americancentury.com

SUSTAINABLE INVESTING

Perspectives From ESG Leaders

Asset owners share their current practices, preferences and challenges

Data gathered by
Kirstein A/S

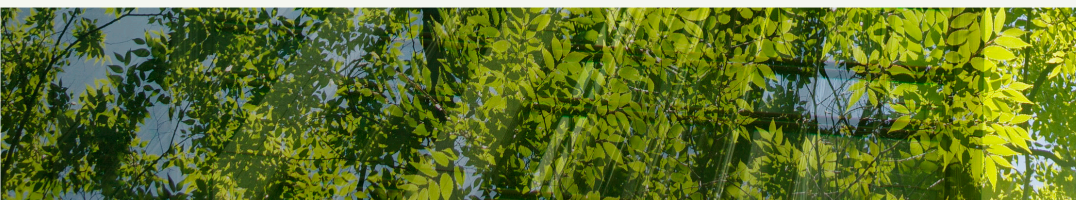


Table of

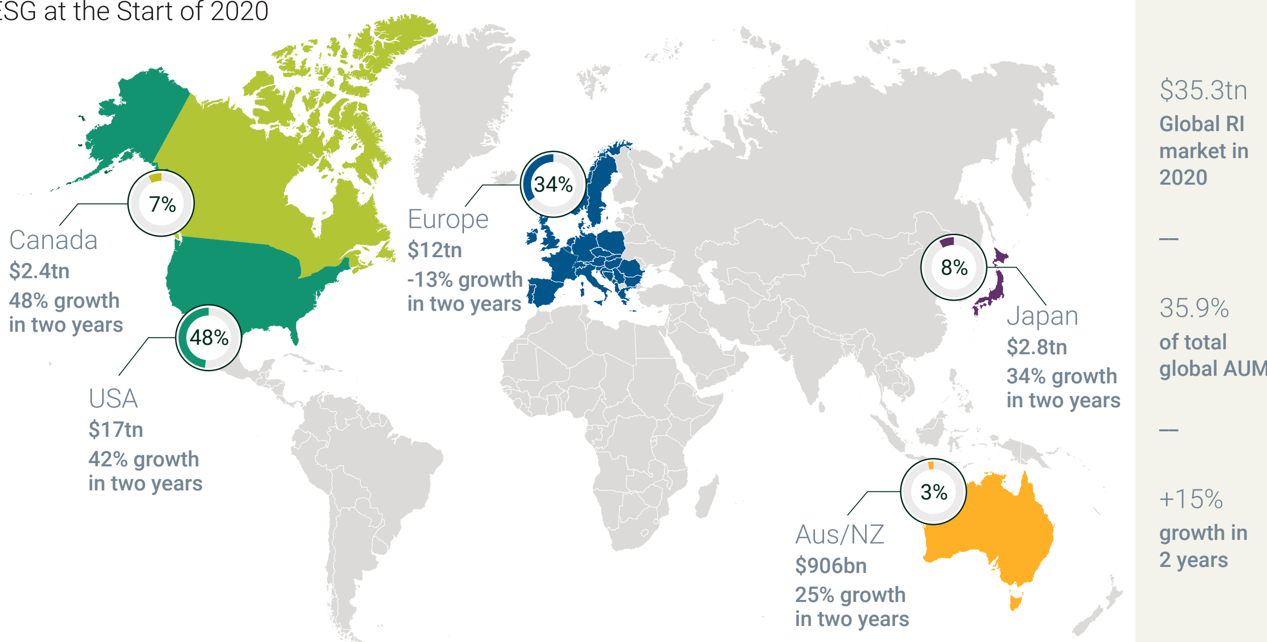
Contents

1.0	Background and Research Methodology	02
1.1	A Strong Commitment to Investing Sustainably	04
1.2	Importance of SFDR Products	04
2.0	Pursuing Sustainable Goals in Equity Investing	06
2.1	Active ESG Strategies Have the Edge Over Passive	06
	Regional Differences in Current Preferences	*07*
2.2	Allocation Preferences Don’t Match Performance Expectations	09
2.3	Based in Europe, but With a World View	11
3.0	Asset Managers and Value Creation	12
3.1	Does Organizational Structure Matter?	12
3.2	Engagement Goals	13
3.3	Measuring E, S and G Factors	14
3.4	ESG Reporting–Important, With Room for Improvement	15
4.0	Our Take: A Conversation with Sarah Bratton Hughes	17

1.0
Background and Research Methodology

Environmental, social and governance (ESG) considerations are now seen as an essential aspect of asset management by investors around the world. All categories of asset owners, from pension funds to sovereign wealth funds to retail investors, are calling on asset managers to consider ESG risks and opportunities, ranging from climate change to pay equity to board integrity and many other E, S and G concerns alongside more traditional investment analyses. Why? Because these issues affect the long-term sustainability of businesses and entire economies everywhere.

ESG at the Start of 2020



**Source: Global Sustainability Investment Alliance (2021)*

Expectations regarding an asset manager's ability to proactively manage ESG-related risks and opportunities have increased significantly compared to just a few years ago. In fact, the global investment community's interest in ESG has arguably reached a tipping point—the majority of investors now want third-party managers to embed sustainability criteria in their investment processes. Having said that, the goals of so-called "ESG investing" are multifaceted and far from uniform: Some investors expect risk-adjusted returns to benefit from applying an ESG perspective, others are primarily seeking to comply with rising regulatory standards, and many see ESG as a way to positively impact economic prosperity in the wider community, thus promoting a "virtuous circle" through investing.

Leaders Among Asset Owners

Institutional asset owners in the Nordic region and the Netherlands are often seen as leaders in sustainable investing. To gain insights into these trendsetting investors' views on their ESG investing and expectations for third-party asset managers in this space, American Century Investments teamed up with Kirstein A/S, a leading asset management

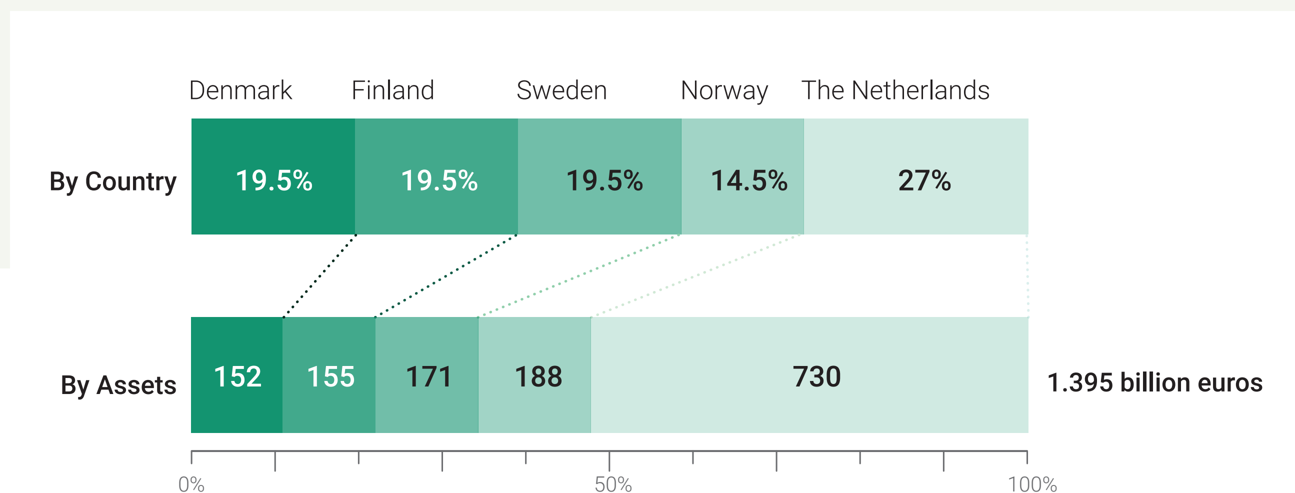
consulting firm headquartered in Denmark, to uncover opinions regarding ESG investing across large Nordic and Dutch asset owners who invest in listed equities through third-party managers. These asset owners, primarily large pension funds, are considered leaders in the ESG space–not only in Europe, but also globally.

