EMBEDDING ESG FACTORS INTO LISTED EQUITY INVESTMENTS

A summary guide for pension trustees

Listed equity investments generally make up a large part of any portfolio designed to generate returns. Investors can participate in real economic growth by having a stake in the profits of leading global companies. The breadth and depth of public equity markets globally gives investors access to a highly liquid asset class with a track record of producing long-term returns significantly higher than inflation.

Relevance of ESG considerations in achieving these objectives

ESG issues that are material to value creation in the short, medium and/or long-term will affect business's financial performance and share price. To ensure sustainable business growth and a continued return on investment, both the business and investors need to be aware of these material ESG factors.

This means that pension scheme trustees (as investors) and their asset managers should consider and incorporate ESG risk factors when selecting, managing and monitoring equity investments. The Pensions Regulator (TPR) in the UK has stressed the impact ESG factors can have on scheme investments. When it comes to climate change, for example, TPR warned that if trustees don't consider climate change risks and opportunities, or exercise effective stewardship, investment performance may suffer and, hence, savers could be deprived of better outcomes.[1] TPR has also published guidance for trustees on how they could build ESG factors into their investment decision making processes.[2] Currently, most of TPR's guidance is focused on defined contribution (DC) schemes, although some references have been woven into existing defined benefit (DB) investment guidance.

A new single code of practice is expected from TPR, though it is likely that this will include guidance for the trustees of all pension schemes on the role of sustainable investment and ESG factors in an effective system of scheme governance.

Just like traditional financial risk factors, how companies deal with ESG issues affects their potential for long-term growth. It also affects long-term returns, and so the ability of the pension scheme to meet its long-term funding objectives. The relevance of ESG factors will vary across industries and regions; every company has to understand ESG risks and opportunities within their own context and understand the long-term importance of these factors.

Integrating ESG into the investment process presents an opportunity: pension scheme trustees can choose to invest in sustainable growth industries and in companies well-placed to succeed in a low-carbon economy.[3] Also, these industries may align with a scheme sponsor's own approach to sustainability.

For these reasons, ESG considerations need to be incorporated across the investment process. This is being made easier by the increased availability of ESG data and analysis in the market. Rapidly evolving pensions law will also support integrating ESG factors in this area; it already requires trustees to treat ESG factors as financially material in selecting, retaining and realizing investments. Forthcoming legislation will increase trustee obligations in climate-change risk: trustees will have to take specific steps to manage these risks and must disclose their approach.[4]

1 The Pensions Regulator: A changing climate for pension trustees (October 2020)
2 The Pensions Regulator: Managing DC benefits: Investment governance (July 2019)
3 Business & sustainable development commission
4 (UK) Pension Schemes Bill 2019-2021

ESG maturity map

The A4S ESG maturity map, part of its ESG Toolkit for Pension Chairs and Trustees, sets out example behaviours for integrating ESG into equity investment decision making. At the beginning of a pension scheme's journey, trustees may seek to demonstrate they can confidently discuss the various types and availability of ESG data; whereas at the leading edge of this journey, trustees may be collaborating to push passive index funds to become more sustainable by default.

	Level 1 Understanding	Level 2 Adopting	Level 3 Deepening	Level 4 Leading
Example behaviours	The Board: • can confidently discuss the relationship between ESG factors and equity returns • can confidently discuss the types and level of availability of ESG data for listed equities, and how this can be used in investment decision making • has considered and documented its appetite to integrate ESG factors into equity investment decisions and risk management practices • can confidently speak about the role asset owners have in driving better corporate behaviours in listed equity companies • exercises votes in alignment with investment beliefs (either directly or indirectly through an external asset manager or proxy voting agency)	The Board: • is developing a framework for integrating ESG factors into direct equity investments (including its use of active and passive equity funds) • has identified the material issues their investments are exposed to and has defined expectations of what companies and/or its fund managers should be doing to manage and mitigate these • has identified sources of ESG information and data for publicly listed equities • has developed and implemented a coherent stewardship strategy for listed equities, where engagement activities and voting are fully aligned • has a fully considered policy on how to respond when stewardship activities fail to drive targeted change in listed equity investments	The Board: • has implemented a framework for integrating ESG factors into direct equity investments • has a process for continual assessment of external equity managers' ESG investment capabilities through regular reporting against a clearly defined set of metrics • has at least one Board member who attends at least one investee company AGM per year and asks ESG-related questions as part of the engagement process • is committed to reporting on listed equity stewardship activities and outcomes achieved	The Board: • actively and publicly talks about the challenges and opportunities of ESG investing in public equities • collaborates with platforms promoting better disclosure on ESG factors by publicly listed companies • collaborates with index providers to push passive funds to become more sustainable by default • has at least one Board member who regularly attends at least 5 AGMs per year • leads collaborative engagement activities and collective shareholder resolutions in listed equity investments on relevant ESG issues related to priority areas

Practical actions that trustees can take

Area	Action
Education	• Arrange for all trustees to be educated about the ESG risks and opportunities associated with investing in public equities, including how ESG factors can influence share prices and dividends through impacts to company valuation. • Recognize the variety of approaches to ESG investing within public equities (for example: ESG-tilted passive funds, actively managed thematic, best-in-class strategies etc).
External manager expectations	• Ensure there is a consistent approach to assessing new and existing external managers on capabilities around ESG equity investing, by examining: – Firm-level approach to ESG for listed equities and whether these are aligned to the trustees' investment philosophy and principles; – Whether and how manager uses negative and positive screens for equity-investment decisions; – Quality of annual disclosures following UN Principles of Responsible Investing guidance on equity investing; – How a manager identifies ESG-related risks and opportunities; – How a manager uses ESG analysis and data in the equity investment process; – The manager's approach on investor stewardship and willingness to engage in stewardship alongside scheme; – Capabilities and approach around ESG-metric reporting.
Direct equity investing	• Oversee the development of an in-house framework for integrating ESG analysis and data into the equity investment process. Ensure that this is resourced appropriately and incorporated in internal structures and governance. • Refine the framework through ongoing review of available ESG data sources in the market and latest thinking and research around impact on ESG data on equities.
Stewardship	• Oversee development of a stewardship strategy which facilitates pushing for better ESG performance from investees. • If appropriate, identify themes to focus stewardship activities around that are commensurate with the aims and objectives of the scheme and the risk exposure of the scheme's underlying investments. • Ensure that engagement and voting activities are complementary and work with external managers to align expectations around voting. • Publish voting record in full and include successes and failures of stewardship activities. Engage with management when voting against, explain the decision and facilitate productive dialogue.
Collective action	• Identify, participate and, if appropriate, provide a leadership role in collective action platforms (such as Climate Action 100+) to encourage companies to focus on ESG issues and provide better disclosures.
Measurement and reporting	• Actively explore ways for the scheme to generate ESG metrics from the real estate portfolio, such as: – Social metrics – people employed through construction, social tenants housed and social businesses provided with commercial / office space; – Environmental metrics – including carbon emissions, trees plated and water recycled.

This summary guide for pension trustees is part of an ESG Toolkit for Pension Chairs and Trustees by The Prince's Accounting for Sustainability Project.