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# How We Integrate ESG Factors

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Interest in environmental, social, and governance (ESG) factors is expanding at a rapid pace among institutional and retail investors. In this paper, adapted from our June 2017 webinar, we explain how we have worked to integrate ESG factors into our investment process over the past few years, bringing it to life with specific examples from the consumer discretionary and consumer staples sectors, which have been important areas of focus for our portfolios over time given our high-quality growth orientation.

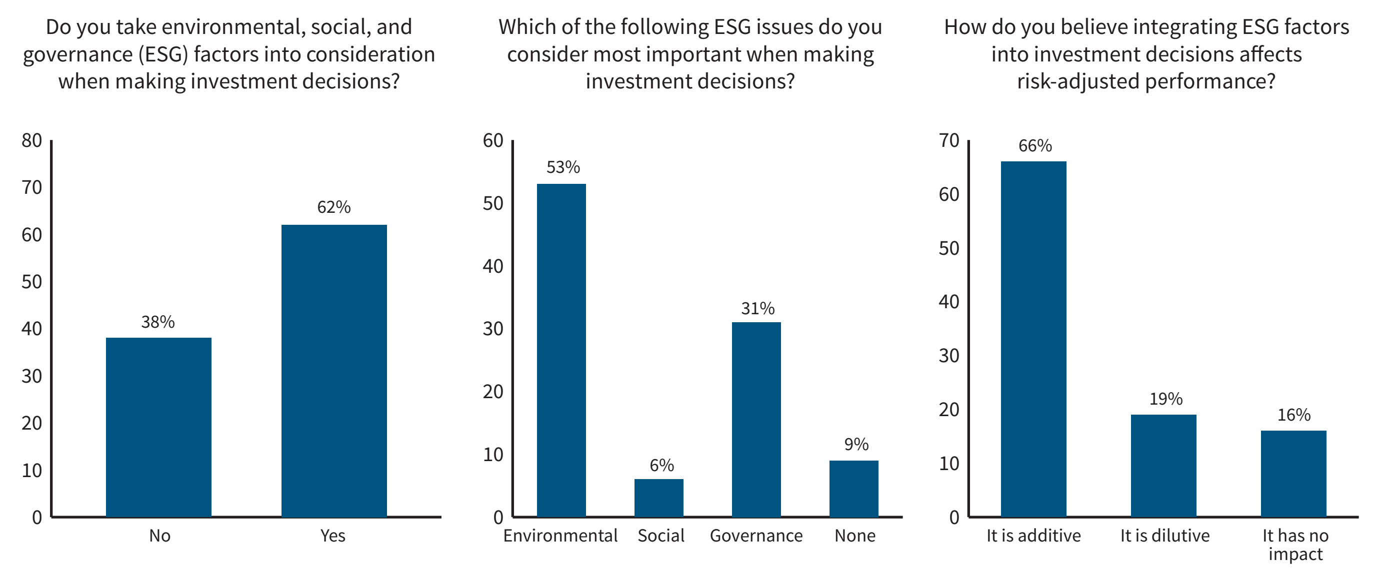
### How Do Investors View ESG?

A majority of respondents to a June 2017 William Blair poll (62%) think it makes sense to incorporate ESG into investment decisions.

When asked which factor (E, S, or G) investors considered most important in making investment decisions, environmental was quite high, at about 53%. Governance is also very important to our clients, coming in at 31%. We were surprised that only 6% of respondents consider social the most important ESG factor when making investment decisions. Although not evident in our informal poll results, we know that many of our clients place significant emphasis on social factors. In fact, as of March 31, 2017, 20% of our assets under management are managed to traditional socially responsible guidelines, including social screens, which fall under the ESG umbrella.

Of course, the big question is, "Why does it matter in the first place?" In other words, does ESG have any impact on performance? The consensus seems to be that ESG considerations are important in mitigating risk and volatility. But we are also seeing increasing evidence that ESG provides an alpha-enhancement opportunity. Certainly, recent studies have been signaling that materiality is very important—in terms of driving corporate performance, as measured by return on capital.[1]

**Figure 1:**




Source: William Blair, as of June 2017.

1 Mozaffar Khan, George Serafeim, and Aaron Yoon; "Corporate Sustainability: First Evidence on Materiality"; Harvard Business School; March 24, 2015.

