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ESG investing – a case study

June 2023 Edition

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Contents

The main acronyms used in this document are:

AGM	Annual general meeting	**SBTi**	Science Based Targets Initiative
COP	Conference of the Parties	**SDG**	Sustainable Development Goal
CSRD	Corporate Sustainability Reporting Directive	**SDR**	Sustainability Disclosure Requirement
EGM	Extraordinary general meeting	**SFDR**	Sustainable Finance Disclosure Regulation
ESG	Environmental, social and governance	**SIP**	Statement of Investment Principles
FCA	Financial Conduct Authority	**TCFD**	Task Force on Climate-related Financial Disclosures
GHG	Greenhouse gas	**UN**	United Nations
NEST	National Employment Savings Trust	**WACI**	Weighted Average Carbon Intensity
PRI	Principles for Responsible Investment	**WDI**	Workforce Disclosure Initiative

Learning objectives

Reading this publication, you will be able to:

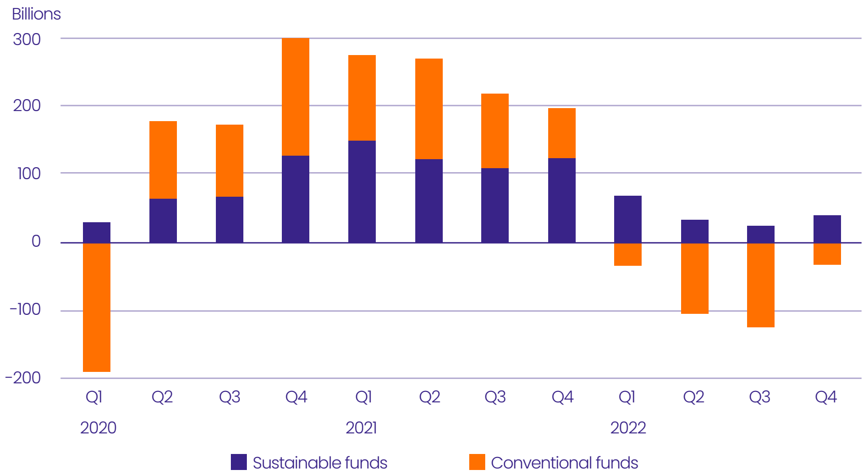
1. Understand what ESG is and the different forms of ESG investing
2. Discuss the recent performance of ESG funds and some of the issues measuring this
3. Describe stewardship, voting and engagement and how investors may carry these out
4. List and outline some of the main global ESG initiatives
5. Summarise the recent UK and EU regulation around ESG investing

Introduction

Interest in sustainable investing remains strong across Europe.

The indigo bars in Figure 1 from Morningstar show European sustainable fund[1] flows on a quarterly basis since the start of 2020. Flows have remained positive over the whole of this time, although they did slow in 2022 as both equity and bond markets fell through most of the year. To put these numbers into some context, however, the orange bars show flows for non-sustainable funds. As can be seen, they saw outflows in 2022 and also Q1 2020, at the start of the Covid-19 pandemic.

Figure 1: European fund flows over the last 12 quarters (US$)



Source: Morningstar Direct, Manager Research. Data as of December 2022

Other numbers from Morningstar show that at the end of 2022 the European sustainable fund universe was just over $2trn (83% of the global sustainable total) in terms of assets and more than 5,300 funds (76% of the global sustainable total). The figure of just over $2trn also represents 20% of total European fund assets and compares with 18% at the end of Q3 2022.

Many UK workplace pension funds have been considering and implementing sustainable/ESG investing to an increasing extent over the last few years, and later in this document we look at exactly what some of the default funds are doing in this space.

Before we do that we will: discuss what ESG investing is, as well as the different levels of ESG investing; look at the performance of ESG funds over the last few years and some of the issues around measuring this; mention the main benefits of stewardship, voting and engagement; list and outline some of the main global ESG initiatives; and provide an update on both UK and EU regulation.

[1] Sustainable funds in this section refers to open-ended and exchange traded funds that, by prospectus or other regulatory filings, claim to focus on sustainability, ESG factors or impact.

What is ESG?

ESG factors

ESG stands for *Environmental*, *Social* and *Governance*, which are the three factors used to measure the sustainability and societal impact of an investment in a company. Some examples of the areas covered within each factor are:

ENVIRONMENTAL

- climate change
- greenhouse gas emissions
- resource depletion, including water
- waste and pollution
- deforestation

SOCIAL

- working conditions, including slavery and child labour
- local communities, including indigenous communities
- conflict and humanitarian crises
- health and safety
- employee relations and diversity

GOVERNANCE

- executive pay
- bribery and corruption
- board diversity and structure
- fair tax strategy

ESG vs ethical investing

ESG has come a long way from the days of ethical investing. Previously, ethical investing typically meant that investment managers would exclude traditional 'sin stocks' from their portfolios (such as tobacco, alcohol and adult entertainment). This reduced their investable universe, which consequently increased the risk of the portfolio and limited the manager's ability to generate alpha.

