Responsible Investing Spectrum

Our guide to developing a responsible investment approach that suits you

Executive Summary

> It is important to define your responsible investment approach to set the foundation for ESG integration within your investment strategy.

This paper aims to provide UK investors with a range of potential approaches to develop a suitable Environmental, Social and Governance ("ESG") policy. We summarise the key considerations around assessing a variety of ESG risks and investment returns, as well as the governance requirements of each approach.

We present the potential approaches as a spectrum which can help you to identify where you are now, where you want to be and how you can get there.

The momentum behind responsible investing is growing

The growth of responsible investing ("RI") as investors incorporate ESG factors into investment portfolios is clear. Many asset managers and institutional investors have cited RI as their key theme for 2020. Organisations such as the UN PRI and the Task Force on Climate-related Financial Disclosures ("TCFD") (two well-known international organisations promoting RI) have grown in prominence, and their membership numbers have increased. The assets-under management of RI strategies continues to swell, reaching $30.7 trillion as at the end of 2018[1].

Regulators are raising ESG factors to the top of their agenda

In the UK, regulators are starting to demand more of asset owners to demonstrate how ESG factors are considered in constructing investment portfolios. Regulations require investors to state their policies on managing ESG risks as well as reporting progress against any stated ESG policy objectives. It is likely that there will be further climate change regulation introduced in the short-to-medium term.

What does the growing importance of ESG factors mean to you?

Policies on the management of ESG risks can no longer be considered a "nice to have" optional addition to an investment strategy. It has become an essential part of setting strategy as well as regulatory compliance. Before you can implement an ESG policy, you need to decide your approach and ESG beliefs.

How we can help

We can help you take your chosen RI approach and form it into an ESG policy that fits with your ESG beliefs and objectives. Once your ESG policy has been agreed, we can help you to integrate it into your investment strategy.

[1] Global Sustainable Investment Review 2018

The trends in the RI space and why you should adopt an ESG policy

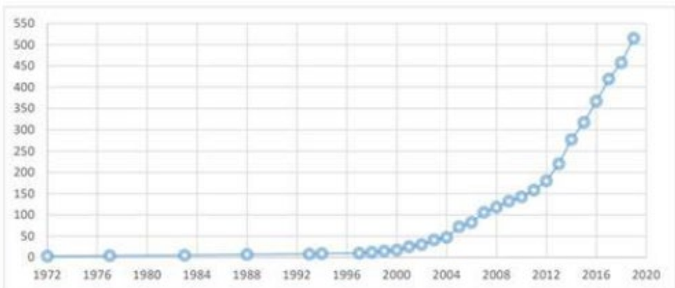
The growth of RI has been driven by a combination of factors:

- Growth in ESG related regulation;
- Investor attitudes changing; and,
- ESG centric strategies providing downside protection through volatile periods.

The dramatic world-wide rise in interest in RI marks it as an issue which investors can no longer ignore. We believe that investors who have a clearly defined ESG approach will reduce the risk to their investment portfolio from future market downturns and are better able to identify investment opportunities early. We think this can lead to sustained periods of outperformance for investors as a growing number of countries, other public bodies and companies pursue sustainable policies in their future plans.

Growth in ESG regulation

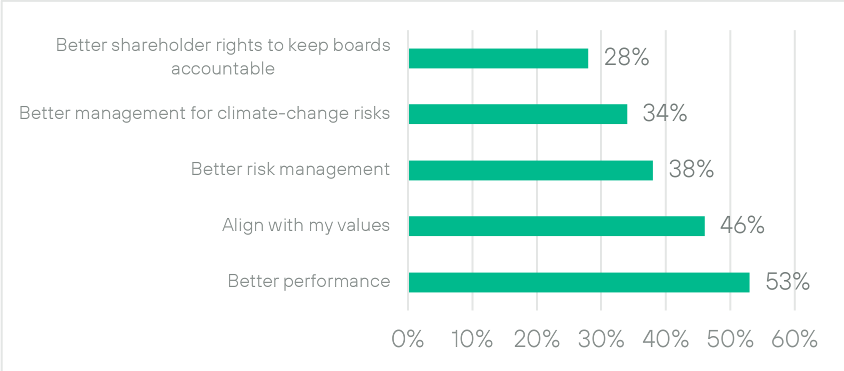
The below chart shows the growing number of policy interventions on ESG issues. Regulators have been responding to the requests from the scientific community for governments to provide a solution to global problems, such as climate change. The UN PRI describes an “inevitable policy response”, legislation on a global scale that will be enacted before 2050, which will likely have far reaching impacts on markets – there will inevitably be big winners and losers at the industry and company level.



