A turning point

A change in attitudes has fundamentally altered the way governments, regulators, businesses and investors view environmental, social and governance issues. Natalie Tuck explores the impact this has had on pension funds and their approach to ESG

In recent years there has been a fundamental shift in the way businesses and investors view environmental, social and governance issues (ESG).

The term is broad, encompassing a "huge range of topics", Schroders head of sustainable research Andy Howard says, "from climate change strategies to labour standards in supply chains". He adds that fundamentally, it is about understanding how companies interact with societies, and environments they belong to, and how they adapt to the changing pressures and expectations they face.

There is no clear trigger for what caused a turning point in investor attitudes, but rather several factors that have increased the importance of incorporating ESG issues. For pension funds, one that is often referenced is the Law Commission's report from 2014, which according to ARC Pensions Law partner Anna Copestake, clarifies that ESG factors should be taken into account, albeit when an investment is financially material.

Furthermore, TPT Retirement Solutions investment officer Jenny Anderson says that policy and the regulatory environment have become more prescriptive on trustees taking ESG issues into account. For example, The Pensions Regulator's Code for Trustees has a section on investment governance, which states that trustees should take ESG factors into account where they are financially significant.

In addition, the Department for Work and Pensions plans to review pension regulation for defined benefit and defined contribution schemes on fiduciary duty and ESG. "It is currently consulting on policy and it is expected that legislation will be brought forward to be approved by parliament in the second half of 2018," Anderson says.

A quick look at some statistics shows the significance of ESG for pension funds, with a study by Create Research finding that none of the 161 pension funds surveyed plan to cut their exposure to ESG assets. Just 14 per cent of the investors said they were either sceptical or did not believe in the logic behind the strategies.

AXA IM global head of responsible investment Matt Christensen notes that these statistics translate into an evolution of the industry where pension funds now demand proof of ESG analysis across asset classes and within the investment mandates as an industry standard. "It is no longer a box-ticking exercise to simply ask if an asset manager has signed the Principles for Responsible Investment, rather, pension funds now ask detailed questions of the portfolio managers about how ESG risks and opportunities are being identified and monitored."

Pension funds may be taking ESG more seriously, but Copestake notes that there is still work to be done. For example, she says that it is still relatively common for trustees to concentrate their efforts on one part of a portfolio, in particular defined contribution schemes that offer an ethical self-select fund for members.

"Those trustees should consider how the default option, and other funds on offer, fit with their ESG strategy, and check that the ethical fund does not risk significant financial detriment. This would mean it shouldn't be offered even if members would agree with its objectives," she adds.

For those that ignore ESG issues or don't get it right, there are risks. Lombard Odier Investment Managers global head of solutions Carolina Minio-Paluello says since 2015, we have entered a "new paradigm" in which global governmental and regulatory policy has shifted towards a more socially and environmentally inclusive agenda. "A shift on this scale can transform economies and capital markets over the long term, which creates both risk and opportunity[…]Ignoring ESG issues means potentially ignoring the significant risks and opportunities resulting from the global shift in policy."

In addition, Christensen explains that ignoring ESG issues can create risks of missing signals that may directly or indirectly contribute to an enlarged understanding of entire sectors or companies. He highlights the automobile industry, where ESG analysis has been helpful to monitor companies that were investing in new technologies around engines in anticipation of a design shift from fossil fuel independence, to battery and hybrids.

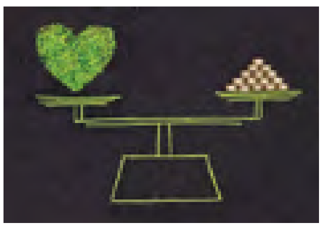
"A case like the Volkswagen scandal which ultimately is a fraud situation, cannot have been anticipated purely through an ESG focus, but without an ESG lens, it would have been difficult to see that the reliance on diesel was inhibiting innovation in other potential energy sources/design that are now becoming a part of the product mix within the industry."

Written by Natalie Tuck

Engagement vs divestment

When it comes to ethical investing, pension schemes have the choice to either divest completely or engage with the companies, in order to try to make a difference. Natalie Tuck looks at the pros and cons to both

Environmental, social and governance issues may be rising up the agenda but, ultimately, a pension fund's first priority is its fiduciary duty. This no doubt impacts a pension fund's decision on whether to divest, or stay invested and try to make a positive difference.



As BMO Global Asset Management director of governance and sustainable investment Vicki Bakhshi notes, historically there had been legal uncertainty over whether divestment decisions may be contrary to this duty. There is now more clarity, Bakhshi says, given the Law Commission's report that said there should not be any financial detriment when considering ethical investments.

More favourably, however, is that multiple studies have shown that ethically-screened funds do not systematically underperform their unscreened peers. "On the contrary, some studies show superior characteristics particularly around risk and volatility," Bakhshi adds.

If it is possible for a pension fund to meet its fiduciary duty, and ethically screen, then what determines whether a fund should engage or divest? There are sometimes apparent cases for divestment, such as pension schemes in the healthcare industry choosing to divest from tobacco completely.

