**Summary**
• Ethical investing can mean the negative screening of stocks or the implementation of environmental, social and governance (ESG) criteria into mainstream investments.
• Equities is the most popular asset class for incorporating ESG considerations.
• There has been a greater focus on the 'environmental' and 'governance' aspects of ESG, rather than the 'social'.
• Concerns linger over the impact of ethical investing on returns.
• Greater regulation, along with increased public awareness on ESG concerns – particularly among millennials – is driving interest for ESG to be considered within a pension fund portfolio.
• Education and  manager engagement are recommended first steps to implement ESG concerns into an investment portfolio.
• Conversations about ESG, along with DB and DC trailblazers, are expected to result in increased action over the coming year.

# Rising tide

**Laura Blows looks at the flood of ESG conversations within the pension fund industry, and whether it is really changing the investment landscape**

What is the hot topic washing over the pensions industry lately? The World Cup? The UK actually having a heatwave? *Love Island*? No, flooding industry discussions is ESG – considering environmental, social and governance matters when making investments. And this is a subject that, unlike the examples above, is expected to dominate conversations beyond the summer.

Pension fund interest in the subject has been steadily growing. According to the Investment Association (IA)'s *Stewardship in practice* report from September 2016, 31 per cent of asset owners discussed responsible investing 'regularly at trustee meetings' over the past 12 months, followed by a quarter doing so on an annual basis, and 14 per cent having delegated this to a sub-committee.

Mercer's responsible investment team principal, Kate Brett, notes that its latest *European Asset Allocation Survey* finds 40 per cent were considering ESG, "so not yet formally the majority, but the direction of travel to being standard is clearer than it has ever been".

The reason for this travel goes beyond any 'feel-good' factor; a Pensions and Lifetime Savings Association (PLSA) and IA stewardship survey finds that 76 per cent of pension fund respondents agree ESG factors, such as climate change and human capital, can be material to investment performance.

Yet if so many are so sure about the positive impact of considering ESG, the amount of discussion and debate still on the subject is somewhat surprising. However, one explanation for the rise in ESG conversations may be because of the confusion as to what incorporating ESG actually means.

**Exclusion versus mainstream**

According to UBS Asset Management head of UK institutional coverage, Malcolm Gordon, ESG should be considered in two parts – the integration of ESG into mainstream investments and the procurement of ESG-specific products.

However, Insight Investment ESG analyst Josh Kendall notes that while ESG is different to ethical investment, a pension scheme "can still be interested and committed to ESG whilst invested in defence or tobacco firms. They are not mutually exclusive".

Organisations with specific ESG issues that they wish to account for through the avoidance of 'sin stocks' for example have probably reflected this in their strategies already, so now schemes are looking at ways in which ESG criteria can be used as a positive factor in setting a successful investment strategy, Barnett Waddingham partner Neil Davies says.

Aon's June 2018 *Global perspectives on responsible investing* report backs this up, finding that that 47 per cent of investors prefer the integration of ESG factors into investment decisions, with negative screening coming in second at 24 per cent.

**Asset classes**

The integration of ESG factors into mainstream investments so far mainly occurs through equities.

According to Kempen Capital Management  head of investment strategy, UK, Nikesh Patel, the most common approach (by AuM) is passive equities through basic exclusion strategies, then by broad infrastructure investments (with a sub-sector push into renewables), followed by 'stewardship' style funds that are typically UK equities focused (though are mainly in decline, he says), and then by passive equity funds that use alternative indices focusing on ESG issues.

However, fixed income is where ESG issues appear to have percolated least well, partly because few products in the market focus on ESG themes within fixed income, he adds.

Considering ESG matters when investing in emerging markets is also difficult, Vontobel head of UK & Ireland business Sheridan Bowers notes, as in many EM countries, "companies are not legally obliged to disclose as much information about ESG criteria as they are in developed markets".

Yet Willis Towers Watson global head of sustainable investment, Adam Gillett, finds that data quality and disclosure within emerging markets is quickly improving. So this historic focus in public equities should no longer be the case, he adds.

