The Asset Manager Evaluation Process on ESG Capabilities

By the Investment Sub-Committee

Version 4
September 2020

Authors: Neil Gaskell, Dr. Christine Chow, Kalika Jayasekera, Lutfey Siddique, Caroline Butler

Contents

Abbreviations

D&I	Diversity and Inclusion
ESG	Environment, Social & Governance
ISC	Investment Sub-Committee
IFC	International Finance Corporation
OECD	Organisation for Economic Co-operation and Development
PRI	Principles for Responsible Investment
SDG	UN Sustainable Development Goals
TCFD	Task Force on Climate-related Disclosures
TPI	Transition Pathway Initiative
UN	United Nations
UNGP	UN Guiding Principles for Business and Human Rights

1. The Purpose of this document

The ISC invests the School's endowments and other reserves in portfolios of different types of investment funds operated by a range of asset managers in order to achieve the best possible long term return consistent with the risk limits set by the School. As part of ISC's own stewardship responsibility it engages actively with these asset managers in order to encourage investment by them in a socially responsible way consistent with the School's SRI Policy and the UN Principles of Responsible Investing and aligned, where relevant, with the School's research goals.

This engagement process is based on an annual ISC evaluation of asset managers' performance in promoting improved ESG related behaviours by companies in which they invest through active engagement on ESG issues with their managements. This document describes in detail the process of this evaluation of asset managers ESG capabilities and its use in the overall asset manager selection process by the School's Investment Adviser;

1.1 Definitions

1.1.1 Stewardship: The LSE defines asset manager stewardship as a combination of (i) exercising the legal right of shareholders of companies through the fulfillment of voting activities (therefore voting for or against all resolutions except in unusual circumstances); (ii) engagement with companies' managements; and (iii) public policy engagement. All these activities are expected to be purposefully conducted with the objective of enhancing the long term value creation capabilities of companies by changing their ESG related behaviour, and as a result, improving the potential financial return of the investor or asset manager.

1.1.2 Engagement: A purposeful dialogue between the asset manager and the target (company, policy maker, regulatory and other key stakeholders such as a NGO or supranational e.g. OECD, UN, IFC) that aims to drive a change in behaviour (for a company) or the establishment of a new or improved standard (for policy maker, regulator) or acceptance of a new idea that will drive market expectations and global policies or regulations (other key stakeholders). Each engagement needs to have SMART objectives – Specific, Measurable, Achievable, Relevant and Time-bound expectations of milestones, and outcomes. Outcomes from the engagement activity must be measured and reported publicly against the asset manager's target (even if the final outcomes may deviate from original anticipation).

2. When do we conduct the asset manager evaluation?

2.1 Annual evaluation:
We conduct asset manager evaluation on an annual basis. The timetable for action is as follows:

Month	*Activities*	*Key persons*	*Deliverables*
Aug-Oct	Review of evaluation process learnings from previous evaluation	Chair of ISC Members responsible for manager evaluation	Assess and update asset manager evaluation criteria, scoring methods (if required) and standard engagement letter template for managers (Appendix 1: standard introduction letter)
Jan	End Jan ISC meeting	All ISC members	Confirm asset manager evaluation criteria, scoring method (if there are changes) and standard letter template
Early Feb	Send letter to managers	Chair of ISC Supported by Secretary	Manager to confirm that they have received our request and will provide a reply
Feb	Managers prepare reply	Chair of ISC Supported by CB Adviser	Answer questions from managers (if any) related to our evaluation exercise
Mar	Reminders for managers	Chair of ISC Supported by Secretary	Receive manager replies before deadline of 31st March
Apr	Final reminders for managers	Chair of ISC Supported by Secretary	Receive and distribute manager replies to evaluators with assessment/scoring template
Apr	Manager evaluation	ISC manager evaluation group	Conduct manager evaluation
May	Third ISC meeting	All ISC members	Challenge and approve asset manager evaluation results and scores. Contribute key observations and improvements needed
Jun	Reply to managers	Chair of ISC Supported by Members evaluation group	Customised standard letter for reply to managers based on the evaluation and areas of improvement that we propose (Appendix 2: standard reply template)
Jun/Jul	Engage with those managers which request discussion	Chair of ISC, Secretary and CB	
Aug			
Sep			
Oct	First ISC meeting	All ISC members	Approve reports to School Finance and Ethics Committees
Nov			
Dec			

2.2 Which managers will be evaluated:
All equity and bond asset managers in the portfolios as at the end of the calendar year and still managing assets for the LSE by end March the following year will be evaluated.

