

HEALTH WEALTH CAREER

# RESPONSIBLE INVESTMENT / ENVIRONMENTAL, SOCIAL & GOVERNANCE (ESG) UPDATE

KENT COUNTY COUNCIL  
SUPERANNUATION COMMITTEE

February 2020



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# AGENDA

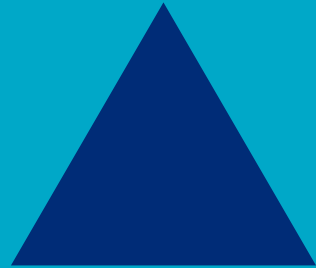
These slides are addressed to the Superannuation Committee (the “Committee”) of the Kent County Council Superannuation Fund (the “Fund”).

They provide refresher training on Responsible Investment and consider how the Committee might wish to develop their current “Statement of Responsible Ownership” and take account of Environmental, Social and Governance (ESG) considerations in the Fund’s investment arrangements.



- **What is ESG / Responsible Investment?**
  - **Why is it important?**
- **What has the Fund done to date?**
- **What next?**
  - Options for implementing Responsible Investment Considerations?
  - Options for developing the Fund’s policy.
- **Suggested Next Steps for discussion**

# WHAT IS RESPONSIBLE INVESTMENT AND WHY IS IT IMPORTANT



# WHAT RESPONSIBLE INVESTMENT IS NOT....

**RI ≠ only investing in  
“nice” companies**

**RI ≠ excluding  
companies or sectors  
which are “bad”**

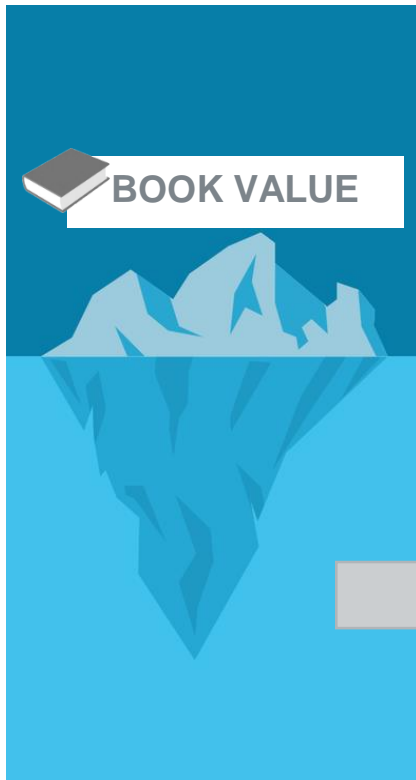
**RI ≠ accepting poor or  
volatile returns to make  
the world a better place**

**RI ≠ climate change  
alone**



# WHAT DOES ESG MEAN?

What is missing from current finance / investment processes?  
How might the future be different to the past?



# MORE DEFINITIONS

## RESPONSIBLE INVESTMENT (RI)

An investment approach that includes environmental, social and corporate governance (ESG) issues and broader systemic issues — for example, climate change and sustainable development — along with active ownership (stewardship).

### ESG

ESG refers to environmental, social, and corporate governance issues that investors are considering in the context of their investment portfolios.

### STEWARDSHIP

Voting and engagement with underlying companies and/or investment managers and engagement with policymakers for risk/return reasons.

### CLIMATE CHANGE

The risks and opportunities that stem from the transition to a low-carbon economy and the physical impacts of climate change.

## SUSTAINABILITY

In its simplest form, sustainability is “the ability to sustain.” The most widely accepted definition is “that which meets the needs of current generations without compromising the ability of future generations to meet their own needs.”

**RI ≠ SRI ≠ Ethical**

## SOCIALLY RESPONSIBLE INVESTMENT (SRI)

Intended to balance an investor’s values with performance considerations, and typically seeks to achieve a trade-off between social and financial objectives.

## ETHICAL INVESTING

An investment philosophy guided by moral values, ethical codes or religious beliefs and originally rooted in negative screening of investments in sensitive sectors.

## IMPACT INVESTING

Investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside a financial return.

← FINANCIAL →

← NON-FINANCIAL →

# WHAT DOES STEWARDSHIP MEAN?



Stewardship aims to promote the **long term success of companies** in such a way that the **ultimate providers** of capital also **prosper**. Effective stewardship **benefits** companies, investors and the economy as a whole.

