



# Wespath Analytical Insights— ESG Integration in External Asset Manager Selection

Uncovering Managers' ESG Strengths  
in the Search Process

# Wespath Analytical Insights—ESG Integration in External Asset Manager Selection

Wespath Investment Management (Wespath)<sup>1</sup> invests in a sustainable and responsible manner, creating long-term value for our participants and clients while aspiring to uphold the values of The United Methodist Church (UMC).

Our comprehensive approach to sustainable investment supports our role as prudent fiduciaries and our aspiration to have a positive impact on the environment and society.

We believe a long-term focus best aligns investment returns and risks with investor needs, and supports the management of plan liabilities. This investment approach requires that we consider how the world might change in the future. We believe companies adept at identifying and managing environmental, social and governance (ESG) issues are more likely to be sustainable, i.e., they will avoid risks and capitalize on new opportunities. As such, Wespath is committed to incorporating ESG issues into investment analysis and decision-making, as we believe the intentional integration of ESG factors in the selection and management of investments positively affects long-term performance.<sup>2</sup>

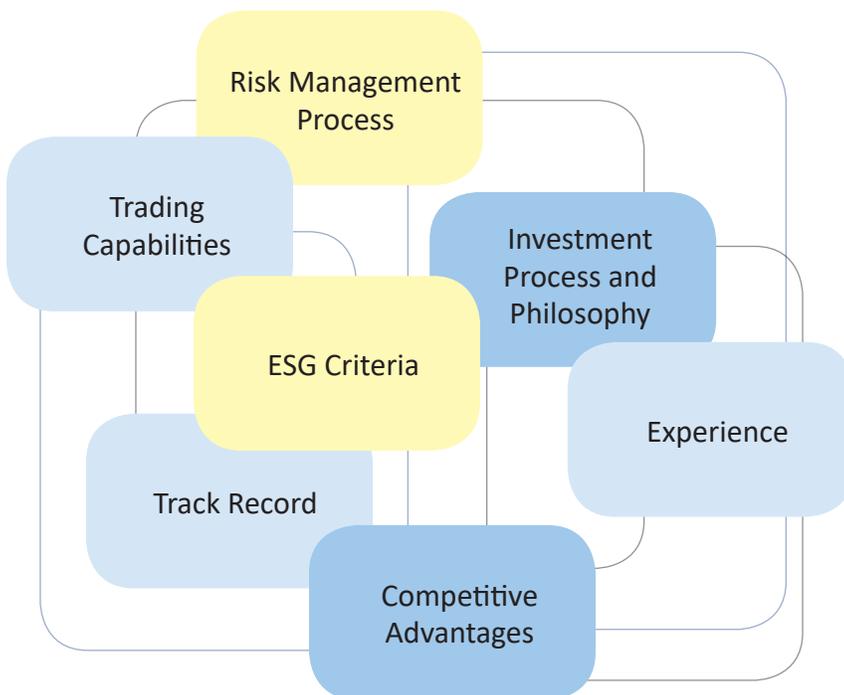
The relationships that we have with our external asset managers reflect this long-term view, and we seek managers who share our perspective.<sup>3</sup> For this reason, when Wespath engages a new asset manager, our evaluation of ESG competencies helps provide valuable information in the search and selection process. These insights complement conventional investment criteria (such as investment philosophy and process, unique competitive advantages, team experience, track record, etc.).

Ultimately, we believe assessing a manager’s ESG competency during the selection process is an important element of enhancing long-term investment returns and mitigating investment risks.

<sup>1</sup> Wespath Investment Management is the Investments division of Wespath Benefits and Investments, a general agency of The United Methodist Church.

<sup>2</sup> Wespath’s Investment Beliefs: <https://www.wespath.com/assets/1/7/5066.pdf>

<sup>3</sup> As of September 30, 2017, Wespath’s total assets under management were nearly \$23 billion—96% of Wespath’s assets are managed by 57 external managers.



