Heartland Capital Strategies

IMPLEMENTATION & MEASUREMENT

MINI-BOOK #6

Companion to The Responsible Investor Handbook

KEY TAKEAWAYS

- A written RI policy is an important tool for trustees seeking to incorporate responsible investment strategies within pension investment portfolios
- Trustees need to be able to sort through a plethora of ESG data and sustainability ratings providers by keeping their focus on the long-term goals of the pension investments as they relate to the well-being of workers & their beneficiaries
- Trustees need to make a concerted effort to emphasize labor rights and standards as part of the "S" in ESG

About Heartland Capital Strategies

Since 1995, Heartland Capital Strategies (HCS) has been mobilizing workers' capital, i.e., pension plans, in the U.S. and Canada, towards greater responsible investments. We do so by convening events, highlighting investment opportunities in the real economy, educating capital stewards, and laying the foundation for bringing together a new generation of responsible investors.

Based in Pittsburgh, Pennsylvania, HCS is a partnership launched by the Steel Valley Authority (SVA), an innovative regional organization that has been successfully restructuring troubled manufacturing firms in the American rust belt for more than 30 years. Heartland was co-founded by the Steelworkers, the AFL-CIO HIT, AFL-CIO IUC and SVA to bring together labor's capital stewards to explore ways to rebuild our economy and reclaim workers' capital. In the aftermath of the 2008-2009 financial markets crash and recession, HCS was re-booted to align its goals with the responsible investment movement and to reflect a broader category of services offered.

Heartland's Mini-Handbook Series

In July 2016, HCS staff authored *The Responsible Investor Handbook: Mobilizing Workers' Capital for a Sustainable World*. The Handbook helps pension trustees re-align their governance and investment strategies with the long-term interests of plan participants (the workers) and their families by incorporating responsible investment practices into the investment decision-making process for plan assets.

Heartland's mini-handbook series takes important topics from the Handbook and breaks them down into individual mini-handbooks, each focused on addressing barriers to the integration of responsible investments in pension plan portfolios. Topics range from clarifying fiduciary responsibilities to highlighting good corporate and pension plan governance practices, showcasing responsible investments across asset classes, and creating effective investment policy statements that take into account responsible investment practices.

Heartland
CAPITAL STRATEGIES

Headquarters
1112 S. Braddock Avenue
Suite 300
Pittsburgh PA 15218
412-342-0534
www.heartlandnetwork.org

Follow Us:
Twitter LinkedIn

Table of Contents

INTRODUCTION

In earlier mini-books, we discussed the role of pension plans as universal owners that own a significant share of the economy and are therefore impacted by changes in broader economic trends, from financial, such as interest rates and growth, to nonfinancial, such as natural resource scarcity or the impacts of climate change. As noted by the National Association of Pension Funds (NAPF), "there is an increasing awareness that if one company does well at the expense of others, a widely diversified investor may well pick up the costs as well as the gains" (NAPF, 2013, p. 4). We also emphasized the link between the long-term nature of pension investments and the impact of ESG factors on the long-term financial value of these investments.

In our final mini-book in the series, we discuss the implementation and measurement of responsible investment strategies. We first present how trustees may develop, implement, and monitor a responsible investment (RI) policy. Such a policy should be based on the ESG risks and opportunities expected to impact the financial value of plan assets as well as the economic, social, and environmental well-being of worker-owners. Trustees will then need to build internal expertise and/or select external managers, execute on ESG themes and engage, and monitor performance and fine-tune the policy.

With regard to measurement, in recent years, there has been a proliferation in the availability of ESG ratings, rankings, and indices, as well as providers —a result of greater investor demand for the inclusion of ESG considerations in investment decision-making.

The ESG data can be used to inform the investment policy statement (IPS), make comparisons between companies, select stocks based on a best-in-class strategy, and engage with management on issues material to the investors, among other uses. A majority of providers are focused on reporting data for publicly traded companies, while a small number provide data on privately held companies.

This proliferation of ESG data, however, has been accompanied by a lack of consistency in data collection methodologies, differences in the number and types of indicators collected, and limited depth in the evaluation of the indicators, particularly social and labor standards, by providers.

To counter these shortcomings, progress is being made by global sustainability reporting and responsible investment programs to standardize data collection and reporting, such as the:

- Principles for Responsible Investment (PRI)
- Global Reporting Initiative (GRI)
- Global Real Estate Sustainability Benchmark (GRESB)
- Sustainability Accounting Standards Board (SASB)

Many organizations are working to apply a consistent standard for measuring sustainability performance across different providers. More importantly, with ESG data collection and reporting being driven primarily by investor demand, pension trustees can play an important role in pushing providers to strengthen the types of indicators collected and the evaluation of those indicators material to their investment policy.

