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BRIEFING PAPER March 2017

MISSING IN ACTION

THE LACK OF ESG CAPACITY AT LEADING INVESTORS

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EXECUTIVE SUMMARY

> The ratification of the Paris Agreement on climate change and the UN Sustainable Development Goals imply significant structural shifts in the global economy. In parallel, growing political attention is being focused on the role of finance to deliver these goals. Asset owners and investment managers will need to play a much more significant role in delivering the transition to a sustainable global economy, while effectively managing the large associated downside risks that have the potential to cause significant financial instability.

> This briefing assesses the internal capacity of leading investors to consider climate and broader environmental, social and governance (ESG) factors by looking at how many specialised ESG staff signatories of the Principles for Responsible Investment (PRI) employ. Our analysis finds that 33% of signatories directly employ no ESG staff and a further 20% employ just one. This means over 500 PRI signatories, representing $6.9 trillion, directly employ one or fewer ESG staff. On an asset under management (AUM) basis, the average PRI signatory hires one ESG specialist per $14bn of assets managed.

> While some investors outsource responsible investing, and others claim to take an integrated approach, it is clear from

this analysis that the majority of PRI signatories need to rapidly expand and strengthen their in-house ESG expertise by employing more specialists and training existing staff.

> Asset owners and investment managers play different roles in responsible investing. An important finding for policymakers is that asset owners tend to rely on investment managers to deliver their responsible investment policies, where these policies exist. Perhaps because of this, we find that investment managers tend to hire more dedicated ESG staff than asset owners. Policymakers should understand this difference when developing sustainable finance strategies. They should attempt to strengthen asset owners' responsible investment policies which, in turn, would encourage investment managers to increase their internal capacity.

1. INTRODUCTION

Delivering sustainable development – including a low carbon global economy – implies a shift in institutional investor behaviour to mainstream responsible investment (RI) practices.[1] Investors need to identify and price the risks and opportunities related to sustainable development to build resilient portfolios and facilitate long-term value creation. Recently there have been significant political commitments to move in this direction, most notably the Paris Agreement on climate change and the UN Sustainable Development Goals.[2,3,4]

Responsible investing requires investors to take a different investment approach from the norm: one that incorporates qualitative assessments and active ownership in addition to traditional, quantitative financial risk/return analysis. Put differently, environmental, social and governance (ESG) factors must be included to assess and price companies' long-term potential.

Taking this approach makes financial sense. Meta-analysis has found that companies that perform strongly on ESG criteria outperform their peers

[1] The terms 'responsible investment' and 'ESG investment' are used interchangeably in this report.

[2] UNFCCC (2015) **The Paris Agreement**

[3] United Nations (2015) **Sustainable Development Goals**

[4] Financial policymakers are also moving forward in this area. Significant work includes the **G20 Green Finance Study Group**, the **FSB Task Force for Climate-related Financial Disclosures** and the **European Commission High-Level Expert Group on Sustainable Finance.**

financially.[5] In addition, McKinsey published a report which concluded that firms focused on long term value creation outperformed the average in revenue, earnings, profit, investment (R&D), market capitalization and job creation between 2001 and 2015.[6]

The next section of this paper investigates the current internal capacity of leading investors – signatories to the United Nations Principles for Responsible Investment (PRI) – to develop, implement and oversee RI policies and seize opportunities arising from the recent major sustainability-related political commitments. We then discuss the important differences between asset owners and investment managers in relation to RI approaches.

2. ESG CAPACITY OF PRI SIGNATORIES

By August 2016, just over 1,500 asset owners and investment managers had signed the PRI.[7] The PRI provided E3G with a dataset containing information on around 1,000 of these signatories.[8] Table 1 describes the sample we used in our analysis.

