TRANSCRIPT

PENSIONS FOR PURPOSE PODCAST – SERIES 1, EPISODE 8

HOW TO MAKE PASSIVE INVESTMENT MORE SUSTAINABLE– WITH CHARLOTTE MOORE, CHARLOTTE O'LEARY AND KEITH GUTHRIE

Charlotte Moore: Hi. Welcome to the latest episode of the Pensions for Purpose Podcast. I'm your host, Charlotte Moore. I'm delighted to welcome back to the show Charlotte O'Leary CEO of Pensions for Purpose. Hi, Charlotte.

Charlotte O'Leary: Very nice to be on the show again Charlotte.

Charlotte Moore: And we are both delighted to welcome our guest, Keith Guthrie, Head of Sustainability for Cardano UK and for NOW:Pensions to the show, welcome Keith.

Keith Guthrie: Good morning, Charlotte and Charlotte, it's delightful to be here.

Charlotte Moore: The double Charlottes. This episode we're going to be talking about how to make passive investment more sustainable. In the UK, the biggest engine of future retirement wealth creation, is DC (defined contribution) workplace pensions. The PPI DC Future Book 2023 estimates, the workplace DC market will be worth around 800 billion in 2030. Market forces and regulation, mean these pension schemes will be making their equity allocations passive. So, we're going to discuss three areas schemes need to address, to make those investments more sustainable. And I'm going to kick off by asking Keith the first question. So, the first lever a DC fund has to pull is its choice of benchmark, but these are constantly evolving. It can be difficult to make the right choice and to keep up, and you could be in a position where you're constantly thinking that once you've made a choice, you need to make a new choice. So how to make sure that you have the right one. What are the challenges Keith?

Keith Guthrie: Yes, so I think this is a very relevant question, mostly because, of course, most pension funds are majority invested in equities, so their biggest strategy is going to be a typically passive equity strategy. And so, it will be the biggest lever that they can use for change, for implementing change and the most important piece of the portfolio for their members. Most of those assets are invested passively, and I think that the choice of both the strategy and the asset manager that you use for that portion of the portfolio, is therefore the most important decision you probably make in the pension fund. And that starts with the choice of strategy. And these days I think the challenge is becoming more and more complicated for trustees, because trustees want to incorporate ESG considerations and real-world impact considerations into their portfolios. But it's now becoming an increasing minefield as to how to do that, so I think there's quite a few parts to that challenge.

The first is being clear about what your beliefs as a trustee are. So, we really see maybe three different types of beliefs that we typically come across. And I'll just go through those to illustrate, you know, the kind of choices that trustees tend to face. The first type of belief would be a trustee who says, 'Well, I really believe that climate change, we're going to transition society rapidly. And you know we're aiming for 1.5 degrees, we should really disinvest from anything that's not aligned with that now', and that's got to come from a sort of stance of believing that actually, the transition is going to happen rapidly, probably more rapidly than it's happening in reality unfortunately, but that sort of set of beliefs of disinvesting in areas that might be high emissions, would be one set of beliefs that that's the right way to go for members.

A second set of beliefs might be, 'I'm not sure where the transition is going to go very quickly, but I'm worried about whether or not risks are fully priced into the market, and so I really want ESG integration in my strategy, but I don't want to take a big bet that you know, things are going to immediately go to 1.5 degrees, I'm not sure about that'. And then I think a third set of sort of beliefs are probably around, 'we really believe that the investment strategy should be aligned with 1.5 degrees, because we think that that's the best outcome for members and what we want to focus on is sort of systemic change to the system to try and drive a 1.5 degree outcome, even though we may not be sure about the financial risks of that, because, you know, change in reality is going too too slowly'.

So, sort of three different types of beliefs, in which each of which might have a different set of solutions for what might be appropriate.

So if I just to go through those, something like that first set of beliefs, we think we're going to go have a rapid transit transition, you might want them to focus on something like the EU Paris-Aligned Benchmark, which sort of disinvests from a lot of high emitters very rapidly and doesn't really try and engage with those companies really says, okay we're on that path, we want to be rid of the high emitters, whereas for the sort of more ESG integration, maybe trustees would focus on something like the EU Climate Transition Benchmarks integrate some climate risk, but don't very rapidly change the portfolio.

