Responsible investment by asset class

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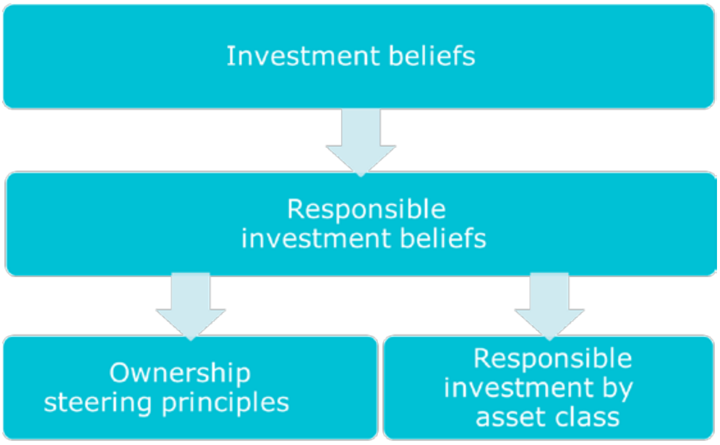
1 Aims

The purpose of this document is to update Keva's operating principles and target-setting relating to responsible investment by asset class.

The objective of Keva's investment management is to support the funding of the local government pension system's long-term liabilities through generating real investment returns. The starting point for Keva's investments is to manage its cross-generational pension liability.

The document is based on Keva's Investment Beliefs document (Keva, 2017a). With regard to responsible investment, the document relies on Keva's Responsible Investment Beliefs document (Keva, 2017b). The structure of the documentation is presented in Figure 1.

Figure 1: Structure of Keva's investment management documentation



(Keva, 2017)

As a long-term investor, Keva aims to understand the long-term ESG risks and opportunities of the entities it invests in. Keva believes that focusing on the factors that are relevant from the perspective of long-term risk and/or return will, in the long term, reduce also the externalities facing the natural and the social environment with regard to Keva's investment assets. (Keva, 2017b).

From the perspective of investment risk and return, it is pivotal to integrate relevant ESG information into the investment process and decisions. Keva is continuously strengthening integration of the ESG perspective with regard both to the assets we manage ourselves and those where management is outsourced. Keva sees responsible investment to be a continuous development with increasing accuracy over time, as measurement methods and terminology evolve. (Keva, 2017b)

Keva makes investments both directly and through external asset managers. From the perspective of responsible investing, processes are different in direct and indirect investing. In external asset management, the entities invested in are chosen and analysed by an external portfolio manager, whereas in internal asset management, Keva is responsible for these duties.

2 Asset class-specific policies

2.1 Direct investments in equities and corporate bonds

From the responsible investment perspective, direct investments in equities and corporate bonds may be broken down into three stages: the search for new investment opportunities, the monitoring of investments in the portfolio, and active ownership.

ESG analysis and norm-based screening (see below) are applied both to the search for new investment opportunities and the monitoring of investments in the portfolio. Active ownership processes are utilised in the context of monitoring the existing portfolio.

2.1.1 ESG analysis

ESG (Environmental, Social, Governance) criteria for investments create a framework for assessing long-term risks and opportunities. ESG information is intended to support traditional investment analysis and seeks to analyse the long-term risks and opportunities. (Keva, 2017b).

In direct equity and fixed income investments, ESG analyses are both carried out inhouse and outsourced from partners. ESG analysis has been integrated into the investing process.

ESG analysis examines the relative performance of the portfolio and its individual investments from the perspective of responsibility indicators.

2.1.2 Norm-based screening process

Norm-based screening is applied to both companies held in the portfolio and companies under consideration for the portfolio. In particular, Keva monitors compliance with the UN Global Compact.

In respect of companies held in the portfolio, Keva obtains on a regular basis reports on norm violations. A norm violation triggers the following procedure:

- While analysis and the engagement process are underway, no additional investments are made. The holding may also be sold in part or in full mid-process when deemed meaningful in terms of Keva’s basic task.

- A dialogue will be initiated with the company either directly or via a service provider within two months of receipt of a report. Dialogue and engagement are the primary policy approach.

- The holding may be increased once the company has changed its policies or announced their change. If no adjustment is announced or made within 24 months of the violation, the holding will be sold. Processes of change tend to take time in large companies.

- The observations made and the steps taken in the process are reported annually to the Board of Directors

2.1.3 Active ownership

Keva's portfolio managers hold regular meetings with company management and ESG are included on the agenda of these meetings as necessary.