As such, in this mini-book, our aim is to enable trustees to effectively navigate the plethora of ESG data by focusing on a few key criteria for responsible investment evaluation, irrespective of industry trends and fads. In addition, we focus on the "S" or social in the ESG, with an emphasis on labor rights and standards, diversity, and stakeholder participation.

Heartland
CAPITAL STRATEGIES

PART ONE: Selection & Implementation

The below steps, which are covered in detail on the following pages, may be applied across asset classes. Where trustees have an opportunity to practice active ownership approaches, either internally or through external managers, both the financial and non-financial outcomes of the responsible investment policy can be enhanced.

1. Develop an RI policy based on ESG risks & opportunities
2. Build internal expertise and/or select external managers
3. Review Investments for Financial & ESG Performance
4. Monitor performance and fine-tune policy

A Note on the Role of Investment Consultants

Investment consultants provide a range of services to pension plans in the allocation and management of a plan's assets. These services may include developing an investment policy statement, assisting in asset allocation decisions, selecting external asset managers, and helping with portfolio performance evaluation. Some consultants may also assist trustees with managing the plan's proxy voting process and engaging in active ownership practices.

Consultants exert much influence on the investment decision-making process of pension plans, particularly for smaller plans that may not have an in-house chief investment officer (CIO) or adequate trustee and/or internal staff knowledge of investments. As a result, consultants are often seen as "gatekeepers" to the integration of ESG factors in the investment of pension assets (Voorhees, 2009).

For pension plans that engage with a consultant, the most important step is to ensure that the consultant's beliefs and philosophy with regards to responsible investments are similar to those articulated by the fund in its own investment beliefs statement (if there is one) or investment policy statement. If a pension fund does not have a responsible investment beliefs statement, then the search for the appropriate consultant should be based on the consultant's ability to help the fund formally articulate these beliefs.

As advised by the UN Investor Network on Climate Risk, in selecting consultants who understand the link between ESG considerations and the financial value of investments, asset owners should ask a range of in-depth questions that go beyond the "Check-box" approach (Snow Spalding et al, 2012). These questions should probe the consultant on their responsible investment beliefs and their process for enabling the integration of ESG factors that are material to the plan's investment goals, among other criteria.

Once an appropriate investment consultant has been selected, they can help trustees develop and/or implement part or all of the steps of an RI policy discussed here.

1 Develop a Responsible Investment Policy

As a first step to investing responsibly, trustees should develop a written RI policy, either as part of the plan's overall investment policy statement (IPS) or as a stand-alone policy. The RI policy should be rooted in a clear understanding of the fund motivations for pursuing a responsible investment strategy. It should incorporate ESG risks and opportunities applicable to the industries, asset classes, and/or geographies in which the pension plan is invested.

Such a policy, like the rest of the IPS, can serve as a governing document that can help protect the long-term interests of plan participants and beneficiaries as it relates to responsible investments. In developing this policy, trustees may consider the following factors:

1 Understand the drivers for pursuing a responsible investment strategy

As we have stressed throughout our work and the mini-book series, achieving competitive long-term returns to meet current and future retiree benefits is the primary objective of pension planinvestments. Related to this financial objective is the need to lower the long-term risks of pension investments so that retiree benefits may be better secured.

Since ESG concerns, such as reduced worker rights, environmental degradation, and corporate mismanagement, have a bearing on the financial value of investments, trustees may be motivated by the need to account for the long-term investment risks posed by such factors. In addition, trustees may be motivated by the desire to enable plan participants and beneficiaries to retire in a sustainable, humane world, where basic rights and dignity are not sacrificed, nor scarce resources squandered, in the production of financial benefits. Understanding and articulating these drivers upfront is important and represents the foundation of an effective responsible investment strategy: “The assets pension funds own and have oversight of can play an important role in determining the future society member’s face and thus, the real value of their retirement income” (NAPF, 2013).

2 Develop an Investment Beliefs Statement

In order to pursue a consistent responsible investment strategy, trustees should establish a clear link between incorporating ESG considerations into investment decision-making and the financial performance expectations from their pension investment portfolio. This link should be clearly articulated in a formal investment beliefs statement that complements the fund’s RI policy and overall IPS.

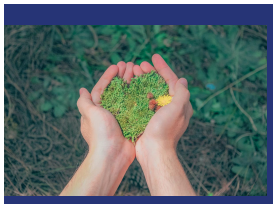
Trustees need to understand and clarify any concerns they may have around responsible investing. The resulting investment beliefs statement will enable the clear communication, implementation, and accountability of the fund’s RI policy with internal staff, investment consultants, and/or external investment managers. Most importantly, it will ensure the continuation of the fund’s responsible investment goals beyond the current generation.

