ENVIRONMENTAL, SOCIAL & GOVERNANCE INVESTING 2015

The fourth annual report exploring the progressing fiduciary duty, the practical application of ESG to non-traditional asset classes and the question of divestment.

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FIDUCIARY DUTY REVISED

1.1 WHITE PAPER
“Is it always about the money?” - Pension trustees’ duties when setting an investment strategy

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How will trustees’ fiduciary duties change and to what extent can we expect the issue of divestment to rise up the agenda?

1.3 WHITE PAPER
Protecting the best interests of pension savers: re-examining pension trustees’ obligations in light of the Law Commission’s clarification on fiduciary duty
In 2012, Professor Kay reviewed UK Equities Markets. He raised concern that some pension fund trustees misunderstood the law of fiduciary duties, thinking that it required them to maximise short-term financial returns at the expense of environmental and social factors. One of Professor Kay’s recommendations was that the Law Commission should review the legal concept of “fiduciary duty” to address these misunderstandings.

The Law Commission published a consultation paper in October 2013 and a final report in July 2014. We also summarised our main conclusions in six pages of guidance, available on our website. We hoped that professional organisations would circulate the guidance to their members, to make it widely available.

COMPLEX LAW

Financial markets are governed by a great deal of law. Trustees derive their duties from several different sources, including the trust deed, pensions legislation, and “judge-made” legal doctrines. Each legal regime is complicated in itself – and the interaction between the regimes is even more so. Fiduciary duties cannot be understood in isolation. Instead they are better understood as “legal polyfilla”, moulding themselves around other legal structures and plugging some gaps. Despite all this complexity, however, we thought that the underlying principles were clear.

The trust deed

When pension trustees invest members’ money, the starting point is the trust deed. Looking at the deed, trustees should ask: what is the purpose of the investment power we have been given, and how can we use that power to promote the purpose of the trust?

The short answer is that the investment should provide a pension – with contributions invested to provide a return, often several years into the future. The primary aim of an investment strategy is to secure the best realistic return over the long term while controlling for risks.

Pensions legislation

Next, trustees must act in accordance with pensions legislation. When it comes to investment, the Occupational Pension Schemes (Investment) Regulations 2005 set out the general principles. For example an investment power should be exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”; and scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings.” Although smaller schemes are excluded from parts of the Regulations, we think that these principles apply to all trust-based schemes as a matter of trust law.

Judge-made duties

The legislation operates alongside a variety of “judge-made” duties, including duties that attach to the exercise of a power, duties of care and fiduciary duties. Among other things, the courts require that trustees must consider the right issues. Furthermore, trustees should take advice; and not “fetter their discretion”, by applying a pre-existing judgement.

FINANCIAL FACTORS

The law does not require trustees to simply “maximise returns”. Returns have to be weighed against risks, including long-term risks. It is often said that trustees should “optimise the risk return ratio”, which suggests that the decision is a mathematical one. But only some risks can be reduced to numbers: others are a question of broad judgement. It may be better to think in terms of securing the best realistic return over the long-term, given the need to control for risks.

The Law Commission drew a key distinction between financial and non-financial factors. Financial factors are any factors which are relevant to trustees’ primary investment duty of...
Is it always about the money?- Pension trustees’ duties when setting an investment strategy

balancing returns against risks. So risk factors are just as much “financial factors” as returns.

When making a long-term investment in equities, financial factors include the risks to a company’s long-term sustainability. These may arise from a wide range of sources, including poor governance or environmental degradation, or the risks to a company’s reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces risks of legal or regulatory action.

The law is clear: trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company’s long-term sustainability, such as environmental, social or governance factors. The Law Commission commented that it hoped to “remove any misconceptions on this issue”: there is no impediment to trustees taking account of environmental, social or governance (or ESG) factors where they are, or may be, financially material.5

The law goes further: trustees should take account of financially material risks. However, it does not prescribe a particular approach. It is for trustees’ discretion, acting on proper advice, to evaluate which risks are material and how to take them into account. It is not necessarily helpful to say that trustees “must” take an ESG approach. The ESG label is ill-defined: it covers a wide variety of risks, and many different approaches. The fact that a particular factor is conventionally classified as an “ESG” factor will not be conclusive as to whether it is financially material to the particular investment. Instead the Law Commission concluded that when investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks, including risks to a company’s long-term sustainability.

NON-FINANCIAL FACTORS

“Non-financial factors” are factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members’ quality of life or showing disapproval of certain industries. For example, withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.

Trustees do not necessarily have to consider members’ views. They may decide to ignore them. But if trustees do wish to consider non-financial factors, they should ask two questions.

Question 1: Do we have good reason to think that scheme members share the concern?

Trustees may not impose their own ethical views on members. If trustees wish to take account of a non-financial factor, they must have good reason to think that scheme members would share their concern. They do not necessarily need survey evidence. In some cases trustees may be able to make assumptions: an example might be activities which contravene international conventions, such as manufacturing cluster bombs. The fact that these are banned by the Convention on Cluster Munitions, ratified by the UK, may give trustees reason to think that most people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, trustees would have good reason to think that they were acting on members’ concerns rather than their own. In other cases, though, it may be necessary to consult members more formally.

In practice, scheme members are unlikely to all agree. But it is not always necessary to achieve 100% agreement. If a majority are opposed to an investment while the rest remain neutral, that may be enough. The more difficult question is where a majority think that the disinvestment should take place but a minority disagree strongly. Where the issue is clearly controversial, it may be better for trustees to focus on financial factors rather than becoming embroiled in disagreements between members.

Question 2: Does the decision risk significant financial detriment?

If trustees wish to take a decision motivated by non-financial factors, they should seek advice from their financial advisers on the effect of the decision on returns to the fund. They should not proceed if the decision risks significant financial detriment to the fund.

Excluding a sector of the market does not necessarily risk significant detriment. The law does not require a portfolio to be diversified to the fullest extent possible. Instead it is

a question of degree. For example, in one case the court held that the Church Commissioners had acted within the law by deciding that excluding 13% of the market would be acceptable, while excluding 37% would not be.6

There are a few exceptions where significant financial detriment is permitted. These are when the decision is expressly permitted by the trust deed; or in defined contribution schemes, where the member has chosen to invest in a specific fund. It is also possible that the court may also apply more flexible tests where members share a strong moral or political viewpoint, such as in a pension scheme set up by a religious group, other charity or political organisation.

TRUSTEE DISCRETION

Pension trustees are faced with crucial but difficult tasks, attempting to safeguard their members’ money in a rapidly changing world. Not only is it difficult to foresee how the world might develop – but trustees are often aware that their collective decisions might also affect those developments. Amid all this uncertainty, the law is not prescriptive. Nor does it judge in hindsight. It requires trustees to ask themselves the right questions, and to question their advisers and investment managers. But it provides considerable discretion about how these questions are answered.

“Trustees may not impose their own ethical views on members.”

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1.2 EXPERT DEBATE

How will trustees’ fiduciary duties change and to what extent can we expect the issue of divestment to rise up the agenda?

Jessica McGhie: Over the last 12 months what changes have occurred in terms of trustees’ fiduciary duties and to what extent do you expect more change to come?

Dr Daniel Summerfield: Much of the last year has been geared towards the Law Commission’s recent review of the fiduciary duties of investment intermediaries, it has helped to clarify the extent to which trustees are able to take into account ESG factors when making investment decisions.

Simon Howard: The law has not changed but the Law Commission’s descriptions and interpretations are tremendously helpful and in particular their letter targeted at trustees.

What’s key here is that they say that trustees should consider material financial issues and it is quite possible that trends like the carbon bubble consideration of the impact on indigenous peoples of resource depletion will be considered to materially financial issues. In making this clear the Law Commission has moved the fiduciary duty debate forward in a sensible and helpful way.

Jessica: Given that these issues have been on the minds of pension funds and other asset owner groups for a while do you feel there is much room for responsible investing and associated divestment to rise up the agenda? Or have we reached a point where asset owners know what is expected of them and how to practically apply it?

Simon: It is part of a much wider issue in that we need to move to a low carbon economy; in terms of rising up the agenda I hope to see far greater attention this year as a result of the inter-governmental agenda and its sustainable goals. All of these issues will rise up the agenda. What is important is that we understand how busy pension fund trustees are and we want the agenda filled sensibly. In regards to the Law Commission’s work on fiduciary duty we understand that there are going to be two consultations in the first half of 2015 as to how recommendations are implemented into the Occupational Pension Scheme Regulations. Therefore, in a sense these issues are shifting from background noise to being firmly on their agenda and therefore rising up it as it were.

Jessica: You mention climate change but what about governance or social issues are there any specific areas there where you expect increased activity?

Daniel: It’s interesting that even though the law hasn’t changed what is very helpful is the additional clarity the Law Commission has provided in its conclusion that all issues which could present a risk to a company’s long-term sustainability and performance should be deemed financial factors, including “ESG issues”. The fact that ESG issues are now deemed to be financial in focus, shedding their historical ‘non-financial’ label, should focus the mind of trustees that these are not simply a nice to have but should be considered by fund managers in the investment decision making process.

Simon: We have been very encouraged by some straws in the wind. The NAPF continues its excellent work in this area whilst UKSIF is working with the Association of Member Nominated Trustees (AMNT) on a voting initiative in this area. We have also seen the very welcome reaction from BP and Shell regarding the “Aiming for A” coalition shareholder resolution and I really feel that there is some momentum behind it now.

Jessica: Do you predict that there will be more activity around specific asset classes and that pension funds will decide not to invest in certain asset classes because of associated ESG issues?

Daniel: There is likely to be further pressure on certain pension funds with active members to divest from certain sectors, companies or countries based on the two tests that the Law Commission has put forward. These are specifically on what the Commission define as non-financial factors such as improving members’ quality of life, or showing disapproval of certain industries from an ethical standpoint.

Simon: It is difficult to point to a whole asset class that would be severely affected by this and as Daniel said it is more likely to be sectors. The way to look at it is in terms of the economic impact which will express itself in a number of ways.

One of those might be divestment but probably the more material one will just be subtle shifts in asset allocation. It will be seen first in equities and then I suspect corporate bonds will follow because if you have long dated fossil fuel or transport related debt ESG factors will be called into question and affect asset values. Even emerging
How will trustees’ fiduciary duties change and to what extent can we expect the issue of divestment to rise up the agenda?

Market sovereign debt and emerging market currencies might have problems and with the low oil price currently perhaps this will be evident sooner than we think.

Jessica: Would you say that UK pension funds are poised to react to such change? Are they equipped to respond to statements from the Law Commission or do a lot of them have a long way to go?

Simon: It is somewhere between the two. Poised is a bit too optimistic in my opinion but then yes, certainly they have less far to go then they did as little as two years ago. Many pension funds are now conscious of the risks and are increasingly conscious of their obligations and so the journey has begun. They aren’t yet poised to take action but within a few years hopefully an approach will become apparent fund by fund and progress will be made.

Jessica: Daniel do you feel that you are ready at USS?

Daniel: We have always believed the Law Commission’s interpretation of the law to be the case and have stood by that position. In fact the Commission’s report does cite the legal advice we were given by our lawyers some time ago which supports the position that we take on engagement as opposed to divestment.

We believe that our process and the way that we carry out responsible investment in USS is compliant with the Law Commission’s guidelines. That said we certainly don’t just rest on our laurels as it is always about constant improvement, refinement and adaption of our approach to the changing environment in which we operate both internally and externally. In particular, we have made significant progress over the last 18 months in extending our RI approach to all of the asset classes in which USS now invests.

Daniel: In terms of the European Commission’s proposal to amend the Shareholders Rights Directive and increase transparency over director remuneration, do you feel that it will have an equal impact on fiduciary duties? What changes is this likely to create for them, if indeed it creates any at all?

Daniel: I don’t believe that the EC’s proposals to amend the SRD will affect fiduciary responsibilities. The document is currently being adapted in light of lobbying from various parties which may result in some dilution of key aspects such as Related Party Transactions. It does focus on the rights of shareholders such as the ability to hold management to account on remuneration.

Simon: The versions of the directive I have seen seem to be travelling in the right direction and we are supportive of the increased transparency.

The risk as Daniel mentioned with the horse trading that inevitably goes on, is that some good stuff disappears but overall it is an encouraging sign of the direction of travel so we are supportive of it.

Jessica: Thank you both for sharing your thoughts on this subject.

“Material one will just be subtle shifts in asset allocation…”
Like many concepts in trust and pensions law, “best interests” and “fiduciary duty” sound deceptively simple. Like the famous characterisation of pornography versus art by the US judge Potter Stewart (“I know it when I see it”), people often have a sense of what it means to be a fiduciary or to act in someone’s best interests, without being able to articulate it.

The Law Commission recognised this as one of the powerful features of fiduciary duties, they are like “legal polyfilla”, moulding themselves around other structures to plug the gaps”. However, for trustees and advisers dealing with real life decisions and for members of pension schemes with real life concerns about their savings, this legal ambiguity can be frustrating. In some respects, these frustrations have not been alleviated by the Law Commission’s final report. The real challenge for those working in the pension sector is to enact the Law Commission’s findings. It is suggested that the key to doing so is for trustees to engage with their members.

How did we get here?

It is almost glib to say that pension fund trustees should seek to protect the best interests of the savers whose money they invest. However, this seemingly simple imperative has been the source of much disagreement and confusion, particularly in the application of the concept of fiduciary duty to investment decisions. In this respect, the Law Commission’s report helpfully provides, at last, a common reference point for interested parties.