## Increasing Emphasis on ESG Among Asset Owners and Consultants

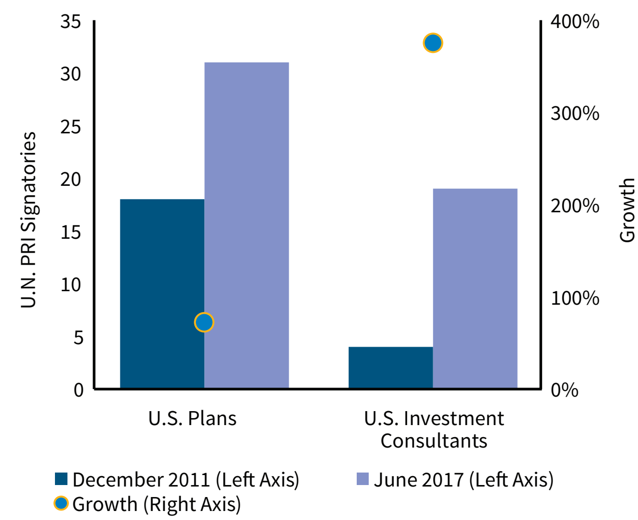
Industry surveys highlight significant growth in ESG adoption by both asset owners and consultants. Figure 2 shows that U.S. plan sponsor signatories to the Principles of Responsible Investment (PRI) grew approximately 70% over the past 5 1/2 years, while U.S. consultant signatories nearly quadrupled. This is corroborated by figure 3, which illustrates that ESG factor adoption by U.S. institutional plans increased significantly from 2013 to 2016.

Breaking adoption down by plan type, the results are not surprising: endowments and foundations have the highest rate of adoption at about 50%, followed by corporates at about 30% and public funds at about 22%. This is consistent with what we see among our client base.

From a geographic perspective, our European clients are at the forefront of the ESG movement, although we are receiving an increasing number of inquiries from our U.S. and Canadian clients as well.

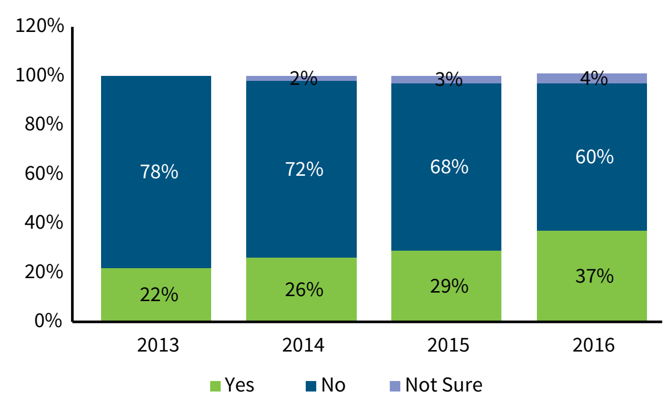
The momentum behind ESG integration has been supported by recent guidance from the U.S. Department of Labor clarifying that ESG factors are not inconsistent with the fiduciary duty. This has effectively removed what had been a barrier to broader consideration of ESG by pension plan sponsors.

**Figure 2:**
PRI Adoption by U.S. Plans and Consultants




Source: InterSec Research, as of June 2017.

**Figure 3:**
U.S. Institutional Plan Adoption

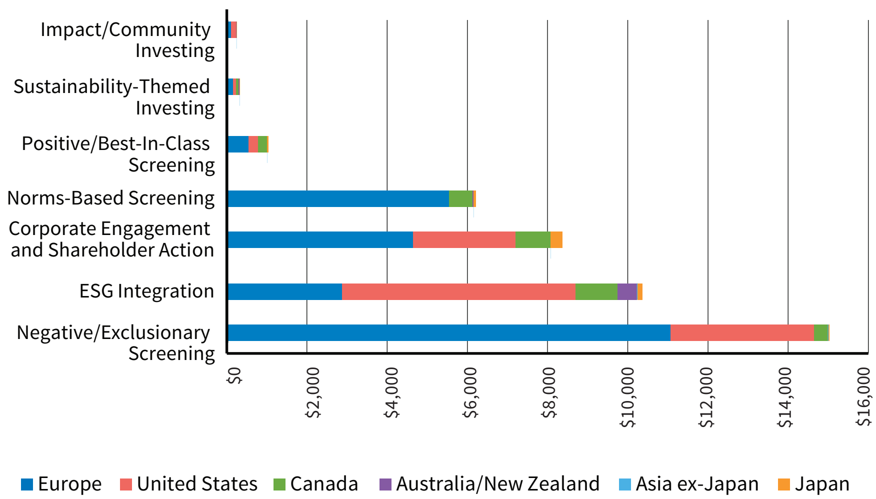



Source: Callan.

### Approaches to Implementation

The Global Sustainable Investment Alliance (GSIA) definitions of sustainable investment have emerged as a global standard of classification, and according to that organization, the dominant ESG adoption strategies, measured by assets, are negative or exclusionary screening and ESG integration, as figure 4 shows. Implementation via exclusionary screening has been more popular in Europe, while ESG integration has been the more prominent implementation method in the United States. It is also interesting to see the growth in these strategies over the past two years ending December 2016. Growth has been strong across implementation methods, but impact/community investing and sustainability-themed investing stand out. The GSIA defines impact/community investing as targeted investments in private markets that are aimed at addressing social or environmental issues (see sidebar). Certainly, this is an area in which our high-net-worth and endowment/foundation clients are already focused.

