AN INVESTMENT FRAMEWORK FOR SUSTAINABLE GROWTH
CAPTURING A BROADER SET OF RISKS AND OPPORTUNITIES – INTEGRATING ESG AND SUSTAINABILITY THEMES
“If the rate of change on the outside of an organisation exceeds the rate of change on the inside, the end is near.”

Jack Welch – Former Chairman and CEO, General Electric

Mercer aims to help you, our client, preserve the value of your long-term investment capital and prepare for what lies ahead. Building ‘sustainable growth’ principles into your investment portfolios will provide additional support in these preparations. Portfolio resilience is increased by identifying and managing the financial risks arising from governance failures, changes in policy and regulation, and environmental and social trends. It also positions you to take advantage of opportunities arising from a shift towards more sustainable economic growth.

In essence, this ‘sustainability lens’ gives you a ‘wide-angle’ view of the future, allowing you to identify a broader range of material risks – and opportunities – as you plan and implement your investment strategy. Including this additional perspective is a gradual evolution, not revolution, of your existing investment process, within your existing governance budget.

In our framework for sustainable growth, we distinguish between the financial implications (e.g. risks) associated with environmental, social and corporate governance (ESG) factors, and the growth opportunities in industries most directly affected by sustainability issues.

We can help you to:
- Mitigate portfolio risk by ensuring ESG factors are captured throughout investment processes
- Demonstrate active ownership to improve the governance of underlying investments, directly or via manager monitoring, through voting practices and engagement
- Construct portfolios that target long-term returns with alpha or beta allocations to sectors and markets expected to perform well, given sustainability considerations

These considerations that are shaping the contemporary reality for long-term investors include: population growth and demographic changes (consumption patterns, health and longevity issues); natural resource constraints (water, fossil fuels, climate change impacts); and changes in public sentiment and the evolving policy response to a range of environmental and social issues.

These developments create a range of risks and opportunities and drive the imperative for an investment framework that includes some focus on sustainable growth.1,2

2 Mercer’s 2011 Climate Change Scenarios - Implications for Strategic Asset Allocation http://www.mercer.com/climatechange

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1,2
Applying sustainable growth principles is most effective when it is integrated into standard investment processes, providing an additional layer of insight and oversight. The framework below identifies where ESG and sustainability considerations sit within the typical ‘Beliefs, Processes, Portfolio’ investment approach.

We recommend you follow a three step process, as illustrated below.

1. Review your beliefs
2. Update your policy and embed it within your processes
3. Create a workplan that incorporates ESG factors and sustainability themed strategies

Each investor’s approach will be unique, reflecting priorities based on the requirements of stakeholders (including regulators), investment structure and approach, available resources and governance budget.
At Mercer, we believe investing should consider a wide range of risks and opportunities, including sustainability factors such as good governance, environmental and social impacts on assets, as well as the associated policy and regulatory implications. We believe this approach is more likely to create and preserve long-term investment capital.
Once beliefs regarding ESG integration and sustainability are established, policy documents should be updated as appropriate and consideration given to implementation within each stage of the investment process. Further detail is provided on the following pages on portfolio implementation by integrating ESG and sustainability themes. If you would also like to review your approach to active ownership, particularly share voting and engagement, please advise your consultant or local contact and we can discuss this in more detail with you.

**STEP 2 – POLICY AND PROCESS**

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Incorporating ESG factors and sustainability themes across asset classes can be considered in the context of risk mitigation and proactive allocations.

**Sustainability overlay**: This may include reweighting passive index constituents or engaging with companies based on sustainability issues. This is most applicable for listed equity.

**High ESG ratings**: We assign ESG ratings at the investment strategy level, enabling clients to identify managers that actively integrate ESG into investment decision-making, and those that do not.

**Pure play allocations**: Focuses primarily on one particular sustainability theme, such as water, clean energy, timber or agriculture.