Let us stand back and reflect on why we have the Law Commission’s report into the fiduciary duties of investment intermediaries. The report is a product of the financial crisis of 2008. It was recommended by Professor John Kay in his review of long-termism (or the lack thereof) in the UK equity market. As Vince Cable noted in the Government’s Progress Report on the Kay Review, Professor Kay “set out a clear challenge to companies, investors and Government to bring about a shift in the culture of equity markets by rebuilding relationships of trust and confidence and aligning incentives in the investment chain”.

Fiduciary duties were identified as a powerful tool in promoting such a culture, but the way in which they were interpreted and applied within the investment sector ran (or, indeed, runs) contrary to this. Many pension fund trustees appear to believe that their duty to act in savers’ best interests should be narrowly interpreted to mean savers’ best financial interests or to maximise financial returns. In fact, prior to the 2008 crash, concern to avoid being seen to make decisions on the basis of non-financial factors led many funds to focus on short-term returns and to avoid activities such as stewardship or ESG integration, which are designed to improve long-term returns.

What is the purpose of a pension?

Blame for the financial crash does not lie with trustee boards. However, it would be wrong not to acknowledge the interest and role that pension funds have in promoting long-termism.

Of course, trustees can only act within their powers, the starting point of which will be the trust deed. As the Law Commission noted, the core duty of a trustee is to promote the purpose for which the trust is created. The Law Commission concluded that, in the case of a pension scheme, the purpose is to provide pensions. Does this somewhat tautological statement really capture the purpose? A pension pot is a means to an end, not an end in itself. A “pension” is a means of retirement income, the purpose of which is to underpin a decent standard of living. But a decent standard of living will encompass wider factors than the financial: have I achieved a decent standard of living if I retire with a comfortable sum of money into a world wrecked by climate change?

A confusing distinction?

The interplay between financial and non-financial considerations in the pension sector is complex. This complexity is somewhat masked by the binary distinction made by the Law Commission between “financial” and “non-financial” factors. It sounds like a neat categorisation and an easy distinction for trustees to make, but the Law Commission’s own example set out in its guidance for trustees reveals the underlying complexity:

Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.
So, if one board of trustees divests from tobacco based on litigation risk, they have made a financial decision. If another board divests based on the nature of the product, they have made a non-financial decision. The outcome may be the same, but the distinction is significant.

The type of factor under consideration – whether it is financial or non-financial – has an impact on the decision making process for trustees. The Law Commission concluded that trustees should take into account financially material factors whilst, in general, non-financial factors may be taken into account if two tests are met. These tests are that: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund. In the above tobacco example, as the Law Commission itself explored in its report, if trustees are to divest on the basis of the nature of the product, a non-financial factor, they would need to show that they had gone through “a careful process to apply the two tests”.

**Applying the tests in practice**

In practice, it seems unlikely that someone will raise an issue like tobacco and give only one clearly delineated reason for proposing divestment – most people exploring the issues associated with tobacco investment would mention both the risk of litigation and the unpleasant nature of the product. The practical issue for trustees will be to evaluate which reason they have for considering divestment.

The practical complexity that arises from the Law Commission’s report is perhaps a reflection of the reality of investment. It is now part of mainstream investment strategy to take into account environmental and social issues: this reflects a realisation of the financial significance of these factors. It is no longer a niche interest to take account of these issues, “ethical” investment has moved on from just screening out “sin” stocks. It seems likely that many investors would take the view that environmental concerns like climate change are financially significant factors that affect the long-term success of many companies. And yet this is an issue on which many major NGOs and charities campaign on moral grounds. Into which “category” should trustees considering the risks associated with climate change place their deliberations – a financial factor that they should take into account or a non-financial factor to be subjected to the Law Commission’s two tests?

Even when trustees have arrived at the conclusion that a factor is non-financial, they will still have to navigate the application of Law Commission’s two tests. Neither test is straightforward: what is a “good reason” to think that scheme members share the concern? What counts as “significant” financial detriment?

One criticism raised during the Law Commission’s consultation was the view that it is implausible that members of a scheme will share a consensus on issues. However, this is arguably too narrow a view of what the Law Commission proposed. As the Law Commission itself explained, some issues, such as the manufacture of cluster munitions will rarely be seen as a good thing. In other cases, the Law Commission proposed that a poll or survey of members will elucidate the trustees’ understanding of members’ views.

In other sectors of the financial world, institutions such as The Co-operative Bank undertake surveys of their customers’ ethical views. They have used these to build a picture of their customers’ preferences. To the challenge that customers of a bank that markets itself as ethical will of course share similar views, it may be countered that convergence of views may be equally possible across employees of the same company. Furthermore, the Commission did allow for trustees, where there is genuine strong disagreement from an impassioned minority, to fall back on considering the financial consequences rather than “becoming embroiled in disagreements between the members”.

**Engaged trustees**

A strong message emerges from the Law Commission’s discussion. Trustees’ decisions will be looked at in the round, with a strong focus on the way decisions were made rather than just a narrow focus on the final decision taken. This is certainly true of the Law Commission’s discussion of the question of financial detriment.

In one respect the Law Commission’s report challenges the status quo: the overall impression created by its analysis is of trustees who are engaged and tuned into their membership. This goes against the prevailing position. Perhaps as a legacy of the application of paternalistic private trust law to pensions, trustees often do not engage with members in relation to decisions made about their money. In fact, it has been argued that such engagement would somehow dilute the fiduciary relationship, perhaps by fettering the trustees’ discretion. However, in the Law Commission’s report we see the recognition that this is not the case: there is no barrier to trustees being connected to members and understanding...
their concerns. Indeed, to do so is a part of trustees' fiduciary duty, not contrary to it.

**Is further clarity needed?**

The Law Commission concluded that the law on fiduciary duty is "complex, difficult to find and not well known". It hoped that its report would go some way to providing clarity. The report does provide a reference point for trustees and their advisers, and goes some way to drawing together the multiple sources of law in this area and clarifying some of the common misconceptions.

However, as discussed above, the practical implementation of its guidance gives rise to a number of further questions and hurdles for trustees seeking to apply the law. Despite this, the Law Commission rejected the claim that statutory clarification – setting trustees’ fiduciary duties out in legislation – would be helpful. It argued that it would be “a lengthy and laborious process, which could have unintended consequences”.

This may be true of an attempt to codify prescriptive requirements that trustees must follow, but it would not be true of permissively drafted legislation which would clarify that trustees may, if they wish, take into account a broader range of factors. This permissive legislation would reassure trustees faced with questions about whether or not to take account of a factor, and give them the confidence to exercise their discretion. It would be one more tool in their decision-making process, should they wish to call on it.

“A pension pot is a means to an end, not an end in itself.”
SECTION 2

PRACTICAL POLICY INTEGRATION

2.1 ROUNDTABLE
Unlocking the true value of ESG investments

2.2 ROUNDTABLE
The nuts and bolts: embedding ESG for a diversified but responsible investment strategy
2.1 ROUNDTABLE
Unlocking the true value of ESG investments

Elizabeth Pfeuti: How do you quantify the E the S and the G in what you do? When you are speaking to clients and members how do you demonstrate that by investing with an ESG mentality you are actually producing a financial benefit rather than dragging on performance?

Nick Anderson: It is vitally important that you quantify these ESG benefits in financial terms. Let’s take a real life example and think of a company that makes highly energy efficient fibre laser cutting material for cutting welding. Of course in this case there is a real cost saving and direct benefit for the company in doing that because it will allow them to take a market share whilst simultaneously bringing external benefits to the environment. It is those latter benefits which are more difficult to quantify but as a company, we should still have that awareness. There are some very direct social and financial benefits out there that we still need to both capture and quantify regardless of whether or not they are more difficult to do so in comparison with other financial benefits.

Elizabeth: Therése, how do you approach this rather intangible idea of the ESG benefits?

Therése Lennehag: As a firm, EQT still has some way to go. Everyone around this table buys into the argument that ESG is really important, but the financial community as a whole does not necessarily and certainly, there are still some scepticism. Therefore, to Nick’s point, it’s extremely important to quantify it because financial terms remain the predominant language that investors use. EQT started its journey with more binary key performance indicators (KPIs) to make sure we looked at the engagement side of things by running analysis and engaging with portfolio company boards. Now we need to take the next step on the quantification front, which is why I am so keen to be part of this discussion.

Dr Daniel Summerfield: It has taken us many years to get to where we are and we are today.

Our responsible investment (RI) function came about as a result of significant member pressure which led to a trustee decision being taken to initiate an RI programme. In the early years, the RI function was rather siloed within the organisation as we didn’t quite know how to integrate it within the investment decision making process.

It wasn’t really until about 6 years after the RI function had been created that we started to provide evidence to the investment managers that by not incorporating ESG factors into our investment processes we were being exposed to significant risks. A few crises helped prove this point which of course culminated with the financial crisis in which a lack of effective governance at certain financial institutions played a major contributory factor. This - together with preventable surprises such as those experienced by companies such as BP- provided further evidence of the benefits of integration and the risks in not doing so.

Our Head of Equities is very supportive of the need to equip our portfolio managers with the tools necessary to ensure that material ESG factors are brought to their attention prior
Unlocking the true value of ESG investments

to investment and for this reason we have introduced an ESG type rating. It’s quite a blunt instrument that gives a score based on our views on the risks inherent in investing in a particular company but, its purpose is to encourage the relevant portfolio manager to speak to us about any risks that are identified.

Nick: It’s dangerous to believe that everything has to be quantified because even in conventional financial analysis we don’t quantify everything; it’s a misconception to think that we’re solely addressing things in terms of discounted cash flows, for example. There are lots of qualitative factors that we consider and we look at strategic positioning of the company, its management capability, its propensity to innovate and how well it can deploy capital.

Therése: If we look at public companies’ market capitalizations today, we can see that a massive transformation has occurred as they have predominately moved from being mostly on the tangible side to much being made up of the intangibles.

James: We live in a world where qualitative and quantitative are equally important and certainly some of those broader environmental, social and governance factors can be incorporated into the qualitative side to further our judgement; it’s not just about turning the handle on the machine with a buy or sell decision through numbers simply popping up on the screen.

Therése: Most managers look at the reputational side and certainly this is an area which EQT’s investors care deeply about because it affects them directly.

Elizabeth: It seems that people like the environmental and social aspects but really, it’s the governance angle that pushes through an investment idea. Whilst the environmental and social aspects are expected to grow, at present they are not the factors governance driving the return growth. It’s interesting because whilst governance drives the growth many take it for granted that companies are well governed.

Daniel: Governance is critical to the other two parts and without it you won’t be able to sustain long-term performance, as one needs a competent and experienced board of directors to ensure the environmental and social risks are managed effectively. There’s empirical evidence from the U.S. demonstrating that companies that are good at allocating capital tend to take more notice of environmental and social issues and are good at managing their businesses; it’s impossible to ever really escape the governance angle.

Elizabeth: Do you think investors, the pension funds, the large foundations and insurance companies, are putting enough value on getting the best companies rather than the returns? You said that at USS in 1999 ESG was very much a ‘nice to have’ and I would argue that there remain a lot of big pension funds yet to even think about embracing ESG as fully. Do you think the view is shifting?

Daniel: USS is a long-term investor, however, the evidence suggests that the holding period for many fund managers is still pretty short and one could argue that ESG considerations do not really fit into an investment process with short timeframes.

Therése: I obviously come from a slightly different space where holding, or rather ownership, periods are much longer (in EQT’s case, 3-8 years) and will make a reflection accordingly. The engagement piece from the private equity perspective has increased substantially over the last 5 years and we are being met with increasingly sophisticated and deeper questions from investors. This is great because it allows us to finally start a dialogue about what we are really trying to achieve or agree exactly how to best measure this.

For EQT, embracing sustainability is about two things. One is promoting good ESG practices within each portfolio company and two is looking at what the actual investment theme is. I monitor all of the portfolio companies in the EQT funds, and it will be especially interesting to follow those portfolio companies whose actual business model, products or services, benefits from the strong underlying sustainability mega factors.

Elizabeth: Do you find investors are asking you to show the benefit as opposed to just being good citizens and investing in good companies?

Therése: Some do but most recognise that the quantitative side of ESG is still an immature area, especially in the private space. I struggle the most with clients who come across as only or mainly data driven. The predominate space for EQT is around engaging in conversations and trying to understand the dynamics by asking for shared examples of what has and hasn’t worked well from their end.

James: We do a lot of work in the private equity space and in relation to ESG due diligence and client engagements, find sceptics challenging us around how ESG integration and embedment into
management actually add to the multiples on exit. To reiterate; just can’t quantity. ESG is good business and you need governance in order for good people to manage that business appropriately. Yes there are environmental benefits and innovation to be had that can enhance returns and reduce costs but essentially, many are just difficult to quantify or just simply can’t be accurately quantified at all. It’s getting that balance and message across.

Elizabeth: Is it helpful for companies and investors to sign up to the UNPRI? I’ve been a firm supporter of the UNPRI for many years but now am not sure if these initiatives have just transgressed into just a tick box rather than a proactive decision to push forward the ESG message. Several Danish pension funds pulled out a couple of years ago saying that they no longer believed. Do any of you think these movements have become just a tick box?

Daniel: There is a risk of that certainly. The credibility of many of the worthy initiatives out there could be at risk because to a certain extent, they have made their entry criteria quite low. Many investors have simply signed up to a code or set of principles because they believe that this is expected of them.

If one takes the UK Stewardship Code as an example, it’s very difficult for a pension fund looking for a fund manager which adheres to these principles in order to differentiate one manager’s approach from another.

