JUSTPENSIONS

# Responsible Investment Trustee Toolkit

2005 Edition

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## About Just Pensions

Just Pensions is a programme of the UK Social Investment Forum (UKSIF) – the UK's membership network for Responsible Investment (RI). Just Pensions aims to influence and educate UK pension scheme trustees about the importance of integrating RI into their investment strategy. As part of its education and awareness raising activities, Just Pensions produces a series of industry sector notes for trustees, co-ordinates in-depth research to assess current practice and works to address the blocks to the growth of RI. Just Pensions also engages with stakeholders on RI best practice and, together with UKSIF and Eurosif, aims to raise RI on the public policy agenda in the UK and Europe.


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# How to use this toolkit

This Just Pensions trustee toolkit aims to help UK pension scheme trustees[1] understand more about Responsible Investment (RI) and how they might integrate RI into their scheme's long term investment strategy.

The toolkit provides trustees with
- best practice first steps for different types of pension scheme;
- potential next steps; and
- 'how to do it' guides on RI, ranging from developing high-level policy to fund manager selection and assessment.

Although the toolkit can be read in its entirety, each section can be read as a stand-alone guide by those without time to take in the full text.

The toolkit is aimed primarily at pension scheme trustees, but Just Pensions hopes that it will be of interest to many stakeholders involved with pension schemes, institutional investment and fund management, as well as individuals interested in RI.



1. For a European Responsible Investment trustee toolkit see: Eurosif (2004) SRI Toolkit: 2004-2005: www.eurosif.org.

# 1. Introduction to Responsible Investment

Long term investors, such as pension scheme trustees are increasingly recognising that there are social, environmental, ethical and corporate governance (SEE/CG) issues that can be relevant to investee company performance.

Simultaneously, and partly as a response to the recent spate of corporate scandals, there is pressure from Government for pension scheme trustees to work with their fund managers to become engaged shareholders, i.e. shareholders that take account of both financial and non-financial aspects of company management and performance and use their influence to maximise long term shareholder value. As a result, institutional investors' interest in what is increasingly called Responsible Investment (RI) is growing[2].

**Box 1: What is Responsible Investment?**

Responsible Investment (RI) refers to investment where social, environmental, ethical and corporate governance (SEE/CG) considerations are taken into account in the selection, retention and realisation of investment and the responsible use of rights (such as voting rights) attaching to investments. RI combines investors' financial objectives with their concerns about SEE/CG issues. There are various approaches that can be used by responsible investors, either separately or in combination:

**Engagement**

Engagement also known as "shareholder activism" refers to the processes through which investors seek to improve a company's SEE/CG performance. There are a variety of methods that investors use to do this. These range from dialogue with company boards and management teams about issues of concern, such as inappropriate remuneration structures and responses to climate change, to exercising voting rights at AGMs. Engagement does not necessarily alter stock selection; for example when engagement is carried out by someone who is not ultimately responsible for managing the underlying assets, or alternatively when engagement is applied to a passive investment portfolio.

**Integration**

Integration occurs when active fund managers include potentially material SEE/CG risks and opportunities into the normal investment analysis, stock weighting and/or stock selection processes. The analysis can be undertaken by the fund manager and/or a specialist researcher, who feeds the information to the fund manager. Good analysis will usually require close dialogue with companies, which allows the researcher or fund manager to influence companies where SEE/CG issues are not being managed appropriately.

**Positive Selection**

Positive Selection, also known as "positive screening" or "support", is a process by which investors select companies that have superior SEE/CG performance. Positive Selection can come in a number of forms, including best-in-class and thematic investment. Best-in-class refers to selecting the companies that are best in their industry in relation to SEE/CG issues, whilst still meeting financial performance criteria. Research shows that portfolios managed in this way can provide superior financial performance[3]. This is achieved by reducing SEE/CG risks and increasing SEE/CG opportunities in the portfolio. Some pension funds are running test best-in-class portfolios on a small share (say 1-10%) of their assets. For example, ABP, the Netherlands' and Europe's largest pension scheme, has a best-in-class portfolio, worth about €150 million. Thematic investment refers to the selection of companies with a commitment to chosen responsible business products and/or services, such as investing in environmental technologies.

