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It's not just about the financials
The widening variety of factors used in investment decision making

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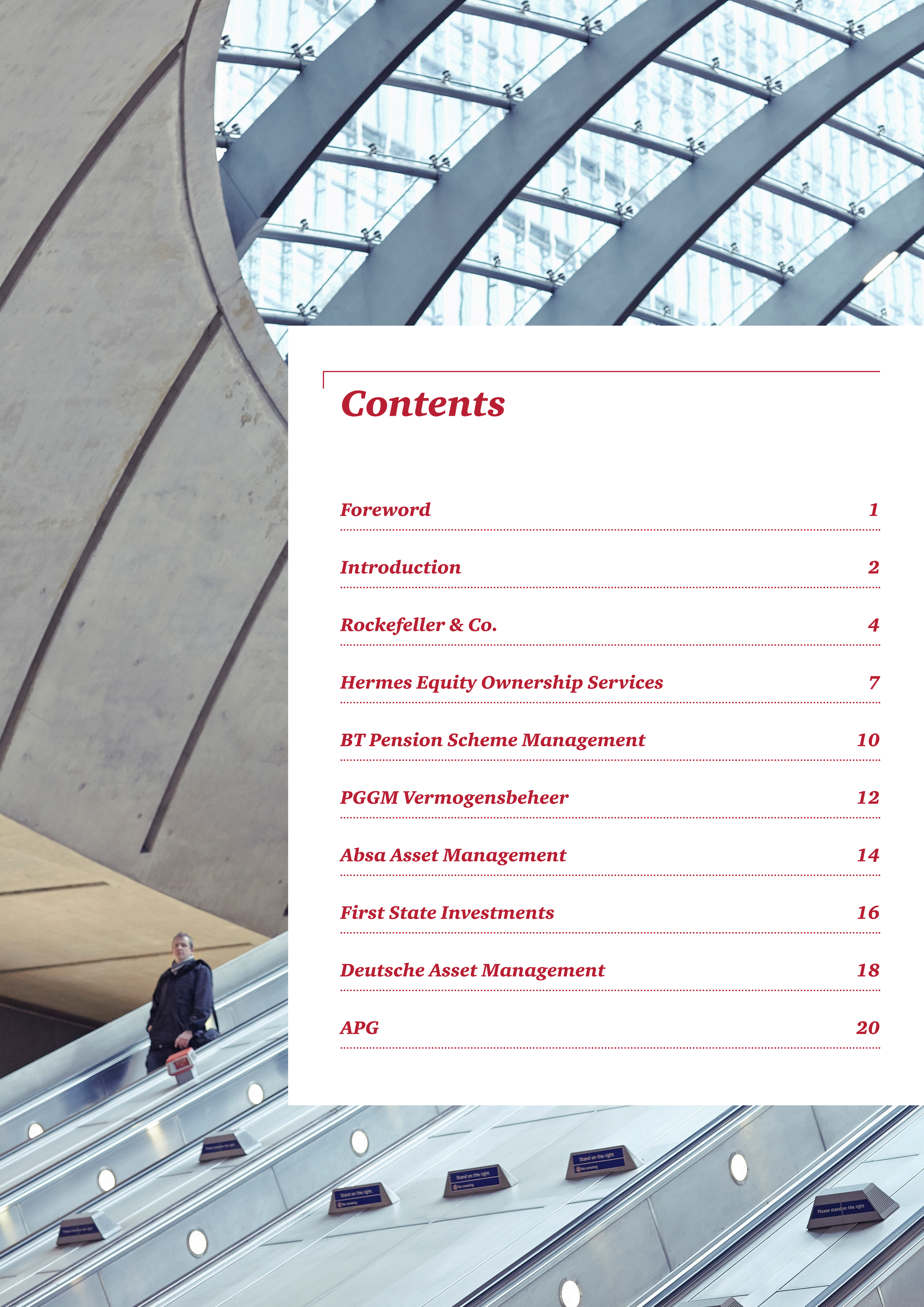

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Foreword

Paul Druckman
Chief Executive, the International Integrated Reporting Council

The case for investment decisions based on insight into value creation

These interviews demonstrate a clear trend: investors are increasingly interested in information on the business model, strategy, and about the range of resources or capitals that the organisation uses and affects. This report is yet further evidence that information provided in integrated reports is important to the investment processes and decisions of fund managers, who – in this case – between them manage or advise on nearly US $2 trillion of assets.

Integrated Reporting, or <IR>, is a market-led response to the need for evolution in corporate reporting. It aims to improve the quality of information available to providers of financial capital by communicating a broader range of relevant information that can help investors to understand the company and its prospects better. The increasing amount of evidence that investors find this evolution in reporting useful to their investment appraisal and decision-making will spur companies to change their reporting practices. This report – which demonstrates that investment practices are evolving to rely on more than the purely financial – provides such an incentive to business.

Many businesses, on starting their journey of integration realised that artificial silos (for example, between financial and sustainability information) were a barrier to better integrated thinking. Just as businesses benefit from integrated thinking, so can investors as they bring together their environmental, social and governance (ESG) and financial teams to do more than simply screen some companies out. Going beyond this, they can reflect other factors in forecasts, risk assessments and discount rates. This should lead to improvements in the way they manage investment risk, evaluate industry dynamics and the regulatory environment, validate an investment thesis and assess a company's forward-looking information.

As they moved towards <IR>, businesses began to adopt the language of the six capitals[1] – which gives parity to all of the resources an organisation uses and affects. It is my hope that investors will embark on a similar journey, and as they integrate their ESG teams with the financial team, their language will also develop to incorporate the full aspects of value creation.

The benefits of this journey are emerging unambiguously. For example, academics from Stanford University, the University of Auckland and the University of Pretoria published research[2] in December 2015 which finds that integrated reporting is positively associated with both stock liquidity (measured using bid-ask spreads) and firm value (measured using Tobin's Q) in South African firms.

The evolution of reporting and investment practices is important. Not just because of the benefits it can bring to businesses and investors alike, but because of the bigger picture. It helps, too, to align investment decisions with wider goals of financial stability and sustainable development. At the heart of this is a shift from short-term thinking to sustainable capital markets – with dialogue between investors and companies based on a wider view of strategy and value creation over time.

We know that investment practices will not change overnight. In fact we are just scratching the surface. We welcome the views of the investors featured in this report who are at the leading edge of the changes I believe are necessary. The International Integrated Reporting Council (IIRC) is committed to its role in this change and we are delighted to work with forward-thinking partners such as PwC on this agenda.

[1] Financial capital, manufactured capital, intellectual capital, human capital, social and relationship capital and natural capital

[2] The Economic Consequences Associated with Integrated Reporting Quality: Early Evidence from a Mandatory Setting

Introduction

Investment professionals are becoming more and more interested in understanding how environmental, social and governance matters affect businesses. So we asked them to talk candidly and in some depth about how they use ESG information, how well they think companies do in communicating it, whether it is growing in importance and where the gaps are in ESG reporting.

Of growing importance

Our interviews had a clear theme: the tide of opinion is turning for ESG information. Far from considering it as 'greenwashing', the investment professionals we spoke with firmly believe that relevant ESG information captures important aspects of corporate performance. They were clear that ESG information is not always non-financial in nature. Instead, they repeatedly cited it as a leading indicator for future financial impacts. And rather than viewing ESG information mainly as a way of explaining how the company affects the environment, investment professionals are starting to use it to understand how the environment (and other areas), affect the company – and what they're doing about it.