Heartland CAPITAL STRATEGIES

Develop a Responsible Investment Policy

3 Identify ESG Risks and Opportunities

The RI policy should aim to manage those factors that are important drivers of the fund's investment risks and returns while limiting focus on factors that are not material to the fund's financial value. In this way, the RI policy can be used to "select better managed companies that can mitigate risks and exploit opportunities." Some common ESG factors include:



Environmental: Climate change, Energy efficiency, Water scarcity, Pollution, and waste management

Social: Human rights, Worker rights, Health and safety, Supply chain management

Governance: Employee Board Representation, Board independence and diversity, Executive compensation, Shareholder rights, Auditor independence

4 Establish Protocols for Active Engagement Approaches

In asset classes where trustees and other fiduciaries can engage in active ownership approaches, the RI policy should also include the types of approach and the extent of engagement that may be employed by the plan's internal and/or external investment management teams.

Heartland
CAPITAL STRATEGIES

2 Build Expertise and/or Select Managers

Once trustees have developed an RI policy, the next step is to implement this policy. Just as with a traditional IPS, so an RI policy may be implemented internally and/or through external investment managers. As such, trustees may either help build internal staff capabilities to implement a part or whole of the RI policy in-house, or select external managers for the same. Each scenario is discussed in more detail below, with examples of pension funds that have taken either approach.

Building in-house expertise to implement RI policy

The extent of internal expertise that trustees wish to develop will depend on the level of internal engagement and control desired in regard to the RI policy. If the goal is to have better control over the resulting financial and non-financial outcomes, trustees may be well served to build in-house investment management expertise for specific asset classes or for the entire portfolio.

In general, in-house expertise can help augment organizational capacity and more effectively manage costs related to ESG analysis and implementation. This is particularly true for larger pension plans, who may be able to enjoy economies of scale by managing more of their investments in-house as opposed to with one or more external managers. It is important to note that building in-house investment expertise, whether in traditional or responsible investments, can be a slow process, and that economies of scale may not be achieved immediately. These challenges are even greater for smaller pension plans. Therefore, a patient and step-by-step approach is recommended. As the Ontario Teachers Pension Plan reports, the fund took “baby steps” in moving more of its assets to in-house investment management since its establishment in 1990 with $20 billion in assets.

In addition, when building in-house expertise, the most important decisions that trustees will make are with regards to the cost savings and the structure of the investment management and governance teams. Aside from recruiting appropriate talent to the organization and creating a nimble investment team, trustees should also focus on improving the plan's internal governance structure as discussed in previous chapters. Such a structure should establish a clear long-term vision and mission for the plan in relation to ESG management, be backed by strong leadership at the board and management level, and allow for quick responses to any conflicts or opportunities encountered. More often than not, trustees may employ a combination of in-house and external management of their ESG and broader investment goals.

Appointing a Chief Investment Officer (CIO)

The role of a CIO within a pension plan includes developing the IPS and engaging in asset allocation, manager selection, and performance evaluation in relation to the plan's investments. A 2007 study by pension governance experts Clark and Urwin identified the presence of a CIO as critical to the success of pension plan investment outcomes. Large pension plans often have the resources to hire an in-house CIO who may also be able to direct a plan's responsible investment strategies under appropriate oversight by trustees. Smaller funds, however, often outsource the functions of the CIO to external service providers such as investment consultants. As mentioned, in selecting investment consultants for the implementation of a responsible investment strategy, trustees should be cognizant of the consultant’s capabilities in relation to ESG risk management. In addition, an appropriate oversight structure should be put into place so as to mitigate agency separation issues (Clark & Urwin, 2007).

Build Expertise and/or Select Managers

Selecting external investment managers

A number of pension plans hire external managers to invest a part or whole of their assets. This is especially true of smaller plans that lack the resources to, or do not want to, build an in-house investment team. Whether the ESG mandate is expected to be managed by an existing manager and/or by a new manager, trustees should seek to understand whether the manager has an RI policy, what it entails, and how it is incorporated into the manager's investment decision-making processes. Such an understanding may be developed through targeted requests for proposals, questionnaires, and interviews.

Ultimately, the manager's approach should be aligned with the plan's ESG goals. Trustees should gauge whether the manager has insights on material ESG risks and opportunities for the sectors, asset classes, and geographies in which the pension fund is invested, and whether the manager is capable of addressing the same. They should also determine whether or not the manager votes proxies and engages in share-holder activism on behalf of its pension clients.

To assess the manager's commitment, trustees may seek examples where ESG factors have influenced final investment decisions by the manager. They should also determine whether the manager shows flexibility with regards to the evolving needs and understanding of the plan's ESG goals and investment mandate.

The number of dedicated staff and their level of expertise in the area of ESG management and implementation is important for both internal and external investment management teams. Trustees should also pay attention to the manager's track record on ESG implementation and impact.

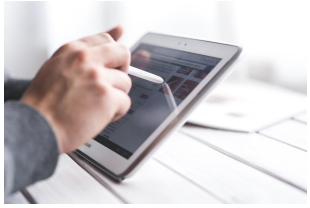
If a manager does not have an active RI policy or approach, trustees should determine whether the manager is able to incorporate the pension fund's own RI policy into its decision-making processes for the fund's investments. Conversely, trustees may consider utilizing the external manager's RI policy as long as it meets the plan's responsible investment goals. Finally, trustees should look to select those managers with whom they can actively engage, once the investment is made, through periodic updates and active ownership practices.

