COLUMBIA THREADNEEDLE INVESTMENTS

IT'S NOT WHAT YOU SAY, IT'S THE WAY THAT YOU SAY IT

Improving trustee engagement with **Environmental**, **Social** and **Governance risk** factors through better framing and explaining.

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As all trustees of UK occupational pension schemes are well aware, from 1 October 2019 they have had to set out how they take account of financially material risks. Crucially, these include material Environmental, Social and Governance (ESG) risk factors, notably climate risk, prospectively the most material and systemic ESG risk of all.

However, in being tasked with taking a position on ESG, trustees don't always have the available information, or the information framed and explained in such a way to make an informed decision about what constitutes a coherent ESG risk management policy, or responsible investment framework. Indeed, most trustees are often reliant on their asset managers and their investment consultant to inform their approach – something that can result in trustees seeing this merely as a tick box exercise, despite the ever increasing risks of doing so. Indeed, it appears that few schemes are currently going beyond the minimum regulatory requirements and few trustee boards are designing bespoke policies with many being heavily guided by advisers' and providers' default positions.

Framing is a cognitive bias whereby people will view a decision problem differently depending on whether it is presented, or framed, positively or negatively. For example, if you ask people to estimate the age to which they will live (positive), this age will be considerably higher than if you ask them at what age they think they will die (negative). While having knowledge of the subject matter is key to understanding, equally important is the way in which the subject matter is framed.

With this in mind, we wanted to establish exactly what was standing in the way of greater trustee engagement with ESG risk factors and why the

industry appears to be failing to help trustees understand the importance of this integral aspect of risk management. We therefore sought to examine and better understand trustee and industry behaviours and the cognitive biases that enter into individual and group decision making when ESG risk factors and their management is the topic of discussion.

Firstly, we tested the opinion that a lack of engagement was an education issue – that trustees were not engaging with the topic because they did not understand it. As it transpired, the qualitative research we conducted uncovered a wider problem – that there remain many different opinions amongst trustees as to what "***ESG***" stands for. In case you are wondering yourself, it is normally considered to stand for "***Environmental, Social and Governance***" – this is certainly what we mean when we use the term. But does that phrase make you any the wiser about what you need to know? Not really. The truth of the matter is that the pensions and investment industry has an overwhelming love of acronyms, and it does not aid understanding by using them without clarifying what they mean.

Indeed, we interpret what a word or acronym means based on our current knowledge and what we associate with it. For many of the trustees we contacted, the acronym "ESG" has an association with altruism, the E often being considered to stand for "Ethical" – which implies a moral or value judgment needs to be made. This ***association bias*** suggests a misplaced perception among many trustees, that taking account of ESG risk factors in investment decision making means compromising on financial return and diversification. This is a view borne out of the ethical investing origins of responsible investment and its prior association with narrowing the investment universe, through negative screening and exclusion. Although current approaches are often very different, nonetheless this acts as a barrier to engaging with the topic and more integral risk management.

Helpfully, the responsible investment framework report recently published by the Investment Association addresses the lack of a common language and framework by which asset managers define and categorise the different responsible investment approaches.[1] However, that still leaves the issue of overcoming the countless behavioural barriers to engaging with the topic.

CONFUSION STILL REIGNS

Many trustees struggle to understand the extent to which their portfolios have ESG-related vulnerabilities, which ESG factors are financially relevant and material in the circumstances, and how ESG risk manifestly affects different asset classes and strategies. This isn't surprising given that ESG comprises myriad factors from resource depletion and climate change to diversity and employee relations to employee compensation and executive pay, with no universally accepted overarching definition of ESG, what each category comprises and the degree of overlap between each. Needless to say, ESG isn't a single factor and ESG risks take on a variety of forms.

Also, the terms responsible investment, sustainable investment and ESG are used interchangeably, despite the subtle nuances that differentiate each.

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[1] The IA Responsible Investment Framework Final Report. The Investment Association. 18 November 2019.

Moreover, there is no one-size-fits-all approach to integrating ESG factors into an investment process with techniques ranging from negative screening, or exclusion, to more sophisticated engagement and social impact approaches.

