Callan

CALLAN INSTITUTE

Survey

2017 ESG Survey

Table of Contents

Executive Summary

Introduction

In August 2017, Callan conducted our fifth annual ESG survey. The results reflect input from 105 unique institutional U.S. funds with more than $1.1 trillion in assets.

Over the last five years, these surveys reveal that U.S.-based institutional investors have increasingly incorporated environmental, social, and governance (ESG) considerations into their investment decision-making process. After several years of education around ESG issues, in 2017 overall incorporation rates held steady with the previous year at more than one-third of total funds.

ESG factor incorporation levels off after years of steady growth

Overall incorporation of ESG factors into investment decision-making plateaued at 37% of respondents in 2017, on par with 2016 (37%) and up from 2013 (22%). This trend reflects changing survey respondents over time (a larger portion of smaller and corporate funds responded in 2017 than in previous years), as well as multiple years of investor education around ESG coming to fruition. Further suggesting a plateau in adoption rates, 7% of respondent firms that have not yet incorporated ESG factors into investment decisions were considering doing so in the future, down from 22% in 2016.

By fund type, we note a slight dip in the rate of ESG incorporation among corporate and endowment funds compared to 2016 (likely due to sample changes over time) while other fund types saw a continued rise in adoption:

- 35% of public funds indicated they incorporate ESG factors into the investment decision-making process, up from 25% in 2016
- Foundations reported the highest rate of ESG incorporation at 56% in 2017 (vs. 48% in 2016)

The largest of funds (with $20 billion in AUM or more) continued to incorporate ESG factors into the investment decision-making process at a much higher rate than their smaller counterparts: 78% for the largest funds compared to 30% for the smallest funds ($500 million in assets or less).

Key Findings

Callan's fifth annual *2017 ESG Survey* reflects trends on ESG adoption for U.S. institutional funds. The results reflect input from 105 unique institutional U.S. funds and trusts with more than $1.1 trillion in assets.

7%

of those who have not yet incorporated ESG factors are considering it

50%

of those who have incorporated ESG added language to the investment policy statement

78%

of largest funds have incorporated ESG factors into investment decisions

Most frequently cited reason to incorporate ESG:

My fund must consider ESG factors as part of our fiduciary responsibility

68%

Increase in the rate of ESG adoption since inception of survey in 2013

ESG incorporation by region

Pacific	53%
Northeast	44%
Central	32%
Southeast	21%
Mountain	20%

88%

of corporate funds surveyed incorporated ESG factors in order to complete their fiduciary duty

56% foundations

39% endowments

35% public funds

25% corporate

41%

of respondents define ESG using the literal definition, implying an acceptance of the definition provided by managers hired

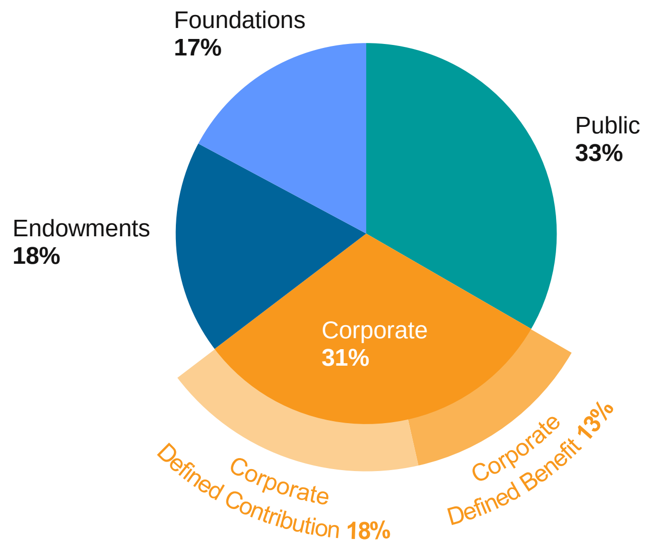
Respondent Overview

105 funds and trusts responded to the survey; approximately one-third public funds, one-third corporate funds, and one-third endowments & foundations

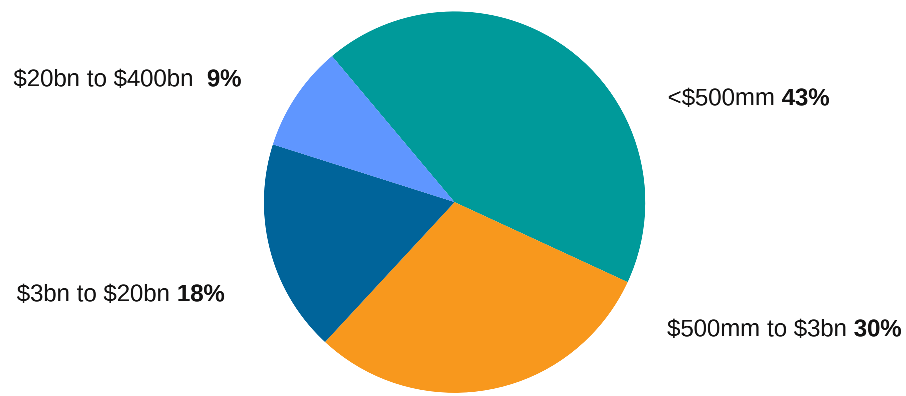
>$1.1 trillion in total assets are represented in this survey

