The Environment Agency and Responsible Investing

by Matthew Craig, LAPF Investments

Over time, certain people or organisations stand as exemplary representatives for a cause, idea or set of values. For example, in winning the 2008 US presidential election Barack Obama stood for hope and change, while technology firm Apple represents the qualities of innovation and good design with its products.

And in responsible investing, the UK's Environment Agency Pension Fund (EAPF) now exemplifies the way that pension fund investment can incorporate wider social, environmental and governance concerns into the objective of safeguarding members' pensions. As such, the pension fund has become something of a beacon to other public and private sector schemes and a regular winner in awards events for pension fund investment.

The environmental regulator's pension fund policies towards investment also showcases how investment thinking is changing as regards how issues such as climate change and sustainability should influence the actions of long-term investors, such as pension funds. In the past, investors with strong beliefs might have used negative screening to filter out certain unwelcome investments from their portfolios, or they might have contended themselves with a relatively small ethical mandate, alongside ordinary investments. Now, the wider picture is coming into in full focus; it is increasingly common to hear the view that pension fund trustees should consider the ESG (ethical, social and governance) issues as part of their fiduciary duties.

It is not surprising to find that the EAPF is a signatory to the United Nations Principles of Responsible Investment (UNPRI), along with a number of other large and forward-looking pension funds around the globe.

The legal case for responsible investment was set out in a report by Freshfields Bruckhaus Deringer in October 2005, commissioned by the Asset Management Working Group of the UN Environment Programme Finance Initiative (UNEP FI). The report looked in detail at the question of whether the commonly held view that fiduciary duties require a portfolio manager solely to pursue profit maximisation is a correct interpretation of the law, or ESG criteria can be integrated into investment decision-making.

The report looked at this across various jurisdictions including the UK, where the adoption of socially responsible investment, or the use of ESG criteria, has often been held back by cases such as Cowan v Scargill, when, in 1984, the National Coal Board and the National Union of Mineworkers clashed over the investment policy of the mineworkers' pension scheme. In that case, it was held that the trust running the scheme should be exercised so as to yield the best return for the beneficiaries, but the report said this case should not be seen as restricting a properly considered and administered ESG investment policy for a number of reasons.

As a result of this report and much other thinking, including more recent legal cases and government regulations such as the requirement introduced in 2000 that pension funds should disclose any ESG criteria in the statement of investment principles, pension funds such as the EAPF now see using ESG criteria as something which is in the long-term interests of their members and in accordance with regulation and best practice. According to a number of investment professionals, the consensus view is that investment performance is not harmed by the inclusion of ESG criteria, or responsible investment principles, and performance may actually be improved.

And for some pension funds, such as EAPF, where the sponsoring employer is engaged in environmental protection and water management in England and Wales, there is a desire to ensure that the investment policies practised by the pension fund and in harmony with the overall objectives of the employer providing the scheme.

So following a review of its investment strategy in 2005, the EAPF has applied an environmental overlay strategy across all of its investments, with its pension fund report for 2007/08 stating: "In line with our fiduciary duty our fund managers are required to take account of financially material environmental risks." The report also commented on extra-financial performance that: "Extra-financial issues are increasingly important in assessing the quality of management and its management of risk relating to ESG issues which may impact on the future performance and prospects of a company."

On corporate governance, the EAPF fund has said it seeks to use its influence as a large invest to support and develop best practice in corporate environmental governance and sustainable environmentally responsible investment.

In implementing its stated investment and corporate governance policies, the EAPF has a strategic asset allocation of 31.5% in UK equities, 31.5% in global equities, 13.5% in index-linked gilts and 5% to both property and private equity, as stated in its 2007/08 report.

In the year to 31 March 2008, the EAPF saw an overall return of -3.1%, compared to a benchmark return of -1.2% and an annualised return over three years of +8.3%, compared to an annualised benchmark return of +8.4%. While these figures are not startling, they show that using an ESG approach does not necessarily have an adverse effect on returns. Indeed, the underperformance against the benchmark for 2007/08 can be attributed to poor performance relative to

the benchmark by certain fund managers, such as European Credit Management (ECM) (fund return of -11.3% against a benchmark return of -0.6%) and State Street Global Advisors (fund performance of -8.5% for UK equities and -7.1% for global equities against benchmark returns of -7.2% and -2.5% respectively).

Given these results, it is not surprising that in September 2008, SSGA had its mandate terminated following a strategic review, as did Capital International. In their place three new global equity managers were appointed; RCM, with a £100m mandate, Generation Investment Management, with a £50m mandate, and Impax Asset Management, with a £35m mandate.

Howard Pearce, head of environmental finance and pension fund management for the Environment Agency, said: “These appointments also evidence our opinion that those fund managers who seek to take into account financially material environmental risks and opportunities, such as climate change, in their investment decision, will produce better financial returns for the beneficiaries of our pension fund, and this is entirely consistent with our fiduciary duty.”

Pearce also said that ECM had been placed under review for poor financial performance and its reluctance to really embrace ESG. He said ECM had not signed up to the UNPRI and that this had compromised the overall performance of the EAPF and its environmental overlay strategy implementation.

Against this, other managers outperformed their benchmarks in 2007/08, with Sarasin & Partners returning 1.1% against a benchmark of -2.5% for a sustainable global equity mandate and Morley returning 3.8% over its benchmark for property. Indeed, in its 2007/08 report, EAPF commented: “Despite the challenging market conditions, Sarasin exceeded their performance target for the third year in a row, making them our most successful equity manager.”

With other managers, EAPF has co-operated on producing reports and case studies aimed at increasing awareness of how extra-financial issues can be incorporated into investment decision-making. In 2007/08, it worked with Standard Life on a report, Carbon Neutrality and Carbon Offsetting in the FTSE All-share, and in December 2007, it produced a joint case study with Robeco Private Equity, Responsible Investment in Sustainable Private Equity, on its mandate. So as well as implementing investment policies that follow the use of ESG criteria, in the belief that this is a valid approach, the EAPF also uses its mandates to promote this approach.

For other pensions in the public private sector, having a role model or thought leader can be a positive influence. Sarasin & Partners deputy chief investment officer Henry Boucher commented: “Historic concerns about sustainable investment have been addressed by many academic studies which show that there is no financial disadvantage. But the EAPF has gone further, and over the last three years has provided the highest quality, practical demonstration of the benefits.

“A wider focus on environmental and social factors adds an additional layer of analysis which is able to identify risks to avoid and new opportunities that might be missed in a traditional, purely financially-focused investment approach. Many such issues are particularly relevant when considered over the long time frame of most pension funds.”

While pension fund take-up of ESG criteria in their investment policies has been generally slow over the period since 2000, funds such as the EAPF are seen as early movers. Pearce commented: “We are happy to share our experiences and thinking on ESG and RI with other pension funds and already publish a lot of what we do on our pensions website and we think we can improve on how we do this.”

With some experts predicting that responsible investment will become a mainstream approach, more pension funds and investment houses in the UK and abroad could be looking closely at EAPF’s approach to see what they can learn.

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