EMBRACING RESPONSIBLE INVESTING
ALIGNING OUR COMMITMENT
TO OUR CLIENTS WITH OUR
MISSION TO AFFECT POSITIVE
SOCIAL CHANGE
At AB, we’ve embraced responsible investing in spirit and in practice. We’ve marshaled our global resources to advance its goals and made it a key facet of our investment process and who we are as a firm.

ESG FRONT AND CENTER
To us, responsible investing is all about exploration, collaboration and relentless improvement. For years, we’ve integrated environmental, social and governance (ESG) factors into our investment decisions. In 2011, we further honed and formalized our approach when we signed the United Nations-sponsored Principles for Responsible Investment. Today, responsible investing is not just a key aspect of how we invest, it’s a part of who we are as a firm and a cornerstone of our corporate responsibility mission.

To us, responsible investing is smart investing. Supporting strong ESG standards can reward businesses and their shareholders. But an ESG failure can do serious damage to a company’s finances and market performance. A growing body of research indicates that firms that score highly on ESG issues also tend to make better long-term investments. It’s critical to stay alert to both the risks and the opportunities of ESG investing.

Responsible investing is also part of a growing social movement. Investors across the globe are increasingly striving for a better world—whether by protecting the environment, promoting fair labor practices, ensuring economic sustainability or encouraging good corporate stewardship. AB is dedicated to these ideals. With our global perspective, deep industry knowledge and collaborative research culture, we believe we have what it takes to meet the varying needs of our clients who are keeping ESG issues in mind. This focus is integral to our fundamental goal to help clients’ capital work harder and smarter.

A FIRMWIDE HOLISTIC APPROACH TO ESG
There are many ways to put responsible investing principles into practice (see glossary on page 8). We’ve developed a holistic ESG-aware approach that helps us make better investment choices and promotes responsible investing across the firm, including:

+ Integrating ESG analysis into decision-making across our fixed-income and equities platforms
+ Creating a proactive, collaborative proxy voting process that incorporates ESG factors
+ Maintaining an ESG education program to inform and engage colleagues from all corners of the firm in our responsible-investing efforts
+ Sponsoring events on topical ESG issues for our colleagues and clients (see sidebar on page 6), and taking part in similar events of other organizations
+ Building a dedicated team of senior professionals focused on developing, guiding and advancing responsible investing initiatives
+ Developing ESG-focused and impact strategies

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An integrated approach to ESG is more proactive than just using exclusionary or negative screening models, which tend to be more mechanical. Integrating ESG requires greater research expertise, data availability, and industry and local-market knowledge. It aligns naturally with our research-centric culture.

But integrating ESG into our investment decisions doesn't mean sacrificing returns. Maximizing performance for our clients is our top priority. As we see it, the two objectives complement each other: integrating ESG provides an added layer of due diligence and reinforces our investment conviction.

NOT A BOX-TICKING EXERCISE
Our investment teams have developed an intensive, collaborative process that looks at both the risks and opportunities of ESG issues as part of their portfolio selection.

ESG issues can directly impact future revenues and expenses—and therefore profitability. But our analysts go beyond numbers and industry statistics, pushing to deeply understand the controversies companies face. They develop their own perspectives and work to gain conviction around the ways each firm is responding to those issues by developing expertise in new fields of knowledge, cultivating new information sources and exploring new markets. Our fixed-income and equity research analysts often collaborate to ensure they’ve covered all the angles.

Our more analytical process stands in contrast to screening-based or exclusionary ESG approaches. Many asset managers buy or build ESG screening tools to help them avoid investing in firms with low ESG scores. We, too, use third-party ESG ratings, but we’ve found that these tools are rarely enough. Instead, we use them to supplement our own independent evaluation.

In other words, third-party tools are only one of the many inputs we use to assess and monitor companies’ ESG issues. Our fixed-income investment teams, for instance, have a proprietary system for rating the ESG risks of corporate issuers as part of their overall credit assessment.

TACKLING THE COMPLEXITIES OF ESG
With ESG analysis, some industries need more time and attention than others. For instance, analysts who cover the energy, commodities, power generation and heavy manufacturing sectors routinely analyze their companies for ESG risks. That’s also true for analysts covering firms in developing and smaller frontier countries, where on-the-ground information is scarce or nonexistent—and sometimes even inaccurate.

Still, the investment implications aren’t always cut and dry. It’s a complex balancing act—and we think it’s best to monitor and manage it holistically.

Though we use third-party and local-market data sources and consultants, our analysts rely more on their own independent fieldwork. They often seek to engage company management teams on ESG issues—conversations that are critical to gauging the scale of the problem and fielding possible solutions.

