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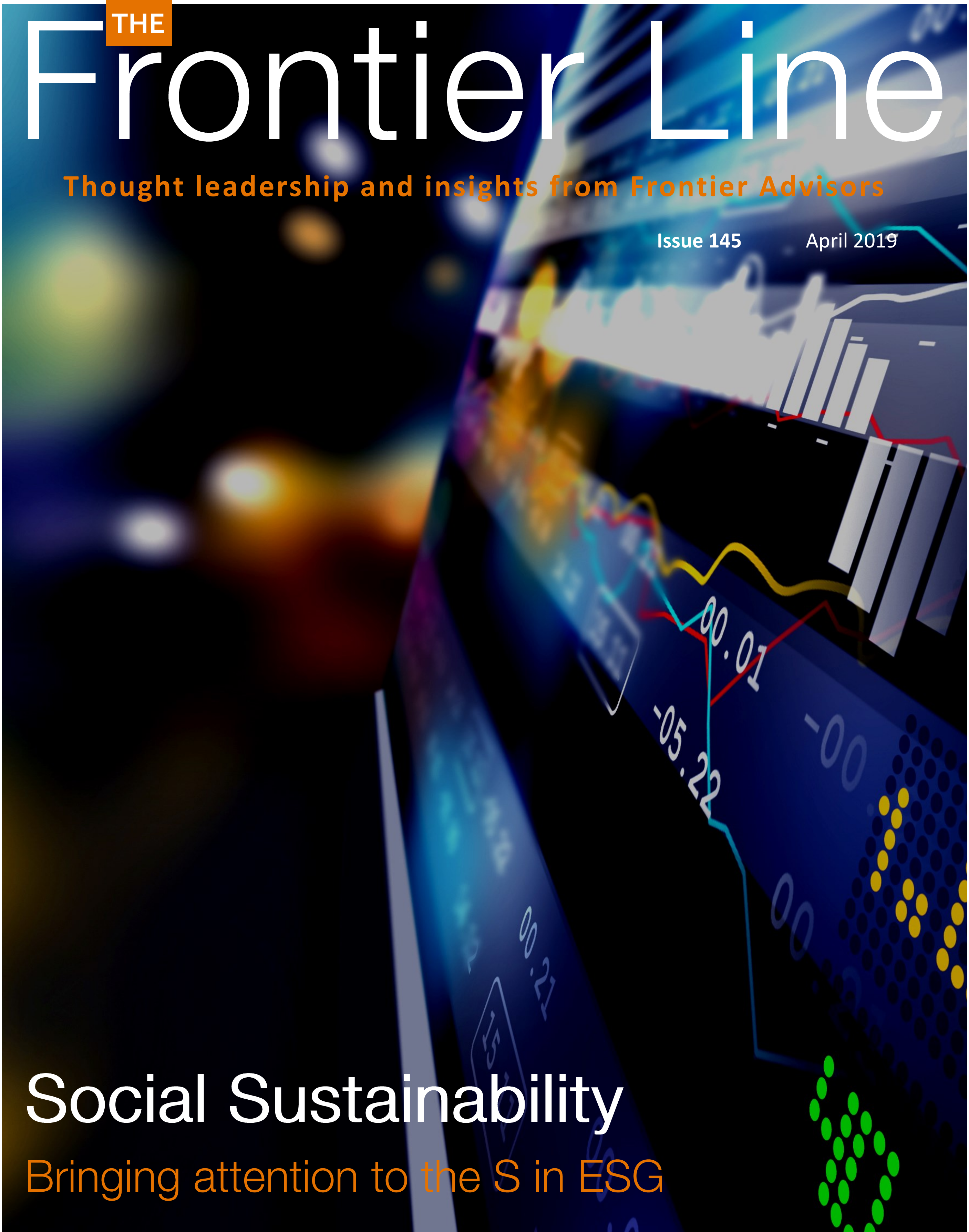

Social Sustainability

Bringing attention to the S in ESG

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Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $320B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Executive summary

Of the three components of ESG, social sustainability (defined here in terms of the health and liveability of communities) is arguably the most challenging for investment managers to integrate into their investment processes. Frontier's most recent ESG survey sought to gauge the progress of public equity managers along several dimensions in this area relative to what we deem to be best practice.

