

Corporate pension funds in the UK

Bringing environmental, social and governance (ESG) factors into the equation

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01 Introduction

With the significant and continual drops in interest rates since 2008, corporate pension funds in the UK are being challenged to deliver the returns demanded by their members, in the short- and long-term. One method which is heavily underused by these funds is "socially responsible investment." This method allocates funds according to financial factors, but unlike traditional investing, does so through a lens of environmental, social and governance impacts of companies and portfolios.

This method has three tangible and demonstrable benefits: **performance parity, end user engagement and moral consistency**. The most regularly disputed of these is performance parity, which is proven by Morgan Stanley, whose research of over 10,000 funds and managed accounts, shows that "investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments." One example they cite shows a 45 basis point difference of like-for-like indexes over a 25-year period, demonstrating a long-term proof of performance parity, which is very relevant for the long-term nature of pension fund investments.¹

Although many of the issues raised in this paper apply to all pension funds (public and private), the focus is on corporate pension funds for the following reasons:

1. They have generally been under less scrutiny and pressure compared to public funds, meaning there is a greater scope for impact.
2. Many of their parent companies have extensive sustainable or responsible objectives, to which their pension funds can be aligned, allowing for improved employee and customer engagement.

3. All new (and many existing) corporate funds are direct contribution (DC), automatically placing members in the generally unsustainable default funds. Members have, but rarely exercise, the choice to choose other, more sustainable funds that consider ESG factors alongside financial performance.



¹Morgan Stanley, 2015. Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies, Morgan Stanley Institute for Sustainable Investing.

02 What is socially responsible investment (SRI)?

Defining sustainability

The most widely-accepted definition of sustainable development was proposed by the UN-established Brundtland Commission in 1987: "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

Some consider that "doing less harm" is inadequate for current or future generations and instead believe the goal for businesses is to be "net positive." Forum of the Future, in collaboration with WWF and The Climate Group, established 12 principles of a net positive approach, defining it as an approach that "aims to have a positive impact which reaches far beyond traditional business boundaries," considering the whole value chain, the natural world and society.

Defining SRI

After many years of development, from the origins of negative screening of specific investments such as tobacco and firearms by church-based investors,² and more recently in certain elements of Islamic finance,³ SRI has become an "umbrella concept"⁴ encompassing a vast range of ethically, socially or environmentally focused investment strategies.

With over 1,500 signatories collectively holding US\$60t assets under management, the UN Principles for Responsible Investment (UN PRI) is the global standard for SRI guidelines. The UN PRI is a voluntary code of six principles, encouraging organizations to actively consider ESG issues in investment decision-making processes:

- ▶ **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.
- ▶ **Principle 4:** We will promote acceptance and implementation of the principles within the investment industry.
- ▶ **Principle 5:** We will work together to enhance our effectiveness in implementing the principles.
- ▶ **Principle 6:** We will each report on our activities and progress towards implementing the principles.

JANA Investment Advisers⁵ provide examples of E, S and G respectively:

- ▶ **Environment:** climate change, energy efficiency, water and waste
- ▶ **Social:** human capital, workplace health and safety, community and stakeholder relations
- ▶ **Governance:** business ethics, transparency of company management and reporting, executive remuneration and board structure

By aggregating SRI statements found on websites of 101 UN PRI signatories, Sandberg et al⁶ proposed the following simple definition summarizing SRI – "the integration of ESG criteria into mainstream investment decision-making and ownership practices."

The market for SRI already exists, with sustainable investments reaching US\$21.4t in 2014, over 30% of professionally-managed assets.⁷

²Schueth, S., 2003, Socially Responsible Investing in the United States, *Journal of Business Ethics* 43(3)

³Wilson, R., 1997. Islamic Finance and Ethical Investment, *International Journal of Social Economics* 24(11)

⁴Sethi, S. P., 2005. Investing in Socially Responsible Companies is a must for Public Pension Funds: Because there is no Better Alternative, *Journal of Business Ethics* 56(2)

⁵JANA Investment Advisers, 2012. *ESG Integration: A survey of global equity managers*

