LCP INSIGHT CLARITY ADVICE

Behind the scenes: Are investment managers delivering on their responsible investment claims?

LCP Responsible Investment Survey

March 2018

Introduction

How we ensure managers are working in members' interests

Every two years we invite a wide selection of investment managers to complete an in-depth survey about responsible investment (RI). It covers:

- their approach to environmental, social and governance (ESG) issues; and
- their stewardship practices, such as exercising voting rights and engaging with company management.

We analyse each manager's responses and assign the manager a score between 1 (weak) and 4 (strong). This report summarises the findings from our recent survey, which was completed by nearly all the major institutional investment managers in the UK.

Our scores show you how good the managers are at taking account of ESG issues and exercising stewardship, and indicate whether there are concerns that might need to be addressed.

Moreover, our continuing dialogue with managers encourages them to improve their practices and – we hope – drives improvements in standards across the industry.

In order to assess each strategy[1] offered by a manager, we gather further information in our research meetings with them, enabling us to validate their responses to the survey and learn about subsequent developments and strategy-specific considerations. **We believe RI is part of identifying investment opportunities and managing risk**. Our RI assessment forms part of our overall view for each strategy that underlies our manager selection and monitoring advice.

This enables you to take account of RI when appointing new managers and overseeing your existing managers, helping to fulfil your responsibilities as trustees.

[1] A strategy is an investment management approach offered by the investment management company. Larger firms may have many different strategies in the same asset class.

About the survey

120
managers responded[2]

90%
response rate

Most responses submitted during September 2017

[2] Statistics and charts are based on 120 respondents throughout this publication, except where otherwise stated.

Headline results

Managers vary significantly in their approaches and credentials

Responsible investment may be one of those things you expect your investment managers to be doing "behind the scenes" as part of the service you pay them for. Indeed, most managers these days will say they consider ESG factors and exercise stewardship.

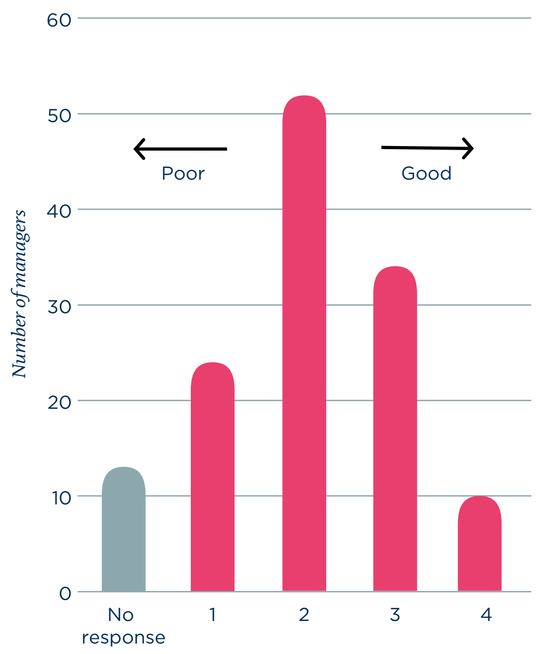
But – when we scratch beneath the surface – it is clear that there is a **huge range between best and worst practice** in this area. Only 8% of respondents were awarded the top score in our survey, whereas 20% received the bottom score. Nonetheless, we are seeing clear signs of improvement and delighted that many managers are proactively asking to discuss RI with us.

Here are some of our findings:

- **34%** of investment managers said that someone oversees and is held accountable for ESG and stewardship issues at board level.
- Managers are developing tools to aggregate security-level information on ESG risks to monitor them for the portfolio. They already do this for **56%** of strategies[1].
- Managers voted against or abstained from at least one motion at **34%** of AGMs on average (with the results for individual managers ranging from 1% to 91% of AGMs!)[2].

Read on for more details.

Manager-level scores from LCP RI survey



[1] More specifically, we asked respondents to say whether they carry out such analysis for the majority of strategies they offer, for each of six asset classes. On average, respondents said yes for 56% of the asset classes in which they offer strategies.

