THE MEMBER BACKING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

December 2021

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG)

MADE SIMPLE GUIDE

ACKNOWLEDGEMENTS

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FOREWORD

AS ACTIVE INVESTORS WE BELIEVE IT IS OUR RESPONSIBILITY TO ENCOURAGE COMPANIES TO MAXIMISE INVESTMENT RETURNS THROUGH GOOD GOVERNANCE, INCLUDING RESPECT FOR SOCIETY AND THE ENVIRONMENT. AEGON ASSET MANAGEMENT IS A SIGNIFICANT INVESTOR IN THE EQUITY AND DEBT OF MANY COMPANIES AND WE ARE WELL-PLACED TO ACTIVELY PROMOTE BEST-PRACTICE IN ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) MATTERS. OUR INVESTMENT MANAGERS AND ESG RESEARCH TEAM WORK TOGETHER TO MONITOR AND ENGAGE WITH THE COMPANIES IN WHICH WE INVEST.

We believe that our commitment to ESG integration brings three principal benefits for our clients:

1. **Deepens our understanding** — Our focus on ESG means we better understand the environments in which companies operate. This helps us to identify additional risks and opportunities.

2. **Strengthens our conviction** — Aegon Asset Management is an active investment manager with a fundamental, research-driven approach. Our ESG analysis supports the management of concentrated, high-conviction portfolios that can meet the performance aspirations of our clients.

3. **Promotes a long-term focus** — A growing body of academic research shows that companies which rank among the leaders in governance and sustainability are more likely to outperform over the long term. Integrating ESG factors in our research helps us to avoid short-term distractions and stay focused on the long-term prospects for companies and sectors.

As a subsidiary of Aegon NV, Aegon Asset Management contributes to and participates in the group's broader responsible investment (RI) activities. We are an active member of the UK Investment Association's Sustainability and Responsible Investment Committee, and therefore closely involved in formulating best practice for responsible investment globally and locally. In addition, Aegon Asset Management is a member of or supports a range of other responsible investment initiatives, including the UN-backed Principles for Responsible Investment, the UK Sustainable Investment and Finance Association, Carbon Disclosure Project, Climate Action 100+ and the Farm Animal Investment Risk and Return initiative. Our participation in these initiatives helps us to deepen our knowledge and maximise our influence on ESG issues for the benefit of clients, the environment and society.

Covid-19 has caused huge disruption, both economic and social, for the entire world. There has been very little about it that can be construed as positive. However, one indirect benefit of the pandemic has been the evident acceleration towards RI. The vulnerability of our society and environment, so exposed during this period, has made many recognise the vital importance of ESG issues. Covid has given the investment industry fresh impetus towards embedding ESG principles into its strategy and approach. We can be thankful for that.

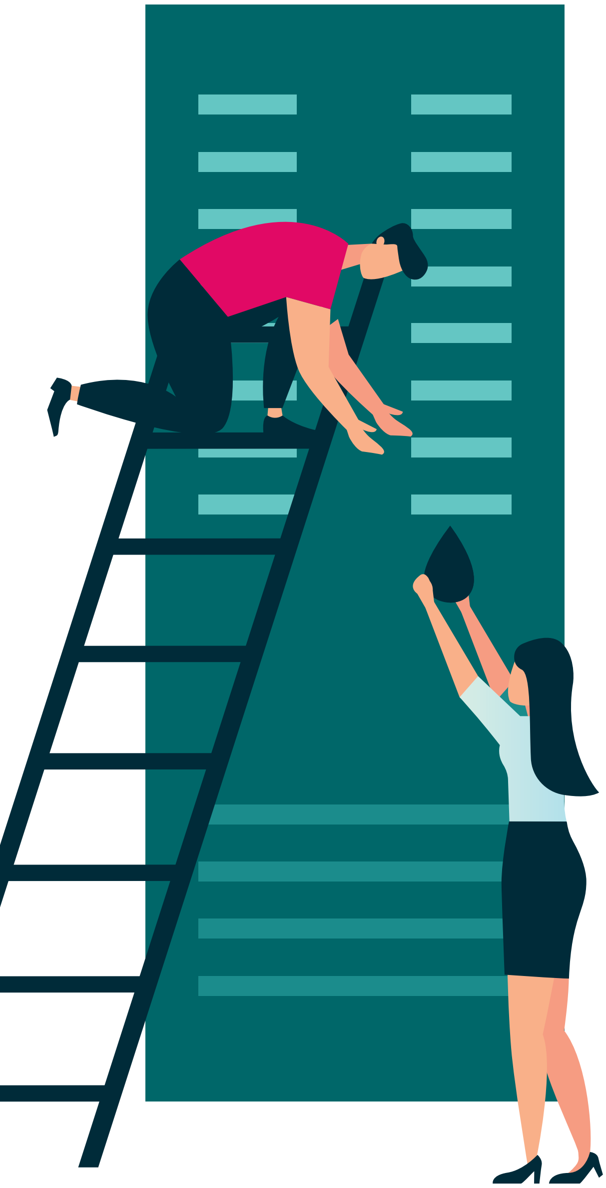
Stephen Jones
Global CIO Multi-Asset & Solutions and Equities,
Aegon Asset Management.

1. INTRODUCTION

ESG (ENVIRONMENTAL, SOCIAL AND GOVERNANCE) HAS BECOME A FAMILIAR ABBREVIATION TO MOST PEOPLE INSIDE – AND INCREASINGLY OUTSIDE – THE INVESTMENT WORLD. BUT WHAT EXACTLY DEFINES IT?