Investment professionals told us that they consider ESG information to be an incredibly important and developing area of performance communications. This isn't a huge surprise. Even analysts at investment banks, such as Morgan Stanley's responsible investment team, are referring to ESG information in their reports[3]. They say it is simply one of many approaches to financial analysis and that ESG factors need to be analysed, not only to properly understand risk, but to seek out revenue boosting or saving opportunities. There is value there both for management and for investment professionals.

Our interviewees said that integrated ESG information allows them to assess a host of important variables including whether to invest, divest, engage or look closer to see if there are other problems in the business. But, crucially, they also said that there are gaps in the ESG information companies report and that often it isn't very well integrated into corporate communications. While acknowledging that ESG information is a fast-developing aspect of valuation, they all argued for improved data, more connectivity and consistently applied frameworks.

ESG and the 'long-term'

One of the most noteworthy discussions we had with many of the interviewees was about their sense of the long-term. ESG information is often analysed as a long-term risk to the 'base case' valuation. But, as Morgan Stanley's responsible investment team points out in their research report, 'the long-term can become the short-term'. And indeed, the investment professionals spoke with some variety about what they consider to be long-term when holding investments and whether they believe that a company's approach to (and communication of) ESG issues converges with their ability to sustain value over the long-term.

While the range of what these investment professionals considered to be 'long-term' varied from three to 20 years (the range-ends can be explained by looking at the type of clients those interviewees serve), all agreed that investments in sustainable businesses are also good financial investments that achieve good long-term returns.

[3] Embedding Sustainability into Valuation 2.0: Our Updated Global Framework for Analysing Environmental, Social and Governance Risks and Opportunities (30th March 2016)

While only a minority said that they work under investment mandates that require ethically-oriented or blanket exclusions for 'bad' ESG practices, the majority agreed that those who integrate ESG concerns into their approach to stewardship will be better placed to execute investment strategies that ultimately outperform the market. The pension fund managers we spoke with were clear that ESG information allows them to deliver better long-term, risk-adjusted returns to their scheme beneficiaries. Even the investment professionals who don't pick individual stocks find that ESG information helps them both to build a good picture of the 'big bets' they hold and to challenge those bets with as wide a range of information as possible.

What next for ESG information?

The interviews describe in detail what investment professionals do with the ESG information they receive. On the whole, they see it as an evolving process and say that their biggest challenge is that there are no comprehensive standards and few frameworks. But change on that front is afoot.

The more ESG information companies prepare and communicate, the more it is becoming obvious that ESG issues have varying and critical impacts on companies. The FSB Task Force on Climate-related Financial Disclosures, for example, argue that climate risk can in many cases be linked to banks and others companies. It comes as no surprise then that regulators in some jurisdictions are moving towards legislating for ESG information to become mandatory.

And there are others working on frameworks for integrating ESG information into company reporting. The Global Reporting Initiative and the accounting approaches designed by the Sustainability Accounting Standards Board in the US are, for example, gaining popularity. And the IIRC – with whom we have written this report – has released a framework that integrates all material factors relating to value creation over time into the annual report. The investment professionals we interviewed discussed the advantages of the International Integrated Reporting Framework (or <IR> Framework) in providing a more holistic picture of the business that encourages the description of how ESG factors are core to its strategy. The <IR> Framework they said, was complementary to a range of other frameworks and standards for reporting. It is clear that makeshift assessment approaches are steadily becoming a thing of the past.

But regulators, standard setters and others would do well to note what the investment professionals in this report are saying: it's not necessarily more information that they want, but more relevant and more integrated information. In particular they want information that is more clearly linked to the business model, information they can rely on, and information that clearly links to how a company creates value and manages risk.

To read these interviews and to have one ear tuned to rumblings in the market is to understand that a consensus is gathering. Investors who develop the most useful way of integrating ESG information into their analyses, and those companies who help them do that effectively by being clear, comprehensive and transparent about their exposure and impacts, will be the market-beaters and the long-term survivors. These interviews tell us that ESG information is becoming more important for analysis of risk and returns and more integrated into the way they look at performance. In other words, investment professionals are pricing it in.

Rockefeller & Co.

Joyce Haboucha
Senior Portfolio Manager and Director of Sustainability and Impact Investments

Joyce Haboucha, Senior Portfolio Manager and Director of Sustainability and Impact (S&I) Investments, Chris Rieger, an equity analyst, and Ran Tao, an analyst on the S&I team, told us about the approach they take to ESG integration.

PwC: How do your teams work together in your investment process? Can you tell us a bit about how the overall process works?

Joyce: Our global equity and S&I strategies have a long-term investment perspective. The investment team considers each stock for inclusion in the core strategy, and then also makes a determination about whether it can be included in the sustainability portfolio. So our fundamental analysis and sustainability analysis teams work together throughout the process.

PwC: How would you describe your overall approach to analysing companies when you are picking stocks for your portfolio?

Joyce: We are long-term investors and in some cases we have owned stocks for over ten years. However, I would say we typically look out about five years. Some times that can be a fool's errand; however, it isn't because we think we know what is going to happen in five years' time. When an analyst pitches a stock to our investment team, the discussion can take up to two hours, and it can be a really grilling process. The discussion focuses on the long-term trends and challenges – that is fundamental. Our analysts really need to be able to talk about the long-term issues the company is facing and also the long-term opportunities that we see. We like to look five years out, so we can see the assumptions being made and where they see the business model going. The business model is really the heart of the long-term discussion. The initial analysis is really the starting point for a much more detailed and broad discussion.

PwC: How much time do you spend looking at company annual reports, 10Ks or other company reporting?

Chris: Generally, looking at a 10K is the first step in our analysis. I usually read at least the last two 10Ks cover to cover, along with the latest proxy statement and recent quarterly releases. The goal is to perform a detailed review of the company's business model, financial positioning and fundamental earnings drivers.

PwC: It is interesting that you mention the business model is the heart of your analysis. When management teams articulate their business model well, does that help you?

Chris: It always helps when you see a clear articulation of what the company does and how they make money, but we need to make an independent assessment. You need to cut through the 'management speak' and standardise the reported numbers so you can have some degree of accurate comparison. I prefer a plain language assessment, something that tells me "this is what we do, this is how we fit into our operating environment". As an analyst, it is my role to think about the company relative to others in the industry – management will always tell you wonderful things about their company, so you have to take what they say with a grain of salt.

The challenge is figuring out where the facts end and the opinions begin, but any colour they can give on their business model and competitive environment is certainly very helpful. Being clear about their assumptions and sensitivities is important.

PwC: What do you think about countries that have mandated more integrated or strategic reporting? Do you think that helps?

Joyce: Well, in London the requirement to prepare a strategic report has really helped, especially in making companies explicitly talk about business model and strategy. In the US and other places where this isn't an explicit requirement, some companies do it, but if they really don't have to do it, many tend not to.

One of the things good integrated reporting brings that connects our judgements to our financial analysis is the focus on intellectual capital and social capital. As we get more involved in <IR>, I realise that intellectual capital is a key piece. Intellectual and social capital are really about know-how. They are the 'secret sauce' that tell us how the company is going about its business. I am focused on this when I am reviewing an annual report. I saw one annual report of a large multi-national company that barely mentioned this, and another that identified it as a material area of focus. That tells me a lot.

Ran: We are excited by companies that provide robust sustainability information in their integrated reports. We are pleased when they talk in detail about how a risk, for example climate change, might impact their business model and give some real insight into their risk management practices. Unfortunately, this is still pretty unusual.

Joyce: The challenge though, is when people see Global Reporting Initiative (GRI) or Sustainability Accounting Standards Board (SASB) type guidelines as a checklist, and then try to disclose every key performance indicator (KPI) in the world. That approach is not helpful.

