

from acronym

to action

What ESG means for you



Environmental, social and governance (ESG) considerations are now central to all corporate and investment discussions. To date, the focus has been heavily weighted to the environmental issues; however, the “S” and “G” are seeing significant momentum.

To help ensure that you, as investors, meet your objectives, you should be prepared for this revolution. In this short paper, we look at each of the components, E, S and G, and we explore how these components have been addressed in our clients' portfolios. We share common questions we receive from our not-for-profit clients globally, along with some top tips for how best to start the discussions around your collective tables.

Background

The world has woken up to the need for change. From reducing carbon emissions to building fairer and more equitable societies, the needle of change is moving faster.

It is no longer just specialist groups or a minority of investors pushing for change. Governments are seeking transparency and accountability from corporations, and they expect asset owners to be active participants in supporting, driving and monitoring this revolution.

These expectations and requirements mean the investment landscape and associated risks and opportunities are evolving quickly. For long-term investors, this means not only integrating ESG considerations into your portfolios but also adopting a framework to monitor and report the exposures and activities of your investment managers.

As mission-driven investors, you have responsibilities beyond those of many other types of investors. The expectations from your stakeholders are often higher, and an investment that is not aligned with your mission can create unnecessary risk.



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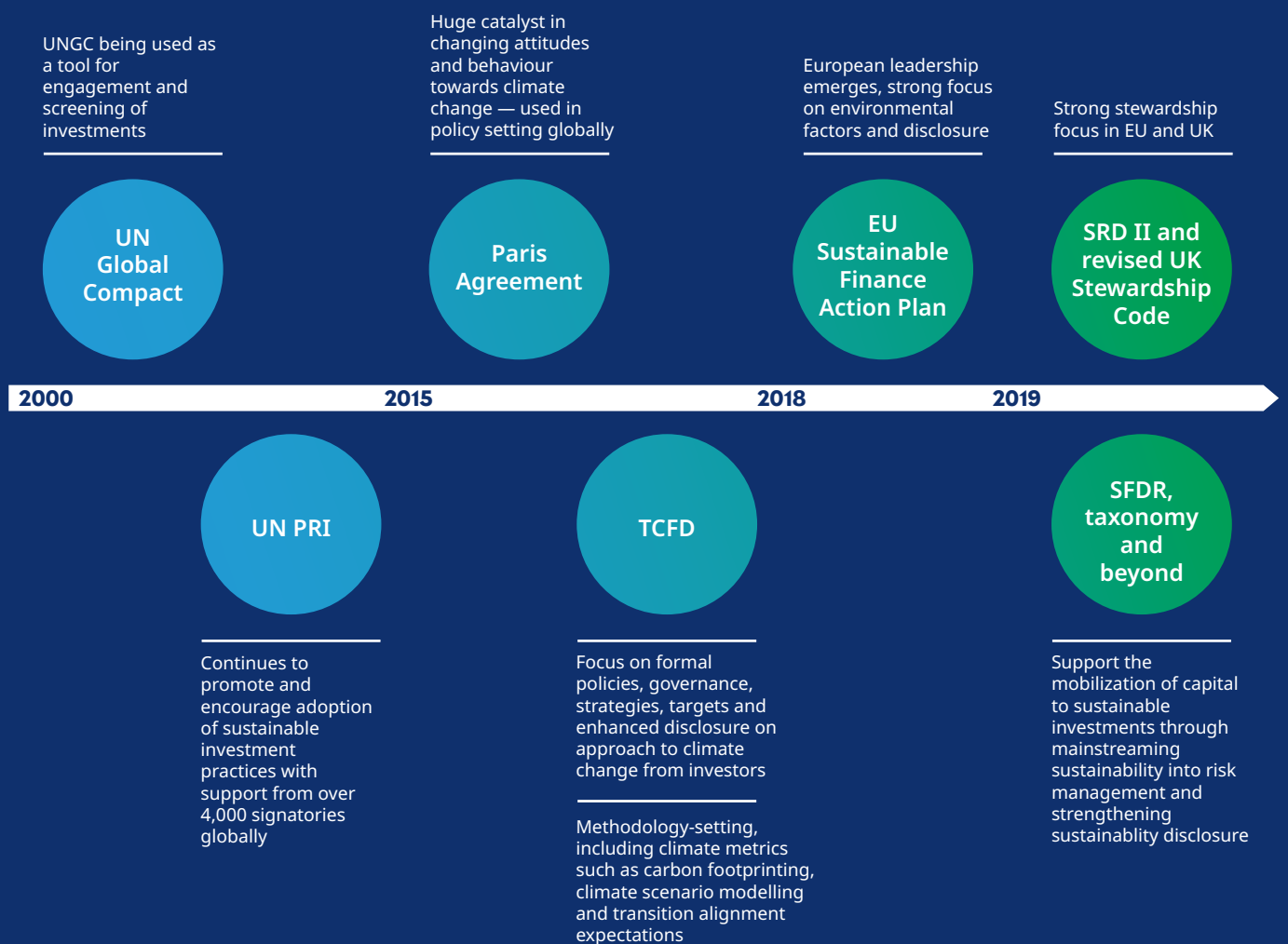
Story to date

