NAPF

Securing the future of pensions

NAPF Engagement Survey:
pension funds' engagement with investee companies

NAPF Research Report

November 2013

Contents

Executive summary

This report presents the findings of the NAPF's ninth annual survey of pension funds' engagement with investee companies. The NAPF believes that engagement with investee companies is a vital part of the investment management process, and the Engagement Survey provides evidence that UK pension funds increasingly share this belief and take their stewardship responsibilities seriously.

The survey shows that pension funds are continuing to get to grips with their stewardship responsibilities as set out under the Stewardship Code. More funds are committing to Code and to its Principles and their expectations of their investment managers are increasing in turn. These are positive developments and demonstrate that pension funds are committed to this important agenda. The Report also suggests that the commitment of other signatories to the Code, such as the investment consultant community, appears to be diminishing and poses a concern.

The NAPF is urging all in the institutional investment community to reflect and recommit to the spirit of the Stewardship Code.

Five of the key findings of this Engagement Survey are:

- There is a near consensus from pension funds that they have stewardship responsibilities.
- A significant majority of funds recognise that extra-financial factors can have a material impact on investments in the long-term.
- Stewardship is not being raised by consultants and when it is discussed signing up to the Stewardship Code is rarely recommended.
- The stewardship policies and activities of asset managers are a factor in manager selection for most pension funds.
- While believing it important, many pension funds are not seeing evidence that the engagement activities (including voting) undertaken by their fund or its managers are influencing changes to company strategy, remuneration or social or environmental policies.

NAPF review of 2013

There is much from 2013 of a positive nature to reflect upon. Indeed after the "Shareholder Spring", the institutional investor community does not appear to have been struck with a collective hangover or with feelings of regret, but instead has embarked on a year of quiet diplomacy with companies and continued improving commitment to the Stewardship Code and its Principles.

The 2013 AGM Season

It is no bad thing that this year did not garner the front page headlines of last year. Gratefully, many companies learnt the lessons of 2012 and there was much in the way of early and largely constructive engagement between companies and their shareholders.

This year the NAPF published the first of what will become an annual report on the AGM season. Looking back at the 2013 AGM season, the report discussed many positives, including the increasing attention that shareholders are giving to important governance issues besides remuneration, including the external audit and specifically the safeguarding of the auditor's independence.

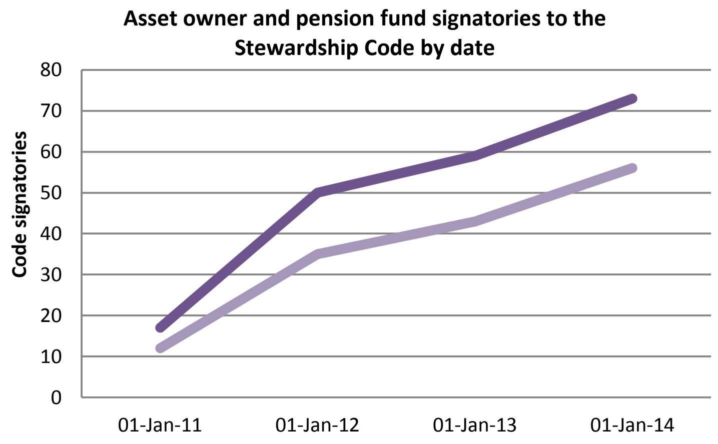
The report did, however, highlight a small number of companies where shareholders felt compelled to express their dissatisfaction for a second successive year on a remuneration-related resolution. Chief among these was Afren which was the only company to have its remuneration report voted down by its shareholders in 2013.

New corporate reporting requirements coming into force in 2014 in relation to remuneration, audit and strategy present new challenges. But they also offer new opportunities for companies to build on or develop positive and constructive relationships with their shareholders.

Stewardship Code coming to life

Of course, the success of the UK Corporate Governance Code, on which the NAPF's Corporate Governance Policy & Voting Guidelines is based, depends upon an engaged investor base utilising the information disclosed by corporates and appropriately holding them accountable. The ongoing success of the Corporate Governance Code is, therefore, to a large degree dependent upon the success of the more recent UK Stewardship Code.

The success of the Stewardship Code requires signatories to adhere to both its letter and spirit.



It also requires bottom-up accountability of the asset manager signatories via their clients. Informed asset owners can then hold engaged asset managers to account for stewarding successful companies.

This past year has seen good progress, with increasing public commitment to the Stewardship Code from asset owners, including pension funds.

The NAPF believes that signing up to

the Code demonstrates that a pension fund believes companies should adhere to the highest standards of governance and that their investment managers should integrate the Code's Principles into their investment processes. Therefore, a greater weight of signatories to the Code will influence behavioural changes that lead to better stewardship by asset managers and companies.

It is very encouraging to see **pension fund sign-up during 2013 increasing by 30%, taking the total to 56**, up from 43 at the start of the year**.** This compares favourably with the 23% increase in sign-up during 2012.

While increasing sign-up to the Stewardship Code's Principles is important, it is crucial to ensure that asset owner signatories are then able to fulfil their responsibilities. The NAPF has suggested that there are three simple actions which can be expected of pension funds as the owners and providers of capital:

1. Include a section on 'stewardship' within the fund's Statement of Investment Principles;
2. Include stewardship criteria in manager searches; and
3. Incorporate monitoring of stewardship activities into manager reviews.

Our members tell us, however, that it is difficult to assess from the UK Stewardship Code statements the various stewardship approaches and activities of different asset managers. For this reason the NAPF published in October 2013 a Stewardship Disclosure Framework which aims to equip pension fund trustees with the information they require to better compare and contrast asset manager approaches to stewardship. The completed Disclosure Frameworks provide a clearer picture of how an individual asset management firm aims to enhance and protect value for their clients and thus enables asset owners to have a more constructive dialogue with their current and prospective investment managers.

Disclosure Frameworks completed by asset managers can be found within the NAPF's new Stewardship Central website. Firms who have responded by late November 2013 include those shown below. We will be reporting further on the response to the Framework in March 2014.

Aberdeen Asset Management	Hermes Fund Managers	RBC Asset Management
Aviva Investors	J.P. Morgan Asset Management	SVM Asset Management
Baillie Gifford	Kempen Capital Management	THS Partners
F&C Investments	LGIM	Threadneedle Asset Management
Generation Investments	Newton Investment Management	

Good progress but more to do

As acknowledged by the respondents to this year's survey, institutional investors, including pension funds, can still play a more active role as stewards of investee companies. However, the signs are that pension funds are increasingly embracing their responsibilities and fostering a market for stewardship.

This positive trend should in turn spark a response from those acting on behalf of pension funds – both their asset managers and their consultants. It is especially important that those who have voluntarily signed up to the Code, such as investment consultants, should seek to live up to the spirit of the Code; otherwise their commitment to the Code's Principles may be questioned.

The signs of a virtuous cycle of improving stewardship and governance practices at asset managers and companies respectively are encouraging. We look forward to monitoring and reporting on further progress in 2014.

Key Findings of the 2013 Engagement Survey

- **Pension funds have stewardship responsibilities:** This year 96% of respondents agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting.
- **Extra-financial factors are important:** 81% also agreed that extra-financial factors – environmental, social and governance factors – can have a material impact on investments in the long-term.
- **More can be done:** Only 56% of respondents felt that institutional investors have played an active enough role as stewards of investee companies over the past year. Similarly, only 54% believed that engagement with investee companies had added (or prevented loss of) value to their fund.
- **Stewardship is on the agenda:** Over three quarters of respondents had discussed the Stewardship Code and related issues during the past 12 months, and 71% have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting.
- **Stewardship is not being raised by consultants:** In only a quarter of cases had investment consultants raised the issue of Stewardship with respondents – down again from 38% last year. In those few cases when it was discussed, signing up to the Stewardship Code was rarely recommended.
- **Predominantly listed equities:** While those who apply the Stewardship Code principles predominantly do so in listed equities, over 60% also do so within realestate, infrastructure and fixed income.
- **Stewardship a factor in manager selection:** The majority (71%) of respondents indicated that they take the stewardship activities and policies of managers into account during manager selection.
- **More questions being asked**: Encouragingly, 43% of respondents indicated that they are asking more stewardship questions during reviews and a further quarter are spending more time reviewing reporting.
- **Quality of reporting disappoints:** The level of satisfaction with reporting from investment managers dropped significantly this year, although the reviews by investment consultants of what investment managers have said about their voting and engagement activities in their reports is a greater concern.
- **Funds are not seeing the evidence:** There was a significant increase this year in respondents indicating they didn't know of evidence that the engagement activities (including voting) undertaken by their fund or its managers were influencing changes to company strategy, remuneration or social or environmental policies.
- **Funds are exercising their votes more**: 96% of funds exercise their votes in the UK (up from 93% in 2011).
- **Fiduciary duty is not a barrier:** Nearly two thirds (64%) of respondents agreed that responsible investing is compatible with their fiduciary duty – only 17% disagreed. Additionally, nearly half of respondents suggested that that their scheme's responsible investment policy influenced manager selection across all asset classes.

Introduction

About the Survey: Purpose

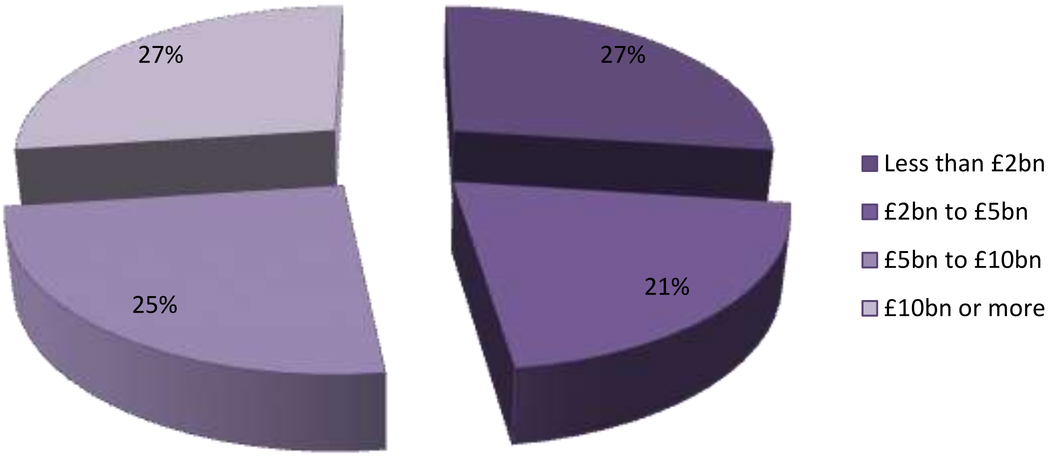
This report presents the findings of the NAPF's ninth annual survey of pension funds' engagement with investee companies. The NAPF believes that engagement with investee companies is a vital part of the investment management process, and the Engagement Survey provides evidence that UK pension funds increasingly share this belief and take their stewardship responsibilities seriously.

The survey is an effective means for pension funds to assess the extent to which their own engagement practices currently meet the best practice of their peers as well as the increasing expectations of regulators and Government.

About the Survey: Who responded?

NAPF fund members with more than £1 billion in assets under management were invited to give their views. Responses were received from 48 pension funds, with combined assets under management of **£394 billion.**

Fig. 1. Respondents by value of assets under management



Of the type of funds that responded, the majority were large private sector occupational pension schemes (60%), 12 were local authorities, and the rest were largely from the public sector.

Where the number of respondents to a question was less than 48, the number is stated.

The NAPF is extremely grateful to all funds that assisted with the survey.

Engagement survey findings

The role of institutional investors

Key findings:

- 96% agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting shares.
- 56% agreed that institutional investors (including pension funds) have played an active enough role as stewards of investee companies in the past 12 months.
- 81% agreed that extra-financial factors – e.g. environmental, social and governance factors – can have a material impact on the fund's investments in the long-term.
- 54% agreed that engagement with investee companies (by the fund or fund manager/s) has added (or prevented loss of) value to the fund.

Within the past year the NAPF published its Stewardship Policy with Principles for Stewardship Best Practice and a significantly updated Responsible Investment Guide. These documents make clear that the NAPF believes that:

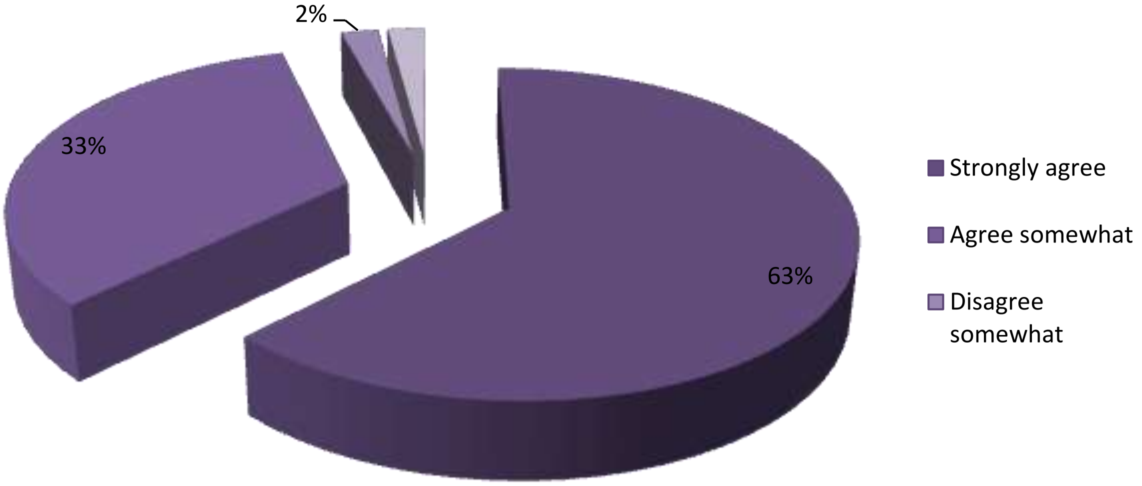
- The informed use of votes, while not a legal duty, is a responsibility of owners and an implicit fiduciary duty of pension fund trustees and investment managers to whom they may delegate this function.
- The management of extra-financial factors, which encompass governance and material environmental 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 potentially improve risk-adjusted returns.
- 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.

Do institutional investors have stewardship responsibilities?

Given the above assertions, the NAPF's Engagement Survey began by asking pension funds whether they themselves believe that they have stewardship responsibilities and whether they agree that extra-financial factors can have a material impact on the fund's investments in the long-term.

Encouragingly, respondents were near unanimous (96%) in their view that institutional investors, including pension funds, do have stewardship responsibilities which include both engaging with companies and voting shares. This result exceeds the already welcome 93% positive response in 2012. Further still, it clearly emphasises that the numbers of signatories to the Stewardship Code does not in itself give an accurate picture of the level of 'buy-in' to this agenda amongst the larger UK pension schemes.