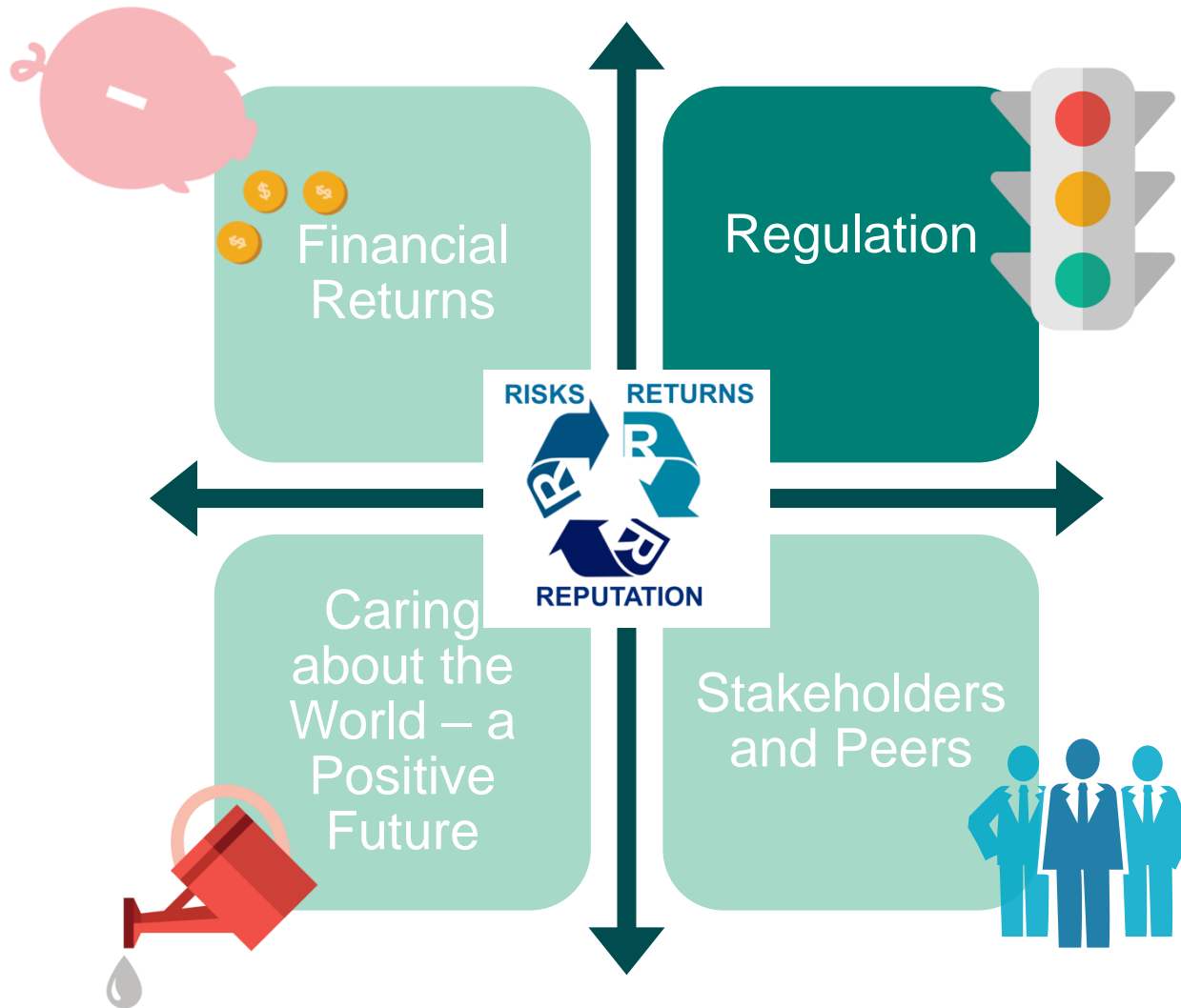
For investors, stewardship is **more than just voting**. Activities may include **monitoring and engaging with companies** on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. **Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.**

Source: FRC

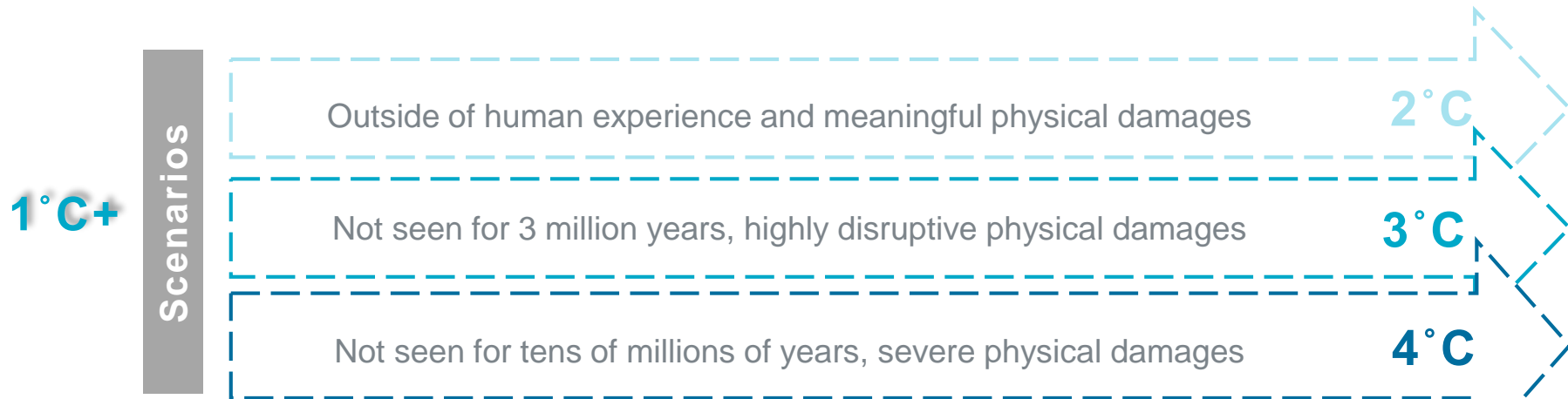
Good stewardship should help to both create and preserve value over the long-term for companies and markets



# WHY DOES ESG MATTER?



# WHY DOES CLIMATE RISK MATTER?



## THE INVESTOR ZONE

## THE CLIMATE ZONE



2019

2050

2100

**Risk Factors**



**Transition**

**SPENDING -  
TECHNOLOGY**

**POLICY**



**Physical Damages**

**AVAILABILITY OF  
NATURAL RESOURCES**

**IMPACT OF NATURAL  
CATASTROPHES**

# WHAT DOES ESG MATTER – GOVERNMENT CONSULTATION

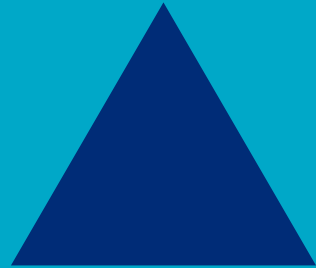
- The Scheme Advisory Board has prepared and is currently consulting on Responsible Investment guidance.
- As such, the draft guidance seeks to consolidate and clarify Responsible Investment duties and obligations within the LGPS - regardless of investment beliefs and views on the “Spectrum of Capital” shown to the right.
- The Guidance sets out:
  - Responsible Investment definitions;
  - Statutory duties and responsibilities;
  - Non-Statutory duties; and
  - Details of recent strengthening of RI requirements and reporting in trust based pensions.
- Mercer don’t believe the guidance is saying much new and are hopeful that part 2, which we understand will follow in due course, will expand on expectations and provide more concrete detail.