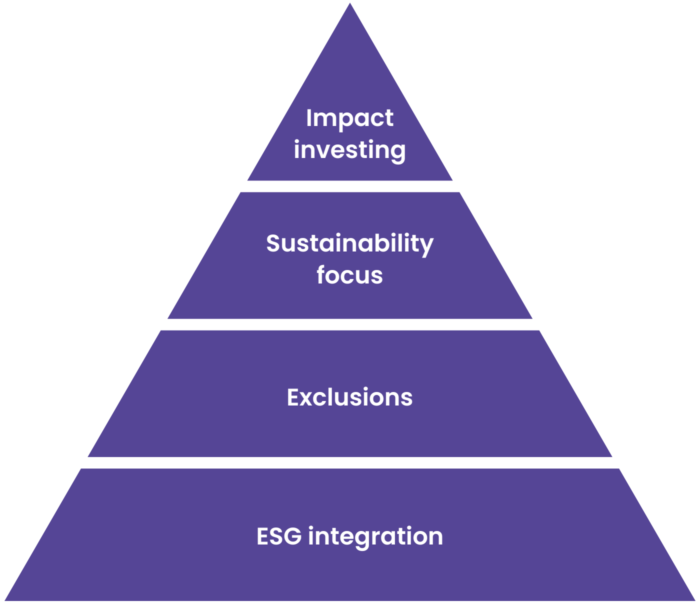
A common misconception about ESG is that it also aims to exclude all 'unethical' investments from the portfolio or only invest in companies that do 'good'. However, ESG is not just about trying to make the world a better place. At its base level, it is another form of risk mitigation. For example, an ESG fund may exclude fossil fuels from its portfolio, not just because oil and gas companies can be harmful to the environment but because there is a risk that as we move to more renewable forms of energy there is less demand for oil, leaving oil and gas companies with unutilised equipment, tankers and shipping vessels (a risk that is referred to as stranded assets). Alternatively, an ESG fund may choose to hold fossil fuel companies but limit its holdings to those that are considered 'best-in-class' in terms of their ESG rating. This may imply that the company is investing in research into more forms of renewable energy. In this case, the investment manager may consider the ESG risks 'priced in' and feel that they are getting an adequate risk-to-reward payoff.

This example highlights a common debate among ESG fund managers: some believe there is no place for fossil fuels in an ESG fund, while others believe removing all investment (and the right to vote and actively engage) is not how you influence change. Clearly, then, the issue of ESG is a subjective one. This is why there is no 'one-size-fits-all' solution and it is important for investors to determine their own preferences.

What is ESG?

Forms of ESG investing

Following on from the above, there will be different approaches to ESG investing taken by a fund. Broadly, these can be broken down into four levels:



At its base level, *ESG integration* is considering ESG risk/rewards as part of traditional financial analysis. This may involve individual company analysis or negative screening where the investment manager excludes specific sectors or companies, below a certain ESG rating, that they deem to be susceptible to higher ESG risks and/or currently operate unsustainable business practices.

Sustainability focus is where investment is made in companies on the basis of them fulfilling certain sustainability criteria and/or delivering on specific sustainability outcomes. This can take the form of positive screening, where the investment manager looks for businesses that are 'best-in-class' based on ESG ratings, or sustainability themed investing, where investment is made in companies that target specific sustainability themes such as climate change mitigation, pollution prevention sustainability solutions and approaches that relate to one or more of the UN Sustainable Development Goals (SDGs).

Finally, *impact investing* is when investment is made with the intention of generating a positive, measurable social or environmental impact. Examples include: a social bond fund which invests in bonds whose funding is ring-fenced for projects or initiatives that have the intention to generate positive, measurable, social or environmental impacts; investing in private equity where it can be demonstrated that the money invested will go towards having a positive social or environmental impact; and SDG impact funds where impact is measured against the SDGs. It can be easy for a fund manager to justify that their investment has a sustainability focus, but the key words here are being able to demonstrate that the impact is 'positive' and 'measurable'. Taking the example of a fossil fuel company that invests heavily into researching forms of renewable energy, it may be argued that the company targets the theme of climate change mitigation; however, it is unlikely that the company's overall impact towards this goal will currently be a *positive one*.

A fund may not necessarily fall into just one type of ESG investing, however. In fact, it is likely that there will be elements of at least two of the different levels in any fund nowadays. The investor can therefore choose where they would like their exposure to reside.

What is ESG?

ESG funds' performance

Another common view is that, as with pure ethical investing, ESG funds underperform their non-ESG counterparts. Up until around 2022, a number of studies showed that a majority of ESG funds had outperformed their non-ESG equivalents or the broad index over various time periods.

Many reasons have been given for this. Examples include the fact that companies that score higher in terms of ESG tend to have better corporate governance policies and/or produce more sustainable products.

During 2022 and more recently, however, this has reversed, with several research pieces showing ESG funds to have underperformed. One reason for this is that many ESG funds follow more of a 'growth' style of investing rather than 'value'.

Growth significantly outperformed value over the 10 or so years up to and including Covid-19. From 2021 onwards, however, value managers and indices have outperformed their growth equivalents. In particular, sectors such as technology, which many ESG funds were overweight in, saw large sell-offs in 2022.

