True Believers and Pretenders: A Summary of How Meketa Incorporates ESG Analysis Into Manager Research

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Investing according to Environmental, Social and Governance ("ESG") principles has risen in popularity and received increasing publicity during the last five years. A growing number of investors are articulating the importance of considering ESG when evaluating investment strategies and constructing their portfolios.

Investment strategies managed in accordance with ESG principles have been around for decades. More recently, an increasing number of investment management firms have incorporated these factors into their analysis. Some managers have come to recognize that considering ESG factors when evaluating a company increases the robustness of their investment process, while others have adopted ESG to meet the demands of an increasingly ESG-aware marketplace.

We have evaluated public markets investment strategies that incorporate ESG considerations as part of our manager research effort for about ten years. In this research note, we provide an overview of our ESG evaluation process, the rating system we have developed to categorize these strategies, and our thinking behind each rating.

The ESG manager research process

At Meketa, our manager research group analyzes investment strategies using a five-part framework. We review a manager's organization, investment team, investment philosophy, investment process and performance. The first four elements are the most relevant when evaluating a manager's ESG capabilities.

At the organizational level, our research group looks at the manager's overall commitment to ESG principles. An important part of this commitment is whether the firm is a United Nations Principles for Responsible Investing (UNPRI) signatory. The length and depth of their commitment is also significant. For example, does the firm's mission statement incorporate ESG factors? Are ESG investing principles applied broadly across a manager's suite of products or to just select strategies?

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The structure of the investment team provides an indication of the extent to which a firm has embraced ESG investing. A majority of the ESG-committed firms have either trained their analysts to incorporate these principles into their fundamental analysis or have dedicated ESG analysts embedded in their research teams. In some cases, investment managers have done both. The number of ESG analysts on an investment team and their tenure is also telling, as is the breadth, depth and thoughtfulness of their internal scoring methodology.

From an investment process standpoint, the degree of integration and the impact ESG evaluation has on new idea generation, investment analysis, and decision-making are critical.

Discerning the degree to which a firm incorporates ESG principles into their investment philosophy and investment process is a key part of our evaluation and provides a window into the manager's mindset. Have ESG principles always been part of the manager's investment beliefs? *Why* is ESG important to the firm and how do these factors play into their investment thesis on individual securities? From an investment process standpoint, the degree of integration and the impact ESG evaluation has on new idea generation, investment analysis, and decision-making are critical. ESG analysis can also provide insights into the risks of an individual investment and the exposures of a portfolio. Many firms say they have added ESG to their process, but very often in our discussions with portfolio managers it becomes evident that this information is "nice to know" rather than a meaningful factor that would prevent them from buying, or force them to sell, a stock or bond in their portfolio.

Engaging with the managements of companies in which they invest and trying to influence their behavior are important parts of ESG investing. Investment managers who can provide examples, document their proxy voting history, and publish annual engagement or impact reports with quantifiable metrics, further enable us to discern how committed a firm is to ESG investing.

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Meketa's ESG rating system

The table below shows Meketa's ESG rating system and our definition of each rating. A more detailed description of each category follows.

TABLE 1
Meketa ESG rating

A	The manager completely incorporates ESG principles into their investment philosophy, due diligence effort, and investment process. The manager supports shareholder initiatives and resolutions promoting ESG principles and is a signatory to the UNPRI initiative. The firm manages client mandates according to ESG principles.
B	The manager incorporates ESG principles on a limited basis into their due diligence effort and investment process, and may exclude certain stocks or industries deemed not socially responsible. They may occasionally support shareholder initiatives and resolutions promoting ESG principles. The firm may manage mandates for clients that incorporate some ESG principles or some socially responsible/mission related guidelines and may be a UNPRI signatory.
C	The manager currently does not incorporate ESG principles into any aspect of their investment process. They may have limited, or no, knowledge of ESG principles. Some managers in this group may express a willingness to manage portfolios according to ESG principles.

"A" rated ESG managers

"A" rated ESG strategies are products managed by the "true believers". In these portfolios, the manager incorporates ESG principles into their investment philosophy, investment process, and due diligence effort. This class of manager genuinely believes that this approach is the right way to run a portfolio. These firms are also signatories to the UNPRI initiative. The following excerpt from one manager illustrates the genuine ESG mindset that characterizes an "A" rated strategy.

