

ESG in Manager Search and Selection

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At State Street Global Advisors, we have a more than 30-year legacy in environmental, social and governance (ESG) investing. As an extension of our firm-wide commitment to ESG investing, we have developed a series of educational modules to guide you on how to incorporate ESG considerations across your investment portfolios.

State Street Global Advisors (SSGA) is a signatory of the United Nations Principles for Responsible Investment (UN PRI), and therefore we have developed these modules to align with the guidance offered by the UN PRI.

The goals of these modules are to:

- 1** Introduce investors to the practice of incorporating ESG factors into investment decisions
- 2** Discuss common approaches to ESG investing and manager selection
- 3** Provide access to additional resources for further research

The relationship between an investor and investment manager is often long-term in nature; hence, it's important to ensure the ESG investment philosophy of the investment manager aligns with your ESG goals and objectives.

The goal of this third module is to provide investors with guidance on evaluating, selecting and monitoring external investment managers.

Key Elements in ESG Manager Evaluation

Evaluating investment managers under the ESG lens requires investors to understand their ESG beliefs, philosophies and goals, so that the degree of alignment with an investment manager can be assessed. Ideally, you will have developed a formal ESG investment policy.

There are three key elements when evaluating an asset manager's ESG credentials: culture, approach and capabilities. The manager evaluation process can be more of an art than a science. However, investors should ensure that these key elements align with their own ESG objectives.



Source: State Street Global Advisors.

The first key element is evaluating an investment manager's corporate culture. It's important to understand how a manager thinks about ESG and how it permeates its corporate culture and whether it is aligned with your own beliefs.

Second, it is important to understand how a manager integrates ESG into its investment processes across asset classes and styles.

Third is evaluating the manager's firm-wide technical capabilities as they relate to ESG.

We'll now delve more deeply into these three areas.

Evaluating ESG Culture

Culture is among the most important elements to consider when selecting an investment manager, as culture cuts across the organization's people, processes, investment philosophy and practices.

If there is a poor cultural fit and understanding of ESG factors between an investor and a potential manager, there is little foundation on which to build a long-term relationship.

You can gain an understanding of a manager's culture by asking probing questions around its investment philosophy and how ESG is implemented across different parts of the organization. Try to be as tangible and specific as possible. We have added some possible questions to consider in the table below.

Examples of Questions to Raise in Assessing Cultural Fit

Investment Philosophy

- How do you believe that ESG factors impact the potential risk and returns of a portfolio?
- How does your firm incorporate ESG considerations into its investment strategies?
- Do processes for incorporating ESG considerations differ across investment strategies and/or asset classes?

Organizational Aspects

- How do you incorporate ESG values across your organization outside of the investment process?
- Are portfolio manager incentives aligned with ESG objectives?
- Describe your governance processes for measuring and ensuring that ESG principles are integrated into your investment strategies, as well as across broader business practices at your firm.

Sources: UN PRI, State Street Global Advisors.

By understanding a manager's corporate culture, you can assess whether its views, beliefs and philosophies are aligned with yours.

Approach to ESG Investing

Questioning an investment manager's investment approach and objectives should shed light on how it produces value through ESG insights. Questions should touch on the "what", "why" and "how".

Understanding the business and investment philosophy of a prospective manager enables investors to ascertain whether such an approach is aligned with their own objectives.

Start with understanding a company's high-level approach, perhaps through a mission statement, ESG Investment Policy Statement or broad investment philosophy. This will give you the best way to assess whether your investment strategy aligns with a manager's firm-wide objectives. As an example, ESG is central to SSGA's overarching mission statement, which is to "invest responsibly to enable economic prosperity and social progress".

Investors should compare the policies of prospective managers, including how managers address ESG factors as well as how policies are adhered to. Policies that marginalize ESG considerations or institutions that have siloed ESG policies may compromise the depth of delivery across the firm on related objectives.

What

Understand the investment manager's overarching ESG investment policy/philosophy. The manager should be able to articulate its objectives and intentions in incorporating ESG principles.

Why

- Ensure the manager has a clear ESG philosophy and that it aligns with your objectives
- Understand how the manager uses ESG factors to drive value in its portfolios

How: Ask Questions

Questions on investment approach:

- Do you have a firm-wide policy that articulates your ESG philosophy and approach? If the policy is not firm-wide, which parts of the organization does it cover?
- What are your beliefs around the role that ESG plays in investing, and does it differ across asset classes and investment strategies?
- How frequently do you review and evolve your ESG policy? What changes have you made over time, and how do you ensure relevance in a changing environment?
- Do you oblige each investment team to incorporate ESG factors into their investment process?
- What is your governance process for ensuring that the firm's ESG principles are incorporated into individual investment approaches?
- How do your investment teams leverage ESG data? Are you leveraging third-party data or ESG providers? If so, which providers and how? Are you calculating your own ESG score, and if so, what is the methodology?

