Rising up to the challenge

Summary

- Once avoided because of a fear of damaging returns, now not incorporating some kind of ESG strategy could leave pension funds exposed to risks.
- There has been an increase in pension funds facing pressure from government, campaign groups and members to divest from certain asset classes.
- However, incorporating more long-term ESG policies is gaining traction, with pension funds also taking on more of a stewardship role to manage risks.
- Each fund will differ in their ESG priorities based on varying factors.

As environmental, social and governance issues rise up the global investment agenda, Natalie Tuck looks at the pressures on pension funds to invest responsibly

Several years ago, the motives for taking an environmental, social and governance (ESG) approach to investments were largely based on ethics and morals, perhaps because there was a view from pension funds that responsible investing would damage returns.

Funds were encouraged to take the lead in the area, even by Prince Charles, who, at the National Association for Pension Funds' (now PLSA) 2013 conference, told the industry the world is facing a "perfect storm" of resource scarcity, climate change, and financial stress, stating that pension funds have "a need, and arguably a duty" to ensure these risks are managed. But as far as pension funds were concerned, there was risk involved with ESG.

Fast forward to 2017 and the pensions industry has, rather like a climate change, warmed to the idea of ESG investments. Pensions and Lifetime Savings Association policy lead for stewardship and corporate governance Luke Hildyard notes that pension funds are moving beyond the debate about whether or not the environmental and social impact of their investments impact long-term returns, and instead the conversation is moving onto what they should do to manage it.

In the past few years, the motives have changed, the pressures have increased; where there was once a risk of damaging returns, there is now a risk that by not investing responsibly you could damage long-term returns. KBI Global Investors chief economist Eoin Fahy says that using ESG investments is now for a large part about managing risks, adding reputational risks to the list.

However, reputational risks are more likely to concern local government pension scheme funds because of Freedom of Information requests, says Squire Patton Boggs pensions partner Clifford Sims.

For other schemes, there could be industry-specific reasons to avoid a certain investment, such as those within the health sector, which are unlikely to invest in the tobacco industry. Campaign groups also target corporate schemes in certain sectors and influence members through the media. When it comes from the member, it tends to be individual members, says Sackers associate director Ralph McClelland.

"The more sophisticated members will start out by asking questions about the scheme's policies and strategy. The more information the member has, the more detailed (and time consuming for the trustees) their questions can become. It is very easy to provide a copy of the scheme's statement of investment principles but much more work is involved in, for example, compiling and sending on very detailed information about the voting records of the scheme's managers or information about carbon footprints," he says.

However, Bfinance senior director Richard Tyszkiewicz notes that there has been a shift away from basic negative screening to clients looking at ESG as a positive long-term investment strategy. Tyszkiewicz says he has seen interest in unlisted infrastructure funds focused on renewables. In addition, Fahy notes there has been an 'explosion' of interest in alternative energy and water.

"Some of our clients are also looking at adding impact investing to their listed equity portfolios as it's seen as the next logical step down the ESG road. The challenge is to maintain adequate financial performance alongside the non-financial aims, as well as measuring the actual impact achieved," Tyszkiewicz adds.

Key themes within ESG

A report by Bfinance noted that certain institutions place more importance on specific sub-themes within the ESG spectrum, most notably climate change. Most certainly, out of all the themes within ESG, such as tobacco, arms manufacturing and adult entertainment to name a few, climate change receives the most attention globally.

At the recent World Economic Forum in Davos, political and business leaders classified the biggest risks for 2017. These are weapons of mass destruction, extreme weather events, water crises, major natural disasters and failure of climate change mitigation and adaptation.

Notably, all of these are related to ESG issues and three (excluding major natural disasters) can definitely be classed as climate change risks. For comparison, going back almost a decade to 2008, the biggest risk was asset price collapse, followed by, retrenchment from globalisation, the slowing Chinese economy, oil and gas price spike and pandemics. It is perhaps unsurprising that pension funds have shifted their attitude to climate change as it has climbed up the global agenda.

However, a recent report by the PLSA on ESG risks within defined contribution default funds found that these schemes should be more concerned with other areas. In a typical default fund, human capital, business ethics, product safety and data privacy and security stand out as the most material ESG issues based on portfolios, despite not receiving as much coverage as climate change.

Funds also look to the United Nations Global Compact or PRI principles as a basis for their ESG guidelines, explains Tyszkiewicz. However, he adds that for many, it will be based on the underlying business or where the member base has a strong influence.

Taking an active approach

With added risk surrounding pension fund investments, there is a need for funds to take a more active approach to the management of that risk. McClelland notes that trustees are faced with the question of whether to take on a stewardship role and influence businesses or whether it is safer to divest.

In the area of divestment, Squire Patton Boggs pensions partner Clifford Sims says there has been an increase, particularly in the local government pension scheme, for disinvestment in fossil fuels in the last couple of years.

However, PLSA research reveals that a growing number of schemes are incorporating voting and engagement practices are becoming a part of an overarching integration process. The PLSA explains that stewardship strategies typically involve two components: engaging with investee companies to encourage (more) responsible social and environmental practices, and developing proxy voting guidelines that cover environmental and social (in addition to corporate governance) issues.

This increase in interest has been aided by a progressive regulatory and policy environment, which includes the publication of the UK Stewardship Code and the Kay report, as well as codes and guidelines developed by industry and civil society, such as the PLSA's annually updated corporate governance policy and voting guidelines.

"Shareholder engagement is more common that straightforward divestment", says Sims, stating that it can be more efficient "behind closed doors". "Even then the largest schemes will use collective bargaining power via their managers to promote changes in, for example, executive pay," he adds.

Whatever they choose to do, trustees are primarily responsible for setting the schemes investment principles, beliefs and strategy, says McClelland. "They also have a key role in that they will make decisions about allocation of assets between different types of asset and the selection of the managers within each allocation. Alongside this, they must make a decision about the role of ESG type issues and how those beliefs fit in to the strategy as a whole. The expression of the trustee's ESG beliefs will, to some extent, be determined by how their assets are allocated and the types of manager they have appointed."

As Prince Charles noted, pension funds do have a 'need' to address ESG risks, especially since in the years following his comments the risks surrounding ESG have increased for schemes. However, it seems with increased levels of stewardship, pension funds are rising up to the challenge.

Written by Natalie Tuck