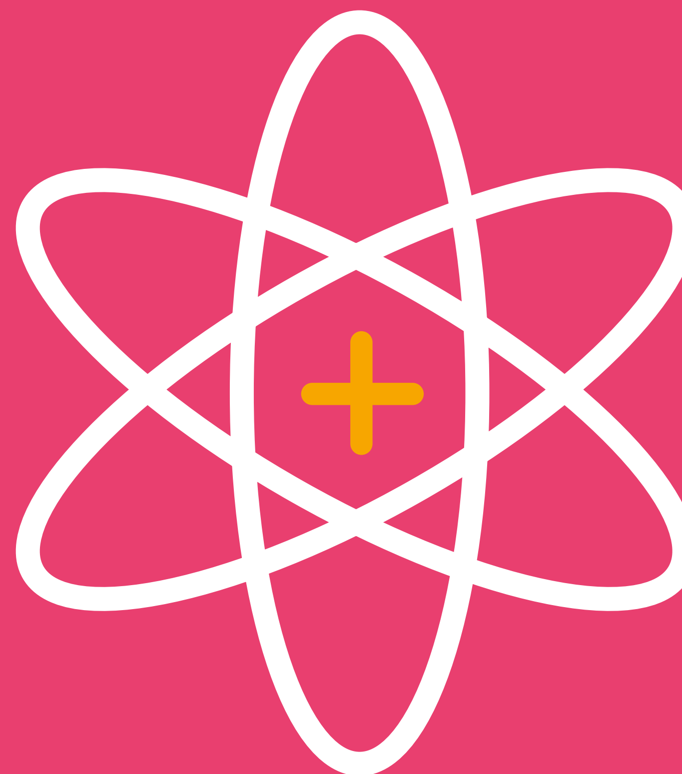
LCP INSIGHT CLARITY ADVICE

A guide to E, S, and G in investment

Environmental, social and corporate governance factors in investment processes

October 2017



What are E, S, and G?

It is becoming increasingly common for investors to incorporate environmental, social and corporate governance (ESG) factors into their investment process.

Examples of ESG issues:

E
Environmental

- Biodiversity
- Climate change
- Energy efficiency
- Pollution
- Waste management
- Water scarcity

Learn more

S
Social

- Community relations
- Diversity and inclusion
- Human rights
- Labour standards
- Product safety
- Training

Learn more

G
Governance

- Bribery and corruption
- Business ethics
- Compliance
- Executive remuneration
- Lobbying
- Succession planning

Learn more

Please note these are just examples of the types of issues covered, not an exhaustive list.

The Pensions Regulator has told trustees they need to take ESG factors into account if they believe they're financially significant[1]. But what are E, S and G factors? And how are they relevant to investors?

ESG is an umbrella term used to cover a wide range of factors that traditionally were regarded as "non-financial" or "extra-financial" and did not form part of any standard financial analysis of investment opportunities. However, it is now finally recognised that these issues can affect financial performance, especially over the longer term.

Investment managers now typically include ESG issues in investment analysis, to varying degrees. They use a variety of approaches and a range of quantitative and qualitative information. ESG-related matters are also frequently the subject of votes at company AGMs and feature often in investors' dialogue with investee companies. Historically, governance issues – particularly those relating to executive remuneration – have received the most attention, but environmental and social issues have risen in prominence.

[1] DB investment guidance, March 2017 and DC investment governance guidance, July 2016

The impact of ESG

How might ESG issues affect company performance?

Poor ESG practices can impact on companies' financial results in various ways, including:

- Misaligned interests and insufficient oversight of management (eg inappropriate pay structures, lack of board diversity);
- Fines or litigation costs for compliance failures (eg unethical business practices, breaching pollutant limits);
- Increased costs from new legal and regulatory requirements (eg higher environmental standards);
- Reputational damage for failing to meet societal expectations (eg human rights, executive pay);
- Loss of market share from changing consumer preferences (eg desire to reduce waste);
- Threats to business model from new technologies (eg renewable energy);
- Vulnerability to shortages or price rises of key inputs (eg water, energy); and
- Exposure to changing weather patterns (eg supply chain disruption, crop failures).

