XPS Investment

XPS ESG Watch
August 2023

ESG assessment of XPS's client funds

Since 2020 XPS has undertaken an annual ESG review of our clients' investments. We publish the detailed findings of this exercise each year, focusing on the progress of funds and asset classes. We are in the process of collating the key themes for 2023, which will be published in late summer, but in the meantime are supplementing that review with a summary of the ESG ratings of our clients' holdings. We believe this disclosure is an important part of monitoring our progress.

This year we have reviewed 227 funds across 53 managers, assigning a Green, Amber or Red rating for ESG risk management. This compares with last year where we reviewed 255 funds across 63 managers.

Key insights

- Looking across our clients' holdings, we have observed that **ESG risk management has improved** across our client base.
- The overall proportion of assets under management rated Green for ESG has **increased from 36% to 47%**.
- **18% of our clients** are now invested **100% in Green ESG rated funds** (up from only 2% of clients last year).
- Improvements have been particularly prominent in **equity** and **multi-asset fund managers**.
- The improvements across the client base are driven primarily by the underlying ratings, rather than by schemes making decisions to switch into funds with higher ratings. This is encouraging and could be a signal of **engagement with, and improved actions by, current managers**.
- However, the results indicate that **laggard managers remain**, so that **further engagement and progress is required**, and that there may be schemes which could consider switching into funds which better integrate ESG.

> The vast majority of Schemes have indicated that they believe ESG factors to be financially material, and therefore it's critical to invest with managers who fully embed ESG into their investment process.

Alex Quant, Head of ESG Research

Introduction

XPS has long believed that ESG risk management is critical to good overall investment management. We define this as the fundamental consideration of ESG factors into the investment decision-making process and believe this is essential for robust risk management across all asset classes.

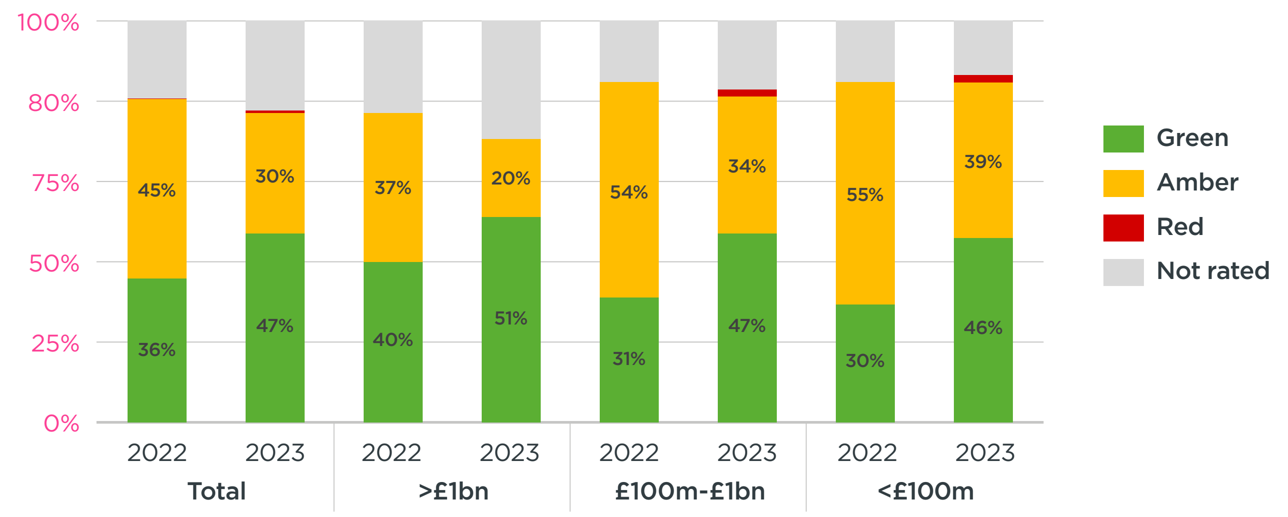
To help our clients, we undertake a review each year of all our clients' funds on the extent to which they consider ESG factors in their investment approach. We assess the approach across 5 key areas: Philosophy, Integration, Climate Change, Stewardship and Reporting. Our Green rating indicates a high level of ESG integration within investment decision-making, evolved processes and tools surrounding both climate change and stewardship and highly informative ESG reporting across a range of metrics.

