



Broadstone Academy

Environmental, Social & Governance (‘ESG’) investment training

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Introduction

- Not everyone believes that they should integrate ESG factors in their investments.



- However, we believe that **it is now part of trustees' fiduciary duties to integrate ESG in their decisions.**
- This presentation provides a framework for trustees to:
 - formulate their ESG beliefs
 - develop policies that they want investment managers to follow
 - explore different ways of implementing policies and
 - how to monitor progress on an ongoing basis.
- These steps are shown in the diagram below:





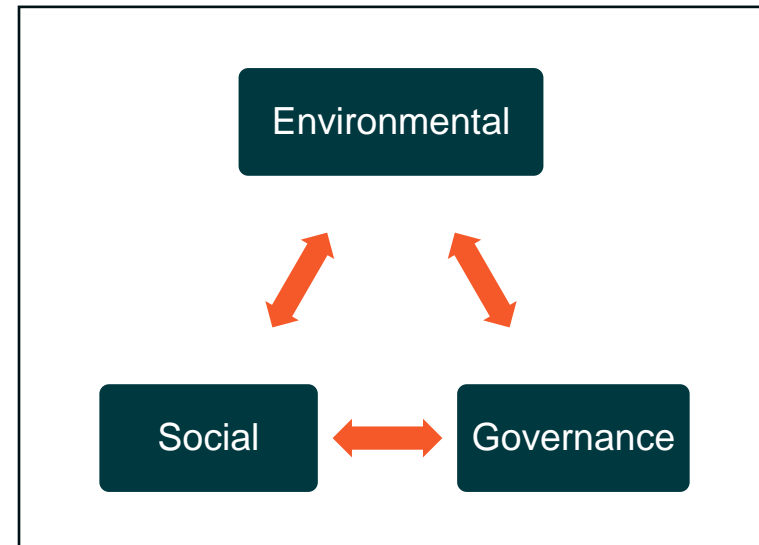
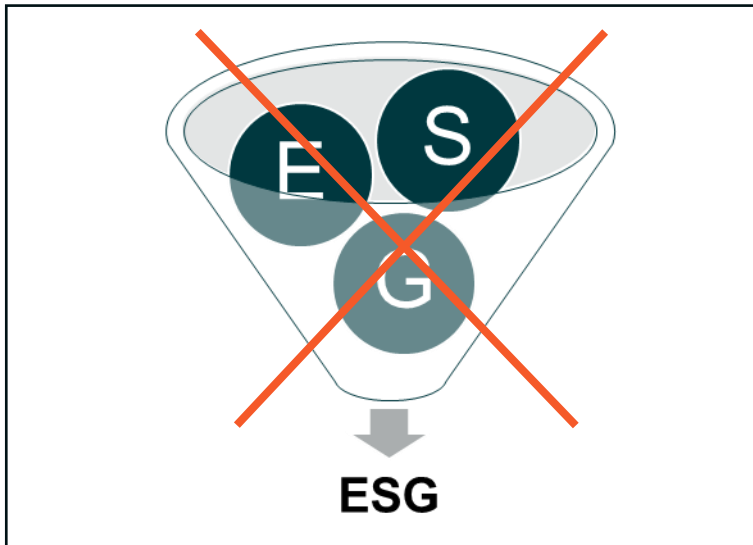
Knowledge & Understanding

Knowledge and Understanding

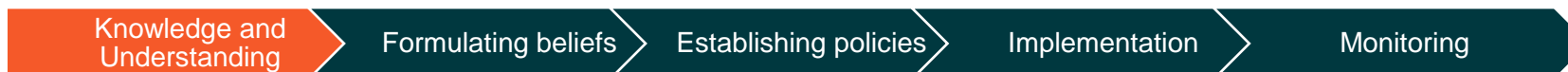
What is ESG, and what is it not?

Environmental, Social and Governance factors

- It will always be difficult to combine a company's E, S and G factors together, as the three concepts are not always consistent:
 - An oil major may have very good governance structures
 - Conversely, a renewables firm may have poor governance, leading it to have a lower ESG 'score' of the oil major.
- A different way of thinking about this is to focus on understanding how **sustainable** an individual company is over the longer term.



Sustainable firms

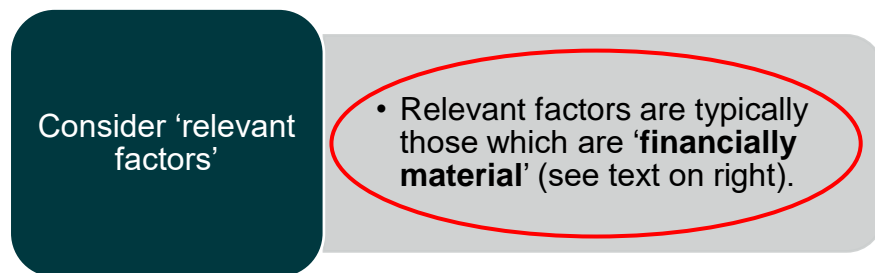


Knowledge and Understanding

ESG and trustees' fiduciary duties

Fiduciary duties

- Guidance from lawyers now is that **trustees can incorporate ESG issues as financial factors** when making investment decisions.
- When looking at their fiduciary duties, the lawyers Sackers & Partners LLP* say that one of the criteria trustees should consider are 'relevant factors'.