Keva aims to step up its active ownership processes by working in collaboration with other investors on the one hand and by using external service providers on the other.

2.2 External equity and fixed income investments

External equity and fixed income investments are managed by external asset managers. External asset management may be broken down into three distinct stages: the search for the new asset managers, the monitoring of the selected asset managers in the portfolio, and the monitoring of the underlying securities in the portfolio. The responsible investment perspective is factored in throughout these three stages.

The search for the new asset managers includes an assessment of the candidates from the responsible investment perspective.

- The request for proposal (RFP) stage addresses the asset managers' responsible investment policies, which in turn acts as a starting point for further dialogue. Most of the selected asset managers have in place a responsible investment policy and corresponding processes.

- The following areas, among others, are observed: how the asset manager integrates ESG criteria into their analysis and investment decisions, how responsibility is addressed at the corporate meetings, and whether the asset manager has signed PRI or intends to do so.

The second stage involves regular monitoring of the selected asset managers.

- An annual ESG survey is sent out to all external equity and fixed income asset managers in the portfolio.

- The survey addresses the asset managers' responsible investment policies as well as their stance towards ESG-related risks and opportunities from the long-term return viewpoint.

The third stage, i.e. monitoring of the underlying securities, entails both ESG analysis and dialogue with the asset manager.

- In ESG analysis, responsibility indicators can be used for relative analysis (such as comparisons with a geographic dimension) as well as for examining individual investments in absolute terms.

- In addition, the portfolio managers in the external equity and fixed income investments unit regularly address responsibility issues in their dialogue with the asset managers.

Keva aims to enhance its active ownership mechanisms in its external equity and fixed income investments by working in close collaboration with the other investors and by using external service providers.

2.3 Alternative investments

The alternative investments unit manages Keva's private equity, real estate, infrastructure and hedge fund investments. In all of these asset classes, the emphasis is on the assessment of the fund manager/management company from the responsibility perspective and in ongoing engagement during the term of the investment.

2.3.1 Private equity investments

During the investment process the ESG criteria and/or the requirement of compliance with UN PRI is included in the process description, DDQ documentation, the fund description and in the legal due diligence documentation. In respect of major holdings, ongoing engagement is sought during the term of the investment through advisory board seats. An ESG survey of the largest funds' management companies is conducted annually.

2.3.2 Real estate fund investments

The same principles largely apply to real estate fund investments as to private equity funds. The ESG policy of both the asset manager and the fund is reviewed in the context of new investments. Specific topics addressed with asset managers, by means of examples, include energy efficiency requirements and environmental aspects. With regard to funds held in the portfolio, advisory board seats allow responsibility issues to be raised as and when necessary.

2.3.3 Infrastructure investments

The same principles apply to infrastructure investments as to private equity fund investments. The ESG policy of the fund is reviewed when reviewing new investment opportunities and environmental considerations in particular are discussed with the fund manager. Advisory board seats are taken in infrastructure funds as well and are a good way to engage with the fund manager.

2.3.4 Hedge fund investments

In hedge fund investments, the responsibility assessment focuses mainly on the asset manager.

2.4 Direct real estate investments

In direct real estate investments, the focus in terms of responsibility is on property energy efficiency. In this respect, energy-savings targets extending until 2020 have been set.

As a rule, international environmental certification is required of all real estate investments involving new construction or the major renovation of existing property holdings.

With regard to energy sourcing, the potential for making use of renewable energy sources is investigated on a case by case basis. Building contractors in Finland are required to demonstrate their corporate responsibility with the RALA Certificate of Competence issued by the Construction Quality Association. An aim for development in the coming years is to expand responsibility reporting in respect of direct real estate investments for greater compliance with the Global Reporting Initiative standards.

3 Objectives and measuring

3.1 Background to objectives

Keva considers responsible investment to be a continuous development with increasing accuracy over time, as measurement methods and terminology evolve. The weight of the asset-class-specific approach in analysis will vary depending on how important and measurable the ESG factors are in the asset class concerned. (Keva, 2017b)

Keva considers responsibility in investments to be inextricably linked to the long time horizon of investments. Responsible investment is return-seeking and risk-reducing long-term investing. Keva believes that responsible investment is only possible if investment operations are long term and purposeful by nature. ESG risks and opportunities are predominantly long-term phenomena. (Keva, 2017b)

In order to gain a better understanding of risks and opportunities in the long term, Keva has conducted a global risk-return analysis in cooperation with its roughly sixty inhouse and external corporate bond and equity asset managers on the basis of the World Economic Forum's Global Risk Report. (WEF, 2017).

