The Frontier Line

ESG manager assessment update

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around $700 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Simone re-joined Frontier in May 2020 as a Senior Consultant and is a member of the Equities Team. Simone previously worked at Lonsec for seven years where she was responsible for undertaking manager research in global and domestic equities, with lead analyst responsibilities for global equities and emerging market equities. Prior to Lonsec, Simone spent five years at Standard & Poor's where she also undertook manager research in global and domestic equities and had lead analyst responsibilities for listed infrastructure and emerging market equities. Simone previously worked with Frontier as an analyst for two years until November 2007. Simone holds a Bachelor of Chemical Engineering (hons) and Commerce from The University of Melbourne.

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Cathryn joined Frontier in January 2023 as an Associate in the Equities Team. Previously, she worked as a freelance writer for The Motley Fool, a retail advisory platform. Prior to that, she spent three years as a generalist Equity Analyst at Rask, an investment research and education company. She holds a Bachelor of Commerce (Accounting and Finance) from The University of Melbourne.

ESG manager assessment update

ESG considerations continue to be an important part of Frontier's assessment of managers and specific products.

This approach aligns with the needs of underlying investors (our clients). We believe active managers are better able to achieve their investment objectives with the appropriate consideration of ESG factors. Finally, passive managers can, and should, seek to improve the intrinsic performance of investee companies themselves through ESG incorporation, including via engagement and proxy voting.

Frontier has been formally assessing the ESG capabilities of managers for many years. After an extensive review process in 2020, we finalised a new and comprehensive scoring system for our sector research teams to use in assessing ESG credentials when rating both active and passive managers (in all asset classes). This is known within Frontier as our *Manager ESG Assessment Toolkit*. The assessment process continues to involve completion of a standard responsible investment (RI) questionnaire, supplemented by targeted dialogue with each manager specifically on ESG matters.

A number of asset owners have utilised Frontier solely to assess managers on their ESG capabilities using this process – for some as a one-off project and for others as an ongoing assessment of their managers ESG capabilities.

Breakdown of the scoring criteria

Frontier's ESG assessment approach covers seven areas, each requiring a score by the research teams. A questionnaire was designed to collect information on these seven categories and, in combination with dialogue with the manager specific to these seven categories, the research teams apply scores on a scale of 1-3 (a score of 1 suggesting lagging the peer average, a score of 2 representing in line with the peer average and a score of 3 representing ahead of the peer average). In practice, some of these seven sections are sub-divided further.

The scored areas are summarised below:

1A	RI philosophy and policy – Does the manager have a philosophy, and does it reference why it integrates ESG factors? How is its RI policy endorsed and monitored, how has it evolved?
1A	RI governance – What is the organisational governance structure and roles and responsibilities when it comes to RI?
2	RI resourcing – Does the manager have a dedicated ESG team? Are investment personnel trained on ESG issues and what ESG research is conducted? Do incentives include ESG objectives?
3A	RI objectives – What are the objectives for integrating ESG factors into the investment approach (product level)?
3B	ESG integration process – What are the most material ESG issues/themes expected to impact the product's performance? How are ESG factors integrated into each phase of the investment process?
4	Active ownership – What is the engagement process including gaining access to suitable personnel and how has it influenced investment decisions and performance outcomes?
5	Collective activity on ESG – What is the rationale of participating/not participating in collective efforts alongside peers and/or other entities on ESG issues and what is the process?
6	Climate change – What are the material investment risks and opportunities arising specifically from climate change which you expect to impact performance and how do you determine these?
7	RI reporting and servicing – What are examples of ESG/RI research and what is standard ESG reporting?

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Assigning the overall ESG score

These underlying scores are aggregated using a proprietary system to establish a single ESG assessment on a scale of 1-5 stars (with 1 star being the lowest score and 5 stars being the highest score). The different Frontier research teams may apply slightly different weighting systems to the various scores in arriving at the combined view. These weights were determined during the trial period and reviewed by Frontier's Responsible Investment Group as well as Frontier's Manager Ratings Committee. For example, our Equities Team applies a higher weighting to active ownership compared to Frontier's other research teams. This is justified as the ownership rights of shareholders (versus bondholders, for example) are more significant and there is greater scope to influence outcomes of company management through both engagement and proxy voting.