**Figure 4:**
Assets by Strategy and Region (In Billions)




Source: 2016 Global Sustainable Investment Review.

**Figure 5:**
Growth of Strategies, 2014-2016 (In Billions)

| Strategy | 2014 | 2016 | Growth | CAGR |
|---|---|---|---|---|
| Impact/Community Investing | $101 | $248 | 146% | 56.8% |
| Sustainability-Themed Investing | $137 | $331 | 140% | 55.1% |
| Positive/Best-In-Class Screening | $890 | $1,030 | 16% | 7.6% |
| Norms-Based Screening | $4,395 | $6,210 | 42% | 19.0% |
| Corporate Engagement and Shareholder Action | $5,919 | $8,365 | 41% | 18.9% |
| ESG Integration | $7,527 | $10,369 | 38% | 17.4% |
| Negative/Exclusionary Screening | $12,046 | $15,023 | 25% | 11.7% |

Source: 2016 Global Sustainable Investment Review. CAGR is compound annual growth rate.

GSIA Definitions of Sustainable Investment

*Negative/exclusionary screening*
The exclusion from a fund or portfolio of certain sectors, companies, or practices based on specific ESG criteria.

*Positive/best-in-class screening*
Investment in sectors, companies, or projects selected for positive ESG performance relative to industry peers.

*Norms-based screening*
Screening of investments against minimum standards of business practice based on international norms.

*ESG integration*
The systematic and explicit inclusion by investment managers of environmental, social, and governance factors into financial analysis.

*Sustainability themed investing*
Investment in themes or assets specifically related to sustainability (such as clean energy, green technology, or sustainable agriculture).

*Impact/community investing*
Targeted investments, typically made in private markets, aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose.

*Corporate engagement and shareholder action*
The use of shareholder power to influence corporate behavior, including through direct corporate engagement (communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

## Our ESG Journey

Our emphasis on quality inherently incorporates ESG considerations, and analysts have always considered ESG factors alongside the more traditional financial factors.

The social and environmental elements of ESG adoption are important because if a company is a good corporate citizen to the world, it will eventually be able to create the sustainable value that a core investor, such as William Blair, is looking for.

That said, governance is particularly important to us because we rely on management and the boards to make the right decisions. Governance has always been at the core of our assessment of management quality.

In our view, governance is essential to understanding whether we can gain a return on capital from an investment. Governance is crucial to our assessment of emerging-market companies, given that many are family owned, and there are potential language barriers and differing standards of regulation in relation to the disclosure of information.

In 2011, we became signatories to the Principles for Responsible Investment (PRI), an international network of investors working together to integrate ESG considerations into investment decisions and raise awareness of sustainable investing. At the time, we began to more explicitly integrate ESG considerations into our investment process.

Today, our research reports have a dedicated section in which analysts must provide information about relevant ESG factors for each company they are researching and explain how it relates to our investment thesis. Our web-based research platform also integrates ESG commentary from our analysts, including company meeting notes. This enables us to share feedback on our discussions with management and formally track our ESG-related interactions.

We also use third-party ESG rating information from MSCI, but have faced challenges integrating some of that data. Most significantly, there is limited coverage of our investment universe, which contains many small-cap companies across developed and emerging markets. We have also found that a lot of third-party ESG ratings data has limited histories with multiple methodology changes, limiting our ability to back-test ESG data for efficacy. We have thus found it essential to do proprietary research and make subjective calls based on our fundamental analysis. So, while we use third-party ESG ratings, they are only one input; our analysts' own judgment is critical to our ESG integration effort.

To further our efforts to more explicitly integrate ESG factors, we have brought in experts from some of our research partners to train our analysts on materiality, recognizing that certain environmental and social factors are more relevant to specific industries. For example, we would rather our financials analyst spend time researching climate-change implications for an insurance company than for a regional bank. As part of the materiality awareness initiative, we have been impressed by the industry framework created by the Sustainability Accounting Standards Board (SASB) and are looking to more explicitly integrate some of that work into our analysis.

Another important element of our ESG integration effort is proxy voting. Clients have told us they want to see more transparency and reporting on our voting activity. In response, we have worked with our proxy advisory firm, ISS, to set up search functionality on our U.S. and European fund websites, and we will continue to look for ways to improve our reporting and offer customization for clients that are seeking more granularity.

