

# ESG

*Better long-term outcomes?*




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## ESG: Better long-term outcomes?

Responsible investing is evolving. Few investors still talk about socially responsible investing (SRI) when targeting better behaved companies. Today the term environmental, social and governance, or ESG for short, is more likely to be dropped into those conversations instead.

The new term has been coined to encompass a wider range of factors, yet it is causing confusion. There is no universal term to define ESG. Is it about ethics? Is it for religious groups? Or is it for people who vote for the Green Party?

Not knowing what it is does not help investors to identify such companies or, more importantly, measure performance.

This is an important point. Although investing in companies that have high governance standards, a diverse leadership team or a low carbon footprint is not a new concept, its popularity is growing.

Part of the attraction is that such an approach to making investment decisions is believed to reduce risk. This is why more and more fund managers are making it their business to explain how they implement ESG factors into their investment strategy when pitching trustees for a mandate. For a growing number of investors it is no longer seen as just an add-on, yet there are many who do not understand it and, as such, have left it off their agenda.

Some ESG managers look to the regulators to help move it into the mainstream. Regulators and law makers are taking notice with the Law Commission making recommendations in this area, the EU introducing the Shareholder Rights Directive and a parliamentary commission is examining how pension schemes are fighting climate change. This can only be good news for those pushing a more sustainable investment agenda. Part of responsible investment's evolution is that it is no longer about screening out certain companies or industries. This has put trustees at odds with divestment campaigners.

Shell and BP are widely seen as huge contributors to climate change and the risks for investors are clear. But will shareholders voting with their feet make the world a cleaner place? These energy giants generate huge cash-flows, which they reinvest into developing cleaner technologies. This is just one example of why engagement and not divestment should be at the heart of ESG strategies.

Another issue has been the difficulty in measuring the non-financial performance of a business. It appears that although better quality research is emerging on the impact such strategies could have on portfolios, ESG is still more belief than proof-led. A lot more work is needed before this changes.

Mark Dunne

Editor, *portfolio institutional*

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Catherine Ogden

*“In the UK, we see government pension schemes paying a lot of attention to engagement, but it’s also encouraging to see some corporates raising the stakes.”*

*Catherine Ogden, Legal & General Investment Management*

**ESG has no common taxonomy, so how do you identify companies with such standards?**

**Richard Tyszkiewicz:** There’s a spectrum that starts with screening out certain stocks or sectors and ends with philanthropy. Schemes need to understand where they are on that spectrum and where they want to be.

**Tony Filbin:** It’s easier to say what it’s not. It’s not ethical investing. Trustees have to identify where an investment strategy is likely to cause a risk to member outcomes. It’s easy in carbon. If you invest in companies that aren’t going to make the transition to a low carbon environment, there is the chance that they’ll underperform. So there’s a clear understanding of risk there.

Similarly, with the G in ESG, some firms have been vocal about a link that’s been established between organisations with better governance and better returns. From my perspective, it’s not about good causes; it’s about understanding what processes the fund managers we choose use in their investment strategy and determining whether we believe there’s a risk to outcomes with that.

**Catherine Ogden:** What we believe is that integrating ESG considerations into investment processes has the potential to lead to better long-term financial outcomes. So ESG is very much thinking about

material financial risks to a business as well as the opportunities. In the broader spectrum of responsible investment, there are other areas such as ethical investments; however, these need to be thought of through a different lens.

**John Belgrove:** Getting that lexicon or terminology defined will help trustees, especially those who are relatively new to this area. I would concur with Richard that we're looking at a spectrum of issues. You can be in the centre of an ESG-aware agenda and as you go left along that spectrum you might get as far as negative screening. As you go right, you might get as far as thematic mission-based aspects. There are stopping points along those spectrums about whether you invest only in best in class or you screen out the worst. So I'm less convinced it's about what it's not because there are many things that can apply under that broad terminology.

What's important is that the conversation has meaningfully changed in the last couple of years. We've moved away from aspects that are perhaps more associated with pressure groups and individual clients with clear beliefs to something more mainstream through policymakers, regulators and companies being asked questions about their carbon footprint, for example. So there are a lot of professionals for trustees to ask for help with the terminology, awareness and education. Also because of all that effort and work, the quality of data associated with ESG is improving and that's allowing investors to take a more granular and informed approach about where they sit and what they need to do if they want to get somewhere different.

**What is driving this change? Is it companies seeing the benefits of strong ESG standards, the regulator pushing for higher disclosure or are investors looking for things they weren't, say, 10 years ago?**

**Filbin:** One of the big drivers for change has been a report by the Law Commission, which specifically mentioned ESG as a risk that trustees have to take into account from a financial perspective. Another reason why asset managers have raised their game is that we trustees have been asking questions. In the request for proposals that I've been involved with, we ask fund managers what their ESG strategy is. Quite recently, I ran a beauty parade for a new investment consultant and asked how they were

going to take on the issue of ESG. The more times you ask that question of consultants and fund managers, the more likely it is to be raised on their agenda.

**Ogden:** Over the last few years we've certainly seen an increase in the quantity and quality of questions from our clients in request for proposal processes; critical mass is growing in this respect. The questions are getting much more sophisticated, there's much less opportunity for a tick box response and so that drives the agenda for asset managers to up their game. That being said, we still meet a fair number of clients and trustees who do not quite have this on their agenda. Yet the regulatory landscape is evolving; think about the Law Commission's recommendations on pension funds and social investment, the EU High Level Expert Group's recommendations on sustainable finance, not to mention the arrival of the EU's Shareholder Rights Directive; these will all help further build ESG momentum over the course of this year.



