Integrating environmental, social and governance (ESG) factors into fund selection

This applies to centrally monitored holdings only. Your Investment Manager has the flexibility, within a controlled framework, to tailor your portfolio with regard to asset allocation and security selection, in order to accommodate your investment requirements.

Quilter Cheviot is one of the largest fund buyers in the UK market. We have a specialist fund research capability responsible for monitoring around 300 closed and open-ended funds. Funds are selected in accordance with Quilter Cheviot's investment strategy, involving both quantitative and qualitative analysis, with significant importance placed on meeting the individual fund managers and their teams.

When we invest via a third-party fund, one of our considerations is how the manager incorporates environmental, social and governance (ESG) factors as well as stewardship practices into their investment process, alongside traditional financial metrics. For us, taking environmental, social and governance issues into account is about ensuring all potential risks to an investment are considered. At worst, not considering ESG factors might lead to reputational and financial damage for companies that are not managing these issues effectively.

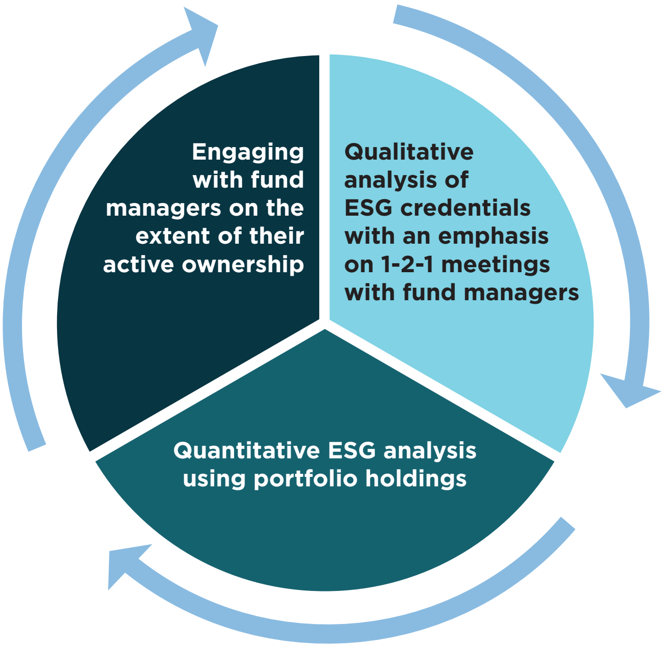
Examples of factors we may look for:

How does the manager approach these factors?

Environmental	Social	Governance
Water & energy: usage/ efficiency/scarcity	Human rights: managing global operations	Remuneration: balancing pay with results
New legislation regarding the use and disposal of plastic	Cyber security: understanding and managing the risks	Board challenge: composition, diversity, succession planning, time served
Commitments to reach net zero greenhouse gas emissions	Business ethics: pay, policies, tax	Share issuance: positive or detrimental
	Safety & quality standards	

These are risks that can lead to reputational and financial damage

The approach encompasses three key elements:



Our Fund Research team considers the approach taken by fund managers to ESG integration and engagement as part of its research and analysis process for evaluating funds. The analysts draw on various ESG inputs including holdings-based analysis via Style Analytics (a factor and ESG analytics provider) and the responses fund managers give to the responsible investment focused Request for Information (RFI) which has firm-level and fund-level questions on areas including responsible investment resource, integration approach, portfolio risk analysis and voting. A key part of the process, however, is the analysts' 1-2-1 meetings with fund managers and other relevant teams, whether as part of their regular due diligence meetings or as separate dedicated meetings, to discuss the approach taken to responsible investment, including:

- The expertise of the investment team and that of any separate responsible investment team, and how these work together.
- How internal and external ESG data is used within the process.
- How ESG factors are incorporated alongside the various traditional financial metrics the fund manager might use to assess companies.
- The extent to which material ESG risks are incorporated in a systematic way into analysis and decision making.
- The extent to which fund managers are engaging with company management with regard to ESG related issues.

The analysts use this assessment to assign an ESG rating to the fund, which reflects the degree to which they believe ESG risks and opportunities are embedded in investment analysis and decision making within the manager's investment process. We believe that ensuring due consideration is given to ESG factors as part of the investment process contributes towards markets properly pricing ESG risks and opportunities and over time should steer portfolios towards more sustainable companies. The Quilter Cheviot ESG fund rating is an internal measure used to compare managers across sectors and asset classes. Given the fast pace of change across the investment fund industry to integrate ESG factors into the investment process, as well as the fast-evolving nature of ESG-related data, metrics, regulations and risks like climate risk, the fund research team see its ESG assessment of fund managers as an iterative process that will adapt over time. The analysts look to build an understanding of not just how ESG factors are incorporated into investment processes and engagement today but also the direction of travel, with further meetings over time to update and engage on progress made.

The ratings used by the fund research team are given below. Funds that have a bias towards sustainability themes or that target positive outcomes will additionally have a + tag. We seek to apply the ratings consistently across regions and asset classes. The ratings are intended to be dynamic as part of an iterative assessment of fund managers as they continue to make progress on investing responsibly.