3. Who is responsible for the asset manager evaluation?

3.1 Accountability: The responsibility of the annual asset manager evaluation rests with the Investment Sub-Committee (ISC).

3.2 Evaluators: At least **<u>three</u>** members of the ISC should conduct and complete the evaluation (the "evaluators"). The evaluators should have the relevant industry knowledge and practical experience. The Chair of the ISC will assign each evaluator with a portfolio of managers which will be rotated each year as far as practical to minimise possible Evaluator specific bias.

3.3 Conflicts of interests: All members of the ISC must make an annual disclosure statement to report on potential conflicts of interests. Additional disclosure is required for this asset manager evaluation exercise should any members of the ISC have concerns over the potential conflicts of interest for members involved in this evaluation.

3.4 Preparation: Each evaluator should do the following preparation before conducting the evaluation:

- **3.4.1** Read this document to familiarise with the asset manager evaluation framework, process and timeframe, as well as the associated actions that need to be taken.
- **3.4.2** Review the written replies provided by the assigned asset managers, including the reference documents and the analysis of published data prepared by Stanhope.
- **3.4.3** Assess consistency of manager claims with published information such as manager and fund websites, blogs and articles.
- **3.4.4** In case any claims by the managers with regard to their ESG related activities are not supported by published material to ask manager for supplementary evidence (through ISC Secretary) and ensure that the time by which the response is needed is clearly specified.
- **3.4.5** Understand each criterion for evaluation (see Section 4) for further details. If there are any questions, raise them with the Chair.

3.5 Process: We recommend that the evaluation of each manager be conducted in one session, unless follow up questions are necessary in order to proceed. When completed and where possible, compare the answers of the managers and the scores from the previous years to spot any trends, failure to deliver proposed actions and anomalies. Once each evaluation is completed, it is sent to the Chair for independent review and aggregation.

3.6 **Checks and balances**: We take an evidence-based approach to conducting the evaluation, including scoring. However, there will be a certain degree of judgement by individual evaluators. Hence, we have put in place an independent review process to ensure that there are checks and balances which can identify possible anomalies in the evaluations .

3.7 **Independent assessment**: The Chair will aggregate all evaluation and pass them to the Senior Independent Adviser (Caroline Butler), who will conduct an independent review to ensure fairness, consistency and appropriateness in scoring. She may recommend adjustments of the scores for consistency reasons. The Chair of ISC and the evaluators will discuss this review following completion in order to learn any lessons for use in future. The Chair of the ISC shall review the final evaluations and categorise managers into four groups: (1) Best in class; (2) Committed to specific improvements towards best in class; (3) limited areas of significant shortfall (4) multiple areas of significant shortfall.

3.8 **Link to financial performance**: All managers are routinely evaluated by the Investment Consultant based on their short and long term financial performance, which is considered alongside this annual ISC ESG performance evaluation. Should financial performance fall below an acceptable standard the Investment Consultant proposes an alternative asset manager. The ESG evaluation generates feedback to the Investment Consultant in the following ways; those in group (4) will be asked to improve towards best in class and should there be inadequate evidence of improvement during the year the Investment Consultant will be asked to identify alternative managers with equivalent expected financial performance and better prospective ESG performance; those in group (3) are asked at the next ESG evaluation to explain how the areas of shortfall noted in the reply have been improved and, subject to the response, may be reclassified into group (4); those in group (2) are asked at the next ESG evaluation to confirm the status of the planned improvements and if not delivered shall be reclassified into either group (3) or (4). Given that many ESG issues are long term oriented, the ISC may consider a longer period if the ESG improvements do not meet expectations by the next ESG evaluation.

3.9 **Approval of the evaluation**: The independently assessed evaluation document will be included in the Second ISC meeting. The evaluation will be subject to questions and challenges by all members of the ISC before the ISC approve of it. The approval includes the managers' ESG performance and how the managers should be categorised based on the three groups described in 3.6 and 3.7.

3.10 **Reply to managers**: The Chair of the ISC will send a customised letter to each manager with an explanation of the areas of shortfall and request for improvements if appropriate and an invitation to a follow up discussion if desired. The objective is to encourage continuous improvement in the managers' commitment to generate better ESG performance in investee companies as part of overall sustained performance – which covers both financial and ESG performance.