**Negative Screening**

Negative Screening, also known as "exclusion" or "avoidance", refers to the exclusion of stocks and shares from investment portfolios on SEE/CG grounds. An example of a negative screen is to exclude companies that make tobacco products. Evidence shows that screening does not necessarily lead to systematic underperformance[4]. An example of a fund using negative screening is the UNISON Staff Pension Scheme, which aims to combine the pension scheme's financial objectives with SEE/CG criteria, including the exclusion of defence and tobacco companies, as well as those businesses with poor human rights, corporate governance and environmental performance. The fund is invested in global equities and the fund's financial objective is to outperform a composite benchmark consisting of mainstream indices by 1.5% p.a. over rolling three-year periods.

2. Increasingly the term SRI has been replaced with Responsible Investment.
3. See Section 3.1. of this toolkit.
4. CIS (2002) Sustainability Pays: www.cis.co.uk; WestLB Panmure (2002) More Gain than Pain: www.westlb.com.

## 2. Recent Regulatory and Legislative Developments

The growth in RI[5] in the UK pension industry over the past few years has been shaped by various factors, including the following regulatory and legislative developments that are directed at pension scheme trustees:

**Box 2: SRI Pensions Disclosure Regulation (2000)**

The amendment to the 1995 Pensions Act, the 'SRI Pensions Disclosure Regulation' came into force on 3 July 2000[6] . The legislation requires that trustees of occupational pension schemes must disclose in their Statement of Investment Principles (SIPs):

– The extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and
– Their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.

The disclosure regulation is also incorporated into Local Government Pension Scheme Regulations, so Local Authority Pension Funds are required to make a similar statement.

**Box 3: Myners Review of Institutional Investment & the ISC Statement of Principles (2001/2002)**

The Myners Review (March 2001) recommended that the Government should legislate for shareholder activism, by incorporating US Employee Retirement Income Security Act (ERISA) style principles into UK law[7]. Following discussions with the Institutional Shareholders' Committee (ISC), which includes the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI), the Government agreed to the ISC's proposals to pursue this recommendation, initially voluntarily, through a set of ISC principles[8]. The principles set out best practice for institutional shareholders and agents as to their responsibilities in respect of investee companies and include providing detailed guidance on monitoring the performance of and establishing a regular dialogue with investee companies, intervening where necessary, evaluating the impact of their activism and reporting back to clients/beneficial owners. The Government agreed to conduct a review to assess progress after two years.

**Box 4: HM Treasury Review of Progress on the Myners Principles (2004)**

In December 2004, the HM Treasury published its Review of Progress[9,10] on the Myners Principles and proposed a number of revisions to the principles, including:

– Principle 6 (Activism): To make clear the responsibility of trustees for ensuring appropriate engagement is undertaken, HM Treasury is proposing to revise Myners Principle 6 to ensure that trustees comply with the ISC statement of principles and ensure that the principles are incorporated into fund managers' mandates.
– Principle 10 (Reporting): To improve the quality and availability of information provided to members and stakeholders, the Government proposes to amend Principle 10 to ensure that trustees report on their implementation against all the principles, make performance assessments available to the scheme membership and post on the scheme website the key information they provide annually to members.

The NAPF has agreed to undertake a further review in 2007 of the progress of its members against the Myners Principles and to put the results to Government. In light of the NAPF evidence, the Government will assess whether there still remains a need for further policy action by the end of 2007.

**Box 5: Opra Trustee Knowledge, Understanding & Conversance Scope Guidance (2005)**

The Pensions Act 2004 requires that trustees must have sufficient knowledge and understanding of pension and trust law to run their schemes properly. In February 2005, the Occupational Pensions Regulatory Authority (Opra) published scope guidance for both DB and DC schemes on the topic of trustee knowledge and understanding[11]. In particular, the guidance includes a specific reference to RI and CG in relation to the scheme's SIP and the scheme's statement of compliance with the Myners Principles. The Pensions Regulator, which will replace Opra on 6 April 2005, will issue a code of practice on trustee knowledge and understanding, which will set out how trustees can comply with the legislation. The scope documents will complement the code and will be published alongside it.