Our broad observation is that integration of the "S" remains a work-in-progress. While the general tone of manager responses reflects an encouraging belief that social sustainability impacts long-term performance, the practical side of integration continues to present its challenges.

Selected themes arising from the survey include:

Materiality - equity managers are focusing their energies on areas of social sustainability they deem most material in terms of expected portfolio impact, which aligns with Frontier's view of best practice. High-level, human rights factors are deemed by managers as high priority areas for engagement with companies, while micro-level, industrial relations factors are low priority;

Engagement – while managers broadly emphasised direct engagement with investee companies and active proxy voting as key to driving positive change on social sustainability, Frontier would like to see improved tracking and recording of engagement activities by managers to better measure and report their success or otherwise over time;

Supply chain – Frontier believes fund managers must urge investee companies to identify and manage material social sustainability risks and opportunities across their supply chains. Survey responses in this area diverged widely. A few managers clearly articulated a systematic assessment of investee supply chains, while in many cases, responses were more aspirational in nature, or just emphasised roadblocks impeding the ability to conduct in-depth analysis;

Minimum compliance – while corporates have minimum compliance requirements (e.g. workplace health and safety), these vary widely across jurisdictions and Frontier believes fund managers should not limit assessment of social sustainability to investees' meeting of base obligations. Survey responses suggest significant scope exists for improvement in this area; and

Collective activity – while fund managers are open to participating in collective action on the social sustainability of companies (or industries), the level of actual activity reported is modest. Frontier believes the power of scale is central to driving positive change and fund managers should proactively seek opportunities to initiate and support collective investor actions.

Frontier continues to engage with and assess fund managers on social sustainability considerations.

Background

Over several years, Frontier has conducted extensive surveys of both Australian and international (including emerging markets) equity fund managers to assess the extent to which these managers integrate ESG factors into their investment approaches. This forms part of our effort to engage with managers on an ongoing basis and encourage improvement across all facets of their operations, including the integration of responsible investment considerations.

Historically, we have found that consideration of social factors in the investment process has on average, tended to be a lower priority for fund managers relative to environmental and governance factors. Moreover, social sustainability has typically been viewed within a "corporate social responsibility" context where entities have considered social factors "because they should."

However, 2018 amply highlighted there is a tangible link between an entity's social licence and the sustainability of its longer-term performance. The substantial declines in the stock prices of high-profile companies shown to have acted poorly with respect to their broader stakeholders e.g. AMP and Facebook, were demonstrably linked to investor concerns around the potential impact of impaired social licence on earnings predictability.

To date, fund managers have largely escaped significant scrutiny over the role they may have in identifying and managing risks to performance arising from poor social behaviours. However, it is reasonable to suggest that clients are increasingly expecting their fund managers (and perhaps investment consultants!) to do exactly that.

Frontier has conducted a short survey of equity managers to better understand the extent to which social sustainability is considered when making stock selection and portfolio construction decisions. This paper outlines the key themes and trends we have identified from the survey results in regard to how managers consider the impacts of social factors in their investment strategy.

What is “social sustainability”?

Frontier believes that social factors (the “S” in ESG) impact the sustainability of investment performance over the longer-term. In the same way we consider environmental sustainability in terms of the resilience and continuity of the natural eco-system, we consider social sustainability in terms of the health and liveability of communities. Development activities impacting social sustainability are therefore long-term drivers of change in countries, markets and companies and influence the performance of these entities. Consideration of social sustainability factors is therefore both an opportunity and a risk for investors who ultimately finance such development activities.

Scope of the Frontier Survey

We received survey responses relating to 85 equity strategies broken down as follows:

- 38% Australian equity strategies;
- 32% international equity strategies; and
- 30% emerging market strategies

For the remainder of the report, we discuss the key themes from the survey including :

- The importance of ESG;
- Materiality of ESG factors;
- ESG Frameworks;
- Engagement;
- Compliance and supply chains; and
- Collective action.

