Gamla Brogatan 36–38
111 20 Stockholm, Sweden
Telephone +46 8 791 10 20
Fax +46 8 791 10 29
mail@mistra.org
www.mistra.org

2011 review of the sustainable investment performance of external asset managers

Public report

David Imbert, Ivo Knoepfel
onValues Ltd.
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Executive Summary

This report summarises the outcomes of the seventh annual review of the sustainable and responsible investment (SRI) approaches used by asset managers in charge of managing Mistra assets. This year our review covered 8 managers responsible for 12 Mistra investments in funds or mandates (SEK 2.5 billion per end of 2011, representing 95% of total Mistra assets).[1]

Overall, Mistra's managers show a high level of commitment to SRI, which has created a favourable setting for the funds and mandates investing Mistra's assets. SRI assets under management have remained fairly stable at most managers and progress toward mainstreaming ESG approaches has been constant, if incremental. The ESG component of Mistra's investments had an overall neutral impact on financial results in 2011.

More of Mistra's managers now also aim to fully integrate ESG analysis in investment processes. Several new managers were added in 2011 that explicitly take a full integration approach to SRI, while other managers have ambitions to move more toward ESG integration in the ongoing development of their processes. We view this as a positive trend for Mistra's asset management, both for financial and sustainable development impact reasons.

Most of Mistra's managers demonstrate strong active ownership practices (voting and engagement), particularly in the area of company engagement. This was a focus of last year's review and has been one

[1] The 2011 review did not include Mistra's single hedge fund investment, which will be reviewed for the first time next year.

of the most-improved areas in the course of 2011. Several managers now have in-house engagement teams and a comprehensive approach to engagement. Work remains, however, in the area of share voting for some managers that lack formal processes or sufficient resources.

It is interesting to compare the development of Mistra's equity and fixed income managers over time. Previous laggards have strongly enhanced their environmental, social and governance (ESG) strategies and processes over the past 2-3 years and are now effectively on par with the leaders. All managers with an ESG screening process are aware of the fact that this can cause sector tilts compared to the benchmark in any given year (in some years this results in positive, in other in negative performance effects). Many managers engage with laggard companies as a way of "bringing them up to speed" and turning them into investable companies, which we see as an important contribution to sustainable development.

This year, our analysis included a special focus on newly added managers in the global emerging markets equity and private equity asset classes. The new emerging markets managers avoid using screening approaches and try to integrate relevant ESG information directly into their financial models (integration approach). They both also rely heavily on dialogue with companies in which relevant ESG issues are raised. For the new private equity managers, integrating ESG factors poses unique challenges but also offers the opportunity for engaging with companies or fund managers on a broader range of risk factors (discussed in detail in the section "Private equity managers"). We found that the Mistra private equity managers mainly rely on active ownership techniques to monitor and manage ESG risks. ESG information is not (yet) used at the due diligence/investment decision stage.

Objectives

The funds and mandates reviewed in 2011 (SEK 2.5 billion per end of 2011 representing 95% of total Mistra assets) were all invested using some degree of explicit inclusion of ESG issues.[2] This report to the Mistra Asset Management Committee presents the findings of the seventh annual review of the process used by each manager to integrate environmental, social and governance (ESG) issues into their investment decision-making and ownership practices. Taking this approach affords us a different perspective than traditional portfolio reviews, in that it allows the investigation of the long-term development of investment processes, people and commitment to sustainability, all of which can reveal additional insights about a manager's ability 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, 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.

There were several new managers reviewed for the first time this year, and this process allowed onValues to confirm that these managers comply with Mistra's Investment Policy[3] and also gather information on the level of ESG integration in their investment processes. For other managers, this was the seventh 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 for legacy managers we were able to concentrate on the incremental changes and to revisit areas of concern revealed by previous annual reviews.

The sustainable investment annual review process also allows Mistra to complete the yearly reporting for the Principles for Responsible Investment (PRI) in a detailed and thorough manner.

[2] That is to say that the inclusion of ESG issues is a formal requirement of the asset management agreement or fund strategy.
[3] Available at www.mistra.org

Methodology

As in previous years, the review process included asset managers responding in writing to a short questionnaire and then participating in a telephone conference to clarify open issues. The results of the review were then presented and discussed at a meeting of the Mistra Asset Management Committee. The focus of the review was on constructive conversations with managers that allow them to share insights and concerns. The process also avoids being prescriptive regarding the integration of ESG issues, rather acknowledging that a diversity of ESG investment styles is both possible and arguably desirable. It was nonetheless made clear both in the written survey and in the teleconferences that Mistra's primary interest in ESG issues relates to their ability to enhance risk-adjusted financial return.