The spectrum of capital



\* This integration of sustainable practices across an organisation’s core business may also be termed Corporate Social Responsibility (CSR), although many organisations have a separate (often philanthropic) CSR ‘carve-out’ that is distinct from their approach to sustainability  
 Source: GB Social Impact Investment Taskforce, Asset Allocation Working Group (2014)

# WHAT HAS THE BEEN DONE TO DATE?



## WHAT HAS BEEN DONE TO DATE?

- The Committee has prepared a Statement of Responsible Ownership setting out its high level views on RI.
- The Fund's Investment Strategy Statement also includes a Corporate Governance statement commenting briefly on the Committee's RI views.
  - Are these still fit for purpose or do they require review?
- The Fund has become a signatory to the PRI, “Principles for Responsible Investment” the world's leading investor body for responsible investment.
- The Fund has signed up to ACCESS's voting policy providing managers with clarity on its expectations around exercising the voting rights attached to the Fund's investments
- The Committee receives quarterly manager updates from Mercer which include “ESG ratings” for its investment managers (where Mercer maintain coverage).
  - ESG rating information has been included in the manager selection advice provided to the Committee as part of the Absolute Return and MAC selection undertaken in recent years.
- The Fund invests a small portion of its equities with Impax, who Mercer regards as a market leader in environmental equity investment, in their Environmental Markets Fund.

# MERCER'S ESG RATING SCALE

ESG ratings are undertaken by Mercer's global manager research team. They are on a scale from 1 (highest) to 4 (lowest) and assess how well managers integrate ESG factors into investment processes.

ACTIVE

## ESG 1

Leader in the integration of ESG factors and active ownership into core processes.

## ESG 2

Less advanced than ESG1 investors but with moderate integration of ESG factors and active ownership.

## ESG 3

Limited progress with respect to ESG integration and active ownership, albeit with signs of potential improvement.

## ESG 4

Little or no integration of ESG factors or active ownership into core processes and no indication of future change.

Ratings for passive equity strategies differentiate how well firms undertake their stewardship activities such as voting, engagement, industry collaboration and reporting.

PASSIVE

## ESG p 1

Leaders in Voting & Engagement across ESG topics, with active ownership activities and ESG initiatives undertaken consistently at a global level

## ESG p 2

Strong approach to Voting & Engagement across ESG topics, and initiatives at a regional level, with progress made at a global level

## ESG p 3

Focus tends to be on Voting & Engagement on governance topics only, more regionally focused with less evidence of other internal ESG initiatives

## ESG p 4

Little or no initiatives taken on developing a Voting & Engagement capability, with little progress made on other ESG initiatives

# MANAGER ESG RATINGS FOR THE FUND

Manager	Mandate	Mercer Research Rating*	Mercer ESG Rating**	Rating Change Over Period?
Baillie Gifford	Active Global Equity	A	ESG2	-
Schroders	Active UK Equity	N	N	-
	Active Global Equity - QEP Value	A	ESG3	-
UBS	Passive UK, Global and EM Equities	A	ESGp3	-
M&G	Active Global Dividend Equity	N	N	-
Sarasin	Active Global Thematic Equity	B	ESG2	-
Impax	Global Environmental Markets Equity	A (T)	ESG1	-
Woodford	UK Equity Income	C (T)	ESG4	-
Goldman Sachs	Buy and Maintain Global Credit	N/A***	N/A***	-
Schroders	ISF Strategic Bond	B+	ESG3	-
Pyrford	Global Absolute Return	R	R	-
Ruffer	Global Long only Absolute Return	A	ESG2	-
HarbourVest	Private Equity	B+	ESG3	-
YFM	Private Equity	N	N	-
Partners Group	Infrastructure	B+	ESG2	-
DTZ	Segregated UK Direct	A	ESG2	-
Fidelity	UK Real Estate	A	ESG3	-
Kames	Active Value Property	B+	ESG3	-
M&G	UK Residential Property Fund	A(W)	ESG2	-
A	ESG1 or ESG2	✓		
B+	ESG3	-		
B or C	ESG4	*		

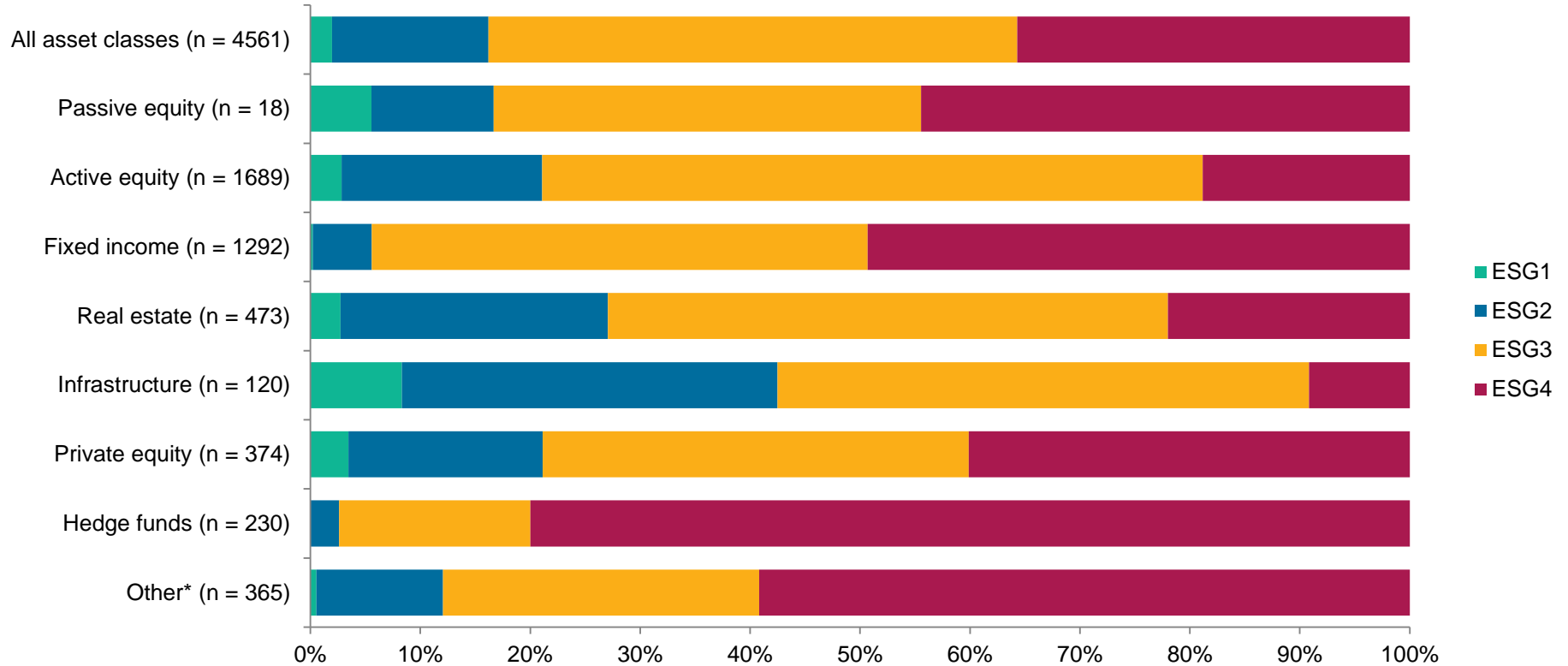
\*For an explanation of Mercer's ratings see the Appendix