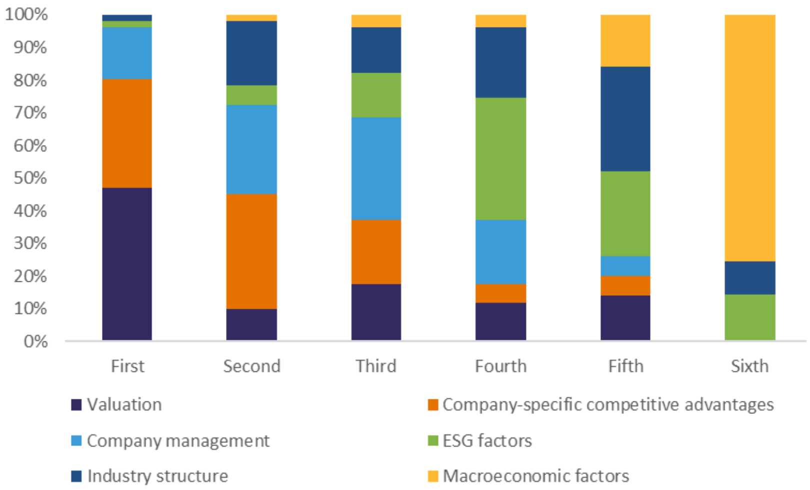
Importance of ESG

While managers believe ESG to be an important factor in stock analysis, it is not the most important factor for them.

We asked managers to rank the importance of ESG factors compared to other commonly considered drivers of valuation. While most Australian and global equity managers take ESG issues into account at the stock or portfolio construction level, it is clear from our responses that it is not viewed as the most important factor (the results can be seen in Chart 1 below).

Chart 1 shows that for both Australian and global equity managers, ESG factors were ranked fourth out of the possible six factors. The results show that while managers perceive ESG factors as a part of their wider investment analysis of a company, they do not view these factors as the most significant driver of investment returns and attention must also be given to other factors.

Chart1 : Ranking of factors when assessing a company

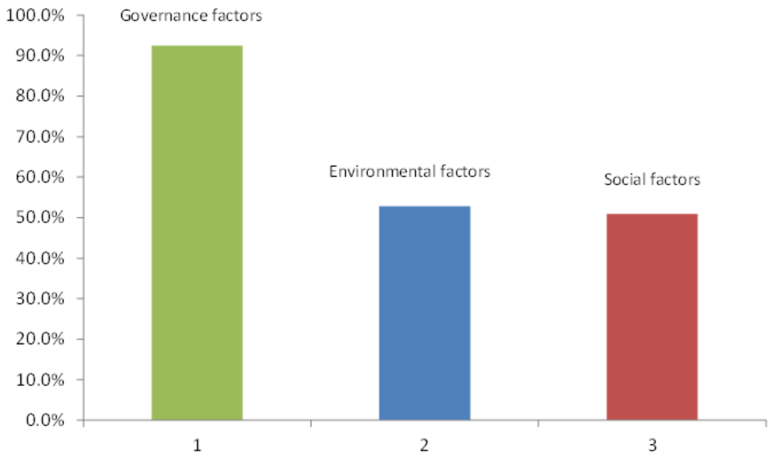


Governance continues to be viewed as the important consideration.

We asked managers to rank ESG factors in order of importance. The majority of managers, both Australian based and global, believe the governance of a company is a vital component of the company's success. Not surprisingly, governance is looked at in the most detail among ESG factors during the investment process. While managers do consider environmental and social issues, it doesn't appear to be to the same degree. Managers suggested these issues were typically a much "longer burn" influence on performance and were therefore often harder to quantify.

We do note however that a few managers surveyed stated they rank the factors of environment, social and governance of equal importance in their decision making process.

Chart 2: Ranking of ESG factors



Materiality of ESG factors

Decision making is impacted if ESG issues are deemed to be material.

A distinct theme which emerged from our results was in relation to materiality. Most managers, both Australian based and global, noted that ESG issues are only integrated into decision-making when they had been found to have a material bearing on the company's business and valuation. In Frontier's view, the more sophisticated managers rate companies based on their performance on a range of ESG factors and also on the materiality of the ESG criteria to the valuation of the company.