Scoring results of the Equities Team

While the scoring framework and ESG Toolkit has remained the same over the past four years, pleasingly managers have enhanced aspects of their ESG integration. In 2022, we produced a research paper titled ESG assessment of managers, detailing our ESG assessment approach, as well as findings from the assessments completed to date by the Equities Team. Given the time that has passed since we first introduced the new framework, we thought it worthwhile to refresh the results to determine if there were similar trends in the output and where the greatest differences or improvements were.

The data was first analysed in mid-2022 and comprised a total of 55 products with the breakdown of sub-sectors included in Table 1. The respective sub-sectors include small-cap strategies. We now have a total of 112 products rated using this toolkit.

Table 1: Number of ESG assessments by sub-sector

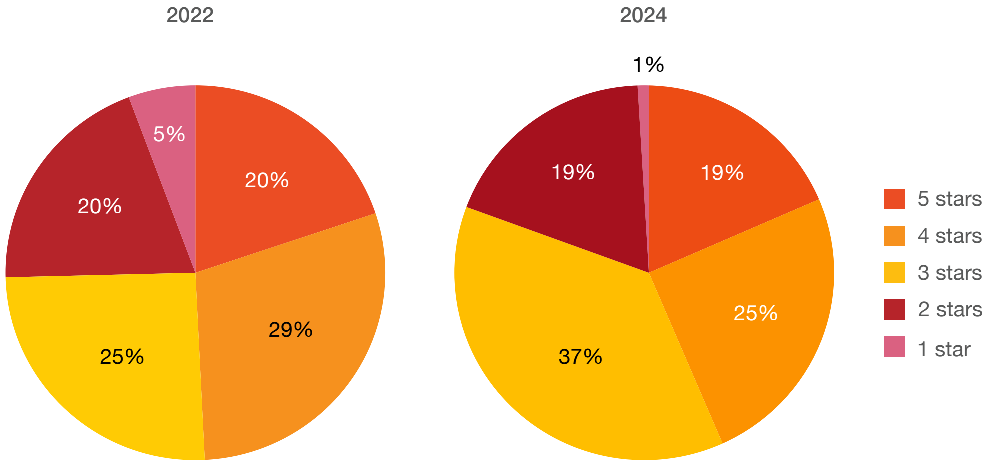
	2022	2024
Global equities	24	46
Emerging markets equities	10	15
Australian equities	21	51
Total	55	112

These scores are typically refreshed every three years, or more frequently if required. However, we discuss ESG in most meetings with managers, including specific company engagements they have had and whether there has been enhancement to ESG integration in the process. While assessments are formally refreshed every three years, we are monitoring ESG more frequently through regular manager meetings as well as through our annual review process.

Summary of ESG ratings

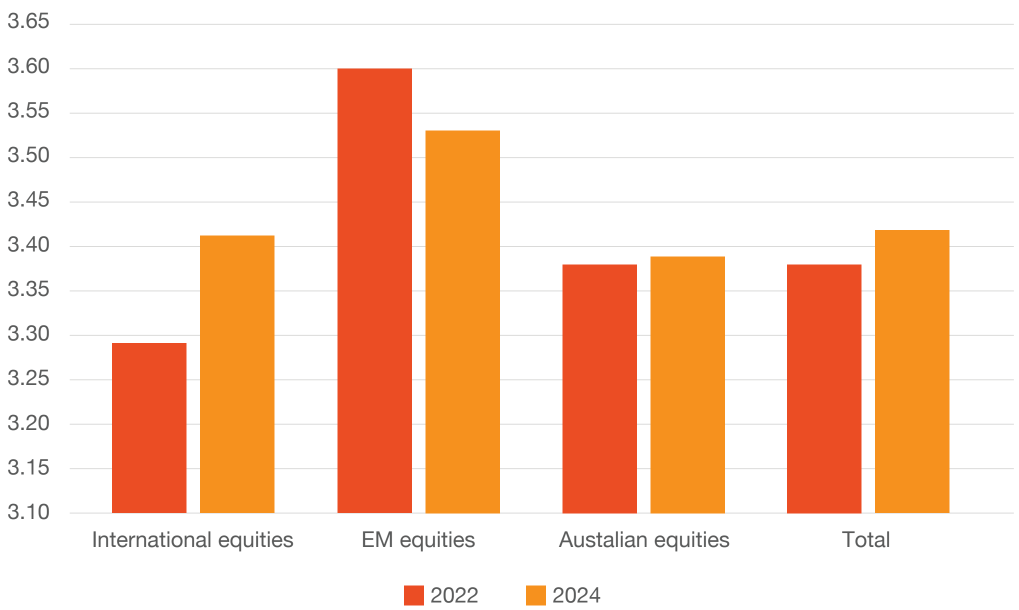
It is again important to highlight our long-held stance on the importance of responsible investment, which can be observed in a bias to strong/higher-rated ESG managers. Given these strong ESG beliefs that underpin our RI philosophy, it is expected there will be a positive skew to managers with better than average credentials in ESG. In addition, the majority of strategies that go through this toolkit are recommended (Buy or Neutral Plus rated by Frontier). Therefore, this is not the 'average' manager, rather is an average of (mostly) Frontier recommended products. That said, there continues to be a spread across the full spectrum of 1 to 5 ESG stars as this remains only one component of the total manager assessment, along with other dimensions including business, team, process and fees.

