HYMANS ROBERTSON

# investment perspectives

Summer 2016

In this issue:



# Welcome

## In the current environment, where achieving sustainable returns is critical, it is unsurprising that responsible investment is a topic gaining prominence amongst institutional investors. Pension schemes, as long-term investors, are potential beneficiaries of this integration of responsible investment into their strategy.

Reflecting the increasing importance being placed upon responsible investment, both amongst our clients and across the market as a whole, we are pleased that Simon Jones has taken on the role of Head of Responsible Investment within Hymans Robertson.

Responsible investment embraces a diverse range of subjects. As introduced in a previous Investment Perspectives, we believe responsible investment considerations have two key dimensions:

- **Sustainable investment**: investors should recognise the potential financial impact of Environmental, Social and Governance (ESG) factors in investment decision making; and
- **Stewardship and governance**: investors should act as responsible and active owners, through considered voting of shares, and engagement with company management when required.

Each of these factors has the potential to improve the financial return to investors or to give rise to risks that could compromise returns. The Pensions Regulator acknowledged such factors as part of the recently published DC Code of Practice, highlighting the fact that responsible investment should be considered by both DB and DC trustees.

In addressing responsible investment in this edition of Investment Perspectives, we highlight four topics which apply at various stages of the investment process (figure 1).

- In the first article William Marshall sets out the benefits a well-defined set of beliefs can bring and explores how investment beliefs can help you consider what sort of responsible investor you want to be.

**Figure 1: Hymans Robertson investment process**

- When considering asset allocation, to what extent are responsible investment considerations applicable to assets other than equities? In the second article Rebecca Craddock-Taylor explores the impact of the two key dimensions of responsible investment across an investment strategy.

- In previous Investment Perspectives we addressed how carbon exposure has been highlighted as a potential risk for investors. As part of the monitoring process, it is important to understand how carbon risk can be measured. In the third article, Simon Jones explores the use of carbon footprinting as a risk monitoring tool.

- Finally, beyond voting for political reform, there is growing evidence of the collective power of investors exercising their shareholder voting rights to achieve desired outcomes. Starting with the premise that equity ownership conveys a degree of responsibility, Nell McRae takes a closer look at voting and considers how you can both stay abreast of what your managers are doing and engage with your managers on their voting policies.

Responsible investment has often been considered by trustees as "a nice to have". However, by understanding how responsible investment can be integrated within an investment process, we believe trustees should regard responsible investment considerations as a component of their decision making process, rather than a decision in its own right.


Andy Green

Chief Investment Officer
andy.green@hymans.co.uk
0131 656 5151

# What do you believe in?

## One feature of a successful investment strategy which is often cited, but frequently overlooked, is the set of investment beliefs around which decisions are made.

### What purpose do beliefs serve?

Beliefs matter. They reflect the way in which trustees, be it implicitly or explicitly, translate their objectives into an actual set of investment arrangements.

The impact of beliefs can be observed across a range of investment decisions that need to be made, including the use of diversification, the willingness to employ active management and the approach to addressing responsible investment issues.

Documenting your investment beliefs could be considered as stating the obvious. However, having your beliefs well-defined and set out on record confers a number of advantages:

1. **Clarity** - Beliefs allow an investment strategy to be articulated and interpreted by internal and external stakeholders and therefore offer a means through which communication can be structured.

2. **Priority** - Beliefs allow trustees and sponsors to determine which decisions are important and question why a course of action may be being proposed. It helps facilitate areas of compromise and set "red lines" not to be crossed.

3. **Consistency** - Beliefs provide a defined framework within which investment decisions are taken. This means that all decisions can be assessed against the same overarching standards.

4. **Continuity** - Trustee bodies change over time which can lead to a loss of ownership of the underlying investment strategy. However, where strategy is reinforced by a set of investment beliefs, trustees may be better able to own both the beliefs and consequently the strategy through time.

5. **Long-term thinking** - Beliefs can help trustees to stand clear of short-term market noise and avoid knee-jerk reactions.