The “E”, the environmental aspect of ESG, has captured the most attention in recent times. To date, regulations have focused almost exclusively on environmental issues such as climate change.

The European Union published its Sustainable Finance Disclosure Regulation (SFDR) in March 2021, introducing definitions and minimum requirements for investments with wide-ranging environmental and social objectives.

This regulation builds on broader initiatives, such as the Task Force on Climate-related Financial Disclosures (TCFD), which has gained significant traction in a relatively short time. An increasing number of governments and regulators around the world have adopted its recommendations, aiming to improve climate governance and reporting by listed companies and even their investors. Significantly, at the most recent G7 meeting, the group agreed companies should disclose using the TCFD framework.¹

Timeline of ESG regulations and developments



¹ Sardon M. “G-7 Backs Requirement That Companies Publicly Report Climate Risks to Their Businesses”, MarketWatch, 7 June 2021, available at <https://www.marketwatch.com/story/g7-backs-requiring-companies-to-report-on-climate-risks-271623064586>.



The rise of social movements such as #MeToo and Black Lives Matter has pushed diversity and inclusion issues rapidly up the corporate agenda.



But although the environment and the myriad of challenges surrounding climate change have been front of mind for financial markets, there are still more issues investors need to address.

The rise of social movements such as #MeToo and Black Lives Matter has pushed diversity and inclusion issues rapidly up the corporate agenda. This falls under the “S”, as investor attention has turned to methods for addressing inequities through investment and engagement.

The Shareholder Rights Directive II (SRD) adopted by the EU sets out to strengthen the position of shareholders and ensure that decisions are made for the long-term stability of a company. It amends the original SRD, which came into effect in 2007, with the objective of improving corporate governance, strengthening shareholder engagement and increasing transparency. This move should help investors grapple with the “G” in ESG.

Our recent surveys among not-for-profit investors tell us the same story when it comes to the importance of integrating ESG factors into the investment process. In 2020, Mercer’s Australian investment survey² found 67% of not-for-profit investors had integrated ESG into their allocation processes, with the rest of the respondents seeing merit in doing so. This momentum is echoed in Mercer’s not-for-profit European investment survey,³ where 52% of respondents see ESG concerns as the third-greatest risk or challenge over the next 12 months (market volatility and a low-return environment being the first and second, respectively). Finally, in Mercer’s 2021 Canadian not-for-profit survey,⁴ 70% of respondents use one or more approaches to incorporate ESG considerations into their investments decisions. Among these, 90% assess and monitor their external investment managers regarding ESG.

Successful integration of ESG within investment portfolios is a journey, and every journey starts with a single step.

² Mercer. *Australian Endowment and Foundation Investment Survey*, 2021.

³ Mercer. *Change Brings Opportunity — Mercer NFP European Investment Survey 2021*, available at <https://www.mercer.com/our-thinking/wealth/2021-nfp-european-investment-survey.html>.

