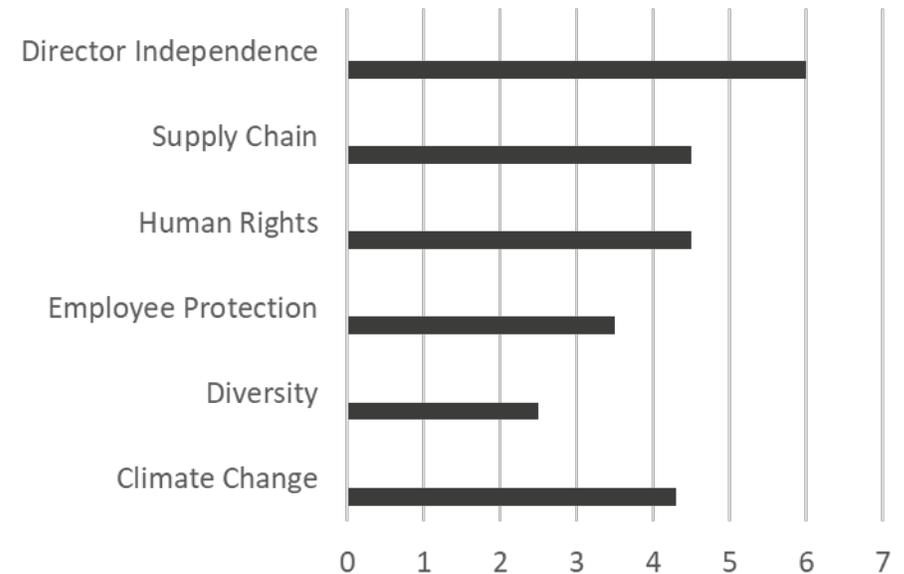
- There are frequent statements on ESG risk/returns in research studies & marketing materials, including that
 - ESG funds do not underperform their respective benchmarks or ESG funds do not detract from financial performance
 - ESG funds have lower portfolio volatility
 - ESG funds limit downside risk
 - Companies with higher ESG scores have stronger balance sheets and are less volatile
- Understanding Returns of ESG Funds
 - Many ESG funds come to market over the past five years during which a number of structural changes took place – decline in energy prices, dominance of big tech and healthcare sectors.
 - Is performance coming from over/underweighting of certain industries?
 - Momentum effect in ESG (flows driving performance)
 - Is ESG a proxy for quality? In particular, the overlap of good corporate governance with typical financial quality metrics (low leverage, low earnings accrual, lower earnings volatility)

How should ESG performance be measured?

- Measurement Time Horizon
 - Near-term vs longer-term
 - Many ESG funds lack long-term track record. Performance may be back-tested.
 - Mixed evidence on those over ten year of live track record as well as potential for survivorship bias
 - ESG scores do not go back far in history and are often backfilled (potential for lookahead bias)
- Appropriate choice of benchmark
 - There are now more than 300 open-end and exchange traded ESG funds in the US. They have different investment objectives and focus.
 - Exclusionary Broad based (S&P 500 ex tobacco, S&P 500 ex fossil fuel reserves)
 - Thematic (gender diversity, clean technology)
 - Best in Class (ESG Leaders)
 - Integrated (with quant factors or alpha overlay, optimized with TE budget)
 - Should ESG funds be measured against broad based, market cap weighted benchmark or should it be beta-adjusted/style-adjusted benchmark?
 - A primary and a secondary benchmark for performance reporting

Without a consistent framework, performance attribution not comparable

- Lack of well defined, systematic steps in how managers integrate ESG in their investment process
 - Makes performance attribution difficult.
 - There is no clear definition as to what ESG integration means and expected outcomes from integration.
- In order to have comparable attribution, we need:
 - Clear disclosures on back-tested performance and backfilled ESG score data used
 - Use of primary and secondary benchmarks
 - Disclosure on expected non-financial outcome – alignment of outcome with fund’s objective
 - Disclosure and independent validation of the degree of ESG compliance – ingredient mapping ▶



What are the considerations for proxy voting in ESG Funds?

- What are funds trying to accomplish in their proxy voting—help shareholders? Help the environment?
- What are the potential pitfalls?
- Who benefits/loses?
- What is the role of proxy advisory firms?
 - Is it significant that ESG funds do not always vote the ESG positions recommended by proxy advisory firms in proxy votes?
 - Should ESG funds be held accountable for proxy voting?
 - Can the funds outsource these decisions to proxy advisors so long as they have rules related to this? Should anything be mandatory in this area for any fund that brands itself ESG?
- What should proxy voting practices look like in fund disclosure?

What enhancements to issuer disclosure could improve investors' ability to invest according their ESG preferences?

- Are there opportunities to improve the quality of disclosure
 - Comprehensiveness
 - Meaningfulness
 - Materiality
 - Comparability
- What gaps are there, and what role can regulation play
- There are multiple standards available (UNPRI, SASB and others), and multiple stakeholders
- Comparability and consistency are sometimes lacking; fewer than 30% of public companies disclose ESG risks, and the percent is smaller for private issuance; fixed income disclosure is often threadbare and focused only on the issuer, or use of proceeds.
- Disclosure is often backward looking rather than forward looking
- Metrics required by public standards could number in the hundreds, making it difficult to consume
- Issuers appear to cherry pick their ESG information for use in marketing materials

What are ESG rating systems and benchmarks?

- ESG ratings systems are scoring tools developed by third parties that rate and rank investment portfolios based on their adherence to one or more ESG principles
 - Akin to credit ratings
- ESG benchmarks adjust an existing index, or create indices from root principles, in order to express ESG tilts in one or more categories of focus

What role should ESG rating systems play?

- While the quality of ESG data has risen in recent years, disclosure by issuers remains fragmented and inconsistent across most sectors. ESG data providers attempt to fill these gaps through estimates and other proprietary processes.
- A number of rating systems focus only on environmental and/or governance practices
- Types of data these can use include
 - Controversy scores
 - Direct disclosure elements
 - News sentiments
 - Impact metrics
 - Shareholder/governance engagement data
 - Screening data on activities
 - Emerging categories (e.g., geospatial such as proximity to water resources, consuming info from sites like Glassdoor)

How comparable are ESG rating systems?

- Ratings systems can differ in key ways philosophically
 - Absolute vs relative
 - How peer groups are defined
 - Whether they focus on financial materiality vs. stakeholder sentiment
 - Whether they focus on disclosure (company policy) vs performance (impact: emissions, water management)

Questions for AMAC members

- What is missing here that you think needs to be explored?
- What are your concerns about potential regulatory responses? What would be helpful, what can you see as problematic?
- What are your concerns about the way the ESG investment industry currently works? What are positives that you think need to be retained, and what are negatives that you think need to be managed?

Next steps for the ESG subcommittee

- Receive feedback from committee members on questions, and on the subcommittee's scope and focus, to make any needed adjustments
- Analyze and present pros and cons of “do nothing” vs. various approaches to “do something” in our areas of focus at next AMAC meeting, including
 - Guidance and suggestion
 - Principles based regulation
 - Rules based regulation
- Develop recommendations based on this assessment and your feedback, targeting end of 2020