Survey Panel and Research Methodology

Kirstein's market research analysts gathered data via surveys and interviews conducted with 41 institutional investors in the Nordic region (Norway, Sweden, Finland and Denmark) and the Netherlands over the period from January to March 2022. The research panel was constructed as a representative sample of ESG leaders in the institutional market in Europe by country, size and segment. Interviewees were senior representatives of pension funds, sovereign wealth funds and other institutions; 90% had the title of chief investment officer or investment director. The combined assets held by the participants at the time of the survey totaled 1.395 billion euros, including 329 billion euros (approximately USD 350 billion) in externally managed equities.

Responses to most of the questions were based on a Likert scale of 1 to 5, where a score of 5 represented "most preferred" or "highest" (depending on the question) and 1 represented "least preferred" or "lowest." Participants also had an opportunity to provide qualitative responses to certain questions.

Figure 1 | Research Panel Breakdown by Country and AUM



Entities from the Netherlands represented over half of the total assets held; among the Nordic countries, participants from Norway were the largest.

1.1
A Strong Commitment to ESG Investing

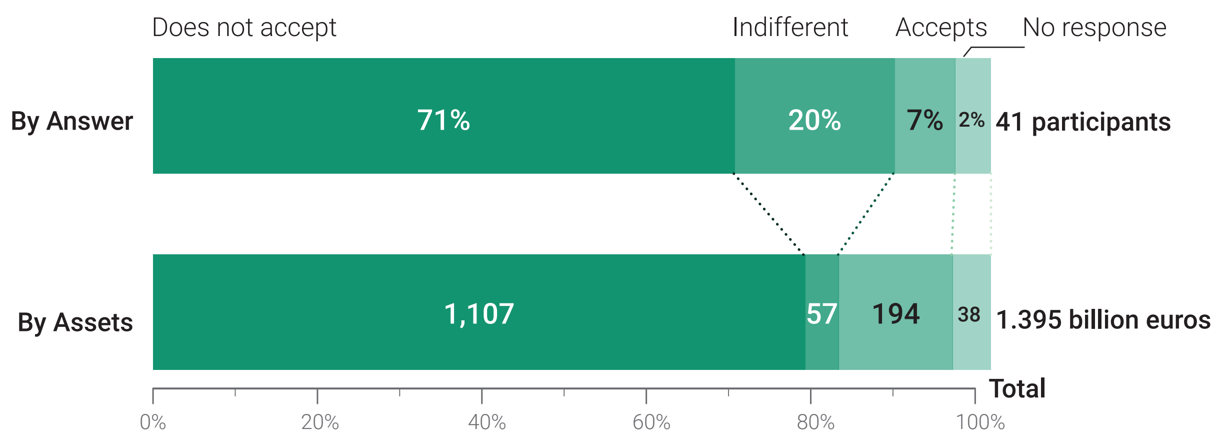
The survey participants are clearly committed to embedding sustainability in their investing. As **Figure 2** shows, 71% of the participants, representing almost 80% of the total assets owned by the entities represented in the research panel, stated that they *do not accept Article 6 funds (those with no ESG considerations) from external asset managers*. Still, more than one panelist noted that the way funds are categorized as 6, 8 or 9 is a bit "fuzzy."

"It's only a matter of time before Article 6 funds are out of the picture."

One participant stated, *"We are skeptical about ratings assigned by asset managers themselves. Some rate what we view as Article 8 products as Article 6, and vice versa. We rely on our own due diligence."*

As an indication of the transformative forces at work in this arena, the three asset owners that currently have virtually all of their externally managed equities in Article 6 funds indicated that such funds will not be acceptable going forward.

Figure 2 | Low Acceptance of Article 6 Funds



**As defined by SFDR, Article 8 and 9 products consider sustainability in a binding way. Article 8 products promote environmental or social characteristics in the pursuit of other financial objectives. Article 9 products seek to make a positive impact on society or the environment through sustainable investment and have a non financial objective at the core of their objective.*

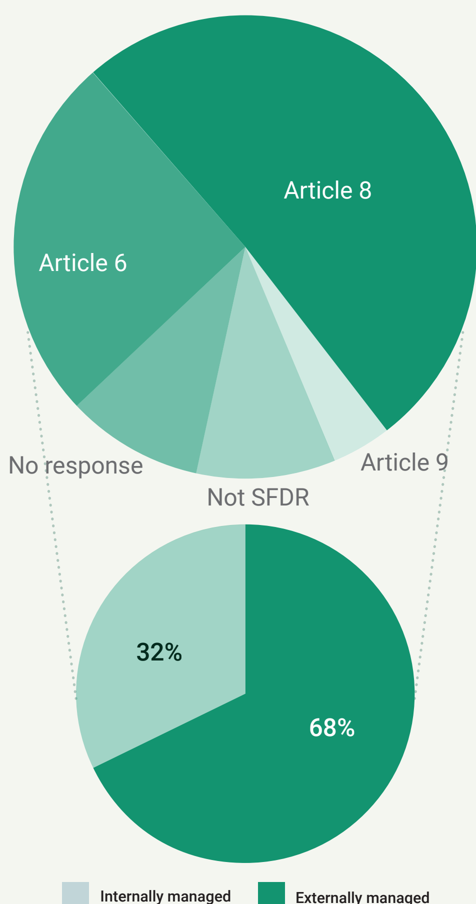
1.2
Alignment With the European Union's Sustainable Finance Disclosure Regulation

Implementation of SFDR is still at an early stage, so it is not surprising that the asset owners surveyed differ in terms of their current allocations to Article 6, 8 and 9 products; however, greater consistency is expected going forward. As shown in **Figure 3** (following page), of the 68% of the assets owned by study participants that are externally managed, slightly more than 50% are invested in Article 8 funds, just over 25% are allocated to Article 6 funds, and about 5% are allocated to Article 9 funds.

It is worth noting that these ESG leaders already have significant allocations to Article 8 funds, and *only three indicate that they will accept Article 6 funds going forward*. This confirms that allocations to Article 8 and 9 funds will increase significantly in the years to come. A number of comments from the interviewees relate this trend to an asset manager's fiduciary responsibility—in other words, ***ESG is a fiduciary issue***. Still, one survey participant noted that regarding Article 6, 8 and 9, *"It is the content that matters, not the label."*

Question: Please specify your current externally managed equity asset base and your preference for Article 6, 8 and 9 products as well as products not compliant with SFDR.*

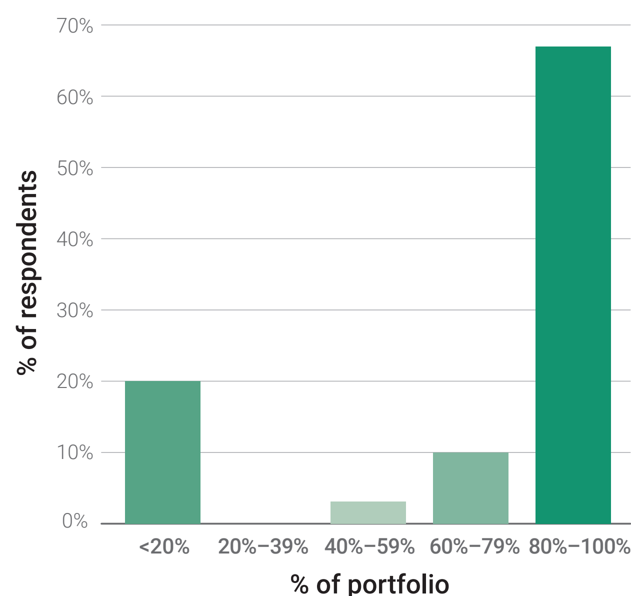
Figure 3 | Importance of SFDR Products in Externally Managed Equities



*Only investors who indicated a high degree of external management were asked to provide their current allocation to Article 6, 8 and 9 products as well as funds that are not compliant with SFDR.

