CACEIS AND LOCAL GOVERNMENT PENSION SCHEMES

An introduction to responsible investment

caceis
INVESTOR SERVICES

AN INTRODUCTION TO RESPONSIBLE INVESTMENT

Local Government Pension Schemes are taking a leading and proactive role towards responsible investment, but as the landscape is constantly evolving, these approaches need to be flexible to remain relevant.

In this area of growing social and regulatory importance, we are already seeing how schemes need to move quickly just to stay up to date.

For example, schemes are already supporting the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD), alongside becoming signatories to bodies such as the United Nations-sponsored Principles for Responsible Investment (PRI) and the UK Stewardship Code.

While nothing is ever certain, it is likely there is more of this to come. The Pensions Regulator (TPR) and the Department for Work and Pensions (DWP) are raising the bar for reporting standards for pensions schemes of all types as part of the UK government's wider aim of becoming carbon neutral by 2050.

This is why we have created our guide to responsible investment. It is intended to be a resource for councillors, officers and other LGPS leaders. Within its pages, we explore several key areas, including different concepts around environmental, social and governance (ESG) measures and the different ways in which asset managers integrate them into their investment decision making.

HOW DO YOU DEFINE ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS?

E, S and G are three very different measures for investors to consider but have been grouped together for convenience. It is therefore worth exploring what each one means in order to understand how managers incorporate them into their processes.

ENVIRONMENTAL

Managers consider a wide range of topics and factors within the environmental theme to ascertain a company's relationship with the world around it. This can include greenhouse gas emissions from processes and products, how cleanly they extract raw materials such as oil, and what plans they have to reduce any negative environmental impact.

As well as ensuring regulatory compliance, this research can also identify risks to business models from the impacts of a changing climate such as extreme weather. Taking a long term view of these risks is a helpful indicator of a company's – or a manager's – attitude towards sustainability.

SOCIAL

The social aspect of ESG is about identifying the companies trying to make a positive difference to people's lives and marking down those that build a businesses on exploitation. This element does not just focus on the treatment of employees, but how a company works with its suppliers, customers and wider community.

GOVERNANCE

Governance covers all aspects of how a company is run – making sure all the relevant checks and balances are in place. However, ESG analysis into a company's corporate-governance practices goes a step further than just ensuring the company is worth holding. It examines executive pay, regulatory adherence, and bribery and corruption countermeasures among other issues. Red flags in these areas can provide early warnings to help avoid failing or high-risk companies.

HOW VARIOUS NON-FINANCIAL ISSUES FIT INTO THE THREE TRANCHES OF ESG

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Greenhouse gas emissions	Human rights	Board independence
Energy efficiency	Labour conditions	Executive pay
Climate change	Community impact	Data privacy
Pollution	Health & safety of products	Bribery & corruption

TAKING OWNERSHIP OF RESPONSIBLE INVESTMENT

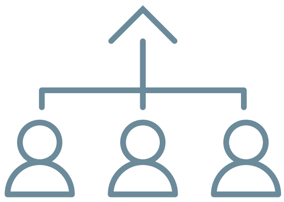
While there is a growing view that all pension schemes need to invest sustainably to serve their members over the long-term, this must also be balanced by how fiduciary duty interacts with ESG and climate change policies.

WHAT'S DRIVING THE ESG REVOLUTION?

There is no single factor driving the recent surge in interest and uptake of ESG within investment, but it is useful for committees and boards to understand why it has gained such momentum and realise that it is no longer a niche concern.

While each of the elements are backed by a different ethos, they adhere to a common theme of trying to ensure investments are viable – and profitable – for the long term.

There are also additional pressures from national and international regulators, who are keen to funnel investor capital into businesses that should strengthen the global economy, and broader society, which has firmly bought into the theory of "doing the right thing".



MEMBER DEMAND

From calling out corporate foul play to melting ice caps, the public consciousness has shifted in recent years to appreciate some of the failings being wrought by businesses around the world. As share or debtholders in many of the perpetrators, investors have found themselves increasingly facing backlash for "allowing" it to happen. Even a small indirect exposure can be highlighted by the media or campaign groups, generating negative sentiment. Implementing ESG factors should help identify the worst offenders, and in turn reduce damage to returns and reputation.

Organisations such as Extinction Rebellion and Friends of the Earth have lobbied individual schemes to address their exposures to fossil fuels, and members are increasingly engaging with these efforts.

For LGPS, the pressure to consider these factors may be more acute than for other pension boards. Being part of the public sector, which has been a first mover on many initiatives that would fall under the ESG banner – recycling projects, living wage, transparent tendering – it follows that investments made by its retirement schemes would also lead the way.

