Environmental, Social and Governance (ESG) Q&A for advisers

This document provides a summary of key questions and answers on what ESG is and how it is incorporated into the M&G Asset Owner ESG Investment Policy and M&G's Treasury and Investment Office's processes and philosophy.

1 Firstly, who are the M&G Treasury and Investment Office (T&IO)?

The M&G Treasury and Investment Office (T&IO) is the in-house investment strategist and 'manager of managers' for Prudential Assurance Company (PAC) in the UK. T&IO are responsible for approximately £176 billion AUM, as at 30th June 2021, across a range of multi-asset investment solutions and other PAC products.

T&IO includes investment professionals with expertise in capital market research, investment strategy design, liability management, derivatives, portfolio management and manager selection and oversight.

T&IO is responsible for the strategic asset allocation of all of PAC's multi-asset funds, in addition to selecting and overseeing all underlying fund managers.

They are also responsible for ensuring that the risk characteristics of each portfolio manager meet given objectives over time. Stock selection is then carried out by internal and external fund managers chosen for their strengths in specific asset classes.

2 What is ESG?

ESG investing is an approach to managing assets where investors explicitly acknowledge the relevance of environmental, social and governance (ESG) factors in their investment decisions, as well as their own role as owners and creditors, with the long-term return of an investment portfolio in mind. In other words, ESG investing aims to correctly price social, environmental and economic risks and opportunities.

The **environmental (E)** dimension measures a company's impact on the natural ecosystem, which comprises its emissions (e.g. greenhouse gases), the efficient use of natural resources in the production process (e.g. in terms of energy, water or materials), pollution and waste (e.g. spills), and innovation efforts to eco design its products.

The **social (S)** dimension covers a company's relations with its workforce, customers and society. It includes efforts to maintain loyal workers (e.g. employment quality, health & safety, training and development), satisfy customers (e.g. produce quality goods and services that keep customers safe), and being a good citizen in the communities where it operates.

The **governance (G)** dimension captures the systems in place for management to act in the best interests of its long-term shareholders, which include safeguarding shareholder rights (e.g. limiting anti-takeover defences), having a functional board (e.g. with experienced, diverse and independent members), maintaining well-designed executive compensation policies, and avoiding illegal practices, such as fraud and bribery.

This is not 'either/or', ESG investing is not mutually exclusive with regular investing. Rather, explicitly pricing ESG risks and opportunities should complement any investment strategy.

3 Why is ESG growing in popularity?

The number of both retail and institutional investors who are looking to allocate their capital to ESG areas is on the rise, with ESG investing representing a growing proportion of overall capital market investments. At the start of 2020, global sustainable investment reached US$35.3 trillion in five major markets (Europe, United States, Japan, Canada and Australia and New Zealand (Australasia)), a 15% increase in the past two years (2018-2020) and 55% increase in the past four years (2016-2020). Source: GSIR-20201.pdf (gsi-alliance.org)

There are a number of reasons as to why ESG is growing in popularity, but there is an overarching statement behind all of them, that ESG investing is here to stay. Over the years, there has been an increasing interest from customers to understand and influence the non-financial outcomes that their investments may be having and hence companies have had to respond to this demand.

On the structural side, one driving force behind the incorporation of ESG issues is societal change – for example, the transfer of wealth from baby boomers to the millennial generation and the increasing proportion of high-net-worth individuals who express a preference for allocating wealth in a more sustainable way.

Another instigator of change is the increased investment regulation in the aftermath of the Global Financial Crisis, such as prudential regulation affecting asset owners, stewardship codes for investment managers, and corporate disclosure rules set by governments or stock exchanges.

Finally, investors have become increasingly aware that ESG factors can impact the risk and return characteristics of companies, sectors and securities. It is increasingly becoming a market standard from investment houses to integrate the financial implications of ESG factor into their investment processes.

4 What are the main types of ESG strategy?

There are a huge variety of ESG strategies within the investment world and you will rarely find two identical strategies. For example, even exclusions alone will vary from fund to fund. M&G plc refers to four different types of ESG funds:

- **ESG integrated funds**
- **ESG+ funds**
- **Sustainable funds**
- **Impact funds**

These funds will all apply different levels of various ESG strategies. For example, all funds in each range will apply an agreed set of exclusions, whether they be norms-based exclusions based on generally accepted international standards or sector screens, which exclude investments based on the sector they operate in (e.g. tobacco, coal). These exclusions may build on each other.

Shareholder engagement is another strategy that all fund ranges will employ where possible. Shareholder engagement reflects active ownership by investors in which the investor seeks to influence a company's decisions on ESG matters, either through corporate dialogue or voting. The fund manager will engage with company management on ESG issues and advise and influence the company where possible.

ESG integrated funds will ensure that financially material ESG data is available to all funds and integrated into the risk management and decision-making process.