Thérèse: These initiatives have without a doubt helped on the disclosure side and in increasing the number of policies and thoroughness of investors’ processes; however, they still struggle with how to standardise ESG outcomes. If you look at the 1,400 signatories and the different asset classes considered there is certainly a huge diversity of investment and ESG strategies being deployed.

Nick: I’m not convinced everything should be standardised and in fact would argue that there is room for a degree of entrepreneurial flair. The bar will be lifted and there is every chance it could be done so through the PRI. They’re publicly putting firms into quartiles and subsequently asset managers will have to increasingly prove to their clients that they are doing exactly what they say they do.

James: I think Principles of Responsible Investing PRI will probably go further on that assurance basis and look to actively check up on managers and asset owners.

Daniel: The NAPF have been involved in a similar sort of initiative where they have provided asset managers with the opportunity to disclose, through the NAPF’s framework, how certain principles are met. This can then be looked at by the asset owner in order to determine and compare different managers’ specific offerings.

Elizabeth: Not to put them out of a job but do we even need the UNPRI? Surely investors are becoming more proactive in this space?

Thérèse: On the supportive side, I would argue that it is great to have a body, such as the UNPRI, really monitoring the space. I read numerous of their papers and can only once again stress the collaboration piece already discussed.

James: I agree that there shouldn’t be standardisation because every company is different. Certainly the clients we work with have so many different interpretations of ESG driving their requests that I really can’t see any benefit to do so. Having said, that some standard criteria to ESG integration and reporting for the industry as a whole could be beneficial.

Nick: It’s a huge space and if you look at the third party data providers and how they categorise ESG risks and opportunities, multiple categories emerge that are often mixed with ethical investing. It’s important that in your mind you have a clear definition and for me, I think of it purely in the long-term as the risks and opportunities that can generate or stifle returns. These definition issues can get in the way though, particularly if you take them to a conventional fund manager and demand very specific ESG elements.

Daniel: It has become quite an ‘in Vogue’ term but I actually think that ‘stewardship’ as a concept works quite well. It sends the message that you are entrusted with assets as a fund manager or owner for which you are responsible while they’re in your care.

Elizabeth: I would love to think that everybody invests with the wider population in mind. For example, in the wake of the Sandy Hook shooting there was a split between pension funds who subsequently said they would no longer invest in guns and others who said the shooting was nothing new and guns made money, which members needed for retirement. It’s a perfect example of something that’s not strictly quantifiable. You have a fiduciary duty as guardians of cash but equally where does responsibility for such problems in the wider world start?

“It’s important that in your mind you have a clear definition. . . .”
Daniel: That is a key issue that The Law Commission have looked at in their Review of Fiduciary Duties.

The Commission helpfully categorised ESG as a financial issue which is interesting as traditionally it has been referred to as a non-financial issue. By changing their category trustees should feel more confident in encouraging their fund managers to take ESG factors into account when making investment decisions.

That said there is also a slight change of emphasis within the Law Commission’s report because it also says non-financial issues, i.e. ethical issues, can be taken into account if two specific tests are met. Firstly trustees should have good reason to think that scheme members would support a specific concern Secondly by pursuing a certain course of action on ethical grounds it must not involve a risk of significant financial detriment to the fund.

Therése: I would say that much depends on the time horizon as well as the values you have as an investment organization. Some of these currently “ESG externalities” might be detrimental to investment returns, depending on the holding timeline. We are all part of the financial ecosystem and we have to appreciate that things will not change overnight. Consequently, a lot of judgement is being applied around how long or how quickly some of these factors will be internalised and it is critical that investors engage to push things in a direction that aligns with their core values.

Nick: The Law Commission clarified that trustees don’t have to maximise returns in the short-term provided of course they are taking the long-term risk into account and that’s absolutely crucial.

For example you could decide that in light of recent commodity changes you want to reduce your exposure, whether it’s fossil fuels or other high carbon consuming industries, and that even if the price bounces in the short-term you know that the long-term potential just isn’t there. It’s that long-term perspective which is critical and certainly we are increasingly starting to see that embodied.

There was an announcement earlier this month from Stichting Pensioenfonds Zorg en Welzijn (PFZW), the second largest public pension fund in Europe, that it was divesting from hedge funds entirely because not enough consideration was being given to environmental and social issues. It marries with our findings that the short-end of the market has become very crowded and as PFZW have done, perhaps now there’s a very economic reason to think longer-term because the short-term potential is being eroded.

Elizabeth: James and I spoke about opportunities and innovation a while ago and if we flip some of these arguments on their head certainly there are opportunities being created. An example would be that as a reaction to the current global water crisis investors have an opportunity, providing they have the mandate, to explore new opportunities and take advantage of the huge plants we have across the globe. James – perhaps you could expand?

James: More and more of our clients are asking about the potential for investing in the low carbon market and projects relating to generating energy from waste. Numerous waste technologies are being developed and we are seeing quite a bit of interest in those and the investment opportunities they bring. There are many untapped financial incentives from taking the waste, putting it through the system and burning it that cannot yet be sold to the grid. There are carbon credits and a carbon / renewables market that enables you to get access those benefits and as a result we are certainly seeing much more of an appetite and uptake.

Elizabeth: I remember the Merseyside Pension Fund investing in an anaerobic digester in North Wales, although it didn’t receive much coverage. That’s the kind of thing investors should be thinking about; Swedish and Danish plans are way ahead with most of the North Sea wind power being owned by Denmark. How do feed these ideas through to your clients and highlight those opportunities? Is it a case of just coming up with the innovation rather than owning the basis points?

Nick: One of the problems has historically been that ESG investing has been done in one corner of the asset management house and conventional management in another whereas actually, the two strengths need to be combined.

I run a global equities portfolio and am perfectly in step with those ideas based around long-term themes. Whether that be environmental or social and I am always looking to combine the ESG opportunities with conventional financial analysis and am confident that the proof stands in the returns you generate. Clients want to see what actually adds value and at the same time you can’t assume that green is always good; for example it has been incredibly hard to make sustainable returns on a long basis from the solar...
Unlocking the true value of ESG investments

industry. The greatest success in the solar industry has been in bringing down the price of solar equipment but from a shareholder perspective it’s been hugely unsuccessful.

**James:** You touched on a really good point about policy. The European Emissions Trading Scheme was set up to drive efficiencies in uptake and technology and because the market mechanism is failing and the carbon price crashing, there’s no incentive for companies to invest in those technologies because it’s cheaper to be business as usual.

**Thérèse:** I too can offer some similar examples from EQT’s portfolio, where like Daniel and Nick we combine the two. Within the infrastructure investment strategy we have definitely seen this energy race and EQT Infrastructure I actually owns one of the largest European facilities handling hazardous waste. You can slightly differentiate the EQT Infrastructure funds from other infrastructure funds because they are geared towards investing in improved operational performance and therefore, the funds can support investment in new technologies to enhance for example recovery methods, which is really important.

Another interesting portfolio company, but called I think this time from the EQT Equity space, is Færch PlastFaerch Plast who is involved in plastic packaging for the food industry. Plastics as we know come with a number of environmental issues, but this company is really forward thinking in terms of driving the cradle to cradle thinking and also investing in new techniques to prolong the shelf life of food, helping to reduce food waste.

EQT works actively with its website and continuously posts articles to relay these stories, not necessarily under an ESG label but rather because it’s interesting and important material to read. Transparency is critical to help investors and other stakeholders to see and understand these opportunities.

**Daniel:** Government policy does play a really important part in determining how we invest within different markets but as is often the case, government policy isn’t necessarily joined up. At a European level there are policies that often appear to contradict one another or are do not appear to include the entire universe of assets in which we invest.

For example, much of the discussion on long-term investment in Brussels has focused on public equity where as we view infrastructure as one of the key long-term investment opportunities.

**Elizabeth:** The policymakers have a rather knee jerk reaction. I know that the NAPF are trying to convey the fundamental problem pension plans face in that the regulators need to better understand that if liabilities are 40 years then they have to be investing in something for more than 2 years. Regulators are concerned with containing risk, not accommodate your members so how do you convince the regulators?

**Nick:** It’s human nature isn’t, short-termism in another guise. As policymakers you have to look beyond the electoral cycle and that’s very hard for them. The one potential hope we have particularly in relation to carbon is Obama and because he can’t be re-elected it’s his final moment of glory to strike a deal. Otherwise though it’s about influencing and lobbying.

Investment managers aren’t very good at lobbying and when we do, tend to focus on policies affecting us as investment managers rather than policy decisions which could affect our ability to invest in these sorts of projects. The European Commission appears to be very sympathetic of your views but unfortunately, because it’s such a huge organisation there can often be a lack of connectivity between departments and policies. I would say this is one of the key risks we face and certainly we need to be pushing back on some policies. Often policies aren’t accountable to anyone and as result people are convinced they are correct and so they snowball. We need to do a much better job in presenting a united front as a fund management industry and avoid simply looking at our own business interests.

**Thérèse:** I agree because as one firm your voice is very small. In the private equity industry, we have worked a lot through the national associations and we are particularly fortunate to have the European Private Equity & Venture Capital Association who both represents the profession and understands how Brussels works.

Very often you need to be there early and the private equity industry has been and continuous to be mindful to respond to the many consultations coming out of Brussels.

**James:** I think you’re right in terms of private equity and certainly we see that, although there is still a long way to go. Coming back to the broader asset management, with hedge funds as the example, we’re not seeing much activity there; although we did recently work with a small fund of funds who realised they needed a responsible investment policy and strategy. The primary driver was to address investor’s requirements who had been asking
Unlocking the true value of ESG investments

these ESG type questions as part of the fund raising process.

Daniel: We’ve done quite a lot of work on hedge funds and focused primarily on ensuring the right governance is in place at fund level and appropriate requirements are in place in the markets in which invest. Ultimately the buck stops at the directors of the fund and it is imperative to ensure that we are happy with the quality of directors prior to investment and have the requisite transparency and disclosure with which we can make an informed decision.

Elizabeth: If we think about the right bright peppy young kids running hedge funds today surely there is substantial room for the growth of innovation.

Nick: Not all hedge funds are about short-term returns and certainly there is flexibility within many of those set-ups. What’s interesting, whether it’s hedge funds, mutual funds or institutional funds, is to look at what the winning formula is for delivering alpha; it’s taking a view and holding that long-term view irrespective of what fund it is. That short-end of the market has become very crowded but if you’re smart, you’ll do more deep diving work and take your clients with you along that path.

Elizabeth: Looking at the true financial value of ESG investments, what can you do as individuals to change the mind-set of the investor themselves, the asset managers and everybody else within finance?

James: In our recent ‘A New Vision of Value’ report we have demonstrated how we have started to look at ways to value some of these externalities that we’ve all talked about today. That can be anything from pollution or emissions right the way through to how your product has a positive benefit in society. It’s a point which I would argue hasn’t been captured in the overall learnings. It’s still a challenge to put raw numbers to these issues but this is something we are working on through the KPMG True Value methodology, which uses a variety of data sets in order to begin trying to put a financial value on some of the issues.

Nick: It is about rebuilding a long-term investment perspective and having that trust throughout the investment chain. Having a stable policy environment is critical because we’ve been wrong-footed too many times by changes in policy. I would again get away from just being quantitative and think about qualitative. Often when I’m looking at a company I’m thinking about where it fits in the spectrum between a management remuneration vehicle at one end, to a business that’s about generating sustainable economic and shareholder returns at the other. Looking at those indicators and assessing how the company manages environmental and social issues helps me to understand the profile of that business. I have to consider other factors and particularly whether or not it has been judicious in its cash flow allocation. All of which collectively builds a picture as to how well that business is managed and whether it’s thinking longer-term, strategically.

There’s also an education piece to push ESG issues further into the wider investment field. For us some of these indicators are already embedded in our risk processes and subsequently every time any portfolio manager has their portfolio reviewed a set of environmental, social and governance factors are equally assessed.

We have a corporate responsibility team but we also have an independent risk team who have worked very well together. Data is a crude starting point but it allows you to ask questions and delve into the issue further to see if there’s a real concern. Having the expertise in-house is really important to us at Henderson.

Therése: We feel it is vital to lead by example. Back in 2010, EQT launched its responsible investment policy which introduced some specific demands on the portfolio companies. Now we are taking that to the next level with more of an engagement blueprint that hopes to inspire the sustainability mind-set and apply relevant ESG components within both the initial and ongoing dialogue to ensure that we’re all walking the talk.

Daniel: My final comment refers to a quote which is attributed to Einstein is ‘not everything that counts can be counted, not everything that can be counted counts’. That’s very true here and as we have all said not everything should be quantified.

Elizabeth: Thank you all for sharing such interesting viewpoints.

“The European Emissions Trading Scheme was set up to drive efficiencies in uptake and technology. . .”
Complexity is accelerating. How you react will define performance, success and reputation. KPMG professionals help you cut through the new complexity, to a more profitable and sustainable future.
2.2 ROUNDTABLE

The nuts and bolts: embedding ESG for a diversified but responsible investment strategy

Moderator
Padraig Floyd
Freelance Financial Journalist, Money Journey Media

Panelists
James Corah
Deputy Head of Ethical and Responsible Investment, CCLA
Ole Buhl
Head of ESG, ATP
Peter Lundkvist
Senior Strategist & Head of Corporate Governance, AP3

Padraig Floyd: The ‘philosophy’ and value of responsible investing is well understood but as an industry, where are asset owners still falling short of total ESG embedment?