**When your clients say they don't have ESG on their agenda, what reasons do they give for not taking an interest?**

**Ogden:** There is still a lack of understanding of what it is. There's always the misunderstanding that it's ethical, it's not material or it's an add-on extra. It just needs awareness raising and a requirement that it is on trustees' agendas.

**Filbin:** It depends if you've got a professional trustee on the board or not. Professional trustees are more aware of these issues and so are more likely to raise it. I've started to put an ESG statement in my chair statements. I'm not required by the regulator to do that, but it's important that we do it. Obviously, to put an ESG statement in my chair's statement I have to ask the fund manager what their strategy is, so it is a two-tier approach. The professional trustee community is aware of ESG issues, but it's the minority of schemes that have a professional trustee.

**Belgrove:** There are many drivers that are raising awareness, but it's disingenuous to imply that all trustee boards have been doing this for a long time. That's not the case for all professional trustee firms or advisers either. I have the privilege of working with many professional trustees and trustee boards and there is a mixed picture. There are also several confusions in the mix, which have driven a misguided avoidance of the issue rather than awareness of the opportunities, like an expectation to pursue fiduciary duty with the assumption that doing something in this space is somehow degrading to future performance, which I strongly argue it is not.

**Tyszkiewicz:** That goes back to the ethical versus pragmatic approach.

**Belgrove:** That's one example of the things that have got in the way. Others have been a strong attention to financial risks and a value at risk-based approach to strategic management, which is different between DB and DC. There are examples of trailblazing markets and clients that are well ahead of this and examples of those playing catch-up. If we talked about the US, it is completely different to Europe and the UK.

**Tyszkiewicz:** Yes, it's much more about negative screening in the US. Although we are seeing US managers rushing to try and catch up because if they want to market their products in Europe they have to get up to speed and some of them are struggling with that.

**Filbin:** It is a huge oversimplification to say that all that's needed is a bit of trustee education. It is far more than that.

**Belgrove:** I agree. I was just saying that for those that have not managed to get it to the top of their agenda, that's often the starting point.

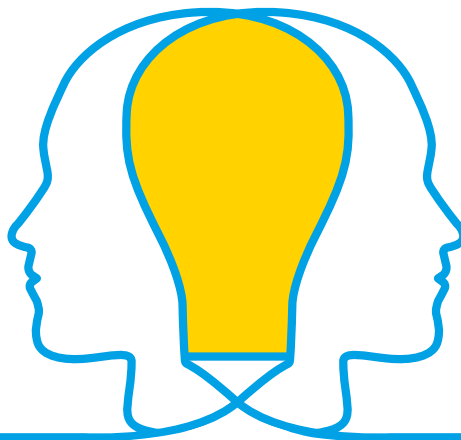
**Duncan Whitfield:** It's unfortunate that three random words from the pensions word search have been put together. While they are related, they don't actually make sense as you put them in order. Frankly, a lot of us are paying lip service to ESG. We will put in our report that we adhere to ESG principles and we even cross-reference an international statement on what ESG might be and how we support it. The devil is then in the detail about how you strategise those three different components in your investment strategy. Just take governance on its own, there are so many different ways of going at it. Governance is all about process behaviours and the conduct of the trustees, the fund managers and those that the fund managers are investing in. So you have multi layers going on in there, which is a meal in itself.

**Tyszkiewicz:** The blanket term 'sustainable' is perhaps more useful than ESG. Just a few years ago, we were all calling it SRI. So there may well be another acronym coming down the road.





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**Whitfield:** SRI was far more widely understood as a concept. From an ESG point of view, if you have three advisers in the room, they'd give you three different perspectives.

**Filbin:** What I'm hearing is that asset managers are using ESG as a source of alpha. They are using it as a factor in factor-based investing, so it is being brought more into the mainstream. I absolutely see the importance of this and more asset managers need to put it into their core strategy.

**Ogden:** There are a number of strategies that schemes can take. In active portfolios, it's about making sure ESG is integrated as part of fundamental analysis. So as asset managers, we are thinking about environmental, social and governance within the core investment process. That means investment analysts being aware of what ESG is, what it isn't, thinking about risks from the bottom up and assessing how well the company is managing them. It means investment managers constructing their portfolios with a consideration of company and sector specific ESG risks over different time horizons.

Then for index strategies, we see three main options: engagement, tilts and exclusion, which can be incorporated without compromising returns.

**Tyszkiewicz:** One of the reasons ESG seems to have gone from being a sideshow to mainstream is this more widespread understanding that it's not about ethics or altruism. It's about long-term risks and opportunities and that any good long-term investor, like a pension fund, needs to be looking at these things. You have examples like fossil fuels. You can have your own personal beliefs about how the environment should be protected, but you also have the Paris Climate Agreement and stranded assets. Do you want to be the last one holding these assets in your portfolio? It's back-to-basics capitalism; you want to make long-term profits on your investments. Everyone has their own personal agenda in terms of the ethics of it and those fit in quite nicely. One minute we'll be doing searches for Shariah-compliant strategies and the next searches for church foundations. That's perhaps what some people still have in their head when they hear ESG, but that's really just programming a customer's benchmark onto an investment platform and excluding certain sectors and that's not what ESG is about.