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ESG criteria complements traditional investment criteria in the search process

# Integrating ESG Factors into the Search Process

## RFP Creation

Include ESG-specific inquiries directed at both the firm and strategy level

## RFP Distribution

Send to diverse group of managers, including those with notable ESG competencies

## RFP Evaluation

Compare key traditional and ESG criteria; manager presentations, onsite due diligence

## Manager Selection

Select managers who support our belief that a long-term view enhances performance and creates positive impact

Wespath's dedicated asset class investment teams typically lead searches for new external managers after the Chief Investment Officer (CIO) authorizes a new search. The Sustainable Investment Strategies (SIS) team, a department in the Investments division, works with the asset class teams to evaluate ESG competencies throughout the search process.

## RFP CREATION

One of the first steps in searching for a new investment manager is the development of a formal request for proposal (RFP). We include specific inquiries in the RFP to help us identify and understand a manager's ESG competencies. As we continue

to refine our RFPs, we have found that requests for information should address both how managers incorporate ESG practices and policies at the *firm* level, and at the specific *strategy* (or mandate) level. This helps us identify managers that apply their ESG practices systematically across investment strategies.

At the firm level, inquiries typically include:

- *Please describe the firm's commitment and experience in sustainable investing, including how ESG issues are integrated firm-wide.*
- *Does the firm have a sustainable/responsible/ESG investment policy? If so, how frequently is it reviewed and updated, and who approves it? Please attach relevant documents and links.*

While firm-level RFP inquiries can apply across multiple asset classes, we tailor requests for information at the strategy level to the specific ESG-related nuances of each asset class. This ensures that we receive information that is relevant to the specific RFP.

At the strategy level, inquiries include:

- **Public Equity**—emphasizing how ESG affects value creation:
  - *Please provide specific examples demonstrating how you identify, prioritize and address material ESG factors at a security level within the strategy.*
- **Private Equity**<sup>4</sup>—stressing the critical role of General Partners (GP) in the underlying fund:
  - *How do you assess that adequate ESG-related competency exists at the underlying GP level? Include any relevant monitoring processes you have in place to assess an underlying GP's management of ESG factors.*
- **Fixed Income**—recognizing how engagement can help mitigate downside risk:
  - *Summarize the extent to which you engage with company management/public policymakers on ESG-related issues.*

<sup>4</sup> Wespath executes its Private Equity strategy through the use of Fund of Fund managers and does not invest directly in private equity funds.

# Integrating ESG Factors into the Search Process (continued)

## RFP DISTRIBUTION

We aim to distribute the RFP to a diverse group of asset managers, from small specialist boutiques to large investment managers offering multiple investment products. Regardless of size, strategy and firm resources, we expect all managers to integrate the consideration of material ESG issues into investment decision-making. For all investment manager searches we draw on discussions with our peers and industry sources, as well as databases to develop a preliminary list of prospects. To complement these efforts, the SIS team maintains a pipeline of managers with ESG competencies and credentials. By keeping an up-to-date internal ‘ESG manager database,’ the SIS team can help streamline the distribution of the RFP.

## RFP EVALUATION

Wespeth summarizes and evaluates the responses to all RFPs in a matrix, which compares key traditional and ESG criteria across responding managers. The ESG portion of the matrix offers a high-level assessment of ESG competencies and strategies, a detailed analysis of individual responses to each RFP question and a relative ESG rating for each submission. The matrix ensures a consistent and reliable process to compare and

*Wespeth’s Investments division debates the relative strengths and weaknesses of every RFP finalist, with each member of the division providing a rationale for his or her top candidates.*

**“Regardless of size, strategy and firm resources, we expect all managers to integrate the consideration of material ESG issues into investment decision-making.”**

evaluate manager responses, and plays an integral role in creating a short list of finalists.

Wespeth invites representatives from all RFP finalists to its offices to present to the entire Investments division. The Investments division debates the relative strengths and weaknesses of each finalist, and each member of the division provides a ranking and rationale for his or her top candidates. In an effort to encourage individual thinking, senior members of the division wait to disclose their perspectives until the other team members have contributed their thoughts. The CIO offers his comments last. The CIO and asset class lead will consider the aggregate ranking of the finalists—combined with the group’s overall comments and concerns—before selecting firms (typically two) for on-site location due diligence visits from two representatives of the Investments division.