Managers were asked to rank a range of social issues based on representing the most material areas of social sustainability risk (and/or opportunity) at present.
The managers showed strong consensus in their responses to this section of the survey.

The top four factors were:

- Occupational health and safety;
- Human rights;
- Corruption; and
- Forced labour/modern slavery/child labour.

The bottom four factors were:

- Poverty;
- Just transition;
- Freedom of association and collective bargaining; and
- Right to work.

While human rights and corruption are core areas of concern, in more recent times, issues relating to technology and automation have started to become more evident. The survey responses suggest that although many social issues are important, some are deemed by investors to have a more significant material impact today.

In December 2018, the Grantham Research Institute along with the Principles of Responsible Investment (PRI) released a report identifying the following trends: a 'fast and fair' just transition is growing in materiality; the responsible management of workforce and community dimensions of climate change are increasingly material drivers for value creation; and the linkage of climate change with social factors provides new opportunities to generate returns and positive impact. It will be interesting to see if these social issues, as perceived by managers in terms of materiality, shift over time in line with the Paris Agreement and UN Sustainable Development Goals.

Many managers identified the use of the Sustainability Accounting Standards Board (SASB) to assist in assessing the financial materiality of ESG factors. In November 2018, SASB published a set of globally applicable industry-specific standards. These identify the minimal set of financially material sustainability topics and their associated metrics for the typical company in an industry.

We view it as best practice for investment managers to clearly identify the industries, countries, companies, projects, investment strategies/models, and social factors which represent the most material areas of impact on social sustainability within their relevant asset classes.

ESG frameworks

Managers continue to adopt ESG frameworks to support consistency when assessing social issues

The survey responses varied in regard to frameworks and protocols managers have adopted in order to help assess social sustainability. While the majority of managers surveyed stated they do use frameworks when assessing companies, 1 in 5 managers do not incorporate any established frameworks. These managers acknowledge the frameworks are useful, but believe their own research has more insight.

One manager commented that "while we sympathise with the mission of the UN Sustainable Development Goals and other well-known protocols in the field of sustainable investing, by design we have tailored our own approach to the subject in order to create a process that helps us uphold our fiduciary duty to our clients." While this still appears to be an area being developed by managers, many managers continue to rely on qualitative filters as well as their own due diligence when assessing social factors.

Of the managers that do incorporate frameworks, the majority cited using the UN Global Compact to assist with guiding principles as well as third party ESG providers (e.g. MSCI ESG Research and Sustainalytics) to provide data on companies in relation to the UN Global Compact Principles.

Interestingly, while most managers surveyed claimed to formally incorporate official frameworks into their assessment of companies, only a small sub-group were able to articulate how, in practice, they apply the frameworks to aid engagement and investment decision-making.

Frontier believes that ESG - aligned frameworks provide a set of standards which in some cases are the closest available to what could be considered as universally-agreed. This allows managers to more systematically and comprehensively integrate social sustainability considerations when engaging with companies on their responsible investment capabilities. Importantly, these also facilitate a more robust dialogue with both investee companies and investors with respect to social sustainability issues. At a minimum, Frontier expects managers to have considered frameworks such as the UN Global Compact and made an informed decision to then tailor an approach that is specific to their beliefs and strategies.

Engagement

Managers believe engagement is their most effective resource

Company engagement was identified by fund managers as the most important tool to assess and influence a company's social risks and opportunities. Most managers surveyed believe direct engagement with company management teams is an important part of the research process. It enables them to better understand management's long-term vision and discuss how social risks and opportunities (among other issues) are being addressed.

Consistent with these findings is that a large proportion of managers have engaged with companies in the last two years. However, we note many managers do not currently formally track the number of companies with which they have engaged, nor the nature or results of the engagement.

Frontier considers best practice by investment managers in stewardship to include continued monitoring and measurement of the success (or otherwise) of engagement activities. This is consistent with our belief that active engagement with relevant market participants and proxy voting can enhance the risk-return profile of investments over time. Many managers surveyed outsource their proxy-voting responsibilities to third parties such as Institutional Shareholder Services (ISS).

