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Pru
part of M&G plc

ESG – Q&A for advisers

A summary of key questions and answers on what ESG is and how it is incorporated within the M&G Treasury and Investment Offices ESG policy.

1 What is ESG?

ESG investing is an approach to managing assets where investors explicitly acknowledge the relevance of environmental, social and governance (ESG) factors in their investment decisions, as well as their own role as owners and creditors, with the long-term return of an investment portfolio in mind. In other words, ESG investing aims to correctly price social, environmental and economic risks and opportunities.

The **environmental (E)** dimension measures a company's impact on the natural ecosystem, which comprises its emissions (e.g. greenhouse gases), the efficient use of natural resources in the production process (e.g. in terms of energy, water or materials), pollution and waste (e.g. spills), and innovation efforts to eco design its products.

The **social (S)** dimension covers a company's relations with its workforce, customers and society. It includes efforts to maintain loyal workers (e.g. employment quality, health & safety, training and development), satisfy customers (e.g. produce quality goods and services that keep customers safe), and being a good citizen in the communities where it operates.

The **governance (G)** dimension captures the systems in place for management to act in the best interests of its long-term shareholders, which include safeguarding shareholder rights (e.g. limiting anti-takeover defences), having a functional board (e.g. with experienced, diverse and independent members), maintaining well-designed executive compensation policies, and avoiding illegal practices, such as fraud and bribery.

This is not 'either/or', ESG investing is not mutually exclusive with regular investing. Rather, explicitly pricing ESG risks and opportunities should complement any investment strategy.

2 Why is ESG growing in popularity?

The number of both retail and institutional investors who are looking to allocate their capital to ESG areas is on the rise, with ESG investing representing a growing proportion of overall capital market investments. The Global Sustainable Investment Alliance (2019) reported that more than US$30 trillion worldwide was managed according to responsible investment criteria in 2018 and this number is on the rise. (Source. GSI-alliance.org 2019).

There are a number of reasons as to why ESG is growing in popularity, but there is an overarching statement behind all of them, that ESG investing is here to stay. Over the years, there has been an increasing interest from customers to understand and influence the non-financial outcomes that their investments may be having and hence companies have had to respond to this demand.

On the structural side, one driving force behind the incorporation of ESG issues is societal change – for example, the transfer of wealth from baby boomers to the millennial generation and the increasing proportion of high-net-worth individuals who express a preference for allocating wealth in a more sustainable way.

Another instigator of change is the increased investment regulation in the aftermath of the Global Financial Crisis, such as prudential regulation affecting asset owners, stewardship codes for investment managers, and corporate disclosure rules set by governments or stock exchanges.

Finally, investors have become increasingly aware that ESG factors can impact the risk and return characteristics of companies, sectors and securities. It is increasingly becoming a market standard from investment houses to integrate the financial implications of ESG factor into their investment processes.

3 What are the main types of ESG strategy?

There are a huge variety of ESG strategies within the investment world and you will rarely find two identical strategies. For example, even exclusions alone will vary from fund to fund. At M&G we refer to four different types of ESG funds:

ESG integrated funds

ESG+ funds

Sustainable funds

Impact funds

These funds will all apply different levels of various ESG strategies. For example, all funds in each range will apply an agreed set of exclusions, whether they be norms-based exclusions based on generally accepted international standards or sector screens, which exclude investments based on the sector they operate in (e.g. tobacco, coal). These exclusions may build on each other.

Shareholder engagement is another strategy that all fund ranges will employ where possible. Shareholder engagement reflects active ownership by investors in which the investor seeks to influence a company's decisions on ESG matters, either through corporate dialogue or voting. The fund manager will engage with company management on ESG issues and advise and influence the company where possible.

ESG integrated funds will ensure that financially material ESG data is available to all funds and integrated into the risk management and decision-making process. Our existing PruFund range of funds fall into this category.

ESG+ funds Apply a positive ESG tilt to companies/issuers with better ESG characteristics (i.e. excluding companies or issuers with poorer ESG characteristics, for example those that have high exposure to significant ESG risks and fail to manage such risks).