43% of respondents are "small" funds with $500 mm or less in assets; smaller funds are less likely than their larger counterparts to adopt ESG practices

Respondents by Fund Type



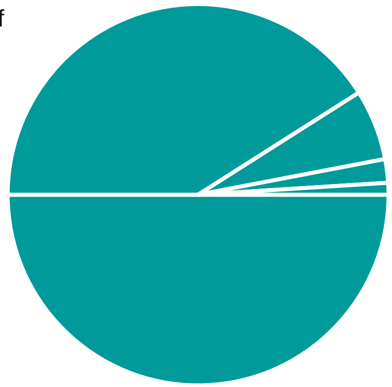
Respondents by Fund Size



Defining ESG

How Funds Define ESG

Callan has found that definitions of ESG vary widely in the industry. Logically, defining ESG is often the first step many funds take in exploring implementation.



50%

of respondent firms did not define or attempt to define ESG in 2017, up from 33% in 2016.

41%

defined ESG using the literal definition of environment, social, and governance considerations, up from 35% in 2016.

Fewer funds (8%) defined ESG by a specific pillar, factor, or mission than a year ago (17%), suggesting broadening definitions of ESG beyond individual issues that can be targeted for divestment.

ESG Factor Adoption Rates

Callan asked whether or not respondent funds have "incorporated ESG factors into investment decision-making." This language is intentionally broad in order to capture as many potential implementations as possible that reflect the prevalence of ESG considerations in the institutional investment arena.

Overall: The percentage of respondents in 2017 that had incorporated ESG factors into decision-making leveled off at 37%, on par with 2016 (37%). This trend reflects changing survey respondents over time (a larger portion of smaller and corporate funds responded in 2017 than previous years), as well as multiple years of investor education around ESG coming to fruition.

By Fund Type: Foundations and endowments have been the greatest adopters of ESG compared to other fund types over the last five years and in 2017 at 56% and 39%, respectively. Corporate funds saw a decrease in ESG adoption year over year, from 30% in 2016 to 25% in 2017, but an overall increase from 15% five years ago. Corporate defined benefit plans saw a modest dip in adoption from 29% in 2016 to 25% in 2017. This was after a leap from 7% in 2015, which Callan partially attributes to the Department of Labor's 2015 bulletin clarifying that investment strategies that consider ESG factors can be in compliance with their fiduciary duty under ERISA. More than one-third of public funds reported incorporating ESG (35%) in the 2017 survey, up from 25% in 2016.

By Fund Size: The majority (78%) of the largest respondents ($20 bn or greater) have incorporated ESG factors into investment decisions. The largest funds have incorporated ESG factors at the highest rate since the inception of the survey in 2013, while smaller funds are less likely to make ESG considerations part of the investment process.

By Region: 2017 survey respondents were from across the U.S.: 36% Central, 26% Northeast, 18% Southeast, 15% Pacific, and 5% Mountain. The Pacific region had the highest percentage of funds incorporating ESG factors at 53%, followed by the Northeast (44%) and Central (32%).

Looking Forward: Only 7% of respondents that have not yet incorporated ESG into investment decision-making are considering doing so. This is less than one-third of the amount considering this decision in 2016 (22%), suggesting many of the firms that have expressed interest in ESG are on the path to implementation or have decided not to implement.

ESG Factor Adoption Rates Overall

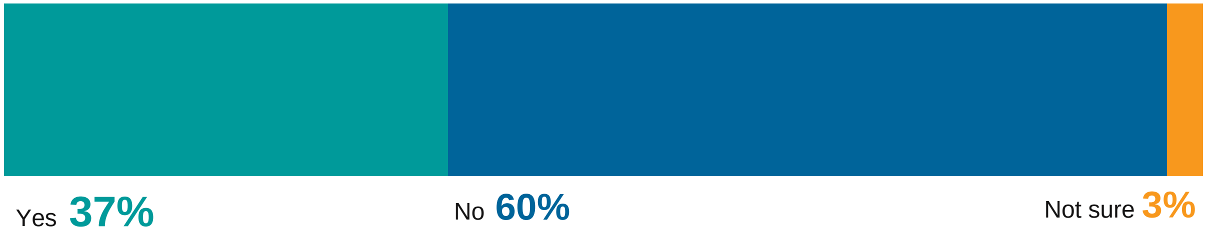
37%

of respondents had incorporated ESG factors into investment decisions in 2017, on par with 2016. The 2017 survey reflects a greater portion of responses from smaller funds (<$500 mm) and corporate funds, which are less likely than larger funds and other fund types to incorporate ESG into the investment process.

