Sustainability and your pension scheme:
Why it matters and what you can do

Report from LCP’s Global Pensions Forum 2015
Introduction

At LCP’s Global Pensions Forum (GPF) 2015, our panel of experts explained how sustainability – specifically environmental, social and corporate governance (ESG) issues – poses risks and opportunities for pension schemes over both the short and long term. They made the case that:

- factoring sustainability into investment decisions makes sound financial sense; and
- doing so is part of trustees’ fiduciary duties to their members.

Over 70% of the audience concurred with the panel that ESG issues should be given more importance by pension schemes.

This paper, written by LCP, summarises the case for sustainability presented by the panel at the GPF. We also explain what actions pension scheme stakeholders can take to protect themselves from the risks, and take advantage of the opportunities, arising from sustainability issues.

We have written this paper from a UK perspective, reflecting the UK’s current pension funding and investment framework, but many of the ideas are relevant in other countries.
Why is sustainability important?

In simple terms, sustainability is about being around for the long-term. It requires organisations to adapt to a changing environmental and social landscape, to have good governance, and to manage risks effectively over both the short and long term.

Tim explained that sustainable business is “just good business”. It’s about reducing cost, reducing risk and safeguarding the environment and community in which the business operates. An increasing number of companies are embracing this, but the investment community still isn’t fully realising its importance.

Sustainability is particularly relevant for pension schemes due to their long time horizon. In a defined benefit scheme, the sustainability of the sponsoring employer affects its financial covenant. The sustainability of the companies a scheme invests in affects the scheme’s investment risks and returns. And this in turn affects the level and volatility of the scheme’s funding requirements.

Around the world, climate change is an existential threat - but if we harness the opportunities inherent in addressing climate change, we can reap enormous economic benefits.

Ban Ki-moon, UN Secretary General
Why is sustainability important?

Environmental risks around the world

The panel gave examples of environmental risks affecting investment returns:

- Water stress has led to massive costs for the Californian economy.
- German utility companies are struggling because of the rapid growth of renewable energy.
- Brazil is facing unanticipated increases in water and energy costs due to water shortages (hydro-electricity is a major energy source).

Meryam commented that pension schemes are affected by these issues, but often don’t realise it because the effects are hard to isolate. Faith noted the extensive research that has been carried out, including a recent report from academics at the University of Oxford (see box below) that found that 80% of studies showed good ESG practices were associated with positive share price performance.

How are investment returns affected?

LCP believes that well-run companies have the potential to outperform. This seems to be supported by academic evidence, for example:


A key question is the extent to which good ESG practices are already reflected in market prices.
Can schemes take account of sustainability?

There is a widespread misconception that pension trustees must focus on maximising short-term financial returns when making investment decisions. In 2014, the UK Law Commission clarified that trustees can take account of ESG issues and other long-term considerations; indeed, they concluded that trustees should take these factors into account when they consider them to be financially material.

The panel argued strongly that sustainability issues are relevant to the financial performance of investments, and so schemes can and should take sustainability into account.

Indeed “responsible investment” approaches (see page 6) that take sustainability into account are increasingly becoming common. Responsible investment is essentially about taking a longer-term view (a better balance between short, medium and long-term considerations) and adopting a broader perspective (considering a broader range of factors that affect financial performance).

Is this relevant for DC schemes?

Sustainability is important for both defined benefit and defined contribution schemes. It affects DC schemes’ investment performance and hence members’ retirement income. Trustees and employers should consider the ESG credentials of the investment funds they offer to DC members, especially the default fund because that is where the majority of members invest.
What sustainable investment approaches are available?

The main ways that actively managed investment funds can incorporate sustainability considerations are:

- **Integration** – making ESG an integral part of buy and sell decisions
- **Screening** – including or excluding companies using specified criteria
- **Themed** – specialist funds that pursue ESG opportunities (e.g., clean energy)

Integration is the dominant ESG approach in the UK and is becoming increasingly mainstream.

