Sustainable investment in action

Practical solutions for investors

Willis Towers Watson

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Contents

Thank you to our contributors:
Paul Jayasingha, Douglas Crawshaw, Duncan Hale, Todor Todorov, Tom Symons and Tim Perry (Private Markets research), Chris Mansi, Mark Davis and David Merton (Portfolio Management), David Hoile and Jeff Chee (Asset research and Portfolio strategy), Stephen Miles, Amandeep Shihn and James Price (Equity research), Tim Hodgson and Roger Urwin (Thinking Ahead Institute), and Shahrazad Khan (Sustainability specialist).

Sustainable investment is about improving investment outcomes – better returns and lower risk. Investors are now rightfully recognising its central importance in their long-term success, and taking the opportunity to embed it within their investment processes.

We wrote last year that it was "Time for everyone to translate thinking into action"[1] and this update showcases some of what we have been doing to deliver on that for our clients. The strengthening regulatory climate has added to the urgency of taking action, but the positive experience of leading asset owners who are successfully integrating sustainable investment is a great boon to everyone on the sustainability journey.

In the following pages we highlight:

- How we have captured long-term sustainability trends in private markets allocations
- New tools we have developed to integrate sustainability in risk management and asset allocation
- Our expanding partnership with Hermes EOS to strengthen our best-in-class solutions
- An ESG-integrated core equity solution we helped design for our clients
- A deep-dive research project into current stewardship practices

Putting this together, we have a way for all investors to address their sustainability needs. We are fully committed to delivering this into client portfolios, as well as continuing to research and develop more solutions to drive the industry forwards.

Craig Baker
Global Chief Investment Officer

Adam Gillett
Head of Sustainable Investment

[1]www.willistowerswatson.com/en-GB/insights/2018/06/sustainable-investment-time-for-everyone-to-translate-thinking-into-action

Real asset solutions: Compelling sustainable investments

Here is a sample of investments we have made as part of our secure income and multi-asset pooled fund solutions. Some of these investments were also made by our segregated delegated accounts, and indeed in some cases also by our advisory clients. Each example is a compelling investment in its own right, supported by long-term sustainability trends, but as a set these investments benefit further from having attractive societal and environmental impacts. It is worth noting that not all of these required a long lock-up, and even those that did are often tradeable on the secondary market, opening up targeted sustainability opportunities to most investors.

Advanced greenhouses for more sustainable agriculture

- Providing project finance for advanced greenhouses in North America, which give numerous environmental benefits including improved crop yields as well as reduced water consumption, soil erosion, use of chemicals and transportation
- $40m committed with a conservative return expectation of 10-15% IRR[2]
- Specialist manager focused on technology-driven agriculture in an emerging sector of controlled food production

Compelling environmental benefits and use of technology	**Expected 10-15% IRR**	**Committed capital of $40m**

Transforming waste into energy

- The UK's largest Energy From Waste (EfW) project – incinerating non-recyclable waste to generate electricity
- Co-investment into a unique EfW asset with privileged London location and access to the River Thames
- Inflation-linked returns in an asset with very high barriers to entry, helping to tackle the UK's energy and recycling challenge
- Highly experienced management team with leading ESG practices and industry engagement

Unique asset with leading management team	**Anticipated 5-10% IRR**	**15-year contractual cashflows**

Co-investment into a leading medical training institution

- A for-profit educational institution specialising in medical training which is the largest provider of graduate physicians in the US
- Addressing the chronic skills shortage of suitably qualified medical professionals available to meet increasing US demand
- Co-investment with a differentiated private equity firm focusing on long-term, actively owned investments
- Strong inflation-linked returns tied to key emerging educational and healthcare trends

Enrolment, revenue and EBITDA have grown every year for the past 15 years	**Provided 3x more work placements than any other US medical school in 2017**
33% historic IRR	**2.4x historic MOIC[3]**

[2]IRR: Internal Rate of Return
[3]MOIC: Multiple on Invested Capital

[redacted] [redacted] [redacted]

[redacted]

Investment in Japanese solar farms with stunning returns

- Global solar capacity has quadrupled in the last five years with the third largest increase in 2017 coming from Japan
- Co-investment with one of Asia's largest independent infrastructure managers who specialise in the development, construction and operation of solar projects across Asia-Pacific
- Strong returns of 70% IRR and 3.1x MOIC from diversified overseas asset, alongside environmental benefits of renewable energy investment

Manager has over 2.4 gigawatts of existing generation capacity, and over 4.2 gigawatts under development	
70% IRR	**3.1x MOIC**

Temporary accommodation for vulnerable families

- Targeting an attractive and under-explored real estate sub-sector to deliver strong inflation-linked returns supported by the government
- Negotiated attractive fee schedule and fund terms to ensure robust investor governance rights
- Strong inflation-linked, government-supported returns delivering wider societal benefit in helping to address the UK homeless challenge

Target net return ILG[4] + 5%	**80,000 UK households in temporary accommodation**	**Expected distribution yield 5%**

Supporting business resilience and climate preparedness

- Advancing corporate resilience and business preparedness for climate change and volatile weather patterns
- Long-standing investors in this manager's products indirectly financing and providing insurance against natural disasters and weather volatility
- Excellent diversification and risk-adjusted returns from insurance-linked investments
- A market leading manager with constant innovation in weather-related insurance products
- Leveraging our internal insurance expertise as a firm to deepen our manager research in niche areas

Over 20 years managing insurance-linked investments	**Market leading research**	**Alternative capital at record levels in 2018**