Equity and credit analysts covering controversial industries must determine how much impact ESG risks can have on financial and market performance. If the risks are material, they consider how effectively management is addressing them. Take energy or other commodity producers as an example. With these types of companies,
A TALE OF TWO UTILITIES

Delving into environmental details is second nature to analysts covering the electric utility industry, much of which still depends on coal and nuclear power generation. Amid rising concerns about carbon pollution and global warming, our utilities credit analyst was early in warning about the widening gap between the prospects of utilities that were grappling with their carbon exposures and those that weren't.

For example, he identified a leading European electric utility pouring billions into large, new coal-burning plants (coal generates more than 60% of the company’s electricity output), with almost no presence in renewables. This big coal bet has left the company vulnerable to a sluggish economy, weak power demand and rock-bottom wholesale prices as it has competed against government-subsidized renewables like wind and solar power. Its credit rating has deteriorated, making future capital spending to fix the problems more costly. Our portfolios don’t own the company’s bonds.

Our analyst also pointed to a US-based utility that’s been ahead of the curve. The company has been investing heavily in renewable energy ventures and new carbon-capture technologies for its coal plants, which now represent less than 3% of its total electricity output. Because of the firm’s early pivot, its profitability is outpacing the industry’s, and its cash flow has grown steadily over the past five years. The company’s credit rating has been stable, reinforcing our analyst’s high conviction in the security. “The environmental train has left the station,” our analyst said. “Get on board or get left behind.”

PHARMACEUTICALS: ESG AND DURABLE GROWTH

Good corporate stewardship and smart investing go hand in hand. Consider the starkly contrasting investment cases of two pharmaceutical companies. Amid rapid industry consolidation, Drugmaker A had become one of the sector’s hottest stocks. Its strategy of acquiring legacy generic products and subsequently raising prices (sometimes multiple times) had fueled phenomenal growth. Despite these feats, however, our thematic growth equity team steered clear. The company had failed to meet a key prerequisite: a business model and governance standards capable of supporting sustainable growth.

One of our investment team’s chief portfolio themes is new discoveries in genomics. The team targets companies that are harnessing the declining costs of DNA sequencing to develop novel treatments for unmet medical needs, which the team believes is the best way to achieve durable business momentum and shareholder value.

On that basis, the team favored Drugmaker B. While passing on price increases in key drugs, the company was also channeling around 20% of its sales into R&D, mostly in pursuit of new therapies to improve standards of care in oncology and other disease areas, including multiple sclerosis, age-related blindness and Alzheimer’s.

In contrast, Drugmaker A’s growth appeared to be on a short runway. Price hikes were the single biggest driver of sales gains in recent years, and the practice had drawn strong public criticism. R&D spending was negligible. Its acquisition campaign had driven up debt, and the premiums paid for those deals had inflated the asset base, reducing return on invested capital to the low single digits.

Meanwhile, Drugmaker B’s in-house R&D and innovative new medicines were generating returns in the high teens to 20% range. Not surprisingly, Drugmaker B won high marks in independent studies for sustainability within its industry. When investing for the long term, shareholder-aligned business practices and governance structures matter.
analysts have to weigh ESG risks along with other hard-to-forecast factors such as changes in government policies or commodity prices.

But even companies with unquestioned ESG credentials can run into ESG controversies that demand greater scrutiny. Consider the case of a popular fast-food restaurant chain. The company had built a highly successful brand around its use of fresh, naturally raised and, where possible, locally sourced ingredients. It was widely praised for its progressive labor practices. But the company’s reputation—and future success—was gravely threatened when an outbreak of E. coli infected multiple locations across the country.

The incident gave our analyst an opportunity to engage more fully with management on ESG issues and to gauge its ongoing commitment. The company immediately closed stores in affected markets for deep cleaning, and moved quickly to implement new food safety procedures, including making several changes to its sourcing, creating the new role of executive director of food safety and committing $10 million to helping smaller, local suppliers meet the company’s new heightened safety standards. Impressed by management’s aggressive actions, our growth equity investment team became convinced that the market had overreacted, and it took a position in the stock.

ESG analysis drives us to thoroughly examine issues across industries and companies, helping us avoid blind spots. It gives us a more accurate picture of a company’s leadership, corporate culture, competitive standing, risk profile and other key characteristics. ESG analysis can also reveal a risk or opportunity others may have overlooked.

**OUR STANCE ON CLIMATE CHANGE**

We recognize global climate change as a very real phenomenon that poses risks and, in some cases, opportunities for our portfolios across a broad range of countries, sectors and industries. The impact of global warming is far-reaching, affecting such obvious industries as energy, utilities and transportation, but also many consumer-based businesses, including food, beverages and recreation.

