PENSIONSAge

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LGIM's approach to responsible investing – *We believe responsible investing can not only mitigate risks, but also lead to better long-term financial outcomes without sacrificing performance* p48

Part of the mainstream – *Andrew Williams explores how responsible investing has moved from a niche thought to part of the mainstream considerations of pension fund investors* p50

Responsible investing focus:

A second wind

Anton Eser, chief investment officer, LGIM

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LGIM's approach to responsible investing

We believe responsible investing can not only mitigate risks, but also lead to better long-term financial outcomes without sacrificing performance

From diesel emissions to oil spills, there have been many tangible examples in recent years of how failures in the way companies are run can have a harmful impact on the environment, society and investor returns.

We believe responsible investing can mitigate the risk of such outcomes and has the potential to improve returns through the integration of environmental, social and governance (ESG) considerations, active ownership and long-term thematic analysis. Crucially, it can also unearth investment opportunities, which the market may not fully appreciate, and should not require a trade-off with performance.

At LGIM, as one of the world's largest asset managers with a long history of corporate engagement on the most material long-term issues, we have the scale and ability to make a real, positive impact on the companies in which we invest and on society as a whole. We share this objective – made far more attainable by ongoing improvements in ESG data – with a growing number of clients.

Responsible investing cannot be just a box-ticking exercise. So from the votes cast by our industry-leading corporate governance team to the investment processes deployed in our funds, we continue to take steps to embed the principles of responsible investing across our entire business – and act on them.

At a time when populism is destabilising global politics, the world faces a growing debt burden and a demographic drag looks set to dominate growth prospects, we believe that such an approach is more necessary now than ever as new systemic threats continue to emerge.

Against this backdrop, there is a clear change in the behaviour of consumers, who are demanding more sustainable products and services due to a growing awareness that they are responsible for the societal and environmental implications of their choices.

A similar shift is underway among investors. Increasing numbers expect the asset managers most likely to deliver the greatest shareholder value over the long term to be those that truly recognise the importance of incorporating long-term themes alongside ESG considerations into their investment processes.

Managing the managers

There are an almost overwhelming number of ways to characterise and conduct responsible investment strategies. We support the consensus view, established by the UN-backed Principles for Responsible Investment, that responsible investing aims to incorporate ESG factors, in order to better manage risk and generate sustainable, long-term returns.

Importantly, unlike other approaches, such as ethical investing, we define responsible investing as seeking to deliver desired financial outcomes, rather than being subject to moral or ethical considerations.

And while the collection of hard, empirical data on responsible investing remains somewhat in its infancy, a growing body of academic and industry work indicates that it can indeed engender better risk-and-return outcomes.

Guess who's coming to your AGM

Active ownership forms a key part of how we conduct responsible investing, as we feel it is incumbent upon us to take our stewardship responsibilities seriously, not least because of our size. This is reflected in the following activity:

• Company engagement
• Using our voting rights globally, with one voice across all our active and index funds

• Addressing systemic risks and opportunities
• Seeking to influence regulators and policymakers
• Collaborating with other investors and stakeholders

Insights gleaned by our corporate governance team, which spearheads much of this work, help us to assess a company's ESG profile. This is most comprehensively evaluated by looking at two different drivers of investment returns.

The first is how its business activities can impact its bottom line; for example, the risk of pollution by a miner leading to the loss of a key licence to extract resources from a country. The second is how long-term trends may determine consumer demand for products and services; for example, the implications of the global battle against plastic for petrochemical companies and demand for oil.

As a result, we conduct a combined research effort across asset classes to evaluate long-term themes – energy, demographics and technology – and understand how they shape, and are shaped by, the political environment.

Making responsible investing mainstream

We have devoted significant resources to extending our capabilities in responsible investing across our business. We also work to make a positive impact through strategies such as our Future World funds, which go even further in addressing sustainability issues.

Markets, meanwhile, do not yet reflect the systematic incorporation of ESG considerations by their participants. But as investors are increasingly recognising that these factors play a crucial role in determining asset prices, we believe responsible investing is destined to become the new normal.

As it becomes mainstream, we are likely to see a virtuous circle of more investors demanding higher standards in order to allocate capital to companies, and more companies raising their standards in order to receive that capital.

We also expect growing numbers of investment decision-makers to view the consideration of ESG factors as a fundamental part of fiduciary duty, as they acknowledge that it need not entail the sacrifice of investment returns.

For our part, we will continue to endeavour to embed these principles in everything we do, in order to deliver sustainable, long-term returns for our clients and help bring about the real, positive change of which the world is in urgent need.

Written by Anton Eser, chief investment officer, LGIM

In association with Legal & General Investment Management

Part of the mainstream

Andrew Williams explores how responsible investing has moved from a niche thought to part of the mainstream considerations of pension fund investors

Summary
• In recent years, responsible investing has moved gradually from a niche investment area for pension schemes to being part of the mainstream.
• Many people now demand more from their investments, particularly when faced with increased regulatory pressure and heightened awareness of the financial cost of inaction in managing risks like climate change.
• More and more observers now report that there is, at the very least, no negative trade-off between performance and responsible investment.

Pension fund managers across the UK are increasingly aware of the need to consider the environmental, social and governance (ESG) impacts of the investments they make. So, what have been the recent trends in the way that UK pension funds invest responsibly? Has the level of interest in responsible investment increased in recent years? What are the main factors influencing the decision to invest responsibly? And do UK funds remain concerned about sacrificing performance when undertaking responsible investment?