Two-thirds of the respondents who provided information about their externally managed equity allocations have at least 80% of those assets in Article 8 funds, and one has 100% in Article 9 funds. Only three have 30% or more in strategies that are not SFDR-compliant.

Figure 4 | Most Asset Owners Now Consider Only Article 8 and 9 Funds



Percentage of equity portfolio held in Article 8 funds

Panelists who provided allocation data

When asked whether they prefer to use funds or separately managed accounts for ESG-related public equity investing, slightly more than 60% of respondents prefer to invest via funds, while roughly 39% prefer customized separately managed accounts. One participant said, *"We prefer to customize our accounts by setting our own sustainable benchmark as well as SDGs. Our managers have to be able to offer that."*

Another participant expressed skepticism about these classifications as they are assigned by the asset managers themselves, saying, *"Some rate what we see as Article 8 products with an Article 6; some the opposite. We rely on our own due diligence."*

2.0
Pursuing Sustainable Goals in Equity Investing

Incorporating ESG and sustainability principles in investing is most definitely not one size fits all. Investors are at various stages on the ESG learning curve, and approaches to defining ESG and what "sustainability" encompasses continue to develop. In addition, countries, cultures and stakeholder groups can differ in how they prioritize certain ESG practices. Examining both the differences and similarities offers interesting takeaways.

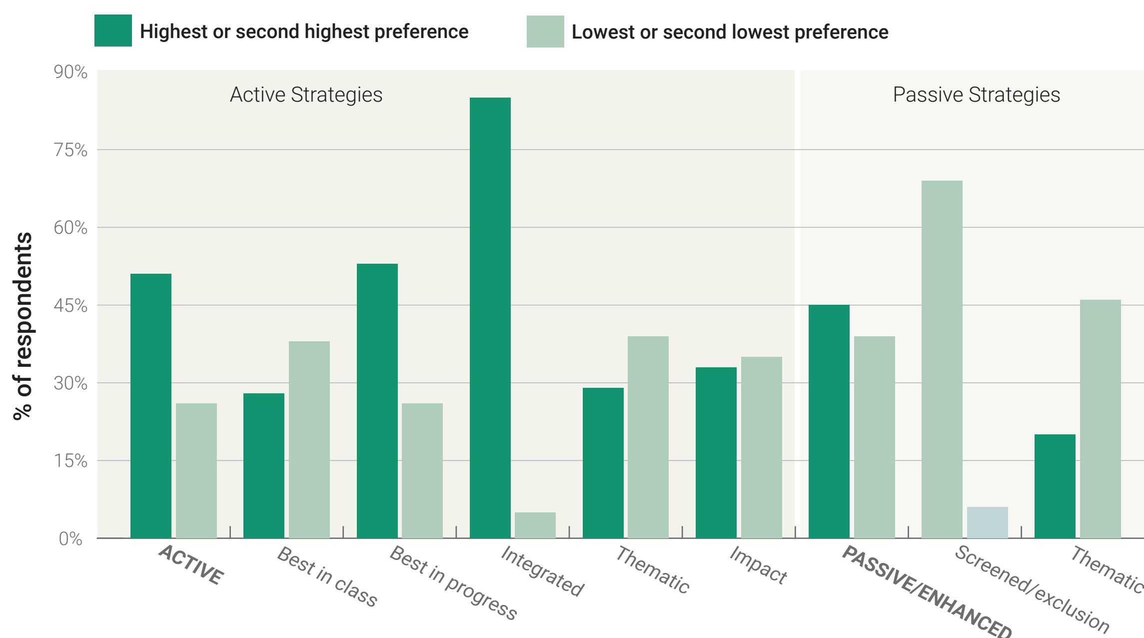
2.1
Active ESG Strategies Have the Edge Over Passive

ESG is incorporated into investment strategies—both funds and separately managed accounts—using various approaches. From norm-based negative screening to impact investing, the asset owners that participated in the survey expressed varying preferences for different forms of ESG-based investing. While the low cost associated with passive investing has won over many investors outside of the sustainable investing arena, **Figure 5** shows that the asset owners in this study favor active management in ESG investing over passive or enhanced passive approaches.

Question: On a scale of 1 to 5 (5=highest), for listed equity mandates awarded to external asset managers, what style of ESG investing do you prefer?

Figure 5 | Active ESG Strategies and Integration Are Clearly Favored Approaches

Many Investment Styles Have Both Devotees and Detractors



Best in class	Investments are selected based on positive ESG attributes relative to peers.
Best in progress	Investments are selected based on improvements in ESG attributes relative to peers.
Integrated	ESG factors are systematically, explicitly included in the investment process.
Impact	Investments are selected to achieve a positive environmental and/or social impact. Requires measuring and reporting to demonstrate intentionality and impact.
Screened/ exclusion	Investments are excluded based on business activities and/or product categories that are deemed unacceptable or violate standards set by certain organizations.
Thematic	Investments are related to a specific goal, e.g., reduced carbon emissions.

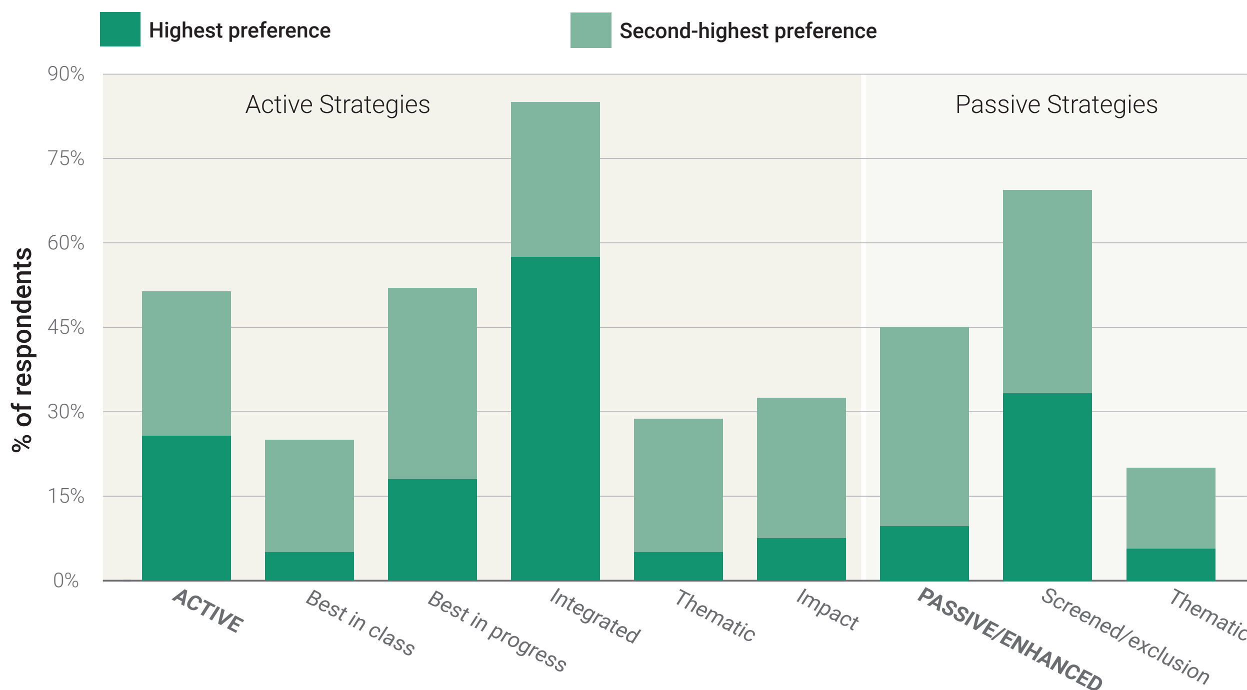
Regional Differences in Current Allocations

By looking closely at the data, we find that the participants' preference for an integrated approach to ESG investing by external equity managers is primarily driven by the Nordic pension funds in the study. In contrast, active best-in-progress strategies are preferred by most of the Danish pension funds, as well as a few Dutch pension funds, insurance companies and other fiduciaries. Some large Swedish pension funds prefer impact strategies, while many of the Finnish pension funds prefer best-in-class strategies.

