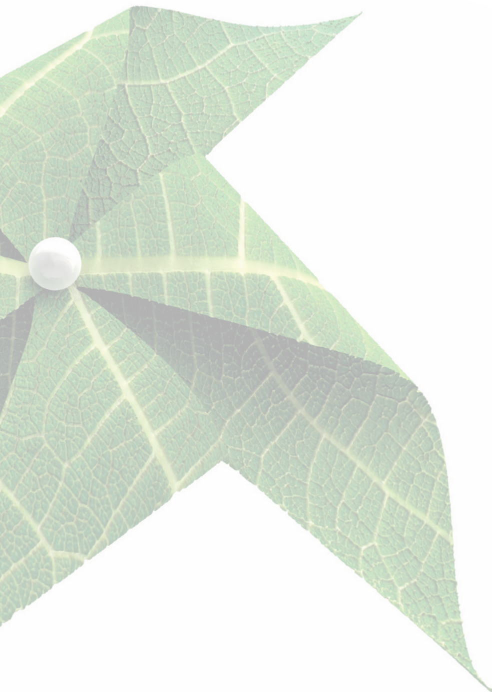
NAPF
Responsible Investment Guide 2013

Securing the future of pensions



This guide updates the NAPF's Responsible Investment Guidance, last published in 2009 and aims to:

- **Summarise the case for why pension fund investors should be seeking to incorporate extra-financial risks – including governance and material environmental and social risks, within their investment decisions in an effort to protect against value destruction, to potentially enhance risk adjusted returns and ultimately support better member outcomes**
- **Set out how pension funds can, in keeping with their fiduciary duty, move the market towards one where responsible investment is considered the norm.**

There is robust evidence that extra-financial factors – often referred to as Environmental, Social or Governance (ESG) factors and increasingly "not-yet-financial" or "unaccounted" risks – can significantly impact a company's long-term value, reputation, brand growth rate, margins, market share and borrowing costs.

There is growing interest in responsible investing, with investors increasingly incorporating relevant criteria into manager searches and agreements. This is mirrored by the increasing membership of organisations such as the United Nations supported Principles for Responsible Investment (PRI), but there is still some way to go to before Responsible Investing can be said to be fully in the mainstream.

The NAPF believes that:

- **The management of extra-financial factors, which encompass governance and material environmental and social factors, is an integral part of good corporate management. Further, the successful integration of such factors within decisions by investors can moderate against investment risk and thus potentially improve risk-adjusted returns.**
- **Pension funds should develop an investment policy which includes an understanding of stewardship objectives and risks. This policy should encourage the incorporation of financially material extra-financial risks within investment decisions and the exercising of stewardship responsibilities such as engagement and voting.**
- **Pension funds should select investment managers, across all asset classes, which act as responsible investors and hold them to account for adhering to the fund's own policy and expectations.**

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Foreword

Sarah Nolleth, Director of HRH The Prince of Wales's Accounting for Sustainability Project (A4S)

THE PRINCE'S ACCOUNTING FOR SUSTAINABILITY PROJECT

The global economy is entering a new era. Companies and governments are increasingly recognising that sustainable economic performance relies on an understanding of the interdependency between financial, social and environmental factors.

Evidence shows sustainability and shareholder value go hand-in-hand by creating more resilient business models. While awareness of these issues is growing, many mainstream investor practices go unaltered.

Pension funds, in particular, have a role to play in the move away from 'quarterly capitalism' to more sustainable, resilient business models and decision-making for the long term. This has the opportunity to increase returns and also to create a more sustainable economy to maintain the real value of retirement income.

The NAPF's Responsible Investment Guide is invaluable reading for the pensions industry bringing long term thinking into the mainstream – and making it 'business as usual'.

What is responsible investment?

> *Sustainable investing is not a feel good exercise*
>
> **Al Gore**

Those referring to responsible investment often use the term to refer to different things. Therefore for the sake of clarity and to emphasise our view that responsible investment should not be considered as separate to or additional to mainstream investment, but instead part and parcel thereof, we will endeavour to forsake with the jungle of acronyms that often blight this topic. Instead we define responsible investment as the below – drawing heavily on the definition devised by the Principles for Responsible Investment and of "Stewardship" provided by the FRC.

> ***An investment approach in which investors recognise the importance of the long-term health and stability of the market as a whole; seeking to incorporate material extra-financial factors alongside other financial performance and strategic assessments within investment decisions; and utilise ownership rights and responsibilities attached to assets to protect and enhance shareholder value over the long term – primarily through voting and engagement.***

Responsible Investment – not to be confused with Socially Responsible Investment

Responsible Investment is often viewed with hesitation by investors due to a misconception that what is being discussed is ethical and/or socially responsible investment (SRI).

A range of investors have a desire to reflect their values in their investment portfolios. These are often referred to as "socially responsible investors" (SRI) and have been advocating for many years an approach that combines investment returns with a moral or ethical role for investing. This additional dimension is generally not driven by financial considerations but is there to ensure that the investment portfolios are congruent with investors' beliefs and values.

Ethical investing has long historical roots and purely ethical investors exclude so called "sin stocks" regardless of their financial performance as a means of avoiding activities that are inconsistent with their ethical, moral or religious beliefs.

SRI investing can be considered an evolution of ethical investing. The key divergence from ethical investing is that as opposed to simply screening out "sin stocks" (although this does still often take place), SRI investors seek to achieve social and environmental objectives alongside financial objectives. It was borne out of an increasing desire among some investors for more of a social focus, and in recent years an environmental focus, and is often typified with shareholder activism.

Neither ethical or SRI investing are the focus of this Guide.

Responsible Investment as a mainstream approach

Like those above, responsible investment is an approach whereby material extra-financial factors are incorporated into investment processes and activities. **The objective of responsible investment is decreasing investor risk and improving risk-adjusted returns.** Unlike those above, investment decisions are not based purely on any ethical or moral stance and companies or sectors are generally not screened out of the potential investment universe. Responsible investment is not about pension funds' investments 'going greener' but about achieving better outcomes for their members.

In line with fiduciary duty

UK based occupational pension funds must ensure that their investment approach is consistent with their legal responsibility. This means treating the financial interests of their members as paramount and managing the fund consistent with proper diversification and prudence.

UK pension funds are generally not permitted to make investment decisions based purely on an ethical or moral stance – if they wish to do so then they should seek legal advice to ensure that their desired approach is in line with their fiduciary duty to the fund's beneficiaries.

Nevertheless, where any factor can be regarded as material and having a current or potential impact on an actual or contemplated investment, whether from the point of view of the return to be expected of that investment, its liquidity and/or its underlying capital value, it is wholly consistent with a trustees fiduciary duty to take those considerations into account[1].

Especially relevant to pension funds

Pension funds traditionally have long-term investment horizons, this longer term perspective fits well with the growing evidence that responsible investment approaches can lead to enhanced long-term returns. The long-term financial implications of extra-financial risks such as good governance, resource scarcity and labour standards are becoming increasingly apparent and are therefore of particular relevance to long-term investors.

Implementing a responsible investment policy also helps pension funds to adhere to codes such as the UK Stewardship Code – the NAPF's Stewardship Policy aims to assist pension funds in both understanding and implementing their responsibilities and to be responsible investors and owners.

Pension funds are often thought of as universal owners – long-term owners of a diversified investment portfolio that is spread across the entire market or markets. Pension funds collectively own a significant share of the economy and are effectively tied into this share in the longer term. Given this, it is suggested that the long-term financial interest of these investments depends on the ability of global markets to produce economic growth on a sustainable basis. As a result, there is a necessity to manage the longer term risk through asset allocations and active ownership practices that are sensitive to longer term factors. There is an increasing awareness that if one company does well at the expense of others, a widely diversified investor may well pick up the costs as well as the gains.

[1] Legal advice to USS on RI exclusions, DLA Piper, Sept06

In addition, pension fund beneficiaries on the whole want to retire with a good pension and into a world characterised by a healthy environment, vibrant economy and peaceful society. The assets pension funds own and have oversight of can play an important role in determining the future society member's face and thus, the real value of their retirement income.

Why adopt a responsible investment approach?