3.1.1 Relevance of time horizon

The relevance of time horizon from the perspective of capital market return distributions, on the one hand, and technological advances, risk realisation and also developments in responsible investing, on the other, is addressed in Keva's Responsible Investment Beliefs document (Keva, 2017b).

- For example, an investment in emerging markets is on the one hand an investment in long-term growth, but on the other hand and on a shorter horizon, an investment in weaker institutional structure and less developed energy infrastructure. Then again, capital may also be viewed as a long-term factor of production which has a positive impact on the structures of society.

- Climate change is one of the greatest risks in our time (WEF, 2017). As an investor, Keva believes that it has a duty to understand the cost risk to the entities in which it invests arising from potential future climate regulation and to seek to limit this risk to its investment assets. At the same time, in the long term Keva must seek exposure to the development of technologies to promote resource efficiency. Working together with other investors, investment entities, and various stakeholders is vital when addressing a broad, long-horizon phenomenon.

- In accordance with its investment beliefs, as an investor Keva wishes patiently to put an emphasis on long-term trends (Keva, 2017a). For example, Keva measures the ESG indicators for emerging market equities against equivalent emerging market indices, while also monitoring the development of its investments' carbon intensity, for example, in the long term. More broadly speaking, active changes in the ESG profile of the portfolio take place patiently and during the course of a long period.(Keva, 2017b).

3.2 Key objectives

Keva's responsible investment objectives are based on its basic task. Keva's investing operations have the objective of supporting the funding of the local government pension system's long-term liabilities by means of real income.(Keva, 2017b).

Keva divides its objectives into return-seeking and risk-reducing objectives, as well as into objectives which target improvements in Keva's processes.

ESG index introduction in the passive portfolio (risk-reducing, 2018–2019)

Keva will gradually replace the benchmark indexes of its passive portfolios with ESG indexes during the years 2018 and 2019. The introduction of the ESG indexes is based on the belief that the better investments from an ESG perspective, the better also in terms of long-term investment performance. (Keva, 2017b).

Decreasing the portfolio's carbon intensity: (risk-reducing, from the level at the start of 2018 until 2022)

- Keva strives to particularise its measurement of carbon risk and believes that its responsible investment objectives will deliver a decrease in the carbon intensity of its equity investments.

- From the investor's perspective, carbon intensity is an indirect measure of the portfolio's static regulatory risk. Keva understands that carbon intensity is a non-predictive and evolving indicator.

- Encouraging recent developments in resource efficiency include the lower prices of technologies for utilising renewable energy sources, for example the development costs towards electrification in the auto industry and even the long-term steps taken in steel manufacturing towards greater resource efficiency. Investment in these long-term trends may, in the short term, partly conflict with the signal provided by carbon intensity alone.

Increasing the share of sustainable development solutions in the equity portfolio (return-seeking, 2018–2020)

Based on its risk survey, Keva will aim to increase the share of sustainable development solutions in its equity portfolio in the years 2018–2020. Similar requirements on the rate of return will apply to this element of the portfolio as to the rest of the portfolio.

- New types of demand provide the basis for new business creation. For example, further understanding of climate change and associated regulation is likely to boost demand for environmentally conscious technologies. To the investor, the solutions to problems such as aging populations, urbanisation in less developed nations, or even information security, may present an opportunity.

Environmental objectives in real estate investments (return-enhancing, 2014-2020) (Keva, 2016)

- Reducing total energy consumption by 7% from the 2014 level by 2021
- Reducing water consumption at residential buildings by 10% in 2014–2021.

Enhancement of active ownership mechanisms (process-improving, 2018-2020)

- Active ownership and dialogue create an enabling environment to influence entities we invest in. In this case, there will also be a wider benefit from the operation for communities, the environment and financially via the more sustainable practices of the entity invested in. (Keva, 2017b).
- In the years 2018–2020, Keva aims to step up its active ownership processes.

4 References

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Keva (2017b). Responsible Investment Beliefs. Helsinki, Finland.

WEF (2017). The Global Risks Report 2017 12th Edition. Geneva, Switzerland: World Economic Forum.