4. Guidelines for evaluation

4.1 Input into evaluation: Primary content from the managers including information from written communication, meeting notes from verbal communication, reference website links, publications, blogs and tweets. We will consider secondary information sources if they are publicly available and searchable as at end March for each year. We do not use any third party research from companies such as such as MSCI, Russell or Dow Jones. However, as the LSE is a PRI signatory, we do take into account the PRI ranking of managers. An analysis of relevant public and PRI data is prepared during March each year by the Investment Consultant.

4.2 Setting expectations: Evaluators should take into account style differences in the ESG approach of managers due to:

4.2.1 Investment approach - Passive versus Active. The primary engagement tools for Passive managers are public policy engagement and voting. They should have up-to-date, coherent and detailed global, regional or market-specific voting policies that are publicly available to help set clear ESG expectations from companies. They should be able articulate what their ESG priorities are and why. They should provide examples of public policy initiatives where they have made a positive impact to raise the overall standards of an investee company and/or on a particular ESG related issue. The primary engagement tools for Active managers are active company-specific engagements, in addition to expectations from passive managers as described above. Active managers should be able to provide case studies on behavioural change by specific companies including the rationale for engagement, the timeframe involved, the short term expectations and long term desired outcomes. All managers should have internal performance goals for the effectiveness of their ESG related engagements in terms of the quality and the time taken to deliver the targeted outcome on which they report publicly.

4.2.2 Asset class - equity versus fixed income and real estate. Stewardship on ESG issues has traditionally been conducted by equity investors based on the argument of shareholders being owners of companies with voting rights. However, it is possible to exercise stewardship across asset classes because irrespective of the actual investment instruments, the School expects its asset managers to focus on long term value creation. We expect fixed income only managers to encourage both good financial and ESG management by engaging with the issuers on capital efficiency, capital expenditure, good mergers and acquisition discipline and prudent ESG risk management. We expect real estate managers to report on ESG issues as per the standards set by GRESB[1] which necessarily differ from those applicable to equity and bond asset managers and therefore cannot be rated on the complete ISC template of criteria. However real estate managers will be rated on as many of the criteria as possible and given feedback in a similar way.

[1] https://gresb.com/faq/.

4.2.3 Size – large managers have more resources for engagement and reporting as well as larger assets which they manage but they will also have a wider universe of investees to cover, especially in the case of passive managers. Smaller managers necessarily have to compete by focusing on a smaller universe of target companies but can still achieve effective impact through focused engagement. The same criteria can therefore be used in the evaluation although the difference between passive and active managers in absolute numbers of engagements should be recognised. However, the policies, quality of engagement, impact and reporting can be best in class in both small and large scale managers.

4.3 Evaluation Criteria: There are 4 categories for evaluation – (1) Policies and activities driving engagement across ESG issues; (2) Relevance of engagements to specific issues linked to LSE strategy; (3) Quality of disclosure of ESG engagement activities; and (4) PRI ratings (Table 4.5).

Table 4.3 Overview of Current Score Allocation

Category	*Factors*	*Max Score*	*Total*
Engagement policies and activities	Number	10	40
	Policies	10	
	ESG Proxy voting	10	
	Impact	10	
Specified engagement issues– relevant to LSE strategy	Climate Change Human Rights, Diversity/Inclusion, UN SDGs TPI	5 5 5 5 5	25
Ranking	PRI	10	10
Disclosure	Reporting Frequency	5	25
	Policy goals	7.5	
	impact performance	7.5	
	Quality of reports	5	
TOTAL			100

4.4 Engagement policies & activities (40 points): We expect asset managers to engage each year directly with management of each investee company on relevant specific ESG policy issues. Asset managers should establish relevant ESG policy goals for each issue on which they will engage with corporate management. We expect balanced engagement activities across each of the E, S and G areas as appropriate for each company. Managers should establish targets for expected impact resulting from these engagements and measure the outcomes, and policies for proxy voting in case engagement does not deliver a result consistent with the manager's goals. Managers are assessed on the extent to which they meet these expectations in respect of frequency, policies, proxy voting and impact.

4.5 **Specified engagement topics – alignment with LSE strategy (25 points)**: The School's 2030 Strategy[2] has three guiding principles – (i) Diversity and inclusion; (ii) Global impact and reach; and (iii) a Sustainable Future. The ISC selects for specific engagement with asset managers, a number of specific ESG topics that are aligned with these guiding principles, and the research strengths of the School. They are:

4.5.1 **Climate change**: The Transition Pathway Institute (TPI)[3] is a global initiative led by asset owners and supported by asset managers. Aimed at investors, it assesses companies' preparedness for the transition to a low-carbon economy, supporting efforts to address climate change. TPI complements other existing initiatives and frameworks, by aligning with prevailing disclosure initiatives and with investors climate change and sustainability expectations. We expect asset managers to provide specific examples on how they have advanced the management of climate change risks and opportunities by companies in their portfolios by aligning to TPI, Paris Accord 2, or other comparable initiatives such as net zero carbon emissions. Managers are assessed on the frequency, consistency and emphasis relative to current best in class, with which they use these climate change initiatives in their engagements with companies.