> *"… institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long-term."*
>
> **Kay Review, 2012**

Responsible investment continues to become more and more of a mainstream concept, driven by an increasing understanding of the financial implications along with increasing regulatory requirements and political and societal expectations.

Recent developments are set against the backdrop of the impact of the financial 'crisis' on institutional investment, most notably the critique that institutional investors were "absentee landlords" of "ownerless corporations" in the lead up to the crash. In addition, some environmental and social risks are increasing in significance and prominence, for example in relation to resource stresses for many industries and controversies in corporate supply chains on issues such as human rights and pollution. In many ways, there have never been more questions about the activity and responsibility of investors in our economies and societies.

Materiality is the key

The materiality of different extra-financial factors will vary across sectors and geographies; however, their materiality means that at some point in the future, they will manifest as a financial impact.

Whilst good corporate governance will likely be appropriate across all sectors and jurisdictions; some aspects may be worthy of more focus than others, for example: executive remuneration structures in financial services or the independence and effectiveness of the board in foreign mining companies. Environmental factors however, may well be much more material to a company which relies upon natural resources than they are to others in the services sector for example.

As an example, 36% of companies researched by EIRIS had identified water scarcity as an issue to be addressed; however, less than 1% of companies are currently adequately managing their water risks. This statistic would suggest that investors should seek to have an understanding of potential water-related exposure in their portfolios.

- **Material extra-financial factors are those issues which are likely to have at least a long-term effect on business results and performance.**
- **Examples of extra-financial factors include, but are not limited to, corporate governance, bribery and corruption, executive remuneration, human rights, occupational health and safety, research and development (R&D), customer satisfaction, climate change, consumer and public health, reputation risk, and the environmental and social impacts of corporate activity.**
- **These tend to be of a medium to long term nature, but may also impact in the short term.**

Material Governance Risks

Board independence

Non-executive Directors play a vital role in overseeing the executive management and safeguarding the interests of shareholders.

Succession planning

An ineffective policy can have implications for a company's performance, including uncertainty over its sustainability.

Board Diversity

Research suggests that shareholders, companies and boards are not best served by an overly homogenous board prone to group think.

Auditors

The independence of auditors plays a crucial role in protecting shareholders.

Material Environmental Risks

Climate change

High intensity industries will incur additional financial costs from carbon regulations in different jurisdictions. Changes in climate will affect company supply chains and fixed assets.

Energy use

Through effective management of energy use companies are able to reduce energy costs as well as build security of supply.

Natural resources

Demand for raw materials is ever increasing, this has implications including increasing regulation around sourcing and use of resources.

Water

A growing global population is leading to rising consumption – this in turn increases costs and creates tensions or conflicts.

Material Social Risks

Human rights

Companies operating in countries with poor human rights records may face significant challenges, such as legal challenges or reputational damage.

Employment

Research indicates that well managed employee relations improve worker productivity and effectiveness in turn benefiting shareholders.

Health and safety

Companies with poor health and safety records may face prosecutions, fines and in extreme cases, the withdrawal of licenses to operate.

Supply chain

Companies are increasingly reliant on a large, global workforce, exposing them to increased risks of disruptions.

An evolving Landscape

UK PENSIONS ACT

In July 2000, the world's first regulation requiring disclosure by occupational pension funds of their policies on environmental, social and governance issues came into force in the UK. The SRI Pensions Disclosure Regulation (2000) placed a requirement on trustees to declare via their Statement of Investment Principles (SIP) "the extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments".

A similar disclosure requirement has since been introduced in many other countries including Germany, France, Spain and Canada. Since 2005, a similar disclosure requirement has been included in the Statement of Recommended Practice (SORP) for UK charity investors.

FRESHFIELDS PROVIDE LEGAL CLARITY

For many years there had been a debate over the ability of pension funds to take social and environmental considerations into account when setting their investment policy. Writing in 2005 for the United Nations Environment Programme Finance Initiative (UNEP FI), Freshfields concluded:

"...The links between ESG (environmental, social and governance) factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."

MYNERS' TAKES AGENDA FORWARD

In 2008, the NAPF published its review of the Myners' Principles, which were first set out in 2001. Its recommendations were broadly accepted by the Treasury and now form an important element of good pension trustee governance. On responsible investing the Treasury stated:

"A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities."

STEWARDSHIP IS CODIFIED

In November 2009, the Institutional Shareholders Committee (ISC, subsequently renamed in 2011 the Institutional Investors Committee, IIC) issued a code of conduct for institutional investors calling for beneficial owners to take their responsibilities of ownership more seriously and to monitor, engage and vote at investee companies.

The 2009 Walker Review of governance in financial institutions invited the Financial Reporting Council (FRC) to take responsibility for the ISC Code.

In 2010, the FRC published the first version of the **UK Stewardship Code.**

A LEGAL ROADMAP

In 2009, the UNEP FI published *Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment.* This report sought to provide ***"a legal roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment."*** It argued that integrating environmental, social and governance considerations into investment decisions is a legal responsibility.

The paper also argued that investment consultants and asset managers have a duty to proactively raise environmental, social and governance issues as part of their advice to institutional shareholders and this duty must be embedded into their contracts.

WORLDWIDE SUPPORT PASSES US$30tr

In 2012, the PRI (having launched in 2006) achieved its thousandth signatory. It now has 1,192 signatories (157 from the UK), including 268 asset owners (29 from the UK) representing assets in excess of $30 trillion.

RESPONSIBLE INVESTMENT CAPACITY GROWS

The growth in resources dedicated to responsible investment within the investment industry continues to grow. Leading investment consultants now employ responsible investment specialists; major investment banks have responsible investment research teams; independent ESG research providers have moved from being national to global; data providers such as Bloomberg and Thomson Reuters have populated their terminals with ESG data on many companies they cover. There has also been a growth in the number of RI staff appointed by pension funds

NAPF PUBLISHES STEWARDSHIP POLICY

The NAPF Stewardship Policy published in 2012 gives pension funds a clear roadmap as to how they can address their stewardship responsibilities. It set out six best practice principles which include developing an investment policy which encourages the incorporation of material non-financial risks including corporate governance factors within investment decisions and the exercising of stewardship responsibilities such as engagement and voting.

MORE REGULATION PENDING

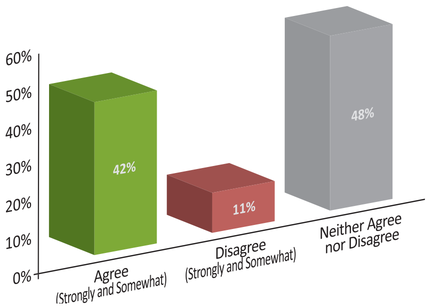
Pending regulation in the UK and EU supports enhanced shareholder rights and responsibilities to improve oversight of companies along with mandating non-financial reporting from companies. In addition the Law Commission in the UK has been asked to set out what the current law requires pension trustees, investment managers and other financial intermediaries to consider in deciding an investment strategy and whether fiduciary duties apply to all those in the investment chain.

The market is moving

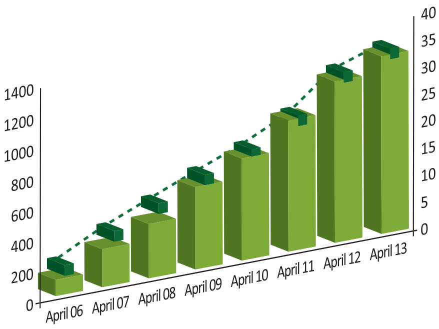
The discourse amongst politicians, regulators and commentators in recent times has been in parallel to an increasing awareness and expectations amongst individual beneficiaries as to how their savings should be invested. In addition, there is increasing scrutiny of such practices from a range of NGOs and journalists. This all means that the reputational risk of not acting as a 'responsible investor' is ever increasing.

Below we summarise some of these increased expectations amongst beneficiaries and how the institutional investment community, especially pension funds, have already been responding.

I would choose to save in pension investments where I can get a financial return on the investment and feel like I've contributed positively to society



No. Signatories   Assets under management (US$ trillion)



Attitudes in the workplace

The NAPF conducted its biannual Workplace Pensions Survey[2] from 15 to 17 February 2013, receiving 2,050 responses. The survey questions looked at respondents' views on auto-enrolment, investment risk, pension charges, corporate governance and expectations for their retirement.