Findings

Efforts to mainstream ESG in the entire assets under management (AUM)

Mistra believes that institutions committed to mainstreaming ESG analysis in their overall operations will, on average, offer Mistra better, more stable SRI investment approaches supported by higher quality staff. Emphasizing the importance of mainstreaming furthermore allows Mistra to promote the development of sustainable investing in the broader market.

- Our overall impression is that mainstreaming work has continued at all the Mistra managers, generally in the form of incremental progress
- Certain managers have made very positive steps this year toward developing mainstream fixed income and equity products that will include a strong ESG component. This style of mainstreaming, where increasing amounts of the investment offer include strong ESG analysis (beyond simple negative screens) is a very promising sign for an institution.
- The main outlet for some managers to mainstream ESG is to participate in initiatives or issue public reports on topics in sustainable investing. Putting a firm's brand behind such activity demonstrates a high-level commitment to sustainable investing.
- **Areas for improvement**: Mistra invites its managers who are not already doing so to publish their annual PRI survey scores, showing their score's historical development and comparison with the broader asset manager signatory group.

Attribution of risk and return to the ESG-related investment process

As in previous years, in order to isolate the contribution to risk and return arising from the ESG component of the process, we asked the managers of public equities and fixed income[4] to compare the Mistra mandate's performance with a reference portfolio of their choosing, where the reference portfolio could include (in decreasing order of preference):

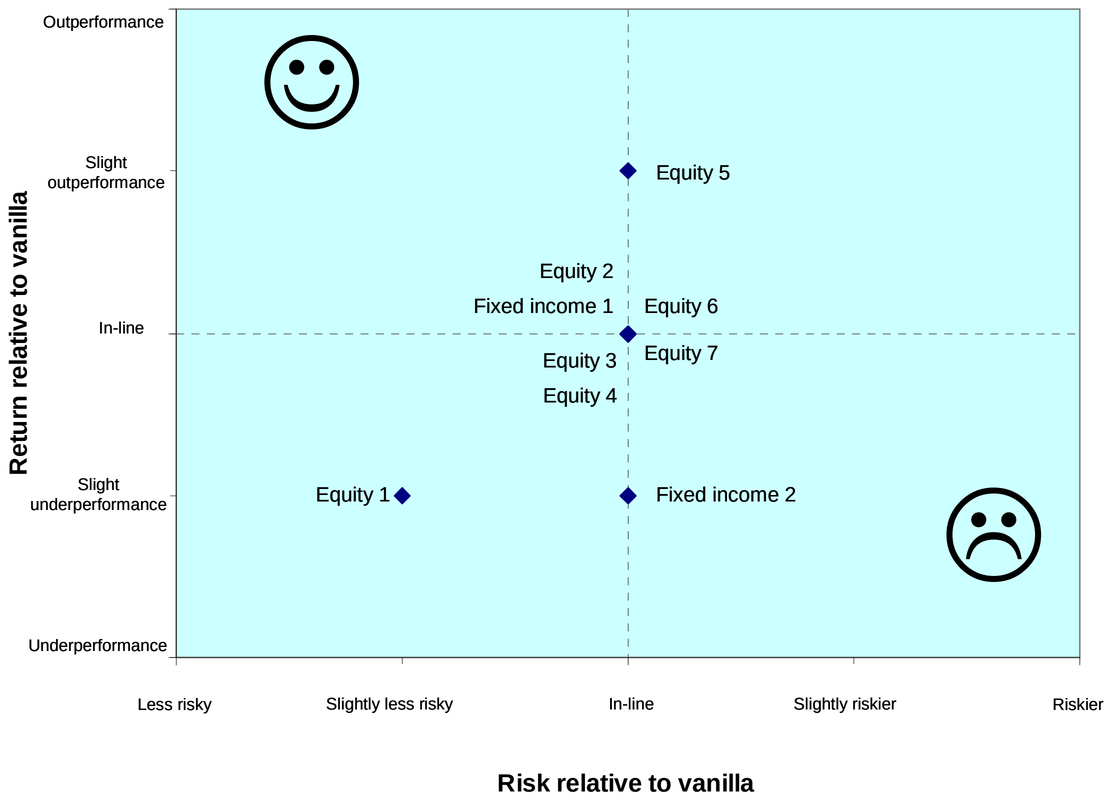
- A closely-related "vanilla" strategy that does not include the SRI component but that is otherwise identical to the Mistra mandate
- A model portfolio that simulates the performance of a portfolio without the SRI component (i.e. a synthetic version of the above)
- An appropriate broad benchmark (e.g. a mandate that invests in large-cap US equity and that has value characteristics might choose the S&P 500 Value Index as the reference portfolio).