\*\*ESG/ESGp = Environmental, Social and Governance.

\*\*\* Mercer do not maintain a rating for the specific GSAM strategy which the Fund invests in but we do rate their Global Buy and Maintain Credit capabilities "A".

# WHAT CAN BE DONE VARIES BY ASSET CLASS

Distribution of 4,500+ Mercer ESG ratings\*\*



Over **4,500** strategies rated currently – ratings began in **2008**



Less than **17%** achieve an **ESG1** or **ESG2**



**ESG** ratings for passive equity introduced in **2014**

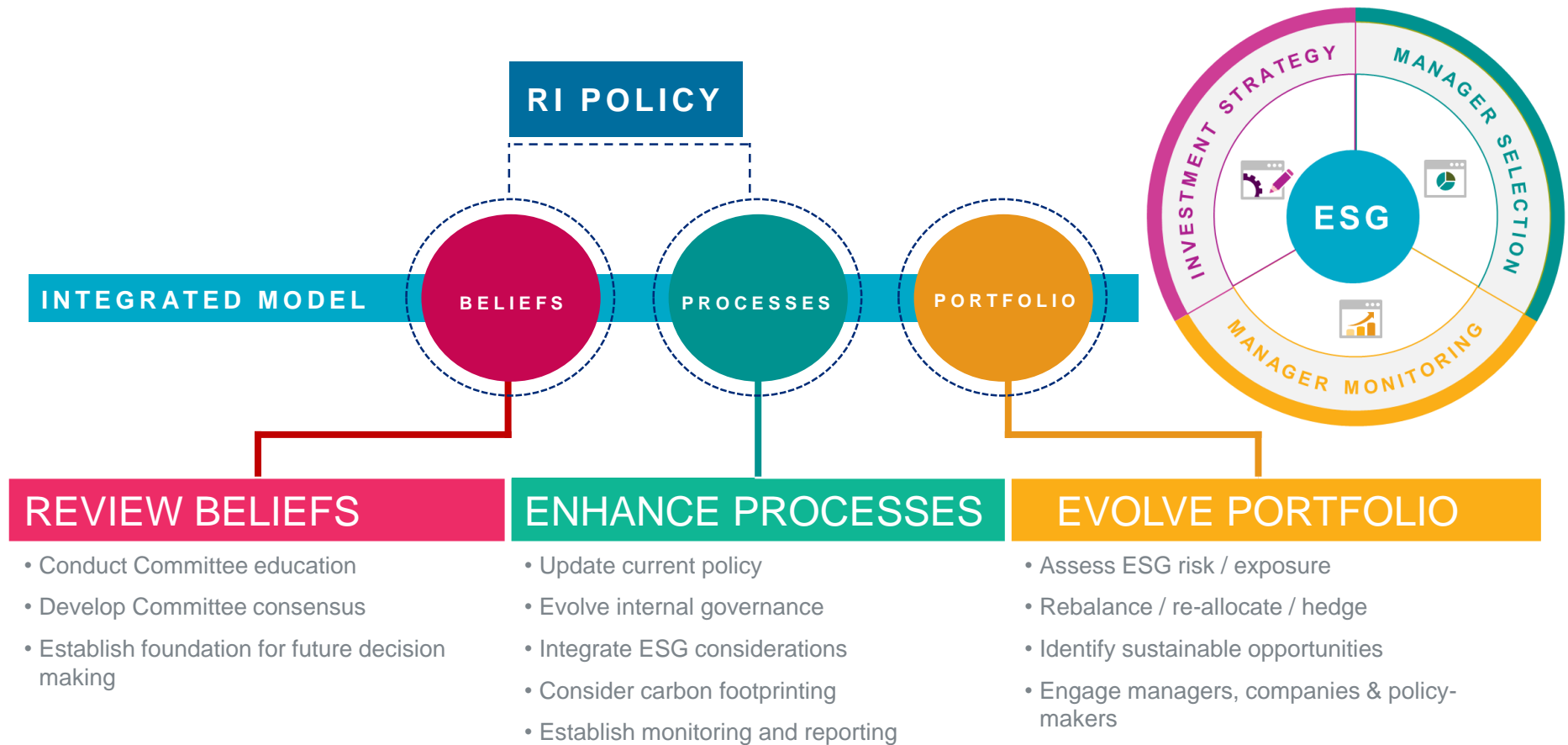




# WHAT NEXT?



# GOVERNANCE – BELIEFS TO PORTFOLIO



**Developments in the Fund's Responsible Investment policy don't need to happen overnight or be revolutionary**

# KEY STRATEGIES FOR IMPLEMENTATION OF RI CONSIDERATIONS



## Integration

Include ESG factors in investment analysis/decisions to assess materiality



**OBJECTIVE:**  
Financial objectives + risk management improvement

## Stewardship

Actively engage with companies failing to address ESG risks through voting and engagement



**OBJECTIVE:**  
Financial objectives + financial system improvement

## Thematic Investment

Allocate to sustain. themes/impact investments, e.g. renewable energy, water, social housing



**OBJECTIVE:**  
Financial objectives + positive social + environmental impact

## Exclusions

Screen out sectors or companies deemed irresponsible or misaligned with values



**OBJECTIVE:**  
Align with values/ reputation/risk management or longer term financial expectations

# OPTIONS FOR DEVELOPING THE FUND'S RESPONSIBLE OWNERSHIP POLICY AND POSITION



## RI Beliefs Survey

**Aim** - Clarify the Committee's views on RI.

**Why?** - Assist in updating the Responsible Ownership Statement and planning future work

## ESG Ratings Review

**Aim** – Understand how the Fund's managers compare to their asset class peers.  
**Why?** – Improve understanding. Set targets for future manager appointments (no lower than ESG3). Engage laggards and measure future progress.