As the consideration of ESG factors has become mainstream in the pension and investment world, UK policymakers have decided to more formally enshrine ESG into investment mandates through clarifying trustee duties around consideration of financially material ESG factors (including climate change). The concept and aims of ESG investing have been rather unclear historically, while fluid terminology and subtle variations have created confusions. The result is that many trustees have been unsure of their fiduciary duties in this respect.

Though investment practitioners and academics broadly agree on the merits of ESG, there is still a debate over what ESG and related 'responsible investing' really means, and how it should be integrated into investment decisions and strategies.



In this guide we aim to explain ESG as an investment concept and suggest how it can be integrated into the investment strategy and oversight of pension schemes. We also examine means of integration, provide a glossary of relevant terms, highlight key ESG-promoting organisations, focus on specific related issues and suggest a template for pension schemes to help them create their own ESG policy.

Investment regulations are tightening, both in the UK and internationally, so ESG factors can no longer be ignored. Gone are the days when they could be viewed as a 'nice to have'. The pressure is on all pension schemes, investors, and companies to formulate their own ESG policies.

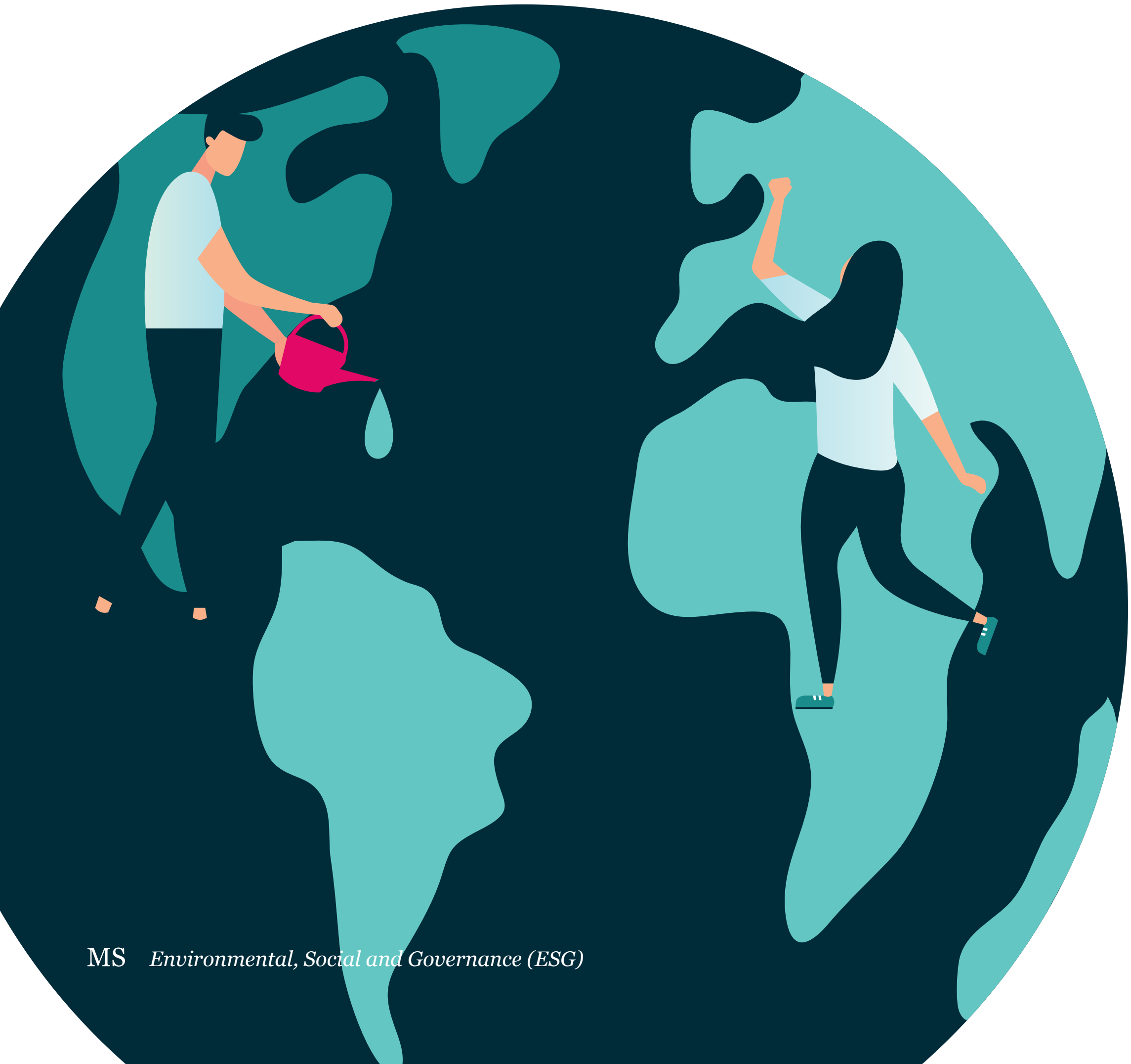
Trustees have perhaps considered their principal duty as being to provide the best possible financial outcome for members – in other words, the maximisation of returns. The actual wording from the Law Commission's 2014 report on the *Fiduciary Duties of Investment Intermediaries* specifies acting in the best "financial interests" of members. This should not, however, according to the Law Commission, be interpreted as simply pursuing the best possible investment returns. While a positive return can be rightly expected by scheme members over time, risks have to be considered. These should not be limited to traditional financial risks, but should also include non-financial risks if these could impact the returns of the fund or the interests of its members.