In regard to recent examples of engagement, in Australian equities, many managers surveyed engaged with Oil Search after a magnitude 7.5 earthquake struck Papua New Guinea (PNG) in early 2018.

Oil Search donated US$5 million in cash to the relief efforts in the highlands and its facilities were used as a coordination point for delivery of aid. Aid workers also used Oil Search helicopters and personnel to help with distribution of emergency supplies. Managers commented that Oil Search's commitments to the PNG community was an integral part of its commercial success and why they retained investment.

A number of managers also provided an example of engagement with Woolworths regarding an Australian Centre for Corporate Responsibility (ACCR) sponsored AGM Resolution Against Human Rights Reporting. Woolworths admitted they are not "at best practice" but are striving towards improving workers' lives. They are focused on improving the domestic supply chain to comply with their Ethical Sourcing Policy and Policy for Employing or Engaging Overseas Workers (WOW 2020 CSR Commitments Clause 16). Consequently, Woolworths management engaged with ACCR and this resulted in the resolution being withdrawn.
A number of managers also stated engagement with Dominos and Aveo.

From a global perspective, a number of managers continue to engage with Nestlé to gain an update on the use of child labour in supply chains. Investors are comforted that Nestlé conducts comprehensive monitoring, implements remediation activities, and provides targeted support to local communities.

> *"Company engagement was identified by fund managers as the most important tool to assess and influence a company's social risks and opportunities."*

Compliance & supply chains

Compliance alone does not result in good social sustainability

The survey results highlighted that adhering to current minimum compliance requirements does not necessarily equate to good levels of social sustainability integration. The responses varied significantly regarding managers adhering to the minimum mandated level of disclosure and the inclination of companies (particularly in emerging markets) to go beyond legal compliance e.g. of disclosure. One investment manager surveyed has built a sustainability database to record analysis, allowing it to cross compare portfolio holdings with other researched companies, specifically in emerging markets.

This is significant given the recently passed Australian Modern Slavery Act. Practically, the Bill establishes a Modern Day Slavery Reporting Requirement for the first time at a Federal level. This will require certain large businesses and other entities in Australia (>A$100 million in revenue p.a.) to produce annual public reports (Modern Slavery Statements) on their actions to address modern slavery risks in their operations and supply chains.

Much can be learnt from the experience offshore where the UK was one of the first countries to specifically address slavery in the 21st century by introducing a Modern Slavery Act in 2015. However, a briefing in August 2018 by the Independent Anti-Slavery Commissioner and the University of Nottingham's Rights Lab found poor reporting and low levels of action by the UK agricultural sector on modern slavery. A report by CORE supports this, finding that of the statements uploaded onto the Modern Slavery Act registry, only around 14% comply with the legal requirements and most provide little information on the six areas that the Act suggests companies may wish to report on.

Frontier believes this highlights the need for managers to continually question their invested companies and that we cannot rely solely on compliance as a measure of good social sustainability practices. Best practice should involve the fund manager's fundamental assessment of social sustainability materiality then tailoring engagement along these lines.

Assessment of company supply chains was mixed

Social issues in the supply chain or operations can have a meaningful impact on a business's performance. The consideration of supply chain issues by investment managers acknowledges the success of an entity is not limited to the actions of that immediate company or project. The rationale is that issues impacting the financial performance of an entity can and do occur at multiple points along the supply chain, so risks or opportunities arising from these should be managed. As such, the consideration of social factors across an entity's supply chain is an increasing focus of long-term investors.

We asked managers how deep into a company's supply chain they seek to identify potential social sustainability risks and or opportunities. There was a wide disparity in responses by the managers surveyed and many stated that it also varied depending on the company and industry being analysed. A number of managers also commented that they assess this on a case by case basis.

Some survey respondents outlined they meet with employees, community and government relations, competitors, vendors and suppliers. A number of managers responded with aspirational statements such as "we seek to identify across the entire supply chain", while others stated that while this was desired, there was "a need to be realistic, as some supply chains are very opaque and hard to analyse, reducing the ability to effectively gain visibility into certain parts of a company's value chain." Some managers stated their analysis is generally limited to the direct supplier arrangement, while others stated that "where possible they consider the inputs to the supplier (particularly where the supplier is a distributor rather than a manufacturer) but accessing information at this level tends to be more challenging." It appears the majority of managers seek to assess across the supply chain as far as possible but it does depend on data availability and accessibility.

