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# ESG and climate change

## Is my fiduciary manager achieving ESG best practice?

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# Introduction

The pensions world has seen a huge impetus behind responsible investment and sustainability. Fiduciary management ("FM") has itself grown in popularity, representing over £200bn of assets under management and an estimated 19% of all UK defined benefit pension schemes.

By definition, FM is the delegation of investment decisions to a third party. With this delegation comes an expectation that fiduciary managers ("FMs") are acting responsibly on behalf of their pension scheme trustee clients. This includes monitoring and managing of Environmental, Social, and Governance ("ESG") issues.

This paper outlines our vision of ESG best practice for FMs right now. To support this we surveyed 14 fiduciary providers on their latest ESG thinking and propositions, and show how the market currently compares with our best practice recommendations.

## The importance of ESG within FM

While trustees retain overall responsibility for managing pension scheme investments, FMs use their stewardship to address ESG risks and opportunities. Examples includes identifying and creating products with ESG-focussed objectives, developing ESG criteria in order to select funds, and even casting decisions on shareholder proxy votes.

The success of this stewardship impacts three key critical factors. These influence the ability of pension schemes  to achieve long-term financial objectives :

**Long-term performance and risk management of your investment strategy**

**How your pension scheme assets interact with the world and adapt to climate change**

**The service and cost control you receive from your fiduciary manager**

# The importance of ESG within FM

## Our vision of best practice

There is currently no agreed standard of ESG best practice for FMs. We propose three pillars of best practice for evaluating FMs informed by our ESG research of the wider pension scheme market. Each of these represent a core responsibility of FMs to trustees:

1 Implementation – how assets are invested

2 Monitoring – how funds are researched and engaged with

3 Reporting – the ESG metrics available for your scheme

## Our assessment – a foreword

We don't believe any one FM meets all of our standards of best practice yet. It is our view that more can be done across the market, most notably through consistency of how ESG is integrated within client portfolios.

What we have seen however is significant improvement in how FMs engage with trustees on ESG issues. While improvements can be made across the market, we recognise the efforts taken by FMs to explore these concepts with trustees, create products, and engage with the wider fund universe.

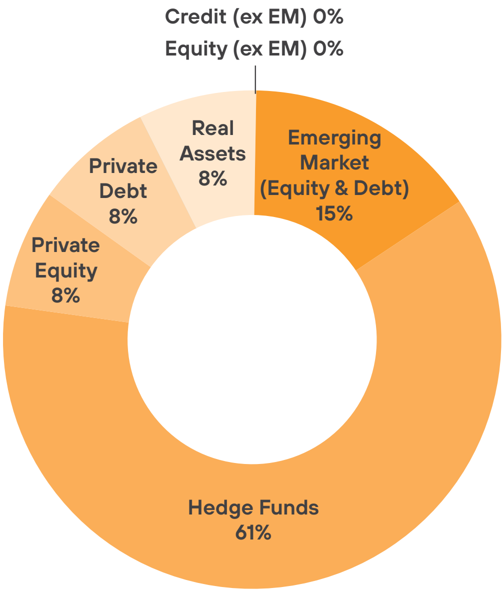
Within this paper we include examples to celebrate this innovation.

# 1 Implementation
## How assets are invested

Many trustees value the ability to delegate asset allocation decisions to FMs. This principally covers which asset classes are invested in and in what proportions. It also covers the flexibility FMs have to implement trustee policies with the toolkit and funds at their disposal.

We set out our first two best practice recommendations below.

### Which asset class is the most difficult to apply an ESG/climate tilt or objectives?




### Are structural reasons behind slow product development?

The chart adjacent highlights the structural challenges of ESG integration across asset classes. 60% of FMs believe hedge funds are the most challenging area.

Interestingly we observe respondents flag less challenge for other asset classes. We therefore question why we haven't seen the same level of integration in these other asset classes. We also question whether manager research is an effective substitute for a fully integrated ESG process in these asset classes.

### Best Practice 1 – Funds with specific ESG objectives are used in all growth asset classes

A plethora of funds with ESG objectives are now available to pension schemes. These are funds with an explicit ESG objective alongside financial objectives such as performance and risk. ESG objectives can for example be the use of tilts (to or against certain industries), screening (such as exclusion policies), and climate related targets (such as carbon emissions). It also includes impact investing.

