PHOENIX PORTFOLIOS ENVIRONMENTAL AND SOCIAL RATINGS GUIDE

Overview

Phoenix Portfolios (Phoenix) undertakes detailed research into all potential investments with the goal of outperforming stated return hurdles, whilst always acting in the best interests of its clients. As part of this process Phoenix assesses a variety of factors which it believes may add to risk-adjusted returns over time. One such element Phoenix assesses is Environmental, Social and Governance (ESG) characteristics. This guide formalises the process Phoenix undertakes in assessing environmental and social characteristics across its investment universe.

This guide is intended to supplement Phoenix's existing policies and procedures and is not intended to fully document Phoenix's ESG-integration within its investment process. Documentation with regards to Phoenix's governance assessment can be found in its most recent IFSA document, its proprietary "agency score" and its Proxy Voting Policy. Phoenix also has an Engagement and ESG policy, which provides further detail regarding ESG-integration in the investment process.

Reasoning for Inclusion

There has been substantive research undertaken with regards the link between ESG outcomes and financial results. The majority of this research "found a positive correlation"[1] between ESG factors and financial outcomes, however the preponderance of evidence suggests that the is "no evidence companies with attractive environmental and social characteristics have tended to underperform"[2].

ESG integration has always been a significant part of Phoenix's investment process. Phoenix has implemented a formalised governance assessment framework for a long period of time. Historically, environmental and social considerations have been considered on a case-by-case basis and aided in valuation and portfolio management considerations. With the proliferation of evidence "ESG- integration in global equity portfolios provides higher risk-adjusted returns than non-ESG-integrated portfolios"[3] and the increase in relevant environmental and social metrics provided by firms, it was deemed appropriate to formalise an assessment process for environmental and social characteristics.

Organisations and frameworks supporting the proliferation of relevant data include:

- Global Reporting Initiative (GRI)
- GRESB
- Dow Jones Sustainability Index
- National Australian Building Greenhouse Rating System (NABERS)
- Task Force on Climate related Financial Disclosure (TCFD)
- Net Promoter Score
- Employee Engagement Score

[1] Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance, p2
[2] ESG Investing It still makes you feel good, it still makes you money, p3
[3] Establishing ESG as Risk Premia, p9

Assessment Framework

Phoenix focusses its assessment on elements that affect the financial outcomes of the firms it invests in and therefore the outcomes for Phoenix's own clients. In its review of over 2,000 reports on ESG, MSCI found "significant evidence" a process focussing on "1) identifying risks that can affect enterprise value and 2) assess the quality of management's control of these risks"[4] produces better risk adjusted returns. Corroborating this, McKinsey found that, "companies that address material ESG issues and ignore immaterial ones outperform those that address both material and immaterial issues by 4 percent and outperformed those that address neither by 9 percent."[5]

Given this evidence, Phoenix's ratings consider environmental and social risks that:

- Are material
- Can reasonably be expected to impact a firm's enterprise value
- Can be affected by the decisions and actions of management

ESG risks can be thought of (like other economic risks) as either idiosyncratic or systematic. A "high" coherence of evidence has found idiosyncratic ESG risk is linked to financial performance.[6] Research suggests it is "not clear" that systematic risk "has earned a premium over time".[7] Furthermore, research suggests that a causal relationship has been found, in the form of a "company-specific transmission channel [related to] how well high ESG-rated companies manage their business and operational risks."[8] Given this evidence, environment and social ratings are considered with respect to idiosyncratic (or company-specific) outcomes rather than broader systematic risks. These risks are considered elsewhere in the investment process, for example, they may impact the beta used in a discounted cash flow analysis.

Methodology

Environmental and social risks whilst related, are assessed independently of each other. This will lead to the creation of both an environmental rating and a social rating, which complements the already existing "Phoenix agency score", which assesses governance outcomes. When combined, these three scores create a Phoenix ESG rating for each firm under coverage. The Phoenix ESG rating, along with its component E, S and G ratings are actively considered in the portfolio construction process.