**Ogden:** That's where a tilting strategy can be beneficial. It enables you to retain very similar returns and keep a diversified portfolio, so you can tilt away to reduce exposure to ESG risks, such as fossil fuel





John Belgrove

*“What’s been important is moving away from flag-waving lobbyists to a more considered regulatory, policymaker and integrated approach. That’s the way forward.”*

*John Belgrove, Aon*

companies that are not preparing for a lower carbon future, as well as potentially increasing exposure to ESG-related opportunities. Exclusion has historically been the simple way that people would do ESG or SRI, but if you create blanket exclusions you have the risk of a concentrated portfolio. You can still exclude on a more selective basis, or even the threat of exclusion can be a potent tool for companies. So there are ways of implementing these ESG strategies which are not the simple way that we’ve seen historically.

**Belgrove:** Let’s come back to where the fund management community is at the moment. At Aon we have the privilege to research and rate something like 15,000 funds. Included in that would be various due diligence questions around ESG factors and it has been palpable the extent to which the quality of the responses around that have been moving in recent years. The fund management community absolutely gets it. For some, it’s necessary to operate in a given market, for others, it’s not. When you delve into the detail a bit more, it’s quite often the terminology that is the barrier rather than the process. Governance has always been an element of good, responsible portfolio management selection.

It stands to reason that a better governed company should get better outcomes.

**Whitfield:** It's almost moving back to the environmental word within ESG. This week our active manager came in to beat the managers up because they're not performing as well as we would like them to. They invested in a Canadian tar sands company and we didn't want them to do that, but we've got nothing in the mandate that says they should exclude anything. They disposed of that asset and they've moved some of the money into BAE Systems. Being a local government pension fund, the chair of the committee then beats them up for investing in BAE because BAE are warmongers. My point is that there is a phasing from moving to a more environmental place. It doesn't happen overnight and actually if we don't want our active managers to invest in fossil fuels or in anything that could be considered to be related to war, we need to build that in a mandate and have a relationship which we both understand and can work with. This is a journey.

**Tyszkiewicz:** It goes back to the earlier points we made about embarking on that journey and understanding where you want to be. There are so many different angles you could take and it helps for schemes and trustees to get involved with the various discussions that are happening. There are industry groupings and bodies and discussions going on in the environmental, social and governance areas that are educating people so that they can then define their own policy because everyone's policies are different. That's one of the problems we have when looking for managers. Most of the Nordic clients I deal with love pooled funds, but they all have different ESG policies. Policy definition has to be the first step. Just generally understanding where you want to be and where you want to go and how you want to apply things. For a lot of my clients, the pension members are putting pressure on their pension funds to apply things that are important to them. There are all these different influences that can then help define where you want to be. You can decide if you want to try and implement sustainable development goals and define something along those lines, but it can be quite confusing because there's such a broad spectrum of things you can try and implement.

**Whitfield:** There's a divergence of views on how we measure this. If you have a strategy that says you're going to go to a certain place and you have to prove it, we've landed on a three year, a 10 year and a forever plan where we think we can realistically get to by way of measurement in three-years, 10 years and beyond. Just having that measurement within your strategy, within your ESG framework, is



quite important, otherwise we will do what we've often done before which is just hide behind passive funds where you don't really know where any of your assets are invested from one day to the next.

**Tyszkiewicz:** Non-financial performance measurement is a big work in progress. The good managers we see are giving a lot of information to their clients. If something comes up, if there's a problem in the portfolio, their clients are the first to find out. We have some clients who are allocating a portion of their portfolio to impact investing, which you absolutely have to measure. Again, that's a big work in progress. There are all sorts of industry initiatives to create standards but there is no one standard. It's pretty hard to get the information on that non-financial impact to be able to report it, but things are moving.

**Ogden:** Schemes have a responsibility and a requirement to consider ESG where it's material. Trustees may choose to incorporate ethical views into their investment beliefs, but that is a separate conversation to what is financially material from a returns perspective.

#### **How do you make sure that each member is happy with the investments in a default fund?**

**Filbin:** The best way, from a DC perspective, to do that is to give the investment choice to the members. As trustees, for the default fund we need to take ESG factors into account from a financial risk perspective and build it into the default fund. For those wanting a Shariah fund or an ethical fund we offer self-select options. Our primary duty of care is with the default fund to ensure that we get the best member outcomes. Best member outcomes include an ESG clause because I like to get better long-term investment results. It is not for us as trustees to decide whether or not to exclude A, B or C. If the members have a strong feeling about that, they access their investment preference through a self-select fund rather than through the default fund. We explain to members what the self-select options are and where they invest. That's a better approach than trying to do all things within the default fund.

**Belgrove:** There's a whole extra level of education challenge with the members. Measurement has a role to play in that. If you have a fund that has a particular focus but you measure it against a benchmark that doesn't have that focus, then there's going to be divergence. Satisfaction is usually derived from positive difference and dissatisfaction from negative difference. If that difference isn't properly understood, you get a whole new challenge on your hands.

**Tyszkiewicz:** That's another choice. Some funds can decide to put part of the portfolio in a sustainable index, but ESG is an opportunity for active managers to get extra returns for those that do well.

**Belgrove:** From a governance standpoint, you don't have to do this all overnight. It's a journey. But some of the consequences of companies not paying proper attention to these issues could be meaningful in the short term. Just read the newspapers at the moment and you've got a number of companies having problems with an E, S or G that's affecting the share price. So the timelines are fascinating in the sense that yes, some of these are long-term plays, but they can actually have near-term financial consequences.

**Tyszkiewicz:** There is a third consideration. We've talked about the ethical and pragmatic risk mitigation approach, but with some of my clients, because they're big public funds, they're under a lot of scrutiny, so there's also reputational risk. They don't want to be answering questions about stock in their portfolio that's had something horrible happen to it in the press. That is another consideration that's perhaps less explicit but quite important.

