Columbia Threadneedle Investments

Leveraging the SASB framework in responsible investment strategies

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Columbia Threadneedle Investments (CTI) is a leading global asset management group that provides a broad range of actively managed investment strategies and solutions to individual, institutional, and corporate clients around the world. With more than 2,000 people, including more than 450 investment professionals based in North America, Europe, Asia, and the Middle East, we manage US$459 billion of assets as of March 31, 2019, across developed and emerging market equities, fixed income, asset allocation solutions, and alternative investments.

We manage approximately US$30 billion of client assets in more than 120 responsible investment (RI) funds and accounts as of March 31, 2019. The RI assets include separate accounts with client-mandated environmental, social, and governance (ESG) exclusions, accounts and funds with a best-in-class[1] ESG approach, and a growing number of impact and outcomes strategies. Dedicated RI strategies include a suite of impact-focused fixed income products, sustainable income ETFs, and an equity strategy focused on positive inclusion.

Across our mainstream strategies in equities and corporate fixed income, we have worked to integrate ESG data to identify and manage risks and, ultimately, enhance investment returns. The focus of our firm's ESG research approach is to understand companies' exposure to and management of material ESG factors, which may impact a company's business model and financial performance. We believe this allows us to develop actionable research insights into non-financial risks and opportunities that are additive to our fundamental financial insights. Applying a materiality lens—such as that established by the Sustainability Accounting Standards Board (SASB)—enhances our ratings models and our deep-dive research by allowing us to focus on the key ESG performance factors, industry by industry, that matter most.

1 Best-in-class refers to active selection of only those companies that meet a defined ranking hurdle established by environmental, social, and governance criteria.

Over the past several years our firm has made a deeper commitment to ESG integration by investing in experienced ESG personnel and enhanced analytics and data. These investments have enabled us to supplement our standard fundamental and quantitative tools and to expand the investment mosaic to systematically consider and integrate ESG factors.

The Problem

A significant challenge to integrating ESG considerations in mainstream investment processes is the ESG data available from companies, which varies in quality, quantity, and investment relevance. Much of that problem is attributable to the fact that ESG disclosure standards lack consistency across global jurisdictions, where they exist at all.[2]

Many companies voluntarily report ESG performance data, which are aggregated by third-party ESG data sources and supplemented with information from regulatory filings and publicly available government and industry data. Some third-party data providers apply their scoring methodologies to this unstructured data, which often result in very different outputs and ratings on the same company. The Wall Street Journal recently highlighted this broad disparity across third-party ESG ratings in examining US companies.[3]

The problem manifests itself further for investors who seek to integrate credible and actionable ESG insights into their forward-looking investment decisions, but struggle given the inherently backward-looking nature of the ratings. Academic

2 e.g., Members of the Organization for Economic Co-operation and Development (OECD), as well as the UK, Australia, South Africa, members of the European Union, and certain emerging markets.

3 "Is Exxon or Tesla More Sustainable? It Depends Upon Whom You Ask." *Wall Street Journal*. September 21, 2018.

and practitioner studies show low or even negative correlations between third-party ESG ratings and future market performance.[4]

We call these broader problems the "ESG ratings muddle."

SASB as an Element of the Solution

Two years ago, we determined to build a solution for ourselves that solves the ESG ratings muddle. Drawing upon Columbia Threadneedle's more than 130 fundamental financial analysts, our dedicated quantitative research team, and our global responsible investment research team, we jointly developed a proprietary ratings system that is pragmatic, data-driven, evidenced-based, and provides actionable investment signals that produce attractive excess returns. Importantly to our ESG integration focus, the ratings and associated qualitative and quantitative data are additive to, rather than replacements for, fundamental research and financial analysis.

Our RI ratings approach is comprised of two separate models. The first builds on proven academic models that have demonstrated their reliability as strong indicators of companies' financial stewardship—effectively a proxy for financial prudence. We call this the CTI Financial Stewardship Model.

The CTI Financial Stewardship Model is paired with a second model focused on the financial materiality of ESG factors. This model references the codified SASB standards and materiality framework, to which we mapped data to measure and monitor company performance. We call this second model the CTI ESG Materiality Model.

The interaction of the CTI Financial Stewardship Model and the CTI ESG Materiality Model yields a rating that we refer to as the CTI Responsible Investment Rating. The CTI RI Rating Model assigns a 1-5 rating to nearly 6,000 companies around the globe, with 1 signifying "high quality" and 5 "low quality."

Our analysts and portfolio managers access the CTI RI Ratings through cloud-based, interactive dashboards (see Figure 1) that feature enhanced analytics and visualization tools to deepen their insights and inform investment decisions. The CTI RI Ratings provide an added signal that helps to form a more complete and systematic review of a company's holistic risk and opportunity profile.

The CTI RI interactive dashboards deliver fundamental and RI ratings and provide contextual ESG qualitative and quantitative information. In the sample dashboard for "Company X," a technology manufacturing company, the upper left corner displays how CTI thinks about that company as expressed through our RI, quantitative, and fundamental ratings, while the lower left corner displays third-party research and risk flags. The main display provides a see-through look at the issues identified by SASB as likely to have material financial impacts in Company X's industry and includes summary performance scores on each SASB issue. Subsequent screens and dashboards provide actionable insights and additional analytics.

