



## 2008 review of the sustainable investment performance of external asset managers

### Public summary report

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### Objectives

At the end of 2008 all of Mistra's externally-managed assets (SEK 2.6bn in 11 mandates / funds managed by 8 different asset managers) were invested using some degree of explicit inclusion of environmental, social and governance (ESG) issues<sup>1</sup>. This report summarises the findings of the fourth annual review of the process used by each manager to integrate ESG issues into their investment decision-making and ownership practices. As with previous reviews, the focus was on the use of ESG data by Mistra's managers to add net financial value over the long term.

Although most of Mistra's assets have now been managed according to an ESG-inclusive style for a number of years<sup>2</sup>, the understanding of how ESG issues can create or destroy value for investors continues to evolve both at the level of individual companies and other issuers or securities, and in portfolio management. As such the review process represents Mistra's wish to understand the response of its external managers to this evolution.

Moreover, the unprecedented market conditions of 2008 presented a chance to see how Mistra's ESG-inclusive equity and fixed income strategies performed in downward and highly volatile markets (after a number of years of generally bullish conditions and historically low levels of volatility).

For most managers this was the fourth time that they had participated in the review. The familiarity of Mistra and onValues with the managers' processes, and of the managers with Mistra's investment objectives, meant that we were able to concentrate on the incremental changes to investment processes and teams from 2007 to 2008<sup>3</sup>, and to revisit areas of concern revealed by previous annual reviews.

In doing so, we structured the 2008 review around three broad themes:

- Detailed attribution of risk and return to the ESG component of the investment process (qualitative and quantitative), following on from a partially successful attempt at this analysis in the 2007 review

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<sup>1</sup> That is to say that the inclusion of ESG issues is a formal requirement of the asset management agreement or fund strategy

<sup>2</sup> 9 of 11 Mistra funds / mandates have been invested for at least one year and have already been through at least one annual review by onValues

<sup>3</sup> Likewise this report concentrates on new analysis and material changes relative to the 2007 review

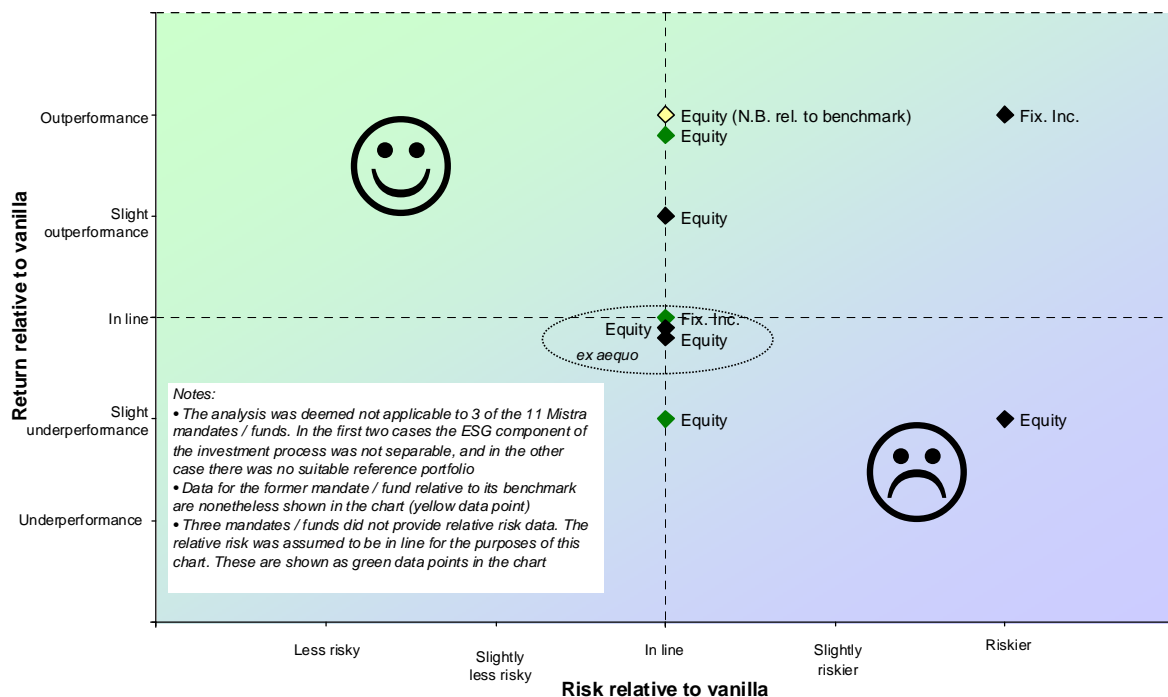
- ➔ We feel that most of the managers' investment processes are stable and beyond the experimental phase, and that it is appropriate to shift our focus from evaluating the 'inputs' of the investment process towards the 'outputs' (i.e. the risk-adjusted return)
- The extent to which the managers acted as active owners on behalf of Mistra — engaging with issuers on strategic issues (related to ESG or otherwise), exercising equity votes where economic to do so, etc.
- Involvement of the managers in the Principles for Responsible Investment (PRI), and their success in meeting commitments of the Principles
  - ➔ Mistra has recently itself become an asset owner signatory of the PRI. One of its commitments in so doing is to monitor the compliance of its external asset managers with the Principles