Chart 1: Summary of ESG stars in 2022 and 2024



While we continue to have scores across the spectrum, the number of 1-star ESG rated products has declined. In fact, only one strategy received a 1-star rating in 2024. We have observed managers evolving in a positive direction over the past few years across all areas and as a result, the bar has become higher as the 'average' manager within our universe enhances its ESG credentials.

Chart 2: Average score (ESG stars from 1-5)

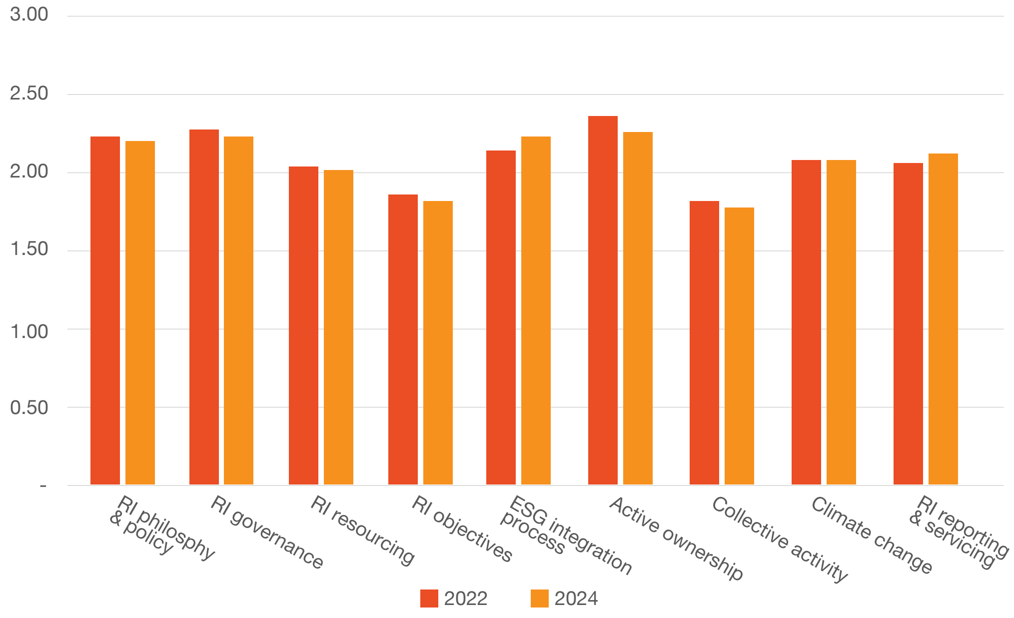


The overall average is slightly higher in 2024, implying the broad group of strategies is better placed than two years ago and continues to be above an 'average' of 3.0 (with an overall average of 3.42 ESG stars). The biggest change is seen in the international equities cohort where the average has increased from 3.29 to 3.41, while the EM equities average has actually decreased from 3.60 to 3.53 but remains the highest average of the three sectors, albeit by a smaller margin. We reiterate our belief from two years ago that emerging markets equities is a sub-asset class where ESG factors will lag the developed world on average and Frontier has a skew to managers with stronger ESG credentials to ensure they can navigate its complexities.

The outcome in the small caps peer group in both Australian and international equities was also notable. These scores are included in their respective broad sectors in Chart 2. As it stands, we have ESG ratings on 14 small cap strategies: three in international equities, one in emerging markets and ten in Australian equities. This is a small sample, particularly in international and EM, where the average score was 2 ESG stars. In Australian equities, the average was 2.9 stars and included scores ranging from 2 stars to 4 stars for ESG.

Digging deeper into the component scores and comparing 2022 results to 2024, Chart 3 provides an illustration of changes over the period. As stated earlier, these are scored on a scale of 1-3.