[*Getting-to-Net-Zero-A-spotlight-on-the-role-of-pension-trustees-May-2022.pdf \(sackers.com\)](#)

Financially Material Considerations and Non-Financial Matters

- The legislation to update pension schemes' SIPs in 2019** introduced the two concepts of:
 - **financially material considerations** and
 - **non-financial matters.**

	Policy needed?	Must be taken into account?
'Financially material considerations' was defined as ESG factors, including climate change, which trustees consider financially material. These need to be viewed over the appropriate time horizon for the scheme.	✓	✓

[** The Pension Protection Fund \(Pensionable Service\) and Occupational Pension Schemes \(Investment and Disclosure\) \(Amendment and Modification\) Regulations 2018 \(legislation.gov.uk\)](#)

Knowledge and Understanding

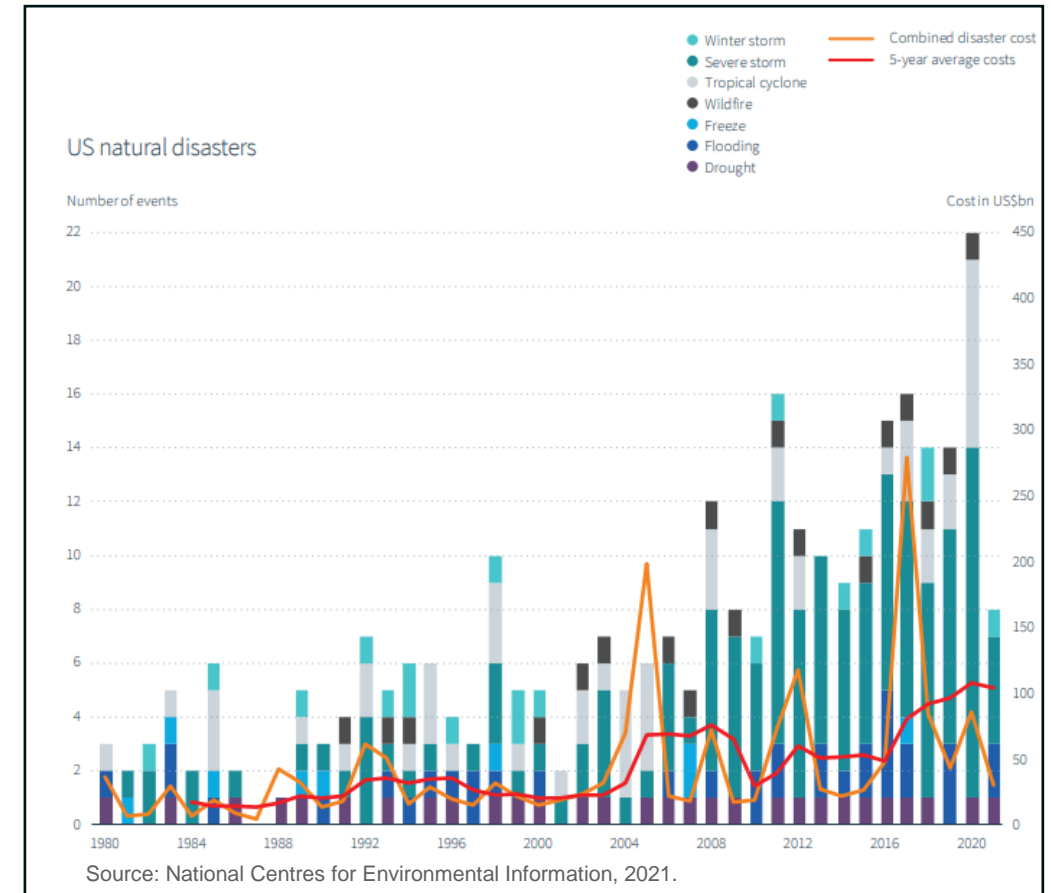
Is climate change financially material?

Paris Agreement and likely climate change

- The Paris Agreement in 2015 was to maintain average temperature rises to 'well below' 2°C above pre-industrial levels, and preferably to limit the increase to 1.5°C.
- The latest research suggests that the world's temperature has increased by about 1.1°C since the pre-industrial era*.
- Including current policies to limit CO₂ emissions, it is expected that the world's temperature will rise by around 2.7°C by the end of the century**.