Two in five of respondents (42%) stated that they would invest in a fund where they could get a financial return and feel like they had contributed to society.

United Nations supported Principles for Responsible Investment

Responsible investment is developing fast – just over a year ago, the PRI passed the 1,000 member mark, taking it to over $30 trillion dollars in terms of assets under the jurisdiction of its signatories.

The PRI[3] Initiative has grown exponentially since its inception in 2006. Today, it counts over 1,100 institutions from more than 50 countries as signatories, including many of the world's largest pension funds, insurance companies, and investment managers. They manage combined assets of more than US $32 trillion.

Manager selection

As implied by the increasing number of signatories to the PRI, this demand from investors has been manifesting itself within the manager selection process with some investment consultants now including ESG ratings in manager search reports to clients. One indicator of this is that the number of questions which relate to responsible investing within requests for proposals have increased significantly in recent years. For example:

- **Internal analysis by Aviva Investors indicates that 89% of their RFIs and RFPs now contain questions about extra-financial risks with 6.5 questions being the average.**

[2] NAPF Workplace Pensions Survey, March 2013
[3] PRI Principles for Responsible Investment, An investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact, 2012

Companies

Companies themselves have perhaps in many cases been ahead of investors in incorporating extra-financial risks within their business strategies.

The UN Global Compact is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption. The Global Compact has grown rapidly in recent years – it now has over 10,000 corporate participants and other stakeholders from over 130 countries.

Research provision

In response to the increased demand from asset owners and thus the increased attention being paid by asset managers, the quantity and quality of information and research has also increased.

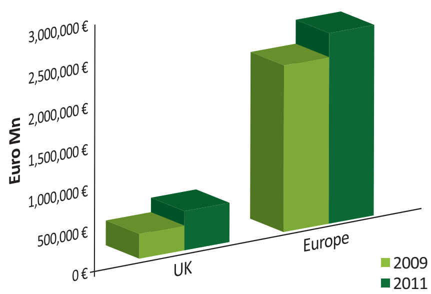
For example, data providers have in recent years begun to populate their terminals with Environmental, Social and Governance (ESG) data on many of the companies they cover.

- **Bloomberg indicate that in 2012 they had 4,700 regular users of ESG data and their ESG data points received 170 million hits in total during 2012 – up from 130 million hits in 2011.**

Being integrated within investment processes

There is increasing acceptance that integrating extra-financial risks within investment decisions forms part of an investor's fiduciary duty to its clients and beneficiaries. The growth of assets being invested via the process of integrating ESG criteria into financial analysis is highlighted here[4] – up to E3.2tr now across Europe.

Growth of ESG integration



A recent survey on behalf of the United Nations Global Compact into the progress of the Principles for Responsible Investment found that the world's major investors are now actively integrating ESG issues into their investment policies and engagement strategies.

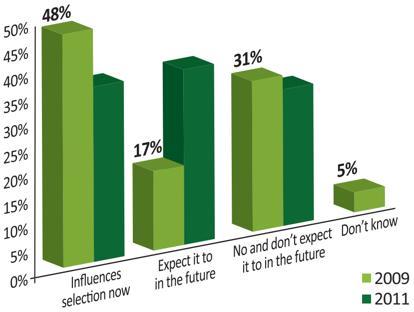
- **88% of investment manager signatories to the PRI are conducting at least some shareholder engagement on ESG issues.**

In addition, the NAPF, via its annual Engagement Survey, has been monitoring the level to which pension funds are incorporating stewardship and responsible investment principles within their manager selections, contracts and reviews.

In our most recent survey, published in December 2012, funds representing assets of £323bn were asked whether their scheme's policy on responsible investment influences the selection of investment managers or consultants. The results found that nearly half (48%) of respondents do take responsible investment into account when selecting managers or consultants – significantly up from the 36% figure in 2011. A further 17% stated that whilst they do not take this into account now,

[4] Eurosif European SRI Study 2012

Does your scheme's policy on responsible investment influence the selection of investment managers or consultants?



they expect they will in the future. These results demonstrated that funds are giving more consideration to stewardship and responsible ownership factors when awarding mandates.

To gain a fuller understanding of the importance placed on responsible investment during the investment process, respondents were given a sample of risk factors which included governance, social and environmental factors, and asked to indicate how important it is that the fund's investment managers take those factors into account when making investment decision.

What was particularly striking about this result was that for almost all the suggested factors trustees considered them more important to investment decisions than the previous year, thus indicating that trustees are increasingly recognising the significance of environmental, social and corporate governance factors on their investments and that as Kay suggested in his final report, investment decisions need to incorporate a broad range of issues which focus on both strategic issues as well as questions of corporate governance and other extra-financial matters.

Examples of how responsible investment is being embraced across the investment chain:

Asset owners →

89% of RFIs and RFPs contain ESG questions

Over the last few years, the Environment Agency Pension Fund has worked hard to put their investment philosophy into practice.

They now only appoint fund managers who demonstrate ESG issues are an important part of their investment decision-making. They monitor their performance.

They have been measuring the environmental footprint of their actively managed equities since 2005. For the last two years, they have also measured the environmental footprints of their corporate bonds.

At the end of September 2010, they became one of the first UK pension funds to publish their Statement of Compliance with the UK Stewardship Code.

Asset managers →

88% of investment manager PRI signatories are conducting at least some shareholder engagement on ESG issues

Blackrock, the world's largest asset manager with assets under management totaling US$3.87tr also acknowledges the importance of Responsible Investment.

Blackrock indicate that there is growing interest in the agenda from their clients and that in general, there is an expectation that they will promote sustainable business practices at the companies in which they invest.

As per its 2011 Corporate Governance and Responsible Investment annual review, it had $270 billion (or 7% of the firm's total assets under management, as of 6/30/11) in mandates that explicitly address social, ethical or environmental considerations.

Companies

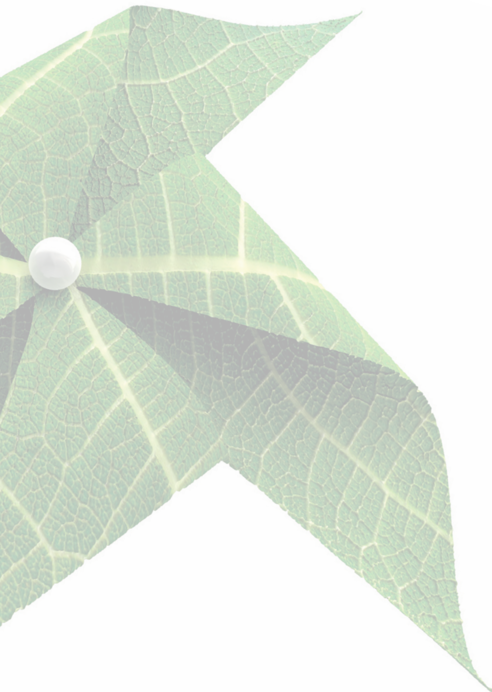
93% of CEOs believe sustainability issues will be critical to the future success of their business

As the leading premium drinks business, Diageo recognise that their social and environmental impacts are diverse, affecting the livelihoods of many people from their farmers who grow the raw materials all the way through to the consumers of their brands.

In their 2012 Sustainability and Responsibility Report Diageo's CFO stated:

"Diageo's investment in environmental sustainability has multiple paybacks: improved risk management around resource scarcity, increased efficiencies and cost savings, while importantly reducing our environmental impact"

The (financial) evidence is out there



If a company fails to appropriately manage its material extra-financial risks, including governance and where material, social and environmental issues, this can be an early indicator of wider management or financial problems which may not yet have come to light.

The impact of these risks are becoming more pronounced as corporate practices become more transparent with more comparable information being made available to investors. At the same time companies are becoming more global, as such many extra-financial risks, for example labour protests and safety concerns or ecosystem damage are embedded in vast corporate supply chains, where they are getting more attention. When they occur, supply chain disruptions can have longer-term financial consequences.

