ESG: An investment boom

In recent years, there has been a boom in the popularity of ESG investing by UK pension funds. So, why exactly has it become more popular? Andrew Williams investigates

Summary
- In recent years, ESG has become an increasing focus for UK pension funds. This is caused by a range of factors, including recognised financial benefits and responsible risk management, public policy and regulation.
- The largest single style and country combination is engagement and voting in the UK.
- A likely future trend will be the increasing availability of data, which should allow the sector to better understand financial materiality and facilitate better reporting.

Since around the late 1990s and early 2000s, there has been a growing desire in some quarters for a more responsible approach to investing, as well as a growing awareness of environmental issues and, in particular, concerns over the impact of climate change on the planet.

According to Newton Investment Management's portfolio manager, global equity team, Raj Shant, there has also been a growing awareness of social inequality, while 'greater prominence' has been given to companies' behaviour, in terms of accountability and transparency around corporate governance.

DWS's managing director and head of UK institutional, Gareth Davies, agrees that environmental, social and governance (ESG) issues have become an increasing focus for UK pension funds due to a combination of factors, including recognised financial benefits and responsible risk management, as well as public policy and regulation relating to areas such as climate change and financial responsibility.

Redington's head of responsible investment, Honor Fell, also identifies three drivers for investors to consider ESG investing: Financial materiality, regulation and stakeholder pressure, all of which "have strengthened over recent years".

"We're getting an ever-improving data set on the financial materiality of ESG issues; regulation in the UK and also at the EU level is asking pension trustees to provide increasing levels of transparency regarding their governance processes for managing ESG risk– and stakeholders including sponsors, beneficiaries and civil society are increasingly requesting transparency from pension funds about the investments held within the scheme," she says.

Elsewhere, AXA Investment Managers' head of UK client group, John Stainsby, believes there is "no doubt" that ESG investing has become a greater focus for UK pension funds in recent years, for several reasons. To begin with, he thinks that, as a society, we have "simply become more aware of environmental, social and governance issues". Secondly, as an industry, ESG has "become more of an investment issue, not just a box-ticking exercise" – and thirdly, pension funds have recognised they have an obligation to consider ESG factors given the size of assets and time horizons involved.

"Over six months ESG risks might be less of a concern, but over 30 years it becomes hard for schemes to justify why they're not considering them," he says.

Increasing conviction

When measured by assets under management (AUM), Davies reveals that the most dominant ESG investment styles in the UK are engagement and voting and exclusions. For example, €2.2 trillion of UK assets exclude harmful industries such as arms, alcohol and tobacco, second only to Switzerland (€2.3 trillion).

"The largest single style and country combination is engagement and voting in the UK, which is practised in respect of €2.84 trillion of assets," he says.

"Meanwhile integrating environmental, social and governance factors into investment decisions has grown by 76 per cent in the UK compared with 60 per cent in Europe overall in the two years ending 2017. One of the fastest-growing areas is impact investing, which grew by 230 per cent between 2015 and 2017 but in AUM terms is still small at €15.3 billion," he adds.

Stainsby points out that cashflow-driven investing (CDI) is another interesting example that has gained in popularity recently, particularly because pension funds, looking perhaps 30 years into the future, need the confidence to know that cashflow delivery is secure and predictable and reassurance that the money will be there after 20-plus years to continue to meet pension payments as they fall due.

"ESG is central to ensuring these cash flows are sustainable. While integration has become more mainstream across traditional asset classes, the challenge now is how to do this beyond these core areas. As an industry we need to think about how we can do this as there will be demand for managers to keep innovating and integrating across other investments such as alternatives," he says.

Elsewhere, Shant reports that Newton has witnessed increasing conviction among asset owners that careful consideration of sustainable criteria can lead to better long-term investment outcomes. For him, a sustainable approach means using ESG-focused analysis to differentiate between companies based on their actual fundamentals and strategies rather than their sector classification.

"We believe that a more engaged approach can help investors to avoid poorly performing companies and identify higher quality companies regardless of their sector. An interesting example is the United Reformed Church Minister's Pension Trust Limited, which moved from a traditional ethically constrained mandate to a sustainable investment mandate," he says.

Improved reporting

As far as the impact of responsible investment on returns is concerned, Insight Investment's senior ESG analyst, Josh Kendall, believes that considering ESG concerns helps pension funds to improve their understanding of risk.

"In our view, the more sensitive investors are to the risks that ESG factors can represent, the better equipped they will be to mitigate those risks," he says.

"We believe that ever-increasing numbers of pension funds will consider responsible investment a sensible investment solution. In our view, this sharpening focus will be driven in part by regulation, and also by greater reporting requirements for UK pension funds," he adds.

Looking ahead, Davies expects a further improvement in the quality of ESG data, which he believes is likely to enhance the materiality of ESG data from an investment perspective. He also expects an increasing focus among pension funds and the broader investor community on impact reporting of their investment holdings in both private and public markets.

"This means in addition to assessing financial returns, investors will attempt to measure more robustly the environmental and social impacts of their investments. We expect the United Nations' Sustainable Development Goals will form a useful framework for impact reporting," he says.

For Stainsby, the key question for funds moving forward is how to deliver the best possible investment return to their clients, which he argues can be achieved by minimising uncertainty, by understanding risks and by identifying long-term challenges.

"Risks will always be there but an ESG framework ensures these are taken into account when investment decisions are made. Essentially, you want to deliver the same return for less risk. Over the long term, taking less risk is going to matter," he says.

Shant also observes that there is a perception in some quarters that investing with a sustainable remit can mean giving up some investment return, but points to a growing body of academic research demonstrating that, by focusing on actively engaging with companies on responsible and sustainable investment factors, UK pension funds' returns have actually been enhanced.

"Newton has been a long-term supporter of the Centre for Endowment Asset Management at the University of Cambridge's Judge Business School, which has provided valuable data to back up this assertion. In 2015, the centre undertook an active ownership study, which examined 2,152 engagement sequences around ESG factors at 613 US companies between 1999 and 2009.

"The results of the study revealed that successful ESG engagements can have a positive impact on returns, with very limited risk if an engagement is unsuccessful, illustrating the value of active engagement not just for society, but for firms and shareholders too," he says.

Fell observes that another key trend in the next few years will be the increasing availability of data, which will allow the sector to better understand financial materiality and facilitate better reporting.

"Better reporting will enable pension schemes and asset managers to manage these risks better and will also enable beneficiaries to gain a better understanding of the ESG impact of their long-term savings. Standardisation of reporting and of terminology is required and I expect to see this happen over the next few years," she says.

Written by Andrew Williams, a freelance journalist

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