## Carbon Footprint Analysis

**Aim** – Understand the carbon intensity of the Fund's equity portfolio.  
**Why?** – Improve understanding. Set targets for reducing it over time.

## Voting & Engagement review

**Aim** – Assess the level of engagement and voting managers are undertaking on the Fund's behalf.  
**Why?** – Allows Fund to engage with managers (ACCESS?) to do better.

## Stewardship review

**Aim** – Understand whether the Fund's managers have reported in line with the new 2020 Stewardship code and how well they comply.  
**Why?** – Allows Fund to engage with managers to improve.

## Climate change scenario stress testing

**Aim** – Understand how the Fund will perform in different climate change scenarios.  
**Why?** – Improve understanding. Incorporate into strategic decision making.

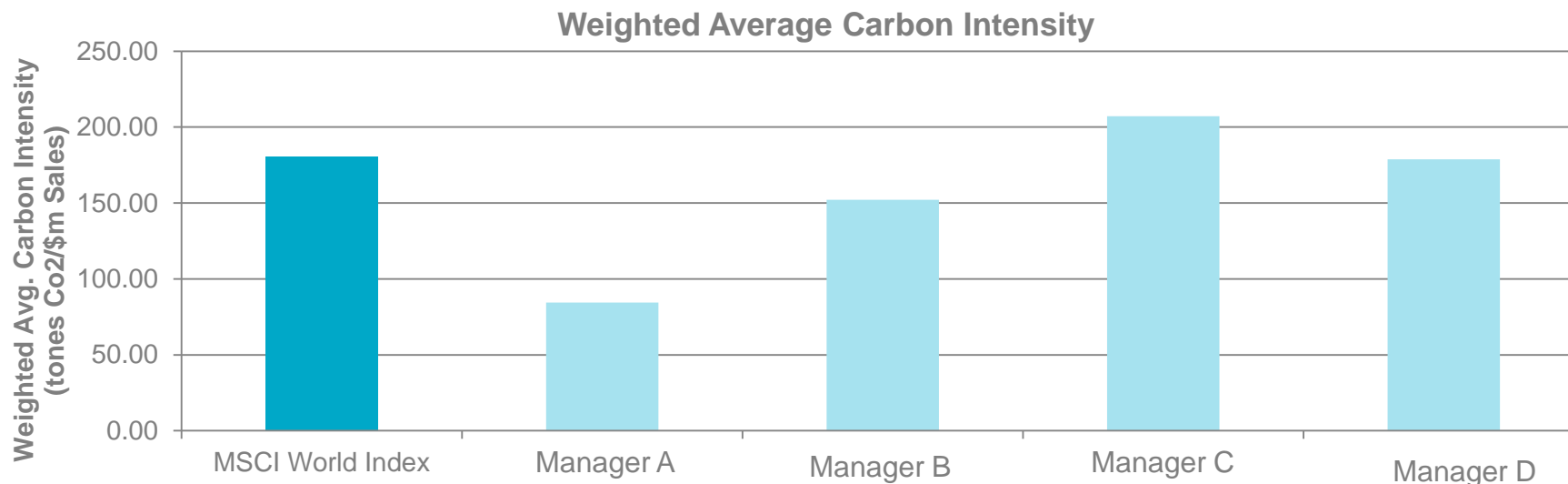
## Consider introducing thematic allocations

**Aim** – Better manage risks or capitalise on the potential returns from a move to a low carbon economy and broader sustainable opportunities.



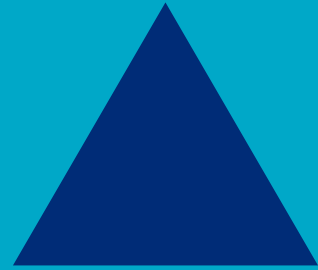
e.g. through the ACCESS arrangements UBS offer a "Climate Aware Global Equity Fund"

# CARBON FOOTPRINT ANALYSIS



- Relative to the MSCI World benchmark:
  - **Manager A** is 53% less carbon intensive
  - **Manager B** is 16% less carbon intensive
  - **Manager D** is 1% less carbon intensive
  - **Manager C** is 15% more carbon intensive. The carbon intensity is attributable to its overweight exposure to Utilities relative to the benchmark
- **Potential Actions**
  - Engage with higher intensity managers to understand whether they are aware of their carbon footprint and which companies are contributing to it. Do they have plans to see it reduce?
  - Consider appointing a manager with a low carbon approach to reduce the Fund's exposure to climate risk.

# SUGGESTED NEXT STEPS



# SUGGESTED NEXT STEPS

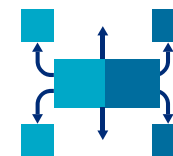


Agree if any action is required to update the Statement of Responsible Ownership

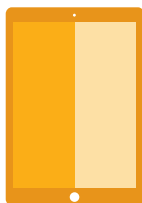
More training? RI belief's survey?