Furthermore, volatility in the global business environment due to financial risks, regulatory uncertainty, extreme weather, rising business interruption premiums, crop failures, commodity price volatility, and social unrest means that what may seem to be black swans are now perhaps more likely than previously thought.

In addition, for universal owners, there is an increasing awareness that if one company does well at the expense of others, a widely diversified investor may well pick up the costs as well as the gains.

The financial case

There has been a large amount of research seeking to assess whether integrating extra-financial factors within investment decisions leads to enhanced returns, the findings can be summarised as: integrating such factors may lead to improved performance, it certainly shouldn't lead to detrimental returns and will provide protection against potential shareholder value destruction.

Some examples of this research include:

- **Pooling results from 36 studies, the consultancy firm Mercer showed that 30 studies evidenced a neutral to positive relationship between ESG factors and financial performance[5].**

- **A recent study by Deutsche Bank of 100 academic studies of sustainable investing around the world concluded that 100% of the academic studies agree that companies with high ratings for CSR and ESG factors have a lower cost of capital in terms of debt (loans and bonds) and equity[6].**

- **Research by Professor Elroy Dimson of London Business School won the 2012 Moskowitz Prize for Outstanding Research in the Field of Sustainable, Responsible, Impact (SRI) investing. Having analysed shareholder activism with US companies over ten years to 2009 it was found that the average alpha return in the year after a CSR engagement was 1.8 per cent, with a 4.4% alpha return for successful CSR investor engagements[7].**

- **A study by Harvard Business School found evidence that 'High Sustainability' companies significantly outperform their counterparts over the long-term, both in terms of stock market and accounting performance[8].**

- **Research commissioned by Thomson Reuters revealed that US companies with stronger ESG scores consistently beat earnings estimates more frequently than those with lower scores. The gap in outperformance between ESG leaders and laggards persisted consistently across time[9].**
- **MSCI looked at the capital market responses to ESG events. They noted that these have steadily increased in magnitude over the past decade. Analysis of the average price movements for a series of companies that experienced large scale ESG events indicated that during the past 5 years there would be a 33% share depreciation on average and a 450% jump in volume from pre-event levels[10].**

Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes? A Realistic Prudent Investment Test[11]

In order to assess the financial effect of integrating any ESG criterion into an investment process from the perspective of pension funds, a study in 2011 developed a test of the prudent integration of ESG criteria in realistic pension fund investment processes. The academics analysed over 1,500 firms from 26 developed countries over a 77 months period using aggregated and disaggregated corporate environmental responsibility ratings supplied by EIRIS.

Results show zero indications that the integration of aggregated or disaggregated corporate environmental responsibility ratings into pension fund investment processes has any detrimental financial effect.

The study concludes that pension funds' fiduciary duties do not appear to prohibit the integration of environmental responsibility criteria into their investment processes.

[5] Mercer, "Responsible Investment's Second Decade: Summary Report of the State of ESG Integration, Policy, and Reporting," presented at the CalPERS Global Peer IESG Exchange, 2011.
[6] M. Fulton, B. M. Kahn, and C. Sharples, Sustainable Investing: Establishing Long-Term Value and Performance, DB Climate Change Advisors, Deutsche Bank Group, 2012;
[7] E. Dimson, O Karakas, X. Li, Active Ownership, London Business School, 2012
[8] R. G. Eccles, I. Ioannou, and G. Serafeim, The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance, Harvard Business School, 2011
[9] C. Greenwald, ESG and earnings performance, Thomson Reuters, 2010
[10] Measuring the Managers: How the Asset Management Industry Integrates ESG, MSCI, 2011
[11] Hoepner, Andreas G. F., Rezec, Michael and Siegl, K. S. , Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes?: A Realistic Prudent Investment Test (September 19, 2011). Available at SSRN: http://ssrn.com/abstract=1930189 or http://dx.doi.org/10.2139/ssrn.1930189

Case studies

The impact of failing to manage extra-financial risks has been clearly demonstrated in a number of recent cases:

Olympus – corporate governance issues

> ***One of the biggest and longest-running loss-hiding arrangements in Japanese corporate history***
>
> **Wall Street Journal**

In April 2011 the Japanese camera-maker Olympus appointed its first foreign president, Michael Woodford, a Briton and 30-year company veteran. Six months later he was sacked after questioning $1.7 billion in suspicious transactions

Olympus had bought three tiny, profitless companies in 2008 for $800m, only to write down three-quarters of their value by the end of the financial year. And it gave nearly $700m in “advisory fees” to an entity in the Cayman Islands whose ownership and legal standing were unclear. When Mr Woodford learned of this (after it was reported in a small Japanese business magazine), he sought answers from the firm’s chairman, Tsuyoshi Kikukawa; to no avail.

Michael Woodford was subsequently ousted as Chief Executive of Olympus for blowing the whistle on what amounted to a $1.5Bn accounting scandal.

On 8 November 2011, the company admitted that the company’s accounting practice was “inappropriate” and that money had been used to cover losses on investments dating to the 1990s.

Following exposure, shares in Olympus subsequently plummeted by almost 75 per cent and the firm came under investigation from regulators and enforcement agencies across the globe.

Vedanta Resources – social issues

> ***Vedanta is a particularly grave case of historic ESG mismanagement by a company listed on the London Stock Exchange.***
>
> **Aviva Investors**

Over a period of several years leading up to their 2010 AGM, Vedanta Resources came under increasing international scrutiny regarding alleged environmental and social impacts at some operations, particularly concerning plans for a bauxite mine, the expansion of its Lanjigarh alumina refinery in Orissa and the accident at a power plant which cost the lives of 41 employees because of the lack of safety procedures.

In August 2010 an Indian Environment Ministry enquiry rejected Vedanta’s plans for a bauxite mine in Orissa province. At the time the government expressed concerns that the mine would destroy the way of life of local tribes. It also accused a local subsidiary of Vedanta of violating regulations on forest conservation and other environmental issues.

In the week after the Indian government’s decision to block Vedanta’s controversial mining project, the company’s share price slid sharply in a bad finish to a three month period during which Vedanta’s share price trailed the FTSE 100 by 20%.

BP – environmental issues

BP's recent history is a sad tale of how environmental liability can affect a company's very survival.

Robecco

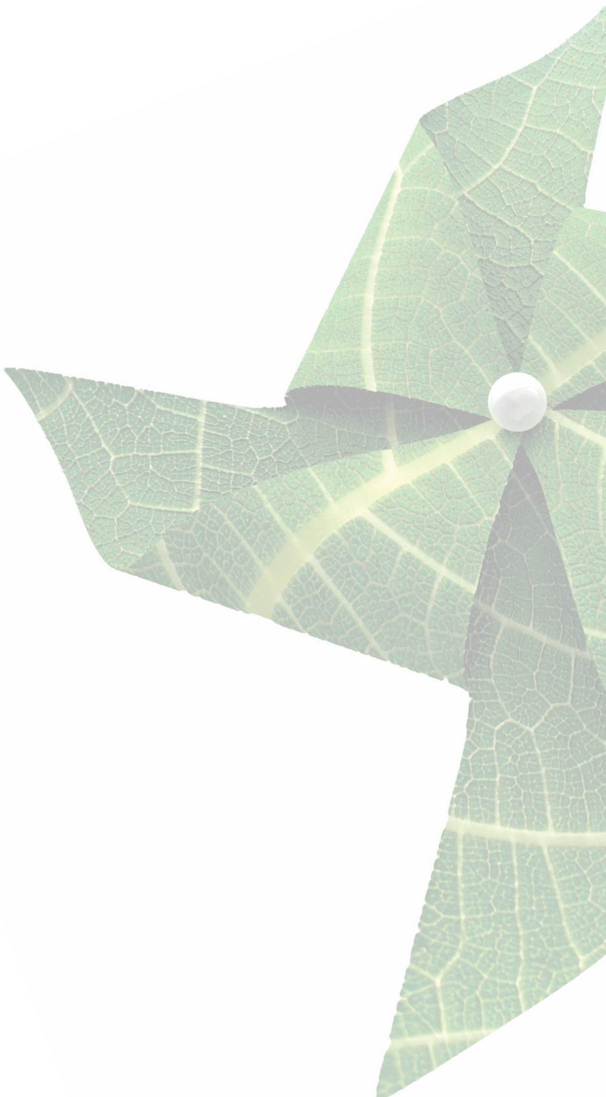
BP is in recent years the most commonly cited case study for integrating environmental, social and governance criteria into investment decision making.

