Lonsec

BIOmetric #4—ESG

Lonsec's BIOmetrics have set a new standard in transparency and usefulness for financial planners and advisors. Our Environmental, Social and Governance (ESG) BIOmetric has been further refined to ensure a more in-depth review of a managers' ESG practices as well as a peer relative benchmarking process.

Responsible Investing

There has been long standing confusion within the financial industry around terminology and definitions for different approaches to Responsible Investing.

Terms such as 'Ethical Investing', 'Socially Responsible Investing', 'Responsible Investing' and 'Sustainability Investing' have been used interchangeably and without agreed definitions. While some debate continues, most in the industry now accept that the term 'Responsible Investing'('RI') describes the overall 'movement', within which three main approaches exist:

- **Ethical investing**: Investing that screens out investments in certain stocks or industries in line with defined (but varying) ethical guidelines.
- **Sustainable and impact investing**: Investing that screens in companies or industries with the aim of achieving defined (but varying) social or environmental objectives.
- **Environmental, social and governance integration (ESG)**: Investing that integrates ESG factors into fundamental investment analysis to the extent that they are deemed material to investment returns.

Importantly these approaches are not mutually exclusive, with many managers offering ethical or sustainable approaches as well as delivering ESG integration.

ESG and returns

Despite concerns that ESG integration posed a potential trade-off between incorporating these elements and performance, this is not supported by the research.

The Journal of Sustainable Finance and Investment noted that more than 2,200 academic studies undertaken in the past 40 years have examined the relationship between ESG factors and corporate financial performance. More than 90% of them have found that ESG factors have a positive or neutral impact on financial returns.[1]

Further, recent manager surveys conducted by Lonsec have found that over 90% of rated Managers agree with the statement "that the assessments of ESG factors provides an opportunity to improve investment returns or risk management". The integration of ESG into the investment process has now mainstreamed.

Over the decade since the introduction of the Principles for Responsible Investment (PRI) by the UN, ESG integration has become an established approach with the PRI providing standards for voluntary adoption by fund managers. The PRI have become the industry benchmark against which Signatories to the PRI agree to take ESG factors into consideration where they believe they are material to investment performance.

[1] Journal of Sustainable Finance & Investment, 2015, Vol. 5, No. 4, 210–233

The guidelines and principles of the PRI are deliberately general in their wording and non-prescriptive in their definition.

Lonsec's position on ESG integration

Following extensive consultation and discussion, Lonsec Research has agreed on the following positioning statement on ESG:

- Lonsec believes that the incorporation of Environmental, Social and Governance considerations into investment analysis by fund managers is likely to improve risk or return outcomes and should ultimately translate into a higher potential for a manager to achieve their investment objectives.
- Lonsec will incorporate ESG as a discrete element in the rating process for all products. As a consequence, the assessment of ESG considerations can influence the final rating outcome.
- Lonsec's approach acknowledges that there are multiple ESG models implemented by managers and will ensure sufficient flexibility in its assessment as not to unduly penalise managers based on their chosen asset class, product type or investment style.

Lonsec will assess a manager's ESG integration using the framework provided by the broad parameters of the PRI's six principles:

- **Principle 1**: We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2**: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3**: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4**: We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5**: We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6**: We will each report on our activities and progress towards implementing the Principles.

ESG BIOmetric—what it is

Lonsec has further refined its assessment of fund managers to benchmark the extent of ESG integration evident in the policy and reporting framework of the manager and in the actual portfolio research and construction processes undertaken by their portfolio managers.

While the ESG integration measure is being included into Lonsec's manager research process, Lonsec is also providing this measure explicitly as the ESG BIOmetric. Lonsec's ESG BIOmetric takes into account an investment manager's:

- extent of public commitment to ESG;
- strength and disclosure of the ESG policy framework including proxy voting and engagement elements;
- evidence of integration of ESG factors into the investment process;
- depth and usefulness of public reporting on ESG activities;
- evidence of seeking disclosures on key ESG issues including reviewing the approach to data collection and/or validation; and
- evidence of genuine collaboration.

Importantly the ESG BIOmetric is a peer-based ranking, not an absolute score, and as such ensures that the 'bar is continually being lifted' as managers continue to improve their own ESG approaches.

Lonsec is implementing the revised ESG assessment methodology to the 2020/21 fund reviews. Lonsec acknowledges that different asset classes will require slightly nuanced approaches and that assessing the ESG characteristics of some products, such as alternatives, provides challenges.

As a result, our peer ranking process will be performed on an asset class basis to ensure strategies across the spectrum are treated fairly.

Prior to March 2020, ESG was assessed using an alternate methodology. For details of the methodology applied for reports issued prior to the date of this guide, see the document located at **www.lonsec.com.au/esg-awareness**.

ESG BIOmetric—what it isn't

Lonsec's ESG BIOmetric is not calculated with reference to any particular investor values or ethics, i.e. screening out of particular policies or activities from a manager's investment process cannot be derived from the score.

While 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.

How to use Lonsec's ESG BIOmetric

Lonsec's ESG BIOmetric should be used to provide additional information into the financial planning process whenever investment advice containing financial products is given. While this BIOmetric has been included by Lonsec into its rating process and ultimate rating outcome, the ESG BIOmetric provides a means of differentiating between managers seeking to exploit the alpha opportunity or improved risk management from ESG assessment versus those managers choosing not to.

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

Sustainability reporting

Importantly, as highlighted above, a high ESG score does not necessarily make any comment about the sustainability or ethical characteristics of a portfolio. To assist investors in this regard Lonsec will be launching its new Sustainability report in 2020.

Issue date: 17 April 2020

Melbourne
L7, 90 Collins St
Melbourne, VIC 3000 Australia
T 1300 826 395

Sydney
L21, 200 George St
Sydney, NSW 2000 Australia
T 1300 826 395