Independent of these preferences for active or passive management, adhering to the U.N. Global Compact and being a signatory to the UNPRI are considered hygiene factors or "table stakes."

Figure 6 | Integration Is the Preferred Active Approach

The Extent to Which Various ESG Investment Strategies are Preferred or Highly Preferred Varies



Asset Management Preferences

Among the management approaches, **Figure 6** shows that integrating ESG considerations into the investment process stands out among all of the choices:

- 85% of respondents somewhat or highly prefer integrated approaches; only a few ranked "integrated" at or near the bottom in terms of allocation preference.
- 69% of respondents preferred or highly preferred passive ESG screened/exclusion strategies, the second highest among all of the categories. This may be because this category covers both positive and negative screening.
- 52% of respondents preferred or highly preferred best-in-progress strategies, i.e., selecting companies that have been showing substantial improvement in their ESG practices.

While the majority of the survey respondents expressed either the highest or second-highest preference for both integrated and screened/exclusion strategies, the integrated approach was highly preferred by more respondents.

2.2

Allocation Preferences Don't Match Performance Expectations

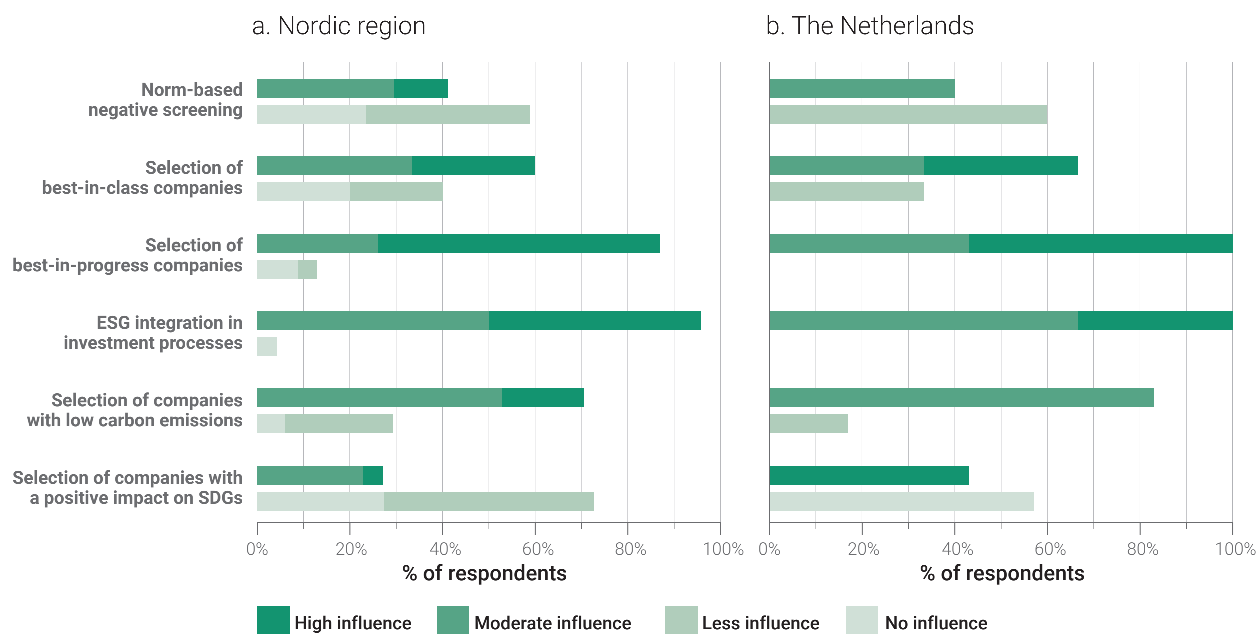
The popularity of passive screened/exclusion strategies as shown in Figures 7a and 7b is an interesting finding. In addition to the fact that it covers both positive and negative screening, it is plausible that at least some respondents prefer this approach because it is familiar and easy to explain, whereas ESG investment strategies such as integrated or best in progress may be less so. Still, it is surprising because *the participants also say that screened/ exclusion strategies are not likely to have a positive influence on future investment performance.*

As **Figures 7a and 7b** show, panelists in both the Nordic region and the Netherlands believe *ESG integration and best-in-progress strategies are the two approaches that are most likely to have a positive influence on future performance*. They also mostly agree that norm-based negative screening and selecting companies based on the U.N. Sustainable Development Goals (SDGs) will have a limited or no positive influence on performance going forward. We note that some respondents specifically mentioned that selecting companies with low carbon emissions is likely to boost future performance. This may be because carbon emissions receive widespread attention, so buying stocks of companies that are strong in this area, i.e., minimizing exposures to heavy carbon emitters, is seen as a way to minimize risk and avoid poor risk-adjusted returns.

Question: When investing in listed equities through third-party asset managers, how do you expect the following ESG investing approaches to influence long-term financial performance going forward?

Figures 7a and 7b | Expected Influence of Different ESG Approaches on Financial Performance

Regional Differences of Opinion Exist



Note: Asset owners that did not respond to this question and those who are indifferent are excluded.

Key takeaway: As noted on the previous page, most asset owners expect ESG to have a positive influence on performance primarily through active ESG integration or best-in-progress strategies. This means asset managers will need a capable research team to identify ESG risks, define what constitutes "progress" and explain how ESG factors are integrated into the investment process and contribute to alpha generation.

2.3

Based in Europe, but With a World View of ESG's Influence

The participants were also asked to specify the region(s) of the world where they believe ESG investing can make the biggest difference. At first glance, the results shown in **Figure 8** suggest that respondents believe strategies with either a global or European focus will have the greatest ESG impact compared to U.S. or emerging markets ESG strategies.

A Danish pension fund elaborated, saying, "You can always argue where you obtain the highest impact. We have a global focus, and from an ESG perspective, we believe that will have the greatest impact."

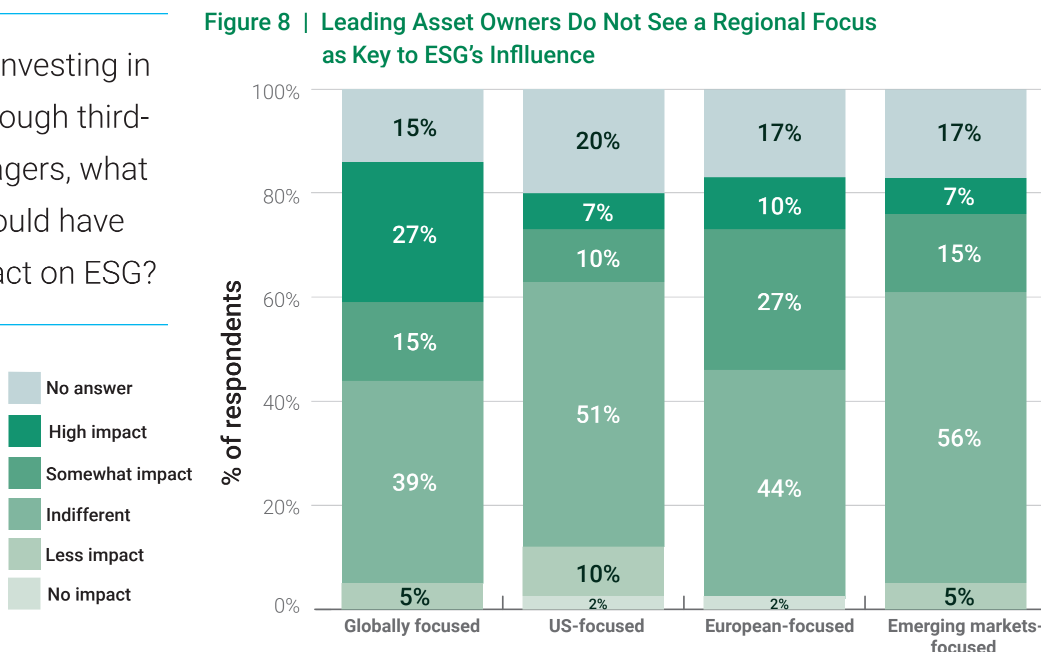
However, **Figure 8** also shows that *44%-56% of these influential asset owners chose "indifferent" when rating whether they expected ESG investing to have a more positive impact on a particular region or market relative to the others*, and a significant portion declined to answer the question at all. In other words, many investors did not single out any particular region as most likely to see a positive difference from ESG investing.

