



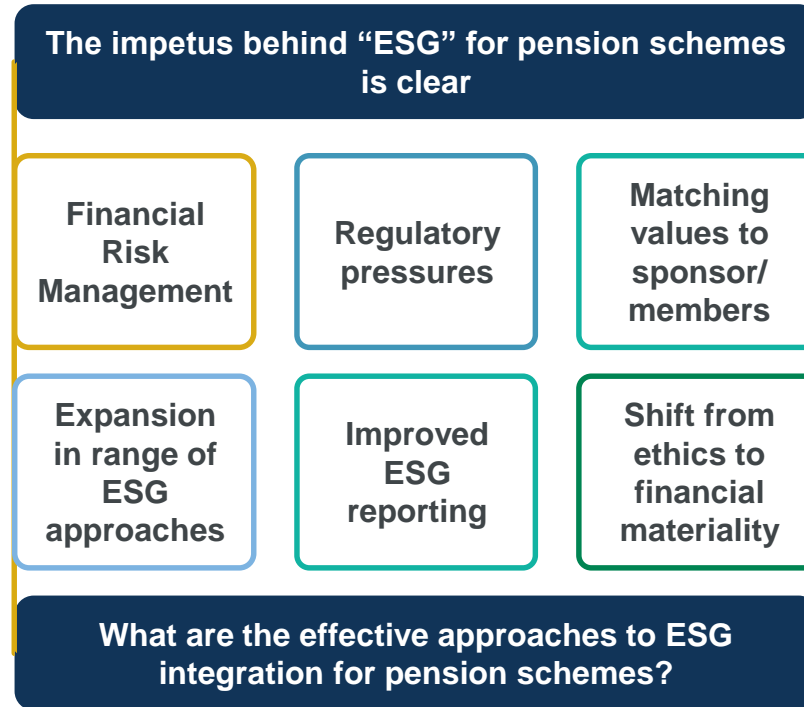
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ESG – 7 Habits of Highly Effective Pension Scheme Integration

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LGIM

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ESG Integration – why is clear, the question is how?



What are the regulations?

The DWP regulations aim to strengthen the policies and disclosures regarding:

ESG integration

“Financially material considerations over the appropriate time horizons, including how those considerations are taken into account in the selection, retention and realisation of investments”

Stewardship

Stewardship obligations, such as voting and engaging with investee companies

What's Changed?

- ESG issues are not “to do with personal ethics or optional extras” → role of default fund (DC)
- Look ahead – ‘appropriate time horizons’
- Report on implementation of SIP, not on breaches
- All schemes must have a stewardship policy

Requirements

- All trustees of schemes over 100 members: update SIP by 1 October 2019
- Trustees of ‘dual section’ and DC pension schemes must also:
 - explain default investment strategy
 - produce implementation statement by 2020



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Our checklist for trustees

Thought piece to help navigate the regulatory changes



1. **Build** knowledge on the relevant ESG issues

- “Financially material” considerations cover “environmental, social and governance considerations”, including climate change
- ESG issues are not “to do with personal ethics, or optional extras” (as opposed to ethical investing, for example)

2. **Define** your investment beliefs and incorporate them into the Statement of Investment Principles (SIP)

- What is the scheme’s governance structure?
- Review ESG policies, risks and opportunities throughout the entire investment process

3. **Review** strategy and asset allocation

- What is the impact on the scheme’s assets and liabilities?
- What is the impact on the default and self-select investment strategies?

4. **Incorporate** ESG issues into the selection and monitoring of asset managers

- How are asset managers assessed on their ESG activities, including stewardship?
- Do you know what your asset managers are investing in?

5. **Report** publicly

- Check to see if you are reporting in line with the recommendations of the Taskforce on Climate-related Financial Disclosures
- Use this information to engage your members



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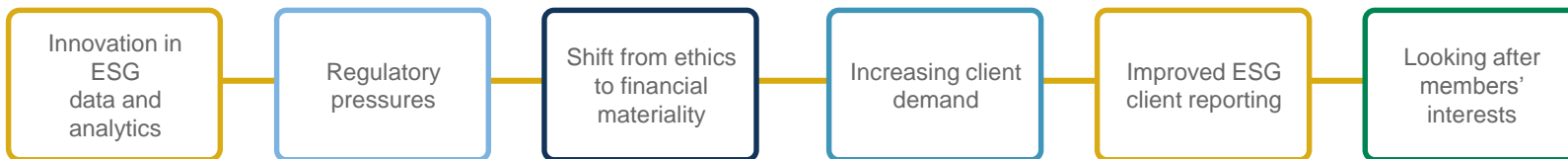
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1. Build Knowledge & Establish Beliefs

How to think about ESG

If this is something you want, how do you express it?

Market changes



Different ways to implement ESG



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Questions for discussion

	yes or no		yes or no
ESG is about delivering desired financial outcomes rather than moral or ethical considerations?	<input type="checkbox"/>	The long-term nature of the liabilities implies a long-term investment horizon?	<input type="checkbox"/>
Are ESG risks present and can they be identified and managed?	<input type="checkbox"/>	ESG may help identify the winners of the future?	<input type="checkbox"/>
ESG risks can also have a harmful impact on the environment and society?	<input type="checkbox"/>	Integrating ESG risks does not require a trade-off with performance?	<input type="checkbox"/>
Engagement adds value?	<input type="checkbox"/>	Investors have a responsibility to the broader market?	<input type="checkbox"/>