There is no right answer when it comes to setting beliefs. Each trustee body will have its own unique beliefs which depend both on their own circumstances and the views of individual trustees.

Once established, beliefs should be periodically reviewed to ensure that they continue to reflect the combined views of the trustee body.

### CASE STUDY

*A client had come under considerable scrutiny from members to take action on its investments in fossil fuels. Rather than taking immediate action to change, we worked with the client to help them frame their own policies by developing both a set of investment beliefs and a set of responsible investment beliefs. While the client was initially sceptical, this exercise subsequently allowed them to provide a more robust response to their members and has led to a broader understanding of engagement issues and more informed discussion with investment managers.*

## What sort of responsible investor are you?

As illustrated by the case study, trustees can use beliefs to address specific aspects of investing. This may include equity investment beliefs, incorporating some the principles we set out in a previous Investment Perspectives for example, or beliefs around responsible investment.

Given responsible investing decisions exist at each stage of the investment process, a key consideration for trustees is to determine the extent that they wish to explicitly address these issues within their investment arrangements. To do this, trustees need to determine what sort of responsible investors they want to be.

Beliefs around responsible investment may be driven at an organisational or an individual trustee board level.

Some investors may believe they should seek to drive broader changes in behaviour and therefore adopt a leading position whereas others may have less strong beliefs around driving change, but still wish to remain active.

Discussion on investment beliefs provides avenues for engagement on responsible investment issues. Trustees can effectively use such discussions to make an informed choice as to the position that they want to adopt. Table 1 illustrates some of the actions that can be taken to reflect the chosen position.

Regardless of the position taken, developing investment beliefs gives trustees greater ownership of their investment decisions, and can consequently create more responsible investors.

**Table 1: Possible trustee positions on responsible investment**

| Core position | Active position | Leading position |
|---|---|---|
| Developing a statement of investment beliefs | *Core position plus...* | *Active position plus...* |
| Engaging with investment managers on ESG policies | Understanding/reporting on potential ESG risk exposures | ESG issues embedded in all investment decision making |
| Regular reporting on manager voting and engagement activities | ESG factors explicitly considered in some investment decisions, e.g. manager selection | Active engagement with investee companies for value enhancement |
| Periodic training on responsible investment issues | Support for broader industry initiatives, e.g. UK stewardship code | Collaboration with other investors to create change |

William Marshall
Partner
william.marshall@hymans.co.uk
0131 656 5116

# More than a matter for equities

## Responsible investment is not solely the domain of equity investors. In the pursuit of sustainable returns, we believe it is an issue that applies to the whole investment strategy.

As pension schemes mature and allocations to equities are increasingly replaced by income generating assets, such as property and bonds, trustees should not assume that responsible investment considerations can be ignored. For each asset class in which they invest, trustees should understand the potential relevance of ESG issues in investment decision making and be prepared to question their investment managers on how such factors are integrated into their investment processes.

### The role of the long-term investor

Equity owners, as direct shareholders in a company, have been perceived to have more influence over the company's future direction (and share price appreciation) than, say, debt holders. Having a long-term approach, especially as an equity investor, means company management should be more willing to negotiate with shareholders and make changes if they believe investors are in it with them for the long haul.

However, the same can be considered true for other asset classes. For example, while there is a contractual relationship between the investor (as landlord) and tenant for real estate investments, anecdotal evidence suggests that tenants are receptive to engagement from their landlord to ensure that their needs are being met. This mean that lease renewals are more likely.

For long-term investors, regardless of the asset class, relationships clearly have value!

### Achieving sustainable returns means considering potential ESG risks

Investors often assume ESG factors are used solely to restrict the investment universe for ethical investors. However, the assessment of ESG factors can help all investors identify potential risks that could impact financial returns.

Most investors agree that relevant ESG factors should be assessed both prior to investing and throughout the holding period of any asset. However the expected holding period of an asset has a bearing on the significance of ESG factors - investment managers with high levels of turnover are likely to place less weight on ESG factors.