DECIPHERING THE **E**, **S** AND **G** IN **ESG**

As mentioned, the acronym "***ESG***" stands for ***Environmental***, ***Social and Governance***. You'll often hear asset managers and investment consultants talking about identifying and monitoring ESG risk factors, but what does that actually mean? Here's a quick illustrative guide:

> ENVIRONMENTAL RISK

The sustainability of our environment faces many risks. All of us are aware of climate change, prospectively the most damaging and systemic environmental risk. But we also need to look at the quality of the air we breathe and how we manage vital finite resources like water, the energy we consume and how this energy is generated. Simply put, when you're screening for environmental risks, you're looking at the quality and functioning of the natural environment and of natural systems. Environmental risks can be incredibly costly for companies when their activities lead to heavy fines, litigation, regulation and reputational damage.

> SOCIAL RISK

Social risks are those that relate to people, starting with their basic human rights. These comprise how people work, whether they suffer unfair or unsafe working conditions and are free from slavery and bonded labour. Are they allowed to associate with who they like? Are they free to express themselves? Is child labour employed? Extending to health, access to medicine, protecting consumers, avoiding controversial weapons and data privacy, there are many social risks which, if left unchecked, can potentially adversely impact your pension scheme investments.

> GOVERNANCE RISK

How are the companies and other investments your pension scheme holds governed? Who sits on the board? How big is that board? How is it led? Is the composition sufficiently diverse? Does the board have the structure, skills and independence to deliver the results you would expect? Is there transparency around how the company is run? Does the company have sufficient cyber-security controls? Is it able to prevent bribery and corruption?

These and other key facets of company stewardship, including company policies on diversity and inclusion, how executives and employees are remunerated, and how a company interacts with stakeholders, all fall under governance risks.

At Columbia Threadneedle Investments, we recently added to our research effort by launching a responsible investment ratings system that combines an assessment of a company's financial stewardship with a view on how well it manages its ESG risks. By combining both aspects into a single, forward-looking company rating, this proprietary tool reflects our conviction that prudent management of financial and ESG factors is important to a company's ability to create long-term, sustainable value. In providing enhanced analysis of 5,000 listed companies worldwide, it offers our investment professionals clear insights into how the above risk factors affect their current and potential investments.

UNDERSTANDING AND ADDRESSING BEHAVIOURAL IMPEDIMENTS

The first behavioural bias our industry has to recognise it succumbs to is ***the curse of knowledge***. Simply put, people often forget what it's like to not be familiar with a topic and talk in acronyms and platitudes which alienate the intended audience.

Therefore, if trustees are to engage with what their investment consultants and asset managers are telling them on how to manage ESG risk factors, the information needs to be presented in simple, relevant and, ideally, scheme-specific terms. In short, it's not what you say, it's the way that you say it. After all, when we are presented with a decision problem that's ambiguous and unsupported by the full facts, ***ambiguity aversion***, a preference for the familiar over the unfamiliar, means we tend to disregard it. However, the problem with most ESG-related communications is that they tend to be presented in a complex and abstract, or vague, manner and often lack examples of application in practice.

For our brains to make sense of problems, we need to be able to create a clear mental picture. By making a risk clear, vivid and relevant, you can shift perceptions, and therefore shift the understanding of what that risk entails and how it should be managed.

ESG RISKS ARE VERY REAL

Policymakers, financial regulators, NGOs and professional bodies all have Environmental, Social and Governance risks firmly in their sights. Indeed, a plethora of recommendations, directives and guidance have been issued with the aim of strengthening integration of these factors in the investment processes of all asset owners. And for good reason. Well-governed companies with strong credentials in managing these risks should deliver more sustainable returns by not being so materially exposed to operational, regulatory and reputational risk. Indeed, the UK Pensions Minister recently sent a letter to 50 of the UK's largest pension schemes requesting them to disclose "what substantive measures they have made – and when – to their investment strategies to take account of environmental, social and governance and climate change [risks]".