By contrast, FMs can select regular funds that have no formal ESG objectives. FMs can then use ESG criteria in their research to ensure these funds at least meet a certain standard. Without formal objectives it can however prove difficult due to the subjective nature of many ESG decisions. It can also result in investment decisions that don't prioritise or even conflict with EGS principles.

We believe ESG-specific funds have the greatest ability to align with trustee investment beliefs, particularly where trustees prioritise ESG. The existence of passive and factor-based funds makes the underlying cost of these funds more viable and often not significantly more expensive than regular funds.

FMs have steadily increased their use of equity funds with ESG or climate objectives, with 60% of FMs in our survey incorporating equity funds with ESG or climate objectives in their typical fiduciary client portfolios. Unfortunately, such a wide-spread adoption of ESG focussed funds is not currently present in other assets classes such as bonds, hedge funds and private markets. We think FMs can generally do better and be at the forefront of development across asset classes.

# 1 Implementation
## How assets are invested

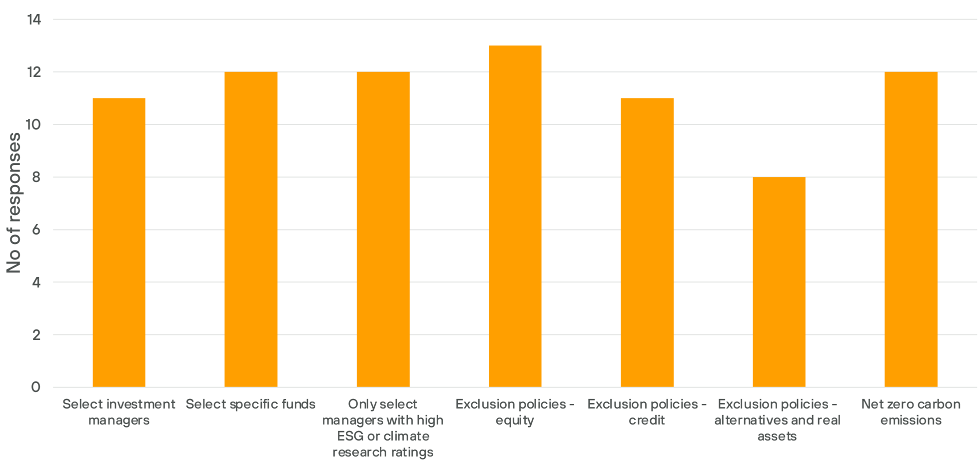
### Best Practice 2 – Managers have flexibility to address a range of client beliefs

Every set of trustees will have a unique set of investment beliefs and policy requirements for their schemes. This presents a challenge for FMs to ensure the right mix of available funds to meet client ESG requirements.

We see best practice is for FMs to offer sufficient flexibility to pension schemes. This can be in the form of selecting specific investment managers and funds, exclusion policies, of the ability to target appropriate ESG objectives (such as a reduction in carbon emissions).

A benefit of the fiduciary management governance model is the speed to implement ideas quickly. Flexibility should not mean introducing delays to implementing ideas. Instead it allows for FMs to engage with trustees on ESG in the course of their relationship, with the ability to make practical changes. The benefit for trustees is the option to tailor their scheme's ESG policy in future, and for it to be feasible from an investment perspective.

### Which of the following ESG and climate related options could you implement for clients if requested?




### How flexible is your FM?

The chart adjacent indicates that the majority of FMs can integrate specific ESG requests for pension schemes of all sizes.

For trustees looking to go one step further, the majority of FMs also allow for net zero carbon emissions targets and to only appoint asset managers with high ESG ratings. We challenge trustees to explore with their FM.

# 1 Implementation

## How assets are invested

### Areas to watch out for, and how to address with your FM

- **ESG tilted funds that can't demonstrate achieving objectives ("greenwashing")**

  We suggest adding ESG as a standing agenda item at your trustee meetings. Ask your FM to discuss how these funds meet their performance, risk, and E,S, or G targets.

- **Flexibility to offer a bespoke ESG service that results in higher fiduciary fees**

  An FM that promises high levels of flexibility to reflect a specific set of trustee beliefs should not charge higher fiduciary fees. Practically however there may be cost implications for the underlying investments in order to implement a very bespoke investment strategy. Discuss fees and costs with your FM at regular intervals, and understand the costs behind any changes to your portfolio.