Table 1: Number of investors and assets under management (AUM, USD billions)

	Number[9]	AUM total	AUM median	AUM max
All	993	50,022	2.8	4,635
Asset Owners	247	6,796	2.4	881
Investment managers	746	43,226	2.9	4,635

About one quarter of signatories in our dataset are asset owners and three quarters are investment managers.[10] Combined they manage $50 trillion of assets with the median signatory handling a portfolio of $2.8 billion. Figure 1 shows the distribution of assets under management (AUM) in our sample. The vast majority (90%) of assets are managed by investors based in Europe and North America. Figure 2 shows the total number of staff

[5] Deutsche Asset Management and the University of Hamburg (2016) **ESG and financial performance: aggregated evidence from more than 2000 empirical studies**

[6] McKinsey Global Institute (2017) **Measuring the economic impact of short-termism**

[7] A further discussion of the PRI can be found in the annex. Additional information, including their six principles, can be found on their website: **https://www.unpri.org/**.

[8] The original data is publicly available at **https://www.unpri.org/directory/**.

[9] E3G cleaned the dataset to omit potential outliers. All signatories with more ESG employees than total employees are omitted. The total number of signatories in our dataset is therefore lower than the total number of signatories to the PRI.

[10] See Figure 5 for an overview of the different roles played by asset owners and investment managers.

employed by PRI signatories and shows that the majority employ fewer than 100 full-time equivalents (FTEs).

Figure 1: Distribution of assets under management[11]

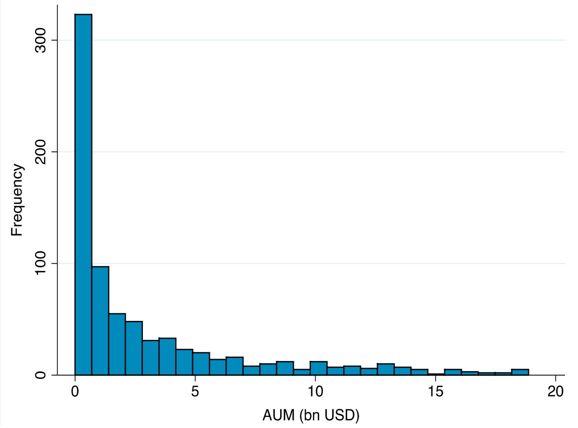
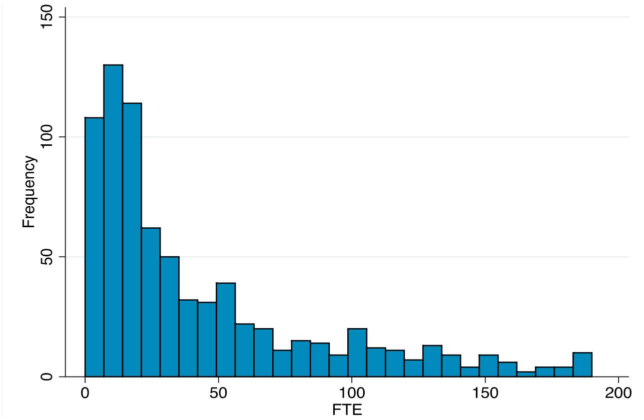


Figure 2: Distribution of full-time equivalents



2a. Specialised ESG staff

Our analysis finds that, in general, PRI signatories directly employ very few ESG staff. Around one-third of signatories employ no dedicated ESG staff and another 20% employ just one (Figure 3).[12] This means that **over half of all PRI signatories (53%) directly employ one or fewer ESG specialists.[13]**

ESG staff are rare – they make up just one in 303 staff employed by PRI signatories. Figure 4 shows that only 15% of all signatories have declared more than 20% of their staff as ESG specialists. On an AUM basis, the average PRI signatory hires one ESG staff member per $14bn of assets managed.

Signatories that employ a high proportion of ESG staff tend to be boutique investors with smaller AUM. The median AUM for signatories with fewer than 20% ESG staff is $2.8bn compared to $0.2bn for signatories with more than 80% ESG staff.

A lack of internal ESG capacity does not necessarily imply that these investors' assets are not managed responsibly – many signatories mandate external asset managers to invest responsibly on their behalf. Redoing the analysis described above, this time excluding asset owners and investment

[11] All histogram (frequency) plots are cut off at the 75 percentile to make the plots readable

[12] PRI defines ESG specialist/staff as follows in their questionnaire: "Dedicated responsible investment/ESG staff are those individuals with the majority of their time allocated to responsible investment/ESG activities (either oversight or implementation)."

