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Responsible Investment at BNY Mellon: Addressing Risk for Investors, Society and the Environment

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While return on investment remains of utmost importance to investors around the world, those same investors increasingly recognize the importance of considering environmental, social and governance (ESG) issues when making investment decisions. Indeed, sophisticated investors have long understood that neglecting these considerations can raise risks of financial loss in their portfolios. Unethical or neglectful behavior by a company or government in one of these areas can harm those who invest in a company's stock or a sovereign's bond as well as the environment or society in which a company or government is located.

How ESG Risk Can Harm Investors and How to Manage It

The revelations that Volkswagen used software in its diesel cars to cheat on government-mandated emission tests is an example of poor corporate governance leading to environmental harm and financial loss for investors. That failure of governance appears to have allowed elevated levels of unhealthy oxides of nitrogen emissions into the air as well as exposing the company and its shareholders to the financial harm from potential lawsuits and fines by regulators.

In this instance, the potential harm resulting from poor governance is not limited to public health and Volkswagen's employees and shareholders. Investors and workers in many unrelated areas of the automotive industry now find themselves facing potential consequences due to increased scrutiny of the sector.

Fortunately, improving governance and promoting corporate and government policies that encourage sustainable, long-term growth can also benefit investors. By using their influence as shareholders, investors can reduce their ESG-related risks by insisting that companies and governments address potential environmental and social factors that threaten the long-term sustainability of companies and the environment.



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BNY Mellon's investment affiliates take a range of approaches to responsible investing that reflect their specialization in various asset classes and areas of the market.

As investors' understanding of the links between ESG factors and portfolio risk grows increasingly sophisticated, investment managers including BNY Mellon's investment affiliates are responding by increasing the role ESG plays in their investment processes. Indeed, many of these investment managers are increasing their capabilities for researching these factors and have integrated what they learn from that research into their investment processes.

BNY Mellon's investment affiliates take a range of approaches to responsible investing that reflect their specialization in various asset classes and areas of the market. Among them, Insight Investment, Newton, Siguler Guff, Mellon Capital and Standish are signatories to the UN's Principles for Responsible Investment, which requires them to consider ESG factors in their investment decisions. Other affiliates are also actively involved with ESG and socially responsible investing.

What Investors Care About

While interest in ESG is now rising among US investors, European investors have long taken a strong interest in the role of these factors in portfolio construction and management. That long-standing interest, combined with regulations such as the UK's Stewardship Code has created an environment where European investors expect managers to not just demonstrate familiarity with the role that ESG factors play in investing, but to have integrated management of these factors into the way they manage portfolios. In the past several years, regulators in Japan, Canada and Australia have also pushed investment managers to pay greater attention to ESG considerations. Stephan Bonte, head of sustainable investing at Standish Mellon Asset Management says, "Europe has been at the forefront of ESG and it continues to be. There, institutional asset owners have taken the lead. They know precisely what they want to achieve and seek the manager who can best deliver it. Increasingly, sustainability and focus on ESG criteria are explicitly written into the bylaws of pension and sovereign wealth funds." Indeed, as the chart below shows, the rise of ESG investment both in terms of the number of managers who practice it and in the size of the portfolios they manage has grown steadily.

Exhibit 1: United Nations PRI Engagement



Source: UNPRI, April 2015

Though US federal regulators have not played the sort of role in encouraging the growth of responsible investing that regulators have elsewhere, they are now removing what had been a significant obstacle to ESG adoption by US institutional investors. In October 2015, the Department of Labor (DoL) revised an aspect of the Employee Retirement Income Security Act (ERISA) that governs US pension funds to increase the ability of plan sponsors to consider ESG factors in their investment choices without breaching their fiduciary duties.