Conversely, good ESG practices are likely to reduce a company's exposure to such risks. They can also be a source of competitive advantage and new business opportunities.

Moreover, some investors view high ESG standards as indicative of sound management practices more generally.

How could ESG affect investment performance?

Analysis of ESG issues tends to focus on individual companies, but overall portfolio exposure is relevant too. Investors may want to consider:

- How might ESG affect a company's financial results and thus the level and volatility of its dividends and share price?
- How might ESG affect a company's financial results and thus its ability to service debt?
- To what extent are ESG risks and opportunities reflected in the current market price of a company's shares and debt?
- Does a given portfolio of securities have an elevated exposure to certain ESG risks due to a concentration of companies in particular geographies or industry sectors?
- What is the overall exposure to ESG risks across the whole portfolio?

In practice, these questions are usually considered by investment managers on behalf of trustees, although trustees retain an oversight role.

Techniques for analysing portfolio-level ESG risks are at a relatively early stage of development. We expect more innovation in this area in the next few years, particularly in relation to climate risk.

Bringing ESG to life

On the following pages we give examples of three companies and three topical developments that we have covered recently in our Quarterly Investment Updates, one for each of E, S and G.

E
for Environmental

Company example: Demands for better climate-related reporting

At a glance:

- At its May 2016 AGM, ExxonMobil faced a sizeable (38%) shareholder revolt on its refusal to report on the resilience of its business model to climate change.
- At its May 2017 AGM, 62% of shareholders managed to pass a very similar resolution, forcing the company to report on the impact on the company of global measures to limit climate change.

> *Climate change is one of the greatest long-term risks we face in our portfolio and has direct impact on the core business of ExxonMobil.*

Trustee of the New York Common Retirement Fund (co-sponsor of the proxy resolution)

In May 2016 ExxonMobil hit the headlines when the Church Commissioners for England and other institutions filed a resolution calling for the company to "analyse the impacts on ExxonMobil's oil and gas reserves and resources" under a demand-reduction scenario in which governments adopt measures "consistent with the globally agreed upon 2 degree [Celsius] target". Historically, the oil giant has strongly resisted moves to disclose how climate change reduction initiatives might affect its business. Having unsuccessfully attempted to have the resolution struck from the ballot altogether, ExxonMobil told shareholders to vote against it. Around 38% of shareholders ignored the company's advice, making it – at that time – the best supported climate-related vote in the firm's history.

One year on, at its May 2017 AGM, ExxonMobil investors rallied behind a very similar resolution and, with 62% of votes in favour, overturned the previous year's defeat. Although voting was anonymous, three of the world's largest passive managers, BlackRock, State Street and Vanguard, who are also amongst ExxonMobil's biggest shareholders, are believed to have voted in favour.

The vote is significant in several ways. First, it shows that persistence pays. Second, if the rumours are true, it shows just how influential "passive" managers can really be. Third, as nearly two-thirds of shareholders in one of the world's largest fossil fuel producers voted in favour of such a resolution, it suggests that climate change concerns are front and centre of investors' minds.

62%

of ExxonMobile shareholders passed a resolution forcing the company to report on the impact on the company of global measures to limit climate change in May 2017.

Topical example: The Task Force on Climate-related Financial Disclosures

At a glance:

- The Task Force on Climate-related Financial Disclosures (TCFD) has issued its final disclosure recommendations for all types of organisations – including pension schemes and investment managers
- The recommended disclosures cover governance, strategy, risk management, metrics and targets. They are supported by implementation guidance and a technical supplement about scenario analysis
- Organisations face "transition" risks from measures to reduce greenhouse gas emissions and "physical" risks from climate change itself

The Task Force on Climate-related Financial Disclosures (TCFD) has released its final recommendations regarding voluntary disclosures for inclusion in mainstream financial filings by all types of organisation, including pension schemes and their investment managers.