Fig. 2. Do you agree that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting shares?



Do extra-financial factors have a material impact on investments?

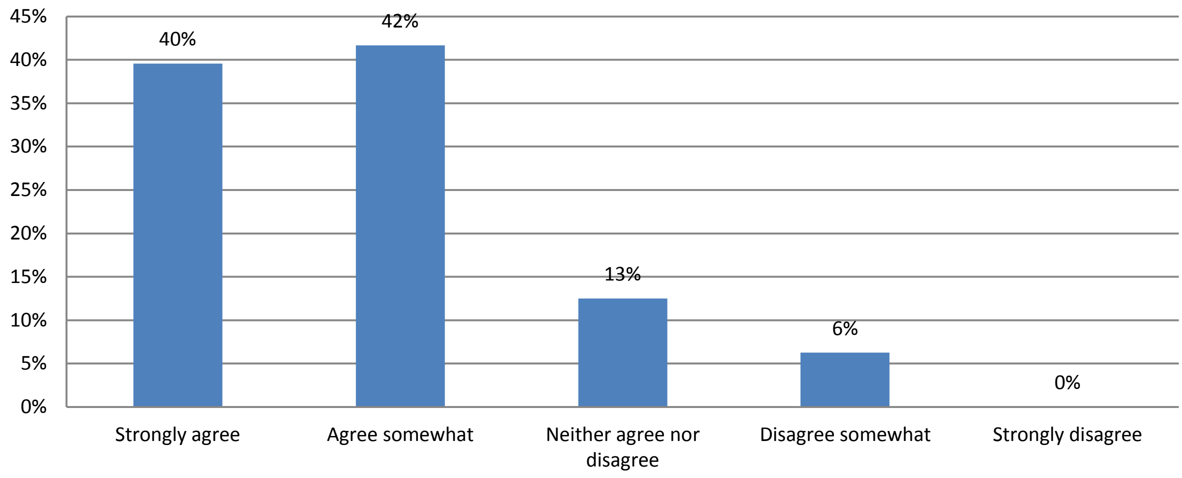
In a new question this year, we sought to explore more specifically whether there is agreement that extra-financial factors, including environmental, social and governance (ESG) factors, can have a material impact on investments in the long-term.

Professor Kay in his 2012 report stated that "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.

It is not long since investors were often hesitant about discussing ESG considerations, due to a misconception that what was being discussed was ethical and/or socially responsible investment (SRI). This has changed significantly in recent years and such considerations are becoming more and more mainstream, driven by an increasing understanding of their financial implications. As outlined in the NAPF's Responsible Investment Guide, 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.

Encouragingly, in our survey, 82% of respondents agreed that ESG factors can have a material impact on their fund's investments in the long-term and more importantly only 6% disagreed.

Fig. 3. Do you agree that extra-financial factors – e.g. environmental, social and governance factors – can have a material impact on the fund's investments in the long-term?

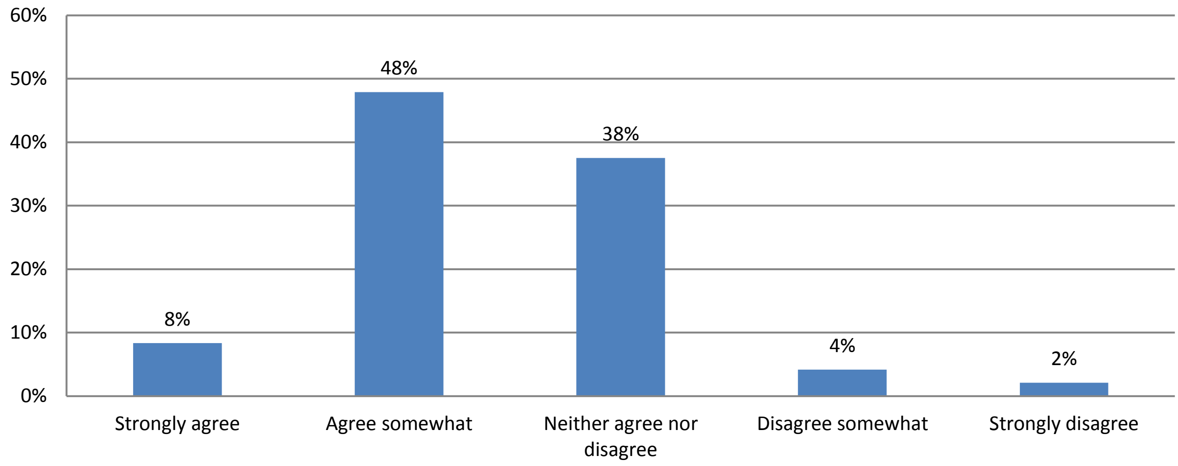


Have institutional investors played an active enough role as owners?

Building on the acceptance that institutional investors have stewardship responsibilities, we asked whether respondents believed that over the past 12 months, institutional investors (including pension funds) have played an active enough role as stewards of investee companies.

Interestingly, given that there were far fewer headlines generated this year than during last year's 'Shareholder Spring', slightly more respondents agreed (56%) that institutional investors had played an active enough role, compared to 50% last year. This demonstrates that trustees want constructive relationships between shareholders and companies and reassurance that their investments are being actively stewarded, and are not satisfied that public battles are a sign of broader effective action.

Fig. 4. Over the past 12 months, do you agree that institutional investors (including pension funds) have played an active enough role as stewards of investee companies?



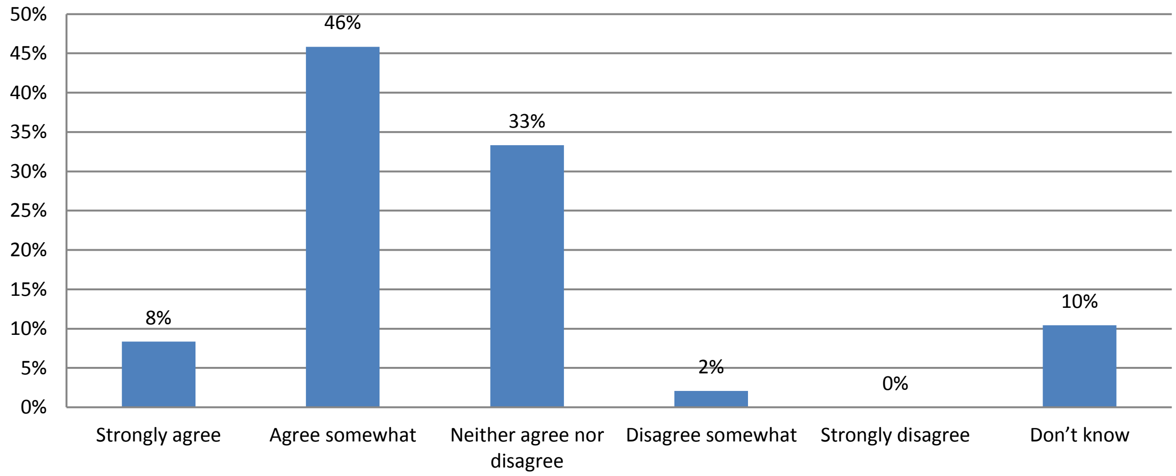
Has engagement added (or prevented loss of) value to the fund?

We also sought to clarify whether funds believed that engagement with investee companies (by the fund or fund manager/s) has added (or prevented loss of) value to the fund.

The results to this question were similar to those in the past couple of years. This may demonstrate that, despite last year's headlines, pension funds are not necessarily being provided with clear evidence by their investment managers that their engagement with investee companies is leading to specific positive change. This year 54% agreed that engagement had added (or prevented loss of) value to the fund (53% in 2011 and 2012), correlating closely with the percentage of funds agreeing that institutional investors had been active enough as stewards of investee companies in the past year.

Given the difficulty in quantifying the value added, and even more so the prevention of value lost, it is not surprising to note once again that 33% neither agreed nor disagreed with this assertion and 10% indicated that they don't know. As discussed later in this report, these results also appear to bear out an increasing expectation from funds for more detailed and specific reporting by their investment managers in relation to their stewardship activities, with funds wanting more evidence that their investment managers' activities are effective. We believe that this is very much a positive.

Fig. 5. Do you agree that engagement with investee companies (by your fund or your fund manager/s) has added (or prevented loss of) value to the fund?



A clear market

These initial results clearly indicate that there is a market for good stewardship. Pension funds increasingly recognise that they have responsibilities which include engaging with companies and voting; they agree that managing extra-financial factors is important to their long-term risk-adjusted returns; and they believe that institutional investors could be doing more as stewards of investee companies.

The NAPF encourages pension funds to 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. Subsequently, the primary responsibility of pension funds under the Stewardship Code is to select investment managers, across asset classes, which take their stewardship responsibilities seriously and hold them to account for adhering to the fund's own policy and expectations.

The initial results of this year's Engagement Survey appear to demonstrate that this sentiment is shared by the respondents. We trust that investment managers will respond to the increasing expectations of their clients.

Stewardship Code

Key findings

- Three quarters of respondents had formally discussed the Stewardship Code and related issues during the past year.
- Over 70% of respondents have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting within their Statement of Investment Principles (SIP).
- A majority (56%) of respondents had formally committed to the Stewardship Code and its Principles, with a further 8% planning to do so within the coming 12 months and a further 15% in greater than 12 months.
- Of those who apply the Stewardship Code Principles, 100% apply them across listed equities. More encouragingly 67% also apply the Principles within real estate and infrastructure and 63% within fixed income.
- By far the most commonly cited reason (79%) amongst those who have not committed to the Code was other priorities taking precedence. Only 21% cited a lack of belief in value added.
- Investment consultants are rarely (25%) raising the issue of stewardship with funds and when they do so, they rarely (17%) suggest signing up to the Stewardship Code.
- A majority of respondents (56%) indicated that the Stewardship Code had affected their approach to engagement issues, with actions split between greater scrutiny of investment managers, increased engagement and increased collaboration.

The Stewardship Code aims to promote the long term success of companies in such a way that the ultimate providers of capital, such as pension funds also prosper. The NAPF has been a vocal supporter of the Stewardship Code since its inception.

The Stewardship Code states that the primary responsibility for stewardship – active monitoring of and engagement with companies - lies with the asset manager; however, it also makes clear that while the asset owner may delegate the activity, it does not delegate the responsibility.

Importantly, a growing number of asset owners have signed up to the Stewardship Code since its introduction. As of November 2013 there were 56 pension fund signatories, an increase of 30% on the beginning of the year. The NAPF encourages others to follow suit, as a greater weight of pension fund signatories to the Code will further influence behavioural changes that lead to better stewardship by asset managers and companies.

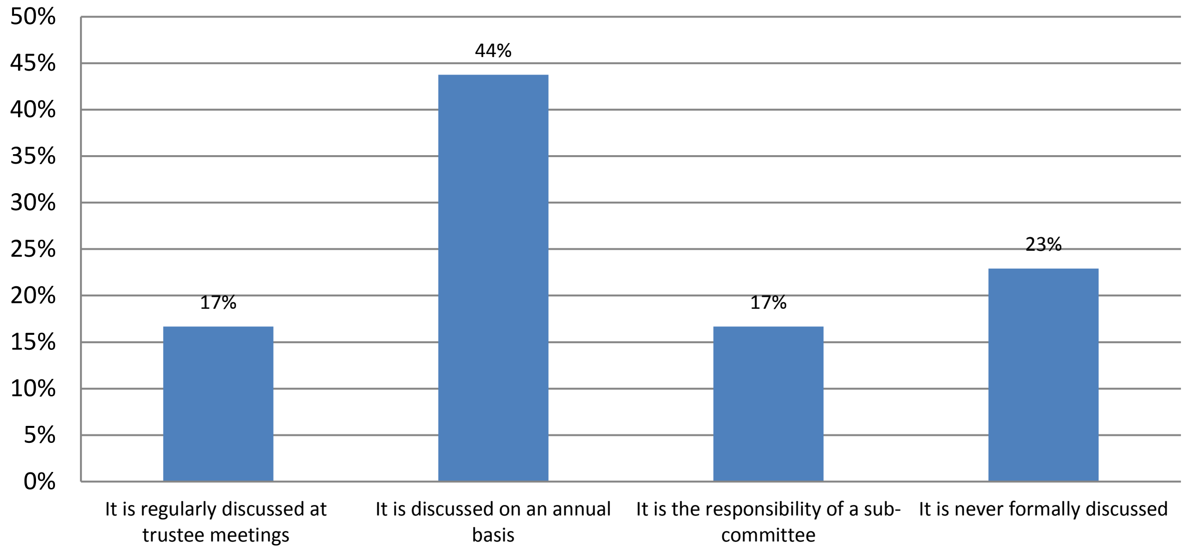
The Engagement Survey seeks to understand how pension funds view the Stewardship Code: whether it is being actively discussed by pension fund trustees, whether its principles are being applied and whether it is affecting their approach to engagement issues.

Have funds discussed the Stewardship Code?

Firstly, we asked funds how often they had formally discussed the Stewardship Code and related issues during the past 12 months.

Encouragingly, over three quarters of funds indicated that the Stewardship Code had been formally discussed during the past year. In most cases (44%) the Code and other related issues were discussed formally on an annual basis and in 17% of cases it was either discussed regularly at trustee meetings or was the responsibility of a sub-committee. Given the busy agenda of most pension funds, with a large number of competing issues, it is pleasing to see that stewardship is being regularly discussed.

Fig. 6. How often has your fund formally discussed the Stewardship Code and related issues during the past 12 months?

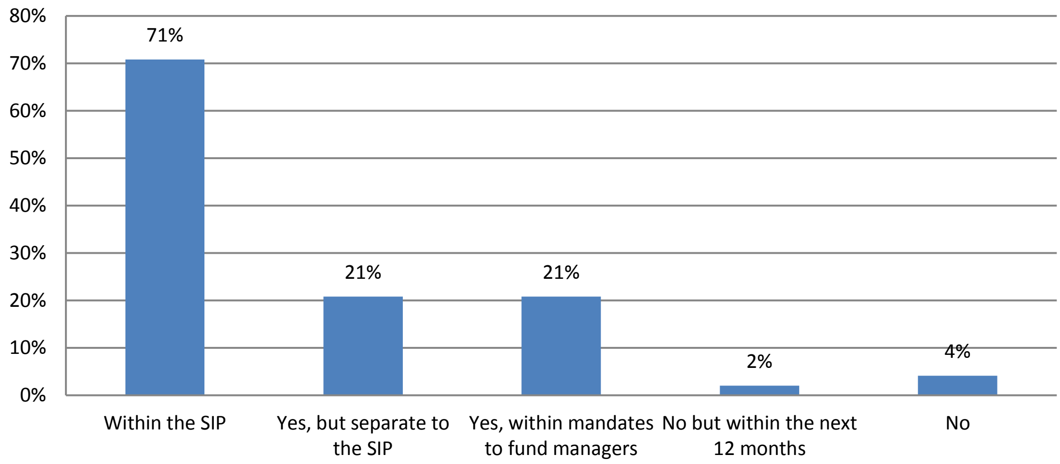


Does the investment policy include stewardship responsibilities such as engagement and voting?