Chart 3: Comparison of component ESG scores



It is clear there has been only marginal movement in the component scores when comparing 2022 and 2024. Interestingly, most component scores are slightly lower in 2024 aside from ESG integration of process and RI reporting and services. Anecdotally, these two areas are where we have seen the most improvements. For example, managers have evolved their processes, with most now explicitly including ESG in the process as a step in fundamental research or including ESG-related data in a quantitative approach. Within the scoring, ESG integration of process is a key component of the overall assessment and weighted accordingly.

Pleasingly, RI reporting has also evolved and has now moved past being available only at a clients request to many managers now providing standardised reporting on ESG and annual stewardship reports for both mandate and pooled fund investors.

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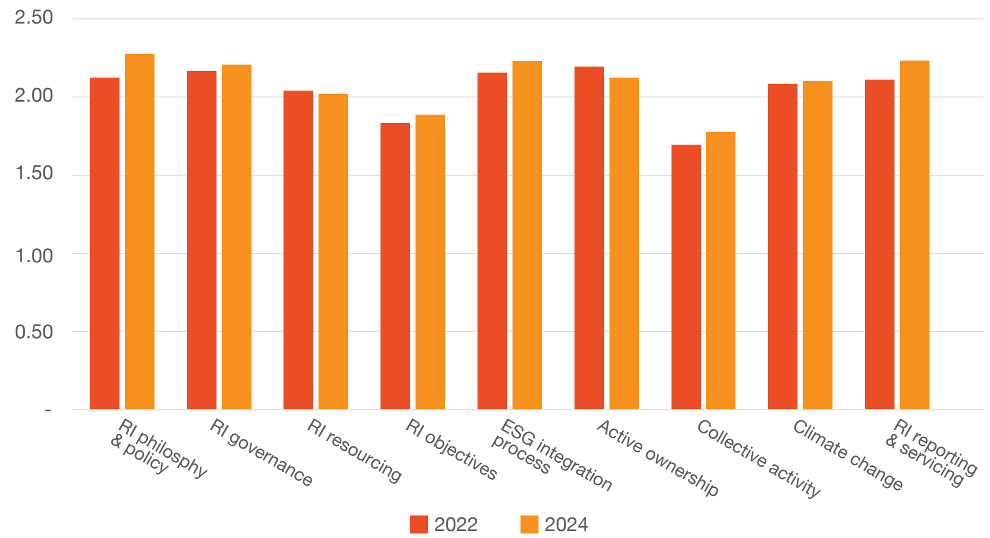
In terms of how the individual component scores fared in 2024, the component with the most maximum scores of three was active ownership (proxy voting and engagement with companies) while RI objectives had the fewest, noting some difficulty in achieving 3 stars for strategies that are not specifically sustainable or impact focussed. The largest number of 'one' scores, implying the poorest component score, was in collective activity. We continue to view this as an area of potential improvement for managers, while acknowledging some managers will remain more resistant than others when it comes to collaborating with their competitors or contributing resources to broader industry efforts.

Climate change is a component where we have seen important enhancement. Companies that emit greater amounts of greenhouse gases (GHGs) will face elevated risks as transition brings about regulatory, technological and market changes. In addition, as climate change progresses, there will be greater physical impacts which is a factor likely to present a financial risk to exposed companies. Many managers now incorporate a carbon price in their valuation modelling, along with detailed climate-related scenario analysis which often incorporates both physical and transitional risk inputs. In addition, managers are, or will be, required to align their environmental practices to minimum industry standards including climate and nature-related financial reporting and disclosure.