To this end, new rules drawn up by the Department for Work and Pensions (DWP), implemented in October, will require schemes with assets exceeding £5 billion and all authorised DC master trusts to implement measures regarding climate change governance as well as publish a Task Force on Climate-related Financial Disclosures (TCFD) report (while those schemes with assets greater than £1 billion will need to comply by October 2022). This is additional to the previous requirements for schemes to clarify and explain their policies regarding ESG (including climate change) and stewardship, that became law in October 2019. These rules are an update of the *Occupational Pension Schemes (Investment) Regulations 2005* and are – rather laboriously – entitled the *Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018.*

These requirements, overseen by the Pensions Regulator, will force trustees to actively measure climate-related risks within the scheme, as well as having targets for limiting those risks. The TCFD report will most likely have to cover how schemes take into account climate-related risks and opportunities in the management of assets within the scheme. The new rules seek to go beyond the prior requirement for trustees of relevant schemes to just publish their policy regarding the stewardship of their scheme's assets, in which schemes with 100 or more members are required to either publish their own Statement of Investment Principles (SIP) or update them. The new rules seek to more clearly set-out the fiduciary responsibilities of trustees after previous guidance was deemed to be too opaque. The DWP states that "financially material considerations include (but are not limited to) environmental, social and governance considerations (including but not limited to climate change)". Furthermore, trustees have the option of including a policy on "non-financial matters", including not only members' ethical concerns but also social and environmental impact matters and quality of life considerations. Effectively this requires trustees to take greater and more active ownership, and to consider ESG factors more comprehensively.

EU members are bound by similar newly introduced guidelines, putting the onus on asset managers and their owners to publish their respective engagement policies, detailing how such engagement is integrated into their investment processes.

As a result, it is vital that trustees have a clear strategy on ESG. Through the remainder of this guide, we aim to make ESG simple for trustees.



2. ESG TERMINOLOGY

ESG IS A DISTILLATION OF THREE SEPARATE BUT LINKED CONCEPTS THAT UNDERPIN SO-CALLED RESPONSIBLE (OR SUSTAINABLE) INVESTING. 'ENVIRONMENTAL', 'SOCIAL' AND 'GOVERNANCE' EACH COVER A RANGE OF FACTORS, THAT WHEN CONSIDERED TOGETHER BUILD A PICTURE OF AN ISSUER'S CREDENTIALS REGARDING SUSTAINABILITY, EQUALITY AND CORPORATE FAIRNESS.

Key ESG factors include:

ENVIRONMENTAL	Energy use, waste disposal, raw material sourcing, carbon emissions, water usage, recycling process.
SOCIAL	Diversity, treatment of minorities, opportunities for women, employee rights, charitable activities, community work, use of agency workers.
GOVERNANCE	Composition of board, external trustees, available share classes, interaction with shareholders, remuneration, voters' rights.

Incorporating ESG factors into investment decision-making has been growing in popularity for several decades, with many UK pension schemes leading the way in doing so. However, we recognise that these terms can still be confusing and are often used loosely, creating an unintended or unclear message. In this section, we provide a glossary to clearly define their meanings.

ESG	Environmental, social and governance factors that may affect the performance of a company or asset.
Responsible investment strategies	This relates to products and funds that use ESG factors as a basis for specific investment strategies.
Negative screening	Excluding securities involved in activities considered harmful to society or the environment.
Positive screening	Choosing issuers with specific ESG characteristics, such as involvement in activities considered positive to society or the environment.
Best-in-class investment	An investment style that involves investing only in companies that lead their peer groups in respect of ESG performance.
Active ownership	Entering into a dialogue with issuers on ESG topics and exercising both ownership rights and voice.
ESG integration	Systematic inclusion of financially-material ESG risks and opportunities in investment analysis, portfolio construction and risk management.
Thematic investing	Investment themes based on ESG issues, such as clean technology, energy efficiency, or water.
Impact investing	Investing with the intention to generate and measure social and environmental benefits alongside a financial return.
SDGs	Investing with the goal of contributing towards one or more of the UN Sustainable Development Goals (**www.un.org/sustainabledevelopment**).
Greenwashing	This refers to the controversial promotion or 'spinning' of a company or investor's 'green' credentials, when the reality can be markedly different.
Socially Responsible Investment	The term Socially Responsible Investment (SRI) is common in the UK and is a legacy term largely replaced by the more generic "Responsible Investment".

3. MANAGER SELECTION

HOW SHOULD TRUSTEES INCORPORATE ESG INTO THEIR SELECTION OF MANAGERS? THE UN-BACKED PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI) GUIDELINES SUGGEST THAT "AN ASSET OWNER SHOULD ENSURE THAT A COHERENT SET OF EXPECTATIONS IS COMMUNICATED TO AGENTS ACTING ON THEIR OWN BEHALF, AND CAN ALIGN INCENTIVE STRUCTURES WITH THESE EXPECTATIONS".