Given the NAPF's recommendation that pension funds should include a section on stewardship within their Statement of Investment Principles, we asked whether funds have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting.

The majority (71%) said they did, and that they included it in their statement of investment principles (SIP). Just over a fifth (21%), sometimes in addition to including the policy in their SIP, includes their expectations separate to their SIP and/or within mandates to fund managers. Just 4% of respondents said they do not have a stewardship policy at all and would not be devising one within the coming 12 months.

Fig. 7. Does your fund have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting?

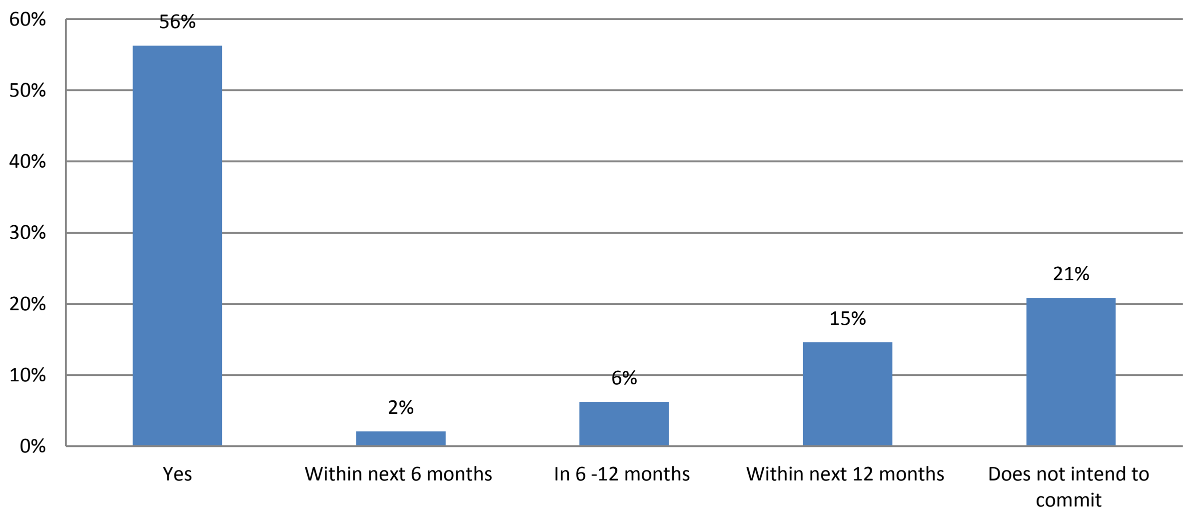


Have funds formally committed to the Stewardship Code and its principles?

The NAPF very much welcomes the 30% increase in pension fund signatories to the Stewardship Code since the start of 2013. We also hope that many more pension funds will sign up in the year ahead.

The Engagement Survey asked funds whether they have already formally committed to the Stewardship Code. The majority (56%) of respondents had done so, with a further 23% planning to do so. This again emphasises that while the absolute number of pension fund signatories to the Code is low relative to the total number of pension funds in the UK, the figure does represent a significant proportion of pension fund assets.

Fig. 8. Has your fund formally committed to the Stewardship Code and its principles?



The NAPF is aware that committing to the Code may initially seem complex or not directly relevant to many smaller funds. Additionally, many funds do not wish to formally sign up to the Code if they are still on a journey towards properly fulfilling its Principles. Where it is a compliance requirement for asset managers to comply-or-explain their adherence to the Code, pension fund signatories are on the whole looking to sign up to both the Code's letter and spirit.

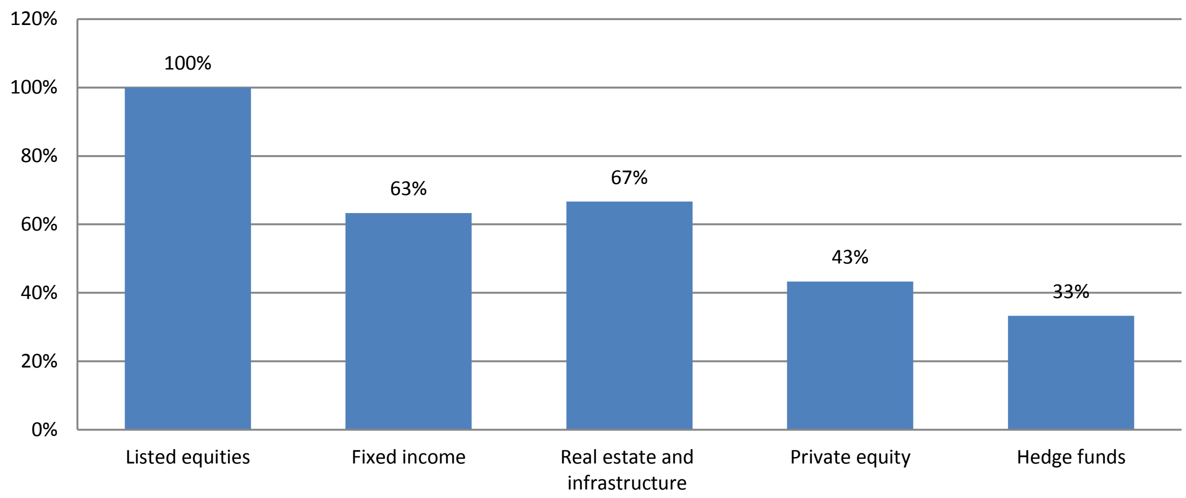
The NAPF has sought to provide practical assistance to pension funds considering how to approach the Code. The recent publication of the NAPF Stewardship Policy and Best Practice Principles sought to clarify the reasonable expectations of pension funds for stewardship, building on our 2011 Stewardship Made Simple Guide. We will continue to assess how we can assist pension funds in not just complying with the Code Principles but in bringing their underlying intention to life.

Which asset classes?

In its revisions to the Stewardship Code in 2012, the Financial Reporting Council (FRC) sought to encourage institutions to apply a stewardship approach to other asset classes beyond listed equities. Therefore, in this year's Engagement Survey we asked those funds which are applying the Stewardship Code's principles, within which asset classes they applied them.

Unsurprisingly, all funds who apply the Stewardship Code principles do so within their approach to listed equities. However, it is encouraging that 67% said they apply the principles within their approach to real-estate and infrastructure, and 63% do so within fixed income.

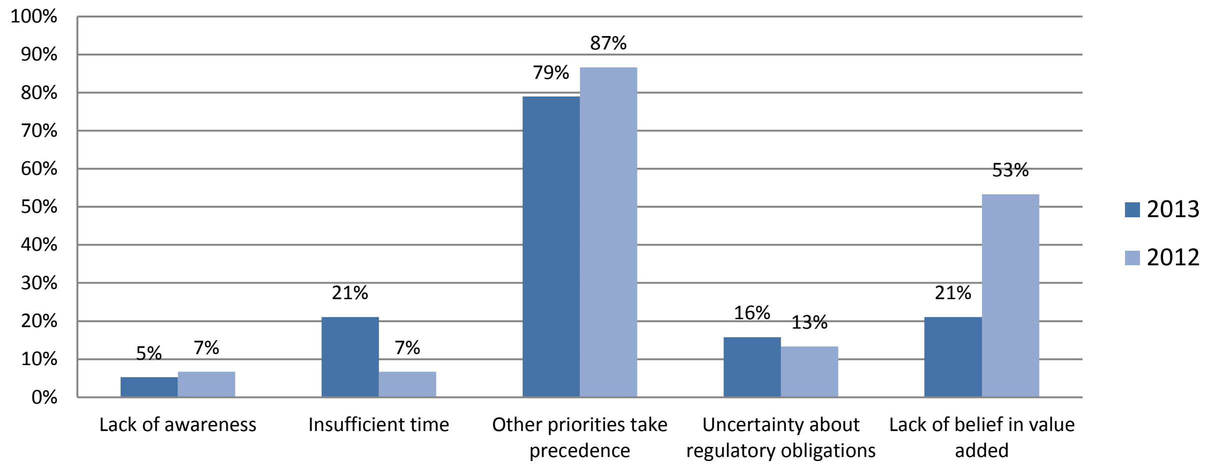
Fig. 9. Within which asset classes do you apply the Stewardship Code Principles?



As last year, we also sought to gain a greater understanding of why some of the larger funds have yet to commit to the Stewardship Code, and why a small minority have no intention of doing so. We therefore asked those who have yet to formally commit to the Code what they consider are the barriers to doing so.

Like last year, the most dominant reason given was simply that other priorities take precedence. This is unsurprising given the many increasing issues which compete for the trustees' finite agenda time such as funding, de-risking and investment strategy. More encouragingly, however, was that while last year the second most commonly cited barrier was a lack of belief in value added, this year that figure reduced from 53% to just 21%. This further suggests that pension funds do increasingly recognise that extra-financial factors can have a material impact on their long-term risk-adjusted returns and that they do have certain stewardship responsibilities. However, the many other pressures on pension funds continue to crowd out the agenda, preventing a number of pension funds discussing how to undertake their responsibilities more formally.

Fig. 10. What do you consider are the barriers preventing your fund formally signing up to the Stewardship Code? (base 19)

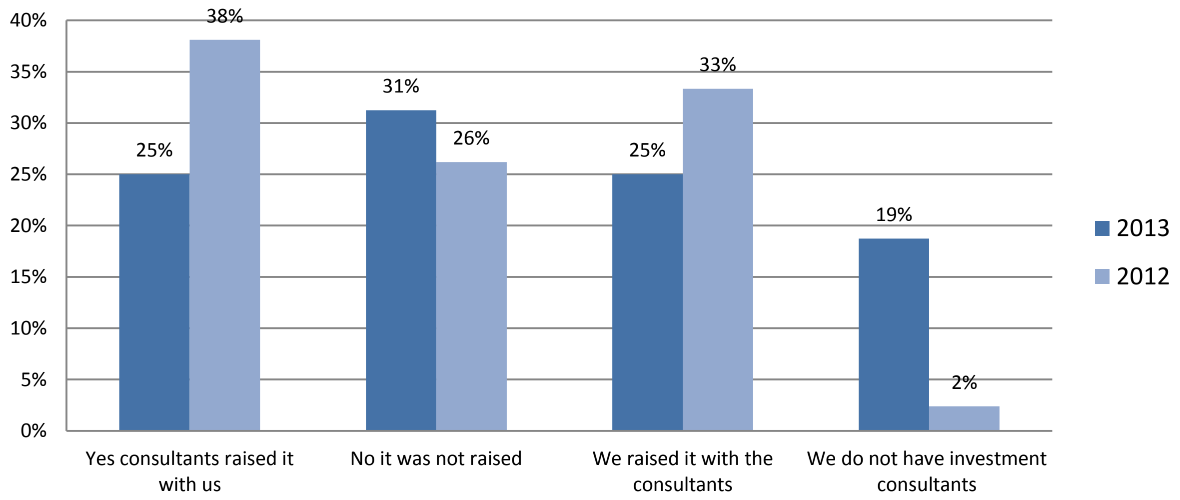


Are investment consultants raising stewardship in discussions with funds?

Given the vital role that funds' investment consultants play in overcoming these barriers and managing the trustees' agenda, we ask each year whether the investment consultants had raised the issue of stewardship in their discussions with the fund.

Last year the result was disappointing and this year it is even more so. Last year, consultants proactively raised the issue in nearly 2 out of 5 occasions, this year that figure is down to just a quarter.

Fig. 11. Have your investment consultants raised stewardship in discussions with you?



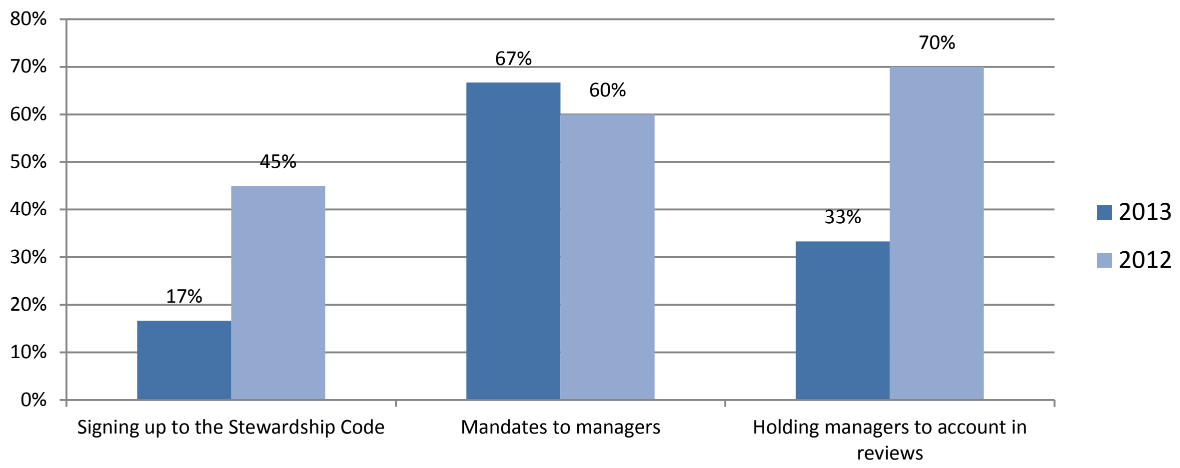
Equally concerning, when consultants did raise the issue with funds, on only 17% of those occasions did they recommend signing up to the Stewardship Code compared to 45% last year.

More positively, however, consultants are suggesting greater use of the mandates awarded to investment managers, with this advice increasing to 67% from 60% last year – although holding managers to account in reviews has dropped from 70% to 33%, perhaps reflective of the fact that this is more common practice.

These findings indicate that despite there being greater articulation within the Stewardship Code in the past year in relation to the role of asset owners, there is not a consistent message being communicated to pension funds by their key advisors.

We encourage the FRC to give appropriate attention as to how it can continue to ensure that those parties who have signed up the Stewardship Code are indeed committed to its Principles and adhering to its letter and its spirit.

