Picture: Stockphoto

Behind the curve: still a long way to go on SRI

By Gill Wadsworth

When the head of Google Eric Schmidt dismissed criticism of his company's 'immoral' tax avoidance policies as 'just capitalism', the behaviour of the world's largest corporations was cause for scrutiny once again.

Like the bloated executive pay packages before it, tax avoidance is the latest example of poor corporate behaviour which, while legal, highlights the need for institutional investors to play their part in curbing dubious business practice.

Reaction from the UK government makes clear it does not believe enough is being done by investors to encourage good behaviour while driving out the bad. In March this year, Sir George Cox conducted an independent review on behalf of the Labour Party into short-termism by British business. Among his conclusions Cox said UK institutions, including pension funds, asset managers and insurance companies, were failing to take their shareholder responsibilities seriously and there was a "vacuum at the heart of the UK's corporate governance system".

Cox's findings followed those of the Kay Review in 2012, a coalition government commissioned review of UK equity markets and long-term decision making, which also highlighted failings in corporate governance and called for investors to improve best practice and transparency.

To help pension funds shoulder this additional burden, in May the National Association of Pension Funds (NAPF) launched a guide to responsible investment.

Updating its earlier 2009 guidance, the NAPF says the document supports pension funds in their environmental, social and governance (ESG) duties, and helps ensure their asset managers are also behaving appropriately. David Paterson, head of corporate governance at the NAPF, says pension funds should make responsible investment the norm. "[Pension funds] should develop clear policies that reflect ESG factors in decision-making, and exercise stewardship responsibilities such as engagement and voting," Paterson says.

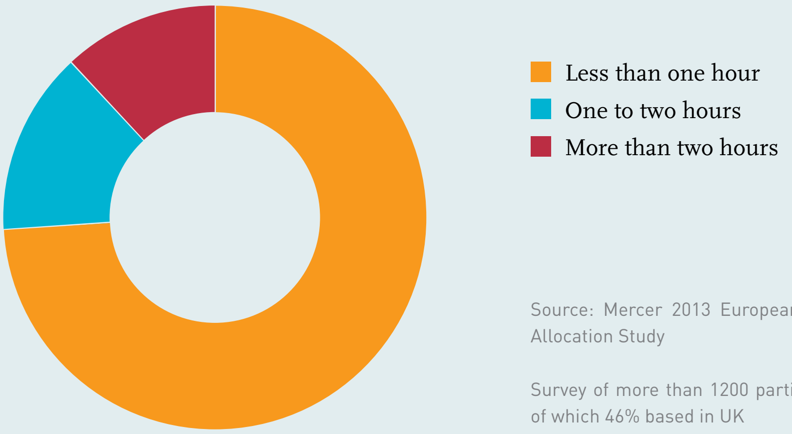
But the fact is incorporating ESG is not the norm for the majority of pension funds.

The 2013 Mercer European Asset Allocation survey found schemes that actively incorporate ESG issues into their investment operations "tend to be large and well-resourced" and noted that "trustees generally have limited experience in assessing ESG issues from an investment perspective and limited time in which to improve their knowledge".

Just 50% of the European pension funds surveyed by Mercer are devoting time in trustee meetings to discussing ESG issues *(see chart on p26)*.

Of course there are several well-known funds in the UK that excel in responsible investments. The Environment Agency, the

Time spent discussing ESG issues during investment committee meetings



Source: Mercer 2013 European Asset Allocation Study

Survey of more than 1200 participants of which 46% based in UK

Universities Superannuation Scheme and many of the local authority pension funds have impressive ESG policies in place. However, these are multi-million, in some cases billion, pound plans with the resources and motivation to take ESG on in-house.

For every other scheme ESG is largely outsourced to intermediaries such as asset managers and investment consultants who are critical to ensuring investors meet their responsible investment obligations.

Paterson says: “It is vital to select investment managers that act as responsible investors and report clearly, and to then hold them to account.”

Room for improvement

However, there is a question mark over the competency and commitment of some intermediaries in delivering a responsible investment strategy.

Vincent Neate, head of climate change and sustainability at KMPG, believes fund managers are behind the curve on responsible investment.

He says: “My sense is that the investment management industry as a whole needs to be more proactive and engaged on the whole question of what it really means to be a responsible investor.”

Meanwhile Will Oulton, global head of responsible investment at First State, says investment consultants are still developing their responsible investment credentials. “Many [UK] pension funds don’t have that [stronger governance] capacity and so they are wholly reliant on the advice and decisions of investment consultants. Investment consultants are still building their own capacity and knowledge in terms of understanding responsible investment and how that benefits their clients’ long-term interests and objectives,” Oulton says.