The Department for Work and Pensions (DWP) guidelines obligate schemes to consider "financially material ESG factors". From October 2019, qualifying schemes have had to produce, update and publish their Statement of Investment Principles (SIP), complete with a statement on ESG. Further information can be found in the PLSA's 'ESG and Stewardship: A practical guide to trustee duties', published in June 2019.What does this mean in practice? The responsibility sits with the trustees to set the standards and agree relevant metrics for measuring their (third-party) asset manager's credentials. Almost all asset managers now have their own ESG strategy and principles; if they do not, schemes must develop them. When hiring a manager, the trustees must make the manager aware of the scheme's standards and expectations, so that there is no future conflict. There should be alignment between the strategies and principles of both the scheme and the asset manager.

Potential conflict and misunderstanding should be avoided at the earliest stage of selection by using a well-crafted and comprehensive questionnaire that covers ESG factors. The trustees, normally with support from their consultant advisers, can then delve into the common features of each ESG strategy and examine how deeply embedded ESG factors are – or are not – at the prospective asset manager.

For most schemes, consultants normally play an important role in the consideration and hiring of asset managers. Most of the major consultants will rate asset managers on their ESG credentials – specifically the integration of ESG factors into investment processes and commitment to active ownership, for example by reviewing company engagements or proxy-voting patterns. Such ratings are, of course, just a starting point, and should not be an excuse for not thoroughly investigating a potential asset manager's ESG credentials.

While most major consultants are committed to helping schemes create and develop an effective approach to ESG, it is normally incumbent on the scheme to set out for the consultants their specific requirements. That is not to say that consultants do not recognise the increasing importance of ESG to their pension scheme clients or their role in shaping the strategy of their clients. The new regulations and widespread adoption by schemes are encouraging consultants to offer comprehensive ESG services which include analysing, rating and recommending managers based on their ESG credentials.

The ratings, based on analysis of both qualitative and quantitative data, are the most visible indicator of each manager's ESG credentials.

We discuss third-party ESG ratings more fully in Section 6, 'ESG Focus'.

However, none of this should lead automatically to full-scale adoption of sustainable investment funds by schemes. That is not the aim of the new regulations. What is critical, and what legislation is encouraging, is the consideration of ESG factors at the trustee level, so that scheme members' strategy on ESG is reflected through their asset managers and their investments.

Further practical step-by-step guidance is provided in the 'template for creating an ESG policy for a pension scheme' section of this guide.

4. INTEGRATING ESG INTO DECISION-MAKING

MOST ASSET MANAGERS NOW HAVE RELATIVELY SOPHISTICATED PROCESSES THAT INTEGRATE ESG FACTORS INTO THEIR INVESTMENT APPROACHES.

The PRI's guidelines define ESG integration as "the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions." It is a holistic approach to investment analysis, where material factors – ESG and traditional financial factors – are identified and assessed in order to form an investment decision.

To achieve comprehensive integration investment managers and specialist ESG research teams should work together to monitor and engage with the companies in which they invest. This activity covers all asset classes, including fixed income, equities, property, alternatives and multi-asset funds. Below, we consider the major asset categories and ways of integrating ESG factors into the analytical process:

Public equities	There is a growing belief that integrating a company's ESG performance within fundamental analysis is a tool for both value creation and for risk management. Simply put, there is powerful evidence that companies with sustainable business models deliver superior long-term financial returns. Analysts should seek to identify and understand the key ESG risks for each of the companies, industries and sectors in which they invest. A company's ESG performance is most appropriately considered within the context of its industry's competitive landscape, in relation to its peers and the geographic regions in which it operates. An understanding of the ESG issues that a company faces therefore requires an in-depth knowledge of the sector in which it operates.
Fixed income	As with equities, fixed income analysts should be aware of an issuer's ESG credentials. Rather than an industry or geographical split, as favoured in equities, analytical responsibilities in fixed income can be apportioned most efficiently by bond market segment: government markets, investment grade non-financials, financials and high yield bonds. ESG analysis by credit research specialists should be more focused on the potential impact of ESG risks on the creditworthiness of the issuer or security structure.
Property	The integration of ESG factors in property should necessarily be a little different. All environmental, social and governance factors are still considered when assessing new properties and managing existing assets. For new acquisitions, the due diligence process should assess the validity and attractiveness of a property in offering a secure investment return for shareholders. A Sustainability Risk Assessment considers the environmental performance of the property, the alignment of interests with tenants and the regulatory landscape. Current property portfolios can be assessed through a structured gap analysis against best practice. The opportunities are then rated and ranked based on their effective contribution to sustainability objectives and vision.
Alternatives	Alternative investments, such as infrastructure and renewable energy assets can also be viewed through the ESG prism. These are typically long-life assets which makes them attractive to pension funds. Management and operating practices, as well as the environmental impact of, for instance, large-scale engineering projects can and should be assessed during initial analysis. This should be relatively straightforward to incorporate.
Multi-asset	Multi-asset funds are essentially a blend of a range of asset classes attempting to meet the investment objectives and risk profiles of clients. ESG factors would normally already be considered by bond, equity, property or alternative analysts. Multi-asset managers might also want to incorporate an overarching ESG policy or 'tolerance' parameters over assets in the fund. This may restrict the weighting of certain assets.

Much of the above is about the comprehensive assessment of risk at each security or asset, from which a more reasonable assessment of future return can be made. The consideration of ESG factors is the gateway to more active ownership – engaging more openly with company management and voting at AGMs – which can only lead to better outcomes for all parties.

