COMPLETING THE ANALYSIS: ESG INTEGRATION

NEPC Impact Investing Committee

Executive Summary

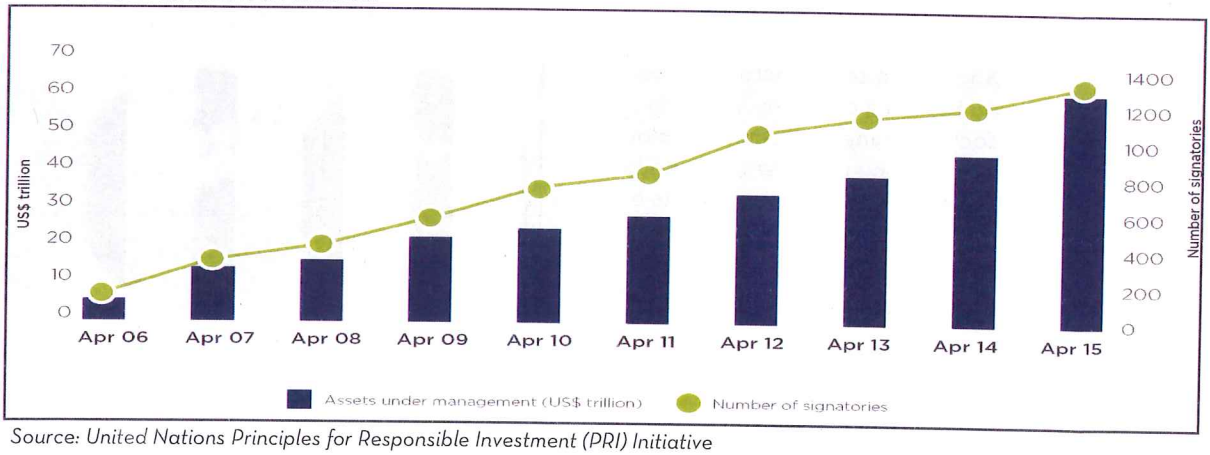
Investment strategies encompassing responsible investing are expanding rapidly amid greater interest from asset managers, pension plans, endowments and foundations, and plan participants, making impact investing more than a passing trend.

The primary challenge remains educating market participants on the different types of approaches and products. Compounding this challenge is the veritable alphabet soup of acronyms—SRI, PRI and MRI, for starters—fueling further confusion in this evolving space. At the risk of adding one more to the mix, ESG is a growing entrant in this field. It relates to the integration of Environmental, Social and Governance (ESG) criteria in the investment process.

At NEPC, we expect the use of ESG analysis to continue to grow as investment managers include it as a complement to the traditional financial evaluation of assets in order to make more informed decisions. At the same time, there is rising demand among investors to align their financial objectives and investment goals with their value systems and beliefs. As a result, assets under management that were "responsibly invested"[1] grew to $59 trillion in 2015, from $4 trillion in 2006, according to the United Nations-supported Principles for Responsible Investment (PRI) initiative (Exhibit 1). The PRI initiative is an international network of investors working together towards responsible investing. The number of signatories grew to 1,380 from 100 over the same period.

We believe that integrating ESG criteria into the investment process is a sound strategy as a growing body of research highlights the material impact that ESG factors have on a company's long-term performance. For instance, a company with weak ESG policies and practices can carry additional headline risk or come under increased regulatory scrutiny, thus making it an unattractive investment prospect. On the other hand, those with strong ESG policies and practices may achieve

Exhibit 1: Growth in ESG Investments



Source: United Nations Principles for Responsible Investment (PRI) Initiative

[1] *Responsibly invested assets under management based on assets under management of UN PRI signatories.*

reputational benefits and potential financial outperformance.

We also believe it is critically important to understand that ESG analysis is not simply a screening approach that confines the investment universe and excludes certain investments. Rather, it is an active investment process utilized to provide an additional context for analysis.

