

Key points

The environmental, social and corporate governance (ESG) factors that sustainable and responsible investment (SRI) analysts and fund managers specialise in are increasingly material to the value of corporations (CFA, 2008).

SRI strategies are being adopted by institutional investors seeking to maximise investment returns.

There are four main SRI strategies: integration, engagement, positive screening and negative screening. These can be deployed independently as alternatives or combined to develop increasingly sophisticated SRI strategies.

However, some contradictions can emerge when combining strategies. The key is in understanding these implications and selecting the approach that the Trustees consider best fits the investment strategy of the scheme.

From a Trustee's perspective, integrating ESG considerations into investment analysis so as to more reliably predict investment performance is permissible and according to the legal firm Freshfields arguably required.

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In order to accurately value a company, the material environmental, social and corporate governance issues should be identified and included in the analysis. Where specific potentially material issues have not been properly valued by the market, then an inefficiency arises that investors may be able to exploit.

There are a number of different terms used within the Sustainable and Responsible Investment (SRI) industry. They have been poorly defined and are often used inconsistently.

This introductory guide is aimed at individuals who may be considering the relative merits of an SRI strategy for the first time. It is intended to cut through the industry jargon by defining some of the various terms (which are italicised). It presents the main SRI strategies, and summarises their associated costs and benefits. It also briefly covers how SRI relates to the fiduciary duties of pension fund trustees, as well as highlighting sources of further information for those looking to gain a more detailed understanding. The primary aim is to clarify the terminology in order to allow trustees to make better-informed investment decisions.

Some of the questions regarding where and how SRI can enhance investment performance are touched on here. However, we have intentionally not highlighted the financial performance of any one fund, nor have we included any stock recommendations.

Background

SRI investment strategies are increasingly being adopted by institutional investors seeking to maximise investment returns. According to the 2010 study by Eurosif of the Responsible Investment market in Europe, total assets under management increased from €2.7 trillion to €5 trillion, as of December 31, 2009. This represents growth of 87% since 2008.

The range of SRI products is also increasing. A few years ago primarily long-only equity funds were available. However, the range now includes balanced funds, fund of funds, absolute return and guaranteed products. SRI is also broadening to include other asset classes, with a particularly notable increase in the availability of corporate fixed income and property funds.

The advent of this interest stems in part from the now \$25 trillion of assets signed up to the United Nations' global Principles for Responsible Investment initiative (UN PRI – see also page 7). This initiative requires commitments from signatories to integrate SRI issues into the investment process, and the demands that they place on product providers. As a result, its members are increasingly stimulating new

product innovation through their requests for proposals for SRI funds and bespoke segregated mandates.

This increased demand for SRI funds also stems from two further areas. First, there is now greater recognition that conventional asset management analysis can be too short term and too narrow in the range of factors that are typically included in the valuation. Second, voters, policy makers, and consumers have become increasingly concerned that global economic development is not on a sustainable footing. This has meant that the environmental, social and corporate governance factors that SRI analysts and fund managers specialise in are becoming increasingly material to investment valuation.

In recognition of this latter point, The Chartered Financial Analyst (CFA) Institute recently issued its first 'manual for investors' on Environmental, Social and Governance Factors at listed companies (CFA, 2008). This manual captures the financial rationale for increasing the number of SRI factors in the analysis as follows:

"Successful investing is dependent on one's ability to discern the factors that influence the market's valuation of a Company and then judge the accuracy of that valuation. Analysts are generally well versed in using financial metrics to understand those drivers of corporate value and lend skilled interpretation to what is often highly detailed accounting data. In recent years, however, non-financial factors – including environmental, social, and governance factors – have figured ever more prominently in the value of corporations. For example, at companies such as Enron Corporation, WorldCom, and Parmalat, corporate scandals, and in some instances outright fraud, have rendered financial data untrustworthy and brought corporate governance issues to the forefront of Investor consideration. Similarly, increased sensitivity to the potential implications of climate change has sparked interest in the investment consequences of companies' strategic positioning to address this environmental concern."

In other words, in order to accurately value a company, the material environmental, social and corporate governance issues should be identified and included in the analysis. Where specific potentially material issues have not been properly valued by the market, then an inefficiency arises that investors may be able to exploit.

