Paving the way

Our responsible investment activities over 2019

Contents

Foreword

Mark Fawcett
Chief Investment Officer

Momentum behind responsible investment has never been higher. In the last year the investment industry has been awash with debate and discussion on environmental, social and governance (ESG) issues. UK pension schemes in particular need to turn this rhetoric into strategies, implementation and tangible outcomes for members.

Others clearly agree. The Financial Reporting Council (FRC) has published its revised stewardship code which puts ESG requirements front and centre for pension schemes. Enhanced Occupational Pension Schemes (Investment) Regulations now require pension scheme trustees to disclose how they consider ESG matters like climate change when making their investment decisions. New European laws seek to increase the level and quality of engagement of asset owners and asset managers with their investee companies.

At Nest, we welcome these developments and support new guidance for pension schemes. We were delighted to contribute to PLSA's ESG & Stewardship: A Practical Guide to Trustee Duties and to have consulted closely with the FRC on the new Stewardship Code and climate change reporting.

For pension schemes to successfully fulfil their new duties to their members, it's important that the fund managers entrusted with their money step up and show their commitment to responsible investment. We continue to work closely with current and prospective fund managers to ensure they fulfil their responsibilities in addressing material ESG factors in the investment process and stewardship on our behalf.

Climate change is one matter we're pushing hard on as it becomes more material to our own investment approach. This year the UK Government become the first major economy in the world to legislate for net zero greenhouse gas emissions by 2050. This shows the direction of travel and radical change expected in laws and regulations relating to the transition to a low carbon economy. The management of climate-related risk and opportunities were therefore at the forefront of our requirements to managers selected to run our new private credit strategies. This is particularly important within our real assets loan strategies. The long-term economic lives and extensive debt horizons of infrastructure and real estate investments bring the need for these assets to be well governed, run sustainably, and to be protected from the impacts of climate change. We are also excited to be tapping into investment opportunities in renewables and are planning for further investment in this space later in the year.

We announced our decision to go tobacco free across our investment portfolios earlier this year. Our carefully researched decision had been in the pipeline for several years, so we were pleased to receive a positive reaction to the news. Our work led us to the conclusion that the tobacco industry has a poor financial future and is likely to be an unsustainable investment for our members.

Finally, the results of our member survey on responsible investment struck a powerful chord with our readers. 73 per cent of Nest members surveyed wanted their pensions invested responsibly and expressed an interest in hearing more about our activities as a responsible investor. We're pleased to be able to update you on the progress we've made on engaging with our members over the last year.

> **73 per cent of Nest members surveyed wanted their pensions invested responsibly....**

As ever, we aim to achieve successful performance while keeping costs low for our members, as our move as one of the first defined contribution schemes into illiquid markets illustrates. We hope this year's report is an informative snapshot on how we're helping secure better financial outcomes for members whilst contributing to a world they want to live and retire in.

Introduction

Investing responsibly is central to how we're run. Our members are saving for their long-term future, so we must carefully consider how investments are selected and managed.

We ensure the fund managers we work with can manage risk and tap into investment opportunities that help the world become more environmentally sustainable, equitable and inclusive. We strongly believe that well-governed organisations that treat their workers fairly, are preparing for a low carbon world and can meet societal expectations, have a better chance of sustaining long-term success and profitability.

This year's report shows how we've been working to strengthen our investment approach and the impact we're having across our members' investments and the broader investment industry.

What's covered in this report?

Chapter one details how we're incorporating environmental, social and governance (ESG) issues in new asset classes like private infrastructure debt. We also provide an update on tobacco investment, factor investing and our work on climate change.

Chapter two looks at how we've engaged with our stakeholders and industry bodies and the contribution we're making to help raise standards across the industry.

Chapter three gives a snapshot of key voting decisions and engagements we've undertaken with investee companies over the year.

Chapter four provides an update on our approach to communicating responsible investment activities to our members.

Chapter five looks ahead to our priorities over the next year.

ESG considerations in our asset allocation

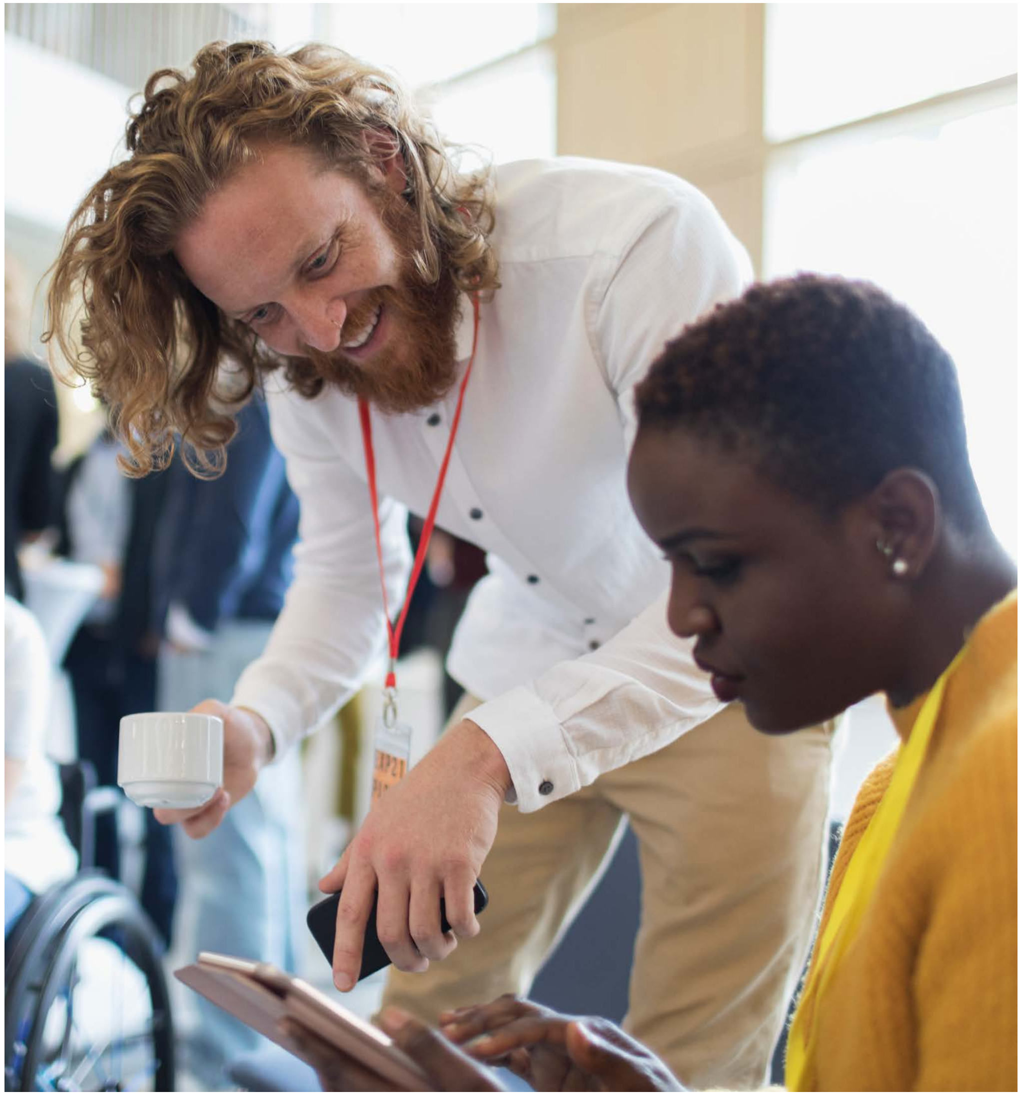
Our investment in private credit

Nest's size and future growth means that we've secured cost-effective ways to incorporate asset classes that haven't traditionally been seen in the default investment strategies of defined contribution (DC) schemes in the UK. These new investment opportunities will help improve diversification and achieve better risk-adjusted returns. One of these asset classes is private credit.