In line with NEPC's commitment to drive developments and trends in the investment landscape while educating investors, this paper provides an overview of ESG factors, while also discussing how investors are incorporating them into the investment process.

ESG "101"

ESG integration is a fast growing form of impact/responsible investing, increasing by 117% between 2012 and 2014, according to a 2014 report by the Global Sustainable Investment Alliance. ESG investing comprises three core non-financial elements, typically assessed in the context of impact investing (Exhibit 2). While there is no standard framework for evaluating ESG considerations, a robust and growing information set has formed over time.

- Environmental: Analyzing a company through an environmental lens focuses broadly on the company's impact on the environment at global and local levels. Considerations include the company's direct impact on the environment from waste to resource utilization and the environment's potential influence on the company, mostly tied to resource scarcity. A company's commitment to reporting on and disclosing its environmental practices is also examined.

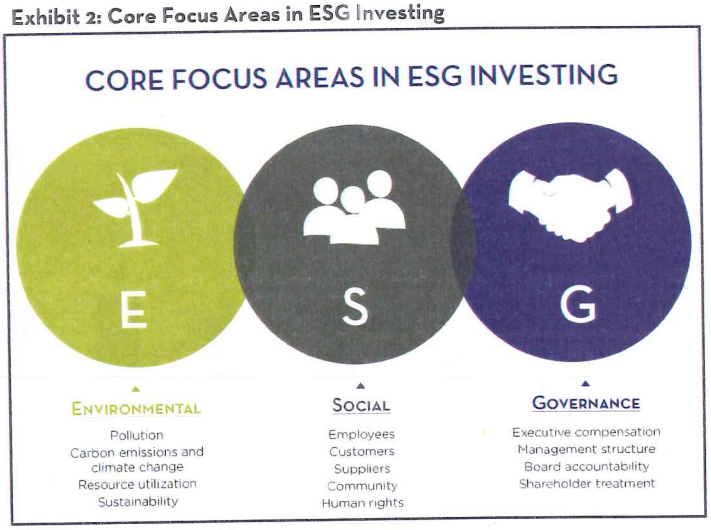
- Social: The social factors are connected to how a company interacts with society - ranging from its employees and customers to the community as a whole. Looking internally at its employees, the focus is on how the company treats its labor force, for instance, on issues related to health and safety, diversity and equitable treatment, and interaction between senior management and subordinate employees. The company's external connections are also examined; this includes the relationship with its customers and whether or not the company fosters consumer protection and satisfaction by emphasizing product quality and safety, and communication and interaction with customers. In addition, the company's philanthropic efforts are also considered.

- Governance: The governance aspect of ESG analysis focuses on the alignment of interests between company management, its shareholders and other stakeholders. Key aspects include assessing management compensation, board structure and accountability, shareholder rights and voting options, and investor communication. Governance factors can also be linked to environmental and social factors as management decisions and company policies are often directly tied to the company's impact on the environment and society.

The Evolution of ESG Analysis

In the evolving world of impact investing, including ESG factors as part of the investment process can be viewed as the next step, leading to a more holistic approach to investing. Often times, when seeking to implement an impact investment program, investors typically use negative screens to reduce the investment universe by eliminating specific exposures not in line with the organization's mission or values. For example, investors with a religious affiliation may exclude certain industries and their underlying securities. These investors may apply a negative screening approach to exclude companies in the alcohol, firearms, defense, tobacco and gambling industries.

Exhibit 2: Core Focus Areas in ESG Investing



Source: UN PRI, ESG Managers

Expanding the negative screening process, investors have also pursued their impact goals through positive screens, that is, identifying and investing in companies that are "best actors." These types of investments may be a strong candidate for an ESG investment or tied directly to an investor's mandate targeting a specific theme, for instance, companies in the renewable energy space if the investor is focused on climate change.