Each of the environmental and social ratings are made up of three components:

- Current outcomes
- Trend/Change in outcomes
- Tail risks

Each of these three components are scored from one to five based on the accumulation of evidence collected for each firm under coverage as follows:

- 1 – Very poor
- 2 – Poor
- 3 – Average
- 4 – Good
- 5 – Very Good

[4] Weighing the Evidence: ESG and Equity Returns, p3
[5] Sustaining Sustainability: What institutional investors should do next on ESG
[6] Weighing the Evidence: ESG and Equity Returns, p7
[7] Weighing the Evidence: ESG and Equity Returns, p8
[8] Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance, p5

Current Outcomes

The measurement of current outcomes simply measures how a firm is tracking regarding environmental or social risks, relevant to quantitative and qualitative outcomes at present. This may refer to the absolute level of most recent ESG outcomes, or the level of current ESG outcomes relative to comparable firms. This is included given evidence, “that companies with favourable environment or social characteristics have on average outperformed companies with negative characteristics”[9], or at the least have not tended to underperform.

Trend/Change in Outcomes

Whilst in certain cases, the current ESG practices of a firm may be priced into its valuation, evidence suggests that investing in those with a positive trend or change in ESG outcomes may lead to better risk adjusted returns. In particular, evidence exists that implementation of ratings that consider, the “highest scores [and] most-improving ESG characteristics have tended to outperform.”[10] Further research found that “companies that show a positive ESG rating trend significantly outperformed both the benchmark and a comparable strategy that tilted to portfolio weights with high ESG ratings.”[11]

Tail Risks

Beyond academic research, one of the common ways ESG risks have manifested in a negative way is tail outcomes occurring. This has been observed by Phoenix and a number of other practitioners over time and can have a substantially negative outcome on investments. This is particularly true for the idiosyncratic ESG risks measured by these ratings. Research suggests, “higher ESG-rated companies showed a lower frequency of idiosyncratic risk incidents”,[12] additionally, “higher ESG scores are associated with reduced downside risk of stock returns”.[13] Tail risks are particularly hard to express in a deterministic company valuation and therefore are explicitly considered in ESG ratings and the portfolio construction process.

Company Disclosure

Disclosure of environmental and social outcomes is broadly improving. Despite this, disclosure is not close to being uniform across the investment universe and quality of disclosure varies significantly. As part of Phoenix’s engagement policy, it continues to advocate for better disclosure and use of standardised and relevant metrics as per TCFD recommendations.[14]

Phoenix does acknowledge there is a cost in providing best practice disclosure and that it may be impractical for every company to achieve this. As a broad rule, Phoenix expects best practice disclosures (e.g. scope 1, 2 and 3 carbon emissions, with explanation of calculation) from all ASX 300 companies. For companies outside the ASX 300 a case-by-case determination will be made as to appropriate disclosure based on costs and benefits.

For all ASX 300 companies (where available) we track:

- Scope 1 CO_2 emissions
- Scope 2 CO_2 emission
- Employee Engagement
- GRESB Rating / DJSI Outcomes
- NABERS Rating
- Net Promoter Score

[9] ESG Investing It still makes you feel good, it still makes you money, p3
[10] ESG investing A Social Uprising, p4
[11] Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance, p12
[12] Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance, p6
[13] The impact of ESG on Stock’s Downside Risk and Risk Adjusted Return, p2
[14] Recommendations of the Task Force on Climate-related Financial disclosures, p32

Environmental Ratings

Environmental ratings will be considered in reference to the assessment framework above. Whilst some specific environmental considerations are referenced in this report, assessments are made holistically on a case-by-case basis, based on information provided by any individual firm and broader research. Research suggests that the inclusion of environmental ratings in the investment process is at least unlikely to lead to negative performance, and suggests that, “portfolios with high… environmental responsibility scores might experience insurance like benefits.”[15]

Climate Change

Phoenix accepts the findings of the Intergovernmental Panel on Climate Change’s (IPCC) 2014 Synthesis Report and the subsequent updates provided by the IPCC. The IPCC states, “there are multiple mitigation pathways that are *likely* to limit warming to below 2˚C relative to pre-industrial levels. These pathways require substantial emissions reductions over the next few decades”[16] Within this context, many firms must consider the risks of climate change and address these risks appropriately. Phoenix assesses these plans and considers them in its environmental ratings. Phoenix also tracks and assesses quantitative evidence in the form of Scope 1 and Scope 2 CO2 emissions. Scope 3 CO2 emission are considered on a case-by-case basis, however “the gaps in emissions measurement methodologies, including Scope 3 emissions and… emissions methodologies, make reliable and accurate estimate difficult.”[17]