Level D	Level 0	Level 1	Level 2	Level 3	Level 4
ESG difficult to apply	No consideration of ESG factors	Some consideration of ESG factors	Building process to formally consider ESG factors	Framework for formally considering ESG factors is in place	ESG is fully embedded within investment analysis and management of the strategy

The fund research team's engagements are currently focused on process, where the analysts seek to identify managers that are laggards in terms of their progress to integrate ESG factors and encourage them to take steps to improve. To do this, the team uses their discussions with managers on investment process and stock examples to assess a manager's analysis and understanding of the company's sustainability and broader ESG issues. In addition to this, the team regularly meets sustainability and corporate governance teams to discuss their approach to engagement and their involvement in industry groups as well as PRI signatory status where applicable.

We are mindful of:

- The asset class(es) the manager is investing in.
- The strategy that the manager is implementing.
- Adoption of global and local codes or principles.
- Quality over quantity.

The strategy that the manager is implementing

Depending on the strategy that the manager has adopted, we would expect certain ESG considerations:

	ESG Integration	Engagement & Voting
Active	Consider the extent to which ESG factors are embedded in the analysts' and fund manager's investment decision making	Engagement on ESG issues at firm level and fund manager level. Does the fund manager leave it to others to engage on ESG issues?
Passive	Consider the approach taken if ESG tilts are applied, including the source of ESG data. Any exclusions applied?	How extensive is engagement with companies and is meaningful voting action taken? What do they do where the exposure is synthetic?
Quant/ Systematic	Consider sources and quality of ESG data and the approach taken. Are ESG risks integrated into the systematic process or is ESG considered as an additional factor to add alpha?	Are the shares held long enough to vote?
Ethical/ Exclusions	Consider the exclusions chosen (e.g. traditional values/ unsustainable/a reflection of engagement), exact definitions (e.g. % revenues) and impact (on breadth of investment universe and tracking error) of the negative criteria applied	Engagement on ESG issues at firm level and fund manager level
Sustainable	Consider whether the emphasis is on best in class, sustainable themes, ESG improvers etc. Consider whether the fund has a focus on companies making a positive contribution or a focus on sustainable revenues in more of a financial sense. Consider the degree of positive bias in the portfolio and what exclusions are applied	Engagement on ESG issues at firm level and fund-manager level
Impact	Understand how positive impact is defined, assessed and measured, including how any negative impacts are considered	Engagement on any negative impacts as well as maximising the positive impacts

The asset class(es) the manager is investing in

Different asset classes present different ESG considerations:

	ESG Integration	Engagement & Voting
Equities	E, S and G factors affecting companies	Ability to use voting rights and engage with the board and company management
Fixed Income	ESG analysis for credit issuers similar to equities. Growth of green bonds and newer areas such as bonds linked to the UN Sustainable Development Goals and transition bonds. Sovereign bond analysis can be limited for developed markets but could increasingly incorporate climate risk in future	While they do not have voting rights like shareholders have, large fixed income managers can influence the funding structure of issuers. They can also engage on similar matters to equity investors and reconsider their funding if no progress is made

	ESG Integration	Engagement & Voting
Property	E & S factors affecting property holdings. Consider BREEAM rating and GRESB benchmarking	Incorporation of ESG issues into ownership policies and practices including measurement of sustainability performance of assets
Infrastructure	Look for ESG factors to be considered across the investment lifecycle	Incorporation of ESG issues into ownership policies and practices including measurement of sustainability performance of assets
Absolute Return/ Hedge Funds	Depends on the asset class and strategy	Depends on the strategy and asset classes invested in, whether investments are physical or via derivatives, and the degree of turnover
Private Equity	E & S factors affecting investee companies. Governance structure of investee companies. Approach depends on whether fund of funds or direct	Incorporation of ESG issues into ownership policies and practices

Adoption of global and local codes or principles

We consider whether a firm is signed up to the United Nations' backed Principles for Responsible Investment (PRI) and UK Stewardship code, where appropriate.

As an additional measure, in June 2021, we implemented a requirement that any new funds included in our portfolios must have UN PRI signatory status via their investment manager/adviser. If this is a fund managed by a recently established firm, we would agree a timeline for the firm to sign up to the UN backed PRI. In exceptional circumstances, new funds may be added to our investment universe which are not, and do not have an intention to become a signatory. However, this would be extremely rare and the rationale for not being a signatory would have to be linked explicitly to the specific strategy that the fund was invested in. Any fund being added to coverage in this instance would need to be agreed by the Chief Investment Officer.

For funds within the current centrally monitored investment universe, we have identified a small proportion which are not PRI signatories. We expect a number of these will attain signatory status in the near term. For those that remain, we will continue to engage with them on this subject to continually evaluate the rationale for not becoming a signatory. We accept that for a very limited number of specific strategies, there is no tangible benefit in attaining signatory status at this stage given the nature of the underlying investments.

Managers may also align their strategy to the United Nations' Sustainable Development Goals (UNSDGs) or support other initiatives. We welcome this but will be sceptical where there is little concrete evidence of how they implement these.

Quality over quantity

In line with best practice, we expect managers to regularly publish details of their voting and engagement. In terms of the latter, we look for quality not quantity. Voting on thousands of resolutions at AGMs may be laudable but we are more interested in the thought process that goes into making these decisions. Often this quantum of voting may simply be the result of an automated voting system which does not lead to engagement with companies on key topics.

Fund research reporting

ESG integration is part of our fund research process. Our fund research is entirely proprietary, therefore we will not usually report publicly on manager-specific matters. We publish our voting and engagement record quarterly. Within this, we will include details of engagement with external managers if appropriate.