#### **Research has found that ESG factors could have a positive impact on financial performance. Is one piece of research enough to get investors thinking that there's more to this than risk reduction?**

**Tyszkiewicz:** There's a common understanding that if it's done properly then at the very least it doesn't detract from performance and at best it's a good risk mitigator. There are also opportunities to generate alpha.

**Belgrove:** The awful phrase is 90% of academic studies find a non-negative correlation with performance.

**Tyszkiewicz:** That sounds like damned with fake praise.



Richard Tyszkiewicz

*“Non-financial performance measurement is a big work in progress.”*

*Richard Tyszkiewicz, bfinance*

**Belgrove:** You can pick and choose your research, but you can also find meta-studies that have a 60% correlation with positive performance on ESG factors. But in many cases people ask: “Prove it to me. Show me that the evidence was there in the past.” That granularity was not there and indeed, those strategies were not being pursued, so you can’t have that sample long-term experience to demonstrate it. So to some degree, there’s an element of it being beliefs led in this area and not looking to historic evidence to pursue these things.

**Whitfield:** I absolutely get that reputation point. Anecdotally, myself and the chair of the pensions committee were doing the Janet and John round robin of our members. We had a lovely slide about the things that we invest in. Hershey’s was in the middle, nice and safe. But we got absolutely mullered by the audience on the basis of Hershey’s having slave labour picking their chocolate beans.

**Belgrove:** There’s a sugar obesity angle as well.

**Whitfield:** It is interesting when we’ve had Local Authorities Pension Plan stuff happening around Sports Direct. We certainly shared our concerns with LGIM and Blackrock over slave labour. LGIM’s response was different from Blackrock’s. Reputationally, these things just punch above their weight. It’s quite interesting. In London, from a local government point of view, you’re going to find that after May a whole load of manifestos coming from the labour groups, which will go heavily after carbon reduc-

tion. They're going to be statements in manifestos saying this is where we're going to be taking our investments. I don't quite know how that then fits into a decision-making process through your pension committees and the trustees because clearly, it must for the purposes of governance. This reputational stuff is going on in the background which is slightly concerning.

**Tyszkiewicz:** Some of the pioneers in this field have been quite small church pension funds. Because of the make-up of their members, they've been at this for 20 years, whereas others are only coming late to the party.

There's quite an interesting industry body, the Portfolio Decarbonisation Coalition, which is a discussion body looking at the practicalities of how you take carbon out of your portfolio, what impact does it have and how should you do it? I'd encourage any pension fund to get involved with those discussions because there's only something to gain from it.

**Belgrove:** Could I just explore the counter-narrative to this? We are coalescing around some of the negative screening and divestment angles here. Ultimately, when you think it through at the highest level, the divestment agenda is challenged. You can only sell stuff to people who are going to buy it. At the same time many of the carbon-heavy industries that maybe institutions are looking to divest from are the sources of R&D for renewable energy and can actually, through an engagement process, be moving in that right direction.

**Filbin:** I'm not a fund manager, but my understanding is that those fund managers who pursue ESG strategies, invest in companies that are taking action on a low carbon future. So they are carbon companies, but they have actions in place to make that transition.

**Tyszkiewicz:** That's my point. It's exclusion versus engagement. The easiest thing is to exclude them but it's not necessarily the long-term solution. Statoil, which among oil companies is considered to be relatively good, is about to take 'oil' out of its name. It is going to call itself Equinor. It is step by step, you can't just plunge into engagement, if you haven't done a few of the other things first.

**Ogden:** We like to call it engagement with consequences. One of the commitments we've made as part of our climate policy is the Climate Impact Pledge. It is a commitment to engage with the largest





companies in six key sectors that we have identified as being key to a low carbon transition. We assess them on their climate governance through a detailed methodology and effectively identify areas where we'd like them to improve; we expect them to demonstrate commitment to thinking about the low carbon transition. Those companies that are not responsive and show no willingness to do anything will be candidates for exclusion from our Future World Fund range. Additionally, companies would receive a vote against the chair on behalf of all of LGIM's equity assets.

#### **How do you select an ESG manager?**

**Tyszkiewicz:** We've seen a lack of good quality information on companies. You've got ratings for developed markets and equities from the likes of MSCI or Sustainalytics and the good ESG managers that we've seen use all of those ratings. They have them, but they don't rely on them; they do their own research. Especially in emerging markets, for instance, where the information is a lot sketchier, they see that as a source of alpha. They find companies that are underrated perhaps because they're not good





at reporting. They don't make all the right noises, they don't publish the right information, but by doing fundamental research on those companies, the managers identify them as improving so they'll invest in them even though they're poorly rated because they've done their own research. A few years down the line, the industry catches up and they get a higher rating and the stock price goes up.

**Whitfield:** Can we go back to divestment, which is an unfortunate one, isn't it? Divestment over time; fine, but the next challenge will be to explain to the lobby groups that we are still investing in Shell and BP because they're moving towards a more sustainable product. This will be difficult because the lobby groups want to divest and they want us out tomorrow, but that is clearly not a sensible route to follow.

**Tyszkiewicz:** The Pensions Regulator put this obligation on pension funds in the UK as having to consider ESG where it's financially material. That covers you in that case. You have a duty to not jeopardise the returns, but in the longer term that can translate into opportunities and fanatic investing. So rather than exclude Shell or BP, you might invest in funds that are looking at cleantech.