Potential impact

- This will lead to significant **physical risks** and **transition risks**, which will affect companies and asset classes differently across the world.
- *Physical risks* are the impact of rising water levels and weather-related changes. The impact of this can be seen in the chart, which shows the number and cost of natural disasters in the US over the past 40 years.
- The *transition* to a low-carbon economy will impact the value of companies which extract fossil fuels, but **also impact banks and other investors in these companies**.



* Intergovernmental Panel on Climate Change

** ClimateActionTracker.org

Knowledge and
Understanding

Formulating beliefs

Establishing policies

Implementation

Monitoring

Knowledge and Understanding

What about Social and Governance risks?

- While conversations on ESG often focus on Environmental concerns, Social and Governance risks can also impact companies.
- VW's 'dieselgate' issues are often mentioned as an example of how bad governance can impact a company's share price.
- However, there are many other examples in recent years where companies and investors have been affected by poor internal controls and / or poor working practices.

Patisserie Valerie collapses into administration putting 2,800 jobs at risk

Cake chain calls in administrators after failing to recover from accounting scandal

Boohoo directors to face shareholder revolt over supplier labour abuse

ISS and Glass Lewis recommend votes against Carol Kane after problems developed on her watch

boohoo

Wirecard: Scandal-hit firm files for insolvency

Royal carpet maker Victoria's shares tumble on auditor's fraud risk warning

Grant Thornton raised concerns over one of group's subsidiaries

BUSINESS



CEO of Deutsche Bank's DWS Asoka Woehrmann steps down after 'greenwashing' raids

Knowledge and
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Formulating ESG Beliefs

Formulating ESG beliefs

ESG Questionnaire

We have developed a questionnaire to help trustees formulate their ESG beliefs. It helps trustees to consider:

- Which aspects of ESG investing are most important to you
- Whether your ESG beliefs should be aligned with the views of the employer and/or members
- Whether the trustees believe some firms or industries should be excluded from the portfolio.
- Explore how ESG can be integrated into bonds and other asset classes.
- The effective ways to monitor your ESG beliefs being implemented in practice.

Using a questionnaire can be useful to gauge the views across the trustee board and what issues to focus on. Doing nothing, or doing only what is necessary, is still formulating your ESG beliefs.

Views and priorities may differ between the components of 'E', 'S' and 'G'.

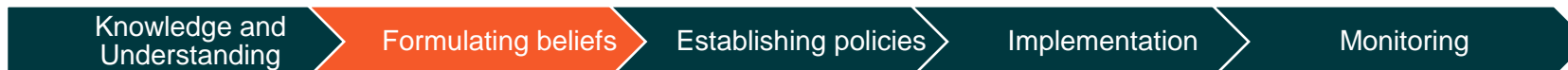
Knowledge and understanding of ESG

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Don't know
I have a good understanding of what ESG investing is	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Trustees can incorporate ESG while carrying out their fiduciary duties to the Scheme members	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
I understand what Trustees have to do as a result of current ESG regulations	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
I would like training on the ESG regulations and initiatives relevant for the Scheme	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Investment managers can influence ESG factors across all asset classes, not just equities	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

ESG beliefs

Thinking about how the Trustees should prioritise ESG, please rank E, S and G by importance:
1 = most important issue, 2 = second most important, 3 = least important.
If all are equally important, please choose '1' for each.

	1	2	3
- Environmental issues (including pollution, climate change)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
- Social issues (including working practices, diversity and wider equality)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
- Governance issues (including risk management, executive pay, board structure)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>