Sustainable funds are driven by sustainability themed considerations, which might include climate change mitigation, pollution prevention, sustainability solutions (environmental, social) and approaches that address one or more of the UN Sustainable Development Goals (SDGs). There is a clear ambition, supported by explicit targets, to drive sustainability across the portfolio and use an investment approach that selects companies/issuers with strong ESG credentials.

Impact funds aim to invest in companies that deliver material, measurable positive societal impacts by addressing the world's major social and environmental challenges, while generating competitive economic returns.

4 How is ESG considered within M&G plc

M&G plc has two ESG priorities of climate change and Diversity and Inclusion, given their importance for the long-term sustainability of all businesses and society as a whole. We aim to be carbon net zero as a corporate entity by 2030. Further, we aim to achieve 40% female and 20% ethnicity representation in our leadership by 2025.

Prudential Assurance Company (Asset Owner) aims to achieve net zero carbon emissions across AUMA (assets under management and administration) by 2050, of which the PruFund range is a material part. This is in line with the Net-Zero Asset Owners Alliance (a United Nations initiative whereby the members commit to reduce the carbon emissions of their investment portfolios to Net-Zero by 2050).

An important aspect of how the Asset Owner manages its investments is the integration of ESG factors into investment decisions, which we believe can help better manage risks and generate sustainable, long-term returns for customers. We do this through implementing ESG considerations into the Strategic Asset Allocation (SAA) process, integrating ESG factors into manager selection and oversight and considering ESG factors in mandate design.

M&G Treasury and Investment Office (T&IO) look to the asset managers they select to:

- engage with companies as active owners that help foster a more sustainable economy,
- participate in voting on key issues such as climate,
- manage assets in accordance with the M&G Asset Owner ESG Policy and
- ensure that ESG is integrated into their investment process.

The majority of PruFund assets are managed by M&G Investments, whose Stewardship and Sustainability team provide issuer and sector specific ESG risk and opportunity analysis and education on sustainability themes to portfolio managers and analysts. They also lead on company engagement on a cross-asset class basis.

5 What is the M&G Treasury & Investment Office (Asset Owner) ESG Policy?

The M&G Treasury and Investment Offices ESG Policy reflects the importance of the consideration of ESG factors in investment strategy, asset allocation, mandate design and manager selection and oversight.

In regards to portfolio exclusions, the Asset Owner Policy currently excludes companies that manufacture controversial weapons including anti-personnel land mines, cluster munitions, biological weapons and chemical weapons, as well as companies that are complicit in violations of the Nuclear Non-Proliferation Treaty. These weapons are currently prohibited by international treaties which the UK has signed and ratified, hence we have complied with the spirit of these treaties.

Although not currently prohibited by international treaty, we have also decided to exclude depleted uranium munitions from our portfolios as we do not wish to support or be associated with the disproportionate and indiscriminate harm that these weapons can do to civilians.

We use norms-based screening to identify companies that maliciously violate global norms in the areas of human rights, labour standards, environmental standards and anti-corruption. We will exclude companies that flag on our norms-based screens as egregious violators from our portfolios, and whom we believe will not change their behaviour in response to engagement.

To give a brief insight into the screening process, the Investment Office will look deeply into each flagged company, and judge them against our values of Care and Integrity, with consideration as to whether violations are alleged or verified, the legality and nature of the event (permanence, impact and planning or negligence), company cooperation with investigations and whether there is a wider pattern of behaviour present across flags that might indicate deeper problems in the corporate culture.

Both the controversial weapons and norms-based screening exclusions are applied to all funds and mandates (active or passive) where the Investment Office is empowered to make investment decisions.

6 Have the M&G Treasury & Investment Office investment beliefs changed?

Our investment beliefs are a key driver of our investment strategies and include factors such as diversification, active management and a long-term approach. The fundamental process of how we manage money has not changed but we have implemented an additional core belief on the importance of ESG factors and risks in our portfolios. Whilst we have taken into account ESG factors and risks in mandate design in the past, this was carried out in line with the ESG policies and views of the investment manager. However, the M&G Asset Owner ESG Policy enables us to implement ESG views and policies more consistently and directly across our mandates.