Passive funds are available that track sustainability-related indices. Claudio gave the example of the Corporate Sustainability Index from the São Paulo Stock Exchange and Tim mentioned the FTSE4Good Index in the UK.

Active and passive managers often undertake **stewardship** activities - such as engaging in dialogue with company management and voting at shareholder meetings – aimed at improving long-term returns. There is growing support for stewardship activities, as evidenced by UK Government and EU initiatives in this area.

Meryam explained why stewardship is particularly important for passively managed funds. Passive managers cannot sell shares which are unduly exposed to ESG risks but they can encourage companies and governments to mitigate these risks.
What can trustees do?

Trustees should consider sustainability when making covenant assessments and investment decisions. Tim emphasised that this is about making financially sound decisions, not about adding unnecessary complexity or making compromises.

You don’t need to be an expert in sustainability. Indeed, this is not realistic – sustainability is a wide-ranging and complex topic. Faith and Meryam explained how your consultants and investment managers can help you, and highlighted some free online resources (see box below).

Further reading:
Law Commission guidance on fiduciary duties
UN Principles for Responsible Investment
NAPF stewardship policy and tools

Covenant questions to ask your sponsoring employer

1. What do you consider are the main risks to the medium-term (5+ year) and long-term (10+ year) viability of the company?
2. How do you identify, assess and monitor ESG risks to the business?
3. What steps are you taking to manage the risks identified in Q1 and Q2, including ensuring your business model is robust under a wide range of possible futures?

You may also want to ask about specific ESG issues that are particularly relevant to the company’s circumstances and sector.
What can trustees do?

Delegating sustainability to your investment managers

Trustees have ultimate responsibility for investment decisions, including the approach to sustainability. Whilst in practice you can delegate most of the work to your investment managers, it is important you are satisfied with their capabilities and approach in this area.

Meryam explained that many investment managers do not automatically integrate ESG considerations: they need an explicit instruction to do so. She warned that managers use a lot of window dressing in this area. She recommended asking your managers a few questions and comparing the credibility of their answers. Tim confirmed that the answers had initially been patchy when his scheme tried doing this.

Questions to ask your investment managers

1. How do you use shareholder engagement with management as a tool to improve the long-term performance of the companies you invest in?

2. Give a recent example where you voted against an AGM resolution. How do you intend to follow this up with company management?

3. How do you form a view on ESG issues and incorporate this into the investment process?

LCP’s quarterly ESG Issues updates (available on request) include topical questions to ask your managers.
What can trustees do?

The panel’s tips for sustainable investment

The panel stressed the importance of:

- including sustainability in your investment requests for proposals
- asking about sustainability issues when selecting new managers and only appointing those who give credible answers
- giving clear instructions to your appointed managers about your ESG requirements, eg documenting them in investment mandates
- asking managers for regular reports on their implementation of your ESG instructions
- being willing to change managers if you are not satisfied.
What can companies do?

Although trustees have the primary responsibility for investment decisions, companies should take a keen interest in sustainability because of the way investment performance affects their own pension scheme contribution requirements and accounting figures.

Tim and Claudio explained that companies might have greater understanding of sustainability than trustees because they are already considering how their business might be affected. You can encourage your trustees to engage with this topic and help them question their investment managers.

If, like many companies, you have embedded sustainability in your business model, then this is an additional reason to talk to your trustees about sustainability. You can explain how your company’s financial strength is improved by managing the business for the long-term and mitigating its exposure to ESG risks. And if sustainability is core to your company values, you can protect your reputation by encouraging your trustees to act consistently with these values.
In summary

Sustainability is a source of risks and opportunities for pension schemes. By including sustainability in your investment decisions, you can protect and enhance your financial position.

You do not need to be an expert in sustainability to do this: your investment consultants and managers can help.

As a **trustee**, you should:

1. Familiarise yourself with the Law Commission guidance on fiduciary duties
2. Decide how you want to include ESG factors in your investment decisions
3. Select managers who can do this on your behalf and instruct them accordingly
4. Monitor how your managers are implementing your instructions and take action if necessary

As a **company**, you can encourage and support your trustees in this process.
Contact us
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