Delving deeper into the sub sectors

International equities

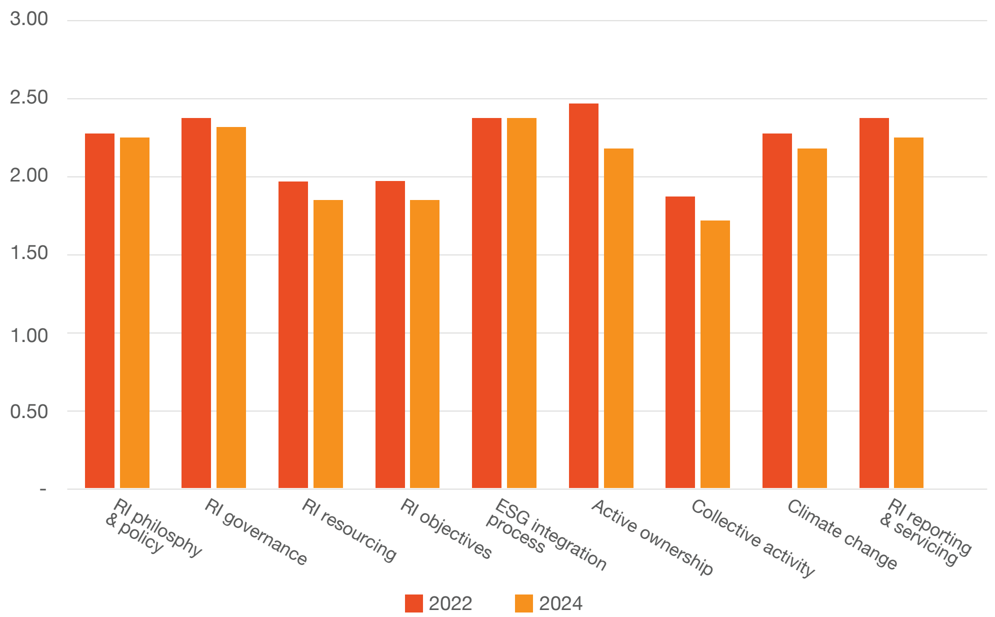
Chart 4: Component scores across international equities strategies



Within the larger international equities cohort of 2024, the most notable increase in component scores is in RI philosophy and policy. A clear majority of managers now score 2 or 3 for this category as most now have an RI policy that articulates philosophy when it comes to responsible investment. That said, it is not enough to simply have an RI philosophy or policy, with other considerations including whether it is fit for purpose and the frequency in which it is updated. Active ownership is the area that declined the most over the period, albeit still by only a small amount. From an absolute perspective, scores for this component remain high (above 2).

Emerging markets equities

Chart 5: Component scores across EM strategies



In emerging markets equities, the most interesting observation is that all component scores trended down over the period, with all average scores equal to or lower in 2024. The biggest decline was seen in active ownership. This is a smaller sample set relative to international and Australian equities. We don't believe this is an indication of deterioration within the group on active ownership or ESG more broadly. It is worth noting of the five additional EM strategies assessed in the 2024 cohort, two are quantitative or passive managers that typically exhibit weaker ESG credentials, particularly with respect to company engagement.

Three average component scores have dropped below 2, including RI resourcing which scores the lowest in EM relative to Australian and international equities (where both are greater than 2). Only two strategies in the EM cohort have received a 3 for RI resourcing. Two quantitative and two fundamental strategies, where there is little to no ESG specialist skills in the firm, scored a 1. The bulk landed in the middle at 2, indicating ensuring access to ESG expertise is an area of potential improvement in the sector.

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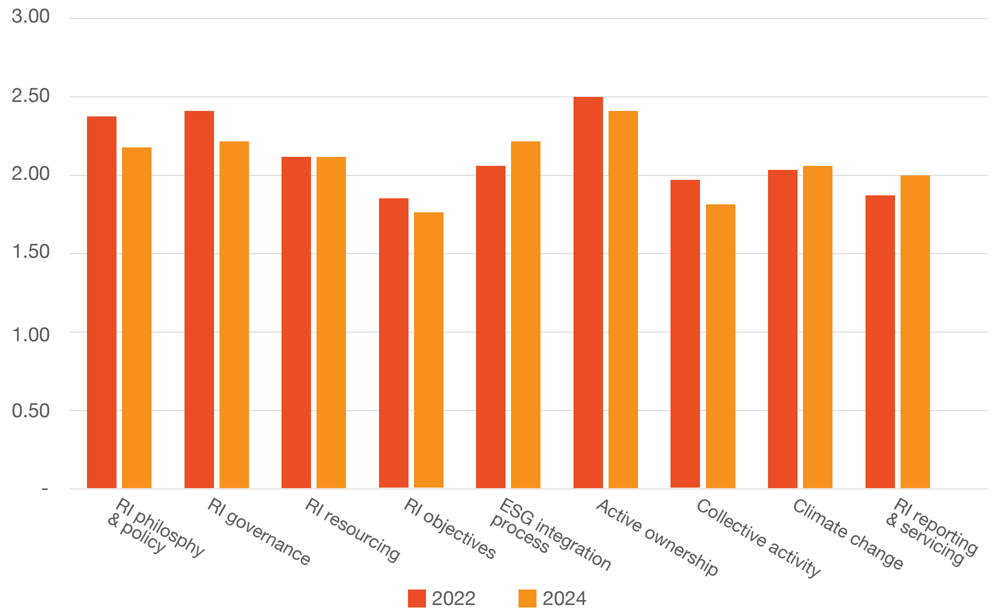
Australian equities