[4]ILG: Index-linked Gilt

Venture capital to harness world-leading scientific research

- Leveraging the intellectual power and capacity of the University of Oxford faculty and resources, alongside a high quality and skilled investment team to turn "a thousand years of world-beating science into the next generation of world-leading companies"[5]
- Co-investment with a venture capital firm to finance businesses and projects coming from the University of Oxford's scientific and medical research departments
- Investing in difficult-to-access, unique and innovative entrepreneurial projects and start-ups

World-renowned academic research	**Co-investment with prestigious fellow investors[5]**	**£15m capital allocation**

Specialist social housing for disabled adults

- Providing long-term capital to a developer and manager of social housing projects to address the chronic shortage of affordable specialist housing
- Co-investment to provide specialist supported housing in the UK
- Worked with a manager to structure a fund with attractive fees and governance on an exclusive basis, including being on the investor advisory board
- Strong inflation-linked returns while also contributing to wider societal benefits

90,000 individuals with specialist supported living requirements	
Co-investment with attractive fees and investor governance	**Inflation-linked UK property market exposure**

Investing in UK solar farms

- Invested with one of the UK's largest independent managers sourcing capital for over 60 UK farms and handling 470 megawatts of energy generation capacity
- Members of the investor advisory board to provide in-depth ongoing stewardship
- Strong inflation-linked risk-adjusted returns, while also contributing to wider environmental benefits and the UK decarbonisation agenda

Manager with 470 MW generation capacity at 60+ solar farms	**Record 30% share of UK electricity came from renewables in 2017**

Unlocking hydropower energy in Scotland

- Hydropower is the largest global source of renewable energy
- Co-invested in a Scottish hydropower development working with a specialist mid-market European infrastructure manager
- Low volatility inflation-linked returns generated a net IRR of 37% when sold to a strategic buyer for 40% above the holding value
- Asset simultaneously contributing to the UK's renewable energy agenda

Hydropower produced around 17% of the world's electricity in 2017	
37% net IRR	**Investment sold to a strategic buyer for 40% above holding value**

[5]www.oxfordsciencesinnovation.com – Fellow investors include the Wellcome Trust, Temasek and Tencent.

Early mover investments in government-backed social infrastructure

- Seed and subsequent fund investments with skilled manager aligned to UK National Infrastructure Delivery Plan to invest over £100 billion in housing and social infrastructure by 2021
- Seat on investor advisory board, negotiated improved fund terms, significant fee discount and seed investors in first fund
- Stable contractual cashflows in long duration inflation-linked assets, performing in line with target gross IRR of 10.5%, whilst also providing tangible wider economic and societal benefits

Aligned to £100 billion+ National Infrastructure Delivery Plan	**Seed investor of 30% of initial fund and seat on investor advisory board**
Preferential fee deals negotiated	**On track for target gross IRR of 10.5%**

Co-investment opportunity in early stage cybersecurity venture capital

- Supported by significant tailwinds from technology and digitalisation, co-invested with a venture capital specialist with a strong 20-year track record in cybersecurity
- High expected returns from privileged access to niche venture capital opportunities linked to emerging risks and technological change
- Cybersecurity continues to represent a growing threat globally with cybercrime cost estimated to reach £5 trillion by 2021
- Benefitting from our firm's cybersecurity and insurance insights and expertise to strengthen our research

Manager expertise with 27 cybersecurity investments and 16 exits since 1998	**Early stage co-investment negotiated**

Sustainable investing should be ingrained in real asset investing

In the case of real asset strategies such as property, infrastructure and agriculture, we believe sustainable investing is a natural part of being a successful long-term investor. For example, good property managers understand that developing an energy-efficient building will lead to a broader pool of potential tenants as well as better and less volatile occupancy rates than less efficient buildings. However, even for those investors struggling with this mindset, legislation is now forcing their hand, such as the Energy Act in the UK.

Social infrastructure projects, like the building and maintenance of a school, are long-term projects involving working with government bodies, developers and contractors for the collective need of local communities. Given the investments are asset-based in specific locations, technical, environmental and community impact due diligences are often embedded as part of the main investment thesis. It is vital to make sure these kinds of long-term investments have the support of the nearby community who can help with looking after the assets, as opposed to having a hostile community who can potentially become a threat to the security of those assets. Therefore some of our infrastructure managers have run charity programmes or education programmes in the areas where their assets are based which could have a positive impact in the community, especially when they are in remote rural areas in a developing country.

Stepping up on governance

In several investment cases, we have advocated for, and the investment managers agreed to, one or more independent investment committee members being appointed as part of the governance oversight. These independents have veto rights to stop an investment being made by a fund, and can bring important insight in considering non-financial aspects of investments such as reputational impacts. We believe that improved governance structures directly improves the sustainability of returns in these types of strategies.

Sustainability tools for portfolio management

Our Asset Research Team has been hard at work developing tools to help investors understand how to integrate sustainability, megatrend, and climate-related risks and opportunities into their risk management and portfolio construction processes. We have started to make use of these in our own delegated investment process and are able to advise on how to embed them in other investment processes.

Critically, the focus of this work is to help guide practical actions which can mitigate previously unrecognised risks or target new opportunities to add return. With robust sustainability-related tools historically having been an area of market weakness, our team have sought to take advantage of improving data and measurement to create decision-useful analysis and user-friendly output. The development of these tools follows our megatrends project where we partnered with the Principles for Responsible Investment (PRI), working to identify the key emerging risks and opportunities to investors.[6] We highlight three examples across ESG integration, Stewardship, and Risk, Return & Impact.

