ARC Pensions Law

RIVER AND MERCANTILE SOLUTIONS

ESG: Are you asking the right questions?

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A practical guide to ESG and Stewardship

You'll have read a lot over the last few months about the role of environmental, social and governance (ESG) factors and stewardship in the trustee investment decision-making process. Some great papers have been published about this important topic. So why did we write this guide?

We wanted to give trustees some practical help with the information gathering process, ahead of the 1 October 2019 deadline to update their scheme's statement of investment principles (SIP). Trustees can lose valuable time trying to identify what questions they should be asking themselves, their investment consultants and investment managers. This guide helps explore what those questions might look like.

We don't try and provide any answers because the process has to be scheme specific. Instead, we hope this guide is a helpful starting point to get the conversation started sooner rather than later.

Do the ground work: Trustees' legal duties and the scheme's portfolio

Before you do anything else, do you understand what your legal duties are? This guide assumes you can answer yes to this question. If you are unsure, you might want to organise some trustee training.

Trustees should take into account financially material factors, including financially material ESG factors such as climate change, and may take into account non-financial factors (e.g. moral or ethical viewpoints) if they have good reason to think members share the views and there's no risk of significant financial detriment. Care should be taken not to confuse or conflate the two. In practice they may overlap (e.g. a company's long-term poor health and safety record is morally objectionable but a trustee may make a financially driven decision to disinvest due to concerns with the company's long-term performance). There's a fair bit of law behind the question of what is 'financially material'? You're best starting by thinking about what you, as trustees, are aiming to do – i.e. provide retirement benefits – and taking it from there. Legal advice is advisable. The example questions in this guide assume all "ESG" factors being discussed are financially material.

Tricky issues can arise when applying the legal principles to real life trustee decisions. A top tip is to make sure you understand if you are treating a factor as financial or non-financial. There are additional considerations on the important issue of non-financial factors including whether and how to seek members' views. Such an important and sensitive topic does not lend itself to a guide of this type and has been deliberately excluded. Trustees should take legal and investment advice on this issue, which will be particular to their scheme and its circumstances.

Finally, you should make sure you meet your legal duties and are able to document the trustees' policies on financial materially considerations, non-financial matters and stewardship in the updated 2019 SIP (as required by legislation). DC schemes will also have additional SIP reporting requirements in 2020.

Do you know the shape of your scheme's portfolio and why that matters?

Pension scheme assets are commonly held through pooled funds. This limits the trustees' ability to directly influence a manager's approach. That said, they may still exert indirect influence (via investor pressure) and, all things being equal, ESG may turn out to be a differentiating feature when it comes to product selection or when to disinvest from an underperforming fund. The questions below have pooled funds in mind. Larger schemes with segregated mandates will have more options when it comes to impacting manager behaviour, through selection, monitoring and Investment Management Agreement provisions. They will therefore want to consider additional questions over and above those contained in this guide.

Remember that ESG is an important consideration for some investments but not all. For example, the relevance of ESG to an actively managed equity portfolio is clear. It is less obvious when hedging risks using derivatives and may have no relevance to automated, quick turnover strategies which exploit only market inefficiencies. Similarly, it's not true to say that ESG cannot be integrated into passive solutions, but options are still relatively limited and trustees need to be aware of 'green-washing' (something looking more ESG focussed than it is). We think it's sensible to focus first on areas where trustees can make a difference.

Establish your ESG beliefs

Once the groundwork is done, ask some questions to help establish the trustees' ESG and stewardship investment beliefs. This will help you start reviewing the ongoing suitability of the scheme's investment strategy. This could take the form of a wider investment beliefs survey if time permits. Here are some example questions:

Do the trustees, sponsor, Investment Consultant and Investment Manager(s) have different or shared views on what ESG factors are financially material?

Do the trustees, sponsor, Investment Consultant and Investment Manager(s) have different or shared views on how to integrate financially material ESG factors?

For example, could their approach be bucketed into "Exclude", "Engage" or "Score and Report"? Would the trustees be comfortable having an ESG positive tilt, if this led to lower returns (and/or higher costs) in return for anticipated risk reductions? Is there a threshold on the impact of returns and/or cost the trustees would be willing to bear?

From an integrated risk management perspective, does the sponsor have any views / or alternatively, are there any ESG risks to the sponsor covenant that should input into the trustees' view?

For example, exposure to ESG watch areas as part of the sponsor's business (weapons manufacturing, gambling, alcohol, tobacco, fossil fuels etc.) may impact the sponsor's ability to maintain contributions in the future. How can the trustees allow for these factors from an integrated risk management perspective as well as in portfolio implementation?

Quiz your investment providers about their approach

This section is to understand your Investment Consultant's and Investment Managers' approach to consideration of ESG factors and stewardship. The answers might help you frame the trustees' investment beliefs and/or understanding if your investment providers are aligned with those beliefs. Here are some example questions to consider. You'll want to consider who is best to answer them (i.e. the Investment Manager, Consultant or both).