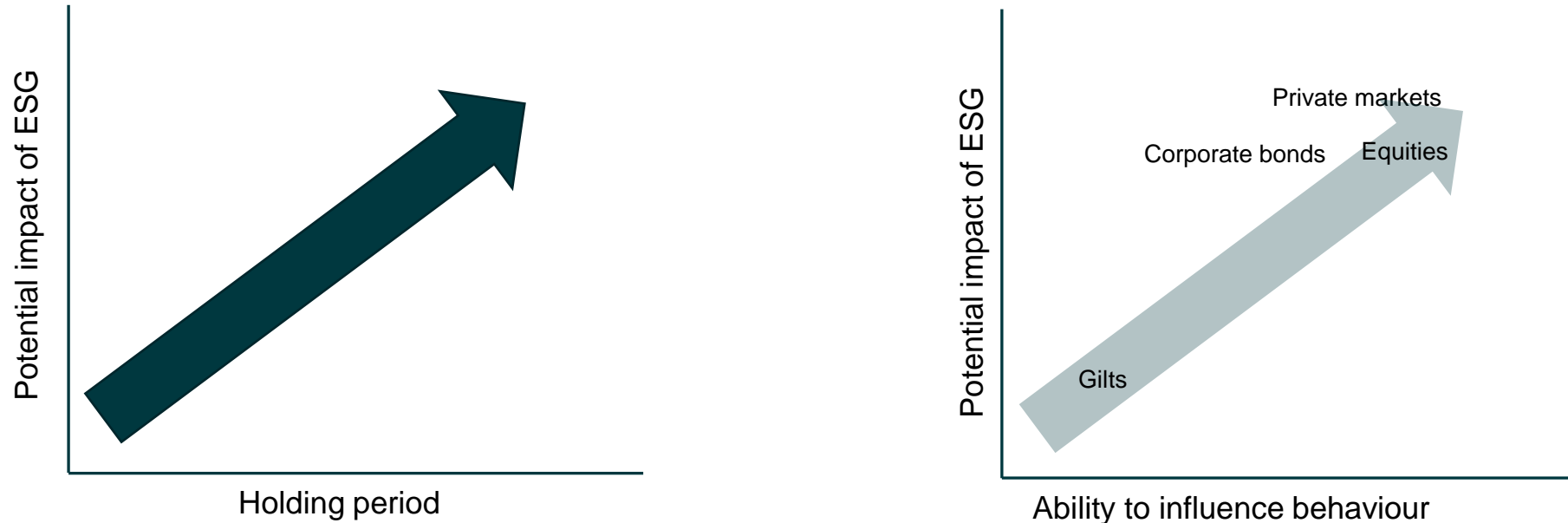
Establishing ESG Policies

Establishing ESG Policies

Potential impact of ESG

Before documenting ESG policies, trustees should consider the potential impact of ESG on their portfolio.

- This will depend on the potential holding period of each asset (and how that may change over time as the scheme de-risks)
- Trustees should also consider the ability investors have to influence behaviours of underlying firms, which depends on the asset classes held.



Establishing ESG Policies

Translating beliefs into SIP policies

Since October 2019 and again in October 2020, there have been a number of ESG policies which need to be included in pension schemes' SIPs.

In 2022, the DWP clarified that SIPs also need to set their own voting and engagement policies, rather than delegating these to the Scheme's investment manager(s).

The same guidance encourages trustees **to explain how stewardship policies are in their members' best interests**.

Here are some examples of policies in the Statement of Investment Principles ('SIP') depending on the Trustees' ESG beliefs:

ESG Belief	Example SIP Policy
Desire to align investments to the Paris Climate Agreement .	The Trustees invest in funds and approaches that seek to achieve the objectives of the Paris Climate Agreement. This aims to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels.
Desire to exclude any unethical industries, such as tobacco, armaments and mining.	The Trustees have put in place an agreement with their investment managers to exclude investment in companies within the tobacco, armament and mining sectors, including any companies who derive more than 5% of their revenue from these sectors.
Desire to promote a positive social impact .	The Trustees invest in funds/ approaches with a focus on social impact investing, including social housing, charitable projects and social enterprises.

The Trustees' Implementation Statement will confirm how these policies have been enacted over the year.