We appointed Amundi, BlackRock and BNP Paribas as our fund managers for these new private credit strategies due to their strong ESG integration and reporting abilities. Our new strategies include corporate loans, infrastructure debt and commercial real estate debt fund. The latter two investments are known as real assets, which tend to be highly distinct and come with a unique set of ESG characteristics, risks and opportunities. The case study on the next page explores ESG considerations within our infrastructure mandate.

What is private credit?

Private credit investments are typically loans that are directly negotiated between an investor or small group of investors and the loan's recipient/ borrower. As they aren't traded on public exchanges, investors negotiate bespoke rates but are expected to tie up their money for the whole term of the loans. They are normally rewarded with better returns, known as an 'illiquidity premium'.



Case study
ESG in private infrastructure debt

Our investment approach is to build diversified portfolios with long-term investment horizons. Private credit aligns with that strategy, allowing our members to benefit from an illiquidity risk premium as well as additional diversification benefits.

Investing in infrastructure debt allows us to access projects that contribute positively to the environment and society. In addition, investments like renewable energy, electric transportation technology, healthcare services, water treatment facilities and social housing not only help us deliver our risk-adjusted return goals, they also have the potential to contribute long-term benefits for the environment or communities they serve.

Private infrastructure investors tend to hold their loans to maturity. This long-term investment horizon creates many opportunities and risks that need managing. As with all new asset classes, we carried out extensive research to understand how ESG risks in infrastructure evolve and how they're being identified and managed by the fund managers we work in partnership with.

The selection process

ESG considerations formed an integral part of our evaluation of private debt funds.

In our request for proposals we questioned fund managers on their ability to assess ESG risk at the due diligence stage and their approach to monitoring and addressing ESG issues that develop after investment. We also wanted to understand the opportunities they're seeing in renewable energy and social infrastructure.

We looked for examples of how ESG risk analysis was delivered in all stages of the investment process. This included data sources, personnel and engagement with the management of the entities looking to finance their activities through the issuance of private debt. We asked how climate-related risks and opportunities were managed, including physical climate risks. For example, whether the fund manager had factored in excessively high temperatures and the higher likelihood of wildfires in a particular region when considering making a loan to finance a hotel chain, and how these risks might affect the borrower's ability to repay its debt if tourism should fall.

We also questioned how fund managers dealt with social risks, such as labour and health and safety issues, particularly where construction is taking place. Our expectations are that construction workers are well supported, have a safe working environment and are paid fairly. Performing poorly in these areas could affect the outcome of the project and the repayment of any loans.

Political and regulatory risk are also key considerations. If a fund manager was unable to demonstrate a good understanding and management of these issues, it was reflected in their final selection score.

The outcome

We appointed BlackRock for our infrastructure debt mandate. Their consideration of ESG was a well-articulated component of their investment strategy. Risks are considered throughout their investment process, with a risk screen conducted at the beginning of the due diligence stage.

For example, their initial risk screen of a loan to a hospital identified potentially corrupt procurement practices. Following discussion with BlackRock's risk and financial crime teams, the investment team declined on the opportunity. BlackRock works with several external due diligence providers to identify and manage these often complex and technical risks, including engineering, environmental and energy management consultants.

If material ESG risks are identified during the initial underwriting and investment phase, the team seeks to mitigate these through:

- requesting changes to the design or operation of the project
- negotiating enhanced covenants in respect of ESG standards of operation, as well as additional reporting covenants in respect of the identified risks.

Our strategy aims to invest approximately 50 per cent of assets in infrastructure debt in positive impact sectors like social housing, health facilities and renewable energy including wind, solar projects and smart meter providers. BlackRock have developed metrics to measure the impact of financing these assets.

BlackRock's impact milestones

Environmental

- Avoided c. 10.3 million tonnes of carbon missions per annum
- c. 5.1 million households powered by renewables

Social

- Funded three housing associations with c. 70,000 social housing units
- Funded c. 10,000 student beds
- Financed c. 12 schools
- Supported the delivery of c. 1,000 new rail cars

Governance

- Improved corporate governance at three investee companies

Source: These estimated figures have been provided by BlackRock's infrastructure debt team as at January 2019. The figures are project specific rather than reflecting pro-rated for BlackRock's exposure.

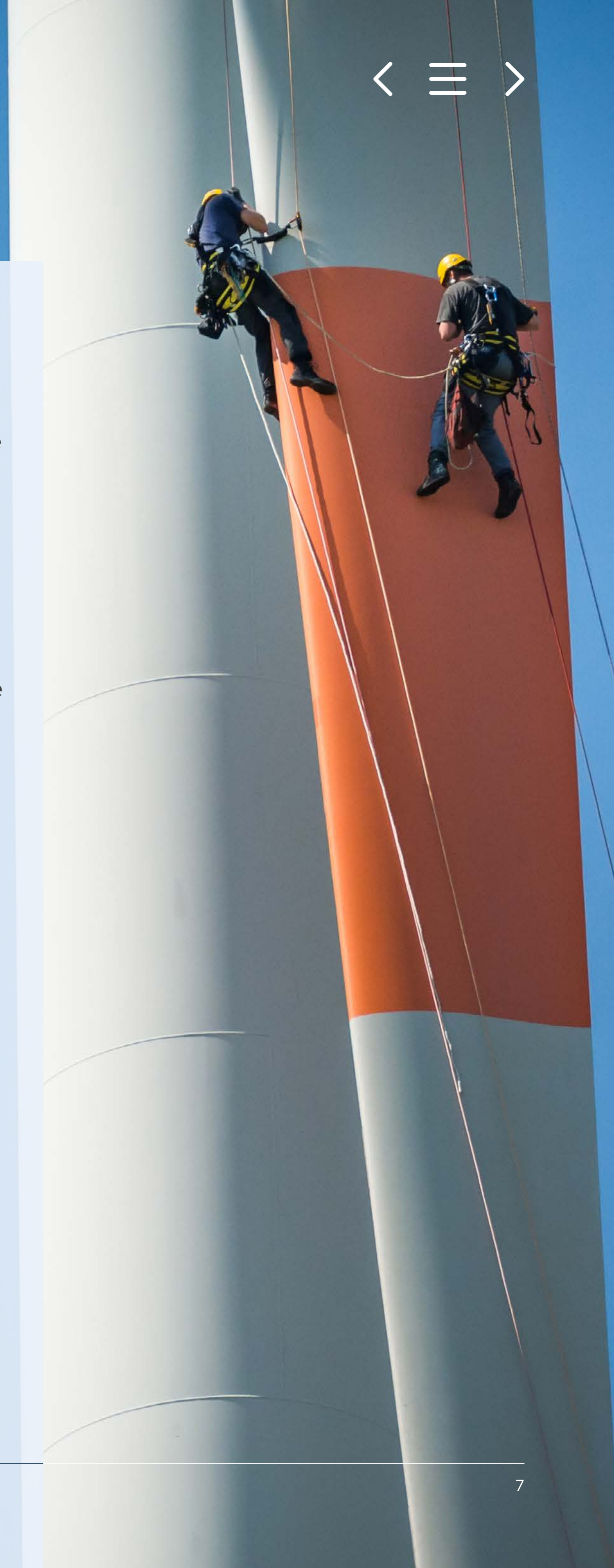
Our ESG requirements

There are certain infrastructure investments in particular regions that we're uncomfortable putting our members' money into. We also want risks like climate change adaptation to be fully considered.

