Investing in a greener tomorrow

ESG has increasingly been on the pension scheme agenda, but could the current pandemic mark a sea-change moment for responsible investing?

Environmental, social and governance (ESG) factors are increasingly viewed as a core aspect of investing, and recent months could mark a point of change for industry action on ESG issues. Whilst in January a survey by the Society of Pension Professionals (SPP) revealed that the majority (57 per cent) of funds have made no portfolio changes, despite genuine interest in ESG, SPP president, James Riley, argues that changes are now starting to take place.

"We are seeing some schemes being particularly proactive in the area with ESG being viewed as one or more of: a return driver, a risk management tool or an opportunity to align a scheme's investments with the values of the scheme and sponsor," he explains. And whilst motives may differ, an increasing number of large schemes have upped their commitment to responsible investing over recent years, potentially marking the end of the 'early stages' of ESG, and the start of more action-based trends.

Nest, for instance, recently announced that it had fully divested from the tobacco industry a full year ahead of schedule, whilst June also saw the Universities Superannuation Scheme announce plans to exclude a number of "financially unsuitable" sectors.

This type of action is perhaps more in line with the initial aim of socially responsible investing (SRI) than the direction of some regulatory updates. As Scottish Widows head of pension investments, Maria Nazarova-Doyle, explains, SRI was originally developed to allow investors to avoid companies they disliked for ethical or values-based reasons. This has shifted to become what is now known as 'exclusions' or 'negative-screen' investing, with other SRI strategies developed over the years, such as positive screen or thematic investing, where only companies aligned to the investors' values are held.

Increasingly, pension schemes are also looking to use their influence as a shareholder, within less ESG compliant sectors, to promote positive change, rather than simply "running away from the problem", PTL managing director, Richard Butcher, highlights.

He adds that, whilst fiduciary duty is at the core of any investment decision, for a pension scheme trustee, this means working to identify and mitigate risks for a long-term horizon that will inevitably capture more climate-related risks. Butcher says that, in this context, it is reasonable for trustees to question whether some organisations, such as those in the oil or tobacco industries, will continue to exist amid societal pressures.

While in the past such extremes may have seemed unlikely, the Covid pandemic has set new precedents in every sector, and every country. Pension investments are no exception.

The changing tide?

"This is a watershed moment for sustainable investment," stresses

Nazarova-Doyle, emphasising that ESG strategies have proved resilient relative to other funds through the recent market downturn resulting from the Covid-19 outbreak. She notes that this has already translated into action, as investors continue to 'pour' money into ESG funds. In fact, according to research firm Morningstar, around $45.6 billion was funnelled into ESG funds in the first quarter of the year, compared to outflows of $384.7 billion for the overall fund universe.

Nazarova-Doyle stresses that whilst this performance will undoubtably be, in part, driven by limited exposure to oil and energy, the bias of ESG funds towards well-run businesses, underpinned by good governance and strong balance sheets, will have been crucial in helping them to "avoid the worst of the turmoil".

Proof in a pandemic

Indeed, Sackers partner, Ralph McClelland, describes the pandemic as a "potent illustration" of the volatility that can be caused by natural events, in turn highlighting how important and challenging effective financial risk management is. Dalriada Trustees responsible investment officer, Clár Christie, explains that these lessons should be applied to climate risk now, emphasising that if trustees act now to adjust their investments according to climate investment research, they can proactively work to limit exposure to those sectors.

Considering the impact of a global event such as Covid-19 on markets, Christie stresses that, should the physical risks associated with climate change occur in the future, it seems likely that this kind of global market shock could happen more often. "And given the irreversible nature of climate change, it may be more difficult to recover from these shocks," she adds.

Nazarova-Doyle states that the sheer scale of the Covid crisis could also "radically change investor perspective" as to what sustainable actually means, clarifying that it should be about companies making decisions in the best interests of society and their workforce, allocating capital responsibly and mitigating the climate impact of their businesses.

Adding to this, Riley notes that although the financial benefits of ESG have been "borne out in the initial phases of the pandemic", the crisis has also seen consumers embrace "togetherness and social responsibility".

"Their expectations are likely to move the focus from shareholder value towards recognising that the long-term viability of companies is intrinsically linked to the wellbeing of all their stakeholders including employees, suppliers, customers and communities," he explains.

Indeed, the ongoing pandemic has seen an increasing shift towards the social impact of corporate actions, with some firms praised for their proactive stance, and others quickly condemned for their failures. PLSA senior policy lead of investment and stewardship, Caroline Escott, says that it is not only a social issue but that, overall, it makes "good financial sense" for schemes and employers to be considering the 'S' in ESG now more than ever.

"How companies behave now towards their workforces will likely have a material impact on their future revenue, operating costs and even the post-Covid-19 regulatory environment. This in turn has consequences for scheme investors' risk-adjusted-returns and ultimately for the value of beneficiaries' savings," she says.

An engaged membership?

Whilst there will likely be a renewed focus on environmental and social issues following the crisis, Nazarova-Doyle argues that the pensions industry has "long been failing" to engage members on ESG issues. She argues that sustainable investments have the power to 'unlock' member engagement, by empowering savers with the knowledge that their savings are being used to build a future worth living in.

However, Butcher notes that whilst there is consumer-led demand, there is not currently an equally corresponding amount of purchase activity by members. As such, the immediate focus for many pension schemes will remain on meeting regulatory updates.

As McClelland notes, recent years have seen a shift in gear towards ESG investing, and work for the foreseeable future will focus on regulatory compliance, both in terms of the changes to scheme statement and investment principles for 1 October 2020 and preparing for the upcoming requirement to publish implementation statements, which explain how trustees have complied with some parts of their obligations.

Asking the question

However, Nazarova-Doyle predicts that the pandemic will actually see increased demand in communication from schemes to their members, to better explain how their investments are helping in the economic recovery, and working to 'build back better' towards a low-carbon economy. Considered alongside consumer campaigns, such as the newly launched Make My Money Matter (MMMM) Campaign, which was co-founded by film director, screenwriter and producer, Richard Curtis, it seems likely that member pressure on ESG issues will only increase.

The MMMM campaign has already brought renewed attention to pension investments, with familiar names such as Gary Lineker openly discussing the issues around where pensions may be invested. So one thing that is increasingly clear is that ESG is going nowhere. The time for deliberation is over; now is the time to make sure that members have a pension they can genuinely be proud of, in a world they can be proud of.

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In association with SCOTTISH WIDOWS