XPS Investment

XPS FM Watch

Do you fully understand your fiduciary manager's approach to ESG?

As part of our XPS FM Watch series, we surveyed 19 managers from the UK Fiduciary Management ('FM') market to understand their current approaches to incorporating environmental, social and governance ('ESG') and sustainability practices within the fiduciary mandates they run on behalf of their clients.

Key findings:

58%

58% of fiduciary managers are now incorporating key performance indicators ('KPI') and/or remuneration policies that refer to ESG matters

42%

42% of fiduciary managers do not exclude underlying managers who have been assigned their lowest ESG rating

84%

84% of fiduciary managers monitor the voting and engagement activity of underlying managers

68%

68% of fiduciary managers do not have any explicit climate-related requirements for third party managers and are not able to conduct climate change-related scenario analysis and stress tests of clients' portfolios

What trustees can do:

- ✔ **Discuss and understand** your fiduciary manager's approach to ESG integration
- ✔ **Capture your beliefs** to outline and set clear priorities to your fiduciary manager
- ✔ **Challenge and scrutinise** the extent of integration of ESG practices into your fiduciary management solution
- ✔ **Assess the alignment** between your ESG beliefs and what is being implemented
- ✔ **Apply oversight** to monitor continued development, integration and application of ESG practices

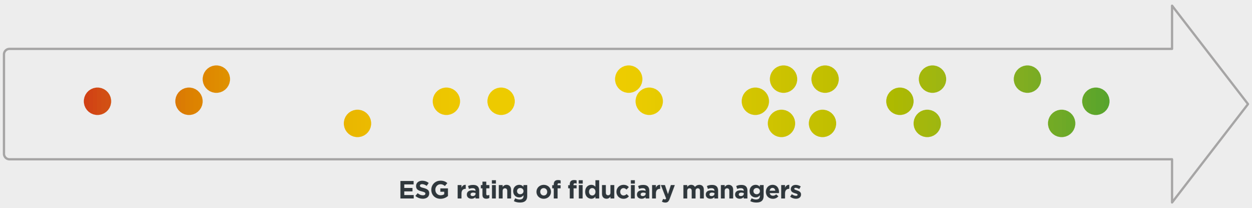
Overview

As the awareness of global, environmental and social risks grows, the desire and need for pension schemes to consider ESG and sustainability issues has shifted significantly. This has been encouraged by changes in regulation that require pension scheme trustees to demonstrate how ESG and climate change risks are being managed within their schemes' investment strategies.

For pension scheme trustees using FM, understanding the manager's approach towards such issues is crucial as the trustees will remain a step removed from most investment decisions.

Our research consists of a detailed review of each of the fundamental aspects that contribute to the overall ESG rating for each fiduciary manager as assessed by the XPS Fiduciary Management Oversight Team. Chart 1 and table 1 below indicate that whilst the majority of fiduciary managers are rated as Amber overall, a closer look reveals more of a dispersion between them under each of our areas of assessment.

Chart 1: Fiduciary manager XPS ESG rating



🔴 **Poor to no integration of ESG**. Minimal focus on stewardship activity of underlying managers and climate risks.

🟡 **Varied level of ESG considerations** within portfolio construction and stewardship activity. Processes to incorporate ESG and climate risk management may still be evolving.

🟢 **High level of ESG considerations** within portfolio construction process (including manager selection) and stewardship activity. Demonstrate robust and consistently applied processes with an explicit focus on incorporating climate risk management.

	Overall	Philosophy	Integration	Climate change	Stewardship	Reporting
🟢	16%	37%	32%	–	32%	79%
🟡	84%	63%	68%	84%	68%	16%
🔴	–	–	–	16%	–	5%

Percentage of fiduciary managers rated Green, Amber or Red against key areas.

Under the delegated model of FM, trustees are reliant on their appointed fiduciary manager to implement their ESG policies. Given this reliance, fiduciary management mandates should offer a developed approach to incorporating ESG practices.

When considering the fundamental aspects of ESG issues in isolation and taking a closer look under the bonnet, fiduciary managers differ in their approaches far more than may initially be apparent. It is often also the case that an individual fiduciary manager displays strong credentials in certain ESG and sustainability practices and weaker credentials in others.

