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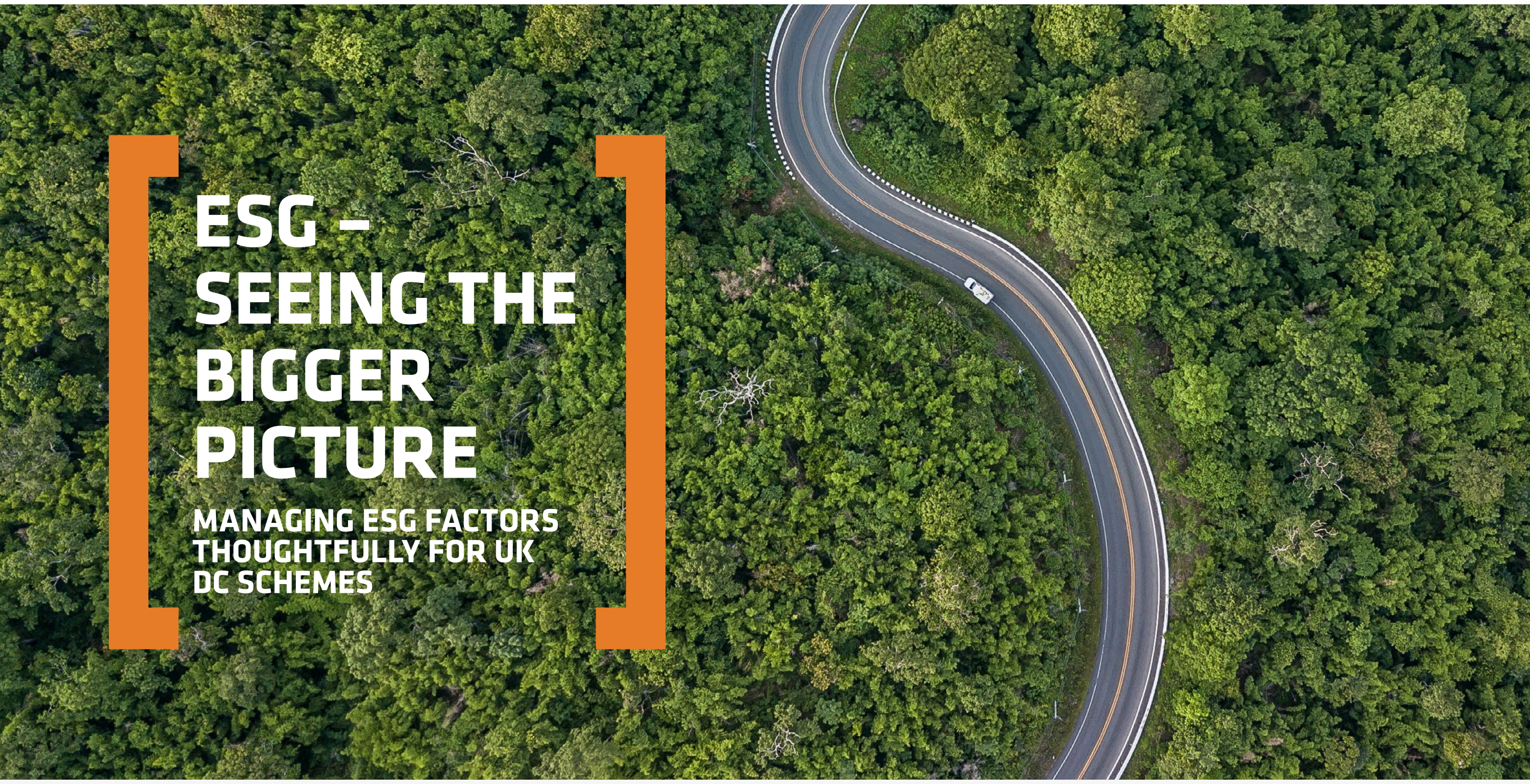

ESG – SEEING THE BIGGER PICTURE

MANAGING ESG FACTORS THOUGHTFULLY FOR UK DC SCHEMES

At AB's recent seminar, three leading experts with very different vantage points discussed environmental, social and governance factors (ESG). Together they created a complete picture that shows why ESG is of vital importance to investors, and how DC trustees and investment managers need to respond to ESG risks and opportunities.