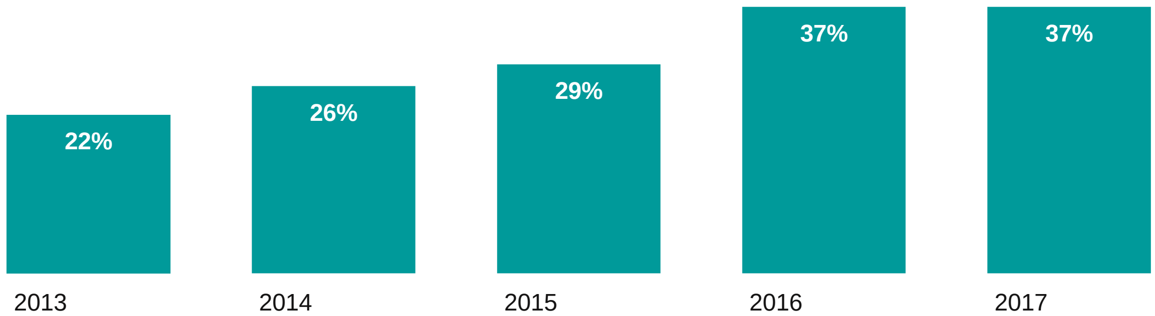
68%

increase in respondents that have incorporated ESG factors into investment decisions from 2013 to 2017.

2017: Does your fund incorporate ESG factors into investment decisions?



Funds that have incorporated ESG factors into investment decisions over time

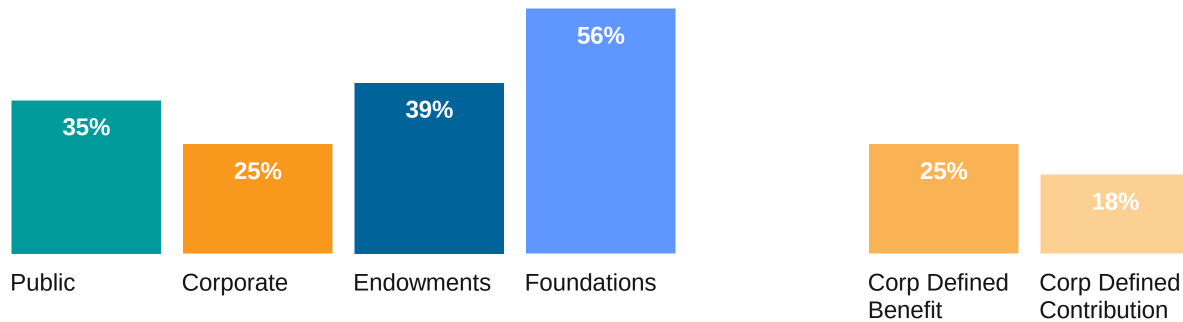


ESG Factor Adoption Rates by Fund Type

56%

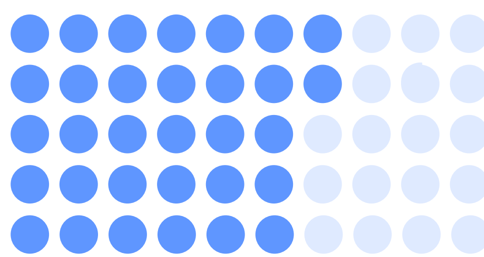
of foundations have incorporated ESG factors into investment decisions, the 2017 survey found. Foundations have incorporated ESG factors at a higher rate than all other fund types in 4 out of the 5 years that Callan has fielded this survey.

2017 funds that are incorporating ESG factors into investment decisions



By fund type over last five years

2013	2014	2015	2016	2017
Foundations **31%**	Foundations **35%**	Foundations **39%**	Endowments **53%**	Foundations **56%**
Endowments **22%**	Endowments **34%**	Endowments **37%**	Foundations **48%**	Endowments **39%**
Corporate **22%**	Public **22%**	Public **27%**	Corporate **30%**	Public **35%**
Public **15%**	Corporate **15%**	Corporate **15%**	Public **25%**	Corporate **25%**



64%

of foundations have incorporated ESG factors into investment decisions in 2017 or are considering doing so in the future.

ESG Factor Adoption Rates by Fund Size

78%

of the largest respondents (>$20 bn) have incorporated ESG factors into investment decisions. The largest funds have incorporated ESG factors at the highest rate since the inception of the survey.

136%

Increase in respondents >$20bn that have incorporated ESG factors into investment decisions from 2013 to 2017.