BP had been struggling with fundamental problems in safety and risk management for several years. There had been previous significant incidents such as an explosion at a Texas City refinery in 2005 which killed fifteen workers and an oil spill in Alaska; in fact there had been 760 "egregious willful" citations from the UK health and safety authority in the 3 years prior to 2010.

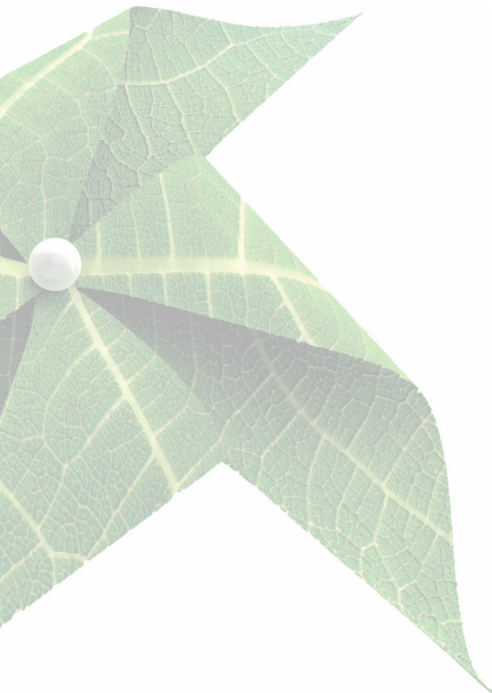
In April 2010, a gas release and explosion on the Deepwater Horizon oil rig resulted in the deaths of 11 people and caused millions of barrels of oil to gush into the Gulf of Mexico – the largest accidental spill in history. It took BP 87 days to cap the well and stop the leaking.

Estimate suggest that this disaster could cost BP a total of $20 billion due to delays in other projects, overall reputation damage and compensation to local businesses and the survivors of the eleven workers killed.

In the aftermath BP shares hit a 14-year low, at one point, having declined by more than 50%.



Across asset classes



Research shows a clear trend toward developing models and tools for integrating extra-financial risks across all asset classes, with unsurprisingly a stronger penetration in the public equity space. Out of 5,175 ESG strategies analysed by the consulting group Mercer, 57% were in listed equities, 20% were in fixed income and the remaining 23% were spread across alternatives[12].

Pension funds, as institutional shareholders, are in a position to exert significant influence over the companies (and assets) in which they invest – whether as owners or creditors – to protect and promote members' interests and to help improve and protect the returns on their investments.

Public equities

- **"93% of CEOs believe sustainability issues will be critical to the future success of their business[13]"**

Key points/questions for pension funds:

- Include relevant criteria within manager searches in an effort to understand whether the prospective manager has an appropriate responsible investment approach?
- Is the fund manager is a PRI signatory – if so ask them for their PRI assessment of how they are performing against the Principles and their peers. If they're not, why have they not signed up?
- Hold managers to account during the manager review processes, ensuring that managers are exercising the funds' ownership rights in an appropriate manner – including voting shares in a considered manner and engaging with companies in relation to material risks.

Historically, it is public equities that have been the focus of most responsible investment activity, with attention given to the ownership rights that are attached to shares and the obvious risk in the investments.

The primary motivation for assessing extra-financial factors is to manage those risks which are important drivers of risk and returns. In this context, extra-financial factors can be used to select better managed companies that can mitigate risks and exploit opportunities – e.g. spot the diamonds in the rough and avoid buying the lemons. The assessments of extra-financial risks can and should be subsequently incorporated into engagement and voting initiatives.

The NAPF has stated previously that it believes the informed use of votes, while not a legal duty, is a responsibility of owners and an implicit fiduciary duty of pension fund trustees and investment managers to whom they may delegate this function. Fundamental to any analysis of an equity investment should be an appreciation of the quality of the company's management, its structure, the appropriateness of its internal controls and the assurance that all material extra-financial factors are managed to the benefit of the long-term investor value.

[12] J. Ambachtsheer and K. Burstein, "Mercer's ESG Ratings Update: 5,000 and Counting. Mercer.com Insight, February 13, 2012, www.mercer.com/articles/ESG-ratings-update.

[13] P. Lacy et al, A New Era of Sustainability, UN Global Compact-Accenture CEO study 2010

Pension funds should be concerned with how their investment managers identify and manage these extra-financial factors, how they incorporate these factors into their stock selection, company engagement and voting activities and whether the managers' policies and activities are in line with their expectations. They should also expect an appropriate level of robust and meaningful disclosure of how the manager undertakes these activities in a timely manner – this should then be available upon request to be communicated to the pension fund's beneficiaries.

Rise of index funds

With more use being made of passive-index funds, the importance of monitoring and engaging on extra-financial risks in equity investments is ever more important given the importance of the health of the market as a whole.

In addition, in the UK, the FTSE index constituents increasingly include companies with unusual ownership structures, such as foreign mining companies listed in London. Whilst the governance standards required for entry onto the UK's Premium Market are rightly robust, this trend does highlight the importance for investors of being vigilant in monitoring and engaging with investee companies. The unusual ownership structures of some of the foreign mining companies listed in London and the clear materiality of governance, resource constraints and social risks to their business model and often license to operate demonstrate well the importance of effective management of extra-financial risks, especially where an investor does not have the option to "sell".

Engagement

For equity (and to a lesser extent bond) investments, a key stewardship responsibility is effective engagement with companies on issues ranging from strategy and performance to risk and corporate governance. In most cases pension funds delegate this responsibility to their investment manager and/or a third party provider. However, this delegation of activity does not include a delegation of responsibility – funds should endeavour to hold their managers to account, ensuring they are undertaking this activity and seek to understand how effective they have been.

Engagement may include dialogue or collaboration with other investors, organisations or forums.

HERMES EOS (on behalf of a range of pension funds)

Lloyds Banking Group – sustainability

Beginning in 2010, Hermes EOS intensified their engagement with the Lloyds banking group to discuss their sustainability strategy and governance following their disappointment with the bank's efforts in this direction. They had a frank discussion with the bank about the serious shortcomings identified. Hermes EOS believed that the governance was flawed, with no direct board responsibility and a split between the oversight of the wholesale bank and that of the rest of the group.

Hermes EOS were also concerned that Lloyds' sustainability programme as articulated was too philanthropic in nature and without an overarching sustainability goal linked to the corporate strategy. Their concerns were expressed in a series of meetings and the bank's strategy now is more cohesive and linked to commercial priorities, including better relationships with potential customers.

When they met the bank again in 2011, Lloyds had appointed an executive and a non-executive director to its' sustainability steering committee and unified the previously split responsibilities into one programme under a new head of sustainability.

Strathclyde Pension Fund

Lochard Energy – performance

In early 2012 Strathclyde Pension Fund's UK smaller companies manager, Henderson Global Investors indicated that they wished to bring to an end the prolonged period of destruction of shareholder value which had occurred under Lochard Energy's Chief Executive Haydn Gardner.

Henderson's investment managers briefed the Fund on their concerns regarding business and governance failures at the oil and gas exploration company and advised that they intended to seek the removal of two directors by a ballot of shareholders.

As a significant owner of Lochard Energy shares with a visible Responsible Investment policy Strathclyde Pension Fund was best placed to facilitate this action and requisitioned an EGM to remove the directors which was held on Friday 13 April. The Fund's Investment Manager attended the EGM with representatives of Henderson Global Investors and the proposed resolutions were passed with over 80% of votes cast in favour.

On 18th April and following a brief suspension of trading Lochard Energy announced the appointments of three new Non-Executive Directors and a new Non-Executive Chairman.

CalPERS

Apple – governance issues

CalPERS, the Californian pension fund engaged with technology giant Apple over a number of years with regard to its concerns around board accountability.

