TRANSCRIPT

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SYSTEMIC STEWARDSHIP: WHY ASSET OWNERS SHOULD DO MORE TO INFLUENCE CLIMATE

Charlotte Moore: Hi, welcome to the latest edition of the Pensions for Purpose Podcast. I'm Charlotte Moore and I'm your host. I'm delighted to welcome Karen Shackleton, Founder of Pensions for Purpose back to the podcast. Hello, Karen.

Karen Shackleton: Hello, Charlotte! It's lovely to be here today.

Charlotte Moore: We're both delighted to welcome Claire Jones, Head of Responsible Investing at LCP to the show. Welcome, Claire.

Claire Jones: Hello, Charlotte! Hello, Karen! I'm delighted to be with you today.

Charlotte Moore: I'm delighted to have you both here ladies. Today, we are going to be discussing systemic stewardship. The first obvious question goes to Claire, what do you mean by systemic stewardship?

Claire Jones: Yes, a bit of jargon there. What I mean by that term is investors using their influence at a systems level, with the objective of addressing systemic risks that have the potential to materially harm financial outcomes. So if I unpack that a bit, what I mean by influencing at a systems level, is that we're not talking about influencing individual companies. But instead, looking to change the rules, the structures and the norms within which companies and investors operate. The focus here is on systemic risks, so risks that can affect the whole economy and the whole financial system. Indeed things that could be sufficiently serious that could cause instability of financial markets. So, we're talking about the kind of risks such as climate change, biodiversity loss and inequality - the things that are financially material to investors.

Charlotte Moore: My next question was going to be, why do you think this is important, but given how you've explained how important it is, I think it's slightly redundant now. You've made it clear it is about the bigger picture, and about stuff that can influence everyone. Why do you think asset owners specifically should be thinking about this?

Claire Jones: If we look at what asset owners can do, these are the risks they can't avoid through diversification or divestment. That's why using influence is so important. The scale and the urgency of change needed means every actor across the investment system should have a part to play in this. It's insufficient for asset owners to leave it to their asset managers, not least because their asset managers' job is to do what their clients ask of them. So they need to be setting expectations for their asset managers in this area, and indeed asset owners are best placed to look across their whole portfolio and look at which risks are most important to them overall. Whereas, asset managers will inevitably be focused primarily on the portfolio they've been given to manage.

Charlotte Moore: Karen, to bring you into the conversation. What are you hearing from pension schemes about this? Is this something they're starting to think about, or is it not quite on their radar yet?

Karen Shackleton: I think opinion is beginning to change. I'm hearing more discussion about systemic stewardship, but that's probably coming more from the investment consultants and the asset managers at the moment, rather than being driven by the asset owners themselves. But if you unpack it in the way Claire did early in terms of what is systemic stewardship. I think fairly consistently asset owners would say, yes things like climate change and biodiversity risk are important. We need to be thinking about it across our whole portfolio and for the world as well. So I believe, thinking is beginning to change. Not everybody is quite yet sure what they should do about it.

Charlotte Moore: That's interesting, people are beginning to grasp the concept and to help people with that. Claire, I know you have put together five climate policy asks. Can you tell us a bit about what they are, and why you produce them?

Claire Jones: Yeah, so there are a set of five requests to governments and regulators, particularly those based in the UK. They are five requests in relation to climate change, which we think are particularly important from our clients' perspective to see the changes protecting their long-term financial outcomes. As well, of course, as being supportive of wider benefits for society. So the idea of writing them down as five asks is to give focus and structure to the conversations we are having with policymakers, and to make sure we're being consistent. So when different people within LCP are talking to policymakers, we are asking for consistent things. Also, to be transparent to the outside world about what it is we are asking for. Then the final aspect of these policy asks is that we are giving the opportunity for asset owners, whether they're our clients or not to sign up and show their support for their asks.

Claire Jones: Which means, not only do we have added weight when we're talking to policymakers, because we can show there is significant weight of asset owners backing them. But it's the small step that asset owners themselves can take to address climate risk. So far we've got about 50 asset owners signed up with a total of £185bn of assets. So they are resonating well with the asset owners we're talking to.

Charlotte Moore: The one that I found particularly interesting is talking about addressing the policy gap between ambition and implementation. That's something I've explored quite frequently in articles and events. It's one thing to set a target, but it's quite another to actually achieve that target. So, Claire can you talk to us more about why you think that gap is important to bridge?