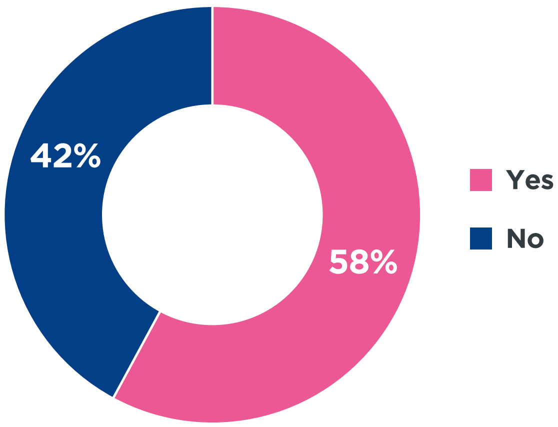
Philosophy and integration

The increasing awareness and importance placed on ESG risks has seen many organisations put this topic to the top of their agendas and fiduciary managers have not been slow to demonstrate their commitment to various ESG initiatives. However, pledges and signatory commitments are not enough to demonstrate that ESG practices are being acted upon and trustees should scrutinise the extent of integration of ESG practices into their fiduciary manager's investment decision-making processes.

A good starting point is for trustees to assess a fiduciary manager's depth of resource committed to ESG matters. Whilst we are seeing an increase in such resource generally across the UK market, there are still many managers who do not have dedicated ESG teams or who are just beginning to build teams. This is particularly surprising given the large size of some fiduciary managers in the market and the breadth of their manager research teams. We are often informed by fiduciary managers that they have been following ESG practices for years and yet it is only recently that ESG-specific hires have been made.

As fiduciary managers continue to present information explaining that an ESG focus is embedded into their processes, trustees must be alert to 'greenwashing' so that they can properly understand the alignment between a fiduciary manager's philosophy and the actions being taken. We consider KPIs and incentives to be important for demonstrating accountability until greenwashing truly becomes a thing of the past. Fiduciary managers should also be challenged on how they set ESG-specific targets and on how performance is defined and measured when it comes to applying ESG practices. Our research indicates that this is an area of continued development and progress as 58% of fiduciary managers are now incorporating KPIs and/or remuneration policies that refer to ESG matters in contrast to our previous survey when this was just 44%.

Chart 2: Do your KPIs and/or renumeration refer to ESG?

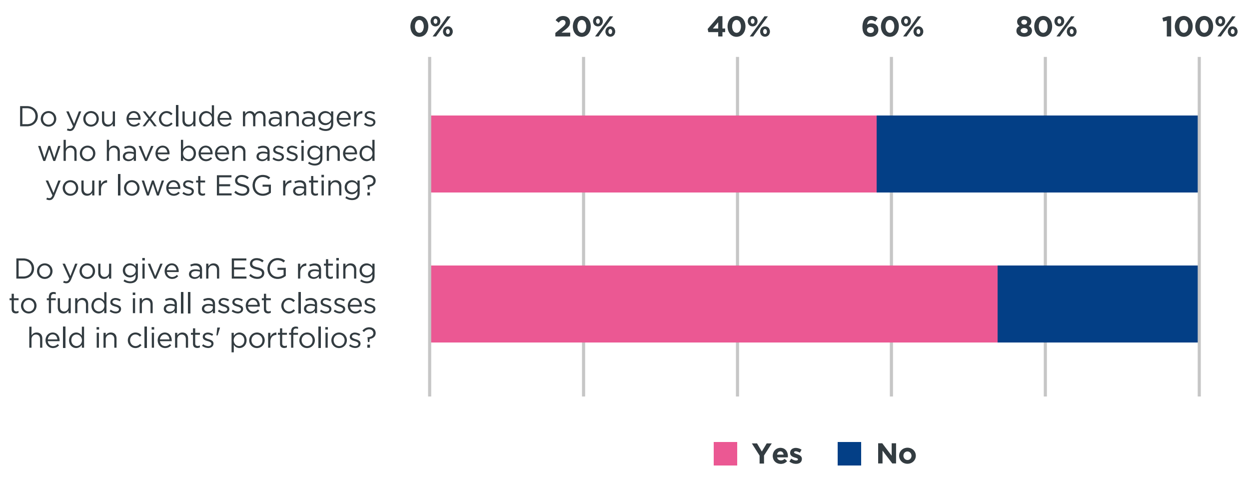


Source: *XPS Investment*

Many fiduciary managers are committed to the development of better ESG and stewardship practices. Integration should be the focus for trustees when assessing whether their manager is turning commitment into action.

Trustees should also challenge their fiduciary managers by understanding whether they are setting minimum thresholds relating to ESG issues when constructing portfolios. Many fiduciary managers use underlying funds to build their solutions but not all fiduciary managers employ ESG ratings. Furthermore, underlying managers with unsatisfactory ESG ratings can still be included in many of the fiduciary managers' portfolios, with 42% of fiduciary managers not excluding managers that have been assigned the fiduciary manager's lowest ESG rating. This could result in an overall portfolio for a pension scheme that is exposed to ESG and climate change risks that are not being properly managed. Where fiduciary managers are employing managers assigned with their lowest ESG rating, the integration process should be questioned or, at the very least, trustees need to understand the reasons why the lowest scoring ESG ratings can be included in their portfolios.