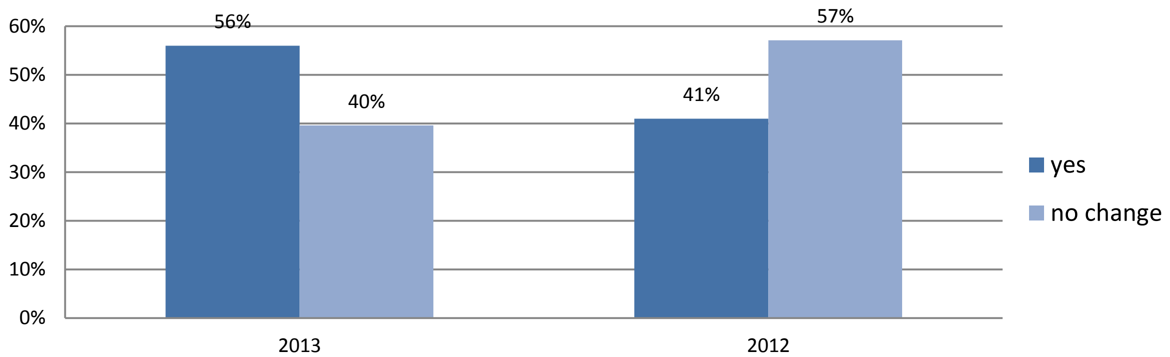
Fig. 12. How did they recommend you undertook your stewardship responsibilities? (2013 base 12)



Has the Stewardship Code affected funds' approach to engagement issues?

Finally, in this section we were keen to assess whether, three years on from the introduction of the Stewardship Code, its introduction has affected how pension funds approach engagement issues.

Fig. 13. Has the Stewardship Code affected your approach to engagement issues?



Pleasingly, the majority of respondents do indicate that the Code's introduction has had an impact on their approach to engagement issues, with 56% suggesting they had altered their approach. Of the 40% who said there had been no change, many indicated that this was because appropriate practices had already been put in place.

Where funds had altered their approach, the actions taken roughly split between greater scrutiny of their investment managers (25%), increased (direct or indirect) engagement with companies (21%), or increased (direct or indirect) collaboration with other investors (25%).

Manager selection and reviews

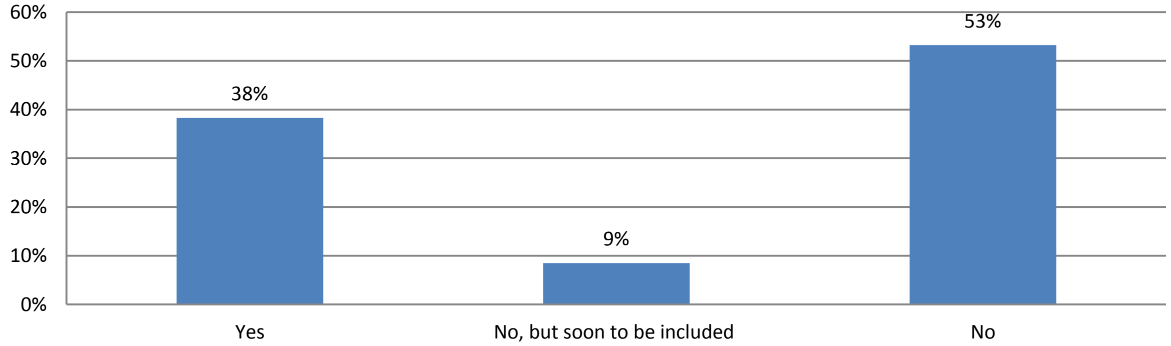
Key findings

- Nearly two fifths (38%) of respondents had incorporated the Code principles into their contracts with investment managers, and a further 9% were soon intending to do so.
- Almost three quarters (71%) of respondents indicated that they took into account the stewardship policies and activities of investment managers when selecting managers.
- A majority (60%) of respondents monitor their investment manager's compliance with their policy on stewardship via periodic manager reviews. A further 17% have specialist review meetings.

Have the Stewardship Code principles been incorporated into contracts with investment managers?

The NAPF encourages pension funds to incorporate the Stewardship Code principles into their Statement of Investment Principles (SIP) and their contracts with investment managers. Encouragingly, therefore, when asked whether they were doing this, nearly half of respondents indicated that they were indeed incorporating the principles into manager contracts or were planning to do so soon.

Fig. 14. Have the Stewardship Code principles been incorporated into your contracts with investment managers? (base 47)

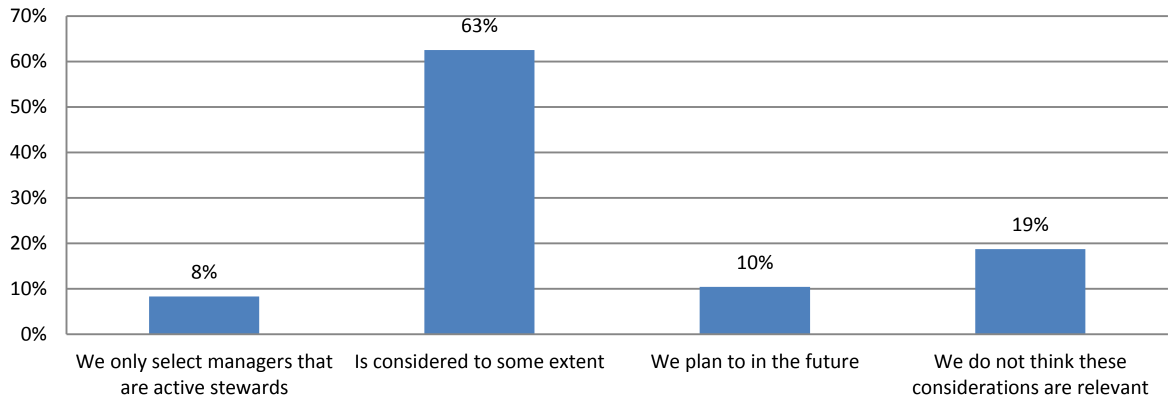


Influencing manager selection

Of course, while it is positive that stewardship aspects are being included within contracts with investment managers, the Code will really get traction when there is a truer market for stewardship, and – this requires stewardship to become a standard consideration in manager selections. We asked funds whether when selecting managers they have taken their stewardship activities and policies into account.

This year's results echoed those of last year, which were themselves encouraging. As with 2012, 71% of respondents stated that they did take the stewardship policies and activities of asset managers into account to at least some extent. A further 10% suggested that they intend to do so in the future, while 19% indicated that they did not think these considerations were relevant for manager selection.

Fig. 15. When selecting managers, have you taken their Stewardship activities and policies into account?



The NAPF's recently-published Stewardship Disclosure Framework aims to provide greater transparency around the stewardship policies and activities of those asset managers who are signatories to the UK Stewardship Code. At present, our members tell us that it is difficult to assess from the UK Stewardship Code statements the various stewardship approaches and activities of different asset managers. The Disclosure Framework therefore aims to equip pension funds with the information they require to better compare and contrast asset manager approaches to stewardship.

Within four weeks of publication, 14 asset managers had already completed and returned the Framework for their firm. Their responses can be found on the NAPF Stewardship Central website www.napf.co.uk/stewardship. We hope that this greater transparency will encourage more funds to incorporate stewardship into their manager selection process and to have a more constructive dialogue with their current and prospective investment managers.

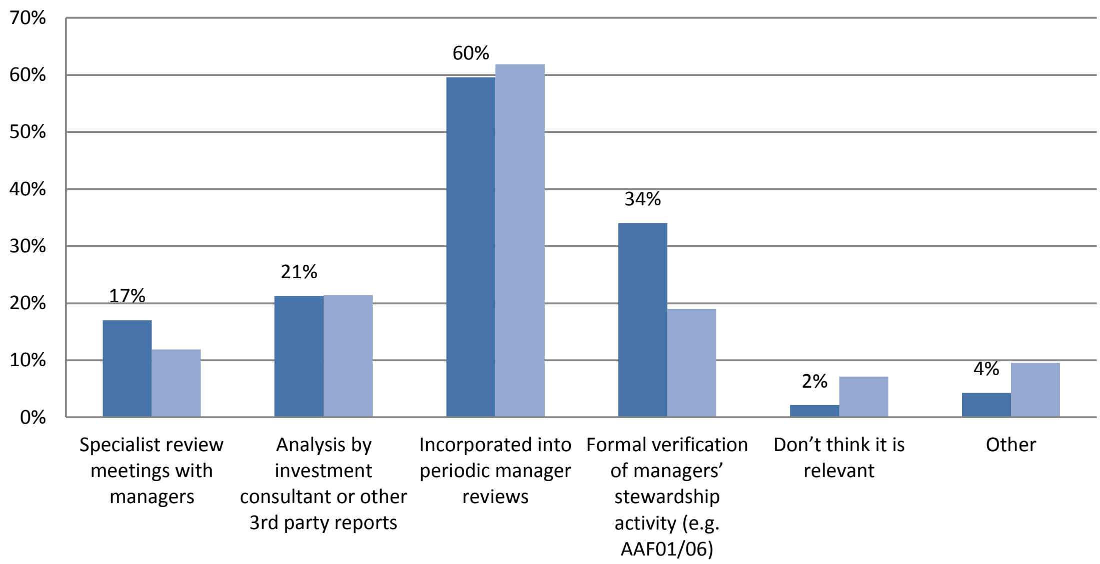
Monitoring investment managers' compliance

The success of the Corporate Governance Code relies upon the users holding the issuers accountable; the Stewardship Code is similarly reliant upon clients being demanding of and holding their investment managers to account. To aid that process, the NAPF has published a Quizzing Fund Managers template (also available on the Stewardship Central website) and publishes on a monthly basis topical questions to help trustees question the effectiveness of their managers' stewardship activity.

When asked how they monitor (or intend to monitor) the fund's investment managers' compliance with their stewardship policy, most (60%) respondents indicated that this was incorporated into their periodic manager reviews, which is exactly the aim of the NAPF's topical questions.

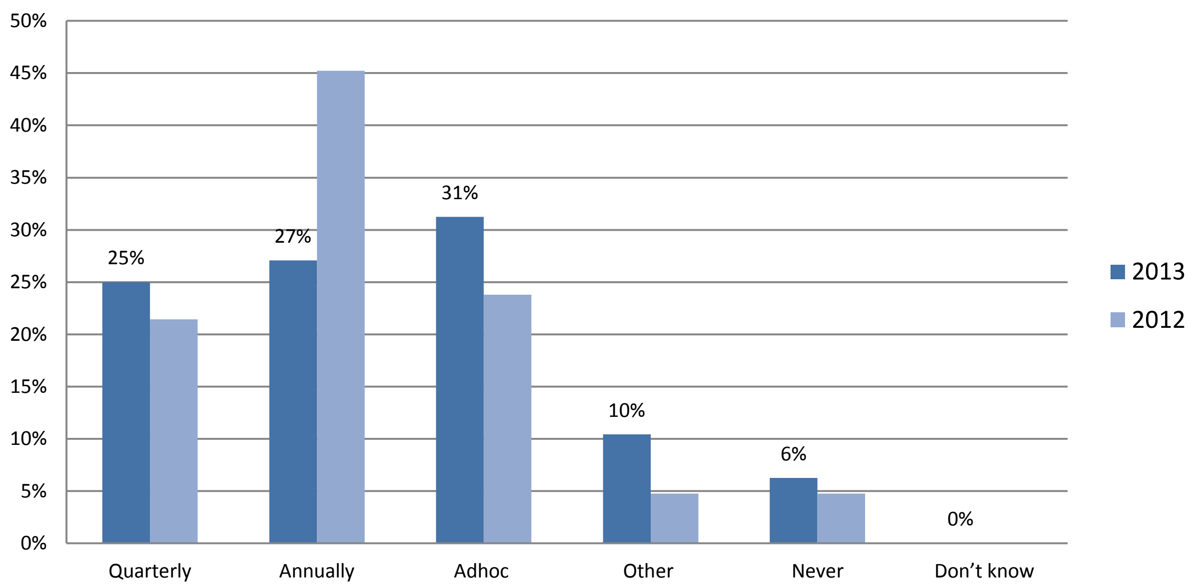
In addition, last year's changes to the Stewardship Code require asset managers that sign up to it to obtain an independent opinion on their engagement and voting processes (having regard to an international standard or a UK framework such as AAF01/062) and to make the existence of such assurance reporting public and available to clients. This clearer wording appears to be having an impact, with 34% of respondents indicating that they now require formal verification of their managers' stewardship activity.

Fig. 16. How do you monitor (or intend to monitor) the fund's investment managers' compliance with their policy on stewardship? (base 47)



The monitoring of investment managers' stewardship activities appears to becoming a more standard aspect of routine performance conversations. This is evidenced by funds suggesting that they are increasingly reviewing on an ad hoc basis their investment manager's application of their stewardship policies rather than in specific annual sessions. In the past, the most common response from respondents was that they reviewed their investment managers' stewardship activity annually (45% in 2012); this year it has fallen to 27%. Instead, 31% of respondents now suggest this conversation is much more ad hoc and 25% say it occurs at least quarterly.

Fig. 17. How often do you review your investment managers' application of stewardship policy?



Effective engagement

Key findings

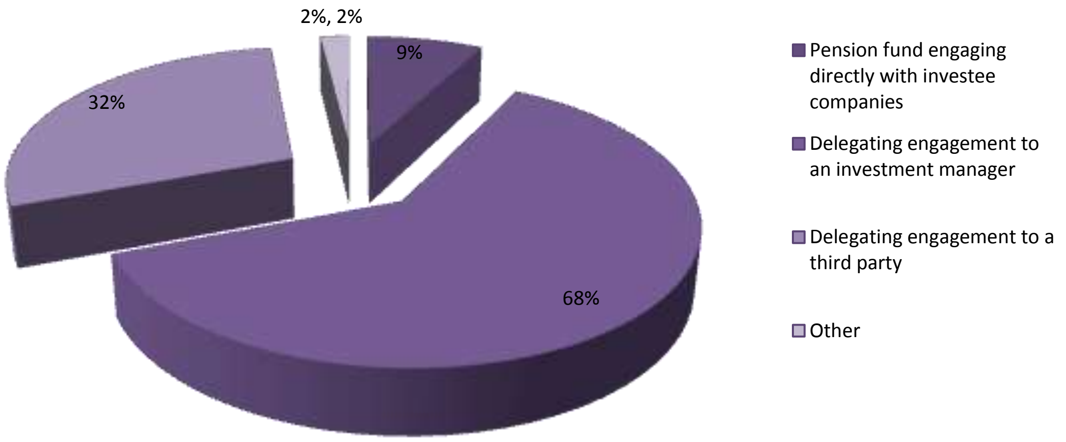
- The main approach of respondents to engagement with investee companies is via their investment manager.
- Nearly a third (31%) of respondents indicated that both the corporate governance and investment functions at their investment manager had responsibility for engagement.
- There was a significant increase in respondents indicating that they didn't know of evidence of engagement activities (including voting) undertaken by their fund or its managers influencing changes to a range of factors.
- A majority (54%) of respondents was aware of their fund managers collaborating with other investors on their behalf – an increase from 40% in 2012 and 2011.