Indeed, many comments show the respondents see the world as interconnected and therefore do not believe that a region-based view makes sense. As one participant put it, *"We are a multi-asset investor and have a position as a global role model. We do not think in terms of regional impact with respect to ESG. We cover all regions, and all regions have an equally important impact on ESG."*

However, a number of investors argue that ESG investing can have the greatest impact through strategies focused on emerging markets. Some base this on the fact that populations in emerging markets, particularly Asia, are the largest in the world, while others believe that because many emerging markets countries are at an early stage when it comes to ESG, the marginal impact is likely to be significantly higher compared to developed markets. As one asset owner put it, *"The easiest place to fix something is in the emerging markets. But it is also there where it is worst."*

Question: When investing in listed equities through third-party asset managers, what regional focus would have the greatest impact on ESG?

Figure 8 | Leading Asset Owners Do Not See a Regional Focus as Key to ESG's Influence



Note: Participants were asked to rate the perceived impact on ESG across four regions/markets on a scale from 1 (no impact) to 5 (high impact).

3.0

Asset Managers and Value Creation

As asset owners are increasingly focused on the added value that ESG can offer, it is interesting to explore the panelists' views about how asset managers create value through sustainable investing and what differentiates a given type of manager from its competitors.

3.1

Does Organizational Structure Matter?

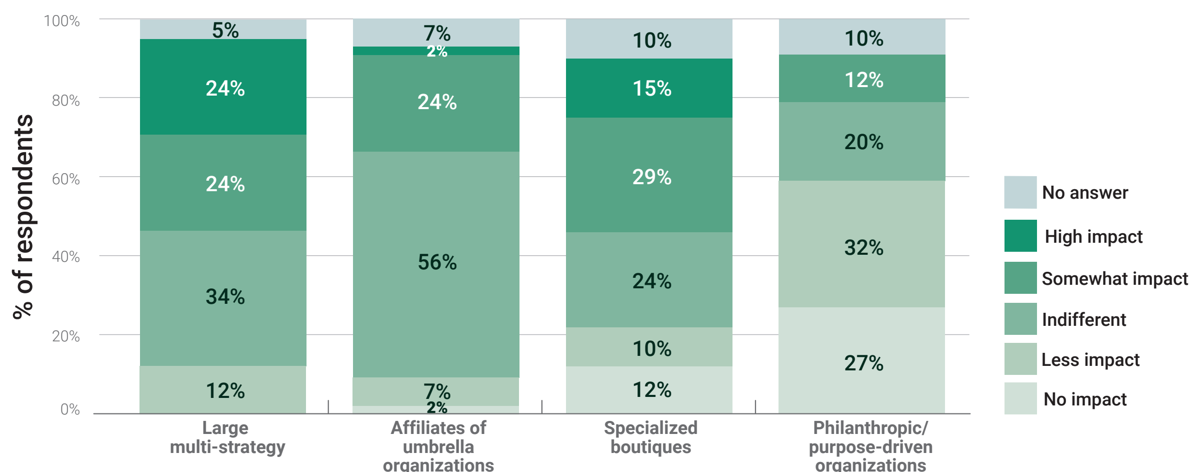
Figure 9 shows how the survey participants view the attractiveness of four different organizational structures for asset managers with respect to ESG value creation. The results show that either large, multi-strategy asset management firms or specialized boutiques are expected to have a more positive impact on ESG than other types of managers. Many of the investors believe that large asset managers are more cost efficient, resourceful and better at adapting to an investor's agenda, while others say that specialized boutiques are more agile and more adaptable precisely because they are smaller.

By a slight margin, the asset owners in the study prefer large, multi-strategy asset managers (such as Blackrock and Fidelity), while specialized boutiques are favored among mostly Danish and Norwegian investors. Interestingly, the smallest percentage indicated a preference for asset management affiliates of large financial services organizations

Question: On a scale of 1 (no impact) to 5 (high impact), when investing in listed equities through third-party asset managers, how attractive are the following organizational structures in relation to ESG value creation?

Figure 9 | Organizational Structures' Positive Impact on ESG

Large, Multi-Strategy Asset Managers and Specialized Boutiques Are Preferred



such as Virtus Investment Partners, AMG and Bank of New York Mellon. In a revealing comment, one participant said, *"I do not believe that the type of manager makes that much of a difference. Scale has power, but I hear from smaller pension funds that bigger American managers sometimes do not listen to their needs; they only listen to the larger pension funds."*

While a handful of the participants believe that philanthropical or purpose-driven organizations are best at ESG value creation, most investors in both the Nordics and the Netherlands are somewhat skeptical of this choice, concerned that such organizations are focused less on returns and more on pursuing their own strategic goals. A Nordic pension fund elaborates: *"The danger with philanthropic/purpose-driven managers is that they follow their own DNA—and we want a manager that adapts to our DNA. We can only support a purpose that our members see fit, and we would therefore be careful in selecting a manager in that category."* Another asset owner observed, *"The purpose-driven have the right focus on ESG but they are not good at managing returns—and that will always remain the most important aspect."*

3.2 Engagement Goals

Many large investors, such as the influential asset owners that participated in this research effort, believe that active engagement with investee companies is a key component of the alpha-generating potential of ESG investing.

"Engagement is our top priority. We firmly believe that you can only change the world through engagement—screening with best in class does not create as large of an impact on ESG as engagement/best-in-progress companies."

According to the panelists, the two most important engagement activities their third-party asset managers should pursue as part of ESG investing are:

1. Meeting regularly with senior management at investee companies.

2. Monitoring and reporting on progress and outcomes.

Both were highlighted as important or somewhat important by 75% of the research panel. As a Dutch asset owner stated: *"Active ownership and engagement come through a strong relationship, and you can only have that through regular meetings with senior management and the company."*

In addition, 70% cited collective engagement with other managers on specific issues as a useful activity. One research participant commented, *"I do see a great value in managers collaborating on engagement. Size has value."*