5. See Eurosif (2003) Socially Responsible Investment among European Institutional Investors: www.eurosif.org or Russell Sparkes (2002) SRI: A Global Revolution: John Wiley & Sons.
6. HMSO (1999) The Occupational Pension Schemes Amendment Regulations 1999: Statutory Instrument 1999 No. 1849: www.legislation.hmso.gov.uk/si/si1999/19991849.htm.
7. Paul Myners (2001) Myners Review of Institutional Investment in the UK: www.hm-treasury.gov.uk.
8. Institutional Shareholders' Committee (ISC) (2002) The Responsibilities of Institutional Shareholders and Agents – Statement of Principles: www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.
9. HM Treasury (2004) Myners Principles for Institutional Investment Decision-making: Review of Progress: www.hm-treasury.gov.uk/media/DCB/53/myners_principles_web.pdf.
10. The Government is consulting on the proposed changes until mid-March 2005.
11. Opra (2005) Trustee Knowledge, Understanding and Conversance – Scope Guidance: http://www.opra.gov.uk/TrusteeKnowledge/Index.asp.

# 3. The Case for Responsible Investment

### 3.1. The Shareholder Value Case for Responsible Investment

*"There is a correlation between good practices and good investment results. People in the investment industry often want to put a wall up between the two things, but they are related".*
Philip Angelides, State Treasurer of California and a Board Member of Calpers, California's $165 billion public employees pension fund and America's largest investment fund of any kind.

When considering an RI approach, pension fund trustees will first and foremost want to know that it will add value (and avoid loss) to the pension scheme. Many SEE/CG risks and opportunities are investor relevant[12], particularly in the longer term, and can, therefore, lead to superior long term performance. As such, trustees need to understand how their fund managers are taking SEE/CG issues into account in stock selection and/or engagement activities.

With regard to corporate governance there is extensive research that supports the proposition that there is a positive link between good corporate governance in investee companies and share price performance[13]. For example, an assessment by Deutsche Bank on the governance of FTSE350 companies at the end of 2000 and 2003 (using 50 differently weighted corporate governance standards) found a link between corporate governance and share price performance in the companies assessed[14]. During the three year period investigated, the 10% of companies with the best corporate governance structures and behaviour outperformed those in the bottom 10% by 25%. This, plus other opinion-based research, focus list research, and governance ranking research, is summarised in a report entitled 'Corporate Governance and Performance'[15] by Hermes (which is owned by, and manages the funds of the BT Pension Scheme).

Extensive research has also been undertaken to assess whether there is a positive correlation between good SEE performance in investee companies and shareholder value. For example, as part of a review of its pension fund's investment strategy, the Environment Agency commissioned research to investigate the link between corporate environmental governance and financial performance[16]. The final report, based on a thorough literature review and 15 case studies, found that 85% of the literature review studies demonstrated a positive correlation between environmental governance and financial performance. The individual case studies, in turn, supported the findings in the literature review. For example, forest and paper products companies with above average environmental governance standards and environmental track record financially out-performed companies with below average ratings by more than 43% (4,300 basis points) over the four years from March 1999 to March 2003. The companies with the best environmental record also out-performed the below average environmental performers in the integrated oil and gas sector (by 11.8% over three years and 2.6% over one year) and the water utilities sector (by 4.5 percentage points over three years).

In summary, SEE/CG issues are clearly investor relevant and can lead to superior long term performance. Therefore trustees should make sure that their fund managers are taking SEE/CG issues into account in stock selection and/or engagement activities.

### 3.2. The Regulatory and Legislative Case for Responsible Investment

As highlighted in Section 2, the Government clearly recognises the importance and substantial benefits to shareholders of taking potentially material SEE/CG risks and opportunities into account.

### 3.3. The Industry Best Practice Case for Responsible Investment

The view of industry associations, such as the NAPF and the ABI, on RI (and specifically engagement) is articulated in the ISC statement of principles (See Box 3). These principles set out best practice for institutional shareholders and agents as to their responsibilities in respect of investee companies[17]. These include monitoring the performance of and establishing a regular dialogue with investee companies, intervening where necessary (See Box 6), evaluating the impact of their activism and reporting back to clients/beneficial owners.

12. See Association of British Insurers (ABI) (2004) Risk, Returns and Responsibility: www.abi.org.uk; and Just Pensions Sector Research Notes: www.justpensions.org (the General Retailers sector note is in the pocket at the back of this toolkit).
13. See Gompers et al (2003) 'Corporate Governance and Equity Prices' Quarterly Journal of Economics, 18: 107-155 and Bebchuk et al (2004) 'What Matters in Corporate Governance?' Olin Paper No. 491, Harvard Law School.
14. Deutsche Bank (2004) Global Corporate Governance Research: Beyond the Numbers – Corporate Governance in the UK, February 2004.
15. Hermes Investment Management (2004) Corporate Governance and Performance: http://www.hermes.co.uk/corporate_governance/corporate_governance_and_performance_feature.htm.
16. Environment Agency/Innovest (2004) Corporate Environmental Governance: www.environment-agency.gov.uk.
17. Institutional Shareholders' Committee (ISC) (2002) The Responsibilities of Institutional Shareholders and Agents – Statement of Principles: www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.