Chart 6: Component scores across Australian equities



In the Australian equities sector, we have seen the greatest change when comparing component scores in 2022 and 2024. We observed the average score for ESG integration increased the most in 2024 to 2.22 while the average score for RI philosophy and policy, closely followed by RI governance, declined the most over the period (to 2.18 and 2.24, respectively). There was very little change in the average component scores for RI resourcing and climate change. From an absolute perspective, and similarly to international equities, all scores were above 2 except for RI objectives and collective activity. Active ownership was the highest score, as was also the case in 2022.

ESG rating refreshes

Given we formally reassess our ESG ratings every three years on average (and in some cases, more frequently), we are now at a stage where some strategies have ESG ratings across multiple time periods. Specifically, there are 16 strategies with ESG ratings at two points in time that are at least two years apart. There are 11 additional strategies with ESG ratings that are one year apart.

We acknowledge these are small sample sizes with no real commonalities in that various sectors and types of strategies are represented, as are different ESG ratings. We will be able to draw more broad-based conclusions from this data as more strategies are formally re-assessed. In the meantime, these initial findings provide some specific insights.

Chart 7: ESG assessments one year apart

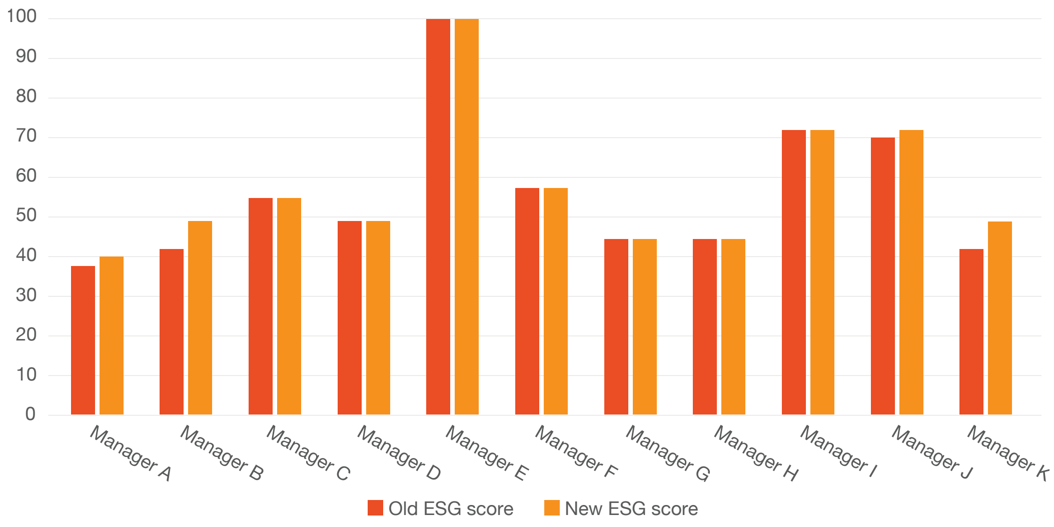
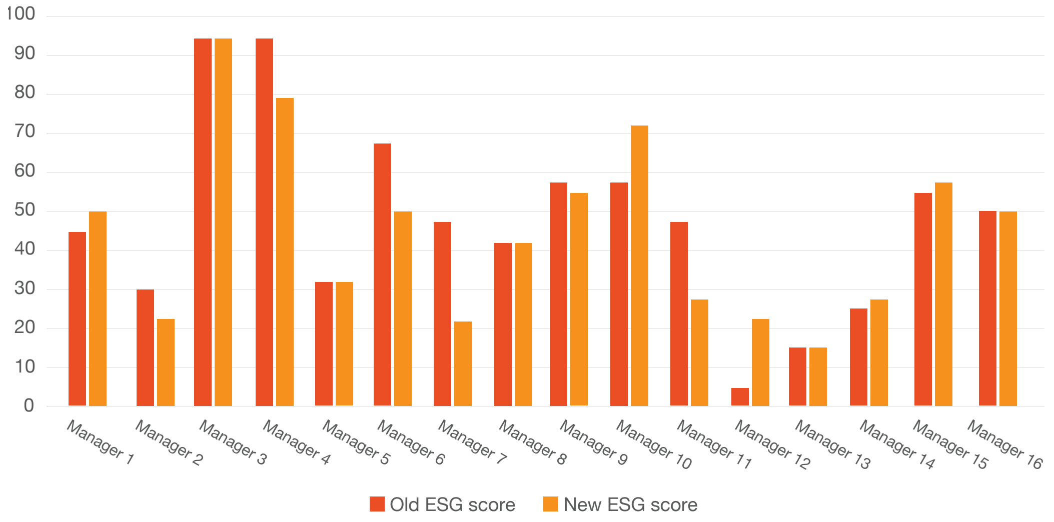


