Making an impact

Paul Myles
Director, Institutional Business
BMO Global Asset Management

"New regulations mean that UK Local Government Pension Schemes are having to take sustainability and governance related factors into account when making investment decisions and proactively address issues through engagement and voting activities."

The investment rationale for considering environmental, social and governance (ESG) factors is increasingly recognised. History is littered with examples of the price investors can pay when businesses fail to prioritise related issues and act responsibly, with BP's Deepwater Horizon disaster and the VW emissions scandal just two instances in which shareholders have recently suffered significant loses. There is also ample evidence to support the view that there is a positive relationship between sustainability and governance factors and a company's performance and that of its shares.

New regulations mean that UK Local Government Pension Schemes are having to take sustainability and governance related factors into account when making investment decisions and proactively address issues through engagement and voting activities. With over £259 billion under management, the collective voice of the sector is considerable and the scope for Local Government Pension Schemes to make positive impact with their activities significant.

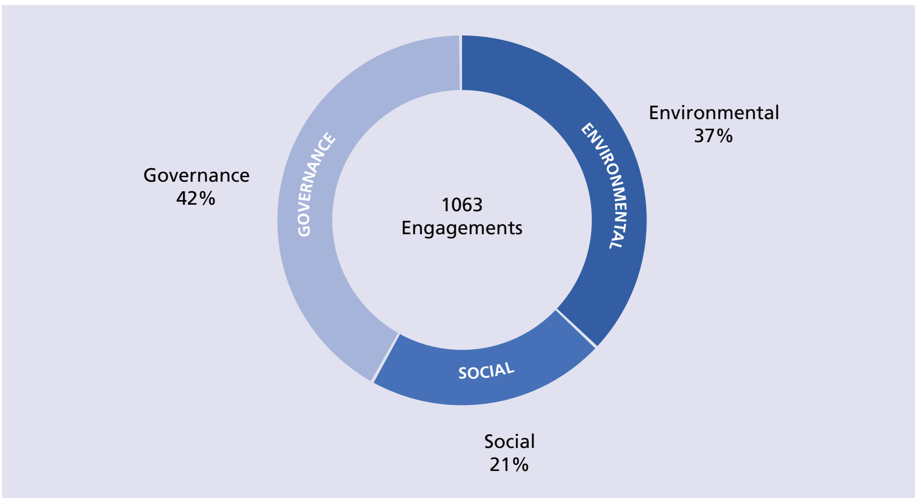
At BMO Global Asset Management, we have long been aware of the benefits of taking ESG seriously and mindful of our responsibility as stewards of our clients' capital, having launched Europe's first ethically screened fund in 1984. We also engaged on behalf of 32 clients with £144 billion of assets in our Responsible Engagement Overlay (reo®) service that we launched in 2000.

In this article we will look more closely at some of our engagement activities in 2017, explain how these relate to the United Nations' Sustainable Development Goals (SDGs) and highlight five themes to watch in 2018.

Engagement activities and areas of focus

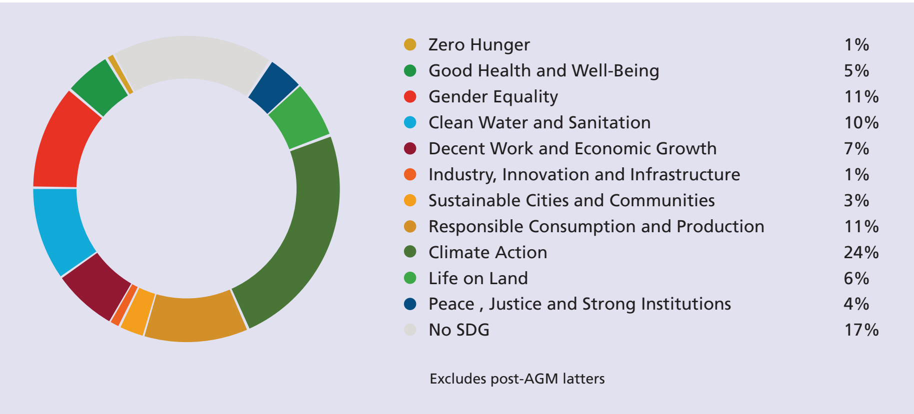
In 2017, we had 1,063 engagements with 676 companies, of which 37% were on environmental standards, 21% were on

Figure 1: Environmental, social and governance engagements in 2017



Source: BMO Global Asset Management

Figure 2: Investor engagement in 2017



Source: BMO Global Asset Management

social issues and 42% were on corporate governance topics.

Much of our environmental engagement continued to focus on climate change. This engagement was shaped by the guidelines published by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), which aim to bring greater consistency to the way companies and investors report climate relevant analysis. We were also actively involved in setting up a global investor collaboration to scale up engagement on this theme via an initiative called the Climate Action 100+.