⁶Sandberg, J. et al, 2009. The Heterogeneity of Socially Responsible Investment, *Journal of Business Ethics* 87(4)

⁷GSIA, 2014. *Global Sustainable Investment Review* (online), available at: http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf

The case for SRI

There are three key ideas underlying the case for SRI:

1. Performance parity
2. End customer engagement
3. Moral consistency

Performance parity

Some suggest there is a performance penalty attached to socially responsible investing (SRI) and argue that a screened portfolio of assets will deliver lower returns because certain aspects of the market are inaccessible.⁸ Analysis of leading SRI indices has found no statistical difference in SRI returns compared to broad market benchmarks.⁹ Further to this, “research showing that investment strategies which consider ESG factors lead to better performance over the long-term is finally making headway with mainstream investors.”¹⁰

A recent study by Morgan Stanley, which evaluated over 10,000 funds and managed accounts, shows that “Investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments. This is on both an absolute and a risk-adjusted basis, across asset classes and over time.”¹¹ This study illustrates the outperformance of the MSCI KLD 400 (an index containing firms which meet a very high ESG standard), which achieved an annualized return of 10.14% since 1990. During this same span, the S&P 500 achieved an annualized return of 9.69%, a difference of 45 basis points.

The impact of not considering ESG factors within investment decisions was quantified by the UN PRI and United Nations Environment Programme Finance Initiative (UNEP FI) in 2009, finding that approximately US\$2.15t of environmental damage had been caused by the 3,000 largest global companies

in 2008.¹² The economic implications of environmental issues and social challenges are gaining more widespread recognition.¹³

End customer engagement

Consumers of investment products are becoming more concerned with not only the performance of their investments, but also the companies included in their portfolios. EY’s report *Tomorrow’s investment rules 2.0* demonstrates a number of examples whereby investors are becoming more concerned with ESG or nonfinancial performance. According to the survey, 62% of respondents consider stranded asset (and more broadly climate change) risk when considering an investment. Also, 82% of the survey respondents (72% of which are from institutional investors with more than US\$10b under management) believe that good corporate citizenship and company policy on business ethics are important or essential to them as investors. In addition, according to Morgan Stanley, 84% of global millennial investors (due to receive over US\$30t of inheritable wealth) are interested in sustainability investing.¹¹

Moral consistency

In addition to the purely commercial arguments above, there is a debate about the moral inconsistency of helping a new generation of savers save for their retirement in 50+ years’ time when those investments are not trying to protect the world in which they will spend those savings, let alone trying to make it a better place. This is a less tangible argument but adds further weight to the likelihood of the millennial generation being keen for their investments to have ESG considerations.

⁸Geddes, P., 2011. Measuring the Risk Impact of Social Screening

⁹Liao, L. and Campagna, J., 2014. Socially Responsible Investing: Delivering Competitive Performance

¹⁰Morgan Stanley, 2015. *ESG & Corporate Financial Performance: Mapping the global landscape*

¹¹Morgan Stanley, 2015. Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies, Morgan Stanley Institute for Sustainable Investing

¹²UNEP FI, 2009. Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment, Geneva

¹³Giles, C., 2014. IMF warns on threat of income inequality (online), available at: www.ft.com/cms/s/0/b3462520-805b-11e3-853f-00144feab7de.html#axzz2raiTUxtr