5. ESG AND DC PENSIONS

HISTORICALLY, IT HAS BEEN DIFFICULT FOR DEFINED-CONTRIBUTION PENSION SCHEMES TO CLEARLY INTERPRET THE ESG MOOD AND TURN IT INTO PRINCIPLES AND CONCRETE ACTION FOR THEIR FUNDS. WHILE THE WILL HAS ARGUABLY BEEN THERE, THE REGULATORY GUIDANCE HAS BEEN OPAQUE AND CONFUSING.

The Defined Contribution Investment Forum (DCIF), in its paper of April 2018, Navigating ESG: A practical guide, acknowledges the challenges faced by DC pension schemes in their efforts to reflect ESG principles in their funds. As the paper puts it: “Are trustees obliged to prioritise investment returns above all else? Do savers really care how their pensions are invested? How do you even define ‘responsible investment’, anyway?” The law has hitherto been ambiguous, seemingly content to leave it to schemes’ discretion as to whether to incorporate ESG factors. This often led to a conservative interpretation of schemes’ responsibilities and encouraged a wait-and-see approach.

However, what is increasingly acknowledged is that ESG risks are material, and it is, therefore, the fiduciary duty of trustees to consider these risks alongside others such as longevity or liquidity. The grey area has largely been in the notion of non-financial matters, under which ESG risks have been deemed to sit. The reality is that many ESG factors can affect the financials of corporations and be financially material.

While schemes should not impose moral or ethical views, they can and should reflect the views of their members if there is a majority view that ESG issues are of concern. Nor should schemes take a passive view of non-financial risks. There is also a sense that, given the nature of the assets in DC schemes and the long-term risks they face, ESG factors should be properly considered, given that they are long-term by nature, embracing issues such as climate change, company governance, and the longstanding suppression of minorities and women.

Part of the issue for DC schemes is explaining or clearly defining what ESG risk is, because there is no standard definition. Also, regarding ESG, where exactly does the accountability lie? While members may be concerned about ESG matters, they have not always seen the necessity of their scheme to engage more fully with asset managers about these issues. There was previously some evidence of generational differences, with younger investors seemingly more engaged with these issues relative to older members. However, this appears to be changing, with the DCIF observing, in a 2020 survey, that “older people are just as interested as younger people” in RI.

While this is encouraging, the DCIF concludes that more work still needs to be done in pushing ESG into the mainstream. It is partly an issue of education, and recognition by scheme members that their viewpoints on ESG matters can be incorporated into the scheme’s stated policy, which can, in turn, have an impact on the asset managers and the practices of the underlying companies.

This may call for greater engagement from schemes with both their members and their asset managers, as members becoming aware that ESG principles can be integrated into their schemes’ policies and really make a difference. For some, it can be a surprise that their schemes may not be actively advocating ESG principles.

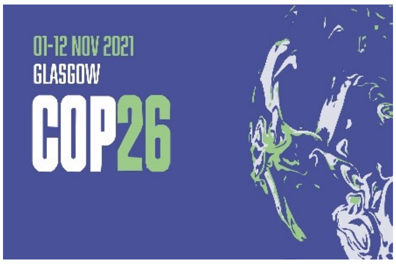
The good news is that UK pension schemes are, by and large, embracing their responsibilities regarding ESG investing. This partly reflects a membership that believes that ESG matters are important. Indeed, 87% of members “believe that businesses have a wider social responsibility than simply making a profit”.

6. ESG THEMES

IN THIS SECTION WE EXPLORE SEVERAL EMERGING ESG THEMES WHICH ARE GROWING IN PROMINENCE AMONGST PENSION SCHEMES.

CLIMATE CHANGE AND CARBON PRICING

THE EVIDENCE OF THE CATASTROPHIC EFFECTS OF CLIMATE CHANGE ARE INCREASINGLY VISIBLE, AND THERE ARE MANY EXPERTS WHO BELIEVE WE ONLY HAVE A COMPARATIVELY SHORT PERIOD OF TIME – 10 OR POSSIBLY 20 YEARS – TO PREVENT IRREVERSIBLE DAMAGE TO OUR WORLD. THE PURSUIT OF SUSTAINABLE WORKING PRACTICES AND HABITS IS EVER MORE CRUCIAL TO PREVENT A TIPPING-POINT, FROM WHICH THERE MIGHT BE NO RETURN.



The Paris Agreement of 2015 on global climate change committed signatories to keeping the increase in average global temperatures to less than 2.0 degrees, and preferably less than 1.5 degrees, centigrade, compared with pre-industrial levels. It is of course incumbent on us all to change our habits and make decisions that are environmentally friendly. From an investor point of view, there is increasing evidence that investment decisions really do make a difference. The consideration of environmental factors is important for two reasons: they can make a difference on climate change and they can benefit the investor. For example, investing in a carbon-light emitting or renewable energy company will most likely be beneficial in the long run for the environment and potentially for portfolio returns. It is a win-win situation. Though the COP26 – the 2021 UN Climate Change Conference – in Glasgow didn't secure an agreement on new targets on cutting emissions overall, we did see new agreements on climate finance and on 'phasing down' coal use. This has certainly been met with some disappointment, but world leaders will meet again in 2022 in Egypt to have another go. A good outcome would be a general agreement on even more ambitious but achievable targets on cutting emissions, given the growing urgency as the world faces ever more extreme climate-change-induced weather events.

