XPS Investment

Investment briefing

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Sustainable investment: Harnessing the power of pensions

UK pension schemes control £1.6 trillion of assets, putting pension scheme trustees in a position of great influence, which should not be underestimated.

Building Environmental, Social and Governance (ESG) into investment decision-making has grown in prominence in recent years, but there still exists widespread confusion between responsible, sustainable and impact investing approaches.
In this briefing note we explain the difference, and demonstrate why moving away from a traditional investment approach need not be considered a charitable exercise, but rather one motivated by earning stable returns over a longer time horizon.

The society we live in has an increasing awareness of sustainability and society is starting to demand more from corporations and governments.

Companies are increasingly being confronted about how they deal with environmental issues such as climate change and pollution; social issues such as labour rights and data privacy; and governance issues around how a company is run. Governments have a track record for incentivising corporate behaviour by taxing, regulating or legislating against activities that society deems undesirable. This creates new costs and new risks for investors. Examples of this include the progressive clamping down of coal-fired power stations which will be phased out of the UK by 2025 or the tightening emissions regulations around petrol and diesel cars.

Investing responsibly is just a matter of common sense and every profit motivated investor should be doing it.

Sarita Gosrani
Head of ESG, XPS

However, these issues don't just relate to environmental considerations. There are a whole host of issues that society is growing less tolerant of which investors will be affected by. For instance, Facebook's record fine of $5bn for its part in the misuse of personal data in the 2016 US election. This is an issue that Mark Zuckerberg himself admitted would have been difficult to foresee in the early days of Facebook, given it is primarily a website for friends to share news and pictures.

In this context, ESG considerations are no longer a 'nice to have' for a company, as they present financially material risks to its ability to generate sustainable long term returns. Asset owners such as pension schemes and other institutional investors have an important role to play in driving improvement. Furthermore, ignoring the risks posed by climate change could have consequences more serious than eroding investment returns. As described by Mark Carney, Governor of the Bank of England, **'climate change is a significant risk for global financial stability'**.

Institutional investors are in the spotlight for policy makers due to the sheer size of assets they control. We expect this area to continue to receive increasing attention in the form of future legislation around how pension schemes themselves are governed, such as the DWP requirements that were introduced in October 2019 and further requirements that will come into play in October 2020. Similarly the updated 2020 Stewardship Code by the Financial Reporting Council has been extended to include asset owners such as pension schemes along with an increased focus on ESG considerations within stewardship.

What is your investment approach?

There is lot of confusion over the different 'ESG' approaches to investment. We have simplified this complex area into four broad categories:

Traditional

Investment decision-making based on fundamental analysis of company accounts, sales growth and other financial data.

This will look to build a clear picture of a company's commercial opportunities and differentiators.

Responsible

Building on the traditional approach using an additional lens to consider material ESG risks within a company, to provide a more complete understanding of future risks and opportunities.

Further to this, voting and engaging with companies is seen as a key means to drive responsible practices.

Sustainable

Building on a responsible approach by incorporating a specific steer towards companies and sectors that are demonstrating good or improving ESG behaviours, and away from areas that are demonstrating bad or static practices.

Impact

Impact goes beyond a sustainable approach and looks to specifically target non-financial outcomes in addition to pursuing financial returns.

These can often relate to one or more of the 17 UN Sustainable Development Goals (SDGs) but also capture other values or ethical practices that are considered important by the investor.

Our View

Traditional: In the new world with new risks, fundamental analysis is not sufficient anymore – because it does not paint the full picture.

A fund manager that employs purely a traditional approach with no consideration to ESG will not be recommended to XPS clients.

Responsible: Risks relating to ESG are fundamental and should not be overlooked. Taking these risks into account means investing with your eyes open.

As a minimum XPS requires all funds it recommends to clients to employ a responsible investment approach.

Sustainable: Sustainable investing is looking to the future and at its simplest could be seen as focusing towards longer term outcomes.

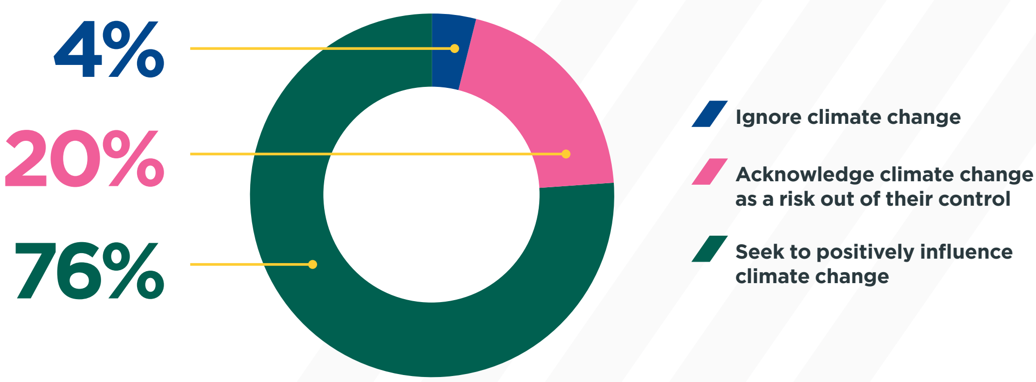
We believe there is a case for all schemes to consider if their strategy could benefit from being more sustainable.

Impact: Impact investing won't be for everyone but it is important to not assume that impact means lower return or more risk. At its extreme this is likely to be the case but a moderate level of impact can be achieved without materially compromising overall risk and return.

Schemes surveyed said they employ the following approach*:

Traditional	Responsible	Sustainable	Impact
44%	48%	4%	4%

At our client conferences in October and November we asked a total of 400 pension scheme trustees and corporates their approach to climate change:



* Combined results of XPS client conferences on 3 October and 14 November 2019 – survey of 400 pension scheme trustees and sponsors, representing approximately £300bn of pension scheme assets.