Advantages & Disadvantages of In-House Expertise and External Managers

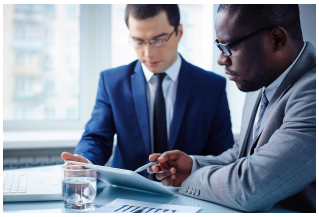
	In-House Expertise	External Managers
ADVANTAGES	• Generally cost-effective • Economies of scale • Better alignment with goals • Better control over outcomes • Opportunity to attract and increase talent pool	• Can be selected according to specific mandate/asset class • Better access to global markets through local presence • Access to high-quality talent pool • Wider skills base
DISADVANTAGES	• Gradual - building expertise and coherence will take time • Limited local presence in global markets • Narrower skills base	• Generally higher costs • Less bargaining power • Potential for weaker alignment with fund's stated goals

3 Review Investments for Financial and ESG Performance

If a plan's RI policy is implemented in-house, the investment team can undertake the following steps to align the RI policy with their investment decision-making process:



SCREENING
In selecting potential responsible investments from a large universe of financially competitive investment opportunities, the internal team may analyze the ESG characteristics of individual investments and sector commitments for alignment with the plan's overall investment policy, including its ESG objectives. Financial performance must always be given the first priority, but ESG characteristics can be considered to the extent that doing so does not discount anticipated performance or, in fact, enhances it.



DUE DILIGENCE
Once the investment universe has been narrowed down to investments of interest, the focus should shift to in-depth financial valuation and ESG impact analysis to determine which investments will best meet the plan's financial and ESG goals.

INVESTMENT
When due diligence is completed and an investment is made, the team should keep an eye on the outcomes expected vs. outcomes achieved and scale up or scale down the investments accordingly. When trustees select external investment managers for the implementation of their RI policy, the investment process and decision is delegated to the manager. However, delegation does not absolve trustees of oversight responsibility. In fact, it increases the need for adequate monitoring of the external manager with the plan's established mandate.

Whether the RI policy is implemented internally or externally, trustees have the ability to exercise active ownership approaches that can enhance the plan's financial and ESG goals. As discussed previously, active ownership tools such as proxy voting and shareholder proposals can be used to engage constructively with underlying portfolio companies, positively influencing corporate governance as well as environmental and social outcomes. Trustees should advise their investment teams of these tools and actively engage in their implementation in tandem with the managers.

Example of a responsible asset manager

The Dutch pension plan PGGM sums up its responsible investment approach as a combination of the following:

1. Fundamental financial analysis **2. ESG integration** **3. Active ownership**

PGGM believes that active ownership allows for "strategic increases or decreases in the stake of a company to stimulate ESG advancements, actions that could substantially leverage the credibility and effectiveness of active ownership in a way that external ownership services cannot"

4 Monitor Performance & Fine-Tune Policy

Regardless of whether the RI policy is implemented internally or through external managers, trustees should take adequate steps to follow up on the impact of the policy. This is particularly important when one or more external managers have been selected to implement the policy. Trustees should therefore develop a process to hold the external managers accountable to the plan's policy and expectations as outlined below. In addition, trustees should continue to fine-tune the plan's RI policy in keeping with evolving circumstances and lessons learned.

Monitor Performance

If the fund's RI policy is invested internally, trustees are able to exercise greater control over the implementation and outcomes of that policy through regular oversight and reviews. Similarly, as part of their monitoring activities of external managers, trustees should request scheduled periodic updates from the asset manager(s) on the financial and ESG performance of the portfolio companies,
sectors, asset classes, and/or geographies that are material to the plan's long-term success. When conducting due diligence and selecting external managers, trustees can set up expectations upfront for a monitoring schedule that may include formal tools (such as quarterly reports) and/or informal tools (such as telephone calls) to request information from managers.

For issues arising between reporting periods that may be of material importance to the fund, trustees should establish protocols for receiving notifications from the external manager on a timely basis. Conversely, if trustees identify new risks and opportunities, they should be able to alert the external manager on these issues and receive an update on its consideration by the manager. Overall, trustees should endeavor to determine the effectiveness of their managers' investment decisions in relation to the RI policy and hold the managers accountable to the same throughout the duration of the investment.

Example of responsible investment monitoring

Amalgamated Bank's LongView Funds regularly communicate with institutional clients on their corporate governance program, current engagements, and projects, and often collaborate with clients and similar investors on core issues of concern. The bank provides regular reports to all clients that detail how it votes its proxies alongside a rationale for each of the votes. The reports also include a review of any shareholder engagements the bank has led or participated in. Similarly, MCG Capital regularly monitors the investment managers it helps select for its clients in order to ensure compliance with the clients' investment goals, particularly in relation to responsible investments. The firm believes that continual monitoring of the portfolio characteristics and qualitative conversations about ESG issues are the best way to monitor and evaluate the success of a manager in meeting clients' responsible investment guidelines.