# Indicators of Best Practice

While each new search allows us to expand and refine our understanding of best practices, the managers that we consider ‘best-in-class’ demonstrate three distinguishing characteristics regarding ESG integration:

## CHARACTERISTIC 1



**They take a long-term view of all factors that could materially impact operational strategy and performance, including ESG issues**

While managers may not always self-identify as taking an “ESG-specific” approach, leading managers incorporate an assessment of material ESG factors into an analytical framework that extends beyond short-term business cycles. They recognize how ESG factors can expose potential investment opportunities and risks, and impact financial performance. They also recognize these factors provide insights into the quality of a company’s management team and strategic direction in the near and longer-term.

## CHARACTERISTIC 2



**They systematically define and prioritize ESG risks and opportunities by sector**

Managers that appear particularly skilled at incorporating the analysis of ESG factors into their research frameworks tend to define and prioritize ESG opportunities and risks on a sectoral basis. This reflects the fact that material ESG issues vary depending on industry sector, geographic region and core business activity. We have found the Sustainability Accounting Standards Board (SASB) standards best represent the emerging criteria used to identify sectoral materiality. While not all managers use SASB’s sector-based approach, Wespath considers the SASB framework an important benchmark in determining RFP candidates’ ESG awareness and understanding.

## CHARACTERISTIC 3



**They recognize that effective ESG integration provides analytical insights and a greater understanding of a truly sustainable economy**

Managers who effectively integrate ESG considerations into their analysis are able to demonstrate to us that they gain specific insights into a company’s business strategy and financial performance. These managers are also more likely to evaluate how corporate activity might positively or negatively affect all stakeholders (e.g., employees, local communities, customers, etc.) in a dynamic, complex and interconnected world. In doing so, best-in-class managers are increasingly highlighting connections between long-term value creation and the development of a truly sustainable economy that creates positive financial, social and environmental impacts. These managers are also increasingly emphasizing connections between unsustainable economic practices and value destruction. From a fixed income perspective, given the importance of non-corporate issuers to the overall market, best-in-class managers are more likely to recognize the connections between ‘real-world’ impacts and systemic risk within the financial markets. For example, in the lead-up to the financial crisis, clearer links might have been made between the social and financial risks represented by the over-leveraging of the sub-prime debt market, and the role of collateralized mortgage obligations (CMOs) in precipitating the market crash.

**“Best-in-class managers are increasingly highlighting connections between long-term value creation and the development of a truly sustainable economy that creates positive financial, social and environmental impacts.”**

# ESG Integration Challenges

We have also identified three shortcomings that prevent managers from effectively integrating ESG factors into their analysis:

## CHALLENGE 1

### A narrow interpretation of how ESG factors can materially affect company performance and investments

Certain managers only evaluate how ESG issues might affect a company's reputation. While reputational risks may be material in certain industries, many other ESG factors affect company performance. We believe that such a narrow interpretation of ESG integration precludes a manager from gaining possible insights into the quality of a company's management and the viability of its long-term strategy and financial performance.

## CHALLENGE 2

### A reactive and fragmented approach to ESG integration

Managers that have a reactive and fragmented approach to ESG integration often fail to demonstrate a systematic research process that assesses material ESG risks across portfolios. These managers focus more on how individual companies respond to short-term, reactive events—like environmental, social and governance crises. In doing so, they lack a repeatable and scalable research process that helps them analyze whether a company has sustainable business policies and practices. Furthermore, evidence that a manager focuses on shorter-term, reactive events, provides us with information that their investment time horizons may not be aligned with our own.

## CHALLENGE 3

### Elements of ESG integration are driven solely by possible client demand, rather than long-term value creation

While Wespath supports the development of ESG-related products and services, our expectation is that managers are primarily motivated to integrate ESG factors into all of their investment decision-making as a means of enhancing long-term value creation. Indications that ESG integration is solely responsive to client demand rather than an inherent belief that ESG integration is value-driven, raises concerns that managers are professing ESG competence in order to develop new products for a segment of their target market.