The TCFD was established by the Financial Stability Board in 2015 in response to a request by the G20 Finance Ministers and Central Bank Governors.

It is chaired by Michael Bloomberg and consists of 32 individuals in a wide range of senior roles across the globe. Its remit was to develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters in understanding the serious risks that climate change poses to the global economy and organisations within it.

The recommended disclosures for organisations cover four areas:

- **Governance** – the organisation's governance around climate-related risks and opportunities;
- **Strategy** – the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning;
- **Risk management** – the processes used by the organisation to identify, assess, and manage climate-related risks; and
- **Metrics and targets** – the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The report distinguishes two types of climate-related risk:

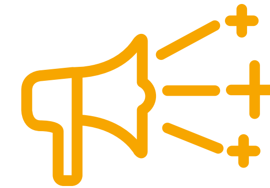
- **Transition risks** – related to the financial and reputational impact of policy, legal, technology and market changes arising from a transition to a lower carbon economy;
- **Physical risks** – related to acute risks from weather events and chronic risks from longer-term shifts in climate patterns, which may directly or indirectly affect an organisation's financial performance through its supply chain.

An implementation guide provides supplementary guidance for four types of financial organisation (banks, insurance companies, assets owners, asset managers) and non-financial organisations in sectors that are judged to be more likely to be financially impacted (energy, transportation, materials and buildings, agriculture, food and forest products). There is also a technical supplement about the use of scenario analysis in disclosure of climate-related risks and opportunities.

The work of the Task Force on Climate-related Financial Disclosures will help to accelerate global investments in technological innovation and clean energy by increasing transparency. And, in doing so, it will help make markets more efficient, and economies more stable and resilient.

Michael Bloomberg

S
for Social



53%

Proportion of independent shareholders who opposed Keith Hellawell's reappointment in 2016.

Company example: Criticism of poor working practices

At a glance:

- At Sports Direct's 2016 AGM, independent shareholders vented their spleen on hapless chairman Keith Hellawell, with over 50% of them voting against his reappointment. Majority owner Mike Ashley's vote saved him.
- The company's working practices came in for heavy criticism from MPs and institutional investors – underpayment of workers and staff too frightened to be sick.
- The company has since included an employee-elected representative on the board and promised to pay £1m to underpaid employees.

With Sports Direct's working practices in the news for all the wrong reasons, it was no surprise that shareholders chose to express their anger at the firm's 7 September 2016 AGM. Given chief executive and majority shareholder Mike Ashley's impregnable position, chairman Keith Hellawell was the target of their ire. Around 19% of shares were cast against his reappointment, representing some 53% of independent votes.

Support for Hellawell's chairmanship had increased slightly by the next AGM on 6 September 2017, but 47% of independent voters continued to oppose him.

Before the first vote, MPs and several large pension fund investors had strongly criticised Hellawell following "significant failings in the company's human capital management practices", including the underpayment of workers on the minimum wage, zero-hour contracts and a "six strikes and you're out" system that made staff afraid to take time off sick – one heavily pregnant worker gave birth in the toilet. No surprise then that the firm's vast Shirebrook headquarters was described as more workhouse than warehouse.

> *Too often, bosses are treated as untouchable talent to be retained at all costs, while millions of workers are seen merely as costs to be reduced.*
>
> *Dr Wanda Wyporska*
> *The Equality Trust*

Sports Direct has bowed to shareholder pressure to implement an independent review of the firm's corporate governance and working practices, and allowed the election by employees of a board representative with 12-month terms. The retailer and its employment agencies also agreed to pay out around £1m to employees who had not been receiving the national minimum wage, following intervention from HMRC and the union Unite.

75%
ShareAction's target for FTSE 100 companies to become accredited Living Wage employers by 2020.

Topical example: The Living Wage

At a glance:

- In contrast to the statutory "national living wage", the Living Wage is voluntary and is deemed to be the wage necessary to cover the basic cost of living for individuals and their families.
- Although paying higher wages is a direct cost to businesses, it can reap rewards through increased staff retention and morale.
- The Investor Collaborative for the Living Wage is successfully encouraging adoption of the Living Wage by FTSE 100 companies.