We believe transparency of disclosure and communication is a key aspect of driving improvement in outcomes. This note sets out a high-level analysis on the breakdown of ESG ratings results across our client base, indicating how effectively ESG is integrated within our assets under advice.

As well as being useful for our clients, we think it's important that the ratings process is part of a two-way dialogue with investment managers. We have therefore provided detailed feedback on each fund's rating to help them understand areas for improvement.

Client investments feature better ESG risk management than 12 months ago

Chart 1: Breakdown of ratings by scheme size (% AUA, DB and DC Trustee clients only)



Source: XPS research, based on asset-weighted allocation of XPS trustee advisory (DB and DC) client base. 2022 figures using ESG ratings from 2022 and holdings at 31 December 2021. 2023 figures based on ESG ratings from 2023 and holdings at 31 December 2022.

The proportion of XPS assets under advice ('AUA') invested in Green-rated has increased from 36% to 47%. The proportion invested in Red-rated funds overall has increased from 0% to 1%. It's important to note that our assessment criteria have not changed in the last 12 months, so the results indicate objective improvement by certain managers, and deterioration in approach by others.

It's clear that the overall distribution of 2023 ratings is relatively size agnostic, are the improvements seen in the last 12 months. **This is encouraging, in that clients of all size are seeing improved ESG risk management by their managers.**

The charts below indicate how the ratings distribution across our client base has shifted in the last 12 months. It's clear to see that the allocation to Green rated funds across individual schemes has increased. Specifically, 18% of our clients are now invested 100% in Green rated funds (up from 2% last year).

Chart 2: Comparison of ratings distribution year on year

Source: XPS research, y axis represents each XPS client ordered from the top by those with the highest allocation to green rated funds. 2022 figures using ESG ratings from 2022 and holdings at 31 December 2021. 2023 figures based on ESG ratings from 2023 and holdings at 31 December 2022.

By analysing the Rating outcomes between 2023 and 2022 we observe that the improvement is driven primarily by improvement in the underlying ratings. Whilst there has been movement in and out of funds, these changes do not explain the change in overall distribution of ratings.

This is a sign that the **engagement undertaken with existing managers is contributing to improvement** in practices and hence higher ratings.

However, it's **clear that there is still room for improvement by many managers**, so that further engagement and progress is required. Furthermore, schemes with **Red** rated managers may wish to consider whether they could switch more of their assets into Green-rated managers who are more aligned with their beliefs around ESG, and their stewardship aims.

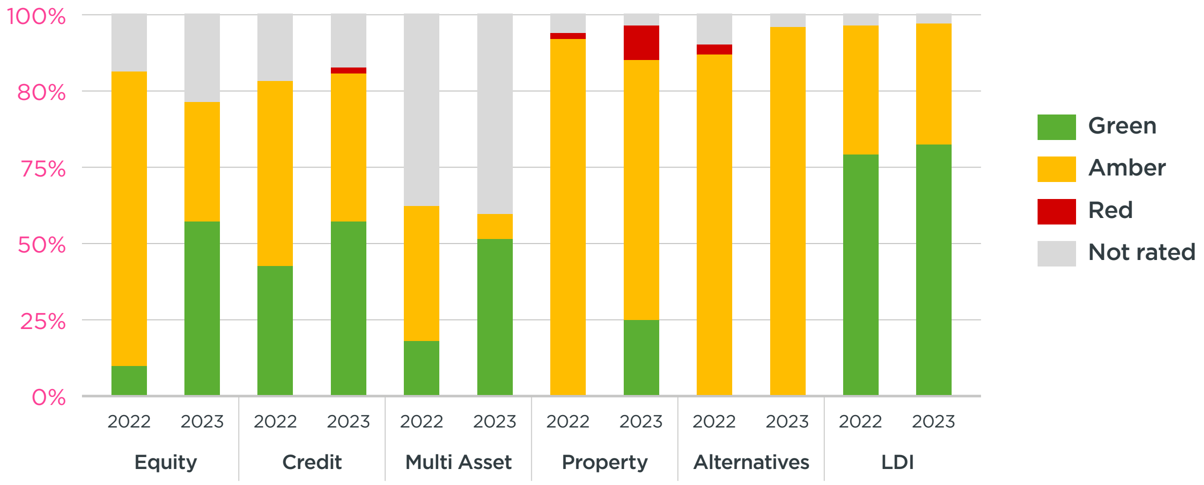
> We've seen an improvement in ESG Risk Management across our client base; 18% of our clients are now invested in 100% Green rated funds.