For 2011, this attribution analysis showed the following results:

[4] Private equity managers could not be evaluated at this point and are dealt with in a later section.

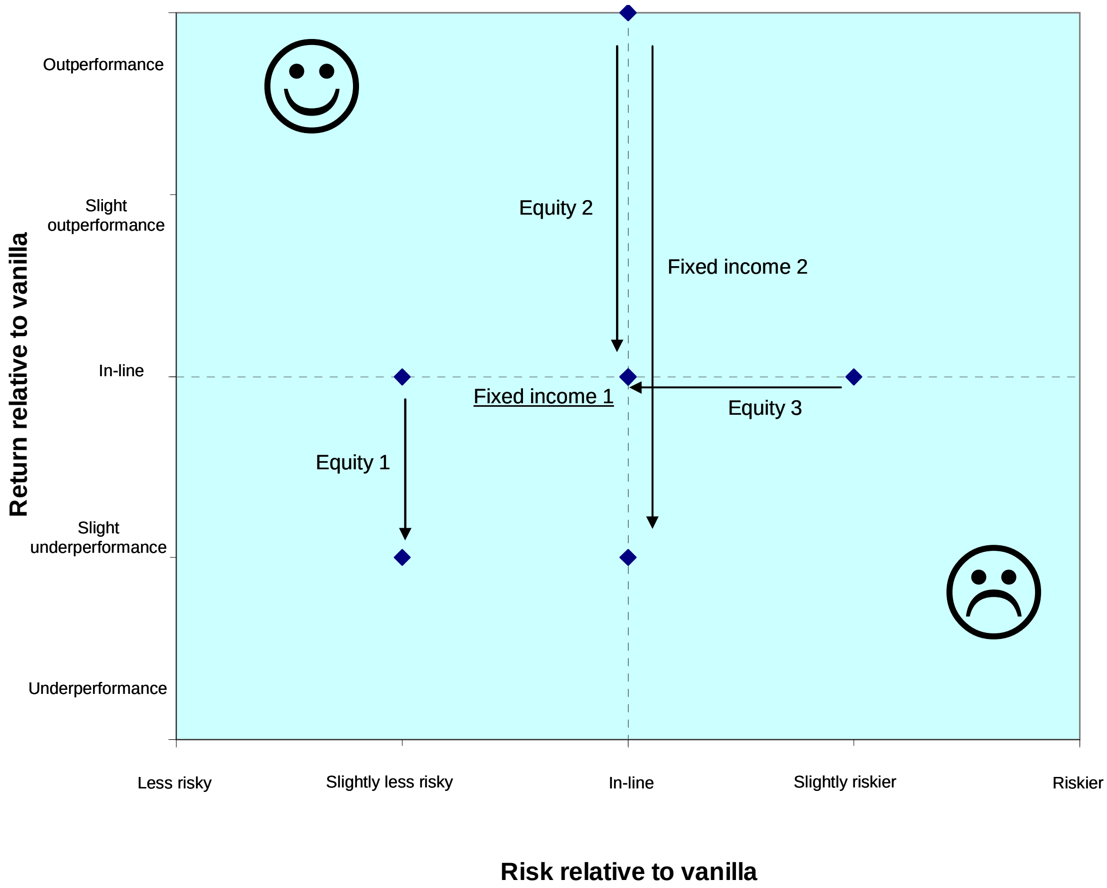
- 6 of the 9 mandates / funds evaluated this year showed performance basically in-line with a non-SRI “vanilla” strategy, as can be seen in the figure below
- In one case, the contribution was positive this year and in two cases the contribution was slightly negative
- In almost every case the ESG component does not contribute to higher risk (as measured by standard deviation or tracking error) compared to the reference portfolio. In one case, the ESG component contributed to marginally lower risk.
- Overall, it can be said that the ESG component had a negligible influence on the financial performance of Mistra’s portfolio this year, though 2011 was generally a difficult year for many managers in terms of generating positive alpha.