Source: UN PRI

Investor attitudes changing

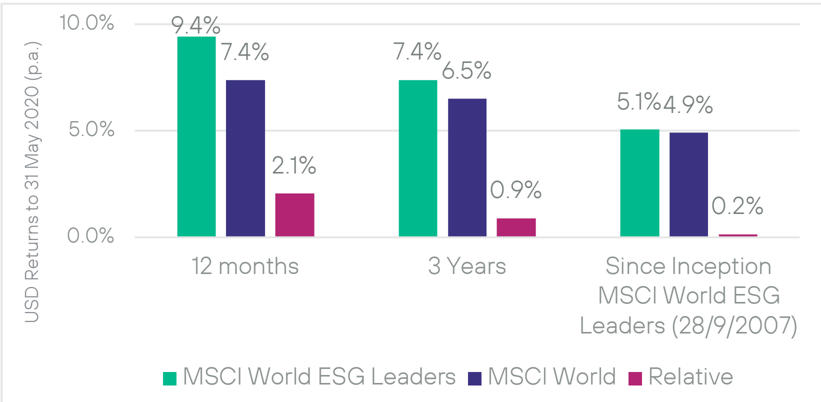
We are seeing a shift in the attitudes of investors, with a significant portion becoming increasingly engaged in RI. Most investors are aware of the trends in regulation, environmental and social issues as well as the benefits of a robust governance model in the companies in which they invest. This has led many investors to believe that ESG centric strategies will outperform non-ESG centric strategies over the long term. The chart below demonstrates that many investors are citing better risk/return charateristics as important reasons for incorporating ESG factors in their investment strategies.



Source: Nuveen, Fifth Annual Responsible Investing Survey 2019, 1007 Investors surveyed

ESG centric strategies providing downside protection through volatile periods

Specialist ESG centric strategies have experienced strong performance over the past decade, most notably through the recent COVID-19 crisis. There is an increasing amount of evidence to suggest that incorporating ESG factors in your investment strategy can enhance risk-adjusted returns.



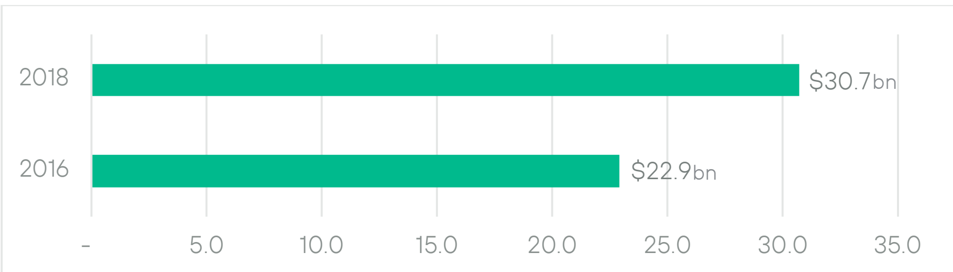
Source: MSCI

Note: MSCI ESG leaders indices select the highest ESG rated companies in each sector of the parent index

There is a fast pace of change in RI. It is important to set solid foundations and agree a robust RI approach to enable you to navigate this dynamic space in a way that will enhance your investment outcomes.

Impact of the above 3 trends: RI is increasing

The key trends highlighted above have contributed to the growth of RI. The Global Sustainable Investment Alliance (GSIA), in their biennial survey, found that the assets under management (AUM) of global RI strategies has grown in every region in both absolute and relative terms. We are expecting that their 2020 survey will show further AUM increases relative to 2018. It is very clear that RI is not just an investment fad and the heightened focus on ESG factors is here to stay.



Source: Global Sustainable Investment Alliance 2018, AUM of global RI strategies

Spectrum of RI approaches

Understanding the spectrum

This page presents the spectrum of RI approaches you can implement into your investment strategy. The chart below defines each RI approach and highlights the key objectives, the ESG and financial impacts, and governance requirements of each approach.

How to use the spectrum

This chart will help you to map where you currently sit on the RI Spectrum. If there are any objectives that are not being met by your current approach, it will highlight the governance requirements you need to implement to achieve your ideal approach.

	Traditional	**Fully Delegated "Light Touch" Approach**	**Values-based/ Exclusionary/ Ethical Investing**	**Sustainable Investing "Integrated Approach"**	**Impact Investing**	**Impact Only/ Philanthropic Investing**
	ESG factors not considered.	Reliance on investment managers' RI Policies.	Reflect core values of an investor. Avoids sectors that are controversial.	Manages ESG risks whilst seeking positive ESG outcomes.	Investing in companies, funds or infrastructure that provide solutions to social and environmental issues that look to deliver market rate financial returns.	Impact investing, but market returns are a lower priority.
ESG Impact						
Financial Impact	Focus on delivering long-term returns					Below market returns
Objectives		ESG risks managed				
				Pursues positive ESG outcomes		
					Seeks specific ESG targets	
Governance Requirements		Regular training to review ESG beliefs, set objectives and integrate ESG policy				
		Manager monitoring and engagement		ESG Reporting	ESG targets set and impact measured	
			Review of strategy and allocation to funds aligned with ESG policy			

Our view on the different RI approaches

Currently, we see that many investors follow a "Fully Delegated" approach. This places significant reliance on appointed investment managers' ESG policies, which may not be wholly aligned with your own objectives. We recommend taking a stronger RI approach such as "Sustainable" or "Impact" investing. Although there may be additional governance requirements in the short-term, we feel these will be offset by better investment outcomes for your investment portfolio.