2017 funds that are incorporating ESG factors into investment decisions

By fund size over last five years

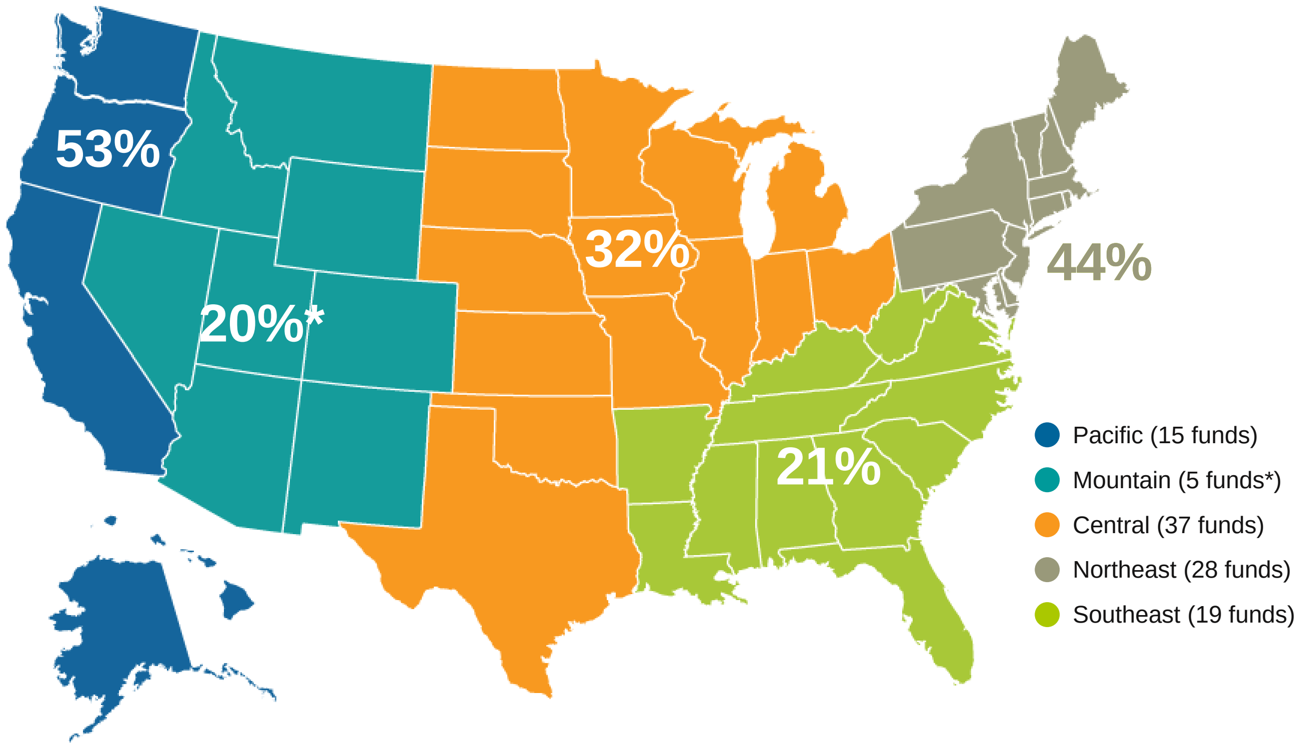
$20bn to $400bn **33%**	$20bn to $400bn **31%**	$20bn to $400bn **35%**	$20bn to $400bn **71%**	$20bn to $400bn **78%**
$3bn to $20bn **29%**	$500mm to $3bn **24%**	$3bn to $20bn **31%**	<$500mm **39%**	$500mm to $3bn **42%**
$500mm to $3bn **23%**	<$500mm **22%**	<$500mm **26%**	$3bn to $20bn **33%**	<$500mm **30%**
<$500mm **20%**	$3bn to $20bn **18%**	$500mm to $3bn **26%**	$500mm to $3bn **29%**	$3bn to $20bn **22%**
2013	2014	2015	2016	2017

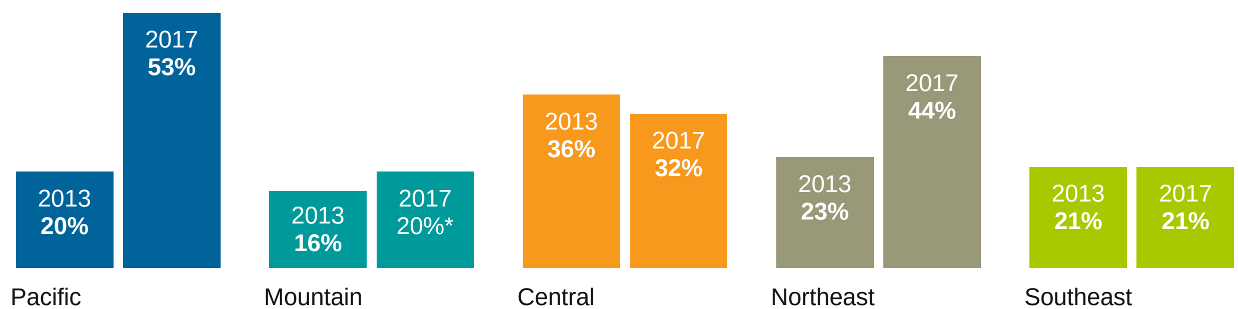
ESG Factor Adoption Rates by Region

165%

increase in rate of Pacific region respondents that have incorporated ESG factors into investment decisions over a five-year period.

2017 funds that are incorporating ESG factors in investment decisions by region





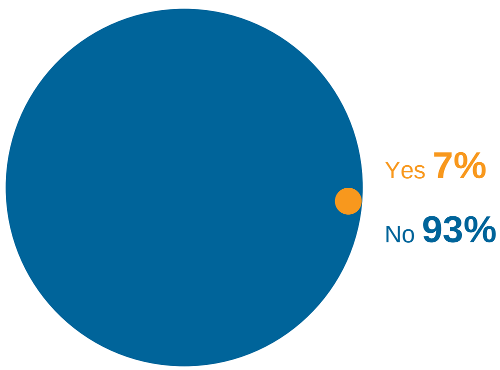
*Note the small sample size.

