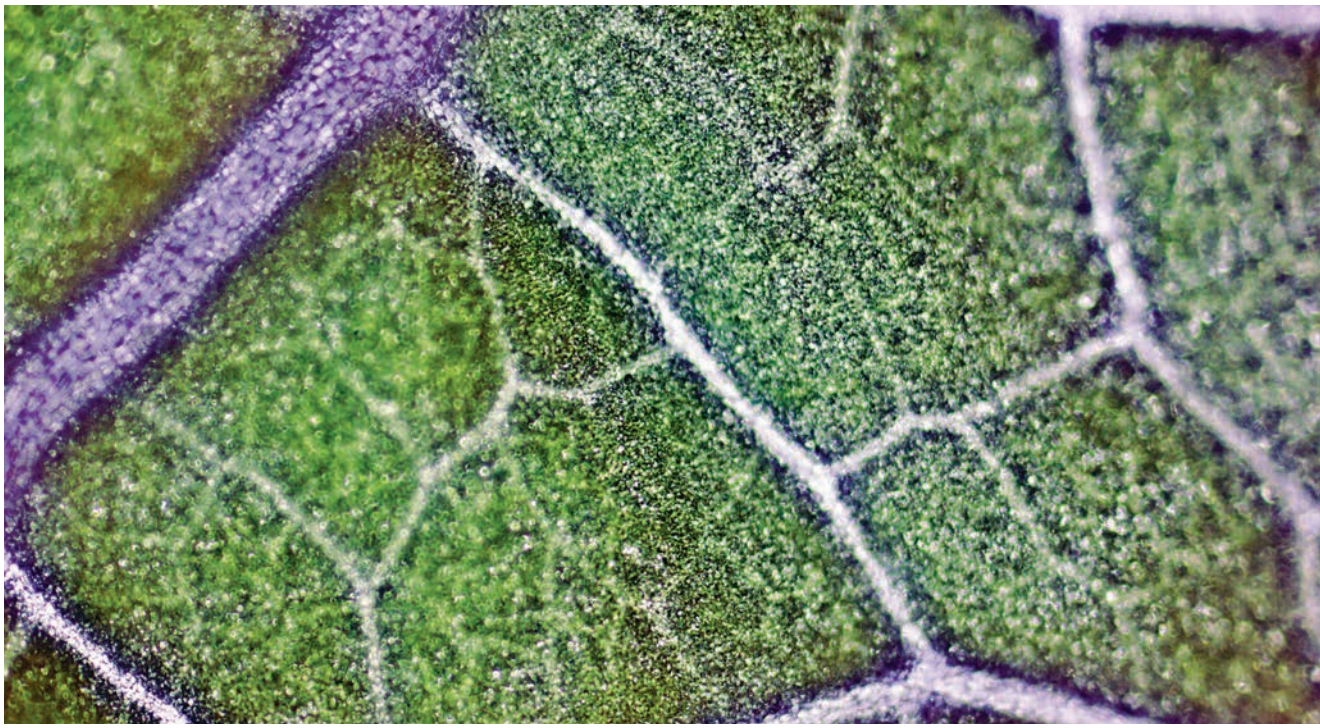
Lonsec

BIOmetric #4: ESG Awareness



Recommending financial products to clients has always been a staple of the financial planning process. And while the way we do this and the way we've used investment research to support this advice hasn't changed much over the years, the political and operating environment within which we work, has.

Financial planners have set a clear goal to transition from industry practitioners to 'professionals' and at the same time, governments and regulators have reshaped remuneration practices and increased planner obligations around personal financial product-based advice. These influences combined have diminished the relative importance of financial products in the advice process, but... the financial product advice that is given must now be better. Enter Lonsec's BIOmetrics.

Responsible Investing

Investors purchase financial assets primarily, but not exclusively, for their return potential. However other criteria have and continue to be included in the mix for a significant proportion of investors. These include political considerations and ethical factors.

For the latter category, there has been long standing confusion around terminology and definitions for different approaches. Terms such as 'Ethical Investing', 'Socially Responsible Investing', 'Responsible Investing' and 'Sustainability Investing' have, until recently, been used interchangibly and without agreed definitions. While some debate continues, most in industry now accept that the term 'Responsible Investing' ('RI') describes the overall 'movement', within which three main approaches exist:

- **Socially-responsible investing (SRI)** — investing that screens out investments in certain stocks or industries in line with defined (but varying) ethical guidelines;
- **Impact investing** — investing that screens in companies or industries with the aim of achieving defined (but varying) 'mission related' social or environmental change; and
- **Environmental, social and governance investing (ESG)** — investing that integrates ESG factors into fundamental investment analysis to the extent that they are deemed material to investment returns.

The three approaches obviously differ. SRI and impact investing aim to meet a defined set of investor values. ESG investing on the other hand aims to improve investment performance. That said, there is clearly overlap between categories which is indicative of convergence and the generalised shift over time from approaches using exclusion of certain types of investment to approaches targeting certain characteristics within investments.