And then the third option where we'd say, focusing more on systemic risk, the approach that we've focused on there, is using really what we describe as an enhanced index approach, which is an approach that really tries to maybe incorporate climate change and other systemic risks, and focus on how you could drive the systems change in the portfolio.

So those would be some ideas about how the sort of minefield that faces trustees when they are presented with this choice.

Charlotte Moore: And Charlotte, what's been your experience talking to pension schemes and asset managers about this?

Charlotte O'Leary: Yeah, I think Keith points out a really difficult conundrum for pension funds, and when we say pension funds, we sort of lumping them all together as though they're all exactly the same, you know, it's a really heterogeneous group that can be, you know, at a kind of tail end very small schemes that are very reliant on their managers all the way up to, you know large schemes that have big in house teams.

And I think the difficulty here comes back to the point that that Keith made about market risk. How confident do we feel that these things are being priced into the market, and part of the challenge with that is you need to be doing other things as an investor to really understand whether the market has grasped the significance of these sorts of different factors.

And that's why I think you have to have other strategies outside of passive as well to help compliment. Because, for instance, if you were just investing in a passive manager, that wouldn't give me the confidence that they understood or had all of the expertise necessary to understand what's happening outside of a kind of index linked fund, so that's something that I would want to know. How does the asset manager go about doing their research? What kind of interaction do they have with regulators, market standard makers, that those sorts of things.

Because, for example, I went to a really really good session yesterday with Sasha who's the ESG Director at the FCA, and the work they're doing on, you know, funds, whether it comes down to labelling or whether it comes to ESG rating providers or benchmarks, is really quite significant, and you need to know and understand what the Regulators are doing, what's coming down the track because it's going to be significant.

And those could lead to market shocks. So I think the point about this at the moment is, there's such a lot happening in the regulatory space, that it can't just be that you rely on just your manager or just a type of investment, you need to be going along and supplementing your intellectual capital with other knowledge, other information. Because certainly from what I see and what I hear, there are some really significant changes coming down the track from the likes of the ISSB, IFRS which are I know these are not helpful as acronyms, but you know these are all the kind of global sustainability standard setters.

And there's a recognition in the marketplace, even by those who co-founded the GRI for example, that reporting isn't enough anymore, that there's been a lot of greenwashing, green hushing, all these sorts of things. And so there is going to be more discipline, more consistency needed, and there will be far more scrutiny, and the market will therefore have to respond to that, and I just think if you're in passive funds you're not necessarily going to be aware of all of those changes as quickly as you would be in active funds, and that so that's what I would be preparing myself for. It's not to say that you can't invest passively.

Some people have to do that from a cost perspective, and because of lack of resource, lack of time, but I think you need to be supplementing it with other things in order to really understand what's going on and kind of empower yourself with your strategy. The other thing that I would say that Keith pointed out is the intentionality is just so important now.

We don't have the same mandate of asset managers as we do for pension funds and investors. TCFD, TNFD, all of these things have been put in the hands of investors, and it's to get asset owners to drive the market so, to really kind of grapple with that you need to set out your intention right up front and you need to make sure that your asset managers, your advisers, are aligned with that intention, and that can't just be in their strategy, it needs to be at an organisational level.

So how is that being integrated into other strategies, it's not enough to say I'm just going to invest into this product, all I need to know is about what's happening with that product, and that's the kind of mistake with something like SDR for example. Thinking that just having one label on one product means that that asset manager is doing everything they need to do on sustainability and impact, that doesn't mean that. So just having, like full clarity and transparency on what is really going on and having intentionality at the outset in terms of what you're trying to achieve.

Charlotte Moore: And I think that leads us really nicely on to the next question, because if, as Charlotte says, there's lots of change happening in the sustainability standard setters, and that means we're going to move beyond the tools that you use to construct the intra index and look underneath the bonnet and start thinking more about stewardship. So, Keith, how can we make stewardship effective? How much is the responsibility of the scheme, and how much is the responsibility of the asset manager? What can we do in that area?

Keith Guthrie: Yeah, I think this is a really important question, and probably the most important question when appointing, particularly a passive asset manager, because with a passive asset manager you know that you're essentially tracking a benchmark, or you're very close to a benchmark and almost the most important component of having some sort of influence of driving returns for members becomes, how is that manager stewarding the assets?