[2] Of 76 managers supplying data for this question.

What we look for in managers

Managers with these characteristics score highly in our survey

Investment process

- Integrate ESG throughout the investment process
- Ensure ESG considerations affect buy/sell decisions
- Consider multiple sources of ESG data, taking steps to ensure its quality and robustness

Staff

- Have senior management accountable for ESG integration
- Give all relevant staff ESG training
- Have specialist staff providing in-depth ESG expertise as required

Stewardship

- Use voting and engagement as a tool to improve investment performance
- Exercise all votes, form own view on voting decisions and willing to vote against management
- Have robust policies on issues like climate-related risk, executive pay, boardroom responsibilities and diversity

General

- Are a signatory or member of relevant codes and initiatives
- Can provide evidence of collaborating, as appropriate, with other investors. For example participating in joint engagement activities
- Have clear reporting, including fee transparency

Responsible investment is an integral part of our manager research. We look for evidence that managers are giving due consideration to ESG factors throughout the investment process and exercising our clients' ownership rights appropriately.

Matt Gibson
Head of Investment Research

Our survey shows that being a PRI signatory is necessary, but not sufficient, for managers to demonstrate good responsible investment practices.

Claire Jones
Senior Consultant

Are managers committed to responsible investment?

Most managers have made public statements of support

The first thing we look for is whether managers have made public commitments to RI by signing up to relevant codes and organisations. This is an area where many managers score well.

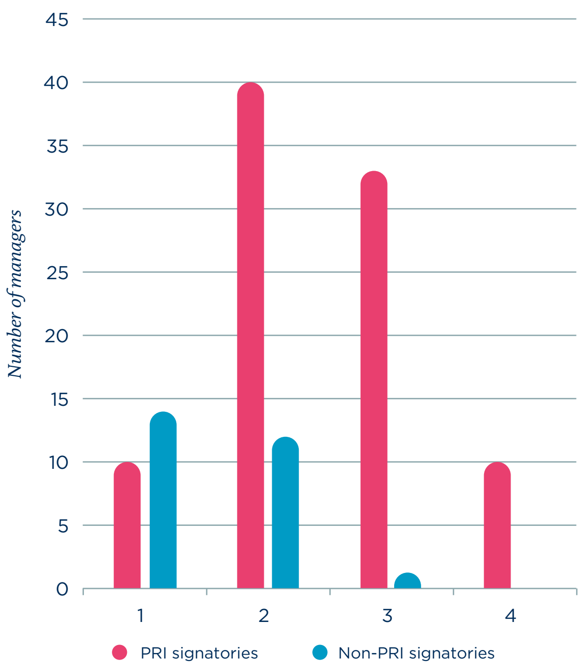
On average, respondents are signed up to **4.7** relevant codes and organisations, with 14% of respondents signed up to 10 or more. The key code is the UN-backed Principles for Responsible Investment (PRI). **78%** of respondents are signatories, a significant improvement on the **66%** in our 2015 survey.

As the bar chart shows, managers who are PRI signatories tended to score better in our survey than non-signatories.

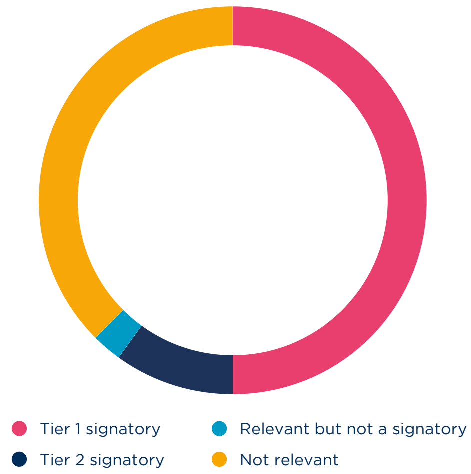
We expect firms that manage UK listed equities and have a significant UK presence to commit to the UK Stewardship Code. Of the respondents which meet these criteria, **96%** are signatories.

