

Pensions Week: Special Focus: No easy remedy.

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While bananas and cocoa beans may lend themselves well to the conscientious consumer phenomenon, pension schemes have not sat so easily with the ethics behind the ethical.

For many trustees, responsible investment has been considered at best insignificant and at worst close to a breach of their fiduciary duty.

But with an increasing number of reports connecting the health of the planet with the health of the balance sheet, is it time trustees raised the issue on their agendas, and took a fresh look at the wider implications of sustainable speculation?

Karina Litvack, head of governance and socially responsible investment (SRI) at F&C Asset Management, says fiduciary duty is the pivotal point in the whole debate and has long stood in the way of pension funds moving forward in terms of ethical investment.

According to Paul Moody, head of investment development for Morely Fund Management's specialist products, a lot of trustees were previously advised by consultants that, by definition, dealing with SRI could result in underperformance which may breach fiduciary duty.

Historically, SRI was the domain of the screened product, most notably used by charities and church organisations, with fund managers disregarding investment opportunities that breached certain ethical criteria.

An approach described by one asset manager as "effectively investing with one arm tied behind your back".

Tim Currell, investment consultant and head of the sustainable investment and corporate governance manager research team at Watson Wyatt, explains that as all SRI funds need to have some type of negative screening, pension funds have struggled to include it, concerned that overlooking investment opportunities, in favour of non-financial criteria, may be seen as a breach of fiduciary duty.

However, following the publication of last year's Freshfields report, which stated it may be a breach of fiduciary duty to ignore environmental, social and governance (ESG) issues given the link reported by economic analysts between ESG and positive financial performance, consensus began to change.

Some fund managers now argue ethical investment is no longer just about investment abstinence but about actively engaging with ESG issues to ensure sustained healthy returns in the long term.

"Ten years ago we were having the discussion of whether to focus on ethical investment or on plugging the deficit, but it's a false conflict. We're now debating a new role for ethical investment in adding financial value to schemes. You can invest how you always invested. Not just including or not including stocks, but becoming ethically engaged," adds Litvack.

Julian Lyne, head of institutional at HSBC Investments, echoes Litvack's comments adding: "HSBC believes responsible and sustainable investment is vital both for shareholder value and what that means in terms of how we grow. Managers are starting to take in sustainability in terms of share price and people are being rewarded for considering these things."

And Currell agrees the area of sustainability is a key issue in terms of long-term performance, not a subsidiary issue to pay lip service.

"We believe strongly in sustainable investment. It is not just a case of trustees getting around fiduciary duty. It is a long-term investment. Pension fund trustees should be thinking about this.

Over the next few years SRI is going to have a big impact, and pension funds need to find fund managers who are starting to look at it," explains Currell.

Duncan Exley, campaigns manager at Fair Pensions, the lobby group committed to raising trustee awareness about the benefits of ethical investment, argues the real danger lies in ignoring the issue.

"What is more risky is that not adopting responsible investment (RI) best practice may breach a scheme's duty to maximise returns. Further, because RI involves monitoring ESG issues, responsibly invested pension schemes are more likely to identify factors that may become financially relevant such as probable litigation, regulation and reputational damage. Few people would confidently say that reduced returns due to ineffective monitoring do not represent a breach of duty."

A report on climate change set up by the government and carried out by Mercer Investment Consulting also identified climate change as a big risk to share price.

The Mercer carbon report found that virtually all classes of pension assets had the potential to be affected by climate change, either directly in terms of damage to agriculture and real estate or through policy driven strategies to mitigate climate change, such as legislation likely to be issued on car industries.

Anne Desgagniers, sustainable pensions adviser at the UK **Social Investment** Forum, adds: "The regulations are happening now and the government commitment will roll down. So climate change will have a financial impact. ESG is currently described as 'extra-financial' but this is a misleading term because it is financial, it would be better phrased as non-traditional."

While both consultants and fund managers seem convinced of the benefits of sustainable investment, it remains to be seen whether pension funds and trustees will be persuaded in the same way.

John Gray, pension observer for the Tower Hamlets Pension Scheme, says trustee suspicion will never be overcome until there is increased awareness across the board.

He explains: "Fund managers themselves are not interested in any sort of inference to RI, or a lot of them just pay lip service to it. To progress there has got to be improvements in education and training."

And Morley's Moody agrees the key to the future is through teaching: "There is still a lot of education of trustees that needs to be going on. It is still seen as quite a minor area with everything else eclipsing it. Raising it on the agenda is difficult. It is down to us as fund managers to inform trustees that you can enhance returns."

But both Morley and HSBC reported an increased interest from schemes keen to explore the sustainable avenue.

Harriet Parker, SRI analyst at Morley, says: "A lot of pension funds have been actively approaching us to find out about how to set up responsible investments. Both actual SRI and incorporating ethical principles into mainstream funds."

And Howard Pearce, head of pension fund management at the Environment Agency, reported glowing results after adopting eight managers dedicated to responsible investment.

"We believe it is financially beneficial to invest in this way. It is from a financial duty viewpoint rather than a moral stance," adds Pearce.

The future of ESG was given another confidence boost with the announcement the controversial National Pensions Savings Scheme included a proposal to ensure a range of investment options, including ethical ones, were provided under the government's personal accounts system.

According to this year's European SRI survey, the UK faces two major long-term policy challenges: managing the transition to sustainable development, and reforming pensions to ensure financial security in retirement for tomorrow's pensioners.

"It is important both are achieved together, by a partnership not a trade-off," concludes the report.

And with an increasing number of initiatives advocating sustainability, the launch of the United Nations' Principles of Responsible Investment - a framework for addressing ESG issues, signed by a number of large players in the investment industry, and the introduction of an ethical investment declaration to be included in every pension fund's statement of investment principles, it seems likely that the role of ESG in making investment decisions is set to grow and grow.

But it's clear there are still obstacles to overcome, because according to Moody, the UK is lagging behind its European counterparts - having previously been considered investment leaders.

"The UK market is being left behind by France, where organisations are looking at ESG to improve performance, and in no way to jeopardise it. Perhaps UK pension funds will see developments in France, Norway, Sweden and be encouraged to follow suit," suggests Moody.

But whether the fault lies with reticent fund managers or wary trustees, the idea that financial and environmental health sit in tandem has still not fully permeated throughout the pensions industry in the UK and until it does, there will always be the tendency for ESG issues to be sidelined.

Neither the health of the planet nor the health of pension funds are going to be solved by a quick fix, both are in need of considered long-term solutions, and both will always be the subject of long-term debate.

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