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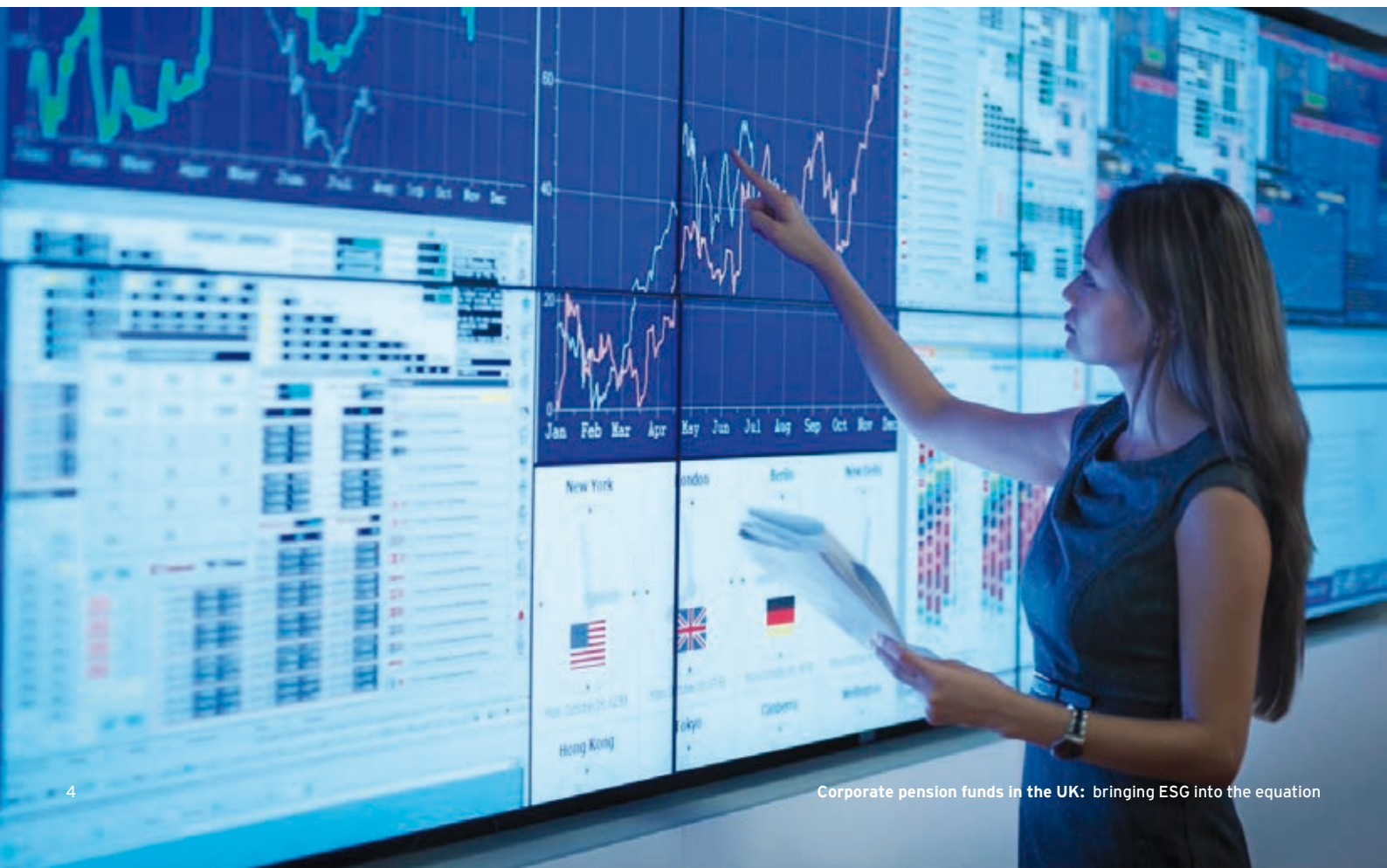
How does this apply to UK corporate pension funds?

According to the March 2016 Pension Protection Fund (PPF) update, "the aggregate deficit of the 5,945 schemes in the PPF 7800 Index is £302.1b." Corporate pension funds are always challenged to deliver long-term returns for their members, but this has been made even more difficult with the long-term dramatic drop in interest rates post-2008. These issues are also relevant for public pensions, but due to the lower maturity in terms of ESG integration and minimal scrutiny in comparison, this paper is focused on corporate funds.

The challenge is twofold for corporate pension funds with regards to their long-term viability. The first is internal governance, ensuring that they have systems in place which manage the vision of the fund. The second is to find innovative ways to plan for the long term, increasing the understanding of the risks inherent in their investment decisions. One of these innovative approaches to de-risking investments is

liability driven investment (LDI), involving complex derivatives. Although the complexity of LDIs could render additional SRI analysis more cumbersome and complicated, examples such as Legal and General's long-term debt investment of £400m in DP World's London Gateway Port, is supporting local infrastructure, a positive for society.