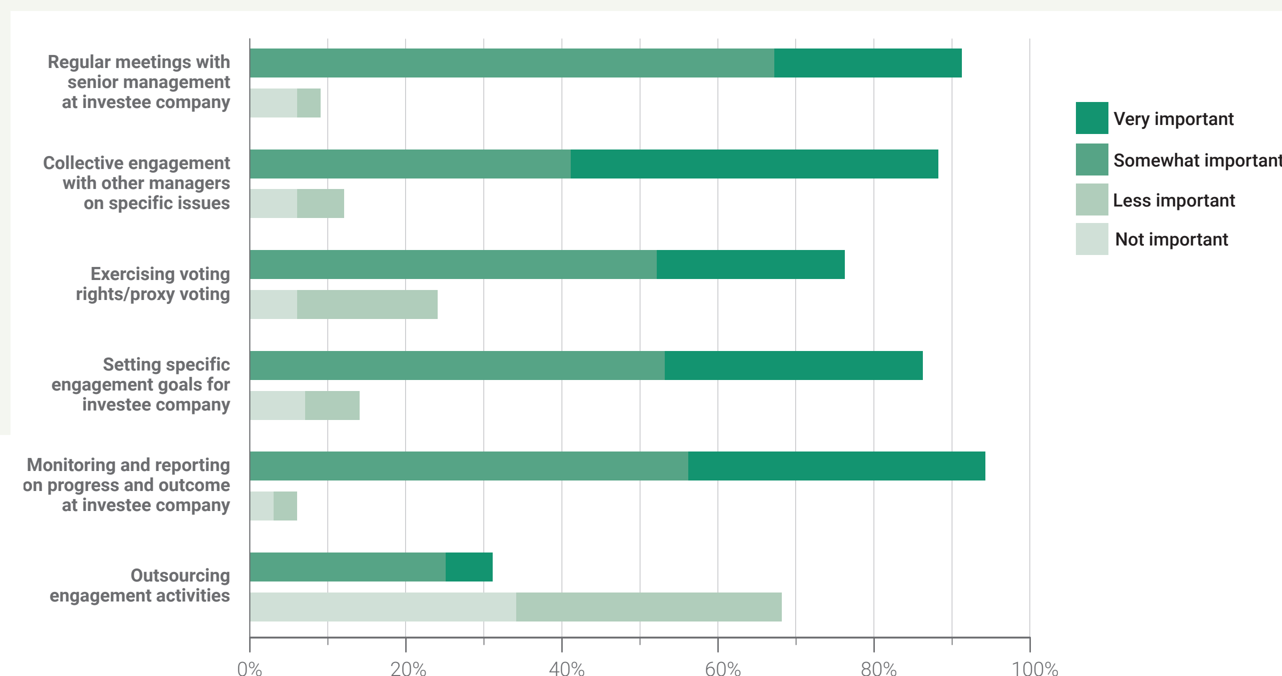
These findings are consistent with what we discussed in **Section 2.2**, namely that ESG integration and best-in-progress approaches are the ESG investment strategies that the panelists expect will have the greatest influence on long-term financial performance. Engaging with company management and reporting on progress are ways an asset manager can demonstrate that ESG is integrated into the investment process and/or that investee companies are making progress on ESG issues.

However, not all engagement lives up to the name. As one participant put it, *"Give me quality reporting! Some (asset managers) report that they have 1,000 engagements, but it is just phone calls and nothing with impact. Better one than 100 if that one is of high quality."* Another remarked, *"It is not the number of meetings that makes engagement, but the quality of the meetings."*

Question: Using a scale of 1 (not important) to 5 (very important), when investing in listed equities through third-party asset managers, which of the following active ownership and engagement activities should be carried out by the managers to create value through ESG?

Figure 10 | Engagement Activities With Positive Impact on ESG

Asset Owners Rely on Progress Reports from ESG Engagement Activities



**Note: Investors who did not respond to the question and those who responded with "indifferent" are excluded.*

3.3

Measuring E, S and G Factors

The widespread acceptance of ESG as an important component of investing has raised expectations, internally and externally, particularly for pension funds. It is now rare to find institutional investors without sustainability guidelines and policies in place, and many report on separate components of ESG as part of their sustainability profile. Therefore, this type of reporting is a natural requirement when hiring external managers.

Figure 11 (following page) summarizes the research participants' views regarding the ease or difficulty of measuring the separate components of E, S and G. Not surprisingly, 81% of the research panel participants said that the social pillar is "very difficult" or "somewhat difficult" to measure. This opinion holds across countries, segments and size brackets. Many of these investors highlight the lack of data and defined guidelines for measuring the aspects of the social

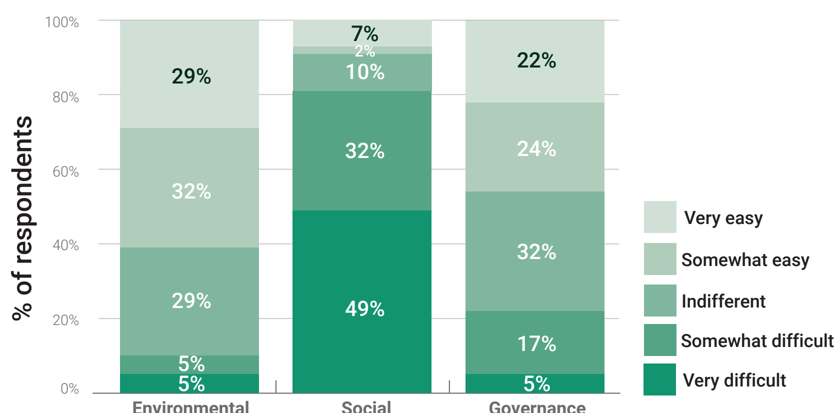
pillar but also the fact that the "S" factor is based on "soft" issues that are reported qualitatively (if at all), making it difficult for asset managers to measure them. One investor elaborates: *"The social factor is without a doubt the most difficult to measure for asset managers and for all of us. It is the least defined component, and I have not seen much (on it) so far."*

One panelist stated, *"We have not yet seen any manager that measures the components of E, S and G to our satisfaction. They all seem to have difficulties—whether it is a question of priorities, I don't know. They have the data but maybe not the systems."*

Question: On a scale of 1 (very difficult) to 5 (very easy), when investing in listed equities through third-party asset managers, which component of ESG is currently the most difficult for managers to measure?

Figure 11 | Difficulty of Measuring the Components of E, S and G

Social Factor Is Most Difficult to Measure



3.4

ESG Reporting—Important, With Room for Improvement

Regarding investors' interest in ESG reporting from external asset managers, the panelists' needs and expectations are fairly diverse, as shown in **Figure 12** (following page). We asked the asset owners to indicate the most important elements of ESG reporting, and they identified the top three as: (1) reporting on progress and outcome of engagement activities, (2) reporting on greenhouse gas intensity and (3) reporting on carbon footprint.

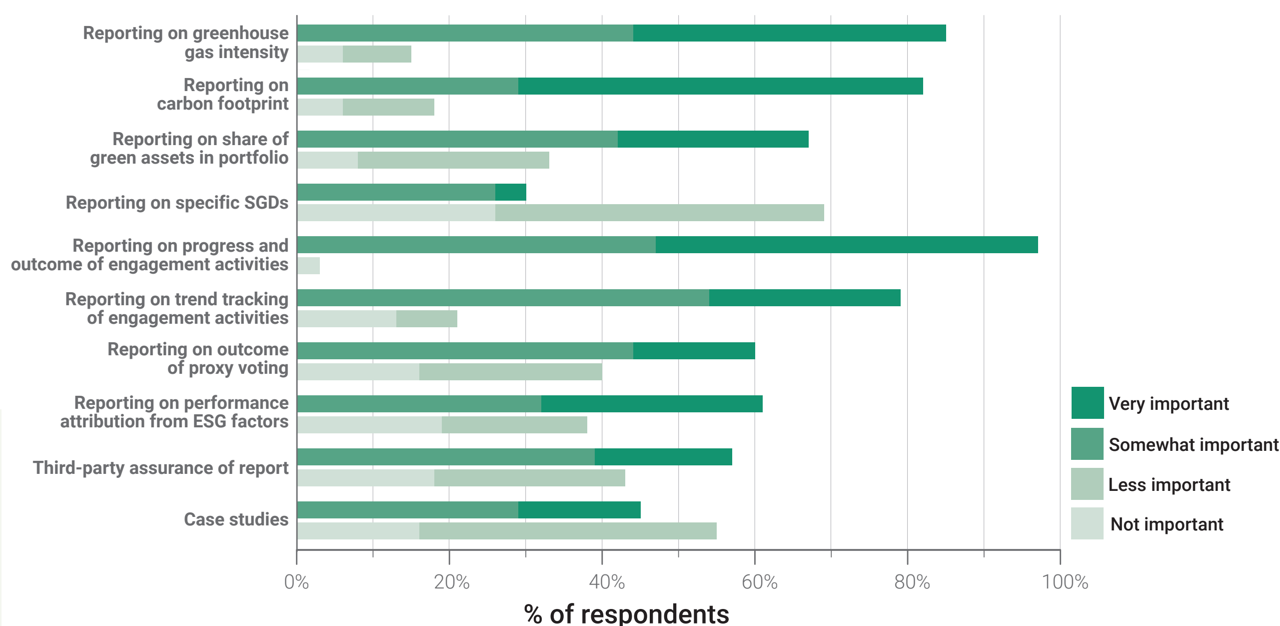
Reporting on the progress and outcomes of engagement activities was rated as either very or somewhat important by 82% of the respondents, representing both Nordic and Dutch investors. Many commented that asset management firms that cannot conduct engagement activities internally are automatically red flagged. A number of the investors on the panel believe that best-in-progress reporting has the most potential going forward—this is linked to transparency (one cannot assess progress without transparency), a key requirement for many investors.