Increasingly, fund managers are claiming that they seek to use a deeper understanding of a company's environmental, social and corporate governance performance to exploit this inefficiency and beat more conventional investment approaches. This range of factors has come to be termed **ESG**, and covers a very broad spectrum of issues: from remuneration, shareholder rights, corporate control, and accounting practices, to human capital, climate change, human rights, supply chain labour standards and business ethics.

In terms of the evidence regarding the performance impact of **integrating ESG** issues, Mercer Investment Consulting and the United Nations Asset Management Working Group² conducted a broad ranging global study of SRI academic and broker research and assessed the contribution that ESG factors add to investment performance. It concludes "**the argument that integrating ESG**

factors into investment analysis and decision-making will only lead to underperformance simply cannot be made". Mercers (2009) states in the foreword that:

"Of the 16 academic studies reviewed in this report, 10 showed evidence of a positive relationship between ESG factors and financial performance; two found evidence of a negative-neutral relationship; and four reported a neutral association. Pooling these results together with the 2007 report, there are 36 studies in total: 20 studies showing evidence of a neutral-positive relationship; three showing evidence of a negative-neutral relationship; eight showing evidence of a neutral relationship; and three showing evidence of a negative relationship."

This ESG integration approach has been broadly endorsed by a number of influential institutions. For example, in the UK, the National Association of Pension Funds (NAPF) has said that it:

"recognises the importance of incorporating ESG considerations into investment decisions. As long-term investors, its members should benefit from the application of these principles in terms of: long-term financial performance; [the] closer alignment between the objectives of institutional investors and those of society at large; [and the] management of reputational risk" (NAPF, 2007, p35).

However, SRI is an all-encompassing term. Not all SRI funds have been set up with a focus on investment returns. For example, for some, the "S" in SRI stands for Social. For others it is short for Sustainable. This is an important difference as it highlights the extent to which an investor focuses their analysis on companies contributing to and benefiting from long-term sustainable economic development, as opposed to companies undertaking socially responsible actions such as philanthropy albeit on a voluntary basis.

Therefore, investors that are primarily concerned with the financial performance of their funds need to understand the specific investment philosophy and strategy that applies to the fund and fund manager in order to select an appropriate product and provider. Conversely, investors that are most interested in avoiding certain potentially controversial investments should ensure that this is part of the process.

The four main SRI strategies

Some in the SRI industry can point to over ten different SRI strategies, but we believe that they can essentially be boiled down to four. However, it is important to highlight at the outset of this section that while these four strategies can be used uniquely as alternatives, they can also be combined to develop increasingly sophisticated SRI strategies that are tailored to individual client investment requirements (see *Combining Strategies* on page 7).

These four main SRI strategies and the top ten questions institutional investors should consider for each are reviewed below:

2. Aviva Investors is a member of the AMWG, which is convened by the United Nations Environment Programme.

SRI Strategies: Integration

Mercer Investment Consulting define integration as “The active investment management processes that include an analysis of environmental, social and corporate governance risks and opportunities” (Mercer Investment Consulting, 2007). It should be applied across the full pension scheme and involves adapting a more conventional investment process to explicitly integrate an analysis of how ESG issues impact corporate earnings and affect valuations. The purpose is principally to achieve better overall investment decision-making and enhance risk-adjusted outperformance. It is based on the premise that there is market inefficiency in this area and that investors can underestimate the value of sustainable and responsible businesses.

Investment implications

If there is a market inefficiency surrounding ESG issues, and the issues are relevant to the company concerned, then integration should reduce risk and enhance returns.

Sustainability implications

Integration analysis may conclude that unsustainable and/or irresponsible behaviour is not material to investors’ time horizon and is therefore not an issue for investors. However, if there is a financial market inefficiency in analysing ESG issues – and good corporate practices would be rewarded – then integration has considerable potential to promote responsible long-term business behaviour. Where a market failure exists – and unsustainable business practices are rewarded by the market – some leading fund managers are beginning to engage with government policy makers to promote appropriate government responses that avert the worst economic impacts of the issue (see Hawley and Williams for more on what has come to be called the Universal Owner hypothesis).