"Stewardship is a good example of this," he explains. "Many investors have confined this to engagement and voting on public equities, however the ability and importance of debtholders' engagement with issuers is increasingly well-recognised, and in private market investments such as infrastructure the amount of asset engagement and active management that a manager has is crucial to their ability to deliver desired investment outcomes for the pension fund clients."

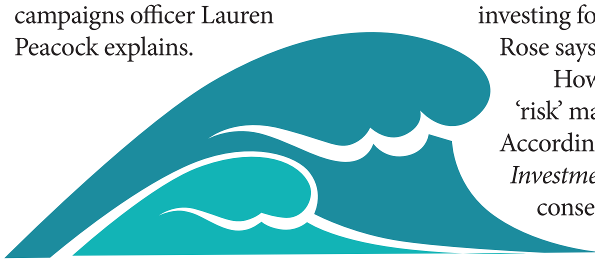
However, the difficulty in defining suitable ESG factors makes incorporating a policy beyond core asset classes more challenging, Davies finds. "For example, it is relatively simple to establish the ESG factors impacting a fossil fuel producing company, but doing the same for portfolio of properties with multiple tenants and uses is less simple," he explains.

**E and G – less S**

This may be why the focus has tended to be on the 'environmental' and 'governance' sides of ESG, and less so on the 'social'.

Aon's report found that climate change and fossil fuels/carbon footprint was the responsible investment issues of most concern to investors, as 42 and 43 per cent, respectively. Governance issues in terms of bribery and corruption came third at 37 per cent.

"As climate change poses systemic risk across the economy it is easier to understand how it will impact returns and has therefore received more attention. The 'S' has received less attention partly due to the lack of company disclosure on social issues, like the workforce, which investors can base decisions on," ShareAction senior campaigns officer Lauren Peacock explains.



**Difficulties**

The difficulties of monitoring the 'social' aspect may be indicative of a wider problem.

According to Bowers, if ESG implementation becomes too rigid, it could either distract investors from the real issues or provide a false sense of security.

"If one ESG provider determines there are 30 key ESG metrics that should be considered by investors, the perceived risk of each factor can become diminished at just 3 per cent. However it only takes one significant ESG issue to have a material impact of the company's share price, something that was felt by shareholders in BP following 2010 Deepwater Horizon oil leak," he explains.

The risk is that "ESG becomes another tick box exercise, green-washing if you like, instead of being fully understood", Bowers adds.

PensionsEurope head of sustainable finance Matthies Verstegen finds the lack of comparable data to be the main issue. "Without high quality non-financial data, it is difficult to assess the ESG risks linked to the investment," he says.

Indeed, Aon's report finds that 38 per cent considered the biggest hurdle to responsible investing to be the lack of consensus over the impact of responsible investing on investment returns.

"Many investors are still concerned that by integrating ESG considerations into the investment decision, they will lose out on return (a common concern associated with screening). Cost is also a consideration, especially if a manager charges an extra fee for screening," Aberdeen Standard head of ESG investing for client and product Cindy Rose says.

However, thinking of ESG as a 'risk' may be the wrong approach. According to Schroders' *Sustainable Investment Report, Q2 2018*, a conservative ESG premium estimate of 1 per cent for a DC account can increase the savings balance by 16 per cent over 40 years – the equivalent to an additional 1.5 per cent per annum of contributions.

"The oft-sighted barriers such as definitions, evidence of the financial benefits, regulatory clarity, and availability of strategies have now largely been overcome," Gillett says. "The biggest one left is asset owner governance. The challenge of running a pension fund is enormous and the size and complexity of that task is ever-growing. This is largely a structural, industry issue, and the fundamental solutions lie in consolidation, improved governance and intelligent use of delegation."

Jumping over these hurdles takes

time, so what has made ESG rise up in pension fund trustee importance right now? In one word: regulation.