**Box 6: The View from the NAPF and the ABI on Responsible Investment**

**An Excerpt from the ISC Statement of Principles[18]: Intervening When Necessary**

Effective monitoring will enable institutional shareholders and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders. Many issues could give rise to concerns about shareholder value. Institutional shareholders and/or agents should set out the circumstances when they will actively intervene and how they propose to measure the effectiveness of doing so… Instances when institutional shareholders and/or agents may want to intervene include when they have concerns about:

- The company's strategy;
- The company's operational performance;
- The company's acquisition/disposal strategy;
- Independent directors failing to hold executive management properly to account;
- Internal controls failing;
- Inadequate succession planning;
- An unjustifiable failure to comply with the Combined Code;
- Inappropriate remuneration levels/incentive packages/severance packages; and
- The company's approach to corporate social responsibility (CSR).

### 3.4. The Legal Case for Responsible Investment

Trustees can legally take account of SEE/CG issues in relation to their investments, so long as this delivers improved or equivalent financial returns, and is subject to the overriding requirements of trust law in respect of beneficiaries. As the shareholder value case demonstrates, there is evidence that SEE/CG issues can positively correlate with financial performance. Therefore, the adoption by trustees of an appropriate RI approach as part of their investment policy, in order to take into account these non-financial risks and opportunities appears to be consistent with trust law.

In fact, some industry experts, such as Yve Newbold, who chaired the NAPF Committee of Enquiry into Voting Execution argues that trustees may be in danger of incurring legal risk by not considering SEE issues:

*"The requirement to state in the SIP the extent to which social, environmental or ethical (SEE) considerations are taken into account in investment decisions means that for all but the smallest trust funds a position of having no such policy would or could be called into question as being unsound in the climate of today's heightened awareness of the influence of such issues on corporate reputation and value"*[19].

Shareholder value driven engagement and integration are widely accepted approaches and considered best practice by Government and industry bodies. Negative screening and positive selection are also appropriate methods for trustees to consider when they have a sub-set of members that hold particular core values (so long as the approach delivers unchanged or improved financial benefits to all beneficiaries). Screening-based approaches might also help trustees achieve participation targets by encouraging certain employees to join or remain in the scheme, for example employees with strong religious convictions.

### 3.5. The Moral and Values-based Case for Responsible Investment

The move towards RI has also been driven by the argument that investors have a moral responsibility to support and encourage companies to achieve higher standards of corporate responsibility according to legitimate ethical principles. These arguments are based on the view that ethics are determined by outcomes and consequently people involved in market transactions have an obligation to act on the consequences of their actions. Some therefore argue that investors, as owners of the companies in which they invest, have a moral obligation to act to mitigate any negative social or environmental impacts of these companies. This moral argument is strengthened by commercial arguments for those pension schemes whose membership has in some way articulated the desire to see its money managed according to principles valued by a significant proportion of beneficiaries, as well as financial excellence. It is legally possible for investors to ensure that companies achieve higher SEE/CG standards. Internationally authoritative conventions and guidelines can act as a legitimate reference point in what constitutes these standards. Of course, this has to be applied in parallel with delivering unchanged financial benefits to all beneficiaries.

### 3.6. Summary

Taken together, the various cases for RI provide a compelling argument that trustees should be considering SEE/CG issues by adopting an RI approach that is most appropriate for their scheme (See Section 4).

18. Institutional Shareholders' Committee (ISC) (2002) The Responsibilities of Institutional Shareholders and Agents – Statement of Principles: www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.
19. Statement by Yve Newbold (2001).

# 4. First Steps

Section 4 provides best practice first steps for four different types of pension scheme.