The top-ten questions on integration to consider:

1. How does the fund manager integrate ESG analysis into stock selection?
2. Are you convinced that the fund manager’s approach to integration is genuinely applied? Can they provide you with a number of credible examples of this analysis?
3. Do they have sufficient dedicated resources, experience and expertise?
4. Does the fund manager’s SRI portfolio outperform more conventional approaches to investment over different time periods?
5. What are the risk characteristics of their process?
6. Do they direct research commission towards high quality broker research on ESG issues?
7. Can they demonstrate that they provide broker feedback on this research?
8. What atypical sources of investment information do they use – ie where do they source their ESG research from?
9. How is engagement incorporated into the investment process? Will an intransigent company be divested?
10. Will the fund manager engage with government policy makers to help correct a market failure?

SRI Strategies: Engagement

Some fund managers engage with companies in order to encourage more responsible business practices and to increase corporate accountability to shareholders in companies they own or seek to own. If this strategy is chosen it should also be applied across the full portfolio or pension scheme. Engagement mainly takes the form of dialogue between investors and companies on issues of concern, and should include the proxy voting practices at company annual general meetings (AGMs). The aim is generally to work with the company to improve corporate performance on ESG issues and to enhance long term returns to shareholders. It can also be known as *shareholder activism*, although some use this term for a style of company engagement that is much more adversarial.

Investment implications

A dialogue between major investors and companies on issues of concern should reduce risks, and support long-term wealth creation. As an engagement strategy can overlay an otherwise conventional portfolio, it does not necessarily change stock picking, and may therefore not have any positive or negative implications at all for investment returns. However, we believe that engagement is best conducted in the context of an actively managed portfolio, where the results can be integrated into the investment analysis.

Chapter 5 of the Myners Principles covers the role and functions of fund managers (HM Treasury, 2004). The section on shareholder activism is the most significant for SRI concerns. In response, the Institutional Shareholder Committee has drawn up a document entitled "*The responsibilities of institutional shareholders and agents: Statement of Principles*" (2005). This "*sets out best practices for institutional shareholders and/or agents in relation to their responsibilities in respect of investee companies*". These concern the way institutional investors and their agents discharge their responsibilities, monitor performance, make necessary interventions and evaluate and report on the effectiveness of their engagement, and are increasingly included within Investment Management Agreements (IMAs).

Sustainability implications

Some believe that engagement can be used as an excuse for holding a company with poor ESG performance. However, at its best we believe that engagement is a credible and effective strategy for generating corporate improvements on a range of ESG issues. As owners of the company, investor views are influential. In our experience, supporting good ESG practices and challenging poor performance at company-investor meetings can motivate significant corporate improvement across a range of issues. This is particularly the case when engagement is integrated into both the investment decisions as well as the proxy voting actions at company annual general meetings (AGMs).

There are a few fund managers that provide *unbundled engagement* or *engagement overlay products*. This means separating, or unbundling, the fund management and voting/engagement arrangements between two or more parties. However, we believe that it is far better to integrate the results of engagement into an actively managed portfolio and for any engagement to be conducted by the fund managers and analysts who are also responsible for making the investment recommendations. This ensures that the engagement recommendations are genuinely in the long-term interests of the creation of shareholder value. It also ensures that any derived financial value becomes directly embedded within the portfolio's investment process.

The top-ten questions on engagement to consider:

1. How is investment incorporated into the engagement process – ie how do the results of engagement get reflected in the investment decisions?
2. Do they have sufficient dedicated resources, experience and expertise?
3. What are the aims of the engagement process – just to improve long term shareholder returns, just to improve corporate responsibility – or both?
4. Does the fund manager actively support good corporate practices as well as challenging poor performance?
5. Is there an approach to managing the engagement that targets specific companies on particular issues?
6. Do they measure their effectiveness? If so, how effective are they?
7. Is there evidence that the fund manager's engagement has helped improve shareholder value?
8. Does the fund manager actively use the AGM proxy voting process? If so, does the vote apply to all funds under management or just those in the specific client's portfolio?
9. What oversight of the engagement process is there?
10. Is the fund manager an active member of the UN PRI? If so, are they prepared to share their annual performance assessment and can they demonstrate active use of the *PRI Engagement Clearing House* in order to collaborate with other institutional investors?

