Summary

• The discussions over ESG is over and its implementation into pension fund portfolios has begun.
• By October 2019 trustees will have to update or prepare their strategic investment policy (SIP) to include their rules on ESG.
• Trustees should make efforts to understand what their investment managers' ESG actions are.

The age of ESG responsibility

With discussion over whether ESG issues should be taken seriously coming to an end, implementation has begun. Elizabeth Pfeuti looks at how schemes can integrate an ESG approach into their investments

As school children march about climate change, demanding action is taken to reduce its speed and impact, they are calling on the generation in power to take moral responsibility.

For pension fund trustees, however, this responsibility is already being imposed by regulatory forces looking to harness the power of institutional assets to help reach targets on environmental, social and governance (ESG) issues.

In September 2018, the Department for Work and Pensions (DWP) published its response to a consultation on changes to regulations around how retirement funds should invest. Within this response was the new instruction that trustees needed to consider ESG issues when making investment and asset allocation decisions.

Despite a shift having already been taken by some in the industry to highlight risks around climate change and other societal challenges, it was the first time the government had been explicit in calling for trustees to consider them.

Under these new regulations, by October 2019 trustees will have to update or prepare their strategic investment policy (SIP) to include their rules on ESG. These rules will be included under the "financially material considerations" tab, indicating the importance the DWP considers these factors to have, leaving trustees to ponder the "appropriate time horizon" over which to measure it.

Trustees will also have to set out how they intend to engage as investors, indicating the DWP thinks stewardship should move up the spectrum of responsibility for owners of some of the world's largest – and smallest – asset owners.

All in this together

While the above applies to both DB and DC schemes, for those with members actively allocating their own investments, there is an additional duty.

By October 2019, DC schemes must show on a publicly available website how their SIP complies with these new regulations – and a year later report back to beneficiaries how the trustees have acted on their responsibilities.

Legal & General Investment Management head of DC client solutions, Simon Chinnery, says doing nothing was no longer an option.

"New guidelines from the DWP clarify that ESG information can have an impact on the financial bottom line," Chinnery says. "The consideration of ESG information can therefore help pension scheme trustees meet their core objective of providing retirement benefits for members."

Hermes Investment Management head of sustainable investing, Andrew Parry, says, rather than just conforming to a current way of thinking, the DWP measures would help pensions stay ahead – or at least up to date – with how the economy might be affected by ESG issues.

"The main obligation for trustees remains to meet liabilities," he notes.

"Funding ratios are still challenged, so the most important thing for them to look at is their risk/return and how they are going to meet that challenge."

It is important to note that the DWP has not set out an explicit formula on how it wants pension investors to conform. Due to the range of investors around the country and the differences in scale and sophistication, it would not have been practical.

Parry says trustees needed to think about these new responsibilities as a focus on long-term risks and use the outline given by the DWP to consider what the issues mean to them and how they can best tackle them.

Pays your money, takes your choice

For most pension funds, DB and DC, investment decisions are delegated to third-party providers. Barnett Waddingham partner, Neil Davies, says most asset managers would be incorporating ESG factors into their investment processes, but the extent of this will vary.

Davies explains: "Trustees should seek to understand what their current managers are doing to take account of the ESG opportunities and risks in their portfolio during their investment decision making process; how these are monitored throughout the life of the investment; and how managers engage with companies and vote as shareholders, where possible."

He adds that most trustees would take a steer on their investment policy from looking at existing strategies but doing this would be adhering to the bare minimum. Rather, many in the sector see this move by the DWP as a chance to better explore the opportunities available by repositioning a portfolio.

Chinnery says there was a range of ways to integrate ESG considerations: Taking direct action in investments; committing to support responsible investing organisations and initiatives; or by setting explicit expectations when selecting and monitoring asset managers.

He adds that historically, ESG integration had been associated with screening out companies or entire sectors, but instead of exclusions, data-driven approaches "may promote capital allocation to companies that are well managed, using information that has fallen outside of traditional financial analysis".

"Approaches such as stewardship; demanding high standards from companies in which you invest and holding those that fall short to account through corporate engagement and voting activities, contributes to market stability, a key driver of investment performance," Chinnery says.

Parry says the world was going through a series of changes – good and bad— and people were noticing the growth opportunities appearing as a result. He notes: "Changes in tech, increasing global trade and changing demographics are impacting everything."

He says trustees, through their investments, could capitalise on these changes, rather than get left behind.

"The question must become: 'Why wouldn't you integrate ESG into your approach?' rather than 'why would you?'," Parry states. "If you don't think about the impact of S and G, you are not going to get a picture of future sustainability. Survival of everything – including companies – is the most important thing for investors, and ESG inputs should help ensure survival."

He says that while there were no guarantees that putting a sustainable label on something would produce the future returns a pension fund needed, trustees should be aware of the portfolio's inherent ESG risks.

"If you have no policy on this, it will be as big a problem as it would be in any other part of the management of your fund, such as interest rates and longevity," said Parry.

First steps

Despite some investors ardently believing in ESG issues and setting a strategy some time ago, others may be just starting out on the journey. Aviva Investors chief responsible investment officer, Steve Waygood, suggests a range of first steps to set these trustees on the way.

"Sign up to be a member of the United Nations Principles for Responsible Investment (UNPRI) and ensure your managers have done so," Waygood states. "If they have not, trustees need to find out why and put pressure on them to adapt to the approach investors around the world are starting to expect."

Waygood adds that unlike many areas of the investment world, where getting an inside edge was key, those working on sustainability were more collaborative: "For trustees just starting out, there are plenty of others within the UNPRI who are further along the path who will help. The pool of resources is very deep."

How do members fit into all of this? Davies says it was optional to take members' views into account around ESG issues, but trustees should be aware of the time horizon of DC and how implementing these factors openly may play out over the scheme's lifetime.

With the impact of climate change already being seen and pushing changes in demographics and global trade, it is likely that by the end of a pension fund's time horizon the world will look very different to today. For Waygood, members are the key to the whole point of "responsibility".

"It is the beneficiaries who are asking the question and they deserve an answer, but it is not just about activists vs grown-ups. The European Union, Financial Stability Board and the Organisation for Economic Co-operation and Development are looking earnestly at what needs to happen," he says. "If trustees have not looked at their strategies, their fiduciary duty now compels them to do so as the regulatory push has arrived."

Written by Elizabeth Pfeuti, a freelance journalist