The development of carbon pricing is just one of a series of innovative climate-conscious methods of offsetting the impact of carbon emissions. Carbon emitters such as fossil-fuel energy firms or utility companies can buy tradeable permits to offset the amount of carbon they emit into the atmosphere. As carbon producers, the incentive is on them to cut emissions or pay for permits (which, in turn, helps drive forward or pay for carbon clear-up). The PLSA and ClientEarth recently produced guidance for schemes to help provide a clear and practical framework for trustees considering climate risk in their investments. To review, visit www.plsa.co.uk/Policy-and-Research-Document-library-More-light-less-heat.

ESG RATINGS

THERE ARE A RANGE OF INDEPENDENT ESG-RATING AGENCIES IN THE MARKET. EACH HAS ITS OWN SPECIFIC METHODS AND CRITERIA OF RATING COMPANIES AND INVESTMENT MANAGERS ON THEIR APPROACHES TO ESG, WITH AN OVERALL SCORE PROVIDING CUSTOMERS WITH QUANTITATIVE GUIDANCE REGARDING ESG CREDENTIALS.

While these are undoubtedly useful at a superficial level, they have to be treated with some caution. The criteria used can be quite narrow and vary quite significantly between agencies.

The single rating does not always tell the whole story and it can distort the impression of a company or manager's ESG credentials. This is partly because some of the criteria used are not always material to a company. Some agencies may aggregate a whole host of measures equally, without weighting the importance of some, or all, of them, or indeed questioning the relevance of them to the company concerned.

Additionally, ESG screens generally do not consider the sustainability of a company's products or services. By focusing mostly on how a company operates (rather than what it does) the ratings can inadvertently attribute strong sustainability credentials to companies whose products may be fundamentally unsustainable. In the view of some managers, including Aegon Asset Management, the sustainability of a company's products or services is vital to its long-term strategic success. An unsustainable product (such as coal) is a huge strategic headache for any management team, just as a sustainable one should create a tailwind of opportunities.

Furthermore, the criteria used by rating agencies tends to favour large-cap companies & developed markets over smaller companies and emerging markets. This is because some smaller companies cannot provide all the data, often because they are in the early stages of their existence or lack the resources to respond effectively. Emerging markets practices also may lag the more developed markets. As a result, they can score poorly on certain factors relative to larger or more mature companies.

Ultimately, the issue with solely utilising third-party ratings as a means of determining a company's ESG credentials is that they can be too rigid. Ratings are also necessarily backward-looking, saying nothing about the potential changes to a company's ESG strategy. One could potentially miss those management teams that, while not scoring highly at the present time, are making marked efforts to improve their sustainability record. Such companies that begin to embrace ESG can also be powerful performers in portfolios.

A publication by the Society of Pension Professionals (SPP) in September 2021, titled the 'Environmental Social and Governance Guide', specifically warns trustees about blindly accepting ESG ratings without digging deeper to fully appreciate a company's ESG standing and approach, and being on guard for instances of 'greenwashing'.

Quantitative ratings can be useful as a starting point and as a short-cut to evaluating a company's ESG credentials. However, they should also be combined with qualitative, bottom-up appraisal of a company, to form a real understanding of its business and goals. Bottom-up, rigorous analysis best captures the nuance of material products' impact and the effect of ESG factors when valuing a company.

It is important for schemes to carefully consider the various ESG data providers and select the one that most readily supports and embodies their own philosophy and process. This should be then clearly communicated by the investment manager so that stakeholders are aware of the approach. Subscribing to multiple ESG data providers allows for contrasting and comparing different methodologies and interpretations of an issuer's ESG profile.

ESG AND GOVERNMENT BONDS

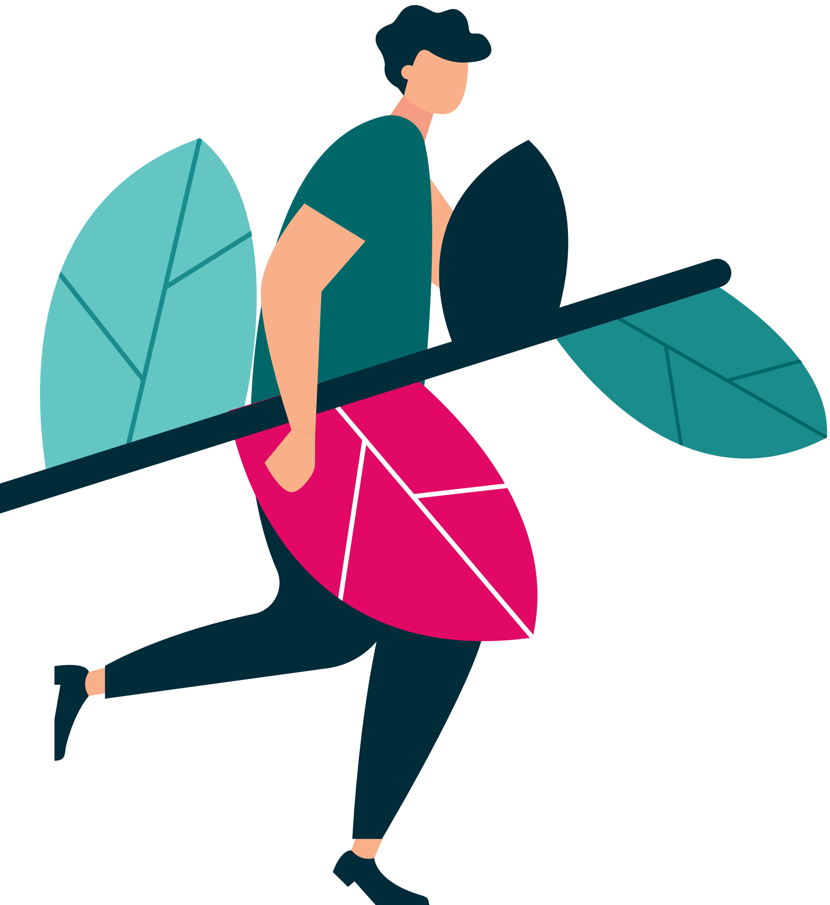
ASSESSING ESG FACTORS WITHIN GOVERNMENT BOND PORTFOLIOS ASSISTS THE IDENTIFICATION OF SOVEREIGN CREDITS WITH LOWER LONG-TERM CREDIT OR DEFAULT RISK NOT REFLECTED IN CURRENT MARKET PRICES. EACH ESG COMPONENT HAS A DIFFERENT MATERIAL IMPACT ON THIS RISK, SOME MORE SIGNIFICANT THAN OTHERS.THIS IS PARTICULARLY RELEVANT GIVEN THE RELATIVELY HIGH ALLOCATIONS TO UK GOVERNMENT BONDS BY DB PENSION SCHEMES.