CalPERS asked the company to improve board accountability by relinquishing the plurality voting model that allows multiple candidates to the board to be elected with a single In Favour vote. A CalPERS proposal at the 2011 AGM won the support of 73% of Apple's shareholders and a similar proposal in 2012 received over 80%. This subsequently led to Apple agreeing to change.

That improvement in corporate governance has helped the pension fund protect future returns from its stake in the company.

Fixed income

Key points/questions for pension funds:

- Does the manager have a formal policy outlining their approach to responsible investment in this asset class?
- Does the manager understand how extra-financial factors relate to risk/return – e.g. credit risk?
- Include relevant criteria within manager searches to understand whether the investment manager is incorporating all relevant risk factors within investment analyses. Can they cite examples where extra-financial factors have influenced their investment decision?
- Is the fund manager a PRI signatory – if so ask them for their PRI assessment of how they are performing against the Principles and their peers. If they're not, why have they not signed up?

Fixed income represents a growing share of most pension fund portfolios as they face a maturing of their liability profiles.

It is increasingly being recognised that integration of extra-financial considerations are as relevant to fixed income investment decisions as they are to equity investments, supplementing traditional approaches as part of an assessment of credit risk and bond selection.

Corporate bonds

Companies are increasingly issuing longer-term debt in response to market demand for long-term fixed income assets. Therefore with the increase in fixed income within pension fund portfolios, corporate bonds increasingly matter, and increasingly matter for the long term. It is thus imperative for long-term investors to consider the impact of long-term risks on their bond portfolios.

Long-term factors relevant to the current and likely future health of the company matter to both bond and equity-holders – many pension fund investors will of course likely be both bond investors and shareholders in many companies. While the cash flows from bonds held to maturity will not change unless an unmanaged risk causes the company's on-going existence to be under threat, the value in an investor's portfolio will nevertheless be impacted. As the equity buffer is eroded, value is also lost on the bond side: even if the cash flows remain intact, the yield on the bonds will widen and the mark-to-market valuations reduce whether or not the credit rating is downgraded. Therefore poorly managed and mitigated extra-financial risks can destroy value for both equity and bond investors.

The primary objective of a bond investor is often to mitigate downside risk. Given that, in bonds the potential upside is limited and more modest than in the case of investing in equity, it is perhaps at least as important, if not more so, to ensure that

long-term risks from extra-financial factors are incorporated into pre-investment analyses to reduce the default risk that an investor is exposed to.

- **BP's Gulf of Mexico oil-spill in 2010 had an acute impact on the company's credit risk premium, agency debt ratings, and corporate reputation.**

- **Evidence suggests that weak management of environmental risk correlates with lower credit ratings and a higher cost of debt financing. Conversely, proactive management of environmental practices is associated with a lower cost of debt[14].**

Sovereign bonds

Many pension fund investors are trying to find new ways to evaluate the creditworthiness of sovereign bonds, especially in light of the Eurozone debt crisis. An increasingly common method is to apply extra-financial criteria to portfolios.

A key issue for pension fund investors is the long-term sustainability of a country's economic and political situation and therefore addressing extra-financial issues naturally aligns with this. Many institutional investors, especially pension funds, wish to limit reputational or headline risk to avoid negative perceptions associated with a particular activity or regime, thus being aware of securities that carry certain political, environmental, social or governance risks can be helpful in this respect.

Of course in contrast to in equities and corporate bonds, voting is not relevant and engagement is very difficult. There is thus a much reduced set of available engagement tools. Exclusion is therefore the most common tool used, although integration is also getting more advanced and there are an increasing number of research houses providing ratings.

Assessment of governance may consider matters such as fiscal policy and corruption; the social dimension may review democratic accountability and human rights; while the environmental aspect may take into account water stress and total carbon emissions.

- **Analysis by Axa Investment managers recently noted that on a risk-adjusted basis, since the Eurozone crisis took root in 2009, bonds issued by sovereign issuers that scored well on ESG issues tended to outperform those that scored poorly on this measure[15].**

[14] Rob Bauer and Daniel Hann, Corporate Environmental Management and Credit Risk, p.2 (December 23, 2010) Available at: http://ussif.org/resources/research/documents/2010MoskowitzPrize.

[15] L. Moret, P. Sagnier, Sovereign Debt Investing: ESG Framework and Applications, Axa Investment Managers Responsible Investment, 2013

Real estate

Key points/questions for pension funds:

- Does the manager have a formal policy outlining their approach to responsible investment in this asset class?
- Allocate a material weighting to sustainability issues within the real-estate investment process part of the RFP.
- Consider whether the prospective manager is pricing in environmental and regulatory risks.
- Assess whether the prospective property investment manager takes into account and manages extra-financial issues in their portfolio – are such issues integrated in standard investment appraisal models and incorporated into management, monitoring and reporting procedures?
- Is the fund manager a PRI signatory – if so ask them for their PRI assessment of how they are performing against the Principles and their peers. If they're not, why have they not signed up?
- Are they completing the Global Real Estate Sustainability Benchmark survey? If yes, ask them for their results.

A responsible investment approach towards real-estate investing is now also moving increasingly up the agenda, as it is in relation to fixed income.

Real-estate investment can often involve longer time horizons than other asset classes, which means that long-term issues such as changes in regulation, consumer expectations and physical risks (such as flooding, drought etc.) have the potential to have an impact on fund and asset performance.

Given that the property industry is often cited as at the centre of sustainability issues – it produces 40% of worldwide CO2 emissions and is responsible for the use of 40% of natural resources – the sector is unsurprisingly the focus of many government initiatives. It would therefore be unwise for an investor not to factor in sustainability issues within its investment decisions in this space. Such consideration may allow investors to gain a competitive advantage by getting ahead of more stringent regulatory environmental and social requirements.

Integrating extra-financial factors alongside traditional measures of financial risk as part of an asset allocation and portfolio risk analysis can enhance the existing analysis that lies behind investment decision-making. The subsequent results of such analysis will enhance decisions about whether to acquire or dispose of an asset, or identify which assets would benefit from specific interventions to improve their operational efficiency.

Given the above funds should consider allocating a material weighting to sustainability issues within the RFP process. It is also worth considering whether the reward structure of the investment manager encourages them to address and take into account the longer time frames typically involved in real estate investment management.

Private Equity

Key points/questions for pension funds:

- Does the manager have a formal policy outlining their approach to responsible investment in this asset class?
- Conduct appropriate due diligence to ensure the alignment of interest, governance and transparency of the GP to the fund is satisfactory.
- Do the GP's policies, processes and resources enable it to effectively incorporate extra-financial factors into their investment assessments and on-going interactions with the fund's portfolio companies?
- Is the fund satisfied that its own responsible investment beliefs are shared by the other LPs?
- Is the manager a PRI signatory – if so ask them for their PRI assessment of how they are performing against the Principles and their peers. If they're not, why have they not signed up?

While ownership structures and governance differ between public and private equity, the underlying asset in which they invest is the same – a company. The information and analysis needed to identify and manage material extra-financial risks and opportunities is the same in public and private equity.

Private equity has a long-term investment horizon, and in many cases, private equity is a stewardship-based style of investment and should benefit from increased focus on extra-financial issues. Responsible investment therefore should be seen as a natural for private equity investors.

Private equity does not usually include the governance challenges that largely define investors' work on responsible investment in public equities (i.e. aligning the interests of company managers and a diverse pool of shareholders). However, investors face a different governance challenge: how to align the interests of the General Partner (GP) responsible for managing the investments with a diverse pool of capital providers – usually institutional investors or high net worth individuals (LPs). Pension funds also need to be assured that where GPs are not taking a controlling position at an investee company; they have undertaken appropriate analysis of the governance in place. Just as investors have advocated changes to corporate governance and disclosure practices to be able to more effectively act as stewards of publicly-owned companies, so too an LP should consider fund governance and disclosure practices to act effectively as a steward in private equity.

An investor will usually be a passive partner in a private equity fund. Therefore a GP often has sole discretion for investment and ownership decisions. It is important therefore that before investing in a fund, a pension fund should assess the degree to which the manager has the policies, systems and resources needed to integrate material extra-financial factors into investment decisions and ownership activities. An LP can engage with a GP to assess the effectiveness of the

GP’s policies and resources for identifying and managing material extra-financial risks within the fund’s portfolio companies. Such engagement need not conflict with requirements of a limited partner.