1. ESG integration: a total portfolio approach to assessing resilience

What does it do?

We calculate a “resilience” score for a total portfolio. This gauge indicates the total exposure of a portfolio to a wide range of sustainability issues, taking into account major structural differences between different asset classes and public and private markets.

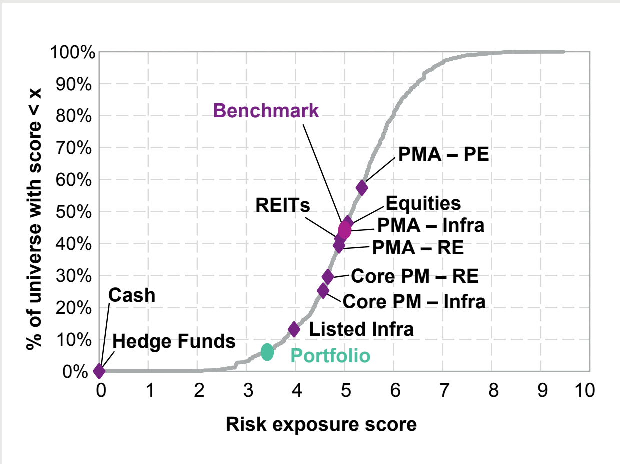
How is the score calculated?

We use big data to identify the sustainability issues that are most material to businesses, regulators, and society. We then apply this materiality assessment across a total portfolio by mapping the exposure of different securities and asset classes to these risks. We also incorporate ESG ratings into the gauge to indicate whether individual assets and the total portfolio are positively or negatively exposed to these issues. A risk exposure score relative to portfolio benchmark is the end result (see *Figure 1*).

Why is it useful?

A fund or portfolio achieving a high resilience score should be less impacted by disruptive sustainability trends over the long term, where resilience can be evaluated in absolute terms or relative to a benchmark or peer group.

Figure 1. **Portfolio sustainability risk exposure vs. security universe**



Source: Willis Towers Watson and MSCI

Resilience scores can also provide a high-level guide to tilting capital allocation to (or from) areas with higher (or lower) scores, thus enhancing strategic asset allocation decisions.

[6]Further detail around these megatrends and accompanying report available at www.willistowerswatson.com/en-GB/insights/2017/12/2017-investment-institutions-trend-index

2. Stewardship: value creation through engagement

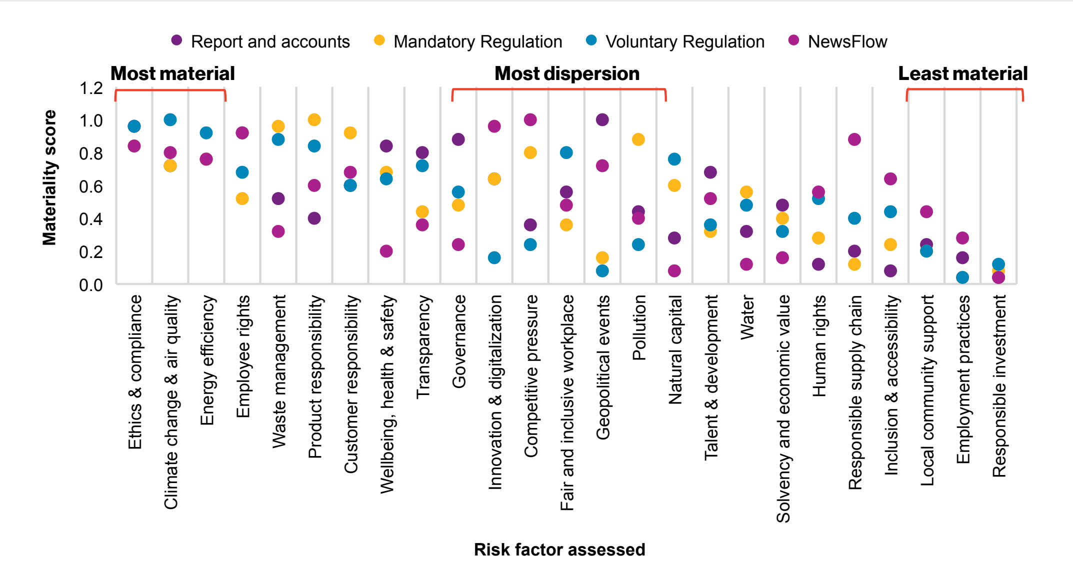
What does it do?

Using big data and natural language processing algorithms we identify and track in an objective way which ESG and technology risks are material to businesses at any point in time. We also analyse how businesses are performing on these topics relative to their peer group. Information on the materiality of these topics comes from companies (via their report and accounts), regulation (which can be voluntary or mandatory) and the news media (i.e. distributed publicly available information). Where topics are highly material for a company or groups of companies this helps us to prioritise these in our risk monitoring and it guides areas for potential engagement.

Give me an example:

Starting at the very high level, for a global universe of public and private companies, "Climate Change and Air Quality" is a material topic for businesses given high levels of new cross-industry mandatory and voluntary regulations and rising societal pressures through news flow. On the other hand, analysis of this objectively sourced data suggests "Local Community Support" is not of material importance to businesses in aggregate despite this being a common area of involvement for their corporate social responsibility teams.

Figure 2. **Materiality map across risk factors**



Source: Datamaran, Willis Towers Watson

3. Risk, Return and Impact: climate scenarios for portfolio and business strategy, and gauging environmental impact

What are climate scenarios?