The DoL's shift in its approach to ESG under ERISA comes at a time when many US investors are reconsidering how they think about risk. Sandra Carlisle, head of responsible investment at Newton Investment Management, sees a rise in interest from investors around risks that seem increasingly real. "Investors are increasingly concerned about big long term risks to the sustainability of firms and industries, such as those posed by climate change. In 2009, the UN Climate Conference in Copenhagen was largely ignored by US investors. Since then, interest in climate has increased in part due to the increasingly visible effects of changing weather patterns in the US as well as a much more sympathetic administration," she says.

Confronting Carbon Concerns

Many investors seek to reduce or remove exposure to carbon-intensive industries from their portfolios. Their interest in low-carbon strategies reflects the same sentiment shown by the nations at the 2015 Paris climate summit who called climate change a "common concern of humankind" and set a goal of limiting the earth's warming to less than two degrees above pre-industrial levels.

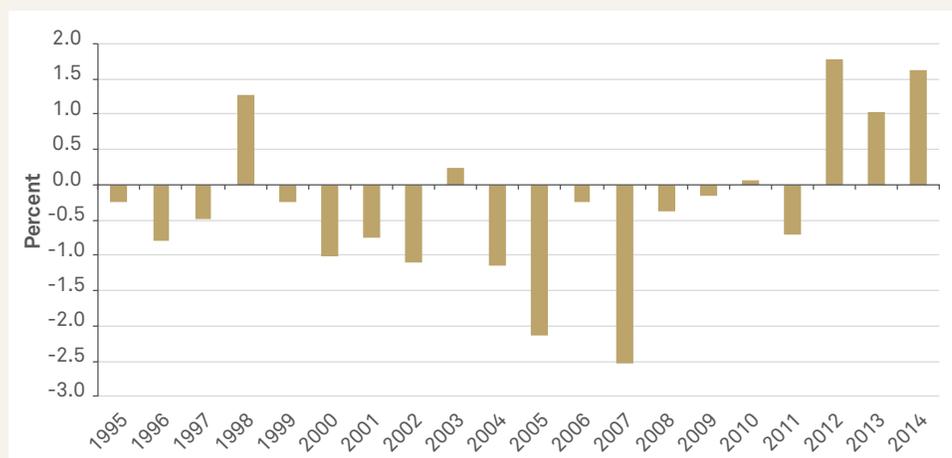
The political will on display in Paris suggests that regulation of carbon emissions will increase, with implications for institutional investors. Karen Wong, Head of Equity Portfolio Management at Mellon Capital Management, notes some US states and cities are actively pushing for carbon divestiture in their retirement plans.

Carbon emissions are easier to measure than other ESG criteria. Significant advances have been made in measuring the carbon footprints of corporations and in standardizing the measurement of emissions. More reliable data may increase investors' confidence that low-carbon strategies can impact emissions.

Mellon Capital CEO Gabriela Parcella recognizes the urgency around reducing emissions. "ESG factors are now being viewed as risk factors that need to be taken into account as part of an investment decision," she says. "We have seen growing numbers of foundations, universities and other institutional investors interested in investing where they can address environmental and social challenges. It is our responsibility as an investment management firm to support this innovative approach." Parcella explains that Mellon Capital takes an all-encompassing approach. "Our strategy's main objective is to provide broad equity exposure while assessing, recognizing, and supporting strong climate performance. We target a 50% or greater reduction in carbon emissions versus the benchmark and a deviation in investment performance, or tracking error, of 50 basis points or less."

Annual Return Impact from Energy Divestment

Percentage by which removing energy stocks from the MSCI All Country World Index would have lowered or increased the index's return from 1996 to 2014



Source: Mellon Capital and MSCI. Returns are gross of tax. Tracking error as of 31 December 2014, ex-ante - 0.99%, ex-post - 1.30%. Past performance is not a guarantee of future results.

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Taking ESG Beyond Long-only Equity and Fixed Income

While carbon emissions are an area of rising concern right now for both investors and BNY Mellon's investment affiliates, other social considerations have long been taken into account by our affiliates.