Corporate pension funds should be fully aware of these sustainability issues. Many of their parent companies are extremely involved with sustainability. There seems to have emerged a misalignment of values and strategies between parent companies and their corporate pension funds regarding sustainability. Notable examples where this is not the case are Unilever's Pension Fund Uninvest and the BT Pension Scheme. Both of these schemes have a clear sustainability alignment to the strategies and policies of their parent companies.



Business point of view

By incorporating ESG into investment decisions, corporate pension funds can bring about positive change for sustainable development, alongside material internal implications, through four key benefits:

1. **Long-term returns:**¹⁴ stable, long-term financial returns from responsible investments is a benefit to the business as it secures the pension fund pot and provides further assurance to employees that their pensions are safe.
2. **Employee engagement:**¹⁵ employees of the company through whom the pension is provided will gain increased security with the integration of longer-term risks and feel connected to a firm that is conscious about the impact it has on society.
3. **Demonstrating industry leading practice:**¹⁶ by understanding where the pension fund benchmarks against industry standards, the pension fund can leverage its position against the best practice framework and thus differentiate itself from the competition.
4. **Having a purpose:**¹⁷ many organizations have a specific purpose which goes beyond their core business strategy. It involves supporting local communities, contributing to society or enhancing lives outside of their direct impacts. Through aligning their pension fund strategy and policies to their overall purpose, companies can demonstrate a desire to achieve best practice for a sustainable pension, thus contributing to wider society and the environment.

¹⁴Investment Leaders Group, University of Cambridge Institute for Sustainability Leadership, 2014. The Value of Responsible Investment

¹⁵Bhattacharya, C., Sen, S. and Korschun, D., 2008. Using Corporate Social Responsibility to Win the War for Talent, MIT Sloan Management Review

¹⁶Day, G. and Wensley, R., 1988. Assessing Advantage: A Framework for Diagnosing Competitive Superiority, Journal of Marketing 52(2)

¹⁷Urminky, M., Self-regulation in the workplace: Codes of conduct, social labeling and socially responsible investment, MCC Working Paper No. 1, International Labour Office, Geneva

04 What does a sustainable pension fund look like?

Before creating the model for a sustainable pension fund, it is first necessary to understand general pension fund structures.

Pension fund governance is an essential process to help structure investment practices¹⁸ and can be defined as “the oversight, accountability, transparency, and decision-making norms underpinning the operations and investments of a pension plan.”¹⁹

In the UK, pension fund governance is based upon the law of trust,²⁰ providing a frame for pension fund trustees within which duties to the beneficiaries are established. Fiduciary duty is an essential component of a pension fund trustee’s role and responsibility, with two of its components – loyalty and prudence – closely aligning to SRI.²¹ According to the Law Commission, fiduciary duty must also take into account the wishes

of pension fund members, which can be obtained via comprehensive engagement: “Non-financial concerns (may) be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund.”²²

The sustainable pension fund model draws from:

- ▶ Clark and Urwin’s 2008 governance study of UK and US pension funds.²³
- ▶ The UN PRI six principles.
- ▶ Woods and Urwin’s proposal for sustainable Anglo-American pension funds (2008).
- ▶ Research by the Dutch Association of Investors for Sustainable Development (VBDO).

¹⁸Merton, R. and Bodie, Z., 2005. The Design of Financial Systems: Towards a Synthesis of Function and Structure, *Journal of Investment Management* 3(1)

¹⁹Monk, A., 2009. The Geography of Pension Liabilities and Fund Governance in the United States, *Environment and Planning* 41(4)

²⁰Richardson, B. J., 2007. Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?, *Banking & Finance Law Review* 22(2)

²¹Woods, C. and Urwin, R., 2010. Putting Sustainable Investment into Practice: A Governance Framework for Pension Funds, *Journal of Business Ethics* 92(1)

²²Department for Work and Pensions, 2015. Consultation on changes to the Investment Regulations following the Law Commission’s report “Fiduciary Duties of Investment Intermediaries”, public consultation

²³Clark, G. L. and Urwin, R., 2008. Best-Practice Pension Fund Governance, *Journal of Asset Management* 9(1)

Table 1: The model – what does a sustainable pension fund look like?

