COMMENT

Embedding ESG can't end with equities

TEGS HARDING

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THE FULL EXTENT OF THE economic consequences of coronavirus is yet to be seen, but the industry focus so far has understandably been on the short-term risks to sponsor covenants and investment strategy. We have to be careful that in this moment of crisis we don't lose sight of the longer-term risks, chief among them the considerations arising from ESG issues.

Most investors now understand that over the longer term, the challenges arising from ESG considerations will create winners and losers. It is entirely possible that this crisis has significantly shortened that timeframe.

Since the lockdown has started, the suppression of economic activity has led to record falls in CO_2 emissions across the globe. We have seen a renewed interest in societal issues facing the UK, while the billions doled out by the Treasury to prop up corporate Britain has led to an increased political and media focus on the governance of companies in receipt of the payments. In short ESG issues have never been more relevant. As professional trustees we need to think about how we should shape our existing investments in this rapidly developing "new normal".

One case I have been working on at ITS presents a fantastic example of how trustees can embed ESG into a scheme's investment strategy.

Sustainability is important to the scheme's sponsor, itself an adopter of recommendations from the Taskforce on Climate-related Financial Disclosures (TCFD). As trustees, it was a natural decision to extend this reporting to the pension scheme. Redington, their investment consultant, has designed a quarterly ESG dashboard showing the environmental impact of the portfolio and we are already looking at strategy through the lens of a two-degree stress test.

Like many schemes, we sensibly focussed on quick wins and had already agreed to move the passive equity allocation to a more sustainable equivalent. Everything is being communicated to members through the scheme's newsletter – an important but often overlooked step. Ultimately we are accountable to members for how we invest their money; telling them how their money is invested responsibly is important too, particularly as public expectations around investments change.

All of this is a brilliant start, but the scheme is mature and has largely de-risked. To make a meaningful difference, embedding ESG can't end with the equity portfolio. The scheme in question has two buy and maintain credit mandates and although the ESG dashboard gives us a snapshot of the overall environmental footprint, we are focusing on how improvements can be made. We are working with the corporate bond managers to not only monitor the environmental impact of the bonds but to make changes to the investment guidelines.

The idea is to identify those linked to high-impact activities and where another bond can meet the same portfolio needs but with less impact, in which case we will replace it where it's practical and makes economic sense. A simple, yet powerful idea that could be rolled out on a larger scale across the industry.

Best practice is developing rapidly, with new ideas and products continually made available for institutional investors. As ESG considerations become more widely understood, there will be scope to drive schemes' investment approaches further, not only reducing the harm done to environment in the schemes' portfolios but looking for ways to positively contribute.

One issue I am looking at is setting investment managers a target allocation of bonds within a portfolio that should be linked to a useful societal function.

This may be an aspiration for the moment – but as better data becomes available and impact investing becomes more mainstream for institutional investors it will become a reality for many schemes soon.

Moving beyond compliance and meaningfully embedding ESG in strategy is a journey and we will keep pushing forwards.

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