Fine-tune RI Policy and Outcome Expectations

As mentioned previously, just as with traditional investments, so investments made with an ESG mandate should be evaluated on a scheduled basis. Based on the evaluation, trustees and their investment management teams should continue to refine the understanding and application of their ESG- linked investment beliefs and processes to strengthen the quality of the investment analysis, asset allocation decisions, and outcomes.

COLLABORATING WITH LIKE-MINDED INVESTORS

Trustees may share the knowledge they gain from the implementation of their RI policy with their peers as well as among their internal and external managers. Such knowledge sharing is likely to improve the ultimate outcomes of their own policy and promote greater responsible investments within their peers. Indeed, as noted previously, collaborations among pension plans have been shown to increase the success rate of environmental/social shareholder engagements

For smaller pension plans in particular, collaborations with other like-minded pension plans can be an effective way to access responsible investment opportunities and expertise. For example, collaborations on large investment deals, particularly in infrastructure projects, have been a hallmark of the investment success of top Canadian pension plans. By co-investing with like-minded, long-term investors, pension plans such as the CPPIB, OMERS, and OTPP have been able to not only access large-sized deals, but also leverage the in-house expertise of the each of the participating funds.

Similarly, signatories to the PRI have engaged in a number of collaborative initiatives on ESG issues through the PRI Collaboration Platform (previously the PRI Clearinghouse) that gives signatories “enhanced power and legitimacy” when engaging with a company on ESG issues (Piani, 2013).

PART TWO: Measurement of Responsible Investment Outcomes

Once investments are made, trustees and fiduciaries of pension assets will want to evaluate the performance of these investments against the goals of the fund. For pension plans invested responsibly, these goals include achieving competitive financial returns on invested assets, alongside positive ESG impacts such as improvements in corporate governance, the creation of well-paying jobs, reductions in greenhouse gas emissions, and the development of much-needed infrastructure.

As mentioned, in recent years, there has been a proliferation of ESG data, accompanied by a lack of consistency in data collection methodologies, differences in the number and types of indicator collected, and limited depth in the evaluation of the indicators, particularly social and labor standards. This has led to increased “survey fatigue” among companies providing data and, in the absence of standard data-collection methods and indicators, reduced reliability and usefulness of the reports for investors.

There are hundreds of sustainability agencies administering questionnaires to thousands of companies globally, seeking information on specific areas of concern or across the ESG spectrum. Some providers collect sustainability data on companies through publicly available information, while others do so through tailored questionnaires. One study found that while providers incorporated and analyzed environmental and governance issues in depth, “they usually do not go beyond the formal commitment of the company “in matters related to social and key labor indicators”.

Due to the variety of responsible investment approaches, there is also limited consensus on the metrics that should be used for measuring ESG impacts. This problem is further complicated by investors assigning different weights to specific ESG issues based on the importance of those issues in their overall portfolio, Investment Policy Statements and/or Investment Belief Statements.

To enable trustees to effectively navigate a plethora of available ESG data, we have distilled responsible investment evaluation into seven key criteria.

Seven Key Criteria for Responsible Investment Evaluation

- Focus on long-term performance evaluation
- Factor in economic impacts on the broad economy
- Evaluate ESG factors
- Select the right benchmark
- Use a combination of research resources
- ESG performance evaluation is an iterative process
- Not everything that counts can be counted

Sample Indicators

Below is a sample list of indicators covered by a ratings provider:

ISSUES	INDICATORS	BUSINESS BEHAVIORS
ENVIRONMENTAL	• Environmental strategy and ecodesign • Polution management (prevention & control) • Development of green products and services • Risk management related to the affect on biodiversity • Sustainable water management • Rational energy consumption • Management of atmospheric emissions • Waste management • Management of local pollution • Impact of transport and distribution • Environmental impact on the overall life-cycle of products & services	• Integration of environmental factors in the supply chain • Product safety (process and use)
SOCIAL	• Respect for the fundamental human rights & safeguarding measures • Promotion of labor relations • Respect for trade unions and right to collective bargaining • Nondiscrimination • Exclusion of child labor and forced labor • Promotion of social dialogue • Encouragement of participation • Reorganization policy • Care for individual career planning and professional availability • Quality of remuneration • Improvement of safety, health & prevention • Working hours policy • Contribution to economic & social development of the territories of establishment and their human communities • Social impact of products or services • Contribution to causes of general interest	• Information to customers • Responsible customer solutions • Sustainable relationships with suppliers • Integration of social factors in the supply chain • Product safety (process & use)
GOVERNANCE	• Efficiency of the board of directors and associated committees • Effectiveness of internal controls & audit systems • Respect for shareholders' rights and transparency and efficiency in executive remuneration • Integration of corporate social responsibility (CSR) into corporate governance structures and processes	• Prevention of corruption • Prevention of anti-competitive practices • Transparency and integrity of influence strategies and practices

