HYMANS ROBERTSON

investment perspectives

Summer 2015

Welcome to our summer edition of Investment Perspectives for 2015.

The debate around Responsible Investment, and in particular the impact of climate change and sustainable investment, has been on an upward trajectory. This is likely to reach something of a crescendo in December 2015 when the UN and world governments meet in Paris at the COP21 conference with the aim of agreeing a new global deal on limiting global warming.

With the whole area taking on a new level of significance, we include two key articles in this quarter's publication:

- First, a piece by Clare Gardner, our Head of Corporate Social Responsibility, providing an holistic view of Responsible Investment; and
- Secondly, a piece by Simon Jones looking more specifically at the implications for investors of climate change and the transition to low-carbon economies.

The third article in this quarter's publication provides a different perspective on equity investing. In a joint paper, Alistair McKissack, Head of Equity Research, and I set out our beliefs for investing in listed equities, and provide an example of how this can be applied in building equity portfolios in practice.

If you wish to find our more on any of these topics, please contact any of the authors or your usual contact.

Andy Green
Chief Investment Officer

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Responsible Investment

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"Responsible investment is about managing risks and identifying opportunities."

Over the past six months the debate on responsible investment has been heating up, in large part due to the growing movement against climate change and the associated fossil fuel divestment campaign.

In the UK, we have seen an increasing number of asset owners announce plans to divest from fossil fuels - even the Vatican recently announced it is considering divestment. However, decisions on these matters are complex, and each asset owner's rationale is different.

What is clear is that the subject is no longer based on just ethics and values. The way that asset owners act as responsible investors is changing.

How does it work?

Responsible investment is about managing risks and identifying opportunities. Our activity in support of this falls into two key areas:

- Sustainable investment – This involves considering the financial impact of environmental, social and governance (ESG) factors on investments.
- Stewardship and governance – This concerns investors acting as responsible and active owners, through considered voting of shares, and engaging with company management when required.

What are trustees' fiduciary duties?

Trustees have a fiduciary duty to act in the best interests of their members, as well as acting prudently, responsibly and honestly. Within the context of these duties, which include controlling risks, they must aim to achieve the best realistic return over the long term.

In our view, acting as responsible investors does not need to conflict with this aim. However, it has been perceived this way in the past due to associations with negative screening and ethical views.

Ethical investment differs from responsible investment in that it considers moral reasons for including or excluding specific investments (i.e. ethical investment is values driven not financially driven). We view responsible investment as a holistic, financially driven approach to investment aimed at managing risks and identifying opportunities.

In its report last year, the Law Commission also distinguished between these perspectives, referring to financial and non-financial (values driven or ethical) factors. It confirmed that:

- trustees should take environmental, social and governance (ESG) considerations into account where they believe they are financially material to the performance of an investment; and
- ethical views can be aligned with fiduciary duty, as long as trustees can prove that scheme members generally share the concern and that there is no additional financial risk.

Who determines what is financially material?

The decision on which factors are financially material is for each group of trustees to decide. It is a difficult area and many trustees may be of the opinion that they are not best placed to make that judgement. In this case, they can ask their fund managers to take such decisions.

However, there are scenarios when trustees may feel compelled to take a view on financially material factors themselves. For example:

1. When assets are invested passively and the trustees do not wish to invest in a specific sector for financially driven reasons; or
2. When the trustees wish to take a longer time horizon than the fund manager (and market) would take.

These scenarios have been cited by those trustees wishing to divest from fossil fuels.

Responsible investing – what steps should trustees take?

Figure 1 below sets out a framework for trustees to develop and implement their approach to responsible investing. We consider each element in turn.

Figure 1 Responsible investment framework

Form an informed view

The first step as a responsible investor is to ensure that all trustees receive the necessary training and education so they are sufficiently well informed to develop a policy. The subject matter is complex and it's important that trustees are in a position to be able to develop an appropriate response for their scheme.

Develop an appropriate policy

Trustees need to weigh up the benefits of adopting a particular policy alongside any potential barriers to implementation, including additional costs, which could affect the outcome.