Approaches to engagement

For the past few years, the NAPF Engagement Survey has tracked the mechanics of pension fund engagement with investee companies. This includes the main approach to engagement that pension funds take and whether pension funds are aware of engagement influencing changes.

As in previous years, the majority (68%) of pension funds delegate engagement activity to their investment manager, with nearly a third (32%) outsourcing their engagement to a third party (commonly an overlay service provider). Just under a tenth (9%) of funds consider that engaging directly with investee companies is their main approach to engagement with investee companies, a very slight increase from 2012.

Fig. 18. What is your main approach to engagement with investee companies? (base 47)



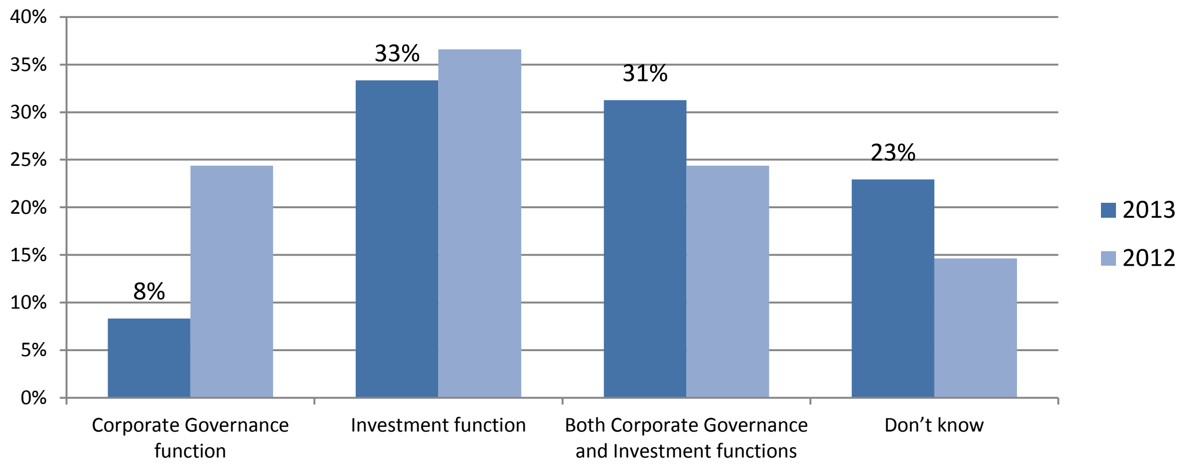
These results reflect many funds' appreciation that effective engagement requires resources, and that greater voice can be achieved when their interests are pooled with others via their investment manager or via an overlay service provider.

Responsibility for engagement

Given that pension funds on the whole delegate the prime stewardship activities to their investment managers, it is important to understand how this is being undertaken: is it a joined up process with the fund managers involved or is it left to the corporate governance teams?

In recent years a common complaint has been that asset managers are speaking with two different voices in their conversations with investee companies, with companies saying that they receive very different messages from the fund manager and their corporate governance colleagues. Encouragingly, however, this year only 8% of respondents indicated that they believe that the corporate governance function alone had primary responsibility for engagement with investee companies, down from nearly a quarter last year. Further still, 31% suggested that the responsibility lay with both the corporate governance and investment functions – up from 24% in 2012. This is a positive turnaround and hopefully reflects better practice. We encourage funds to clarify how their investment managers approach engagement to ensure that there is indeed a joined-up approach.

Fig. 19. Which function at the asset management level has responsibility for the fund's engagement with investee companies?

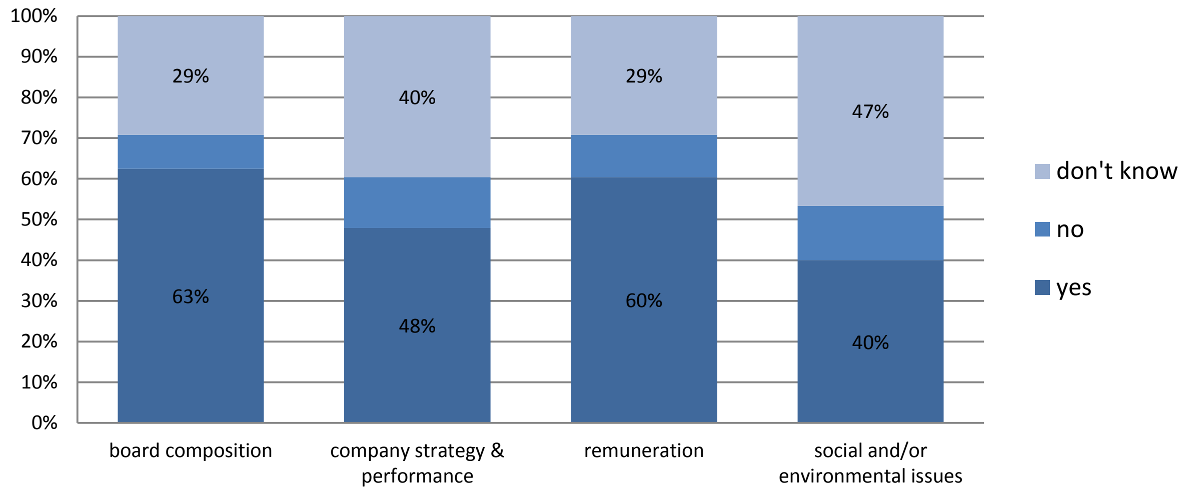


Is the engagement effective?

What pension funds most need to understand is whether the engagement undertaken on their behalf by their investment managers is actually effective. We therefore asked funds whether in the last year they have seen evidence of engagement activities (including voting) undertaken by the fund or its managers (on their behalf) influencing changes to a range of factors.

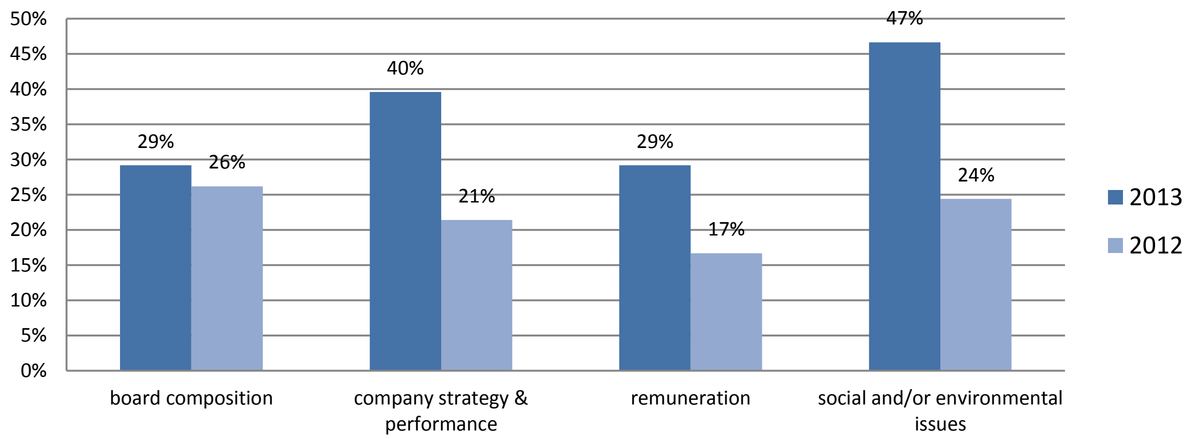
The response is broadly positive. In relation to both remuneration and board composition, most had seen evidence of engagement activities resulting in changes. In addition, nearly half of respondents had seen evidence of changes to company strategy resulting from engagement activities and 40% had seen evidence of changes in relation to social and/or environmental issues.

Fig. 20. In the last year have you seen evidence of engagement activities (including voting) undertaken by your fund or its managers (on your behalf) influencing changes to



However, we also found that pension funds are expecting to see clearer and more specific evidence that their investment managers' engagement activities are leading to actual changes. As highlighted in figure 21, there was a significant increase this year in the percentage of respondents indicating that they don't know whether engagement activities had created change. For example, 40% of respondents were not aware of any evidence of engagement influencing changes to company strategy – nearly double the figure in 2012. Similarly, 47% of respondents were not aware of any evidence of engagement influencing changes to social and/or environmental issues – up from just 24% in 2012.

Fig. 21. In the last year have you seen evidence of engagement activities (including voting) undertaken by your fund or its managers (on your behalf) influencing changes to... "Don't know"



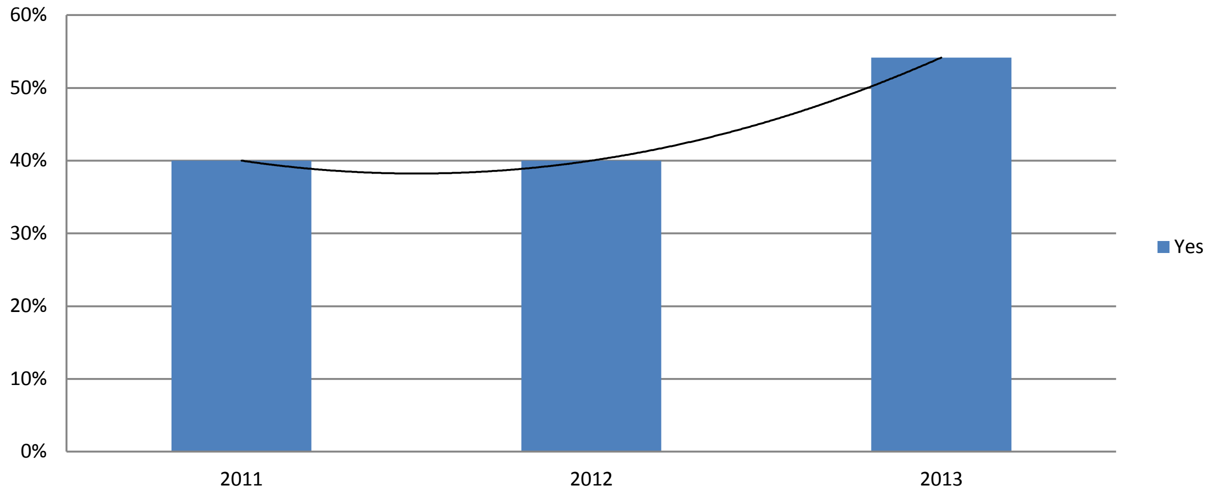
Collaboration

The Stewardship Code states that investors should "be willing to act collectively with other investors where appropriate". This principle is important, given that collaboration with other investors is an effective way of achieving greater influence and thus sending a strong message to companies on specific issues. It is especially important given the increasingly fragmented nature of many companies' share registers.

Given that pension funds largely delegate their engagement activity to their investment manager, we have for the past few years asked funds whether they were aware of their investment managers collaborating with other investors on their behalf.

This year the results were more encouraging than the past couple of years. This perhaps reflects the increasing focus on collaboration in the 2012 Kay review and pension funds' growing understanding of their stewardship responsibilities. A majority of respondents (54%) indicated that they were aware of their fund managers collaborating with other investors on their behalf, an increase on the 40% figure of the past two years. In addition, most (56%) also indicated that they intend to encourage their fund managers to collaborate more.

Fig. 22. Are you aware of your fund managers collaborating with other investors on your behalf?



The NAPF supports the work of the Collective Engagement Working Group, which has been seeking to identify how investors might be able to work together in their engagement with companies to improve both sustainable, long-term company performance and the overall returns to end savers. We will consider closely the recommendations of the Working Group which are due to be published very soon and will work with our members to improve the environment for collective engagement.

Accountability

Key findings

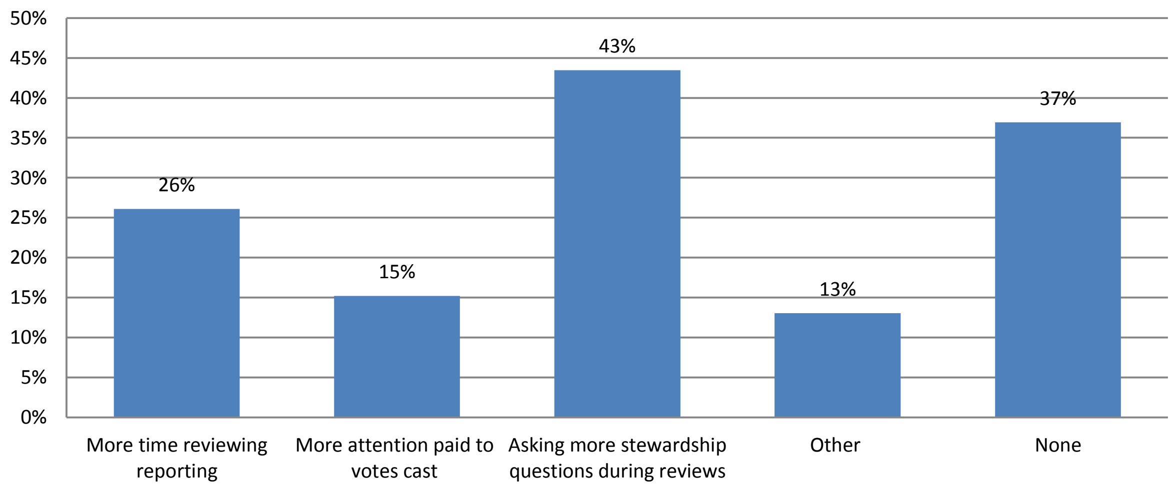
- Many funds (43%) are asking more stewardship questions during manager reviews and a quarter are also spending more time reviewing reporting.
- Less than half (46%) of respondents were satisfied with the standard of stewardship reporting from their investment managers – down from 64% in 2012.
- Less than a quarter (23%) of respondents were satisfied with their investment consultants' review of what investment managers have said about their voting and engagement activities in their reports – down from 36% in 2012.

The Stewardship Code is clear that: "Institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. However, they cannot delegate their responsibility for stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship."

The NAPF's Principles for Stewardship Best Practice suggest that within the regular manager reviews trustees 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".

Given this, we asked respondents what steps have they taken in the past year to increase scrutiny of their investment manager's stewardship activities. Reassuringly, nearly half (43%) indicated that they were asking more stewardship questions during manager reviews. In addition, just over a quarter (26%) are spending more time reviewing reporting and 15% are paying more attention to how votes are cast. This is all very promising, especially as many of the 37% of respondents who ticked 'none' actually indicated that this was because they were already closely scrutinising their investment manager's stewardship activities.