Infrastructure projects consist of many sustainable assets which deliver long-term benefits to the environment or the communities they serve. We encourage fund managers to take advantage of these asset types as opportunities arise.

Our strategy specifies that:

- we do not invest in coal power plants
- a maximum 25 per cent of loans are to projects or buildings on greenfield sites
- climate risk considerations should be considered in all loans
- we are given bespoke ESG and climate reporting for specific projects.



Update on factor-investing

In last year's report, we flagged that our investment team were considering an equity factor allocation for Nest's members. Our analysis shows that factor-investing delivers improvement in long-run investment performance above a market capitalisation equity index.

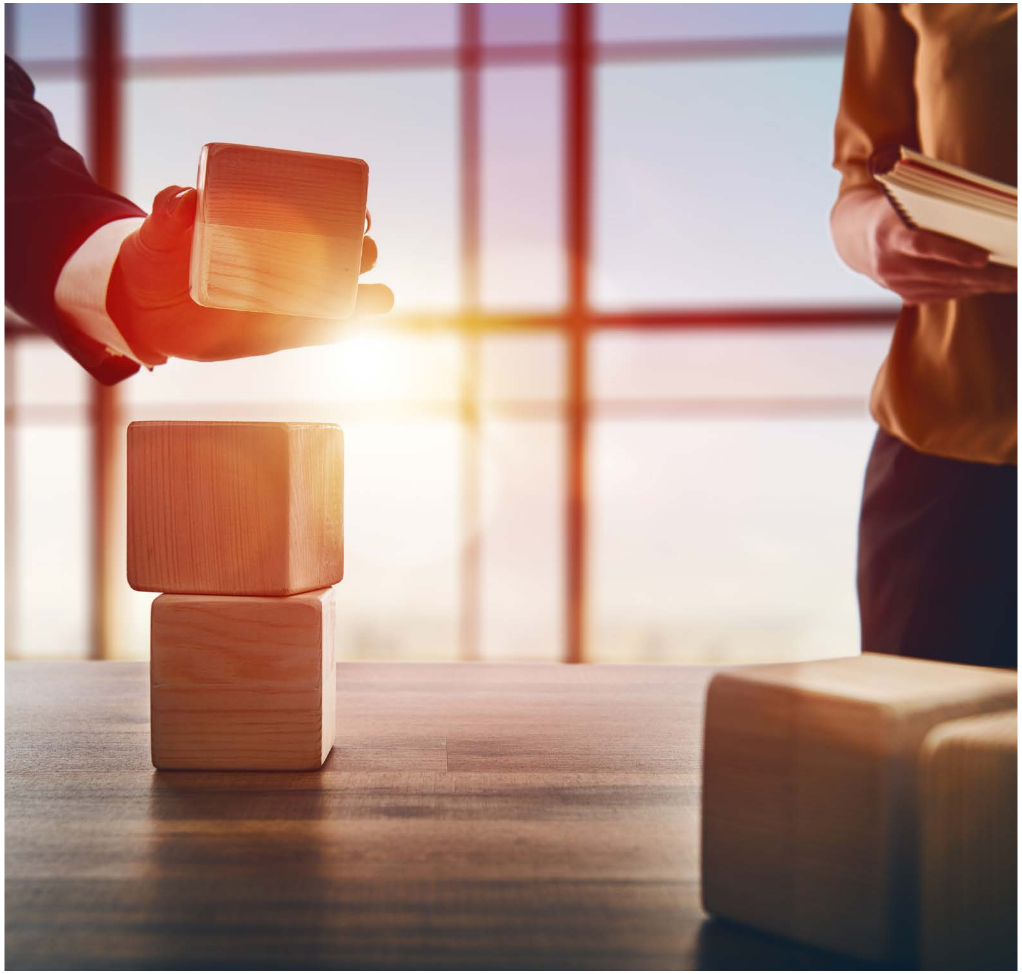
We examined the interaction between traditional investment factors – like small company size, value, momentum, quality, low volatility and dividend yield – and ESG investment risks and performance. An equity factor approach creates different ESG risk exposures to those of a market capitalisation equity benchmark because fewer securities are held and the investment weights are different.

Investing in some factors to improve investment return can cause a portfolio to take on additional ESG risk, especially risks related to the transition to a low carbon economy. We wanted to evaluate what effect factors have on ESG risk and performance so that we could address any issues at the design stage.

We identified several considerations for a prospective factor approach:

- If ESG risk exposures are too high, the prospective fund manager should be prepared and dynamic enough to reduce risk exposure while not diluting the factor exposure.
- Overly high allocation to high dividend yield equities should be avoided. These are often defensive value and low volatility stocks like tobacco, oil, gas and coal companies that carry a high concentration of ESG investment risk.
- Understanding how implementing our ESG policies on tobacco, controversial weapons and climate change affects factor exposures and how can these be managed to ensure our targeted exposures aren't impacted.
- The factor exposures we're targeting shouldn't lead to heightened ESG risk, especially on issues that Nest has been focussed on addressing, like climate change, workforce risks and poor governance.

The relationship between factors and ESG investment risks shift over time.



Climate update

Our Climate Aware Fund

Over the year to September 2019, the Climate Aware Fund (CAF) increased by £400 million to £1 billion. We have:

- £203.7 million (22.4 per cent) more invested in companies positioned to benefit from a low carbon economy. This includes renewable companies like Meridian Energy, EDP renewables and SSE.
- £203.7 million (22.4 per cent) withdrawn from companies that need to change but are making little progress on adapting for a low carbon future. This includes utility company KEPCO and oil and gas companies Chevron and Exxon Mobil.

£1 billion

The value of the Climate Aware Fund in September 2019. An increase of £400 million since September 2018.

Our members' investments in the CAF have resulted in reduced carbon emissions equivalent to:

taking 44,180 cars off the road each year

stopping 23,557 tonnes of waste going to landfill

powering 10,133 homes for a year compared to the benchmark.

September 2019

Engagement update

UBS and Nest have engaged with 28 utility companies and 22 energy companies considered to be the 50 weakest performing businesses from a climate change perspective over the last year. Each engagement was built on a baseline quantitative assessment of the company and its position in the fund regarding the low carbon transition. The Taskforce on Climate-Related Financial Disclosures (TCFD) was used to develop an eight factor scorecard to measure their progress and performance with:

- responsiveness to engagement
- governance of climate change
- risk management
- strategy and policy
- metrics and performance
- targets
- lobbying activities
- overall levels of disclosure.

For further details on scorecard performance, individual company engagements and next steps please see UBS' The View One Year On.

We were particularly keen to understand the relationship between governance and climate change performance. UBS conducted analysis on our behalf to measure the correlation between general governance standards using ISS scores and climate change performance based on the scorecard metrics. We saw correlation in only half of the 50 companies, suggesting high standards of governance doesn't necessarily translate into effective management of climate risk. We will continue to investigate why this may be the case.

"

The Climate Aware Fund currently incorporates a forward-looking 2C global warming glidepath, giving greater exposure to companies that operate their businesses according to this target.

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What's next

We're currently looking at ways to broaden the scope and objective of the CAF's methodology to reflect the quickly evolving nature of climate change risk and its likely impact on our members' investments.

In October 2018, the UN Intergovernmental panel on climate change stated there are 'only a dozen years for global warming to be kept to a maximum of 1.5C – beyond which even half a degree will significantly worsen the risks of drought, floods, extreme heat and poverty for hundreds of millions of people'.