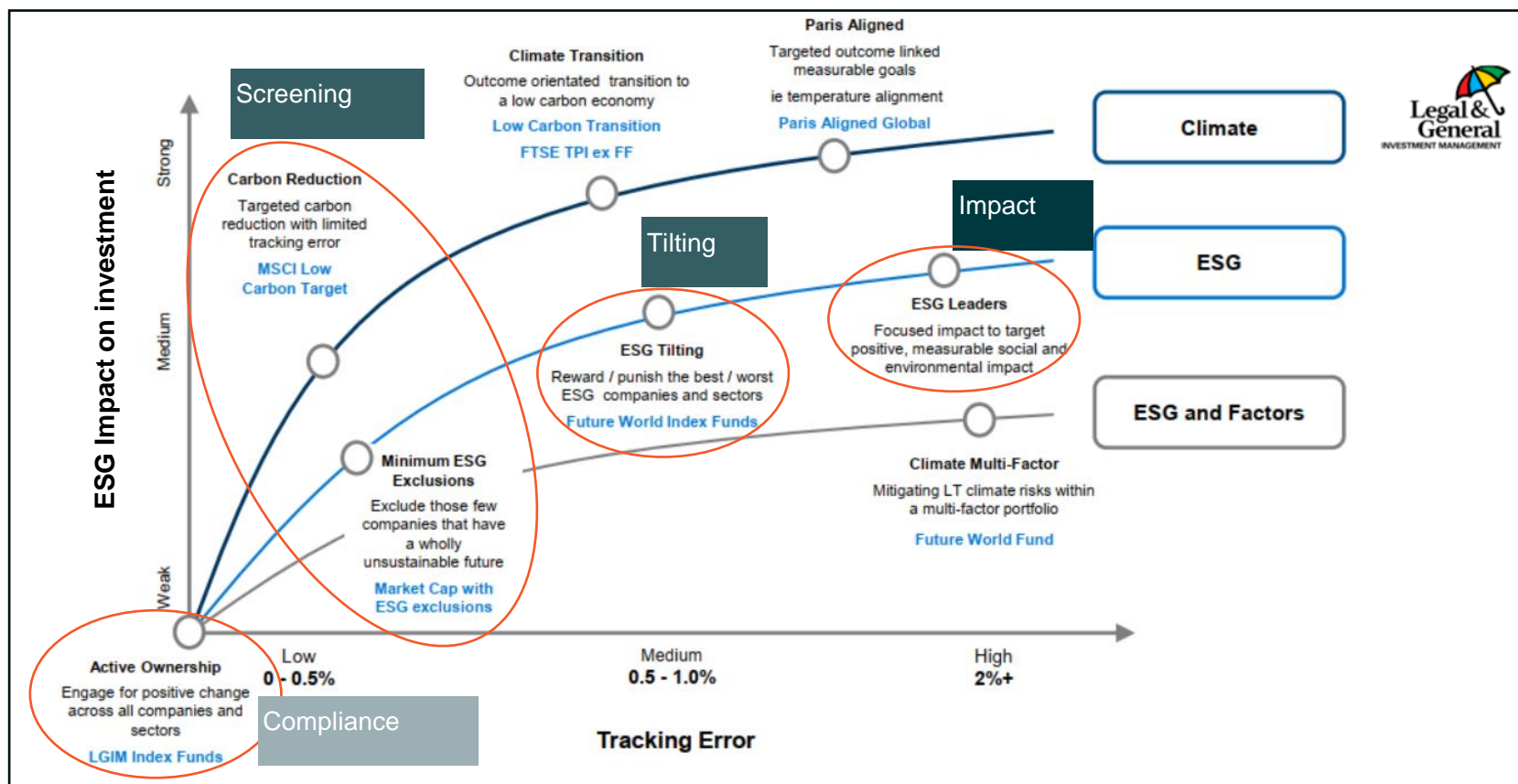


Implementing ESG investing

Implementation

ESG integration and tracking error

The following diagram from LGIM shows that the greater the ESG integration, the greater the likely variance from a standard market-weighted index.



Implementation

ESG Scoring

Index providers have different methodologies to score companies, which can lead to very different results when comparing across providers.

Index provider	Rating	Comments
LGIM		<ul style="list-style-type: none"> Due to the low Environmental scores of energy and extraction companies, the overall ESG scores from LGIM are poor.
MSCI		<ul style="list-style-type: none"> MSCI scores are relative to the industry sub-sectors. E.g. Apple is rated against the 'Technology hardware, storage & peripherals' industry.
Sustainalytics		<ul style="list-style-type: none"> Sustainalytics show ESG risk ratings, where lowest scores are best. Shows mining firm BHP having lower ESG risk than Amazon.

Due to their relatively high ESG scores, there is usually an **overweighting to technology companies in ESG indices**.

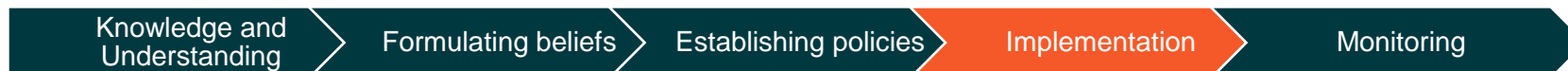
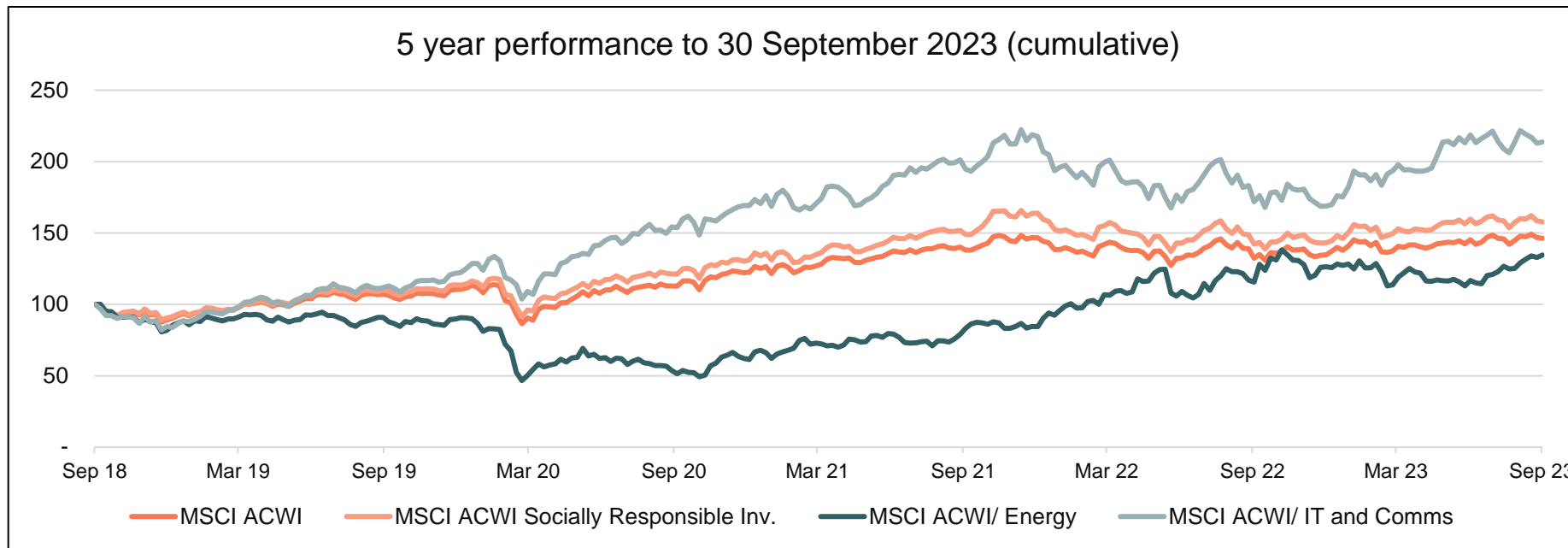