**Broad sustainability**: Focuses on strategies that target a range of environmental and social trends as a key investment driver. In addition to the pure play themes, they often include social opportunities in health, education, and other sustainable goods and services.
ESG RATINGS

Incorporating ESG factors within portfolio decisions typically leverages Mercer’s ESG ratings for managers. These are standard within Mercer’s manager research process across most asset classes. There are now over 5,000 strategies with a Mercer ESG Rating which captures to what extent a manager includes ESG factors and active ownership principles throughout their investment process.

1. APPLY MERCER ESG RATINGS

• Screen for highly rated strategies from both a research and ESG perspective e.g. select only strategies that are A rated and ESG2 or ESG3 and above, where possible
• Review the average rating for your portfolio as a whole, compared to the ratings universe

2. UNDERTAKE ADDITIONAL DUE DILIGENCE

• Select potential strategies based on ESG ratings and then ask additional ESG questions during the final due diligence stage
• Identify managers with the capacity to improve on ESG, and drive this change during your monitoring process.

SUSTAINABILITY THEMES

We have seen a growth in client interest and in managers identifying opportunities in sustainability as a theme. These strategies isolate one or more environmental and social demand or risk drivers and identify investments that are best positioned to benefit from these.

Risk and return expectations for each asset class are typically the same as a ‘mainstream’ equivalent, given the fundamental asset class drivers are the same. However, policy and regulatory developments, market inefficiencies, often underpinned by different views on time, and associated environmental and social benefits are all additional considerations. Access via listed or unlisted options will depend on the usual client considerations such as timeframes, liquidity, fee budgets, current portfolio diversification etc.

In the listed markets the opportunity set typically includes equities, with only a limited number of fixed income ‘green bond’ strategies currently available:

Equities
• Pure Play: water (including water infrastructure, technologies and utilities); renewable energy and energy efficiency; food and agriculture.

While the property asset class does not tend to explicitly access new sustainability themes, ESG factors are now captured within best practice property portfolio decisions e.g. water and energy usage.

There are over 700 investment strategies with sustainable opportunities now available in GIMD.

This research is increasingly being utilised by clients as an additional tool for differentiation in the manager selection and review process. Different approaches exist for incorporating ESG factors. It could mean simply applying a minimum standard for ESG ratings (e.g. ESG3, applied either at the individual strategy level or the average across a whole portfolio), or could include more structured due diligence and engagement.

For example, a growing number of clients review the average ESG rating for their managers and set targets to improve this score. Your consultant will be able to discuss the ESG ratings in your reports and manager research notes, or you can search for these directly if you have access to Mercer’s Global Investment Manager Database (GIMD).

Approximately 10% of the 5,000+ rated strategies receive the highest ESG ratings (ESG1 or 2).12


• Broad Sustainability: A broad market approach, with focus on the range of pure play themes as well as social demographic opportunities in health, education, and other sustainable goods and services.

In the unlisted markets the opportunity set includes:

• Private Equity, Private Debt: Businesses in environmental sectors such as energy, waste, water, materials and systems, at both the technology development stage (e.g. ‘cleantech’) and growth stage businesses looking to expand.

• Infrastructure: Most likely to include clean energy infrastructure e.g. renewables, but can also include waste recycling and energy efficiency centres.

• Agriculture: Commodities, including grains, fruits, nuts and livestock, that taps into food and energy related trends.

• Timber: For its renewable and low carbon credentials.

There are over 700 investment strategies with sustainable opportunities now available in GIMD.
WHAT NEXT?

This paper outlines a framework for applying sustainable growth principles. We can help you to review your beliefs, policies and processes to capture this additional perspective, accompanied by an implementation approach that suits your requirements.

A more detailed reference guide on integrating ESG and sustainability themed investment drivers and opportunities by asset class is also available. Please contact your consultant or local contact to receive a copy and to discuss how you could implement these approaches within your portfolio.

Contact information: www.mercer.com/ri