# 2 Monitoring

## How funds are researched and engaged with

Choosing the right funds is critical to long-term performance and risk management. ESG has become a more prominent part of this selection process. FMs are recognising this by hiring specialist ESG research teams, defining “ESG ratings” for the funds they review, even firing funds due to ESG-based rationale.

We set out our recommendations for best practice below.

**Poor**
Fund demonstrates minimal alignment with ESG requirements

↕

**Satisfactory**
Fund recognises ESG issues but processes could be strengthened

↕

**Best in class**
Fund demonstrates a high level of ESG integration

### Best practice 3: Research ratings follow a suitably defined scale

There are clear benefits to using a research scale or scoring system to assess funds from an ESG perspective. It ensures consistent application when making decisions, relative comparison across the fund universe, and a basis to engage with fund managers to improve their ratings. Example research rating structure on the left::

We see best practice as those fiduciary managers who define robust criteria for funds to meet. This would reserve the top rating only for funds who demonstrate they are “best in class” in ESG integration. For example, requiring commitment from a firm and leadership level, targets for how the funds are managed (such as team diversity), and importantly how companies invested in are engaged with on ESG issues.

If funds are assigned a satisfactory or poor rating, the FM should use their stewardship to engage with these funds to improve. All funds should aspire to achieve the best in class rating. Furthermore, it should also reflect realistic standards across different asset classes (i.e. how equity funds act on proxy voting rights, or how credit funds review ESG in assessing default risk).

# 2 Monitoring
## How funds are researched and engaged with

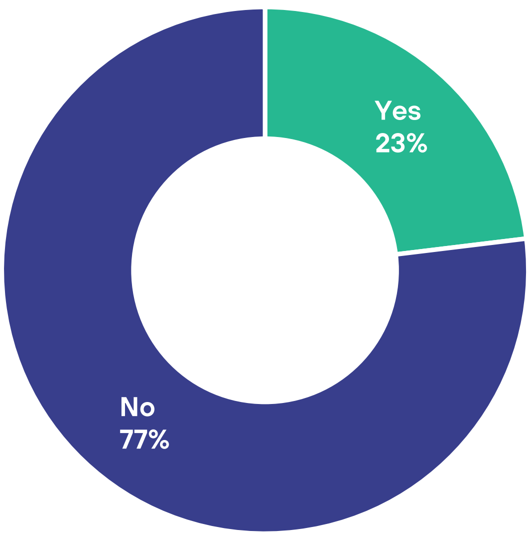
### Best practice 4: Your FM demonstrates engagement with poorly scoring funds

When a fund scores poorly against ESG criteria, it should be a red flag for both FMs and trustees. The fund is either not demonstrating recognition of ESG in their investment decisions, is not showing the engagement with companies on the right issues, or does not see ESG as integral to their investment process. All three are concerning.

We think FMs should demonstrate to you that they are engaging with funds that are assigned poor or weak ESG ratings. Poor ESG decisions can present a long-term financial risk to performance, in the same way that funds are assigned buy/hold/sell ratings. These ratings should be taken seriously, where the funds have to demonstrate improvement or face being up for review.

FMs are the gatekeepers between the pension scheme funds and the asset management universe, and can establish stronger ESG requirements before investment is made. Our survey found currently out of the 14 respondents to our questionnaire only 1 FM makes it a requirement to be a signatory of the UN Principles of Reponsible Investment ("UN PRI") before investing pension scheme assets. We believe FMs can also set a high standard for the selection of new funds going forwards, to ensure ESG integration is tending towards best in class.

**How many FMs have ever fired a fund due to consistently poor ESG research ratings?**




**Does robust ESG criteria mean firing poorly scoring funds?**

Only 25% FMs that we surveyed have **ever fired a fund due to consistently poor ESG research ratings**.

While this figure appears strikingly low, it does not show where FMs have engaged with asset managers to improve. Engagement instead of firing in our view is likely to lead to better outcomes and reduce unnecessary disinvestment costs.

# 2 Monitoring

## How funds are researched and engaged with

### Areas to watch out for, and how to address with your FM

- **Poorly scoring funds are in your portfolio**

  Ask your FM to provide you ratings for all funds within your portfolio. We suggest querying why certain funds have been assigned the lowest rating and what your FM is doing to address it.

- **ESG ratings for funds are not frequently communicated**

  Request that your FM include these ratings in regular reporting. Alongside these ratings request that your FM discusses the rationale for changes and any disinvestment costs.