**Belgrove:** The media doesn't allow the subtlety of the conversation to play out, does it? You have some



Tony Filbin

*“I’ve started to put an ESG statement in my chair statements. I’m not required by the regulator to do that, but it’s important that we do it.”*

*Tony Filbin, Capital Cranfield*

strong lobbyists that have high-profile cases. At the moment, the parliamentary committee has written to the top 25 UK pension schemes asking: “What are you doing?” It’s making statements about what is right and what is wrong, yet the reality is much more complex.

**The results of that are going to be made public; it almost seems like a bit of naming and shaming. Is this the way to move things forward in the pensions industry?**

**Belgrove:** What’s been important is moving away from flag-waving lobbyists to a more considered regulatory, policymaker and integrated approach. That’s the way forward. The lobbyists, as catalysts, clearly have a role to play, the conversation has got to understand the complexities and issues better now and that happens in the mainstream.

**Tyszkiewicz:** That’s why it’s good that there’s a discussion going on at regulatory level in the UK and Europe. People can point to that and say: “These are common norms that we’re looking to apply,” rather than just pressure from lobby groups.

**Whitfield:** My accounts were challenged last year on the basis that we invest in fossil fuels. The conversation with the auditor was along the lines of: “Well, that’s clearly not going to be upheld.” If we’d said we were divesting in fossil fuels that would be more likely to be a challenge that needs to be answered

with some numbers that actually justify our strategic allocations. It is a matter of time before somebody challenges a public body on the basis of their divestment at a single point or over time.

**Filbin:** To be fair to some lobbyists, they're not just going for divestment; they are going for engagement. One particular lobbyist was asking all BP and Shell stockholders to ask at their AGMs whether their remuneration policy was directed at pumping out more fossil fuels or making the transition, which is a fair question to ask. There has been a case in the States brought against trustees for an underperforming fund because they didn't take ESG into account. As a more general point, trustees, particularly DC trustees, have got to ensure that their fund selection takes into account a whole range of factors. That's why working with the investment consultants is key for pension funds to make sure that they choose the right funds and get the right outcomes.

**Ogden:** Absolutely. You need an investment consultant to be advising trustees when they're not thinking about these issues. If consultants are not providing that advice then the schemes need to question why not.

**Tyszkiewicz:** I was at a PRI event where all the UK consultants and asset owners in the room were being given a hard time. Everyone, it's implied, is slightly behind the curve. We see it as an opportunity to stand out from the crowd, but it's all part of it becoming mainstream and no longer a side issue or an afterthought. You can't just have a little paragraph in your reports; it's got to be built in at all levels.

#### **Do you believe that ESG is now mainstream and is no longer niche?**

**Tyszkiewicz:** We have clients in Asia and the US where it's perhaps less important, but it's still moving that way. European markets have been at the forefront, and perhaps a little bit more in Northern Europe than Southern Europe. The involvement of Nordic schemes in all these international, supranational bodies is quite telling and it's something that cannot be left off the agenda. It can't be just a rubber-stamping exercise at the end of a discussion or a process.

**Ogden:** Traditionally the Nordics and the Dutch have been leading the way but it is encouraging to

see that Japan is pushing the ESG agenda forward through its largest government pension scheme. So we're seeing momentum there, which we hope will push forward more broadly across Asia.

**Tyszkiewicz:** The Chinese are big on cleantech. They are way ahead of some UK cities in terms of implementing cleantech in public transport.

**Ogden:** In the UK, we see government pension schemes paying a lot of attention to engagement, but it's also encouraging to see some corporates raising the stakes. For example, HSBC changing their default DC scheme to incorporate climate considerations. While we don't see all corporate schemes doing that, we need to look to those leaders to set the direction of travel.

**Tyszkiewicz:** One point worth mentioning. There has been a general investment trend away from just long-only equities and mainstream asset classes into alternatives. That's a whole different ballgame in terms of applying ESG across all these different asset classes, so we've just launched a search for impact infrastructure, for example. It's a fairly new area for us, it's going to be interesting, but that's there



because schemes are starting to put so much more into private markets, hedge funds, alternatives and risk premium. ESG is coming up in all of these selection processes as well and managers are having to play catch up. Traditionally it's the equity managers who pay more attention to this, but scheme trustees and the investment teams have to put pressure on all their asset managers to come up with answers.

**Whitfield:** It's difficult. I sympathise with fund managers inasmuch as they could come for an interview in Southwark and we would home-in on ESG and socially responsible ethics. They could go to another London borough and they wouldn't be challenged on that. As pooling occurs in London, this is immediately a bit of a point of difference. I'm really taken by the training and the education to get some of these less informed trustees to understand that this is something to embrace, it's not something to fear. They're not there yet. How do you manage that as a fund manager with your standard script to sell your product? It must be awfully difficult when you're going to those different arenas.

**Filbin:** I've got no sympathy. If you're a salesman you find out what matters to your customers. You don't turn up and discover it halfway through your pitch. You find out beforehand what matters to them and then you pitch on that basis.

**Whitfield:** If you have generic products that do what they say on the tin, how you sell those products, and be genuine, is very hard.

**Belgrove:** We all try hard to focus attention on value for money; what are you getting for your fees as opposed to what's the lowest fee. It's embedded in there and it's one of the challenges. Would you expect that extra ESG lens and effort applied by the manager to be worth more? I'd say, yes.

**Tyszkiewicz:** What surprised us from our manager selection exercises that we've done for ESG mandates, is quite a lot the final half dozen managers don't call themselves ESG managers, partly because they've been doing it for 20 or 30 years. They have this fundamental belief in assessing stocks in terms of not just financial reports. People need to be aware that you don't need to pay a premium, but you need to dig deep into what the managers are doing. For instance, we've seen managers that are high profile on the ESG scene, they are part of industry bodies, but they have lots of different strategies and asking them awkward questions about how they apply the E and the S can uncover the fact that it's actually a little bit of an afterthought.