Implement the policy

Investment managers are usually well placed to provide input on responsible investment strategy and implement responsible investment policies on behalf of trustees. Trustees should ensure that managers are able to demonstrate that they:

- have adequate resources in place;
- actively research, monitor and review ESG factors;
- are engaging with companies and actively voting shares; and
- report on ESG and stewardship activities to clients.

Engaging with companies can improve business practices – as owners of companies, trustees and their investment managers have a responsibility to hold the management of companies in which they invest to account through the voting of shares and, if appropriate, direct engagement.

Investment managers should comply with the Financial Reporting Council's (FRC's) Stewardship Code; this sets out stewardship guidelines for investors, which we believe represent good practice for all investment managers. We believe managers should be signatories and comply with the FRC's Code (including publishing a Stewardship Disclosure Framework) to ensure greater accountability and engagement.

Communicate the policy

It is important that trustees communicate their approach to responsible investment. As a minimum, this should be communicated as part of the Statement of Investment Principles to ensure members can access, understand and provide their feedback on the policy adopted.

Monitoring the managers

Being a responsible investor does not just mean leaving the investment managers to it. It means actively engaging with the investment managers on relevant issues to ensure they are meeting trustees' requirements.

Reporting is a key part of this and trustees should request and review examples of responsible investment practices on a regular basis.

Want to learn more about responsible investment?

If you would like to learn more, please contact our Responsible Investment Team by emailing responsibleinvestment@hymans.co.uk

Implications for investors of the transition to low-carbon economies

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"The current debate around fossil fuels is here to stay and its importance politically, economically and for investors is growing."

The current debate around fossil fuels is here to stay and its importance politically, economically and for investors is growing. Investors need to start to think about the implications on companies in which they invest and determine the extent to which they wish to take any action.

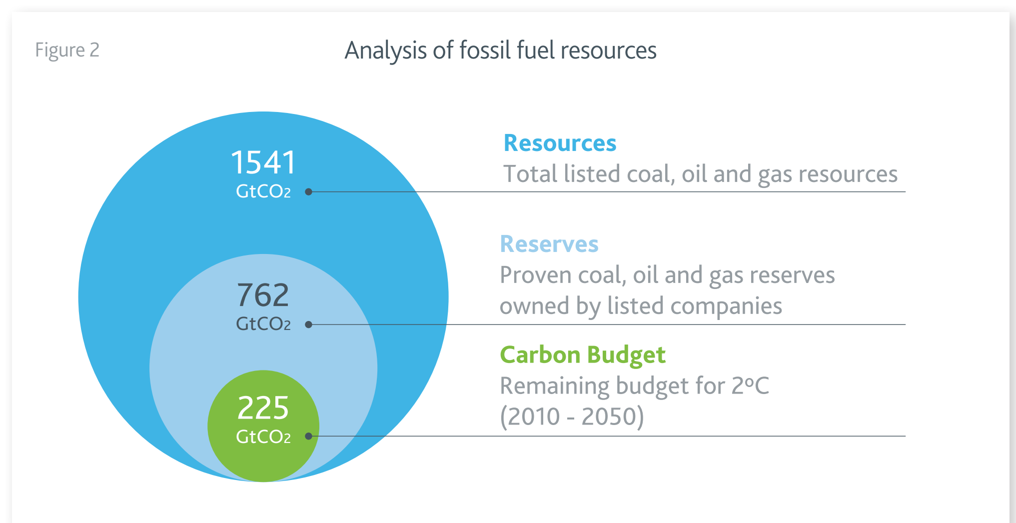
The Issue: Dealing with carbon risk and stranded assets

Science suggests that build-up of CO2 in the atmosphere is causing our planet to warm and, if nothing is done, there is a material risk that we will reach a tipping point where global climate change becomes irreversible. The potential long-term consequences were addressed by the Foreign and Commonwealth Office (FCO) in their recent report, Climate Change: A Risk Assessment.