Tailor to governance capabilities of the scheme

Increasing number of clients seeking to put in place RI policies



- Trustee training
- Beliefs sessions
- Investment solutions



	Pension scheme A	Pension scheme B	Pension scheme C	Pension scheme D	Pension scheme E
Responsible investment policy					
Differentiates between responsible investment (RI) and ethical investment	•	•	•	•	•
Includes policy statement on climatic change risk	•	•	•	•	•
Incorporates RI into asset allocation and manager selection decisions	•	•	•	•	•
Voting policy					
Delegates voting to investment managers	•	•	•	•	•
Sets additional bespoke voting guidelines on specific matters	•	•	•	•	•
Ask managers to report back on exceptions to policy	•	•	•	•	•
Ask managers to report back on voting activity	•	•	•	•	•
Corporate engagement policy					
Delegates engagement activity to investment managers	•	•	•	•	•
Employs additional third-party engagement overlay provider	•	•	•	•	•
Engages directly with businesses on specific matters	•	•	•	•	•
Measurement					
Aims to measure impact on RI policy	•	•	•	•	•
Sets specific goals around RI penetration, carbon emissions etc	•	•	•	•	•
Communication					
RI policy made available to members	•	•	•	•	•
RI policy publicly available	•	•	•	•	•
Resourcing					
Employs in-house staff dedication to RI	•	•	•	•	•
Collaboration: codes and initiatives					
Signatory to UN principles of responsible investment	•	•	•	•	•
Signatory to UK stewardship code on corporate governance	•	•	•	•	•
Member of institutional investors group on climate change	•	•	•	•	•
Support other organised collaborative groups	•	•	•	•	•





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2. Effective Stewardship

Effective stewardship is core to an effective ESG policy

Effective for pension schemes

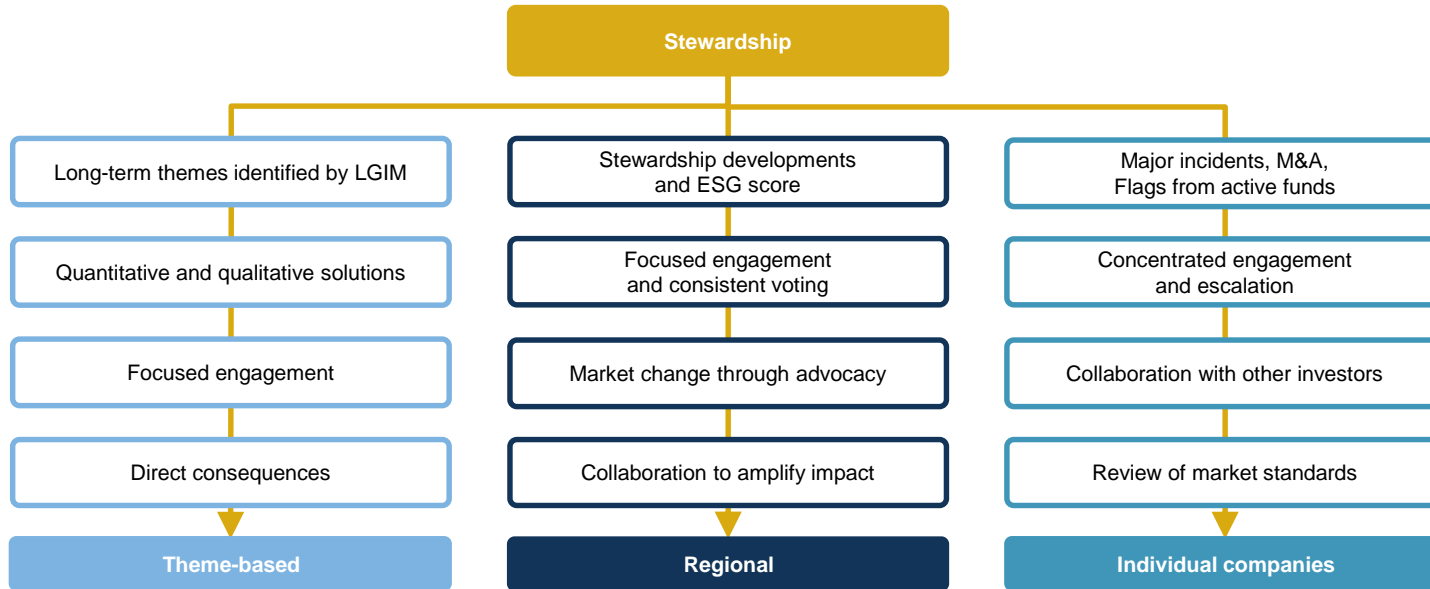
1. **Asset manager does not need explicit mandate to engage on material ESG issues**
2. **Small schemes can delegate to asset manager**
3. **Only option for traditional index funds investments**
4. **Proven way to improve company behaviour**

What to ask asset managers

- **Scope of Voting – limited to “G”?**
- **Consistency of voting & engagement aims (incl. ESG)**
- **Level of disclosure**
- **Extent of reliance on proxy advisers**
- **Willingness to collaborate with other investors**
- **Engagement with key actors (regulators, stock exchanges, index providers) to positively influence company behaviour**



Planned and proactive stewardship



Examples:

- Climate change
- Board independence
- Gender diversity
- Health (planned)

Examples:

- Board independence
- CG code
- CEO / Chair separation
- Shareholder rights

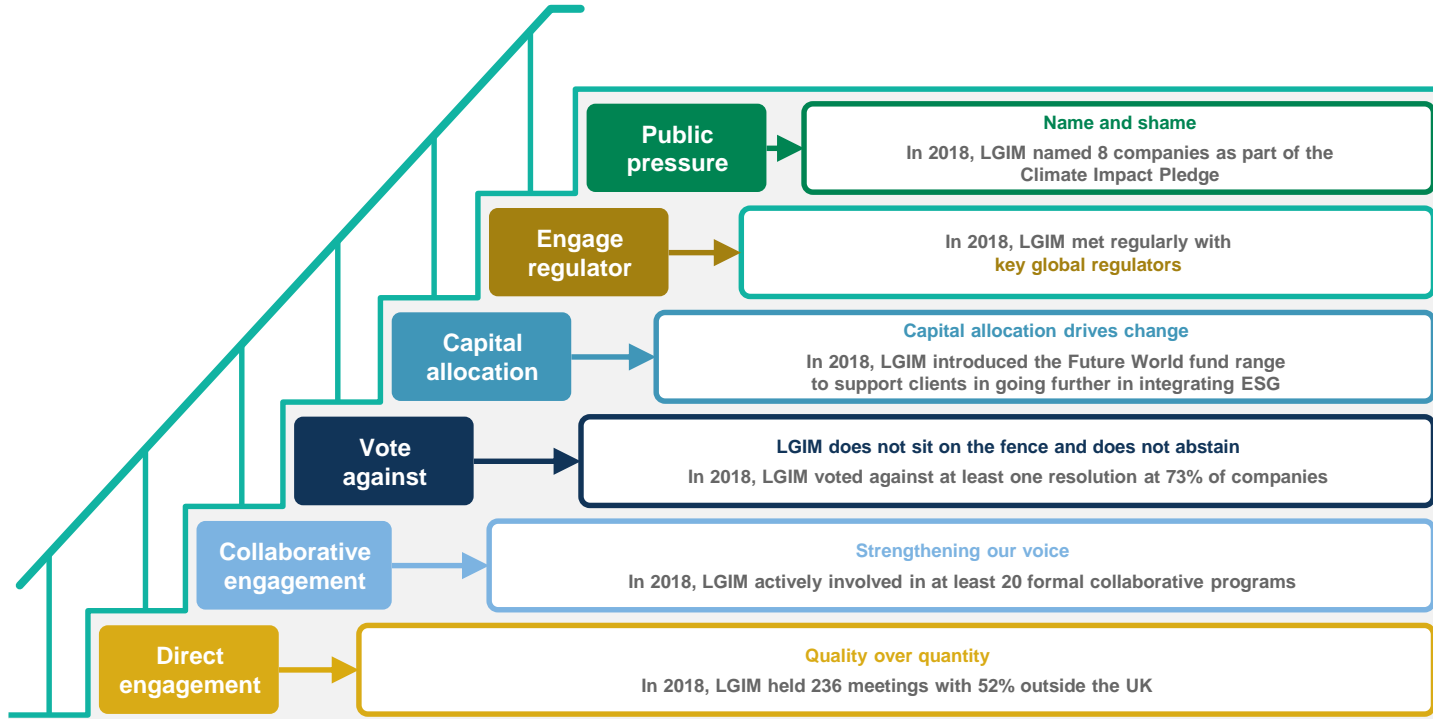
Examples:

- SNAP
- Unilever
- Toyota
- Royal Dutch Shell



Engaging with consequences

Tools for effective engagement - escalation procedure



Case study: BP and Paris Agreement

Focused engagement in collaboration with other major shareholders

LGIM's concerns



Climate change and the energy transition will disrupt the energy market

LGIM's actions



Co-filed shareholder proposal:

- Is each new material **capex** investment consistent with the Paris goals?
- What **metrics** and **targets** the company is BP adopting as a result?

Outcome for all



Board of BP support the resolution

LGIM attended the AGM in person with 99% of shareholders vote in support



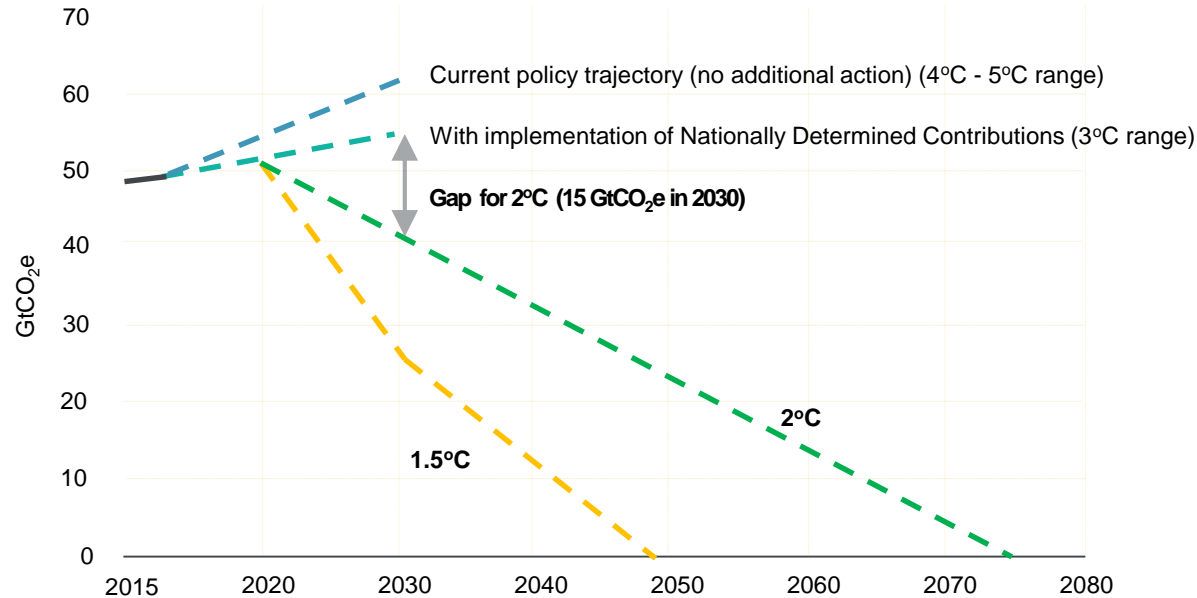
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3. Climate Risk Management

Currently a large gap between current COP21 NDCs and what is required to reach the Paris temperature targets



The problem

1/3 of equities and bonds linked to high carbon sectors which may lose value during the low-carbon transition¹

The challenge is now to **accelerate action** to 2030 to close the gap. Requires immediate action across whole economy. Must peak emissions in next few years and go to “net zero” in next 50-60 years