## 4.1. First Steps for DC Schemes with Members who have Diverse Values

| Ensure that the default fund is managed appropriately in terms of SEE/CG risks and opportunities | Add a screened fund option for members |
|---|---|
| **Why do it?**<br><br>**To Manage Risk and Enhance Returns:**<br>As highlighted in Section 3.1, some SEE/CG risks and opportunities are investor relevant, particularly in the longer term. As such, trustees need to ensure that SEE/CG issues are being taken into account in stock selection and/or shareholder activism[20] by their fund managers and other service providers. | **Why do it?**<br><br>**To Increase Member Choice:**<br>Currently nearly 500,000 people in the UK have chosen screened funds for their investments – that's 5% of the investing population. Indeed, eight in ten UK investors believe that employers should "*offer an ethical [screened] investment option for occupational pension schemes*"[21]. |
| **Which schemes are doing this?**<br>FTSE 100 companies with DC schemes which are doing this include Barclays, Friends Provident and Legal & General. | **Which schemes are doing this?**<br>In January 2004, Professional Pensions found that Barclays, Legal & General, and BP were amongst those FTSE 100 companies which offer a screened fund option in their DC scheme. |
| **How can trustees do this?**<br>Firstly, it is important to reflect the trustees' decisions in the scheme's Statement of Investment Principles (SIP) and fund manager mandate and/or service provider contract. See section 6.2 for more details.<br><br>However, to ensure full implementation of SEE/CG policies, it is also important to assess fund managers and/or service providers, and to report to members on a regular basis. See section 6.4 and 6.5 for more details. | **How can trustees do this?**<br>Many DC providers have screened fund options.<br><br>However, if a scheme sources investment funds from a variety of managers, your investment consultant[22] should be able to help you find a good screened fund with strong investment potential.<br><br>Member consultation will help ensure that the chosen fund meets employee needs. |
| **In summary:**<br>Good proactive trusteeship includes ensuring that SEE/CG risks and opportunities are managed appropriately by everyone in the investment chain. | **In summary:**<br>Most large DC schemes could enhance member choice very easily by offering a screened fund option. This could form part of the scheme's response to Myners' call for DC schemes to offer members a larger range of options. |

20. To make clear the responsibility of trustees for ensuring appropriate engagement is undertaken, HM Treasury is proposing to revise Myners Principle 6 to ensure that trustees comply with the ISC statement of principles and ensure that the principles are incorporated into fund managers' mandates.
21. NMG Research (November 2003): NMG Research polled 674 investors within a fully representative sample of 2000 UK Adults (age 15+).
22. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

### 4.2. First Steps for DB Schemes with Members who have Diverse Values

| Ensure that the majority of assets are managed appropriately in terms of SEE/CG risks and opportunities | |
|---|---|
| **For Passively Managed Mandates:**<br>**Shareholder Activism only**<br>**Fund managers or service providers engage with investee companies on SEE/CG risks and opportunities . The information is then integrated into voting strategy** | **For Actively Managed Mandates:**<br>**Integration and Shareholder Activism**<br>**Fund managers engage with investee companies on SEE/CG risks and opportunities. The information is then integrated into stock selection and voting strategy** |
| **Why do it?**<br>**To Manage Risk and Enhance Returns:**<br>As highlighted in Section 3.1, some SEE/CG risks and opportunities are investor relevant, particularly in the longer term. As such, trustees need to ensure that SEE/CG issues are being taken into account in shareholder activism[23] by their fund managers and other service providers. | **Why do it?**<br>**To Manage Risk and Enhance Returns:**<br>As highlighted in Section 3.1, some SEE/CG risks and opportunities are investor relevant, particularly in the longer term. As such, trustees need to ensure that SEE/CG issues are being taken into account in stock selection and shareholder activism[23] by their fund managers. |
| **Which schemes are doing this?**<br>The British Coal Staff Superannuation Pension Scheme, which has a passive core, has delegated responsibility for shareholder activism issues across £6 billion of equities to Hermes (which is owned by, and manages the funds of, the BT Pension Scheme). | **Which schemes are doing this?**<br>*"Shell has linked its pension principles to its previously developed general business principles"*[24]. |
| **How can trustees do this?**<br>Firstly, it is important to reflect the trustees' decisions in the scheme's Statement of Investment Principles (SIP), and the fund manager mandate and/or service provider contract. See section 6.2 for more details.<br>However, to ensure full implementation it is also important to assess fund managers and/or service providers, and to report to members on a regular basis. See section 6.4 and 6.5 for more details. | **How can trustees do this?**<br>Firstly, it is important to reflect the trustees' decisions in the scheme's Statement of Investment Principles (SIP), and the fund manager mandate. See section 6.2 for more details.<br>However, to ensure full implementation it is also important to assess fund managers, and to report to members on a regular basis. See section 6.4 and 6.5 for more details. |
| **In summary:**<br>Good proactive trusteeship includes ensuring that SEE/CG risks and opportunities are managed appropriately by everyone in the investment chain. | **In summary:**<br>Good proactive trusteeship includes ensuring that SEE/CG risks and opportunities are managed appropriately by everyone in the investment chain. |