The Financial Reporting Council classifies UK Stewardship Code signatories as Tier 1 or Tier 2 based on the quality of their statement of support. It is pleasing to see that 83% of the signatories in our survey have been classified as Tier 1. This means they have provided a good quality and transparent description of their stewardship approach and explanations of an alternative approach where necessary.

Manager-level scores from LCP RI survey



UK Stewardship Code status of respondents[1]



[1] "Relevant" managers are those which manage UK listed equities and have a significant UK presence

Are managers taking account of ESG factors?

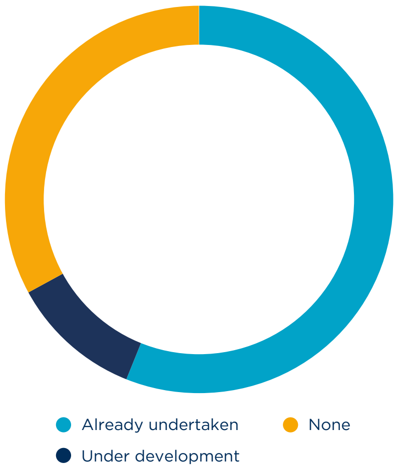
Most say yes, although it is by no means universal

We asked managers whether they explicitly consider ESG issues in their investment process across six asset classes (equities; government bonds; non-government bonds and loans; property and infrastructure; multi-asset strategies; other). Most said yes, but worryingly, **35%** said they did not for at least one relevant asset class[1].

Managers' descriptions of their RI process often focus on the effects of ESG factors on individual securities. It is less common for managers to consider the impact of macro-level ESG trends or analyse ESG risk exposures at the portfolio level. The latter is quite challenging as it requires security-level data in a consistent form that can be aggregated across the portfolio. However, we expect our clients will increasingly want to see this information, as it will help them understand their overall exposure to ESG risks.

Encouragingly, managers are already undertaking or developing portfolio-level ESG risk analysis for **about two-thirds** of strategies, although managers are not yet ready to share much of this with trustees.[2]

Portfolio-level analysis of ESG risks[2]



[1] Asset classes which the manager does not offer were excluded when calculating this statistic.

[2] We asked respondents to say whether they carry out, or are developing, such analysis for the majority of strategies they offer, for each of six asset classes. On average, respondents said yes, they are already carrying out analysis, for 56% of the asset classes in which they offer strategies and are developing it for a further 11% of the asset classes.

Which staff have RI responsibilities and expertise?

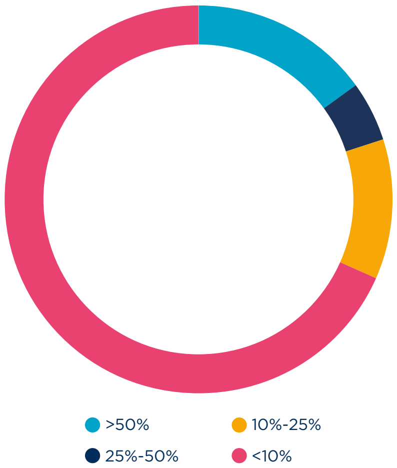
Involvement in RI extends far beyond specialist staff

To demonstrate that RI practices are truly embedded, we expect a wide range of individuals to have some responsibility for ESG issues and stewardship. This is an area where improvements could be made by many managers. Only **52%** of respondents seemed to have assigned widespread responsibility for RI and few investment professionals have RI in their job description or performance objectives.

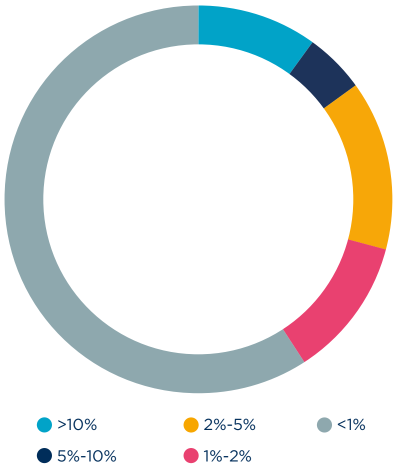
We also expect someone senior to oversee, and be held accountable for, RI. Disappointingly, only **34%** of respondents indicated that this was someone at board level.