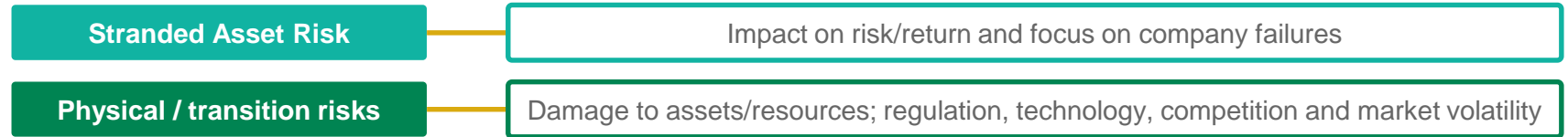


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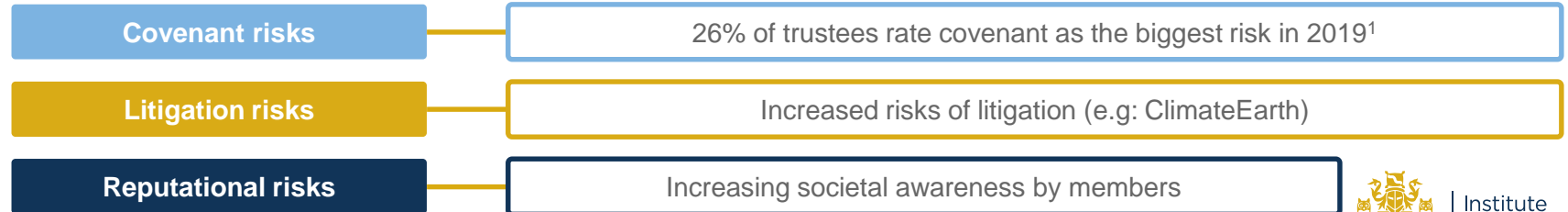
Climate change risk – relevant for pension schemes