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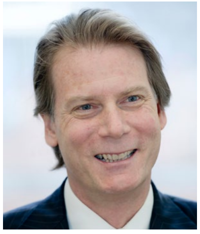
ESG IS VITALLY IMPORTANT AND HERE TO STAY



MICHAEL SHEREN
Senior Adviser,
Bank of England

Why focus on ESG? As central bankers, we're concerned about the implications of risks associated with ESG on financial stability and the safety and soundness of bank depositors and insurance policy holders. Greater awareness of ESG factors is generating change in the global economy and this will have meaningful implications for investors. Companies will need to adapt to a world moving towards low carbon, clean energy, new technologies and an increasing responsibility for negative externalities such as pollution, plastic and the misuse of customers' data. It seems clear many business sectors may struggle to cope with the transition to a sustainable economy. Hence, engagement by asset managers on ESG issues will be key to transitioning companies. Unfortunately, some sectors, due to technological change or cost, repositioning business models or delaying action may find the transition unachievable.

Previously, companies could avoid paying for the costs of many of the negative externalities that they generated – for instance, in terms of pollution and harm to their employees' well-being. These costs were met by the taxpayer and by healthcare providers. Now companies themselves face both the hard costs and reputational damage of those externalities and must expend capex to modify their business models and practices to become sustainable.

The potential impacts from ESG factors are huge and the timescales to adapt are short. Notably, climate change is an existential risk. That's why governments and central banks are collaborating on many wide-ranging ESG initiatives, including the Task Force on Climate-related Financial Disclosure (TCFD). Related research, such as the 2015 climate change study from Cambridge University 's Institute for Sustainability Leadership, highlights the prospective climate-related risks for investment portfolios. Many of these are unhedgeable – so without prompt analysis, investors could face severe financial impacts should they not recognize and respond to these risks as they begin to manifest.

KEY TAKEAWAYS

It seems clear many business sectors may struggle to cope with the transition to a sustainable economy, and some sectors may find the transition unachievable

Climate change is an existential risk and many climate risks are unhedgeable

- Task Force On Climate-related Financial Disclosure
- Cambridge University climate change report: unhedgeable risk

For investors, it's crucial to understand not just the timescales, but the linkages and threads that connect ESG factors to real-world outcomes and financial impacts. The transition to a sustainable global economy is not just about avoiding risks – many see the ESG transition is arguably the greatest alpha opportunity of a lifetime. Research from leading investment banks demonstrates that analysis of ESG factors can be used not only to reduce risk but also to improve risk-adjusted returns through reallocating capital to sustainable investments. And, while countries such as China have done amazing work to develop electric cars and sustainable solar energy technologies, there is great expertise closer to home too – a company in Hull is one of the world's most technologically advanced manufacturers of wind-turbine blades.

Engagement is a huge element of improving the ESG profile of an investment portfolio . Some sectors won't make an effective transition because their management won't adapt quickly enough to the changing landscape. Investors must play their part and undertake careful analysis, work out who is providing the most transparent information, and meet with management to compare peer performance and encourage best practice. That will help determine who will be the winners and who will not.

Hence, if you are a long-term investor, your fiduciary responsibility is to consider all risks including those embedded in ESG. Investors must identify and adapt to trends in regulation, understand the path of travel per government policy and evidence-based research and analyse how well the real economy and the actors therein are adapting to the transition.

KEY TAKEAWAYS

Many see the ESG transition is arguably the greatest alpha opportunity of a lifetime

Engagement is a huge element of improving the ESG profile of an investment portfolio

Fiduciaries have a responsibility to understand important trends and risks and invest accordingly

THE INVESTMENT CONSULTANT

DC TRUSTEES MUST SET OUT THEIR OWN ESG VIEWS

LUCY TUSA

Director, Mercer

By 1 October 2019, the Department for Work and Pensions (DWP) guidance states that both DB and DC trustees need to state in their Statement of Investment Principles: 1) their policy on how they take into account financially material considerations, including ESG and climate change; 2) their stewardship policy (voting and engagement); 3) their approach (if any) to taking account of member views; and – for DC schemes only – 4) publish their Statement of Investment Principles on a public website. They must also update this policy document for their approach on these issues in the default strategy. From October 2020 DC trustees also need to publish an implementation report detailing how they have taken these steps and the changes they have actually made.