[13] The measure of employees used is full-time equivalents (FTE). This means that if one full time employee spends 50% of their time on ESG issues they would count as 0.5 FTEs.

managers who fully outsource responsible investing[14], we find that average ESG staff numbers and the proportion of ESG staff to total staff do not change significantly[15]. **We find that over a quarter of all signatories neither employ any ESG staff nor fully outsource responsible investing.**

Figure 3: Distribution of ESG full time equivalents (FTEs) [16]

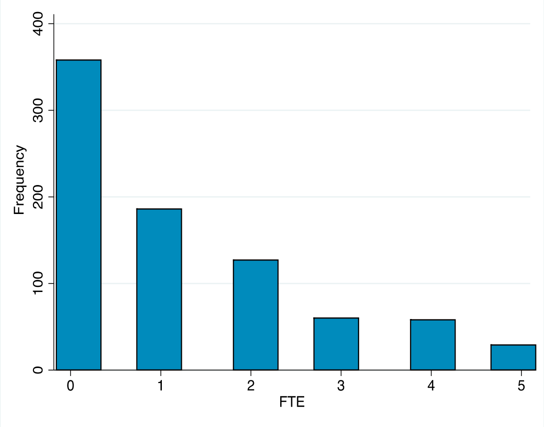
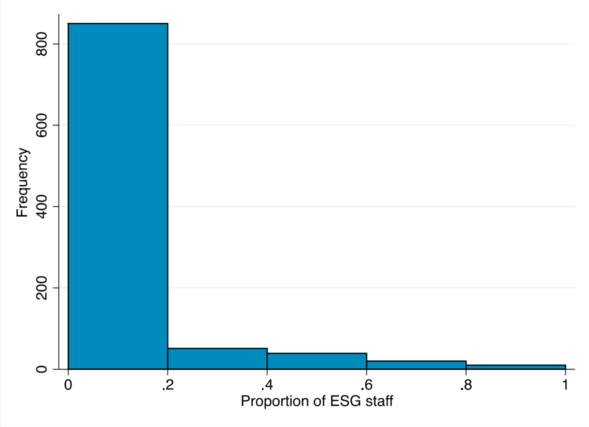


Figure 4: Distribution of proportion of ESG staff to total staff



It is also possible that signatories report that they have no dedicated ESG staff because responsible investing is fully integrated throughout their business. This could be true in certain circumstances, for example at investment managers that specialise in ESG investing. However, based on **our conversations with many leading responsible investors and observing the data, we find that boutique ESG investors tend to declare all staff as ESG**.

Given the recent news that the PRI will start delisting signatories for not fulfilling the principles, it seems likely that the majority of PRI signatories reporting that they have no dedicated ESG staff do indeed have zero capacity[17]. **E3G recommend that these signatories rapidly expand and strengthen their in-house ESG expertise by employing more specialists and training existing staff.**

2b. Leading responsible investors

Our analysis finds significant differences within PRI signatories – some are doing far more on responsible investing than others. We looked at recent

[14] 129 of 993 signatories report 100% AUM externally managed. Confirming their distinct roles of oversight and implementation (see also figure 5), 36% of asset owners' and only 5% of investment managers' assets are fully externally managed.

[15] The conclusions from the regressions in Annex 2 do not change when excluding signatories that have 100% of their AUM managed externally.

[16] Reported ESG FTE numbers are rounded to the nearest integer.

[17] Reuters (2016) **Responsible investment group may toss firms for lack of effort** . PRI has since conducted a survey among members revealing that 66% of its members are in favour of delisting: **http://bit.ly/2lxuSqP**

RI award winners[18] to see what they are doing differently and found the following:

- Award winners – both asset owners (6 compared to 1) and investment managers (13 compared to 1) – hire more ESG specialists than the average PRI signatory.
- Award winning asset owners engage more with the companies they invest in on ESG matters (100% vs 72% for award winners vs the rest); are more likely to take RI factors into account in investment decisions (75% vs 34%); and are more likely to use proxy voting (100% vs 64%)[19]
- Award winners dedicate oversight and/or implementation of RI policies to a higher hierarchical level.
- Award winners signed the PRI around 2 years earlier than non-award winners[20].