Risk and return of Mistra investments in 2011
relative to “vanilla” reference portfolio (schematic)



We also look at how the managers' positioning with regard to the ESG contribution to risk and return has changed from 2010 to 2011 (next graph). This year marked a clustering around the mid-point of risk and return, with previous outperformers falling to in-line or underperformance. Several managers were removed after last year's assessment and do not appear here, while several managers were new and did not receive an assessment last year.

**Change of managers' positioning from 2010 to 2011
with regard to the ESG contribution to risk and return (schematic)**



Note: Underline represents no change in ESG contribution to risk-return profile since 2010.

Integration of ESG issues into the investment process

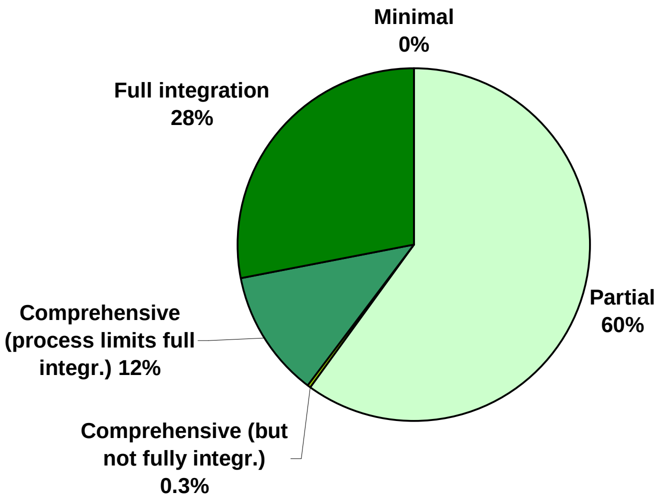
ESG integration—when asset managers systematically assess environmental, social and governance issues to gain an informational advantage in their traditional investment decision-making process—is by some measures the "holy grail" of sustainable investing. Principle Number 1 of the PRI requires signatories to "incorporate ESG issues into investment analysis and decision-making processes" and some of the most successful examples of ESG investing pursue the integration approach. Nevertheless, by its nature, integration is difficult to monitor and assess: its implementation happens in the minds and detailed financial models of investment analysts. Its quality is also highly dependent on the culture of an institution and on how fund managers' performance is measured and remunerated.

Assessing ESG integration has always been a major focus of Mistra's annual asset manager sustainable investment review. In the chart below we present the onValues assessment of the degree to which ESG is integrated into financial analysis in a way that is likely to optimise risk and return over the long term.

The results of our integration assessment can be subdivided by groups of managers:

- Three managers declare their processes to be fully ESG integrated. Of these, we find the most successful examples of integration at managers where a long-term investment approach is part of firm culture and where employees have financial incentives to manage investments for long-term performance.
- At Mistra's other equity and debt managers that do not claim full integration we find that SRI teams and portfolio managers work closely together so that ESG issues play an important role in the investment process via sector specific screens and best-in-class approaches. These managers have all converged at a relatively high level with regard to their ESG investment processes. One manager has made significant progress this year in conducting ESG analysis and informing the investment process with its results. This manager had previously been the laggard in the group in terms of sustainable investing, but now is in a position to overtake the others. On the basis of this improvement we upgraded this manager from "Partial" to "Comprehensive" integration, while noting that full integration has not yet been achieved.
- **Areas for improvement**: As before, the large fixed income component of Mistra's portfolio received only a "Partial" rating, as ESG criteria are usually applied only to the corporate bond part of the portfolio.

Rating of ESG integration among reviewed managers[5]



[5] As stated above in footnote 1, the 2011 review did not cover one manager. The managers reviewed represent 95% of Mistra's assets.

Private equity managers

Mistra currently has three managers and mandates active in the domain of private equity. Two of these are new to the review process this year. All three private equity managers were posed a special set of review questions (see Appendix) for the first time this year as well. Consequently, we felt it was important to highlight the unique dynamics of incorporating ESG issues into private equity investments.

