Analysis: DC's new sustainability challenge

As new rules oblige trustees to consider environmental, social and governance factors in their asset allocation, industry experts say more guidance is needed. Joe McGrath reports

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From the start of October 2019, trustees overseeing auto-enrolment defined contribution schemes will

be obliged, by law, to give due consideration to a greater number of factors that may impact the performance of their investments. The changes to the Occupational Pension Schemes (Investment) Regulations, first outlined in June

2018, explicitly specify that trustees must consider the impact that corporate governance, environmental and social impact issues may have on investment holdings in their portfolios. For some, it seems, this is likely to be a bewildering prospect.

"Most trustees are still learning about their obligations and often rely on their investment consultant

for guidance," says Vassos Vassou, a professional trustee at Dalriada Trustees, one of the UK's largest providers of professional trustee services.

"As most schemes invest in large, well-resourced asset managers, trustees sometimes feel confident that their asset managers are taking the necessary steps to include ESG into their investment

process and reflect trustees' ESG obligations. However, trustees are usually at least one step removed from the actual investing of their funds," says Vassou.

If this approach is widely adopted, it may not be sufficient to meet the new rules. From October, trustees are expected to be able to articulate how they consider ESG metrics in their investment allocations. The new rules become even more prescriptive a year later.

By 1 October 2020, trustees must publish their statement of investment principles on their website together with an explainer on how their sustainability policies have been implemented, along with the reasons for their approach. Consultants say that while most trustees are likely aware of what they need to do, it is unlikely to be reflected in their investment strategy just yet.

"In terms of preparation, most trustees are well advanced in updating their SIP by the 1 October deadline, although it may take a ittle longer before we see ESG fully implemented in DC investment strategies," says Redington director of DC and financial wellbeing Jonathan Parker

Potential approaches

The new rules allow a degree of flexibility for trustees in interpreting what constitutes a financially material consideration.

But, while there is no obligation, at present, for trustees to research scheme members' views on material issues such as asset sustainability, the industry is being urged to bring members into the discussion, so they understand why decisions are being taken.

"If, as an industry, we want to build trust and awareness around pension plans, trustees should consider speaking with members to better understand the issues they care about," says Franklin

Templeton Investments director of defined contribution strategy David Whitehair. "This may help inform the debate as to which areas should have greater focus."

Consultants and corporate advisers say that trustees would do well to quiz their investment managers about their approaches so they can better articulate the decisions in their Statement of Investment Principles. They may also want to factor in the ESG issues that are likely to be uniquely important to their scheme memberships.

This information can steer trustees through the fund options they may wish to offer scheme members or even result in introducing new default options that have a specific ESG or sustainability focus.

"Having evidence about their beliefs on investment strategy can help in demonstrating suitability for a particular workforce," explains Parker.

"In its July 2019 update to investment governance, The Pensions Regulator provides clear guidance on how trustees should approach ESG and stewardship in respect of their investment strategy."

Catering for all

Those workplace schemes that have to cater for a vast and diverse workforce, however, may find the ne w re q u i re me n t s more challenging than smaller schemes. Parker is among the many industry experts to have asked the regulator for further guidance as to the best approach for doing so.

Barry Parr, an independent trustee for the Salvus Master Trust, says large schemes with a diverse membership are likely to hold similar views to the general population; even though some master trusts may seek the reputational appeal that a specific ESG factor stance may present.

"If surveyed, and if responses can be taken to be representative, then there may appear strong evidence in support of certain specific ESG factors," he says. "But trustees should be very thoughtful before deciding that a selected factor truly represents the membership views, apart from the core objective judgement of financial impact."

Vassou agrees with Parr's assessment, not ing that "communicating with members is notoriously difficult". He explains: "Getting an accurate idea of their values is hard. An ESG survey may only be answered by those that feel passionately about it, while those not completing it may not want ESG integration, making the results insignificant."

Vassou says if the scheme sponsor is more focussed on ESG risk as part of their everyday business, there may be slightly more engagement.

Measuring the value

When it comes to charting the importance of ESG on financial performance, the debate is still raging. There are myriad studies that suggest companies taking into account future sustainability trends outperform.

A 2016 Harvard Business School study, entitled Corporate Sustainability: first evidence on materiality, for example, made a clear link between the two. Similarly, a 2017 paper entitled Shareholder Engagement on Environmental, Social, and Governance Performance, written by Barko, found companies that engaged with shareholders on ESG issues did better.

“There is now massive evidence of ESG outperformance,” explains Earth Capital managing partner Jim Totty. “The key market issue currently is to distinguish between

‘backwards’ looking ESG reporting and ‘forward’ looking impact investing,” he claims.

“For larger established businesses, ESG reporting can be the limit of what is possible as dependence on fossil fuels, plastics and polluting processes can take many years to change. Impact investing, on the other hand, can be accessed through investing in newer more nimble ‘pureplay’ sustainable businesses which are often private equity funded.”

Legal and General Investment Management head of DC client solutions Simon Chinnery cites Morgan Stanley analysis of more than 11,000 ESG funds going back to 2004, which concluded that investors do not have to sacrifice returns in order to ‘do the right thing’.

He explains: “A recent World Economic Forum paper on seeking return on ESG argues that increasingly, the evidence demonstrates that a focus on strong environmental, social and governance performance can deliver both business and societal impact.

“A large and growing body of e videnc e lin ks c ompan y performance on particular ESG dimensions to its ability to deliver financial value for investors and to outperform the market over the long term.”

Pressing issues

Within the realm of sustainability, there are dozens of sustainability issues that trustees may wish to consider. These include the impact that issues such as modern slavery, supply chain issues, fat cat pay, climate change and water scarcity may have on investments in their portfolio.

Currently, environmental issues are featuring prominently in the news cycle, which has also kept them front of mind for investors assessing portfolios, but the work of non-governmental organisations can also be an indicator of issues that are beginning to bubble to the surface.

Sigwatch managing director Robert Blood says experience tells us the issues NGOs are pushing are a good predictor of future st ake holde r and mar ke t expectations.

“NGO campaigning put climate, arms trade and human rights on the ESG agenda,” he says, noting that decarbonisation, single use plastics, livestock farming, commodity agriculture and the communities of indigenous peoples were all themes discussed by NGOs before they were priced into financial markets.

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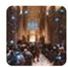

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