The many shades of ESG

The E in ESG dominates discussion of the concept – unsurprisingly, given the urgency of the climate crisis. But to what extent are pension schemes also seeking to improve their performance on the S and the G? David Adams investigates

Summary

• Unsurprisingly, given the prominence of the climate crisis, when most of us think of ESG we think of its environmental aspects; the social and governance elements tend to be overshadowed.
• The past few years have seen an increased focus on social issues such as diversity, employee rights, human rights and corruption; while governance has always been important.
• Growing numbers of schemes, their advisers and service providers are seeking to find ways to increase focus on the S and G, including finding ways to measure impact.
• Mature, integrated ESG strategies will be based as much on enhanced models for stewardship and engagement as on divestment.
• The E may continue to overshadow the S and the G, but all three will continue to be prominent in business and investment strategies in future.

Unless you spend every day working on environmental, social and governance (ESG) investment or business strategies, the chances are that when you come across the acronym, it's the E in ESG you think about first. In many ways that's unsurprising, because climate change is arguably the biggest crisis humanity has ever faced; and businesses of all kinds face increasing pressure from policymakers, regulators, shareholders (including institutional investors like pension funds), customers and employees to improve their environmental performance.

But the past few years have also seen more attention paid to many social issues, leading to increased scrutiny of businesses' responses to issues from racism to treatment of employees, or interactions with other businesses, organisations or political regimes engaged in corrupt activity or human rights abuses. And governance has always been important to pension schemes: Governance of schemes themselves, of their sponsors, service providers or the businesses in which schemes invest. How effectively are pension schemes performing on S and G – in their investment strategies and in other aspects of their operations?

Answering that question is not straightforward. As WTW director and head of sustainable investment, Adam Gillett, points out, part of the reason the E has occupied so much attention in recent times is that so much effort has gone into creating structures that businesses and other organisations can use to quantify environmental risks and impacts.

"It has translated into investment language and pension schemes' thinking, in terms of quantifying a climate risk and allocating capital," he explains. "But with the S in ESG, say, that translation is more difficult."

Meaningful data needed

LGIM head of DC investment strategy, Veronica Humble, stresses the need for meaningful information and metrics that businesses and pension schemes can use to assess S and G performance. "You can't just make subjective judgements; you need objective data," she says – although she also warns of the limitations of a data-driven approach as a guide to future performance.

Master trusts have been among the organisations to have made most progress in developing truly integrated ESG investment strategies. For instance, The People's Pension's ESG approach incorporates use of negative screening, which has led to divestment from almost 150 companies. Some were carrying out activities that the master trust and its members regard as socially unacceptable, related to weapons, human rights violation or corruption. Others have been involved in environmentally damaging activities.

At Nest, senior ESG consultant, Georgina Chiu, says strategy is based on a view that "companies that manage social risks would be better governed and better able to deliver sustainable performance"; and a willingness to challenge businesses on these issues. As an example, she cites the benefits that businesses gain from paying a real living wage: more motivated staff and better staff retention. Nest has addressed FTSE 100 companies on this question directly; 50 of those companies are now accredited Living Wage Employers.

But measuring positive social impacts is difficult. "One reason why social issues haven't got the attention they deserve is that there's less of an evidence base around their financial materiality," says Cardano group head of sustainability, Will Martindale.

However, he continues, there

are some frameworks that can help businesses to benchmark and guide improvement of their work on the S and the G. They include the UN Sustainable Development Goals (SDGs) and OECD guidance on Due Diligence for Responsible Business Conduct; and Multinational Enterprise Guidelines on Business and Human Rights.

Pressure from all sides

In future it seems likely that businesses and pension schemes will also be asked by policymakers and regulators to focus more closely on the S. In spring 2021 the DWP ran a consultation on the effectiveness of occupational pension scheme trustees' policies and practices in relation to social factors, seeking to discover how well scheme trustees understand social factors and how closely considerations of financially material social factors were integrated into investment and stewardship activities. At the time of writing the DWP is yet to release its response to feedback received through the consultation.

Humble says it is no longer enough just to have a policy to improve performance against the S. She reports multiple conversations with clients about how to measure performance on diversity and inclusion, in response to pressure from scheme members and the wider public.

For the past two years LGIM has run a survey of scheme members tracking their views on ESG. Results have highlighted the importance of S and G issues, including employee pay and conditions, the gender pay gap; as well as inclusion and diversity. Results from the 2021 survey showed that 81 per cent scheme members who are in generation X said they would engage more with their pension if they knew it was actively encouraging companies to have a positive impact.

There is a clear overlap here between S and G issues, in part because a company or pension scheme's attitude to the S in ESG will be determined in the boardroom. These issues are also now regarded as important by growing numbers of professional and institutional investors – for practical business reasons, besides any other motives.

"The evidence suggests that cultural diversity, social inclusion and personal/professional development of employees play a key role in mitigating risks at the corporate level, enhancing performance via reducing groupthink; and … the cognitive biases that business leaders are prone to," says The People's Pension investments managing director, Jon Cunliffe.

He sees a strong link between the standard of a company's governance and the quality of its environmental and social performance. "It's all to do with risk mitigation," he says. "A badly run company will tend to have bad risk mitigation, so badly run companies will tend to score badly on the E and the S."

Humble says the fact that more businesses are now starting to link strategies and benchmarking to some of the UN Sustainable Development Goals (SDGs) will help. "More corporates are thinking that way, asking how their engagements and products are aligned to the SDGs," she says. "It's a very useful framework and it also leans towards showing impact."

Responsible stewardship

Finally, whether the E, S or G is most prominent, a more complex ESG strategy will make more use of stewardship and engagement than the blunter tool of divesting from businesses engaged in environmentally or socially harmful activities, says Hymans Robertson DC investment consultant, Alison Leslie.

"This is about being good stewards and engaging to drive change," she says. "Some companies that we think of as 'dirty' will be critical to the technological revolution needed in the E space, which will have a massive impact on the S space. We need to engage with those companies, to drive that change."

Cunliffe agrees. "Simply divesting from companies that you think might be bad for the environment may not help if it damages their business model and doesn't enable them to go down the pathway of carbon transition," he says. "If you sell a company it's quite possible somebody else might buy it at a cheap price and be quite happy to hold it, because they don't utilise ESG principles. So you can't do this unless you are prepared also to engage directly with companies, to help with their transition to less carbon-intensive business models."

During the next few years, while the urgency and importance of environmental issues may mean the E in ESG overshadows the S and the G, the high profile of ESG in general should help to drive improvement in overall ESG strategies.

Those outcomes will be environmental and social goods, but they will also be good for scheme members and the businesses that pursue these strategies, says Cunliffe. "The long-term effects are better risk-adjusted returns," he says. "What we're looking to do is engage in investing that mitigates risk and increases opportunities for good quality returns as well. So if you do integrate S and G more thoroughly into ESG as an approach, arguably over time you will get better risk-adjusted returns."

"Overall, we've come such a long way," says Humble. "Five years ago you had a few schemes starting to think about this; now every conversation we have with clients is an ESG conversation. Some of that is focused on trustees' regulatory obligations, but there is also a genuine desire to think about members' interests and to act upon them."

Written by Dave Adams, a freelance journalist

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