Chart 3: XPS FM ESG survey response



Source: *XPS Investment*

Ratings and minimum thresholds are important measurement criteria against which fiduciary managers can be analysed to determine whether trustees' ESG beliefs are being captured within their solutions.

For trustees, understanding the depth and quality of their fiduciary manager's ESG team, how they are incentivised, and whether ratings are resulting in a minimum threshold being applied to portfolios are just some of the many aspects that should be considered.

Whilst ESG views amongst trustees vary greatly, trustees need to understand whether their ESG beliefs, whatever they may be, can be implemented and therefore reflected effectively by their fiduciary managers.

Our latest FM Watch:

A review of how fiduciary managers have performed

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Climate change

There is no longer a question mark on whether climate change poses a systemic threat that will impact pension schemes and trustees need to ensure that their fiduciary manager is managing this risk within their scheme's investments.

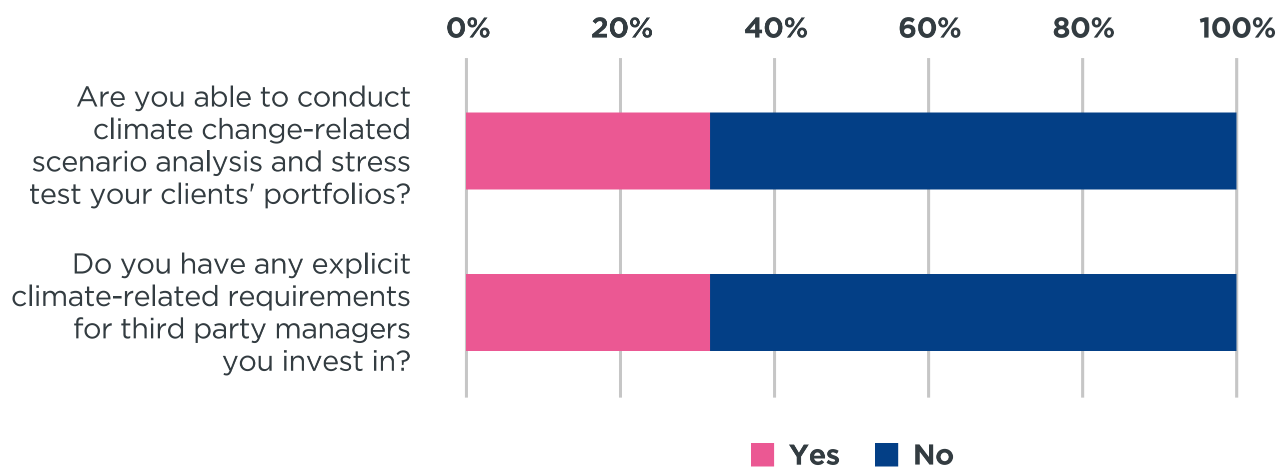
In fact, in many instances, climate change is being highlighted as the highest priority ESG issue facing investors and is an area that will drive change across multiple economic sectors. Our research indicates that the investment industry is evolving at a significant pace to find ways to capture, measure and mitigate the impact of the physical risks of climate change and the transitional risks of moving to a greener economy.

Given the significance of this ESG factor, trustees should not only expect to see their fiduciary managers managing climate change risk, but they should also expect to see them taking advantage of investment opportunities arising in this area.

Whilst many fiduciary managers will cite the importance of climate change, there is still a lot of work in progress when it comes to the construction of portfolios focussed on controlling the risks associated with climate change. Our assessment shows that 68% of managers do not have explicit climate change requirements for the underlying managers they invest in and some managers do not explicitly consider climate change-related risks within client portfolios at all.

The high number of fiduciary managers that do not have explicit climate change related requirements when building portfolios demonstrates that the market is evolving. Some fiduciary managers have made great progress managing such risks, particularly those who have developed scenario analysis models.

Chart 4: XPS FM ESG survey response



Source: *XPS Investment*

Overall, there is a large dispersion in the capability of fiduciary managers to incorporate climate change risks into their offerings and whilst some are behind, others have demonstrated encouraging levels of development. Those with the most advanced capabilities have either developed processes internally or partnered with external firms in order to be able to carry out climate change scenario analysis and model the impact of various scenarios. Whilst there are currently few that do this, it is the area in which we think we will see the most development over the coming years.