Governance is the principal factor in indicating sovereign credit risk, particularly at the lower end of the ratings scale. Many past sovereign defaults have been directly related to institutional and political weakness, such as political instability, unwillingness to pay debt, corruption, inadequate governance or weak budget management.

Social factors are less significant but can be highly correlated to GDP and wealth conditions which are drivers of sovereign risk. Education, equality, health, life expectancy and poverty can all impact social cohesion and productivity, which contribute to competitiveness and potential for growth.

Environmental variables are least correlated with risk, although countries that are prone to weather-related issues are more effected by climate change. It is also possible that governments that seek to make positive changes in environmental matters can detrimentally effect returns. A pleasing recent development has been the first-ever issuance by the Bank of England of a green gilt. The £10 billion issue, launched last month, was the largest of its kind and attracted huge demand, with the proceeds targeted towards specific environmentally friendly projects such as more wind farms and the decarbonisation of homes and offices. More issues are planned by the central bank.

Although the vast majority of developed markets are stable with robust infrastructures, the above ESG factors remains a fundamental component of effective research analysis.



7. CREATING YOUR PENSIONS SCHEME'S ESG POLICY

WHILE MANY SCHEME BOARDS AND TRUSTEES WOULD HAVE ALREADY GONE THROUGH THE PROCESS OF IMPLEMENTING THEIR OWN ESG STRATEGIES, FOR THOSE THAT HAVE STILL NOT DONE SO, OR THAT ARE IN THE PROCESS OF DEVELOPING A STRATEGY, WE PROVIDE A SUGGESTED CHECKLIST OF THE STEPS THAT A SCHEME COULD TAKE TO BECOME FULLY ESG COMPLIANT. FURTHER DETAILS CAN BE FOUND IN THE PLSA'S ESG AND STEWARDSHIP: A PRACTICAL GUIDE TO TRUSTEE DUTIES (JUNE 2019). THE SOCIETY OF PENSION PROFESSIONALS ALSO PUBLISHED AN ESG GUIDE IN SEPTEMBER 2021 WHICH CONTAINS A USEFUL CHECKLIST FOR TRUSTEES.

ESG CHECKLIST		
1. Educate	As a starting point, ensure that board members and trustees have received training and education in ESG matters, covering areas such as defining financially materiality, governance and climate change.	✓
2. Discuss	Discuss the relevant and appropriate ESG factors to reflect in your scheme at board and trustee level. Define and agree your investment beliefs and ensure they reflect your view of the risks and opportunities relating to ESG. Discuss ESG governance structure.	✓
3. Define	Once the board and trustees have decided on a scheme's ESG strategy, it should incorporate it in a clear Statement of Investment Principles. This should set out how the trustees will invest the assets of the scheme and outline the principles and policies governing investment decisions made by or on behalf of the scheme.	✓
4. Communicate	Communicate the strategy to the scheme's consultants, managers, members and sponsoring employer.	✓
5. Evaluate	With help from the consultants, assess existing asset managers on the stated ESG strategy, either as part of regular reporting or as a standalone project.	✓
6. Review	Assess the scheme's ESG policy, and manager's compliance with it, at future trustee meetings.	✓
7. Report	Consider reporting in line with the recommendations of the Taskforce on Climate-related Financial Disclosures. While this is not yet mandatory for smaller schemes, it has been for schemes with assets greater than £5 billion and for all DC master trusts since October, and it will be for those schemes with assets greater than £1 billion by October 2022. This is mandatory for eligible schemes from October 2021 and best practice for current non-eligible schemes. Since October 2020, trustees of DC schemes have been required by law to publish a report, on an annual basis, detailing how they have complied with the policies set out in the Statement of Investment Principles. *(See Ref 1 and 2)*	✓

8. ESG FRAMEWORKS

IN THIS SECTION, WE LOOK AT SOME OF THE LEADING UK AND INTERNATIONAL ORGANISATIONS THAT PROMOTE ESG. PARTICIPATION IN THESE INITIATIVES HELPS PENSION SCHEMES AND INVESTMENT MANAGERS TO DEEPEN THEIR KNOWLEDGE AND MAXIMISE THEIR INFLUENCE ON ESG ISSUES.