What I like about <IR>, is that it is principle-based, and focuses on providing a narrative. Twenty pages of KPIs typically results in missing the forest for the trees.

PwC: How do you think about the six capitals in the <IR> Framework as part of your investment process?

Joyce: My view is that the more a company can discuss these issues and how those issues affect the business model, the better positioned the equity analyst is. You can tell how much management understands the environment they are working in and their plans by the quality of these disclosures. We need to know how management understands, identifies and mitigates risks. Boilerplate disclosures are of no use.

Ran: In practice, on a day-to-day basis we have a different list of factors that we assess during our process. Those are our six pillars: governance, product and marketing, work place issues, environment, community and human rights. You can map them, but they are a little different.

PwC: How do you go about doing that assessment?

Ran: The first thing we do is assess a company's inherent risks on each of those pillars, or what risks we think the business model itself creates. Then, we assess how well we think management is handling those inherent risks, and we call that 'leadership'. We give a combined score for risk and leadership on each pillar.

We are still evolving our process. Historically, we would look at a lot of third party research, as well as the company's own publications and find stories and qualitative information that we can use to make a judgment. This field is becoming much more quantitative. There are lists of KPIs we care about, so we are moving towards a system based on our KPIs as a second layer of the process.

PwC: Is that list of KPIs internally generated? How did you go about deciding on them?

Ran: It is internally generated. We looked at what we have found worked well in the past, and we look to new KPIs, for example the ones defined by SASB.

Joyce: It comes from years of looking at good practice, and narrowing that down to the critical success factors, and flexing that for different sectors.

PwC: What about quality of disclosure? Does that have an impact?

Ran: Absolutely, our process gives companies a score for disclosure. And the disclosure score is derived from the information the company provides on the KPIs for each of the six pillars. We are looking for narratives around issues which we believe are material to a company based on its business model, but we are not necessarily looking for a particular KPI to be disclosed. If companies are not reporting on issues which we deem to be important, we think that can be a real risk to both the company and to the investor. In some ways, what you don't know is the biggest risk.

We see the scoring on disclosure as confirmation of our scoring on the underlying factors. It allows us to scale up or down our confidence level in the rest of our research.

PwC: What happens if companies score badly?

Joyce: We tend to ask companies to provide more disclosure and engagement is typically our first step. We usually need more information. There is always something that comes up, even if the company is doing well on X, Y and Z. So in the first instance, we will ask them to provide more information.

Ran: If a company shows high risk in one of the pillars, as well as laggard leadership on that pillar, and we haven't been able to engage with management, the decision comes down to one essential question: can we justify the inclusion of the company in the portfolio?

PwC: How does that fit with the financial side of the analysis?

Chris: A lot of it is done concurrently, and we work very closely together. Once we (the investment analysts) determine that we are going to be spending some time on a particular company, we alert our colleagues on the S&I team so they can begin their work on that company as well.

Ran: Absolutely, we dive into companies together, and there is a lot of collaboration and communication between our teams.

PwC: Chris, from an equity analysis perspective, are you trying to financially quantify those risks to get them into your model? Or is it more indirect, maybe altering discount rates, or adjusting future cash flows?

Chris: I don't think it makes sense to have a direct relationship between these issues and our discount rate, but if you have a number of long-term sustainability issues within a company, generally there are concerns elsewhere in the company, so there is a good chance we may build a degree of conservatism into the discount rate and growth assumptions that we use.

PwC: When you see the connections from the broader longer-term issues to the financials, how do you connect that in your model?

Chris: We would likely build some conservatism into our earnings and cash flow expectations. If you see a slew of sustainability issues then it may make sense to add a degree of caution into our assumptions, especially over the long-term.

Joyce: My role is to push for more integration. I hope we will get to a place where we can integrate some of this directly. Often we can't because we don't have enough information, and sometimes it is because the market itself doesn't accept these factors as having a valuation impact. Until companies begin to provide better reporting and disclosure on some of these factors, it is still speculation – for example, as to what will happen to carbon pricing.

Chris: Absolutely. If we knew what the forward regulations would be, we would seek to incorporate a carbon cost into our model.

PwC: Does the level of assurance over the data have an impact?

Ran: We are concerned about 'greenwashing'. As long as sustainability reporting exists outside of the main financial report, we worry about the assurance of sustainability numbers. We can't rely on these numbers as much, and that makes it difficult to directly tie them into the financial model. By integrating sustainability issues into the annual report, the company can be held to a higher standard, as the management team knows the report will be scrutinised by all investors. Currently, we find it encouraging that some companies get third-party assurances on their sustainability reporting.

PwC: One of your key pillars is governance. Can that be factored into financial analysis?

Chris: Sure, some aspects are more easily quantifiable, like linking executive compensation with specific shareholder-friendly performance metrics. Board independence can't be directly incorporated, but it is something that should be taken into account.

Joyce: I have been a member of the International Corporate Governance Network (ICGN) for 18 of their 20 years, and I think they do a great job at identifying best practices. I agree with Chris that executive compensation is an important indicator for financial analysis. If it is designed so that it is well aligned with the long-term strategic goals of the company then it signals good governance and good management. I have had an issue with the emphasis on stock price that is built into compensation. When management incentives are focused on stock price it generally increases the likelihood of activities being undertaken that are short-term focused and potentially detrimental in the long-term.

I believe that reporting on the Capitals as advocated by the <IR> Framework would help change that by aligning with the long-term strategic goals and health of the company. We are much more interested in process than in outcomes, and believe that if the process is right, eventually the company will get there on performance. For example, we don't care if you have five women on the board, but rather want to know how a company is actively trying to incorporate more diversity in management and on the board. We expect management to identify the risk and to tell us how they are going to manage and mitigate that risk. If we don't have disclosure, we won't know. It isn't just about the numbers, it is about the process.

Rockefeller & Co. is a global asset management and investment advisory firm with approximately US $15.1 billion in assets under advisement for individuals and families, family offices, non-profit organisations, foundations and endowments as at 30 June 2016.

Hermes Equity Ownership Services

Roland Bosch
Sector Lead: Financial Services

We met Roland Bosch, Sector Lead for Financial Services, to discuss how the team uses ESG reporting in their work engaging with companies on behalf of Hermes Equity Ownership Services' (EOS) pension fund clients.

PwC: How do you narrow down the universe of companies you are invested in to decide which companies are the right ones to engage with?

Roland: At Hermes EOS, we aim to protect the value of our clients' assets by engaging with companies on the risks that affect the long-term growth and profitability of their business. When choosing which companies will be part of the engagement programme we take a variety of issues into consideration. Firstly, we listen to our clients. We work for over 40 pension funds with hundreds of thousands of beneficiaries who are interested in investing in companies which create sustainable value over the long-term. Our engagement themes are based on the issues that they feel are important.

In addition to our own market knowledge, we also make use of various providers of ESG information and ratings: Trucost, Sustainalytics and proxy advisers, among others. When we see low ratings on ESG factors we look into these in more detail to understand what is driving them and whether we need to include them in our engagement programme. In addition, we write our own policies (corporate governance principles) for different jurisdictions, which can be a guideline for how we look at various situations to decide whether we need to engage.

Generally, we escalate our engagements when we believe it will lead to an increase in the value of a company over the long-term and/or it will prevent or limit a decrease in the value of a company over the long-term. In determining whether and how the engagement is taken forward, we take into account the level of a company's exposure to the issue at hand, the likelihood of engagement success and potential to bring about positive change and the value of our clients' ownership of the company.

PwC: Do you read company annual reports?