Chart 7 shows there has been little change in the ratings of strategies one year apart, which in all cases occurred in 2023 and 2024. The greatest move in a strategy's overall ESG score (out of 100) was +7.5. The overall trend is positive, with all strategies either maintaining or increasing their ESG score, suggesting an improvement in the ESG credentials of this cohort.

Chart 8: ESG assessments 2+ years apart



As shown in Chart 8, unsurprisingly we see more meaningful moves in ESG scores that are compared over periods longer than one year. It is also worth highlighting a consistent ESG score doesn't necessarily mean there haven't been changes to the underlying component scores. These changes can counteract each other, neutralising the effect on the overall ESG score.

In any case, of these 16 strategies, six have seen their overall ESG score change by more than 10, with five of these score changes leading to a change in the strategy's ESG star rating. Interestingly, the overall trend for this cohort is negative, with more of the meaningful score changes being on the downside. This supports the notion that the ESG credentials of the average manager within our universe are improving, therefore managers need to continue evolving or else face the risk of falling (in some cases further) behind.

Of the four strategies that experienced meaningful score downgrades, all were marked down on the RI resourcing component score. The varying reasons for this are naturally manager-specific but it's worth noting this sub-component goes beyond simply headcount, with arguably more consideration given to dimensions such as experience and embeddedness within the investment team or process.

Summary of findings

Two years on from our first analysis of the manager ESG assessment data and we now have 112 equity strategies assessed using the updated toolkit.

Broadly speaking, the trends we observed in 2022 are still apparent in the larger cohort two years on. This includes:

- the average ESG score for emerging market managers being greater than that of Australian and international equities
- small caps lagging the broad cap group.

Frontier's own RI philosophy and ESG bias continues to positively skew to managers with better than average credentials in ESG. That said, ESG ratings are spread across the full spectrum of 1 to 5 stars as this remains only one component of a holistic manager assessment alongside other dimensions including business, team, process and fees.

On reflection of the changes in ESG scores, while there has been only marginal change, clearly managers have lifted their game over this period. We continue to hold managers to a high standard and the bar has shifted as this positive evolution has occurred. This can be seen particularly in the strategies that have been assessed multiple times.

Looking at the overall cohort, most of the products (70) are considered broad cap strategies while a smaller number were small caps (13). Of the small caps assessed, none received a maximum 5-star ESG rating.

Twenty products assessed are quantitative strategies and the majority of these have now achieved a 3-star ESG rating. ESG processes amongst this group have improved, reflected by the fact there are no longer any 1-star ratings in this cohort while at the other end of the spectrum, one strategy has even received a 5-star ESG rating.

We have observed almost all assessed managers have recognised the importance of ESG and have taken steps to improve internal processes. Across all of our ESG ratings, there is now only one strategy receiving a lowly 1 star and this is a passive product.

Unsurprisingly, sustainability-focussed strategies have higher than average ESG scores. Around half of the 5-star ESG rated strategies have a sustainable focus whether as an impact or sustainable product.