In relation to social themes, key engagement areas included two projects in the pharmaceutical sector: one on approaches to corporate drug pricing in the US market and the second on access to medicine. Furthermore, we continued engagement on labour standards with a focus on supply chains. As part of this work we visited many clothing factories and warehouses to get a better understanding of worker conditions following allegations of bad labour practices.

We also engaged companies on a wide variety of corporate governance topics. In addition to engagements based around company-specific issues that arose at shareholder meetings, we completed a number of other engagement projects, including on the responsiveness of US companies to majority-supported shareholder resolutions; on executive remuneration in the UK; and on board effectiveness at Indian companies. This last project included a research trip to the region to engage with industry regulators and other market participants.

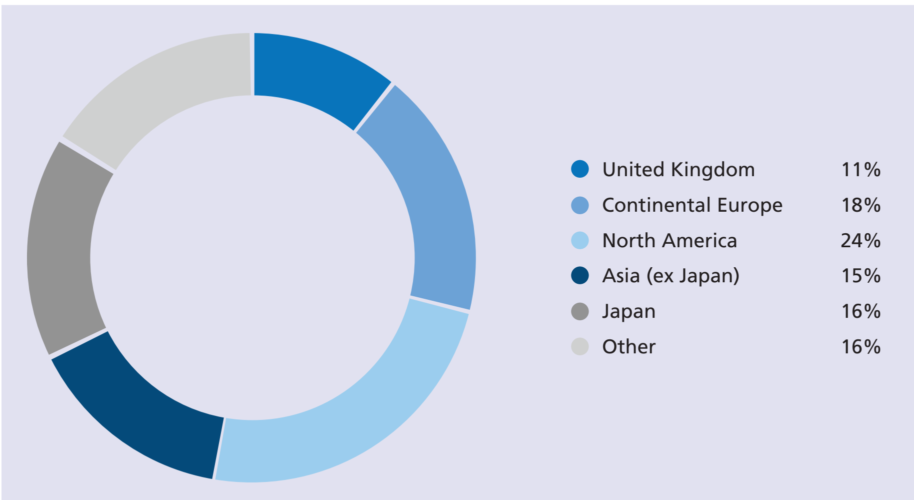
Engagement and SDGs

Historically we have categorised our engagement into ESG issues. However, the SDGs are fast emerging as a common language for governments, corporates and investors to talk about positive sustainability impacts. For a second year, we have therefore mapped our engagement against the SDGs in order to better understand the overlap.

Engagement outcomes

The greatest success area for 2017 was our engagement on climate change – where investor pressure is leading companies to rethink their business models and assumptions.

Figure 3: Companies engaged by country



Source: BMO Global Asset Management

Our engagement targeted companies in all major markets, covering 62 countries in total. Members of our team travelled to 12 countries over the year to engage, including Brazil, India, Japan, the US, and Malaysia. In 2017, we recorded 199 instances of change ("milestones") by companies, where businesses have improved policies or practices following engagement.

Momentum in 2017 was driven by the publication of the guidelines by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), coupled with the climate-related shareholder resolutions increasingly winning majority shareholder support, even in the US. Specific engagement results have included companies committing to improve their public reporting in line with the TCFD, as well as changes in business strategy.

The other significant area of progress was on promoting good corporate governance standards, with 47% of milestones falling within this category. Examples included companies unbundling director elections and establishing minimum standards for board independence. Pay was also an area where we saw marked improvements in markets like the UK, where binding resolutions on pay put pressure on companies to be more accountable.

Progress on social issues was, overall, somewhat tougher to achieve. No single dominant theme emerged in 2017, but there were instances of improved practices, ranging from improved strategies on nutrition in the food sector, greater transparency on drug pricing in the pharmaceutical sector, telecoms companies strengthening their approach to free expression and privacy, to technology companies adopting formal policies relating to migrant workers in their supply chain.

Our engagements in action

Industrial and Commercial Bank of China

Background

ICBC plays an influential role in shaping the Chinese economy. For the past three decades, it has financed heavy industries which powered the rise of China in the world economy. Now, the government is pushing for cleaner economic development.

Action

We have engaged ICBC on environmental finance since 2008. In 2017, we had a rare opportunity to meet its senior executives. The most striking revelation was that ICBC had made $8 billion of new loans to environmental projects in 2016. This dwarfs the amount provided to coal-related industries.

Our view

ICBC has transitioned to play a key role in financing China's efforts to mitigate environmental damage and reduce greenhouse gas emissions. The bank has further steps to take to improve its environmental reporting – but it is significantly better than when we first engaged the bank a decade ago. Following the meeting, the bank issued its first green bond to finance renewable energy and electric railway projects. We invested in the green bond.