Roland: From an engagement perspective we certainly do, particularly the strategic report or sustainability report. It is important to remember that different teams will look at different areas, so across the organisation we will use different elements of an annual report. For example, while we in the engagement team might focus on corporate governance and sustainability disclosures, the Hermes Investment Management teams might focus on the balance sheet and cash flow disclosures. However, their assessments of risk to enterprise value will include an assessment of the ESG risks and thus their analysis will incorporate information garnered from both the front and back of the annual report.

PwC: Why is an integrated report more effective for you when you are looking at a company?

Roland: We take a holistic view of how we think companies should create value over the long-term. That means we need to look not only at financial indicators but also include governance, social, ethical and environmental factors to assess risk and develop our expectations of the long-term value of companies. So <IR> is really helpful as it shows us how companies are thinking about how they create value over the long-term.

There are so many examples of companies that failed to take care of their wider stakeholders, whether that is customers, employees or across their supply chain. This has resulted in real reputational damage and huge losses in shareholder value. <IR> gives that more holistic view; it helps us target risks for engagement.

PwC: Do you consider the various capitals in the <IR> Framework, or do you use your own system to break down these kinds of issues?

Roland: Our first split is always E, S and G, and then for each of those areas we will address various sub-issues, depending on the nature of the company. So for environmental we might look at carbon risk, water or waste management. For social we might consider cyber security, supply chain management, labour rights and human capital management. For governance we address issues like board effectiveness, board structure and executive remuneration.

We have our own classification of issues, but we like many of the others that are available. We think the SASB has a good classification of the various issues for each industry and area. Sometimes the <IR> Framework can lead companies to be a bit simplistic with their disclosures. For example, sometimes companies say, "We have four or five stakeholders groups, and this is how we have created value for each of them". For me this is too high level; I would like to see companies do more to discuss the material issues for their business and key stakeholders and in turn give much greater priority to those aspects relevant to them and less priority to those less relevant.

PwC: Looking at some of the elements of an integrated report, can you explain how you might use a business model disclosure in practice in your engagement work?

Roland: If companies explain the business model well, including the wider supply chain and stakeholders, it can be very helpful. It helps us to see how they plan to execute their long-term strategy and how they manage relationships with key stakeholders to make that happen.

The decision for investors generally is to invest, divest or engage. At Hermes EOS, we focus on engagement, trying to influence governance practices for the better and help companies to improve. In that context, a well-explained business model will enable us to have more focused and constructive engagement with a company which will be of more value to both parties.

PwC: Do you think the quality of a company's reporting impacts the quality of the engagement you have? What is the incentive for companies to report better?

Roland: I don't think there is necessarily a link between better reporting and us having easier access to a company. A better explanation of long-term strategy is really helpful for our engagement. Equally, weak disclosure means we may be spending our time, and indeed the company's time seeking more information on an issue on which the company is performing well but has simply not communicated this adequately. This subsequent mis-allocation of time and resources is unhelpful to both parties. More pertinently, if a company's report is the window through which to view a company, poor reporting will provide our investment teams with a lower level of confidence in the company's story and may thus negatively influence their decision as to whether to invest in that company. There is an increased recognition that balanced and integrated reporting improves risk transparency and lowers the cost of capital.

We need to be able to understand the strategy to discuss it, so high quality reporting helps us to challenge management to check that what is reported is really happening – are they living the values they have reported? It can be a concern, if we don't see the integrated thinking behind the reporting evidenced in the conversations we are having with companies and we will need to do some more digging.

Boilerplate reports on corporate social responsibility (CSR) are unhelpful and make us a bit sceptical, so backing up reports with case studies, specific targets and performance metrics can help us understand the company's performance more clearly. These things give us more confidence; a high-level discussion and a few nice pictures really isn't enough.

PwC: How does EOS interact with Hermes Investment Management?

Roland: We have lots of meetings between the investment management teams and Hermes EOS – information goes both ways. I think this is more and more the case across the industry. It is a good thing that more traditional asset managers are increasingly looking at these factors and integrating them into their investment process. It is much more difficult for our colleagues on the investment side to invest in companies with a lot of red flags from an ESG perspective. When we have serious concerns, we also prefer to engage with companies to improve. In a worst case scenario, if there is no willingness from a company to engage and improve, our investment teams might choose to divest. But we do believe that engagement is always preferable to divestment.

PwC: What would you most like to see companies do with their reporting to help your engagement be more effective?

Roland: Linking all reporting back to long-term strategic drivers would help. It needs to be about more than just telling a story; having a forward-looking approach is important. We need objectives and targets within each area, we need to know what the plan is to achieve those goals and then we need to see how that is progressing over time – consistency of metrics and measurement is key to this. We need to see a clear link to the financial side, how will the positions you are taking and the goals you are setting impact financial performance, how does your capital allocation work? Linking all this is very helpful in assessing the longevity of the strategy and the link to executive remuneration.

PwC: You've mentioned 'long term' a few times. What does 'long-term' mean to you?

Roland: I would say significantly longer than the ordinary business cycle. From the remuneration side, I think if executives held a significant shareholding until retirement, it would ensure they took decisions that were in the best interest over the long-term and crucially beyond their tenure at the company. After all, our relationship with a company may generally extend across the tenures of multiple CEOs.

The views and opinions contained herein are those of Roland Bosch, Hermes EOS, Hermes Investment Management, and may not necessarily represent views expressed or reflected in other Hermes communications, strategies or products.

Hermes EOS is one of the largest stewardship teams, established in 2004 to act as stewards of the investments managed by Hermes Investment Management Services. Hermes EOS aims to protect the value of clients' assets by engaging in the long-term risks that affect the long-term growth and profitability of the companies they own. They have approximately £169 billion of assets under advice (as of March 2016).

BT Pension Scheme Management

Daniel Ingram
Head of Responsible Investment

We spoke to Daniel Ingram, Head of Responsible Investment about how the BT Pension Scheme integrates ESG factors into their investment process.

PwC: Why do you think it is important to integrate ESG into your investment process?

Daniel: By integrating ESG factors into our investment decisions we aim to deliver better long-term risk-adjusted returns.

PwC: Can you tell us about how your process works?

Daniel: As the in-house investment adviser to the Trustee Board of the BT Pension Scheme we focus our responsible investment efforts on the areas we provide services to the Trustees, including, for example, investment strategy, portfolio design, manager selection and monitoring and oversight of stewardship activities.

PwC: Specifically, how does ESG integration factor into your investment strategy?

Daniel: The Scheme has a long-term investment horizon so we try to identify the characteristics that assets are expected to deliver in the long run. While we need to address short-term risks, we also need to attempt to measure and manage risks (including environmental issues) that may only emerge over longer time periods. For example in 2011 and again in 2014 we sponsored Mercer, along with 15 or so other organisations, to undertake research based on forward-looking climate change scenarios to help us explore alternative views of the Scheme's future asset returns.

PwC: What about portfolio design? Are you screening out companies based on ESG performance?

Daniel: As you know, there are lots of ESG integration tools out there which don't simply involve screening out companies. While some responsible investors may stick to one tool like divestment or negative screening, we prefer to be flexible and use a range of different tools depending on the particular investment characteristics we are seeking exposure to. Our approach depends on the extent to which any of E, S, and G are financially material to the investment strategy. We prioritise based on the particular market we are considering, or the sector or length of holding period as well as the costs and benefits of implementing ESG in day-to-day investment decisions.

PwC: How are you integrating ESG into the manager selection decision-making process?

Daniel: First and foremost we look for managers with investment skill perhaps derived from their edge, their desire to succeed, their sound processes for continuous improvement and excellent and stable teams. We take into account these attributes in our holistic evaluation of managers, which includes detailed due diligence on the extent to which they are walking the walk – not just talking the talk – on responsible investment. We take a 'scorecard' approach and rate managers on the quality of their responsible investment practices. We use a detailed set of criteria to evaluate our managers' responsible investment policies and processes and we regularly update our criteria to reflect emerging best practices.