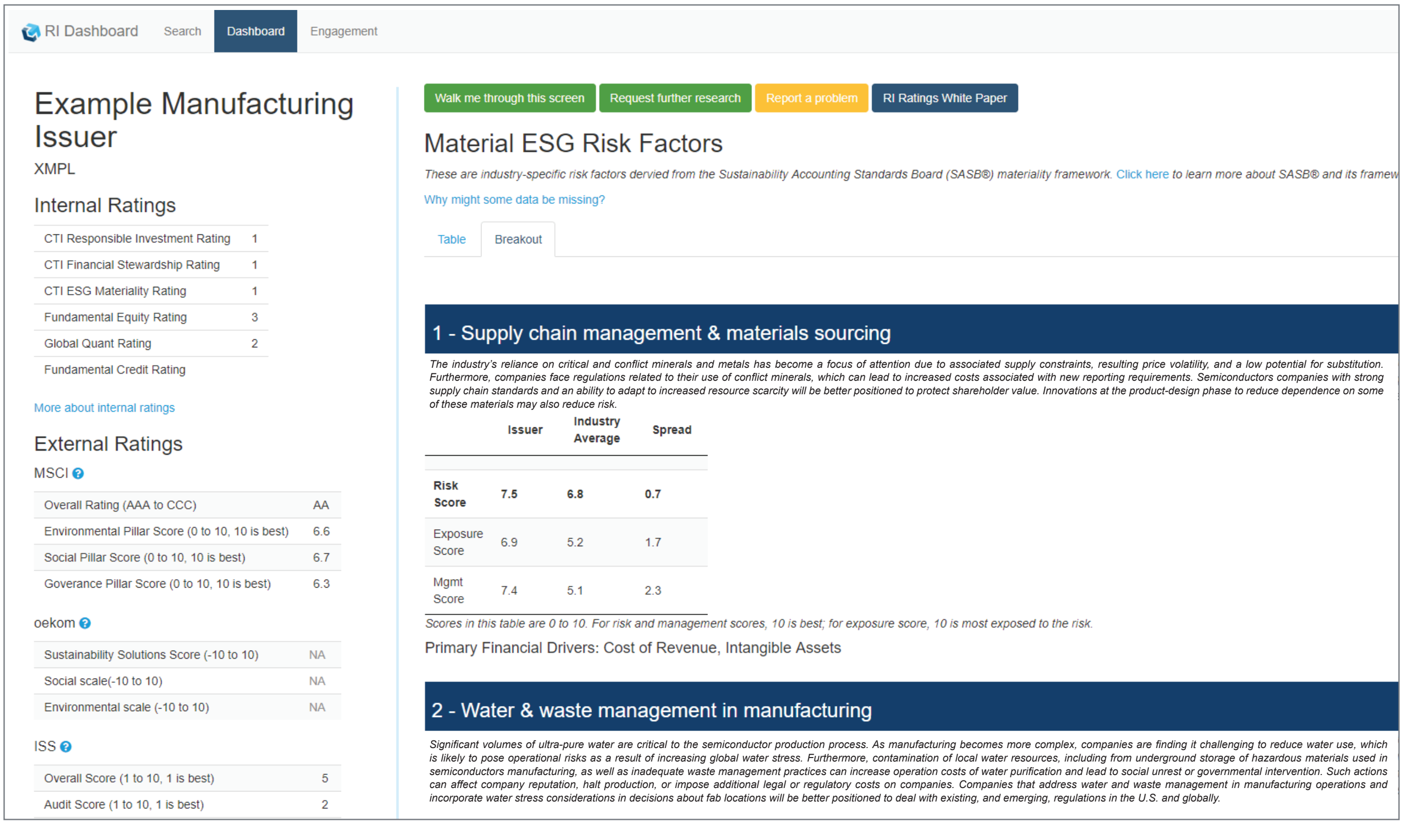
The RI dashboards provide analysts and portfolio managers with real-time, enhanced analytics through bottom-up company analyses, like that shown for Company X, and top-down analytics that include performance attribution tables and related charts to assess ESG performance across portfolios. All these tools help us to better and more systematically integrate ESG insights into our investment processes. With the help of SASB and our cloud-based computing environment, we have harnessed and organized

SASB has played an important role in helping investors solve sustainability data issues through an evidence-based, market-informed approach to standardizing investor-grade ESG disclosures for 77 industries. The SASB standards serve as an important guide for voluntary reporting by public companies and were researched and designed to reflect the ESG factors that are likely to materially impact the financial condition or operating performance of companies.

The industry-specific nature of the SASB standards is critical to us as investors because, for example, mining companies face distinctly different material ESG issues than do software-as-a-service companies. Thus, SASB serves investors like us in two important ways: 1) the standards provide a critical means to enhance systematic, comparable, and decision-useful ESG disclosures by companies around the globe, and 2) the research underpinning the standards serves as the evidentiary-based framework for understanding and contextualizing the importance of ESG issues and how they can bear on financial performance within a given industry.