Implementation

Potential impact on performance(1)

Some MSCI ESG indices have outperformed the market-weighted All-Countries World Index over the 5 years to the end of September 2023.

- The MSCI All-Countries World Index (ACWI) is shown in orange in the following charts.
- The Socially Responsible Investment (SRI) index, investing in firms with the top 25% ESG scores in each sector, has outperformed the standard index.
- Overlaying the ESG index are the returns of two key sectors which performed very differently in recent years:
 - Information Technology firms, which performed strongly in 2020 and early 2021
 - Energy firms underperformed in 2020 and 2021, but have delivered strong performance since the start of 2022.



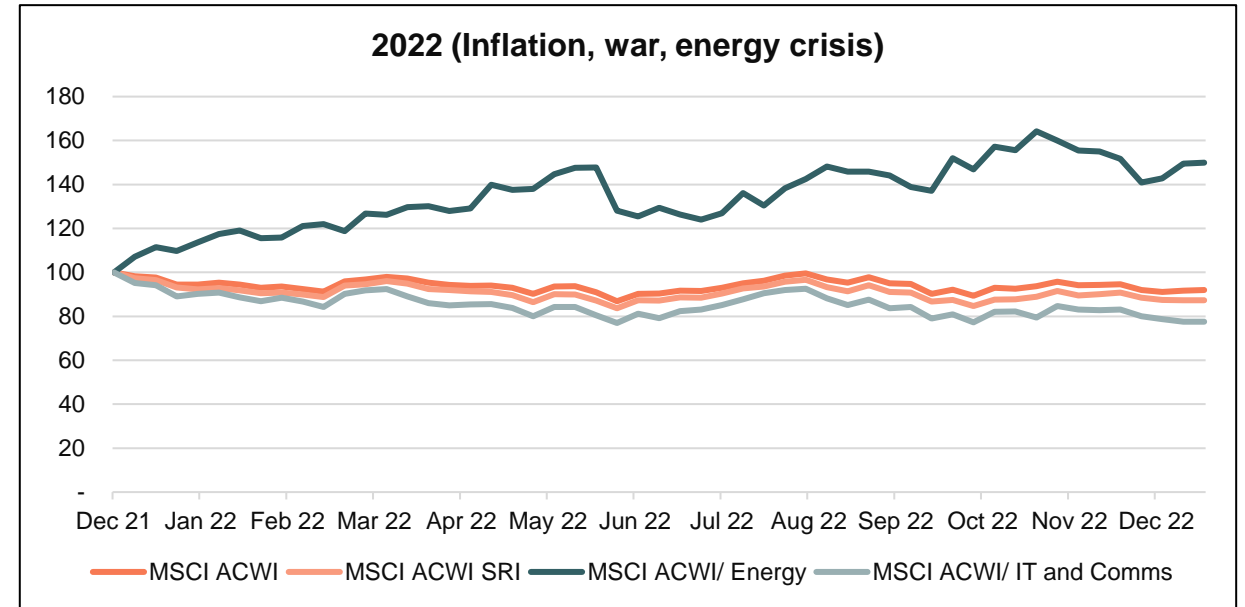
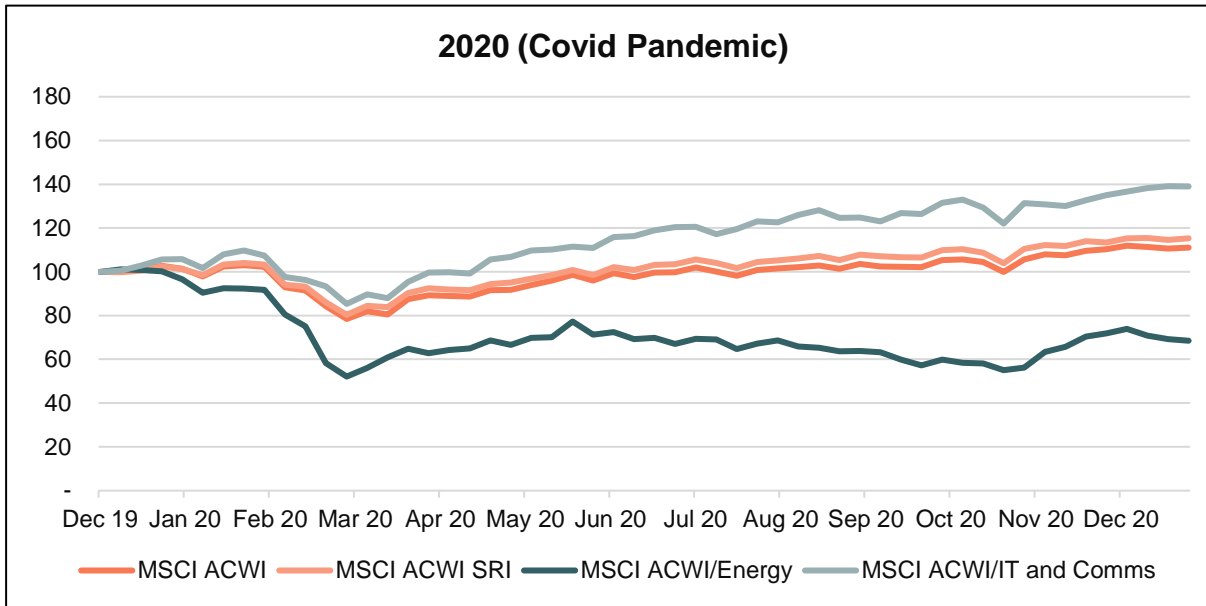
Implementation