Model factor	Best practice
ESG integration	<ul style="list-style-type: none"> ▶ ESG issues integrated into investment decision-making process and analysis (UN PRI) ▶ Managers given guidance, instruction and respective accountability with respect to ESG integration (VBDO)
Mission clarity	<ul style="list-style-type: none"> ▶ Clarity of the mission and the commitment of stakeholders to the mission (Clark and Urwin) ▶ ESG will be incorporated into ownership policies and practices (UN PRI) ▶ Promote intergenerational equity within the fund by focusing resources and planning for the longer term (Woods and Urwin)
Strong investment beliefs	<ul style="list-style-type: none"> ▶ Strong investment philosophy and beliefs commanding fund-wide support that aligns with operational goals and informs all investment decision-making (Clark and Urwin) ▶ Engagement with investee companies can enhance the financial performance of an investment (Woods and Urwin) ▶ Oversight of fund managers' ESG integration in investment analysis and decision-making (VBDO) ▶ Disclosure requested for investees' ESG position (UN PRI)
Effective focusing of time	<ul style="list-style-type: none"> ▶ Resourcing each element in the investment process with an appropriate budget considering impact and required capabilities (Clark and Urwin) ▶ Trustees to map out resources required to implement a sustainable investing strategy (Woods and Urwin) ▶ Collaboration to ensure ESG is effectively implemented in a timely manner (UN PRI)
Leadership	<ul style="list-style-type: none"> ▶ Leadership, evident at board, investment committee and executive level, with a key role being the investment committee Chairman (Clark and Urwin) ▶ Trustees should provide strong leadership to mediate varying opinions about the value of a sustainable investment strategy (Woods and Urwin) ▶ The fund in question should support other funds in implementing ESG, helping the industry as a whole (UN PRI)
Risk budget framework	<ul style="list-style-type: none"> ▶ Frames the investment process according to a risk budget which is aligned to goals and incorporates formal risk indicators, e.g., alpha and beta (Clark and Urwin) ▶ Trustees should place quantifiable, measurable and realistic ESG risk parameters (Woods and Urwin) ▶ ESG risk policies fully align with the wider risk framework (VBDO)
Fit-for-purpose investment manager line-up	<ul style="list-style-type: none"> ▶ The effective use of external managers, governed by clear mandates, aligned to goals, selected with rigorous application of fit for purpose criteria (Clark and Urwin) ▶ Trustees should ensure that fund managers have appropriate capability for implementing a sustainable investing strategy (Woods and Urwin) ▶ Fund managers should report on activities and progress specifically with regards to ESG (UN PRI)

05 How does a fund become sustainable?

There are four methods that pension funds can consider:

1. Shifting the “default fund”
2. ESG and SRI education and training
3. Pension fund member engagement
4. Full compliance with Clark and Urwin’s six core factors

Shifting the default fund

As mentioned previously, the default fund is that which members (i.e., employees of the parent company) are automatically placed into when they auto-enrol into their organization’s pension scheme. Although many workplace pension funds do have ethical or sustainable fund options for members to choose from, the National Association of Pension Funds (NAPF) found that 84% of auto-enrolment members remain in the default fund.²⁴ Any fund striving for a best-practice sustainable DC scheme could therefore shift the default fund to a more sustainable portfolio, as this would have the desired effect of moving circa 84% of members to ethical or sustainable investments. Alternatively, they could highlight the ethical or sustainable nature of the default fund, encouraging people to consider their non-default fund options, particularly ethical or sustainable funds.

ESG and SRI education and training

A major component of a sustainable pension fund is the understanding, consideration and implementation of ESG, demonstrated by its prominence in The Model shown earlier in this document. For many funds, ESG is little more than a basic regulatory compliance statement on the Statement of Investment Principles (SIP), without any impact on the investment decision-making process.

The education and training of individuals (such as pension fund trustees) and organizations with investment responsibilities (such as the fund managers responsible for choosing the portfolio of investments) can have a substantial impact on the wider sustainability challenge, unlocking ESG considerations and SRI implementation.