Fig. 23. In the past year, what steps, if any, have you taken to increase scrutiny of your investment manager's stewardship activities? (base 46)



Reporting from investment managers and consultants

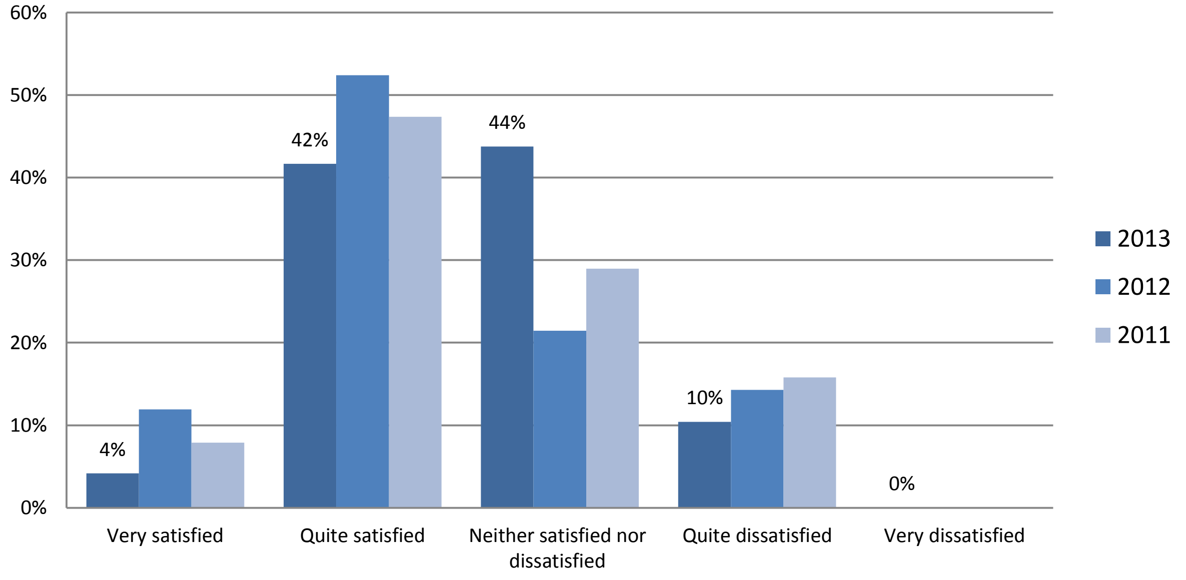
As pension funds are responsible for ensuring that their investment manager's activities are consistent with the fund's own approach to stewardship, the quality of reporting from their agents is vitally important, not least so that trustees are well equipped to provide challenge and accountability and thus discharge their stewardship responsibilities.

In the NAPF Stewardship Disclosure Framework, grade 'A' reporting to clients requires "evidence of activities undertaken – with identified case studies – an illustration of progress against objectives; disclosure of holding periods and an analysis of ESG risks within the portfolio". In addition, stewardship is expected to be integrated into the broader reporting process and the manager is expected to articulate how their activities have enhanced and protected value. This level of reporting is deliberately aspirational, although not unrealistic, and is delivered by some.

The Engagement Survey has consistently asked funds how satisfied they are with the standard of stewardship (previously stewardship and corporate governance) reporting from their investment managers. This year saw the level of satisfaction drop below 50%, with only 46% indicating that they were either 'very' or 'quite' satisfied. Most striking was the increase in those who were 'neither satisfied nor dissatisfied'– more than doubling to 44% from 21% in 2012.

The fact that only 10% of funds were dissatisfied with the standard of reporting from their investment managers is, of course, positive news; it is in fact the lowest level of dissatisfaction for some time. It would appear, therefore, that the expectation of funds for more succinct but specific and bespoke reporting is increasing. Perhaps most importantly, 30% of respondents who were dissatisfied with the quality of reporting were keen to see more of a link made with the broader performance reporting.

Fig. 24. How satisfied are you with the standard of stewardship reporting from investment managers?

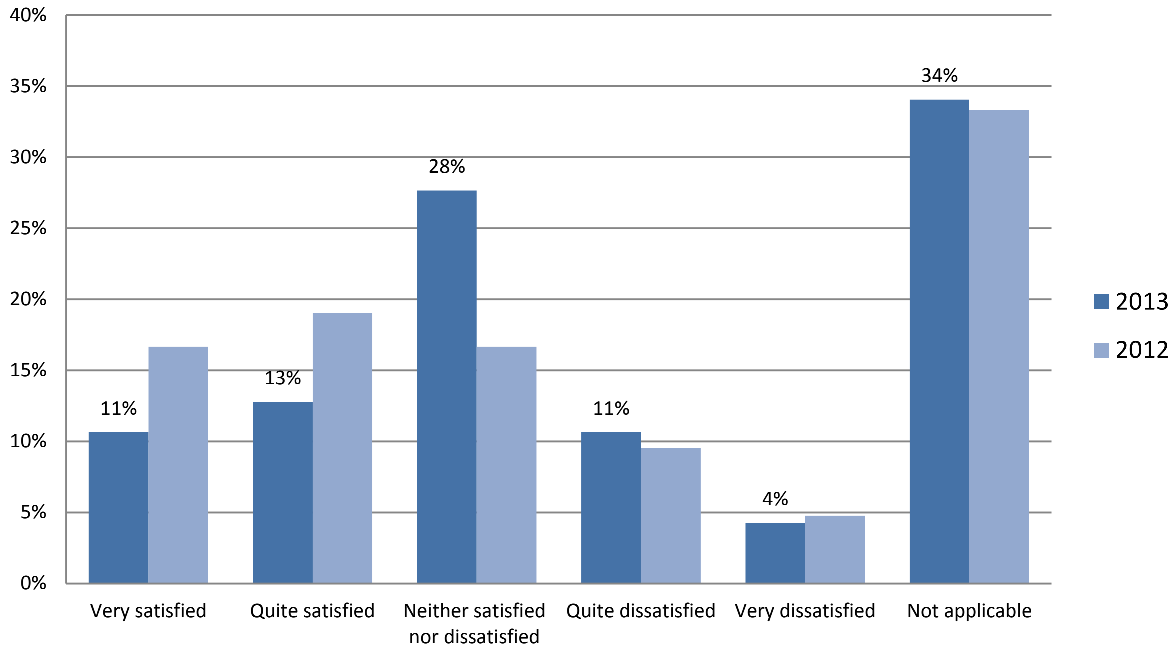


Investment consultants play a vital role, advising pension funds on a range of important issues, from asset allocation through to the performance of their investment managers. Given their pivotal role in the relationship between pension fund and asset manager, we again asked this year whether respondents are satisfied with their investment consultant's review of what their investment managers had said about their voting and engagement activities in their reports.

This year saw a further drop in satisfaction from 2012, with just 24% saying they were either 'very' or 'quite' satisfied. As with the reporting from investment managers, the percentage of respondents who were 'neither satisfied nor dissatisfied' rose significantly – in the case of investment consultants it rose to 28% from just 17% in 2012.

The overall level of dissatisfaction in itself is not of major concern, remaining steady at 15%. What is concerning, however, is when these low satisfaction figures are combined with some of the other survey results the conclusions appears to be that pension funds are not able to rely on their key advisers for proactive advice about stewardship or an assessment of the effectiveness of the stewardship activities of their investment managers.

Fig. 25. How satisfied are you with your investment consultants' review of what investment managers have said about their voting and engagement activities in these reports? (base 47)



Voting

Key findings

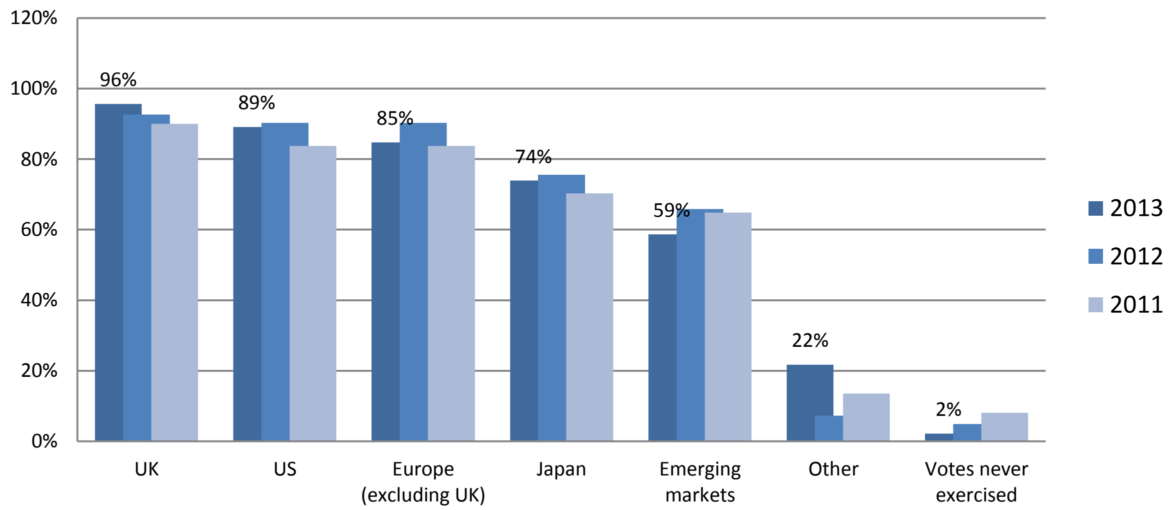
- 96% of respondents exercised their votes in the UK (93% in 2012).
- There is an increase in disclosure of voting to scheme members, up to 48% from 36%, and a further 13% on request.
- There is also an increase in public disclosure of voting.
- Approaching half (44%) of respondents recall stock for at least contentious votes, up from 35% in 2012.
- A third of respondents do not lend stock.

Voting rights

The NAPF believes that 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. Therefore, the Engagement Survey has consistently tracked the extent to which pension funds exercise their voting rights in the UK and in overseas markets.

This year's survey found that respondents are continuing to exercise their votes, with 96% doing so in the UK – continuing the upward trend from 93% in 2012 and 90% in 2011. There were slight decreases in some markets, for example the figure for Europe dropped from 90% to 85% this year but this is probably due to general drops in voter turnout in some big EU markets like France and Germany. In Germany there was a 5% drop in voter turnout this year, mainly due to re-registration requirements imposed by some custodian banks for 2013, which had the effect of soft share-blocking. In addition, 22% of respondents also indicated that they were aware of their voting rights being exercised in 'other' markets, including Canada, Australia, Hong Kong and Singapore, an increase on 5% in 2012.

Fig. 26. In the past twelve months, have your voting rights been exercised in the following markets? (base 46)

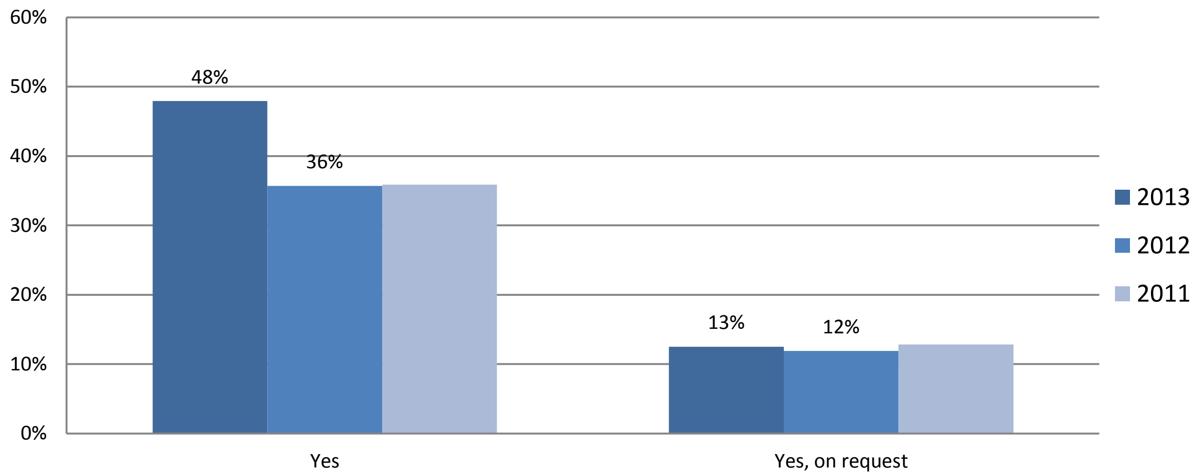


Voting disclosure

Principle 6 of the UK Stewardship Code states that "institutional investors should have a clear policy on voting and disclosure of voting activity". Principle 7 states that "institutional investors should report periodically on their stewardship and voting activities" and goes on to say that "asset owners should report at least annually to those to whom they are accountable on their stewardship policy and its execution".

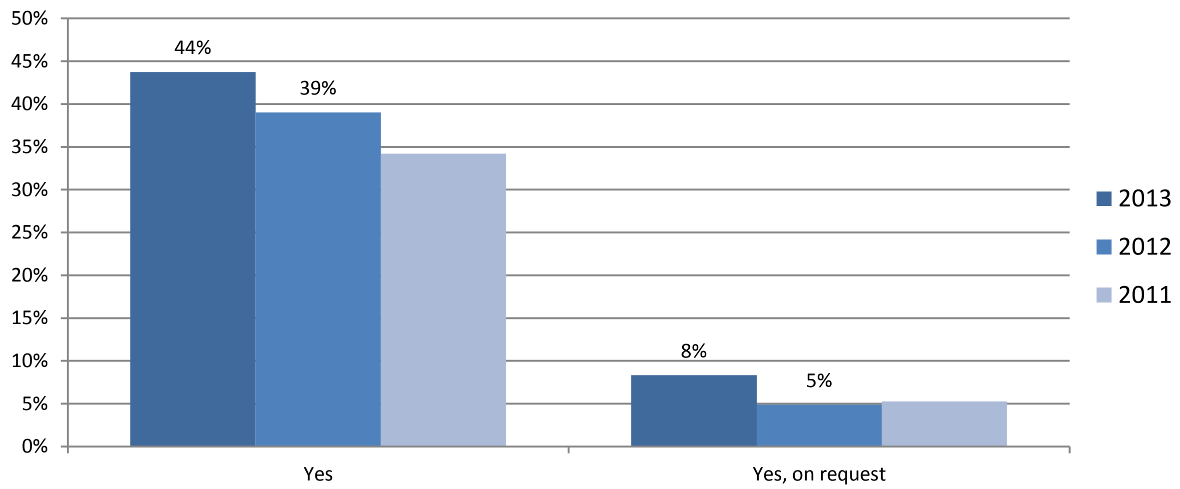
Funds were therefore asked whether they disclose information on voting to scheme members and, if so, whether they disclose the voting policy, voting information, or both. This year saw nearly half (48%) of respondents indicate that that they disclose information on voting to scheme members – a significant increase on 36% in 2012. In addition, three quarters (76%) of those who disclose information on voting to scheme members disclose both their voting policy and voting information. This increase, however, is likely to be related to the increased number of local authority respondents (11) to this year's survey, compared to 2012.