Investment Risk



Broader Scheme Risks



Climate change risk – responses for pension schemes

Multi-faceted &
long-term persistent

Difficult to
quantify precisely

Hard
to hedge

Effective Responses

Incorporate into
Strategic Decision Making
& Review

Ensure Asset Managers
driving change

- TCFD?
- Policy support (e.g. G20/PM letter)
- Climate Action 100+

Build out reporting of exposure as data
reliability improves

1. Carbon Footprint / ESG Scoring



xx% lower carbon reserves than
the benchmark

Equivalent to xxx fewer barrels of
oil consumed



xx% CO2 emissions than
the benchmark

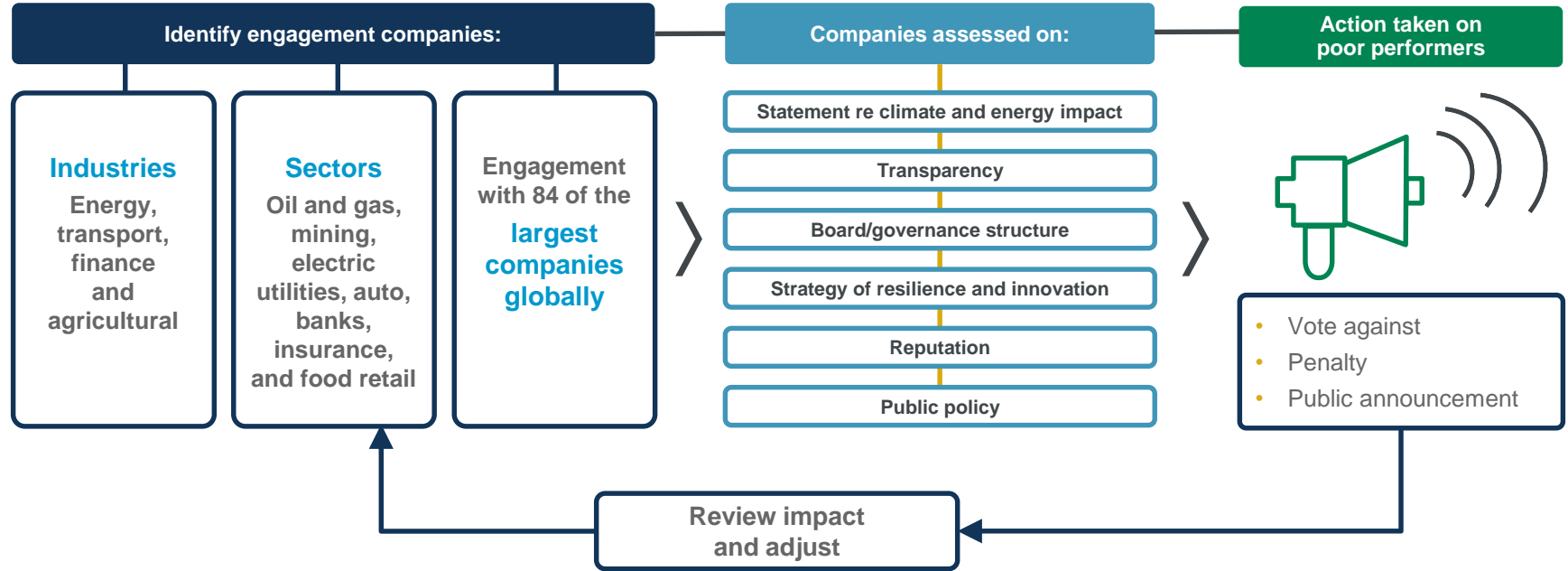
2. Scenario Analysis / Stress tests

Consider de-risking portfolios
by reducing exposure to
exposed companies



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Climate Impact Pledge



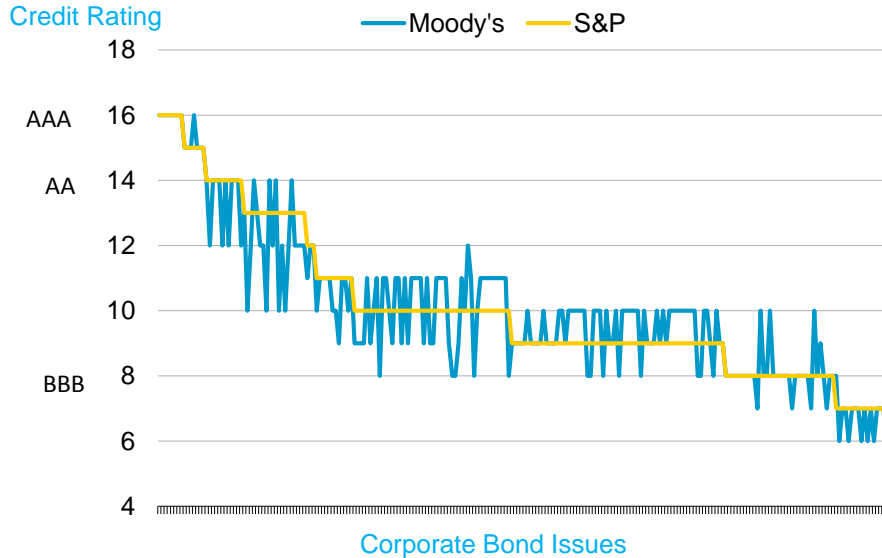


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4. Measure what matters

Credit Ratings – a consistent metric

Largest corporate bond issues in iBoxx \$ Investment Grade Corporate Bond ETF, ranked by S&P ratings

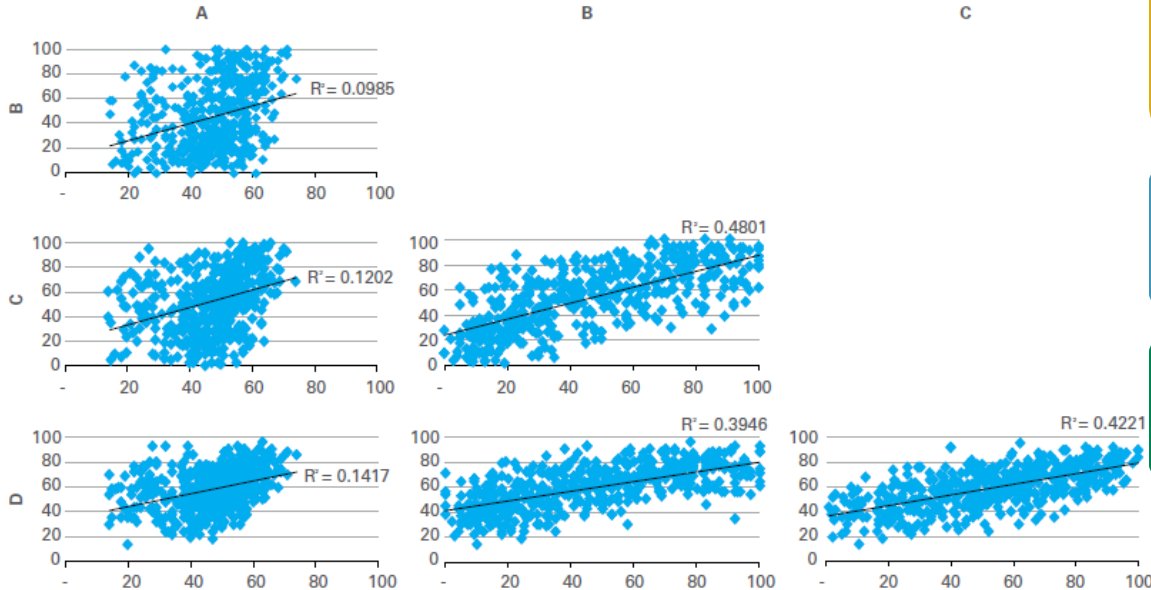


- Credit ratings broadly consistent across providers
- Consistent in purpose
- Established frameworks for interpretation and market pricing



ESG Ratings – inconsistent metric

Correlation of four ESG score providers on 500 of largest listed US companies



- Poor consistency in ESG ratings
- Choice of data points and weighting system
- Reflecting different purpose and beliefs of providers

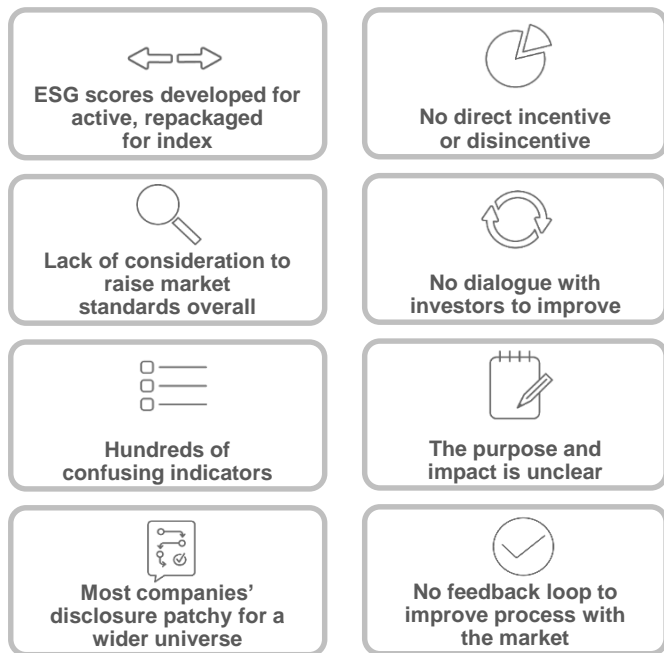
Goodhart's Law: "when a measure becomes a target, it ceases to be a good measure"

"a good measure is the target"

