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ESG IN AUTO-ENROLMENT: ENTERING THE MAINSTREAM

VALUE OVER VALUES:
IMPROVING UNDERSTANDING OF ESG

ENVIRONMENTAL CONNECTION:
ENGAGING THROUGH POSITIVE ESG NARRATIVES

IN
ASSOCIATION
WITH



OUR ROUNDTABLE PANEL



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DC schemes face new obligations to consider ESG investment strategies. The industry has its work cut out to improve understanding of ESG and to integrate it into workplace propositions, hears Emma Simon



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Improving member engagement with workplace pensions will be key to ensuring higher participation and contributions levels. Positive narratives around ESG could be the key to connecting with savers of all ages. Emma Simon reports



WORK IN PROGRESS

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It is likely that 2019 will go down as the year ESG investing entered the mainstream for DC pensions professionals. October's regulatory pinch-point, the date from when trustees will have to start at least considering ESG factors in their decision-making, will make sure of that.

But we still have a long way to go before we get to a point where we can genuinely say that ESG strategies have become normalised. And connecting with the public will take even longer.

Integrating ESG into workplace pensions presents numerous challenges, but it also offers significant opportunities.

At the top of the list of challenges is understanding of what ESG actually is. Separating the ethical from the governance, the values from the value, is a big job. It is complicated by the fact that some ethical factors make their way into regulation – see smoking, carbon industries, low pay. In these cases values influence value.

Then there is the issue of determining what actually constitutes an ESG approach that delivers value for members. As with any other industry buzzword, providers have latched onto ESG and claimed their proposition offers it. An asset manager with an active voting record offering a FTSE 100 tracker with can rightly claim it runs it on an ESG basis, as its stewardship activities reflect the 'G'. But that is a long way from a fund that excludes companies because, for example, they excessively expose the investor to long-term risks such as climate change.

Aside from the potential benefits of better long term returns, achieved by avoiding stocks exposed to identified risks (something the ESG-lite tracker referred to earlier would not benefit from), proponents argue an ESG approach offers the potential for building rich narratives around the positive changes being made by pension funds supporting better practices in relation to factors such as climate change, low pay, child labour or certain weapons manufacture.

Millennials are rightly cited as a potential engagement targets for responsible investment stories, but the same will be true of individuals of all ages.

But here the industry needs to be careful of not over-promising and under-delivering. If pension providers push their ESG credentials on, say, climate change, and lobby for change through their stewardship activities, but are then seen to have remained invested in carbon-heavy companies for years, they risk being accused of hypocrisy.

And then there is the issue of cost and implementation. Screening, filtering, tilting all costs money, and operating within the price cap means innovative thinking will be needed to deliver effective new propositions.

None of these problems are insurmountable, and providers and asset managers are applying new thinking to the challenge. But we have a way to go before we have a clear understanding of what ESG actually means for defined contribution pensions.



ESG IN AUTO-ENROLMENT: ENTERING THE MAINSTREAM

VALUE OVER VALUES

DC schemes face new obligations to consider ESG investment strategies. The industry has work to do to improve understanding of it and to integrate it into workplace propositions, hears **Emma Simon**

Environmental, social or governance (ESG) factors have shot up the agenda in the DC pensions sector, driven by regulatory action, political momentum and asset manager product development. But confusion remains over what ESG does and doesn't stand for, how it impacts performance and how its benefits can best be harnessed for DC savers within charge-capped products, said delegates at a Corporate Adviser round table event last month.

Advisers and consultants at the event said that three years ago ESG-led investment strategies were highly unlikely to be raised as an issue when setting up default pension strategies or discussing AE options. Today they are fast becoming a key part of the DC pensions landscape. Most delegates at the event predicted that within a decade an ESG-led investment policy would be a ubiquitous part of any default pension fund.

Increasingly asset managers are analysing a whole range of ESG factors as a part of the risk management and investment process. But many attending the round table agreed that there remains considerable confusion amongst employers and even advisers as to how these ESG strategies are deployed across the industry – and what the potential benefits might be for both employers and members.

At the crux of the issue is whether adopting an ESG strategy delivers better returns for members.

Nest, which has been a long-standing proponent of ESG investment strategies, argues there is now considerable evidence that pension providers and asset managers that incorporate ESG analysis as part of their investment process can deliver better risk-adjusted returns over the long term.