Private equity presents unique challenges and opportunities for investors interested in the sustainability performance of their holdings.[6] On one hand, a private equity investment usually entails a long holding period in an illiquid market environment (it is often impossible to sell an investment). Therefore investors must either 1) understand a company's ESG performance before investment and/or 2) work to improve the company's ESG performance over the life of the investment.

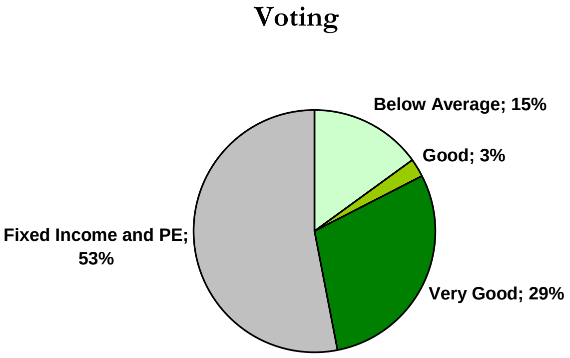
On the other hand, private equity investors enjoy greater control over their investments compared, for example, to public equity investors. They often take large ownership stakes and are directly responsible for appointing and compensating company management. In a fund of funds, the manager usually has a seat on the advisory boards of the funds they invest in and is able to exert a certain influence in this way. Single fund managers, on the other hand, especially if they are major shareholders, can directly influence the course of companies.

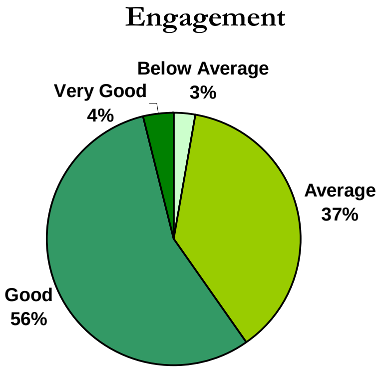
Mistra's private equity managers do take such controlling positions in their portfolio companies and their fund of funds manager likewise is an important LP in its underlying funds. These managers apply a combination of pre-investment ESG analysis and post-investment constructive management intervention on ESG issues to ensure that holdings reflect a high standard in sustainability and in fact improve their sustainability performance over time.

Active ownership (proxy voting and engagement)

Principle 2 of the PRI reads: "We will be active owners and incorporate ESG issues into our ownership policies and practices." The annual review aims to provide Mistra with the information it needs to report on its progress against this PRI principle and to monitor the quality of active ownership practices at its managers.

- We found that most managers had good approaches to active ownership. This assessment was based on a review of the formal voting and engagement policies, past track record of voting shares and engaging with companies, and overall quality of active ownership results:





Notes: Only equity portfolios have voting rights. Private equity active ownership is assessed in the separate discussion of the private equity managers, though not depicted in these graphics. Percentages shown are of assets assessed (95% of total assets).

[6] For a more complete discussion of this topic, see "Responsible investment in private equity", PRI 2011, available on www.unpri.org.

- While engagement by its nature is difficult to perfect, we were encouraged by the policies and practices of the managers that best efforts are being made to influence company behaviour to improve shareholder value. Notable is the strong focus on active dialogue with companies by the new emerging markets equity and the private equity managers.
- For Swedish equity managers that start with a limited universe (ca. 120 companies), engagement is a key tool to expand that universe by pushing companies that are excluded for sustainability reasons to improve their practices and thereby become eligible for investment. We also observed that for these strategies, engagement was an important complement to the screening and best-in-class approaches used in portfolio building.
- On voting, we observed a bifurcation between above-average approaches and below average approaches, with very few managers falling in the middle. There is a clear need to professionalize voting practices at certain managers.
- **Areas for improvement**: The active ownership practices of most of Mistra's managers are approaching a very high level. On the engagement front, some managers can still add specialist staff and gain experience while others can make ESG issues a more central part of manager meetings. On voting, as discussed, there is a need for some managers to adopt a more comprehensive approach.