4 Assessing Risk Through Environmental, Social and Governance Exposures (2017), AQR Capital Management.

Figure 1. Sample CTI RI Interactive Dashboard



Source: Columbia Threadneedle Investments, 2019. Included for illustrative purposes only.

more than 250 million ESG data points that enhance our data comparisons and make otherwise unstructured data integral to investment decisions.

Materiality-Focused RI in Action

By way of example, we recently analyzed the persistent low-quality (5-rated) companies in our universe of nearly 6,000 rated companies, and we took a special interest in the companies that most consistently, or for the longest duration, exhibited weak scores. This analysis allowed us to isolate and better understand the dynamics and contributing factors to the low rating, and simultaneously gain insight into how low-quality companies can become high-quality companies.

What we discovered from across our universe of nearly 6,000 rated companies:

- In the prior six months, 432 companies had been 5-rated
- 20 companies were 5-rated for the last 4 years at least 75 percent of the time
- 7 companies were 5-rated for the last 5 years at least 90 percent of the time

We developed the CTI ESG Materiality model by leveraging, extending, and customizing the findings of a Harvard Business School study that was the first to demonstrate that companies realized significantly higher accounting and market returns when they addressed material ESG factors (as identified by SASB) unique to their industry, and significantly higher returns still when they concentrated on material ESG factors to the exclusion of immaterial ESG factors.† The Harvard study thus validated the efficacy of the SASB framework as a potential source of alpha reliant upon previously underutilized data and insights.

† Mozaffar Khan, George Serafeim, and Aaron Yoon (2016). "Corporate Sustainability: First Evidence on Materiality." *The Accounting Review*: November 2016, Vol. 91, No. 6, pp. 1697-1724.

Statistically speaking, because the greatest alpha opportunity is turning a low-quality (5-rated) company into a high-quality (1-rated) company, there is ample incentive to explore low-rated companies and fully understand these characteristics.

Armed with the above data, we can form a focused list of companies where we will seek to engage with management around their company's financially material ESG risks and opportunities. Our engagement conversations first focus on gauging management's awareness of the issues SASB research has identified for companies in that industry. The SASB *Engagement Guide* helps bring concise focus to our discussions and provides specific questions linked to the ESG issues most likely to be material in each industry.

Management's response to our questions can be very telling: if the company is aware of the material issues, we engage in a discussion and encourage them to articulate how they think about those issues (regardless of whether they are a risk or an opportunity) and how they mitigate the identified risk or leverage the opportunity. Conversely, if a company is unaware of the materiality of the identified issue(s), or if they cannot adequately articulate how they view the issue, we point them to SASB's Materiality Map and the SASB standards applicable to their industry.

Our engagement discussions may in some cases exclusively focus on data gaps identified in our CTI RI ratings model, situations in which no data is available from a company that we can connect to an issue identified by SASB as likely to be financially material. While some investors may view such gaps as problematic for their analyses, we view them as an opportunity to engage with companies and inquire about and educate on key ESG issues. In several instances, our inquiries have raised awareness about financial materiality among company managers who have agreed to enhance their disclosures.

Looking Ahead

We are encouraged by a recent survey[5] that showed a high percentage of European and US respondents are either likely or very likely to adopt the SASB standards in their future company reporting. We believe this will benefit not only investors, but companies themselves as they increasingly use financially material ESG information to inform their business and sustainability strategies. This trend is underscored by a recent paper[6] from the Strategic Investor Initiative, which encourages long-term thinking by investors and corporates. The paper specifically underscores that corporate long-term plans should include disclosure of information that is material to the operating performance and financial prospects of a business, and recommends CEOs look to SASB for such guidance.

5 The Sustainability Imperative: Business and Investor Outlook. 2018 Bloomberg Sustainable Business & Finance Survey.

6 Emerging Practices in Long-Term Plans: How CEOs Talk About the Long-Term. October 2018. Strategic Investor Initiative, CECP.

We are further encouraged by the recent announcement[7] by Glass Lewis & Co. that it has integrated SASB's materiality framework into its proxy research reports for use by investor clients. This advancement helps bolster the relationship between investors' consideration of the ESG issues faced by their portfolio companies and their proxy voting policies and voting decisions.

As these developments illustrate, SASB's industry-specific standards represent a dual opportunity for investors to enhance analysis and decision making. First, they provide crucial market infrastructure for the delivery of comparable, decision-useful ESG disclosure by companies around the world. Secondly, and in the meantime, their underlying materiality framework serves as an invaluable tool for understanding and prioritizing key ESG issues in an industry context.

Columbia Threadneedle is proud to be a long-standing supporter of SASB and its work to develop financially material ESG accounting standards; we participated in various Industry Working Groups that researched and helped shape SASB's early standards and remain involved in the ongoing maintenance and evolution of the standards as a member of SASB's Standards Advisory Group.

We believe there are important benefits to investors and companies alike from integrating SASB's standards and materiality framework into investment processes and disclosure practices.

7 Glass Lewis to Integrate SASB's Industry-Specific Materiality Guidance Across Research and Vote Management Products. September 12, 2018.

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