“Our expectation is that managers are primarily motivated to integrate ESG factors into all of their investment decision-making as a means of enhancing long-term value creation.”



# Aspiring towards Comprehensive ESG Integration

Wespath is a long-term investor. We believe it is imperative that the companies in which we invest demonstrate sustainable business policies and practices, helping to ensure their viability well into the future. For this reason, we believe that integrating ESG issues into our searches for new managers:

- Enhances our ability to select partners that align with Wespath’s long-term, sustainable investment horizon,
- Contributes to our funds’ financial performance, and
- Results in positive impact for our multiple stakeholders.

Our sustainable investment strategies and asset class investment teams continue to strengthen their collaboration when searching for new managers to achieve these aims. In the 18 months through October 2017, we reviewed 39 RFP responses for six new mandates across public equity, fixed income, private equity, and private debt asset classes. For each of these new mandates, there was consensus between the SIS and asset class investment teams on the finalists that should present to Wespath’s entire Investments division. We believe this reflects:

- A more coordinated understanding of the attributes that Wespath expects from best-in-class managers, and
- An increasingly strong pool of prospects able to demonstrate how ESG integration supports long-term financial performance.

“We hope that the intentional integration of the consideration of ESG factors in any search process can help extend the investment horizons of asset owners and asset managers.”

More broadly, we hope that the intentional integration of the consideration of ESG factors in any search process can help extend the investment horizons of asset owners and asset managers. We believe, like many other sustainable and responsible investors that focusing on longer-term investment horizons can promote greater financial stability. This will enhance investment performance for broad market participants while also creating scalable positive impact for the environment and society. We hope this paper encourages further consideration of ESG factors, alongside traditional financial criteria, when asset owners evaluate service providers’ ability to manage investment risks and opportunities.

## RFP Activity (April 2016–October 2017)

Reviewed:

**39** RFP responses



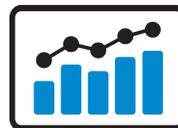
Including:

**Over 400**  
individual ESG-specific  
questions



Across:

**5** asset classes



Result:

**6** new mandates  
run by managers  
with demonstrable  
ESG integration



## AUTHORS



### Nicholas Abel

Sustainable Investment Specialist, Sustainable Investment Strategies

*Nick joined Wespath in October 2016. As a sustainable investment specialist, Nick works to integrate ESG factors into Wespath's investment process. Nick also leads Wespath's*

*corporate governance engagement activities. Previously, he was a senior investment analyst at investment consultant RVK, Inc., where he performed ESG-product portfolio analysis, capital market research and investment due diligence for institutional investors. Nick received his bachelor's degree in Finance from Western Washington University.*



### Juan Lois

Research Analyst, Sustainable Investment Strategies

*Juan joined Wespath in September 2015.*

*As a sustainable investment research analyst, he ensures that Wespath's investment program incorporates ESG metrics into the investment*

*process. He is also responsible for overseeing Wespath's ethical exclusions and contributes to the team's corporate engagement and proxy voting activities. Prior to joining Wespath, Juan worked in institutional sales and business development at Cornerstone Capital Group, a financial services firm dedicated to mainstreaming the discipline of sustainable finance. Before that, he worked in the energy industry in Latin America, focusing on mining, electricity generation and renewable energy technologies. Juan received his bachelor's degree in Latin American Studies from Tufts University, and his master's degree in International Relations from The George Washington University.*



## Wespath

BENEFITS | INVESTMENTS

*Caring For Those Who Serve*

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## About Wespath Investment Management

Wespath Investment Management (Wespath) is a division of Wespath Benefits and Investments, a general agency of The United Methodist Church. Wespath provides investment solutions for the endowment and retirement plan (defined contribution and defined benefit) portfolios of United Methodist-affiliated institutional investors, including foundations, higher education institutions, health care organizations and churches through a broadly diversified family of daily-priced funds. Wespath's investment process proactively incorporates the consideration of environmental, social and governance (ESG) factors into investments across asset classes and in the selection of external asset managers. Wespath's activities promoting sustainability include proxy voting, corporate and public policy engagement, and positive impact investing. As of September 30, 2017, total assets under management were approximately \$23 billion.