4.5.2 **Human rights**: The UN Guiding Principles on Business and Human Rights (UNGP)[4] set the standards by which companies should consider human rights impact in their businesses and supply chain. The OECD has also published the Guidance on Responsible Business Conduct for institutional investors[5], aligned with the UNGP. Managers will be assessed, relative to current best in class, on the quality of their policies in relation to human rights and evidence of frequency with which they have been advocating the application of UNGP and the implementation of the OECD Guidance.

4.5.3 **Diversity and inclusion (D&I)**: The meaning of diversity and inclusion in the work force varies in different markets and sectors . Generally, ethnic diversity is an established engagement topic in the US and the UK; gender diversity is of particular importance in the financial and technology sectors globally, and more specifically an issue in Japan and South Korea, compared to Hong Kong or Singapore. Managers should clearly articulate how they define diversity and inclusion in the markets they operate in, and the reasons why they have chosen specific D&I issues to engage on. Managers will be assessed, relative to current best in class, on their use of a consistent yet customised approach towards addressing D&I issues.

4.5.4 **Sustainable development goals (SDGs)**: The UN 17 Sustainable Development Goals are mainly aimed at governments but some, such as

---

[2] http://www.lse.ac.uk/2030/assets/pdf/LSE-2030full-text-as-approved-by-Council-5-Feb.pdf

[3] http://www.lse.ac.uk/GranthamInstitute/tpi/about/

[4] https://www.ohchr.org/documents/publications/GuidingprinciplesBusinesshr_eN.pdf

[5] https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf

sustainable land and water use or gender equality, also apply to companies. Managers are assessed on their alignment of the ESG engagement policies with relevant SDGs, with clear objectives, metrics and mapping.

4.6 **Manager PRI ranking (10 points)**: We assess managers based on their annual PRI ratings for each of the 3 PRI criteria- Strategy and Governance, Incorporation, Active Ownership as set out in Table 4.5.

Table 4.5 PRI rating versus LSE asset manager score

PRI ranking per category	*Score per category*
A+	3 (3 A+ scores get extra bonus point ie 10)
A	2
B	1
C/D/E	0
Not a signatory	0

4.7 **Disclosure (25 points)**:

4.7.1 **Frequency**: Managers who provide quarterly public reports on specific engagement activities and voting receive a score of 4 in this sub-category. Half-yearly reporting gets 3 points; annual reporting gets 2 points. Reporting annually on overall stewardship activities and policy development will also be expected and will get one point. Reporting only to clients and not in public will lose two points. No structured or regular reporting regime (e.g. only occasional disclosure on websites or through media interviews) scores zero.

4.7.2 **Manager impact**: Managers who provide case studies on environmental, social and governance engagement that demonstrate impact of the manager on companies and report on outcomes vs performance targets (See Section 1 on the definition of engagement) receive up to the maximum 7.5 points in this sub-category based on the frequency, balance and impact of the engagements. Leadership of a collaborative engagement will be a positive factor in the assessment.

4.7.3 **Policy Goals:** Managers who publish a comprehensive set of specific policies which drive their ESG engagements with goals for expected responses from investee managements will receive a maximum of 7.5 points in this sub-category.

4.7.4 **Quality of reports**: Managers should provide quality reports covering a wide-ranging set of ESG topics that showcase its leadership on stewardship, with voting metrics categorised by ESG issues, markets and votes for, against management are assessed on coverage, clarity and ease of use with the best receiving a maximum score of 5 in this sub-category. Reporting only at the manager aggregate level with no detail for the fund in which LSE is invested will lose one point.

Appendix I Standard introduction letter

Dear

The London School of Economics and Political Science ("LSE", henceforth referred as the "School"), has a Socially Responsible Investment Policy, which applies to all of our endowment funds. The School's Socially Responsible Investment Policy includes engagement with the asset managers of the funds in which our endowments are invested to encourage better performance by the manager of the fund in relation to the sustainable environmental, social and economic/governance (ESG) activities of its investees.