Update Corporate Governance statement in ISS (if applicable) and include ESG risk in risk section



If beliefs have evolved, consider how best to align investments with these

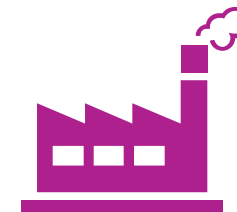


Monitor and assess what the managers are doing on the Committee's behalf

Develop a list of RI questions to use at manager review meetings



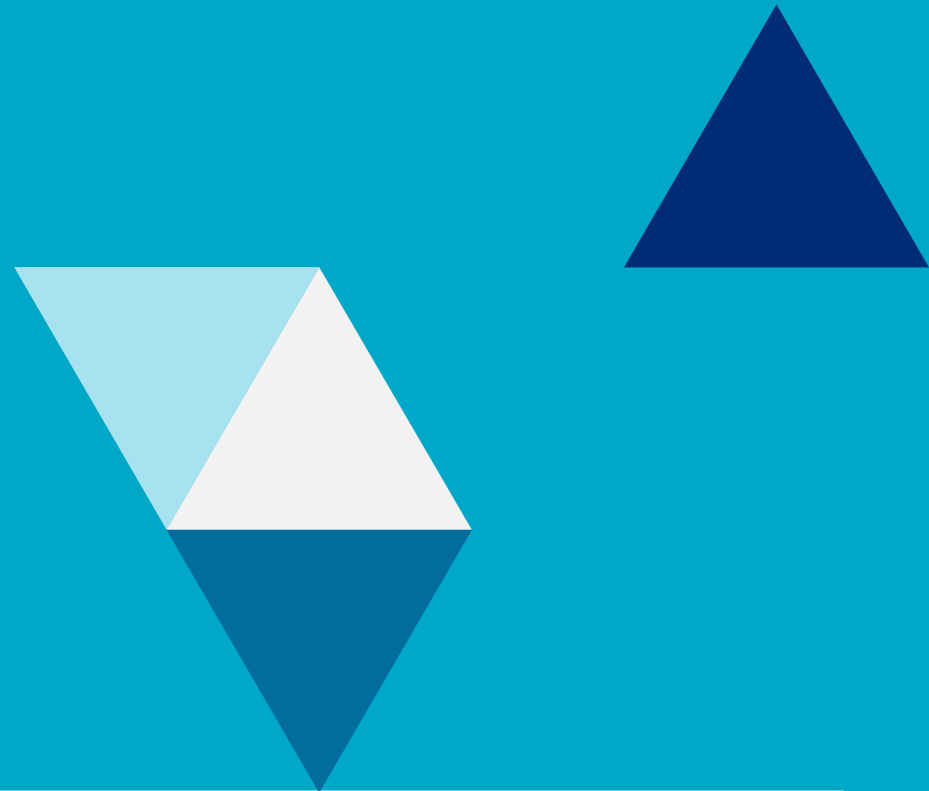
Consider whether carbon footprint analysis would be worthwhile



Consider exploring thematic opportunities and low carbon e.g. the UBS Climate Aware fund available through ACCESS

What else do ACCESS plan to offer?

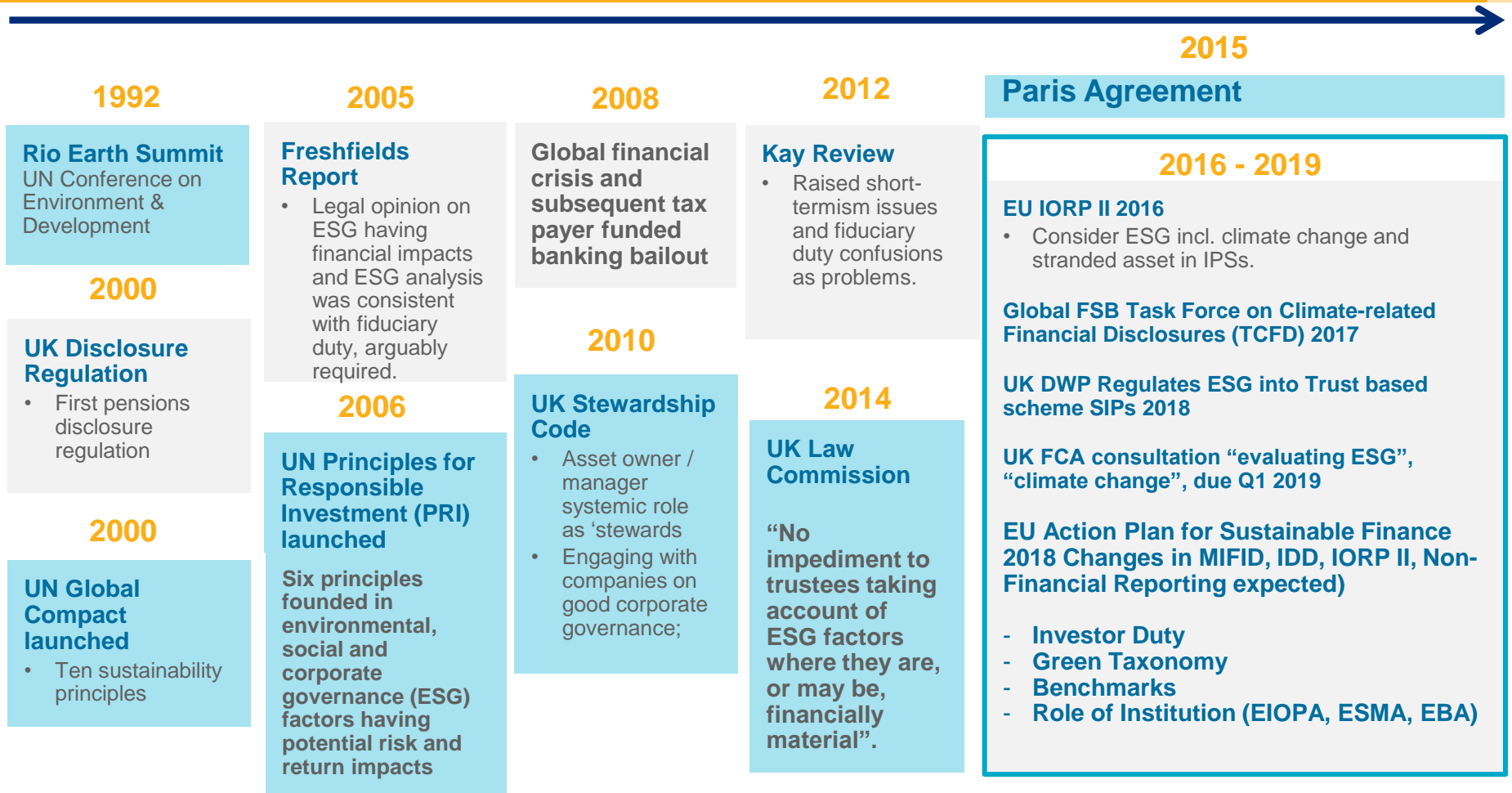
# APPENDIX





# THE INVESTMENT CASE – DUTY

INVESTMENT DECISION MAKERS WITH DISCRETIONARY POWERS HAVE A FIDUCIARY DUTY TO THEIR BENEFICIARIES, WITH INTERPRETATION OF THESE DUTIES EVOLVING OVER TIME



# MERCER'S ESG RATING CRITERIA

## ACTIVE (all asset classes)

### IDEA GENERATION

- ESG factors integrated into active fund positions as a source of value added.
- Identification of material ESG factors - skill of team members, data sourcing

### PORTFOLIO CONSTRUCTION

- Efforts to integrate ESG driven views into the portfolio's construction.

