Understanding sustainable investment and ESG investment terms

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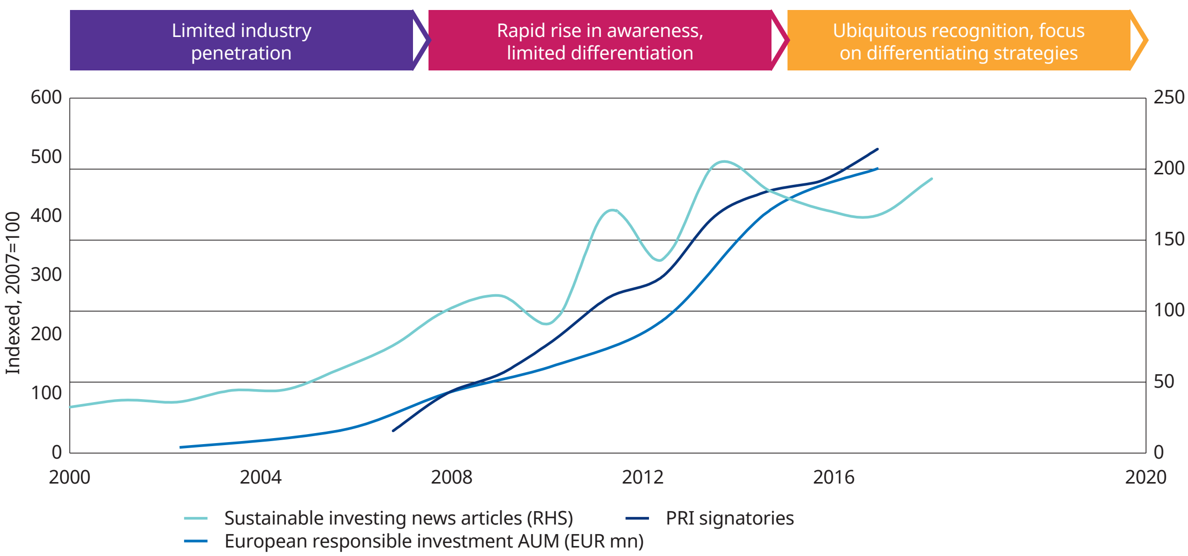
Schroders

Contents

In this brochure, we lay out Schroders' view of the landscape of activities, strategies that fall under the broad umbrella of sustainability and "ESG", and our assessment of the terms most commonly associated with each.

Introduction

Over the last decade, sustainability has become an increasingly crucial aspect of investing. Institutional asset owners began to ask about managers' credentials in integrating environmental, social and governance (ESG) considerations a decade ago and these discussions have now become a standard feature of our interactions. Retail investors have also shown an appetite for products that recognize and reflect the relationship between their investments and an ever more challenging social and environmental backdrop.



Source: Hightail (news search for articles containing "sustainable investing" relative to all articles referring to "investing", Principles for Responsible investment (number of signatories) and EuroSIF (combined AUM invested in different ESG strategies, adjusted for double-counting)

Today, almost all large asset managers trumpet their commitment to sustainable investing. Nine in every 10 of the world's largest fund managers have signed the UN's Principles for Responsible Investment (PRI), demonstrating a public commitment to ESG integration. As the number of investors focusing on sustainability and ESG issues has expanded, so has the volume of terms applied and the field has become saturated with confusing nomenclature and a lack of clarity on the various approaches.

For most of the last decade, much of our industry appeared content focusing on rhetoric over substance. Keeping details, definitions and methodologies vague allowed investors to infer their own expectations of what constitutes sustainability. As a result, the market now has an eclectic mix of strategies sitting under the sustainable investments banner. As much effort appears to have gone into labeling and positioning as into developing more effective tools, frameworks or strategies to integrate sustainability and ESG considerations.

With investor attention turning increasingly to the details of how companies conduct their businesses and why, we set out to provide a clear overview of the landscape of issues, acronyms and approaches commonly used across the industry.