ESG factors can be embedded into fundamental equity analysis, but they can also be observed in other asset classes such as property. For example, with effect from 1 April 2018, any property that is assessed with an Energy Performance Certificate rating of F or G cannot be let until the property meets the required higher standard. This does not necessarily mean such properties should be excluded from portfolios or ignored as potential investments, but the costs of remediating this risk through asset management will need to be quantified as part of the property management process.

> *“Companies are more willing to engage with us because we are viewed as a long-term investor.”*
>
> Baillie Gifford

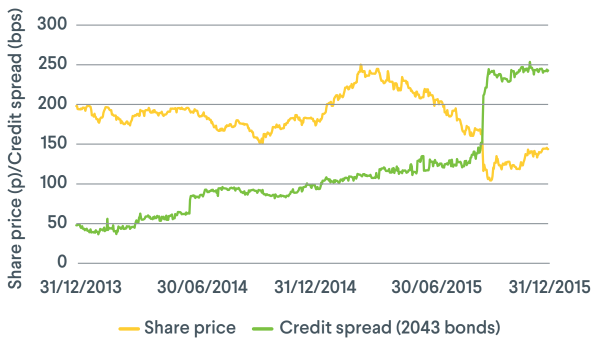
At a broader level, environmental factors such as energy efficiency, water usage and waste have an impact on the cost of occupying a property by tenants. Social factors such as employee wellbeing, which can be influenced by the choice of property, are also an issue of growing concern. Companies may therefore choose to occupy properties that are aligned with their own corporate sustainability objectives. In time, “greener” properties could command higher rents or better quality tenants.

## Corporate governance is an issue for all investors

There is an increasing body of evidence that links corporate governance (implications of a company’s culture, attitude and the people it hires) with financial returns in both equities and corporate bonds. This means bond managers should not just restrict their focus to financial metrics as it is clear that governance factors can impact the creditworthiness of a company.

This was perhaps most evident in the recent case of Volkswagen (VW). Over the course of September 2015, equity investors lost 36% in value, but bond holders also suffered a 17% decline in value as the credit spread on VW bonds widened significantly in the wake of the emissions scandal (Chart 1).

**Chart 1: Volkswagen share price and credit spread**




Source: Bloomberg, Datastream

There was evidence that should have concerned investors: credit spreads had widened by around 100bps over the preceding 21 month period while MSCI noted a declining governance score that led to VW being dropped from their ACWI ESG index in May 2015. Further, in downgrading the credit rating of VW in 2015, S&P cited ‘general deficiencies in its management and governance and general risk management framework’.

With traditional valuation approaches being unable to take account of the broad range of ESG risks, many fixed income professionals acknowledge that integrating ESG factors into their fundamental credit analysis will result in a more comprehensive understanding of a company’s risk factors.

## Integrating responsible investment considerations

Investors, including trustees and investment managers, are increasingly recognising that ESG factors have relevance at all levels of decision making. The process of integrating responsible investment considerations into the whole investment strategy begins by understanding how it is currently addressed.

We suggest there are three key actions for trustees:

- **Education**. Trustees should ensure they have the necessary training on how responsible investment impacts their investment strategy. For example, carbon risk is likely to impact longer-term decisions.
- **Understanding**. Trustees should seek to understand the relevance of responsible investment issues for each of their investment managers and/or asset strategies. For example, the considerations for passive equities are different to active equities and the considerations for bonds are different to property.
- **Engagement**. Trustees should question all their investment managers on the actions they are taking to monitor and manage responsible investment factors effectively.

As pension schemes seek to invest in assets that will generate value over varying time horizons, trustees should be conscious of the different influences of ESG factors and corporate governance on achieving sustainable returns.


Rebecca Craddock-Taylor
Associate Investment Consultant
rebecca.craddock-taylor@hymans.co.uk
0207 082 6345


# What's your carbon footprint?

## Institutional investors are facing growing pressure to disclose their exposure to carbon risk. Carbon footprinting can help trustees measure and manage carbon risk in their equity portfolios.

### What is a carbon footprint?

A carbon footprint is, quite simply, a measure of the exposure of a company or an investment portfolio to carbon emissions. However, not all emissions are the same. Some relate to the direct actions of a company whereas others relate to indirect activity, for example, from consumers use of a company's products.