- **ESG ratings criteria appear “too soft”**

  Review your FM’s ESG criteria for fund manager selection and monitoring. Question whether the top ratings appear too easily achievable and raise with your FM.

# 3 Reporting
## The ESG metrics available for your scheme

Trustees are communicating their ESG policies and actions to members, stakeholders, and the general public more than ever before.

It is paramount that trustees are aware of the actions taken by their fiduciary manager. We believe the following two items will make a clear difference for trustees.

### Best practice 5: Climate change measures are reported with meaningful benchmarks

Climate change measures that specifically relate to each pension scheme are becoming more commonplace. This includes information about portfolio carbon emissions, climate change scenario analysis (such as stress tests based on different temperature changes), and even the impact of rising sea levels on invested companies.

We believe FMs should be including climate change measures in your regular reports that are specific to your scheme. It provides useful information about risk in your portfolio, such as exposure to carbon intensive sectors, and the actions taken by both the funds and your FM to address climate change.

Some FMs have begun to include carbon emissions reporting within regular investment reports. Whilst this can be helpful to prompt discussion, it can lack context without an appropriate target. We suggest FMs either use a representative market index as a benchmark for comparison, or work with trustees to define a suitable target. For example, many schemes are pledging to become net zero on carbon emissions, and reporting against such a target would enhance its usefulness.

**Climate change impacts the following areas of your FM mandate:**

- Your FM's asset allocation and fund selection decisions
- The ongoing risk and return expected from your strategy
- Your long-term journey plan
- How your FM engages with fund managers and companies on climate issues

**Strategic advice and climate change**

Out of the FMs surveyed, **62% of respondents** include **climate change as a risk factor** within their strategic advice to fiduciary clients.

While this is a positive reflection of how serious FMs are treating this risk within their investment strategies, we question why this is not yet 100%.

At your next investment strategy review we recommend discussing how climate change is considered within your FM's assumptions.

# 3 Reporting
## The ESG metrics available for your scheme

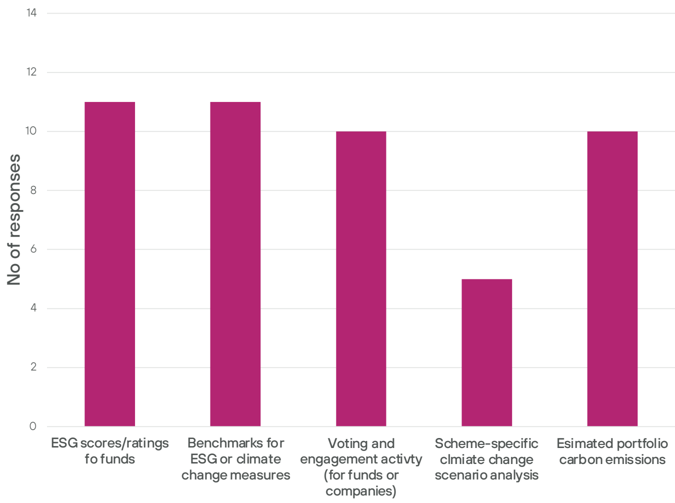
### Best practice 6: Fund ESG ratings are reported alongside changes

ESG ratings of funds are effectively a risk metric for pension schemes. FMs should be reporting their ESG ratings of the funds they appoint on your behalf. This includes how ratings change over time, and the ratings of new funds they appoint.

Furthermore it is important that FMs demonstrate to you the steps they are taking to engage with funds. Reporting the ratings information alone can lack context of the FMs stewardship decisions.

Over time FMs may decide to hire or fire funds for predominantly ESG reasons (for example, poor ESG ratings). Reporting changes to fund ESG ratings provides another forum for FMs to explain their investment process and cost control.

### Which of the following can be included in your regular standard reporting for fiduciary clients?




### What do you receive in your regular reporting?

The chart shows you that the majority of FMs can report specific ESG measures regardless of the size of your scheme.

By contrast, in our experience not all FMs currently include these measures within regular reporting.

**This disparity flags two issues:**

1. A responsibility for FMs to explore ways to provide and discuss this information with their trustees; and
2. Options for trustees to request ESG information from their FMs that they may know exist

# 3 Reporting
## The ESG metrics available for your scheme

### Areas to watch out for, and how to address with your FM

- **Reported measures have no defined objectives or benchmarks**

  The existence of metrics alone is a start but lacks direction without additional information. Discuss where potential targets can be included and monitored against (for example, net zero carbon emissions pledges by a realistic date).