As expected, most managers employ just a small number of RI specialists. However, many other investment professionals are receiving RI training. **30%** of respondents said that at least three-quarters of their investment professionals have undertaken at least two hours of training on ESG and stewardship in the last two years, a proportion we anticipate will rise in future.

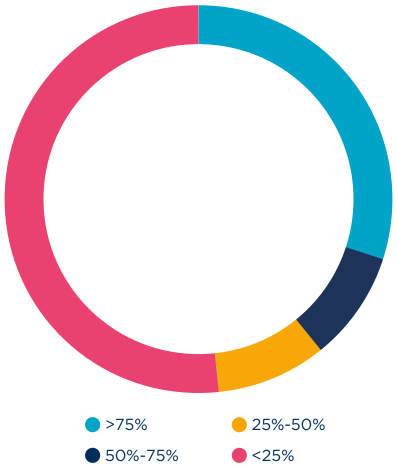
Proportion of a firm's investment professionals with RI mentioned in job description and/or performance objectives



Proportion of a firm's investment professionals who are RI specialists



Proportion of a firm's investment professionals who have had at least two hours RI training in last two years



How are managers responding on topical issues?

Answers were surprisingly weak, even on climate change

The most prominent ESG issue is currently climate change. Despite many high profile commitments from financial institutions on this topic, managers' responses to our survey questions about climate change were surprisingly weak.

We asked managers about the following **five actions** they can take to manage climate-related risks:

- considered systematically prior to investment at security level
- considered systematically prior to investment at strategy level
- used as a key topic for engagement
- included in risk reporting at security level
- included in risk reporting at strategy level.

These actions are relevant to most asset classes and investment styles, and can be used in tandem with each other. On average, managers said they had only adopted **1.5** of the five actions[1].

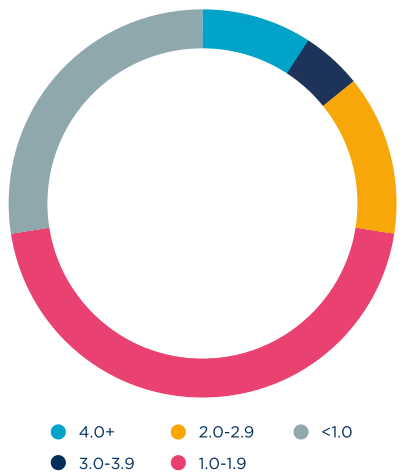
To find out about managers' engagement practices, we selected one topical issue on each of environmental, social and governance: water scarcity, fair pay across the workforce, and boardroom roles and diversity.

We asked them to describe their approach to engagement on each topic (with investee companies, regulators or policymakers) and provide examples of action their organisation had taken.

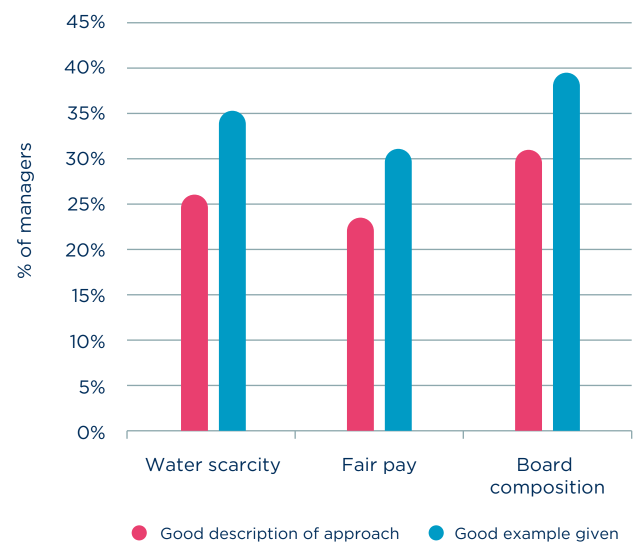
For each topic, only **around one-third** of managers gave a moderately detailed description of their approach or provided a good example.