> "Sustainable research is wholly integrated with fundamental due diligence in our process. In our minds, we do not separate the two concepts. We believe that some of the most attractive, durable business models available in the large cap equity universe are those with sustainable drivers at their core. Clean energy, health and wellness, and other sustainable trends are massive sources of revenue growth for many companies. Efficient operations that reduce the use of energy, water and other resources can lead to considerable cost savings. Companies that lead on ESG practices or that help customers solve meaningful environmental or health challenges are often able to greatly enhance their brand or franchise value."[1]

[1] Brown Advisory Large Cap Sustainable Growth Strategy 2018 Impact Report, page 4.

The firms that fall into this category meet with company managements to discuss ESG issues and use the proxy voting process to express their views. They support shareholder initiatives and resolutions promoting ESG principles. Proxy voting enables these investment firms to communicate their belief that adherence to favorable ESG policies enhances the long-term success of a company's business. They engage the managements of the companies they invest in to improve on the

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"E", the "S" and the "G", and push them to be better corporate citizens. "We consider engagement to be successful when we observe progress toward one or more of three potential outcomes: better corporate policies, more sustainable business practices, and greater ESG transparency."[2] This group of managers often publishes an annual engagement or impact report that outlines their efforts and the progress they have made at each portfolio company.

[2] Walden Asset Management 2018 Annual Impact Report, page 3.

We recognize that some bona fide ESG managers invest in industries not typically seen as ESG-friendly such as the energy sector. Instead, these firms use a *relative* ESG investment approach in which they look for companies with better ESG profiles than their sector peers. They also engage with company management teams to improve their ESG profiles.

Our evaluation process and rating system attempt to separate managers that really believe in ESG investing.

Investment firms that manage "A" rated ESG strategies usually have dedicated ESG analysts who work in conjunction with the firm's fundamental research team. These analysts act as another set of eyes in evaluating companies from an ESG perspective. Although a number of ESG rating services are available, there is invariably a subjective element to their analysis. Internal ESG analysts can synthesize the ratings of multiple services and bring their own perspective to the ESG analysis through their investment due diligence.

"B" rated ESG managers

"B" rated ESG managers incorporate ESG principles on a *limited* basis into their investment process and due diligence effort. They may also exclude certain stocks or industries deemed not socially responsible.

"A" and some "B" managers recognize that ESG can be a source of risk for companies. Environmental liability is the most common, but labor issues or controversial business and governance practices may also cause problems. "B" rated managers may occasionally support shareholder initiatives and resolutions promoting ESG principles.

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A second type of "B" rated ESG manager may not explicitly incorporate the evaluation of ESG principles into their investment process, but because of the universe they invest in, their portfolio scores well when evaluated using ESG metrics. Some growth managers fall in this category because they tend to focus on the health care, technology and consumer discretionary sectors, while avoiding some of the more treacherous ESG sectors like energy, industrials and materials.

"C" rated ESG managers

Meketa assigns "C" ESG ratings to managers who do not incorporate ESG principles into any aspect of their investment process. Many presentation books have changed during the last few years. Often done as a marketing initiative, firms we have followed for a long time have added new slides to their presentations that highlight ESG principles. These slides imply that the manager has now incorporated ESG into their investment process. However, this is often not the case. Asked whether they now consider ESG factors in their evaluation of companies, a telling manager response is often: "Well, we've always looked at *governance*." When we hear that statement, we have some doubt that the manager is representing the strategy accurately. To confirm our suspicions, we ask more questions about how the manager evaluates environmental and social factors to determine if these are really part of the manager's investment process.

We agree that evaluating firm governance is an important part of analyzing a company. However, when the "E" and "S" are not considered, we view this manager as an "ESG pretender" and assign them a "C" rating.

Conclusion

At Meketa, we recognize the importance of ESG to a growing number of investors. Astute managers incorporate an evaluation of these factors into their investment process to identify attractive investment opportunities and to control risk. To enable our clients to identify suitable strategies that can help them meet their investment goals while incorporating ESG considerations, our evaluation process and rating system attempt to separate managers that really believe in ESG investing, and manage their portfolios accordingly, from those who do not.

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