In addition, oil and gas, which ESG funds tend not to hold, rallied as a consequence of the war in Ukraine and the resulting energy crisis. It should be noted that the 'growth versus value' explanation refers to equities only, although this is the largest asset class held by ESG funds by far.

There are several caveats around the various studies on this subject. In particular:

- There is no single rule for what qualifies as an ESG investment.
- ESG investing is still relatively new, therefore time periods are still quite short, which in turn means resulting numbers could be less statistically significant.
- Performance is usually for ESG funds as a whole – there are many different types of ESG fund with different aims and investment processes, hence there is much dispersion of performance across these funds.

Stewardship, voting and engagement

Stewardship

Stewardship is often used as an overarching term covering the approach that investors take as active and involved owners of companies (and any other entities in which they invest) through voting and engagement. It is also the process of intervention to make sure that the value of the assets is enhanced over time, or at least does not deteriorate through mismanagement.

Voting

Voting tends to focus on corporate governance matters raised at shareholders' meetings, either the annual general meeting (AGM) or at an extraordinary general meeting (EGM). Examples of such matters are: executive pay, structure of the board and capital structure of the company.

Many asset owners will make use of proxy voting advisory firms. These firms offer analysis and advice on voting decisions as well as voting recommendations across most public companies.

Engagement

Engagement is the way investors put into effect their stewardship responsibilities, through individual interventions to preserve and enhance value and usually via dialogue with the management and boards of the investee companies. The purpose will vary from engagement to engagement but usually involves improving companies' business practices, especially in relation to the management of ESG issues.

By working with companies' management – either individually or collectively – investment firms are able to influence companies to adopt better ESG practices and/or relinquish poor practices.

Some asset owners will choose to engage with companies directly. Others expect their external fund managers (where applicable) to deliver this work, either through the portfolio managers or through a specialist team within the fund management firm. Alternatively, engagement activities can be outsourced to specialist providers.

Whichever route is taken, it may well be that if the initial engagement doesn't achieve the desired outcome, then the engagement has to be escalated. This could include: holding additional meetings with company management; intervening jointly with other institutions; or formally adding the company to an exclusion list or otherwise exiting or threatening to exit from the investment.

Many studies have shown stewardship and engagement to be beneficial, enhancing shareholder value as well as adding value to portfolios and reducing downside risk. There are, though, some barriers to engagement. The main ones are:

- Lack of resources to engage effectively with all of the (usually high number of) companies held by the asset owner.
- Lack of expertise and in-depth knowledge on some of the issues being raised.
- Lack of sufficient leverage with the investee due to the relatively small size of holding. This can be addressed through working collectively with other investors, although this may introduce another challenge of not being able to reach a consensus, especially if the group becomes quite large.

Global ESG initiatives

Initiatives for companies

There are various initiatives on ESG and sustainability, setting out frameworks for companies and aiming to develop best practice.
Some of the best known ones are discussed next.

United Nations Global Compact

This was launched in 2000 as a collaboration between leading companies and the United Nations (UN). Its corporate signatories agree to adhere to ten principles: two covering human rights, four relating to labour, three covering the environment and one in relation to anti-corruption.

UN Sustainable Development Goals

The SDGs were adopted by UN member states in 2015 and focus on the 17 areas shown below. Each goal has detailed targets, totalling 169 across the 17 goals and intended to be delivered by 2030.

Many companies have already aligned themselves with the SDGs most relevant to their business or are in the process of doing so. In addition, more and more fund managers are making efforts to measure and report the contribution of their portfolios to the SDGs.

Global ESG initiatives

United Nations Framework Convention on Climate Change

This dates back to 1992 and aims to stabilise greenhouse gas (GHG) emissions. It has been the basis for the annual Conferences of the Parties (COP) meetings. The COP 3 meeting in Kyoto and COP 21 meeting in Paris led to agreements between nation states that are signatories to try to restrain GHG emissions and hence limit climate change. The agreement from the latter meeting intends to keep the global rise in temperature to less than 2°C (and preferably 1.5°C) above the pre-industrial level.

Task Force on Climate-related Financial Disclosures

The Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) attempts to operationalise the above 2°C target for the business world. Its June 2017 'Final Report' urges companies to disclose the following:

- **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 business, strategy and financial planning.
- **Risk management** – the processes used by the organisation to identify, assess and manage climate-related risks.
- **Metrics and targets** – the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The TCFD recommends these disclosures be provided as part of the mainstream financial filings.

Initiatives for investors

TCFD

The TCFD also sets expectations for investors to consider their own impact on climate change and what they need to do to respond. There is separate guidance for the different types of business – banks, insurers, asset owners and asset managers. The TCFD further encourages investors to enhance their ESG activities as well as their transparency around them.

United Nations Principles for Responsible Investment

The United Nations Principles for Responsible Investment (UNPRI) are often seen as the leading investor initiative relevant to ESG and a benchmark of ESG performance for asset managers. There are six principles.

The first two principles – 'we will incorporate ESG issues into investment analysis and decision-making processes' and 'we will be active owners and incorporate ESG issues into our ownership policies and practices' – have the greatest operational implications for the investors that have committed to implementing them.