PwC: How about information on a company level? How useful do you find companies' reporting for your allocation decisions?

Daniel: As we are not stock pickers, we use company-level ESG information to understand and sometimes challenge our investment managers on why they made certain decisions. We're not trying to second guess our investment managers but we do require some comfort that where managers explicitly take ESG risks, that they will be sufficiently compensated in return.

PwC: Do you think the data companies produce is helpful? What could they do to improve?

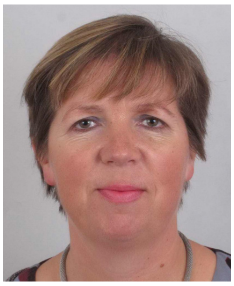
Daniel: I have great sympathy for CSR/ sustainability reporting teams in corporates. The plethora of standards and requirements out there puts great pressure on companies to produce a vast range of disclosures on ESG. How reasonable is it to ask a company to disclose an ESG metric where the company does not determine that particular metric to be material to their business' long-term value?

Companies that can link ESG practices and performance to tangible benefits for their stakeholders, including investors, will save us all from unhelpful and unnecessary disclosures. This is where the <IR> Framework can be really useful. <IR> should give companies freedom to think more holistically about their ESG practices as core to their long-term business strategy.

The views and opinions contained herein are those of Daniel Ingram and may not necessarily represent views of the organisation.

BT Pension Scheme Management Ltd. provides investment and advisory services solely for the BT Pension Scheme. The BT Pension Scheme is the UK's largest corporate defined benefit pension scheme, with market values of assets of over £43,084m as of June 2015.

PGGM Vermogensbeheer



Angeli van Buren
Advisor to the Chief Investment Management

We discussed PGGM's approach to ESG integration with Angeli van Buren, Advisor to the Chief Investment Management. She is a member of the IIRC.

PwC: Why does PGGM feel it is important to integrate ESG factors into your investment process?

Angeli: We believe very strongly that sustainable assets contribute to an inhabitable world in which the participants of our clients can enjoy their pensions. We also believe that sustainable assets are good financial assets. We have a long-term horizon, so our investments need to be sustainable to allow us to make money in the long run. For us, it is an integrated part of the way we do business to make sure that our investment portfolio is as sustainable as possible.

We work for several pension funds, who have very strong beliefs about the changes they would like to make within their investment portfolios between now and 2020, so we are seeing a demand for a large reduction in CO_2 emissions and an increase in the overall sustainability of the portfolio.

Pension fund participants expect to receive their pension in 30 or 40 years, so we take a really long-term view. Our manager mandates and fund investments are usually five to 10 years, but some infrastructure investment mandates can be up to 20 years.

PwC: How does this integration work in practice? Is responsible investment a separate team?

We have a separate responsible investment department that works with all our investment managers as well as on our responsible investment mandates. We are currently taking the next step to integrate responsible investments practices into our investment processes. In this way we are aiming for all our investment managers to take ESG matters into account when they make investment decisions. This will make our investments as sustainable as possible across all our asset classes.

PwC: Do you have a systematic approach to integrating ESG factors into your analysis?

Angeli: Yes, in each asset area we have an approach. About 40% of our assets under management are managed by external managers, so choosing and monitoring the managers is a key part of our process. We will score the manager to make sure that their process takes into account wider ESG factors in a suitable way. We have an internally-generated scoring system for selecting managers. We score on five factors, which include 'planet' (our ESG measure), as well as some operational due diligence criteria for governance and stewardship. Our scoring is the primary way we look at it, but we also take into account external ways of measuring ESG performance. We also make use of an exclusion list for all our assets.

Our programme 'Investing in Solutions', which is also known as impact investing, integrates responsible investments into all asset categories. An example of this program is a specific sustainable equity portfolio mandate we manage for a client. We have created a universe of 300 companies that the manager can choose from on four themes: climate, water scarcity, food security and health. Those 300 companies also serve as a benchmark. To get into the list, we have an in-house developed set of criteria that companies must meet based on ESG factors and other financial metrics. Integrated reports of companies can really help here because they help us better understand strategy and the sustainability of the company's business model.

PwC: How do you think <IR> benefits your investment process?

Angeli: If a company can tell us what they stand for over the longer term, we are able to decide whether to invest in them or not. Whether we have an active approach in a portfolio and are choosing stocks, or we are engaging with companies across our entire equity portfolio, in order to really know what the company is about we need a good report. We very much prefer the <IR> Framework as it combines ESG, strategic elements, risks, financial performance and a forward-looking perspective. It is important for us to be able to see what companies are working on, what they aim to improve and what their performance measures are.

PwC: How does your investment team use an integrated report?

Angeli: Across the organisation, the strategy, business model, risks, KPIs and financials are all used. We have various teams who will each look at different areas. For example, the credit team needs to calculate the cash flows but will also take into account the future sustainability of the business model and the risks to cash flows, which they will then model. The engagement team will focus more on the qualitative aspects of an integrated report in order to understand the effectiveness of governance, but that wouldn't go into a model as such.

PwC: Does it help you to make your engagement more effective when a company has an integrated report?

Angeli: That really depends on the quality. Recently we visited a number of companies who said they were doing integrated reports, but in reality they were not all of a good enough quality, so they are not as helpful as they could be. In these cases we will need other sources of information.

PwC: What are the things you would most like companies to improve?

Angeli: Part of the problem seems to be that often there is no one person or department in the company that has a complete overview of everything needed for a good integrated report. It needs to bring together corporate strategy, finance and sustainability. I think the key thing companies can improve is making sure that the right people are coming together to write the report.

Another important thing is to get a comprehensive but concise report. Two hundred pages is really too much – we have a lot of companies to look at! We would also prefer reports to be more forward looking and ideally audited.

PwC: When you say 'audited', what do you mean?

Angeli: We would like to see the non-financial part, or at least as many components as possible, to be audited. I understand this can be difficult, but we would ideally like to see some kind of independent opinion to know it has been looked at and reflects the story of the company. We would welcome more independent reviews on wider non-financial data.

The views and opinions contained herein are those of Angeli van Buren and may not necessarily represent views of the organisation.

PGGM is a cooperative Dutch pension fund service provider and is the second largest pension fund manager in the Netherlands. It manages pension assets worth over €200.2bn.

Absa Asset Management

Cornette van Zyl
Associate Portfolio Manager and Investment Analyst

We spoke to Cornette van Zyl, Associate Portfolio Manager and Investment Analyst, about the South African asset manager's approach to ESG integration.

PwC: Why do you think integrating ESG factors into your investment process is important?

Cornette: In South Africa, it has become much more important over time. Our clients (individuals and institutional investors like pension funds) consider the integrity of a company's management as critical, and ESG factors play an important part here. We have had instances of corporate misconduct which resulted in fines being imposed on companies, resulting in a big negative impact on the share price. Our clients are thus asking more and more questions about how we take these factors into account when assessing an investment in a specific company. This is not just at the point of initiating the investment, but also about our work on an ongoing basis when assessing a company and engaging with its management. For example, every time a large institutional client performs a due diligence on us as asset managers, they ask us about our ESG policies and their integration in our investment process.

PwC: How do you incorporate ESG factors into your investment process?