And Paterson’s point about the imperative to monitor investment managers may be easier said than done. The Kay Review makes clear the difficulties facing trustees in overseeing their intermediaries and asks: “The question of who guards the guards is inevitably followed by the question of who guards the guards who guard the guards.”

While there may be some doubt over the financial service industry’s capability in the ESG department, fund managers themselves are quick to espouse their responsible investment merits.

Oulton says: “It is hard to find an asset manager that would say [ESG is] irrelevant to their business. They would be an exception today which might have not have been the case pre-financial crisis.”

A quick look at the number of signatories to the United Nations Principles for Responsible Investment (UNPRI), which is a joint initiative to drive good corporate governance, reveals 743 investment managers on the list. The huge amount of assets under management is also testament to a burgeoning ESG interest.

According to the Global Sustainable Investment Alliance (GSIA), at least $13.6trn (£9.02trn) of professionally managed assets incorporate ESG concerns into their investment selection and management of which 65% is based in Europe.

Different strokes

But how asset managers implement an ESG policy into their overall investment strategy varies tremendously. The GSIA found the most common strategy used globally is negative screening, accounting for $8.3trn of assets, while corporate engagement and shareholder action accounts for $4.7trn.

In the UK, engagement has become a preferred tool for asset managers and pension funds keen to avoid any conflict of interest which may arise when excluding certain sectors. However, First State’s Oulton says the fear that responsible investment means ethical screening and is in some way a breach of fiduciary duty is overblown.

“There is a misconception about that; it’s more of perception than a reality. It’s not the case. [Concerns about breaching fiduciary

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>
> Vincent Neate

duty] have held back many trustees' views of enhancing their thinking around responsible investment," Oulton says.

A fine balance

In fact, ESG has become so entrenched with some investors that ignoring these issues could in itself become a breach of fiduciary duty.

Tim Creed, managing director at private equity firm Adveq, says: "There is very clear evidence that firms with better governance perform better. With regards to environmental and social issues these have been analysed for a shorter period of time and therefore there is less evidence but we have anecdotal examples of where benefits have been made."

Neither Adveq nor First State employs a negative screening policy, however, favouring engagement with investee firms instead. SVM, an asset manager, does employ screening in its All Europe SRI fund, choosing to exclude pornography, tobacco and armaments. Yet explaining the rationale behind excluding these specific sectors does not come easy. Neil Veitch, co-manager of the SVM SRI fund, says: "It's a difficult question and there is no perfect answer. We consider those three areas so socially abhorrent to any investor that it warranted excluding them completely. It is a fine balance and I am not sure we've got that completely right but we looked at the universe and decided we wouldn't feel comfortable investing in those areas."

Proving that one man's meat is another man's poison, SVM does invest in gambling companies but Veitch says "gambling per se does not have the same impact on individuals' lifestyle and health as tobacco does".

All about performance

Whether a fund manager chooses to screen, engage or use a combination of both will be largely irrelevant to investors if their performance is not up to scratch. The SVM SRI All Europe fund returned 12.4% in the year to 31 March outperforming its benchmark of the FTSE World Index by 2.4%.

It is this performance, Veitch says, that is the key to securing investors while engagement and screening policies are of secondary concern. "The hook is the performance and then we get into the discussion around what our views are on ESG," Veitch says.

Image: Shutterstock

But fund managers cannot afford to rest on their laurels if responsible investment is to remain fruitful.

A 2012 survey of ethical funds conducted by Share Action (formerly FairPensions) found "many providers seem to be stuck in the past applying a traditional screening approach to an outdated set of ethical priorities".

Driving the agenda

Additionally, Neate at KMPG says the investment management industry is "15 to 20 years behind the world of public companies when it comes to thinking about responsibility", and argues investment managers should do more to drive the ESG agenda.

"Over the next five to 10 years the forward-thinking, fleet of foot in the corporate world, and therefore in the investment world, will benefit from taking the responsible [investment] agenda seriously," he says. "They will maintain their reputation and performance and therefore maintain their clients. The corollary of this is that those that don't get engaged, don't plan and don't think it through will lose reputation, performance and clients."

In particular, there is growing evidence that those companies focusing on the social and environmental issues alongside governance will be the success stories of the future.

Oulton says: "There will be an emergence of innovators and leaders in the asset management industry who will look beyond the performance numbers and ask 'what are the environmental and social benefits of these investments?'. The leaders will identify and quantify that information."

Responsible investment no longer sits on the periphery of institutional investment portfolios but it would be a stretch to call it core. Government appears to appreciate the need to get the industry to do more but investors and intermediaries are inconsistent in their approach to responsible investment. Whether the carrot (regulation) or the stick (performance) drives more institutions to take ESG seriously is unclear but it is without doubt that responsible investment will continue to climb up the asset management agenda.