Quarterly Investment Briefing
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Are new requirements a push towards active management of equities?

New legislation, issued by the DWP, requires trustees to update their Statement of Investment Principles by 1 October 2019. The SIP must explain how trustees take into account financially material matters over the appropriate, potentially long, time horizon of the scheme's investments.

These matters include **E**nvironmental considerations (including climate change), **S**ocial matters, and Corporate **G**overnance (ESG)

In this briefing we discuss how the DWP requirement may push pension schemes towards active management of equities.

Equities and ESG

As asset classes go, equities are particularly exposed to long term ESG risks.

The profitability and growth of a company will ultimately drive long term returns for equity shareholders. However, profitability and growth of a company can be adversely impacted by long term risks such as:

- an inability to adapt to climate change,
- difficulty recruiting and retaining staff due to poor working conditions or inequality between employees,
- poor management and/or corporate governance.

A fund manager investing for the long term should be very mindful of these risks when investing in a company. Furthermore, many managers seek to protect the investments that they make by engaging with companies to reduce the likelihood that such risks become a problem in the future.

Many pension schemes invest in passively managed (i.e. index-tracking) equity funds – particularly in developed markets. The reasons for this are sound; the evidence that active management can add value in developed equity markets is not compelling generally and passive management is much lower cost.

However traditional passive management has weaknesses when it comes to mitigating long term and ESG risks.

Firstly, within a passive fund, the allocation to a company depends only on the market capitalisation of that organisation (i.e. the overall size of the company). The fund manager has no mechanism to reduce exposure to companies where the fund manager may have concerns regarding the long-term risks.

Secondly, passive managers face conflicts of interests around how they engage with companies.

- Performance of a passive manager is assessed solely on the ability to track a benchmark index. Since any consequences of engagement with a company held will impact the fund and the benchmark index equally, a manager may conclude that the cost and effort of such activity is unnecessary.

- A further conflict can arise if the fund manager also operates active funds. Where an active fund does not hold (or potentially even bets against) a company in an index, the manager will be rewarded for the position if the company does not fare well. If the same company is held within a passive fund, the manager may not be inclined to vote to improve the company – such action will not impact the performance of the passive fund (relative to the benchmark index) and may be to the detriment of the position held in the active fund.

So for those concerned about long term risks, how can they be mitigated?

Separation of fund management and engagement

The ideal governance model for passive investment would, in our opinion, follow the approach adopted by local authority pension schemes. Here the fund management is carried out by fund managers and the engagement is undertaken by the local authorities with the support of their expert, unconflicted, advisors.

Currently however this governance model is generally only available to large pension schemes with segregated accounts. Those investing in pooled passive funds are therefore forced to rely on their passive fund manager to manage the conflicts described above.

Tracking a better index?

There are a number of funds that track “ESG focussed” indices. Here the index provider assesses the ESG credentials of companies and assigns each an ESG score. They will then tilt the index towards those with the highest scores.

Passive fund managers are increasingly launching funds which track such ESG focussed indices. These funds operate in much the same was as a traditional (market capitalisation) passive fund. As such, fees are comparable with traditional passive management.

The weakness of this approach is that the index provider will only use high level and readily available information to assign its ESG score. In contrast shareholders, and fund managers or advisors acting on their behalf, have much greater access to the companies in which they invest. As such, they are able to make a more informed assessment of ESG risks.

Active management

As we said in our Q1 2018 investment briefing, picking winners ain't easy when selecting active fund managers! This was certainly the finding of the FCA in 2017[1] and the Competition and Markets Authority in 2018[2]

However, many active managers will undertake a thorough assessment of all aspects of a company (including the control of long-term risks) before they invest. As such, active management of equities could appeal to those;

- Looking to delegate the management of long term and ESG risks.
- Prepared to accept underperformance relative to a traditional equity index (if the fund manager's stock selections do not prove to be beneficial).

Trustees will have to determine how important long term and ESG risks are in the context of all the other risks they face.

Those who see long term ESG risks as a major concern may consider active management fees to be a price worth paying.

In the absence of a better governance option for traditional passive investment, others may favour the lower cost options of retaining a passive fund that tracks an ESG-focussed index.

Others still may conclude that, relative to other risks faced by their scheme, the ESG risks are not a major concern.

[1] Investment Consultants' Market Investigation
Working Paper: Asset Manager Product Recommendations, March 2018

[2] Investment Consultants' Market Investigation
Working Paper: Asset Manager Product Recommendations, March 2018