In the past few years a number of guides have been produced which are publicly available and can be used by LPs as a basis for discussions with GPs. These include: the PRI’s A Guide for Limited Partners and ESG disclosure framework for private equity, along with the ILPA Private Equity Principles and ILPA Standardised Due Diligence Questionnaire. In addition, a broad range of private equity associations have published guides on ESG in private equity, including in the UK.

Hedge Funds

Key points/questions for pension funds:

- Does the manager have a formal policy outlining their approach to responsible investment in this asset class?
- Incorporate a governance assessment into the fund's formal due diligence process. Will the directors of the hedge fund will protect the funds interests.
- Is the fund manager a PRI signatory – if so ask them for their PRI assessment of how they are performing against the Principles and their peers. If they're not, why have they not signed up?

The quality of hedge fund governance has become an issue that is increasingly being addressed by investors in their due diligence process of potential hedge fund investments. Responsibility for the governance of the fund rests with its board of directors, who owe the same duties as directors of any other corporate entity. Although the board may delegate the management and administration of the fund, the directors are responsible for the management of the company and have a fiduciary duty to shareholders for supervision and control.

A governance assessment should be incorporated into a fund's due diligence process to ensure that the pension funds' interests as investors will be effectively addressed and protected by the board and its directors. A key part of the due diligence process should focus on the background, role, contribution and oversight functions of the independent directors as well as the board's overall governance structure.

As part of that due diligence, the quality of the fund's board should be assessed, in particular, in its protection of investors' interests. Accordingly, for each director, information should be sought regarding their workload commitments as a director and their past experience. A director with adequate capacity and, who may have successfully navigated difficult circumstances, being an obvious asset to the governance of the fund.

Other asset classes

- **Infrastructure assets often involve long-term outlooks and have a changing risk profile depending on the stage of their development. These investments often have potentially significant positive or negative impact on the environment and society. Most of the considerations outlined in the previous sections are equally relevant here.**
- **Commodities can directly or indirectly expose investors to a range of extra-financial risks including environmental sustainability, labour rights in the supply chain and resource rights.**

Key actions

Responsible Investment should not be seen as a "box-ticking" exercise but instead be based upon an understanding of the issues, engagement with companies (or appropriate accountable organisation) and participation in the development of standards.

Develop a Policy → **Incorporate criteria into manager selection and mandates** → **Monitor investment manager (or equivalent) activity** → **Require regular and useful reporting**

1. Have a policy

Develop an investment policy which includes an understanding of stewardship objectives and risks.

This policy should encourage the incorporation of financially material extra-financial risks, including environment, social and corporate governance factors, within investment decisions and the exercising of stewardship responsibilities such as engagement and voting. This policy should ideally be set out within the funds' Statement of Investment Principles (SIP).

Strathclyde Pension Fund states in its SIP that it ***"requires its managers to monitor investee companies and engage with company management where Environmental, Social or Governance (ESG) practices fall short of best practice."***

The Royal Mail Pension Fund within its SIP states that it ***"aims to be an engaged and responsible long-term investor in the assets and markets in which it invests. The Trustee believes that the integration of these factors within Investment Managers' investment processes is not detrimental to the risk and the sustainable long-term expected returns from the Plan's investments. All of the Plan's Investment Managers are encouraged to take these factors into account within their respective investment processes."***

Shell Pensions Trust has published a Responsible Ownership Policy in which they state that ***"environmental, social, economic and governance performance are fundamental to a company's success and thereby its long-term financial returns."***

2. Manager selection – make the market work

The definition of best practice in responsible investment is evolving quickly. A few years back, being a PRI signatory was considered advanced; it is now commonly seen as a minimum requirement of asset managers and the focus is shifting to measuring better the effectiveness of actually integrating extra-financial factors within investment decisions and monitoring the quality of engagements with companies. Now instead of simply asking whether a prospective investment manager is a PRI signatory – funds should ask how they are performing against the Principles? Actions speak louder than words.

Pension funds should seek to get beneath any generic marketing material provided by prospective investment managers and question them about their experience and approach to responsible investment. It is important to ask questions in the RFP process and during the subsequent manager presentation stage (beauty parade) to gain a greater understanding of the investment managers' stewardship approach and gauge whether they are aligned to the funds' own policy.

The NAPF has published a "Quizzing Fund Managers" crib-sheet to assist funds with this process.

Example interview and RFP questions

- How are extra-financial risks incorporated into investment decisions?
- What resources does the investment manager have available for extra-financial risk analysis?
- What codes of conduct or principles have you signed up to and how do you rate against them?
- Are you able to demonstrate the effectiveness of your stewardship activities?
- How do you respond when a extra-financial risk is identified in an investee company or asset?

Funds should request evidence to support answers where possible.

The majority of schemes delegate some – if not all – of the management of their investments externally, so it is crucial that once selected, investment managers are given clear policies and instructions within the Investment Management Agreements (IMA), particularly if the investment is within a pooled fund.

Pension funds should consult their legal counsel regarding including relevant clauses within their IMA, however, below are some example clauses from the International Corporate Governance Network's Model Mandate initiative which may be worth considering:

PROPOSED MODEL TERMS FOR MONITORING ESG

The Manager will have a process for monitoring current or potential investments in relation to relevant long-term factors such as ESG concerns. The Manager will ensure that its' staff apply due care and diligence to applying this monitoring process, including considering the extent to which such long-term factors generate investment risks or opportunities.

PROPOSED MODEL TERMS FOR ONGOING DUE DILIGENCE

The Manager will facilitate access by the Client to its staff and systems such that the Client can gain assurance on an on-going basis that the Manager is appropriately implementing the Client's responsible investment policy set ... (as agreed with the Client in schedule XX) ..., monitoring key longer-term risks and integrating such factors into its investment and risk management decision-making.

PROPOSED MODEL TERMS FOR VOTING

Alternative 3
(where voting control is delegated to the Manager)

The Manager will procure the exercise of all voting rights attached to the Portfolio investments on the Client's behalf, in accordance with the Manager's voting policy and any market-specific guidelines approved by the Client. The Client reserves the right to rescind, upon (one day's) advance written notice, the Manager's authority to make voting decisions for specific companies, issues or time periods. The Manager will use best endeavours to facilitate such Client voting decisions to be implemented. The Manager will have in place appropriate policies to manage any conflicts of interest in relation to voting matters and shall report at least quarterly on all votes involving companies where the Manager or an affiliate have a contractual relationship or other material financial interest.

The BT Pension Scheme (BTPS) – works with its fund managers to encourage and assist them to integrate long-term factors into their investment decision-making, and to instil an approach to fund management which matches the Scheme's need for long-term performance. The Trustee seeks where possible to include some requirement to take account of sustainability factors in its contracts with fund managers, and then seeks to hold the managers accountable for delivery against this standard.

NEST includes ESG questions within their RFPs and subsequently question fund managers on their approach to responsible investment at the presentations stage to clarify aspects of the RFP.

3. Monitor managers – monitor the *how*

It is vital to develop the relationship with the appointed managers by monitoring their activities and holding them to account for delivering via regular dialogue.

Funds should monitor their manager's investment performance no more frequently than is necessary, and ideally with reference to long-term absolute performance. During the course of the year funds should be endeavouring to understand how their investment managers invest and how their ownership rights have been exercised; gaining an understanding of their approach to integrating extra-financial issues will give funds a helpful insight into the day to day investment process at the investment manager. When assessing investment performance, funds should seek to discuss performance with reference to the previously agreed upon investment strategy and not feel pressured to respond to what may be short-term market fluctuations. Consideration should be given to the impact of factors which may not be reflected in current market values, but may impact on the value of investments over the long-term.

Within the regular manager reviews, funds should ensure that managers are adhering to the funds' stewardship policy. This may include questioning the effectiveness of managers' engagement activity and how they plan to engage with key holdings which have performed poorly over a period of time.

The NAPF provides monthly topical questions for funds to utilise in order to quiz their managers.

