CACEIS AND LOCAL GOVERNMENT PENSION SCHEMES

Part 2

Assessing your asset managers' ESG approach

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This chapter of our ESG guide illustrates the wide range of approaches asset managers take to sustainable investing, along with some of their commonly used terminology. We have designed it to help you understand the landscape and facilitate stronger dialogue with your existing and potential providers.

A VARIED APPROACH

No two asset managers take the same approach to ESG and even between those that may appear similar, there are likely to be significant differences. This is because companies embraced – or in some cases are still embracing – the idea at different times and have to make it fit their existing investment thesis.

While many managers are still working to integrate the approach coherently across their fund ranges, some already apply ESG factors across an entire strategy menu. Others, too, have chosen to slice out dedicated or thematic funds, while operating plenty of others that do not submit to an ESG remit.

However, as sustainable investment approaches have evolved, we see one consistent thread emerging: the use of ESG as a risk management framework embedded into a strategy. Increasingly, asset managers are using "non-financial" factors as a lens to estimate how a portfolio company's profits may be impacted by them in the future.

But just as there is no set method for investing in equities, bonds or any other asset, there is no agreed way to implement ESG. Even proposals from global regulators and initiatives are open to interpretation, which is why committees and boards need to be equipped to question, test and even challenge asset managers on their theses.

"We will incorporate ESG issues into investment analysis and decision-making processes" –

UNPRI signatory pledge.

ACCREDITATIONS AND QUALIFICATIONS

Many asset managers are members of the Principles for Responsible Investment (PRI) and have signed up to the UK Stewardship Code. Both bodies provide a strong framework around areas of governance and sustainable investing, but leave the actual implementation of their guidelines to the specific asset manager.

NEGATIVE SCREENING

Some managers have been applying a so-called negative screen to their portfolios for decades. The approach excludes certain businesses, sectors or countries that do not meet pre-defined ESG criteria. Companies engaged in tobacco, weapons, gambling and palm oil production are just some of those often rejected using an exclusionary strategy, with others based in regions that are on government banned lists removed from an investor's universe. Additionally, companies with suspect governance and management practices can also be withdrawn from selection.

Passive approaches often take this form as well, with many indices available replicating popular stock markets but excluding specific industries.

But while this type of screening can effectively help a manager stick to its ESG policy, the approach has been criticised for narrowing the pool of available investment opportunities – and therefore potential for making returns.

Another criticism levied at the approach is its failure to attempt to improve companies through engagement. Essentially, without a seat at the table, investors who want companies to "do the right thing" hold little to no power to effect change.

POSITIVE SCREENING

If negative screening removes the companies that flout specific ESG rules from a pool of potential investments, positive screening does the opposite. It supports businesses that are solving environmental and social problems, and running companies in a progressive, sustainable way.

Asset managers use this process to select companies that outperform their peers on ESG criteria, show potential and drive for improvement on these issues, or are focused on solving specific ESG challenges.

By selecting companies that fall into these three categories, managers expect to limit the losses in their portfolio by avoiding those that are more susceptible to controversies or changes to regulation.

In addition, index providers and data companies have created benchmarks based on assessments of companies on ESG criteria, with indices weighted in favour of higher scoring stocks.

However, this process faces the same criticisms as negative screening, as only selecting from a small pool of companies can reduce the potential for returns – and can increase overall risk through a lack of diversification. It equally does not always allow investors to engage with companies that need to improve on ESG matters, essentially allowing the problems the strategy is designed to solve remain unsolved.

INTEGRATION

Over the past few years, an increasing number of asset managers have claimed to have fully integrated ESG into their entire investment process. This means ESG themes – and the myriad risks they highlight – has become a fundamental consideration in stock selection and asset allocation.

Managers use ESG factors to help highlight the opportunities some companies, sectors and regions may hold for long-term investors, but also where they may come unstuck.

Within this sector of managers claiming this approach, there is huge divergence. Data and research underpinning an ESG policy may be created in-house or bought from a third party, and interpretation of this information is particular to each asset manager's own regime.

Additionally, while many claim full integration, these managers sit on a wide spectrum based on not just their underlying ethos and ESG criteria, but how much materiality (see box out) they weight them with. Some may give individual portfolio and fund managers the autonomy to ignore or override the ESG policy if they see an asset or security that they think offers significant value, for example. Others may be more strict, or – in the case of passive or computer-driven strategies – be unable to easily act on the exception to a rule.

It is important for boards and committees to quiz managers on how they have integrated their ESG policy to ensure they align with your pension fund's stated aims, beliefs and objectives.

IMPACT INVESTING

A step further than an ESG-based portfolio, impact investment actively tries to make a difference. By investing in companies or organisations with the express purpose of creating a positive social or environmental impact, investors can change the world.

However, unlike philanthropy, impact investment also seeks to generate a financial return. Many asset managers use the United Nation's Sustainable Development Goals as targets, and seek out opportunities aligned with these goals, which include eradicating poverty, reducing inequality, and ensuring access to affordable clean energy.