23. To make clear the responsibility of trustees for ensuring appropriate engagement is undertaken, HM Treasury is proposing to revise Myners Principle 6 to ensure that trustees comply with the ISC statement of principles and ensure that the principles are incorporated into fund managers' mandates.
24. Mark Mansley (2004) Green Pensions: Reality or Rhetoric? Claros Consulting, London.

### 4.3. First Steps for DC Schemes with Members who have Similar Values

**Offer a range of funds, with different levels of investment risk, all of which reflect the employer's mission and employees' values**

**Why do it?**

**To Allow Members to Reflect Their Values in Their Investments:**
Employees of values-based organisations, like charities, political and campaigning organisations, often share a core set of values. Reflecting these values in their investment and consumption choices is often very important to them. However, employees' risk appetites will vary, both across the workforce and over time.

**To Align Organisational Policies with the Overall Mission of the Organisation:**
Values-based organisations can enhance the organisation's mission and avoid adverse criticism, by aligning important internal policies with their organisational mission.

**Which schemes are doing this?**
A good example of this approach is the sustainable development charity Forum for the Future, which offers a range of screened funds with different levels of investment risk. See detailed Case Study on page 9.

**How can trustees do this?**
Some DC providers have a range of funds that are values-based, and/or engage with investee companies on a range of values-based issues.

However, if you source investment funds from a variety of managers, your investment consultant[25] should be able to help you find a good range of suitable funds, from appropriate providers, with strong investment potential.

Member consultation will help to ensure that the range of funds meets employee and employer needs.

**In summary:**
The range of funds offered within DC schemes gives values-based organisations an ideal opportunity to reflect their own mission and the values of their employees in their pension investments.

25. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

# Case Study: Forum for the Future's DC Pension Scheme

Forum for the Future is a sustainable development charity. Through its DC provider, the Forum offers its pension scheme members a range of screened RI funds with different levels of investment risk.

According to pension fund member Emma Hunt, Head of Sustainable Finance Education at the Forum's Centre for Sustainable Investment: "*We have a range of sustainability funds available to scheme members. This recognises that members have different risk appetites and therefore allows them to reflect their principles in their investments, whether they are choosing to invest in corporate bonds or in the shares of companies with high growth potential. The scheme members, all of whom work or have worked at Forum for the Future, have a strong affinity with sustainability issues and where practical, aim to incorporate these into their personal consumption and investment choices".*

The screened RI funds align corporate, social and investor interests to generate long term benefits consistent with the concept of sustainable development. The funds screen and rate stocks using a sustainability matrix, which consists of two key elements. The first is product sustainability, assessed by the extent to which a company's core business (the products or services it offers) is helpful or harmful to society or the environment. The second is management quality, which is assessed by various criteria, including good governance practice, appropriate stakeholder engagement, integration of SEE/CG issues into business strategy and the effective execution of a corporate responsibility strategy.

As each new person joins the Forum's scheme, they are required to complete a personal details form, which includes their financial needs as well as questions about their SEE/CG choices. There is also an assessment of each new member's attitude to investment risk. The Forum's independent financial adviser (IFA) then provides them with advice on their best options, including which of the RI funds would be most appropriate, based on the information they have provided.

According to the Forum's IFA, Lee Coates from the Ethical Investors Group, "*No one has opted to choose a different pension fund to date, as to do so would be to deny the long term benefits of sustainable business practice. By including sustainability issues within a long term pension investment, staff at Forum are reinforcing the aims and objectives of their work and will stand to benefit in the long term as this work generates real corporate change*".

By offering a wide range of funds, Forum for the Future has also acted in line with Myners call for DC schemes to offer members a larger range of options.

Website: www.forumforthefuture.org.uk.

### 4.4. First Steps for DB Schemes with Members who have Similar Values

**Add one or more specialist mandates that reflect the employees' values or employer's mission**

**Why do it?**

**To Increase Organisational Impact:**
Strongly focused and/or screened funds have been shown to be sensible investments for long term investors like pension funds. Organisations with a role in say, environmental management, poverty reduction, or community regeneration can focus part of their investments to reflect their role.