Duncan Whitfield

*“SRI was far more widely understood as a concept. From an ESG point of view, if you have three advisers in the room, they’d give you three different perspectives.”*

*Duncan Whitfield, London Borough of Southwark*

**Belgrove:** Is the premium relative to what? That sort of activity is usually regarded as an active fund management approach that carries a premium fee relative to a passive approach. So it depends on what the anchor point for the client is in terms of what fee they’re prepared to pay. Passive can obviously engage through voting, but ultimately it has to hold all the stocks in the right proportions. You can’t do anything else. If, however, cost is the driver, then it starts to rule out some of the active strategies.

**Tyszkiewicz:** There are passive ESG funds for developed markets, but in the emerging markets there’s a real argument to be made for active management.

**Whitfield:** I have no sympathy with managers around fees. It is part of the journey and managers are not geared up to the fact that I do not expect to pay more for a reduced carbon fund than I pay for an index tracker for doing very little extra than plugging their software into the machine, which brings up red flags not to invest. The industry needs to be moving towards the benefits and the opportunities again and reflecting that through fees. I do get that challenge about why would I move to a higher fee for the same performance? Then you have to use all the stranded assets kind of arguments and so on and so forth; but the industry does need to tune into consistent fee levels for the sustainable funds.

## All climate change scenarios could spell trouble for pension funds

*Mark Jeavons and Tim Manuel are part of the Responsible Investment team at Aon*



Man-made climate change is one of the biggest threats facing our world today. Governments have made commitments to reduce greenhouse gas emissions to limit its damaging effects. To meet these commitments, more aggressive policy action and a rapid shift away from fossil fuel use will be necessary. This will likely cause considerable disruption, increasing costs and reducing growth globally, while raising the risk of a global recession.



The UK is one of the global leaders in tackling climate change. It signed the Climate Change Act (2008) which set legally binding targets to reduce carbon dioxide (CO<sub>2</sub>) emissions by at least 80% by 2050 (from 1990 levels). By 2016, the UK is just over half way there, at 42% below. To meet the 2050 target though, emissions will need to fall by 3% each year, needing more challenging measures. Globally, the position is worse with substantial action required. The world and the UK are actively working together towards tackling climate change. However, the question to ask is: will it be enough?

Pension funds, as long-term investors, could find themselves exposed under many of the potential future scenarios around climate change. The long-term effects of un-tempered climate change are likely to be damaging, but the economic transformation required to deal with the challenges could also cause pain in the near term for those that are unprepared.

The Paris Climate Change Agreement aims to strengthen the global response to the threat of climate change by limiting the global temperature rise to well below 2°C above pre-industrial levels. The scientific consensus is that keeping the global temperature rise below this level will help avoid the worst effects. Every country in the world, with the exception of the US, has now signed up to this agreement. The Intergovernmental Panel on Climate Change has shown that if emissions continue on their current trend, global warming is likely to be more than 4°C above pre-industrial levels. This is well above the danger limit and would likely put our planet and society at risk from more severe climate change effects before the end of the century.

To remain within the target would require us to emit no more than 720 billion tons of CO<sub>2</sub> worldwide for the rest of this century. With the world emitting around 40 billion tons of CO<sub>2</sub> every year, this means that at current levels we have less than 18 years before global temperatures hit the danger limit.

This leaves little time to put in place effective policies to reduce carbon emissions sufficiently to avoid the calamity scenario. Global emissions need to start falling quickly in order to have a realistic chance of limiting the worst effects of climate change. This means more ambitious goals than those set out in the Paris agreement, including the international regulation of carbon emissions and a rapid shift away from fossil fuels in favour of renewable energy sources.

Under the 'green scenario', where global collaboration manages to act to address the challenges, there is still the likely threat of a shock from climate regulation changes that could lead to large losses across pension funds' portfolios in the near term. The implications of the alternative 'climate change calamity' scenario may avoid some of that near-term pain, but does not bode well for future generations or investors' returns.

The risks from climate change are much greater over the long run than over the next decade. However, the window for limiting emissions and avoiding disastrous change is narrow. Under both scenarios there is scope for economic pain at some point on the road, either near or far.

Tackling climate change is a Herculean task, which requires efforts of communities, companies and individuals alike. The actions (or inaction) of governments worldwide will have ramifications for society and the global financial system.

Pension funds, insurers and other financial institutions will need to consider how likely they are to be impacted by climate change and decide how they will manage the risks and future challenges over multiple timeframes.

Scenario analysis can be used to help trustee boards and corporate treasurers to consider a range of climate change outcomes, and to better understand how their assets and liabilities are likely to be impacted. This analysis can be used to stress test investment strategy and make informed funding and investment decisions. This allows for better planning for future conditions, which will hopefully lead to a brighter future.



## How index investors can change the future



There are multiple ways for tracker funds to help foster better financial and societal outcomes, says *Meryam Omi*, head of sustainability and responsible investment strategy at Legal & General Investment Management.

The face of traditional investing is changing. Stocks worth hundreds of billions of dollars are still traded daily but a growing number of investors are turning to index investing. Rather than attempting to beat the market by picking securities that are likely to outperform, index fund managers seek to track the market.

In equities, they own shares in every company that forms an index, such as the S&P 500. As such, index fund managers may be less concerned with the fate of any particular stock, but will probably care about the systemic issues that can affect entire markets such as climate change.