Nest head of responsible investment Diandra Soobiah said: "We certainly believe this is the case. All the academic and



financial evidence we've seen looking at this issue shows a strong positive relationship between a company's ESG track record and how it performs for shareholders.

"Companies that adhere to ESG principles in terms of how they are run tend to outperform, with lower volatility, lower cost of capital, and improved share price performance and profitability over the longer term.

"This is why it is fundamental to the way we manage money."

One of the best known pieces of evidence that supports an ESG-led approach is a metastudy conducted by DWS (part of Deutsche Bank). This analysed more than 2,000 individual studies into the link between ESG criteria and subsequent corporate financial performance. It found a positive relationship in a large majority of these studies, which spanned a 35-year time frame, and found very little correlation between ESG investments and negative performance.



Delegates agreed an ESG-led approach isn't about ethics, but is about good governance to avoid long-term risks

Despite the emerging evidence to support an ESG-led investment strategy, and the sense that an ESG approach sits well with companies' corporate social responsibility obligations, those attending the roundtable agreed there still remained a "latent scepticism" within some corners of the industry about its potential benefits.

This comes from both corporate clients, who may not prioritise an ESG-led approach as well as some scepticism from trustees and even individuals within asset managers.

Some of those attending thought at least some of this scepticism was due to confusion about what is meant by an ESG-led strategy. Lane, Clark & Peacock senior consultant Nigel Dunn said: "There is the danger that ethical and ESG issues can be conflated."

Delegates agreed an ESG-led approach isn't about ethics, but is about good governance to avoid long-term risks and thereby avoid stocks that will be hit by those risks. An ESG strategy sees data analysed to identify potential risks, such as where companies are over-reliant on fossil fuels, which could impact future profitability, as regulation seeks to reduce usage to limit climate change.

Dunn said: "An ESG-led strategy is an important risk management tool that can support a more sustainable long-term investment approach."

Participants at the round-table thought there was an important distinction to be

made about values and value, and that an ESG-led investment strategy should focus more firmly on the latter.

But Aon head of DC investment James Monk pointed out that the two are not entirely divorced, and that an ethical dimension that flows from an ESG approach has the potential to engage consumers with savings and pensions. If ethical factors influence politicians, who then change regulations with the aim of making certain sectors less profitable, then ethics do ultimately influence ESG strategies.

He pointed to the opportunity that climate change presents in terms of engaging with members. Many people are aware of the longer-term financial risks presented by issues such as climate change, and would welcome their pension provider taking a positive stance. "They want asset managers to be taking a proactive stance on their behalf to minimise these risks, as well as driving more positive change."

Delegates debated how individual providers could deliver an ESG-led investment mandate.

Willis Towers Watson consultant Mark French pointed out that there were various approaches across the industry, and this can lead to very different definitions of what is meant by 'an ESG investment fund', particularly within the world of default DC propositions. ►



He said: “We can see providers using both divestment and engagement, and a combination of the two.”

With engagement, providers use their capacity as sizeable shareholders to raise ESG issues, and drive positive change through shareholder votes.

French said: “This stewardship aspect can be harder to define. Asset managers are using their influence to drive the sustainable agenda, but there seems to me to be a less clear-cut relationship with improved member outcomes.”

This can lead to some confusion within workplace pensions when it comes to defining and outlining what is meant by an ESG strategy.

Some providers – for example LGIM – claim that they adopt an ESG strategy across the entirety of their portfolios, including passive funds that simply track an index like the FTSE100.

This is because of their approach to stewardship and engagement – even on funds where there is no option to disinvest, if the company doesn’t improve its ESG credentials. By taking an active approach to voting in relation to virtually all the stocks they hold, they have made an ESG intervention, even for trackers that others might not describe as ESG funds.

Others only use the ‘ESG’ badge on portfolios where they can actively select and reduce exposure to individual companies or sectors which have good or poor ESG track records. This will also include passive strategies which take into account ESG factors, such as the FTSE4Good index.

Dunn said: “It seems to me that it’s more difficult to identify how stewardship affects returns. If an asset manager encourages a FTSE 100 company to adopt a fairer tax policy, reduce their carbon footprint or appoint more women to the board, then surely everyone who invests in that index benefits.”

Soobiah pointed out that there is often a divergence in ESG approaches when it comes to active and passive strategies.

She said that this issue is particularly critical when it comes to default fund strategies within auto-enrolment, which have to meet a charge cap, meaning there is often a reliance on more passive strategies.