Our analysts evaluate climate-related risks as part of their overall research assessment, focusing on each company’s climate strategy, the political and regulatory backdrop, potential environmental liabilities and greenhouse-gas emissions. We may also seek to invest in opportunities...
in companies that are pursuing renewable energy or making a timely transition to a low-carbon strategy. Assessing carbon risk can be challenging given the lack of reporting standards and general transparency. In an effort to gain insights, we regularly engage with companies on all of these issues, and encourage them to provide more detailed, relevant climate-related reporting. We also support shareholder proposals that ask for improved reporting and transparency.

**INNOVATING WITH ESG-FOCUSED AND IMPACT STRATEGIES**

Among our ESG portfolios are frontier markets equity and emerging consumer strategies. These are portfolios in which ESG is a key driver of returns. They serve as guiding lights for the firm’s ESG engagement.

For example, ESG analysis is a central component for stock selection in our frontier markets equity strategy. Finding companies with sustainable business practices in these early-stage countries is important to AB, as well as to the fund’s investors, which include the International Finance Corporation (IFC), the private investment arm of the World Bank. The IFC has a long history of trying to improve capital allocation to these economies as a way to advance their economic development. The organization specifically sought a manager that could incorporate its stringent performance standards in building a public-market portfolio. The team maintains an ESG focus throughout the stock-selection and portfolio-construction stages. If a company doesn’t pass the IFC standards screen and the team’s independent ESG evaluation, we won’t invest in it.

Our emerging consumer equity strategy emphasizes bottom-up, grassroots research, so ESG plays a major role in the investment strategy. As part of its selection process, the team runs a “pre-mortem” risk assessment on each prospective stock. This forward-looking “what if” exercise seeks the possible reasons for failure, and then ranks each company on the basis of its ESG, financial, operational and strategic risks. Based on this analysis, the team calculates the direct impact of these risks on the cost of capital, incorporating those estimates into its long-term earnings forecasts and valuation model.

AB continues to incubate other ESG-focused products across asset classes, including a municipal bond impact strategy that funds projects with a direct social and/or environmental goal, as well as a sustainable thematic equity strategy and a responsible global multi-factor strategy.

**AN ACTIVE OWNERSHIP PERSPECTIVE**

As an investment advisor, we are shareholder advocates. We have a fiduciary duty to make investment decisions that are in our clients’ best interests. As a company’s ESG practices can have a significant effect on the value of the company, ESG considerations underpin our proxy voting policies and practices. As a shareholder advocate, we’ve been a longtime supporter of proposals that encourage strong corporate governance structures, shareholder rights and transparency. By engaging actively, we give voice to our clients’ concerns on ESG issues.
We’ve also built a robust proxy voting process. Our Proxy Committee, which includes senior investment professionals and legal and operations personnel, meets at least three times a year. The committee reviews the voting process, formulates AB’s positions on new proposals and updates policies to capture our latest thinking.

Teamwork sets our proxy voting process apart from those of other asset managers. We’ve designed it so that our Proxy Committee collaborates proactively with our equity portfolio-management teams to wrestle with the issues. Through the years, we’ve found that this partnership gives us the broadest perspective, helps build consistency across our ESG efforts and ensures that our vote has a positive impact.

DEDICATED RESPONSIBLE INVESTING RESOURCES
To tie it all together, we’ve assembled a team of senior professionals averaging nearly a quarter century of experience in the business and 15 years at AB.

A 17-member Responsible Investment Committee, a head of Responsible Investment, a full-time ESG analyst and a governance staff have joined forces to develop ESG strategy and policy, establish best practices and provide thought leadership—in partnership with investment teams. The membership of our Proxy Committee and our Responsible Investment Committee intentionally overlap, and the same person chairs both committees.

Our Responsible Investing team also monitors and ensures the progress of our responsible investing strategy and its implementation, advising our investment groups and clients on the issues. We’ve appointed one of our Partners as our “ESG Champion,” charged with representing responsible investing at the highest level of the firm, advocating for these principles firmwide and carrying our efforts into the future.

EDUCATION AND INVOLVEMENT ARE CONSTANTS
We regularly hold lively ESG “consciousness raising” and training sessions for AB’s global staff. At one such gathering in New York, our fixed-income utilities analyst and equity consumer-products analyst shared their experiences and best practices for how they handle the tough ESG issues confronting the companies they cover. At another meeting, the head of frontier-market equity research reviewed the team’s exhaustive ESG process with a group of chief investment officers.

We also sponsor industry-specific ESG training sessions, inviting sell-side analysts from other firms to talk to our research analysts about their views on the ESG issues affecting their industries.

We frequently take part in, and sponsor, ESG-related industry events. For example, AB representatives hosted Women in Governance, an event attended by 50 female company directors and 50 governance professionals.