PRI Principles for Responsible Investment

1. **Principles for Responsible Investment (PRI)** was launched in April 2006 by the UN and has grown in stature and authority since. Its aim has been to incorporate its principles regarding sustainability into investment companies' philosophy and processes. There are six defined 'Principles' that signatories agree to: Incorporate ESG issues into investment analysis and decision-making processes.
2. Be active owners and incorporate ESG issues into ownership policies and practices.
3. Seek appropriate disclosure on ESG issues by the entities in which they invest.
4. Promote acceptance and implementation of the Principles within the investment industry.
5. Work together to enhance effectiveness in implementing the Principles.
6. Report on activities and progress towards implementing the Principles.

SUSTAINABLE DEVELOPMENT GOALS

The **UN Sustainable Development Goals**, define 17 targets or goals set by the UN for delivery by 2030. They include a mix of ESG issues such as education, gender equality, climate action, the eradication of hunger and poverty. The goals are broad but do have related and measurable indicators. How signatories interpret the best means of achieving these goals is left to them. The goals are intentionally ambitious, and if reflected in investment processes require some measure of 'impact investing', meaning investments are made with the aim of furthering some, or all, of these goals.

Climate Action 100+
Global Investors Driving Business Transition

Climate Action 100+ is a five-year initiative led by investors to engage with the world's largest corporate greenhouse-gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures. Over 250 investors, including Aegon Asset Management, are signatories to the initiative. The initiative is designed to implement the investor commitment first set out in the Global Investor Statement on Climate Change in the months leading up to the adoption of the historic Paris Agreement in 2015.

CDP

CDP (formerly Carbon Disclosure Project). CDP is a not-for-profit organisation that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts. Over the past 15 years CDP has created a system that has resulted in unparalleled engagement on environmental issues worldwide.

Established in 2015 by the Jeremy Coller Foundation, the **Farm Animal Investment Risk & Return (FAIRR)** initiative is an investor network that aims to put factory farming on the environmental, social and governance (ESG) agenda.

Issues associated with factory farming present a range of risks to investors. Above the surface, scandals such as swine flu, avian flu and horsemeat have shown how industrial production methods can lead to value destruction. FAIRR is working with its network to highlight other related risks associated with this method of livestock production. FAIRR acts as a global collaborative network that shares research, fresh thinking and best practice with global institutional investors, policy makers, academics, NGOs and other related actors.

The ***Financial Reporting Council (FRC)*** promotes high standards of corporate governance in the UK. Asset owners and asset managers can become signatories to its Stewardship Code, and each year must publish an annual statement to explain compliance.

The FRC's UK Stewardship Code defines stewardship as follows:

"Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society".

The Code applies to all asset owners, such as pension funds and other large institutional investors, asset managers and service providers. At its core is a list of 12 'apply and explain' principles for asset owners and asset managers, grouped around four main headings: purpose and governance, investment approach, engagement, and exercising rights and responsibilities. There is a separate list of six principles for service providers. The Code does not attempt to define the approach taken by asset owners, managers and service providers towards stewardship. However, it clearly requires them to develop their own policies to effectively embed the principles in their operations, as well as report on them in a relatively uniform and consistent manner.

The **Global Real Estate Sustainability Benchmark (GRESB)** evaluates the environmental, social and governance credentials of real estate and infrastructure funds.

GRESB is an industry-driven organization committed to assessing the sustainability performance of real assets around the globe, including real estate portfolios (public, private and direct). On behalf of over 120 institutional investors, GRESB has assessed over 1200 property companies and funds globally.

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

The **FSB Task Force on Climate-related Financial Disclosures (TCFD)** has developed climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. They fall under four headings: governance, strategy, risk management, metrics and targets.

The Task Force has considered the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries.

These disclosures will likely be mandatory by 2025 in the UK, although premium-listed companies will be required to report on these disclosures for the first full financial year after 1 January 2021. These disclosures are aligned with global standards implemented by the TCFD.

For more information visit **www.fsb-tcfd.org**.

9. CONCLUSION

RECENT REGULATORY CHANGES HAVE PROVIDED THE IMPETUS FOR ESG TO BE MORE FULLY EMBEDDED ACROSS ALL INVESTMENT PRACTITIONERS. WHILE THE OCTOBER 2019 REGULATIONS FROM THE DWP DIRECTLY DEAL WITH PENSION SCHEMES AND THEIR APPROACH TO ESG, THE KNOCK-ON EFFECT FROM THIS AND OTHER RELATED REGULATIONS AND GUIDANCE WILL BE FELT BY OTHER STAKEHOLDERS SUCH AS CONSULTANTS AND ASSET MANAGERS.

ESG, if it wasn't already, is mainstream. Proper and full integration of ESG factors has become a necessity for schemes. It is one that should be embraced as it can lead to better, more comprehensive risk assessment, better long-term returns and better outcomes for the world at large. There is clear evidence that this is already happening, and that asset managers and schemes more fully recognise their responsibilities with relevance to ESG and see the potential benefits. While some of the regulations and the numerous initiatives that are at large can appear confusing, careful consideration, with the help of consultant advice, can produce a positive experience and outcome that is beneficial to all stakeholders.

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