## Fundamental Research Integration in the Consumer Sectors

With that as a broad overview, let's look at some case studies in the consumer staples and discretionary sectors, where some example ESG drivers include governance, product safety, supply chain oversight, and eco-friendly product innovation. To understand how these factors are affecting companies we research, we assess relevant risks and opportunities as we perform our due diligence. Third-party ESG ratings are helpful in questioning or confirming what we uncover. We try to understand what factors, both positive and negative, influenced the ESG rating, and we seek to identify the negatives and also false negatives. Doing this, we have at times found companies with poor ESG ratings despite a track record of generating value for shareholders. We provide a few examples below.

### U.S. Food and Staples Retailer

One of the best global retailers in the food space has generated outstanding shareholder returns over the past 20 years, but it receives the lowest possible rating from MSCI.

In seeking to identify the drivers of that rating, we found that the largest was social impact, primarily in terms of food safety. This is an inherent problem in food production and retailing because such companies have large global supply chains. This company had a problem a few years prior when a food poisoning outbreak was linked to shrimp it sourced from Thailand. As a result, MSCI scored this company poorly for social impact.

We, on the other hand, try to identify and differentiate the structural (versus temporary) problem. We also look not just at the issue, but how the company responds. In this case, the problem was resolved, and the company took measures to ensure that food safety along its supply chain is well identified and controlled—positives, in our view.

### Philippines Food Products Company

Another example is a large Filipino food packaging company that has a poor ESG rating primarily because of its significant family ownership, which lowered its corporate governance score.

We do not assume corporate governance is poor because a company has high family ownership: such ownership is not uncommon for emerging market companies, and even companies in certain developed markets, such as Japan.

We look at the company's track record instead. Because there is a continuity of policies, family ownership can be positive, as long as the family owners' interests align with shareholders' interests, and the company is transparent about capital allocation and management decisions.

To better understand this company's ESG attributes, we reached out to management and highlighted some of the major ESG issues identified by MSCI. One was overboarding, which refers to directors sitting on a large number of boards, resulting in excessive time commitments and compromising their ability to fulfil their duties. Applying MSCI's governance ratings methodology, it was black and white: If there's overboarding, it's bad. This isn't meant to criticize the methodology, but demonstrate the importance of not relying exclusively on ratings data to make decisions.

As it turns out, that overboarding stemmed from the family's ownership of many other companies in the Philippines. It is a typical Filipino conglomerate, so directors on the company's board had to sit on the boards of other companies in the conglomerate.

As a result of our discussion, the company decided to step up its ESG efforts, going so far as to hire a third-party consultant who we engaged with to provide feedback on governance, as well as relevant social and environmental factors. We find this to be positive, not only from an investment perspective, but also because our integration objectives include helping companies improve in regard to their ESG measures.

### German Athletic Apparel and Footwear Company

Lastly, a global athletic apparel and footwear company had weaker ESG ratings on the environmental side because many of its products are manufactured in Asia with oil-related derivatives.

This company recognized the problem and took active steps to use more recyclable materials in its products—and in seeking to improve its environmental risk profile, this company actually innovated its product line. Products made with the recycled fabric can be sold at a higher price point because consumers want more sustainable products.

This is a good example of how ESG provides benefits from both an investment and operational perspective. Over time, this company's steps also improved its social risk profile by working to improve its Asian supply chain. Standards there used to be low in terms of workplace safety, and because of this company's efforts, they are improving.

These examples illustrate how we look at ESG factors from a bottom-up perspective, incorporating both third-party ratings and our own due diligence (which usually includes conversations with both a company and its vendors) to ensure that the quality of the company and returns on capital are up to our standard when we invest.

### Walking the Talk

We have provided an overview of our efforts to better integrate ESG considerations in our fundamental research, consistent with our investment process. More broadly from a firm perspective, it is important to highlight that sustainability is at the heart of William Blair's corporate values. We have demonstrated this through our extensive community engagement efforts, including the William Blair Foundation's community partners initiative and our generous matching gifts program. Our commitment to employee satisfaction has been recognized by *Pension & Investments'* Best Places to Work in Money Management survey. Our senior management also recognizes that our diversity and inclusion initiatives—including the Women's Initiative Network and Veteran's Affinity Network —will be critical to our future success.

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Blake Pontius is a portfolio specialist on the Global Equity team. Blake participates in the team's decision-making meetings, conducts portfolio analysis, and is responsible for communicating portfolio structure and outlook to clients, consultants, and prospects. Previously, he was a client relationship manager responsible for the firm's institutional non-U.S. strategy clients. Before joining William Blair in 2005, Blake worked in consultant relations at UBS Global Asset Management and was senior analyst at Mercer. He is a member of the CFA Institute and the CFA Society of Chicago. Education: B.A., economics, with honors, Michigan State University; MBA, finance, with distinction, DePaul University.

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