1 91 of the 100 largest active asset managers listed by P&I are shown as signatories on the PRI website

Overarching view: Schroders sustainability roadmap

The most commonly used terms include "*sustainable*", "*responsible*", "*impact*" and "*ESG investing*". These are often used interchangeably to cover a wide spectrum of goals and strategies. At one end of the scale, ethical screens eliminate companies engaged in controversial activities, reflecting asset owners' values and should have little expectation of improved investment returns. At the other end, sustainability analysis can, when approached thoughtfully and integrated with more traditional analysis, improve insights and enhance performance. Each approach has different objectives, requires different skills and demands different tools.

To illustrate this point, the chart below broadly maps the main approaches we have identified in terms of expected performance benefits relative to social benefits, as well as the top-down thematic or bottom-up, company-driven starting points.

The X axis runs from **Values** (which is based on clients' ethics), to **Value** (which is more focused on financial outcomes).

The Y axis identifies whether the investment approach is grounded in a macro view of cross-sector challenges and opportunities or in a micro view of a company's business models or activities.

Source: Schroders. For illustrative purposes only.

Every approach plotted above covers a wide spectrum of distinct activities, and an even wider range of terms (many of which were intentionally left off for the sake of simplicity). The next several sections offer our assessment of the various areas of activity encompassed by each broad category. This is intended as a roadmap to help investors understand the different approaches used across the industry, and common interpretations of each.

This brochure is not intended to offer any views or recommendations on what might be the most effective or intelligent choices as such decisions vary greatly depending on investors' goals and investment strategies.

Sustainability terms

I. Integration

Divestment: The sale of an asset for social or political goals. Examples of divestment include the selling of South African assets during the apartheid era or, more recently, investments in fossil fuel-related assets. In many regions, local legislation drives divestment guidelines, which can influence the extent to which public funds can or cannot invest in certain regions. Divestment is also sometimes known as divestiture.

Environmental factors: Issues related to resource use, pollution, climate change, energy use and other physical environmental challenges and opportunities. Investors will typically consider a company's environmental performance either in terms of the company's impact on the environment or the impact of natural capital constraints on its profitability. Common measures include carbon emissions, water and energy consumption, waste management and pollution.

ESG analysis: The examination of a company's environmental, social and governance performance, which could be designed and used in any of the approaches described here.

ESG integration: An investment approach in which a range of sustainability and ESG-related risks and opportunities are considered in addition to traditional financial analysis. In principle, this can lead to a more fundamental assessment of the environment in which a company operates and its performance in managing different stakeholders. It should therefore provide a more complete understanding of future opportunities and risks compared to traditional fundamental analysis. In practice, its effectiveness in doing so hinges on how that integration is approached and implemented.

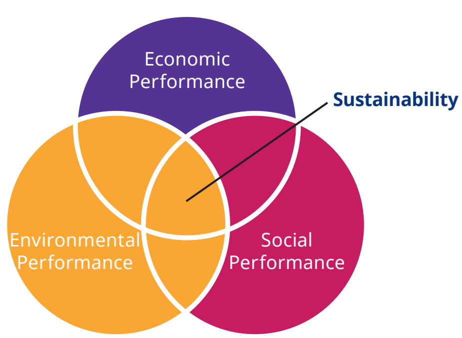
ESG research providers: Firms that conduct quantitative and qualitative analysis of a company's ESG performance and provide a standardized measure (such as a company ESG rating). Approaches and results can vary significantly across providers. MSCI and Sustainalytics are widely used ESG research providers.

Extra-financial factors (sometimes known as non-financial factors): Factors that are not the usual, financial variables considered in investment analysis and whose monetary impacts are typically hard to quantify. The term can be applied to any measure whose unit of measurement is not monetary.

Fund ESG ratings score: A third party rating that attempts to indicate the ESG credentials of a particular fund relative to an investment category or peer group, based on an assessment of the ESG credentials of a fund's underlying holdings. Typically combines the ratings ESG research providers publish with portfolio holdings.