[1] Answers averaged across the asset classes offered by the manager, from a list of six asset classes. Managers were asked to respond based on the approach for the majority of strategies in each asset class.

Average number of actions taken to address climate risk across asset classes[1]



Engagement on topical issues



Disappointingly few managers have a comprehensive approach to managing climate-related risks. We expect this to improve over the next few years.

John Clements
Partner

Are managers exercising your voting rights?

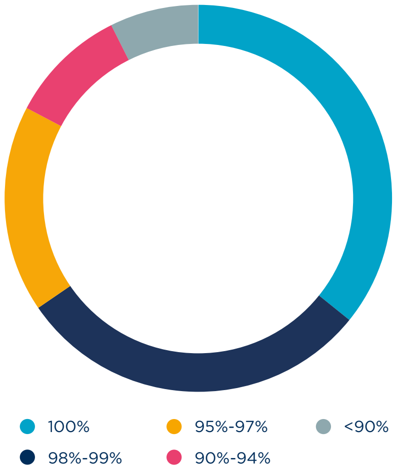
Managers generally do this well

Voting rights are an important way in which shareholders can hold company management to account. Trustees therefore expect managers to vote on their behalf wherever practical. Our survey shows that equity managers do exercise most votes – **97%** on average, for those supplying data[1].

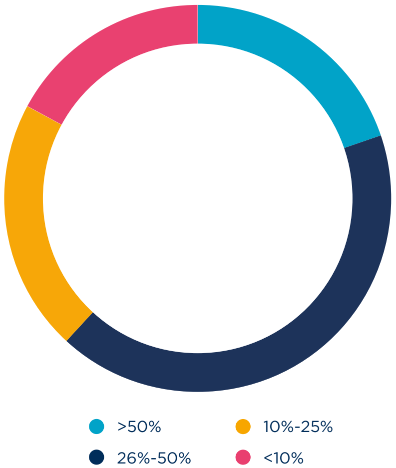
Reassuringly, a high proportion of managers are willing to vote against company management or abstain when appropriate. On average, they did so for at least one motion at **34%** of AGMs[2], higher proportion than in our previous surveys. However, there is a wide variation, with the managers' individual answers ranging from 1% to 91% of AGMs.

We asked managers to describe how they make voting decisions. Many of them obtain recommendations from proxy voting advisers, with only **57%** forming their own view when deciding how to vote on a particular motion[3].

Proportion of votes exercised[1]



Proportion of AGMs with at least one vote against or withheld[2]



[1] Based on 81 responses

[2] Based on 76 responses

[3] Based on 91 responses

Fee transparency

Most managers will need to improve their disclosure of costs

Managers' fees and the costs they incur on behalf of clients are coming under increasing scrutiny. Investment management fees can significantly reduce net investment returns, therefore reducing members' benefits (in DC schemes) or increasing sponsors' costs (in DB schemes). Historically, there was little visibility of some of the costs incurred.

Funds have for some time had to disclose total fees paid to managers and other services providers (the Ongoing Charges Figure). For DC schemes, managers must now disclose the transaction costs members incur. Similar regulation is expected for other types of client when recommendations from an FCA working group are revealed later this year.

Until it becomes a "must do" for all clients, we think greater transparency on costs is an important indicator of responsible investing. We would like to see managers volunteer information in standard reports on not just their fees, but also on other costs the client pays in their portfolio.

Our survey revealed (as at September 2017 for most respondents)[1]:

- Performance was quoted after investment management fees for **84%** of strategies
- Transaction costs, in differing formats, were volunteered by **36%** of strategies
- Only **3%** used a form of "slippage"[2] cost methodology in their standard reporting of transaction costs. Hence few were prepared for the announcement that FCA-regulated firms must use this approach from January 2018 when supplying cost information to the governance bodies of DC workplace pensions. That said, many managers have subsequently indicated that they would provide transaction costs in the slippage cost format from Q1 2018.