The CAF currently incorporates a forward-looking 2C global warming glidepath, giving greater exposure to companies that operate their businesses according to this target. During the past three years, the CAF has had -2.4 per cent average annual growth rate of CO_2 emissions. In comparison, the FTSE Developed Index has had +1.6 per cent average annual growth rate over the same period. We're now stress testing the fund using a 1.5C scenario. This more ambitious target means the CAF will tilt more rigorously away from companies generating large carbon emissions and towards those that are at the forefront of the climate transition or who have very low carbon emissions.

We're also looking at expanding the sectors covered by the CAF methodology. The methodology is applied to sectors that the International Energy Agency believe are critical in the shift towards a low carbon economy, like oil and gas, coal, transport, utilities, industrial and materials. However, this doesn't include sectors such as agriculture, autos and retail, which have an important role to play if the Paris Agreement is to be met. A broader scope will help us assess and monitor the climate change performance of high-risk sectors and engage with them where necessary.

The CAF allocates additional money to companies that focus solely on supplying renewable energy equipment, machinery or technology to renewable energy generation companies, for example Vestas Wind Systems. Industrial conglomerates like Siemens AG and General Electric also have business lines developing technology and machinery for renewable energy companies, but this level of revenue-based supply chain isn't well publicised. We're looking at machine learning methods to detect green technology revenue streams in large conglomerates so we can factor these companies into the CAF methodology.

Managing climate risk and opportunities in emerging markets

We believe all companies should manage their climate risk and impacts. The investor community has largely focused on businesses in developed markets, but there are a number of state-backed, high-profile oil and gas companies in emerging markets that continue to extract fossil fuels with mounting reserves and are not held accountable for their actions. That's why we're evolving our ESG Emerging Markets fund to include the assessment of climate-related risks and opportunities.

We're working with our current manager Northern Trust to reduce exposure to the biggest climate risks and invest more in companies with green revenue streams. The fund will continue to address the biggest governance risks by excluding them. It will also exclude coal, weapons, tobacco and companies in breach of the UN Global Compact principles.

Nest are proud to join the Climate Action 100+. This initiative is a group of investors who actively engage with the world's 100 biggest CO2 emitters, seeking to curb emissions and improve the governance of climate-related issues. We will use this opportunity to target US and emerging market companies, which have tended to lag behind European companies in planning for a transition to a low carbon economy.

New ESG data tools

We appointed data providers RepRisk and Sustainalytics to help identify and manage ESG risks. Their data helps us assess what products, activities and controversies our investee companies are exposed to. We can also monitor what reputable news agencies are reporting about them so that anything affecting a company's reputation is quickly brought to light and informs our engagement and voting decisions.

Our long-term aim is to take a more holistic view of companies and portfolios, assessing ESG factors alongside more traditional investment risk factors. We plan to do this by integrating high quality, timely ESG data into our risk management framework.

Removing tobacco from our funds

Following our 2018 case study on the tobacco industry, we've decided to remove tobacco investments across all our portfolios.

The motivating factors

Our research indicates that the tobacco industry has a bleak financial future and is likely to be unsustainable. Tobacco companies face increased regulation and litigation by governments around the world, which impacts consumer demand, sales and profits.

The industry's ESG profile is inconsistent with our principles. This was the catalyst for examining its financial sustainability. We usually prefer to engage with industries, but our discussions with individual tobacco companies convinced us that we had no choice but to reconsider our investment approach.

E-cigarettes

Most tobacco companies are transitioning from high margin cigarettes to low margin and currently loss-making vaping. E-cigarettes already face regulatory pressure. The World Health Organization has advised countries to 'consider banning or restricting advertising, promotion and sponsorship of electronic cigarettes', most likely because long-term health effects aren't yet properly understood. Unlike the manufacture and sale of cigarettes, tobacco companies don't have an oligopoly and face a fragmented market. For these reasons, we don't view e-cigarettes as a sustainable, viable product alternative.

> **"Our goal is to reduce holdings in companies whose main income comes from the manufacture and production of tobacco from 0.4 per cent of total assets today to zero."**

Next steps

We've already started the process of removing exposure from our portfolios. Our goal is to reduce holdings in companies whose main income comes from the manufacture and production of tobacco from 0.4 per cent of total assets today to zero. The majority of our mandates are already tobacco free and any new mandates must be tobacco free to pass our selection criteria. Where tobacco is held within existing mandates, we will assess our options with fund managers and investigate the most straightforward and cost-effective ways of removing these. We aim to be tobacco free by summer 2021 at the latest. We believe this will help us improve longer term outcomes for all our members.

Chapter two

Creating better functioning markets

To support long-term wealth creation for our members, we've continued engaging with key industry players and government departments on various topics. We aim to help shape investor frameworks and raise standards through the following initiatives:

Consultation responses

We responded to Sir John Kingman's review of the Financial Reporting Council (FRC) and his additional questions about changes in audit that may better promote the interests of users of accounts. Our responses can be found in our position papers. We made several points including:

- Requesting that the FRC and Competition and Markets Authority (CMA) evaluate and examine whether the concentration and competition within the statutory audit market is in the interests of users of accounting statements.
- Recommending that there be a shareholder vote on the audit committee report. We believe that this report is no less important than the remuneration committee's report that shareholders currently vote on. The vote would be even more effective if it could be configured to be more than advisory.
- Encouraging the work of the audit committee to be spread between its Chair and members and for the appointment of more diverse audit committee chairs.
- Expressing concern at poor diversity at senior management levels in the audit and accounting professions, which the FRC has addressed in their Key facts and trends in the accountancy profession report.

The CMA addressed these issues in its final report and is recommending that the government takes these matters forward through legislation.

"We aim to help shape investor frameworks and raise standards...."

Investor roundtables

Social impact investing

We hosted a focus group in collaboration with the Investment Association on pensions and any associated opportunities and challenges around social impact investing. It was a chance for asset managers and pension scheme representatives, including trustees, chief investment officers and contract-based scheme providers, to have an open dialogue. It was agreed that any resulting work would be progressed to the Social Impact Implementation Taskforce.

The Taskforce has been responsible for implementing the recommendations of the *Growing a Culture of Social Impact Investing in the UK* report published in November 2017. The objective of our focus group was to understand barriers to social impact investing and how the industry can help pension funds overcome challenges around investment opportunities, research and data, impact and return trade off, fiduciary duty and liquidity.

ESG issues in fixed income

We co-hosted a corporate bond event on climate risk where we discussed ShareAction's research on how bond fund managers manage climate-related risks and opportunities in their investment processes.

We undertook our own ESG review of our fixed income managers. We made several high-level observations:

- Fund managers are incorporating ESG to varying degrees. All of them aim to make it a fully integrated part of their investment process.
- The level of ESG integration in fixed income comes down to the beliefs and commitment of the individual portfolio manager (PM). If the PM believes that ESG materiality could impact aspects like credit risk and default risk, they're more likely to factor it in.
- Fixed income strategies are perhaps less likely to follow the overall ESG direction that the firm is trying to implement than other teams, such as equities or real estate.
- ESG risk analysis tends to be mainly bottom up with less thinking around thematic issues at the portfolio level, like climate risk.
- Fund managers tend to identify and monitor ESG issues so they can mitigate downside risk as opposed to benefit from opportunities. These attitudes are slowly changing.

Case study
Cyber security

In 2018, we investigated the potential impact cyber and data security could have on investments. The topic was chosen as it's systemic in nature and affects global companies across different sectors.

We felt it was important to develop a deeper understanding of the issue and assess whether there were any concrete steps we could take to address this complex risk across a global portfolio.