Improvement seen across most asset classes

There were improvements seen across most asset classes, apart from the Alternatives asset class (Secure Income, Diversified Private Markets and Infrastructure).

We note that whilst there are more Green ratings, there are also more Red ratings across credit and property.

Chart 3: Breakdown of ratings by asset class (% AUA)



Source: XPS research, y axis represents each XPS client ordered from the top with the highest allocation to green rated funds. 2022 figures using ESG ratings from 2022 and holdings at 31 December 2021. 2023 figures based on ESG ratings from 2023 and holdings at 31 December 2022.

How XPS uses the ratings exercise to help our clients and next steps for schemes

Integration of ESG is an important part of good investment management, ensuring better management of risk, and as a way of identifying market opportunities.

It's clear from this high-level analysis that managers in general have made good progress in the last year, whilst others still have room for improvement – we will unpack the key trends in funds and asset classes further in our more comprehensive Ratings Review report which will be released in late summer.

For those schemes invested in managers with inadequate ESG risk management, we believe this is a material concern and should lead to questioning of whether this is considered acceptable and what timeframe might be put in place to assess if action is required.

We encourage all investors to review the ESG ratings of their managers and speak to us about where improvements could be made with existing managers or by switching to new managers who may better manage ESG risks.

If you would like to find out more about XPS's ESG research or are interested in having an ESG assessment undertaken for your scheme, please get in touch with Alex Quant or speak to your usual XPS Investment contact.

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About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 81 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £96bn of assets under advice.

Award winning

Pensions advisory

Professional Pensions UK Pensions Awards 2022 – WINNER – Actuarial/Pensions Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 – WINNER – Actuarial/Pensions Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 – WINNER – Actuarial/Pensions Consultancy of the Year

Investment consulting

Professional Pensions UK Pensions Awards 2023 – WINNER – Fiduciary Evaluator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2022 – WINNER – Investment Consultancy of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 – WINNER – Investment Consultancy of the Year – XPS Pensions Group

Corporate

Corporate Adviser Awards 23 – WINNER – Best Pension Adviser

Administration

Professional Pensions UK Pensions Awards 2023 – WINNER – Third-Party Administrator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2022 – WINNER – Third-Party Administrator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2020 – WINNER – Third-Party Administrator of the Year – XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 – WINNER – Third Party Administrator of the Year

Accredited Member – Pensions Administration Standards Association – assess | aspire | achieve

Technology

Professional Pensions UK Pensions Awards 2022 – HIGHLY COMMENDED – Technology Innovation of the Year – XPS Pensions Group

Pensions Expert Pension and Investment Provider Awards 2020 – Winner – Technology Services of the Year – XPS Pensions Group

Culture and Sustainability

The Sunday Times Best Places to Work 2023 – Big Company

Professional Pensions UK Pensions Awards 2023 – WINNER – Diversity & Inclusion Excellence Award – XPS Pensions Group

Business Culture Awards 2020 – Gold Overall Winner

UK Employee Experience Awards 20 – Gold Award Winner – Employee Engagement

UK Stewardship Code

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