And the big question, I think, is one of how aligned is the manager with the trustees' beliefs. And I think this is where the industry, if you look sort of the approach that's been taken in recent years, has really been one of attempting to change the asset manager. So, it's sort of one of, we have expression of wish trustees telling asset managers how they would love them to be voting, or sort of questioning managers on their most significant votes. All sort of efforts, even going down the split voting route.

If it's to attempt to get better alignment between the asset manager and the asset owner by cajoling them into changing the way they're doing things, and I think that's got a little bit the wrong way around, because the sort of starting point should really be, what are the beliefs of the asset manager when they are actually engaging with a business? If you look at their voting, their voting is only one component of the whole stewardship process, and it starts with their engagement with companies.

And I think that there's a commercial reality, for many big asset managers is that different asset owners are going to have different beliefs, and they're going to have some asset owners who are anti ESG and some asset owners who are very pro ESG and they're commercially caught between those different commercial interests. So, the sort of attempt to change the asset manager, has not really been effective because there are commercial realities there. So, if instead trustees start with, where are the beliefs of the asset manager, that is going to define how the asset manager is then speaking to a company when they start engaging? What are they actually, what message are they giving, that then goes through to how are they voting, which is only one component and the expression of wish and all the rest of it. But then, also how they're escalating, so when might they vote against management? When might they file a shareholder resolution? When might they decide to disinvest from the position, or be more public about their stance on it?

And so, I think you've got to look sort of holistically at that whole stewardship process. And I think part of what drives the current focus, has very much been an obsession with fees. The very low fees obviously, we've gotten to a point where most index providers are providing very low fees, and if you're a large asset owner, you really have the ability to command very low fees. But now the sort of negotiation is about one or two basis points, which over 20 or 30 years is going to be very limited in its effect on the on the portfolio.

What is going to make a very big difference over 20 or 30 years, is the stewardship, and so are you paying for the stewardship that you need? And are you prepared to pay for that stewardship? Because I think this is a very under resourced component of the asset management industry.

And so really, I think, trustees starting to value the stewardship component more when they're appointing a manager and saying, this is the most important part of this passive decision is, what is that asset managers, beliefs about stewardship? And am I prepared to pay something towards that? Am I convinced that they have the resource and the technical capability and the beliefs, the mindset to be engaging in a way that is consistent with the way that I believe that they should be? And then after that, things like the voting will automatically flow with an alignment to the asset owners' beliefs.

Charlotte Moore: That's certainly something I've heard a lot in the last few years, that schemes are looking much more for asset managers to align with their beliefs, and they'll be using that as a way to assign a mandate to an asset manager. Is that something you're seeing reflected Charlotte when you're out having conversations, that there is this greater sense of alignment and an understanding of how that stewardship responsibility needs to be split between the two parties?

Charlotte O'Leary: Oh, it's a really challenging one, because I have empathy with, the split voting mentality and I can understand where that comes from. It's whether it ultimately leads to the best outcomes, and I think, as Keith has highlighted the difficulty here is really about the intention of the asset manager. The asset manager has a business that has its own risks, it's not just its clients' risks. And so, if they don't have conviction around engagement and stewardship, it means that they are all things to all people.

And that's really challenging, particularly as a global asset manager, because you can see that happening with, you know, and we could probably point out some names, I'm not going to name any names. And I understand from speaking to those asset managers, how difficult it is because they are commercial entities. It's very hard to say 'no we absolutely believe in this stewardship and engagement policy, and this is what we will double down on. We will not invest into these sorts of stocks, and we will push management on these particular issues. If they have a large number of clients saying, 'we just won't give you any business' and if you won't take on these companies view, that's very difficult commercially. And this comes down to the point that I was making earlier, which is about a misalignment of the different stakeholders in this process.

So, you know, you've got long-term thinking by pension funds, or at least we should have long term thinking, and you've got short term commercial reality for asset managers in terms of bringing in that business. So, I think what you're really looking for with asset managers, is the conviction around what they're saying and putting that into practice, because, that's what's going to drive their engagement and stewardship decisions. I think that by doing a lot of this policy setting around stewardship and engagement, we really are draining resource and time if I'm honest, based on what I've seen from these processes and reporting, without really seeing the type of change that we need.