Scenario analysis helps us understand how assets and portfolios may perform under different states of the world, both favourable and unfavourable. For climate change this crucially involves considering both physical risks and the risks from a transition to a lower carbon economy, and how these are impacted by action or inaction from global policymakers.

How have these climate scenarios been developed?

Our initial inclination was to analyse the impact of climate-driven changes top down – by gauging economic costs/benefits and using that to infer what the most likely and important changes are for asset class prices. This is a useful first step but it is not a sufficient one. To properly quantify the impact of climate change on portfolios or businesses it is also essential for analysis to be undertaken at a microeconomic level – by looking at the impact of physical and transition risks on operational assets and industry profit pools.

How can you measure physical climate risk exposure?

Sophisticated reinsurance modelling tools can be applied to investment portfolios to estimate the exposure of individual assets and the total portfolio to a variety of physical perils, such as floods, wildfires, and cyclones.

We show some sample analysis for a real estate portfolio below. In this case we have calculated the exposure of each property to a set of natural perils and summarised their risk exposure using a simple 1 to 5 risk score. Scores can easily be aggregated across different assets or funds and compared with benchmarks or peer groups. More detailed analysis allows the estimation of the value at risk for individual assets or the portfolio, which calibrates risk in dollar terms using a metric that is familiar to investors.

Figure 3. **Physical risk mapping and peril scoring**

Aggregate Risk Score for an Australian Direct Property Portfolio

Risk by Peril

Coastal Flood	4	Tornado	2	Hailstorm	2
Earthquake	2	Tsunami	2	River Flood	5
Flash Flood	3	Wildfire	0	Tropical Cyclone	1
Lightning	2	Winter storm	4	Volcano	0

Breakdown by Peril

	Winter storm	Coastal Flood	Flash Flood	River Flood
Peril Score	2.53	1.07	3.25	2.07
% Locations	66%	33%	100%	33%
% Asset Valuation	75.4%	26.8%	100%	26.8%

Peril score is an average of each location's score, weighted by total insured value. Percent exposed indicates the proportion of locations by count or by total insured value with a high risk score for each (3 or higher)

River Flood Peril Scores Low High

Source: Willis Towers Watson

Improving stewardship with Hermes EOS

Effective stewardship is a key pillar of sustainable investment. It can protect and enhance the value of assets, and is a critical part of a well-functioning investment system.

We are active industry participants, involved in numerous collaborative initiatives, and are vocal proponents for a robust, effective and fair investment industry. In addition to the work we do ourselves, we have partnered with Hermes Equity Ownership Services (EOS) for the last five years to leverage our public advocacy impact, including having a seat on their client advisory board. The Hermes EOS team of best-in-class stewardship experts engage with policy makers, key industry bodies and oversight organisations, working to raise important, systemic issues and drive positive investment industry change. They work with their clients to give a powerful voice on critical issues, and this is something that all Willis Towers Watson clients directly benefit from.

More recently, we have expanded our relationship with Hermes EOS and appointed them to conduct corporate engagement and provide voting advice on the equity holdings in our flagship pooled equity solution for institutional clients.

With assets of over $4 billion, this solution targets equity outperformance through high conviction, concentrated, long-term mandates. Stewardship is very clearly aligned to this investment philosophy and style, and is consequently an important part of our approach. Therefore, in addition to the stewardship carried out by the fund's underlying managers, Hermes EOS are able to supplement this with their resources and expertise to further enhance the investment proposition. Given the fund size, this additional layer of stewardship delivers compelling value at minimal cost, and access to best-in-class stewardship that would otherwise be very difficult for all but the largest asset owners to get.

[redacted]

[redacted] [redacted]

Hermes EOS credentials[7]

- Over $450 billion of assets under advice invested in >10,000 companies worldwide
- 14+ years of experience
- Global team of 28 professionals
- Engaged with 241 companies on 547 issues during Q3 2018

Services provided

Corporate engagement

Voting

Public policy

Covering a wide range of issues including:

Climate change	Executive remuneration
Human rights	Cyber security

Benefits

- Protect and enhance performance
- Align management with investors
- Drive industry improvements for a better functioning investment system

EOS = Equity Ownership Services

[7]Source: Q3 2018 Hermes public engagement report and www.hermes-investment.com as 30 September 2018