That's a lot to do in a short time – especially considering that some DC trustees may likely have just one trustee meeting between now and September. At Mercer, we believe it's very important to have a framework for thinking about these complex questions that impact every part of the investment process. Indeed, we encourage our clients to make sure that ESG considerations are embedded throughout investment frameworks, from beliefs to policy and processes and all the way through to the portfolio.

That's why we applaud the DWP's focus on getting trustees to deliberate and arrive at their own ESG beliefs rather than just ticking a box. And we believe it's very important for trustees to devote enough time to these ESG discussions and to agree solutions that are right for them. ESG is not a straightforward area and there's a lot for trustees to understand. Addressing different viewpoints can be hard. To get the best out of trustees' discussions – and their engagement with members – we direct our clients away from focusing on the negative, and instead get them to think about how they can invest in the right industries for the future.

At Mercer, we have a team of about 16 globally, just focusing on responsible investment. We saw its importance early, and we were one of the drivers behind the UN Principles for Responsible Investment (PRI). Responsible investment is absolutely not a flash in the pan. In fact, over the last two to three years awareness of ESG factors has accelerated enormously. It's great to see the regulator pushing trustees on ESG; at the moment, their guidance is a series of nudges, but it's inevitable that there will be further regulation in due course .

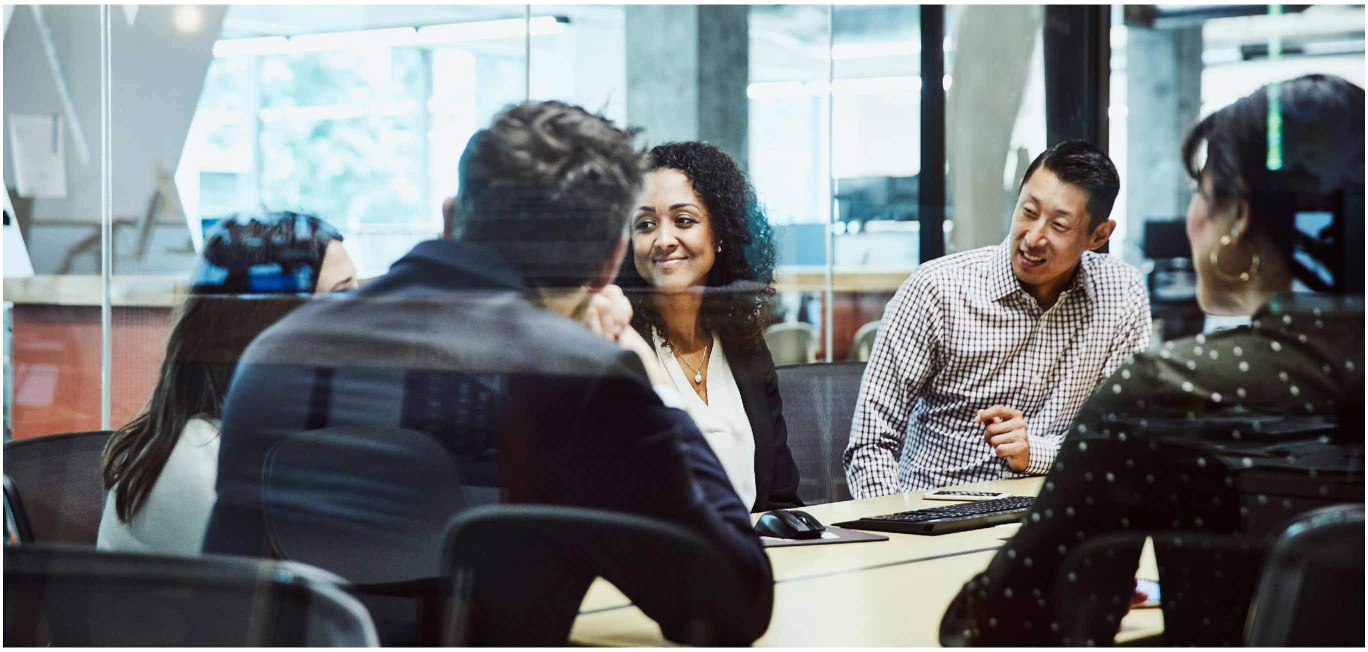
KEY TAKEAWAYS

Trustees face tough deadlines to set out their ESG beliefs

They need the right framework for their deliberations

It's very important that they devote enough time for discussion, and focus on positive outcomes

ESG is so important that trustees should expect further regulation in future



Including ESG products in a scheme's fund range can raise several issues. Pressure on costs is always a problem area for trustees, particularly at smaller funds, so indexed funds are sometimes a more cost-effective option. There are a growing number of good active products but some can be expensive. And it can be particularly tough on cost grounds to include ESG-focused alternative strategies.

A lot of our analysis centres on testing whether active managers are just applying an ESG veneer or whether they are genuinely addressing the underlying issues and integrating ESG in their investment process. We also have a concern about how well trustees understand the growing number of manager products that are halfway between active and passive, using tilts to express specific ESG views. Trustees need to be aware that these tilts will change over time and need monitoring – it's not like buying a passive fund and saying, "job done". Consultants can help by ranking and rating the different products and analysing the growing volume of data. We also encourage clients to apply their ESG beliefs consistently across their whole fund range – some people might question the rationale of adopting an ESG focus in your default and not in your freestyle funds.