Governance factors: Factors that measure the quality and robustness of a company's internal structure and practices, its consideration for shareholder rights, its accountability and wider transparency framework. Measures of governance can include board structure, board independence, executive compensation or auditor independence.

Integrated reporting: Company reporting that communicates the relationship between a company's strategy and its financial, governance and sustainability performance.



For illustrative purposes only.

Responsible Investment (RI) or Socially Responsible Investment (SRI): This is considered the oldest and most established term relating to sustainable investing, and was originally grounded in more ethically and values-focused approaches to investment. The term is now widely used to cover a broad range of activities and approaches, including **ESG integration**, **Engagement** and **Active Ownership**.

Social factors: Issues related to social trends such as demographic changes, social attitudes, social trust and other beliefs or behaviors. Investors may use the analysis of these factors to gauge the contribution a company makes to society (as responsible corporate citizens) or to assess a company's ability to adapt to the pressures those social trends exert on business models and profitability.

Sustainability: Describes the features which ensure companies, industries or markets can operate within their means and maintain stability over the long term. Although sometimes interpreted through more of an environmental lens, it is applicable across the spectrum of ESG issues and requires societies' and stakeholders' expectations are met.

Triple Bottom Line (TBL or 3BL): An accounting framework originally developed in an effort to measure sustainability. TBL goes beyond traditional measures to incorporate three additional dimensions of performance: social, environmental (or ecological) and economic. Michael Porter has more recently popularized a Shared Value framework that has similar elements and emphasizes the importance of expanding the value created for shareholders to all stakeholders.

Sustainability terms
(continued)

2. Governance & active ownership

Active ownership: Actively engaging with the managers and boards of directors of investee companies on business strategy and execution, including specific sustainability issues and policies. It is seen as a means of reducing investment risk, enhancing long-term shareowner value, or both.

Board of directors: Appointed by shareholders to represent and protect their interests in decision-making and ensure the development and execution of a successful value-creating strategy.

Corporate governance: The system of rules, practices and processes by which a company is directed and controlled, designed to ensure management acts in the best interests of its shareholders. Corporate governance covers a wide scope from reviewing board independence, remuneration and risk practices, to capital allocation and accounting practices.

Corporate governance codes: A set of standards detailing good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. These purposeful dialogues are established by local regulators on a country-by-country basis.

Engagement: A purposeful dialogue between a company and its shareholders that aims to enhance and protect the value of investments. This might take place to seek additional information about a company's practices or to encourage improvements in performance and processes. An engagement may take place via face-to-face meetings with executive or non-executive board members as well as with other managers. More formal requests may be submitted in writing.

Fiduciary duty: The legal duty of one party (the fiduciary) to act in the best interests of another (the principle). In the investment chain there are a number of these relationships including the duty that boards have to shareholders, the duty between trustees and beneficiaries and the duty between asset managers and their clients.

Independent directors: Neither past nor present employees of the company or affiliated with it in any other way. In some jurisdictions those who serve on boards for a set period of time are no longer considered independent, even if they began their tenure in that category.

Lead director/senior independent director: Acts as an independent leader among directors and provides an independent point of view to the chairperson. The lead director can also act as chairperson if the chairperson is conflicted or unavailable, and can be an effective conduit for shareholderconcerns.

Non-executive board members: Sit on the board but do not form part of the management team.

Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance: A regularly reviewed set of principles that set down the guidelines on how to create a sound corporate governance system. Principles include transparency, accountability, board oversight, and respect for the rights of shareholders and the role of key stakeholders.

Shareblocking: A practice whereby restrictions are placed on the trading of shares which are to be voted upon prior to an annual general meeting.

Shareholder activism (or advocacy): A public form of engagement whereby investors use their shareholdings to engender change at a company. This can be done through submitting shareholder resolutions or a public media campaign against a company. Shareholder activism tends to be a more confrontational approach to promoting change.