EDUCATING ON WOMEN’S EMPOWERMENT
AB hosted a panel discussion, “Women’s Empowerment: Economic Impact and Investment Implications in Emerging Markets.” The event addressed economic and investment opportunities arising from the advancement of women in developing economies. More than 100 people from inside and outside the firm attended. AB research analysts began the event with a presentation on how gender inequality in the developing world isn’t just a human rights issue, but also an economic issue. They debunked several myths about the emerging middle-class consumer, pointing to success stories of female empowerment and the opportunities these cases created for investors.

Mary Ellen Iskenderian, President and CEO of Women’s World Banking, and Beverly Jennings, Head of the Office of Supplier Diversity & Inclusion at Johnson & Johnson, joined the AB panelists. The two leaders stressed holistic financial inclusion as a key to economic independence for women. They also gave examples of the tools and resources enabling women to become more fully integrated in their local economies. Attendees were encouraged to continue pursuing investment opportunities that promote female empowerment—another reminder of how we can all do well by doing good. Events like this are a crucial part of our drive to improve our ESG efforts for clients and to promote ESG initiatives internally.
AB: RESPONSIBLE INVESTING IN ACTION

Actions speak louder than words

- 8,506 proxies voted globally
- 83% Votes for greenhouse-gas-emissions reporting and targets*
- 91% Votes for sustainability reporting and targets*
- 100% Votes supporting shareholder rights*
- >3,200 companies evaluated on ESG criteria
- 3,284 management meetings†
- 23 Responsible Investing and Proxy Committee members
- 23 markets covered

* AB’s voting record for the 2015 proxy season; votes supporting shareholder rights include proposals addressing shareholder access, voting standards, board classification and anti-takeover devices.
† For the year ended March 31, 2016
RESPONSIBLE INVESTING CAN MEAN MANY THINGS
Increasing global sensitivity to the environment has compelled investors to sharpen their focus on environmental, social and governance (ESG) issues in their portfolios. But responsible investing means different things to different people, so clarifying the terminology is important to helping investors consider the most appropriate approach.

For the asset-management industry, this evolution is a complex process that must balance fiduciary responsibilities with risk and return objectives and ethical concerns. By understanding the options, we believe investors can ask managers the right questions to determine which approach is most effective and appropriate for their investing needs.

Here are the most common ways that investors can apply ESG considerations to building their portfolios.

ESG INTEGRATION
In this approach, investors explicitly consider ESG factors in their research and integrate their economic impact into the fundamental investment analysis, which helps form the final investment decision.

+ Pro: Considers ESG risks and opportunities without reducing the investment opportunity set. Doesn’t use a specific set of values, which might not be appropriate for all investors
+ Con: May invest in companies with ESG risks, which are assessed in the research process

ESG SCREENING
In this approach, the investment universe is narrowed through negative or positive screening based on certain ESG criteria, or driven by the investor’s moral/ethical perspective.

In negative screening, certain types of investments are excluded based on specific criteria, such as alcohol or tobacco companies, weapons manufacturers and producers of fossil fuels.

Positive screening takes the opposite approach by applying a specific threshold of ESG criteria, often using a best-in-class approach relative to peers. For example, ESG research providers publish ratings and indices to help investors distinguish between companies that score better or worse on ESG criteria, even if they’re in industries that are often considered problematic, such as energy.

+ Pro: Allows investors to proactively apply values to portfolios and customize to their own preferences
+ Con: Investment opportunity set is reduced

SUSTAINABLE THEMATIC
These strategies focus on one or more specific themes, in which a social and/or environmental need creates an opportunity to allocate capital. Examples of themes include resource scarcity, renewable energy and green bonds, where investments support climate-related or other environmental projects.

+ Pro: Investors can make an impact on ESG issues through the public markets. Adding themes may provide more portfolio diversification and lower volatility
+ Con: Narrower opportunity set

NORMS-BASED INVESTING
This includes investments that adhere to a set of global norms or standards, such as those established by the United Nations and the Organization for Economic Cooperation and Development. This approach may exclude or underweight instruments that don’t meet the prescribed standards, while overweighting those that do.

+ Pro: Allows investors to apply global standards to their portfolios
+ Con: May reduce opportunity set

IMPACT INVESTING
Portfolios driven by impact investing target a specific social and/or environmental goal. These portfolios may include private equity or private debt market funding for specific projects in underserved areas, such as schools or hospitals in emerging countries. Today, the term “impact” is increasingly used to include public investments as well.

+ Pro: Funds are allocated directly to projects
+ Con: Investors are usually more focused on the impact of the project, which may take precedence over financial returns. The actual impact of the investment may be difficult to measure

GLOSSARY OF TERMS

Source: Global Sustainable Investment Alliance and AB