Sources: UN PRI, State Street Global Advisors.

Breadth of ESG Capabilities

When selecting an investment manager, you should first look at the firm's overall ESG alignment and its capability in a specific asset class. Then, you can choose a suitable investment product.

An investment manager may not have the same level of ESG competency across all asset classes due to style, culture or resources. You should therefore understand how managers use ESG insights across each of the different asset classes.

A firm's approach to investment governance will depend on (among other things) its culture, style and size. Sound governance ensures that a firm's investment approach is embedded throughout the organization.

Finally, it's important to understand how your investment manager measures and communicates ESG impact. What tools are used and how are metrics reported?

Asset Class Capabilities

ESG capabilities differ across investment managers, so it's important to fully understand how each manager incorporates ESG insights across asset classes.

- 1 Does the manager's ESG policy/framework cover all asset classes and investment strategies?
- 2 Does each investment team and/or asset class have a unique ESG philosophy? If so, how does the firm ensure alignment with its broader ESG principles?
- 3 How extensive is the firm's ESG solution?

Governance & Organizational Structure

Ensure the manager has adequate governance processes to ensure that ESG policies and practices are implemented.

- 1 What are the governance processes in place to ensure the ESG investment policies are properly implemented?
- 2 Which reporting systems and/or tools are used to facilitate effective oversight?

Reporting & Analytics

Understand the process the manager implements to monitor, measure and communicate the ESG impact.

- 1 Which tools, metrics, and data sets are leveraged in measuring and reporting the portfolio's impact?
- 2 Are ESG metrics included in the standard reporting packages, and if so, is customization possible?

Source: State Street Global Advisors.

There is a very wide spectrum of how investment managers incorporate ESG considerations into portfolios, from exclusionary screening to a fully integrated process or thematic approach, or a combination of different approaches. We explain the different ESG investment approaches available to investors in **Module 1**. These processes can create different levels of ESG exposure and have different impacts on portfolio risk and return.

In portfolio construction, parameters like tracking error can be important as they can directly influence choice of investments, but such parameters may be less critical depending on your risk budget and/or investment objective.

An exclusionary approach is just that — it excludes companies based on preset criteria. However, it's important to understand how the investment manager identifies which companies are excluded, how exclusion and inclusion policies are implemented and how it develops and maintains an exclusion list.

ESG integration relates to the process of embedding ESG considerations into fundamental investment valuation and related engagement and applying insights acquired to investment decisions. In the manager selection phase, a key objective for investors is to assess the quality of a manager's ESG integration practices against their own expectations.

A big challenge of assessing ESG integration is that there are no widely-adopted industry standards that you can follow. To what degree is the investment manager truly integrating ESG factors into investment decision making? To answer this question, it's important to delve into a manager's investment process to assess how it is integrating ESG.

We highlight below some questions to consider regarding an investment manager's portfolio construction approach.

Methods for incorporating ESG characteristics

Exclusions/Inclusions

- How does the manager develop an exclusion list? Does the manager have a proprietary list, or does it rely on external providers and/or customize for clients?
- Are exclusion lists applied to all ESG strategies (and non-ESG labeled) across all asset classes?
- Are exclusion and inclusion policies always implemented, or are there situations that constrain these policies? (e.g. tracking error, turnover limits etc.)
- How are companies identified for inclusion in the portfolio? (e.g. data provider, ESG score, industry code etc.)

Integration

- How are ESG data and insights combined with traditional financial data to make investment decisions?
- What challenges does the manager face when integrating ESG into the investment decision-making process, and how does it address them?
- Are the portfolio managers engaging directly with ESG insights, or are these insights being provided by another team?
- What ESG data, research and tools is the manager leveraging to influence its investment decisions?

Sources: UN PRI, State Street Global Advisors.

Investment Decision Making

As an extension of the portfolio construction process, it's important for investors to understand the process by which ESG characteristics influence investment decision making.

Two approaches of incorporating ESG not covered previously are thematic and impact investing.

Like screening approaches, thematic investing (e.g. climate investing) applies specific criteria in selecting securities, and therefore impacts asset allocation decisions. Again, you must determine if the investment manager's methodology is effective and aligns with your goals.

Investors interested in impact investing should pay particular attention to how investment managers define and measure positive impact. Along with measurement comes the capability to report impact.

| Thematic & Screening | Integration | Impact |
|--|---|--|
| Fully understand the manager's methodology, rules and screening process | Understand how the manager weighs ESG considerations alongside traditional elements of the investment decision-making process | Identify how the manager defines impact and how impact is measured |
| Look for quality and accuracy of data, as well as consistency of process | Understand which ESG metrics/ data are used and how the manager determines materiality | Ensure impact investments contribute to clear, measurable and sustainable outcomes |
| Be aware of any potential liquidity issues, which could arise from portfolio constraints, such as screens or investment themes | Assess if the effectiveness of a manager's ESG integration approach satisfies your own ESG objectives | Understand how the manager balances impact characteristics versus traditional inputs of investment decision making |

Source: State Street Global Advisors.