Diversification can help reduce risk, but only up to a point. Consider that out of every £1 paid in dividends by the largest 100 public UK companies, about 20p comes from just two large energy companies, our research suggests. More broadly, around a third of the world's equity and bond markets are linked to carbon-intensive sectors, such as energy, utilities and mining<sup>1</sup>. As the pressures stemming from climate change intensify, how many of these companies will reinvent their business to survive – or even thrive – in the low-carbon economy?

Of course, none of us can predict the future, but this should not be an excuse for inaction. In fact, in a conventional globally diversified equity portfolio, investors could be unknowingly financing global warming of 4°C compared to the pre-industrial period – a world of “unprecedented heat waves, severe drought and major floods in many regions,” according to the World Bank. It goes without saying that portfolio returns are unlikely to be positive when even the road to the local cash machine might be under water.

Index fund managers are not powerless, though. We outline a few of the options available here:

### Tilting

There is more than one way to construct an index. One useful option is ‘tilting,’ which starts from a broad universe of companies and then increases or reduces their index weight according to specific criteria, such as the management of climate change risks. For example, the alternative investment approach of one of Legal and General Investment Management’s (LGIM) funds has lowered exposure to the carbon emissions of its underlying companies equivalent to that produced by 20,000 cars (compared to traditional index investing). Without sacrificing diversification, profits and long-term purpose can be combined, in our view.

### Engagement

Index fund managers have to hold on to stocks for as long as they are part of an index. So they will want all the companies they invest in to do well. This raises the importance of engagement – using one’s shareholder rights to hold companies accountable and help shape their business models. We will meet company boards, have a direct dialogue and vote at shareholder meetings to send a consistent message to the companies in which we invest. During 2017, for example, LGIM supported 100% of shareholder resolutions calling for better disclosure on climate change.

1) <https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability>





### **Divestment/Reduction in holding weights**

Blanket divestment from companies and entire sectors can be a risky strategy, since it results in a more concentrated portfolio. Yet limited exclusion – and the threat of it – can still be a potent tool: research has shown that the targeted exclusion of certain stocks (e.g. companies with the worst ESG records) need not have significant impact on the tracking error of index funds, or the difference between their returns and those of the index they follow.<sup>2</sup> At LGIM, we have designed index funds that exclude companies that consistently fail to meet sustainability standards, but with very little impact on overall performance.

These tools at our disposal are not mutually exclusive. In fact, we believe they are best used in combination. At LGIM, we offer index investors the opportunity for exposure to entire markets, while seeking to lower the chance of ‘nasty surprises’ in their holdings. In addition to helping lead to better financial outcomes, we believe this approach can also make a positive contribution towards societal goals.



#### **Important Information**

The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested. Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA [www.lgim.com](http://www.lgim.com)  
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<sup>2</sup> Tim Verheyden, Robert G. Eccles, Andreas Feiner (2015) - ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification

# Is big really better

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The link between executive pay and company performance is widely debated, but, thanks to new research, is the era of unjustifiably high pay packets in the boardroom coming to an end.

*Mark Dunne* investigates.

# er?

A company that sells products for children found itself at the centre of an adult debate late last year. Toys R Us became another high street retail chain to lose the fight against online competition when it collapsed into administration in September. The story remained in the headlines thanks to the company asking the courts for permission to pay its executives bonuses that could have seen them share up to \$32m if Christmas sales targets were achieved. This request fanned the flames of the debate on executive pay.

For investors looking for sustainable growth, the pay of those sitting around a boardroom table matching the performance of their company is a hot topic. The question many shareholders ponder is does setting high salaries or dangling large bonuses in front of executives produce better performing companies? And if not, does an underperforming company handing over a large proportion of cash to its directors create a less sustainable business?

Toys R Us is a case in point. It sought the protection of the courts after losing \$1.8bn over five years. However, while standing on the brink of administration it shelled-out \$8.2m to various executives to stop them jumping ship. This was followed by the request to share millions of dollars among 17 executives if sales targets were met.

Many might find it difficult to justify such rewards for people who were at the helm of the company when it crashed into administration. But for Ric Marshall, MSCI's executive director of ESG research, offering bonuses to the directors of a failing company is not his main concern.

"Part of the problem here is that they are asking for an extraordinary amount in the face of what could only be a short-term solution to a bigger problem," he says.

"To agree to pay-out a huge amount because they managed to turn it around for one season makes no sense from an investor perspective."

Marshall adds that these bonuses could

only benefit short-term traders looking for a quick bump in the stock. "For most institutional investors that is not how they work anymore," he says. "They want to invest in a company that is going to last."

He acknowledges the challenges bricks and mortar-based retailers face, believing that the board needs to find a strategy that will create sustainable value for decades.

"It may need to partner with someone, they may need to go online or they may need to think about what is beyond online," he adds. "That is where the big bonuses should be in my view."

### OUT OF WHACK

Marshall believes his views stand on strong foundations. In October he published a report into the relationship between the remuneration packages of chief executives of US companies and the performance of

“There are pay plans that seem to be working, but that is a minority.”

Ric Marshall, MSCI

their businesses. Its conclusion was an eye opener: the size of a chief executive's pay packet does not reflect long-term shareholder returns.

The study – *Out of Whack: US CEO Pay and Long-term Investment Returns* – found that chief executive pay in 61% of the 423 MSCI USA Index constituents was poorly aligned with the company's total shareholder return (TSR) between 2006 and 2015.

Amongst the most poorly aligned companies, 23 underpaid their boss for superior stock performance, relative to their sector peers, while 18 overpaid for below-average stock returns. "I'm always sensitive to talk about cause and effect, but clearly they are not well linked [here]," Marshall said.