The box below sets out the different classifications of emissions as defined by the Greenhouse Gas Protocol.

### Which emissions are being measured?

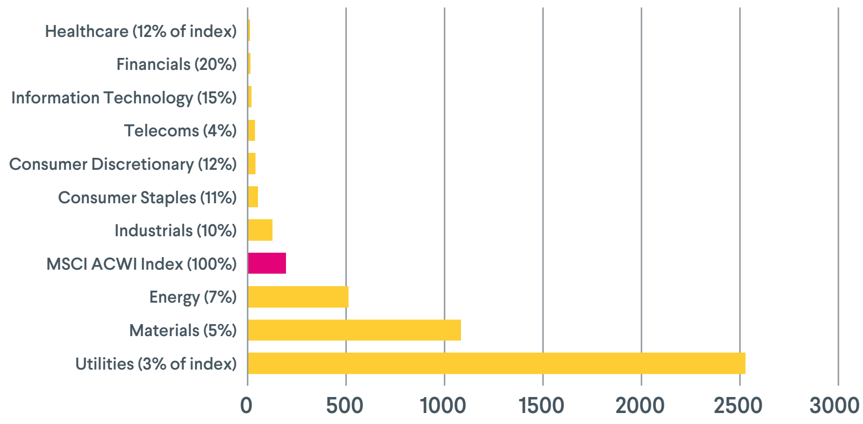
- *Scope 1 includes direct emissions from sources which a company owns or controls; for example, emissions from boilers, furnaces or company cars.*
- *Scope 2 covers indirect emissions relating solely to the generation of purchased electricity.*
- *Scope 3 covers all other indirect emissions. For example, emissions relating to the extraction and processing of purchased materials (supply chain) and emissions relating to the transportation and use of products sold (in use).*

Companies are subject to investor pressure and, increasingly, regulatory requirements to disclose emissions data. Indeed, the UK stock exchange recently became the first requiring listed companies to disclose emissions data. Improved access to data, albeit typically through specialist organisations, offers investors the ability to calculate their exposure to carbon emissions. Due to data availability, analysis typically focuses only on Scope 1 and Scope 2 emissions.

While absolute levels of emissions can be measured, a more common approach is to derive and report a "normalised" level of emissions such as carbon emissions per unit revenue, known as carbon intensity. A typical carbon footprint would therefore be calculated as the weighted average carbon intensity of the underlying investments: weights simply reflect the proportion each stock represents in a portfolio or index.

A carbon footprint can be calculated at an overall portfolio level, but can also be broken down by industry, sector or region. For illustration, chart 2 illustrates the carbon intensity of the global equity market by sector, as at 30 June 2016.

**Chart 2: Carbon intensity (tonnes $CO_2$/Sales USDm) of equity market by sector**




Source: MSCI

A carbon footprint is only a snapshot. It allows investors to judge the position of a portfolio relative to a benchmark measure at a given point in time and to identify areas of potential concern. Unsurprisingly, much focus is likely to be given to companies within utility, materials and energy sectors. However, a company is not "bad" simply because it happens to operate within a carbon intensive sector, and it is important to recognise that some sub-sectors will have very low carbon intensity. For example the utilities sector includes both water companies (low carbon intensity) and electricity companies (high carbon intensity).

## How can trustees make use of carbon footprinting?

As with other risk assessments, carbon footprinting can inform various aspects of investment decision making - we have already seen some equity managers undertake exercises for their portfolios and report on carbon risk to clients. We see three ways that trustees can begin to make use of this tool:

1. As a tool to support engagement with investment managers. Improving the understanding of risks within equity portfolios should allow trustees to better hold their managers to account, by asking more informed questions and thus judging how managers are addressing this emergent risk in their activities.

2. As a benchmark for assessing investment manager activity. Trustees may increasingly expect investment managers to make use of carbon risk assessments in their own decision-making. For example, companies with clear management action plans to reduce carbon intensity, regardless of its absolute level, may be preferred to companies without such plans in place. The periodic measurement of carbon risk exposure allows trustees to judge the effectiveness of such activity at a portfolio level.