We met with cyber experts from various organisations and industries, including representatives from PWC, National Cyber Security Centre, Templar Executives, Principles for Responsible Investment and Legal & General Investment Management. These meetings helped us develop a more rounded view of the topic, understand any barriers to action and establish approaches that lead to the development of suitable strategies.

What we wanted to know

- How can we assess whether companies have taken adequate measures to protect themselves from cyber hacks and data breaches?
- What does good cyber security look like? What indicators should we look for?
- Who at the company should be responsible?
- Is there any reporting to shareholders on this and what should shareholders expect?
- Is level of spend a good indication to how much a company is doing?
- As an index investor, how can we identify the biggest laggards?

What we found

Companies can't stop attacks from occurring, but preparation and operational resilience are key to managing any damage. It's important that a company has strong business continuity and security strategies that can respond quickly to threats. Investors should question boards about their preparation to assess how well a company can continue to operate under attack.

Measures of good cyber security include:

- Most security breaches can be traced to what people have done wrong, so embedding cyber security in people's day-to-day work is important. It's crucial that businesses have a strong corporate culture that raises awareness, trains and educates staff on cyber threats.
- The board should regularly look at the right metrics to assess risk, ask intelligent questions and take operational action from the data used.
- Any metrics must be right for the business and should be easy to explain and understand.
- A strong translator for the IT team with board-level responsibility is needed so board members can understand technical information, have high quality discussions and make important decisions.
- Cyber security spend should increase year on year and be used on the right things. The risk is fast-moving, so currently robust mitigation systems might leave the business vulnerable as threats evolve.
- Following regulatory standards like ISO27001 and Cyber Essentials Plus is important, but compliance doesn't always mean good security. It's more important to understand how companies are implementing these standards, what controls they're choosing to implement and why.

While the chair and chief executive officer need to take ownership of cyber security, it's important to understand the role of the chief information security officer and their reporting line to the board. The National Cyber Security Council has developed a range of questions that it believes will help generate constructive cyber security discussions between board members and their CISOs.[1]

It's difficult to measure cyber risk and therefore hard to identify laggards. Increasing disclosure could actually create a scenario where both weak and strong companies become targets. This deters companies from improving their cyber security reporting, which isn't beneficial to investors. However, certain disclosures aren't counterproductive for companies' security, such as assurance that they adhere to best practice standards. In addition, we'd want to know whether they have a strong cyber security awareness culture across their organisation and their process for managing cyber threats.

1 ncsc.gov.uk/guidance/board-toolkit-five-questions-your-boards-agenda

As index investors, we're keen to learn how to identify the biggest cyber security risks across our investments given the lack of reporting from companies. We found that certain types of companies are bigger targets as they're typically more susceptible to attack, including those that:

- hold the most data
- carry the most systemic risk in the market
- are conglomerates that are likely to have old legacy systems
- have recently undergone a merger or acquisition
- have global supply chains.

It's also a good idea to engage with companies that have just been hacked to assess the company's resilience, response and recovery and what might need to change or improve going forward.

Next steps

Many studies concentrate on what getting cyber security wrong looks like. Research has uncovered potential board-related challenges such as:

- boards underestimate cyber security risk
- board structure is inappropriate to manage cyber security risk
- boards that are out of their depth
- investors knowing better than directors
- markets punish companies on revelation of cyber incidences
- companies see cyber security as a liability on the balance sheet rather than a value add that could strengthen long-term strategic performance and investor ownership.

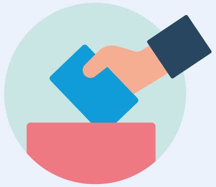
We've since published a paper with RailPen on Why UK pension funds should consider cyber and data security in their investment approach.

Chapter three

Active ownership highlights 2019

Sustainability issues played an important role at many company annual general meetings (AGMs). Nest's global developed equity manager was active in supporting many shareholder resolutions on sustainability and holding boards to account on reoccurring corporate governance issues including executive remuneration, board independence and auditor tenure.

We're pleased to see our fund managers take a firmer approach to voting this year. More resource is being allocated to voting and engagement as fund managers are increasingly aware of the importance their clients place on this. We will continue to engage with our fund managers, ensuring they factor in a range of issues and are voting consistently across their holdings.



Nest's voting subset

We expanded our active monitoring subset to include all UK Companies that are non-Living Wage accredited. This helps us continue to monitor this issue closely as part of our broader focus on workforce and human capital. It also strengthens our alignment with the Workforce Disclosure Initiative (WDI) and ShareAction's petition which calls on employers to pay all staff the Living Wage. This September we'll be meeting with several UK companies to discuss reporting on workforce issues.

Voting themes 2019

It's important to hold companies to account on their corporate governance practices because well-managed companies with strong corporate governance structures, are more likely to be successful in the long term than companies who don't. It's a critical investment factor that helps us provide our members with the better retirement outcomes.

Executive remuneration

Our work on fair pay and the workforce shows that boards should consider the wider workforce when setting executive remuneration policies, including pensions contributions. We've always advocated that pension contribution rates for executives should be in line with those of the wider workforce. This view is now included as regulation in the new UK Corporate Governance Code, which came into effect on 1 January 2019.

Several companies that we hold shares in aren't yet doing this, for example SEGRO, AstraZeneca and Daimler. They've been given a year's grace period to align pension contribution rates, and we'll be keeping a close eye on progress ahead of 2020 voting season.

There were a handful of votes on pay where we opted to override UBS's votes:

- We voted **against** executive remuneration at Airbus, Rio Tinto, US Bancorp, SEGRO, Credit Suisse, Sanofi, Centrica, Anglo American, AstraZeneca and BlackRock.

Some of our reasons for voting against executive pay at these companies include:

- remuneration committees not considering ESG factors when setting performance targets
- significant overlap in performance conditions with bonuses and long-term incentive plans
- the absence of clawback provisions and pensions not being paid in line with the wider workforce.

> **"It's important to hold companies to account on their corporate governance practices because well-managed companies with strong corporate governance structures, are more likely to be successful in the long term than companies who don't."**

Combined chief executive officer and chair positions

We generally expect the chief executive officer and chair roles to be performed by different people. This year we used our voting override option to vote against the re-election of the combined Chief Executive Officer and Chairman at Iberdrola, J.P. Morgan and BlackRock.

We believe large, globally-diversified banking organisations and asset managers should comply with good governance practices. They're more likely to hold the companies they invest in to account and to challenge poor practice if they themselves uphold high standards of corporate governance.

We believe that energy companies with strong governance structures which include a separate chief executive officer and chair are more able to address the challenges posed by climate change and successfully transition their businesses to a low carbon economy.

Improved vote monitoring and execution

This year Solactive, an index, financial data and technology provider, made a strategic investment in Minerva Analytics, our proxy voting provider. This investment will accelerate the growth of electronic voting, stewardship and ESG research services available to us. Minerva will now be able to offer us global coverage 24 hours a day, so we can keep an even closer eye on relevant issues across more investments globally.

Lack of female representation at board level

As a member of the 30% Club investor Group which campaigns for greater gender diversity on boards and senior management teams, we expect companies to have policies in place which support women in senior positions and roles of responsibility. This year we had concerns with poor female board representation at Centrica. We chose to vote **against** the chair of the Centrica nominations committee as female representation stands at 16.7 per cent, well below the FTSE 100 average and the Hampton-Alexander Review's target to reach 33 per cent by 2020. We also have concerns around the absence of measurable targets or strategy for how Centrica intends to improve gender diversity at board level. You can read more about our engagement with Centrica on page 20.