Stewardship: An ongoing and purposeful dialogue between shareholders and boards that aims to ensure a company's long-term strategy and day-to-day management is effective and aligned with shareholders' interests. It includes monitoring a company's practices and performance, engaging on areas of concern and voting on shares held to ensure management is acting in the long-term best interests of its shareholders. Good stewardship should help to enhance and protect the value of investments.

Stewardship codes: A set of standards that help set expectations for asset managers and asset owners on oversight and engagement with investee companies. These codes are established by local regulators on a country-by- country basis.

Voting rights: Equity investors typically enjoy rights to vote at either an Annual General and/or Extraordinary General Meeting (AGMs and EGMs). The resolutions on which shareholders vote will vary according to individual countries' legal frameworks. They may include voting on an individual director's appointment, remuneration or mergers and acquisitions.

3. Screened investments (ethical investing)

Best-in-class investment: A comparative investment style that involves investing only in companies that lead their peer groups in respect of sustainability performance.

Cluster munitions and anti-personnel mines (APMs): Cluster munitions are weapons designed to disperse multiple explosive sub-munitions. Anti-personnel mines are explosive devices designed to harm or kill civilians. Schroders fully supports the international conventions on cluster munitions and APMs. Consistent with this support, and in line with our commitment to responsible investment, we will not knowingly hold any security that derives revenue from or provides funding for either.

Negative/exclusionary/ethical screening: An investment approach that incorporates an investor's moral principles by excluding companies involved in certain activities or industries (e.g. alcohol, gambling and adult entertainment).

Norms-based investing: Investing that excludes companies (or government debt) from a portfolio on account of any failure by the issuer to meet internationally accepted norms such as the UN Global Compact, the Kyoto Protocol or the UN Declaration of Human Rights etc.

Positive screening: An investment strategy that aims to select companies that demonstrate leading sustainability practices and are better positioned to benefit from, and build resilience to, long-term societal and economic trends.

Sin stocks (or vice stocks): Stocks of companies either directly or indirectly associated with activities considered to be unethical or immoral, such as tobacco, alcohol, gambling and adult entertainment.

Values-based investing: Investing that prioritizes investors' sustainability objectives, rather than maximizing returns in isolation.

Sustainability terms (continued)

4. Thematic investing

Carbon footprint: A measure of the total greenhouse gas emissions, expressed in tons of carbon dioxide. It is one way to assess the potential impact of climate change on a portfolio. It will measure at least one of the following:

- Scope 1 emissions: direct emissions from owned or controlled sources
- Scope 2 emissions: indirect emissions from the generation of purchased energy
- Scope 3 emissions: all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions

Clean technology: A range of products, services and processes that reduce the use of natural resources, cut or eliminate emissions and waste, or have the potential to provide performance competitive with traditional alternatives.

Climate risk: The investment risk resulting from a failure to keep global temperature rises to below 2°C above pre-industrial levels.

Circular economy: An economic system designed to produce no waste or pollution.

Environmental funds: Funds that are primarily exposed to sustainable environmental themes such as clean energy, water and waste, or invest in companies with positive environmental management.