A new equity solution for all

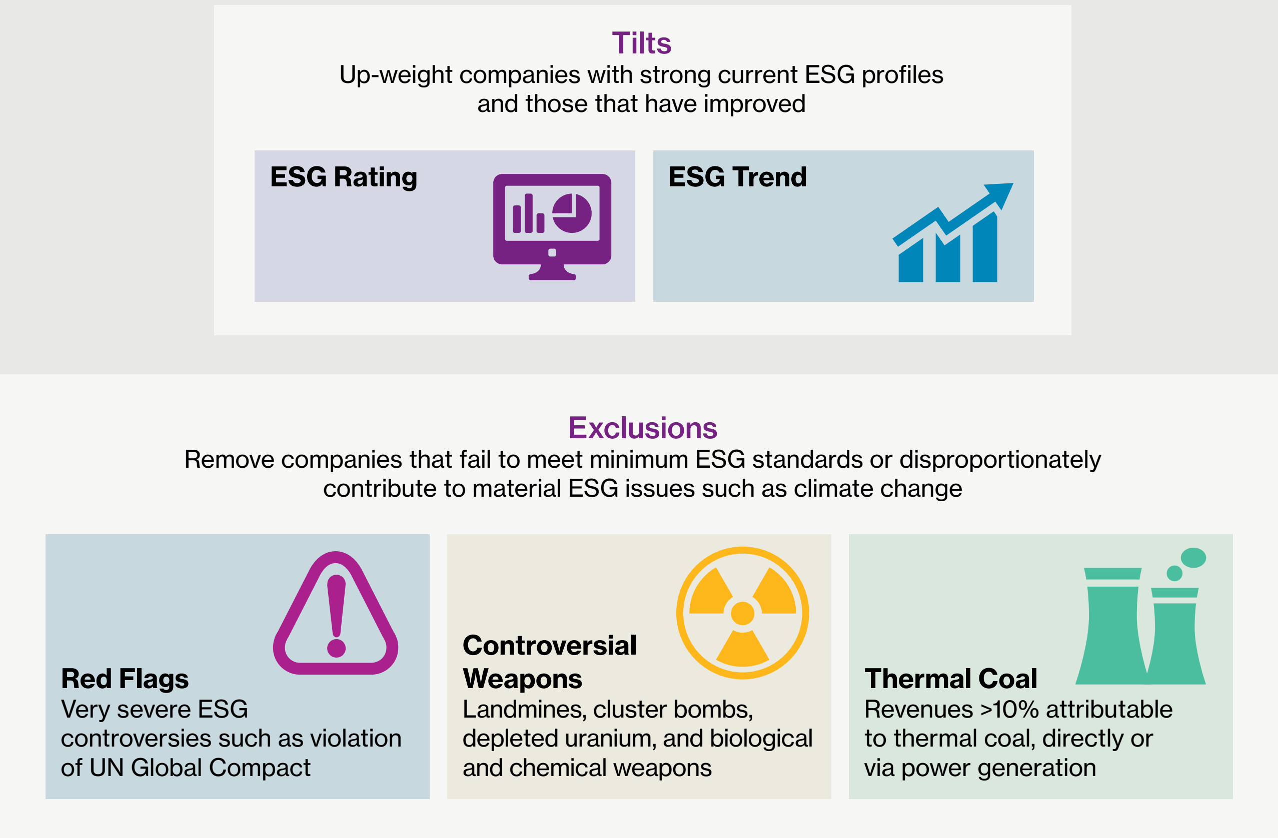
Adaptive Cap ESG Universal is an innovative way for investors to integrate ESG within their core equity allocations

We were delighted to work with MSCI in the development of a new core equity strategy which emphasised the importance of integrating ESG factors within the investment process.

The strategy, known in its simplest form as Adaptive Cap ESG Universal, is a simple, low-cost and differentiated way to invest in listed equities. It is ideal for all investors – less than six months after launch, it has nearly £1 billion in assets as part of DC default strategies (including the Willis Towers Watson UK DC MasterTrust, LifeSight) and core DB allocations.

The strategy is for investors looking to manage a broad range of ESG factors within their public equity portfolios rather than those focusing on a particular issue. It invests in both developed and emerging markets with a highly diversified portfolio that spreads capital and risk more evenly between stocks compared to a traditional index strategy (where large capital and risk allocations go to the largest companies). The strategy invests more in companies with strong and improving ESG attributes. It will exclude a small number of companies that fail to meet minimum ESG standards i.e. those with material exposure to thermal coal, those involved in controversial weapons and those considered to have severe business practice controversies. This means that investors retain the ability to proactively engage with the vast majority of individual companies to drive positive change.

Figure 4. **Adaptive Cap ESG Universal methodology**



Investor stewardship: one hand on the wheel?

What investment activity, when done well, means improved outcomes for everyone: better returns for investors, better run companies, better controlled societal and environmental footprints – all while being cost-effective?

The answer: Stewardship, where asset managers or asset owners engage and vote to positively influence assets they invest in.

Arguably, good stewardship is the most useful function the asset management industry performs. Unlike trying to outperform a benchmark, where there are winners and losers, evidence suggests that effective stewardship has broad benefits.[8] Stewardship is expected by regulators to offset potential conflicts where there is separation of ownership and control. We have seen past examples of what can happen when there is too little oversight: accounting scandals; excessive executive compensation; value destructive acquisitions; environmental damage; loss of customer trust. Of course, this does not all lie at the feet of shareholders, but shareholders do have a responsibility as one of the key checks within the system – alongside boards and regulators.

Unfortunately stewardship activities account for only a very small fraction of asset management industry activity. Why? It is tricky to measure, can involve uncomfortable conversations with company management and it is difficult for asset managers to monetise given the free rider problem that stems from fragmented ownership interests.

In 2009, referring to the global financial crisis, Lord Myners suggested institutional investors were "asleep at the wheel" when it came to stewardship. Perhaps it is now fair to say investors have one hand on the wheel, at least amongst some of the biggest asset managers and asset owners.

But there is still lots more to do. This note is a call to action for the investment community to redouble its stewardship efforts.

To bring the subject to life, this paper is based on our research of six large asset managers emphasising index tracking who collectively manage assets in excess of US$ 17 trillion: BlackRock, Legal & General Investment Management (LGIM), Northern Trust, State Street Global Advisors (SSGA), UBS Asset Management (UBS) and Vanguard. Index managers play a critical role in company stewardship given increasingly large, and growing, ownership levels. Over the last ten years the six managers above grew total assets by 144% on average compared to 35% across the largest 500 asset managers globally.[9]

[8]Dimson, Karakas, Li. Active Ownership, Review of Financial Studies, 2015.
Junkin. Update to the "CalPERS Effect" on Targeted Company Share Prices, Wilshire Associate, 2013.
Hoepner, Oikonomou, Zhou. ESG Engagement in Extractive Industries: return and risk, 2015.
Gond, O'Sullivan, Slager, Homanen, Viehs, Mosony. How ESG engagement creates value for investors and companies, 2018.