⁴ Mercer. *Canadian Endowments, Foundations and Not-for-Profits Investment Survey*, 2021, available at <https://www.mercer.ca/en/our-thinking/wealth/canadian-endowments-foundations-and-not-for-profit-investment-results.html>.

Getting to know ESG — and what it means for your portfolio

The “E” — Environmental: What does “net-zero carbon emissions” mean? How can we measure our portfolio’s carbon footprint — and how do you report it?

Since the Intergovernmental Panel on Climate Change (IPCC) published its landmark climate change report in 2014⁵ detailing the stark reality of what will happen if we do not address global warming, governments and organisations of all kinds have been setting targets for reducing their carbon emissions. For most, this takes the form of “net-zero” pledges — target dates by which each entity intends to reduce its carbon footprint and offset remaining emissions.

Setting a net-zero emissions goal means incorporating absolute emissions data — both positive and negative contributions — and using these to set decarbonisation targets. Net-zero targets can be set at an institution level (that is, including operational emissions) or just at an investment-portfolio level.

Given the long time horizons of most mission-driven portfolios, investors are highly likely to be impacted by the transition to a low-carbon or net-zero-emissions economy. In Mercer’s 2019 report, *Investing in a Time of Climate Change*,⁶ we detailed how different climate-change scenarios could affect investment portfolios through both opportunities and risks.

Understanding your portfolio’s exposure to carbon is a vital part of forward-looking risk management. Not only is it likely that you will have to report on your portfolio’s exposure, but there is also potential risk to your investment returns in failing to understand it.

However, there are different ways to measure carbon

footprints, and progress on standardisation has been slow. Therefore, it is more important than ever to understand the different methodologies, including their associated strengths and weaknesses. There is no single way to track carbon emissions, especially when comparing across different asset classes — such as equities, fixed income and private markets — and different data providers often have different areas of strength. An advisor can help you understand these complexities and choose the most appropriate frequency and measure of carbon.

Due consideration should be given to how pledges will be delivered before making them public — your stakeholders will hold you accountable for the promises you make. Don’t view this as a “race to the bottom” for reducing carbon emissions as soon as possible. Determine what works for you, and make a plan around this.



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⁵ IPCC. *AR5 Synthesis Report: Climate Change 2014*, available at <https://www.ipcc.ch/report/ar5/syr/>.

⁶ Mercer. *Investing in a Time of Climate Change — The Sequel 2019*, available at <https://info.mercer.com/rs/521-DEV-513/images/Climate-change-the-sequel-2019-full-report.pdf>.

The “S” — Social: How can diversity improve our investment portfolio?

Over the past few years, the importance of diversity, equity and inclusion (DEI) within business has become an emerging priority. With mounting evidence that diverse views, backgrounds, outlooks and experience can lead to better outcomes, we believe the time has come for a change in behaviour.

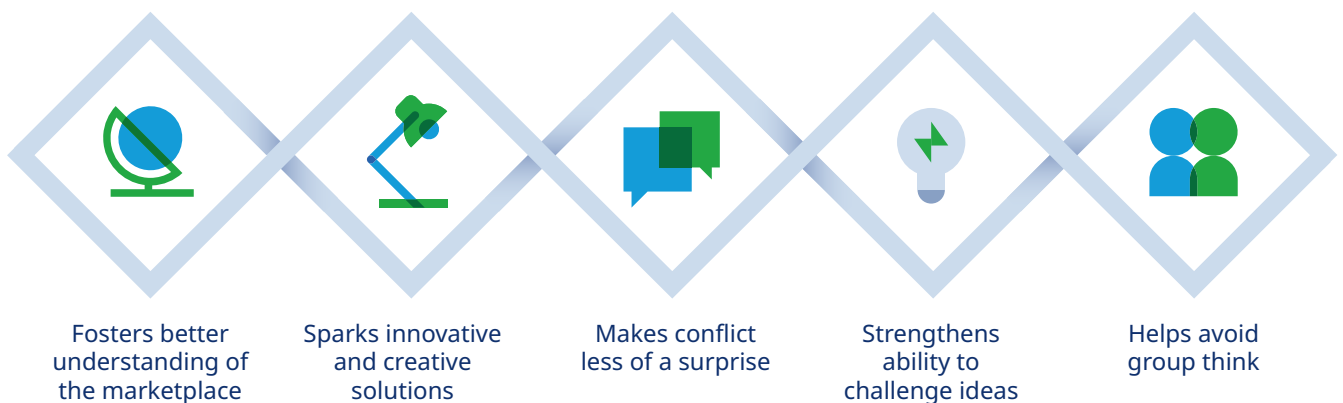
For some time, the focus of Mercer’s independent and forward-looking investment research has been DEI’s impact on returns.