**Regulations**

The government's Department for Work and Pensions (DWP) launched a consultation in June, proposing that pension scheme trustees must produce an updated statement of investment principles by 1 October 2019 that will take into account their financial material considerations, "including but not limited to those arising from ESG considerations, including climate change".

The consultation was in response to the Law Commission's 2017 report, which states that ESG and ethical issues should be taken into account if financially significant. It also highlights that non-financial factors can be taken into account if there is good reason to believe that scheme members share the trustees' view and there is no risk of significant detriment to the fund.

TPR, which is supporting the DWP in the development of these proposals, now makes reference to ESG in its investment guidance, for instance by stating that schemes could take non-financial matters into account by offering funds that select investments according to particular religious, environmental or social principles.

For PLSA policy lead, investment and DB, Caroline Escott, the DWP consultation should help remove confusion around how and when schemes should take ESG risks into account in their investments and ensure trustees are clear on the distinction between when an ESG issue is a financial consideration or an ethical one. "This will remove a key obstacle to trustees considering ESG factors in their investment plans," she explains.

**Leading the way**

Unsurprisingly, it is the larger schemes leading the way with ESG on the DB side, particularly the pooled LGPS funds with their focus on fossil fuel divestment.

In September 2016, the Waltham Forest local government pension fund was the first LGPS to commit to divest from all fossil fuels. Others have since followed suit. Earlier this year, London mayor Sadiq Khan added his support for London's LGPS to divest from fossil fuels, and in January, Unison launched a campaign to encourage LGPS to divest £16 billion from carbon initiatives.

Pictet Asset Management senior business development manager Tim Bird has seen a few larger DB pension funds discussing tapping into the long-term thematic trends in areas like water and timber, while Peacock highlights ShareAction's work over the past two years with TfL, which has established a new framework for assessing their asset managers on ESG, and the Co-operative, which has developed the themes for engagement that they feel their stakeholders support.

DC schemes are considered generally behind the curve with ESG implementation compared to DB schemes. More ESG action seems to occur for trust-based schemes than contract ones, Peacock finds, as contract schemes have less history of governance in the scheme structure, meaning ESG responsibility is delegated out to asset managers and can be lost along the chain.

"Independent governance committees have been established to fill this gap but our research this year found that only two out of 16 referenced ESG in their reporting," she adds.

Two trust-based DC trailblazers are Nest and HSBC, which have both incorporated ESG into their default offerings.

Nest had UBS develop the UBS Life Climate Aware Equity Fund, while in 2016 HSBC's pension scheme got Legal and General Investment Management (LGIM) to develop the Future World Fund as its equity default option, which according to LGIM head of DC Emma Douglas, is multi-factor global equities index fund that incorporates a climate 'tilt' to address the investment risks associated with climate change.

The use of ethical funds within the DC default is a welcome one for Sackers partner Stuart O'Brien, as he says a lot of trustees fall into the 'trap' that they can tick the ESG box by offering some sort of ethical/green fund option for members with certain moral views to choose if they wish.

"However, this completely misses the point that ESG should be considered as a financial factor not an ethical choice," he explains. "It should therefore be considered for DC default funds. If trustees consider that climate change, for example, poses financial risks to their DB portfolios then they open themselves up to challenge if they don't similarly consider managing it in DC default funds."

So while there may be some 'poster child' funds leading the way within both DB and DC, there is still much more ground to gain before it becomes the norm across all pension funds.

For instance, a report from the Environmental Audit Committee in May found that nine of the 25 largest pension schemes have no plans to report in line with the recommendations of the FSB's 2017 task force of climate-related financial disclosures (TCFD), while only 12 have considered it at board level.

Also, a June report from ShareAction, *The engagement deficit*, found two-thirds of the UK's largest auto-enrolment providers do not have any policies in place to prevent investments in companies that profit from chemical and biological weapons.

**Growing importance**

This may have to change as younger people come up into the workforce – millennials are considered to be a powerful driver for ethical investing.