Members' opinions are "the most important factor to take into account", when it comes to deciding on what to do, says Bakhshi. For those in certain sectors, such as healthcare, an opinion may be obvious, but for others, those preferences may be harder to find out. Bakhshi recommends using stakeholder meetings and online surveys to gauge members' beliefs.

With member opinions holding weight, a recent YouGov survey would explain why so many funds have taken to divesting from fossil fuels. Fifty seven per cent of the UK public believe that it is the responsibility of investment managers to ensure that savings are managed in a way that is positive for the environment and society.

In the UK, trade union Unison is the latest organisation to launch a campaign calling for the divestment of fossil fuels, targeted at local authority pension funds. In the past year Hackney Council's pension fund has committed to going carbon free, along with Waltham Forest and the Avon pension fund.

The campaign against fossil fuels is not just formed on member opinion, however. Since the announcement of the Paris Climate Agreement there has been increasing awareness about climate change on their portfolios. In the past trustees may have avoided ethical investments in order to comply with their fiduciary duty; this has been turned on its head.

"We argue that the risk is not climate change itself but the risk that governments around the world will introduce significantly stricter regulation to reduce greenhouse gas emissions, most likely by the imposition of carbon taxes or carbon pricing," says Impax Asset Management director Scott Thompson.

Despite the increased momentum building around divestments, Bakhshi points out that a disadvantage to omitting something completely from a portfolio is the loss of opportunity to engage directly. But, she says, divestment "sends a strong signal to companies".

Where there is an ethical or values-driven investment policy, exclusion is an easy and common approach, says First State Investments global head of responsible investment Will Oulton. "However, where material corporate change is an objective, engagement plays a critical role of not only holding companies to account for their behaviours and environmental and societal impacts, but also in improving their long-term business performance. In such instances, both shareholders and wider society benefit."

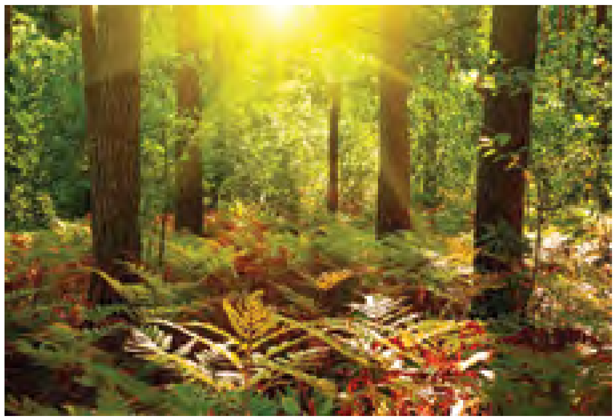
Another argument in favour of engagement over divestment comes from Barnett Waddingham partner Neil Davies, who notes that completely divesting form certain sectors has an immediate impact of reducing the opportunity set of investments available to managers, and so there is still a risk than an exclusionary approach may impact return opportunities.

"Even for those investors with a moral objection to certain investments, there is an argument that engagement can be a more positive way of addressing that concern. For example, for those that oppose the use of fossil fuels, it may well be those companies that currently exist as a result of those fuels who are best placed from a technological and business perspective to develop alternative energy sources."

Written by Natalie Tuck

Making an impact

As the campaign against fossil fuel investments gains momentum, the case for exposure to green investments is building, with attitudes towards their financial value shifting. Natalie Tuck looks at the opportunities available



There was a time when green investments were left largely for those with a vested interest in the cause, but as global views among world leaders and governments change, the idea of greener investing has gained pace, no longer being seen as niche.

"There's no doubt that the popularity of green investments to pension funds is growing rapidly," KBI Global Investors chief economist Eoin Fahy says, referring to both statistical and anecdotal evidence. He notes a survey by Eurosif that showed huge growth in impact investing. "Of all SRI/ESG strategies, green investing showed the strongest growth, rising by almost 400 per cent in just two years," he adds.

Anecdotally, he says a quick browse of asset owner searches reveals that many of the largest asset owners in Europe, and the US, have been allocating substantial mandates in this area. Conferences and webinars on the topic are also numerous and well attended, he says.

Typically we think of green investments as renewable energy, sustainable forests and clean forests, pollution control and waste management but there are other less obvious areas to invest in. For example, Xafinity Punter Southall head of investment north Ben Gold notes the redevelopment of brownfield sites, and Fahy says energy efficiency and sustainable infrastructure, such as water pipes needed to bring clean water to emerging economies also have their place.

"Most evidence suggests that while wind turbines and solar cells get most public attention, the development of new technologies or materials to reduce energy consumption can have just as much impact on reducing emissions. It's less glamorous but just as important," Fahy says.

The benefits and motivations for such investments include helping to mitigate climate change, to improve the long-term sustainability of society and the economy, says Fahy. "As pension plans usually have a long investment time horizon, for obvious reasons, they have a clear interest in promoting a healthy global economy.

