HYMANS ROBERTSON

Sixty second summary

Understanding ESG: E for Externality

It has long been known that, whilst generating wealth for investors, economic activity also creates externalities or impacts. These externalities have associated costs that are not wholly borne by the entity that creates them.

Policy change is increasingly likely to require companies to reflect the cost of these externalities in their business models. This creates both a risk to future returns for investors, but also offers the potential for innovation and opportunities. In the midst of this change, is it acceptable for investors to simply do nothing?

Shifting responsibilities

The effects of our day-to-day lives, both at an individual and at a corporate level, have an impact on our societies and our environment. We all create externalities as part of our daily choices and activities, for example, the disposable cup from your morning coffee; the plastic bag from your weekly supermarket shop and the exhaust fumes from your car. However the costs associated with these externalities are often not borne by those that create them. Rather, these costs are borne by current and future taxpayers whilst the often unseen cost to society and the environment is simply tolerated.

We are beginning to see a change in view as to who should be taking responsibility for the social and environmental costs created by economic activity. Individuals, investors and policy makers are increasingly questioning how much longer the taxpayer can (and should) continue to fund any negative externalities caused by the corporate sector.

In recent weeks we have seen the EU legislate to ban single use plastics, perhaps in response to the issue being in the media spotlight. We have also seen policy measures to phase out the internal combustion engine and plastic bag usage. Even the Queen has banned plastic straws and bottles from the Royal estates! But, the promise of action to address the risks of climate change still looms large.

In the face of growing policy uncertainty, companies can expect to be challenged to properly account for the externalities they create and those that don't adapt their strategies to take account of these potential costs are more susceptible to risk.

Increasing attention placed on environmental externalities

Pollution and climate change are among the long list of environmental by-products from our current lifestyles and consumer choices. These environmental externalities or costs fall within the "E" of ESG and the most visible of these externalities is climate risk. Earlier this year, ClientEarth wrote to the trustees of 14 pension schemes highlighting the risk of litigation for failing to protect their investments against climate risk. In effect, pension schemes have been placed "on notice" for not building climate risk considerations into the investment decision making.

One common response is, "it's not our problem" as many perceive it to be the job of the investment manager or the corporate to deal with how investments interact with the environment, and to manage the associated risks. In many cases, such a response may be reasonable: ultimately it is the pension fund (or the Pool) that employs the investment manager. However, as part of their governance role, committees are responsible for ensuring that the investment manager (or Pool) is taking account of all the risks and costs associated with an investment. As pooling progresses, committees will be increasingly able to focus on this governance role.

The pension scheme value chain

The relationship between investment decision making and externalities is not widely understood. Yet, as policy change forces action, pension fund committees will need to consider not just the major externalities associated with long term investments, but also the impact that those externalities could have on the success of the pension scheme.

For many pension schemes, the value chain (illustrated below) begins with the beneficiary and ends with the underlying asset. Pension schemes are typically focused on financial transactions - the buying and selling of financial assets – and there is limited, if any, concern about what sits beyond the financial return to the fund.

Pension funds often overlook the fact that the assets in which they invest – equities, bonds, property - represent a claim on income derived from the provision of goods and services from one party to another. The sustainability of these income streams is ultimately dependent on both a stable social system and a well-functioning natural environment. Any damage caused by externalities on our society or the environment places the long-term sustainability of these income streams at risk.

Long-term asset owners, such as LGPS funds, have a vested interest in corporates generating sustainable returns. They have a role to play in both understanding the risks to their return and, either directly or through their delegates, in challenging the companies in which they invest to better understand the externalities that lie beyond the asset returns earned.

Responsible investment is about understanding risks and opportunity

Policy makers are becoming increasingly aware of, and are beginning to take action to deal with, a broader range of environmental risks. This has meant that long-term asset owners are being increasingly placed in the spotlight as institutions that have a role to play.

Pension committees are in important participant in this value chain. Whilst their ultimate goal is to ensure their beneficiaries receive their expected retirement income, in pursuit of this goal they make numerous decisions about which assets to hold, which investment managers should invest these assets and how long assets should be held for. What is sometimes forgotten, or perhaps simply hidden within regular performance figures and risk statements, is an understanding of the impact arising from the investments made.

It is important to recognise that some investments can have a measurable benefit to society or the environment, typically those badged as “impact investments”. However committees need a means of measuring that impact. Whether externalities are positive or negative, committees need to remember that the value chain does not necessarily end with the performance figure shown in a quarterly report or the additional level of income paid to an account each month. There are other aspects of their investments which are measureable and, where appropriate, should be built into investment monitoring and decision making.

Education and information gathering are likely to be the first steps that many pension committees need to take to equip themselves to deal with these challenges. For example, as part of information gathering, have you considered how environmental externalities may influence your investments? Are you aware of what your investment managers are doing to address the risks from externalities such as climate change? Can you improve your reporting to consider additional metrics?

Please speak to your Hymans Robertson consultant to discuss this subject further and identify potential next steps.