- **Additional reporting that requires higher fiduciary manager fees**

  You should not expect to pay higher fiduciary fees for additional ESG or climate reporting. Ask your FM for a breakdown of fees and costs on an annual basis.

# 4 Are FMs meeting best practice?

**No one fiduciary manager currently meets all of our standards of best practice.**

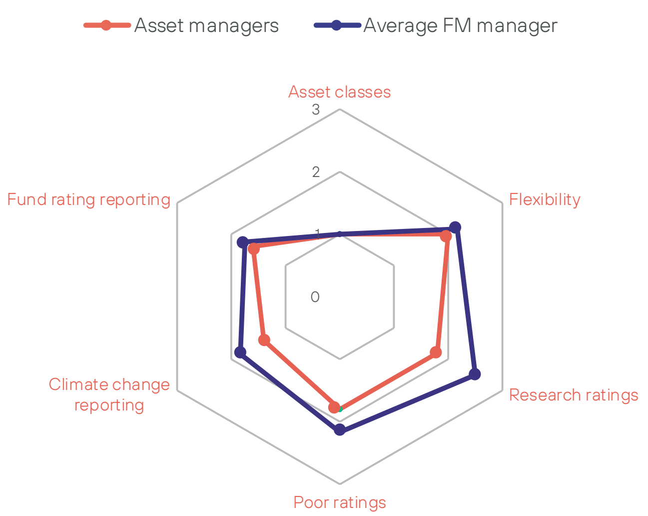
We recognise this is an impactful statement. It is also true of the whole industry, asset managers and investment consultants alike. More can be done to address ESG across the market, and FM providers are well placed to lead this innovation and movement.

Below we demonstrate this by scoring the 12 managers we formally assign research ratings to against the best practice measures presented in this paper. We have anonymised these managers and consolidated their responses by the type of fiduciary manager **(e.g. asset manager, specialist and consultant)** and compared them with average FM score. in each category.

**Key**

1 = Little/no evidence 2= Some evidence 3= Clear evidence

| | | |
|---|---|---|
| 1. **Implementation** | **Asset Classes**<br>**Flexibility** | FM invests in ESG-specific funds in all growth asset classes<br>FM has flexibility to reflect a range of client beliefs |
| 2. **Monitoring** | **Research ratings**<br>**Engagement** | FM uses an ESG ratings system to assess funds<br>FM engages with poorly scoring funds |
| 3. **Reporting** | **Climate change reporting**<br>**Fund rating reporting** | FM includes climate measures in regular reporting<br>FM includes ESG ratings in regular reporting |




## Example 1 – Asset manager (definition: firms whose principal business is investment management)

Asset managers display evidence of flexibility to reflect client beliefs, by offering a substantial number of funds and products.

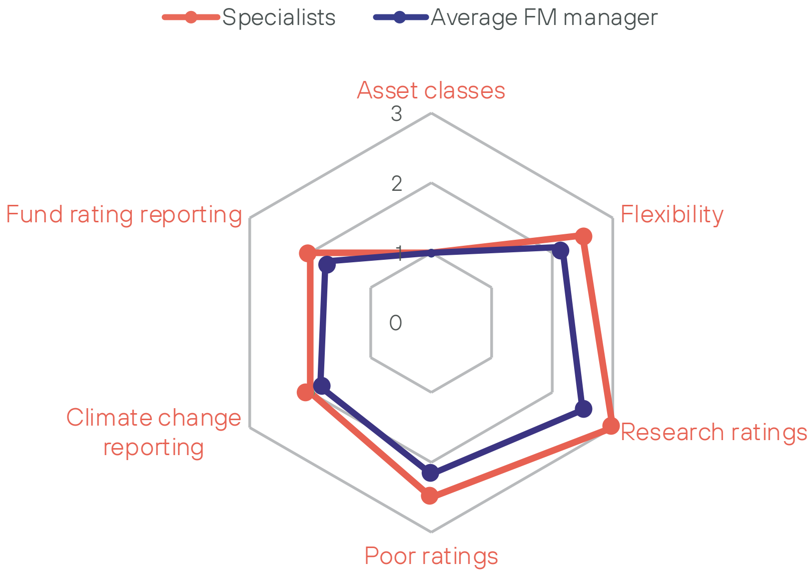
We are however surprised at how few funds with specific ESG objectives are used in typical growth portfolios. The industry is at the forefront of developing these products but are yet to integrate these fully within fiduciary client portfolios. Perhaps a barrier to is the desire to offer a simpler "cost effective" fiduciary service.