ESG ANALYSIS PROVIDES AN ADDITIONAL CONTEXT FOR SECURITY SELECTION

While it is clear that negative and positive screening tactics are fundamentally tied to ESG factors, a comprehensive ESG analysis within the investment process goes beyond these approaches. ESG analysis aims to expand beyond the traditional analysis of securities, which focuses predominantly on financial data. This is done by including non-financial ESG elements. The end goal: a more informed investment decision-making process. ESG analysis is not meant to preclude certain investments; rather, it is used to provide an additional context for security selection.

Why Does ESG Matter to stakeholders?

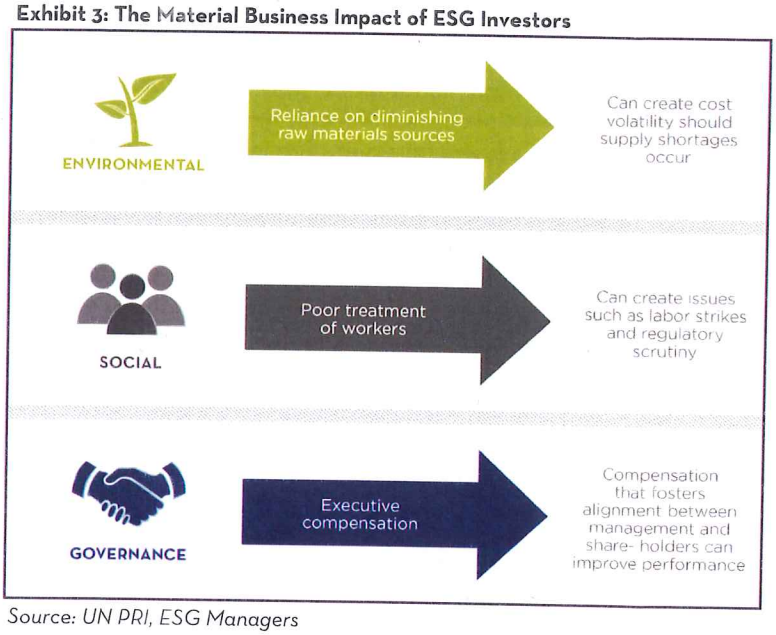
ESG factors have increasingly become a focal point for a number of capital markets participants. Initially viewed as part of the impact investing landscape and driven largely by investors with multiple mandates (investment and impact goals), ESG analysis has evolved into a complementary addition to the traditional investment process. To this end, ESG criteria integration by asset managers reached $4.31 trillion in assets under management in the United States, according to a 2014 report from the Forum for Sustainable and Responsible Investment (US SIF). This represents an increase of over four times since the prior report in 2012, when total assets under management were reported at $1.01 trillion.

The dramatic growth is likely tied to the view that ESG factors can have a material impact on a company's performance. For example, a company with poor waste management policies has the potential to come under scrutiny from public and regulatory bodies, which could ultimately adversely affect its business. In another instance, a company with a strong focus on energy efficiency could potentially benefit from growing social awareness of the environment and regulatory support. A recent Harvard Business School study shows that over time, companies that scored well on material sustainability factors outperformed those that scored poorly. The study analyzed the performance of 2,396 companies from 1992 to 2013, in conjunction with their scores on sustainability/ESG factors determined by the Sustainability Accounting Standards Board (SASB). Companies that scored well on material sustainability factors generated an annualized alpha of 4.83% while those that scored poorly generated an annualized alpha of -2.20%, a difference of 7.03%.[2]

Within each ESG category, similar parallels can be drawn between the non-financial factors and their potential impact on a company's long-term success or failure (Exhibit 3).

As a result, investment managers are increasingly

Exhibit 3: The Material Business Impact of ESG Investors



Source: UN PRI, ESG Managers

[2] *Khan, M., G. Serafeim, and A. Yoon. 'Corporate Sustainability: First Evidence on Materiality." Harvard Business School (working paper) (March 2015).*

incorporating ESG analysis as an additive layer of investment analysis to assist in making more informed investment decisions. For instance, the number of funds incorporating ESG factors into their investment process increased to 925 in 2014 from 201 in 2005, according to the 2014 US SIF report.