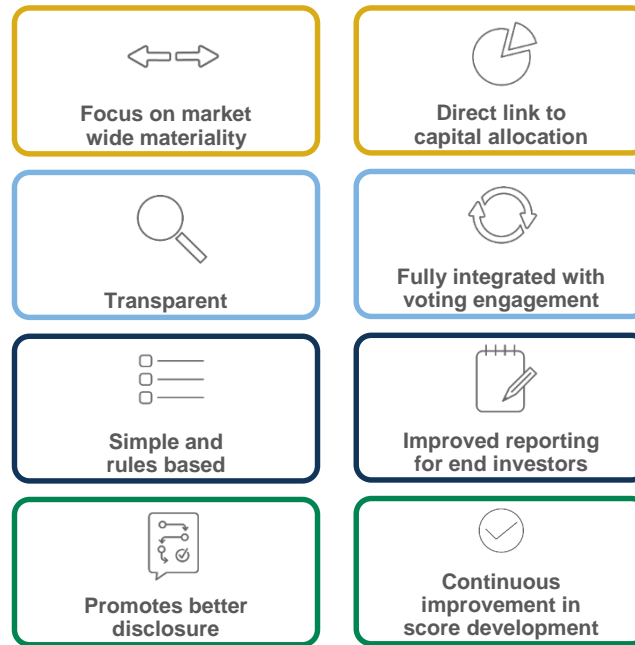
Rationale for proprietary ESG scores

Drives consistent message from investors

Wider market approach

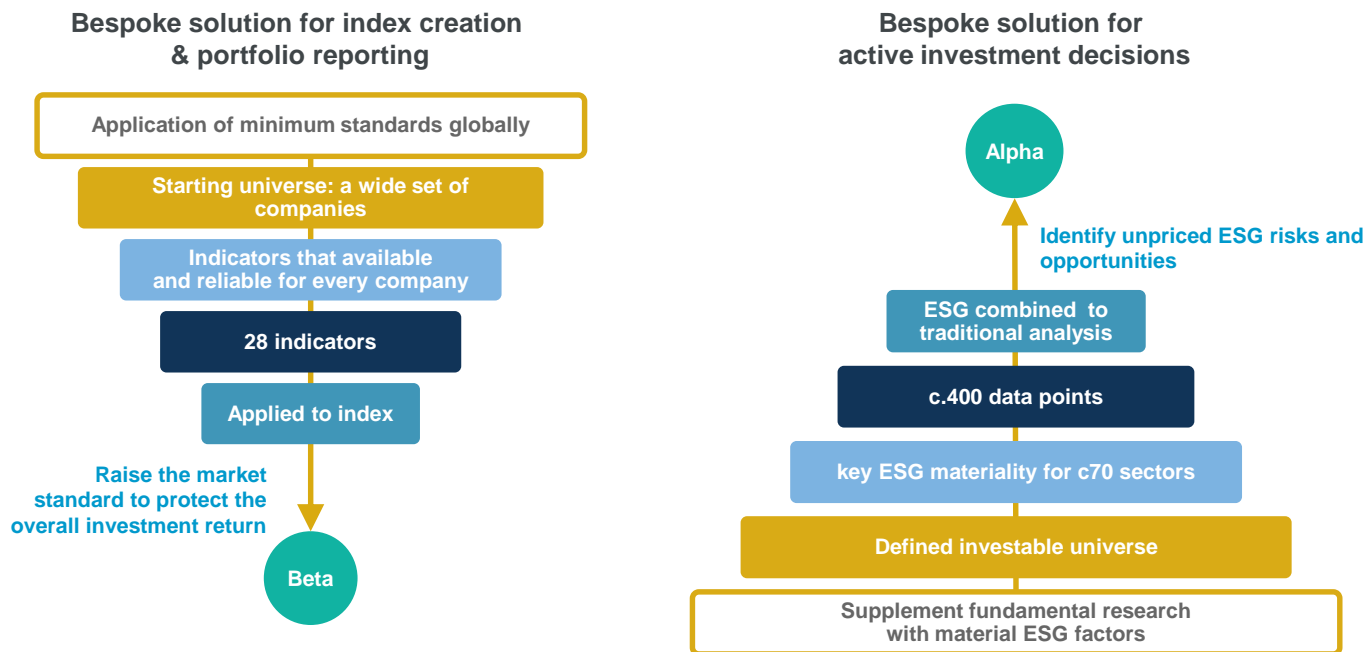


LGIM approach



Designing data driven approaches

ESG data derived for two different purposes



LGIM ESG Score

Data driven approach drives engagement and index construction

Understandable, Transparent

4

Independent raw data providers

- Thomson Reuters
- Sustainalytics
- Trucost
- HSBC

28

ESG data points

c.13000

Companies scored internally. Could be as large as the dataset

6

Months published externally

Simple, rules-based approach

Based on indicators we believe to be most significant

Score translates into 0-100 for reporting purposes

Company name	LGIM's Global ESG Score
3i Group PLC	65
3M Co	42
ABB Ltd	56
Abbott Laboratories	49
AbbVie Inc	58
ABC-Mart Inc	28
ABN AMRO Group NV	64
Accenture PLC	71
Accor SA	25
Acom Co Ltd	20
ACS Actividades de Construcción y Servicios SA	47
Activision Blizzard Inc	52
Aculity Brands Inc	45
Alibaba Group AC	70



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5. Use Negative Screens and Divestment Selectively

Negative screens & divestment



LGIM Future World – Protection List

Coal Mining

Coal use and extraction is responsible for significant levels of planet-warming greenhouse gas emissions. The inability of 'pure' coal companies to diversify puts this business model at risk

Controversial Weapons

Controversial weapons are those that have an indiscriminate and disproportional humanitarian impact, in many jurisdictions their use is illegal

United Nations Global Compact

The UNGC's principles set globally accepted standards on human rights, labour, environment and corruption. Companies who have violated these principles consistently for three years or longer will not be held within the Future World funds

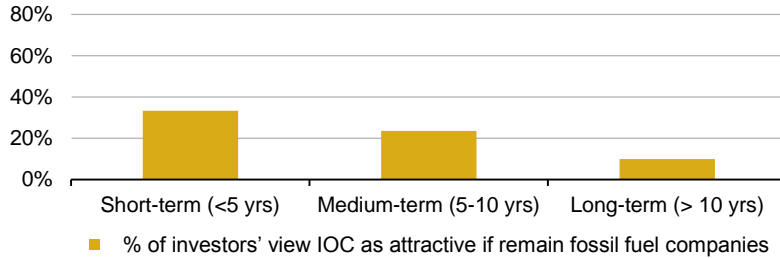


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Divestment of fossil fuels – a role in the future?

