



Engaged Investment

A TUC trustee guide

As the recent financial crisis has shown, the way our biggest companies are run and the decisions taken by their boards have a profound impact on the lives of people in the UK and across the world. Pension funds have a responsibility to act in the interests of members and are in a critically important position to influence the records of the firms they invest in, on issues such as fair employment, good governance and environmental sustainability: all of which can have an effect on returns. After all, the funds that pension trustees are responsible for are the savings of ordinary people. Responsible investment means recognising the responsibilities that come with ownership and working to manage ‘ESG’ (environmental, social and corporate governance) risks as part of efforts to safeguard returns on investments over the long term. Engagement activity is a central pillar of any strategy that aims to do this.

This guide is designed to be used to support pension fund trustees in their activity as engaged and responsible investors. It gives a brief introduction to what engaged investment is, why it is important and what trustees can do make their own scheme a more engaged and responsible investor. It also includes a series of pointers that trustees can use to develop an engagement policy for their own scheme. The outline policy can be adapted according to the priorities of the scheme and built into the statement of investment principles.

What is engaged investment?

Engagement involves pension funds exercising their rights as shareholders by using dialogue and other routes to engage with the companies in which they are invested, particularly on ESG issues. These factors can be more difficult to measure than the traditional financial risk areas considered in investment, but they can all affect long-term shareholder value and should therefore be subject to trustee attention.

Engagement is a different approach from ‘screening’, in which investors screen out certain sectors or companies and do not invest in them (also known as negative screening), or screen in ‘good’ companies and sectors (positive screening). Whilst screening is appropriate for some schemes and can be combined with engagement activity, engagement should be part of good governance by all pension funds.

The engagement approach allows investors to have a positive impact on corporate activity and ESG issues; including those that may not come up for votes at company AGMs, but are critical in determining long term performance.

For example:

- On labour standards, engagement might take place over ensuring that companies comply with internationally recognised standards such as the ILO Core Labour Standards, and that they have good health and safety policies and measures for employee consultation and involvement.
- On environmental issues, investors might engage to ensure that companies have robust policies in place to reduce their environmental impact and adapt to climate change – thereby making the investment a more sustainable long term

prospect, and avoiding the risks posed by climate change or by sanctions such as fines for high emissions.

- On corporate governance, investors engage on issues such as the composition of boards of directors, separation of the roles of the Chair and Chief Executive, remuneration policy and transparency. Recent evidence has shown how the failure to properly link pay and performance at the top has led to excessive risk-taking in some sectors, with knock-on effects for share prices.

Engagement includes a number of steps outlined below (in the 'how' section), including meeting with company management, writing to companies, working with international best practice groups, and voting shares at AGMs. Engagement can be direct: by pension funds themselves, their fund managers or other service providers. It can also be indirect, such as through collaborations by groups of investors with a focus on particular issues. It is a strategy that can be used by active or passive investors – indeed, engagement is the main means of influence available to those who follow a passive, indexed approach to investment.

Why should investors engage?

The working people who pay into pensions are, through the investments made by those pension funds, the owners of shares in major corporations around the world. Pension schemes therefore have a duty to be active and responsible investors on behalf of their beneficiaries. Trade unions have a central interest in institutional investment and play an important role, for instance through encouraging and supporting union members to become pension trustees.

Engagement is a way to manage the risks and opportunities presented by ESG issues. It can drive change, pushing companies to behave more responsibly, generating better long term financial rewards for investors, more sustainable prospects for the businesses, and positive impacts for the workforce, communities and environments affected by corporate activity.

Although engagement and the impact it has can be difficult to measure, there is evidence to show that it has an impact on company activity. A 2008 NAPF survey¹ found that a large proportion of the pension funds surveyed had brought about changes through engagement, with 79% seeing changes to company remuneration policy and 68% driving changes to social and environmental policies. A major UN study found that sound integration of social, environmental and governance issues does not compromise investment performance, and in many cases can improve it².

Engagement with investee companies on social, environmental and governance issues can therefore have a positive long-term effect on investment and company

¹ <http://tiny.cc/BO4cR>

²

http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

performance, corporate governance and the wider social, economic and environmental context.

How can pension funds be engaged investors?

This guide sets out to give some initial advice for trustees thinking about increasing their engagement activity. An important step is to have a clear engagement policy, set by the board of trustees and built into investment activity through the statement of investment principles and contracts with fund managers or other agents.