### IMPLEMENTATION

- Engagement and proxy voting activities (if applicable).
- Investment horizon align with ability to effectively implement ESG views?

### BUSINESS MANAGEMENT

- Firm-level support for ESG integration, engagement activities and transparency.



## PASSIVE (equities)

### VOTING & ENGAGEMENT

- Policy, process and prioritisation.
- Quality of engagements.

### RESOURCES & IMPLEMENTATION

- Data analysis to enhance active ownership.

### ESG INTEGRATION

- Skill set of resources.
- Effectiveness of engagement outcomes.

### FIRMWIDE COMMITMENT

- Collaborative initiatives and engagement with regulators and policymakers.

# APPLICATION & OPPORTUNITY BY ASSET CLASS

	Manager Progress on ESG Integration*	Availability of Sustainability Themed Strategies **
Public Equity (Active)	Medium/High	Low/Medium
Fixed Income	Low/Medium	Low
Real Estate	Medium/High	Low
Private Equity and Debt	Medium	Low/Medium
Infrastructure	High	Medium/High
Natural Resources***	Medium	Medium / High
Hedge Funds	Low	Low

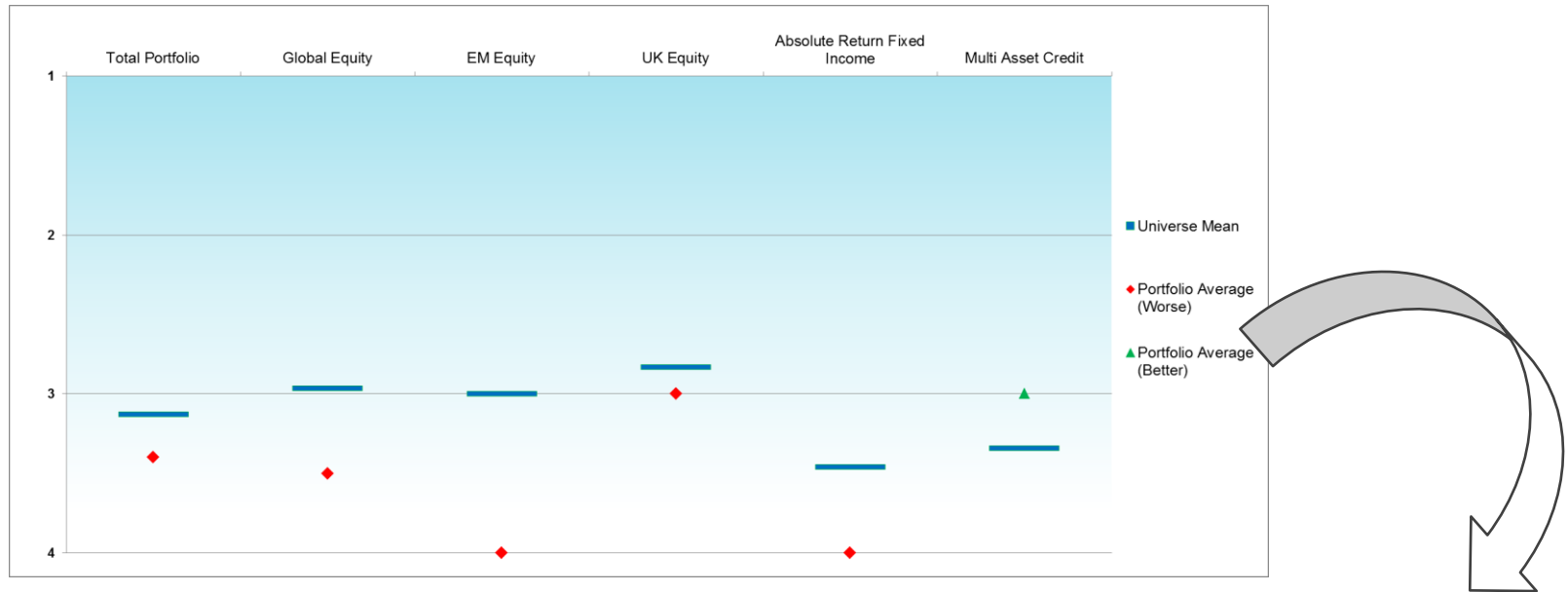
**Note:** Low: <5%; Low/Medium: 5-10%; Medium: 11-20%; Medium/High: 21-40%; High: >40% (As at April 2018),

\* Refers to the percent distribution of ESG1 and 2 rated strategies in GIMD, where available.

\*\* Refers to the percent distribution of sustainability themed strategies compared to mainstream by asset class – noting equities is a large universe so the low relative number is not actually a low absolute number.