Claire Jones: Yeah, this is the most fundamental ask of ours, the most big picture one. It's really about demonstrating investor support for strong climate action by government. If we look at the United Nations' Emissions Gap report that came out a couple of weeks ago, it was showing at the moment if all the Government policies around the world are implemented, we're on track for 3.1°C of temperature rise above pre-industrial levels. Even if all of the nationally determined contributions under the Paris Agreement are implemented in full, that would still only bring the temperature rise down to 2.6 degrees, which is clearly way too high. So, we think it's really important that governments hear the message loud and clear, they need to be acting more significantly, more urgently to bridge that gap, and there's investor support for doing so.

Charlotte Moore: Bringing Karen back into the conversation. Well, is there one that you find particularly interesting of those five climate policy asks?

Karen Shackleton: I thought they were all really good policy asks and all completely relevant. I suppose the one that resonated with me was climate regulations for investors should aim for real-world impact, not just disclosures. The reason it resonated with me was that this did come up in our most recent Impact Lens research on emerging markets. What we found was asset owners recognised the importance of real-world impact, but they didn't always seem quite prepared to follow through on action in a region perceived to be high-risk, and in fact perceptions were probably that it was a higher risk than it actually was, if you looked at the data. So, for me this comes back to thinking long-term: having a long-term, time horizon, and recognising asset owners, particularly pension funds, can be patient investors and can ride some of that volatility and at the same time achieve real-world impact. One interesting thing that came out in the research was asset owners were prepared to some of them, not all of them, were prepared to allow a little more flex in emerging market regions, in terms of things like their climate horizons. When did they expect them to reach net zero by? They were prepared to allow those regions a little bit more time to reach their Paris Alignment targets than they were in developed markets. I think that is really important to generate real-world change, because these countries are further behind to begin with, they are under resourced, and have a lot of catching up to do.

Charlotte Moore: So I think we've made a fairly convincing argument, for why asset owners should be thinking about systemic stewardship and be thinking at a higher level than just their own portfolio, and thinking about how to interact with policymakers. Could you tell us, Claire, what the different steps are? I know this will probably vary, depending on the size of the scheme, so can a large scheme do something different to a small scheme?

Claire Jones: Yes, absolutely. I mean the large schemes have plenty of resource behind them and can do a lot in this space. But there are things smaller schemes can do as well. One of the most obvious things is direct engagement with policymakers and regulators that might be through their one-to-one interactions. They might have direct contacts in relevant places, but they might also be invited to take part in roundtables. Responding to consultations is another example that is inevitably reactive in nature, and the questions are set by the Government or the consulting body. I do think it's important there is an element of proactive engagement as well, so where there are gaps in what is on the policy agendas, asset owners are speaking up about issues important to them. A lot of the activity in this space would be done in collaboration with others, because pension schemes don't have much spare resource for this kind of thing, and most of the major investment investor initiatives do undertake systemic stewardship activities. They might not call it that, but most of them are active on policy matters. So there's scope for asset owners to get involved by joining working groups, contacting their representatives there to find ways to get involved potentially initiating new activities within those collaborations, if they feel the things that are important to them are getting insufficient attention.

Claire Jones: For the smaller asset owners one of the most fundamental activities is overseeing investment managers. That is something which I think asset owners of all sizes should be doing. As I said, near the beginning of the conversation, it's important asset owners set their expectations for their managers – what level and type of policy advocacy they expect their managers to be undertaking. Then they monitor what the asset managers are doing in practice and intervene if they don't feel it's meeting their expectations. Ultimately, they are potentially picking different managers, who are better in this space, because we come back to the rationale of why we're doing this. It is about addressing the most fundamental risks that will determine their long-term outcomes as investors.

The final activity asset owners can be undertaking, whatever their size, is showing their support for investor statements. So there are various bodies who will gather together signatories for public statements of various policy positions. One of them, The Global Investor Statement to governments on the climate crisis, that the investor agenda convenes most years. It's an easy action for pension schemes and asset owners to sign up to those. And similarly, the LCP Policy ask is something of that nature.

Charlotte Moore: Ok. Karen, do you think there is one group of pension schemes that are ahead of the game on this?

Karen Shackleton: I've long thought the Local Authority Pension Schemes have been tackling this head on and are leading the way for others. So they work collaboratively. That's partly been driven by pooling, but it's also, even before pooling they were gathering together so that they could have more impact in things like their engagement with companies. The Local Authority Pension Fund Forum (LAPFF) is really effective in engagement, and of course it's a cost-saving exercise for the individual funds, because they're not individually having to go and engage with those companies. LAPFF can point to successes they have had by saying, look at the collective assets under management represented by our member funds, you need to listen to us. They produce a fantastic and detailed quarterly report for investors, showing exactly what progress they have made, and that I think is really important. Engagement is one thing; progress is another. As Claire said, being willing to take action if you're not getting the progress you need is important, because ultimately that will lead through to added risk for the underlying investment.

