Guide to Aon's ESG ratings for fund managers

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Overview of our ESG ratings

Aon has developed an Environmental, Social and Governance (ESG) rating system for buy-rated investment strategies which is designed to assess whether and how well investment managers integrate Responsible Investment (RI), and more specifically ESG considerations, into their investment decision making process.

The ratings will sit alongside our existing strategy and operational due diligence ratings (e.g., staff, business) and are designed to provide an added dimension of fund analysis.

The ESG ratings are based on a variety of qualitative factors, starting with a proprietary due diligence questionnaire, which is completed by the fund manager.

We also conduct a review of managers' RI-related policies and procedures, including a review of their RI policy (if they have one), active ownership, proxy voting and/or stewardship policies and examples of real-time application of these policies.

After a thorough review of the available materials, data and policies, as well as conversations with the fund manager, the lead researcher will award an ESG rating, which is subject to peer review, using an agreed reference framework. Ratings will be updated to reflect any changes in a fund's or strategy's level of ESG integration and developments across the broader RI landscape.

The ESG assessment process is consistent with the UN PRI's Investment Manager reporting framework. The UN PRI is a leading authority within the industry, and has wide and global recognition across the RI community. Their framework is helpful to an industry that contains a wide range of views and interpretations as to what constitutes 'Responsible Investment'.

The ratings are assessed according to the same 1 to 4 scale as all manager research ratings and a description of each ESG rating is as follows:

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4	The fund management team demonstrates high awareness of all known and potentially financially material ESG risks in the investment strategy and, at present, has incorporated appropriate processes to identify, evaluate and potentially mitigate these risks across the entire portfolio.
3	The fund management team demonstrates an above average awareness of potential ESG risks in the investment strategy and has taken essential steps to identify, evaluate and potentially mitigate these risks.
2	The fund management team is aware of potential ESG risks in the investment strategy and has taken some steps to identify, evaluate and potentially mitigate these risks.
1	The fund management team appears unaware or unconcerned with ESG risks in the investment strategy and has not taken any material steps to address ESG considerations in the portfolio.

Assessing manager RI behaviours

The ESG ratings assess the key RI behaviours:

ESG Integration

The degree to which ESG risk factors are incorporated in a manager's investment decision making processes.

To date, investment managers have built valuation models based primarily on traditional financial analysis. ESG integration looks for evidence that managers are also reviewing investments in the light of sustainability issues over longer investment horizons.

Active Ownership

The level of active share ownership a manager can demonstrate alongside active proxy voting policies.

We would distinguish this from an 'activist investor' approach which may cover some common ground but is generally focused on a much shorter time horizon.

Active ownership by means of proxy voting is one mechanism for managers looking to mitigate ESG risks and bring about improvements, particularly in governance. Policies and actions should be demonstrable and equity managers should, at the very least, be able to give evidence of a good degree of engagement in terms of active ownership.

Engagement

The willingness of a manager to engage with companies in relation to ESG risk factors, and the ability of a manager to make progress on these issues.

Managers should be willing to engage with companies that exhibit weaker ESG risk management in order to effect positive change and ultimately increase stock value. For example, fixed income holders, who do not have the ability to vote, can employ many other ways to engage and pursue important issues with companies to bring about change. Levels of engagement should be tracked and monitored.

Collaboration

The extent of external collaboration a manager undertakes with the wider RI community, furthering best practice and understanding.

While arguably of less direct relevance to an ESG rating, levels of collaboration are indicative of a manager's resolve and commitment to furthering understanding and best practice. Ultimately, we believe that higher levels of collaboration will lead to better integration of ESG risks into portfolio management decisions.

A best-in-class approach to RI needs all of the above behaviours within an organisation to fully address sustainability issues at the product level. A strong RI culture is also needed within an organisation and its portfolio management teams for high levels of ESG integration at product level to be credible. While the level of a manager's ESG integration at the product level is at the core of our ESG ratings, other behaviours listed above are then taken into account to form an overall view.

Other perspectives on manager RI capabilities

There are various perspectives on a manager which we can use to gain insight for the above listed RI behaviours, contributing to our overall ESG rating assessment:

Organisation

A manager with a high qualitative ESG score for any strategy is likely to also score highly for its credentials on an RI culture at the organisational level. This will include having a clearly articulated RI policy (among other relevant policies) that is publicly disclosed and actively promoted throughout the organisation with senior management oversight and accountability. Strong governance should be well established and there should be an emphasis at a company level on risk reduction and long-term capital value creation through the integration and consideration of ESG risk factors.

Staff and Resource

Inevitably there will be some benefits of scale in terms of having the resources to identify and to manage the greatest proportion of ESG risks and opportunities. However, we recognise that some smaller boutique firms are very focused on these issues, despite the lack of a separate ESG resource.

Larger investment managers increasingly have an ESG data provider(s) and research resource, with a credible process around integrating ESG risks. They are employing dedicated personnel to articulate and manage sustainability issues across investment platforms for investment teams to leverage.

We prefer portfolio managers and research analysts to have accountability for the integration of ESG risks and a level of senior sponsorship to drive an ESG risk culture in organisations of all sizes.

Process

The ESG landscape is both growing and evolving. Navigating it is highly subjective. As yet, there are no widely accepted global standards that define 'materiality' for ESG impacts. As a result, the assessment of an ESG rating is more about determining whether the manager's process is credible, robust, consistently applied and repeatable.

This is subject to change in the future as consensus emerges around which impact metrics are financially material and as 'impact' eventually becomes easier to measure. We look at key aspects of a manager's investment process and the extent to which the research and integration of ESG risk factors is systematically incorporated into processes.
If you are interested in finding out more, please contact your usual consultant or one of the contacts below.

Contacts

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