She pointed out that investment managers can tilt portfolios to take account of ESG factor to take a more filtered approach. But where a passive strategy is not being used there can be a significant cost to consumers when it comes to ensuring a tilt towards a low carbon portfolio. Nest has worked with UBS Asset Management to create a new climate ►



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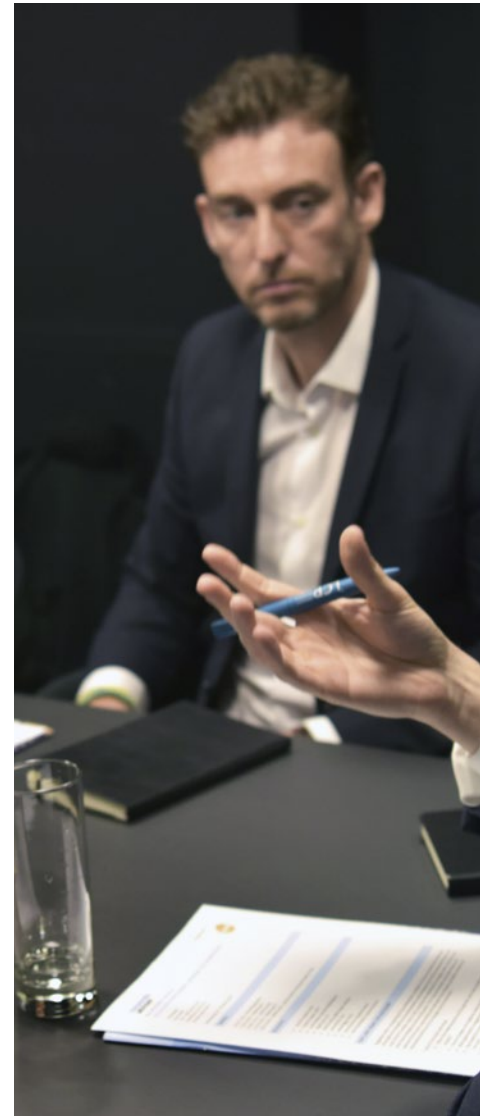
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aware equity fund – the UBS Life Climate Aware World Equity fund – which tracks the FTSE Developed Index, but which either increases or decreases its exposure to companies depending on their alignment with the transition to a low carbon economy.

Soobiah agreed that it can be a challenge to communicate how corporate engagement and stewardship works, but she says the key is to pinpoint specific stories. “This is something we are keen to communicate with members. For example action by companies like Nest has forced companies like Persimmon to adopt a living wage.”

Lorica consulting and wellbeing partner James Biggs said if asset managers believe ESG strategies lead to better risk-adjusted returns then this should be embedded within the investment process, rather than leaving employers, or employees to “select” an ESG approach.

Many he said may be unwilling to do so, fearing it could lead to lower returns.

One of the challenges for asset managers is to construct an ESG default funds that reflects a diverse and large membership within the typical workplace DC scheme.

Dunn pointed out that the regulators initially proposed that trustees should look to improve governance standards by seeking members’ views on a range of ESG issues. But he noted that there was “considerable push back on that” from the industry.

As he pointed out, this can be hard to achieve through surveys, and may switch the focus more onto member-led values – which may be contradictory – rather than what trustees or IGCs believe is the best way to deliver long-term value instead.

That said, Dunn argued advisers and providers should listen to feedback from members and use this to help build a

constructive ESG-led strategy that engages pension savers.

Biggs highlighted the communication challenge the DC pension sector faces in this respect. “Providers need to explain more clearly what their approach to ESG is, and how they deliver it, as well as what this means for member outcomes.”

He added: “But there is the danger that this generates just more jargon, which most people fail to connect with or understand, with those trying to explain their ESG strategies doing so in more granular detail than people have the patience to digest.”

Round table panelists agreed that regulation would drive changes within the sector. Soobiah said: “The recent Department of Work and Pension clarification on fiduciary duties, particularly in relation to looking at climate changes as a systemic risk, is a real game changer.”

These new rules – which come into effect this October – force trustees to



consider whether a range of ESG factors, including climate change, present a financially material risk to the assets they manage.

At the same time the FCA has recently launched a discussion paper which looks at whether IGCs on contract-based schemes should have to consider the same factors. This is expected to land next year.