Interacting with your investment manager is very important. Managers are getting used to answering questions about how workers are being paid, diversity issues, supply chains, how suppliers are being treated and so on. Trustees need to have a dialogue with their managers and make sure that ESG is not just an add-on for their investment process, it's really integral to what they do. And they need to ensure their managers are voting their shares at company meetings, and reporting on how they use their votes and engage with company management.

KEY TAKEAWAYS

Fund selection raises several issues, notably cost and manager monitoring

Trustees need to monitor their managers' ESG credentials and their voting and engagement work

THE DC INVESTMENT MANAGER

MANAGERS SHOULD INTEGRATE ESG, ENGAGE AND CUSTOMIZE

DAVID HUTCHINS, FIA
Portfolio Manager – Multi-Asset Solutions,
AllianceBernstein

At AB we are firm believers in the importance of ESG, and we have made ESG considerations an integral part of our investment process. We aim to make ESG work for the majority of members, and not just for an enthusiastic minority. So we have created a fund range that can cater for the different circumstances and needs of most DC schemes, and can address the specific beliefs of individual boards of trustees.

Our DC products include target-date fund (TDF) default ranges, a retirement income solution, and a range of DC-friendly specialist funds for lifestyle default solutions.

We recognize that trustees may need to implement their ESG beliefs using custom solutions – in fact, customization is an important part of our offer. So, for instance, in our standard packaged TDF range we use a mix of passive and systematic strategies, and we have already actively incorporated a positive ESG tilt. This creates underweight positions in companies with the lowest ESG scores and reallocates capital to more sustainable investments. We also offer simple-to-customize TDFs, where we can go further to reflect clients' very specific requirements – for example excluding tobacco companies, or placing a greater emphasis on carbon reduction than we have already adopted in our standard range.

At AB, integrating ESG into our investment process is central. Every one of our analysts considers ESG factors when they are researching a stock, and every one of our portfolio managers considers ESG impacts as they construct their portfolios. That comprehensive integration drives superior investment outcomes for clients, and helps create strategies that better reflect clients' particular values and beliefs.