3. ASSET OWNERS AND INVESTMENT MANAGERS

Asset owners and investment managers play distinct but somewhat overlapping roles in implementing RI policies. Generally, asset owners set the investment strategy for the funds they manage, which may include an RI policy.[21] Although some asset owners have in-house analysts and portfolio managers, many outsource the investment and management of their funds to external investment managers. These investment managers may use ESG specialists to ensure the portfolio is compliant with the asset owner's RI policy. RI policies can also involve direct engagement in and enforcement of strategic changes in investee companies (e.g. via proxy voting). Figure 5 shows a highly simplified illustration of this relationship.

We separated the PRI's data into asset owners and investment managers to determine whether the type of institution affects the number of ESG staff hired. We found that whilst the vast majority of asset owners and investment managers employ fewer than 10% of their staff as ESG specialists, investment managers are far more likely to employ larger proportions of ESG specialists (Figure 6) – an observation that is confirmed

[18] We defined award winners as 2015 Responsible Investor (asset owners) or Investment Week Sustainable Investment (investment manager) award winners. The sample size is small so the results of this analysis should be treated with appropriate caution.

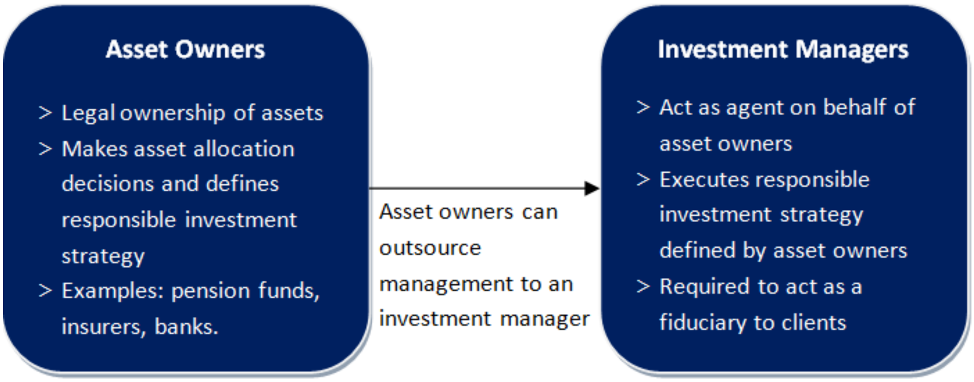
[19] This finding only applies to signatories that invest in listed equity. This is 685 of the original sample of 993 signatories.

[20] In general, our analysis found that early signatories of the PRI are more likely to hire more dedicated ESG staff. This finding is confirmed by regression analysis (see Annex 2). A reason for this could be that it takes time to hire ESG staff and embed a culture of responsible investment.

[21] In most cases asset owners do not have a responsible investment policy

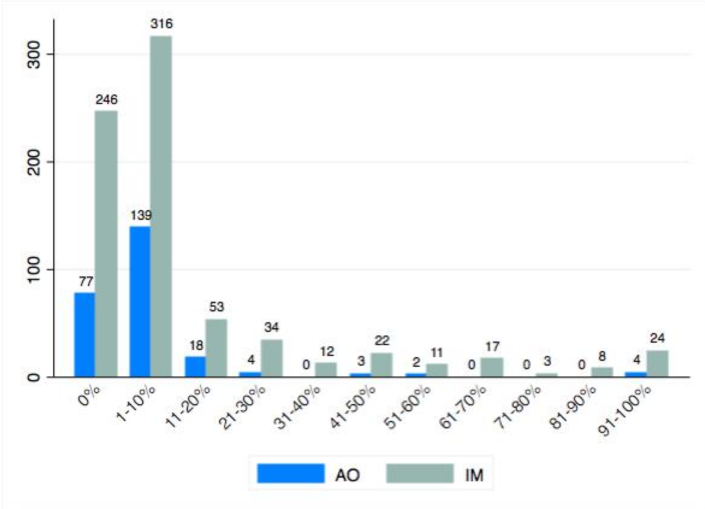
by regression analysis[22]. The existence of these specialists suggests that there is a market for boutique investment managers specialised in ESG.