7 What are the M&G Treasury & Investment Office ESG principles?

Our general ESG investment principles allow us to approach any ESG issue with a general mode of thinking that enables us to derive an appropriate investment strategy. Our overarching principle is that we will take into consideration ESG factors that have the potential to have a material financial impact whilst continuing to take a long-term and multi-generational approach to investing.

Where we use active management, we will require the investment managers that we appoint to engage with and influence investee companies on our behalf, to achieve more sustainable business models and change their behaviour where appropriate. We also expect our investment managers to report on the results of their engagement strategy.

We believe that active ownership should be aligned with active management. Active ownership that focuses on transitioning companies towards the creation of a more sustainable economy is possible and desirable across all types of investment mandates.

If we are unable to change, or believe that we will have little effect on an investee company's behaviour, we may revise our mandates to require our asset manager to reduce our holding in that company in favour of a company whose behaviours are more aligned with our views. We may also exclude a company from our investment portfolios, as a last resort.

These are just some of our ESG principles that we take into account when considering our investment decisions. It is important to note that we review our ESG thinking and investment strategies regularly in order to align with scientific and technological improvements, changes in global economy, and evolution in sustainability and ethics.

8 How is the M&G Treasury & Investment Office integrating ESG factors into the Strategic Asset Allocation (SAA) process?

The Long Term Investment Strategy (LTIS) team recommends the asset allocation of the Asset Owner's fund ranges. The team produce a set of Capital Market Assumptions, based on historical data, ex-ante analysis, internal and external research, for the expected returns, volatilities and correlations of the various asset classes within the PruFund ranges. LTIS then use a proprietary Economic Scenario Generator 'GeneSIS' to carry out stochastic modelling based on these assumptions, which involves mapping out a full range of possible future asset allocations.

ESG factors are integrated into the SAA process through three main channels. These are:

- **Sensitivity analysis** – portfolio exposures to ESG factors assessed in terms of physical, transition and litigation risks
- **Country Risk Categorisation** – framework extended in 2019 to add environmental factors alongside existing social and governance factors
- **Benchmark construction** – analysis to understand the distribution of ESG factor exposures within benchmarks

9 How is the M&G Treasury & Investment Office integrating ESG factors into investment manager oversight and selection?

The investment due diligence (IDD) process is carried out by the Manager Oversight team within the Investment Office. The team looks to the asset managers they select to:

- engage with companies as active owners that help foster a more sustainable economy,
- participate in voting on key issues such as climate,
- manage assets in accordance with the M&G Asset Owner ESG Policy and
- ensure that ESG is integrated into their investment process.

The investment due diligence process is designed in such a way as to enable the Manager Oversight team to gain conviction that an active investment manager will add value for policy holders over the long-term. As such, the team needs to gain assurance that an investment manager is managing the assets in a way that is consistent with M&G's Asset Owner ESG Policy and ESG considerations are now being factored into the Manager Selection process through three main channels:

- **Annual ESG Questionnaire** – to review how ESG factors are integrated into the asset manager's policies and procedures
- **ESG Case Studies** – the team conducts regular quantitative and qualitative analysis to evidence compliance with the asset manager's stated ESG policies and procedures
- **Annual due diligence meetings / IDD scorecard** – including ESG as a standing agenda item

10 How does ESG apply to the PruFund range?

An important aspect of how the Asset Owner manages its investments is the integration of Environmental, Social and Governance (ESG) factors into investment decisions, which we believe can help better manage risks and generate sustainable, long-term returns for customers.

The process and philosophy behind how we manage PruFund money has not changed, only evolved. We are, and always will be, long-term investors and so believe that ESG factors should be considered in addition to and alongside the more traditional financial metrics. We also believe that companies which capture and embed ESG opportunities and risks into their strategy are more likely to be successful.

As Asset Owner, we ensure that ESG considerations are integrated into all of our investment decisions relating to asset allocation, manager selection and oversight and mandate design.

The new M&G ESG Asset Owner Policy has provided a framework for agreeing exclusions and how to manage engagement in regards to the PruFund range. However, it is important to note that the introduction of the policy did not change the 2020 SAA nor did it change existing Expected Growth Rates (EGRs) or fund charges. Some exclusions such as cluster munitions were already in place for PruFund but the policy did lead to some additional exclusions in relation to coal and United Nations Global Compact violators.

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