James Corah: I can approach this from both an asset owner and manager perspective. CCLA is a UK fund manager dedicated to working with charities and not for profit organisations, [this is] in addition to acting as Secretary to the Church Investors Group which is increasingly the European asset owner body helping churches to simultaneously represent their faith and embed ESG activities.

Predominantly we work with relatively small asset owners and much of our client base has been on a heavy ESG learning curve over the past decade. In many ways though they have been subsequently leading ethical investors on how investments can reflect the organisations values. I would say though that they haven’t necessarily understood responsible investment fully, what it means to be a long-term investor and the risks and opportunities associated with ESG.

With those investors we have been involved in ongoing conversations to help them better understand how they can embed ESG. Now that we have arrived at that point, these asset owners have become in turn become interested in how they can use their [position as values-led organizations] to lead other investors in the ESG community.

Ole Buhl: I don’t believe that there is one philosophy and one value for responsible investing. There are many values, based on multiple philosophies and so from the outset you have to really consider who is actually answering this question. ATP is the largest Danish pension fund and whilst we do engage managers, we do also manage some of our assets ourselves and so in that respect act as an asset manager.

There is still a lot of thinking that needs to be done around what ESG really means, where it makes sense and we should proceed in our expectations of managers. When it relates to direct financial impact as a result of prior ESG knowledge it becomes harder to assess and decide exactly what we want in terms of provisions applied by our managers.

Padraig: Ole, you mention representing the views of the Danish population but isn’t that too broad a grouping to be able to confidently say you represent all within that policy?

Ole: We account for more than 4 million people but of course that doesn’t mean we have we 4 million views. We are challenged by the fact that we can only have a single view on all issues and this why we are doing a lot of work in respect of the Danish system to get as close to the Danish official view as possible, on how all of this can be translated into how as an investor, we should act.

Our policy states that whatever convention Denmark has signed up to
the answer we derive from this, should also abided by in our policies. This is why we don’t invest in ammunition producing countries because Denmark has signed up to a commitment not to.

**James:** I would echo that because we too manage money for clients with a whole array of perspectives just as Ole does in respect to the Danish population. One of our most important tasks is helping clients embed ESG and not to confuse it with ethical investments because the latter is completely different and requires a different approach depending upon the values of each different organization.

As a house our ESG strategy is designed to maximise invested value over the long-term and is implemented across all of our assets under management but of course we do look to integrate our clients’ differing, ethical investment requirements.

**Padraig:** How can asset owners improve their ESG practices, who should they partner with and what level of diversity can they expect in ESG offerings?

**Peter:** We have tried to learn from best practices currently available in the market and have found it very helpful to work with Dutch and Danish pension funds to share experiences. It’s also equally important that companies report any relevant information so that you can make a proper assessment; since 2010 we have worked closely with service providers such as MSCI to try different approaches.

**Ole:** It’s crucial that all asset owners have open dialogues with managers as in reality much of the ESG application isn’t as easy as it might seem. ESG means different things in different situations and in different asset classes; therefore it is important to have a discussion with your manager to make them understand what ESG means to you.

**James:** I would only echo the importance of having the alignment with your investment manager. We are a hybrid asset owner/manager and strive to ensure that we have absolute alignment with the views of our clients.

In doing this we are then able to do more. With my Church Investors Group hat on we are working to help church asset owners, who share the same asset manager, come together to focus collectively on the issues that matter to them.

Another point regarding partners is stewardship. This is an integral part of ESG and we should not simply define ESG in portfolio construction terms. It’s about finding the right partners to conduct collaborative engagement with. One example is the Aiming for a coalition we have been coordinating. This has brought together like-minded investors to encourage the ten-largest UK-listed utilities and extractives companies to achieve an ‘A’ Grade in the CDP Carbon Performance Rankings. This has resulted in shareholder resolutions being filed at BP and Royal Dutch Shell’s AGM allowing other investors the opportunity to signal their support for long-term value creation.

**Padraig:** To what extent is evolving stewardship lessening the work needed to convince the board that ESG investing is an articulated business case?

**James:** We should remember that, in many cases, the companies themselves are actually ahead of the investors.

That said in many of the companies that we speak to dialogue has become increasingly sophisticated and collegiate. Take the Aiming for A shareholder resolutions for example, through this engagement the coalition members responsible for the relationship with Shell, the Central Finance Board of the Methodist Church and Rathbone Greenbank, reached a point where the company are now recommending a vote for the resolution that we and our partners have co-filed. It’s an example of the increasing alignment between engaged ESG investors and the company’s goals. We have become, in many ways, a critical friend.

**Peter:** Today most companies are largely aware of sustainability issues and they are no longer just part of a ‘tick box’ culture. I too agree that we have come a long way in this respect.

**Padraig:** In order to establish a sustainable ESG strategy should asset owners favour growth stocks or value stocks and large or small-cap funds?

**Peter:** I’m not sure about value or growth as you need to have a portfolio performance with sustainable growth. When it comes to large or small cap I image it to be easy to find sustainable companies in the large cap group due to the fact that it is easier for small cap companies to fly under the radar. On the other hand there are many larger companies who do run into the ditch despite their ESG propositions and so I don’t think you can define it as narrowly between choosing between large and small cap companies.

**Ole:** In terms of sustainability our experience has been that if you really want to commit to an ESG strategy 100% it isn’t about growth stocks, large or small caps but rather about...
having comparatively few companies. It comes down to the engagement argument and how many companies you can really dig down into and understand. To effectively pursue a sustainable strategy you need to take into consideration more than just the views of the company and so from that perspective it becomes even more important that your portfolio isn’t overcrowded with too many companies.

Peter: That is the biggest problem of all with portfolios and as I said earlier we have over 3,200 companies within our portfolio and have to carry out daily risks assessments on each. We have to be aware of any inherent ESG risks and be able to confidently handle those that arise. Some risks you look to control and others you look to reduce by acquiring good companies and for those you can’t bear at all, you sell off.

Ole: It might seem as though I disagree with Peter but I actually agree that sometimes you do need these 3,200 stocks in your portfolio. The reason I mention these concentrated portfolios is that if you want to have a portfolio that you consider to be your most ESG strategy sustainable portfolio, it bottles down to concentration. It is only through concentration that you are able to do the deep diving into the companies.

James: Fundamentally, regardless of the company type it comes down to philosophy. I am predominantly responsibly for corporate governance here at CCLA. We regard low standards of corporate governance as creating a low probability, but high impact risk. No matter what type of company we are looking at or what strategy we are adopting we are always looking to avoid the same characteristics. Another important element for us is the act of monitoring our holdings, because we have a relatively concentrated portfolio we really can know who we are working with and whether those risks are escalating or decreasing.

Padraig: Do these considerations and the practical application of ESG change for pooled funds?

James: Principally a large part of our business is running pooled funds because, originally, we came into existence to help smaller charities pool their assets to invest with economies of scale.

For our ESG, responsible investment, considerations our strategies stay the same according to what we think is going to be the long term driver of value. The ESG risks that we are seeking to manage are the same across any portfolio. What does differ is how we represent the underlying values of our client basis. Each of our pooled funds are designed to attract a different part of the church, charity or local authority sector and so we survey each of the different clients to make sure that we are continuing to represent their views. So, from an ESG perspective all of the Funds are managed in the same way, but the ethical investment policies differ depending on the views of the underlying client base.

Ole: The question is more interesting when it comes to other funds and of course sometimes it is a challenge as why should all others want the same values as one participant in a pooled fund. If you want it done your way then you have to have a managed account and although to some degree that can be an issue, it’s just the way it is.

Padraig: Thank you for sharing your views on this subject.

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Padraig: Thank you for sharing your views on this subject.
DIG DEEP FOR MANAGER ACCOUNTABILITY

ROUNDTABLE

What qualitative and quantitative approaches should you take to monitor your manager’s day-to-day ESG practices?
Jessica McGhie: From a qualitative perspective how do you assess the extent to which your asset managers meet your ESG benchmarks, both as three separate strands and as one collective?

Katie Beith: We have three policies that we require all of our managers to adhere to: a Responsible Investment Policy; a Climate Change Policy and a Voting and Engagement Policy. It is these three policies that set the stage for what we expect our managers to be doing regarding responsible investment activities. For each manager we have an annual review meeting where we discuss things like their compliance to the Investment Management Agreement (IMA) and our policies, strategy and business updates, investment performance, risk and attribution analysis, and responsible investment is very much an integrated part of that agenda.

We also biannually request information from our managers regarding their responsible investment activities and aggregate that information up, reporting it to our investment committee. We also review the Transparency Reports of our managers who are PRI signatories as well as their own responsible investment reports.

Sara Nordbrand: We heavily assess this element prior to selecting our managers because we have to be sure that their approach is aligned with ours; we have one particular financial policy that dictates that asset managers we select have to integrate ESG into investment decisions. Subsequently we have to be confident that our managers have strong sustainability skills internally. They must in turn be skilled at identifying companies that are interesting from a sustainability perspective in addition to having strategies for influencing companies in need of improvement.

A quite efficient way to better understand their approach to sustainability is to look at the list of holdings and ask them to describe what motivates each holding and the respective strengths and weaknesses of individual companies. This has given us good insight into both their investment strategy and overall capacity when it comes to ESG issues. We also look at the skills of the team and what in-house resources they have and we encourage asset managers to have long-term incentive systems.

Once the investment is made we continue to have regular contact with the asset managers; we are regularly discussing different holdings and sustainability themes. We also subscribe to a sustainability rating services and a service for norm-based screening. Although we don’t regard them as representing the absolute truth, they have given us good input for the discussion with our asset managers. More recently we have started conducting a few footprint studies, for carbon and a broader range of environmental factors, to better understand the risks tied to each portfolio. We want to make sure that the funds we invest in are resilient against challenges such as climate change and water scarcity.

Jessica: Will, do those approaches mentioned by Katie and Sara reflect those followed by the majority of UK pension schemes?

Will Pomroy: Certainly they are indicative of the major trends we are seeing amongst the UK’s leading pension funds in terms of how they assess their managers’ performance.
What qualitative and quantitative approaches should you take to monitor your manager's day-to-day ESG practices?

Having surveyed our members for the last decade on how they approach responsible investment, it is very much the larger schemes that are leading the way. The majority of schemes spend a significant amount of time assessing manager’s at the pre-selection stage and certainly, we have seen an increase in the complexity and materiality of the criteria used to assess managers.

The above focus tends to drift away after selection. That said, over the last couple of years we have seen our members asking more and more regular questions in order to get a better feel for how each manager integrates ESG at the more practical level. It has moved beyond asking what used to be simply tick box questions, such as whether or not they are a PRI signatory. Today questions are much more focused around the investment approach – for example with respect to investments in specific stocks, why the manager made a specific investment and what initial analysis did they do beforehand.

This enables a livelier, ongoing discussion that puts the ESG question into a real world context. Here at the NAPF we provide monthly questions for pension funds to utilise in that ongoing ESG conversation with their managers to keep it both live and topical. Certainly any pension fund that reads The Telegraph or the Financial Times can likely get a feel for the sorts of questions they could be asking to keep managers on their toes.

A couple of years ago we developed a Stewardship Disclosure Framework and more recently we initiated a series of stewardship accountability forums designed to help smaller pension schemes, who lack significant internal resources, engage with their managers on this topic. We want to help them achieve a better sense of how the investment strategy that they have bought into is operating on a day to day basis.

If you look across the whole spectrum of UK pension funds you will see a wide range of approaches taken from a very engaged approach at the top to a lighter approach at the bottom. However, the common approach is certainly to try and achieve a more constructive relationship between all parties and keep the conversation live so that everyone understands what is happening on the ground.

“questions are much more focused around the investment approach.”

Jessica: Sara what have you done on the quantitative side?

Sara: Service providers are offering an increasing number of tools and more data is indeed available. Will mentioned portfolio assessments of carbon risks and this is something that some of our asset managers have started doing. This footprint analysis generates an interesting starting point for a discussion. We combine such quantitative data with a more qualitative analysis in order to really understand the risks as well as the context. A combination of tools and methods gives us the opportunity to assess them from different angles to hopefully deepen the understandings of the risks and opportunities.

Katie: The increasing level of regulatory scrutiny, as well as requirements from initiatives like the PRI and the UK Stewardship Code to report on your activities, has really pushed us to put in place systems that collect very accurate data and enable us to report fully. I agree that it is important to support any quantitative data with qualitative contextual commentary to ensure that it is interpreted accurately.

In the first few years of the Pensions Trust taking on a Responsible Investment Officer, we were more focused on getting to know our managers better and understanding their attitudes and approaches towards responsible investment.

As we have progressed and evolved we have become much more demanding in what we ask of them. The “Guide to Responsible Investment Reporting
What qualitative and quantitative approaches should you take to monitor your manager’s day-to-day ESG practices?

in Public Equity” report that was published at the end of January, supported by The Pensions Trust and 15 other UK asset owners, is an example of how asset owners are becoming more demanding of their managers. They are starting to ask for more quantitative information showing the added value of a manager’s ESG integration and stewardship activities.

With regards to climate change, we have also done work to assess the carbon intensity of our portfolio. Understanding exposure is one thing but understanding how that translates into risk and figuring out how to mitigate that risk in order to protect investment value is another. We are definitely on an evolutionary journey and are trying to bring our managers on that journey with us.

Jessica: Any ESG related investment is linked right from the initial mandate’s start. How do you make sure it is then consistently applied throughout the whole investment process and by default, across the whole portfolio?