[9]Source: Thinking Ahead Institute and Pensions & Investments "The World's largest 500 asset managers", 2018. Index manager sample includes all assets managed by those managers.

Improving practice

"Passive management" is a misleading label when it comes to stewardship. More and more, index managers actively seek to improve the basket of securities within an index by acting as long-term owners.

All the managers in our sample acknowledge their responsibility and opportunity to create value in this area. They contribute to stewardship both at the company level and to various policy initiatives. All are signatories to numerous local stewardship codes.

It is good to see that approaches are progressing from a more rules-based corporate governance function into a broader stewardship approach that looks to address key drivers of long-term value creation. The processes and areas of strength differ between managers which adds diversity – there is no single 'right way'.

Here we highlight positive examples from each of the managers:

BlackRock: Voice from the top

BlackRock has clear 'tone from the top' from Larry Fink's well known public annual letters to company CEOs. This has included a public commitment to double resourcing for the stewardship team which, at the time, was already the largest across the group of managers.

LGIM: Climate Impact Pledge

This is a well signposted multi-year campaign to encourage companies to manage their exposure to climate risk. Launched in 2016, LGIM issued a 2018 progress report naming leaders and laggards. While others note climate risk as a priority, the difference here is the level of coordinated effort and strong communication around a particular theme.

Northern Trust: Hermes EOS

To augment its internal team Northern Trust partners with Hermes EOS, a longstanding, high quality and well-resourced third party stewardship provider. They have worked together on policy and other initiatives. This approach complements the internal engagement platform in the US. One solution to the ownership fragmentation challenge is for different asset owners and asset managers to pool resources and use a group such as Hermes EOS.

SSGA – Gender diversity on boards

Stewardship activity has in the past largely been kept behind closed doors. But if the objective is to achieve broad-based change then sometimes a creative public campaign is powerful. The Fearless Girl sculpture commissioned by SSGA in 2017 got people talking. SSGA identified over 1,200 companies across the United States, Australia, Canada, EMEA and Japan without a single woman on their board. They voted against the Chair for over 500 companies each year – in 2017 and 2018 – that failed to take adequate steps to address this issue. Partly in response to these efforts, 301 companies added a female director.

'Fearless Girl' sculpture by Kristen Visbal

UBS – Solutions

UBS has created bespoke investment solutions which integrate stewardship, particularly in the areas of climate change and impact. These have been developed through leveraging partnerships with leading asset owners, academics, top universities as well as in-house intellectual capital.

Vanguard: Team construction

Vanguard's team has been established and grown significantly over the last few years including new joiners with diverse functional experience from a variety of backgrounds. This helps them to engage credibly with directors on relevant topics (such as risk, audit, human capital, finance, legal, investments) to assess board strength and quality of process. Vanguard also appears to effectively leverage its relationship with certain active managers.

Call to action

We recognise the efforts made by stewardship teams and acknowledge encouraging momentum in both resources and activities. That said, we think there is a long way for the industry to go given the commitment so far has been limited and the opportunities to add value seem so significant.

Below we set out topics where progress seems slow and discuss how stewardship tools might be better applied.

Some may view the list as stretching but we would argue that large indexation managers have a major opportunity and responsibility to bring robust stewardship with deeper engagement models – leveraging their long horizons, breadth of influence and sizable stakes – rather than allowing a stewardship gap to exist following the diminishing interests of traditional active managers.

Topics:

Board quality: Boards of corporate or non-corporate entities provide critical oversight. Each of the asset managers considers this area but we typically see limited emphasis on:

- the effectiveness of the nominations process
- the processes of independent directors: skill diversity; time commitment; resources available to them; range of duties; level of vigilance; how independent they are
- having meaningful input on the appropriateness of individuals for board positions

Executive compensation: An area that consistently takes up significant bandwidth and with strong shareholder rights but evolution seems gradual.

Smaller companies: Tend to receive relatively limited attention, particularly companies based in markets away from the domestic base of the index managers (such as Asia).

Capital structure: Deterioration in corporate balance sheets, for example due to share buybacks is rarely discussed. Related, the challenge of balancing interests of bondholders and shareholders.

Climate risk: On everyone's priority list but, in our view, many progress initiatives lack sufficient urgency and depth.

Local market norms: We understand that cultural nuances across markets can make pushing against the status quo challenging, however, areas such as limited gender diversity of boards in Asia or lack of auditor rotation in the US are often placed in the 'too difficult box'.

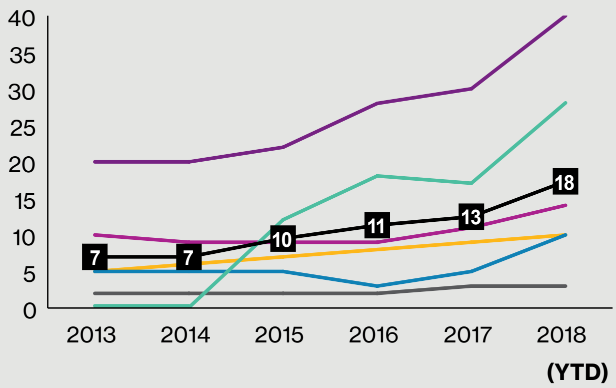
Sensitive subjects: Areas where personal or political values meet financial value – remain underdone, for example transparency on corporate lobbying activities. Without full transparency it is difficult for shareholders to understand potential financial and reputational risks or determine if the board is adequately overseeing those risks.