BP and Climate Action 100+ shareholder resolution

We were pleased to see that UBS played a significant role in co-filing the Climate Action 100+ shareholder resolution at BP's AGM, which called on BP to improve its climate change disclosures. We were also pleased that the board of BP set a recommendation to vote for the resolution.

It's encouraging to see one of the world's largest oil and gas supermajors start to engage with shareholders and take a proactive approach in tackling climate change and promoting the transition to a low carbon economy. The resolution received 99 per cent support at BP's AGM and is a positive example of how collaborative efforts with the Climate Action100+ Group can push companies to change.

From 2019 onwards, BP will use its Strategic Report to outline how the company's strategy is consistent with the goals of the Paris Agreement. We'll be closely monitoring their progress in this space.

Shareholder resolutions at Amazon

A total of 12 shareholder resolutions were filed by employees and shareholders at Amazon's AGM. These resolutions were asking the company to improve working conditions, health and safety practices, start including ESG metrics into executive remuneration policies and report how it plans to reduce its dependency on fossil fuels amongst other things.

Prior to the AGM, we attended an investor briefing hosted by the Trade Union Congress which raised some supply chain and labour rights issues for Amazon employees. Before the AGM we discussed voting intentions with our fund managers, UBS and BMO, to ensure their votes were being cast in line with our expectations.

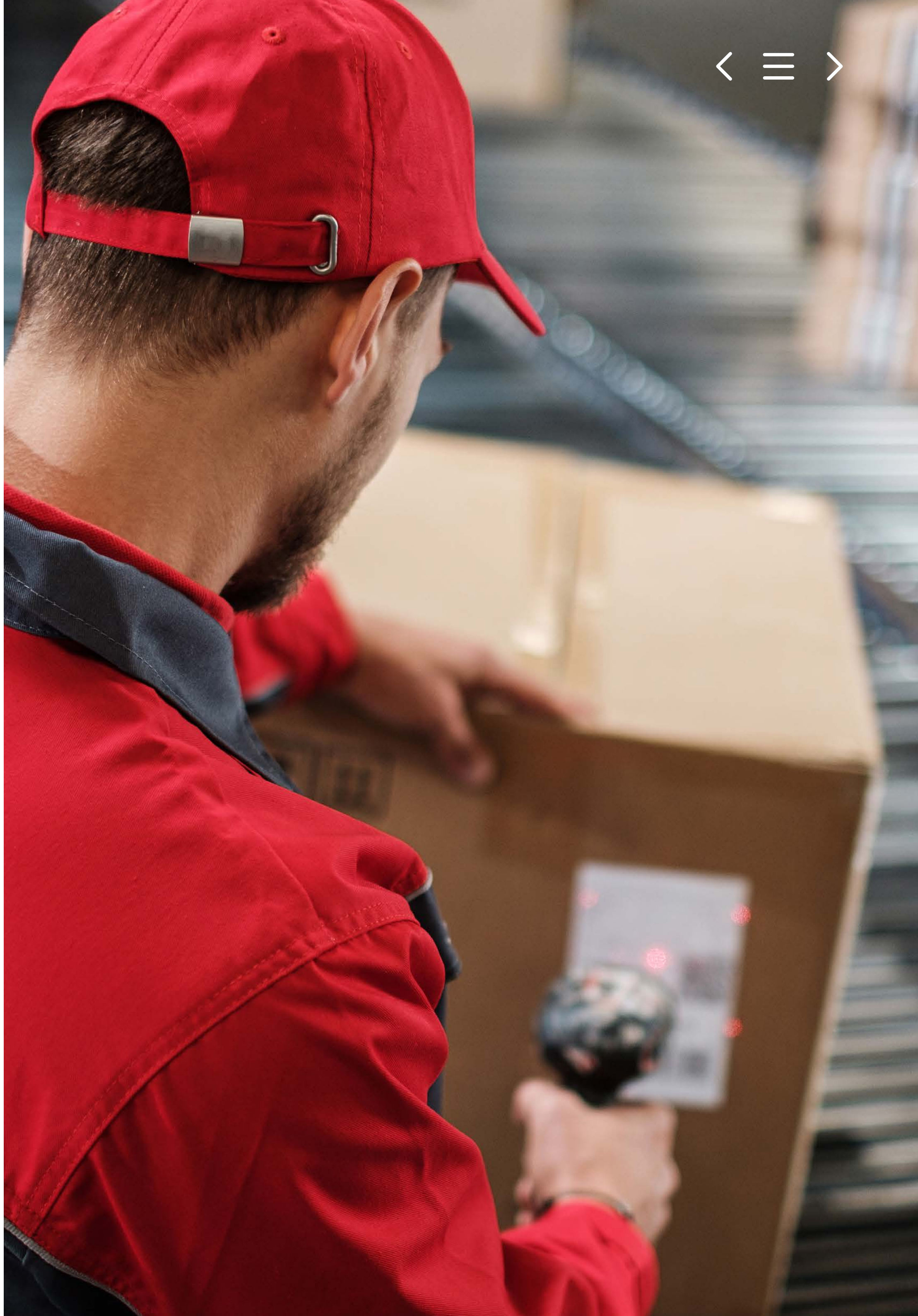
> **We voted on 3,000 resolutions covering but not limited to audit and reporting, board composition, remuneration and several corporate actions.**

CoreCommodity voting

Following the onboarding of our commodity fund last year, this was our first year of voting all the fund's shares in-house. Minerva, our proxy voting provider, assisted us by providing vote recommendations in line with our voting policy. We voted on 3,000 resolutions covering but not limited to audit and reporting, board composition, remuneration and several corporate actions.

The energy sector saw some mergers and acquisitions (M&As) this year. We feel it's important to factor in a climate risk perspective to voting on M&As within the oil and gas industry. Whilst these mergers are designed to bring short-term value for shareholders, we were concerned that some acquisitions could strengthen drilling rights and companies' ability to access more pipelines and increase oil production.

As long-term climate aware investors, it's important to assess whether this type of M&A activity is in line with our investment strategy and climate objectives. We want to explore whether the companies involved or the investment banks underwriting these deals consider climate risk and the resulting impact on future carbon emissions.



Voting-led engagement

Following voting season, we wrote to selected companies to explain our rationale for voting against management on certain resolutions. We take a collaborative approach where possible and reach out to other investors who have similar concerns on the same issues, asking them to co-sign our letters to show support. We believe joint engagement raises the profile of these concerns and has a higher chance of delivering positive outcomes. It's therefore more likely to create change that will benefit our members.

"We take a collaborative approach where possible and reach out to other investors who have similar concerns on the same issues, asking them to co-sign our letters to show support."

This year, we wrote to several companies to explain why we voted against management, setting out our concerns and expectations for change. These included:

- **Centrica** – we highlighted concerns around their low female board representation, standing at just 16.7 per cent. Members of the 30% Club investor Group representing £3.5 trillion in assets under management co-signed our letter. In it we encouraged Centrica's new Chairman, Charles Berry, to use his experience as a member of the Steering Committee of the Hampton-Alexander Review to promote women to senior positions at the company. We set out our expectations for the publication of a diversity policy and succession plan which include tangible targets that support the company's commitment to diversity and inclusion. We're pleased to report that Charles Berry has responded to our letter and invited us to discuss plans for improving board gender diversity. We met with Charles Berry and heard about plans to improve diversity at board level.
- **J.P. Morgan** – we expressed our concern on the current structure and independence of the board. We voted **against** the re-election of Jamie Dimon, who serves as both Chief Executive Officer and Chair at J.P. Morgan. We highlighted that it is generally our policy to not support boards that have joint chief executive officer and chair roles without good reason.
- **Iberdrola** – we explained our concerns around the combined Chief Executive Officer and Chair role held by José Galán. As a multinational electric utility company that's undergoing an energy transformation to meet a zero net carbon emissions goal by 2050, we believe Iberdrola would be better able to address the challenges posed by climate change and successfully transition its business to a low carbon economy with an independent chair. They have since responded and we're currently reviewing their letter.
- **State Street** – we wrote in relation to our decision to vote against the re-election of EY as State Street's external auditor. EY have served as State Street's external auditor for 47 years which raises concerns about its ability to exercise independent and unbiased judgement. As investors, we rely on financial statements and reporting to inform us of companies' performance. Having an independent and unbiased auditor helps us trust the information disclosed, which builds confidence in our investments. We believe auditor independence is essential to ensuring robust standards are maintained.