What is the Living Wage?

The Living Wage is the minimum hourly wage deemed necessary to provide accommodation, food and other basic necessities for individuals and their families, as determined by the Living Wage Foundation. Living Wage employers ensure all their UK staff and contractors are paid at least the Living Wage.

The Living Wage is not to be confused with the statutory "national living wage" which the UK Government introduced on 1 April 2016 for all workers aged 25 and over. As at September 2017, it is £7.50 per hour compared with the hourly Living Wage (for workers aged 18 and over) of £9.75 in London and £8.45 across the rest of the UK.

The financial case for the Living Wage

From an investor perspective, there is a financial case for companies to pay the Living Wage – in addition to the moral one. While there is a direct financial cost to businesses of paying the Living Wage, the argument is that doing so can help financially via:

- higher productivity through improvements in staff turnover, absenteeism and morale; and
- enhanced corporate reputation, leading to increased consumer loyalty, improved recruitment and higher staff retention.

There may also be macroeconomic benefits from increased consumer spending, as lower paid workers tend to spend a higher proportion of additional income than higher paid workers.

Investor Initiative

In 2011, an Investor Collaborative for the Living Wage was established to encourage adoption of the Living Wage by FTSE 100 companies. The collaborative is a group of institutional investors, including some major investment managers, co-ordinated by the responsible investment charity ShareAction. It aims to have 75% of FTSE 100 companies become accredited Living Wage employers by 2020.

The initiative focuses on large listed companies since many of them operate in sectors with a high percentage of relatively low paid staff (eg retailers, hotels and restaurants). Those companies' influence extends beyond their direct employees, to third-party suppliers and to the wider business community through their informal position as standard-setters. In addition, the inherently high media profile of FTSE 100 companies is expected to magnify the impact of the practices they adopt.

During the first five years of the initiative, the number of accredited FTSE 100 companies rose from 2 to 30, and now includes firms such as National Grid and Unilever as well as investment manager Legal & General. A further 20 FTSE100 companies say that they meet the standard although are not formally accredited.

G
for Governance

$185m

Amount Wells Fargo was fined for setting up two million fake accounts for unwitting clients.

Company example: Poor business ethics triggers legal action

At a glance:

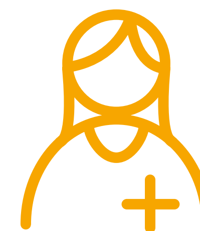
- Wells Fargo has been fined $185m for setting up two million fake accounts for unwitting clients. Some 5,300 employees have been fired over the scandal.
- CEO and Chairman John Stumpf – key man in pushing employee sale goals – has resigned. A case of bad governance, bad culture, bad practice, leading to a very bad outcome.
- Bad press and legal action are unlikely to cease soon: the bank has since been accused of tampering with mortgage terms for bankrupt customers without seeking the proper approvals.

Warnings bells should ring when a bank's CEO and Chairman – whose bonuses are tied to sales performance – exhorts its employees to cross-sell products and target eight accounts per client using the rhyming logic that "eight is great".

Wells Fargo, the American bank, has been subject to investigation and prosecution since late 2016 on the grounds of having opened two million fake accounts in the last five years. Unsurprisingly, CEO and Chairman John Stumpf has fallen on his sword. His suggestion that "The vast majority of our people did it [cross selling] the right way" fell on deaf ears. After all, it was clear that several thousand employees must have done it the wrong way – over 5,000 have been sacked.

Following this evidence of malpractice, the company's stock price fell, shareholders sued the company, while fines hit $185m and public trust collapsed. However, the publicity nightmare isn't over for Wells Fargo's. In June 2017 it returned to the news, this time providing further column inches following disclosure of mortgage-adjustment irregularities: the lender apparently lowered monthly payments and extended the term of repayment by decades for bankrupt creditors without going through the proper court-mandated process. It is alleged to have received up to $1,600 of government money per loan adjusted.