KEY TAKEAWAYS

Our fund range puts ESG to work for the majority of members, not just an enthusiastic minority

We integrate ESG strategies into our standard range, and can offer different levels of ESG customization

Comprehensive integration drives superior investment outcomes for clients

Because our TDFs use an open-architecture approach, we build our strategies to include a number of third-party managers. We need to make sure that we hire managers that align with AB's own policies and are also PRI signatories. Recently, for predominantly ESG reasons we divested from two managers that only offered passive products. We felt that they lacked the research resources and active manager insights that come from managing active funds, and that this impaired their ability both to engage with companies and to use their voting rights to full effect. For a passive manager to hold over 10,000 stocks and bonds from different issuers, but to employ only about 30 research staff, inevitably means they cannot research in-depth or engage with insight. By comparison, at AB we employ over 200 specialist active analysts who each focus on a relatively limited number of stocks. We also employ a discrete team of governance specialists – because we believe voting and engagement really do matter.

We exclude controversial weapons from the funds and mandates which AB controls, which is a further differentiator from purely passive investment houses, which have to date struggled to adopt ESG alignment on this issue.

In our discussions with clients we strongly advise a prudent pace for implementing big changes. If you see addressing climate change as a 30-year project, there is no point in creating regret risk by making all the changes to your portfolio in one go. We also caution against relying too much on historical ESG data – this can be limited in terms of history and completeness, so you need to be very careful, especially when implementing ESG views purely systematically. Active management of the process is unavoidable. And of course, trustees need to consider how much ESG news has already been priced into markets. For instance, Tesla's high valuation already reflects expected rapid growth from their new electric vehicle technologies, whereas arguably Ford's lowly-rated shares do not reflect their potential to use their deep resources to create clean auto technologies.

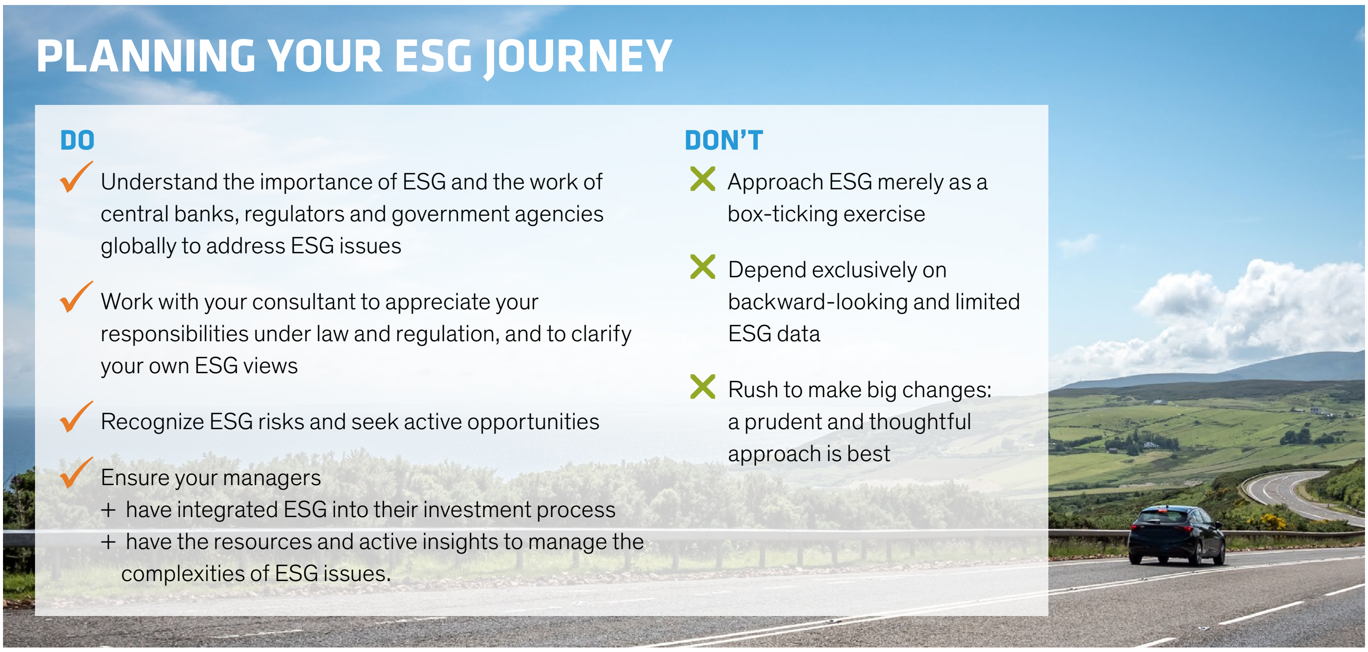
Our ESG work is part of a continuous programme, not a "one and done" project. We base each initiative on research and on the feedback from our regular DC member surveys. Our aim is to stay very focused on trustees' and members' needs, to create superior governance solutions and to provide exceptional value for money.