In addition, investment managers are also offering a greater variety of products to better satisfy growing investor demand for including ESG considerations into their investment mandates.

THERE IS MATERIALITY TO ESG FACTORS AND THIS PLAYS A ROLE IN A COMPANY'S PERFORMANCE

To this end, it is important to understand what an investment manager is truly doing when it says it incorporates ESG analysis into its process – investors should distinguish between marketing and an impactful contribution that is the result of thoughtful analysis of each investment by considering a combination of financial and non-financial factors.

Investors have also demonstrated growing interest around ESG analysis, urging investment managers to include these elements in their investment process. Earlier this year, an announcement from CalPERS, the largest US pension fund, underscored the developing support and demand for the implementation of ESG factors in the investment process. In May 2015, CalPERS announced it would require the investment managers it works with to identify and articulate ESG considerations within their investment processes. While there are likely multiple reasons behind this decision, it is certainly based around a belief that understanding ESG factors is critical to fully evaluating a potential investment.

NEPC's Stance

At NEPC, we consider ESG analysis important for the following reasons:

i. We believe there is materiality to ESG factors and this often plays a role in a company's long-term performance. A strong body of research suggests that incorporating ESG factors into the investment process can influence returns and risk. In many ways, an effective ESG approach is a well-articulated version of what we see from many investment strategies with sound investment theses – a focus on identifying quality companies able to deliver long-term value for all stakeholders.

ii. Our clients are interested in ESG and we want to meet the investment needs of our clients. We have been fortunate to partner with a number of clients to identify and allocate to high-quality ESG strategies.

iii. We pride ourselves on our deep knowledge of investment strategies. To this end, it is critical for us to understand how investment managers implement their respective processes. More and more frequently, the dialogue around a manager's investment process involves the integration of ESG. In many cases, we have provided insight and feedback to investment managers around best practices in ESG integration.

iv. As leaders in impact investing, we feel it is vital to advance the conversation with clients and investment managers around ESG factors to further understanding and create improved outcomes for all parties.

Varying Approaches to ESG Integration

While the incorporation of ESG analysis into the investment process has grown, approaches and interpretation of ESG factors vary (Exhibit 4). To establish a level of comparability, the differing styles and applications can be broken down into three main areas: Who is performing the analysis? What resources are utilized to help gather information? How does ESG analysis factor into the decision-making investment process?

We have generally observed two different camps based on our broad interaction with managers with regards to who is performing the ESG analysis within an investment organization. Some managers utilize a dedicated and separate ESG team tasked with independently analyzing and developing ESG ratings for companies within their investment universe. These ratings are subsequently married with the traditional/ financial analysis performed by the investment team. Alternatively, other investment managers task their core investment team to incorporate ESG analysis in addition to traditional/ financial analysis. The merits of each approach can be debated. On one hand, dedicated ESG analysts can dig deeper and specialize in understanding the nuanced elements

Manager: Wellington Management

Strategy Type: Traditional and alternative investment strategies. ESG analysis is utilized across the firm.

Why ESG? Wellington believes that ESG factors represent material elements that can drive company performance. Therefore, including ESG analysis in the investment process should allow its investment teams to make more informed decisions for their portfolios.

How? Wellington has an independent ESG analysis team producing research, engaging with companies, and assisting in ESG-related portfolio reviews. Wellington's other investment professionals—portfolio managers and analysts—will leverage the work and insights of the ESG team when analyzing potential investments or assessing portfolio-level risks. Integration of ESG in the investment process can occur during multiple stages. Portfolio managers can combine the work of traditional investment analysts with ESG analysts in assessing investments for the portfolio. They can monitor on-going research and request assistance in evaluating developments at portfolio companies. Additionally, they can utilize the ESG team to perform overall portfolio reviews to gauge exposure to specific ESG risks.

behind specific ESG issues. On the other hand, having a single team responsible for performing traditional and ESG analyses leads to a more holistic understanding.