I think a far better use of time would be going to the right asset manager with the right set of beliefs, so that you're not having to spend huge amounts of time actually trying to push that asset manager to think or behave differently. And then the other thing, I would say is, you've got something that sits alongside stewardship engagement, which is working with other asset owners and then potentially with asset managers as well, to change market frameworks and standards, because ultimately business is run and regulated by other entities, so what we really need to be doing is changing the threshold for business, so that actually, what you're having to engage on and steward doesn't require so much resource, doesn't require so much time, because actually, you've raised the standards for business, and so I think it's about really thinking about best use of time.

Obviously, you should be engaging, and you should be stewarding assets, but it needs to be on the right things. And I think to a large extent, we haven't changed what we're actually bringing to shareholders when it comes to resolutions. We haven't changed what's on the table when it comes to things like total compensation packages, diversity and equity inclusion on boards, over boarding or under boarding. You know these sorts of things that are actually on the table, of the things that need to be discussed, not just the amount of engagement or stewardship.

Charlotte Moore: Yeah, and I think that's a really interesting point there, Charlotte, because you are really talking about that how that alignment could really drive things going forward, and that could be the difference in sort of winning or losing new business. And I can see also from those commercial entities that you mentioned, that are conflicted because they have different clients asking for different things that actually, if it's regulated, it solves that problem for them, because then they say they can legitimately hold their hands up and go 'I'm sorry I have no choice, the Regulator has chosen told me that I have to do this', so it's in their best interest to become better campaigners and influencing policy decision makers.

So, I'm going to move on now and talk about something that I know, is very close to Charlotte's heart and talk about impact investing and ask Keith, how do you introduce impact investing into passive investing because they're fundamentally different and almost conflicted, one is highly active, the other is highly passive. How do we do that, Keith?

Keith Guthrie: So, as you say, Charlotte, it really is a challenge. When we look at the positive impact universe, we sort of define it as those companies, we think in the global markets that actually are having an intentional positive impact on issues like climate change, biodiversity. We think that's only 5% of the market. And so, you know you, you cannot create an index strategy that sort of focuses entirely on that, that they have a very big skew towards smaller companies towards high growth companies, and so you have very big tracking errors, and you've seen in recent years massive underperformance from that part of the market.

So, I would ask the question a slightly different way, which is, if you're trying to make an impact, how do you make the most impact you can? And I think that in the context of passive investing, the focus should probably be more on those adapted companies which represent 40, 50% of the market and where you can really make a very big big change to the world. And then think about as Charlotte was saying earlier on, perhaps more active strategies as another portion of your portfolio where you might be thinking about impact. That's the first thing I'd say.

The second thing is also public market investing, the act of just buying the shares in the secondary market does not supply new capital to a business. It's not the most impactful thing you could be doing with your capital. So, I think that there is definitely a place for public market impact investing, but I would as a trustee, be thinking more in my total strategy, where can I have the most impact? And, for example, in the public markets, I would say that making sure that you have got some green bond exposure in your portfolios, that you've got this use of proceed bonds that are providing new finance to projects that you know are going to positive impact situations. That's probably a more impactful way to be investing in the public markets in impact, and then think about the private market exposures you might be having where you can have much more direct control supply of capital to new ventures, and maybe those are the areas where you can have bigger impact. So I think it's not automatically the case that we should just emphasise the impact investing component within that more passive components of the portfolios, I think there the focus should probably be on the adapting companies, the companies that want to change, and that you can help change to decrease carbon emissions, make an impact on biodiversity, those sorts of things.

Charlotte Moore: Charlotte, I saw you nodding vigorously there, so I take it that that's something you agree with, that you separate out your impact investment agenda from the passive allocation?

Charlotte O'Leary: It's something we've made it a very complicated area, I really do think that because what I wouldn't want people to go away from is, think that when we're talking about impacts, we're talking about impact investing. You know that they are separate things, and I think it's worth sort of defining this a little bit better. So, impact investing is about being intentional and an additional in terms of the positive environmental and social impact you're trying to have alongside a market rate risk adjusted return and that's certainly the case for pension funds who obviously have fiduciary duty consideration.