In 2006, EACM, BNY Mellon's multi-manager fund of hedge fund specialist, brought societal considerations to the world of hedge fund strategies by specifically prohibiting the managers whom it hires from investing in areas such as abortion, stem cell research and pornography, as well as restricting exposure to gambling, tobacco and weapons. According to Tracey Hayes, Chief Risk Officer at EACM, this social impact emphasis appeals strongly to a diverse group of investors, including religious orders, social service agencies, healthcare providers and educational institutions. EACM also assesses its managers' portfolios' broader ESG footprints as well, and appreciates that the vast majority of their underlying holdings rank highly on such metrics.

Concerns about governance, too, have long played a role in investment decision making among our affiliates. Jay Koh of Siguler Guff says, "Our firm has considered ESG issues in its investment theses and processes throughout the firm's history, and formalized our ESG framework with the adoption of the firm's responsible investment policy in 2013. As the first US private equity firm to directly invest in Russia, we quickly learned the importance of ESG issues from an investment, due diligence and monitoring standpoint." Koh says making ESG part of Siguler Guff's approach to investment risk analysis and asset management is "particularly important because we invest in emerging markets where the governance landscape can vary, and environment and social issues can be quite pressing."

Responding to Interest in ESG

The approaches BNY Mellon's investment affiliates take toward implementing ESG considerations in their investment processes reflect their areas of specialization as investment managers. Each approach used by our investment affiliates falls into one the categories in the chart below.

	Investment Objective		Financial Return Objective		Notes
	Values or Impact	Financial Return	Below Market Rate of Return	Competitive Market Rate of Return	
Conventional Finance					
ESG Integration					ESG integration targets a competitive market rate of return. ESG integration may also address investor values as companies with strong management of ESG issues are emphasized, all else being equal.
Active Ownership					Active ownership such as engagement, shareholder resolutions and proxy voting may encourage companies to act responsibly and pursue long-term financial performance.
Screening					"Positive" and "best in class" screening and tilts may target market rates of return. The use of negative screens that reflect investor's values may require acceptance of below market returns.
Impact Investing					Impact investing may target either a market rate or a below market rate of return. Thematic investment targets market rates of return.
Philanthropy and Grants					

How Equity Investors Can Press for Change

Equity investors who want to have an impact on climate or social considerations look at whether corporations have good governance, labor relations and policies to mitigate risk of injury and pollution. They can use their rights as shareholders to press for improvements in those areas. Equity managers such as Newton have built up their research capabilities and are using what they glean from that research to apply leverage to company managements in a process known as engagement, using an investor's rights as a shareholder to push for changes in policy or governance. Carlisle says, "Before we make an investment decision, we give every holding on the Newton research recommended list an ESG quality review that assesses material ESG factors. Where we assess a high degree of ESG risk, we will always engage the company when we invest. For example, if we are unhappy about the lack of independence on a board, we will ask the company to put in independent directors. We also engage on climate change with extractive companies to understand their approach to stranded asset risk in their portfolios. And in addition to engagement, we vote all of our proxies actively, so that companies know in every case whether we are supporting management or withholding support."

Leigh Todd, investment analyst with The Boston Company Asset Management, also emphasizes the role of research for equity investors pursuing ESG strategies. She says her team's ESG research emphasizes identifying the factors that are most likely to harm a company's sustainability and long term growth. "I think that there's an ability to more cohesively look at the whole market from an ESG perspective, more so than us as individual analysts or portfolio managers looking only at our own respective portfolios."

ESG for Fixed Income Investors

ESG investing differs for groups such as Standish which are limited in engagement because as fixed income specialists the managers do not hold shares. Fixed income offers unique opportunities, though. "Fixed income's potential as a new instrument for impact investing is increasing due to the development of tools to directly finance projects including green bonds, green bond principles and potentially also social bonds," says Bonte. "But green bonds are not the whole story. Research shows that it is possible to lower the carbon footprint of credit portfolios significantly without materially affecting historical or future risk-adjusted expected returns. That approach combined with green bonds and equity considerations can make up the basis of a climate-aware allocation."