Tools:

Resources

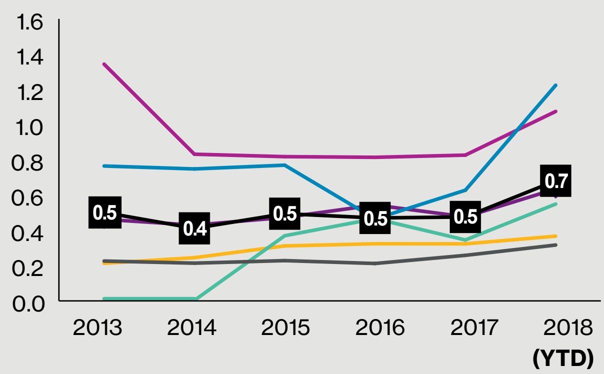
It is encouraging to see that the majority of firms have increased internal stewardship resources over time (see *Figure 5*). However, this upward trend is less obvious when compared to total firm assets under management (see *Figure 6*) and compared to the total number of investment professionals employed.

Figure 5. **Size of stewardship teams over time – the black line shows the average**



Note: Figures supplied by managers; excludes wider firm resources that may contribute to stewardship activities such as internal active investment teams

Figure 6. **Size of stewardship team per $100 billion assets under management – the black line shows the average**



Note: For 2018 YTD, data is as at Q2 or Q3 depending on latest availability; assets data sourced from eVestment

So what's the right number?

The indexation stewardship team job spec is vast given the spread of ownership interests (see *Figure 7*): corporate engagement on dozens of complex issues covering close to 10,000 companies, voting on tens of thousands of resolutions, regionally fragmented public policy engagement, research, disclosure and external communication. This practical task list alone necessitates far bigger teams and the value proposition further justifies increased resourcing.

If just a quarter of a basis point – often merely a rounding error – of every asset invested was directed to stewardship, that could mean teams orders of magnitude bigger than at present (we estimate over 10 times bigger on average).

This would also allow hiring of people with diverse and highly skilled backgrounds including:

- experienced business leaders
- technical experts in areas such as the environment or legal
- those with traditional active management experience

Currently, this type of expertise is often not present.

Figure 7. **The index manager ownership fragmentation challenge**

Many potential topics to tackle such as:

- Long term strategy vs quarterly earnings
- CEO effectiveness and alignment
- Succession planning
- Executive compensation
- Board independence, structure, tenure
- Board diversity, skills, training, resource
- Firm purpose, culture, ethics
- Inclusion and diversity practices
- Shareholder rights
- Reporting and transparency
- Audit
- Capital structure
- Mergers and corporate restructurings
- Human capital management
- Legal compliance
- Cyber and data security
- Climate risk
- Pollution, packaging, energy use
- Consumer issues and public safety
- Resource efficiency
- Supply chain management

Across ~ 10,000 companies

Clarity

We observe a lack of tangible, specific milestones around what stewardship success looks like, even on prioritised topics such as remuneration, climate risk or board quality. Perhaps related, stewardship seems to lack urgency and accountability is soft.

This may lead to the pursuit and celebration of what are inadequate initiatives – in terms of timeliness, scope or magnitude – particularly in pressing areas such as climate risk.

Policies, high-level annual voting statistics and selected anecdotal examples of company discussions paint an incomplete picture. Clearer objectives alongside detailed activity and impact reports on key stewardship themes would allow progress to be measured and enable more engaging communication with clients.

Another useful disclosure would be explanations of voting decisions, including related engagement activity, at controversial AGMs.

Levels of transparency around stewardship activity currently differ widely by manager.

Voting

Care needs to be taken when reading into voting records. Sometimes an asset manager will be making significant engagement efforts behind the scenes with good progress on a particular issue such that a dissenting vote is then not required.

Still, we feel at times there can be too much reticence to vote against company management in order to protect relationships and perhaps to avoid being associated with an 'activist approach'. One example is non-routine shareholder resolutions where some asset managers appear to have a strong default position of supporting company management. This may act as a barrier to change and send a false signal to other investors and peer companies about the issue in question.

Despite it being one of the tools available for stewardship, none of the asset managers in our sample has ever filed a shareholder resolution although we understand that one plans to do so in future.

Stock lending frequently occurs but it is very rare to recall stock before a vote. This does not seem ideal especially given sometimes third parties may borrow stock with the intention of gaining voting power.

Collaboration

There are pockets of excellent collaboration across the industry but inter-manager collaboration within our sample seems low. Large index managers are used to competing intensely for market share, but stewardship is an area where collaboration, not competition, is often in the interests of their clients.

Only the three smaller managers in our sample are signatories of Climate Action 100+, the world's largest collaborative initiative around managing climate risk.

Leadership

The stewardship challenge calls for leadership-minded thinking and, particularly for large indexation managers, a universal owner mindset[10] could capture both the responsibility and opportunity. They could more proactively set out their investment beliefs and consequently the standards expected of companies across a range of issues including, and beyond, those raised in this paper.

The long and winding road ahead

Stewardship is an underappreciated but critical part of corporate oversight. It is showing encouraging momentum across the industry and indexation managers are stepping up with good signs of progress. Still, there is a lot more to reach for with structural challenges to cut through given highly fragmented ownership interests.

For asset managers to put both hands firmly on the wheel more of their clients and intermediaries need to pay close attention and call for a safe journey. Then there's reason to be optimistic.

