Newly Issued Guidance for UK Pension Schemes Emphasizes Need to Consider ESG Factors

Sustainable investing and the consideration of environmental, social, and governance (ESG) factors continue to gain prominence. The new 2017 investment guidance[1] for defined benefit (DB) schemes from The Pensions Regulator (TPR) in the United Kingdom has material new ESG content. This follows similar guidance for defined contribution (DC) schemes issued last year.[2] Cambridge Associates has prepared this short piece to summarise this guidance and its implications for pension scheme investment strategy, including how we might help.

PUTTING TPR'S GUIDANCE IN CONTEXT

The new guidance requires DB trustees to 'take environmental, social, and governance (ESG) factors into account if you believe they're financially significant'. A section titled 'Sustainability' also states:

> Most investments in pension schemes are long-term and are therefore exposed to long-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, and unsound corporate governance. Despite the long-term nature of investments, these risks could be financially significant, both over the short and longer term.
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> You should therefore decide how relevant these factors are to inform your investment strategy. You could ask your investment manager(s) and investment adviser for help with this.

The TPR guidance includes an example of scheme trustees setting investment strategy and concluding that climate risk is financially material to their investment strategy since it has the potential to significantly affect the value of investments. The example goes on to show how this belief is then reflected in the Statement of Investment Principles (SIP) in three ways: stating the expectation that managers will integrate climate risk into their risk analysis; affirming the trustees' intention to manage new and existing arrangements in a manner accounting for climate risk; and noting that climate change risk consideration will be incorporated as part of monitoring managers. TPR concludes this example with the strong statement that 'Many factors can impact investments over the long-term. Where you consider these to be financially material, you are required by law to factor them into your investment decision-making.'

Drawing on recent guidance from the Law Commission, the document also clarifies that while a financial return should be the main concern, trustees may consider non-financial factors where members share their view—for example, incorporation of ethical considerations in the investment policy—and when there is no risk of material financial detriment to the fund.

This new guidance clearly places the onus on trustees, and therefore the advisors and managers that serve them, to consider the materiality of ESG issues. While many pension schemes have already taken these issues into account in their strategies (see sidebar for an example), the increasing prominence of ESG as an issue and this new guidance in particular only serve to highlight the importance of doing so for all pension schemes.

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[1] For more, see The Pensions Regulator's *Investment Guidance for Defined Benefit Pension Schemes* (March 2017) at http://www.thepensionsregulator.gov.uk/docs/db-investment-guidance.pdf
[2] The Pensions Regulator's *Guide to Investment Governance, To Be Read Alongside our DC Code of Practice no. 13* (July 2016) can be found online at http://www.thepensionsregulator.gov.uk/docs/dc-investment-guide.pdf

AN EARLY ESG ADOPTER EXAMPLE

Some UK pension schemes are already globally recognised leaders in integrating ESG in their investment policy, with further notable developments in this space over the last year.

For example, in November 2016, HSBC's UK DC pension scheme selected a new climate-aware strategy as the default equity option, allocating £1.85 billion. Aiming for better risk-adjusted returns, this strategy tilts away from a standard capitalisation-weighted index, and instead combines a multi-factor smart beta approach with a 'climate tilt' by reducing exposure to companies with high emissions and fossil fuel reserves while increasing exposure to companies generating revenues from low carbon 'green' opportunities.

ESG INTEGRATION: SOME PRACTICAL SUGGESTIONS

While the approach must be unique to each pension scheme, a number of practical steps can be taken toward ESG integration.

ADOPTION OF UNPRI. Signing the United Nations Principles of Responsible Investment (UNPRI) can be an excellent starting point. Indeed, the points TPR makes in its guidance are encapsulated in the key commitment of signatories: 'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)'.[3]

This key commitment is in turn expressed through the six principles. All six principles encapsulate a framework for better incorporating ESG into investment policy, not least the first three:

> **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
> **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
> **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Going through a reporting cycle, receiving detailed feedback from UNPRI, and striving to improve can form the basis for the development and implementation of an effective ESG investment policy. This iterative process can be beneficial when embraced in a proactive way. Cambridge Associates can assist with UNPRI reporting and alignment.

DEVELOPMENT OF CLIMATE AND ESG POLICY. Establishing a clear policy relative to climate change is also an important step. Climate change presents both risks and opportunities for investors. As part of long-term investment decision-making, a Cambridge Associates report has suggested investors consider whether and how to stay ahead of the climate risk curve to preserve value in their portfolios, as well as whether and how to position themselves to capitalise on investment opportunities arising from technological advances, business model innovations, and policy evolution.[4]

The UN Sustainable Development Goals and the goals of the Paris 2015 Agreement are helpful frameworks for policy specific to climate change. We recently provided more colour on how both of these frameworks can be used in ESG policy development—both for climate change and more

[3] For more on the six United Nations Principles of Responsible Investment principles, please see https://www.unpri.org/about/the-six-principles
[4] Liqian Ma, 'Risks and Opportunities from the Changing Climate: Playbook for the Truly Long-Term Investor', Cambridge Associates Research Report, 2015.

broadly—in a short paper that aims to help investors engage on, and develop policies for, successful sustainable investing.[5] The paper shows how articulating purpose, priorities, and principles in a well-designed investment policy can help interested institutions effectively incorporate consideration of ESG factors.

RIGOROUS INVESTMENT SELECTION. The options for investors seeking to invest in ESG-aligned opportunities are growing. Our Mission-Related Investment (MRI) team tracks more than 1,000 mission-related funds across all asset classes. Just considering climate change, for example, investment options range from reducing risks through the use of low carbon or other ESG tilts in passive allocations; to investments in active public equity and debt managers that integrate ESG factors; to private equity, infrastructure, and venture managers actively investing in new technology solutions for the transition to a low carbon economy. Investors shouldn't sacrifice thorough due diligence to make ESG-aligned investments. We apply our same rigorous due diligence standards to evaluating investment opportunities that integrate ESG factors, and are committed to helping our clients build sophisticated portfolios that enable them to meet both their ESG and investment return objectives.

ESG-FOCUSED INVESTMENT EVALUATION. In our research we have examined the materiality of ESG data for investment performance for listed equities in both emerging markets and developed markets and considered how active managers integrate these factors in their strategies.[6] We suggest asset owners work with their advisors to have better visibility on the ESG attributes of both managers' investment strategies and their selected underlying holdings. This can also include analysis of specific measures such as portfolio carbon emissions and exposure to at-risk companies (e.g., fossil fuel producers), as well as broader analysis of the ESG attributes of strategies across asset classes. As a first step, investors should insist on discussion of ESG considerations as a standard part of all presentations on any investment strategy.

CONCLUSION

The focus of regulators on the importance of ESG consideration in the fiduciary duty of pension trustees, as demonstrated by the TPR guidance, will continue to grow. We feel this is appropriate and increasingly aligned with a sound economic basis given the materiality of ESG issues, such as climate change, on the investment landscape. Cambridge Associates will continue to work with clients to develop and implement policies for successful investing with an ESG lens.

[5] Please see 'Considerations for ESG Policy Development', Cambridge Associates White Paper, 2017.
[6] Chris Varco, 'The Value of ESG Data: Early Evidence for Emerging Markets Equities', Cambridge Associates Research Note, October 2016.