Figure 5: Differentiating asset owners and investment managers[23]



By contrast, asset owners tend to employ few ESG specialists. Where they do, the staff tend to define an RI policy and monitor its implementation by investment managers.

Figure 6: ESG specialists as a percentage of total staff by institution type



4. CONCLUSIONS

Ratification of the Paris Agreement as well as the Sustainable Development Goals imply significant structural shifts in the global economy. In parallel, growing political attention is being focused on the role of sustainable finance to deliver these goals. **Asset owners and investment managers will need to play a much more significant role in delivering the transition to a**

[22] We used a linear OLS (robust standard errors) and a probit specification. Regression results are in Annex 2.

[23] Adapted from Blackrock (2014) **Who Owns the Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation**

sustainable global economy, while effectively managing the large associated downside financial risks.

Our analysis suggests that amongst PRI signatories, in-house capacity to help identify forward-looking ESG risks and opportunities is very low. **One-third of signatories employ no dedicated ESG staff and another 20% employ just one**. Whilst some investors outsource responsible investing, and others claim to take an integrated approach, it is clear that the majority of investors assessed here need to rapidly expand and strengthen their in-house expertise by employing more specialists and training existing staff. Those investment managers that have specialised in ESG investing look well placed to take advantage of growing demand for their expertise.

An important finding for policymakers is that **asset owners tend to rely on investment managers to deliver their RI policies, where these policies exist**. Sustainable finance policy responses should acknowledge the fact that best practice development of RI policies needs to start with asset owners, even if much of the implementation is “one level down” at investment managers. As such, policymakers should aim to strengthen asset owners’ RI policies which, in turn, would encourage investment managers to increase their internal RI capacity.

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ANNEX 1: PRINCIPLES FOR RESPONSIBLE INVESTMENT

The Principles for Responsible Investment (PRI) is the result of an effort of former UN Secretary-General Kofi Annan, who brought together a group of large institutional investors in 2005 to develop the principles. The initiative was formally launched in 2006 with the goal of understanding the investment implications of ESG factors and to help develop and mainstream the integration of these factors into investors' daily work.

The initiative is voluntary and currently attracts almost 1,700 signatories from over 50 countries, representing $62 trillion. The initiative continues to receive support from the UN, but remains independent. It interacts with both governments and the industry, its most valuable service being the creation of a comprehensive database on ESG incorporation among investors. The PRI receives no funding from the UN, but is primarily funded by signatories, who pay a contribution based on their AUM. In 2013 membership fees covered around 90% of the PRI's budget.

PRI centres around six investment principles on ESG incorporation. It is important to note that by signing PRI, investors "publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities." Investors also "commit to evaluate the effectiveness and improve the content of the Principles over time."[24]

Currently the PRI do not have comprehensive procedures to monitor signatories' adherence to the Principles. This appears to be creating tension amongst signatories. Fiona Reynolds, Managing Director at PRI, explained, "the [PRI] had received feedback revealing disgruntlement among some signatories that others are not doing enough to live up to the principles".[25] Currently, "the only reason why a signatory could be delisted is if it does not report on its activities and progress towards implementing the principles, as per the sixth principle."[26]

PRI has since conducted a survey among members revealing that 66% of its members are in favour of delisting.[27] In September 2016 Fiona Reynolds announced that there will be random audits of signatories and that signatories would be delisted for incurring fines or other regulatory sanctions that are not in the spirit of the PRI and that it will move towards reporting on outcomes and impact.[28]

[24] UNPRI (2016) **Principles for responsible investment**

[25] IPE (2016) **PRI must push signatory practice, says independent review**

[26] Ibid.