Tesco

Background

Food waste is a financially material and ethically sensitive issue for Tesco; the company has set ambitious targets and is on track to achieve these. Tesco supports SDG12.3, which is to halve global food waste by 2030 at the retail and consumer levels, and within production and supply chains.

Action

We began engaging Tesco on this subject in 2012, encouraging food waste to be quantified and systems to be implemented to reduce it throughout the value chain. Over the years Tesco has detailed the challenges to us and through our engagement in 2017 we have seen the extent of progress made by the company.

Our view

We are encouraged by the work Tesco is undertaking in this area, and see positive momentum for further progress. Key achievements to date include: published, independently assured food waste data; the Tesco CEO chairing "Champions 12.3", a coalition of leaders dedicated to accelerating progress on food waste; and no food waste going to landfill. In 2017, 39,000 tonnes of food waste were generated; this was used for energy recovery, animal feed and anaerobic digestion.

Five themes to watch in 2018

What does 2018 hold in store? We take a look at some of the trends we believe will shape the responsible investment agenda for the year ahead.

#metoo – a watershed for working culture?

Popularised after the allegations against Harvey Weinstein, the #metoo hashtag quickly went viral and became a global movement empowering individuals to speak up against sexual harassment. Whilst the allegations continue to emerge, the morphing of #metoo to its successor movement *Time's Up* reflects how the initial outrage and anger is now being mobilised towards action to tackle the root causes. This is where #metoo converges with existing investor action on issues including board diversity and gender wage inequality. In 2018 we believe there will be heightened focus on workplace culture – particularly in male-dominated industries, the technology sector being one example – and on women's representation – not just on boards, but in senior management.

Challenging the throwaway society – ocean plastics highlight wasteful consumption habits

After years of campaigning by NGOs, it took a seminal wildlife documentary – *Blue Planet II* – to get politicians to pay attention to the devastation being wrought by the disposal of plastics. More than eight million tonnes of plastic are discarded into the oceans every year, equivalent to 16 full shopping bags for every metre of the world's coastline. Policy experiments have proven remarkably effective. The UK's plastic bag charge cut usage by 85%. We expect to see similar policy initiatives developed in 2018. Single-use plastic bottles are a likely target, given that a million plastic bottles are sold every minute, but only a small percentage of which are made from recycled materials. There is a potential cost here for companies which have to change their production processes – but it also opens up opportunities for those developing innovative new packaging solutions.

A-commerce and privacy – as technology enables our buying decisions to become ever more automated, what about privacy?

E-commerce may be surpassing bricks and mortar, but it is no longer at the cutting edge of retail technology. Automated commerce – a-commerce – holds the promise of making purchasing decisions simpler, with algorithms replacing time-intensive browsing and research. Despite the undoubted convenience advantages, we see new risks arising from this increased reliance on consumer data within retail business models. Regulations on data use, such as the EU's General Data Protection Regulation (GDPR), are becoming far more stringent, with high penalties for misuse. Where retailers are obliged to ask their customers if they really want their personal data used to predict their future purchases, they may get a less than enthusiastic response.

Candy crushed – regulatory and consumer pressure on sugar use rises as health evidence mounts up

Sugar is cheap, but its public health impacts are considerable. Obesity, formerly seen as a rich-world problem, is increasingly rife in many emerging markets, with rates of diabetes in countries like Mexico at epidemic levels. As waistlines grow, so do the public health costs to the taxpayer. Growing frustrated that their healthy eating messages are not getting through, governments are getting tougher, looking at measures including labelling schemes and taxation. Food and beverage companies are going back to the drawing board to re-formulate much-loved recipes where brand loyalty is a key differentiator. Those who mismanage the process may lose customers – but those slow to act are vulnerable to longer-term risks of diminished sales and reputation.

Entering the impact zone – investors reconsider their purpose

The 17 Sustainable Development Goals (SDGs) are a blueprint for a better world. Covering issues from poverty, inequality, the environment, to education and public health, the SDGs identify 169 targets to track progress towards the 2030 target date. Responsibility for achieving progress was once seen very clearly as the duty of governments, perhaps with the help of charities and NGOs to fill the gaps. But times have changed. We are shifting to a new paradigm where both companies, and investors in them, are expected to recognise that their actions have wider consequences on the economy and society, and to think deeply about how they can square their duties to deliver risk-adjusted returns with the imperative to manage these consequences. What does that mean in practice for investors? As well as further growth in the rapidly-expanding impact investing industry, we also anticipate further momentum behind efforts to measure portfolio-wide sustainability impacts, as investors seek to demonstrate their understanding of their alignment with the SDGs.

In conclusion

The 2016 LGPS Investment Regulations were key to granting schemes more investment freedoms with less central prescription, however schemes must also now take into account and publish a policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention or realisation of investments.