Fig.27. Do you disclose information on voting to scheme members?



In line with the UK Stewardship Code Principles, respondents were also asked whether they disclose information relating to voting to the general public. The results showed that while fewer funds are currently doing so, this is increasing. This year just over half (52%) either automatically disclose or disclose on request such information publicly, compared to 44% last year. In nearly two thirds of cases (62%) this disclosure included both the voting policy and voting information.

Fig. 28. Do you disclose information on voting to the general public?



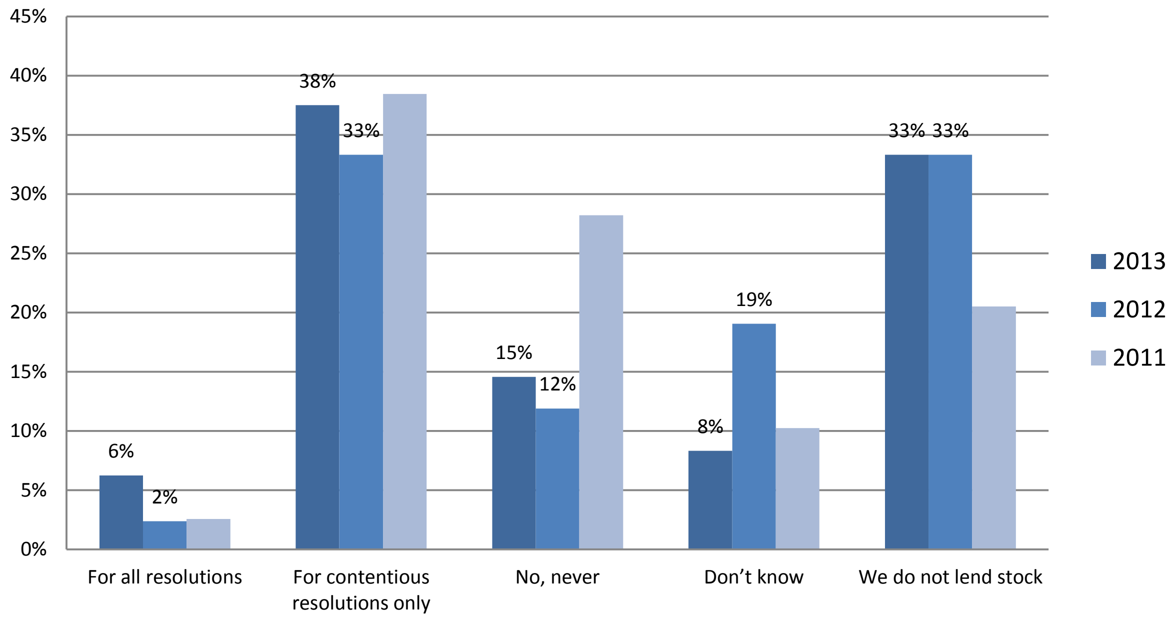
Voting on loaned stock

Principle 6 of the Stewardship Code states that "institutional investors should disclose their approach to stock lending and recalling lent stock". As securities on loan cannot be voted by the 'owner', if a fund wished its voting rights to be exercised it would need to recall these securities in advance of the company meeting.

Many argue that there is a conflict between stock lending and the ability to fulfil stewardship responsibilities, specifically the responsibility to exercise rights as shareholders. However, stock lending aids market liquidity, reduces the cost of trading and provides an income stream to many funds. It is therefore important for funds to discuss their policy in this area and to communicate it to their agents.

We asked funds again this year whether they (or their investment managers) recall stock that is out on loan in order to regain control over the voting rights. A sizeable number – 44% of respondents – indicated that they do recall lent stock, either for all resolutions or just for contentious resolutions. Only 15% of funds suggested that they never recall stock and, as in 2012, a third (33%) do not lend stock at all, a result reflective of the post "crisis" sentiment.

Fig. 29. Do you (or your investment managers) recall stock that is on loan in order to regain control of the voting rights?



Approach to responsible investment (RI)

Key findings

- Over half of respondents had reviewed their RI policy within the past year.
- Nearly half indicated that their scheme's RI policy influenced manager selection across all asset classes.
- There is increasing recognition of the importance of considering Environmental and Social factors when making investment decisions.
- Where a specific RI policy existed, it is commonly implemented via 'integration'. Only 8% of respondents use negative screening.
- Nearly two thirds of respondents agreed that responsible investing is compatible with their fiduciary duty – only 17% disagreed.

Approach to the responsibilities of investors as shareholders

The NAPF published a Responsible Investment Guide in May 2013. Within this Guide, a distinction was drawn between ethical/SRI investing' and 'responsible investing'. The Guide defined responsible investment as:

"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."

The NAPF believes that the traditionally long-term investment horizon of pension funds fits well with the growing evidence that responsible investment approaches can lead to enhanced long-term risk-adjusted returns. Implementing a responsible investment policy also helps pension funds to adhere to codes such as the UK Stewardship Code.

In addition, pension fund beneficiaries generally 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 members face and, therefore, the real value of their retirement income.

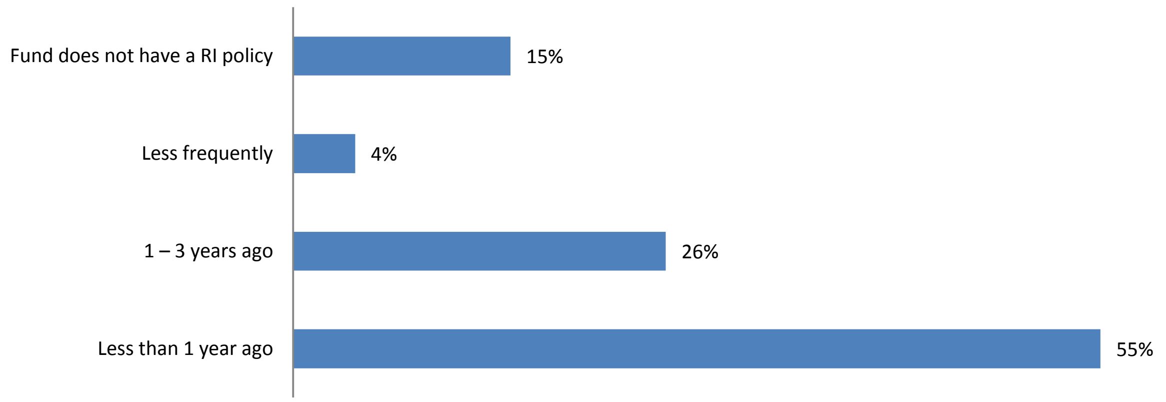
Pension funds are often thought of as universal owners; long-term owners of a diversified investment portfolio that is spread across the entire market or markets. Pension funds collectively own a significant share of the economy and are effectively tied into this share in the longer term. Given this, 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, it is necessary to manage the longer term risk through asset allocations and active ownership practices that are sensitive to longer term factors.

Responsible Investment Policy

The SRI Pensions Disclosure Regulation 2000 requires "that trustees of occupational pension funds disclose in the Statement of Investment Principles the extent (if at all) to which social, environmental and ethical (SEE) considerations are taken into account in their investment strategies".

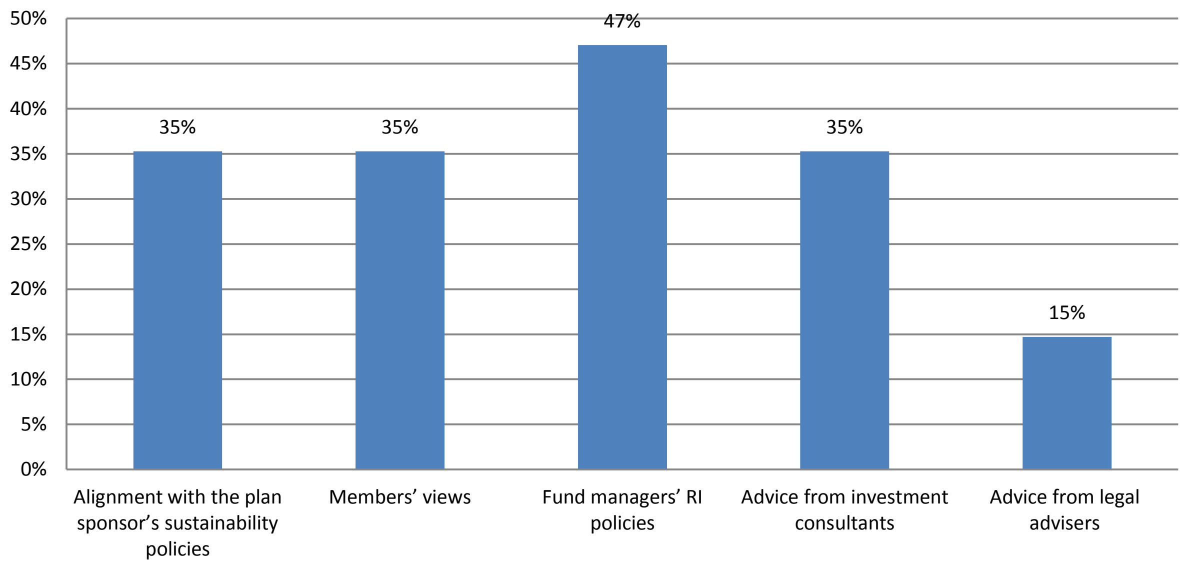
We asked respondents when the fund had last reviewed its responsible investment policy. This was deliberately phrased to relate to the NAPF's definition of responsible investment as opposed to the common interpretation of the Regulation's SEE policy – i.e. one which is based on ethical considerations and involves a screening of the investment universe. Over half of respondents indicated that they had reviewed their responsible investment policy within the past year and a further quarter had done so within the past three years.

Fig. 30. When did the fund last review its Responsible Investment (RI) policy?



We were also interested this year in how funds decided on the appropriate RI policy/strategy for their membership. We asked which inputs their RI policy most reflected. Nearly half suggested that their RI policy was reflective of their fund managers' own RI policies. In addition, over a third said alignment with their plan sponsor, members' views and advice from investment consultants were key inputs.

Fig. 31. Which of the below does the funds' RI Policy reflect? (base 34)

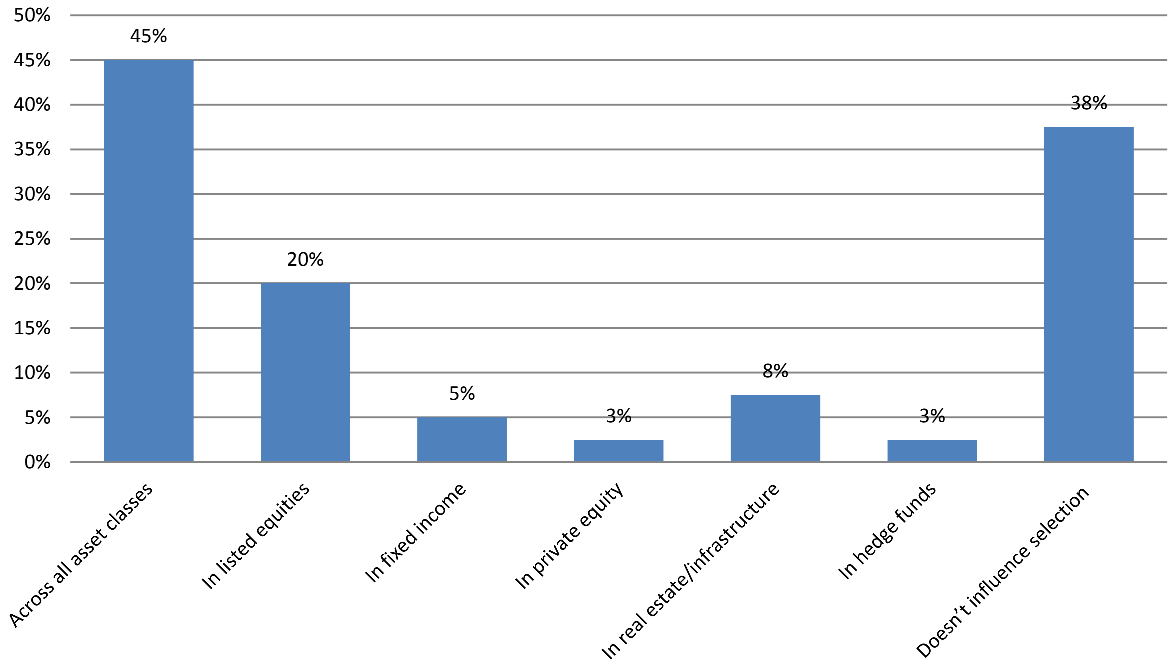


Given that pension funds most commonly look towards their chosen investment managers as the key input to their RI policy, it is important to recognise whether the scheme's policy on responsible investment influences the selection of those investment managers, and, if so, across which different asset classes.

Nearly half of respondents suggested that their RI policy did indeed influence the selection of investment managers across all asset classes – together with the 20% who suggest that RI influences selection within listed equity mandates, this presents a positive picture.

Within the negative responses, there was some conflation of ethical investing and more mainstream responsible investing and in a number of cases respondents indicated that they anticipated including RI considerations within their selection criteria for asset managers in the future.

Fig. 32. Does your scheme's policy on responsible investment influence the selection of investment managers across different asset classes? (base 40)



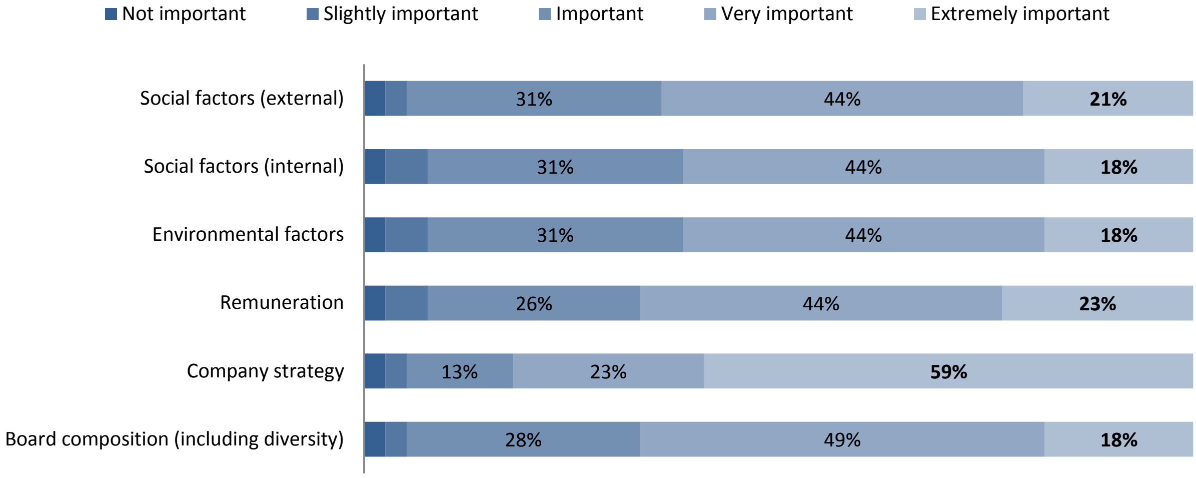
Factors influencing investment decisions

This section of the survey sought to build on one of the initial questions of the survey, which asked whether respondents agreed that environmental, social and governance factors can have a material impact on the fund's investments in the long-term. In this section, we asked funds how important they believed it is that the fund's investment managers take into consideration a range of ESG factors when making investment decisions.