Potential impact on performance(2)

While ESG indices have tended to perform well over the longer term, the following charts show that **this outperformance should not be assumed**.

Over specific timeframes, we can see the biases in the ESG indices impacting performance.

- Over 2020 and the Covid pandemic, being underweight Energy stocks benefitted performance. As a result, indices with strong ESG integration outperformed the standard ACWI index.
- However, over 2022 Energy stocks rebounded, leading to the ESG indices typically delivering lower performance than the ACWI.
- In both charts, the Socially Responsible Investment index which aims for high ESG impact, shows variance from the standard market-weighted index.



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Monitoring

ESG Monitoring

Reporting

ESG reporting can be split into ad-hoc updates, annual, or progression towards agreed targets.

Ad-hoc reporting

- This can include developments such as changes in legislation, issuance of green bonds, or performance of ESG funds.

Annual reporting

- The annual **Implementation Statement** will cover a number of topics, including voting and engagement activity on behalf of the trustees.
- As well as this, reporting can include greenhouse gas emissions from the Scheme's investment portfolio. These could be absolute amounts, but it is more informative to have **comparisons against a benchmark, or how they have changed over time**.
- This should be at the fund level, and also aggregated for the scheme across funds and asset classes.

Progression towards ESG targets

- For those schemes reporting against the TCFD requirements (either due to their size or at the request of the Trustees), reporting can show progress towards the Environmental targets the Trustees have set.
- Other targets could be broader, by improving social and governance metrics within the portfolio.