Frontier believes it is important managers seek to analyse and engage with entities along an investee company's supply chain as part of managing material risks and opportunities arising from social issues. While we recognise that in some cases it can be difficult to obtain access and information on supply companies, we encourage managers to continue to push for greater clarity on all links in their supply chains. We believe expectations of investors of their managers will likely grow going forward – disadvantaging those who claim supply chains are "too difficult to analyse."

Collective action

Collective efforts around social sustainability remains in its infancy

While most managers surveyed stated they are open and willing to engage in a collective effort in regard to social sustainability, there are a limited number of managers that currently do so or have done. Several managers stated a preference for one-on-one interaction and engagement on complex issues but “would consider collective efforts on matters affecting the market as a whole, such as disclosure.” One response stated “we have actively avoided signing onto a large number of external initiatives, as we only want to sign onto something if we believe we have the time and experience to be a substantial contributor to that group’s work.” This emphasises the importance of the quality and intention of engagement, whether private or collective. The majority of managers stated they participate in collective engagement initiatives facilitated by the PRI.

An interview of corporates by PRI in April 2018 outlined the pros and cons of collective forms of engagement from their perspective. They found engagement on a one-on-one basis was believed to be more productive as it allows them to explain how ESG issues relate to their corporate strategy. It can also support the development of long-term relationships with institutional investors. From a practical perspective, these meetings were viewed as being easier to organise with one single investor. Alternatively, collective engagement is seen as more likely to provide more traction on ESG issues within companies e.g. working conditions of employees, given the total amount of assets under management usually represented in such processes. However, it was also found that not all investors involved in collective engagements have the same level of interest in the company (or exposure) and, as a result, they may lack the level of commitment needed. Additionally, organising a large group of investors for face-to-face meetings can be difficult. Notwithstanding these views, it is apparent corporate boards are becoming increasingly sensitive to the voice of shareholder collectives.

Frontier believes the benefits of collective action are significant and it is an important way to bring about change through the power of scale. We believe robust collective action on relevant ESG issues alongside like-minded market participants can reinforce the effectiveness of addressing those issues relative to acting in isolation. We consider it best practice for managers to proactively initiate and support collective class actions.

The final word...

In Frontier's view, the incorporation of ESG factors into an overall investment analysis has become essential for financial fiduciaries. In the past, governance considerations have historically been widely integrated by fund managers into investment strategies. Environmental considerations have gained greater prominence as asset owners and regulators have recognised the material impact that these factors will have on investment risk. However, social considerations have historically lagged in focus, somewhat due to the challenge of incorporating largely qualitative factors into more quantitative valuation frameworks. By conducting this survey of equity managers, our focus is on engaging, reviewing and assessing fund managers' approaches to the incorporation of "S" factors into investment processes.

As a broad observation, Frontier's survey results show that most managers today incorporate ESG factors within their investment processes. In general terms, ESG factors are taken into consideration when they are deemed to have a material impact on a company's business and valuation and are generally considered on a qualitative basis.

However, when addressing social sustainability more specifically, it appears that several managers are still in the development stage of thinking how best to incorporate these issues into their decision-making processes.

For many managers, the analysis of social sustainability is done on a case-by-case basis with approaches differing depending on the company, the sector and industry.

While many managers see the value of integrating social sustainability, it appears that the practical side of analysing it remains quite challenging and in its early stages. This is most evident when discussing the assessment of supply chain issues, where a number of managers provided aspirational statements claiming to identify the entire supply chain, while others stated the limitations of opaque supply chains, data availability and accessibility. This highlights the point that social sustainability is a newer area of consideration for a lot of managers and we do not have all the answers yet. Of note however, was just how powerful engagement is viewed as a resource to assess and influence a company's social risks and opportunities.

Going forward, we will continue to engage with managers in regard to their views and attitudes toward social sustainability and in particular, how this has translated into the way they analyse companies, make decisions and construct portfolios.

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