Cornette: When we consider a company for investment, we determine a relative rating based on its financial performance and valuation. But we also apply subjective overlays like quality of management, strategy, point in the investment cycle and ESG concerns. About 80% of our rating is based on a company's financial performance and valuation. We will look at fundamental valuation versus the current market price, earnings growth and sector-specific items (like return on capital for a bank, or sales growth for an industrial company). The other 20% of our rating is more subjective and is based on how highly we rate management on their experience, business practices and other factors like management ownership and risk management.

So, the financial aspects make up the majority of the rating, but the ESG overlay is a critical part of the process before we can get to a buy or sell decision. We have a weekly investment team discussion about the house view portfolio and investment opportunities we see in the market. At those meetings we discuss the ESG concerns relating to stocks we hold or are considering buying.

PwC: Where do you get the information to decide on ESG ratings?

Cornette: First, in South Africa we have a smaller market, so our analysts and portfolio managers all meet with management teams at least on a biannual basis. Those meetings give us a good sense of management's capabilities and culture and give us a forum to discuss any ESG concerns. Secondly, integrated reports are an important source because they can give you a sense of the company's strategy and governance information.

Of course, we also vote at annual general meetings (AGMs) on behalf of our clients. For example, if a resolution comes up on executive remuneration or a specific deal and we decide to vote 'no', our formal proxy voting policy requires analysts to explain and document their rationale for such a decision, i.e. what they considered, their concerns and any discussions held with the company or other industry experts. The next time such a company comes up in our investment team discussion, we can refer back to these notes and consider our governance concerns.

PwC: Companies in South Africa are required to prepare an integrated report. Do you feel that the transition to <IR> has resulted in better and more useful information?

Cornette: Overall yes. I think one of the key benefits is that the Integrated Reporting requirement forces the management of a company to formally put their strategy down on paper. I think that this internal exercise is important. It gives me something to consider when I discuss a company's strategy with its management team.

If I meet with a management team and they say something inconsistent with their strategy documented in the integrated report, it indicates to me either that they are not being entirely honest in their disclosures, that they are not really clear about what exactly their strategy entails, or that they might be saying something different to someone who owns their stock compared to what they would say to the general public, an indication of a weak corporate culture. All of those things would be a real concern from an investment perspective.

I also think <IR> has put more information in the public domain. Generally, the more information available, the more informative investment decisions the market is able to make. We might not always read integrated reports cover to cover (we have a lot of companies to look at and only a limited amount of time), but there is useful content in them which is handy when we need more information on a specific issue.

PwC: What are your thoughts on the capitals in the <IR> Framework? Do they align with how you look at companies?

Cornette: I think the E, S and G are historically the terms we use. Analysts like consistency, so that is really still how we look at things. I don't have any problem with the capitals in theory; they seem to cover everything. At the end of the day investing is about considering risks in a company and then deciding whether the valuation at that moment justifies the risk that I take if I buy the stock.

For me, when I think about ESG, I think about risk. What is out there that I don't know about that I should know about as an investor in the company? The capitals cover risks in different areas, so that is helpful.

PwC: Are there any areas of an integrated report, or qualities of an integrated report, that are particularly useful?

Cornette: Directors' remuneration disclosures can be really helpful, both for investment decisions and for proxy voting. Seeing how management is incentivised to run the company really helps to understand whether they will be able to execute on their strategies communicated to the market.

Certainly for me, as a financial sector specialist, risk reporting is also really useful. Being able to see the scenario testing and sensitivities really helps us when we are thinking about what might happen in the future.

PwC: What are some of the challenges you have with using integrated reports? Could companies do anything differently?

Cornette: Management teams sometimes seem to use them as a bragging tool, only stating the positives, which isn't helpful; we need to see a balanced picture. But the biggest problem is that the Integrated Reports are not always consistent in the information they provide and the metrics shown. They are not consistent across industries, or even for a given company over time, so that can make comparing companies and seeing trends difficult. More standardisation would be useful. As an analyst, the most powerful information for me is a trend over time. If you can have the comparable information over a number of years across companies, that really helps with our analysis.

PwC: What do you think about the reliability of information? Would you like to see more assurance on ESG factors?

Cornette: I don't worry too much that the information is not reliable. I think that it is reliable because when companies lay out really clear targets to reach over a stated timeframe and then subsequently indicate to the market that they are unreachable or postponed, share prices get punished. I think shareholders of listed entities keep management teams honest.

What I would want auditors to check is consistency. Are companies talking about the same issues consistently over time? I think the 'selective disclosure' problem is an area where more auditor involvement can help.

The views and opinions contained herein are those of Cornette van Zyl and may not necessarily represent views of the organisation.

Absa Asset Management is a division of Absa Investments, the investments and wealth arm of Absa Group Ltd., one of the largest listed financial services groups in South Africa and a member of Barclays.

First State Investments

Will Oulton
Head of Responsible Investment

We met Will Oulton, Head of Responsible Investment to hear about his approach to ESG integration.

PwC: Why do you think integrating ESG factors into your investment process is important?

Will: Very simply, we believe it makes us better investors. If we are not looking at ESG factors, and issues such as the culture and quality of management, we are really only doing half our job. ESG integration is fundamentally aligned to the quality of our investment process. If we don't integrate these factors into our view of the long-term financial quality of an enterprise we are considering investing in, then we have got a sub-optimal investment process, and we might miss something significant. That could be a material risk or a long-term value creation opportunity. It is important for us to have the highest quality investment process possible to deliver the best outcomes we can for our clients.

PwC: You have recently won awards for your ESG integration. Can you tell us about how your process works?

Will: The first thing is that we have a clear strategy and plan to achieve our goal of excellence as a responsible investor. The plan is built around three core pillars: quality of the investment process, our role as stewards of our clients' assets and culture and engagement with our people internally. We are trying to develop a culture where all our investment professionals and our clients understand why achieving best practice in responsible investment is important.

PwC: How do you integrate this thinking into your company culture?

Will: We think it is crucial that we have a company-wide appreciation of our commitment to responsible investment and a shared sense of the value that this brings to our clients and our business. Our challenge is to take our responsible investment principles forward and to work to make sure they are consistent across the whole of the business. In practice this has meant looking across our employee life cycle, including training and continual awareness building to ensure that everyone knows what we do, why we do it and has the opportunity to get involved. One area of focus has been the issue of diversity within asset management itself, particularly with respect to gender. We now publish our investment team gender diversity levels, and we are committed to doing that every year. We are striving to make responsible investment part of our culture.

PwC: How might one of your portfolio managers actually integrate this information into their decisions?

Will: This is all about the investment process. We want to make sure we have the best quality, most timely ESG data available to our investment professionals, and in a form that is suitable for them. It needs to be information, not just data; they don't have time to do a lot of sifting of data. We have developed tools to enable them to see summary data for their asset classes on Bloomberg and FactSet and have developed a proprietary ESG portfolio monitor tool. The source of all data is available if they want to do a deep dive, but we try to make it as easy as possible for them.

What they do with that varies, they are looking at a company's quality, both from an ESG and financial perspective. The financial and ESG data points are inputs that are important in the process of investment analysis and decision making. It is important that they use their knowledge and judgement to make those calls informed by the information available.

PwC: So, you don't have specific criteria or screens in place? Or an exclusion list?

Will: We have one exclusion, based on a regulation in the Netherlands regarding investment in controversial weapons, but we are not a negative screening house. Our search for quality businesses tends to mean we don't have some of the more controversial types of businesses, in our portfolios.

PwC: Are they taking the data from Bloomberg or FactSet and trying to model cash flows? Or is it more about adjusting expectations or views of management?

Will: We don't believe that markets are efficient, so none of the models that run on that theory really work. So, we are quite cynical generally about the value of many financial models. A lot of the work that teams do will include fundamental financial analysis but, ultimately, we are also seeking to know the motives, strategy and culture of management in companies we are considering investing in. You can model whatever you like, but if you have poor quality management, something is highly likely to go wrong at some point or the interests of minority shareholders may not always be protected.