The UNPRI requires signatories to report on their implementation of the principles, both across the organisation as a whole and within each asset class.

The International Corporate Governance Network

This is an association of investment institutions dating back to 1995. While its principal focus has always been corporate governance, it has in the last few years extended to ESG more broadly.

Regulatory update

UK government

The UK government legislated in 2019 to deliver net zero GHG emissions by 2050. In the run-up to the COP 26 meeting in Glasgow the UK made further commitments, including:

- An interim target to reduce UK GHG emissions by 78% by 2035.
- The aim for the UK to become the world's first net zero-aligned financial centre.

The government, along with regulators, has been aiming to harness the increased interest among people to invest sustainably, in particular to help mitigate climate change, while preventing 'greenwashing' (providers labelling a product as ESG, sustainable or similar in order to attract inflows when in fact there is little to do with ESG in the investment process) and making sure investors and consumers get the useful ESG information they need. This, however, risks being clouded by divergent UK and EU approaches.

Disclosures

Corporate level

At the corporate level, rather than adopting the EU's approach from the Corporate Sustainability Reporting Directive (CSRD) the UK has instead embarked on a two-stage process of implementing global corporate standards: first, through the adoption of the framework recommended by the TCFD, and second, through the planned adoption of the Sustainability Disclosure Requirements (SDRs).

Product level

The EU has introduced the Sustainable Finance Disclosure Regulation (SFDR), which focuses on mandating investment firm and product level sustainability disclosures.

This has resulted in the following labelling system:

- **Article 6** – Funds that do not integrate ESG considerations into the investment decision-making process.
- **Article 8** – Funds that promote environmental and/or social characteristics among other characteristics and the companies in which the investments are made have good governance practices. This implies that ESG investing is not core to these products.
- **Article 9** – Funds that have sustainable investment as their core objective.

Regulatory update

Disclosures

Product level

The UK is taking a different route: first, mandating climate-related product disclosures in line with elements of the TCFD recommendations; second, publishing plans for broader sustainability disclosures; and third, introducing a new sustainable investment labelling regime for retail products. Under this, the products would be categorised into one of five buckets:

- **Not Promoted as Sustainable** – No integration of sustainability risks and opportunities into the investment process. *Similar to SFDR Article 6.*
- **Responsible** – Consider ESG factors, but no specific sustainability goals. Managers expected to evidence ESG integration in the investment process. *Similar to SFDR Article 8.*
- **Transitioning** – Aim to influence underlying assets towards meeting sustainability criteria through active investor stewardship. *Also similar to SFDR Article 8.*
- **Aligned** – High proportion of assets verifiably established to be sustainable, with minimum thresholds for asset allocation. *Similar to SFDR Article 9.*
- **Impact** – Net positive social and/or environmental impact alongside financial return. Additionality should be verifiably measured. *Also similar to SFDR Article 9.*

The Financial Conduct Authority (FCA) is also proposing three consumer-facing labels with specific requirements to which firms can elect to manage their products:

1. **Sustainable focus** – for products investing in assets that are environmentally or socially sustainable.
2. **Sustainable improvers** – for products investing in assets to improve environmental or social sustainability over time, including in response to the stewardship influence of the firm.
3. **Sustainable impact** – for products investing in solutions to environmental or social problems to achieve positive, measurable real-world impact.

Market progress

Defaqto sent out a questionnaire to all of the known workplace pension fund providers in the market asking them what they and their funds are doing in terms of ESG and responsible investing. The responses from those who replied are summarised next.

It should be noted that all default funds are required to halve their 2019 CO2 emissions by 2030 and be carbon neutral by 2050. These are UN and UK legal requirements.

Aon

Aon's belief is that ESG factors impact long-term returns and risk management and therefore these are factored into investment decisions. All underlying managers have to achieve a minimum ESG rating from their manager research team.

As an initial step they have outlined four commitments:

- **Engagement** – promoting best practice and PRI principles.
- **Net Zero** – net zero carbon emissions by 2050.
- **Biodiversity** – recognition of systemic global risk from further loss of biodiversity.
- **Tackle Modern Slavery** – support the investment community to tackle modern slavery.

There are various exclusions applied and these include:

- tobacco
- controversial weapons
- companies that violate the UN Global Compact
- thermal coal and oil sands.

Aon offers three solutions: Aon Managed Retirement Pathway, which is a target dated solution; Aon Master Trust; and Aon Managed Core Initial Growth Phase

Market progress

Collegia

Collegia has over 20 Sustainable Retirement Strategies funds, which are target date funds.

A portion of each portfolio will be invested in companies that benefit society and the environment. This is achieved by ensuring that those companies align with the UN SDGs. These are encompassed with an emphasis on climate, healthcare and empowerment, while minimising controversial business activities.

Each portfolio invests across different asset classes, including global responsible developed market equities, global responsible multi-factor equities, responsible emerging market equities, sustainable impact equities, sustainable impact multi-asset and sustainable impact credit. The asset mix of each portfolio will depend on how close the fund is to the retirement date. Various exclusions are applied to the investments in each asset class. The list of key screens is as follows:

- adult entertainment
- alcohol
- coal/thermal coal/fossil fuels
- gambling
- GMOs
- nuclear power
- private prisons
- tobacco
- weapons.