Investors should seek to utilise all the tools at their disposal, exercising the right to vote is an important aspect of good corporate governance. The vote against management can be the ultimate sanction a shareholder has and can be a powerful way to engage with the company. For smaller investors, the vote is most effective when they seek to collaborate with other investors to enhance their voice. In such circumstances when constructive engagement is failing, investors may also wish to consider filing a shareholder resolution and/or as a last resort go public with their concerns.

Typically pension funds are one of the main providers for stock lending, so stock should be recalled from the borrower in order to exercise votes – especially in more contentious cases. A policy in this respect should be incorporated into the IMA.

Most investment consultancy firms have dedicated substantial resources to the issue of responsible investment in recent years and often now have significant capability in this area. Pension funds should ensure they are being provided with adequate and appropriate support from their consultants to assist them in understanding the materiality of extra-financial risks and in judging the policies and undertakings of their current and prospective asset managers. This is especially key for those funds which have limited internal resources, in such cases it is important to ensure that the consultant fully understands and implements the pension fund's expectations in this area.

The **Lloyds Banking Group Pension Scheme** indicate in their SIP that the "Trustee monitors investment managers' actions and their compliance with integrating ESG issues in their investment decision making processes. Where investment managers make statements regarding ESG issues, the Trustee monitors these statements as part of its investment manager due diligence processes.

The **Greater Manchester Pension Fund** acknowledge that day-to-day responsibility for managing their equity holdings is delegated to their appointed asset managers, and the Fund expects them to monitor companies, intervene where necessary, and report back regularly on activity undertaken. Each appointed external active asset manager reports in detail on its policy and activity in these areas by attending the Fund's specialist "Ethics and Audit Working Group" on an annual basis.

4. Reporting – what gets reported gets done

Responsible ownership however, is not just about voting shares. Schemes should ensure their investments are being managed responsibly – whether managed internally or externally. As part of this they should expect effective transparency and reporting on their investments from all within the investment chain. This reporting should:

- **Be timely, bespoke and succinct.**
- **Include a summary of the key material extra-financial risks identified within the portfolio and how the manager intends to monitor and manage these.**
- **A voting report, provided in a useful format and at least highlighting votes against management;**
- **An engagement report, summarising specific engagement activities in that quarter, evidencing any successes, and progress against objectives.**

The **Coal Pension Trustees Services Ltd** provides the voting records and engagement reports of its investment managers on its website on a quarterly basis.

The **London Pension Fund Authority (LPFA)** in addition to publishing quarterly the voting and engagement activities of their investment manager, they also publish their voting records which highlights where they decided to vote for, against (withhold), or abstain on a particular resolution. This includes an online searchable tool which allows individuals to view brief explanations for each resolution where they have decided to vote against management.

Appendix

PENSION FUND SIGNATORIES TO UK STEWARDSHIP CODE (50) – MAY 2013

AP1

Aviva UK

Avon Pension Fund

Bedfordshire Pension Fund

British Airways Pensions

British American Tobacco UK Pension Fund Trustee Ltd

British Coal Staff Superannuation Scheme

BT Pension Scheme

CB&I John Brown Pension Scheme

DHL Trustees Limited

DMGT Pensions

East Riding Pension Fund

Environment Agency Active Pension Fund

Greater Manchester Pension Fund

Gwynedd Pension Fund

Lincolnshire Pension Fund

London Borough of Bexley Pension Fund

London Borough of Hillingdon Pension Fund

London Pensions Fund Authority

Lothian Pension Fund

Marks and Spencer Pension Scheme

Merchant Navy Ratings Pension Fund Trustees Limited

Merseyside Pension Fund

Mineworkers Pension Scheme

Nationwide Pension Fund

NAPF Trustee Limited

NEST

NFU Mutual

North East Scotland Pension Fund

Northern Ireland Local Government Officers' Superannuation Committee

Northern Powergrid Group of the Electricity Supply Scheme

Ontario Teachers' Pension Plan

Pension Protection Fund

Railways Pension Trustee Company Limited

RBS Pension Trustee Limited

Royal Mail Pension Plan

Scottish Life

Société Générale UK Defined Benefit Pension Scheme

Somerset County Council

Strathclyde Pension Fund

The Barclays Bank UK Retirement Fund

The BBC Pension Trust Ltd

The Co-operative Group Pension (Average Career Earning) Scheme

The London Borough of Ealing Pension Fund

The Pensions Trust

The Tyne and Wear Pension Fund

Universities Superannuation Scheme (USS)

West Midlands Pension Fund

Whitbread Group Pension Fund

Wiltshire Pension Fund

PRI UK ASSET OWNER SIGNATORIES (29) – MAY 2013

Alliance Trust PLC

BBC Pension Trust Limited

BP Pension Fund

BT Pension Scheme

CDC Group PLC

Environment Agency Pension Fund

Joseph Rowntree Charitable Trust

Lloyds Banking Group

London Borough of Haringey Pensions Committee

London Pensions Fund Authority (LPFA)

Lothian Pension Fund

Marks & Spencer Pension Scheme

Merseyside Pension Fund

National Employment Savings Trust (NEST)

North East Scotland Pension Fund

Northern Ireland Local Government Officers' Superannuation Committee

Old Mutual PLC

Pension Protection Fund

Railways Pension Trustee Company Limited

Royal Mail Pension Plan

Shell Contributory Pension Fund

Strathclyde Pension Fund

The Church of England National Investing Bodies

The LankellyChase Foundation

The Pensions Trust

The University of Edinburgh

UNISON Staff Pension Scheme

Universities Superannuation Scheme (USS)

West Midlands Pension Fund

PRI UK INVESTMENT MANAGER SIGNATORIES (98) – MAY 2013

3i Group

Aberdeen Asset Management

Actis

Alken Asset Management LLP

Alquity Investment Management Limited

Altius Associates Ltd

Apax Partners LLP

Appian Holdings

Arle Capital Partners Limited

Aureos Capital Ltd

Auriel Capital Limited

Aviva Investors

Baillie Gifford

Baird Capital Partners Europe Limited

Balfour Beatty Infrastructure Partners, LLP

BC Partners

Bedlam Asset Management PLC

Berkeley Partners LLP

Bridgepoint

Bridges Ventures

Cantillon Capital Management

CapVest Partners LLP

Cazenove Capital Management

CCLA

Charlemagne Capital

Cinven

Climate Change Capital

Craigmore Sustainables LLP

Culross Global Management

Doughty Hanson & Co

Dundas Partners LLP

Earth Capital Partners LLP

Ecclesiastical Investment Management (EIM) Limited

Epworth Investment Management

Equitix

F&C Asset Management

Generation Investment Management LLP

Genesis Asset Managers

GFI Consultants Ltd

Governance for Owners

Growth Capital Partners LLP

Henderson Global Investors

Hermes Fund Managers Limited

Hermes GPE

Hexam Capital Partners LLP

HgCapital LLP

Highclere International Investors LLP

HSBC Global Asset Management

iCON Infrastructure LLP

Impax Asset Management

InfraRed Capital Partners Limited

Insight Investment

Intermediate Capital Group plc

Investindustrial Advisors Limited

J O Hambro Capital Management Group

Jupiter Asset Management

Kames Capital

LaSalle Investment Management

Legal & General Investment Management Limited

Lloyd George Management

Longview Partners

M&G Investments

Man Group PLC

Martin Currie Investment Management

Montanaro

MSS Capital

Newton Investment Management

NorthEdge Capital LLP

Orion Capital Managers LLP

Pampa Capital Management LLP

Panoramic Growth Equity

Pantheon Ventures

Par Equity LLP

Permal Group Limited

PRUPIM

Quadriga Capital

Rathbone Brothers PLC

Rockspring Property Investment Managers LLP

Royal London Asset Management

S C Davies & Company Ltd

Sarasin & Partners LLP

Schroders

Scottish Widows Investment Partners

Silk Invest Ltd

Silverfleet Capital Partners LLP

Stafford Timberland Limited

Standard Life Investments

SVG Advisers Limited

Temporis Capital LLP

Terra Firma Capital Partners

The Co-operative Asset Management

The Environmental Investment Partnership LLP

Threadneedle Asset Management Ltd

Triton Advisers Limited

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