Engagement is a critical part of our investment process and by that we are not talking about writing letters but the process of interaction with a company's board and management, and to do that you need to meet them. We track and report on the percentage of companies in our portfolios that we have met as well as those we have held for at least five years to test whether our convictions were right and that we are really investing for the long-term. We have that responsibility as owners on our clients' behalf. It is a bit like owning your home: people who rent houses tend not to look after them too well, but when you own your home you take a lot more care of it.

One of the tools we find effective for our engagement is a reputational risk tracker. It has a number of media and civil society sources that can give us a view of the risks the company faces or incidents that have occurred. We think you can tell a lot from management responses to questions about such incidents particularly regarding their understanding and oversight of the business.

PwC: Everyone is talking about 'long-term investment' lately. What do you mean when you say 'long-term'?

Will: As a global asset management business with a range of asset classes, we don't have a single definition of 'long-term'. For direct infrastructure holdings it might be somewhere between 12 and 15 years. But if you are looking at our money markets business, they are looking at placing deposits for 30 days, so it really depends. On average, for equities we are looking at around five to seven years. We have companies in some of our portfolios that we have owned for 25 years. Incentives are important behavioural drivers and we incentivise our investment professionals on a one, three and five year timeline – weighted more towards the three and five year end.

PwC: When you are looking at a company, what are the more useful elements of company reporting? And what could companies do to improve?

Will: Our investment teams will look occasionally at a sustainability report for specific issues or perhaps for environmental data. However, the key is comparability between companies in certain sectors or markets, so a way to do that is also important both for financial and extra-financial data. Financial information is available via our information vendors such as Bloomberg and FactSet who provide that functionality of easy comparison.

As an active manager we take a highly engaged approach with companies to ensure we have the best understanding we can of them. But we recognise that some of the big passive index managers don't have the capacity or need for knowing in detail each individual company they invest in, in the way we can and do. Annual reports are therefore most useful if you are doing desk research.

PwC: How do you make sure you can rely on the financial and ESG information you get from the data providers? What are your views on the importance of assuring that information?

Will: With financial information outright fraud is thankfully still very rare. Investors expect companies to meet the internationally accepted accounting standards and deliver their accounts on time as a minimum. Issues can occur in terms of trying to interpret reports and accounts on areas such as tax exposures and payments and executive compensation schemes.

The challenge with the ESG information is that there is no internationally accepted standardisation. That makes it difficult to compare, but also difficult to assure. I think there will be an emerging field of extra financial performance assurance in the future, but I don't think we are anywhere near that point today. A regulatory framework for reporting standards is perhaps the part that is missing.

First State Investments is a global asset management business, and is a division of the Commonwealth Bank of Australia. They manage approximately £103.21 billion in assets (as of March 2016) on behalf of institutional investors, pension funds, wholesale distributors, investment platforms, financial advisers and their clients worldwide.

Deutsche Asset Management

Christian Strenger
Board Member

We spoke to Professor Christian Strenger, Board member, and Susana Penarrubia, Portfolio Manager, to understand how ESG factors fit into their investment process and why they feel Integrated Reporting is helpful to them.

PwC: Professor Strenger, what do you think is the key benefit to investors of a good integrated report?

Christian: We think <IR> can enhance the approach that portfolio managers take. The key benefit is the way companies articulate their business models and link the inputs and outputs. The best integrated reports focus on the specifics. If you look at a good example like SAP in Germany, they say 'we invest X in health prevention of our people, and as a result we have Y reduction in sick days' – you can really model the impact on the bottom line, and demonstrate the key risks and dependencies that are linked to value generation of the company.

PwC: How would you like to see reporting evolve in the future?

Christian: As <IR> becomes more widespread, we need to promote reporting consistency from companies around the world. It would help if we have a clear separation of the headline items that are relevant for all sectors and then the granular details which are sector specific. As active managers we like to get into the depth of matters, so the availability of detailed sector reporting is very helpful.

PwC: Does the quality of reporting impact your willingness to invest?

Christian: If a company is more transparent, we are more inclined to invest. The final decision depends substantially on the management quality of the company. There is obviously a risk of disappointment for companies that then do not deliver. The key to good <IR> is that it reflects good management and good governance. The market rewards better transparency with higher investment and provision of attractive debt and equity financing.

PwC: How do you integrate ESG matters into your process across the bank?

Christian: We feel that ESG is highly relevant for all equity and debt investments. Our analysis, research and portfolio management is done on an integrated basis by the investment team. Adherence to a defined ESG investment policy is also a regular discussion feature in our board meetings. We are actively promoting its benefits to our institutional clients: while we have ESG integrated into our overall investment approach, we also offer specific products and overlay structures.

PwC: Susana, as a portfolio manager, how often do you look at the annual reports of the companies you are invested in, or considering investing in?

Susana: I look at annual reports, but I don't read everything. Across the portfolio, we receive a huge amount of information: the annual report, the CSR report, the capital markets days, and the quarterly reports – that could easily be 1,000 to 1,500 pages a year for each stock. I might in practice look at about 30% of the information that is in the annual report.

PwC: How do you integrate wider ESG factors into your investment decision making process?

Susana: We integrate wider factors across the whole process. We have three of our own measures built into our databases for company analysis: ESG ratings, reputational risk ratings and carbon emissions.

We determine the ESG rating by taking metrics and KPIs from ESG data providers' and putting them through our proprietary ratings generating system. For reputational risk, we have our own software that integrates six or seven external data provider's metrics plus social media data. Carbon information comes from external providers, and we are developing the model now to include other important environmental performance ratings.

PwC: How easy is it to integrate the specific ESG circumstances of any given company into your financial model?

Susana: What we are trying to do is compare the return we expect versus the risk we are running by holding the stock – we are always looking for the best balance for our clients. When I understand how a company is managing an ESG risk to create value or reduce a risk I will put that into my model. Unfortunately, at the moment there is often no real link made within a company's ESG reporting to how the key factors link to financial value, yet companies still complain that we don't give them value for it! Most of the time we don't see these wider factors being integrated into the strategy of the company, and they can't tell you how it links to value creation. If a company can't make those links, how can I put that into my model?

If I am able to reflect the information from an integrated report in my projected P&L or cash flow then I will adjust my expected numbers directly, which is clearly the ideal situation. Unfortunately, most of the time we are only able to make a determination about risk reduction or overall management of risks, in which case we have no alternative but to adjust the discount rate.

For example, let's say the stock is currently trading at a market value of €100, but my cash flow valuation model values it at €120. If I can't put a direct value on the key risks and say they might cost €X, then I have to increase the discount rate, or make a rough approximation of the potential downside risk, say 10%, and then adjust my model to include that potential cost. This allows me to calculate my expected returns.

PwC: Can an investment fall out of your universe purely on ESG grounds?

Susana: We don't have an exclusion list, because we think it would too limited to exclude companies based on ratings that are calculated only on publicly-disclosed information. Lots of companies, particularly small and mid-caps, don't publish the information that the ratings are based on.

I will always have an up-to-date list of all the companies in my portfolio and my benchmark, which is the index of companies whose performance I am trying to beat. It shows me the ESG rating, the risk rating and the carbon emissions. They are all ranked, A-F, on how well they score. So companies ranked A-C are leading, and F is the lowest score. We wouldn't necessarily not invest in a company that doesn't score well, but if we are thinking about buying a stock that falls lower down the rating scale, perhaps a D or E, we need to do some more work to justify our buy decision before bringing it to our investment committee meeting. It might be that the companies don't consider some of the metrics key for their sector, or they are small and don't disclose as much.