Cushon

The Cushon Sustainable Investment Strategy has a particular focus on driving down carbon emissions. Cushon states that to date it has been able to deliver a 60% reduction in Scope 1 and 2 emissions and has committed to a forward-looking reduction target of 80% by 2030 (both from a base year of 2022). In achieving these reductions and setting out their forward-looking target, this strategy invests in a range of climate mitigation, climate adaptation and natural capital strategies in both developed and emerging markets. These are:

- Cushon Global Equity Index (75%)
- Wellington Global Impact Bond Fund (5%)
- Lombard Odier Target Net Zero Global Credit Strategy (5%)
- Schroders Climate+ (15%).

In order to ensure broader ESG integration the Global Equity Index looks at companies' alignment with the UN SDGs and it excludes companies with the lowest scores, while adding a tilt towards companies with high scores. The bond funds include climate impact strategies that support companies in hard to transition sectors.

Schroders Climate+ is a private markets portfolio which builds new renewable energy capacity, provides transition support and invests in climate technology. Its investments include wind and solar farms, forestry, battery technology, green hydrogen, climate insurance and social housing. In addition to the default fund, Cushon offers 15 self-select funds to members and their asset classes include ESG equities, ESG corporate bonds and a positive change equity fund.

Cushon believes that it is the only pension provider to have Tumelo voting technology integrated into the core member experience within their app.

Market progress

Fidelity

Sustainable investing is embedded within the corporate culture, with a commitment to be net zero operationally by 2030 and with additional interim targets by 2024, as covered in their Corporate Sustainability Policy. As a member of the IIGCC Net Zero Asset Managers initiative, Fidelity is committed to the goals of the Paris Agreement.

FutureWise is the default investment strategy for members, using target date funds which are managed towards a specific time period in the future. Each fund will aim for higher growth when it is a long way from the target date, investing in investments such as company shares. Then at a set number of years from the target date the fund will gradually move some of its assets out of shares into investments focusing on generating an income, such as bonds.

Exclusions for sectors not deemed suitable for positive engagement are:

- controversial weapons (including nuclear) and semi-automatic weapons
- thermal coal and oil sands
- tobacco
- UN Global Compact violators
- country Russia and Belarus securities.

Alongside the FutureWise proposition, Fidelity also offers a range of investment funds either managed by Fidelity or other providers, with an increasing focus on sustainability.

Lewis Investment

During 2022 the scheme Trustees took the decision for all future contributions into the Default Portfolio to be invested in funds incorporating ESG issues. The strategy supports the transition to net zero emissions by 2050 and the aims of the 2015 Paris Agreement and recommendations of the TCFD.

The default investment option is split into separate sections to facilitate lifestyling as members approach retirement. The underlying constituents of each are invested through funds offered via the Legal & General Investment Management (LGIM) platform. LGIM regularly reports on the absolute emissions of each fund along with voting practices. The strategies are:

- **Default strategy 1** – up to age 60
- **Default strategy 2** – for ages 60+
- **Default strategy 3** – for ages 62+
- **Default strategy 4** – for ages 64+

Alongside the investment challenge, the Trustees have challenged key suppliers for infrastructure to reduce their operating emissions by 50% by 2035 and to be net zero by 2050. Suppliers will be required to submit metrics around electricity usage, water efficiency, waste and recycling, and transportation so clear and measurable targets can be set.

Market progress

Mercer

Mercer offers a default investment solution titled the 'Mercer SmartPath' for which there are two multi-asset funds of funds – Mercer Growth Fund and Mercer Diversified Retirement Fund. The Mercer Master Trust, of which the above two funds are part, is also one of the default funds they offer.

Expectations are that portfolio carbon emissions will be reduced by 45% relative to 2019 baseline levels by 2030. Mercer believes that a sustainable investment approach is more likely to create and preserve capital and that climate change poses a systemic risk.

A four-pillar framework for ESG integration is incorporated into the investment arrangements:

- **Integration** – this is monitored using Mercer's proprietary ESG ratings. Ratings are considered upon the selection, retention and realisation of investments.
- **Stewardship** – Mercer's ESG ratings also include an assessment on voting and engagement practices.
- **Investment** – the multi-funds also include an allocation to a passive sustainable global equity fund.
- **Screening** – exclusions are considered in line with the investment managers' exclusion framework.

Nest

For the main growth phase, Nest (the National Employment Savings Trust) has a target-dated approach for the default option. There is a range of funds available, with the date in the fund's name corresponding to the member's expected year of retirement. The funds in the range (of nearly 50) follow the same investment process, with the asset mix varying depending on how far away the retirement date is.

Nest prioritises certain key ESG issues so that their resources are put to the best possible use. In addressing their ESG priorities and delivering on their responsible investment objectives, Nest takes action in four core areas: asset allocation, manager selection, active ownership and risk monitoring.

There is a fuller case study on Nest later in the document.

Market progress

Options Pensions

In the case of the Options Workplace Pension Trust (Options), there are four default funds:

- **Target Date Fund**, managed by Alliance Bernstein
- **Quilter Carey Lifestyle**, run by Quilter Cheviot
- **Lifepath**, managed by BlackRock
- **Balanced Fund**, run by TAM Asset Management.