The **ESG Plus** and **Sustainable funds** may apply a strategy know as 'Best-in-class' which is where companies will only be selected for investment if they overcome a defined ranking hurdle, established using ESG criteria within each sector or industry.

Impact investing is at the end of the ESG scale and refers to investments made with the specific intent of generating positive, measurable social and environmental impact alongside a financial return.

5 How is ESG considered between M&G plc, Prudential Assurance Company (the Asset Owner) and M&G Investments (the Asset Manager)?

M&G plc has two ESG priorities of climate change and Diversity and Inclusion, given their importance for the long-term sustainability of all businesses and society as a whole. They aim to be carbon net zero as a corporate entity by 2030. Further, they aim to achieve 40% female and 20% ethnicity representation in their leadership by 2025.

The Prudential Assurance Company (PAC) is now a signatory to the UN Principles of Responsible Investment and the UK Stewardship Code. PAC aims to achieve net zero carbon emissions across AUMA (assets under management and administration) by 2050, of which the With-Profits Life Fund is a material part, in line with the Net-Zero Asset Owners Alliance (NZAOA). The Asset Owner became a member of the NZAOA in September 2021. The NZAOA is a United Nations initiative whereby the Asset Owner has committed to setting and reporting on interim carbon emission reduction targets to enable carbon emissions across the investment portfolio to be net zero by 2050.

An important aspect of how the Asset Owner manages its investments is the integration of ESG factors into investment decisions, which they believe can help better manage risks and generate sustainable, long-term returns for customers. They do this through implementing ESG considerations into the Strategic Asset Allocation (SAA) process, integrating ESG factors into manager selection and oversight and considering ESG factors in mandate design.

The With-Profits Life Fund is managed by a range of high quality internal and external managers, whereby over 90% of the assets under management is managed by managers who are signatories to the UN Principles of Responsible Investment (source T&IO as at September 2021). T&IO look to the asset managers they select to (1) engage with companies as active owners that help foster a more sustainable economy, (2) participate in voting on key issues such as Climate, (3) manage assets in accordance with the M&G Asset Owner ESG Policy and (4) ensure that ESG is integrated into their investment process.

The majority of With-Profits Life Fund assets are managed by M&G Investments, whose Stewardship and Sustainability team provide issuer and sector specific ESG risk and opportunity analysis and education on sustainability themes to portfolio managers and analysts. They also lead on company engagement on a cross-asset class basis working in collaboration with the fund managers.

6 What is the M&G Plc Asset Owner ESG Investment Policy?

The M&G Plc Asset Owner ESG Investment Policy reflects the importance of the consideration of ESG factors in investment strategy, asset allocation, mandate design and manager selection and oversight.

In regards to portfolio exclusions, the M&G Plc Asset Owner ESG Investment Policy currently excludes companies that manufacture controversial weapons including anti-personnel land mines, cluster munitions, biological weapons and chemical weapons, as well as companies that are complicit in violations of the Nuclear Non-Proliferation Treaty. These weapons are currently prohibited by international treaties which the UK has signed and ratified, hence they have aligned their position with these treaties.

Although not currently prohibited by international treaty, they have also decided to exclude depleted uranium munitions from their portfolios as they do not wish to support or be associated with the disproportionate and indiscriminate harm that these weapons can do to civilians.

The policy explains that as Asset Owner, they use norms-based screening to identify companies that maliciously violate global norms in the areas of human rights, labour standards, environmental standards and anti-corruption. They will exclude companies that flag on their norms-based screens as egregious violators from their portfolios, and whom they believe will not change their behaviour in response to engagement.

To give a brief insight into the screening process, T&IO will look deeply into each flagged company, and judge them against the Asset Owner values of Care and Integrity, with consideration as to whether violations are alleged or verified, the legality and nature of the event (permanence, impact and planning or negligence), company cooperation with investigations and whether there is a wider pattern of behaviour present across flags that might indicate deeper problems in the corporate culture.

Both the controversial weapons and norms-based screening exclusions are applied to all funds and mandates (active or passive) where T&IO is empowered to make investment decisions.

7 Have the M&G Treasury & Investment Office investment beliefs changed?

T&IO's investment beliefs are a key driver of the Asset Owner's investment strategies and include factors such as diversification, active management and a long-term approach. The fundamental process of how they manage money has not changed but they have implemented an additional core belief on the importance of ESG factors and risks in their portfolios. The M&G plc Asset Owner ESG Investment Policy enables T&IO to implement ESG views and policies more consistently and directly across their mandates.

8 What are the Asset Owner and Treasury & Investment Office's ESG principles?

The general ESG investment principles allow T&IO to approach any ESG issue with a general mode of thinking that enables them to derive an appropriate investment strategy. Their overarching principle is that they will take into consideration ESG factors that have the potential to have a material financial impact whilst continuing to take a long-term and multi-generational approach to investing.

Where the underlying funds are actively managed, T&IO will require the investment managers that they appoint to engage with and influence investee companies on their behalf, to achieve more sustainable business models and change their behaviour where appropriate. They also expect the investment managers to report on the results of their engagement strategy.

