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# Why ESG Should Matter to Institutional Investors

**An excerpt of the Privcap webinar "The LP Case for ESG"**

## The Panelists


**Natasha Buckley**
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# The LP Case for ESG

A deep dive into why institutional investors should consider implementing an ESG—environmental, social, and governance—program, and what they should look out for. Two senior investment officials from the North Carolina Department of State Treasurer explain the Principles for Responsible Investment they've been following, and what impact that has had on their investments' performance.

## The Panelists

**Natasha Buckley**
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Principles for Responsible Investment

**Melissa Waller**
Chief of Staff, Deputy Treasurer,
North Carolina Department of State Treasurer

**Sondra Vitols**
Senior Investment, Research and Policy Officer,
North Carolina Department of State Treasurer

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**Privcap: We're very pleased to be joined by Natasha Buckley from the Principles for Responsible Investment (PRI), who will give an introduction.**

**Natasha Buckley, PRI:** I'm very pleased to introduce this webinar by giving a brief introduction to the PRI initiative and our private equity program, which I manage. The Principles for Responsible Investment were launched 10 years ago, and developed by investors for investors. We now count over 1,600 signatories to our principles from over 60 countries.

The principles themselves are not prescriptive, and each signatory will decide on their own approach to responsible investments. What unites our signatories is the belief that the consideration of environment, social, and governance factors will lead to better informed investment decisions. So it's not necessarily about what you invest in, but how you invest and being better placed to identify investment risks and also investment opportunities.

We have witnessed a tremendous update of ESG integration by private equity investors, and there is of course that natural alignment between the stewardship style of private equity investing and responsible investment.

We currently have 29 asset owners signed up to the PRI in the U.S. across nine states, and we are witnessing growing interest from their peers. The work that North Carolina Department of State Treasurer has done truly embodies the spirit of the principles, that of promoting acceptance of responsible investment and that of industry collaboration.

**Melissa, what led your organization to determine that it needed to do a deep dive into the role that ESG can play in an institutional portfolio?**

**Melissa Waller, North Carolina Department of State Treasurer:** It is best to start at the beginning of understanding why a large institutional investor would come at it from this perspective.

We were fortunate enough to have the ability to really look at it holistically across the department. A lot of times, when you look at different institutional investors or different groups, that sometimes the corporate governance [goes] in one direction and the investment philosophies or investment policy statements go sometimes in another direction. And so for us, it was really important to have this collective collaboration on where our goals were and where we were setting those from an institutional investment [standpoint] and looking at long-termism being a part of that.

And then, looking specifically as ES&G pertain within that, we determined that it would be a great way to have this research project that would give us a due diligence phase and a learning phase to go through and look at our peers and look at folks and how they've done this well in the past, as well as things that are trending in the future and best practices that we not only looked at abroad, but also domestically. And then take some of that collaboration and look at best practices across all of those.

**Sondra Vitols, North Carolina Department of State Treasurer:** It may be helpful to lay out what our pension plan portfolio looks like. We currently manage about $90B in assets, which are allocated across both public and private market investments. And we do a variety of internal management, direct trading, and securities selection, as well as external management, which includes our private equity exposure.

We have a dedicated private equity asset class, which is a return-seeking portfolio. In addition, we have other types of private market and private equity investments that rest in portfolios that are for diversification and hedging purposes. One of the things that we hoped to do right off the bat with our research project was to view it through the lens of thinking of these issues as factors and not approaching it with any given ideology in mind, either being potentially pro-sustainable investing or against it but really treating it as a factor-based exercise to see how, if any, of these issues either impacted attribution among our investments or also could help with mitigation of longer-term risks embedded in our portfolio.

In addition … we thought about this from a perspective of portfolio construction, risk management, and, specifically, the kind of portfolio we have at the full pension-plan level. And one of the approaches we adopted early on was this idea of materiality. I'm sure, as all of the folks that have worked in this space recognize, there are a myriad number of environmental, social, and governance issues that matter to a variety of stakeholders. Our perspective was formed by being a long-term investor and focusing on those issues that had material impact, either on performance attribution either at the public company level, and then looking at how that might matter across asset classes and investment strategies.

We also started grappling with issues around ESG data and standardization. There is a heck of a lot of information out there, but if you're an investor, there are challenges with pulling out a signal from noise in that space. And that relates to the fact that currently most of the data is self-reported, and there isn't a standardized way of reporting it.

And then in linking to our corporate governance activity, we generally found supporting engagement on issues versus taking a divesting approach more constructive. Quite frankly, while it may feel good to divest from certain stocks—particularly in more developed public equity markets—it really has very limited impact on altering the behavior of the underlying company.

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**You mentioned engagement on issues as being something that works. Can you put that through the private equity lens?**

**Vitols:** One thing to consider from our perspective is the GP-LP relationship versus being a majority shareholder. In general, for both public equity and private equity, the evidence supports that good governance leads to better performance.

But the degree of influence and engagement and the approach that's taken will be somewhat different if you are a majority shareholder versus an LP.

**What do you find that institutional investors expect from their private equity GPs as it relates to ESG? And how do you think those expectations will change over the next five to 10 years?**

**Waller:** It's in everyone's best interest to be on the same page and to be getting the information that we need as investors to do our jobs.

In some of these working groups that I'm seeing … some of the groups that had good stewardship principles in place and good open dialogues across with the firms were really having discussions openly around the due diligence processes or some of our checklist items or the things that we have as expectations that we're going to try to work into our processes.

They actually have established some great sample interaction checklists and things to open that conversation up specifically around private equity. I found that very helpful, when I brought that back to my team, to say, "Maybe we need to be having these conversations where people are understanding what we need in order to make some of those decisions or to have governance over some of those pieces." Because I do think it's new for all the players on every side.

**Vitols:** Institutional investors are quite different, even though they all may be LPs for a given private equity firm. But [there are] two areas that are coming up where I think there's going to be sustained long-term LP interest and pressure. One is more transparency about getting information, particularly around portfolio management companies. And you can apply an ESG lens to that area.

More specifically, understanding and getting more detail around the fee structures that GPs have and how that relates to the net IRR return over longer time periods is important to us, to see if we ultimately are compensated for that illiquidity premium embedded in this strategy. And that ties in very well with this issue of just getting better reporting. And then there is also thinking through and guiding our GPs on establishing which are the specific ESG issues that matter to us, and making sure we get information around those material issues.

The other recurrent theme in this group is conflict-of-interest resolution between GPs and LPs, which sits very squarely in the governance wheelhouse of ESG. And that's something that North Carolina has been engaged in a long time.

**Do you see any trends right now with regard to third-party resources helping institutional investors establish their ESG programs? Or do you see a trend for institutional investors bringing this expertise and these screening and monitoring capabilities in-house?**

**Waller:** One overarching comment that I find in the investor community is that several groups are very under-resourced in being able to have expertise in-house around those things.

**Vitols:** We actually surveyed what consultants are doing in this space. There's a lot of dispersion about the level of involvement and the depth, depending on the consultant. It's also important to distinguish between groups that work as investment management-type consultants versus groups that are engaged in the ESG space on behalf of other stakeholders.

One actively growing area, which I think is particularly productive, is from a corporate governance viewpoint, outsourcing and augmenting shareholder activism through groups that have the skill sets and are able to engage a public company over a longer time period. Because one of our observations is if you are getting engaged with a public company on a particular issue—say board diversity or board independence—that's going to be a long conversation. ■

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> – Sondra Vitols, NC Department of State Treasurer