Although this latest piece of regulation doesn't compel trustees to adopt an ESG-led approach, the fact they have to engage with the questions about how they manage the risk of climate changes, is seen by many as an important call to action.

Nest senior business development manager Stephen Argent added: "There is the possibility that trustees could be sued if they ignore these issues. It is an important wake up call for the industry."

But although this rule change is only months away the consultants and advisers at the roundtable fear that a number of



There is also the question of whether the trustees' views on this issue are aligned with membership of a pension schemes

providers still don't have a clearly defined ESG policy on their AE schemes.

French said: "There could be a wider range of options available, particularly from platform providers." He points out that choices are limited for those looking to build their own solutions.

But he said that October's regulatory "pinch point" should concentrate minds within the industry and he expected to see a wider choice of ESG-led options by this date.

Dunn said: "I have some sympathy with providers. They are essentially providing what the market asks for, and to date there hasn't been demand from the intermediary market or employers for these types of solutions."

These regulatory changes are also expected to focus the minds of both trustees and IGC boards. Dunn said: "We've found that there may be a degree of scepticism about the benefits of ESG from trustees initially. But once they start to spend time and effort looking at the issues involved, we find there is a lot more receptiveness to the issues at stake."

Monk pointed out that there can be an element of conservatism among trustee boards, and like any group there is the danger of a group-think mentality taking hold.

There is also the question of whether the trustees' views on this issue are aligned with

membership of a pension schemes. This isn't always the case, according to Soobiah.

Dunn said consultants have a role to play here. "We need to ensure we ask the right question for clients and educate them about both the options and changing regulatory landscape before putting together a default strategy. Then there might be more choice out there."

Looking ahead Biggs pointed out that this pace of change will continue. He expected that in 10 years' time, it will be the norm for default pension schemes – be they master trusts or contract-based – to integrate ESG strategies.

French said: "At the moment, there is little competition between providers when it comes to ESG as this is not a selection factor at present. But it is early days and I expect this to change."

Biggs said this will present additional challenges from the intermediary sector, who need to "get under the bonnet" and understand how successfully these various ESG strategies are applied.

Monk added: "The role of the intermediary will be to provide transparency, and understand how important ESG factors are for the client, trustees and member to ensure an appropriate solution is selected. This can only be done though if consultants fully understand what providers offer in this space." ■

ESG IN AUTO-ENROLMENT: ENTERING THE MAINSTREAM

ENVIRONMENTAL CONNECTION

Improving member engagement with workplace pensions will be key to ensuring higher participation and contributions levels, as well as better retirement outcomes. Positive narratives around ESG could prove an opportunity to connecting with savers of all ages, hears **Emma Simon**

Auto-enrolment has certainly been successful in boosting contribution levels. Opt-out rates remain low, despite stepped contribution increases, and there are now more than 10m people enrolled in workplace pensions, many of whom are in master trusts. But a system that relies on inertia is not ideally primed to boost levels of engagement among members.

Delegates at a round table – *ESG in Auto-enrolment: Entering the Mainstream* – hosted by Corporate Adviser last month argued that the pensions industry has a fresh opportunity to reach out to savers by constructing narratives around the positive impacts of environmental, social and governance (ESG) investing.

Nest head of responsible investment Diandra Soobiah said talking to scheme members about ESG factors can be an effective way to turn around the low levels of engagement with pensions.

She said: “Nest has 7m members, and all our research indicates that there is a great deal of interest in a whole range of ESG issues, from climate change to how companies pay their workforce, and manage supply chains.

“By implementing a clear ESG strategy that reflects these concerns we can hopefully get them more engaged and interested in pension savings.”

Soobiah said that while Nest looks at a whole range of ESG factors, it has a thematic focus on both environmental and social issues. Nest has chosen to prioritise factors that matter financially to its members, she said.

These environmental and social factors include climate change, human capital in the workplace – such as companies’ fair pay and living wage policies – and banking culture and conduct. Fair pay is a particularly relevant issue for Nest, she



said, because many of its members are low earners, some of whom will themselves be earning less than the living wage.

Soobiah referred to research among Nest members that found almost half of those surveyed, from a pool of 3,000 respondents, said they wanted their workplace pension to adopt an ESG-led approach, even if this meant slightly lower returns. She pointed to research that showed the reverse is more often true of performance, and an ESG-led strategy can boost long-term risk adjusted returns, rather than comprise them.