SRI Strategies: Preference or Positive Screening

This approach seeks to invest in those companies with a commitment to responsible business practices, positive products and/or services and can come in a number of forms. These include best of sector, or sustainability thematic investment, such as investing in environmental technologies, or use the impacts of climate change as a way of highlighting investment opportunities.

Investment implications

Some forms can lead to a bias towards smaller companies with implications for the volatility of the fund's performance against its benchmark. However, as mentioned above, when done well there is good evidence that ESG thematic analysis can lead to performance improvement.

Sustainability implications

Positive screening can lead to a reduction in cost of capital for more sustainable businesses and help them raise capital – particularly for the smaller cap companies. Some see this as priming the pumps of sustainable development and one of the most important contributions that an investor can make towards creating a more sustainable future. However, if the investor wants to support micro-cap social enterprises listing on the Alternative Investment Market (AIM), then they should ensure that they are within scope as the risk parameters will often lead to them being excluded.

The top-ten questions on positive screening to consider:

1. Should the full scheme use positive ESG screens or themes? If so, which ones?
2. Do the Trustees believe that allocating part of the portfolio towards specific ESG themes would be a useful way of adding diversification strategy?
3. Do the schemes defined contribution beneficiaries want to be able to choose positively screened SRI funds?
4. Does the fund manager's SRI portfolio outperform more conventional approaches to investment over different time periods?
5. Is it better to specify investments in single-themed funds (for example, climate change, water etc), or allow the fund managers to select between the relative benefits of a range of different themes based on prevailing market conditions?
6. Is a bias towards smaller companies inherent within the approach of the fund manager? If so, what are the implications for the volatility of the fund's performance against its benchmark?
7. What is the volatility tolerance within the fund and can derivatives be used to manage risk?
8. What is the process for ensuring that the portfolio adheres to the fund remit?
9. Does the portfolio breakdown appear to be consistent with the stated funds aims?
10. Do the Trustees want to ensure that they include social enterprises? If so, what should be the minimum market value of these companies and how much of the portfolio should they represent?

SRI Strategies: Avoidance or Negative Screening

This is the most commonly recognised form of SRI. It means not investing in companies that do not meet the ethical standards by which the fund is run. This is often also referred to by the term “*ethical investment*” and essentially means avoiding companies that provide products or services that are ethically (if not legally) questionable. Most ethical funds, for example, will not invest in tobacco or defence companies.

This strategy initially evolved for certain church and charity groups that wanted to ensure that they were not benefiting financially from investments in companies that were inconsistent with their beliefs or aims.

Investment Implications

When used as the only SRI strategy, such funds are more likely to underperform the overall market while excluded areas that are performing well. Conventional wisdom suggests that arbitrarily excluding a sector will decrease the return/risk ratio for a fund. Proponents would counter that many ethical exclusions do have investment relevance making the impact less pronounced. There is some research into the long-term impact on retail ethical funds that suggests that risk-adjusted returns can be at least as good. The key here is fund manager selection.

Sustainability implications

This strategy ensures that individual investors are not benefiting financially from investing in certain areas, which can be centrally important to institutions seeking to ensure that their organisational ethics or brand integrity are maintained. However, it is unlikely to decrease a company's access to capital as the volume of assets currently affected is swamped by ethically unconstrained assets. Separately, negative screening removes the potential for ownership engagement. However, if a company can change to become approved for the fund, then it may. Finally, some question whether simply avoiding certain types of company actually results in a portfolio that can be described as ethical.