ESG and returns

The SRI approach held sway for many years but it was often perceived as too restrictive. Further, it did not adequately address the question of whether any trade-off in performance was being made to meet one's ethical, religious or moral values.

In being broader in concept and in linking its analysis to a company's expected performance, ESG overcame (to a degree) the criticisms of the SRI approach. ESG is now bordering on 'mainstream' acceptance, driven primary by mounting evidence that poor company behaviour — at least within the 'E' and 'G' components — erodes shareholder value over time.

The turning point for ESG investing was the promulgation of the Principles for Responsible Investment (PRI) by the UN in 2006. PRI is a set of practice standards for voluntary adoption by fund managers. Signatories to the PRI agree to take ESG factors into consideration where they believe they are material to investment performance.

Signatories are encouraged to analyse ESG issues alongside 'standard' indicators of return and risk when making their initial investments. They are also encouraged to become 'active', that is, engage companies about potential material ESG issues and opportunities. Tempering this somewhat, most in industry agree that the PRI was a good start but its non-prescriptive self-assessment approach can lead to ambiguous compliance outcomes. This view has informed Lonsec's approach to scoring managers on their approach to ESG, as outlined below.

As far as evidence for efficacy, a recent meta-analysis by DB Climate Change Advisors of more than 100 academic studies concluded that incorporating environmental, social and governance data in investment analysis is "correlated with superior risk-adjusted returns at a securities level"[1].

ESG BIOmetric

What it is

Lonsec has utilised our database of financial product ESG information to consciously look through other external indicators of ESG awareness to design our ESG BIOmetric. We believe this second order validation approach allows investors to have a high degree of confidence in the integrity of the ESG assessment. Lonsec's ESG BIOmetric takes into account an investment manager's:

- Investment philosophy towards ESG factors
- ESG charter or Responsible Investment policy
- Integration of ESG factors into the investment process
- ESG activism
- Shareholder voting policy
- Historical voting behaviour
- Use (or not) of an ESG investment objective
- Use (or not) of a specific ESG measurement benchmark

Lonsec's ESG BIOmetric is therefore a graded measure of the degree of ESG awareness practiced by the investment manager with respect to the product under review.

What it isn't

Lonsec's ESG BIOmetric is not calculated with reference to any particular investor values or ethics. That is to say, it cannot be derived from the score what particular policies or activities have or have not been screened out or in to a manager's investment process. Whilst there is an inferred correlation between certain values based activities and the ESG score, specific exclusions or inclusions are not guaranteed merely by way of a fund achieving a particular score. Advisers should therefore refer to individual Lonsec research reports for this information.

Note, Lonsec does not ascribe ESG scores to products within all asset classes and sectors. Currently, only products within equities and listed property/infrastructure based asset classes are ascribed a Lonsec ESG BIOmetric score. Due to the above limitations, multi-asset products are not currently ascribed a Lonsec ESG BIOmetric score. As the market evolves and new product innovation crystalises, ESG awareness scores within the remaining asset classes will be ascribed (when a critical mass of product becomes available).

How to use it

Lonsec's ESG BIOmetric should be used as a key input into the financial planning process whenever investment advice containing financial products is given. To this end, Lonsec's ESG BIOmetric provides a means of differentiating between managers seeking to exploit the alpha opportunity from ESG assessment versus those managers choosing not to.

The ESG BIOmetric is also a facilitator of the best practice advice framework Lonsec introduced to the industry in 2014, known as the 'Quality Use of Financial Product (QUFP)'. Lonsec's QUFP framework has four pillars. Further information can be found within the Lonsec Whitepaper *It's Time to Co-Regulate the Financial Product Advice Chain*.

In Reports

Lonsec's ESG BIOmetric can be accessed via the "Features and benefits" table within Fund Reviews.

	LOW	MODERATE	HIGH
CAPITAL POTENTIAL		●	
INCOME POTENTIAL	●		
LIQUIDITY (ACCESS)			●
COMPLEXITY		●	
ESG AWARENESS		●	
TAX EFFICIENCY		●	

1. *Sustainable Investing: Establishing Long Term Value and Performance*, DB Climate Change Advisers 2012

Summary

Financial planning is changing and in particular investment advice containing financial product advice is changing. Whether it's the higher regulatory bar or higher professional standards, financial planners must re-think the way they recommend financial products to their clients. ESG awareness is no longer just a values based consideration when it comes to product recommendations. Evidence continues to mount that incorporation of ESG factors into the investment process is at worst neutral for performance, and is in fact most likely positive. Financial planners now have the opportunity to utilise financial product ESG assessments to not only ensure they dispense high quality financial product advice but to also engage with their clients. Lonsec believes that our ESG BIOmetric will prove to be timely and useful for financial planners as they seek better investment outcomes for their clients.

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