But not all of the panelists at the round table discussion on the role of ESG strategies in DC pension provision were convinced that the majority of pension savers were willing to put principles before profits.

Lorica consulting and wellbeing partner James Biggs said: “My sense is certainly that millennials, and the younger



‘generation Z’ have a keen interest in this environmental and social justice issues.”

But he said a recent straw poll that he had conducted with younger people, which he accepted was statistically not significant, found that there while there was an interest in ESG, none wanted to adopt this approach if it meant lower returns on their pension or investments.

He pointed out that when there is an option to select an ethical fund, as part of the wider fund selection in a workplace pension proposition, take up is typically low.

Aon head of DC investment James Monk said that the conversation shouldn’t focus on any presumed trade-off between ESG investing and returns.

He said an ESG-strategy should be primarily about longer-term risk management of assets. For this reason he said it should be fully integrated within the default fund. But he added that an ESG-led strategy also offers an opportunity to ►





boost engagement levels among members.

"This is a good way to start a conversation, about how pensions are being used to transition to a low carbon economy, for example.

"People can see the potential risks to their savings by having too much invested in assets which are over-reliant on fossil fuel production, for example.

"It is a good story to tell, with tangible examples. If an ESG strategy is done well, and communicated properly, it could also help rebuild trust in the pensions industry."

But these issues highlight some of the more complex issues surrounding an ESG-led strategy for a default workplace pension scheme.

While the panel agreed there was evidence to suggest that companies that adhere to ESG-principles tend to perform better over the longer term, there can often be significantly different views from professional research companies as to what

an individual company's ESG credentials actually are.

Lane, Clark & Peacock senior consultant Nigel Dunn said: "You would think it should be clear which are the 'good' companies, and which are the 'bad' ones, in terms of ESG criteria. But this isn't always the case."

He points out that third party rating agencies that compile ESG data for the asset management and pensions industry each have very different methodologies. The way they 'rate' individual companies varies, often significantly. A prime example is Tesla which scores very differently with each of the three major ESG rating agencies. Asian investment bank CLSA said that as at 17.9.18, FTSE ranked Tesla last for global auto ESG, while MSCI rated it best and Sustainalytics ranked it in the middle of its range.

Soobiah said that often these agencies are looking at one specific dataset – one might be more focused on governance

issues, another on a company's environmental policy and track record. This can account for such discrepancies.

Companies – like Tesla – may look attractive in one sense, for example developing electric cars that have the potential to significantly reduce pollution on the road. On the other hand Soobiah pointed out there are currently a lot of environmental issues around the mining of components needed for batteries for cars, as well as other additional governance questions to address.

Similarly, individual pension providers and their asset managers may look at a different range of factors when conducting their ESG assessment. Some may look at far more factors than others, which can lead to very different portfolio constructions.

Delegates at the roundtable agreed that this was a major challenge for them going forward, as there was clearly a need for them to get "under the bonnet" and fully ►



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understand what sits behind the various ESG-led strategies in the DC workplace sector.

Dunn said: "It is going to take time for consultants to understand what the best methods and approach actually are."

Over the next few years, as master trusts become more dominant, ESG may become an important differentiator when it comes to selecting a workplace pensions proposition.

Willis Towers Watson consultant Mark French said it is not a differentiating factor at present, but he expects this to change. He pointed out that there are likely to be reputational issues for corporates – as well as master trust providers – if they don't have clearly defined ESG strategies.

Pressure groups such as ShareAction already highlight companies which fail to adhere to some ESG standards. There could be issues for corporates who have exposure to companies with extremely poor records on issues such as fair pay or

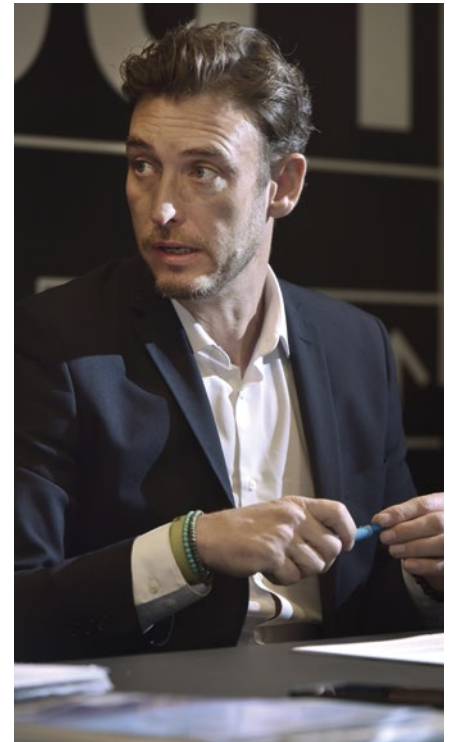
pollution through their pension fund.