Mercer’s 2019 report on DEI⁷ examined how a diverse team might create a stronger approach to investment than one comprising people with similar views or experiences. We concluded that “a diverse team with shared values is more likely to outperform its less-diverse peers” — which plays a part in how we assess fund

managers around the world. If ever there were a free lunch in investing, we think it is very likely that the secret sauce in this dish would be diversity (Figure 1).

In December 2019, we conducted a diversity exercise and found that 63%⁸ of funds listed no women in a position of authority, with representation across asset classes also demonstrating low percentages (see Figure 2). Disclosure about race, sexual orientation and other diversity indicators was equally limited. But with our global reach and scale, we are positioned to challenge, question and encourage positive change — and the first step towards this is transparency and disclosure. The more data we can make public, the more power we have to set targets and influence companies towards better diversity policies.

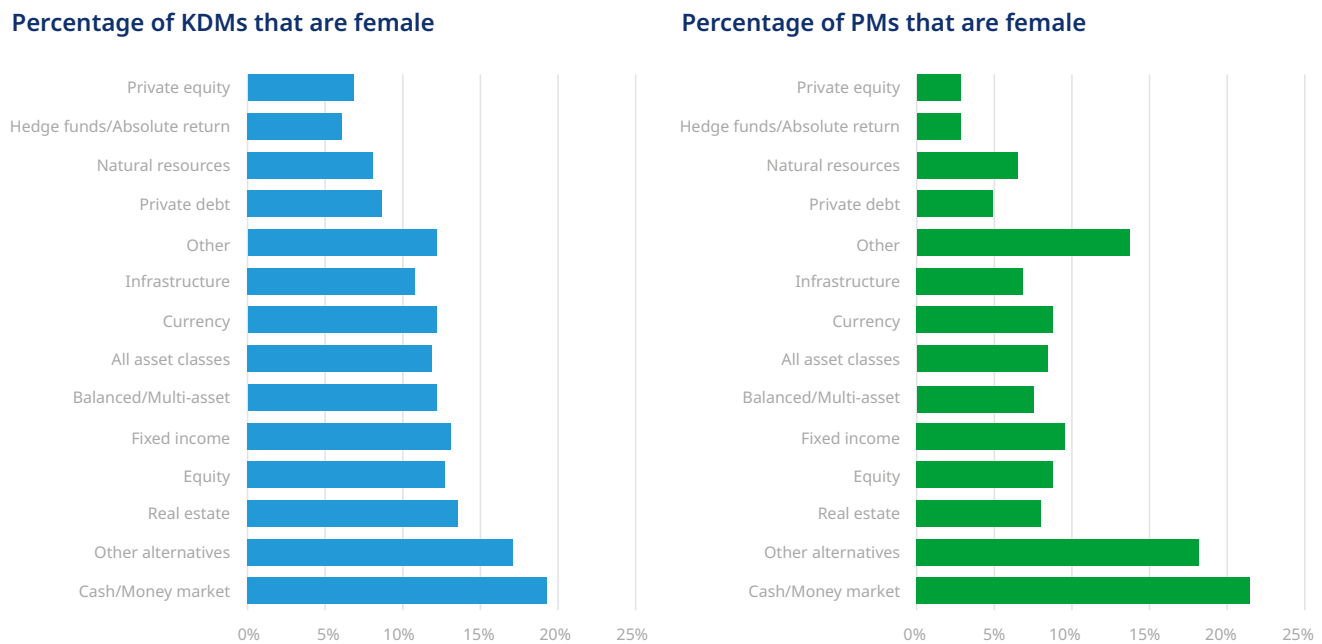
Figure 1. Driving better solutions: Benefits of diversity



⁷ Mercer. *How Diversity and Culture Impact Mercer’s Manager Ratings*, September 2019, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2019-wealth-how-diversity-and-culture-impact-mercer-manager-ratings-mercer.pdf>.