It is generally agreed that by limiting carbon emissions and hence the concentration of CO2 in the atmosphere, the risk of climate change can be reduced. However, this implies the existence of a limit on how much CO2 can be released: a carbon budget. Recognising that the burning of fossil fuels contributes to the release of CO2 suggests that if we want to remain inside this budget, then not all fossil fuels can be burned.

Very simply, a certain proportion of our known coal, gas and oil reserves may have to stay in the ground. To the extent that these assets carry a value on the books of companies that will in future look to exploit them, these assets are stranded, i.e. they cannot be monetised. The potential extent of this is illustrated in Figure 2 below.

Figure 2 Analysis of fossil fuel resources



Source: Carbon Tracker Initiative (Gt = Gigaton = 1 billion tons)

The drivers for change

While many like to debate the science, for investors the focus should be on the implied investment risks. Many pension schemes still have investment horizons measured in decades. It is over the coming decades that the impact of these risks is likely to emerge.

The UK has a statutory requirement to cut carbon emissions by at least 80% of 1990 levels by 2050. This legal requirement implies a process of transition towards a lower carbon economy. However, managing climate change is a global challenge and will require change around the world. Such change, when it comes, is likely to be driven by three forces:

- Political leadership. Dealing with climate change requires the concerted effort of global governments. The climate change summit in Paris in December 2015 offers the opportunity for governments to secure a legally binding agreement on emission reductions.
- Social pressure. Having been stimulated by the 2012 report on Unburnable Carbon by Carbon Tracker Initiative, the divestment campaign has been successful in both highlighting the issue and prompting action from some prominent investors, including the Rockefeller Foundation and the Norwegian Government Pension Fund, both of which have committed to reduce their exposure to fossil fuel companies.
- Market/technological developments. As the cost of providing energy from renewable sources such as solar power reduces, storage technology improves and the cost of extracting fossil fuels in both energy and cost terms increases, so investors and consumers will gravitate towards more sustainable sources of energy and return alike.

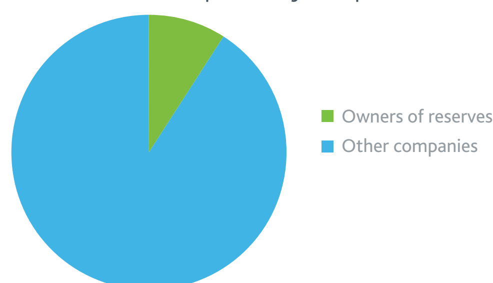
What should investors be doing?

Against this backdrop, there is a growing acceptance that carbon risk requires, at the very least, to be acknowledged by investors within the governance of their investment arrangements, even if these arrangements remain unchanged. We believe that in developing a framework for dealing with carbon risk, there are three steps that investors can take:

1. What could be affected by carbon risk? It is impossible to escape the fact that our global economy is currently built around our ability to use fossil fuels. Every investment will have some level of dependence on fossil fuels and hence some exposure to a future transition to a low carbon economy. It is the extent of this dependence and the level of preparedness for change that investors need to understand.

   Carbon footprinting, the identification and ongoing monitoring of the extent of carbon exposure within a portfolio, offers a sensible first step for investors in building their understanding of carbon risk. Chart 1 below illustrates a simple breakdown of a world market cap equity index (MSCI ACWI) by fossil fuel ownership, with the owners of reserves being the primary targets of the divestment campaign (which is considered in more detail below).

Chart 1 Carbon exposure by companies



Source: MSCI

However, to view carbon risk exposure by reference to the ownership of reserves is too simplistic. A more comprehensive approach should consider not just ownership but the emissions from all the activities of an organisation and a company's strategy for managing and reducing future emissions.

2. How carbon risk may affect investment returns. Having understood the extent of their carbon risk exposure, investors need to consider the impact on future investment returns of bearing this risk. Investments with a higher carbon footprint may be more susceptible to a loss of future returns, for example, through assets being stranded (and hence unexploitable) in the case of fossil fuel companies, or through a "carbon tax" for heavy users of fossil fuels such as electricity-generating utilities. The impact can be explored at both an asset specific and an asset class level in developing a policy.