PwC: Can a company improve its chances of receiving investment by doing better, more integrated reporting?

Susana: We are aware of many more ESG issues than we were in the past but the ESG ratings we have today still really only give you a general feeling of performance, not a direct financial cost or benefit. We need companies to take the information behind those ratings and make the links to value creation or destruction. Companies that lead the way in developing the quality of this communication will be much easier to model, and I think <IR> can really help.

The first thing we do when a company scores poorly is try to engage, discussing with the company how they consider ESG, what are their targets, what can we expect over the next 12 months. We will then ask for more disclosure, and try to encourage them to improve. This is a really important part of our work, because if we don't have the information we cannot integrate it into our model.

We are consistently asking companies to work towards <IR>, even if they will take a few years to get there. In the end I think it is more cost effective for a company to produce one Integrated Report, which really answers investors' questions. I think a lot of investors don't ask for <IR> because they don't know the benefits, not because they wouldn't find it helpful.

The views and opinions contained herein are those of Christian Strenger and Susana Penarrubia and may not necessarily represent views of the organisation.

With about €739 billion of assets under management (as of June 2016), Deutsche Asset Management is one of the world's leading investment management organisations. It is part of Deutsche Bank Group.

APG

Herman Bots
Head of Fundamental Equities

Claudia Kruse
Managing Director for Sustainability and Governance

Herman Bots, Head of Fundamental Equities, and Claudia Kruse, Managing Director for Sustainability and Governance (S&G) and a member of the IIRC, talked to us about how they integrate ESG factors into their investment process and how <IR> can be helpful to them as investors.

PwC: APG is a prominent voice in favour of integrating ESG factors into the investment process. Why is this important to you as an organisation?

Herman: There are really two broad reasons why we think ESG integration is critically important. Firstly, we invest on behalf of Dutch pension funds that attribute great importance to being responsible asset owners. Hence we need to make sure that we fully understand the risks and opportunities our investee companies face, and engage with them to improve their conduct where necessary.

Secondly, there is a real valuation risk in terms of licence to operate. If a company is generating cash at the expense of negative externalities, we think even if there is no explicit price for those externalities today we still need to try to take them into account.

We want to own everything for a very good reason.

PwC: When you are doing your analysis and stock selection, how do you integrate ESG factors into your analysis?

Herman: We think 80% plus of a company's value is based on the longer term, i.e. more than three years out, so we look at the strategy of the company and how that fits with the market in which it operates. For example, we will look to see if they are in a price driven market or an innovation driven market, then we will assess how well that fits with the company's stated strategic goals.

We are typically trying to take a long-term view on a company's prospects, its markets and how it is positioned in those markets. We combine that into our valuations, and then if the current price is lower than our valuation we will invest; if it is higher, we won't.

PwC: The <IR> Framework refers to six capitals. Do you think about things that way, or do you have your own system?

Claudia: We have developed our own approach. Our clients have defined a responsible investment policy, the basis of which is the UN Global Compact's Ten Principles, so our engagement follows that. The capitals in the <IR> Framework capture aspects of performance that are very important to us, but they don't guide our approach. We also look at the governance of the companies; the way a company is managed can have a real impact on the probability and potential impact of all of these risks.

Herman: That's right, we don't need all companies to do the same things. We don't need a bank to have an oil spill response plan, but we very much value that for an oil and gas company. Even within a sector, we need to be aware of the nuances, it is more about saying, "if you have this type of risk exposure, you need to have this type of management in place".

PwC: How do you combine those factors into your valuations? Are you using some kind of scoring or adjustment?

Herman: We take a systematic approach. We use external ratings companies to help us identify where the risks might be for each company, generating a sort of heat map. Where higher risks are identified we might follow a number of different routes. We either might join the S&G team on engagement efforts, or if it is a really bad risk and management doesn't respond to engagement, we will avoid the stock.

For those key risks, we do a scenario analysis for different risk factors. For example, we'll look at possible prices for carbon emissions, and then assign a probability to each scenario happening. We calculate a cost using probability multiplied by impact and then integrate that into our valuation of the company. For example, the adjustment for one oil company might be different than for another because, while both have the risk of a spill, one has a much more well-developed risk management process and response system, so the potential impact is lower. This difference is critical and we want to reflect that in the valuation.

In order to do that properly, you need to have a good idea of the potential exposure and the potential impact. While some things, like carbon, are relatively easier to model, other risks are more difficult.

PwC: How often do you and your analysts look at the annual reports of companies that you are looking at for investment?

Herman: Most of the time; I would say at least 80% or 90% of the time – either a US Securities and Exchange Commission filing or an annual report. Part of the challenge though is that there is a lot of marketing speak in those documents, so they are not always the best use of time to read cover to cover. We always start with the source and then supplement that. What the company has to say about itself is a really important starting point.

PwC: Do you see companies integrating information well in their reporting? If so, does that make it easier for you to do forecasting?

Herman: It is not so much that it helps with better forecasting; the main benefit is that it facilitates a better discussion with management. It helps in the sense that it makes companies put their strategy in the context of their market and their business model, and link that to their key financial and operating performance. It gives you a good starting point. If you only see the numbers it is much harder to contextualise your thoughts and although one of our sector specialists might be able to do so from the outside in, knowing management's thought process is useful.

Claudia: We have various investment strategies for our clients, and each of them uses this information in different ways. For example, our quant team [a team that uses quantitative analysis using computer-based models to inform their investment decisions] uses data mining tools that allow them to scan huge amounts of information from these reports. This helps them better define their thinking on which of these ESG-type matters can be a useful decision making tool. All our teams are actively trying to work together on integrating ESG information. The sustainability and governance team has a lot of discussions with the quant team, and both teams have dedicated staff working on advancing the integration of ESG issues.

PwC: Is there a clear link to your governance work and your conversations with management?

Herman: All of this flows through into our discussions with management. The S&G and portfolio management teams talk to company management teams together. We send the message that responsible conduct is very important to us. We think engagement is critical because it ensures that a good investment opportunity can be even better if it improves its conduct.

Claudia: The value of a lot of this lies in enhancing the quality of our dialogue with companies. Understanding the extent to which the board has considered a broader range of risks and stakeholders when setting strategic goals and assessing performance is critical.

PwC: You use a wide range of inputs. How do you go about getting comfortable with the quality of the information you are using? Would you like to see this information being audited?

Herman: Well, the big challenge with audit of much of this ESG information is that there are no standards. I think the Non-governmental Organisations do a good job. For example, Carbon Tracker lets us cross reference what the companies are saying. We always cross reference everything to other sources, so audit would help, but we think it is likely to be a while before there are standards for things like customer satisfaction, net promoter scores etc.

Claudia: We don't reject data that hasn't been audited because at the moment that isn't realistic, but we do strongly encourage movement towards this wider data being audited, or at least auditable in the first instance.

PwC: One last question for you: if you could ask companies to do one thing differently in their reporting to help you in your work, what would it be?

Claudia: I would want them to show more connectivity between remuneration and incentive structures and their goals and targets around these broader factors, such as climate change, and understand what insights their related internal discussions have produced.

Herman: At the moment, every risk they can think of is thrown in. I would like to see a ranking. A clear ranking showing "this is the most important risk, this is the second most important risk etc. and this is how we manage them". I don't need quantification of the risks – that is my job as an investor to assess.

APG, located in the Netherlands, is one of the largest administrators of collective pensions in the world. APG is responsible for the administration, asset management and communication for pensions in a range of sectors, with combined pension assets of €433 billion (as of June 2016).

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