# 4 Are FMs meeting best practice?

## Example 2 – Specialists (definition: firms whose principal business is fiduciary management services)

Specialists demonstrate a greater degree of flexibility in their approach than the industry. We also note the development of robust research ratings to assess, compare, and engage with fund managers.

We do however start to see a consistent trend. The use of funds with ESG objectives is heavily focussed on equity and less developed for other asset classes such as credit and private markets.



# 4 Are FMs meeting best practice?

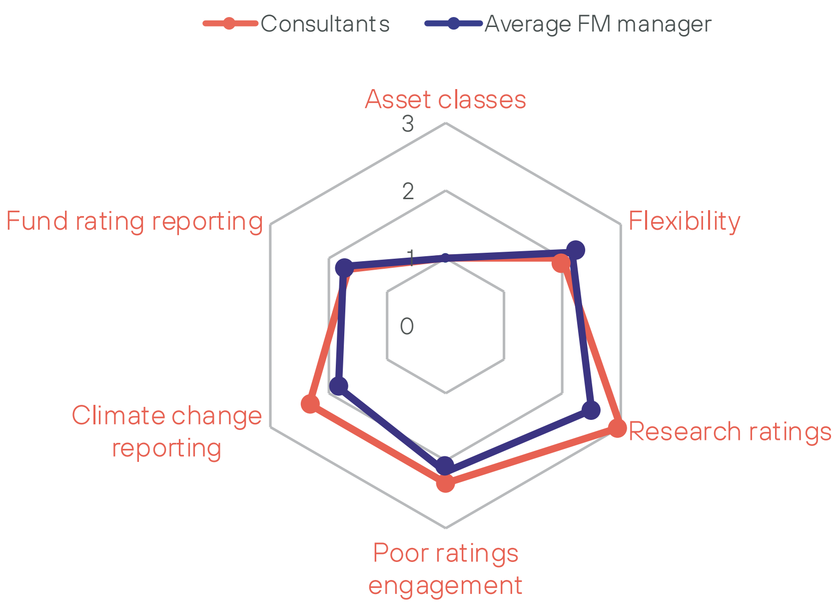
We do see some evidence of sophisticated solutions such as segregated accounts, which can result in a more tailored approach compared with pooled funds.

### Example 3 – Consultant (definition: firms whose principal business is pensions consulting services)

Consultants display similar trends to specialists, offering a degree of flexibility and with the development of robust research ratings. Interestingly consultants scored higher against the best practices measures for reporting, indicating improved awareness of trustee engagement compared with asset managers and specialists.

We see greater use of equity funds with ESG specific objectives compared to other asset classes. We do however see variations on the types of ESG fund, including one with an impact investing focus.

In our experience consultants can result in investing in a larger number of funds when compared to other fiduciary managers. This could create a barrier to future integration, for example, for very small allocations to certain funds.



# 4 Are FMs meeting best practice?

## Isio observations of the market

ESG funds are prevalent in equity but less developed in other growth asset classes, such as liquid credit, alternatives, and private markets. This is true regardless of each FM's primary business.

ESG research ratings are often used behind the scenes to support internal research conclusions. Few FMs are using these ratings as a tool to communicate views and changes with Trustees. FMs are demonstrating engagement with poorly scoring funds.

FMs have begun to introduce climate reporting regardless of client size. Further regulatory rules are expected for all DB pension schemes to report against climate change metrics, and it is pleasing that FMs are adapting their reporting to reflect this.

## Talking points

Our review highlights that there is more that FMs can be doing, particularly in the construction of pension scheme portfolios. It does also highlight a discrepancy between what FMs offer as a "standard service" and the many options at trustees' disposal.

One of the advantages to the FM governance model is reducing the ongoing time and resources burden on trustees. In our view trustees do not have to compromise on the governance benefits with perpetual engagement on ESG issues. Instead trustees should look to their FM for guidance in developing suitable ESG related objectives and how the FM can make these happen, through different asset classes, funds, and reporting. We strongly believe this will lead to improved long-term outcomes for trustees.