Changes to ESG-related processes and teams

- This year, most investment processes and teams did not change substantially, with the significant exception of one manager where a new SRI process based on positive screening and best-in-class analysis was implemented and several new SRI team members were added. Other changes in people and processes were marginal and should not alter the outlook of Mistra's investments.
- The portfolio turnover observed in the Mistra mandates/funds is basically consistent with the declared investment approaches and with managers' expectations.
- We noted this year that several managers used external ESG monitoring services to assess portfolio holdings or flag potential high-risk companies. We think that these independent "portfolio checks" are a valuable addition to an existing investment process.
- **Areas for improvement**: There is still room for closer collaboration between ESG specialists and the portfolio management specialists.

Appendices

<u>Surveys sent to external asset managers</u>

Annual review of asset managers' approach to sustainable investment (SI)

Mistra and onValues
December 2011

Goals and process

This is the seventh annual review of Mistra's external asset managers. You will notice that the structure of the questionnaire is more or less unchanged compared to last year, which we hope will make it easier for you to reply. If an answer to a question is unchanged compared to last year, please simply mention that. You may also point to existing documents (e.g. fund documents or a copy of your PRI reporting for 2011) in answering a specific question.

Please send **<u>brief</u>** written answers to the following questions (with attachments if required) to Ivo Knoepfel, Managing Director, onValues and to Fredrik Gunnarsson, Administrative Director, Mistra **<u>by close of business on Friday, 20 January 2012</u>**. Your answers will be used as the basis for a constructive teleconference discussion, which will take place in early February 2012. As in previous years, onValues will present the results of the annual review to the Mistra Investment Committee.

The Mistra Investment Committee and onValues greatly appreciate your commitment to this process.

Questions

All answers should refer to the period 1 January – 31 December 2011 or to the situation at 31 December 2011 (please indicate if this is not the case). If you manage more than one fund for Mistra please make clear when answers apply to a specific fund.

1. **Changes in SI commitment and AUM at institution level**
    a. Please indicate how your institution's total AUM in the SI field has evolved in the calendar year 2011.
    b. If possible, break out by asset class and country / region, and by SI style (negative screening, positive screening / best-in-class, integrated, engagement overlay, etc.). If precise data are available at the headline level but not for regions, styles, etc., please give any qualitative commentary you can on the underlying trends (e.g. "Our US negatively-screened funds and mandates saw net outflows.", "Our net growth in new accounts in Sweden was flat. New clients preferred engagement approaches", etc.)
    c. Please include examples of your institution's 2011 commitments and efforts aimed at "mainstreaming" the consideration of environmental, social and governance factors in the management of your entire AUM. Have these commitments and efforts been communicated publicly and/or to clients?

2. **Contribution of SI investment process to risk and return**
    a. Please provide data for 2011 for the contribution to risk and return made by the SI component of the investment process of the fund managed on behalf of Mistra. You might want to compare the performance of your SI strategy with a reference portfolio, such as (in decreasing order of preference):
        i. A closely-related, 'vanilla' strategy that does not include the SI component but that is otherwise identical to the Mistra fund

   ii. A model portfolio that simulates the performance of a portfolio without the SI component (i.e. a synthetic version of i. above)
   iii. An appropriate broad benchmark (e.g. a mandate that invests in large-cap US equity and that has value characteristics might choose the S&P 500 Value Index as the reference portfolio)
b. Please comment the contribution to risk and return made by the SI component of your investment process. Please indicate reasons for an eventual out- or underperformance of the Mistra fund compared to the reference portfolio. What elements of your SI process have worked well, which ones need improvement?
c. Please highlight the concrete example of a change in the portfolio based on SI considerations (inclusion/deletion of a specific position, changes in the weighting of a position) and comment on the expected contribution to portfolio risk and return.

3. **Active ownership activities**
   a. Has a new proxy voting policy addressing ESG issues been introduced in 2011 for the fund managed for Mistra? (please attach the policy)
   b. For listed equities, please indicate the ratio of (proxy) votes cast, either directly or via third parties, against those you could have cast in 2011 (specify if your answer applies to number of ballots, meetings or assets under management).
   c. To what extent do you and/or your agents review shareholder resolutions put forward by other shareholders to determine whether or not to support the resolution?
   d. Do you have a written engagement policy addressing ESG issues or other documents that direct engagement with issuers included in the Mistra fund? (please attach the policy)
   e. In total, how many issuers did your organisation engage with on Mistra's behalf on ESG issues in 2011? Please indicate the total number of engagements and qualify them according to the PRI scale "basic", "moderate", "extensive". Could you please describe (in general terms) the engagement activity and who performed it?
   f. For what portion of your engagement activity for Mistra do you set ESG engagement objectives and evaluate engagement successes? What percentage of engagements is typically deemed successful based on your ex-post evaluation?