Charlotte Moore: Yet that reinforces a point Claire made earlier about the importance of collaboration and collectivism in achieving your goals. One pension scheme on its own, no matter how large it is, isn't really big enough. You mentioned also, Claire, the importance for smaller schemes who maybe feel they don't have enough skin in the game. It is important to oversee their asset managers. Can you give some concrete examples of the kind of work you've been doing, maybe with the investment managers, to help improve this whole systemic stewardship agenda?

Claire Jones: This has been an area of increasing focus for us over the past year or so. We’ve been assessing asset managers more thoroughly on systemic stewardship and giving more weight to it in our manager assessments. We started off by doing a deep dive into liability-driven investment (LDI) managers, because obviously LDI and gilt holdings are material for private sector defined benefit (DB) schemes, and quite a few of our clients had been saying to us they didn't know what stewardship they could do in relation to their gilts. We highlighted that essentially they're lending to the UK Government, which gives them a seat at the table potentially to influence Government policy on these important issues. So we looked at what the asset managers were doing in this area.

We started off by having conversations with five major LDI managers, and through those conversations we developed a set of best practice principles of what we would expect from them, then assessed the five managers against these principles, and went back with specific requests for areas where we thought they could improve. One of the positive things coming out of that research is that there is activity going on in relation to all of those five managers engaging with the UK Government and other regulators in relation to climate change. However, perhaps what was missing was clear, policy positions fully aligned with our clients’ long-term best interests. We found there was generally a reluctance to call out the gap between policy ambition and implementation that we were discussing earlier. There was a tendency to be reactive to the things the Government was consulting on rather than calling out the fundamental problem that the pace of action is not fast enough to address the risks.

Charlotte Moore: I think that's really fascinating, because that's always struck me as a blind spot when it comes to being more activist around sovereign debt, since that's always seen as tricky. If you're thinking about investing in other countries and trying to tell policymakers what to do, it can look quite controlling , maybe even neocolonialist. But for LDI, there is this amazing opportunity where there is so much money, and so many assets held by the pension scheme and concentrated in the hands of a few asset managers, and you are holding that debt on behalf of UK citizens. To me, there is a clear-cut pathway to use your voice as a steward to be able to influence UK Government policy. I'm delighted to hear you're working on that, and I've always felt there's a weird reluctance to grasp that opportunity, if you see what I mean? How do you feel, Karen? You're smiling. Obviously, other people can't see, but you are smiling at that.

Karen Shackleton: What's really interesting is if I go back three years, all the discussion around stewardship was in equities. It's really shifted in the past three years. There's so much more focus now on fixed income, in both listed and private markets, in fact, and a recognition that fixed-income asset managers have a role to play here, which is fantastic. I mean, it is absolutely necessary. I'm smiling because I'm thinking, "Yeah, you're spot on, but it is necessary."

Charlotte Moore: What are you going to be looking at next in terms of working between the asset owners and the asset managers? Are there some obvious other, maybe low-hanging fruit, to challenge next, Claire?

Claire Jones: We have just done our big biannual survey of investment managers, where we put extra questions this time around systemic stewardship to find out what level of activity was being undertaken. It was perhaps a bit disappointing, though unsurprising, that managers were not putting much work into this area – certainly compared with the amount of effort they're putting into stewardship with individual issuers. Only 16% of managers say they engage frequently with policymakers on systemic issues, which clearly isn't enough.

So, our next step is to take the best practice principles we've already developed for LDI managers on climate policy advocacy with the UK Government and generalise those so they will be applicable to all asset classes and policy work around the world. Then we'll be looking to socialize those and build them into our conversations with investment managers over the coming year, because we do think this is an area that needs more attention than it currently gets.

Charlotte Moore: Does it vary according to the asset, what you can do? Karen mentioned before about equities, and there was an obvious voting connection with the companies. But if we're talking about systemic, how does that vary across asset classes?

Claire Jones: I think that's a good question, because we started our LDI research on the premise that LDI holders are lending to the UK Government. What we found was that asset managers are engaging with Government and regulators as large asset owners. It is agnostic regarding the asset class most of the time. So, that means most of the systemic stewardship activities we are talking about could be undertaken in relation to any asset class. As you were alluding to, the fact we are talking about market-wide issues means they are relevant across the board.

Charlotte Moore: Karen, have you found there's a bit of a gap – put it mildly – between the understanding policymakers and finance have? Policymakers don't always understand the world of finance, and finance doesn't always understand the world of policy. Is there a gap to be bridged? And are we hoping this focus on systemic stewardship will help to bridge that gap?