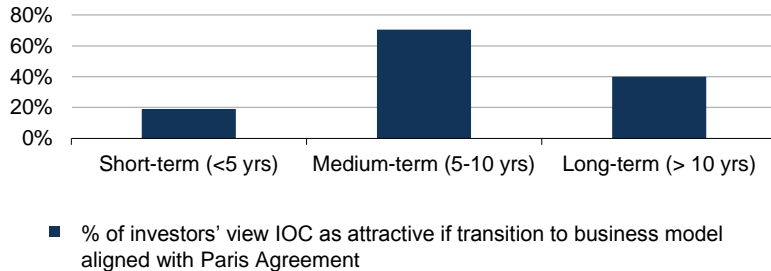
Integrated Oil Companies – investors view

Remain fossil fuel companies

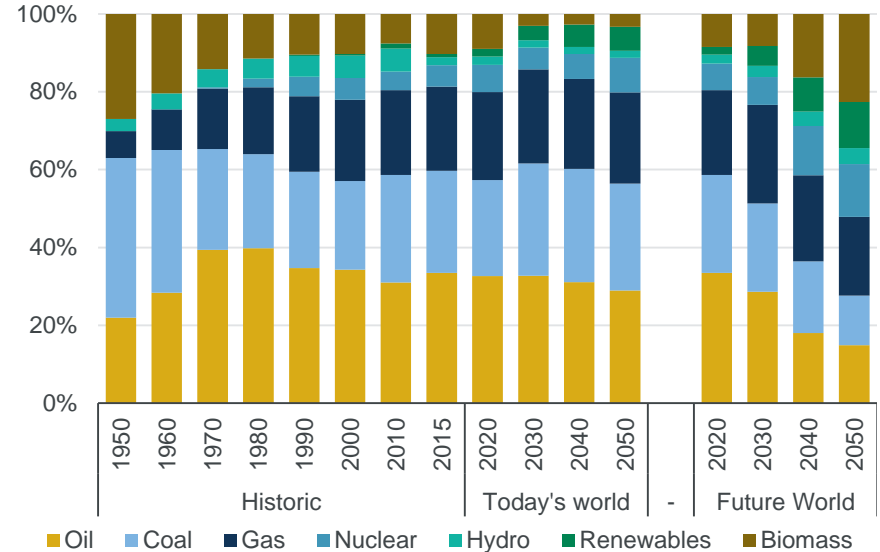


Transition to business model aligned with Paris Agreement

Transition to business model aligned with Paris Agreement



LGIM – projected evolution of primary energy consumption by type



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The alternative to blanket negative screens and divestment

- What does 'tilting' achieve?
- Using a Power Tilt (e.g. 2)
- And an ESG Score at -1 to +1 scale

Formula: $(1 + \text{ESG Score})^2 \times \text{Market Cap Weight}$

- Apply stock and sector constraints
- Reweight

Company ESG Score (0-100)	Company ESG Score (-1 to +1)	Tilted Weight (Initial 1%)
90	0.8	3.2%
75	0.5	2.3%
50	0	1%
25	-0.5	0.3%
10	-0.8	0.0%



Effectiveness of ESG Tilting versus Divestment

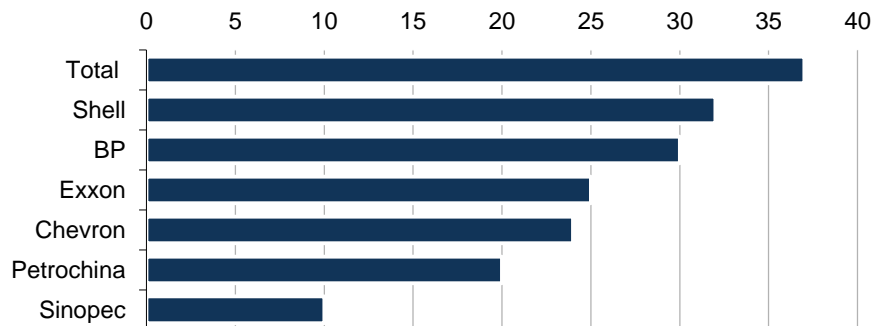
Effective in reducing carbon footprint

	Carbon emissions intensity vs. benchmark	Fossil Fuel reserves vs. benchmark
MSCI World ex-Fossil Fuel	-14%	-100%
FTSE All World Climate Factor	-48%	-73%
L&G Solactive ESG Developed	-49%	-70%

Effective in changing company behaviour

- Retain 'seat at the table' for engagement
- Retain voting rights
- Retains threat of divestment

LGIM ESG Scores





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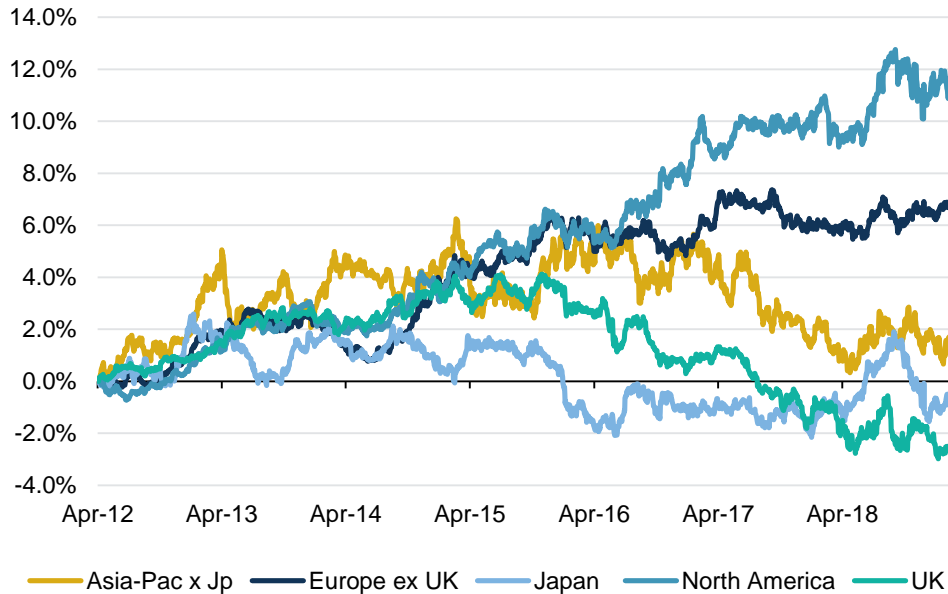
6. Performance

13 June 2019

Have ESG strategies been effective in increasing returns?