The emphasis with Options is very much on climate change and the risks associated with it. The Trustee has embedded climate risks and opportunities into the investment process. Options has shared their climate beliefs with the above managers and they review their voting decisions.

Three climate metrics are utilised to measure the climate impact of the default funds. These are:

- Weighted Average Carbon Intensity (WACI)
- Percentage of companies with Science Based Targets Initiative (SBTi) goals
- Absolute Carbon Emissions (in terms of tonnes of CO2).

In addition to the UN and UK legal requirements, Options has the targets of: 50% of equity investments in companies with net zero targets (SBTi or other) by 2025, and 50% reduction in emissions (based on WACI and compared to the base year 2019) by 2030. The above metrics help Options to ensure that it is progressing towards these goals as well as understanding what impact they are having on the environment.

Royal London

Royal London offers a number of ready-made solutions within their workplace pension solutions offered. All of the options fall under what is termed their Governed Range:

- **Governed Portfolios**, for which there are nine options.
- **Governed Retirement Income Portfolios**, for which there are five options.
- **Lifestyle Strategies**, for which there are three options.

All underlying asset managers are asked to ensure that ESG is explicitly included and integrated into their investment choices. Managers review a range of information around a company's ESG practices to create an ESG score. Within Royal London Asset Management the managers are supported by a specialist Responsible Investment team.

Exclusions include cluster munitions, anti-personal landmines, and biological and chemical weapons.

In addition to the UN and UK legal requirements, Royal London has the below two strategic goals around emissions:

- net zero direct operational emissions by 2030
- net zero scope 3 value chain emissions by 2050.

Market progress

Scottish Widows

The core of the workplace pension proposition is the Pension Investment Approaches (PIAs), of which there are three, and each of the PIAs has ESG considerations integrated into them as Scottish Widows believes these do have a financial impact on investments. The three PIAs are:

- Cautious
- Balanced
- Adventurous.

There are five default funds: Scottish Widows Pension Portfolio One/Two/Three/Four/Five and five series of each. The PIAs all have different weightings in each of the five funds.

The equity components within the PIAs are managed by State Street Global Advisers and BlackRock.

The ESG investment approach considers four aspects:

- **Screening** – screening out controversial weapons manufacturers, thermal coal and tar sands, and UN Global Compact violators.
- **Integration** – embedding ESG factors within the investment process.
- **Allocation** – to sustainable themes or impact investments.
- **Stewardship** – exercising shareholder rights, encouraging companies to evolve activities responsibly and engage with policymakers.

Smart Pension

The Smart Pension Master Trust has three default funds, with an investment philosophy aiming to strike a balance between risk, cost and return:

- **Smart Sustainable Growth Core Fund** – 100% passive
- **Smart Sustainable Growth Fund** – 23% active, 77% passive
- **Smart Sustainable Growth Plus Fund** – 70% active, 30% passive.

The approach is to ensure investments actually decarbonise the global economy, rather than simply offset emissions or use strategies which don't invest directly. The trust will only work with investment managers who can engage and influence companies to reduce their emissions.

Exclusions include:

- involvement in the manufacture of controversial weapons
- pure coal miners
- perennial violators of the UN Global Compact
- companies which refuse to engage and change behaviour
- companies failing to meet minimum standards for climate transition.

Market progress

TPT

TPT offers a ready-made default investment, referred to as the Target Date Fund. The asset allocation strategy for this is designed by Alliance Bernstein.

TPT incorporates their expectations on ESG and climate change in the manager selection process to ensure they understand the extent to which ESG is integrated in their investment philosophy and process. Managers have to report back on their responsible investment activities on a regular basis.

TPT then assesses the approaches against the TPT Responsible Investment Manager Rating System, which scores across four areas: Values, Stewardship, ESG Integration and Transparency. Each receives a rating between A and D, with A being the highest and D the lowest.

Willis Towers Watson

LifeSight is the Willis Towers Watson (WTW) master trust. The default fund is titled Medium Risk Drawdown (LifeSight Equity Fund) and sits alongside other lifecycle strategies.

LifeSight takes action in three broad areas to implement their sustainable investing policy:

Capital allocation – using tilts and exclusions to invest in more companies that lead the way in sustainable business practices and less in those who fall behind.

Stewardship – company engagement and talking to companies to change their practices for the better; and system engagement, working with parties such asset managers, policy makers and government to advocate change.

Monitoring – monitoring and reporting on the actions taken and impact they have.

Learning objectives

Having read this document, you will now be able to:

1. Understand what ESG is and the different forms of ESG investing
2. Discuss the recent performance of ESG funds and some of the issues measuring this
3. Describe stewardship, voting and engagement and how investors may carry these out
4. List and outline some of the main global ESG initiatives
5. Summarise the recent UK and EU regulation around ESG investing

Test yourself for CPD purposes

To assess your knowledge having read this publication, why not work your way through the following questions?

You can find all the answers for the test in the content of this publication.