The School's endowments currently hold xxx units/shares in your ………Fund./Investsment Trust You will recall that we contacted you last year and thank you for your response on which we gave you our feedback.

Last year a)b)c)or d),

a) we evaluated your performance relative to others as among best in class. The only suggestions which we made were that……………………………………………….
b) We evaluated your performance relative to others as approaching best in class (the second of our 4 groups). The main area in which we felt others had set the standard for best in class was ……………………………...
c) we evaluated your performance relative to others as falling short of best practice in some areas (the third of our 4 groups). The areas in which you fell short were primarily …………………………...
d) we rated your performance relative to others as falling short of best practice in most areas (the fourth of our 4 groups). The areas in which you fell short were ………………..

This letter is the follow up which we promised we would make this year to understand the development of your ESG related activities since then and, in particular, in the following policy areas;

1 There have been several regulatory developments related to ESG issues since our engagement with you last year including;

i) The **UK Stewardship Code 2020** which both strengthens the responsibility of asset owners and clarifies reporting requirements in the ESG areas. It states that;

'*Environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship*'.

Please can you describe the changes you are making to comply with the new UK Stewardship Code both in your engagements and your reporting of them?

ii) The **2019 EU Regulatory Framework for Fund Managers and Institutional Investors** offering financial products, which will also apply in the UK, provides that all investment activity should be consistent with promoting environmental sustainability and links this to the UN Sustainable Development Goals (SDGs).

Last year we asked you to explain how the specific environmental, social and governance policies which you are promoting map onto the SDGs. You failed to respond to this and we would appreciate this year an explanation of the fit between your ESG policies and the SDGs and specifically of environmental sustainability.

2 We would appreciate your confirmation that your fund managers engage directly with each investee management to encourage compliance with best practice including at least the following;

i) that their published reports include a statement of the potential financial impact of climate change on their business model, with a commitment to conducting scenario analysis consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), and clear goals such as compliance with Paris Accord 2 or net zero emissions;

ii) disclosure of their plans to progress in relation to diversity and inclusion in their company's labour forces and your policies on how to respond to any inadequacy of these plans.

iii) the extent to which your investees commit to publishing evidence of their efforts in ensuring responsible human and labour rights practices throughout the supply chain consistent with the framework of the UN Guiding Principles for Business and Human Rights, also known as the 'Ruggie Principles'

3 Please could you also update us in respect of your own operational activities in pursuit of improved ESG performance by investee companies;

i) Nature, quantity and impact of direct E and S engagements with investee boards in 2019,

ii) Improvements in frequency, and clarity of your public reporting of your ESG engagements,

iii) Your proxy voting record for re-election of board members where the investee board is not acceptably responsive to your ESG policies.

Please reply to us in writing by Friday 3 April 2021.

Chair of Investment Sub Committee

Please respond to:
Chair of the Investment Sub-Committee
c/o Jenny Febry, Finance Division
London School of Economics and Political Science, Houghton Street, London
WC2A 2AE
Or via email to
xxxxxxx__________ Cc J.Febry@lse.ac.uk

Appendix II Standard reply letter

Dear ,

Thank you very much for your reply of the xth April to our letter of xxth February asking for details of your ESG policies and engagements. We have now reviewed the replies which we have received from each of the fund managers with which we invest and shared the resulting evaluations with the LSE Investment Committee. This is the fourth year in which we have engaged directly with our fund managers in relation to ESG matters and we have evaluated the replies in the same way as last year focussing mainly on the quantity, policies, voting and impact of your ESG engagements combined with the clarity of your reporting on these activities and with your commitment to key Environmental and Social issues. We will be making public the results of our engagement with managers in terms of overall ranking and, where relevant, significant strengths and weaknesses in specific cases.

We hope that you might be able to benefit from our feedback and we would be happy to discuss this further with you if you wish.

Based on the replies and the related website reporting, we placed each fund manager as falling into one of 4 groups;

1. Among the best in class
2. Committed to improving towards best in class
3. Some areas of shortfall from best SRI practice
4. Significant shortfall from best SRI practice

You may recall that last year you were evaluated as being in the first/second/third/fourth group. This year, 'best in class' is again at a higher standard than last year with improvements in [the quality of the policies driving engagements, the reporting of the resulting impact and in the focus on key E and S issues.] The following is a summary of your specific evaluation this year;

Thank you for your cooperation with our efforts to understand better the xxxxxxx ESG approach and practice. We will be following your further development in this area and if you would like to discuss any of the above further with us, please let me know.

Yours faithfully

Chair LSE Investment Committee