Karen Shackleton: We always welcome Government representatives into our discussions for that very reason, and certainly from the LGPS regulatory side, we get regular attendees from people like the Local Government Association (LGA) Scheme Advisory Board, and so on. Communication is really important as a communication flow, but it works two ways. So yes, I think there's more we can do. We've attended some of the All-Party Parliamentary Group discussions. They've set those up, and we've been invited. Charlotte Moore has spoken as well at an event. So we just keep chipping away, and we're doing some exciting research on what asset owners are doing in terms of systemic stewardship. That publication will be coming out next year, so it'll be fascinating to see what progress is being made. Claire talked about the asset managers not perhaps making as much progress as they may have hoped. So let's see what the asset owners are doing. If there's a call to action for asset owners, it's to start thinking about this and pushing their asset managers to do a little more.

Charlotte Moore: I'm just wondering how that relationship between the asset owners, the asset management and asset managers works? Is the idea for the policy change and the systemic stewardship coming from the asset owners, and is it dribbling down to the asset managers, or is the conversation more of a two-way one? How do you see that developing over time, Claire?

Claire Jones: That's a good question. I think there needs to be a two-way conversation here, because it is about aligning the interests and activities of asset owners and asset managers. Asset owners certainly need to communicate their expectations to asset managers, but asset managers, in turn, need to provide feedback on their own experiences, their viewpoints, and particularly where they find barriers in relation to this kind of work.

There is sometimes a perception this can get political, which is one of the reasons why we believe it's important that the conversation is grounded in systemic risks, where there is clear evidence backing the case for action so that it isn't misinterpreted as being political in nature. Asset managers will face constraints, not least when they've got asset owners with different interests and priorities. I think there may need to be a conversation about which types of systemic stewardship activities should remain with the asset owners, because it isn’t appropriate for them to be delegated to third parties, and indeed, where it can be more effective when it is the asset owners speaking directly to governments.

Charlotte Moore: Can you think of some areas where that would be the case?

Claire Jones: We’re seeing a particular sort of tension between UK and US viewpoints on this. Of course, US investors are subject to the same systemic risks as UK investors in relation to climate change. But given the nature of fiduciary duty, and how it differs between the two jurisdictions, asset managers based in the US may find it difficult to speak up on some of these policy issues. So it may be better in those cases for the asset owner to lead the conversations with policymakers.

Charlotte Moore: Interesting. I wonder if at some stage we're going to see a representation of asset owners and asset managers at COP to try to influence the agenda on an international level. Would that be the pipe dream, Karen, to carry this to an international level? Because realistically, that's where we need to go.

Karen Shackleton: I think there has been some of that already, with asset managers attending COP and representing the industry. My personal view is we just have to encourage as much collaboration as possible and hear from all parties – not only political parties but also asset owners, investment managers, consultants, and politicians – so we can all agree on the best way forward, having taken everybody's views into account. So I'm a big fan of collaborative effort.

Claire Jones: I think it's also important this conversation includes the generation of ideas because often asset owners and policymakers may have common objectives. For example, they may agree that we want to pivot the focus of climate regulations away from reporting to actions that are going to have real-world impact, but policymakers don’t necessarily know the best way of doing that. So I think that's one of the reasons why this kind of activity is so important – it's generating potential solutions to problems where there is consensus that something needs to change. Asset owners, their asset managers, and consultants are well-placed to come up with suggestions and help make the policies implementable in practice.

Charlotte Moore: I think we've had a fascinating and fairly intense and dense conversation, with a lot of smiling along the way. I would just like to ask each of you, what would you like listeners to keep right here in the front of their minds from this particular episode of the podcast? Claire, I'll ask you first – just one thing you want them to remember?

Claire Jones: It's hugely important that asset owners and asset managers use their influence to address systemic financial risks, as these could be the most significant determinant of investment performance over the coming decades, and not enough is currently being done to address them.

Charlotte Moore: Karen?

Karen Shackleton: Pension funds should be considering what the world their employees will retire into will look like and consider actions to ensure that future is genuinely sustainable for the next generation – and the generation after that – recognising that this is entirely consistent with their fiduciary duty. It's all about making pension funds sustainable for the long term and providing pensioners a reasonable retirement. So that's my message: think about it in that context, not just about the investment returns you'll get tomorrow.

Charlotte Moore: Yes, I think it's a call to think about things on a holistic, bigger-picture scale. To really think about your power as an asset owner and asset manager to influence and shape the world in a way that, as Karen says, you're going to retire into.

Thank you, Claire and Karen, for your truly excellent insights. It's been a delight and a pleasure discussing this today – a truly fascinating conversation and one I personally empathise with a lot. Listeners, if you want to ensure you never miss an episode, hit the the follow button, and thank you, as always, for listening.