Katie: It’s a much easier task when you are taking on new managers because discussions about responsible investment begin right at the beginning of that relationship, especially when your expectations are mandated in an IMA. It is more challenging working with managers who you have a long-term relationship with and who haven’t necessarily looked at ESG issues in a systemic and integrated way.

We find there are some managers who are really happy to come on the journey with us, learning and developing as we do. Others are less open to adapting their ways. I find that striking a balance and gaining mutual respect for the validity of activities really helps both to see each other’s point of view.

Will: Traditionally the ESG focus has been around public equities because you have the ownership rights attached to these investments. Here you are also afforded with a greater level of transparency which isn’t necessarily translated across to other asset classes.

Clearly though pension funds now, whether it be through technological advances or regulatory changes, have a much greater overview of the risks throughout their whole portfolio and across all the asset classes in which they are invested. Subsequently they are better able to understand where exposures are in relation to particular risks and even particular geographies, and monitor these.

There is a greater ability to disentangle the risk and return drivers within the investment portfolio and to isolate specific risks so that you can have slightly more challenging conversations with managers. The nature of these conversations will be different dependent upon the nature of the asset class and investment strategy concerned; this is an evolving area which will continue to develop within the coming years.

Jessica: Are there any asset classes where monitoring managers on that daily basis is more challenging, and if so, for what reasons?

Sara: We have recently started to invest more in alternatives and have been primarily focused on real estate and impact investment funds. The latter are a completely different story though and we cannot just copy our traditional methods.

However, when we initially invested in these funds we came in as seed investors and this gave us the opportunity to discuss governance issues and the type of reporting that we wanted very early on. Outside of this we have also collaborated with other investors interested in the same funds. For most of us it really is new ground and we are in the middle of an ongoing learning process.

Governance issues are very important to look at. We have to be confident that the asset manager is well equipped to generate the expected positive impacts that they have promised us and deal with the risks. It is a very different type of assessment; it is resource intensive, not just a copy and paste of what we used to do.

Katie: Our monitoring systems are the same for all of our managers, no matter what the asset class. However, the quality of responses that we get through different communication channels varies. There are definitely some types of investments within certain asset classes where it is still a struggle to see how ESG analysis, stewardship and voting activities are relevant. We have a manager who runs a fund of insurance-linked securities and while we treat this manager the same as every other, the sorts of discussions that we have are very different because you are not investing in a physical asset.

Will: The conversations are very well understood in certain asset classes, predominantly equities and increasingly in fixed income and real estate. Beyond that the conversation is quite embryonic and the understanding of what you can meaningfully ask and assess is quite difficult. Not least in some of the investment strategies and asset

“There is a greater ability to now disentangle the risk and return drivers. . .”
classes that Katie eluded to it is not immediately obvious exactly how ESG links to performance or what analysis can be made. There is quite a long way to go in this respect.

**Jessica:** Ultimately where do you consider responsibility to lie— with the asset owner or asset managers?

**Will:** It quite clearly lies with both and that is the conclusion reached by the Law Commission’s review in the UK. It is pretty explicit that pension funds can delegate the stewardship activity and for the purpose of this conversation we can draw in responsible investment and ESG integration but, what cannot be delegated away is the actual underlying responsibility itself.

The challenge for UK pension schemes is that there are a number of very small schemes which do not have the internal resource to commit to this agenda and so there is a challenge for us to try and find the appropriate mechanisms, forums and tools to enable these schemes to engage with the topic. Individually they might not necessarily represent significant assets but as a collective clearly they do and, as a collective they can significantly influence changes in the markets. This is very high on the NAPF’s agenda and we hope that our Stewardship Accountability forums will provide a mechanism where smaller funds can join with larger funds to collectively leverage their voice to the wider market.

**Sara:** One has to look at the whole investment chain and it is important to stress the role of the asset owners. If we as asset owners don’t give asset managers long-term mandates and targets or explicitly require a sustainable approach, then they will continue behaving with a short-term mentality which will only prevent a sustainable investment chain.

**Katie:** I agree that the whole chain has a role and responsibility here but I do feel that the asset owners have an underlying responsibility to our members and beneficiaries. It is our responsibility to ask questions of the managers and make sure that managers are managing our beneficiaries’ money in a way that takes into account all of the risks as well as returns.

**Jessica:** Thank you all for sharing your thoughts on this subject.

“they are better able to understand where exposures are in relation to particular risks...”
SECTION 4

BEYOND EQUITY- THE NEXT STEPS

4.1 ROUNDTABLE
Developing your climate change strategy to mitigate risk in both current and future real asset investment projects

4.2 WHITE PAPER
Showcasing the impact of climate change

4.3 ROUNDTABLE
The ‘stranded assets’ debate: should asset owners treat fossil fuel investments as short-term vehicles?

4.4 WHITE PAPER
Overcoming the controversy of pooled funds and hedge funds for successful ESG

4.5 INTERVIEW
Capitalising on innovative opportunities in energy efficiency finance
4.1 ROUNDTABLE
Developing your climate change strategy to mitigate risk in both current and future real asset investment projects

Moderator
Pádraig Floyd
Freelance Financial Journalist, Money Journey Media

Panellists
Faith Ward
Chief Responsible Investment and Risk Officer, Environment Agency Pension Fund

Ritu Kumar
Director, Environment and Social Responsibility, CDC Group

Therese Kieve
Senior Analyst and Engagement Officer, Green Light Campaign, ShareAction

Pádraig Floyd: Is a greater awareness of climate risk and a further evaluation of asset owners’ position on projects they are invested in still required?

Faith Ward: Absolutely, there is certainly more to be done. Although asset owners are increasingly engaging on this issue. Climate risk is complex and there remains a long way to go in terms of understanding how we can integrate its considerations across all of the strategic decisions that we as asset owners make.

We use the term “climate risk” as a catch all phrase for a broad range of different risks and opportunities at a fund investment level. As a result, unbundling this in order to figure out how we can integrate its considerations across all of the strategic decisions that we as asset owners make.

Ritu Kumar: As a development finance institution, our focus is different from pension funds as we are deliberately seeking to deliver blended returns, financial as well as social and environmental. CDC has been working on the climate dimension of its investments in developing countries for many years – with numerous stakes in renewable businesses, for example. However, we recognised that we needed a more comprehensive approach in light of the growing centrality of climate factors to the countries we work in. So, in 2014, CDC adopted a new climate strategy with three priorities: energy efficiency, water and resilience to climate shocks. We are now working on implementing this across our portfolio, starting with our direct equity investments which we manage in-house.

Therese Kieve: At ShareAction, we believe it is crucial that asset owners, particularly pension funds, introduce policies to understand, re-assess and manage their climate risks. Education of the trustees is very important as unfortunately some feel that their fiduciary duties only relate to maximising financial returns. We want them to take on board the long-term assessment of ESG principles, including climate risk.

Faith: I would prefer to use the word comprehensive rather than sophisticated as that makes what we are doing sound potentially very resource intensive and inaccessible to other asset owners. The Environment Agency Pension Fund was conscience when developing its own strategy to be pragmatic. We recognise that we need to prioritise as some of actions will take a long time to tackle as answers aren’t immediately attainable. It’s an area that we have been exploring for over a decade and are continually evolving how we integrate climate risk. We are...
encouraged to witness that more and more asset owners are considering climate risk strategically, as part of their asset allocations.

We worked with Mercer as one partner on their project looking at impacts of climate risk on strategic asset allocation. We are confident that such projects will help tremendously in clarifying to asset owners that climate risk is a strategic risk that all asset owners need to be considering. We want to help communicate the fact that climate risk isn’t just something at the margins but rather that it should be a core consideration, just as liquidity or volatility might be.

Ritu: Within its portfolio, CDC is seeking to implement the government’s commitment to keep global warming below 2 degrees Celsius. In practice, this means that we will not make any new investments in thermal power generation using coal – and we are making sure that all our investments follow good practice in terms of energy efficiency, the cheapest and fastest way of cutting carbon. Beyond carbon, for many of the African and Asian countries where CDC invests it is the raw reality of climate impacts that pose the greatest risk to both development and our assets.

So as part of our strategy, we will be making sure that our new investments, for example in agri-business or infrastructure, are resilient to future climate shocks.

Pádraig: What starting point would you recommend for asset owners still struggling to get a cohesive climate change strategy off the ground and what should their core checklist be?

Faith: If your money is being managed externally you need to firstly ask what is already happening on your behalf. There are fund managers thinking about these risks, in many cases focused on particular sectors or asset classes, but there may well be that more is being done then you realise.

Many fund managers have mobilised a lot of their own internal resources to look at climate risks in a far more robust manner than ever before.

In terms of prioritisation, a little bit depends on what your own asset allocation is. Let’s say you have a lot in listed equities or bonds, you could use an initial carbon footprinting methodology on one or more of your portfolios. This methodology is extremely helpful in introducing both officers and trustees to where carbon risks are and how specific companies in various sectors might perform.

If your assets are in property I would advise to look at the IIGCC Trustee’s Guide: Protecting value in real estate. (http://www.iigcc.org/publications/publication/trustees-guide-protecting-value-in-real-estate-through-better-climate-risk)

It has been recently updated and is a really useful set of questions for trustees to ask of those managing their real estate portfolios and, a lot of this is equally applicable to infrastructure.

In terms of the expectations from beneficiaries I would direct them to the ShareAction Green Light. We have found it very useful in shaping our communications as to how we are tackling climate change issues.

There is a lot of information out there with most of it being completely free and available to asset owners. The prioritisation depends on what your own portfolio looks like, but a definite starting point is to ask your managers what is already happening on your behalf.

Ritu: The key is to make sure that climate factors are part of the regular investment process – not a green side-line.

Therese: It is important that the values of asset owners and fund managers are aligned. The asset owners need to scratch below the surface to ensure that there is a long-term vision there.

With respect to investing in a low carbon future, there should be a bit of caution about the types of projects you invest in. The same is true of green investments and sustainable funds because in addition to ensuring that they are low carbon, you have to be confident that the projects won’t impact negatively on water and food resources. There have been issues with items like biofuels and further down the line we may see adverse impacts.

Pádraig: Water is increasingly becoming a board level operational risk in that from a governance perspective they are conscious of not getting fined. How important do you rank this as?

Ritu: Water is not a distant threat for Africa and Asia – but is a real issue today. Unlike energy, however, much of the private sector doesn’t pay the true cost of water, removing the incentive to drive efficiency. One way of overcoming this as an investor is ensuring that portfolio holdings adopt best practice standards. For example, in Ghana I worked with local companies to set up the Green Building Council. This then introduced the Green Star certification scheme to drive improvements, notably in water and energy, primarily for commercial
Developing your climate change strategy to mitigate risk in both current and future real asset investment projects

buildings. In this case, the next step for investors is to ensure that not just the building is green, but that tenants adopt water saving behaviours.

Therese: It is certainly moving onto the radar because it no longer just affects developing countries. California has been in the worst drought for many years but Californian companies are reacting by taking the importance of water into account when investment decisions are made.

Faith: Water risk is extremely interrelated with climate risk. The advantage with thinking and communication about water risk is that impacts are occurring now. There are other aspects of climate risk which carry a significant degree of uncertainty as to who, what, why and when. Water risks need to be managed now because it is affecting many businesses globally either directly or indirectly through their supply chain.

On the upside this creates investment opportunities around water conservation just as there has been in the energy efficiency sector. As well as challenges the climate risk debate throws up investment opportunities in the form of solutions and innovations. The Environment Agency has a strategic target to have 25% of its fund in clean technology and strongly sustainable companies.

Pádraig: How varied does the climate strategy need to be between asset groups and geographies? For example do the considerations differ when dealing with projects in emerging markets?

Ritu: CDC only invests in emerging markets – where the environmental challenges are greatest and the capacity to respond is weakest. Even where environmental laws may be on the books, they are often not fully enforced and so the challenge for a responsible long-term investor is thus far more profound. The big advantage we have as an equity investor is that we can build long-term relationships with the management of portfolio companies and work with them to make ESG priorities such as climate a reality. With board level representation, we can often drive the agenda – and show the linkage between environmental issues and long-term value creation.

Therese: Carbon emissions from the developing world have now exceeded the developed countries and are set to rise further. Some projections have estimated that by 2020 nearly 2/3rds of global emissions will come from developing countries and so clearly much needs to be done to combat this.

Conversely, developing countries are also the least equipped to deal with the effects of climate change. These effects are starting to happen already. Take something like infrastructure, the challenge is immense and so as part of your green investments it is vital that you take on board these concerns when you are considering your asset allocations among asset types and countries.

Faith: In regards to emerging markets I would say the issues are broader than just climate risk; there is a whole host of environmental and social risks that need to be carefully considered and managed.

When we looked to increase our own fund’s exposure in emerging markets we put a strong amount of emphasis on finding a manager that we felt understood those risks and would manage them robustly on our behalf. We went through a manager selection process and 25% of their score was based on their capacity and knowledge in managing ESG risks. Focusing on climate risk, emerging markets is one of the more acute areas of concern because of both the direct impact and the more limited capacity and resources of the countries to adapt. This is the principal challenge facing the new global agreement on climate risk to be finalised in Paris at the end of the year.

Asset allocation is another key consideration when we are looking at climate risk and we need to examine how features of specific asset classes interact with both climate risks and other risks such as e.g. portfolio liquidity.

For illiquid assets and unlisted areas of our portfolio, the decisions that we make are much more heavily focused on the long-term approach to climate risk. The consideration and management of the risk has to be far more present at the front end of the investment process as once that investment is made and is in someone else’s hands, it is quite hard to exit should we find later that the decision was inappropriate.