[27] See UNPRI (2016) **PRI consultation – accountability & differentiation. Full results**

[28] Responsible Investor (2016) **Principles for Responsible Investment confirms plans to de-list underperforming signatories**

ANNEX 2: REGRESSION TABLES

Table 1: Regression results (OLS, robust standard errors)[29]

VARIABLES	(1) Number of ESG FTE	(2) Number of ESG FTE	(3) Number of ESG FTE[30]
AUM	0.00961***	0.0253***	0.00989***
	(0.00344)	(0.00574)	(0.00352)
FTE	7.43e-05***	5.90e-05**	8.01e-05***
	(2.30e-05)	(2.44e-05)	(2.22e-05)
Owner / Manager Dummy	2.047***	1.840***	2.037***
(1=Investment Manager)	(0.549)	(0.577)	(0.582)
Year PRI signed	-0.577***	-0.527***	-0.554***
	(0.176)	(0.133)	(0.175)
CC laws in place[31]		-0.0575	
		(0.0354)	
Portfolio Balance Dummy[32]			2.221**
(1=Emerging Market)			(0.876)
Regions			
Africa	3.884*		
	(2.270)		
Asia	-0.876		
	(0.846)		
Latin America	3.656*		
	(1.869)		
North America	-0.174		
	(0.782)		
Oceania	-2.703***		
	(0.536)		
Constant	1,161***	1,062***	1,116***
	(353.1)	(266.8)	(352.1)
Observations	993	793	985
R-squared	0.118	0.186	0.103

Standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.1

[29] The base region is Europe, Middle East is omitted as there are too few observations. A country fixed effects model shows similar results.

[30] Results for the third specification are almost identical when including "CC laws in place".

[31] The preliminary inclusion of regulatory stringency (CC laws in place) yielded no significant results. using the LSE Global Climate Legislation Database and the Yale Environmental Performance Index (Climate and Energy subsection).
The LSE database is available at **http://bit.ly/2l1Qbnu**
The Yale database is available at **http://bit.ly/2l22a4q**

[32] Base category is developed market portfolio (>50% of AUM). The significance of emerging markets portfolio could be due to some collinearity with regions (emerging becomes insignificant if regions are included). However, the portfolio choice reflects more than just geographic location.

Table 2: Regression results (probit)

The probit regression estimates the effect of the variables in the first columns on the choice of a signatory to have at least one ESG employee (vs. less than one or zero).

VARIABLES	(1) ESG employee = YES	(2) ESG employee = YES	(3) ESG employee = YES
AUM	0.00386***	0.00695***	0.00418***
	(0.000973)	(0.00169)	(0.000960)
FTE	9.42e-06	1.08e-05	1.06e-05
	(1.00e-05)	(1.16e-05)	(1.01e-05)
Owner / Manager Dummy	0.230**	0.266**	0.195*
(1=Investment Manager)	(0.106)	(0.111)	(0.105)
Year PRI signed	-0.133***	-0.0974***	-0.110***
	(0.0191)	(0.0208)	(0.0183)
CC laws in place		-0.00787	
		(0.00760)	
Portfolio Balance Dummy			0.377***
(1=Emerging Market)			(0.119)
Regions			
Africa	0.304		
	(0.242)		
Asia	0.0981		
	(0.226)		
Latin America	0.118		
	(0.211)		
North America	-0.233**		
	(0.113)		
Oceania	-0.754***		
	(0.142)		
Constant	268.0***	196.0***	221.4***
	(38.44)	(41.84)	(36.87)
Observations	993	793	985

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

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Acknowledgements

The authors would like to thank Mike Clark, Ario Advisory and Dr. Bjarne Steffen, Energy Politics Group, ETH Zürich for extensive comments on earlier drafts of this paper and the PRI for providing the data and their comments.

About E3G

E3G is an independent, non-profit European organisation operating in the public interest to accelerate the global transition to sustainable development. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere.

More information is available at **www.e3g.org**

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