As impact investing is still in its relative infancy, boards and committees need to ask asset managers how returns made by this approach will be measured. There are increasing numbers of providers that offer standardised methodology to monitor both impacts and financial gains, so make sure you understand what you should expect before committing capital.

ENGAGEMENT

Asset managers take a range of different approaches to try and effect change at their portfolio companies. Under the heading of "corporate governance" or "stewardship", managers use their might as shareholders or owners of debt to improve company performance – and thereby their return.

Equity managers typically turn out at annual general meetings where they have the ability to vote against directors' wishes. Debt and credit managers buying and selling in financial markets can help dictate the rate at which loans are issued, with companies failing on ESG criteria increasingly receiving higher rates. The biggest investors can sometimes influence the terms of debt when it is first issued, setting requirements such as what the money can or cannot be used for (see green bonds boxout).

Additionally, all managers meet with companies in closed-door meetings, hoping quiet persuasion and dialogue can help change some stubborn corporate minds.

DID YOU KNOW?

As an investor, boards and committees need to know their rights – and responsibilities – around voting and reporting on shares. While asset managers buy and hold the shares on your behalf, the pension fund remains the ultimate owner. This means how shares are voted at meetings is entirely down to you. This is true of both passive and active managers of segregated or pooled funds. However, your wishes need to be communicated to managers well in advance of a meeting, meaning you need to understand what you hold in your portfolios and how you would like to vote. Your manager may recommend you vote a certain way, but investors can also take third-party advice, which is available from a range of providers.

WHAT IS MATERIALITY?

A common buzzword in asset management, "materiality" is a term boards and committees need to understand as it plays a key role in risk management techniques.

Materiality refers to the strength of the effect, both positive and negative, that ESG factors can have on a company's financial performance. Gauging the size of this effect informs the asset manager about how important it is to their decision-making.

For example, increasing levies on fossil fuel will have a major impact on a traditional haulage company. But if an asset manager can see the company has addressed the issue and is planning to upgrade its fleet, the materiality of the impact is much lower and the ESG score is increased. Similarly, the levies would also have a massive impact on oil and gas producers, but the materiality of this risk can be estimated by looking at how these energy companies are planning for the future.

Therefore, materiality is considered as a risk that needs to be assessed, and if possible eliminated, or an asset manager will want to be compensated well for taking it on, through a lower purchase price or a strong dividend.

FOCUS ON CLIMATE CHANGE

While all elements of ESG have gained traction with asset managers, climate change is where most of the focus has been. This is due to societal focus on the pressing need to address the warming planet, but also the rapid – and in some cases severe – actions of regulators, too.

Asset managers around the globe have come under pressure to accurately calculate the carbon emissions of their portfolios – and this requirement will soon be applied to pension funds, too. Knowing the level of emissions from a fund or holding can also help investors better manage risk.

It is clear that the transition from fossil fuel to clean energy creation is happening at pace and companies failing to adapt face challenges. This means the companies producing these fuels, as well as those relying on them within their business models, will face increased investor pressure to change.

Through engagement or simply divesting, asset managers – and their clients – are working to get their voices heard. And as the government works towards its stated aim of reaching net-zero greenhouse gas emissions by 2050, major investors such as the LGPS will be expected to play their part.

DISCRETION IS THE BETTER PART OF ESG

In a sophisticated investment universe, there are many ways to allocate our capital. Some markets are more technologically advanced than others, for example. In addition, some governments are engaged with societal progression, while others struggle to keep up. Some sectors need 10 years to evolve their business models to a new way of working, with others taking just 10 days.

While asset managers often use the same ESG criteria for all these sectors, a certain amount of discretion needs to be applied, based on their in-depth knowledge and experience.

Ask your managers about how they evaluate and apply their ESG criteria over their full range of portfolios.

GREEN BONDS

This subset of the bond market has expanded rapidly in the past decade. Any bond labelled 'green' by its issuer must be linked directly to environmental projects in some way. Investing in these assets allows pension funds to target their allocation towards specific environmental themes while also being assured of an income through the bonds' regular coupon payments.

As with impact investing, the green bond sector is small and still evolving, so pension fund leaders must be sure of the credentials of their managers and the objective of their investment before allocating money.

YOUR GOVERNANCE PARTNER

At CACEIS, we are proud of our strong expertise in UK pensions governance and our innovative solutions to support this market to improve overall governance. We support and offer LGPS cost transparency, ESG, other governance reporting solutions and custody, and aim to help the LGPS to navigate an increasingly challenging environment.

As part of our education partnership with the PLSA, which focuses on data governance, we host workshops and speak at conferences and seminars to share our insight, especially on areas around cost transparency and ESG.

To learn more about our ESG and Climate Change reporting solutions, please call James Paris, at CACEIS UK, on 0207 153 3665 or email james.parish@caceis.com

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