Climate risk is very complicated and although we are getting more tools and information on how to deal with it, there is still a long way to go regarding how you manage the risk and how it interrelates with other portfolio risks.

Pádraig: Do you have any views on the impact of the current oil prices? We have already seen some investors try to move away from some of their less forward thinking oil companies out of a fear of ending up with captive assets if they didn’t diversify towards other renewable types of energy.
Therese: We don’t know if it is just a short-term blip but we are seeing a lot of strategies trying to address these carbon intensive types of portfolios. It could be engagement with oil companies to try and get them to take it seriously but it could also be just a case of improved stock selection.

Pádraig: Thank you for sharing your views on this topic.

“25% of their score was based on their capacity and knowledge in managing ESG risks . . .”
How can investors and business start a transformation in 2015?

2015 is set to be a year in which Environmental Social and Governance (ESG) factors are high on the agenda for investors, and are also among the most urgent global issues in the minds of business and political leaders and civil society. The opening weeks of the year have already seen the spotlight shine on two issues that Oxfam is focusing on because they are central to the fight against poverty and injustice – inequality, and climate change. Oxfam is focusing on these issues because of the way they are affecting the poorest people.

Climate change is already impacting food systems fundamentally, often in unpredictable ways. Extreme weather events disrupt production and distribution systems; changes in growing seasons and rainfall patterns are making it harder for smallholder farmers to sow, cultivate and harvest their crops; and increasing uncertainty makes it hard for them to manage risk and get a good, predictable price in the market. There could be as many as 25 million more malnourished children under the age of five by 2050 as a result of climate change – as many as all the children in the US and Canada.

Economic inequality is rising and becoming a critical problem within countries – both rich and poor. The sheer scale of inequality today has hit the headlines in early 2015, with Oxfam’s updated research adding to that discussion – including by showing that on current trends the richest 1% of the population will have more wealth than the remaining 99% of people by 2016.

Extreme inequality threatens to undermine progress to overcome poverty. Oxfam analysis shows that if India stops inequality growing it could lift 90 million people out of extreme poverty by 2016. But crucially, there is an increasingly strong body of evidence showing that extreme inequality hurts us all, by hindering economic growth, stifling social mobility, corrupting politics and fuelling insecurity and conflict – presenting a major global risk.

These two fundamental issues share some important characteristics. In terms of development and poverty reduction, they hit the poorest people the hardest, but they also threaten prosperity for everyone. For business and investors this is also true: as well as having significant direct impacts on the reputation, operations and profitability of businesses, inequality and climate change threaten to trigger much wider and systemically important impacts – disrupting and damaging the fabric of our society, environment and economy.

The impacts of inequality and climate change are at their most acute far down complex supply chains. The root causes of these issues and the solutions to individual challenges frequently lie beyond the immediate boundaries of the business, in wider industry/sector practices or in weak governance frameworks. They also lie beyond the traditional scope of sustainability or ESG teams, in the fundamental structure and purpose of a business.

Ensuring workers get a living wage and ensuring companies pay fair tax contributions and cutting carbon emissions to the level required to mitigate catastrophic climate change are all necessary to tackle inequality and poverty, and are examples of where businesses find it hard to act alone. The issue of living wage relates both to the direct employees of a business and those in their supply chain. The average pay of a UK CEO in a FTSE 100 company, which has doubled in a decade, is 131 times that of an average employee and around 2000 times as much as a typical garment worker in Bangladesh. Income inequality like this compounds other pervasive forms of injustice – inequality, and climate change. Oxfam is focusing on these issues because of the way they are affecting the poorest people.


How can investors and business start a transformation in 2015?

inequality – in particular that between women and men. For example, women make up the vast majority of the lowest-paid workers and those in precarious jobs.

Universally decried abuses like slavery and child labour sit at one end of a spectrum that includes millions of ‘low road’ jobs that trap people, especially women, in in-work poverty, as evidenced in three recent Oxfam studies, in Vietnam (with Unilever), in Kenya (with IPL/Asda) and in the tea industry (with Ethical Tea Partnership). The latter found wages below the poverty line in India and below the extreme poverty line in Malawi, despite meeting the legal minimum and providing in-kind benefits.

There has been some progress recently. The Living Wage Campaign in the UK has been supported by the public, politicians and investors, and has had a real impact. The number of the top 100 UK Companies which are living wage employers has risen from two in 2011 to 21 now, with more in the pipeline. ShareAction led the establishment of the Investor Collaborative for the Living Wage which has helped inform and amplify institutional investor support on this issue; and the campaign has produced clear messages about the benefits a living wage can bring to investors and businesses and the way in which they can overcome the perceived barriers to its implementation.8

The retailer H&M remains a rare example of a business that demonstrates it has grasped the need for a more holistic approach in its “Roadmap to a Living Wage”, which highlights the roles of governments, trade unions and employers as well as stating its willingness ‘to pay more so that our suppliers can pay higher wages’9. It was one of the major fashion retailers who responded positively to the plight of Cambodian garment workers demonstrating on the streets of Phnom Penh, by stating that they were willing to factor increases into their pricing to enable the minimum wage to be raised. The new rate of $128 a month remains some way short of the living wage benchmark of $177, but represents significant progress both for wage levels and in the approach taken to address the challenge.

But still there remains insufficient acknowledgment in company policies about where we need to get to: the expectation for businesses to ensure they support the payment of a living wage throughout their supply chain. There is also a dearth of information and effective indicators for investors to assess progress. It is almost a century since the ILO Constitution recognised the need for workers to earn a living wage – one which enables them to meet their own and their families’ essential needs. Yet there is very little assessment of how companies are implementing it and with what outcomes.

“clear messages about the benefits a living wage can bring to investors . . . ”

The debates and revelations around corporate tax behaviour which have already shifted the political agenda are similar. It is clear that legal compliance is an insufficient approach for companies to take. It neither protects companies from reputational risk, nor addresses the questions at the heart of the matter: is the business playing fair and contributing to the common good? The distinction between what is legally defensible and what is right lies at the heart of defining responsible behaviour on tax, and ultimately the question is how (rather than whether or not) to develop ways to conduct business activities that are compatible and designed to support paying sufficient tax.

From the established investor initiatives to tackle climate change, to the groundswell of public support behind fossil fuel divestment, to the breakthrough in perception of risk triggered by the Carbon Tracker Initiative on stranded assets – the issue of climate change has brought strong recognition of the need to address the role of business in systemic transformation. We are seeing greater urgency and appetite to hold investee companies to account. In 2015 this will be more important than ever to expose the blockers who could undermine progress towards a global climate change agreement at the Paris Conference of the Parties that will deliver ambitious progress towards a global climate change agreement at the Paris Conference of the Parties that will deliver ambitious emissions reductions to keep global warming below 2C and delivers finance at scale for mitigation and adaptation.

How do we tackle transformation?

Tackling systemic issues like these involves nothing less than a transformation in current approaches. Rather than taking the external environment and business strategy as our given starting point and working forward to what changes are available (and for which a business case can be made); we need to ask ourselves a transformative question - what would we need to change in order to normalise payment of a living wage and a fair amount of tax? How can we structure our operations and influence our environment to achieve those goals while succeeding as a profitable and sustainable business?

How can investors and business start a transformation in 2015?

These are challenging questions, but they must be tackled. Oxfam’s recent report, ‘Steps Towards a Living Wage in Global Supply Chains’, breaks down the forces for and against taking action on living wages. This helps illustrate the need to think about a single issue like this in the context of transformation over time in business models as well as market and governance systems.

Investors can drive business change on issues like the living wage and tax, as they have begun to tackle climate change impacts and risks in investments. We need to close the gap between high expectations and norms for the social impact of business and the reality of the need for much greater progress on key issues like living wage and tax as well as on climate change. We encourage investors to help close that gap in several ways:

- Support the establishment of clear norms and standards to set the bar for business and investor performance on issues like the living wage and tax, and engage with investee companies to ensure they commit to progress towards them.

- Work with businesses, civil society organisations and other concerned stakeholders to improve understanding of the actions businesses can take (individually and together) to meet those commitments; and to establish effective ways to assess policy and performance that promote a race to the top.

- Support a transformative approach – looking deep into the business, looking down the supply chain, and looking out at external factors to ensure that the efforts made today by individual companies and across sectors support a shift that situates social, environmental and human rights impact alongside financial sustainability at the centre of company strategy and business purpose.

- Ask companies to disclose their lobbying activities on key issues, and challenge them in cases where their influence on policy (direct or through business associations/lobby groups) fails to support their own commitments and the established norms and standards they need to reach.

Among new initiatives, the project to create a Corporate Human Rights Benchmark has great potential to encourage just such a transformative approach in a systematic way across the capital markets, starting with a few sectors where human rights are key. Oxfam hopes to see initiatives like this realise that potential, and aims to have more and deeper engagement with investors as well as companies - raising awareness of the issues, challenging behaviour that hinders progress, identifying lessons, and demonstrating the benefits that are within reach if we stretch beyond business as usual.


“Investors can drive business change on issues like the living wage and tax . . .”
Pádraig Floyd: Matthew, I understand that back in 2013 Storebrand began to divest from fossil fuels, citing that they were financially worthless assets—what evidence brought you to this conclusion and was it the only driver behind this decision?

Matthew Smith: We don’t have a position at Storebrand that all fossil fuels are inherently worthless. What we do see is that certain carbon intensive forms of fossil fuels have the potential to be squeezed over the next 5-10 years.

When we started our divestment programme back in 2013, we focused on very specific fossil fuels producers that were extensively exposed to coal and/or predominantly involved in the production of oil sands from the Canadian oil fields. Our divestment is driven by our targeted identification of fossil fuels that are carbon intensive and therefore expected to lose competitiveness in the long-term.

As a long-term investor our view is that fossil fuels will come under significant pressure, sandwiched by two complimentary forces. The first is more stringent carbon regulation which will increase taxation on emissions. At an international level there have already been bilateral agreements between China and the U.S. to ambitiously cut carbon emissions by 40% by 2030, and we expect similar agreements to follow.

The other side to this is that cost effectiveness of renewable energy sources is increasing. China gets a lot of flack in the media for its coal production and coal fired plants but what’s often underplayed is that in 2014 they were also the world’s largest producer of renewable energy.

Our decisions on fossil fuels are informed by international research such as research done by the Carbon Tracker and University College London which shows that if we are to reach our 2 degree target that the Intergovernmental Panel on Climate Change (IPCC) has set, then we have to leave 82% of coal in the ground and 49% of all known gas reserves.

Frank Curtiss: We have also been following developments closely and agree that the Carbon Tracker thesis of stranded assets advocates is a situation in which we could conceivably end up in. It’s by no means far-fetched and it is a sobering thought for a long-term investor like us whose liabilities stretch decades; our tail end liabilities are 50 years in the future and so of course such events will affect our beneficiaries. However, we don’t think the time has come to divest entirely because of the wealth of alternatives that we are certainly considering, some sort of carbon tilt for example.

A lot of our index positions are by nature carbon intensive and we have been exploring whether or not it would be feasible to create an index that strips out or underweights the most carbon intensive stocks. We are also slightly ahead of the Montreal Pledge because we have already carried out a carbon snapshot several times in the immediate past and found that despite our significant passive index exposure to high carbon stocks, our active exposure was actually lower than expected. Using our carbon consultant Trucost’s methodology, it’s been clear that by stripping out up to 20 stocks we have potentially reduced the emissions attributed to our portfolio by almost a third.

To reduce active positions you have to think hard as to whether or not it’s the right path but I would still say creating indices that eliminate certain stocks is much more challenging, as my portfolio construction colleagues made very clear to me. It’s certainly an area that we are actively exploring because we feel that in the long-term too much carbon will have repercussions; coal and tar sands are the most vulnerable with natural gas just behind.

Edward Mason: There is obviously an investment issue here and the Carbon
The transition to a low carbon economy.

For us it’s an issue of public policy because the Carbon Tracker scenario will only come about if the right public policy framework is put into place. This is the current problem for the investment management industry and until the policy is in place investors are unlikely to plan for a world that will stay within 2 degrees of warming.

Consequently our activities focus on seeking to influence public policy into establishing the most appropriate incentives and carbon pricing to prevent a situation of catastrophic climate change. We also do a lot of engagement with companies to try and encourage them to adapt to the transition to a low carbon economy.

The challenges for asset owners differ from those that asset managers face. We use multiple external asset managers and normally don’t take a view on the economy’s strategic shifts because we rely on our managers to respond appropriately to technological changes. In a sense part of our investment protection is the fact that we seek to employ investment managers who can respond in the best way to these challenges and protect our investments accordingly.

It’s only through our ethical investment policy that we would adopt a macro view. We plan to adopt a new climate change policy in the first half of this year and this will create an enhanced ethical investment framework for how we approach climate change.

We are advised by an Ethical Investment Advisory Group who have already stated that they are unlikely to recommend full fossil fuel divestment. As a result we expect a policy with a comprehensive suite of ethical and responsible investment tools that appropriately respond to the climate change challenge. For us, it’s about playing a constructive part in hastening the transition to a low carbon economy.

Matthew: You haven’t yet enacted any changes then?

Edward: We have – for example a major sustainability mandate with Generation Investment Management. We are working to enhance the sustainability of our portfolio and further develop our insights into sustainability themed investment management.

Matthew: The exclusions that we have apply to all assets under management as opposed to just a dedicated environmental fund.