Mainstream

In recent years, responsible investing has moved gradually from a niche investment area for pension schemes to being part of the mainstream. According to Aberdeen Standard Investments' head of ESG investment – clients and products, Cindy Rose, the main recent trend has been the fact that pension funds increasingly recognise that responsible investment is more about engagement with companies rather than a simple screening in or out approach. In her view, this entails engagement "with a view to moving the dial with companies towards better practices to provide better risk and opportunity management".

As Legal & General Investment Managements' (LGIM) head of sustainability solutions, Caroline Ramscar, explains, the market is changing, meaning that people want and expect more from their investments, particularly now that they're faced with escalating regulatory pressure and an increased awareness of the financial cost of inaction in managing risks such as climate change. That said, Ramscar stresses that climate is not the only issue that should matter to investors – and points out that the focus is broadening as the financial implications of diversity and good governance are increasingly recognised.

As far as LGIM is concerned, Ramscar reveals that, as an established long-term investor, its focus on the future means that it has always believed in taking structural changes into account and is working to embed principles of responsible investing across the entire business. In practical terms, this means that LGIM approaches responsible investing through the integration of ESG considerations, alongside active engagement with companies and long-term thematic analysis.

"This plays out in how we engage with companies, develop innovative products, evolve our investment process and manage risk to deliver sustainable long-term value. We have evolved our approach by extending our Future World fund range in 2018. The ability to have impact at mainstream level is what we have been aiming for – the solution needs to be mainstream to be successful in realigning assets to sustainable investments," she says.

"Our strategies range from index approaches targeting issues such as climate and gender diversity, through to multi-asset, real assets and fully unconstrained active strategies, giving our clients choice across mainstream sustainable investment products."

Exponential growth

In terms of uptake, Ramscar reports that LGIM has observed a marked increase in the level of interest in responsible investing among UK pension schemes in recent years – with investors increasingly realising that ESG factors play a crucial role in determining asset prices and are beginning to view consideration of these factors as a fundamental part of their fiduciary duty. Even so, Ramscar believes that the UK still lags the rest of Europe in terms of ESG integration for a number of reasons, including the perceived inability to measure investment impact and the lack of stakeholder demand.

"Both of these are being addressed as the quality of data continues to improve, and government intervention is placing greater onus on trustees to consider ESG integration," she says.

Elsewhere, KBI Global Investors' head of responsible investing, Eoin Fahy, believes that the level of interest in responsible investing has grown exponentially in recent years. Although conscious of the difficulty of measuring such trends in a numerical or quantitative way, he reveals that an analysis of interactions with prospective clients showed that in 2018 (to date) about two-thirds of new business requests for proposals (RFPs) received by KBI involved the company answering very detailed questions about its approach to responsible investing.

"Four or five years ago, it was rare to be asked more than a single, often

quite perfunctory, question about our responsible investment approach, and more often there were no questions at all on this topic. So, we can say with absolute confidence that the level of interest has increased very rapidly," he says.

Although it is somewhat more difficult to be sure exactly why this has happened, Fahy highlights several potential reasons, including the fact that the aftermath of the global financial crisis focused minds on corporate behaviour and that the millennial generation, now moving into middle and senior management roles, are known to have a more favourable approach to responsible investing than older generations.

"Similarly, the increased number of women in senior management roles today, relative to a decade or more ago, may possibly be a factor," he says.

"The general acceptance that climate change is a real and urgent issue, for society, for our environment, and indeed for the global economy, may be another factor in driving the much-increased interest in responsible investing, particularly as it relates to issues like fossil fuel divestment and clean energy funds," he adds.

Performance impact

According to Ramscar, another crucial factor influencing the increased uptake of responsible investing is the fact that many investors now recognise that it need not entail the sacrifice of investment returns.

"UK pension schemes are certainly keen not to give up any investment performance when undertaking responsible investing – as are most other investors, too. But we believe responsible investing should not require a trade-off with performance. In fact, it has the potential to mitigate risks and improve long-term financial outcomes by helping to identify the companies that will succeed in a rapidly changing world," she says.

Meanwhile, Rose argues that sacrificing performance only becomes relevant if you screen out stocks.

Ultimately, Fahy believes that UK pension fund trustees want to be sure that they are acting in the best interests of their members and within relevant laws and regulations – meaning they are careful in their deliberations on undertaking responsible investment.

"It is rare to see trustees switching to a responsible investment strategy without a careful consideration of the issues. They ask themselves whether this is within their legal powers, whether it might endanger investment returns, whether it is what their beneficiaries and sponsors would desire," he says.

Fahy also argues that, in reality, it is "quite unlikely that a careful consideration of these issues will, in the end, throw up material barriers" and points out that trustees are well within their powers to consider material ESG risks and take reasonable measures to address those risks via a responsible investing approach to their investments.

"Companies that are well-managed when it comes to the consideration of ESG factors such as good corporate governance, management of carbon emissions and other pollutants, or the respectful treatment of their workforces, are also likely to be companies that are well-managed in more general terms and thus likely to outperform," he says.

"So, to us, while UK pension funds certainly do – and should – consider whether a responsible investment approach could result in lower investment performance, such consideration usually results in the conclusion that there is at the very least no negative trade off between performance and responsible investment," he adds.

Written by Andrew Williams, a freelance journalist

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