Stewardship

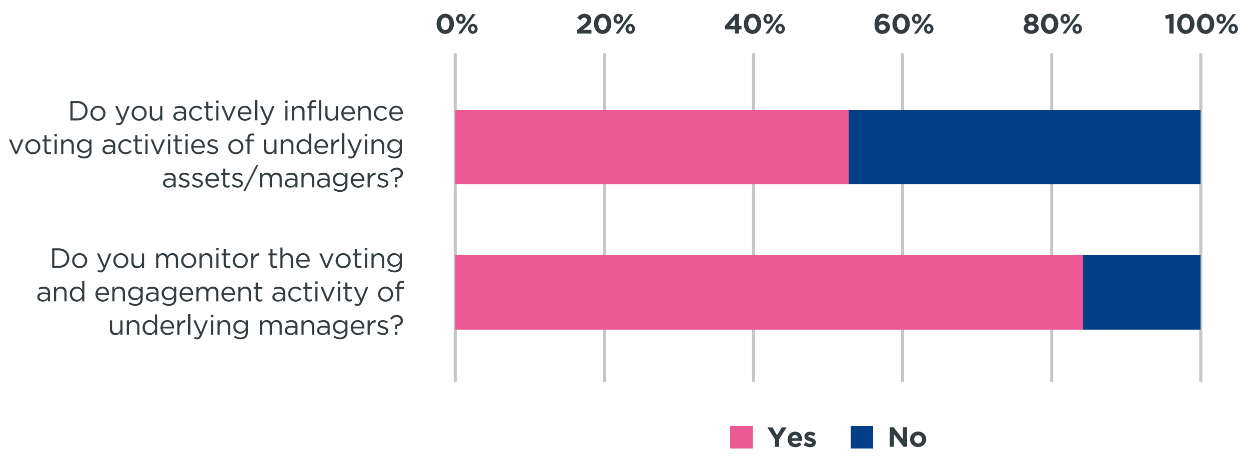
Like climate change, stewardship of assets is an area of growing importance as reflected by the recent regulatory changes.

Stewardship is one of the key methods driving positive change within companies not only to drive sustainable returns but also to deal with the critical issue of climate change.

Trustees delegating investment decisions through the use of FM should be aware that, in most cases, they are delegating stewardship to the underlying managers (with the exception of those that retain power of attorney or have segregated arrangements).

Despite the focus on stewardship, 16% of fiduciary managers do not monitor the voting and engagement activity of underlying managers. Trustees should, at a minimum, expect their fiduciary managers to apply such monitoring to all underlying managers given their significance as asset owners.

Chart 5: XPS FM ESG survey response



Source: *XPS Investment*

Stewardship is one of the most powerful tools fiduciary managers and, in turn, trustees can use to bring about positive changes. In instances where fiduciary managers construct portfolios using external underlying managers, the best fiduciary managers in this area are not only reporting stewardship activities to clients but also setting the expectations of voting policies.

Summary

ESG considerations are continuing to rise up the agenda for trustees as the investment and regulatory landscape alters. It is a learning curve for all, fiduciary managers included, but given the pace at which regulation is increasing, and the requirements placed on pension schemes, trustees should look to capture their ESG-related views at the outset and set clear priorities to their fiduciary managers.

Amongst fiduciary managers, there is great variation in the progress that has been made in applying ESG and stewardship considerations to their portfolios. Some fiduciary managers are at the forefront of this, setting the standards that other fiduciary managers will likely follow. In tandem with setting their ESG priorities, trustees appointing a new fiduciary manager or reviewing a current FM arrangement must assess the alignment between their ESG beliefs and what is being implemented. This should include a particular emphasis on the integration process to fully understand how ESG considerations are applied in practice.

> With ESG being such a fast-developing investment area, both trustees and fiduciary managers must not only be open-minded to change but willing to take a step out of their comfort zones as the industry learns this relatively new investment approach. For trustees embarking on that journey, it begins with establishing their ESG beliefs.
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About us

XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, covenant, investment consulting and administration. The XPS Pensions Group business combines expertise, insight and technology to address the needs of more than 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 920,000 members and provide advisory services to schemes of all sizes including 36 with over £1bn of assets.

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Appendix

Five key areas that we consider to be fundamental when assessing ESG practices:

Philosophy

Firm-level philosophy relating to ESG, stewardship and broader sustainability issues.

Integration

Implementation of the firm's ESG philosophy within research and portfolio construction.

Climate change

Explicit climate change considerations within the investment and stewardship processes.

Stewardship

Approach to voting and engagement to drive positive change in invested companies and underlying managers.

Reporting

Transparent communication of activity to stakeholders.

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