

ESG in DC – heading in the right direction

► **Francesca Fabrizi looks at how ESG is evolving in the DC space and why this new world could represent a turning point**

Environmental, social and governance (ESG) investing has had its fair share of attention in the UK pensions arena over the past few years. Prior to coronavirus taking hold and dominating all topics of conversation, ESG was one of the biggest themes discussed at any pensions event. It was a prominent agenda item at all trustee board meetings, and the term ‘ESG’ garnered more column inches than even Brexit in the pensions press.

But while DB schemes may now be more familiar with the term and what it might mean for their investment portfolios, what has the spotlight on ESG meant in terms of DC investment?

“ESG in DC has evolved considerably”, says Legal & General Investment Management (LGIM) head of DC, Emma Douglas. “A few years back, it was all about having a self-select option and that was very much an ethical fund. You would have your range of equity and bond funds, then maybe an ethical fund and the Shariah fund, and those were the main components of what made up DC self-select choice. Occasionally, you would also have a green fund.”

Consequently, as a self-select option, ESG tended not to attract very much in the way of assets, continues Douglas. “These options were there as lip services; they weren’t very well used. Now, things have changed and what we are seeing is that those ESG considerations are being built into defaults.”

Mercer principal and European head of responsible investment, Kate Brett, agrees that ESG in DC has evolved in recent times and things are moving in

the right direction. Given the increase in transparency of how schemes are implementing their approach to ESG, she expects further improvement across the market over the next few years.

“We are seeing DC offerings move away from a single ethical self-select fund to integrating ESG more broadly throughout the offering, including within the default,” says Brett.

This move towards incorporating ESG into defaults however has been gradual, having been led by some of the larger schemes which, alongside their consultants, managers and index providers, have developed bespoke propositions that reflect their own views. For example, explains Douglas, the Future World Fund that LGIM created with HSBC was designed with much more of a climate-focused tilt than a focus on the ‘S’ or the ‘G’.

“This is the period I call ‘50 shades of green’ – everyone wanting to do something, but everyone doing something different; there has been a massive expansion of interest in how we get these sectors reflected in a default fund, but with so many different ways of doing it,” she says.

There are other barriers to this development, of course, cost being one of them and, until member demand steps up, PwC head of DC pensions and benefits, Saq Hussain, argues that, while discussions may be rife, practical progress will be slow: “From a DC perspective, I would argue we have not seen huge demand just yet. Employers and trustees are certainly discussing the use of ESG funds and interestingly,



from an employer’s perspective, these discussions have also focused on how introducing ESG fits in with their broader sustainability and corporate goals. However, whilst there is plenty of discussion, employers and trustees are less eager to introduce ESG funds as default funds due to the higher cost. If there is increased demand from their scheme members, we may begin to see this change,” he says.

Brett concurs that, despite all the noise around ESG, actual industry response has been measured and while there has been innovation in product offerings, particularly on the index tracking side where there has been a wave of new solutions, there is still more to be done. Importantly, there remains an opportunity for investment managers to improve their offerings and reporting, particularly with respect to impact.

“Communication to members, in particular, is an area where we should see increased innovation in terms of impact reporting,” she adds.

ESG – the hidden superpower

Effective communication continues to

be crucial when it comes to ESG and, in some cases, the industry will need to start with the basics. While a well-informed trustee might understand what ESG means, Douglas argues that there is still confusion among members: “As a term, ESG isn’t understood by members very well. Our recent research, *‘Finding the greenest generation’*, highlighted that some people weren’t really sure what was meant by ESG or even responsible investment, so we need to spell out what this means in nice, simple terms.”

The key here is getting away from jargon – something the pensions industry has always struggled with. “ESG or responsible investing might not mean much to some people, but if we talk about climate change, human exploitation, pay gaps, not enough women on boards – these are all tangible issues that people can relate to,” she says.

Once members start to understand ESG better, this then opens up a whole new opportunity for the future of DC – once they start to understand where their money is invested and what impact it is having either in relation to environmental, social or governance issues, members are more likely to engage with their pensions.

Douglas explains: “This is potentially a hidden superpower that can help us get members more interested in their pensions. If we can tell stories about how members’ money has been put to work, what it has achieved – whether that’s in relation to regeneration, affordable housing, or clean energy – we are bringing the investment side of DC to life for members in a way that has never happened before. They have watched their money go up, they have seen it fall, but, beyond that, investment is largely a black box for most people.

“Here we can open up that box, make it more relatable for people. Then, as they start to care more about what their money is doing, they will start to feel a greater sense of ownership for it.”

Willis Towers Watson senior director, DC Investment, Anne Swift, agrees that this could represent a turning point

in the world of DC: “From a member perspective, it feels like there is a real chance here to re-energise and re-engage members because ESG gives us a positive way of looking at investment in a way that members perhaps haven’t quite thought about in the past.

“It starts with getting more messaging around engagement and the work that their DC investments are doing – whether that’s in relation to the environment, within their social communities or around the governance structure,” she says.

Willis Towers Watson head of sustainable investment, Adam Gillett, adds that ideally this would lead to increased contributions: “There are some interesting studies as to how better communication and improved engagement might even increase members’ willingness to contribute and the amount they would be willing to contribute, which would be a phenomenal outcome in a DC context,” he argues.

Coronavirus – playing its own part

The coronavirus pandemic is already acting as a further catalyst towards change in the ESG space – while pre-Covid-19, environmental issues were gaining a lot of attention, one side-effect of the current crisis has been that the ‘S’ and the ‘G’ have been pushed further into the spotlight.

Gillett explains: “Previously, the ‘S’ was the one that fewest people had got to grips with and had been harder for people to fully understand or engage with. But Covid-19 and the associated impacts of it have brought ‘S’ issues right to the fore.”

That includes, he says, broad issues like inequality or more specific issues in terms of how companies treat their workers. “There is a whole raft of ‘S’-based case studies and topics of conversation that are at the forefront of people’s minds today whereas, rewind six months, a lot of ESG discussions were dominated by the ‘E’ part of ESG.”

Brett comments that the current

pandemic has also highlighted the importance of financial resilience of individual savers. “Stewardship and ESG integration is vitally important for the industry to maintain trust with savers given financial pressures and strains as a result of the pandemic. Engagement with members will be critical at this time.”

A more concerning side effect of the pandemic could be that discretionary spend is halted temporarily, Hussain warns: “Inevitably we will see employers look to focus on business critical operations at this time, so we could see them rein in discretionary spend in areas such as investment reviews, possibly delaying the adoption of ESG approaches. At this stage we do not see employers wanting to pivot to ESG funds due to the pandemic, but it will be interesting to see how this may evolve.”

All in all, however, the general feeling is that the future presents new opportunities for the DC pensions space. As Swift concludes: “Everything changed so quickly with the virus but, looking ahead, we must consider the opportunities – opportunities to invest in a sustainable way that is going to achieve success for members. If you think about this in a DC context, for most members, this is a long-term arrangement and if you are looking ahead the sustainability agenda is essential.”

As BESTrustees president, Alan Pickering, reflects: “I was very uncomfortable in a world where ‘ethical’ was used as a prefix. This had more to do with marketing spin than investment content. There is greater definitional clarity in the world of ESG.

“There will be different approaches but trustees, together with their investment consultants, will be able to determine what ESG approach most clearly meets the needs of those members for whom they are responsible,” he concludes.

Written by Francesca Fabrizi

In association with