   Investors must also consider the risks associated with low carbon alternatives. Such risks include changes in government policy, such as a reduced subsidy for renewable energy which could reduce returns to investors. In addition, there remains the possibility that change does not occur and that there is no impact, at least to investors, from carbon risk.

3. What actions can be taken to mitigate carbon risk. Having identified both the contributors to risk and the potential impact on returns arising from these assets, investors are typically faced with one of three possible courses of action, noting that these actions are not mutually exclusive:

   - **Divest**: There has been a high profile and somewhat successful campaign seeking to encourage investors, particularly educational bodies, foundations and public sector entities to adopt a programme of asset sales, focused on removing exposure to "higher risk" fossil fuel companies. However, while divestment reduces direct carbon risk, it also removes the ability of investors to actively engage with companies and therefore influence behaviour. By transferring ownership from those with a long-term outlook to those who have a shorter-term outlook and therefore less desire to effect change, it is questionable whether divestment will ultimately achieve its goal.
   - **Tilt**: Investors can manage their carbon risk by introducing either positive or negative biases into portfolios. Low carbon indices which either exclude or re-weight exposure to carbon-intensive companies while limiting short-term risk against a broader equity benchmark have begun to gain traction and offer a solution for passive investors. Investors could also consider tilting portfolios positively so as to introduce a bias toward companies and technologies that are likely to benefit from a migration to a low carbon economy.
   - **Engage:** This approach recognises that equity ownership offers investors the ability to influence the behaviour of the companies in which they invest. Engagement offers the ability for investors to (a) better understand the development of business plans, the extent of a firm's planning for a low carbon future and their risk management (through, for example, scenario testing) and (b) apply pressure on management to increase their efforts in these areas where appropriate. Indeed, whilst fossil fuel companies may contribute to carbon risk, many also have the potential to be a material part of the solution in a transition to a low carbon economy.

All three approaches are legitimate responses to dealing with carbon risk, but all should be addressed by investors to ensure that they are fully aware of the extent of the risks that they face and the benefits and costs that will be conveyed by the actions they take. Investors should also be aware that each of these approaches is likely to result in increases in at least one of the areas of transaction costs, portfolio management costs, or governance required for company engagement.

The bigger picture for pension funds

Climate change and carbon risk is one prominent example of how a risk in the natural environment can impact on institutional investors. Most of the debate is, perhaps sensibly, focused on the asset side of the balance sheet and, while much of the activity to date has focused on equity investment, other asset classes such as debt, real estate and infrastructure also have a carbon footprint and should not be ignored. Pension scheme trustees should also be aware of the risk that climate change could have on liabilities, through changes to mortality and morbidity rates and potentially higher inflation.

Investment Beliefs: Listed Equities

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The framework for our investment advice combines our long term beliefs with current investment themes. Our investment beliefs are defined to be relatively high-level, but their interpretation forms the cornerstone of our advice on strategy, portfolio design and implementation.

In applying these beliefs to investing in listed equity markets, we believe that it is possible to enhance the risk and return characteristics (i.e. the risk-adjusted return) of a portfolio compared to passively investing in a global market cap index, through a combination of selected exposures and factor tilts.

We set out below the investment beliefs that underpin our advice to pension schemes regarding the implementation of the listed equity allocation.