"If the global economy within the reasonably foreseeable future faces severe growth constraints due to the physical impact of climate change or due to a lack of clean, safe, water food or energy, the financial damage to pension plans could be severe. So investing in green investment strategies that seek to provide solutions to these problems can very readily be said to be in the best financial interests of its members, even leaving aside the fact that such investments could also be very profitable in their own right."

For many trustees, such investments will appeal to their own set of moral beliefs, but Gold notes that a scheme's fiduciary duty should always come first, and moral views on green investing should be secondary. But as Fahy notes the profitability of impact investing, is there a way to satisfy both?

UBS Asset Management head of sustainable impact investing Michael Baldinger states that as transparency has increased, so too has research into the consequences for portfolio returns. "Academic studies suggest that by incorporating sustainable investing in the investment process, returns are not harmed. On the contrary, it may help lower the cost of capital and limit downside risks."

Gold is less convinced, believing from a pure return perspective, "the case is somewhat mixed", noting that there is "limited evidence of higher returns from green investments or SRI". Nonetheless, he says that a "forward-looking case certainly be made that some green investments have a good chance of being successful over the long term, especially with government intervention in favour of green practices".

Regardless, all the experts agree that the trend of green investing is set to grow, with Gold adding that so too will the size of the green investment universe. "The characteristics are appealing. As green investing becomes more accessible and the governance burden of accessing it becomes lighter, many more schemes will likely dedicate a specific 'green' allocation," he adds.

Written by Natalie Tuck

Making your vote count

The PLSA's Luke Hildyard explores how pension funds can engage in shareholder activism to influence the governance, strategy and culture of the companies they invest in

Pension funds are responsible for about £2.2 trillion of investments managed in the UK. This equates to about two-thirds of the money managed on behalf of institutional investors. The Pensions and Lifetime Savings Association's (PLSA) annual survey suggests that around one third of this money is invested in listed companies. Therefore the performance of these companies is of critical importance to pension fund investors.

It is therefore beholden on pension funds to engage with these companies – either directly, or through their asset managers – and to ensure they are account for their governance, strategy, culture and other factors that are likely to affect their performance.

Annual general meeting (AGM) voting rights are amongst the most important tools available to investors for holding their investee companies to account. For pension funds, these can be used directly when investing in the companies themselves. When they outsource investment decisions to an external asset manager, the manager's voting policies and practices should be a consideration when awarding, monitoring and reviewing mandates.

Typical AGM resolutions relate to the approval of the annual report and the accounts; the appointment of the auditor; the re-election of the company directors; and the company directors' pay. Though not all the AGM voting resolutions are binding, significant levels of shareholder dissent can put the spotlight on particular practices and represents a powerful means of exerting influence.

The PLSA's research found that in 2017, around one-fifth of FTSE 350 companies experienced 'significant' dissent of over 20 per cent of shareholders either voting against management's recommendation or abstaining on at least one resolution at their AGM. The most common resolutions to attract dissent relate to executive pay and the re-election of directors to the board. Of the 117 resolutions attracting significant dissent in 2017, 49 related to executive pay and 35 to the re-election of directors.

Very high executive pay packages raise questions about the corporate culture and governance of the company – a large pay package could suggest that the company is overly-dependent on a single individual executive, or create intra-company resentment toward the executives from lower-paid workers.

A PLSA survey of pension funds views on executive pay, found that 87 per cent of respondents said executive pay was too high and 85 per cent felt that pay gaps within companies were a concern for them as investors. Despite this, the PLSA's hidden talent research on corporate reporting of employment models and working practices found that just 7 per cent of FTSE 100 companies currently report on their pay ratio between their chair and their median worker.

The re-election of company directors may reflect concerns about the individual in question, their qualification and their perceived commitment or independence. They can also act as a proxy for wider issues with the running of the company. For example, a large numbers of shareholders at Sports Direct have opposed the re-election of the company chair in recent years, in response to controversial employment practices at the company. The PLSA's recent guidance on the risk posed to pension funds by climate change suggested that a vote against the re-election of the chair may be appropriate at companies that fail to explain how their business models are compatible with international greenhouse gas emissions reduction targets.

Whatever the resolution, AGM votes are a useful tool for investors who have failed to achieve a satisfactory response to attempted engagements with a company on a particular issue, yet do not (or cannot, for those funds investing via an index) divest from the company altogether.

The PLSA's Corporate Governance Policy and Voting Guidelines set out specific recommendations for circumstances under which shareholders should consider voting against management. We encourage our members to examine their asset managers' approach to AGM voting, how they have applied that approach in practice and concrete examples of where their AGM votes have successfully influenced an investee company. We also recommend that pension funds report on how the shares they own have been voted to members, and seek to understand their members' values and interests, in order to bear these in mind when directing their own votes or those their asset managers.

Written by PLSA policy lead for stewardship and corporate governance Luke Hildyard