In around a third – or 163 – of the 423 companies sampled, the pay collected by the

chief executive was generally well aligned with TSR. "There are pay plans that seem to be working, but that is a minority," Marshall says.

The report highlighted that there is a stronger alignment between pay and performance in the short-term, but this evaporates when taking a longer-term view over 10 years.

Marshall says that three years is the typical testing and vesting period for most long-term incentive plans (LTIP). "The problem is that from a long-term investor perspective they are holding these positions for longer than three years, so longer-term that connection is lost and you end up with a random effect," he adds.

### WRONG TARGET

There are many components to an executive's pay package. There is the basic salary, which can be topped up by pension contributions, but there is another element that could be a problem. Bonuses are typically paid annually and so are linked to short-term achievements. Marshall explains that on average 60% to 70% of an executive's pay is a bonus, which in the US is almost universally equity-based. "So if you see targets that are blatantly short-

term you have got real problems," he adds. Bonuses, or awarded pay, are intended to align an executive's interests with those of the company owners and they came under MSCI's microscope in the *Out of Whack* study. The result might surprise you.

MSCI discovered that the bottom fifth of companies by equity incentive award outperformed the top fifth on average by almost 39% on a 10-year cumulative basis. Marshall says that one reason pay has become so dysfunctional or poorly aligned is that there is an over-emphasis on stock-based performance measures, such as total shareholder return.

"When an equity award is combined with targets that look primarily at the value of the stock and not revenue growth, return on equity or operationally-based perfor-

mance measures, that is where you get the biggest problems,” he adds.

One solution is to dilute the potential effects of relying too heavily on stock-based targets. So look for companies that have incorporated environmental, social and governance (ESG) factors into bonus targets, such as having a low negative impact on the environment.

Lucia Meloni, an SRI and corporate governance analyst at Candriam Investors Group, agrees that investors could benefit long-term if performance is linked to sustainable success. “It is a good step for companies to set ESG-performance criteria, which is a long-term measure,” she adds. One company that has penalised its boss for a poor operational performance is BT.

The telecommunications group announced in May 2017 that it was scrapping its chief executive’s bonus following a profit warning.

An accounting scandal that left the group more than £500m out of pocket was blamed alongside a £42m fine for inadequate compensation payments linked to late broadband installations. In the end, the chief executive’s pay for the year to April 2017 was 74% lower than it was 12 months earlier.

### THE SHAREHOLDERS STRIKE BACK

Investors have become more proactive in the area of executive remuneration. In recent years, more and more investors have voted to reject the pay deals offered to executives.

Meloni says that this was because some packages are seen as excessive and are not linked to performance, adding that shareholder revolts against remuneration reports are a “signal that they are not fair”.

In one example, almost a third of shareholders in luxury brand Burberry did not back the remuneration report on the pay of its executives in July 2017, believing it to be too generous.

Meloni believes that investors could use their influence by voting to help build sus-

tainable businesses. “In the long run it is going to be an important instrument for the shareholders and management will have to deal with it,” Meloni adds.

A lack of disclosure appears to be part of the problem. Investors need to know the details of what needs to be achieved for the boss to collect their award.

“Is it a share-based incentive? A long-term incentive? What is the performance crite-

“ It is a good step for companies to set ESG-performance criteria, which is a long-term measure. ”

Lucia Meloni, Candriam Investors Group

ria? How it is calculated? Are the targets challenging?” Meloni asks. “Very often they are not [challenging], so they can be easily achieved.”

She adds that disclosure in this area is improving, but more work is needed. “They want to disclose more. We have seen throughout the years that there is a will to disclose more [details] because they are facing a lot of opposition. There is an improvement, but there is a lot more to do on this.” Candriam practices what it preaches. In 2015 it voted against 49% of resolutions relating to executive pay. A lack of transparency, challenging performance conditions or a lack of correlation between pay and performance were behind its decisions.

For Candriam, executive compensation must promote performance without excessive risk-taking, but it is not just about financial targets. It believes that pay in the boardroom should not be disconnected from employee lay-offs or incidents that have a negative impact on the environment.

### HEAVYWEIGHT SUPPORT

The drive to disclose more information has the support of government and industry. In

August business secretary Greg Clark outlined the government’s plans to reform corporate governance. The headline here was that all listed companies must publish a pay ratio of its chief executive’s pay to that of the wage of its average UK worker.

For Meloni this is an important move. She says that if there is a huge difference in the pay between the chief executive and that of the company’s average worker then “maybe

we have to think about what is wrong”.

The government also wants companies to clearly spell out what their remuneration policy is and what executives have to achieve to earn their bonuses. This is to help justify why the boss is worth so much.

The industry’s attempt to rebuild trust in executive pay structures came from the Investment Association’s (IA)

Executive Remuneration Working Group. It floated 10 proposals in this area in July 2016. The group spoke to more than 360 investors, asset owners and workers before drawing up its recommendations.

It sought to simplify pay structures and improve the alignment of the board’s interests with those of the shareholders. It rejected a one-size-fits-all approach and instead opted for a pay structure that works for shareholders at each company. It mirrors the government’s proposals in that it wants companies to justify why they have set the chief executive’s pay structure and what targets have been set.

The group wants to make remuneration committees more accountable. It believes that there are concerns companies are not adequately responding to “significant” shareholder opposition to what they pay their executives.

The debate over executive pay packages will continue to rage even after Toys R Us closes its doors for the last time, but with research failing to find a long-term link between pay and performance and with Westminster backing higher pay disclosure, we could be on the brink of an era of more justifiable rewards for executives.

# portfolio institutional

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