**Which schemes are doing this?**
A good example of this approach is the Environment Agency, which has a specialist environmental mandate, comprising 7% of the fund. See detailed Case Study on page 11.

**How can trustees do this?**
Investment opportunities that reflect the organisation's mission are likely to exist, e.g. environmental technology funds, emerging market funds, community development funds. A specialist investment consultant[26] should be able to help organisations identify a suitable approach.

Consultation with the employer and fund members will help ensure that the option(s) chosen is (are) appropriate.

**In summary:**
An organisation's DB scheme can be aligned with the organisation's mission and its employees' values.

**Ensure that the other funds are managed appropriately in terms of SEE/CG risks and opportunities**

**Why do it?**

**To Manage Risk and Enhance Returns:**
As highlighted in Section 3.1, some SEE/CG risks and opportunities are investor relevant, particularly in the longer term. As such, trustees need to understand how SEE/CG issues are being taken into account in stock selection and/or shareholder activism[27] by their fund managers and other service providers.

**Which schemes are doing this?**
A good example of this approach is the Environment Agency, which has placed an environmental overlay strategy across its entire pension fund. See detailed Case Study on page 11.

**How can trustees do this?**
Firstly, it is important to reflect the trustees' decisions in the scheme's Statement of Investment Principles (SIP) and fund manager mandate. See section 6.2 for more details.

However, to ensure full implementation of SEE/CG policies it is also important to assess fund managers and service providers and report to members on a regular basis. See section 6.4 and 6.5 for more details.

**In summary:**
An organisation's DB scheme can be aligned with the organisation's mission.

26. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.
27. To make clear the responsibility of trustees for ensuring appropriate engagement is undertaken, HM Treasury is proposing to revise Myners Principle 6 to ensure that trustees comply with the ISC statement of principles and ensure that the principles are incorporated into fund managers' mandates.

# Case Study: The Environment Agency's DB Pension Scheme

In 2004, the £1 billion Environment Agency pension scheme redesigned its investment management strategy to become a more active shareowner. According to Howard Pearce, Head of Environmental Finance and Pension Fund Management: *"It did this to ensure that its fund managers take account of environmental and other longer term risks and opportunities that can affect financial returns."* The Agency deems this strategy to be entirely consistent with its fiduciary duty to manage the pension fund to maximise financial returns for its beneficiaries. The Environment Agency is the leading public sector body dedicated to protecting and improving the environment so that tomorrow's generations inherit a cleaner and healthier world. As such, the Agency's Pensions Committee (whose membership includes non-executive board members, senior manager, employee, trade union, and pensioner representatives), consider it important to align the corporate values of the Agency with the investment principles of its pension fund.

After three years of poor stock market returns and following some media criticism of the Environment Agency's current investment approach, the Agency's Pensions Committee undertook a fundamental 12 month review of its investment management strategy. The strategy under review was primarily based on four "balanced" style fund managers, to which an "eco-enhanced" index tracker fund had been added in 2001.

This review included:
- An examination of the current fund managers' performance and compliance with the Agency's corporate governance and environmental investment policies;
- Detailed asset and liability risk budgeting and manager structure modelling, undertaken in partnership with the Agency's actuaries and investment consultants;
- A "greenness" benchmarking study, including a review of the environmental fund market and research into the links between corporate environmental governance and financial performance[28].

In light of the results of this review, the Committee decided to redesign its investment strategy. It agreed to lower the asset allocation to equities and increase its allocation to bonds, and to diversify its investments by making small allocations to property and private equity and to replace balanced managers with specialist managers.

It also took the opportunity to review its approach to RI, which resulted in:
- Placing an environmental overlay strategy[29] across its entire pension fund, to be followed by all managers, with specific requirements for each asset class;
- Having one specialist environmental fund manager comprising 7% of the fund;
- Reviewing and strengthening its approach to corporate environmental governance and engagement.