We are also engaging with a company about its proportion of expenditure on non-audit services relating to tax, provided by their external auditor. We view companies which spend a disproportionate amount on tax planning can threaten auditor independence. We are looking into whether this is an appropriate measure to consider and are speaking with other investors about ways they identify poor tax practices within companies.

Collaborative engagement

We participate in collaborative engagement where it aligns with our responsible investment objectives and the themes we address.

Fossil fuel bank financing

With regards to climate-related risks, we believe the banking sector has a critical role to play in ensuring businesses meet the commitments of the Paris Agreements. At the same time, banks themselves are growing increasingly vulnerable to climate-related risks given the fast-paced changes affecting the fossil fuel sector globally.

This year we co-signed a letter with 81 other PRI signatories to J.P. Morgan regarding its approach to managing climate risks. The letter detailed investor concerns that J.P. Morgan has been the world's biggest financer of fossil fuels overall since the Paris Agreement, financing $196 billion, nearly 30 per cent higher than the number two bank. The letter called for J.P. Morgan to adopt a plan to align their lending policies and practises with the Paris Agreement's goal of limiting global warming to 1.5C while fully respecting human rights.

We participated in a ShareAction-led initiative and wrote to HSBC Bank to request that they stop financing new coal power plants. We also asked that the bank align itself with leading peers and expand its existing coal project finance exclusion policy to include highly polluted emerging market countries like Indonesia, Bangladesh and Vietnam. The company wrote back to us disclosing that it has made a time-bound commitment to cease financial support of all new coal power plants by the end of 2023.

Labour rights and fair pay

We co-signed a letter to Amazon written by Öhman, a Swedish investor, regarding labour rights in Amazon's operations and supply chains. The letter encouraged Amazon to implement human rights impact assessments conducted in line with the UN guiding Principles on Business and Human Rights, applicable to its own operations and employees. It also requested that they disclose what audit systems are in place to monitor compliance with the Code.

We co-signed letters to companies in the FTSE 100 that aren't Living Wage accredited employers. These included Bellway, SevernTrent, Smiths Group, United Utilities and Vodafone. A 2017 survey found that 75 per cent of over 800 businesses reported increased motivation and employee retention rates since accrediting as a Living Wage employer.[1] It helps to ensure a company's continuing productivity whilst earning the loyalty of staff at all levels. As a result, momentum behind the standard has grown and the Living Wage has become a symbol of responsible business practice. We continue to promote the importance of accreditation with our investee companies.

We wrote to a number of companies who haven't yet responded to the Workforce Disclosure Initiative. The survey run by ShareAction asks companies for workforce information about them and their suppliers, ranging from pay and workers' rights through to health and safety practices. Companies that respond to the survey and give permission to publish their information help investors better understand the risks and opportunities on their workforce management practices and have constructive conversations.

1 Heery, E., Nash, D. and Hann, D. The Living Wage Employer Experience (April 2017), Cardiff Business School. Available online at: cardiff.ac.uk/__data/assets/pdf_file/0008/722429/The-Living-Wage-Employer-Experience-Report.pdf.

Engagement outcomes

Last year we reported on the controversy surrounding the executive remuneration vote at Persimmon which led to the Chief Executive Officer of five years stepping down. The size of the pay package and the poorly formed pay structures weren't the only contentious elements. The company failed to pay its staff and/or contractors the Living Wage despite years of engagement from investors.

This year we attended a meeting with the company just after it had agreed to pay nearly all direct staff the Living Wage. It's currently in discussion with the Living Wage Foundation to see how they can apply this rate of pay to trainees and sub-contractors. We were pleased with this development and the meeting was also an opportunity for us to discuss our broader views on workforce and ask questions about the company's corporate governance structure and culture.

We aim to encourage our investee companies to be fair employers and to treat their staff decently, not only because it leads to more sustainable and profitable businesses. It's also in the best interests of many of our members, who make up a large part of the UK workforce.

Chapter four

Engaging with members

Members views

Last year we published data exploring whether our members were interested in our approach to responsible investment. What stood out from that report was our members' enthusiasm. This year's survey showed that this topic still resonates, with around three quarters of our members saying responsible investment is very important to them. It also showed that two thirds of Nest savers wanted to know more about our status as a responsible investor.

Last year we mentioned our support for a Cambridge Institute for Sustainability Leadership research project that aims to understand how to best present information on social and environmental impact in investment fund fact sheets. Although pension industry factsheets are generally targeted at industry professionals, over 7,000 of our factsheets are downloaded every quarter. Nearly half of these are downloaded by Nest customers.

We wanted to understand whether members downloading fund factsheets understood the information presented to them, and whether our members had any preference between two funds with different environmental and social impacts. 76 per cent of all respondents passed comprehension questions, suggesting a reasonable level of understanding of complex industry factsheets. Secondly, the data suggested Nest members typically preferred sustainable funds even when that option cost more or performance was shown to be poorer than the alternative, suggesting the appetite for funds with sustainable ratings is high.

We also asked our members questions like 'How would knowing that your pension provider is considering environmental and social factors when they invest your money make you feel?'. The highest response rates to this question were for 'Happy now I know that they are doing the right thing' and 'Happy but I would expect them to do this kind of thing anyway'. This demonstrates our members' interest in responsible investing and confirms there is a certain expectation that a scheme would be taking these issues seriously.

What we've done

We've spent the last year trialling different ways to communicate our responsible investment approach to members. We wanted to develop more member-facing communication activities, such as videos, social media content and online information, including a member-friendly version of last year's report.

We brought a range of pensions, communications and behavioural finance experts together to explore how the pensions industry can build trust, confidence and interest in pension saving.

A report for members

We created a member-facing version of our responsible investment report, simplifying ESG explanations and using real life examples. We used more visuals and focused on benefits we believed our members would want to hear about, namely our move into commodities investing and our climate aware fund as two case studies they were likely to relate to. After we produced the member report, we tested it with our new online member research community. We wanted to see if it was something they would read and whether there were areas for improvement.

We shared the content with a small sample of the group and received positive constructive feedback for writing this year's members' summary.

Feedback from our members

'It tells me about how you are responsibly investing my savings and making sure they are not doing damage to the planet. I want my grandchildren to see tigers and polar bears as they grow up.'

'Conveys potentially complex ideas in a simple way.'

'It's clear and concise and provides a good overview of how the pension contributions are invested.'

Results from our roundtable – how to engage our members

Be brave

Evidence shows that members would like to know more about responsible investment and that there could be reputational risks if we don't take these issues seriously. We should be braver in publicly demonstrating what we're doing.

Find a common language

The pensions industry often uses multiple terms to describe the same thing, leading to confusion. We must establish a common language for talking about responsible investment in a way that makes sense to industry outsiders.