4. **Turnover**
   a. Please indicate the turnover rate of the fund managed for Mistra. Please calculate turnover as the lesser of annual purchases or annual sales divided by the average net asset value in the past year (in %)
   b. What is your forecast long-term turnover for the fund?
   c. What was the turnover of the reference portfolio chosen in question 2. above?

5. **Changes to investment process / team in 2011 / any other issue**
   a. Please describe any changes to your investment process, sources of investment research or data (ESG or mainstream research), or team members in the year 2011.
   b. Are there any other issues you would like to highlight or questions for Mistra? Please let us know.

6. **Fund documents**
   a. Please send us the Dec. 2011 factsheet and the available quarterly/semi-annual reports of the fund managed on behalf of Mistra.

Further information

David Imbert or Ivo Knoepfel
onValues Ltd.
Josefstrasse 59, 8006 Zürich, Switzerland
Tel: +41 43 344 9493

Annual review of private equity managers' approach to sustainable investment

Mistra and onValues
December 2011

Goals and process

Every year, besides assessing traditional financial performance aspects, Mistra also reviews asset managers' approaches aimed at incorporating environmental, social and governance (ESG) issues into investment analysis/decision-making and into active ownership practices. onValues, a specialist consultancy working on behalf of Mistra, is in charge of this review.

Mistra is a signatory to the Principles for Responsible Investment (PRI, see www.unpri.org) initiative and is committed to implementing ESG criteria in its entire asset management. PRI offers guidance for General and Limited Partners available at www.unpri.org/privateequity/.

Given the fact that you are participating in this review for the first time, we kindly ask you to reply to a set of introductory questions. In addition, we will organise a conference call with you at the beginning of Feb. 2012 in order to understand in more detail your approach.

Please send **brief** written answers to the following questions (with attachments if required) to Ivo Knoepfel, Managing Director, onValues and to Fredrik Gunnarsson, Administrative Director, Mistra **by close of business on Friday, 20 January 2012**. Your answers will be used as the basis for a constructive teleconference discussion, which will take place in early February 2012. As in previous years, onValues will present the results of the annual review to the Mistra Investment Committee.

The Mistra Investment Committee and onValues greatly appreciate your commitment to this process.

Questions

1. If your fund targets specific sectors, please indicate for each sector whether there are any specific ESG risks[7] that you pay particular attention to during the investment analysis and/or due diligence process.
2. Do you have a policy that describes your firm's approach to identifying and managing ESG risks within portfolio companies[8]? If so, please provide a copy. If not, please indicate whether you believe ESG factors can impact returns on investment and whether you would consider adopting a policy.
3. Has your fund also adopted a policy to exclude certain investments in any sectors or regions, or based on any ESG criteria?
4. Describe your process for identifying and evaluating potentially material ESG risks during due diligence (i.e. scoping and implementation of the due diligence).
5. Describe how you resource this aspect of your investment process (internal resource, external consultants, etc) and highlight the specific qualifications of this resource with regard to ESG factors.
6. Please provide examples, if any, from your current or last fund where a material ESG risk was identified during the due diligence process. Where relevant, please include a description of any follow-up action undertaken.

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[7] Examples for an environmental risk: soil pollution on the compound of an investee; For a 'social' risk: an unprofessional human resources management; For a corporate governance risk: a remuneration system for board and senior manager members that incentivises short-termism and excessive risk-taking

[8] Not just with regard to the business activities of the companies, but also in relation to the companies' own environmental and social risk profile, and their approach to corporate governance.

7. Under what circumstances, and through what process, would you consider whether to review and assess a portfolio company's approach to managing ESG risks?
8. Is your institution a signatory to the PRI? Please include examples of your institution's commitments and efforts aimed at "mainstreaming" the consideration of ESG factors in the management of your entire private equity AUM. Have these commitments and efforts been communicated publicly and/or to clients?
9. Please send us the available 2011 quarterly/semi-annual reports and a detailed English presentation of the fund managed on behalf of Mistra.

Further information

David Imbert or Ivo Knoepfel
onValues Ltd.
Josefstrasse 59, 8006 Zürich, Switzerland
Tel: +41 43 344 9493