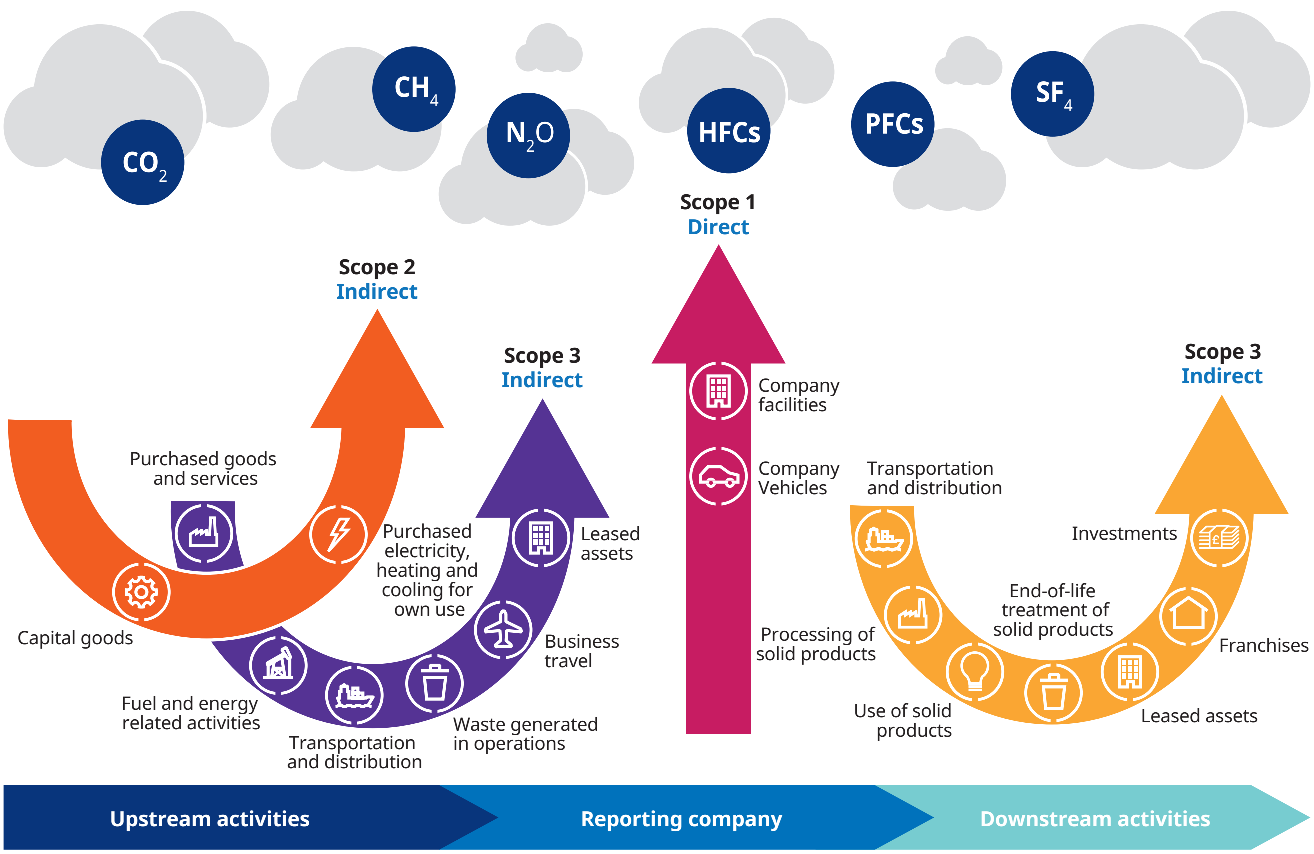
Green investing: Investing in companies and technologies that are considered to be positive for the environment, such as companies offering alternative sources of energy or those that have demonstrated a track record of reducing their environmental impact.

Low carbon funds: Funds that invest in companies with a low carbon strategy or low carbon emissions.

Stranded assets: Assets that suffer from unanticipated or premature write-downs and are unable to operate to the end of their economic lives due to changes in the market and regulatory environment. Most focus on regulation relating to climate change, but could include other changes that cause assets to become uneconomic.

Renewable energy: Energy collected from resources that are naturally replenished such as sunlight, wind, water and geothermal heat.

Water funds: Funds that invest in companies providing technology, products and services relating to the water value chain, such as water distribution, management, treatment and analysis or irrigation.



Source: The Greenhouse Gas Protocol, 2011 cited in: "Portfolio Carbon" UNEP FI Investor Briefing July 2013.

5. Impact investing

Community investing: Investments made directly into low-income or disadvantaged communities, small businesses or community services (for example child care, affordable housing and healthcare).