REGULATORY CHANGE

Many major regional and industrial regulators have begun to demand higher standards from the companies they police, meaning those falling behind are likely to underperform their peers over the long term in investment portfolios. This is a key point for investors to consider when quizzing their asset managers around their ESG research and engagement policies.

For pension schemes, the DWP is pushing for amendments to investment regulations to mention climate change as an environmental consideration that could be financially material to investors. The next step, according to ministers, is to compel all pensions to complete disclosures on the carbon footprint of their entire portfolio.

More generally, financial regulators are increasing their pressure on investors and their third-party providers to clearly illustrate their sustainability data and operate in a responsible way. Initiatives including the European Union's push on sustainable finance should see asset managers increase the transparency of their own holdings, activities and products, meaning investors should more easily be able to show their own.

Local Government Pension Scheme administering authorities are required to publish their policy on ESG considerations as part of their Investment Strategy Statements.

FINDING THE SHAREHOLDER VOICE

Since the financial crisis in 2008, good governance – a company's culture and conduct – has become a key aspect of shareholder concern as it ultimately impacts investment returns.

Asset managers have become increasingly active in attending and voting at shareholder meetings and conducting closed-door engagement to press on corporate governance issues.

Pension schemes, too, have stepped up and demanded their voices be heard through groups such as the Local Authority Pension Fund Forum, expecting asset managers to fulfil their engagement duties on their behalf.

The DWP is currently consulting on guidance for all pension schemes to align their reporting with the TCFD's recommendations, and the government has made several statements indicating its intention to raise the bar for schemes of all kinds.

Furthermore, the new Stewardship Code, which came into effect in early 2020, also places additional requirements on signatories to take ESG factors – including climate change – into account. For pension schemes that have signed up, this means ensuring that investment decisions are aligned with the needs of their members.

HOW ASSET MANAGERS INTEGRATE ESG

For LGPS board members getting to grips with ESG, a good starting point is to understand of how asset managers integrate it within their investment approaches.

Over the last couple of years, there has been a major shift by asset managers to step up their focus on ESG. At the very minimum, many have signed up to the UK Stewardship Code and the PRI.

But many now claim ESG has become an integral part of their investment process, acting as a vital tool for determining the prospects of every security across equities, fixed income and alternatives. In fact, ESG can give asset managers an idea of a company's prospects in a rapidly changing world and how it might adapt or confront risks to its business model. This allows the manager to make informed decisions and even engage with businesses on outstanding ESG issues.

It is important for pension schemes to realise that the degree to which asset managers integrate ESG into their investment processes varies widely, and some investigation is required in to claims they make about application of these factors. But by understanding these nuances, pension schemes will be better equipped to navigate the dialogue they have with their providers.

ASSET MANAGERS ON CLIMATE CHANGE

At an asset allocation level, there are a range of considerations that can become a challenge for pension schemes. Rather than issue a blanket policy, pension funds may need to consider the impacts of climate change across different regions, along with how the risks in transitioning to a low carbon footprint may impact their wide range of portfolio companies. Importantly, as our understanding of climate change progresses and national and international policies adapt, pension schemes may need to make changes to their approach quickly, which means flexible thinking is key. Before creating climate change policies that will shape scheme decision making, boards need to gather information that enables them to ask the right questions of their various providers. Organisations such as the PRI, the TCFD, or the Transition Pathway Initiative (TPI) - a global, asset-owner led initiative that assesses companies' preparedness for the transition to a low carbon economy - can provide schemes with guidance on what information they need from asset managers.

WHAT ARE THE BENEFITS OF A ROBUST ESG POLICY?

- Potential to deliver better returns for members by investing in companies with sustainable, long-term growth prospects.
- Mitigate some pension scheme risk by identifying and avoiding companies struggling to keep up with ESG factors, potentially affecting their future performance.
- ESG research can help spot the companies reducing their costs through lower energy consumption and reduced water intake.
- Many companies that score well on ESG criteria earn more government subsidies.
- Greater access to companies that look after their employees – enhancing productivity and attracting more talent.

TURN THE TABLES!

While investigating how an asset manager approaches ESG in its investment portfolio, it might be interesting to turn their own questions on them.
Ask about their own policies and how effectively they practice sustainable thinking across their own organisation. For example, do they track their own carbon footprint? Do they have a diverse workforce or hiring policy? What is their internal remuneration policy? Answers to these questions will undoubtedly impact the way they assess ESG issues in other companies.

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.

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

caceis
INVESTOR SERVICES

WWW.CACEIS.COM