Developing your ESG Policy

We can help you take your chosen RI approach and form it into an ESG policy that fits with your ESG beliefs and objectives. In developing your ESG policy, there are three key areas we look at - objective setting, implementation and monitoring.

Objective setting:

Starting with an ESG training session, we will highlight the key considerations in the ESG space. At the training session we will provide you with the tools you need to decide which RI approach on the spectrum you would like to target. Once you have decided on your approach, we incorporate your beliefs, as well as the beliefs of any key stakeholders, into an ESG policy to incorporate it into your strategy in a way that is bespoke to you.

Implementation

We conduct a review of how your investment managers manage and identify ESG risks and opportunities, and how they align with your ESG policy. We highlight any key issues or actions that we suggest may warrant further engagement with the investment manager.

At this stage, we will review your investment strategy to check the compatibility of your investments with your ESG policy. This could lead to a change to your investment portfolio, however where possible we look to remedy any issues identified through working collaboratively with your existing investment managers.

Engagement and ongoing monitoring

A key part of the ESG policy framework is engaging with investment managers and monitoring any changes to their ESG policies. We engage with all investment managers on the issues we have highlighted and we detail any changes to their ESG capabilities, as a result of this engagement, in a progress report.

We recommend ongoing monitoring of investment managers and that your ESG policy is reviewed at least annually. This is in line with recommendations from the DWP, who advise that investors regularly receive training, review their ESG policy and review their investment managers' approach to managing ESG risks on an ongoing basis.

Next Steps

Talk to your investment consultant who can work with you to develop an ESG policy. We can help you articulate your beliefs and integrate them into your portfolio, keep you up to date on ESG related investment trends and regulation, and bring you the latest ESG related opportunities.

For more information on how we work with our clients to develop and implement ESG policies as well as some news stories of ESG issues affecting pension schemes please see the appendix.

Appendix

Client case studies

Sustainable investment framework

Working collaboratively with stakeholders to design a bespoke ESG policy

We worked with a DB pension scheme of a large multinational corporation whose sponsor is regularly ranked amongst the world's greenest companies.

The scheme wanted to align its ESG policy with the ESG objectives of its sponsor and invest according to that policy.

Our role:

We ran a beliefs session with company representatives to understand the key priority areas. We then developed a bespoke beliefs statement and ESG policy.

We ensured that the sponsor was consulted at various stages in developing the scheme's ESG policy to enable them to feed in their beliefs and develop a policy that considered the key objectives of the sponsor. The ESG policy drives the scheme's investment strategy and the scheme has been actively engaging with the investment managers on key issues.

Having a robust ESG policy in place has had positive reputational impacts. The pension scheme has been recognised as a frontrunner in implementing a well-integrated and strong ESG policy. They have also had success in engaging with asset managers and have helped them to develop ESG policies in areas such as climate change reporting.

Values-based investment

Tobacco-free default design in DC Pensions

We have helped two major UK charities to ensure their DC pensions schemes have a tobacco-free default option.

Our role:

Working collaboratively with key stakeholders, we developed an understanding of the needs of the charities, the schemes and the employees and used these beliefs to create an ESG policy.

We reviewed the charities' investment strategy to find a solution that met their financial objectives, as well as the organisations' ethical beliefs.

We implemented the solution through one of the UK's largest asset managers. We worked with the asset manager to create a default investment strategy that met the clients' needs in a cost-effective manner.

"Our investment consultant assisted in our move to a tobacco-free default investment which we believe to be the first in the UK. This went very smoothly and generated very few issues and was well received by our people."

Mark Allen, Executive Director of HR, Cancer Research UK

ESG in the news

Headline: Landmark vegan case threatens to disrupt pensions industry, Financial Times

Story : In a case brought by Jordi Casamitjana, it was claimed that he was unfairly dismissed by the League Against Cruel Sports, an animal welfare charity, for raising concerns about the way the League's pension scheme was invested – including in companies that experimented on animals.

The employee's concern was that donors expect their donations to be invested in a way compatible with their beliefs.

The employment tribunal ruled that ethical veganism is a philosophical belief that is protected by law against discrimination.

Why it is important: This demonstrates the importance of balancing the ESG objectives of a pension scheme in line with the sponsor's ESG philosophy and objectives.

Some institutional investors may be at risk of reputational damage if they do not have an appropriate ESG policy in place that reflects the beliefs of all stakeholders.

Headline: £30bn pension fund: we'll sack asset managers that ignore climate crisis, The Guardian

Story: Brunel Pension Partnership, a £30bn pension fund which manages pension money for nine councils in south-west England, as well as for the Environment Agency, said it would review the mandates of asset managers that don't reduce exposure to climate risk by 2022.

The Bristol-based pension fund will demand that companies in which it invests take steps to align their emissions with targets agreed at the 2015 Paris climate summit.

Why it is important: This is an example of one of the largest pension funds in the UK investing according to their ESG objectives. They have used these beliefs to set objectives for their asset managers using concrete targets put in place by the widely recognised Paris Agreement.

It is likely to result in many more asset owners taking an active approach to managing their capital, and consequently asset managers and corporations will need to demonstrate they are taking action on climate change.

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