Fund managers, advisors and investment consultants have an important part to play. Most schemes do not have the resources to carry out engagement in-house and will therefore mandate their fund managers or another service provider to carry out engagement activity on their behalf. Clear guidance from trustees about what they require of fund managers on engagement is therefore essential, as are clearly agreed monitoring and reporting mechanisms to ensure that it is carried out.

Developing an engaged investment policy

A series of elements are outlined below that trustees should consider building into an engaged investment policy. Not all of the points below will be appropriate for all schemes, but they are designed to offer some practical principles around which a policy can be built.

An engagement policy can be implemented through building it into the scheme's Statement of Investment Principles (SIP) and into contracts with fund managers or with specialist engagement service providers if used.

In developing such a policy it is useful to consider the following:

- An outline of the key issues on which the pension scheme wants to engage – for instance labour standards and employment relations practice, climate change or executive remuneration. Most take a risk-based approach, identifying areas of particular risk and engaging on those issues.
- Clear lines of responsibility for engagement; with clarity about who will conduct engagement activity, and how it will be recorded, monitored and reported to trustees.
- A commitment to active and ongoing dialogue with companies, including:
 - Meetings, letters or other contacts with companies requesting information on issues of interest or concern such as employment relations, health and safety, corporate social responsibility (CSR) policies, environmental issues or executive remuneration.
 - Meetings or other contacts with company management and directors to discuss company policy on issues of interest to the fund, investor priorities or concerns.
 - Meetings or other contact to request changes to company policy or behaviour.

- In extreme cases engagement might take place through public statements that 'name and shame' companies who have failed to make changes called for by investors. The policy should clearly set out the triggers for such activity.
- Also in extreme cases, where engagement has failed to produce results on an important issue, the scheme might consider withdrawing the investment. Again, the policy should clearly set out the triggers for such activity.
- A commitment to develop a policy on how to vote on particular issues at company AGMs, and then to use those voting rights that come with share ownership in line with the policy. If voting is delegated to fund managers, as it is in most schemes, then schemes can consider building the following into their contract:
 - A process for monitoring voting in order to ensure that votes are cast in line with the overall policy
 - A commitment to disclose those votes publicly if possible
 - A policy on whether stock will be lent, and if it is then a commitment to recall stock for key votes.
- Involvement in collaborative organisations and initiatives with other investors to share information and good practice. Examples include the UNPRI, the ISC principles, the IIGCC, UK Social Investment Forum and the Carbon Disclosure project (see page 8 for contact details)
- A statement of how the policy will be taken into account in manager selection.
- Reporting requirements on engagement, in order to ensure regular and comprehensive reporting from fund managers or other agents to the board of trustees.
 - These should include reporting on the risk assessments, nature, timing and quantity of engagement activity, the changes requested and the outcome of engagement.
 - Reporting arrangements should also be developed for trustees to communicate their engagement policy and activity to members in order to meet good standards of transparency and accountability.
- A commitment to the ISC statement on shareholder responsibilities
- A statement on how the views of members will be taken into account in selecting priorities for engagement

Putting it into practice

In designing and implementing an engagement policy for the pension fund, trustees may also want to give consideration to the following areas:

In deciding which issues, sectors or companies to target for engagement:

- The priorities of the fund, as set out in the SIP
- The interests and priorities of members of the scheme, identified through consultation, discussion and existing channels such as the trade unions representing members of the scheme

- The size of the fund's investment in the company or sector in question
- The potential to achieve change and increase long term shareholder value

In selecting fund managers:

- What approach the fund manager takes to engagement and responsible investment, to what extent they prioritise these issues and weight environmental, social and corporate governance issues.
- Whether they have a separate team for RI and engagement or integrate the issues throughout their work.
- The type and quantity (numbers of meetings and so on) of engagement, the outcomes that fund managers have secured and the way in which they assess risks and desired changes.
- The reporting systems that they have in place for informing trustees about their engagement activity and enabling trustees to assess their performance.
- The number of staff dedicated to ESG research, responsible investment and engagement activity.
- Whether the organisation is a signatory to the UN Principles of Responsible Investment.