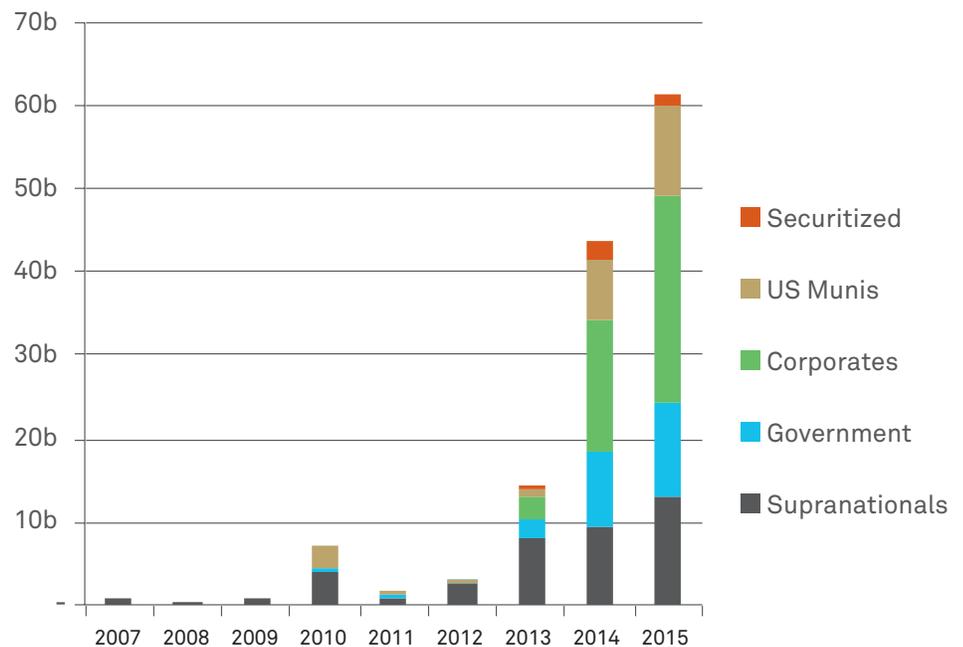
Joshua Kendall, ESG analyst with Insight Investment also emphasizes the importance of increased ESG research and its application by investment teams. "It's not about making ethical or moral judgments. We believe ESG research and its effective application gives analysts and portfolio managers greater insight into the quality and character of a corporate issuer. As a bond investor, we have a responsibility to identify risk factors and ESG complements our approach."

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Green Bond Issuance by Sector

\$133b Cumulative USD-equivalent Issuance



Source: Bloomberg, Standish, December 21, 2015

Impact Investing: Beyond ESG

The momentum driving the mainstreaming of ESG investing appears unlikely to reverse. “I believe it is inevitable that investors will be expected to apply responsible investment strategies across all that they do,” says Kendall. Even as ESG factors become increasingly part of the investment mainstream, some investors such as family offices, endowments and foundations are increasingly interested in using their investments primarily to generate social and or environmental benefits with financial return as a secondary goal. Historically, investors had difficulty finding so-called impact investment opportunities offering the risk and reward criteria equal to those available in the general corporate market, while also advancing a specific non-investment objective. That may be changing, however. “There’s a clear trend toward moving beyond the standard maximization of risk adjusted returns to also considering the impact on stakeholders,” says Bonte. The pace at which that trend yields investment opportunities may also be quickening. “We believe that self-defined impact investment funds that set out to achieve both of these objectives are still pretty early in their development cycle,” notes Koh. “But, when we examine our roughly three and a half billion dollars of emerging markets investments, we identify a significant volume that we believe are likely to generate measurable social and environmental benefits.”

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