⁸ Kinney M. “Diversity Dressing: The Hidden Figures,” 11 May 2020, available at <https://www.mercer.com/our-thinking/wealth/diversity-dressing-the-hidden-figures.html>.

Figure 2. Percentage of female key decision makers and portfolio managers



Source: MercerInsight™, Mercer calculations. The total number of portfolio managers (PMs) in our sample is 6,965, a subset of the total number of key decision makers (KDMs) in our sample, which is 20,040.

The “G” — Governance: How does governance impact my portfolio and organisation? Is my oversight process robust enough?

Good corporate governance should be well-established as a baseline for an investment — if a company is not run well, it should not be in an investment portfolio. However, governance standards are different across different markets, and some companies may require more engagement than others to improve.

Investors, usually through their asset managers, can help guide companies towards better governance through a programme of engagement with boards, directors or other senior management. Regular and positive contact with companies falls under the banner of stewardship, which investors are increasingly encouraged to undertake by regulators and industry initiatives.

It is important for investors to keep a firm grip and oversight on their investment managers to help ensure they are deploying their stewardship efforts efficiently

and effectively. Reporting in this area is crucial — not only on outcomes but also on the extent to which investment managers are fulfilling their agreed briefs.

Internal governance is also an important consideration with your own investment processes, as applying industry best practices can have measureable benefits. We believe a well-structured framework, clear policies and clear accountability help ensure that decisions are taken in a timely manner, based on best available information and executed efficiently. Such a framework also seeks to ensure that the focus of your investment committee remains on the critical and most impactful elements of your asset management, allowing you to make the best use of your time.

Investing time and effort into constructing robust processes can also enable meaningful discussions with investment managers and ensure that you hold them accountable. Understanding how to make sense of ESG data and voting and engagement records can help you make sure that your investment managers’ decision-making is aligned with your goals and principles.

Top tips for ESG integration and how Mercer can help

The “E” of ESG

- Make sure you have a clear set of overarching principles to govern your investment strategy. These should set out your central ESG beliefs and should be shared with investment managers to ensure new and existing offerings are aligned and appropriate for your portfolio.
- Start the carbon discussion by carrying out a portfolio-level analysis of emissions or carbon-intensity data from your investments. Decide early on what the objective of this analysis will be — is it for carbon reduction to a certain level or within a specific timeframe? Make sure you understand the metrics you use and the terminology involved.
- According to Mercer’s 2021 not-for-profit *European Investment Survey*, 47% of investors currently allocate to low-carbon investments, and another 43% plan to do so in the future.

Help me do it

Mercer can help you plan frequencies for analysis and advise on how best to get carbon footprints directly from asset managers or third-party data providers.

Do it for me

Mercer can assess the carbon footprint of your investment portfolio and engage directly with investment managers on how best to decarbonise over time.

- When setting a net-zero target, choose an appropriate timeframe informed by your long-term strategy. Some asset classes will be easier to decarbonise than others, so the plan should be set across the portfolio and needs to be truly long term. Consider setting interim targets or milestones

Help me do it

Mercer can help you understand the implications of decarbonisation on different asset classes and set realistic targets.

Do it for me

Mercer already integrates decarbonisation pathways into our investment solutions for not-for-profit client portfolios. Our commitment covers US\$80 billion in AUM across the UK, Europe and Asia⁹ as well as Australian Funds and Mercer-managed investment options within Mercer Super to ensure they are on a pathway to net zero by 2050.¹⁰

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⁹ Mercer press release. “Mercer Accelerates Steps to Deliver Discretionary Investment Portfolios With Net-Zero Absolute Carbon Emissions by 2050 as Part of Its Global Investment Solution Roadmap”, 31 March 2021, available at <https://www.uk.mercer.com/newsroom/mercer-accelerates-steps-to-deliver-discretionary-investment-portfolios-with-net-zero-absolute-carbon-emissions-by-2050-as-part-of-its-global-investment-solution-roadmap.html>.