Key Criteria for RI Evaluation

To enable trustees to effectively navigate a plethora of available ESG data, we have distilled responsible investment evaluation into seven key criteria:

Focus on long-term performance evaluation

As discussed before, pension plans are long-term investors that start collecting contributions when individuals enter the workforce and may not pay out benefits until 30–40 years later. The investment value of pension assets is therefore impacted by long-term economic trends and ESG considerations that manifest many years into the future. In general, pension fund trustees, like other long-term investors, are advised to not get overly concerned with short-term fluctuations in value, since trading based on short-term volatility could sidetrack your long-term goals.

When evaluating responsible investment performance, therefore, trustees should keep in mind the long-term goals of their pension investments as they relate to the well-being of workers and their families.

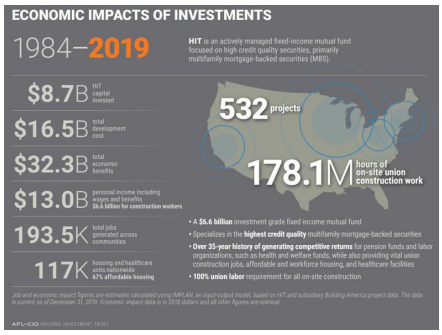
Factor in economic impacts on the broad economy

As holders of broadly diversified investments from all sectors of the economy, pension plans are sometimes called “universal owners.” This is relevant because, while a company can seek to externalize certain costs like pollution or the social impact of poverty wages in order to enhance the company’s near-term bottom line, these costs often negatively impact the broader economy. Since the plan is actually invested in the broader economy through its diversified portfolio, these costs, externalized at the company level, hurt performance at the plan portfolio level. One goal of ESG investing is to identify and consider these externalized costs in investment decision-making.

Economic impacts of investment decisions

As noted by Gladman (2011): A state pension plan may hold stock in a company whose toxic emissions cause illness in state residents and pollute its parks, thereby imposing costs on the state’s health system and reducing state tax revenues from the tourism industry. The company’s pollution may even harm, directly or indirectly, other companies in the state pension plan's portfolio. Seen from the perspective of the state as institutional investor, pension plan returns from this company’s stock may not look as positive after accounting for these related costs. Alternatively, a company that invests in employee education and training may raise the long-term earnings potential of its workers, resulting in higher future tax payments from those individuals to cities and states that may hold the company’s securities in their plans.

Indeed, recent studies on the impacts of responsible property funds, for example, have confirmed that by investing in responsible property plans that specialize in deploying the highest-performing contractors, utilizing team approaches, and crafting trades knowledge and talent, pension funds can play a vital role in creating good jobs and stimulating and strengthening local economies. Below, we provide more details on the impacts of two such pension-financed investment funds.



The **AFL-CIO Housing Investment Trust** (HIT) is a prime example of both a long-term performer and a plan that exhibits full economic impact. Their 2019 Annual Report demonstrated 35 years of investments generating $32.3B in total economic impacts. These competitive returns for pension funds provided vital union construction jobs, affordable and workforce housing, and healthcare facilities. In addition to asset growth, during 2019 the HIT generated gross and net returns of 8.15% and 7.78% for its investors.

Heartland CAPITAL STRATEGIES

Key Criteria for RI Evaluation

Evaluate Material ESG Factors

As previously discussed, pension fund trustees should focus on material ESG factors when incorporating responsible investment strategies. As such, when evaluating the performance of their responsible investments, pension trustees should focus on the key indicators related to their responsible investments in each industry.

Select the Right Benchmark

The success of an investment portfolio is often evaluated against appropriate benchmarks. Generally, market indices tracking a broad asset class, such as large capitalization stocks, or a narrower segment within an asset class, such as technology stocks, are used as benchmarks. Choosing the right benchmark is very important to avoid drawing the wrong conclusions. As such, the appropriate benchmark should reflect the types of investment owned within the investment portfolio. In addition, the underlying riskiness of a benchmark should be evaluated against the established risk target for the benchmarked assets.

Within responsible investments, benchmarks used primarily include the following:

- Exclusionary indices that screen out “sin stock” sectors or companies
- Broad sustainability indices that use a best-in-class approach by “filtering a conventional market index through broad-based sustainability screens”
- Thematic indices that use a bottom-up approach to specifically select companies “exposed to specific activities or issues.” These may include companies with a focus on renewable energy, clean technology, etc.

To enable an apples-to-apples comparison, a strategy that uses exclusionary screens should compare its results with a benchmark that excludes companies based on the same criteria as the strategy. If a strategy combines different responsible investment approaches, it should similarly compare results with a benchmark that does the same.