KEY TAKEAWAYS

Pure passive managers lack the resources and insights to engage in-depth with company management

Trustees need to implement ESG views carefully – without rushing big changes, and without relying too much on historical ESG data

We focus on members' needs, on creating superior governance solutions, and on providing exceptional value for money



PLANNING YOUR ESG JOURNEY

DO

- ✓ Understand the importance of ESG and the work of central banks, regulators and government agencies globally to address ESG issues
- ✓ Work with your consultant to appreciate your responsibilities under law and regulation, and to clarify your own ESG views
- ✓ Recognize ESG risks and seek active opportunities
- ✓ Ensure your managers
  + have integrated ESG into their investment process
  + have the resources and active insights to manage the complexities of ESG issues.

DON'T

- ✗ Approach ESG merely as a box-ticking exercise
- ✗ Depend exclusively on backward-looking and limited ESG data
- ✗ Rush to make big changes: a prudent and thoughtful approach is best

SPEAKER BIOS

MICHAEL SHEREN
Senior Bank adviser, Bank of England Michael

Sheren joined the Bank of England as a Senior Advisor in July of 2013 after twenty eight years in the financial services industry where he specialized in the structuring, distribution and trading of commercial debt for major global financial institutions. Within the BoE Michael is based in the PRA where he provides guidance, advice and challenge around issues concerning financial markets, governance, supervision and policy. Prior to the BoE, Michael spent the first half of his career in New York City where he worked in leveraged finance, commercial real estate and distressed debt. In 1997 Michael moved to London where he was primarily focused on structuring and distributing debt for leveraged buy-outs. In addition, he was active in commercial real estate finance, shipping, distressed debt, structured products and the financing of SME's in the emerging markets. Michael holds master's degrees from Harvard, The London School of Economics and New York University where he studied finance, economics, philosophy and public policy.

He also holds a BA from the George Washington University in Political Science and History.

LUCY TUSA
Director

Lucy Tusa CFA joined Mercer in April 2007 and is a Director in the Investment Consulting department. She was awarded the CFA charter in 2006 and has been an Associate of the UK Society of Investment Professionals (ASIP) since 1986.

At Mercer, Lucy provides investment consultancy services to a range of pension fund,

foundation and endowment clients including the Environment Agency Pension Fund, the Crop Trust and the Joseph Rowntree Foundation. She advises clients on strategy setting, asset allocation, liability- management and manager selection. She is a member of Mercer's Global Dynamic Asset Allocation (DAA) Committee and chairs the European DAA Committee. Lucy is a contributor to the firm's intellectual capital, particularly in relation to equity markets and responsible investment. Lucy manages Mercer's responsible investment team in Europe. She speaks regularly at industry events.

Lucy has an MA (Hons) in History from Trinity College, Cambridge.

DAVID HUTCHINS, FIA
Portfolio Manager—Multi-Asset Solutions

David Hutchins is a Senior Vice President and Head of AB's Multi-Asset Solutions business in EMEA. He is responsible for the development and management of multi-asset portfolios for a range of clients. Hutchins joined the firm in 2008 after spending two years at UBS Investment Bank, where he was responsible for devising and delivering innovative capital markets risk-management solutions for pension schemes. Prior to that, he spent 13 years at Mercer, where he served as a European principal and scheme actuary, providing trustee and corporate advice to a range of UK pension funds and their sponsors. Hutchins holds a BSc in mathematics and a PGCE from the University of Bristol. He has chaired the Investment Management Association's Defined Contribution Committee and formerly chaired the defined contribution industry working group for the UK government's "defined ambition" project. Hutchins is a Fellow of the Institute and Faculty of Actuaries. Location: London