Increasing a Scheme's Engagement with Responsible Investment

What were the Scheme's goals?

Back in 2018, we were pleased to be appointed as the investment adviser to the pension scheme of a UK manufacturing company. At that time, the priority was to restructure the Scheme's investment strategy to better meet its needs. The Scheme had been open to future accrual until April 2021, and there was a funding gap. Working with the trustees, we saw that it was necessary to:

- restructure the growth assets to drive returns in excess of the liabilities;
- improve the credit assets to generate a higher yield and income distributions to pay benefits;
- evolve the Liability Driven Investment portfolio to better accommodate interest rate and inflation hedging as the funding position improves.

How did we raise the importance of Responsible Investment (RI)?

Because of these pressing priorities, the trustees initially saw RI as a secondary consideration that could be revisited further down the line. But we believed it was really important for the trustees to be aware of responsible investing as a way to manage risk in the Scheme. Consequently, we ran several training sessions and incorporated the discussion of Environmental, Social and Governance (ESG) issues into the agenda for the trustees' quarterly manager meetings.

We found that the trustees' initial engagement with RI was relatively low, as their priorities were meeting their regulatory requirements and focusing on what they saw as the key consideration of generating the financial returns needed to close the funding gap.

We gradually built up momentum on the subject, adding relevant topics to the trustees' agendas in the form of training, climate risk modelling, annual RI policy reviews and discussions about the trustees' own RI investment beliefs. This, coupled with a growing focus on ESG considerations at the sponsor, saw a tangible shift in the trustees' attitudes to RI.

When did the Scheme's focus shift to RI?

The 'organic work' on ESG considerations over the last three years bore fruit in June 2021, when we ran a training day for the trustees, focused on RI and climate risk reporting. We showcased our latest RI reporting, explaining how this analysis can be applied to the Scheme's assets, improving investment decision-making and risk management. We also talked about how the reporting has driven engagement with the fund managers.

The initial feedback we received was better than expected, with the trustees very keen to see the scheme-specific results of the carbon footprinting and ESG analysis at their next meeting.

What did the trustees learn from their bespoke RI report?

We produced a scheme-specific RI and climate-risk report for the trustees. This helped them to 'drill down' and better understand some of the risks associated with their current mandates. They learned that:

- although the metrics for the Scheme's assets looked positive relative to the combined benchmark, the results varied significantly across the individual mandates;
- while the average metrics typically scored well at a mandate level relative to their respective benchmarks, the results varied materially at an individual stock level (due to some 'outlier' holdings having particularly poor ESG scores); and
- they could spot these outliers, such as the 'worst offending' greenhouse gases emitters, within the underlying investee companies, and agreed to target these in future engagements with managers.

The analysis in the report generated discussions about the financial risks associated with various assets (such as physical and transition climate risks). This, in turn, prompted the trustees to seek explanations from their managers on the most significant issues identified, e.g. significant outliers at a mandate/stock level.

Beyond these most pressing issues, the trustees identified several other subjects that they wish to address with their managers over the next year or so, beginning the process of building a more focused stewardship programme for the scheme.

How has this new awareness benefited the Scheme?

This is a perfect example of how giving clients the right information means they will ask the right questions.

The trustees are playing their part in challenging managers on their investments and holding them to account.

For us, this represents an incredibly satisfying – and tangible – sign of the trustees' progress on their RI journey, aided by the efforts of the Hymans' client team and the analysis we carried out.

We proposed the current investment strategy to best meet the Scheme's funding needs (considering the required return, level of diversification, costs etc.), so we wouldn't necessarily recommend making any drastic changes based purely on the outcomes of the RI and climate risk report. That said, building out our reporting has been truly valuable. The trustees have a better understanding of the overall level of risk within the strategy (including climate, reputational, and governance risks). In addition, being better informed has given them a basis for engagement with the asset managers, which will in turn build a greater focus on stewardship for the future.

Conclusion

We've been delighted to observe a tangible change in tone from the trustees with regards to RI considerations. We expect to build on this momentum in the coming months as the trustees are keen to continue monitoring the RI and climate metrics in their annual reporting, now that their baseline has been established. They have also discussed the possibility of changing the investment guidelines of various mandates to explore options for better addressing relevant ESG matters.