Economically targeted investing: Investments that seek to promote economic development in local communities and organizations, in addition to competitive financial returns. The investments may be targeted at job creation, generating small business loans, improvement in the affordable housing stock or enhancing infrastructure.

Green bonds: A bond in which proceeds are used to fund new and existing projects with environmental benefits. For example, renewable energy and energy efficiency projects.

Impact investing: Investments made with the primary goal of achieving specific, positive social benefits while also delivering a financial return. Typically, these are investments in small companies or projects with clear social goals, providing them with capital they may not otherwise have accessed.

Mission-related investing: Investments made to further the philanthropic goals, mission and values of an organization that are expected to deliver financial as well as social or environmental returns.

Social impact bonds: Investments designed to improve the social outcomes of publicly funded services. Providers are typically charities that are often pioneering a new approach to a specific social problem. The investment is used to fund the working capital needs of the project.

Sustainability terms (continued)

6. Industry organizations and initiatives

Asian Corporate Governance Association (ACGA): An independent, non-profit membership organization dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. See more at the ACGA website

Carbon Tracker: An initiative working to align capital markets with climate change objectives. See more at the Carbon Tracker website

CDP (formerly the Carbon Disclosure Project): A global not-for-profit organization, founded in 2000 that provides the world's only global natural capital disclosure system. See more at the CDP website

Climate Disclosure Standards Board (CDSB): An international consortium of business and environmental non-governmental organizations (NGOs), set up to promote greater alignment between natural and financial capital through disclosure standards, research and advocacy. See more at the CDSB website

Council of Institutional Investors: An organization of asset managers and asset owners promoting effective US corporate governance practice. See more at the Council of Institutional Investors website

European Sustainable Investment Forum (EuroSIF): The leading European sustainable and responsible investment organization whose mission is to promote sustainability through European financial markets. Different regions have their own local SIF e.g. US SIF, UKSIF, SWESIF. See more at the EuroSIF website

Global Reporting Initiative (GRI): An international organization that develops and publishes sustainability reporting standards and measures for global companies. It has become the closest thing to a global reporting standard for ESG measures; it reports that 92% of the world's largest 250 corporations report on their sustainability performance (source: ibid). See more at the GRI website

International Corporate Governance Network (ICGN): An investor-led organization of governance professionals, ICGN's mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide. See more at the ICGN website

International Integrated Reporting Council (IIRC): A global coalition of regulators, investors, companies, standard-setters, the accounting profession and NGOs that helps businesses and investors adopt integrated reporting. See more at the IIRC website

Principles for Responsible Investment (PRI): An investor initiative in partnership with the UN Environmental Program Finance Initiative and the UN Global Compact. Founded in 2006, the PRI has become the leading network for investors demonstrating their commitment to responsible ownership and long-term, sustainable returns. See more at the UN PRI website

Sustainability Accounting Standards Board (SASB): A US non-profit organization started in 2011 to establish sustainability standards for companies traded on US exchanges. See more at the SASB website

Task Force on Climate-related Financial Disclosures (TCFD): A task force established by the Financial Stability Board to develop voluntary, consistent climate-related financial risk disclosures for use by companies when providing information to investors, lenders, insurers and other stakeholders. See more at the TCFD website

UK Sustainable Investment and Finance Association (UKSIF): The membership network for sustainable and responsible financial services in the UK. See more at the UKSIF website

UN Development Program: The UN's global development network partnering with people at all levels of society to help build nations that can withstand crisis, and drive and sustain the kind of growth that improves quality of life for everyone. See more at the UN Development Program website

UN Global Compact Principles: Ten corporate sustainability principles for long-term success covering the areas of human rights, labor, the environment and anti-corruption. See more at the UN Global Compact's website

UN Sustainable Development Goals: A set of 17 goals adopted by world leaders in September 2015, aimed at ending poverty, preserving the planet and ensuring prosperity for all. See more at the UN Sustainable Development Goals website

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