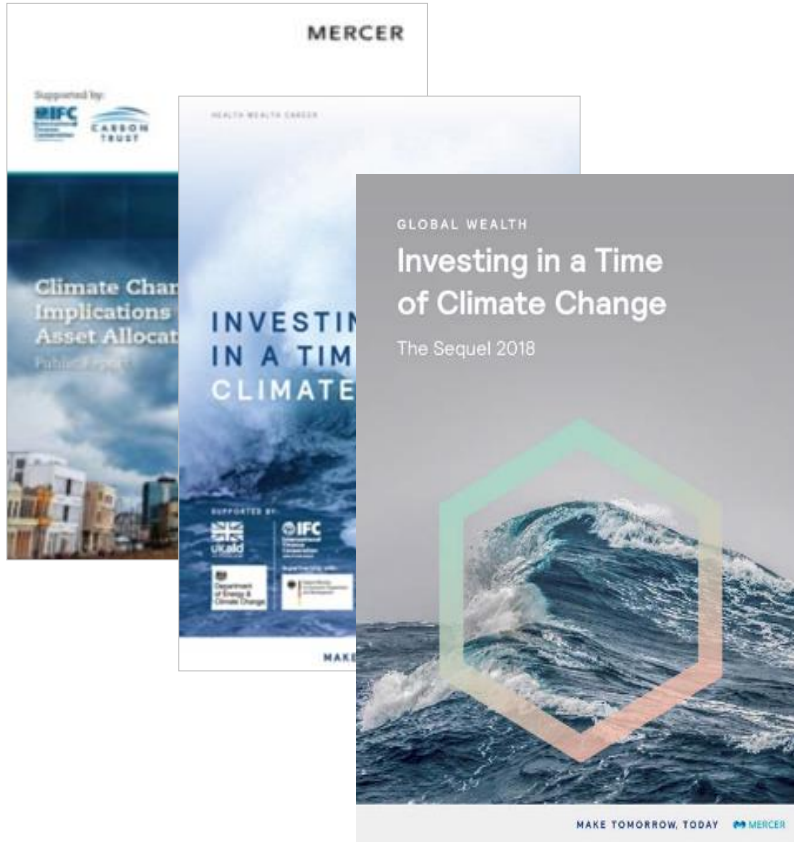
\*\*\*Conservative view - research updates in this asset class may result in a more favourable view than is currently held.

# PORTFOLIO ESG RATING REVIEW ANALYSIS - EXAMPLE

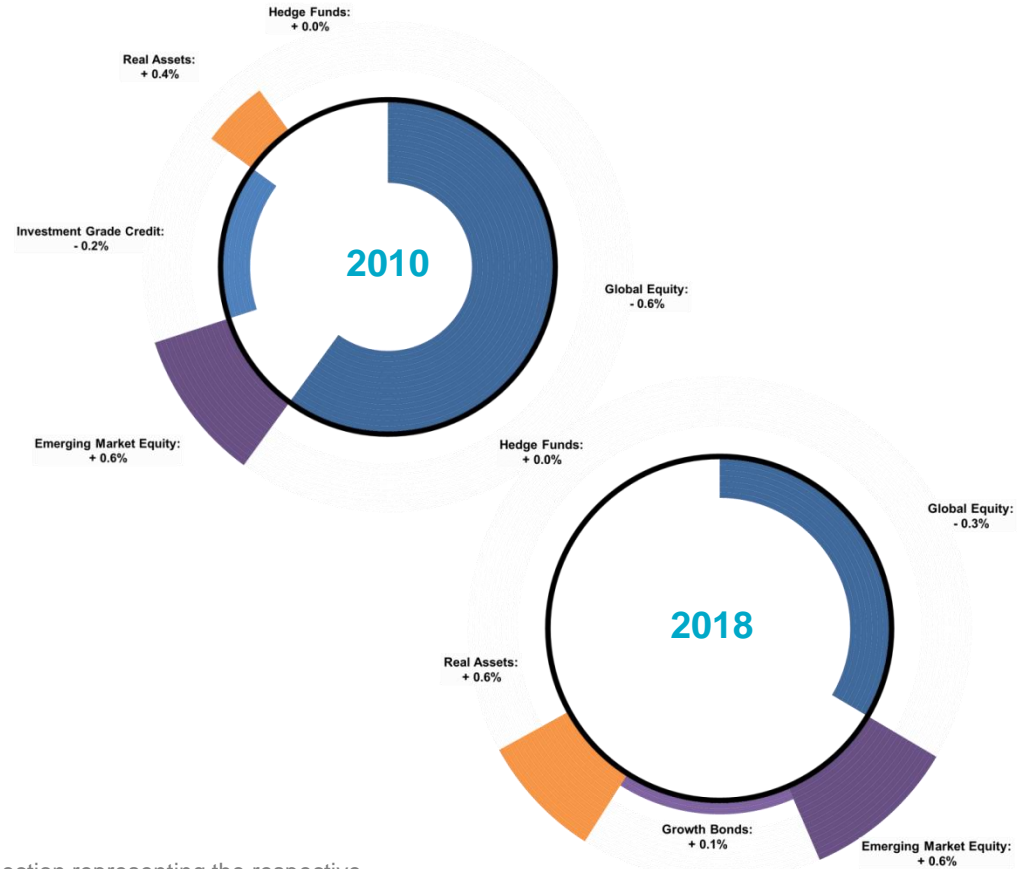


XYZ Pension Fund (Universe)	Underlying Managers		Asset Class and Universe Ratings Distribution Comparison Charts
Absolute Return	Manager 1	Good rating	
	Manager 2	Poor rating	

# CLIMATE SCENARIO MODELLING



## Annual Additional Return Impact – over 10 Years (2°C Scenario)



The black circle represents the total portfolio, with the width of each asset class section representing the respective percentage weighting. Asset class sections expected to experience a reduction in returns will move towards the circle centre and those expected to experience additional returns will move outwards from the circle.

# THEMATIC INVESTMENT OPPORTUNITIES



## RENEWABLE AND ALTERNATIVE ENERGY

Solar, wind, wave, biofuels, and geothermal technology



## ENERGY EFFICIENCY

Storage plus power network, industry, building, and transport efficiency

## WATER INFRASTRUCTURE AND TECHNOLOGIES

Irrigation, storage, treatment, drainage and flood protection



## POLLUTION CONTROL

Pollution control solutions and environmental testing



## WASTE MANAGEMENT AND TECHNOLOGIES

Recycling processing, hazardous and general waste management

## HEALTH AND SOCIAL SERVICES

Positive impacts for social development and poverty or aging population



## SUSTAINABLE CONSUMER GOODS

Meeting shifting consumer demands in sourcing and technology



## RESPONSIBLE FINANCE

Supporting role for real economy

**MAKE**  **MERCER**  
**TOMORROW,**  
**TODAY**

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