Historical and academic evidence

L&G ESG Tilted Index vs. Market Cap



Academic Studies

The overwhelming share of 2,250 peer-reviewed studies found: **a positive relationship between ESG and corporate financial performance**¹

The largest meta-study on sustainability showed that **90% of studies indicate sound sustainability standards lower the cost of capital of companies**²

'Core' ESG Indices in Developed Equities – Performance of ESG versus Market Cap

	Excess Returns (p.a.)	Start date
L&G Solactive ESG	0.48%	2012
MSCI ESG Universal	-0.24%	2009
FTSE ESG	0.14%	2009



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Source: LGIM, Solactive, MSCI, FTSE. Table uses ten years of data or since inception if ten years not available - FTSE from May 2009 to May 2019, MSCI from Nov 2009 to Apr 2019, L&S Solactive from May 2012 to March 2019.

Past performance is not a guide to the future. ¹ <https://www.tandfonline.com/action/showCopyRight?scroll=top&doi=10.1080%2F20430795.2015.1118917>, ² As of 2015. Source: https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf

Will ESG strategies be effective in increasing returns?

Weight of Money

As asset owners explicitly move to ESG strategies

Market Focus

ESG focus shifting from ethics to financial materiality
As active managers focus on ESG factors more

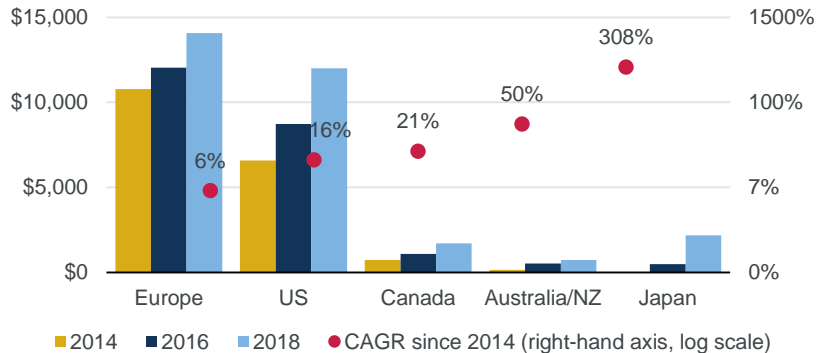
Climate Transition

Under most transitional scenarios, changes to policy and technology, will see negative impacts on high carbon risk investments

Who cares wins

Consumer demand shifting to sustainable products
Regulators reflecting this societal change

Sustainable Investing assets (\$bn)



81% of global consumers feel strongly that companies should help improve the environment



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7. Portfolio perspectives

Effective portfolio perspectives for ESG

Focus on materiality

- Credit risk greater risk driver for DB (allocation & duration)
- In particular, persistent downgrade and default cycle



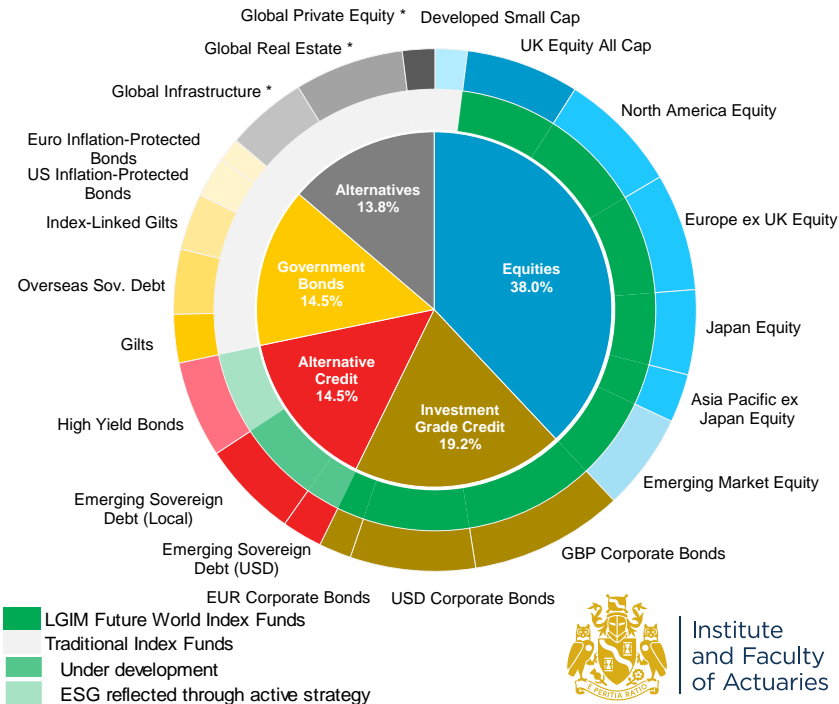
Moody's - 11 sectors with \$2.2 trillion debt have elevated environmental risk exposure

S&P - environmental and climate concerns were materially relevant in 717 (10%) cases from July 2015 to August 2017

Fitch - 22% of current ratings influenced by ESG factors

Incorporate into proven, mainstream strategies

LGIM Future World Multi-Asset Fund – Asset Allocation



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Effective “ESG” Integration for Pension Schemes

1. Build Knowledge & Establish Beliefs
2. Effective Engagement
3. Climate Risk Management
4. Measure what matters
5. Use Negative Screens and Divestment Selectively
6. “Past performance is not a guide to future returns”
7. Portfolio perspectives – materiality and mainstream solutions



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