French added: "As master trusts become more dominant it is clear that there will be a lot of competition around the pricing of default funds. But adding a well-defined ESG strategy can also provide a competitive edge."

Monk said: "It is a question of when this becomes a key differentiator and part of the providers' proposition, not if."

For the larger master trusts – which are predicted to have some £300bn of assets under management by 2026 – one key differentiator could be their use of big data, to help shape a relevant ESG strategy and further boost engagement levels.

Those attending the roundtable thought such developments are likely from providers who also offer a range of banking or insurance products. This offers the opportunity to devise more tailored marketing campaigns, particularly focusing on ESG strategies. For example if someone makes a regular donation to the World



Wide Fund for Nature they may be more receptive to information about the pension funds' environmental policies.

Nest senior business development manager Stephen Argent said: "We already see this data being used to drive engagement and deliver more tailored services in supermarket, via their loyalty schemes.

"At the moment the pensions industry has been slower to adopt this, partly because there has been less of a financial incentive to do so.

"Knowing more about how you pension fund invests its money, and what its ESG policies are is undoubtedly a good thing but will this necessarily translate into higher contribution levels?"

However, French pointed out that the drive to increase engagement, particularly by using new technology and mobile apps, could stimulate change in the sector. If members are able to see a number of their saving and investment holdings through one platform, this could certainly help drive transfers within the workplace pensions market, potentially concentrating more assets with the master trust providers.

Monk said: "This is something that the regulator certainly has its eye on. While it is not against consolidation, it wants to ensure that it is not simply a case of people rolling assets over without shopping around effectively.

"Regulators are alive to the risk of convenience over value and will want to ensure the two are appropriately balanced." ■

OPINION

THE RISK OF RELYING ON THE STATUS QUO FOR DC INVESTING

» Stephen O'Neill Nest head of private markets



When last year's Autumn Budget outlined plans to open up patient capital investments for defined contribution (DC) pensions, the reaction from the wider industry was broadly positive but cautious. Some felt the challenges of integrating illiquid assets into DC schemes would ultimately prove too great.

My feeling however is the greater risk lies in relying on the status quo for DC investing to deliver the long-term risk-adjusted returns savers need; illiquid assets and private markets need to be part of the future of DC.

So far master trust investment strategies have been designed to focus on public markets and ensure costs are kept low. This made sense while schemes were starting up and the amounts being invested were small.

But the DC market is growing, and growing quickly – we've seen another rise in auto enrolment minimum contributions, making the total amount 8 per cent. In addition, we're now experiencing more volatile markets and lower expected returns than we've seen in previous years.

Against this backdrop we need new options to keep our members' money growing sustainably.

Risk management is all the more important in the context of automatic enrolment schemes, which serve 10 million new savers. There is ample research demonstrating these typically younger and lower earning savers are especially sensitive to volatility and losses – the emotional responses explained by Prospect Theory are particularly acute.

Schemes should therefore be developing an investment approach that looks beyond indexed equity markets; diversification is key and finding new ways to produce good, steady returns for similar or even lower amounts of risk than public markets alone can offer.

Already Nest has taken strides in moving towards alternatives. Last year we added a commodities fund to our portfolio with the plan for the allocation to be around 5 per cent across the fund.

But the next big step is into private markets and illiquids. It's the natural progression for a DC scheme of our size.

We know this in part because we've seen it done successfully in other countries. Australian super funds and workplace schemes in the US have been accessing private credit for decades and it is a mainstay of default fund asset allocations.

Risk management is all the more important in the context of automatic enrolment schemes, which serve ten million new savers. There is ample research demonstrating these typically younger and lower earning savers are especially sensitive to volatility and losses

But this isn't just unique to Nest. Most large master trusts have the growing membership and AUM which means collectively we can bring a scale that makes fund managers want to work with us in providing innovative ways to access private markets. Master trusts should find costs less of a barrier than they have in the past.