It is reassuring to see that, as in previous years, the factor considered the most important within an investment decision was company strategy, with 59% saying it was 'extremely important' and a further 23% 'very important'.

From an RI perspective, and supporting the result to one first questions in the survey about the perceived potential financial impact of ESG issues, more than 60% of respondents suggested that each of the suggested factors was either "very" or "extremely" important, including 67% noting the importance of board composition and remuneration.

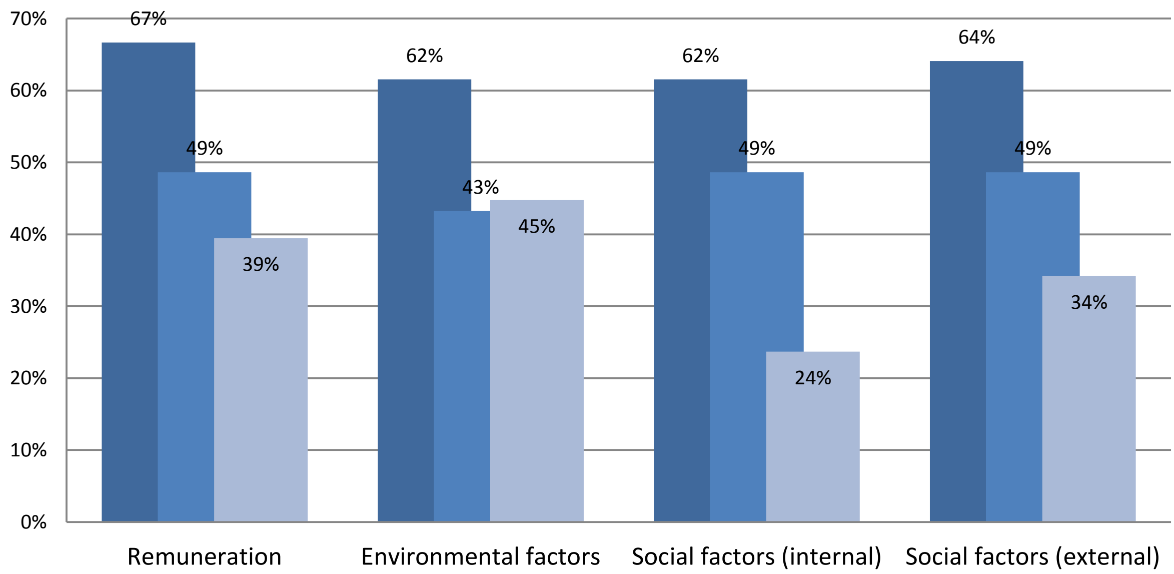
Fig. 33. How important is it that the fund's investment managers take the following factors into consideration when making investment?



It is striking to see the increase in the number of funds considering these ESG factors either 'very' or 'extremely' important. Given the focus in the media and elsewhere on executive remuneration in recent years, it is perhaps no surprise to see the importance of this factor increase from 39% in 2011 to 67% in 2013. However, the upwards trend in importance also applies to environmental factors and social factors.

These results strongly support the view that responsible investment continues to become more and more of a mainstream concept, driven by an increasing understanding of the financial implications of material extra-financial factors. The impact of these risks are becoming more pronounced as corporate practices become more transparent, with more comparable information being made available to investors.

Fig. 34. How important is it that the fund's investment managers take the following factors into consideration when making investment decisions: "very" important - "extremely" important; 2011-2013.



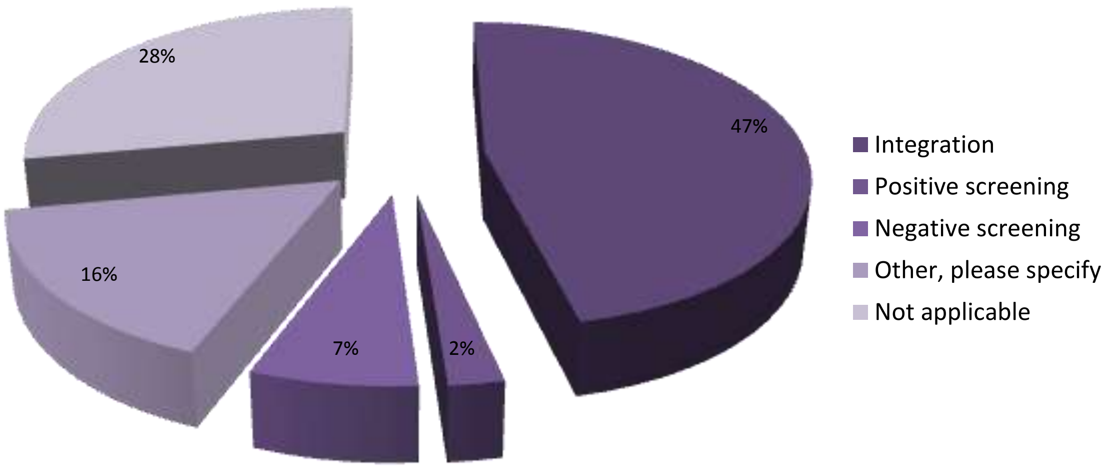
How are policies being implemented

To understand whether integration remained the favoured approach within the UK, we asked for the first time how funds were implementing their responsible investment policies. The process of integrating ESG criteria within financial analysis has recently grown in popularity, not least since the inception of the UN-backed Principles for Responsible Investment (PRI) in 2006.

The 2012 European Sustainable Investment Forum (Eurosif) study suggested that, along with engagement and voting (active stewardship), integration and exclusions are particularly popular responsible investment strategies in the UK market. However, it also identified that exclusions are used mainly by church, charity and private investors rather than pension funds or insurance companies.

Our survey agrees, with nearly half of respondents suggesting that their RI policy was implemented via an integration approach and only 9% saying they use either negative or positive screening of the investment universe. Of those 16% who indicated an "other" approach, this was commonly their fund manager being expected to engage with companies and utilise their shareholder rights to effect change.

Fig. 35. How is your responsible investment policy implemented? (base 39)



A fiduciary duty

In his final report in July 2012, Professor Kay raised questions concerning the way that the law of fiduciary duty influenced decision making in contract-based and occupational pension schemes. Specifically, Professor Kay suggested that trustees of occupational schemes were taking an unnecessarily restrictive view of what they were allowed to consider as fiduciaries.

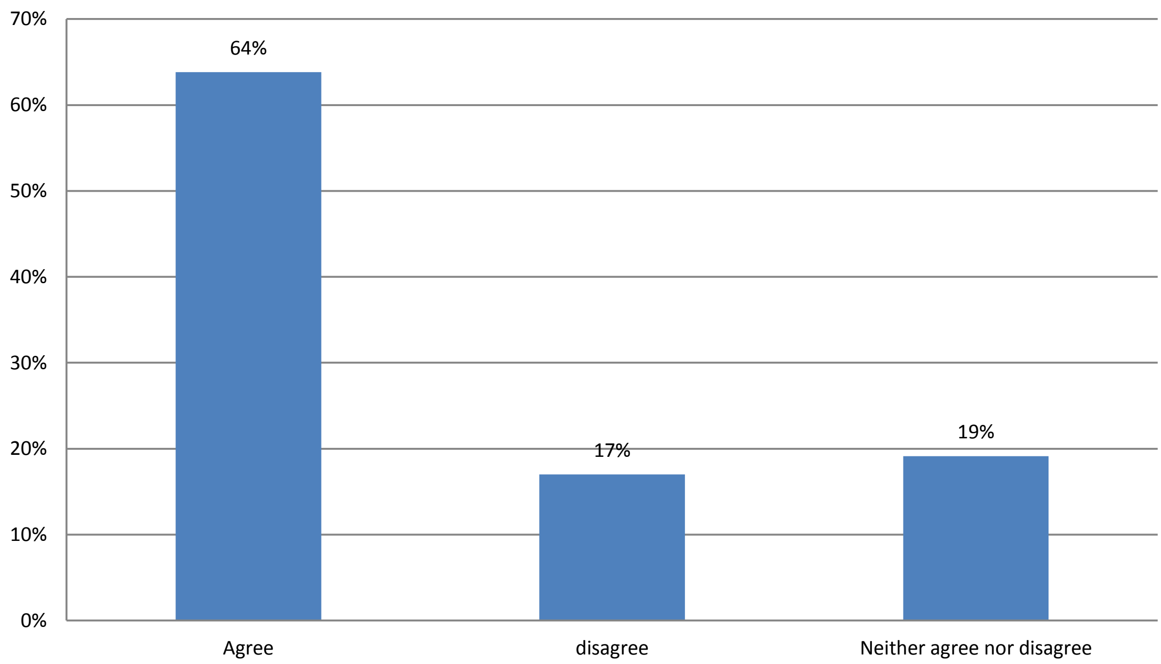
In response, the Law Commission has been asked to look at this area of law. Its consultation paper, published in October 2013, outlines its preliminary conclusions. These include the view that the current law (for trustees) both reflects an appropriate understanding of what constitutes beneficiaries' best interests and is appropriately permissive to allow trustees to consider whether to take ESG factors into account. The NAPF agrees and stated in its preliminary response to the Law Commission that it is wholly consistent with a trustee's fiduciary duty to take ESG considerations into account.

Given the topicality of this issue and the commonly cited view that funds misconceive their fiduciary duty and interpret it in such a narrow fashion as to preclude consideration of ESG issues, we asked respondents whether they agree that responsible investing is compatible with funds' fiduciary duty. The results are fairly clear, with 64% of respondents 'strongly' or 'somewhat' agreeing and only 17% disagreeing.

Some of those who disagreed did so on the basis that, like the Law Commission, they viewed 'ethical investing' as incompatible with a pension fund's primary duty to focus on the financial best interests of its members.

Members' interests in a pensions context will be primarily, but not solely, financial. The NAPF accepts that there are many situations in which an investment presenting attractive short-term financial gain will not be in the members' interests, and there is sufficient scope under current law, as currently understood, for trustees to take a longer term view. We therefore believe that the debate concerning fiduciary duty sparked by the Kay report is helpful in clearing the air about the role of fiduciary concepts in pension scheme management. Equally, more debate about concepts such as responsible investing, ESG, ethical investing and stewardship can only help to increase understanding that it is important to incorporate these considerations in mainstream investment analysis. It will also clarify where the different stewardship responsibilities lie for asset managers and asset owners.

Fig. 36. Does your fund agree that responsible investing is compatible with its fiduciary duty?



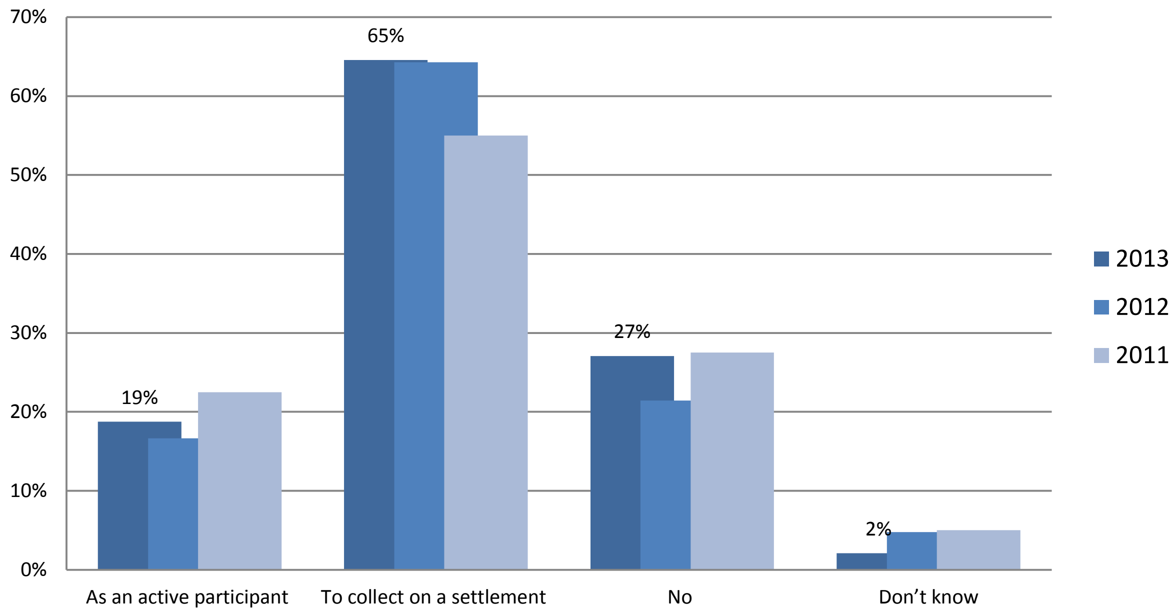
Securities Litigation

Key findings

- 71% of respondents had participated in a class action settled either actively or to collect on a settlement.

This year's Engagement Survey continues to show that a significant majority of pension funds are participating in class actions – 71% of funds either participated in a class action to collect on a settlement or as an active participant. Only 27% said they had not participated in a class action within the past 12 months, and 2% did not know if they had.

Fig. 37. In the past twelve months have you participated in a class action settlement?



With many schemes adversely affected by the recent economic crisis, it remains important that institutional investors continue to seize every opportunity to recover any available proportion of their losses. Our survey suggests that UK pension funds are endeavouring to do just that.

Conclusion

The 2013 Engagement Survey shows that pension funds are continuing to get to grips with their stewardship responsibilities as set out under the Stewardship Code. Encouragingly, more funds are committing to Code and to its Principles and their expectations are being translated into their selection of investment managers. These are positive developments and demonstrate that pension funds are committed to this important agenda.

The Survey also highlights areas for improvement, not least in the commitment to the Code from investment consultants as well as in the quality of reporting to clients from asset managers.

APPENDIX 1: List of figures

Securing the future of pensions

The National Association of Pension Funds Limited©
Cheapside House
138 Cheapside
London EC2V 6AE

Tel: 020 7601 1700
Fax: 020 7601 1799
Email: napf@napf.co.uk
www.napf.co.uk

November 2013

Securing the future of pensions