What can schemes do? 4 ways of putting ESG into practice

There are a number of practical steps that schemes can take to firmly embed ESG within their approach:

1 Evaluate your fund managers

Trustees should not be afraid to question and demand more of managers about how they invest and interact with companies, as this in turn will lead to better overall practices and ultimately higher returns on capital invested.

There is a lot of marketing activity that takes place around ESG, but in our experience this can often create a misleading picture as to the extent the ESG is actually employed across a fund management business – so called 'green washing'. ESG integration is a fund-specific issue and just because a fund manager has strong capability in one fund doesn't mean all its funds are equally as good.

XPS are undertaking a detailed assessment of over 200 pooled funds on an ESG basis as part of monitoring how their stated approach is employed in practice. This will provide granular information on the extent to which good and bad practices are being employed across the industry. We will report the overall findings in a special ESG Watch which we will issue in spring 2020.

2 Consider voting practices

Voting has for some years been recognised to be an important issue for fund managers to build into their strategy with considerable and growing emphasis as highlighted by the updates to the Stewardship Code. In general, market practice is not strong in this area but trustees have scope to influence segregated and pooled fund managers to appropriately incorporate voting and engagement into their management and this is a key area where trustees can be more demanding. A key resource to help with this is the Red Line Voting Initiative developed by the AMNT providing a route for trustees using pooled funds to take a more active asset ownership approach thus becoming more responsible owners. More information can be found at http://redlinevoting.org/.

3 Look to the longer time horizon

By going further to invest in sustainable themes, pension schemes are able to encourage companies that understand and strongly support the management of climate risk, responsible use of resources and the importance of good employee relations and governance. In addition, schemes can choose to allocate specifically to sectors that are drawing on substantial amounts of capital, for example renewable infrastructure. It is expected that $400bn will flow into renewable energy per year over the next 15 years (Source: International Energy Association). This presents institutional investors with a great investment opportunity not only to allocate capital sustainably but also diversify their portfolios.

4 Pursue specific measureable outcomes

Schemes can take the opportunity to utilise investments to target measurable environmental and social outcomes alongside financial returns i.e. impact investing is gaining traction with investors. This is an established concept within the charity sector (with program related investments that invest to pursue charitable goals) and endowment practices. The hallmark of this approach is the commitment to measure and report the social and environmental impact of the investments ensuring transparency and accountability.

The 17 UN Sustainable Development Goals reflect some of the world's biggest challenges and provide a great starting point for trustees considering this approach by providing specific outcomes. Impact investing is evolving quickly, but is still new and therefore working with your advisers to make informed decisions is important.

> The days of traditional investing are gone. The world is changing and the way we invest must change.

Simeon Willis
Chief Investment Officer

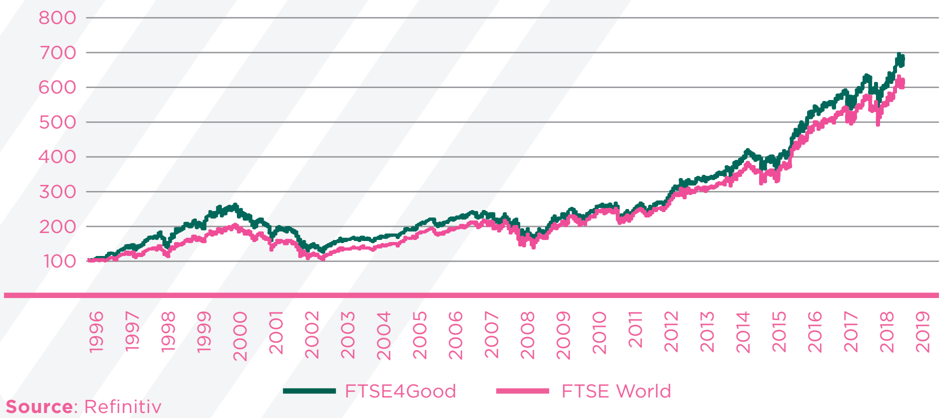
Taking progressive steps is vital if pension schemes are to start using their influence.

Does being responsible erode investment returns?

There has been a general perception that taking a responsible approach to investment naturally leads to a trade off in terms of returns.

There have been a number of detailed studies, including MSCI, that have found the opposite to be the case. An example of this is the performance of the FTSE4Good index, an ESG tilted index with some exclusions.

£100 invested in 1996: FTSE4Good vs FTSE World



Source: Refinitiv

Compared to the FTSE all world index the FTSE4GOOD outperformance has been surprisingly consistent over a sustained period of time.

Despite historical outperformance, an ESG weighted index should not be an expected source of outperformance. We do believe however, that responsible investment holds the key to better market performance overall, by holding companies to a higher standard. This will lead to better investment decisions and these good practices feeding through to the wider market so a lot of the benefit will be observable in a better overall market index return.

Our view

XPS believes that taking a sustainable approach will be of growing importance for many of our clients and to assist them we are awarding funds a 'sustainable' designation where the fund demonstrates the right combination of attributes. Our vision is to offer clients an independently vetted sustainable choice across all asset classes.

These issues affect DB and DC schemes in different ways, but looking at this issue for all the managers you employ will be important. In DC it could prove a key area of driving engagement with your membership.

We continue to see a full spectrum of approaches employed by fund managers ranging from those that are very strong and leading the way, to those that are some way behind. However, our view is that as a whole, the industry has some way to come.

For further information, please get in touch with **Sarita Gosrani** or **Simeon Willis** or speak to your usual XPS Pensions contact.

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