HEALTH WEALTH CAREER

THE ACTIVE SIDE OF PASSIVE MANAGEMENT

MAY 2017

BACKGROUND

Passive equity assets represent a significant portion of the investment industry, and this portion continues to grow each year. Although passive managers cannot express their views on particular companies by purchasing or divesting stocks, they are in a position to engage with, and positively influence, companies on a range of environmental, social and governance (ESG) issues. The long-term investment horizon of passive managers provides the opportunity for ongoing and higher-quality conversations with company management across a range of topics, including ESG issues.

In 2014, Mercer started formally reviewing and rating the largest passive managers on their active ownership activities with the introduction of our ESG passive (ESGp) ratings.[1] Our approach focused on understanding the voting and engagement process, the resources required to implement stewardship responsibilities, internal initiatives to promote and enhance ESG integration, and the level of firm-wide commitment and industry collaboration that the managers undertake to influence the industry. With these factors in mind, we assessed the extent to which we believe these managers exercise their ownership practices, and we assigned an ESGp rating to each manager.

In 2016, we revisited this research, updated our views and extended ESGp ratings to additional passive equity managers. The aim was to review each manager's progress and evaluate how industry practice has, in our view, evolved in recent years. This paper constitutes a summary of our findings; a more in-depth client paper provides further detail on how managers have progressed, where we see potential for further progress, and guidance on actions that clients can take to engage with their passive equity managers, as well as some manager-specific questions to ask.

1 Mercer. *ESG Practices for Passively Managed Equity Strategies*, September 2014, available at http://content.mercer.com/Investments/ESG%20Practices%20for%20Passive%20Equity%20Strategies/ESG%20Practices%20for%20Passively%20Managed%20Equity%20Strategies%20(A4).pdf.

OVERALL RESULTS

Results from the 2016 review show that although we have seen a positive trend in the approach passive managers take to active ownership, we believe more can be done by managers to strengthen their ownership activities. Attaining the highest ESGp rating is not an easy task, and we did not rate many managers high on the ESGp scale; however, within the universe of passive ESG ratings, we have seen some best practices emerging.

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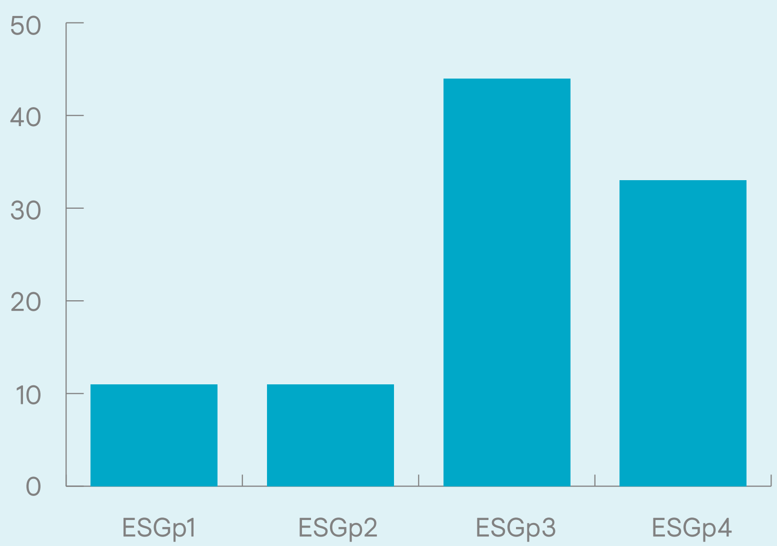
Our results cover a wider distribution of ratings in 2016 compared to 2014, with a scale ranging from ESGp1 to ESGp4. The majority of managers remain clustered around ESGp3 or ESGp4. We observed significant enhancements in stewardship activities undertaken by passive managers, as reflected by the upgrade in ESGp ratings for a small number of managers reviewed for the second time. We have seen the most progress among managers with European or global client bases, whereas managers with a primarily North American client base tended to earn ESGp3 or ESGp4 ratings. Figure 1 below shows the distribution of ESGp ratings among the passive managers we reviewed.

FIGURE 1. ESGP RATINGS DISTRIBUTION



Source: Mercer

RESOURCES AND VOTING IMPLEMENTATION

We believe there is scope for managers to be more explicit in communicating how they implement their voting policies and why voting actions may differ from their stated policies or positions.

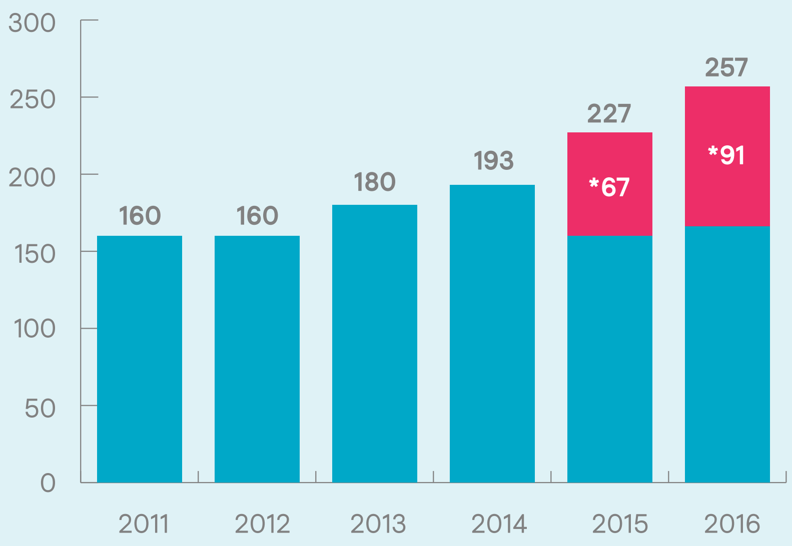
We made a number of key observations based on our overall research. In particular, we believe that the individuals dedicated to stewardship may be under resourced, especially given the scale of ownership within specific markets. Specifically, in our view the number of *skilled* individuals (that is, those with several years of experience) dedicated to high-level engagement with company CEOs is still an area for further development.