We have replaced coal companies and oil sands companies with more efficient and less carbon intensive energy companies and whilst we didn’t reduce our exposure to the energy sector we have moved to less intensive vehicles. We have had an exclusion policy on a range of topics for quite some time and run extensive back testing on the effects of excluding companies. These tests have shown that in order to retain portfolio stability and returns we have to re-optimise and ensure that exclusions are replaced by companies with similar market attributes. Our research has demonstrated that if this strategy is carried out systematically we are able to maintain the same tracking error and expected returns over time.

Frank: There are certainly already signs of change as certain types of fossil fuel companies are regarded as less attractive. It will be interesting to see

Pádraig: You haven’t yet enacted any changes then?

Edward: We have – for example a major sustainability mandate with Generation Investment Management. We are working to enhance the sustainability of our portfolio and further develop our insights into sustainability themed investment management.

Pádraig: Matthew can you give us an idea as to how you replaced vehicles and what the impact was on the fund’s stability and liquidity?

Matthew: The exclusions that we have apply to all assets under management as opposed to just a dedicated environmental fund.

We have replaced coal companies and oil sands companies with more efficient and less carbon intensive energy companies and whilst we didn’t reduce our exposure to the energy sector we have moved to less intensive vehicles. We have had an exclusion policy on a range of topics for quite some time and run extensive back testing on the effects of excluding companies. These tests have shown that in order to retain portfolio stability and returns we have to re-optimise and ensure that exclusions are replaced by companies with similar market attributes. Our research has demonstrated that if this strategy is carried out systematically we are able to maintain the same tracking error and expected returns over time.

Pádraig: Frank have you made any changes that you have tracked and can confidently say have had an effect?

Frank: We’re still considering what to do next given that our carbon snapshots demonstrated that our exposure to carbon was lower than we thought. That said though some of our managers were without a doubt “dirtier” than others and subsequently they are no longer our stable managers; although some were also fired for other reasons. Interestingly most of these managers weren’t even aware of how dirty they were nor that that they were investing in carbon intensive stocks. They simply had no idea of the environmental implications. It is a very good idea to do a carbon snapshot and then slice and dice your external fund managers accordingly because there will always be differences between managers.

Pádraig: The proliferation of the climate change debate has undoubtedly pressurised investors away from fossil fuels but are there short-term benefits still to be reaped?

Matthew: We are a long-term investor and our commitments stretch to the middle of this century. That being said we accept that fossil fuels will continue to be part of the energy mix for the foreseeable future. The challenge is to start making that transition to a green economy and to get the balance right. Already the value of pure coal based companies has taken a hit, losing over half of their value in the last two years and as Frank alluded to, the pressure on these “dirty companies” is being felt. It is time to move before it is too late.

Frank: There are certainly already signs of change as certain types of fossil fuel companies are regarded as less attractive. It will be interesting to see
what will emerge from Paris later on this year as that will have a longer-term effect if they do anything decisive and more conclusive than Copenhagen did five years ago. As the delegations begin to arrive some parts of the market will begin to draw conclusions around fossil fuel prices but until there is a clear direction on how externalities are to be priced and how quickly that will happen, I don’t see revolutionary change.

**Edward:** It makes sense to have a differentiated approach to different types of fossil fuels and we recognise this in an ethical context as well as financial. In both cases the priority is to move away from the highest carbon fossil fuels.

One has to be careful though about drawing too many conclusions from short-term changes in prices and values of securities. We know that there are specific factors at play in the U.S. in terms of shale gas displacement of coal and all commodity producers are subject to share price volatility. What we need is a long-term shift in public policy signals and certainly we are already seeing a strengthening of this.

**Edward:** It is however politically difficult; the current government came to power pledging they would be the greenest government ever and I think David Cameron probably believed it but, five years down the road the opposition from within the Conservative Party has made it difficult to follow this pledge through. I’m not trying to make a political point though because certainly, whoever succeeds the current government in May will have the same difficulties.

**Edward:** It is unrealistic to think in terms of sudden policy shifts particularly in an environment like the UK where we have long-term carbon targets and an established carbon budget system. I would say it’s more about a gradual tightening of policy and as Frank mentioned, there are real political issues at stake; we have seen the government removing the fuel price escalator and actually cutting taxes on fuel, despite their initial pledge.

**Padraig:** Frank and Edward, if the UK Government imposes heavy taxes on fossil fuels as a serious bid to meet their 2015 carbon cutting targets undoubtedly those invested will suffer. What steps should asset owners take to mitigate against yield loss?

**Frank:** They should step up their consideration around what mitigating acts they can take. The UK is only a small part of the global economy and so for us activity here doesn’t necessarily affect the entire portfolio because the U.S. is our biggest market. The UK FTSE 100 is really a global index but I would say that any changes the UK Government make, will only act as a moral example, tangible impact will be limited.

It is however politically difficult; the current government came to power pledging they would be the greenest government ever and I think David Cameron probably believed it but, five years down the road the opposition from within the Conservative Party has made it difficult to follow this pledge through. I’m not trying to make a political point though because certainly, whoever succeeds the current government in May will have the same difficulties.

**Padraig:** In place of fossil fuels, what renewable energy alternatives do you currently consider to be offering the most attractive long-term projections?

**Matthew:** Hydroelectricity is a very attractive investment and one of the first green bonds issued in Norway just recently was in fact a hydroelectric project.

In terms of untraditional renewable projects, solar and onshore wind projects are ones that we feel have the most competitive potential. There is a risk that the recent downturn in oil prices will effect investments in these areas if only in the short-term.

It is important to take on board that being part of a new green economy and accelerating the transition to a new green economy is not just investing in pure wind or solar companies. I say this because many traditional utilities companies are undergoing quite a fundamental change in terms of where they are getting their energy from. Many of these are traditional companies and even though they are still quite dependent on coal, they have the technology to effect quite major changes.

For example, if you look at the performance of EDP in Portugal they have a goal of reducing their carbon emissions by 70% and have reduced the proportion of energy generated from coal from 52% to 28%. They have also increased renewables from 2% in 2005 to almost 35% in 2012 and are now one of the largest wind operators globally. This is an example of the type of company that we are looking to invest more in as even though they still get almost 30% from coal, they are well

“be careful though about drawing too many conclusions from short-term changes in prices and values of securities . . .”
under way in the green transition and it is important to focus on companies like them.

Frank: Yes there are renewable energy alternatives and we are looking at them through the private market part of the portfolio, in terms of both private equity and infrastructure.

As we are risk adverse and concerned with the long-term we are interested in projects that have government backing; Green Bank for example is in the process of trying to raise hundreds of millions for its proposed offshore and onshore wind projects. We feel that this is something worth investigating and have more faith in wind than ever before, particularly given that in the not so distant past there were some problems with the technology and with wind turbine gear boxes failing. That seems to be behind us now and the much improved technology is repositioning this renewable source as an attractive investment proposition. We are aware that there is an awful lot in the world that could power generators and clearly there is a strong renewable source in this country that is worth exploiting.

Solar forms a smaller part of our interest but is under consideration, as is biomass, but really wind is for us the strongest bet at the moment.

Edward: We are in a similar position to Frank in recognising the opportunities in solar and onshore wind. We are in quite an interesting position as rural land is quite an important part of our portfolio, around 10%, which means that we are interested in wind and solar opportunities there and like the reliable UK regulatory regime.

Fundamentally I would come back to the point that what we need is effective public policy that is perhaps neutral on technology. We ideally need carbon pricing that then lets the market decide which technologies are the winners and how best to make carbon savings including through energy efficiency. We must get the policy framework right.

Padraig: Thank you all for sharing your insights into this topic.

"QUOTE . . ."
4.4 EXPERT DEBATE

Capitalising on innovative opportunities in energy efficiency finance

Noel Hillmann: How is the built environment, the real estate sector specifically, addressing the evolving energy efficiency legal framework?

Karen Wordsworth: The real estate sector is addressing the legal framework in two ways. There is polarisation in the market as certainly a number of market participants are now very aware of the legal framework and compliance issues around energy efficiency and the risks involved in creating a compliant real estate portfolio in terms of the valuation risk. If you are not up to a certain level then the valuation level of your portfolio will decrease because you are not efficient and under the Energy Act, will not be able to transact.

On the other hand, the other part of the market is not addressing the topic of energy efficiency because they feel that it is either too difficult, is a multi-tenancy estate or that there is no clear line of sight over who actually owns the energy problem. Payment for the bill is often the responsibility of the tenants and consequently this means that there is no clear direction on who is required to take charge of compliance.

One area of change to that is that the Energy Savings Opportunity Scheme (“ESOS”) comes into effect this year, stating that by the 5th of December 2015 any organisation with real estate assets, who have 250 members of staff and over €50m turnover has to do an asset register and audit of all of their built estate. This is to ensure all of their buildings are compliant with ESOS but we are still being surprised by the number of clients who aren’t aware of that.

The Energy Act says that by 2017 you have to have achieved a minimum standard otherwise you can’t transact. Again there have been some discussions in the market but there are concerns that with an election on the horizon some regulatory aspects might not be carried through to the new parliament.

James Holley: We are also seeing issues emerge as a result of the oil price dropping and it could also be argued that companies are less incentivised to invest in energy efficiency measures. We still see the regulatory framework evolving as it relates to carbon emissions and greenhouse gas targets. In addition to what Karen mentioned there is pre existing legislation such as the Carbon Reduction Commitment Scheme and even though it has faced some challenges, it nonetheless imposes a carbon reduction commitment and energy efficiency targets on businesses. Businesses will need to continue considering energy efficiency type measures in order to meet those carbon reduction commitments and greenhouse gas targets.

In summary we are still seeing a pull towards a need to invest in these areas because legislation continues to drive that requirement.

Karen: Although the oil price is getting a lot of attention it doesn’t overcome the UK issue that the capacity of the system is such that with the aging coal fleet and delays in the nuclear build, there is still not going to be enough energy in the system going forwards. An emphasis will remain on energy efficiency because of course if you are using less power there is obviously more power that can be used more efficiently. However, as we move forward it will certainly be a policy measure largely because of the problem of capacity in the market.

Noel: What types of energy efficiency finance opportunities should asset owners be seeking and why?

Karen: Assets for energy efficiency cover a whole range of items. These range from lighting projects to heating, ventilation, air conditioning right through to combined heat and power generation and creating onsite opportunities to capture heat generated.

Where credible finance opportunities exist are the areas that predominately explore how you make the most of those assets and how you might fund them. For example, we are working with a major utility company to help them respond to and implement the energy services ESCO model. They are offering their clients the opportunity to invest in equipment and technology that would reduce their consumption and this is then paid for out of the energy savings. Such an offering can then be financed through a number of ways; there are specifics around assets and lease funds available through banks and private financiers.

Banks that have a focus on ‘green investment’ provide a number of opportunities to organisations to fund energy efficient assets.

Looking at combined heat and power (CHP) plants we are talking to some retailers who are actually looking...
to put such technologies into their estate. Often they are financed by third party capital but the outcome differs slightly in that they are buying a service rather than an asset. It becomes just an ordinary revenue account or just Operational Expenditure (“OPEX”) in private sector terms instead of a capital outlay. We find that a number of these organisations are capital constrained and so the emphasis should be on finding a way of financing these equipment upgrades through the energy savings that are predicting over the next 5-10 years. These types of arrangements can be done on rolling contract terms; we have seen a large multinational retailer on their 2nd or 3rd lighting refresh simply because technology is moving so quickly and efficiently.

The lighting suppliers themselves are also offering some of the finance and are developing a fully funded lighting proposition. Under these propositions it is feasible to replace all of the lighting in a hotel but fund it against the savings guaranteed by the lighting supplier. Ultimately there are a number of different options and having a lack of finance shouldn’t be a barrier to stopping you take on even the most ambitious energy efficiency projects.

The reasons and barriers for it not taking off in the marketplace is often because it requires segregation of a number of projects over multiple sites that need project management and from that perspective is time consuming.

In terms of the regulatory framework, the ESOS is making it mandatory for any investor to run a portfolio audit to see which assets available can be upgraded.

We are aware of one financial institution looking at how to manage the energy, refurbishment and renovation risks of a large block of former Soviet buildings. A key driver behind this is the fact that the country is heavily reliant on imported gas and is spending around €1.5m per day on it. Of that the residential sector consumes approximately €600k and through energy efficiency projects there is potential for up to €300k per day in savings. It is these saving that could then be used to fund the renovation of the low grade buildings.

From a security of supply and geopolitical perspective, there are a number of reasons as to why this is a cost effective way of renovating buildings that have been abandoned for 25 years. Regardless of whether it is the fabric of the building, insulation, elevators or electrics and so forth, all of this infrastructure can be invested in and paid for through the quite dramatic energy savings.

Noel: Do you feel that there has been a divide between the UK and Europe as a whole in terms of the uptake of such initiatives?

Karen: Energy efficiency in Germany has been very effectively implemented through regulation, the ownership of government buildings and technological advancements and so yes, in that respect, the UK is behind. The Dutch market is similarly doing quite a lot of work in the energy efficiency space whilst Scandinavian countries perhaps have a greater requirement to look at areas such as heating, as opposed to any other geo efficiency under the same banner.

The reason why it hasn’t manifested in quite the same way is that whilst energy is topical and it is fashionable to have a view on it, the actual cost of energy itself is still quite low in terms of the overall cost of running a portfolio. If you are a major hospital or shopping centre owner the cost of your energy is not your number one priority or risk. However, that doesn’t however mean it’s not a significant expense and one that shouldn’t be looked at in the future.