Investment Beliefs: Listed Equity

1. Passively managed market cap based investment has a balancing role to play in most pension schemes' equity allocations, bringing liquidity, transparency and reducing average fee levels;
2. Market cap weighted indices have their drawbacks; adding carefully selected systematic, factor tilted equity strategies can improve risk-adjusted returns, benefiting from disciplined rebalancing (the "rebalancing premium");
   - Exposure to "valuation factors" can improve risk adjusted returns over time. Even if outweighed by technical factors in the short-term, diversified exposure to valuation based factor tilts can add excess return per unit of risk over a reasonable timeframe;
   - Exposure to the "low volatility factor" can reduce absolute equity volatility and improve risk-adjusted returns. Strategies can be implemented which manage downside risk while achieving market returns over time;
   - Exposure to the "small size factor" can improve risk-adjusted returns. A diversified tilt towards medium and smaller sized businesses is generally rewarded over time;
   - Carefully selected exposure to actively managed strategies with a bias to "growth factors" can improve the balance of overall equity exposure and improve risk adjusted returns;
3. Exposure to emerging markets provides diversification and the opportunity for higher returns due to the higher risk premium typically available for investing in these markets;
4. With sufficient research and governance, active equity management can be incorporated to add value relative to market cap weighted indices; overall active equity exposure should be focused predominantly on stock-specific risk;
5. Currency exposure associated with investing in equities can add volatility. While it can be desirable to retain exposure to some currencies, hedging a proportion of non-domestic currency exposure can reduce the volatility of equity investing.

We believe that a combination of exposures that incorporate some or all of these investment beliefs enhances the risk adjusted return of investing in equities, net of fees, relative to passive investment in a global market cap index.

We note that these beliefs do not include references to 'ESG' or 'Responsible Investment' factors. These apply to all investments, and do not apply to equities alone.

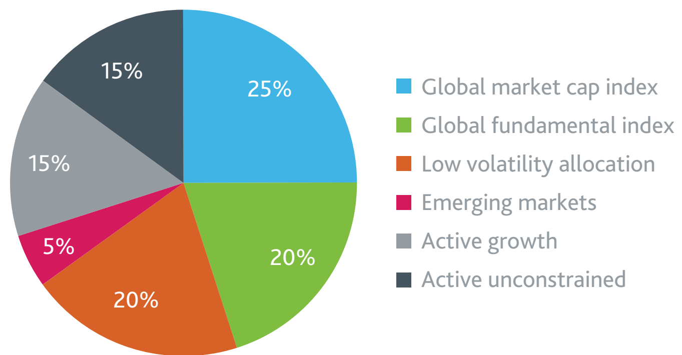
Putting the beliefs into practice

Example portfolio

Chart 2 below illustrates how these beliefs could be incorporated in an equity allocation to improve the risk and return characteristics, when compared against a notional 100% passive global market cap equity allocation. This is just one possible example; we are well aware that governance resources vary and simpler or more complex structures can also deliver useful gains. Hopefully, this type of analysis can help trustees and other investors look beyond the well worn active versus passive management debate.

Chart 2

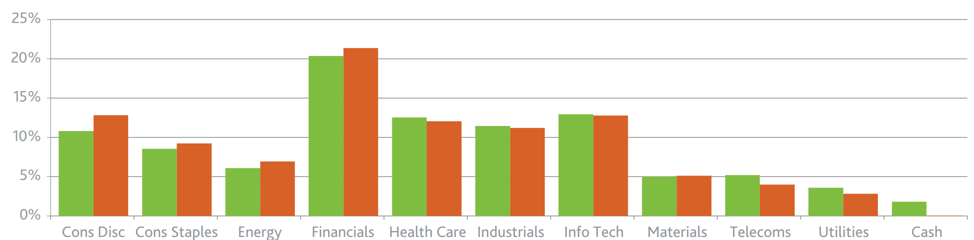
Example equity allocation



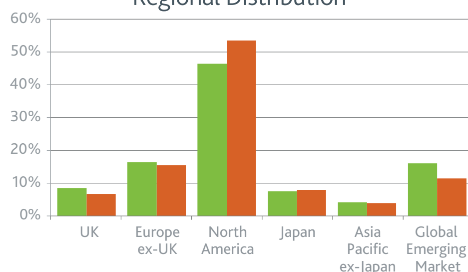
For simplicity, the example portfolio assumes passive implementation for all elements except the active growth and active unconstrained allocations. In practice, we typically advise that active management is also considered for the emerging markets and low volatility allocations. The example portfolio is unhedged, but hedging a proportion of non-domestic currency exposure could further reduce volatility.