How is ESG and stewardship considered when making investment decisions and researching Investment Managers?

For example, do they exclude (tobacco/fossil fuels etc.), engage (voting and activist position), rate and report (on current holdings or changes) or combinations of these? Does the Investment Consultant review the Investment Manager's policies and challenge them on their application?

How does the Investment Manager/Consultant consider climate change as part of their portfolio construction?

Are policies implemented at a firm level? Is this ESG integration applied for all funds or only ESG specific products? Does it vary by asset class?

By checking if the policy is implemented at a firm wide level, it is useful to establish whether this is a universally used risk framework or whether it is only used for specific products.

How does the Investment Manager's approach to ESG and stewardship compare to others of the same asset class?

What are the universe of assets that positions are chosen from? Is the manager also considering "repentant sinners" as well as "angels"?

The universe of ESG positive stocks is very small, so "angels" may be relatively expensive and better value may be found from improving companies' ESG profiles.

Does the Investment Manager/Consultant adhere to any ESG values?

For example, is there mandatory staff training/ESG objectives and alignment with performance/pay? How does their business reward employee/client satisfaction? Are these factors key considerations for executive remuneration?

Does the Investment Manager/Consultant produce regular client communications and offer regular client training?

For example, do they produce voting reports and are these publically available? Is the Investment Consultant able to clearly explain, in plain English, to the trustees how its research team selects and rates managers generally and specifically in respect of ESG and stewardship approaches?

Does the Investment Manager/Consultant have an ESG Policy and are they signed up to any best practice initiatives? Does the Investment Consultant monitor and hold the manager to account?

For example, for poor ESG scores, do they have a quantitative amount of expected return required or any "comply or explain" criteria in place?

Ask managers questions that prioritise ESG impact

This table suggests questions for managers to help trustees make the most of the degree of active ownership they are currently able to exert. It recognises that ESG integration is becoming commonplace in more traditional asset classes. It doesn't include questions for alternatives managers given the difficulties in assessing the ability to impact them. However R&M are currently monitoring innovation in that area.

	Level of possible impact	Sphere of influence	Questions for Managers
LDI manager	Minimal	Limited to counterparty banks	How are counterparty banks selected? Are the banks' ESG credentials considered as part of selection process?
Passive manager	Marginal	Fairly limited in selection (unless specifically ESG positive), able to influence management by meetings and voting	Request the manager's voting and engagement record and policy. How has this been used to positive effect, including case studies?
Active manager – fixed income	Reasonable	Strong relationship with companies issuing debt can allow influencing	Has the manager shown evidence of influencing debt issuers to positive effect? Ask for case studies.
Active manager - equity	High	Able to influence management by meetings, voting and if shareholding is large enough to have a representative on the board	Request the manager's voting and engagement record and policy. Ask for case studies regarding activist positions and influencing journey to better governance.

Monitor against the trustees' ESG policy

How does the Investment Manager/Consultant assess the effectiveness of their ESG strategy?

For example, do they measure added value relative to the relevant benchmark? Do they measure avoidance of permanent capital loss? Improving the world (key for any impact investment)? Case studies are especially useful here.

How does the Investment Manager/Consultant intend to improve the alignment of ESG views between them and the trustees?

For example, are they improving reporting? Looking at how to reshape their holdings or looking at a different way of risk adjusted returns.

How has the portfolio evolved over the last year, has the ESG footprint/focus of the portfolio changed significantly?

For example, has the portfolio taken any exclusionary measures? Or is reporting against industry standards such as UN Sustainable Development Goals, Taskforce for Climate- related Disclosures, Tobacco Free Finance pledge etc. required?

What innovations have been developed in this area over the last 12 months (annual question for Investment Manager/Consultant)?

What next?

Trustees can use the above questions to decide what they will ask their investment consultants and managers. Posing them will also test the trustees' own understanding of the topic.

These questions and their responses will be a key part of the trustees' process to identify and verify the implementation of their ESG and stewardship investment beliefs. In our view, whatever process is adopted should be proportionate, practical and tailored to the scheme. For example, what is your scheme's time horizon for assessing these considerations? The shorter it is (e.g. if you're winding-up) the less weight they may have. Equally, if resources are limited it should focus on what can make the most difference. In essence, it's about having responsible risk management processes and trying to avoid 'box ticking'.

The steps will be broadly the same for DB and DC schemes. However, DC schemes need to remember that they should take financially material ESG considerations, and stewardship, into account in relation to the DC default(s) as well as considering it in the context of having an appropriate range of alternatives for members to choose.

It's worth remembering that ESG is only one factor in the investment decision-making process. We are expecting more industry and regulatory focus (in the UK and EU) on asset owners, including trustees, around the integration of ESG into their risk framework and related disclosures in the coming months. Standardisation and greater transparency is going to be the goal. So watch this space.

If you need any help with this you can contact ARC (legal advisers) or R&M (investment consultants and fiduciary managers).

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