In June 2018, research by PensionBee found that those under 30 were twice as likely to choose an ethically-invested pension than those over 50.

ShareAction's research backs this, with its *Pensions for the next generation* report finding that 84 per cent of millennial savers would prefer a pension that uses investments to encourage companies to operate responsibly.

Yet this drive can not all attributed to the young. There has been growing engagement by society as a whole on ESG matters (just consider the increased concern regarding plastic waste following *Planet Earth*'s showcase of its impact).

"No scheme nor their trustees wants to be in the headlines for not taking a responsible approach to labour standards or climate change," BlueBay Asset Management head of ESG investment risk My-Linh Ngo says.

"As technology makes pensions more accessible and people generally come to expect more transparency, I just don't think it will be acceptable for pension schemes to have no views on responsible investment," O'Brien adds.

Pension schemes will have to listen to member concerns, as in response to an independent advisory group's June 2018 report, *Growing a culture of social impact investing in the UK*, the government says it would like members' views to be more seriously considered, and that it would work with regulators to explore new ideas

"There is a culture in the industry of 'we know best'," Peacock says. "This has led to disengaged members and those who are trying to engage are often pushed back whilst the trustees get up to speed."

For Patel, the consolidation of the DC market into master trusts will help enable DC trustees to increase its attention to ESG issues.

**First steps**

Stepping into the murky waters of ESG investment can be tricky. Therefore, before taking the plunge, education and understanding is vital.

From there, the scheme can decide which ESG approach it wants to take, be it hard exclusions of certain stocks or having ESG criteria a key factor in stock selection, without necessarily excluding stocks.

"Once an approach is agreed, schemes should consider how to assess the credentials of potential managers through a beauty parade, and how to monitor their performance over the longer term," Davies says.

TPR's investment governance states that schemes' stewardship activities are likely to be taken by large investment managers on the trustee board's behalf, so it encourages schemes to become familiar with managers' stewardship policies, and where appropriate, seek to influence them.

The Financial Reporting Council's UK Stewardship Code provides information about how to implement quality engagement between institutional investors and the companies they invest in.

There are also projects such as the Transition Pathway Initiative, Patel says, "which have made and are continuing to make great strides forward in making it easier for pension schemes to follow through ESG policies with more than just words, and providing academic and empirical rigour to what has thus far been a rather subjective field". A number of institutional investors are also signatories to the UN Principles for Responsible Investments.

Fundamentally, Gillett says, investors should not be treating sustainability issues materially differently to how they deal with other investment issues. "Sustainability is just another important lens with which to view the investment process, improve the quality of investment decision making, and help drive better risk-adjusted return outcomes," he says.

**Action**

O'Brien states that most mid-size schemes are generally at the stage of making sure they understand the issues and developing their policies. "I would expect 2019 to see more action in terms of actual investment decisions," he adds.

Octopus Investments head of institutional funds Hiti Singh notes that there is "real change", with ESG not just being a box-ticking exercise for UK pension funds, citing many of its institutional investors being signatories to the UN Principles for Responsible Investments as an example.

So pension fund engagement around ESG issues is increasing, with a lot more activity around ESG over the past six months, Redington head of DC and financial well-being Lydia Fearn notes.

"We know that a number of pension schemes will be implementing new investment funds into their strategies soon; they have just had to wait for some funds to be launched. Other schemes have been analysing and monitoring their ESG position, as well as getting an understanding of what the managers are doing and how they are integrating ESG into their investment decisions.

"Many more conversations are happening and investment managers are thinking seriously about whether their products already do or can integrate ESG. If trustees aren't seriously looking at ESG now or very soon, they will be in the minority of schemes," she warns.

So, the current conversations around ESG is unlikely to be a flash flood of popularity, to be washed away when a new topic of interest comes along.

Instead, as Muzinich & Co managing director and head of UK institutional business Simon Males says: "There has been inertia but like any groundswell, the rising tide of ESG populism will lead to improved clarity and understanding – for all stakeholders."

**Written by Laura Blows**