Potential Impact on Risk and Return

It is important to understand the potential risk/return trade-offs of incorporating ESG characteristics. In particular, consider the impacts on tracking error and return deviations relative to a particular benchmark (or returns for an absolute return product).

Investors must be clear about what risk means to them at each level of the investment process and how it can vary across their portfolio. Also, aim to understand how returns may be impacted by any decisions made when incorporating ESG characteristics.

Below is a summary of the potential risk and return impacts of following different ESG investment strategies relative to a market capitalization-weighted benchmark.

| Types of Portfolios | Potential Impact from ESG Considerations | |
|----------------------------|--|---|
| | Risk | Return |
| Index | Tracking error can vary from low to high relative to a cap-weighted benchmark, depending on the extent of exclusions, inclusions or thematic tilts | Potential impact depends on degree of tracking error |
| | ESG indices based on broad-based market indices may have lower tracking errors | Portfolios with higher tracking error may have more return deviation than the benchmark |
| | Thematic indices, such as climate or gender, could have higher tracking error than cap-weighted benchmarks | |
| Integrated (Active) | Tracking error could differ from an active portfolio that does not incorporate ESG considerations | Return could deviate from a similar active portfolio that does not incorporate ESG considerations |
| | Degree of differentiation would depend on how large a role ESG considerations play in the investment decision-making process | |
| Thematic (Active) | Tracking error could vary greatly relative to a cap-weighted benchmark | Return could deviate meaningfully from a cap-weighted benchmark |
| | Because the portfolio is oriented towards a theme, sector or industry, weights may deviate significantly from the benchmark | |
| Impact (Active) | Tracking error could vary greatly relative to a cap-weighted benchmark because the portfolio's objective is to invest in companies that could generate a beneficial social or environmental impact, alongside a financial return | Return could deviate meaningfully from a cap-weighted benchmark |

Sources: UN PRI, State Street Global Advisors.

Active Stewardship

Selecting an investment manager that has an active ownership approach that aligns with your values and goals is critical in the effective stewardship of your assets.

Hence, you should thoroughly assess the process an investment manager uses to engage with companies. It is important to understand the semantics around engagement and voting practices, as some managers may promote pure voting activities as engagement, leaving out engagement activities, which can directly impact financial performance.

Also important is investigating whether engagements are initiated across all of the manager's assets or an overall percentage, or limited to specific asset classes. Many managers outsource engagement to a third party, in which case you should assess the terms of the arrangement and the sustainability of the relationship.

At State Street Global Advisors, our approach to stewardship focuses on making an impact. Accordingly, our stewardship program proactively identifies companies for engagement and voting in order to mitigate ESG risks in our portfolios. It includes promoting investor protection for minority shareholders through partnerships with local investors and regulators, and working with investee companies to encourage adoption and disclosure of ESG practices.

Engagement

Investors have three options in engaging with companies:

- 1 Direct engagement** Investor directly engages with companies on its own behalf
- 2 Collaborative engagement** Investor and investment manager together engage with companies
- 3 Outsourced engagement**
 - Investment manager
 - Specialist service provider

Voting

Typical starting points with voting:

- 1 An investor has its own voting policy** and wants an investment manager to implement it via
 - Segregated execution (shareholder rights remain with the investor)
 - Pooled execution (shareholder rights remain with the investment manager). It is rare for an investor to impose its voting policy on such funds.
- 2 An investor does not have a distinct voting policy** and relies on an investment manager's standard voting practices, regardless of the fund structure

Sources: UN PRI, State Street Global Advisors.

ESG Reporting

The selection process should consider the ongoing ESG reporting provided by an investment manager and its public reporting practice.

You should assess if the internal investment-related information provided by a manager meets your requirements and whether it serves its own reporting to stakeholders.

An investment manager's external reporting covers all directly published information, as well as items where information is contributed to public reporting platforms, such as the UN PRI and the Task Force on Climate-related Financial Disclosures (TCFD).

Client Investment Reporting

- Does the manager provide specific reporting on the ESG characteristics of its investment strategies?
- Does this reporting contain metrics that are relevant to the specific investment strategy?
- What level of insight and transparency does the reporting provide? Does this address your needs?
- Which ESG data source(s) does the manager use to measure ESG exposures?
- How is this information communicated (e.g. reporting, web portal) and how frequently is it updated?

Manager Public Reporting

- Review publicly available information before meeting with a manager to ensure that you are already familiar with the manager's ESG approach, can raise questions about KPIs, and can identify if the manager's ESG principles align with your plan's objectives.
- Leverage resources, such as the UN PRI and investment manager websites

Source: State Street Global Advisors.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US \$3.47 trillion* under our care.

* This figure is presented as of 31 December 2020 and includes approximately \$75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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