The top-ten questions on negative screening to consider:

1. Are ethical screens consistent with the aims of the full scheme and the fiduciary duties of the Trustees? If so, which ethical screens should be implemented and how will they be applied?
2. Should defined contribution beneficiaries be allowed access to negatively screened SRI options within the scheme?
3. Does the fund manager's negatively screened SRI portfolio outperform more conventional approaches to investment over different time periods?
4. Is a bias towards smaller companies inherent within the approach of the fund manager? If so, what are the implications for the volatility of the fund's performance against its benchmark?
5. What is the volatility tolerance within the fund and can derivatives be used to manage risk?
6. What is the process for ensuring that the portfolio adheres to the fund remit? Is there any independent oversight of the process, perhaps from the internal audit function or from an external advisory committee?
7. Are the Trustees assured that the asset manager can implement the screening?
8. Does the portfolio breakdown appear to be consistent with the stated fund's aims?
9. Will the Trustees require a periodic portfolio screening report to ensure that the screens are being applied?
10. Should the Trustees combine this strategy with other strategies such as positive screening and engagement?

Combining strategies

The previous section highlighted that while the main four strategies can be used independently, they can also be combined in order to develop increasingly sophisticated SRI strategies, tailored to individual client investment requirements.

For example, for defined benefit pension schemes, a combined institution-wide approach might:

- integrate an analysis of material ESG issues into the overall investment process
- avoid some sectors on ethical grounds and/or because they are poor long-term investments and not worthy of consideration
- positively screen a percentage of the portfolio towards companies providing sustainable goods and services on the basis that they will benefit from the long-term secular trends towards more sustainable goods and services
- engage with the companies that they do own in order to support good ESG practices and challenge poor performance.

In addition, for defined contribution pension schemes, depending on interest, there may be scope to offer a range of negatively screened ethical options which beneficiaries can opt into.

However, it should be noted some contradictions do emerge when combining strategies. Most obviously, screening out a company from a portfolio would mean the loss of the ability to engage with it as an owner. The key is in understanding these implications and selecting the approach that the Trustees consider best fits the investment strategy of the scheme.

Fiduciary duty and SRI

The earlier discussion introduces some of the ways in which a Trustee's fiduciary duty relates to sustainable and responsible investment. The single most comprehensive analysis of fiduciary duty and the integration of ESG issues into investment is arguably the "Freshfields Report" (Freshfields, 2005.)

This report was asked to consider the following question:

"Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?"

The Report covered nine jurisdictions, including: Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US, and concluded that *"...integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is **clearly permissible and is arguably required** in all jurisdictions."*

This clear conclusion has served to clarify the legality behind whether pension schemes could consider ESG issues and what they can do. It should be noted that the conclusion includes an important caveat: i.e. *"...so as to more reliably predict financial performance..."*. In other words, where pension scheme beneficiaries are represented by trustees, these trustees must consider the financial return above any purely ethical concerns. It should also be noted that the law as it relates to institutional investment by Charities and Foundations is very different in that an investment may be excluded on purely ethical grounds if it conflicts with the objectives of the charity and/or reduces the ability of the charity to fundraise.

More generally, in the UK, The Pensions Act was amended in 1999 to place a requirement on trustees to declare via a Statement of Investment Principles (SIP) "the extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments" (HMSO, 1999, Section 35(3)(f)). Since then, similar legislation has been implemented in a number of countries around the world.

At the time, this received cross-party support and was considered by a broad range of stakeholders to be an innovative policy change. Since then, a number of other countries have duplicated this reform within their own pensions law.

Sources of further information and best practice guidance

In response to the growing demand from institutional investors, a number of investment consultants have recruited specialist staff in this area. Such consultants include, among others, Mercers Investment Consulting, Towers Watson, Hewitt, Hymans Robertson and Russell Investment Consultants.

The two principal sources of free information in the UK on SRI are the UN Principles for Responsible Investment (UNPRI) and the UK Social Investment Forum (UKSIF).

UN Principles for Responsible Investment (UNPRI)

Aviva Investors is a member of the UN PRI. We highly recommend that pension schemes and other institutional investors consider becoming a signatory to the UN PRI, as the initiative seeks to keep its membership well informed and at the forefront of the various fascinating debates on sustainable and responsible investing. The PRI is also endorsed by the NAPF, which highlights: *"the importance of incorporating ESG considerations into investment decisions."* Its corporate governance and voting policy highlights that by applying the UN PRI, its members could work towards (i) improved long-term financial performance, (ii) closer alignment between their own objectives as institutional investors and those of society at large and (iii) better management of reputational risk.