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The potential impact of these risks, climate risks in particular, on both defined benefit (DB) and defined contribution (DC) schemes are, of course, very real. Indeed, the Bank of England recently highlighted climate change as posing significant risks to both the global economy and global financial stability, while global investment consultant, Mercer, modelled the potential financial impacts of climate change under different climate scenarios and found that sudden sizeable return impacts are likely to dominate pension portfolios that fail to build in sustainability themes.[2]

For DB schemes, the impact is multi-faceted and plays to an integrated risk management approach, in that there is potentially an asset, sponsor covenant and liability impact. Climate risks, in particular, heighten schemes' exposure to unhedged longevity risk, as winter deaths subside in a potentially dramatic fashion. For DC schemes, as ESG risks could materially compromise member outcomes, the regulatory focus is on trustees and independent governance committees to employ default funds that manage these, somewhat hidden, risks on behalf of members. Moreover, for both DB and DC schemes, there is a very real risk of financial assets being materially repriced far in advance of company balance sheets, physical assets and the real economy being impacted. Therefore, trustees need to think ahead of the curve about prospective pre-emptive mitigating actions.

SOCIALISING ESG ENGAGEMENT AND OVERCOMING MYOPIA

As stewards of scheme members' financial assets, pension schemes are notable for two particular traits: (1) a hesitation to be the first mover into a new asset class or investment strategy, and (2) keeping a beady eye on what other schemes are doing.

When it comes to being the first mover, invariably it's the largest schemes who are the early adopters of new thinking, due to their advanced governance and access to the very best advice and due diligence expertise (especially the ability to price, absorb and diversify risk). Therefore, it probably comes as no surprise that as greater numbers of larger schemes have started to adopt responsible investment principles and the accompanying risk management framework as standard procedure, smaller schemes have started to take note.

This process, of schemes comparing and benchmarking themselves to others, engendering a momentum shift in replicating what these others are doing, is known as ***socialisation***.

OVERCOMING MYOPIA

Another common behavioural factor that impedes trustee engagement with ESG risk factors and their management is ***myopia***, or ***present bias*** – a predisposition to ignore the distant future in favour of more immediate imperatives. Indeed, in most aspects of life, anything more than two years out tends to fall off the radar. This is particularly true of the impact of climate change, the full, potentially cataclysmic impacts of which, have failed to

[2] Investing in a Time of Climate Change – The Sequel. Mercer LLC. 2019.

register with most and probably won't do so until its effects are more readily observable.

If myopia is to be overcome, then the future needs to be made more salient. That is, the future needs to be moved from back to front of mind. Trustees need to able to better identify with the distant future and understand how those potential risks might impact their scheme and what mitigating actions need to be taken ahead of the curve.

Indeed, just as public policy measures are used to engender socialisation to collectively change behaviours, so behavioural measures to make the distant future more salient are used by policymakers to overcome myopia. However, when it comes to pension schemes, investment consultants and asset managers also have a pivotal role to play in using these behavioural interventions to improve trustee engagement with material ESG risk factors and transform short-term mindsets.

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CLARITY IS KEY AND DETAILS MATTER

Clearer framing and explaining of why and how to manage ESG risk factors, having the right group decision making structures in place, engineering positive socialisation and measures to overcome myopia, will invariably see more widespread adoption, by trustees, of coherent ESG policies and responsible investment frameworks.

In particular, the industry needs to avoid speaking in jargonese, notably referring to the acronym "ESG" without a context and talking about it as an abstract concept. Only by making the E, S and G easy to imagine, real, relevant and tangible, can these risk factors and their management be brought to life for the intended audience. Clarity is key and details matter.

It is therefore the job of every investment consultant and asset manager, in explaining the idiosyncratic nature of these risks, to make these risks more salient, help trustees comprehend what is at stake if these risks are ignored and to frame the recommended action as a risk management exercise in language that everyone understands.

Of course, even once trustees have fully grasped the ESG nettle, they should keep asking questions of their investment consultant and asset managers until they are satisfied financially material risks, which might otherwise compromise scheme assets, liabilities and the sponsor covenant, as appropriate, are being properly managed. In short, ESG analytics, once fully understood, need to become an integral component of the trustee risk management toolbox if the long-term health of pension schemes is to be assured.

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