The UK has also been held back by the fact that we don’t yet have a consolidated energy efficiency policy; carbon reduction targets came but were then watered down. ESOS has come in but I would argue that it appears to lack real bite because essentially it only requires you to do an energy audit, not to implement the findings. The aim has essentially been to create public awareness of what you could do. Even though there may be shareholder pressure to make those identified savings, there is no regulatory framework in the UK that forces you to enact those fixes.

The financing of energy efficient types of projects has also been quite difficult. Whilst there is no lack of money in the market, to make it attractive for the financial services sector, green finance / funds or any of the high street banks involved need to ensure they have quite a lot of aggregation across the assets.

As of now there is a high degree of political and journalistic interest in energy prices and what providers and suppliers are doing. It doesn’t however; translate into action on energy efficiency. If we think about our own houses we know how we could save money at home but I don’t think such attitudes automatically transfer across into our employment world. There seems to be a behavioral barrier in the UK on perhaps wasting energy.
James: During the recession many companies battened down the hatches and focused solely on trying to maintain a steady stream of business through hard times. Consequently the availability of capital and the provision of capital expenditures (“CAPEX”) into such energy efficiency projects might not have been the focus at the time.

Noel: How can these opportunities help deliver the long-term returns needed?

Karen: With any long-term return you also need to look at the long-term risk. One of the provisions that the Energy Act will introduce in 2017 is that you have to have certain levels of energy efficiency of your buildings to be able to transact on. If you don’t then you can’t transact on a building which means that you don’t get the expected financial returns on those assets.

There is a mindset that says that you have to look at the long-term viability of a portfolio. If you can’t sell them because they need to be refurbished before they get to the appropriate level to transact, then of course you will have a different perspective. There is also a lot of money in the market for long-term propositions. If you can have the resources to develop an energy savings and efficiency programme over a 20 year life cycle you are lucky because at present there is a lot of money available in the market at quite low rates of return to fund such projects.

The opportunities can deliver good returns on refurbishing and valuation of assets. Also, the cost of those refurbishments can be borne out of the energy savings made at very attractive rates of investment. By this I mean that pension funds are very interested in energy efficiency and aggregation of projects. A portfolio manager, for example, who has a supermarket as part of their assets is paying nearly £1m a month on lighting assets and its upgrades. Those types of projects that are fundable over the long-term have a market impact on the attractiveness of the estate and also on the way that your own customer base interacts with you assets. Therefore if you are a retailer, changing the lighting will have an impact on the attractiveness for a customer in your retail outlet.

What we are finding with a lot of portfolio and real estate owners is that there is quite a backlog in maintenance and renovation issues. James touched on the austerity measures and I can only stress that in such times it is refurbishment and upgrades that are stopped. Yet more often than not we find that it is the energy efficiency projects that allow you to pay for a lot of those upgrades.

Noel: To what extent is there a marked regional difference between energy efficient projects?

James: Much is driven by climate and the Scandinavian and Eastern European countries uptake is greater because of the harsher temperature extremes. The potential uptake and appetite for investment in energy efficient projects is perhaps more favorable given the urgent need to address those issues and the cold weather that they face.

Karen: The only other area where there has been regional differences is in the take up of the public sector. In the UK we have seen some cities emphasising energy efficiency and updating their buildings to be more energy efficient. That has been promoted as a mechanism of investing and expectation of the city’s ecosystem. Sustainable city agendas are also starting to push some of these regional differences. Bristol is an example of a sustainable city in 2015. Their policies and data it is going to allow you to continue developing.

If you don’t monitor and manage the processes then naturally you won’t make a difference to any element of your procurement and cost base. As soon as you’ve got the information and data it is going to allow you to put measures in place with a degree of confidence. The business case is then much easier to demonstrate. The whole geopolitical area around energy doesn’t move. Fracking in the UK is having an impact to such an extent that questions are being asked as to what the long-term future for fracking will be.

Similarly political pressures regarding the oil price has led to many questions over its sustainability. There are suggestions that the price might stay at
$70 dollars a barrel for the next 3 years but that is not a long-term prediction.

Added to that are the geopolitical issues around gas in that Europeans are very exposed to the nuances of Russia’s foreign policy. Going forwards energy efficiency is going to be part of the proposition for managing sustainability, with the other two pillars being how you buy your energy and what it looks like. To understand how you do that on the demand side you need to have the data, because it is only with that data and subsequent understanding that you can factor in new technology.

The cost of technology is coming down. Solar panels are markedly cheaper and we are on version three of LED lighting. These upgrades in technology are what allows us to move forwards. There is a lot of emphasis on bringing in new areas of sustainability and we are seeing much interest in ground and air source heat pumps and similar technology. Moreover, the building regulations that are coming in will make sustainability issues more commonplace.

**James:** From a legislative and regulatory perspective there is uncertainty, particularly in the UK where we may have a new government on the horizon. It is fair to say that some of the environmental/energy initiatives and regulations that have been regulated to date haven’t really delivered what they set out to do. We all know about climate change and that the need to reduce the carbon footprint won’t go away. We will need the policy makers to step up and provide more legal certainty so that investors continue to feel comfortable investing in this area. It is without a doubt the area to watch.

**Noel:** Thank you both for sharing you views on this topic.
DEPLOYING CAPITAL RESPONSIBLY

ROUNDTABLE
Do investors expect the social bonds of ‘impact investing’ to deliver the projected returns?
Noel Hillmann: What does your involvement in impact investing currently look like and how does it distinguish itself from both responsible and ethical investing?

Paddy Dowdall: We currently have an impact portfolio investing in housing, lending to small and medium size enterprises, renewable energy and social infrastructure. These investments have followed on from the Investing 4 Growth project which was a collaborative exercise between five local authority pension funds. We hope that by establishing our own successful impact portfolio others will join us.

With regards to the labels of responsible and ethical, my view of responsible investing refers to the shareholder responsibility and ethical investing primarily to screening. We do of course encourage and support engagement with companies and exercise voting rights, in line with our voting guidelines for the Fund’s public equities. However, impact investing is about having a positive impact locally and economically. As a local authority pension fund the twin aims of commercial returns and supporting the area is very important to us for our impact portfolio.

Chris West: We started supporting social enterprises and impact investing soon after we were established in 2000 and these terms were in common use. This reflected our belief that these approaches would be more effective at generating scalable social impact in the emerging markets in contrast to more traditional philanthropy.

We now have a track record of supporting a diversity of pioneering social enterprises. Just as Paddy states, our prime purpose of impact investing is to deliver both social impact at scale and in ways that are financially viable. We have learned that there is a trade off in terms of financial returns, but have demonstrated this to be a more efficient, scalable and sustainable mechanism for delivering social impact.

Our strategy has been very deliberately focused on achieving blended returns. I agree with Paddy that impact investing differs from responsible or ethical investing which, can be narrowly defined as the screening out of investments not aligned with the overall mission. For us, impact investing includes a range of different financial instruments designed to generate both social and financial return.

Noel: Given that the Shell Foundation is associated to a mining company, an oil explorer, how much influence does the sponsor have in choosing your allocations?

Chris: We’re an independent charitable foundation and so we decide what we support, where we work and who we partner with. Nevertheless we have deliberately sought to harness value-adding support from our parent if it can help us and our partners achieve impact in that scalable and sustainable manner.

In my opinion this approach is remarkably different from many other corporate foundations, but we believe we have proven to help us achieve social impact at scale in a far more disciplined and sustainable manner.

Noel: Does the parent company provide any guidance at all or is there a true separation?

Chris: We have business principles that enshrine our charitable independence. It was our decision to engage in supporting social enterprises through impact investing, as well felt it was the best way to achieve of charitable objects. We choose which instruments to use and partners to support. To date we have invested through equity, guarantees and convertible grants. We are flexible on what is the most appropriate form of investment for each particular social enterprise. Any reputational benefit to Shell Foundation, or our parent, is incidental as we seek to enhance the brand of the partners we support.
**Huib-Jan de Ruijter:** FMO is the Dutch development bank. We finance the private sector in emerging markets because we believe that financing entrepreneurs from developing countries leads to a thriving and sustainable environment that can only further fuel economic and social progress.

Our vision is a world in 2050 where 9 billion people live well within our planet’s limits. More recently in our strategic update we set ourselves the audacious goal to work towards becoming the leading impact investor in 2020 by doubling our impact and halving our footprint. In terms of doubling our impact we are looking specifically at doubling the number of jobs created directly and indirectly. Moreover, in terms of halving our footprint we are particularly concerned with the avoidance of greenhouse gas emissions and for us, it is things like these which set us apart from responsible investing. Like Paddy and Chris I feel the latter is more focused on negative screening and risk management from an ESG perspective and not intentionally targeting a positive impact from an ESG perspective. Thus our long standing interpretation of the legal position reinforced by a recent legal opinion commissioned by the LGPS Shadow Scheme Advisory Board and the Law Commission report is that our investments must aim to generate commercial returns but that we can take other factors into account where returns are not likely to be adversely affected.

**Noel:** One of the things that strikes me about the FMO is your fostering development element. How much of FMO’s purpose is an actual political and economic one for the desire for closer ties between the Netherlands and overseas areas?

**Huib-Jan:** Historically we were always geared towards development objectives and in that sense there was no necessity for a link with Dutch businesses or the Dutch economy. That said, on a more political level you can see a convergence in the Netherlands of the aid and trade agenda whereby there is a desire to both build closer links and introduce specific expertise that Dutch companies have. This can be very valuable for development purposes to those countries we are working with and at FMO, we’re keen to play a role in that and essentially form a bridge between Dutch society, Dutch businesses and entrepreneurs in the emerging markets.

**Noel:** What tangible benefits have you experienced from such microfinance projects and are you confident that the bonds will sustain the returns promised?

**Chris:** Our areas of focus include access to energy, sustainable mobility and job creation by the SME sector - not microfinance. We have used a variety of financial instruments, though not bonds. As a philanthropic organisation we start by considering which type of financial instrument would best help our partners achieve social impact at scale and in ways that are financially viable. While measuring financial performance is relatively straightforward, measuring social impact is more difficult, and remains a challenge for many organisations involved in impact investing.

With regards to blended returns, we have seen a trade-off between social impact and financial return. Many of our social enterprise generate marginal financial returns – though deliver social impact at scale. This often means that certain investors have return expectations that are not aligned to what we believe the sector will generate.

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**Do investors expect the social bonds of ‘impact investing’ to deliver the projected returns?**

“It’s important to remember that impact investing differs from responsible or ethical investing.”

In order to create that scale we share our own knowledge and expertise and we have essentially opened up our network for other institutional investors by offering them investment funds and sustainability bonds. These bonds have a risk profile very similar to overall corporate bonds whereas the investment funds have a higher risk profile. Through these instruments we are engaging with the investment community in order to achieve a much bigger impact than we could achieve with our own money only.

**Noel:** Paddy, was your decision driven by investment or a philanthropic considerations?

**Paddy:** We have no basis to make philanthropic decisions because our trustees have to act in line with their fiduciary duty and given that we are a defined benefit (DB) pension scheme, the balance of cost is met by employers.
Do investors expect the social bonds of ‘impact investing’ to deliver the projected returns?

With respect to bonds, I am worried about structures that have mixed motives with respect to certain investors seeking to maximise social impact, and others to maximise financial returns. We have instead found greater success through creating tiered capital structures that can accommodate investors with varied risk/return expectations.

Impact investing as a whole requires “venture philanthropy” to create a pipeline of investment opportunities. Venture philanthropists take early stage high risk positions in helping social enterprises test new business models and start to generate track record. I believe it is important to realise that there’s a need for both venture philanthropy market creation and impact investment to then nurture and grow that market sector. The two are quite closely related and it would be too narrow to just look at impact investing on its own.

Noel: Are there any sub-sets and specialisms of impact investing that you are currently monitoring with the view to consolidate future investments in?

Paddy: We’ve dipped our toe into social impact bonds and are very interested in that being a public sector provider. These are bonds linked to service outcomes and often the service provision can be from third sector organisations. Thinking philosophically it may enable public sector investments to equally deliver financial return and have positive social impact from expenditure/investments.

How that works though reverts back to the people that implement it and how it’s measured but we do feel there is an opportunity for dual positive outcomes. It’s early days though and there are concerns over the scalability of the opportunity; however, we are looking to build a diversified portfolio of investments capable of delivering our target return.

Chris: While we have our own sector focus, our learning is generic. I see a need for better syndication between venture philanthropy – that can create and test new social enterprises – and impact investors. My own view is that there is a need for investors seeking capital preservation before many social enterprises become attractive to impact investors. As this industry is in its early stages a lot of organisations are operating in silos and my gut feeling is that in the next 5 to 10 years we will see people with different levels of risk tolerant capital with a prime social purpose, coming together to really generate a much stronger viable pipeline. I also predict that this will offset what I think is a risk to many impact investors who presently, don’t see a high enough quality of projects coming through.

Huib-Jan: The two areas I’m most interested in are on the one hand green investments and on the other inclusive investments. The latter of which are targeted at the base of the pyramid. These ones we want to do more of.

On the other side of the equation there are two things we focus on; the growth of sustainability, social or green bond markets, which really facilitates more institutional investment in these sectors through low risk bonds. Our fund management efforts are trying to get investors to actually take the underlying equity or debt risk. Activities such as these will be really helpful in scaling up the impact investing space overall and the impact that we create collectively.

Noel: Thank you all for your viewpoints.

“Impact investing as a whole requires “venture philanthropy” to create a pipeline of investment opportunities.”