The data sources utilized in performing ESG analysis also vary by investment manager. This is because there is no standard scoring system associated with ESG and market developments continue to shape what factors should be considered. As such, ESG analysis is an art as much as it is a science. In addition, data to support analysis may be limited and can be challenging to gather. An increasing number of companies are releasing sustainability reports that provide insight on aspects of ESG factors; however, companies with smaller capitalization and those domiciled in emerging markets typically are yet to catch up with their large capitalized and developed market peers. Independent parties, such as the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), are attempting to standardize the processes related to sustainability reporting and disclosures in efforts to increase awareness and access for the investment community. In addition to direct publications from individual companies, third-party research groups offer easy access to ESG analysis and data. Companies, for instance, Sustainalytics, MSCI, Bloomberg, provide a suite of services, including independent analysis and company ratings. Many asset managers utilize these third-party providers to complement their own research efforts – similar to how a buy-side firm might utilize sell-side research.

NEPC has historically identified some variability around how ESG analysis is integrated into the investment decision-making process. Some managers incorporate ESG analysis by adjusting their return targets to coincide with the views and potential impact of ESG inputs; others utilize ESG analysis as veto power against possible investments. This is similar to screening but different in that it occurs during a later stage of the investment analysis process as opposed to screening

Manager: Mariner Investment Group ("Mariner")

Strategy Type: Hedge fund

Why ESG? Mariner became a signatory to the UN PRI in August 2013. The firm is cognizant of the impact that ESG factors can have on its investment positions from the standpoint of alpha generation and risk mitigation. Assessing ESG risks can provide a deeper understanding of the risk of investing in a company. Mariner also believes that shifting social sentiment can drive value for companies from a technical perspective, that is, as investors seek out strong ESG companies, those companies will outperform as investment dollars are allocated to them.

How? Mariner is an early adopter of ESG analysis within the hedge fund community. For example, the firm engages MSCI to score its investments from an ESG perspective for its flag ship multi-strategy product. Given the complexity of some of that account's holdings, MSCI and Mariner worked together to improve its process and develop a more holistic scoring methodology. The ESG scores are aggregated into portfolio-level reports and are utilized by Mariner investment professionals in a variety of ways. Additionally, Mariner's investment professionals incorporate ESG information, from MSCI, Bloomberg, Sustainalytics and/or proprietary analysis, into their investment process where possible and appropriate.

ESG Analysis in Practice

Manager: Blue Wolf Capital Partners[3]

Investment Strategy: Private Equity - Buyout

Why ESG? Blue Wolf's investment strategy incorporates ESG issues throughout the investment lifecycle. The Firm believes its experience in government, labor relations and operations management will help it understand how ESG issues impact multiple stakeholders in businesses.

The Investment: **Healthcare Laundry Systems**

HLS's predecessor company was established by a consortium of not-for-profit healthcare systems in 1973 to provide dedicated laundry services for its owners, who represented some of the largest healthcare institutions in Chicago. In 2002, HLS's former owners commissioned a new facility which operated at a low capacity, creating operational and financial distress. HLS represented an attractive investment opportunity because it was a regional leader with around 30% market share (almost twice that of the next largest player), had strong customer relationships, long-term customer contracts and significant excess capacity. Blue Wolf identified numerous opportunities for improvement across the company as part of the due diligence and active work with HLS after Blue Wolf's investment.

Environmental: Blue Wolf evaluated HLS's environmental impact. Subsequently, it authorized capital spending to reduce water and energy usage, for instance, by investing in a water recycling system to reduce by 20% the amount of water used per pound of laundry, and increasing by 9% the amount of laundry processed per unit of energy.