Energy, Water and Waste Efficiency

Phoenix assesses the energy, water and waste efficiency of its investment universe. Beyond providing benefits to cash flows (such as reduced capital expenditure), resource efficiency can have a tangible impact on key stakeholders. Phoenix predominantly uses NABERS ratings along with company-specific plans to assess resource efficiency. Efforts to improve resource efficiency are particularly seen as positive. For example, improving an existing 2-star NABERS rated building is seen more favourably than the purchase of an existing 5-star NABERS rated building.

Broad Environmental Considerations

The environmental considerations of each individual firm will vary based on their business activities. Phoenix considers whether each firm is addressing its own environmental risks and opportunities on a case-by-case basis. This individualised assessment is central to Phoenix’s environmental ratings and is supported by research suggesting the consideration of idiosyncratic risks in ESG ratings likely maximises risk-adjusted returns.

Social Ratings

Social ratings will be considered in reference to the assessment framework above. Whilst some specific environmental considerations are referenced in this report, assessments are made holistically on a case-by-case basis, based on information provided by any individual firm and broader research. Evidence suggests that “social irresponsibility carries a cost, unlike social responsibility which provides ‘insurance-like’ protection of firm value against negative events.”[18]

Employee Relations

For many firms, performance is closely linked to the performance of employees. Maintaining strong and appropriate employee relations can be a significant factor in company performance. Phoenix tracks employee engagement scores and the use of appropriate employee engagement metrics as an aid to judging the quality of a firm’s employee relations. Phoenix will also gather broader information to make this assessment. This will be compared against a firm’s prior performance, as well as against its peer group.

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[15] Does pension funds’ fiduciary duty prohibit the integration of environmental responsibility criteria in investment processes, p25
[16] IPCC Climate Change 2014 Synthesis Report, p20
[17] Recommendations of the Task Force on Climate-related Financial disclosures, p36
[18] Does pension funds’ fiduciary duty prohibit the integration of environmental responsibility criteria in investment processes, p4

Community Relations

Many firms are granted a “social licence” to operate within their relevant communities. There have been many examples of firms abusing this relationship resulting in destruction of shareholder value and many examples of firms using positive community relations to generate shareholder value. There is also evidence to suggest that “community relations were found to have had a positive effect on risk-adjusted stock returns.”[19]

Diversity

Phoenix assesses the cognitive diversity of firms within its investment universe. This is because when a firm has the ability to “effectively manage the cognition in different managers,” “cognition diversity in the upper echelons positively impacts the performance level”[20] of a firm. Whilst Phoenix considers cognitive diversity to be the key driver of increased performance, other forms of diversity (such as gender, racial and age diversity) can be indicative of cognitive diversity across the firm. Appropriate recognition and encouragement of diversity is seen positively and reflected in stronger social ratings.

Culture

Numerous examples of strong culture leading to strong financial performance and poor culture leading to poor business outcomes have been observed over time. Whilst assessing the culture of a firm externally is notoriously difficult, Phoenix makes efforts to assess the culture of any firm under coverage. This consideration will have a direct impact on Phoenix’s social rating.

Brand and Customer Relationship

Brand and customer relationships are an essential component to the success or otherwise of many firms. Phoenix assesses this using both qualitative information, such as case studies, and quantitative information, such as Net Promoter Scores.

Broad Social Considerations

The social considerations of each individual firm will vary based on their business activities. Phoenix considers whether each firm is addressing its own social risks and opportunities on a case-by-case basis. This individualised assessment is central to Phoenix’s social ratings and is supported by research suggesting the consideration of idiosyncratic risks in ESG ratings likely maximises risk-adjusted returns.

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[19] Stock return in relation to environmental, social, and governance performance: Mispricing or compensation for risk?, p1

[20] Effect of Cognition Diversity in the Top Management of the Firm Performance, p4