One might have thought – following the havoc wrought by the financial excesses leading up to 2008 – that of all organisations, a bank would know how much culture matters and that it is leadership that sets the tone.



29%

Proportion of new board appointments that were women for the UK's largest companies in 2016.

Topical example: Gender diversity progress in UK boardrooms

At a glance:

- In 2011 Lord Davies' Review recommended 2015 as a voluntary deadline to get 25% female representation across FTSE 100 boards. In October 2015 a new target of 33% female representation in FTSE 350 boards by 2020 was added.
- According to The Female FTSE Board Report 2016, by June 2016, female representation had reached 26% across FTSE 100 boards and 20% across the FTSE 250. However, a significant proportion of female directors are non-executive.
- In May 2017, in a backward step for board diversity, a FTSE 100 company elected an all-male board – the first time this has happened in almost three years.

The 2011 Davies Review set 2015 as the voluntary target date to achieve 25% female representation on FTSE 100 boards, subsequently adding – in October 2015 – a similar voluntary target of 33% for FTSE 350 boards, to be achieved by 2020. The Female FTSE Board Report 2016 indicates that Britain's top quoted companies had met that goal by June 2016: 26% of FTSE 100 directorships were female, double the 2011 figure. FTSE 250 companies were lagging, with only 20.4% of directorships being female. Individually, 61 companies in the FTSE 100 and 90 in the FTSE 250 had achieved the 25% threshold of female board representation. However, while in the FTSE 100 the "best" company was Diageo, with 45.5% female representation at board level, as many as five FTSE 250 companies had achieved full-parity at 50%.

It must be pointed out that a significant number of female directorships are non-executive. Of the executive variety, only 9.7% of positions were held by women across FTSE 100 boards in June 2016. The figure was even lower, at 5.6%, for FTSE 250 companies. Momentum in favour of gender parity seems to have slowed down. Biannual research from headhunter Egon Zehnder shows that the rate at which women are being appointed to the boards of the UK's largest companies slowed down in 2016 to 29% of hires (from 32.1% in 2014 and 31.6% in 2012). This lags the rest of Western Europe where the average is 35.4% – in France the figure is more than 57%!

It is within this environment of slowing progress on gender equality that ConvaTec, a less-well-known member of the FTSE 100, elected an all-male board at its May 2017 AGM. The last time that a FTSE 100 member had an all-male board was in June 2014, before miner Glencore dug itself out of that particular hole. ConvaTec's explanation for lack of female representation was twofold:

- it was owned by private equity until its IPO (but doesn't that just point to the same problem elsewhere?); and
- its sector – medical devices – is male dominated (though presumably referring to its workforce rather than its user base) – but isn't it the Board's job to set a lead?

Since then, the firm has appointed its first female to the top team and has promised a female-only shortlist for a second non-executive director position.

Related resources on responsible investment

Where can you go to learn more?

LCP's Quarterly Investment Update

Each quarter, LCP produces a commentary on topical ESG matters. This provides a briefing for trustees on recent developments and highlights companies in the news which they may want to discuss with their investment managers. For example, do the trustees hold shares in the companies mentioned and, if relevant, how did the manager vote at the AGM and what other action is it taking? Or, does the manager hold companies likely to be impacted by the same or similar ESG issues?

If you don't already receive our updates, please speak to your usual LCP contact or request it via this form.

A guide to climate-related risks

In this guide, we explain what climate-related risks are, how they are relevant to DB and DC pension schemes and what actions trustees can take to address them.

Investing responsibly magazine

Our Investing Responsibly magazine caters for our clients' growing interest in ESG.

It covers a diverse range of topics from identifying your investment beliefs to selecting fund managers to exercising oversight of your investments. A common theme is that focusing on long-term sustainable returns may deliver better financial outcomes.

Responsible investment in practice

In this series we talk to a number of investment managers about their approach to responsible investment in different asset classes.

Discover manager insights here

Responsible investment in DC schemes / DB schemes

How can you incorporate responsible investment into your investment strategy?

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Download our DB guide here

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