This education and training on both sides of the process will have a wide-reaching impact on the overall investment decisions of the fund, which will satisfy many of the criteria laid out in The Model. In addition to educating and training the fund trustees and fund managers, information can be shared with the fund members who may also require educating to further understand the issues surrounding ESG.

²⁴National Association of Pension Funds, 2013. Annual Survey (online), available at: <http://www.napf.co.uk/PressCentre/NAPFbuzz/0494-National-Association-of-Pension-Funds-Annual-Survey-2013-key-findings.aspx>

Pension fund member engagement

Engagement is an important tool used by many organizations in a variety of industries. Pension funds can benefit immensely by fully understanding the people for whom they are acting. By engaging with fund members they can gain a deeper understanding of what members are looking for in terms of pension fund investments, governance, structure and portfolios.

In addition to this, there are broader benefits to be gained. When funds put member engagement at the forefront of their processes, those that incorporate ESG and see long-term return benefits are held up as examples of best practice, with competitors soon having to follow suit.

For pension funds to engage comprehensively with members, there are a wide array of options, providing a mixture of quantitative and qualitative data. One example is a survey to all members, which would provide the widest pool of data possible. For more qualitative responses, the engagement could take the form of targeted interviews with members. Members could also undergo the same ESG training as the trustee board to ensure they are adequately informed about ESG and in a position to provide the richest feedback.

Full compliance with Clark and Urwin's six core factors

The Clark and Urwin governance framework, used to form part of the analysis in creating The Model, is in itself a basis for adherence to The Model. This governance framework was created based on a robust piece of research involving multiple public and private funds across the US and UK.

Therefore, alongside considering ESG and responsible investment and engaging with fund members, pension funds should also ensure that their overall governance measures up to general best practice. In order to gauge their position against the Clark and Urwin governance framework, corporate pension funds could conduct a benchmark analysis of their fund against the six factors. The results of this benchmark analysis would provide insight as to where the pension fund is performing against the industry standard, helping to then focus attention on those factors which were not deemed as high performers.

High performance in all six of the Clark and Urwin governance framework factors would put corporate pension funds in an extremely good position to pursue high performance in The Model, with ESG as the key additional factor to becoming an industry-leading sustainable corporate pension fund.

06 Conclusion

As demonstrated throughout this paper, SRI, in the form of ESG integration, is fast-becoming a must-have for all investment organizations, including corporate pension funds. For reasons including long-term financial performance (through both investment returns and competitive benefits), enhanced risk management, increased employee engagement and improved moral consistency, corporate pension funds would be falling short of their fiduciary duty to not be investigating, understanding and incorporating ESG factors into their decision making processes. Pension funds are what people will rely on when they retire, and knowing that their money could be safer through sustainable investments, whilst having a positive impact on wider society and the environment is something that would appeal to a large number of corporate pension fund members, particularly millennials and those entering the workforce today.

This paper has explored the business case supporting sustainability in the context of corporate pension funds, whilst providing guidance as to what a sustainable pension fund could look like, in the form of The Model. Finally, it has demonstrated how pension funds can approach their journey to becoming sustainable, in adherence to the criteria in The Model, by following the four steps indicated in the previous section. All four of these steps have elements of “quick wins” about them, ranging from the creation and usage of communication tools with fund members (to educate about ESG, the position of the default fund and the commercial benefits of SRI) to a relatively simple benchmarking exercise against the Clark and Urwin six core factors of good pension fund governance.

For many corporates who have publically communicated objectives and targets around sustainability, their pension funds have been forgotten when considering these values. The first step is for companies to look at themselves and decide whether they want their pension fund, which represents how former and past employees, managers and directors invest their money to reflect who they are as an organization as well as individuals. The Model,

alongside the four steps towards being a sustainable fund require careful and considered analysis, in alignment with the values of corporate pension fund parent companies, trustees and members alike.

Being “sustainable” commercially is the ultimate objective of all corporate pension funds, but having sustainability at the forefront of strategy, values and investments will help to secure long-term commercial and moral success.



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