As noted, however, excessive reliance on a benchmark is cautioned against. This is especially true in times of market downturns when a selected benchmark may show negative returns. Performing in line with the benchmark is no solace when pension assets are not able to meet promised retiree benefits. As such, trustees should be more focused on achieving returns - financial and ESG-based - that are in alignment with the pension fund’s long-term benefit payments to its workers and retirees.

Different benchmarks for different responsible investment approaches

The Dow Jones Sustainability Index (DJSI) family, which applies a best-in-class approach, includes companies that are ranked high in relation to corporate sustainability within their industry. The Vanguard FTSE Social Index (VFTSX), however, chooses to include only those companies that have been selected based on religious or ethical considerations.

Key Criteria for RI Evaluation

Use a Combination of Research Sources

In order to get a full picture of their investments' ESG impacts, trustees and fiduciaries should seek information from a variety of company-specific and sector-specific research reports such as ESG ratings, greenhouse gas emissions and carbon footprint reports, and corporate governance scores.

Financial data providers such as Bloomberg and MSCI have also begun to provide ESG performance data. For instance, Bloomberg's ESG data service provides ESG performance data on over 10,000 companies side by side with other fundamental financial data on these companies.

In addition, many public companies now issue annual corporate sustainability reports (CSRs) that can be gauged for the ESG impacts of the companies' operations. CSRs may not currently offer a standard format for evaluation, although the SASB and GRI are creating standardized accounting and reporting tools to enable public companies to disclose ESG data in a consistent format.

ESG Performance Evaluation is an Iterative Process

Like any other evaluation exercise, the evaluation of an ESG strategy is a continual improvement process. Just as trustees may begin with applying responsible investment strategies to a part of their pension investment portfolio, so the evaluation of the impact of these strategies may be undertaken step-by-step and eventually applied to the pension plan's entire responsible investments.

Not Everything that Counts Can be Counted

Finally, we note that certain positive practices by companies may not readily lend themselves to financially quantifiable metrics. These practices, however, may still be important to pension plans in their role as universal owners and their objective to provide a safe and decent retirement to the plans' participants. As noted by Gladman (2011): [Some] "investors do not want to hold retailers whose overseas factories employ children or subject workers to harassment or violence; they do not want their manufacturing companies to deplete the drinking water of communities in the developing world; and they don't want the fast food chains they hold to build restaurants next to ancient ruins or on indigenous sacred sites. It may not be possible to make a 'business case' for the prevention of labor abuses, drought, and cultural destruction, but responsible investors also see themselves as citizens and human beings who have broader interests than the simple maximization of profit."

In such cases, trustees may still be able to take factors such as collateral benefits into consideration, so long as they do not sacrifice investment returns.

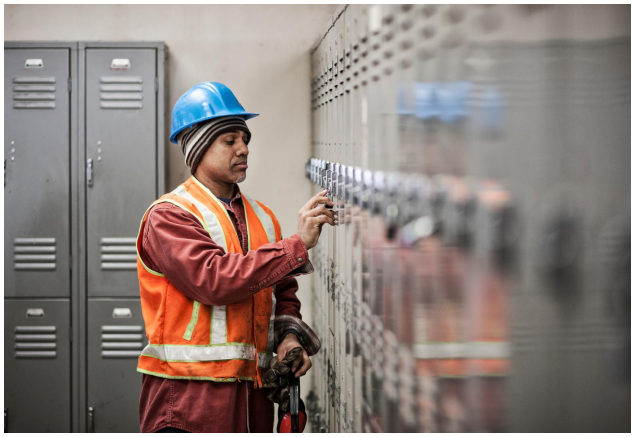
The S in ESG

Heartland and it's "community" of responsible investors, labor and business leaders, treasurers and pension consultants, attorneys and academics have long asserted that responsible investors have, too often, ignored the "S" in ESG. Additionally, we believe that there should be a concerted effort to emphasize labor rights and standards (or, the "L" in social). There is a dire need for stronger labor guideposts for the private assets community, including private equity, real estate, and infrastructure funds. Unions, asset managers, and institutional investors, especially LPs, need to be part of this conversation.

The PRI, which formulated the global ESG principles, is coming to terms with this deficit. This fall, Fiona Reynolds, PRI CEO, invited global labor participants who are UNPRI signatories to respond to a consultation on two of the organization's priorities:

#1 Stewardship on workers' rights
Investors need more leadership from the UNPRI Secretariat and examples of best practice when it comes to carrying out stewardship on "S" (social) issues, specifically on the topic of freedom of association and collective bargaining. Practical examples are required across asset classes and particularly in real assets, public equities and private equity portfolios;

#2 Asset manager accountability
There should be clearer baseline expectations with respect to the integration of social issues - particularly workers' rights - into the asset selection and stewardship performance of signatory asset managers. Asset owners (who use specific asset managers) should have a mechanism to feed concerns around asset manager ESG performance to the UNPRI Secretariat. The PRI Secretariat should work with asset manager signatories to resolve the issues raised by asset owners or run the risk of being delisted.