Reporting on greenhouse gas intensity is deemed important by roughly 71% of the panelists. They acknowledge that it is fairly easy to report on environmental elements and hence often consider it a hygiene factor in terms of an asset managers' ESG reporting. In addition, 68% said that reporting on carbon footprint is very or somewhat important. The survey participants see reporting on carbon emissions as mandatory, due to the extensive available data and measurements. Many pension

Question: On a scale of 1 (no importance) to 5 (high importance), when investing in listed equities through third-party asset managers, how important is the inclusion of the following elements in the manager's ESG reporting?

Figure 12 | Importance of Elements Included in ESG Reporting

Reporting on Progress of Engagement Is a Top Priority



Note: Investors who did not respond to the question and those who responded with "indifferent" are excluded.

funds have internal environmental key performance indicators and tracking the intensity of greenhouse gas emissions and carbon footprint are among the most common. One pension fund concludes: *"In our opinion, companies with high carbon emissions will be out of business in 20–30 years."*

A number of participants suggested there is room for improvement in ESG reporting. For example, one panelist said, *"Third-party assurance of ESG reporting is at the top of my wish list. I do not see any managers doing it—but I would love it!"*

Another raised the bar by saying, *"Reporting on carbon, greenhouse gas and share of green assets is not important to us — we have our own tools for this and can generate the same reporting as the managers. We need data and reporting from our managers that we can actively use in our communication from our stakeholders."*

With respect to reporting on SDGs, one asset owner implied that much of it lacks substance, saying *"It depends on the manager in question and how they work with the SDGs. Don't do marketing—we only want quality and substance."*

A Dutch investor commented, *"Reporting on the SDGs is not so useful. They are first and foremost a marketing and communication tool."*

Another investor made the observation, *"The SDGs are [designed] to look at the positive—it would be so much more efficient to look at the negative and to report on the negative with full transparency—but this is utopia and will never happen."*

4.0

Our Take: A Conversation With Sarah Bratton Hughes

ESG/sustainable investing is not just expanding rapidly in terms of its reach; it is also evolving meaningfully with respect to asset owners' expectations regarding how asset managers embed ESG in their processes. The asset owners who participated in this survey are clearly committed to sustainability but are largely dissatisfied with the current state of ESG reporting from asset managers. On that note, we now turn to a Q&A session with American Century Investments' head of sustainable investing, Sarah Bratton Hughes, for a perspective on the survey results and recent developments with respect to ESG.

Question: *The survey showed that leading Nordic and Dutch asset owners overwhelmingly prefer either the integration approach to ESG investing (the top choice) or best-in-progress strategies, and American Century takes an integration approach. What do you see as the advantages of integration compared to best in progress? Conversely, does best in progress offer something that integration does not?*

Sarah Bratton Hughes: Investors around the world are coming to understand the importance of ESG—as both a source of risk, alongside financial risk and others such as those outlined in Porter's Five Forces, and an opportunity to create value. These investors have return objectives that are driving them to seek outcomes that include ESG alpha or "Alpha-plus", which we define as environmental and social alpha alongside traditional financial alpha. We believe that an integrated approach, one that considers ESG risks and opportunities as part of the analysis an asset manager conducts when making investment decisions, is the best way to do that. We also believe that so-called value stocks are often the best place to find both traditional alpha and ESG alpha, as these companies may be in the process of transitioning to a more sustainable business model.

> "We believe that best in progress is one way to provide both ESG improvement and traditional alpha."

This goal of finding ESG alpha is also driving more investors to look at best-in-progress stocks as those companies are often better positioned to deliver alpha-plus returns compared to best in class companies. Those best-in-class stocks are scooped up by passive ESG strategies that automatically buy the names with high ESG scores, and that buying pressure tends to squeeze out ESG alpha from best-in-class stocks. The potential for alpha is greater for names that were overlooked because they were not best in class and therefore did not make the cut for ESG index funds. Best-in-progress companies recognize the importance of ESG and are taking concrete steps to "up their game"—thus, they are showing progress—but they still represent a "value" with respect to their ESG potential. It is also critical to remember that just because a company is best in class from an ESG perspective does not mean it is appealing from an investment perspective — a stock could be priced to perfection, the company may be struggling to hold onto its market share and so on.

Asset managers have a fiduciary duty to seek long-term returns for investors, and we believe that best in progress is one way to provide both ESG improvement and traditional alpha. So, one could argue that the integration and best in progress approaches are both trying to get at ESG alpha and alpha-plus but in different ways. However, we think using a best-

in-progress method views ESG as a siloed issue, whereas integration takes a holistic view that allows us as managers to consider ESG in the right context.

Question: *When survey participants were asked about their use of passive/enhanced passive strategies, there was an interesting split: 45% rated passive/enhanced as a preferred or even highly preferred approach, while 39% rated it at or near the bottom. What are your thoughts on this?*

SBH: Passive strategies are easy to explain to a board of directors and to those on whose behalf the assets are being invested, such as pension plan participants and others. That may be part of the appeal. They are also fairly low cost to implement, especially when the manager simply tracks an ESG index. However, tracking an ESG index means accepting the challenges embedded in whatever ESG scores are used to rank stocks and build the index. This applies to every ESG data vendor that comes up with scores or ratings. It is well known that ESG vendor ratings vary widely across sources, and that is not surprising. Each one has to decide which data sources to use and which ones to exclude when constructing its scores. Each one has to make numerous judgment calls about the weighting each aspect of an E, S or G score receives. And that's just for starters.

"Tracking an ESG index means accepting the challenges embedded in whatever ESG scores are used to rank stocks and build the index."

In addition to the problems of relying on ESG data vendor scores to drive one's investing, we see passive investing based on ESG ratings as backward-looking. ESG indices typically use ESG scores or ratings to identify best-in-class names to select and weight the constituents. There is nothing wrong with being identified as a leader with respect to one or more ESG factors—kudos to those companies that have been managing ESG risks better than their peers and/or have identified opportunities to generate shareholder value through ESG-related activities! But those things have already happened and are therefore already reflected in share prices.

I believe this a key reason ETFs that track indices of stocks with high ESG scores often underperform. Various controversies hit certain companies in the index and their ESG scores decline, so those stocks are then kicked out of the index; however, the index has already captured all of the negative performance brought on by the controversies. Those stocks are not added back until after their ESG scores have been upgraded, but by that time, much of the positive financial performance associated with that improvement has already occurred. So, the ETFs that track these indices capture all the downdraft but none of the recovery in performance. I believe that asset owners who prefer passive strategies may be focusing on the simplicity of execution or may be comfortable with passive approaches because, as noted above, they are easy to explain.