Focus on benefits and avoid jargon

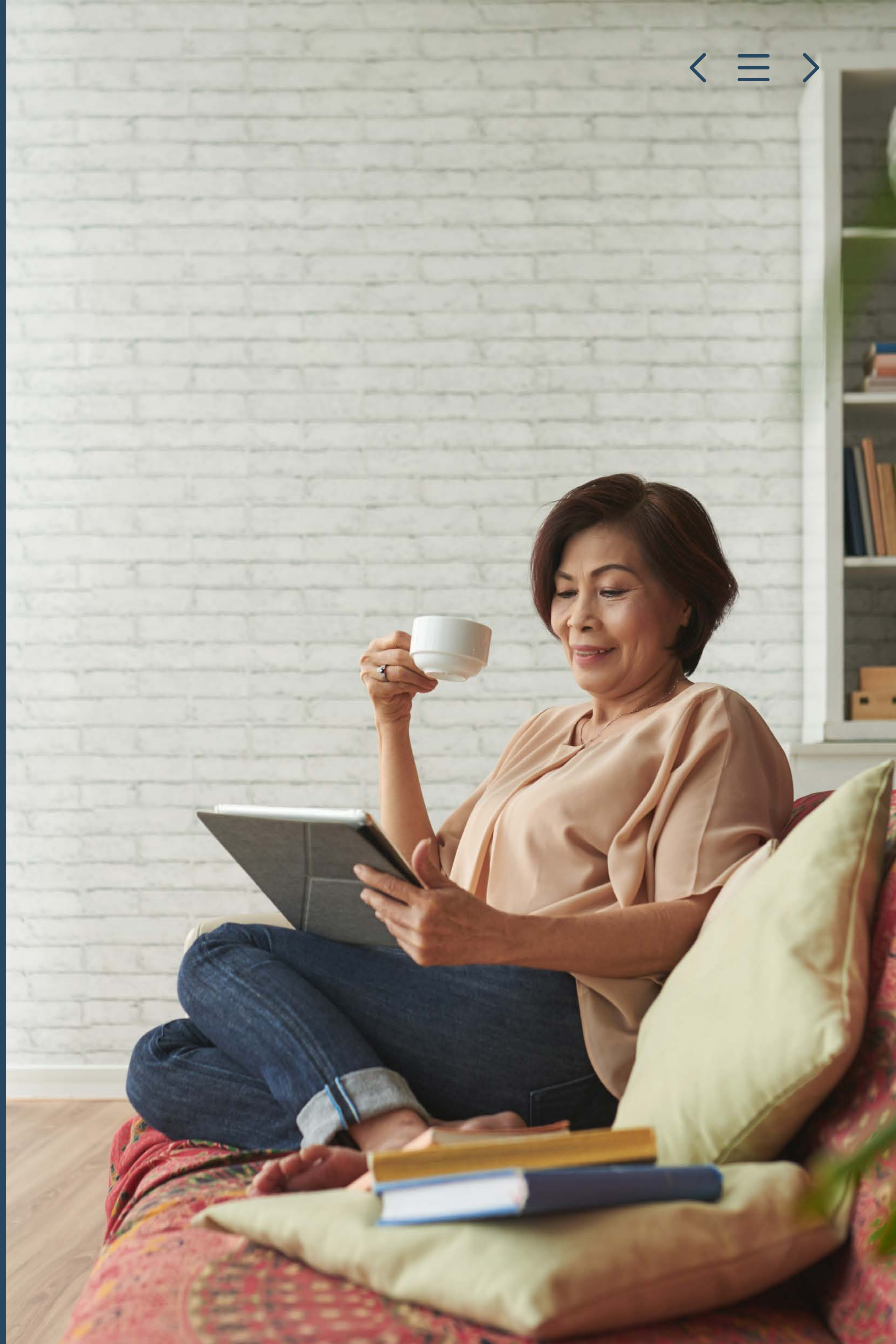
It's important to explain new concepts clearly, simply and without jargon. Many pension savers don't realise their money is invested or don't understand how investments work. Our content should relate members' investments with the impact their money is having, putting it in terms of everyday items or experiences.

Think about framing

Research shows different people respond differently to language and framing. Many people also believe there is a a trade-off between making money and doing what's right. We can make it clear that a responsible approach has financial benefits, while providing information that strikes a chord with members' values.

Test, learn and test again

Videos, podcasts and other new forms of communication are great, but tests suggest members are more likely to trust a straightforward email, written clearly and sincerely. We aim to communicate more with members about ESG topics to test what works and what doesn't.



Member videos

This year's surveys showed that 62 per cent of our members said it was important that Nest helped members understand what we did with their money. We felt that video content distributed by email could help quickly and simply explain our message, with 54 per cent of members preferring email communications when receiving investment information.

We also knew we needed content that would resonate with a broad range of Nest members due to the wide demographics of our 8 million members. We looked to create a visual representation of responsible investment for members with varying levels of understanding of investments and those with no familiarity of the concept at all.

We sent the video to over 100,000 members across all age groups, registered and non-registered, contributing and non-contributing with Nest. The targeted email campaign had a 54 per cent open rate and a 27 per cent click through rate.

We hosted the video together with the member report on our website for members not included in the email campaign to access. It was also made available to employers to host on their intranet.

"We're committed to helping our members save for a better retirement and helping them understand the industry their money goes into."

The start of something new

Our member survey suggests that giving members insight into where their money goes and the impact it has is engaging. It helps us bolster trust and confidence in pension savings and in Nest as a provider. As with the member-facing report, this was the first video in a range we'll be producing. We've used it as a test and learn and will make incremental improvements for future communications.

We're committed to helping our members save for a better retirement and helping them understand the industry their money goes into. We aim to provide members with more tailored and personalised videos and bulletins directly to their inboxes, delivering information that speaks to their values as well as informs them about financial returns.

What is Nest's online community?

Nest launched our online community in August 2019. As of November 2019, we've had 3,200 members sign up.

Online research communities are groups of individuals who actively sign up to get involved in various market research studies. They have been the most successful and most widely adopted new research methodology across many industries.

Our community gives us instant access to our members' opinions, thoughts and insight on many different topics. It also allows for discussions, giving us in-depth insight and ideas from members.

Chapter five

Looking ahead

Physical climate risk

Over the coming year we'll be investigating physical climate change risks in more detail. We want to understand how risks can be identified, measured and factored into investment decisions. We will be organising a series of workshops and research sessions to discuss the following questions:

- What do we know about physical risks and how will they evolve?
- What does corporate adaptability look like? What would it take to move assets and/or supply chains if needed?
- How do we understand how prepared companies are? Is this about risk management and board level actions?
- How can investors assess the potential impact on assets? How do we understand which assets or operations are critical for companies? What does operational disruption look like?
- What disclosures and information are required to help asset owners assess physical risks? Is it possible to structure a corporate engagement around this?
- How are reinsurers valuing and insuring these assets? What is being assessed and how are they managing risks on their side?

Engagement stream with food manufacturers and retailers

Multinational food companies have been regarded as sound investments, offering steady dividends and a way to tap growing investment opportunities in newly affluent populations in emerging markets. But the sector is also a large contributor to climate change and highly exposed to changing customer demands, tighter health regulations and a range of social and environmental challenges.

Issues like food security, single-use plastic, waste, palm oil, sugar, antibiotic resistance, supply chain risks and climate risk are all challenges the food industry are subjected to and coming under pressure to urgently address. We want to explore how food manufacturers and retailers are navigating these challenges and adjusting their business strategies accordingly to ensure long-term sustainability. We are planning a stream of engagement activities with a range of companies in the industry and we will identify targets for engagement where company transparency on managing a number of these risks is poor.

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