The S in ESG

The NYU Stern Center for Business and Human Rights and Robert F. Kennedy Human Rights co-sponsored a two-day workshop in 2016 entitled "Measuring Human Rights Performance: Metrics that Drive Change." A 2017 report, based on the convening, focused on the social ("S") performance of companies, defined as the operational effects of a company on the labor and other human rights of the people and communities it touches.

The ESG industry offers a range of benefits in advancing awareness of labor and other human rights issues in business contexts, including: encouraging companies to embed ESG considerations into their corporate cultures; increasing availability of ESG data; enhancing avenues for stakeholder engagement; and improving understanding of priority social issues within specific industries. But, on the whole, current approaches present serious limitations in measuring the social performance for an investment context.

Five Key Findings

Finding 1
Social measurement almost exclusively targets efforts, not effects

Finding 2
"S" is defined in a multitude of (often vague or limited) ways, making it difficult to draw conclusions about company performance

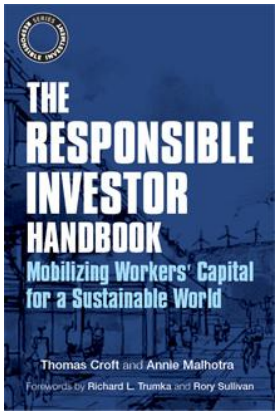
Finding 3
Lack of clarity in measuring "S" increases costs for investors and companies

Finding 4
Supply chains merit special focus, but are largely missing from evaluations of "S"

Finding 5
In the current ESG landscape, transparency too often functions as a substitute for more meaningful measurement of performance

The S in ESG

As an extension to its *Responsible Investor Handbook: Mobilizing Workers' Capital for a Sustainable World*, Heartland is developing guidelines for private asset investment managers and investment vehicles that declare themselves to be responsible investors. This analysis will consider several factors that must first be present for an investment manager and/or investment vehicle to be considered by institutional investors. It will adhere to all appropriate fiduciary guidance. Once these criteria are met, a more discreet analysis of the investment manager and/or investment vehicle will be performed.



Heartland's guidelines will include a comprehensive list of discrete Key Performance Indicators (KPIs) for the Labor component (L) in the Social (S) of ESG. These discrete KPIs will be used first to compile a survey to test the waters, so to speak, of Heartland friends and family. In order to compile this list, we took a step back to prioritize the labor standards that are most important to responsible investors which includes Public pension funds ($4.3 trillion), Taft-Hartley pension funds ($700 billion), Impact investors ($69 billion), Foundations ($1.5 trillion), and Endowments ($617 billion).

The discrete KPIs will flow from these standards:

- **Collective Bargaining Rights: Fair Wages, Benefits, and a Voice**
- **Non Discrimination and Diversity: All levels of the food chain**
- **Responsible Contractor Policy: Fair Wages, Benefits, a Voice, Safety, Education**
- **Employee Board Representation: Voice**
- **Supply Chain Labor Standards: All of the above**

REFERENCES

All material is referenced in The Responsible Investor Handbook. Additional resources for updated information in this mini-book are listed below.

Some useful ESG data sources

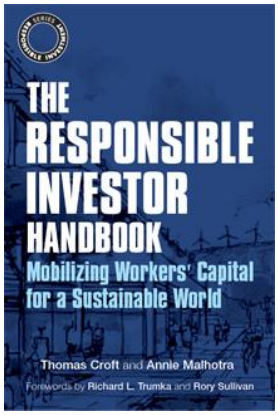
•The Global Reporting Initiative (GRI) provides a standardized reporting framework that is used by a number of companies globally to disclose the ESG impacts of their operations (https://www.globalreporting.org)

•The Sustainability Accounting Standards Board (SASB) develops sustainability accounting standards to help public corporations disclose material, decision-useful information to investors (http://www.sasb.org)

•The Global Real Estate Sustainability Benchmark (GRESB) provides ESG-based data for the global real estate sector (https://www.gresb.com)

•The Centre for International Climate and Environmental Research—Oslo (CICERO) conducts independent, research-based evaluations of green bond investment frameworks to determine their robustness in meeting institutions' environmental objectives (http://www.cicero.uio.no/en/)

•The Green Bond Principles are voluntary process guidelines that recommend transparency and disclosure of the green bond market by clarifying the approach for issuance of a green bond (E&E Publishing, 2014)



Purchase a copy of *The Responsible Investor Handbook* at your favorite bookseller or online

Heartland
CAPITAL STRATEGIES

A product of Heartland Capital Strategies
with assistance from our 2020 Partners

Fellowship Sponsors and/or Hosts