## Summary of findings

### Positive results:

- Most investment processes and teams are fairly stable, with changes being of a marginal nature. The managers seem to be avoiding the temptation to tinker with their processes in these uncertain times. We believe that it is positive that managers have strong conviction in their strategies 'in all weathers' and are thinking of the likelihood of outperformance over the long term, as opposed to reactively changing the process
- The great majority of the managers seemed to continue to take the Mistra review process seriously, investing considerable resources in the survey and teleconferences
  - ➔ A number of the managers referred to the constructive, trusting relationship that they had built up with Mistra over the years. More than one commented that this allowed them truly to act as long-term owner-investors
  - ➔ Most managers made a better attempt at attributing risk and return to the ESG component than in 2007. The purpose of the exercise was well understood, and reference portfolios were mostly well chosen. We also appreciated the fact that most analyses and their discussions were candid about difficulties — the managers did not try to 'explain away' any performance shortcomings
  - ➔ However, as in previous years, managers were more forthcoming about the return component than the relative risk spent to acquire that return
- Although one must be cautious about reading too much into the attribution analysis of the ESG component of the investment process, in most cases the ESG component had a positive or no effect on return, with risk levels that were in line with the reference portfolio (see chart below)
  - ➔ We note that in a number of the cases where the manager outperformed relative to the benchmark (overall active management) and relative to the reference portfolio (ESG component of active management) the performance was related more to wise allocation to sectors than to selection of positions within those sectors

## Risk and return of Mistra mandates / funds relative to 'vanilla' reference portfolio (schematic)



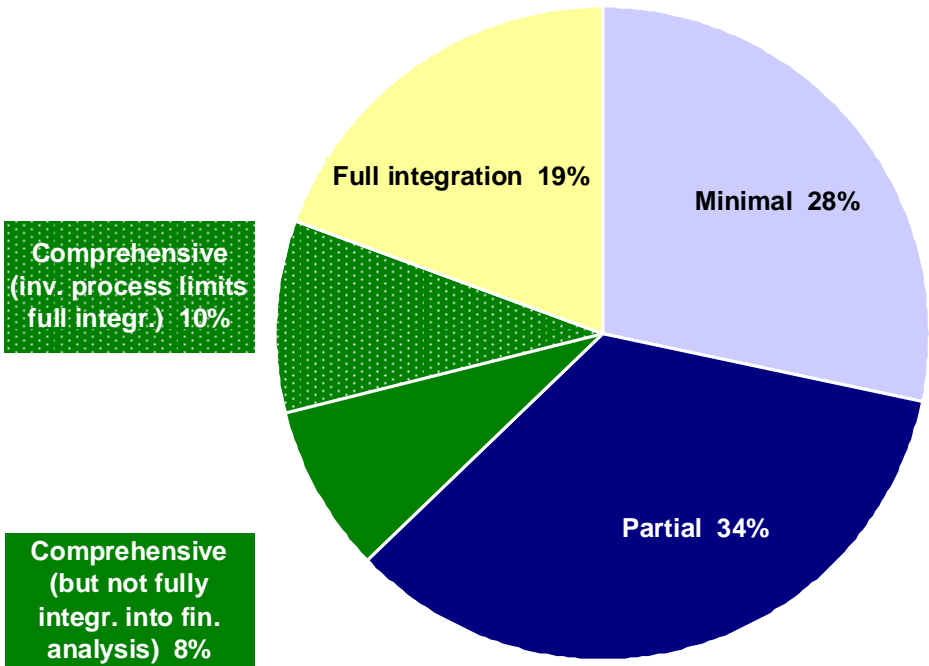
- We had constructive discussions with four equity managers that do not currently exercise Mistra's votes on the possibility of voting according to a policy that includes ESG best practice. We are hopeful for forward progress on this in the near future
- It is very positive to see that engagement on ESG and broader strategic issues seems to have been embraced by the majority of Mistra's managers (66% receiving our top rating on this criterion, with all managers engaging with companies to some degree)
- The majority of Mistra's managers (83% by assets) are already signatories of the Principles for Responsible Investment (PRI). We believe that they are not only sincere in actioning their commitments, but are already benefitting from the economies of scale<sup>4</sup> and learning opportunities that the PRI affords

### Concerns:

- Many of Mistra's managers use the same specialist ESG research provider as a primary source of ESG data. In some cases the provider's data are reviewed critically in-house; in other cases the manager simply accepts the provider's selection of material issues and rating of issuers
- The percentage of total assets under management using a comprehensive or fully-integrated approach to ESG issues has shrunk from 46% in 2007 to 37% in the 2008 review, essentially as a result of the larger share of fixed income in the overall portfolio
  - ➔ In 2008 we also downgraded one of the major managers from 'partial' on ESG integration to 'minimal'

<sup>4</sup> For example in terms of collective engagement activities, where asset owners and managers pool their voices through the PRI to engage issuers on strategic ESG issues

Integration of ESG issues into the investment process



- The fixed income managers remain the laggards in terms of integration of ESG with a value focus
  - ➔ This is understandable in some respects, given that their active bets are seldom on issuer quality
  - ➔ However, we worry that in some cases the FI managers are using ill-considered strategies just to be seen to be doing something
  - ➔ This may result in an uncompensated increase in risk, and potentially an over-allocation to corporate credit due to the greater ease of ESG analysis for those issuers
- Although portfolio turnover is largely stable and actively managed, where Mistra is invested in a fund structure it has sometimes suffered at the hands of co-investors who have abandoned the strategy
  - ➔ It is not clear whether this effect is more or less pronounced for ESG-inclusive strategies (it is possible that long-term, ESG investors may be less likely to redeem), but where the fund is small the effects of redemptions can be painful