In monitoring the engagement activity of fund managers or agents, practical steps to think about include:

- Requiring frequent, detailed reporting on engagement activity, including details of meetings and other contact with investee companies, risk assessments, requests for change and the results of this dialogue.
- Requiring reporting not only on the contact that fund managers have had with companies, but on any requests for change and on the impact of engagement in terms of changes to company policy and activity.
- Monitoring voting to ensure that votes are cast in line with policy and ensure consistency where more than one fund manager is used.

Frequently asked questions

How can trustees ensure their wishes are carried out?

A clear policy, defined by the trustees and including systems to require fund managers to report in detail on their engagement activity and the results of that activity, is essential in order to ensure that genuine engagement takes place in line with trustees' wishes.

How can we measure engagement?

Trustees should require fund managers or other service providers to report on the nature of contact with investee companies, including what specific requests they make for change and the outcomes of engagement activity, as well as the amount of contact (number meetings, letters, voting at company AGMs etc). Trustees may also wish to consider looking at other initiatives and collaborations which assess performance on responsible investment.

Is responsible investment through engagement in line with our fiduciary duty as trustees?

For many years some in the investment community interpreted the Megarry judgement on the 1984 Cowan vs Scargill case (about the investment policy for the mineworkers' pension scheme) as meaning that trustees could not adopt a responsible investment strategy. This narrow interpretation was challenged by the 2005 Freshfields report³, which said that the case had been widely misinterpreted. The report notes that Megarry even took the unusual step of revisiting the case in 1989, emphasising that it was not a landmark judgement. The Freshfields report argues that it is reasonable for trustees to take environmental, social and governance factors into account in investment decisions, as they can have an impact on the long-term nature, risk and likely return on the investments. In fact it could be considered a dereliction of duty not to take these issues into account.

This interpretation is now widely accepted and there have been supportive statements from Ministers in discussing responsible investment in the context of the new Personal Accounts national pension saving scheme.

What are the costs and benefits of engagement?

There is increasing evidence that responsible investment is linked to better long term returns, as it builds in consideration of the risks posed by issues that do not necessarily feature on company balance sheets but may affect profitability. The United Nations⁴ has a raft of publications that investigate the effect of responsible investment strategies on returns and draw together academic research.

A 2007 study⁵ found that the costs of engagement activity by the CalPERS scheme in the USA were far outweighed by the increased returns generated – not to mention the longer term extra financial benefits.

What if our scheme doesn't have the capacity or expertise?

It is likely that only the very largest schemes will have the resources to carry out their engagement activity in-house, and so most will mandate fund managers to conduct it on their behalf, or buy in an 'engagement overlay' service from another provider. This is why it is essential to have a clear policy, overseen by the trustees of the scheme, which requires rigorous monitoring and reporting of engagement activity and outcomes by the fund managers.

³ http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

⁴ <http://www.unepfi.org/>

⁵ Brad Barber, 2007, 'Monitoring the monitor' in *The Journal of Investing*, Winter 2007, p.66-80

Links and resources

There already are a number of recognised good practice standards and guidance that link to this work. Some web addresses where you can find more information are given below:

- The Combined Code on Corporate Governance can be found on the Financial Reporting Council website: www.frc.org.uk
- The report by lawyers Freshfields Bruckhaus Deringer on the legal framework for integrating ESG issues into institutional investment is best accessed via the United Nations Environment Programme Finance Initiative website: www.unepfi.org. The site also includes many other useful documents about how social, environmental and governance issues can be material for investments, and how they can be incorporated into investment practice.
- The Institutional Shareholders' Committee has a statement of principles on voting and engagement: www.institutionalshareholderscommittee.org.uk
- The National Association of Pension Funds (NAPF) also has voting guidelines: www.napf.co.uk
- The United Nations Principles of Responsible Investment: www.unpri.org

There are also a number of organisations working on closely related research and collaborative activity, all of whom have useful publications and links on their websites, and some of whom offer specific services to responsible investors. Here is just a selection:

- Ethical Investment Research Service (EIRIS) www.eiris.org
- FairPensions (a registered charity that campaigns for responsible investment) www.fairpensions.org.uk
- Institutional Investors Group on Climate Change (IIGCC): www.iigcc.org
- PIRC (Pensions Investment Research Consultancy) www.pirc.co.uk
- Responsible Investment Metrics (looking at the measurement of RI activity and impact) www.rimetrics.com
- UK sustainable investment and finance association (UKSIF): www.uksif.org