ESG Factor Adoption Rates Looking Forward

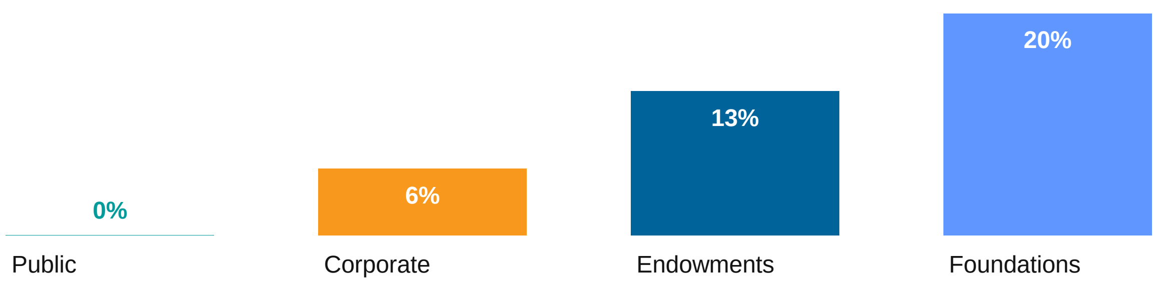
70%

decrease in the percentage of respondents that are considering incorporating ESG factors into investment decisions.

If you have not incorporated ESG factors into investment decisions, are you considering it?



Share of respondents that have not incorporated ESG factors into investment decisions but are considering it (by fund type)



ESG Implementation

Similar to ESG definitions, implementation strategies vary substantially from fund to fund, as investors find the approach that best accomplishes their unique goals. Callan asked survey respondents that have incorporated ESG factors into investment decisions specifically how they had done so to gauge which implementation strategies are most prevalent.

The top implementation method for survey respondents that are incorporating ESG into investment decisions in 2017 was to add language to the investment policy statement (50%), which was also the most common implementation method in 2016 (53%). Callan finds that adding language to investment beliefs or policy statements is frequently a first step that many institutional investors take when pursuing an integrated approach to incorporating ESG factors in investment decisions.

The next most prevalent implementations were:

- to communicate to their investment managers that ESG is important to the fund,
- to hire a manager that has incorporated ESG, and
- to incorporate a screening process and to communicate to investment managers that ESG is important to the fund (42% each).

A negative screening process can address a specific issue (e.g., screen out investments related to tobacco or fossil fuels), but positive screening is also becoming more prevalent (e.g., screen to include only securities that have best practices in a specific sector). Engagement/proxy voting ranked fifth, with 32% of investors utilizing this method. One-fifth of respondents (21%) indicate they are a Principles for Responsible Investment (PRI) signatory, double the rate in 2016 (10%).

ESG Implementation

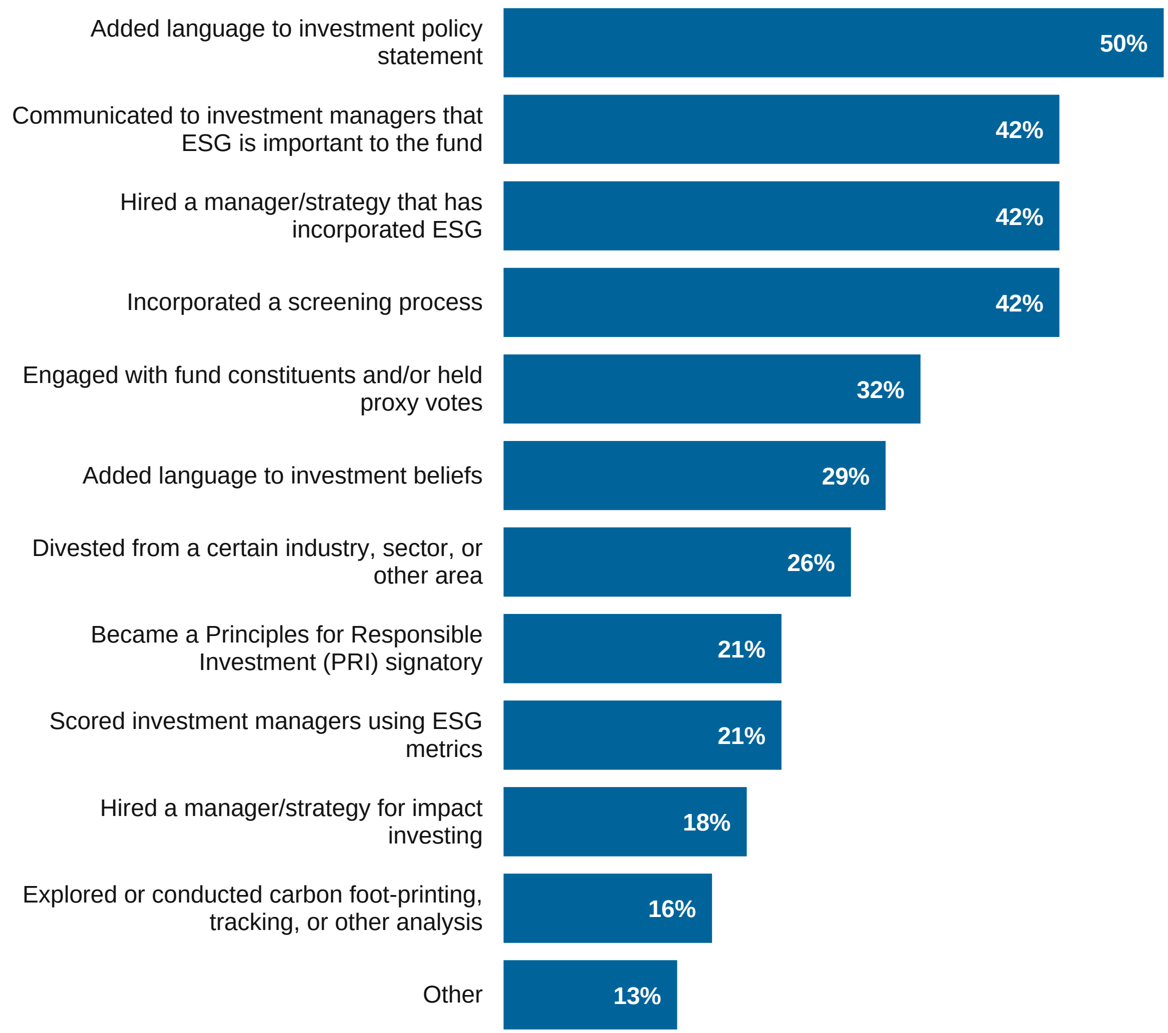
“Other” responses include:

“Divested [out] of industries with negative environmental records”

“Adopted a five-year strategic plan for ESG which includes KPIs, milestones, with targets included in senior staff performance targets”

“Use [consultant] on an ad hoc basis for ESG analysis of managers”

Implementation methods for incorporating ESG factors into the investment decision-making process



Reasons For and Against ESG

Reasons to Use ESG Factors

On the following page we show the motivations for incorporating ESG into investment decision-making. The order of these factors has changed little over the past two years; the top reasons cited for incorporating ESG factors into investment decisions in 2017 were:

– 47%: My fund must consider ESG factors as part of our fiduciary responsibility

– 42%: The fund's investment policy statement dictates that we consider ESG factors

– 32%: We expect to achieve higher returns AND we expect to achieve an improved risk profile

Explicitly documenting ESG factors by way of the investment policy statement (IPS) was a common implementation approach among all fund types except corporate funds. Half of public funds and foundations and 43% of endowments indicated their IPS dictates that they consider ESG factors. Ironically, only 13% of corporate funds' IPS dictated that ESG factors should be considered even though 88% of corporate respondents indicated they must consider ESG factors as part of their fiduciary responsibility.

Reasons Not to Use ESG Factors

More than half (61%) of U.S. institutional investors that responded to our survey in 2017 have not incorporated ESG factors into investment decision-making, in line with 2016 (60%). The most common reason cited in 2017 was that the fund would not consider any factors that are not purely financial in the investment decision-making process (41%).

The next most popular answer in 2017 was that the value proposition for ESG remains unclear (39%), down from 63% in 2016. This was especially true among endowments (86%) that do not incorporate ESG factors into investment decision making.

Reasons For and Against ESG

88%

of corporate funds surveyed utilize ESG factors in order to fulfill their fiduciary duty.

More investors expect to improve their fund's risk profile by applying an ESG lens in 2017 (32%) than fiver years ago (17%).

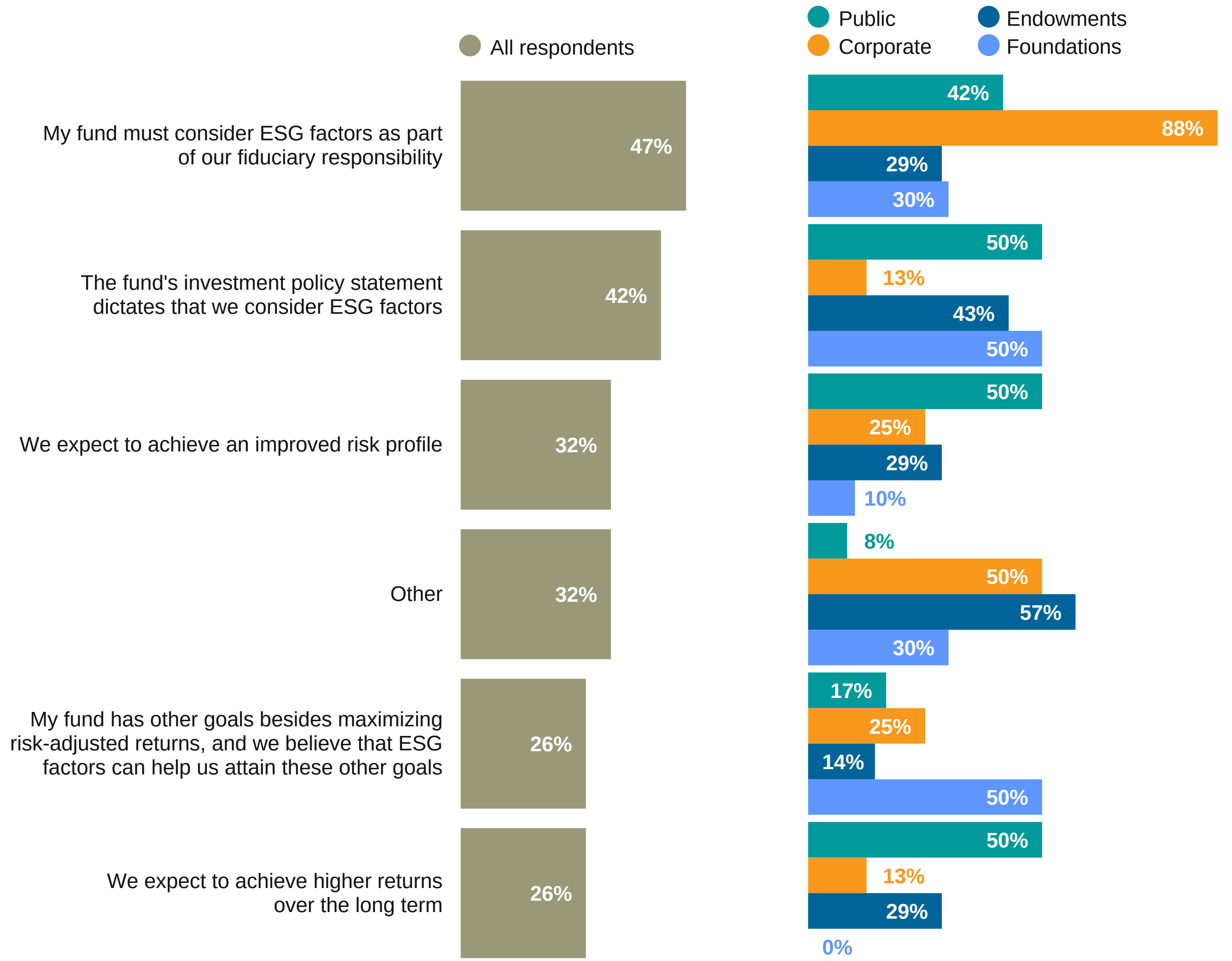
"Other" responses include:

"Participants desire to incorporate"

"We believe it is an important attribute for certain generations of participants"

"Mission alignment with our organization"

Reasons for incorporating ESG factors into the investment decision-making process*



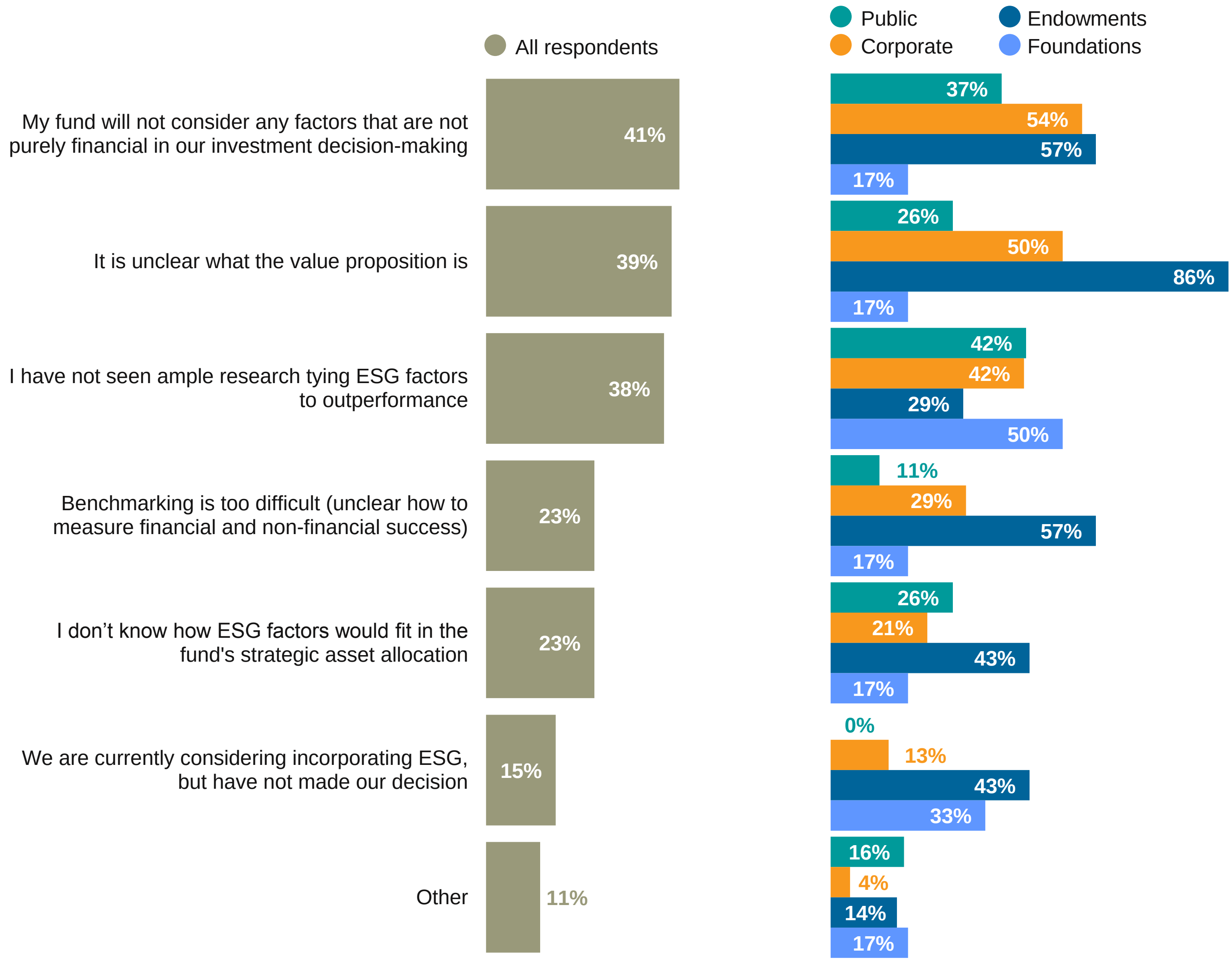
* Multiple responses were allowed.