And so that means, you can't be looking at secondary markets primarily, for that. The impact, i.e. the potential positive impact you can have or the negative impact you have, still is the case across your portfolio. All of the companies that you invest in, all of the types of investments have a negative or positive impact. So, across your portfolio, you should have an impact lens. Ultimately, that's what you would want to have. Now, that's obviously quite difficult, because there are gaps in data but because there are gaps in data, we shouldn't not start the process of trying to understand those negative and positive impacts across the portfolio.

What has tended to happen particularly for pension funds, is that you're just looking at impact over here in this part of your portfolio. When we talk about impact, this is the impact that the company or investment is having on the world. That's not the impact that the world is having on them, that's ESG risk. So, we do need to kind of separate out those different things and so at the moment, that's not really being quantified or understood. So, if you're only doing that in 5% of your portfolio, you're not really understanding the full negative impact that you're having, you know, across your portfolio.

The difference, I think when it comes to impacts when you're thinking about other areas outside of private investments, particularly for real assets is the levers that you use are different, if you're wanting to have impact. You know whether that's passive, or whether it's active and this really gets to the heart of part of the difficulty with kind of being index linked, because many of the sort of sustainability or active or impact strategies, you might see, will be benchmark unconstrained for that very reason. So that's why that intentionality about having an impact lens across your entire portfolio actually is really important, because you're saying to asset managers and to advisers, impact actually matters for all of our assets. We might not have all the data right now, but over time we want to have all of the data, and I've used this example before. But we've worked with a local government pension scheme that uses the SDGs across its entire portfolio, that they don't just say we're only going to target SDGs in 5% of our portfolio, because otherwise it becomes meaningless, you know, because net net, you could be in a worse position.

And that's the same with carbon emissions or anything else. So, I just think that's what needs to be understood by the industry. This move towards using impact as another measure for contributing positively to solutions, not just mitigating risks. You know it's not just a risk return conundrum here. We do need this separate layer, and one of the best examples that I can use for this is, we talk about stranded assets.

There is the potential for stranded risk and that's what I worry about by not building an impact properly, is just because an insurer doesn't want to insure in a particular area anymore, doesn't mean that risk isn't borne by someone, it doesn't mean it doesn't still exist and that's what the market can do. The market can you know, squeeze, or it can remove itself from areas, that means that that's not priced - the risk still exists. So, and I think that's what we need to be building in better as you know, investment advisers as consultants, as managers is a better kind of impact lens into the portfolio construction process.

Charlotte Moore: So, we've gone through our three key areas that you need to focus on when thinking about sustainability in passive investments. And I'd like to ask both of you, I'll start with Keith, if there's one takeaway you want the listeners to have front of their mind after today's podcast, what would it be?

Keith Guthrie: So, I would say it is, select your asset manager for their stewardship beliefs, get your asset manager to clearly articulate what those beliefs are, are they focused on systems change? I think Charlotte has spoken quite a bit about the importance of systems change and about driving real world change across the portfolio. Or are they focused on ESG integration where it's a financial risk consideration but they're not really intentional about wanting to drive change in the real world. Those are two very distinct approaches, and it's fine to have the different approaches be clear on which approach it is that you're investing in.

Charlotte Moore: I think that's two rather than one, but we'll let you get away with it Keith. What about you Charlotte? What would be your one takeaway from today's podcast?

Charlotte O'Leary: This is going to be a sort of big one, but question and challenge your values, assumptions and beliefs because that's the starting point for all of this. We think we understand what we want and what we need, but often as we find with the training sessions we do, when you actually get all the stakeholders together and you start talking about this more strategically, you actually understand, you need to be doing things slightly differently. Once you've done that, much easier to align yourself with a particular manager or adviser to help you implement it.

Charlotte Moore: Well, that's great. I'm going to say thank-you to Keith for being a guest on the show, and for weathering the storm of the two Charlottes. It was great to have you on the show. Thanks to both of you, both Charlotte and Keith, for your excellent insights and observations.

Listeners, if you want to make sure you never miss an episode, then make sure you hit the follow button and thank-you to both of you for participating, and to our listeners for listening.

Thank- you very much.