3. As a basis for strategic decision making. An equity index (and hence an allocation to equities) brings with it an implicit level of carbon risk. Where trustees believe that carbon risk should be reduced relative to the index, they may choose to address this by directing passive equity exposure to low carbon index strategies or as a factor in manager selection decisions.

Ongoing global action is likely to see climate change remain a topic of importance to all. Carbon footprinting offers investors a mechanism for the measurement of, and consequently the management of, this risk. As policy and regulation develops, this is a tool that is likely to see greater use by institutional investors and managers alike.


Simon Jones
Head of Responsible Investment
simon.jones@hymans.co.uk
0131 656 5141

# Your vote counts

## The process of creating opportunities to vote – be it for individuals in a referendum or equity shareholders at an Annual General Meeting – can be long and hard fought. But if Brexit has taught us one thing, it is that exercising the right to vote can give rise to change.

Shareholder voting has gained increasing levels of media coverage with a number of high profile resolutions attracting particular attention. Fund managers investing assets on behalf of pension schemes are coming under increasing pressure to provide more information on how they vote. What can trustees do to exert the influence they hold as shareholders?

### Understanding shareholder influence

Equity ownership typically conveys the right to vote on resolutions put before a company's Annual General Meeting. Resolutions can range from the routine – director elections, executive remuneration, and stock plan amendments – to more specific proposals including those submitted by shareholders. Over recent months there have been several high profile examples where shareholders have been successful in highlighting concerns.

> *“57% of managers said they had collaborated on engagements with other investors.”*
>
> Hymans Robertson research

### BP

*In April 2016, 59% of BP shareholders rejected a proposed pay and benefits package that would have seen the firm's Chief Executive receive c£14m for 2015, despite record losses being reported. The world's largest asset manager BlackRock voted in favour of the deal and has received a significant level of press attention criticising their approach towards this and other remuneration issues it has voted on.*

### ExxonMobil

*In May 2016, shareholders in ExxonMobil voted in favour of a resolution that would allow investors greater control over the nomination of board members, amid criticism surrounding the company's stance on climate change. Significant press coverage also surrounded a resolution requesting an annual assessment of the effect on the company of climate change policies. The proposal failed to win majority support but was backed by a substantial minority (c38%) of shareholders. A similar resolution at Chevron also failed, yet received a similar level of support.*

*Although the resolutions at ExxonMobil and Chevron were not passed, the strong level of support gained from a number of large investors, together with a recommendation to vote against management from two of the leading proxy voting advisors, suggests that shareholders exert significant influence, particularly when they act in concert.*

## Manager engagement

Many investors either choose, or given the manner in which they invest, are required, to delegate voting to their investment manager or another third party. Consequently, individual investors may find it difficult to influence a manager's voting stance. However, a petition launched by clients and shareholders of BlackRock in the wake of the BP remuneration vote has highlighted that asset managers cannot ignore investors.

We have also seen developments in industry policy and specific guidance in this area. Initiatives such as 'The Guide to Responsible Investment Reporting in Public Equity' created by a number of high profile UK asset owners and the Red Lines Voting initiative developed by the Association of Member Nominated Trustees serve to support investors in exercising their stewardship responsibilities.

The Red Lines are a set of tightly drawn voting instructions, initially focused on the UK stock market but covering a wide range of ESG issues. Adoption of such a centralised proxy voting policy could effectively allow trustees to collaborate with other investors and force managers to adopt a "comply or explain" approach in their voting activity.

Ultimately, investors should be aware that voting is a means through which investment managers can express their dissatisfaction with the actions of management. Voting is effectively a last resort with managers being potentially better served by engaging with management to effect change. For passive investors without the ability to disinvest, voting and engagement are the only tools available.

## What should trustees do?

Trustees are required to document their policies on company engagement and voting within their Statement of Investment Principles. As a result it is important that trustees revisit their policies from time to time to ensure that internal governance structures are aligned with these policies and that they have the audit trail to be able to demonstrate compliance with their policies, if challenged.