1. **What are the different levels of ESG investing?**

2. **What are some of the main issues around measuring the performance of ESG funds?**

3. **What are some of the potential barriers to engagement?**

4. **How many UN Sustainable Development Goals and underlying detailed targets are there?**

5. **What are the two parts to the UK regulation for corporate level disclosures?**

CII/PFS and CISI accredit this document for up to **30 minutes** of structured continuing professional development (CPD).

Name	
Signature	
Date	
CPD time recorded	
How has the learning met your professional development needs?	

Answers

As a guide, your answers should include the following points:

1. ESG integration, exclusions, sustainability focus and impact investing.
2. No single rule for what qualifies as an ESG investment, relatively short time periods and many different types of ESG fund, hence large dispersion of performance.
3. Lack of resources, lack of expertise/in-depth knowledge and lack of sufficient leverage.
4. 17 and 169.
5. Adoption of the framework recommended by the TCFD and adoption of the SDRs.

What is Nest doing in terms of ESG investing?

Nest

Nest is a defined contribution workplace pension scheme set up to facilitate automatic enrolment as part of the government's pension reforms under the Pensions Act 2008. As of 31 March 2023 Nest had 12m members and £29bn assets under management.

As mentioned in the 'market progress' section, Nest has a target-dated approach for the default option for the main growth phase. There is a range of funds available, with the date in the fund's name corresponding to the member's expected year of retirement. For example, a member expecting to retire in 2040 would invest in the Nest 2040 Retirement Fund. The funds in the range (of nearly 50) follow the same investment process, with the asset mix varying depending on how far away the retirement date is.

Nest's mission

Nest's investment beliefs

Nest's investment beliefs are set out in their governing document, the Statement of Investment Principles (SIP), and are periodically reviewed. Two of Nest's evidence-led beliefs set out the importance of sustainability and the consideration of ESG risk factors:

- As long-term investors, Nest believes that integrating ESG considerations into the investment management process improves risk-adjusted returns.
- Long-term returns to investors are likely to be more sustainable if companies consider the interests of wider stakeholders – customers, employees and the wider public, as well as shareholders and lenders.

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What is Nest doing in terms of ESG investing?

Nest's responsible investment objectives

In addition, Nest has created their responsible investment objectives to guide and help prioritise their activities. Every three years they undertake a review of these objectives to ensure they are still fit for purpose, support their investment approach and serve the interests of their members. The responsible investment objectives are currently:

- **Better functioning markets** – Nest wants to improve market transparency and how markets operate. Nest also seeks to manage and mitigate systemic risks which have the ability to impact the economy and in turn their portfolio.
- **Long-term wealth creation** – Nest wants to encourage companies and their fund managers to be forward-looking and well run, which involves being clear about the risks and impacts of their activities on the environment and wider stakeholders in order to deliver sustainable performance/good returns for their members over many years.
- **Manage reputational risks** – Nest wants to grow trust with their members by encouraging companies to act in ways their members can feel confident about.
- **Better risk-adjusted returns** – Nest seeks to identify and manage ESG-related risks and opportunities across their portfolio, which should lead to lower risk and/or enhanced returns.

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What is Nest doing in terms of ESG investing?

Nest's ESG priorities

Nest prioritises key ESG issues so that their resources are put to the best possible use. The six priority areas that guide their current work are:

- climate change
- human capital
- cyber security
- digital rights
- diversity
- food.

Examples of what Nest has been doing in these areas are discussed next, as is 'natural capital', a new ESG priority area for Nest.

Climate change

In July 2020 Nest published their first scheme-wide climate change policy, setting a target to align their investment portfolio with limiting global warming to 1.5°C by reaching net zero emissions across their portfolio by 2050 at the latest. This will be enacted through the following four areas of their investment process: asset allocation, fund manager selection and monitoring, active ownership and risk monitoring.

Nest has also published their first 'roadmap to 2025', setting out their shorter-term goals. This includes a target to reduce the Scope 1 and 2 emissions from their listed equity and fixed income portfolios by 30% by 2025, starting from a 2019 baseline. Figure 2 shows Nest to be making better progress in terms of reduction in WACI versus the benchmark.

Figure 2: Nest's developed equities carbon intensity trajectory

Source: Nest, end-March 2023 quarterly investment report

What is Nest doing in terms of ESG investing?

Human capital

Nest supports the ShareAction-led Good Work Coalition, which encourages companies to pay the Living Wage to their employees. Over 2021 Nest focused on engagements with supermarkets, encouraging Sainsbury's to pay the real Living Wage to all of their workers and contractors.

Nest is a founding signatory of the Workforce Disclosure Initiative (WDI). This coalition of more than 50 investors encourages companies to disclose meaningful data around corporate workforce and supply chain practices so they can improve market transparency and benchmark corporate performance.

Cyber security

Nest has been part of a three-phased cyber security engagement programme alongside one of their fund managers and a coalition of other pension schemes. At these meetings companies were encouraged to increase scrutiny and provide reassurance on the coalition's minimum expectations in areas such as governance oversight, training and the cyber security standards of suppliers and partners.

Digital rights

Nest is part of the Investor Alliance for Human Rights engagement initiative focused on information and communication technology companies. Nest's goal is to ensure companies protect digital rights in their business activities and products and services.