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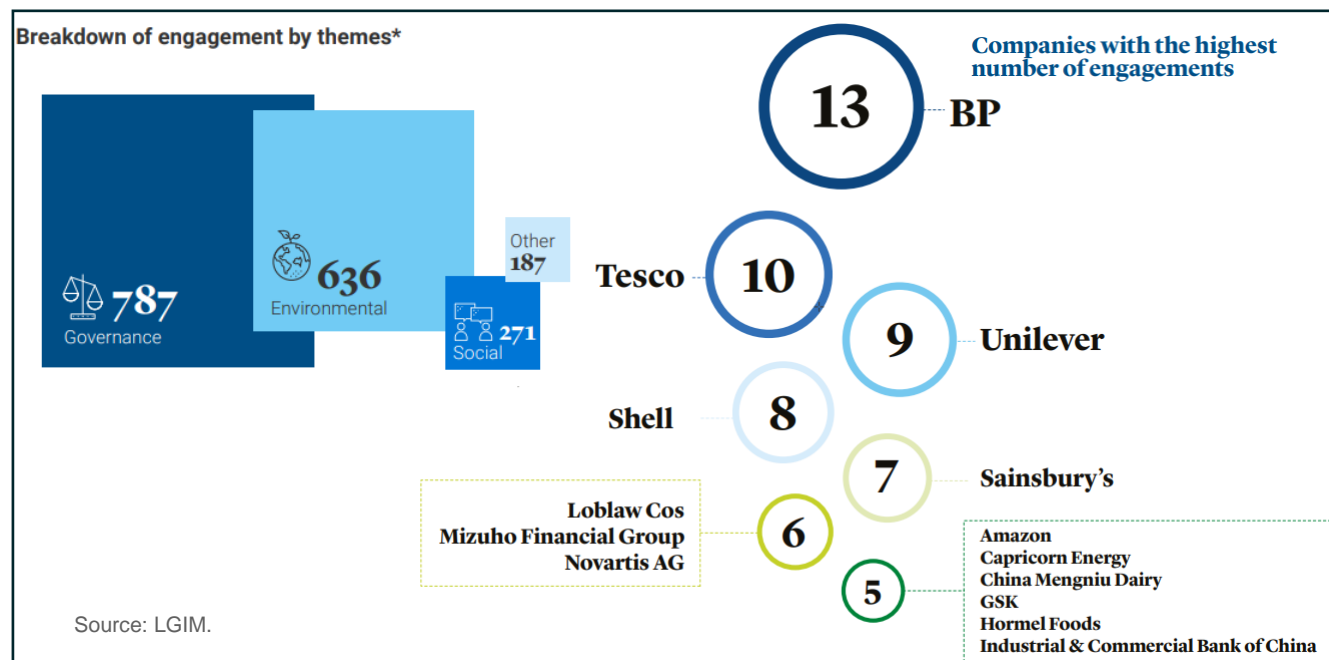
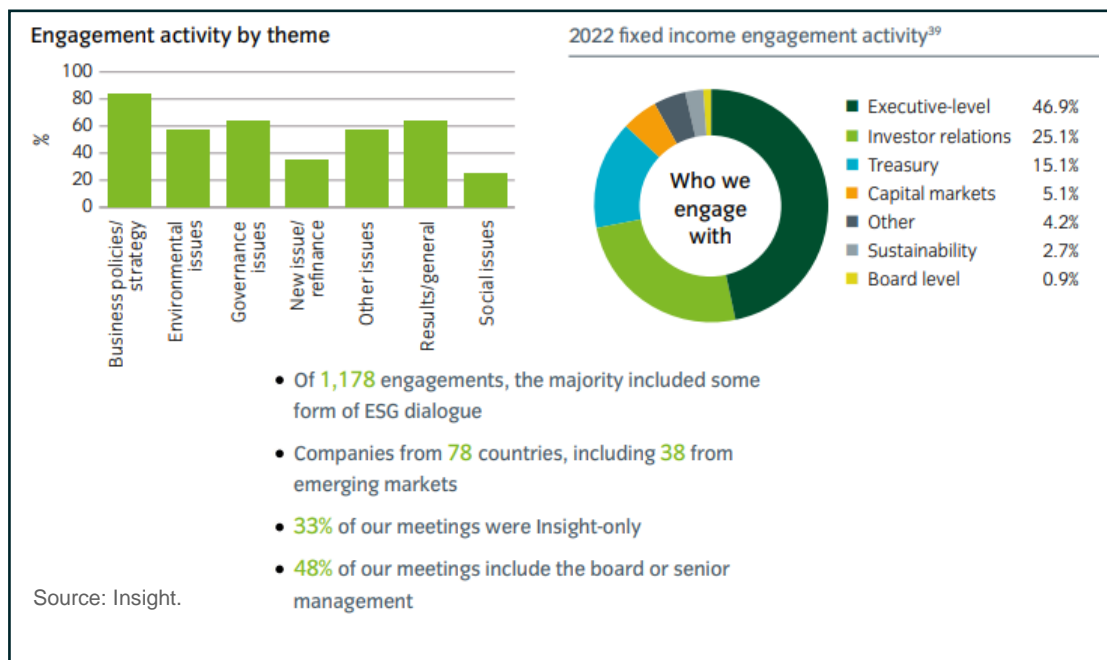
Monitoring

ESG Monitoring

Engagement with underlying companies

Investors can integrate ESG into their portfolios when they do not invest in equities, or invest in passive index tracking funds. While corporate bonds do not have voting rights, investors have regular meetings with decision-makers to influence the actions of underlying companies.

Examples below from Insight and LGIM show at a high level, and also at the company-level, how these investment managers use their influence to change behaviours.



ESG Monitoring

Scrutinising Investment Managers

- In the past, the UK Social Investment Forum has criticised trustees who delegate ESG matters to their investment managers without any associated scrutiny.
- Scrutinising investment managers meets the trustees' stewardship duties, which are often set out in the Statement of Investment Principles, and evidenced in the Implementation Statement.
- Questions to ask investment managers include:
 - Voting policy on equity holdings
 - Examples of votes made and company engagement
 - Policy for divesting from companies
 - Covenants associated with bonds, including use of 'green bonds'
 - The planned use of 'green gilts'
- A questionnaire can be sent out to investment managers for them to demonstrate to the trustees how ESG matters are being dealt with.
- **Do not be afraid to challenge your investment managers!**

Questions?



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