The UN PRI has six main principles. These commit signatories to integrating ESG issues into conventional investment analysis; to being active, responsible owners by promoting good corporate

practice in these areas; and to reporting transparently on what actions they have taken. The UN PRI is fast becoming a de facto industry standard for responsible investment. In the UK, the pension schemes of BT, The BBC, The Environment Agency, and the Universities Superannuation Scheme are all signatories.

For further information see www.unpri.org/principles.

UK Social Investment Forum (UKSIF)

Aviva Investors is also a member of the UK Social Investment Forum (UKSIF). This runs a Sustainable Pension Project (SPP), which maintains a useful library of free publications – including many of those mentioned in this introductory guide. It also issues a free periodic email update.

One particularly useful tool for individuals who are considering the relative merits of an SRI strategy is The Responsible Investment Self-Assessment Template (developed by Mike Taylor, Chief Executive of the London Pension Fund Authority). This is a tool for local government pensions schemes to take trustees through key responsible investment issues. It is based on the methodology used by the Audit Commission, but is also relevant to other institutional investors (see Taylor, 2007).

Additionally, UKSIF worked in conjunction with the United Nations Asset Management Working Group to produce 'Responsible Investment in Focus: How leading public pension funds are meeting the challenge'. This is a practical report that aims to inspire more pension funds worldwide to deepen their responsible investment practices. Fifteen in-depth case studies cover public pension funds across five continents, with assets ranging from USD 33m to USD 460bn. They show some of the most advanced and creative approaches currently being adopted and are again useful to a broad institutional audience (see UKSIF et al 2007).

For further information see www.uksif.org/uksif

Holding the fund manager to account for delivery

Finally, while the aforementioned Freshfields report made a significant contribution to the debate regarding whether SRI issues should be included into investment management decisions by trustees, it stopped short of providing (1) suggested legal clauses for inclusion within Investment Management Agreements (or the equivalent contract between pension schemes and their agents); and (2) suggestions regarding how to govern, sanction and incentivise fund manager performance on the integration of, and engagement on, ESG issues.

Particularly useful guides in this area currently include:

- The Marathon Club: Long Term Long Only report [2007]
- LAPFF: Delegating Shareholder Engagement - Holding Fund Managers to Account [2006]
- USS: How to Be a Responsible Pension Fund [2003]

The UNEP Finance Institution's Asset Management Working Group has also recently announced that it plans to follow up the Freshfields work to produce a guide that helps institutions to increase the accountability of their product providers in this area.

Conclusion

The ESG factors that SRI analysts and fund managers specialise in are becoming increasingly material to investment valuation. From a Trustee's perspective, integrating ESG considerations into investment analysis so as to more reliably predict financial performance is clearly permissible. Indeed, according to the legal firm Freshfields, it is arguably required.

However, some see SRI as synonymous with ethical investment, and therefore question the limitations that this places on financial performance. After all, while the sectors and companies that are screened out are outperforming the benchmark, the fund manager will be fighting a performance head wind. However, as set out above, this does not necessarily lead to underperformance. Moreover, SRI also incorporates a much broader range of investment strategies many of which are explicitly set up to outperform and help the fund manager. These more financially focussed SRI investment strategies can include positive screening, engagement, and integrated analysis.

Perhaps the key point to highlight is that some forms of institutional SRI focus predominantly on enhancing returns, whereas others focus on providing a portfolio of companies that are ethically acceptable to the client. Similarly, some fund managers do attempt to improve the ESG performance of companies by making recommendations for how the business can be improved, whereas others are more passive.

The key is in understanding these implications and selecting the approach that the Trustees consider best fits the investment strategy of the scheme. We hope that this introductory guide will help reduce the confusion in the market regarding the four main SRI strategies.

Readers wishing to explore SRI and the performance implications in more depth may be interested to know that Aviva Investors has an award-winning SRI team, and offers a broad range of investment funds across the equity, fixed income and property asset classes. Should the investment process, portfolio or performance of any of these funds be of interest, then please contact us for more information at investmenttutor@avivainvestors.com

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