Chart 3

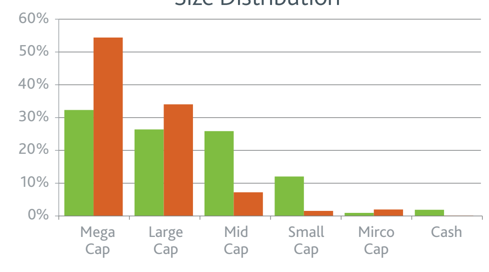
Sector Distribution



Regional Distribution



Size Distribution



Example allocation MSCI ACWI

Chart 3 compares the example allocation with a global market cap index. It illustrates that the example portfolio is slightly more broadly balanced in terms of sector and regional allocations, with tilt away from North America and towards Emerging Markets. However, the tilt to mid cap and small cap stocks is more material in the size distribution, reducing the market cap's bias to the very largest stocks.

Table 1: Historical risk / return outcome

10 years to June 2015	Absolute Return % p.a.	Relative Return % p.a.	Absolute Volatility %	Tracking Error	Info Ratio	Sharpe Ratio
MSCI ACWI (a)	8.3	-	14.3	0.0	-	0.42
Example allocation (b)	9.6	1.3	13.2	2.3	0.57	0.56
Improvement on market cap (b) / (a)	+16%		- 8%			+32%

Compared to a global passive market cap portfolio, over the last 10 years our example allocation portfolio would have delivered an improvement in returns of about 16% along with around an 8% reduction in absolute volatility, with tracking error only slightly above 2%. As a result this leads to a substantial improvement in the absolute risk adjusted return (Sharpe Ratio) for the example allocation portfolio, and an impressive relative risk adjusted return (Information Ratio).

Figures shown use actual past performance data from representative strategies and are net of estimated management fees.

To put this into context, an improvement in annual equity return from the 8.3% delivered by the 100% cap weighted allocation to the 9.6% delivered by the example allocation would equate to a £28m enhancement to the value of a starting £100m equity portfolio over the 10 year sample period.

We acknowledge that over shorter time periods, the persistence of the premiums earned by the selected factors and the choice of the active managers for the growth and the unconstrained allocations could materially affect the results. However, with these caveats in mind and over periods of five years or longer, we believe the return profile shown in Table 1 above demonstrates the scope for significant improvement in absolute risk adjusted returns, which is ultimately what is required by pension funds.

We also recognise that implementation solutions need to reflect practical issues such as governance and materiality. In particular, the governance burden and cost associated with implementing and monitoring a number of strategies and managers will influence the extent to which it is relevant or feasible to capture the equity beliefs. Nonetheless, we believe that at least some elements of this approach are applicable to all equity portfolio structures in the quest to improve their risk and return characteristics.

Market returns to 30 June 2015

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corprate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

	Yield % p.a.		Returns to 31 June 2015* (sterling, % p.a.)		
	31 March	30 June	1 year	3 years	5 years
EQUITIES					
Global	2.34	2.45	10.2	13.6	11.4
UK	3.33	3.46	2.6	11.0	10.7
Developed markets ex UK	2.2	2.3	11.5	15.1	12.6
Emerging markets	2.8	2.8	6.7	5.0	3.3
BONDS					
Conventional gilts	2.0	2.4	8.9	2.8	5.4
Index-linked gilts	-0.9	-0.8	14.2	6.7	8.6
Sterling corporate bonds	3.25	3.9	6.2	7.4	7.3
High yield (US) *	6.6	6.9	-0.5	6.8	8.4
Emerging market debt	6.7	7.2	-9.1	-4.0	-0.1
UK PROPERTY		-	5.5	12.1	10.2
HEDGE FUNDS **		-	1.8	7.4	6.3
COMMODITIES		-	-17.1	-8.3	-1.6

* Return in $ ** Property & Hedge Funds to 29 May

If you would like to find out more about any of the topics discussed in this publication please contact your usual Hymans Robertson consultant or:

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