Reasons For and Against ESG

More clarity

Years of education around ESG by movement proponents appears to be paying off, as the percentage of participants that were unclear of the value proposition of incorporating ESG factors declined from 53% in 2013 to 39% in 2017. However, for endowments this remained the top reason for not incorporating ESG factors.

Reasons for NOT incorporating ESG factors into the investment decision-making process*



* Multiple responses were allowed.

Conclusions

The percentage of U.S. investors that have incorporated ESG factors into decision-making has leveled off at 37% in 2017, on par with 2016 (37%) and up 68% relative to five years ago (22%).

Fund Type and Size Matter: Foundations and endowments have been the greatest adopters of ESG compared to other fund types over the last five years and remained on top in 2017. One-quarter of corporate funds and around one-third of public funds utilized ESG factors in some fashion in 2017, and all fund types have seen increased adoption over the last five years. The larger the fund, the more likely it was to incorporate ESG into investment decisions.

Implementation Varies: How to best implement ESG factors into investment decisions varies substantially from fund to fund, as investors find the approach that best accomplishes their unique goals. The top implementation methods in 2017 were:

- 50%: adding language to the investment policy statement
- 42%: communicating to their investment managers that ESG is important to the fund
- 42%: hiring a manager that has incorporated ESG
- 42%: incorporating a screening process and communicating to investment managers that ESG is important to the fund

Perceptions Change: Years of education around ESG issues and increased awareness of the vast options available to investors have changed how they think about the space. Today fewer investors are unclear on ESG's value proposition than five years ago (39% in 2017 vs. 53% in 2013), and more expect to improve their fund's risk profile by applying an ESG lens (32% in 2017 v. 17% in 2013).

Looking Forward: Climate change, fossil fuel-free investing, and the regulatory environment are a few examples of ESG issues that have been covered by the press in recent years. While fewer survey respondents in 2017 were considering new implementations of ESG in their investment decision-making processes than previous years (7% vs. around one-fifth, historically), perceptions and approaches to implementation have shifted over time. Callan will closely follow these trends as the ESG landscape for data availability and factor integration continues to evolve.

About the Authors

Shane Blanton is a Senior Analyst in Callan's Published Research Group covering business analytics. He is responsible for data analysis and visualization to support Callan's research endeavors. In addition, he is responsible for measuring and benchmarking Callan's communications campaigns. Previously Shane was a member of the Analytical Solutions Group for three years, training Callan's clients to use PEP software.

Prior to joining Callan, Shane worked as an Account Manager for an IC packaging manufacturer, and also worked as a trading assistant to a proprietary options firm. Shane attended Carnegie Mellon University, where he earned a B.S. in Business Administration.

Anna West is a Senior Vice President dedicated to Callan’s research and education initiatives. As Director of the Callan Institute and Co-Manager of the Published Research Group, she oversees the educational content presented at the Callan Institute workshops and conferences. She also works with subject matter experts across Callan to produce white papers, surveys, charticles, and other research for investors. As chair of Callan’s Environmental, Social, and Corporate Governance (ESG) Committee, Anna covers ESG trends and developments. Anna is also a member of Callan's Emerging and Minority, Women, or Disabled-owned Managers Committee and is chair of the Institute Advisory Committee. She is a shareholder of the firm.

Anna joined Callan in August 2006. Prior to Callan, she worked for Vail Resorts, Inc. She earned an MBA from the University of San Francisco and a BA in International Business and French from Washington University.

Disclosure

About Callan

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are backed by proprietary research, exclusive data, and ongoing education. Today, Callan advises on more than $2 trillion in total fund sponsor assets, which makes it among the largest independently owned investment consulting firms in the U.S. Callan uses a client-focused consulting model to serve pension and defined contribution plan sponsors, endowments, foundations, independent investment advisors, investment managers, and other asset owners. Callan has five offices throughout the U.S. For more information, please visit www.callan.com.

About the Callan Institute

The Callan Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

For more information about this report, please contact:

Your Callan consultant or Anna West at westa@callan.com

Callan

Corporate Headquarters

600 Montgomery Street
Suite 800
San Francisco, CA 94111
800.227.3288
415.974.5060

www.callan.com

Regional Offices

Atlanta
800.522.9782

Chicago
800.999.3536

Denver
855.864.3377

New Jersey
800.274.5878

@CallanLLC

Callan