Nest has already engaged with Amazon and AT&T in order to gain insight into their AI guiding principles and policies as well as how they collect and use customer data. This engagement is expected to continue.

Diversity

In the recent past Nest wrote to the Chairs of 26 companies which they believed hadn't shown clear progress on the Parker Review's recommendation for FTSE 100 companies to have at least one director from an ethnic minority background on the board by 2021.

Nest has also published a 'diversity reporting toolkit' compiling industry standards and best practice reporting to help make clear what good reporting should look like in terms of meeting diversity targets.

Food

Nest's engagements have focused on understanding the strategies companies have in place to ensure they are evolving in line with upcoming regulation. Where Nest feels a company is lacking, they encourage them to anticipate and actively address these issues.

Nest has had engagements on sustainable meat sourcing, targeting six of the largest fast food brands with the aim of urging them to analyse and reduce their vulnerability to and impact on climate change, water scarcity and pollution.

Natural capital

Natural capital is the world's stock of natural assets, which include soil, air, water and all living things. This is a new ESG priority for Nest, following some recent research by them which determined that natural capital is a risk and opportunity worth considering in their investment strategy.

Nest has been inviting fund managers to share their views on ways to invest in natural capital, with an initial focus on forestry.

What is Nest doing in terms of ESG investing?

How Nest invests responsibly

In addressing their ESG priorities and delivering on their responsible investment objectives, Nest takes action in four core areas: asset allocation, manager selection, active ownership and risk monitoring.

Asset allocation

Nest looks for opportunities to create or access investment strategies where they can address ESG risks and opportunities across the asset allocation.

Nest monitors the net zero alignment of each asset class they invest in as well as how each asset class might be impacted by ESG factors and what Nest might do to mitigate them. If Nest identifies an asset class with heightened ESG risk, they may reduce investment in the asset class or place the investment manager(s) on a watchlist, which could ultimately lead to the mandate(s) being terminated if concerns are not addressed to Nest's satisfaction.

Manager selection

Nest selects and builds relationships with fund managers who incorporate ESG factors across their investment approach and whose principles are aligned with those of Nest. Nest expects their managers to engage with companies to drive behavioural change and reduce long-term investment risk.

Examples of funds currently held in the various Nest portfolios include:

- UBS/Nest Climate Aware Global Developed Equities Strategy
- Northern Trust/Nest Climate Aware Emerging Market Equities Strategy
- Allspring/Nest Climate Transition Global Investment Grade Corporate Bond Strategy
- BlackRock ICS Sterling Liquid Environmentally Aware Fund

Nest monitors their managers formally on a quarterly basis. Where they have concerns, managers are placed on a watchlist and prioritised for engagement. If concerns persist, the mandate may eventually be terminated.

Active ownership

Nest addresses certain ESG risks and opportunities in their portfolio by voting and engaging on issues with companies.

Nest uses Minerva Analytics as their proxy voting adviser, who helps them monitor the voting intentions of their fund managers and to vote in line with their views set out in their voting and engagement policy. Nest will override their fund managers' votes if they disagree with their views. If Nest votes against management recommendations they may engage with the company directly. They often write letters to companies explaining their voting decisions and areas of concern, seeking resolution or ongoing dialogue.

What is Nest doing in terms of ESG investing?

Risk monitoring

Nest monitors, prioritises and manages ESG risks alongside other financial risks and opportunities across their portfolios. They do this with the help of their responsible investment partners and use of ESG data.

Nest identifies topics that are financially material and relevant to their members. Research is then carried out to better understand the substance of the issue, the key risks and opportunities, and which underlying companies in their portfolios are affected.

Nest has an investment risk committee which meets quarterly to oversee investment risk management activities across the investment process. Its remit includes reviewing key ESG issues such as climate-related risks for Nest's portfolios as well as recent developments in the responsible investment space which could have negative impacts on Nest's portfolios. The committee also ensures that ESG and climate-related risk is properly integrated and considered across the various parts of the investment process, including asset allocation and manager selection.

How Nest makes and implements decisions

Nest's ESG prioritisation framework

Nest's decision-making and prioritisation process adheres to the following key stages:

- identify and prioritise
- implement
- monitor
- review.

Escalating high risk issues

Nest favours constructive dialogue based on relationship-building and they try to avoid actions which could cause harm or volatility to the company. Nest is aware, however, that regular engagement doesn't always deliver the desired outcomes. Before escalating their engagement, Nest will consider: the materiality of the issue, the responsiveness of the company to engagement, any historic patterns of negative behaviour, and the impact and likelihood of success of any escalation.

Divestment and exclusion

If Nest thinks that engagement has reached its limits and the risk of holding the asset outweighs its benefits, they may decide to remove their exposure to a holding or industry.

Nest assesses potential exclusions by conducting in-house research on the risks and benefits of continued exposure. Nest's investment committee is then tasked with reviewing and approving any proposals. Nest regularly updates their fund managers with any exclusion policies.

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Your answers will be treated in the strictest confidence and the results of this will help the development of future publications.

The survey can be accessed at:
www.snapsurveys.com/wh/s.asp?k=144610976149

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