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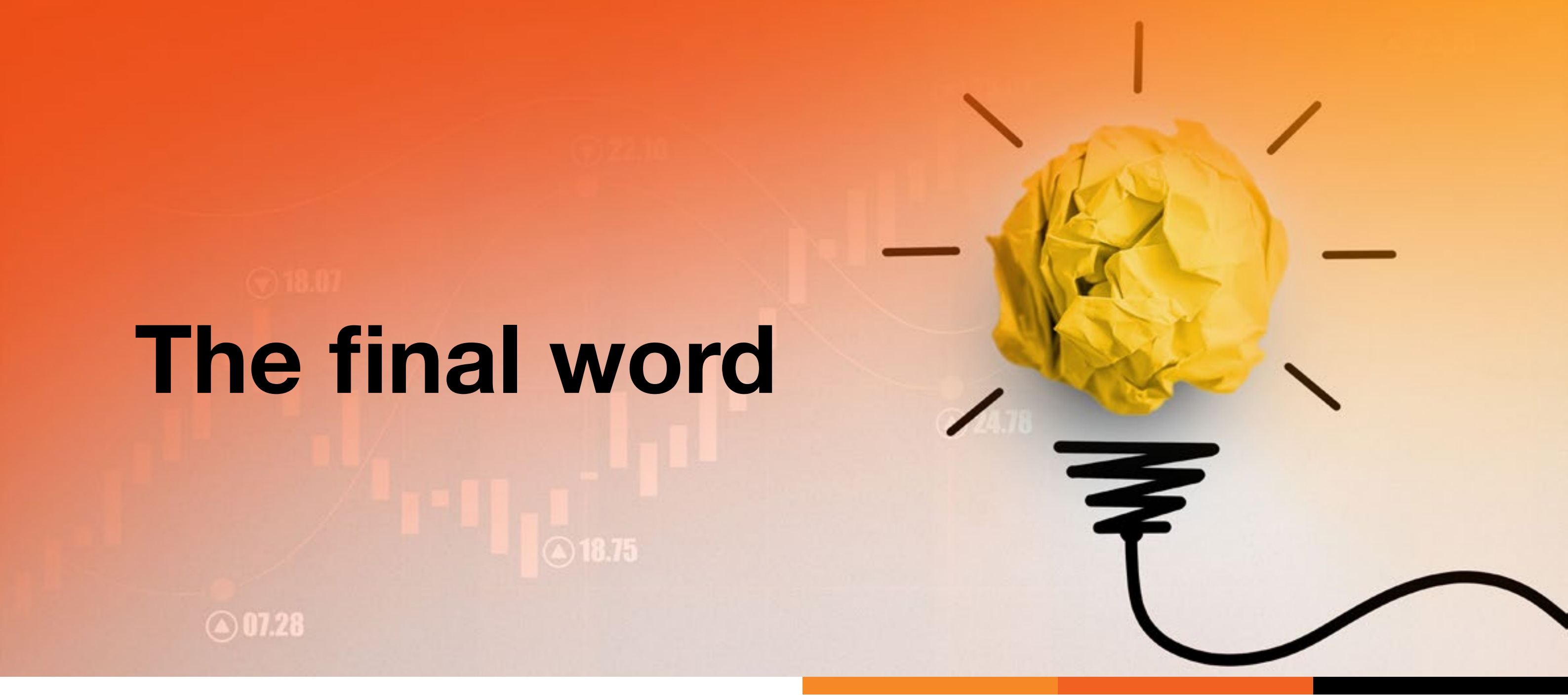

The final word

There are again some important takeaways here for clients with regard to their equity managers and ESG.

- Clients often have a combination of different equities managers that form their portfolio and ESG integration can vary widely. There is a high likelihood most asset managers have at least one manager that needs some push or reminder to continue to review and enhance its ESG efforts.
- We understand the significant time and resources it takes for managers to keep up with this evolution in ESG, particularly for smaller teams and/or firms; however, believe this is an ongoing commitment that is worthwhile and important.
- Small cap managers (domestic and global) should be challenged to keep improving as other equities sub-asset classes continue to advance.
- Equally, we believe there is space for passive managers to evolve and while integration of ESG in the process is more challenging, improvements in company engagement and reporting are areas where enhancement has been focussed and can continue.
- Some managers remain more resistant to others when it comes to collaborating with competitors or contributing resources to broader industry efforts, but we believe there is more that managers can do when it comes to collective engagement.
- Pleasingly, ESG integration of process, a key component of the assessment, and reporting are where we have seen the most improvements. Across the board, managers have evolved their processes and standardised ESG reporting, as well as annual stewardship reports, are now the norm.
- Climate change has also been an important area of enhancement, most notably in ESG risk assessments (transition and physical) as well as disclosure.

While there have not been significant changes when comparing the assessment scores at the aggregate level, these manager ESG assessment scores will continue to evolve at the cohort level and the individual manager level, given the nature of the components and the evolving regulatory standards and stakeholder expectations. It is important data to continue to review and track for clients via this detailed framework.

Learn more

Frontier's Equities Team would be happy to discuss the ESG scoring and assessments further. We are able to provide this information with respect to specific portfolios including component scores and reasoning. This may assist clients in keeping informed of how managers are evolving, including identifying the laggards and how the managers stack up relative to the broader peer group. If you want to discuss this paper in more detail or learn more about how we can help, please get in touch with our Equities Team or your consultant.

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