[1] Answers averaged across the asset classes offered by the manager, from a list of six asset classes. Managers were asked to respond based on the approach for the majority of strategies in each asset class.

[2] Slippage cost is a way of calculating transaction costs that takes account of explicit costs of the transaction, eg broker commission or taxes; the bid-offer spread of a security; and the effect of changes in the price paid / received between making the investment decision and the actual transaction.

Our survey revealed

Performance was quoted after investment management fees for 84% of strategies

Transaction costs, in differing formats, were volunteered by **36%** of strategies

Only 3% used a form of "slippage"[2] cost methodology in their standard reporting of transaction costs.

Conclusions and outlook

Promising signs of improvement, but still a long way to go

Most investment managers are now engaged with the responsible investment agenda. This is evident in the high response rate to our survey – the highest of the four RI surveys we've conducted since 2011.

Some managers score highly across the board, but many have a long way to go. As best practice continues to develop, the bar keeps being raised.

We're particularly pleased that so many managers want to talk about RI and are keen to address any concerns raised by our mutual clients. We therefore encourage trustees to review their managers' approach to RI and put it on the agenda next time they meet a manager.

If you haven't yet seen the headline scores for your managers from this RI survey, or if you want to drill down into any of the underlying detail, please speak to your usual LCP adviser.

[1] The organisation that promotes and supports the Principles for Responsible Investment - see page 6.

What next for responsible investment?

Our survey has revealed several areas where we hope, and expect, to see progress before our next survey:

- Board level accountability for RI implementation
- Better analysis of ESG risks at portfolio level, made available to clients
- Greater action to address climate-related risks
- Evidence of meaningful engagement on a wider range of ESG topics.

Other developments to watch out for:

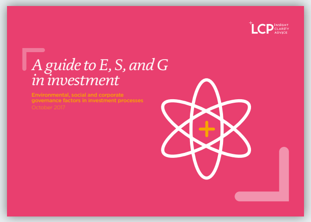
- The DWP has said it will consult on changes to the Investment Regulations (which cover trustees' Statements of Investment Principles) which will facilitate RI
- The PRI[1] plans to start removing managers from its signatory list if they do not meet minimum standards
- The FRC is reviewing the UK Stewardship Code.

Responsible investment resources

Guide to E, S and G in investment

It is becoming increasingly common for investors to incorporate ESG factors into their investment process. But what are E, S and G factors? And how are they relevant to investors?

Download our guide here



Responsible investment in DB and DC schemes

How can you incorporate environmental, social and governance (ESG) factors and stewardship into your investment approach?

Download our DB guide here
Download our DC guide here

Responsible investment in practice

In this series we talk to a number of investment managers about their approach to responsible investment in different asset classes.

Discover manager insights here

LCP's Quarterly Investment Update

Each quarter, LCP produces a commentary on topical ESG matters. This provides a briefing for trustees on recent developments and highlights companies in the news which they may want to discuss with their investment managers. For example, if the trustees hold shares in the companies mentioned, how did the manager vote at the AGM and what other action is it taking? Does the manager hold companies likely to be impacted by the same or similar ESG issues?

If you don't already receive our updates, please speak to your usual contact or request it via **this form.**

Investing Responsibly magazine

Our Investing Responsibly magazine caters for our clients' growing interest in ESG. It covers a diverse range of topics from identifying your investment beliefs to selecting fund managers to exercising oversight of your investments. A common theme is that focusing on long-term sustainable returns may deliver better financial outcomes.

Download our magazine here

A guide to climate-related risks

In this guide, we explain what climate-related risks are, how they are relevant to DB and DC pension schemes and what actions trustees can take to address them.

Download our guide here

Contact us

If you would like more information please contact your usual LCP adviser or one of our specialists below.

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