[10]Universal owners are large, long-horizon organisations that own a slice of the market through their portfolios, and exercise leadership-minded thinking recognising the stake they have and the role they play in the health and effective functioning of the system. See Urwin, Pension Funds as Universal Owners: Leadership Calls and Opportunity Beckons, 2011

Looking to the future

Sustainable investment has come a long way in recent years, however, there is much more to do. At the recent Thinking Ahead Breakfast Seminar[11], over 75% of the audience agreed that the pace of investor action on sustainability remained too slow.

We fully recognise the role we have to play in accelerating this, not least as an OCIO with assets under management in excess of US$120 billion. Sustainability is once again central to the Thinking Ahead Institute's agenda this year, and we are continuing to help investors tackle some of the biggest sustainability challenges including climate change, impact and universal ownership.

Our commitment remains absolute to be at the leading edge of sustainable investment and driving industry progress across our research, solutions and client delivery.

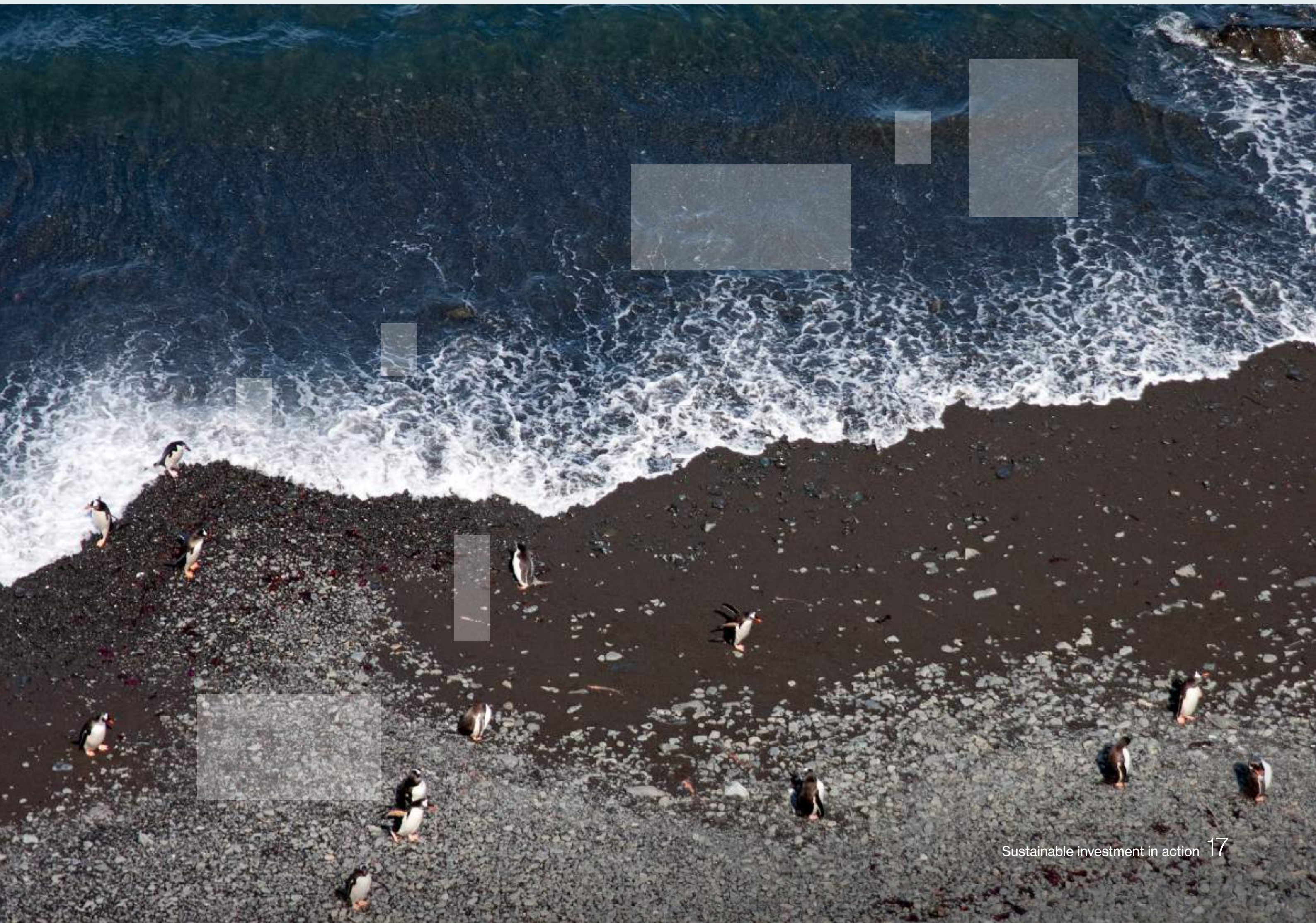
Further information

For more information on sustainable investment please contact your usual Willis Towers Watson contact or:

Craig Baker
Global Chief Investment Officer
+44 (0)1737 284801
craig.baker@willistowerswatson.com

Adam Gillett
Head of Sustainable Investment
+44 (0)20 7170 2492
adam.gillett@willistowerswatson.com

[11]The Thinking Ahead Breakfast Seminar was the first public event of the Thinking Ahead Institute – a not-for-profit think-tank established by Willis Towers Watson with the sole objective of changing the investment industry for the benefit of the end saver. See www.thinkingaheadinstitute.org for more details.



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Willis Towers Watson
51 Lime Street
London
EC3M 7DQ

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