Social: During ownership, Blue Wolf recognized that HLS's labor policies and practices could be improved. Therefore, it engaged a law firm to evaluate all employment documentation, resulting in a workforce turnover of about 60%. Blue Wolf worked collaboratively with HLS's unions to ensure a fair document evaluation program and, despite not being obliged to do so, negotiated severance benefits with HLS's unions for the affected employees. The law firm also provided all HLS managers and human resources professionals with training on best practices in documentation review and hiring processes and ensured that HLS was in compliance with all employment laws. HLS's employment practices were subsequently audited by the federal government, which concluded that HLS was in compliance with the law. Blue Wolf also increased emphasis on safe production practices and, through initiatives to reward safe behavior and shine a spotlight on poor production practices, the incident rate was reduced by 9%.

Governance: HLS was previously governed by a Board of Directors composed of representatives from its constituent owners. Management was fully outsourced to a third party. The Board was not active at the company; moreover, it viewed HLS as an affiliated service. Consequently, HLS consistently undercharged their institutions for services and did not pursue profitable growth. Through active governance, the acquisition of a complementary business located 90 miles away, and the alignment of interests between Blue Wolf and management, Blue Wolf altered the business focus to a profit-oriented approach from providing not-for-profit services, resulting in increased revenues of over 40% and profitability of more than 220% in 27 months.

Results: The investment in HLS is an example of Blue Wolf's approach to investing in highly complex situations with opportunities for improving various ESG factors. By resolving the ESG fundamentals of a market leader with a stable customer base, Blue Wolf was able to sell HLS within 27 months of investment for a robust profit. Blue Wolf's commitment to concrete ESG actions throughout the lifecycle of an investment was also demonstrated by the donation of a vacant HLS property to The Nature Conservancy upon exiting HLS. The move helped Blue Wolf to sell HLS and allowed The Nature Conservancy to meet its goals for a prominent fundraising campaign.

[3] *"Integrating ESG in Private Equity - A Guide for General Partners." Principles for Responsible Investment (March 2014).*

Exhibit 4: ESG Integration by Investment Type

STRATEGY TYPE	LEVEL OF ESG INTEGRATION	NOTES
Public Equity	High	Highest level of adoption; European market generally ahead of US
Fixed Income	Moderate	ESG ratings more applicable for corporate debt; sovereign debt and structured credit generally less compatible; growing adoption
Private Equity	Moderate	Funds are often smaller in size, have shorter track records and are newer entities; ESG issues can present an opportunity to unlock value
Real Estate	Moderate	Value-add and opportunistic strategies are often more focused on ESG given their emphasis on property repositioning
Real Assets	Moderate	Sustainable real assets present a wide range of options from renewables to agriculture
Hedge Funds	Low	Limited but growing adoption of ESG amongst hedge funds; Will be strategy dependent

Source: NEPC

which constricts the potential investment universe during the initial steps. While poor ESG ratings could prohibit or prevent an investment, good ESG ratings could boost the desire to invest. Further, a negative rating or viewpoint on one ESG component does not necessarily exclude the company from the investment universe going forward. In fact, identifying weak ESG factors could lead to active engagement with the company to improve its ESG performance and unlock value.

Conclusion

It is clear that ESG factors represent non-financial components that can have a material impact on a company's performance. Incorporating ESG analysis into the investment process is an effort to assess these factors, ideally resulting in improved decision-making capabilities and enhanced expectations for risk-adjusted performance.

While ESG analysis is often grouped with screening approaches, significant progress has been made to increase awareness and understanding around this concept. As a result, the universe of investment managers integrating ESG analysis into their decision-making process has rapidly expanded. In addition, the capital invested in these strategies has served to drive product innovation and creation.

We expect to see continued growth around ESG analysis. Over time, we expect to evolve from speaking of ESG analysis as an independent element or an impact-based approach. Instead, ESG analysis will become a standard element of the investment process, providing investors with the ability to make more holistic and informed investment decisions.

Disclaimers and Disclosures

- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.
- This report contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.