¹⁰ Ibid.



- Use scenario analysis tools to check how your investment strategy may perform under different scenarios for global warming. This will help you understand what to expect under different outcomes, helping to manage risk and identify potential investment opportunities.
- Establish an allocation to sustainability-themed investments aligned with your investment principles. Choose metrics appropriate to your strategy and asset allocation to measure sustainability performance.

Help me do it

Do it for me

Mercer can analyse your current asset allocation to reveal how returns could be affected under different climate change scenarios.

Mercer can perform scenario analysis on our Investment Solutions client portfolios to illustrate how strategies perform under different scenarios, informing our decision-making and ensuring climate risk is carefully assessed and aligned with your goals

Help me do it

Do it for me

Mercer can help you identify the sustainability themes to which you would like to have exposure and provide advice on manager selection to achieve these targets.

Sustainability allocations and strategies form part of Mercer’s own decarbonisation pathway. We have dedicated strategies to these areas and specialist reporting tools.

This work is based on our *Investing in a Time of Climate Change* analyses that model the impact of climate change on various asset classes over the long term.¹¹

¹¹ Mercer. *Investing in a Time of Climate Change — The Sequel 2019*, available at <https://info.mercer.com/rs/521-DEV-513/images/Climate-change-the-sequel-2019-full-report.pdf>.

The “S” of ESG

- Ask your investment managers for their DEI policies. Do they have strategies in place for monitoring diversity? Do they have any targets in place? Look into the diversity data of your investment holdings. You are not looking for perfection — just more data to facilitate meaningful conversations with your investment managers.

Help me do it

Mercer can support you by reaching out to your managers for their policies, targets and data. If managers do not already monitor these, this is a perfect opportunity to challenge and ask why not.

Do it for me

Mercer regularly assists clients with implementation solutions and proactively improving DEI within their investment portfolios as we believe in the power of diverse portfolio management teams to drive better investment outcomes.

We use our global research database on historically underrepresented investment managers, where the key decision makers are women, racial minorities, LGBTQ+ and people with disabilities. In addition, we monitor and report on stewardship activity in our client portfolios and use the findings to prioritise engagements.

The “G” of ESG

- Go further with stewardship monitoring. Ask your managers for a breakdown of their votes on proposals that matter to you. Scrutinise their engagement priorities to ensure they align with yours. Ask your managers whether they use a third party to vote on their behalf or whether they own this process themselves, as this can affect how much control you have over stewardship and engagement issues.

Help me do it

Mercer can help by reaching out to your managers for their voting reports and providing guidance on key questions.

Do it for me

For clients who have executed their strategies through Mercer, we monitor the voting activity of managers quarterly and ask the managers to complete an engagement survey annually, including collecting examples of successful engagements with companies and the effectiveness of their ESG policies. This is integrated into our reporting to our clients.¹²



You are not looking for perfection — just more data to facilitate meaningful conversations with your investment managers.



¹² Mercer’s voting and engagement monitoring reports are available on our website at <https://investment-solutions.mercer.com/global/all/en/investment-solutions-home/responsible-investment.html>.

About Mercer

Mercer has more than 40 years of experience delivering investment outcomes for charities, endowments and foundations globally. A dedicated team of charity investment specialists ensures Mercer fully understands the requirements and specialization necessary for this market.

Mercer's focus is on providing advice, investment solutions and portfolio implementation that deliver on objectives such as strong performance, capital preservation, income generation, cost management, responsible investment policy alignment and best-practice governance structures. Mercer is uniquely placed to help meet these goals, integrating its heritage in advisory services, investment management and market-leading ESG research. Mercer's portfolio solutions use highly rated managers across asset classes to help clients meet their investment objectives and allow foundations to focus on the impact of their philanthropic missions.

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