

Should trustees incorporate environmental, social and corporate governance (ESG) considerations into their investment decision making?

Dr. Steve Waygood, head of sustainability research and engagement and **Chris Wagstaff**, head of investment education at Aviva Investors, look at the key ESG issues trustees need to consider.

Do trustees have a responsibility to take ESG considerations into account in their investment decision making?

The latest financial crisis and subsequent events have once again highlighted the role that should, but is often not, played by responsible investment strategies. The costs to pension schemes and others of the unsustainable risk taking, misaligned incentives, moral hazard and other issues, such as the problem of 'absentee landlords', that characterised the financial crisis, should be clear to all involved in the pensions and investment industry.

While trustee investment decision making is governed by trust law, legislation, regulation and best practice guidelines, the most common misconception that arises is that trustees' only and overriding investment objective is profit maximisation. The classic citation, wrongly used to promulgate it, is the case of *Cowan v Scargill* (1984). However, given the misrepresentation of that case, the judge took the unusual step of revisiting his judgement, clarifying that the case did not support the thesis that profit maximisation alone was consistent with the fiduciary duty of a pension fund trustee. Indeed, the ruling in *Harries v Church Commissioners* (1991) firmly supported the Church Commissioners' explicit incorporation of ESG factors into their investment strategy.

The most effective document for promoting the integration of ESG issues into investment is arguably the *Freshfields Report*, published in 2005. This report was asked to consider: "Should integration of environmental, social and governance issues into investment policy be voluntarily permitted, legally required or hampered by law and regulation?" Freshfields concluded that "...integrating environmental social and corporate governance (ESG) considerations into an investment analysis



so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions". This conclusion clarified the legality behind whether pension schemes could consider ESG issues. In 2009, the United Nations Environment Programme's (UNEP) Fund Management Working Group followed up this report. Among its suggestions was that advisers to institutional investors, such as trustees, have a duty to proactively raise ESG issues within the advice they provide and that a responsible investment option should be the default position. The report also proposes that investment consultant and fund manager clients should be able to sue for negligence if these issues are not properly considered.

How can trustees integrate ESG issues into their investment decision making?

This, of course, raises the question of how trustees should go about delivering on any ESG fiduciary responsibility. After all, trustees do not routinely get involved in company meetings, stock picking or portfolio construction – often delegating this to their fund managers. Well, schemes can include ESG clauses in Investment Management Agreements (IMAs) and require fund managers to periodically report on their ESG performance. For instance, being a member of the United Nations Principles for Responsible Investment (UN PRI)*

* For further information on the UN PRI see www.unpri.org/principles



requires that “where consistent with fiduciary responsibilities” signatories should commit to integrating ESG issues into investment analysis, to being active, responsible owners by promoting good corporate practice in these areas and to reporting on what actions they have taken. The UN PRI monitors delivery of these principles via a questionnaire, which benchmarks signatories performance in relation to each principle. As trustees have a fiduciary duty in this area, they should require their fund managers to make this information available to them at no additional cost.

What are the key arguments for SRI over “mainstream” investing?

The ESG factors that sustainable and responsible investment (SRI) analysts and fund managers specialise in are increasingly material to the value of companies. As a consequence, SRI strategies are increasingly adopted by institutional investors, such as trustees, seeking to deliver on their ESG fiduciary responsibility and in maximising investment returns. There are four main SRI strategies: integration, engagement, positive screening and negative screening. These can be deployed independently as alternatives or combined to develop increasingly sophisticated SRI strategies. However, some contradictions can emerge when combining strategies. The key is in understanding these implications and selecting the approach that the trustees consider best fits the investment strategy of the scheme.

Looking at ESG issues has been criticised as being a distraction from achieving superior financial returns. This argument assumes that these issues do not materially affect the value of companies. However, not systematically including these issues in the investment decision is not prudent as they fundamentally affect the value of companies now and in

the future. For instance, the global response to mitigating climate change will have a major impact on business as energy costs will generally rise and a secular shift will continue to occur, so favouring lower carbon producers and services. Ignoring this shift or thinking that these effects will be limited and that companies will generally carry on, business as usual, is a potentially expensive position to hold. This is an example of a slow burn but very material issue which can only be met with a systematic approach to identifying companies positioned to benefit from this shift as well as those set to lose – and positioning your portfolio accordingly.

So how do ESG (or SRI) funds perform relative to “mainstream” funds?

Well, consultant Mercer, in conducting a study with UNEP entitled *Demystifying Responsible Investment Performance*, concluded that the research didn’t support the view that SRI funds underperform conventional funds. Equally, the jury is still out on whether there is a market inefficiency that enables SRI funds to outperform conventional

funds over the long-term. We believe that ESG issues are frequently material to long-term performance and that there is a market inefficiency that investors can exploit for financial gain. In our view, with an increasing number of analysts seeking to exploit this inefficiency, ESG analysis will continue to grow in relevance.

Do not assume ESG issues are being incorporated by all fund managers. Ask your fund manager how they do this, and what the main risks and opportunities are in your portfolio. Be wary of fund managers who do not appear to have any interest, or expertise to draw on in incorporating these issues or are unable to back up claims they make in this area.

Want to know more?

Visit www.investmenttutor.com and navigate to the learning topic area and select ESG. The ESG learning topic is designed to provide you with a relevant and information-rich online resource. Here you can find a variety online information and learning tools including video sessions, further reading and details of upcoming web and classroom-based training courses.



Dr. Steve Waygood is head of sustainability research and engagement



Chris Wagstaff is head of investment education and trustee director, Aviva Staff Pension Scheme