T&IO believe that active ownership should be aligned with active management. Active ownership that focuses on transitioning companies towards the creation of a more sustainable economy is possible and desirable across all types of investment mandates.

If the underlying fund manager is unable to change, or believe that they will have little effect on an investee company's behaviour, T&IO may revise their mandates to require the asset manager to reduce the holding in that company in favour of a company whose behaviours are more aligned with their views. They may also exclude a company from the investment portfolios, as a last resort.

These are just some of the ESG principles that T&IO take into account when considering their investment decisions. It is important to note that T&IO review their ESG thinking and investment strategies regularly in order to align with scientific and technological improvements, changes in global economy, and evolution in sustainability and ethics.

9 How is the M&G Treasury & Investment Office integrating ESG factors into the Strategic Asset Allocation (SAA) process?

T&IO's Long Term Investment Strategy (LTIS) team recommends the asset allocation of the Asset Owner's fund ranges. The team produce a set of Capital Market Assumptions, based on historical data, ex-ante analysis, internal and external research, for the expected returns, volatilities and correlations of the various asset classes within the With-Profits Life Fund. LTIS then use a proprietary Economic Scenario Generator 'GeneSIS' to carry out stochastic modelling based on these assumptions, which involves mapping out a full range of possible future asset allocations.

ESG factors are integrated into the SAA process through three main channels, detailed below:

- **Sensitivity analysis** – portfolio exposures to ESG factors assessed in terms of physical, transition and litigation risks.
- **Country Risk Categorisation** – they use a risk categorisation framework that uses environmental, social and governance factors, alongside measures of empirical volatility, market depth and economic development to group countries into risk categories. This informs their allocation decisions by penalising countries with poorer ESG scores via higher volatility assumptions.
- **Benchmark construction** – they conduct analysis to assess the performance of their benchmarks on ESG metrics. For the most heterogenous cross-country benchmarks, they look to adjust country benchmark weights to improve the ESG performance of the benchmark.

10 How is the M&G Treasury & Investment Office integrating ESG factors into investment manager oversight and selection?

The investment due diligence (IDD) process is carried out by the Manager Oversight team within T&IO. The investment due diligence process is designed in such a way as to enable the Manager Oversight team to gain conviction that an active investment manager will add value for policy holders over the long-term. As such, the team needs to gain assurance that an investment manager is managing the assets in a way that is consistent with M&G Plc's Asset Owner ESG Investment Policy, and ESG considerations are an integral part of the manager selection process.

Rather than separating out a dedicated section for the ESG investment due diligence process, the Manager Oversight team has fully integrated ESG consideration into every stage of manager selections and due diligence, as outlined below:

- **Screening** – developing an ESG category score which can be used alongside the existing screening framework of quantitative and qualitative RAG scores in the initial manager screen. The category score gives an indication of managers for whom ESG is an important consideration.
- **Request for Proposal** – ESG focussed questions in various sections of the Request for Proposal, aligned with every area of the proprietary scorecard.
- **Investment due diligence meetings and selection decision** – heavily feature ESG-led questions at every stage of the process and feature in the proprietary scorecard, informing the decision-making process.
- **Ongoing due diligence** – inclusion of an ESG section in the standing agenda of quarterly meetings with managers to discuss how ESG considerations have influenced investment decisions and to highlight any key stewardship activities over the quarter.
- **Mandate design** – Asset Owner ESG exclusions are being implemented across segregated mandates where T&IO has investment control. Where assets are invested in pooled funds, the team look to continually monitor the mangers' alignment to the Asset Owner principles, and where there are divergences, the team look to either engage with managers to encourage alignment with the ESG investment principles, or else would consider migrating the assets to a fund that aligns.

11 How does ESG apply to the With-Profits Life Fund?

An important aspect of how the Asset Owner manages its investments is the integration of Environmental, Social and Governance (ESG) factors into investment decisions, which they believe can help better manage risks and generate sustainable, long-term returns for customers.

The process and philosophy behind how T&IO manage With-Profits Life Fund money has not changed, only evolved. T&IO are, and always will be, long-term investors and so believe that ESG factors should be considered in addition to and alongside the more traditional financial metrics. T&IO also believe that companies which capture and embed ESG opportunities and risks into their strategy are more likely to be successful.

T&IO ensure that ESG considerations are integrated into all of their investment decisions relating to asset allocation, manager selection and oversight and mandate design.

The M&G Plc Asset Owner ESG Investment Policy provides a framework for agreeing exclusions and how to manage engagement in regards to the With-Profits Life Fund. The current exclusions in the Policy relate to cluster munitions (controversial weapons), violators of global norms such as the United Nations Global Compact, and Thermal Coal. It also provides guidance to managers regarding expectations of how they should approach bottom up ESG considerations that cannot be targeted directly by SAA.

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