Private markets should not be seen as off-limits, nor a risky asset. In fact, we hope to demonstrate illiquids can play an important, perhaps essential role in many schemes' default investment strategies. ■

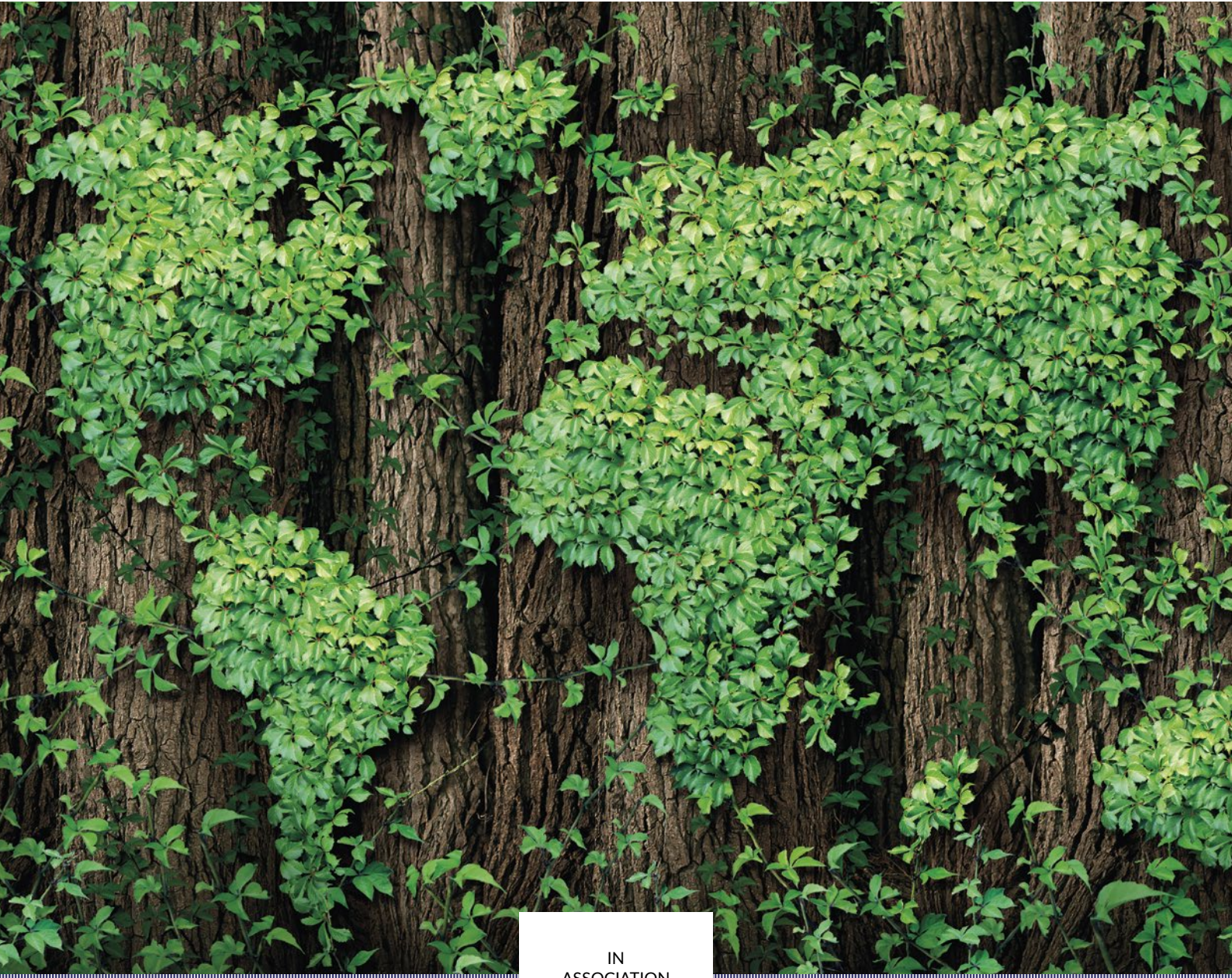
In the coming months Nest will appoint the fund managers who will manage our new mandates allowing us to enter into private credit, including global infrastructure debt, real estate debt and mid-market corporate loans.

Nest's membership can really benefit from the illiquidity premium – our youngest member is 16 and she will likely remain invested with Nest throughout her working life. We have the cash flows and scale to give our younger and older members alike exposure to the benefits of long term illiquids, and also the sophistication to work with fund managers to open up the private credit universe.



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