Question: *Eighty-five percent of the survey participants said that receiving regular updates from their asset managers on the progress and outcome of engagement activities is very important. And yet, skepticism was a key theme in the respondents' comments, including some who do not believe in managers' self-classification of funds as Article 6 versus Article 8. Asset managers say they engage with investee companies but will privately admit it is difficult to do, particularly outside of their home countries. What do you see at essential components of reporting on engagement so that it is more than a check-the-box exercise? What is American Century's view on outsourcing engagement to a third party?*

SBH: There is no shortcut for good, old-fashioned due diligence, and the survey participants clearly recognize that engagement takes the crown. One participant said, "Engagement is the way to change the world." Investors know that it's not the number of meetings that matters; it's the quality of the meetings. In fact, if the number of engagements was a top criteria, it would be relatively easy for an

asset manager to "game the system" by sending brief, perfunctory emails to the management teams of every company in the portfolio.

In our view, it is much more important for investors to ask managers about what they have done to monitor companies on specific issues. Investors should also ask managers how they establish timelines for taking remedial action, how they follow up and how they decide to use proxy voting or even exit if the company's response is inadequate and the risk an issue poses is unacceptable. In other words, investors are looking for clear escalation when engagement fails, which relates to the importance of putting timelines on engagement outcomes. We don't believe this type of engagement can be outsourced.

> "At American Century, our integrated approach looks at "S" in combination with "E" and "G" as it pertains to each industry because the three categories affect each other."

Question: *What are your thoughts on the difficulty of assessing the social component of ESG, which the survey respondents said was the most difficult to measure among E, S and G? Is some type of reporting standard needed, similar to reporting carbon emissions? If so, would the same standards apply to different parts of the world, or would they recognize cultural and demographic differences?*

SBH: It is very challenging to identify, let alone quantify, a company's successes and shortcomings with respect to managing risks and pursuing opportunities in the social category. With no mandatory disclosure requirements, companies that believe they are doing a good job are more likely to publicize things like their employee retention or diversity, equity and inclusion efforts than those that are less confident, but that does not really mean much. A well-known bank in the U.S. was recently punished for regularly interviewing "diversity candidates" for job positions just to meet some requirement. In fact, those interviews were just done to check-the-box and the person who would get the job had already been chosen.

Being data-driven is critical, but we do not want the pursuit of perfection get in the way of the good when it comes to data. When we actively engage with companies, we can get more information than some type of standard disclosure would produce. For example, we look at employee turnover as a key indicator of corporate culture. We not only ask companies for high-level figures; we also try to get at turnover by job level, gender, ethnic minorities, etc. We are also passionate about the "just transition"—in other words, we evaluate whether companies are working to transition to a more sustainable world in a way that does not cause severe damage and upheaval in the process. So, for example, if a power company is shifting to solar and wind, we use active engagement to understand how the company treats and re-skills its workers.

At American Century, our integrated approach looks at "S" in combination with "E" and "G" as it pertains to each industry because the three categories affect each other. For example, a mining company that operates in an emerging market has to address worker safety and environmental issues together. The challenges of measuring the social component of ESG is another good example of why passive

ESG strategies based on scores and rankings are inferior to an integrated approach. Scores depend on objective criteria, and it is difficult to obtain or even define which quantifiable data to use when measuring social issues.

Question: *Much of the world perceives hostility toward ESG in the U.S. How does that affect asset managers, in particular American Century?*

SBH: In short, it doesn't affect our activities at all. We are long-term stewards of our clients' capital, and while some might claim that ESG risks are non-financial risks, they are actually pre-financial risks that can be a forerunner of financial underperformance. With over 90% of the market value of the S&P 500 Index covered by intangible assets, such as brand image and intellectual property that depend on reputation and engaged employees, it is more important than ever to incorporate ESG into the investment process. ESG integration, which is our approach, focuses on financially material factors and is very much process-oriented. Much of the pushback we have seen is at the state level, where some states are boycotting funds that exclude fossil fuels. That primarily affects exclusion/screening strategies.

As an aside, we believe managers should be careful about saying that exclusion strategies negatively affect companies' ability to raise capital. For example, in the oil patch, private companies are having no problem raising capital, so there has not been an overall reduction in drilling as a result of ESG funds excluding oil producers; firms are simply turning to financing from private equity.

We want to make sure we don't exclude companies that are on a positive trajectory and can deliver that Alpha-plus. Also, if you don't own a stock, you can't engage with the company, which means you are likely to miss out when it makes progress on the issues that matter to investors—that gets back to the benefits of best in progress over best in class. It also gets back to pursuing both performance and ESG goals. The U.S. Securities and Exchange Commission is pushing forward with its proposed truth-in-advertising disclosure requirements that are aimed at preventing greenwashing, to make sure that asset managers are delivering on the ESG claims they make. Granted, this is very different than what European Union regulations are doing in terms of pushing for more sustainable investing, but at American Century, we focus our ESG integration on both achieving sustainable outcomes and driving returns for investors.

americancentury.com

For Investment Professional Use Only / Not for distribution to the public.

ESG Integrated: An investment strategy that integrates Environmental, Social and Governance ("ESG") factors aims to make investment decisions through the analysis of ESG factors alongside other financial variables in an effort to deliver superior, long-term, risk-adjusted returns. The degree to which ESG integration impacts a portfolio's holdings may vary based on the portfolio manager's materiality assessment. Therefore, ESG factors may limit the investment opportunities available, and the portfolio may perform differently than those that do not incorporate ESG factors. Portfolio managers have ultimate discretion in how ESG issues may impact a portfolio's holdings, and depending on their analysis, investment decisions may not be affected by ESG factors.

The opinions expressed are those of the portfolio team and are no guarantee of the future performance of any American Century Investments portfolio. This information is for an educational purpose only and is not intended to serve as investment advice. References to specific securities are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. Opinions and estimates offered constitute our judgment and, along with other portfolio data, are subject to change without notice. This information is not intended as a personalized recommendation or fiduciary advice and should not be relied upon for investment, accounting, legal or tax advice. No offer of any security is made hereby. This material is provided for informational purposes only and does not constitute a recommendation of any investment strategy or product described herein. This material is directed to professional/ institutional clients only and should not be relied upon by retail investors or the public. The content of this document has not been reviewed by any regulatory authority.

This promotion has been approved with limitations, in accordance with Section 21of the Financial Services and Markets Act, by American Century Investment Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority. This promotion is directed at persons having professional experience of participating in unregulated schemes and units to which the communication relates are available only to such persons. Persons who do not have professional experience in participation in unregulated schemes should not rely on it.

American Century Investment Management (UK) Limited is registered in England and Wales. Registered number: 06520426. Registered office: 12 Henrietta Street, 4th Floor, London, WC2E 8LH.

American Century Investment Management (Asia Pacific) Limited currently holds Type 1 and Type 4 registrations from the Securities and Futures Commission (SFC). American Century Investment Management, Inc. is not registered with the SFC.

The material in this document is published for general informational purposes only. This document is not designed for the purpose of providing financial product or investment advice. The information contained in this document does not take into account your particular investment objectives, financial situation or investment needs. You should seek personal financial product or investment advice and consider whether the information contained in this document is appropriate to your particular investment objectives, financial situation and investment needs before making an investment decision.

American Century Investment Management, Inc. is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) (Australian Corporations Act) in respect of the financial services it provides to "wholesale clients" for the purposes of the Australian Corporations Act and does not hold such a licence.

American Century Investment Management, Inc. is regulated by the Securities and Exchange Commission under United States laws which differ from Australian laws. Any financial services given to any person by American Century Investment Management, Inc. in Australia are provided pursuant to ASIC Class Order [CO 03/1100].

American Century Investment Management, Inc. is not authorised by is the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)).

American Century Investments (EU) GmBH is registered with the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)).

Kirstein A/S is not affiliated with American Century Investments.

©2022 American Century Proprietary Holdings Inc.
All rights reserved.

Website

www.americancentury.com/institutional-investors

Business address

4500 Main St.
Kansas City, MO 64111

Phone

Main: 1-866-628-8826