A closer look at voting statistics shows that the largest passive managers tend to vote in line with company management on the majority of resolutions. On the one hand, this is not necessarily a negative, as the engagement behind some of these issues may lead to voting in favor of the resolution. However, asset owners have become more active in holding their passive managers to account regarding voting policies and actions. We believe there is scope for managers to be more explicit in communicating how they implement their voting policies and why voting actions may differ from their stated policies or positions. In our view, best practice on voting appears to be emerging as a process that involves not only providing voting statistics across regions and topics but also clearly communicating the link to the manager's overall position on the topic, its engagement efforts with companies on these topics and the action of these engagements through voting (that is, for or against management and the rationales for the votes cast).

FOCUS ON ENVIRONMENTAL AND SOCIAL ISSUES

Though the increase in the level of votes and engagement on environmental and social issues is encouraging, such issues continue to receive low focus relative to other corporate governance issues and represent an area on which we believe managers could place greater emphasis. Data published in 2016 by the Interfaith Center on Corporate Responsibility (which focuses on shareholder proposals during the US proxy-voting season) show that the number of shareholder proposals generally, and climate-change-related resolutions in particular, has been increasing over the past few years.[2] Figure 2 highlights this upward trend.

FIGURE 2. NUMBER OF RESOLUTIONS BY YEAR: CLIMATE-CHANGE-RELATED RESOLUTIONS*



Source: Interfaith Center on Corporate Responsibility

We expect this upward trend to continue as ESG issues increasingly appear on agendas at annual general meetings, and we believe asset managers must be clear on how they are engaging with companies to resolve these broad issues.

2 Interfaith Centre on Corporate Responsibility. "2016 Proxy Resolutions and Voting Guide," 2016.

ESG INTEGRATION A LONG WAY OFF

The majority of the larger passive managers have progressed significantly in their ESG integration initiatives over the past two years. Most encouragingly, this is coming from top management, where we have seen greater commitment to integrating ESG internally through a number of initiatives. However, in reviewing our ESG ratings for actively managed strategies across asset classes, we note that the majority of actively managed strategies (where it is applicable within these asset management firms) tend to be rated ESG3 or ESG4.[3] These ESG ratings suggest that more effort is required by the responsible investment (RI)/corporate governance teams to work internally with portfolio managers to better evolve and inspire integration efforts.

INDEX INNOVATION

Passive managers have generally been proactive in meeting client demand for RI passively managed (index) options. The majority (if not all) of the managers we reviewed have passive funds available that take a values-based exclusions approach (tobacco, controversial weapons, etc.) and are able to accommodate customized options based on client requirements.

More recently, managers have been responding to wider industry initiatives to develop low-carbon passive investment options, such as the Paris Agreement of 2015 and the establishment of the Portfolio Decarbonization Coalition in 2014. The first wave of newly developed indices had the primary objective of reducing exposure to carbon emissions and fossil fuel reserves, with little to no focus on the opportunity side (that is, exposure to companies developing products or providing services that target a low-carbon economy). However, innovation has been rapid over the past 18 months, and a range of indices has increasingly incorporated more forward-looking aspects into their methodology to capture opportunities aligned with a shift to a low-carbon economy. A small number of managers are leading the way in evolving their passive investment suite to track these indices, but we believe index providers will continue to innovate and develop new products as they respond to demands from market participants. We also see strong competition on these approaches from managers less known for their passive products.

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3 Mercer. "Mercer's ESG Ratings — Enhancing Manager Research," available at https://www.mercer.com/our-thinking/mercer-esg-ratings.html.

ACTIONS FOR INVESTORS

We encourage clients to engage with their passive equity managers to promote strong active ownership practices in their passive assets under management. Mercer's ESGp ratings help investors differentiate what managers are doing on their active ownership (via voting and engagement) and ESG integration approaches. Specifically, we recommend the following key areas of focus for clients:

- Use ESGp notes in passive manager selections
- Review existing passive managers and their stewardship approaches
- Monitor consistency of implementation
- Engage with passive managers to strengthen their practices
- Encourage managers to enhance reporting on voting and engagement

CONCLUSION

Mercer holds the view that active ownership aids the realization of long-term shareholder value. Our investment beliefs state that active ownership — exercised through voting and engagement — provides diversified investors with an opportunity to enhance the value of companies and markets.[4] This is as relevant for passive investing as it is for active investing, and Mercer's ESGp ratings provide a clear framework to help asset owners address ESG integration and engagement with managers of passive portfolios.

4 Mercer. *Mercer Investment Beliefs*, 2014, available at https://www.mercer.com/our-thinking/investment-beliefs.html.

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