# 5 Innovations from the industry

### Fund integration

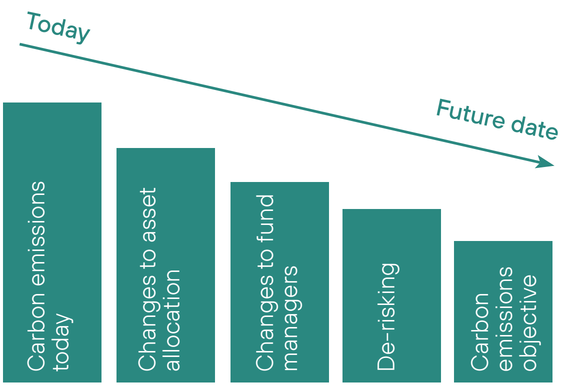
One FM has created a passive equity fund with a multi layered approach to ESG and climate change. This includes:

- Screen companies and exclude industries with poor alignment
- Working with an independent third party to develop and refine ESG metrics
- Tilts towards companies with good ESG scores and away from companies with poor scores
- Active engagement with companies via proxy voting

Greater alignment to ESG metrics results in an estimated meaningful reduction in carbon emissions than a typical global passive equity index. Current management fees are also not significantly more expensive than other passive and factor based global equity offerings.

We see this development as a positive example of an FM addressing their fiduciary responsibility and stewardship, while being mindful of excessive costs to the schemes investing.

### Climate journey plan




Another FM has developed a "journey plan" for trustees based on a specific climate objective. For example, to reduce portfolio carbon emissions by 50% within 10 years.

Within this journey plan the FM can note specific actions available to trustees to achieve this alignment, such as phasing out funds with unsuitably high emissions. It can also address the scheme's strategic journey plan and how de-risking can achieve this target. Furthermore, it can be aligned with objectives of the sponsor.

We perceive this innovation to be positive recognition of the long-term impacts of climate change. It is further supported by an objective, realistic, and measurable target for schemes. We encourage all trustees to explore similar concepts with their FM.

# 5 Innovations from the industry

## Interactive reporting

One FM has created an online interactive tool which allows you to check the score of your portfolio against a respective benchmark for selected categories including:

- **Carbon emissions,**
- **Climate change themes,**
- **The estimated impact of rising sea levels on the portfolio,**
- **Toxic emissions and waste**

This provides a “look through” of each scheme’s portfolio at any point in time. It can also be used to demonstrate how changes to the portfolio such as asset class rotation and de-risking impact key ESG metrics.

We support the use of engaging visual tools that have potential to facilitate enhanced engagement between trustees and their FMs, with data specific to their scheme.

# 6 How can I take this forward with my FM?

It can be tricky for trustees to engage with FMs on a topic like ESG, especially if strategies are complex and ever changing. Below we include a checklist based on our six measures of best practice.

We encourage trustees to complete this checklist for your schemes with the help of the FM. Any answers of "no" could indicate a topic to address with your FM at your next trustee meeting. It could also indicate where additional information is required.

## ESG Best Practice checklist

| | Yes | No | Require further information |
|---|---|---|---|
| **Implementation** | | | |
| 1. Are ESG-specific funds available across all asset classes? | ☐ | ☐ | ☐ |
| 2. Does your FM provide the flexibility to implement a bespoke set of trustee ESG beliefs? | ☐ | ☐ | ☐ |
| **Monitoring** | | | |
| 3. Does your FM rate & score fund managers from an ESG perspective? | ☐ | ☐ | ☐ |
| 4. Does your FM engage with poorly scoring funds? | ☐ | ☐ | ☐ |
| **Reporting** | | | |
| 5. Does your FM include ESG & climate change metrics within their standard reporting (i.e. quarterly reports)? | ☐ | ☐ | ☐ |
| 6. Does your FM include fund manager ESG ratings within their standard reporting (quarterly reports)? | ☐ | ☐ | ☐ |

# 6 How can I take this forward with my FM?

## Taking ESG a step further with your FM

You may require more information about your FM's ESG approach and actions. It may be unclear if your FM is meeting our defined standards of best practice.

## We suggest taking the following steps

Ask your FM to provide more details on their approach

Request for ESG or Climate Change to be added to the agenda of your next Trustee meeting

Consult your latest investment implementation statement

Consider a third-party evaluator to undertake an independent "ESG health check" or cover as part of ongoing oversight. This can have the added benefit of comparing across the industry and where other schemes have taken similar reviews.

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