- Where voting has been delegated, trustees should ensure that managers provide regular reporting on voting activity. Where managers are unwilling to disclose voting information, trustees should challenge their managers.
- Monitoring of voting and engagement activity can be incorporated into regular reporting and trustees should consider what information it may be helpful to receive.
- Bespoke manager voting policies should be reviewed on a periodic basis to ensure that they remain consistent with trustees' investment beliefs and intentions. Trustees unable to implement a bespoke policy can consider the merits of centralised proxy policies.

While the retrospective reporting of manager activity provides trustees with the ability to "tick the compliance box", a forward looking approach is likely to be more beneficial. By more actively discussing specific issues on which they expect their investment managers to engage, so trustees can play an effective role in emphasising the importance of voting and engagement.

> *"83% of managers said they reported on voting activity to clients at least quarterly"*
>
> Hymans Robertson research

Nell McRae
Investment Analyst
nell.mcrae@hymans.co.uk
0141 566 7945

# Market returns to 30 June 2016

| | Yield % p.a. | | Returns to 30 June 2016 (sterling, % p.a.) | | |
|---|---|---|---|---|---|
| | 31 Mar | 30 Jun | 1 year | 3 years | 5 years |
| **Equities** | | | | | |
| Global | 2.6 | 2.7 | 14.0 | 11.3 | 9.9 |
| UK | 3.8 | 3.7 | 2.2 | 5.9 | 6.3 |
| Developed markets ex UK | 2.5 | 2.5 | 16.0 | 12.6 | 11.5 |
| Emerging markets | 3.1 | 3.2 | 3.7 | 3.8 | 0.7 |
| **Bonds** | | | | | |
| Conventional gilts | 1.9 | 1.4 | 13.5 | 8.1 | 7.4 |
| Index-linked gilts | -1.0 | -1.4 | 14.8 | 10.9 | 9.8 |
| Sterling corporate bonds | 3.7 | 3.2 | 9.1 | 7.7 | 7.8 |
| High yield (US) * | 8.6 | 7.6 | 1.7 | 4.2 | 5.7 |
| Emerging market debt | 6.9 | 6.8 | 19.2 | 0.6 | 0.9 |
| **UK Property** | - | - | 9.2 | 14.5 | 10.4 |
| **Hedge Funds** * | - | - | -4.2 | 2.5 | 2.9 |
| **Commodities** | - | - | 5.4 | -6.3 | -5.3 |

* Return in $

Source Datastream:
FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

If you would like to find out more about any of the topics discussed in this publication please contact your usual Hymans Robertson consultant or:


Andy Green
Chief Investment Officer
andy.green@hymans.co.uk
0131 656 5151



Graeme Johnston
Head of Capital Markets
graeme.johnston@hymans.co.uk
0141 566 7998



Mark Baker
Head of Investment Research
mark.baker@hymans.co.uk
020 7082 6340



HYMANS ROBERTSON
CLUB VITA

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk



This communication has been compiled by Hymans Robertson LLP, and is based upon their understanding of legislation and events as at August 2016. It is designed to be a general information summary and may be subject to change. It is not a definitive analysis of the subject covered or specific to the circumstances of any particular employer, pension scheme or individual. The information contained is not intended to constitute advice, and should not be considered a substitute for specific advice in relation to individual circumstances. Where the subject of this document involves legal issues you may wish to take legal advice. Hymans Robertson LLP accepts no liability for errors or omissions or reliance on any statement or opinion.

This information is not to be interpreted as an offer or solicitation to make any specific investments. All forecasts are based on reasonable belief. Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of your investments based on information contained in this document. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the full amount originally invested. Past performance is not necessarily a guide to future performance.

Hymans Robertson LLP (registered in England and Wales - One London Wall, London EC2Y 5EA - OC310282) is authorised and regulated by the Financial Conduct Authority. A member of Abelica Global.
© Hymans Robertson LLP. 4737/MKT/Inv0416