To implement the new strategy, eight new mandates were developed (see below). The Environment Agency sought new managers via the EU procurement process and will use a standardised investment management agreement for all its mandates. The Agency's existing fund managers were invited to re-apply for the new mandates.

| **Investment Style** | **% of Portfolio** | **Mandate Value** |
|---|---|---|
| Multi-asset Passive Manager | 40% | £400m |
| Active UK Equity Specialist Manager | 16% | £160m |
| Active Bond Specialist Manager | 13.5% | £135m |
| 2 Active Global Equities Specialists (50% each) | 13.5% | £135m |
| Specialist Environmental Manager | 7% | £70m |
| Property Manager | 5% | £50m |
| Private Equity Manager | 5% | £50m |

All prospective fund managers were invited to detail how they would integrate financially material environmental risks and sustainability criteria into their investment processes, research, engagement, corporate governance, proxy voting, and performance reporting. According to the Environment Agency's specialist RI adviser, Mark Mansley of Claros Consulting[30]: *"It has been encouraging to see responses from a wide range of fund managers demonstrating a commitment to and an understanding of responsible investment issues".*

The Agency expects to complete the implementation of its new strategy and appoint new managers by mid 2005.

For further information, please contact howard.pearce@environment-agency.gov.uk.

Website: www.environment-agency.gov.uk.

28. Environment Agency/Innovest (2004) Corporate Environmental Governance: www.environment-agency.gov.uk.
29. Environment Agency Active Fund Environmental Overlay Strategy: www.environment-agency.gov.uk.
30. Mark Mansley is continuing this advisory role to the Environment Agency at Rathbone Greenbank Investments.

# 5. Potential Next Steps

After pension schemes have implemented the appropriate best practice first steps outlined in the previous section, the following options are open to them:

### Conduct Portfolio SEE/CG Risk Analysis/Monitoring[31]:

As a way of ensuring that the fund manager is formally assessing and monitoring potentially material SEE/CG risks, pension funds could require any active fund manager to conduct portfolio SEE/CG risk analysis and monitoring and then report back to the trustees any significant anomalies or exposures to risk. There are various ways to assess risk, including:

- *Monitoring the average position of the fund on specific issues or indicators (e.g. carbon emissions)*
  This involves asking the fund manager to assess the portfolio's average risk exposure compared with the average risk exposure of the relevant benchmark (e.g. tonnes of carbon emissions per £million invested). The fund manager could be asked to report on and justify any significant increase in risk.
- *Comparing/benchmarking portfolios to one or several published Responsible Investment Indices*
  With indices, such as the FTSE4Good or Dow Jones Sustainability Indexes, risk analysis could be used to assess: a) whether the active pension portfolio has a high or lower allocation to the "responsible companies" than the index as a whole; b) whether the portfolio has performed better or worse than the index.

### Address Concerns with an 'Avoid or Explain' Policy[32]:

Following on from a Portfolio SEE/CG Risk Analysis (see above), pension schemes could adopt a simple and effective 'Avoid or Explain' policy. This approach requires pension scheme trustees to:

- identify a short list of companies of concern (i.e. those with particularly poor SEE/CG performance or those that might create reputation risk or other problems for the sponsoring employer).
- instruct the fund manager to either avoid these companies or provide an explanation of why investment is appropriate.
- monitor and review.

The main purpose of this approach is to ensure that that the fund manager does not invest in these companies without proper consideration. This approach provides an alternative to simply screening out unacceptable stock, in that it is more flexible, whilst compatible with engagement activities. The actual decision-making is appropriately delegated to the fund manager, but it allows the trustees to understand the reasons for inclusion over avoidance. The fund manager is free to provide a range of explanations such as:

- Performance Reasons: The SEE risks are adequately discounted and the fund manager believes the stock offers good potential.
- Portfolio Reasons: The stock is worth holding for balance in the portfolio (i.e. it is very large or important in its sector).
- Management Reasons: The management is addressing the issues of concern.

### Support Positive Selection[33]:

There is a clear case for pension funds, especially DB schemes with a subset of members who share similar values, to consider investing 1-10% of their assets in a specialist fund with a clear positive SEE/CG focus. These could include venture capital investments (potentially in areas such as environmental technologies), project finance for positive projects (e.g. wind farms, water treatment facilities) and property (e.g. social housing). Such investments should clearly be on a commercial basis, so should offer attractive rates of return commensurate with their risks. A specialist investment consultant should be able to help pension funds identify a suitable approach. Contact Just Pensions or the TUC for contact details of specialist consultants. See page 20 for contact details for Just Pensions and the TUC.

### Encourage Better Broker Research on SEE/CG issues

Trustees should encourage the sell side to provide better research into longer term and non-financial issues by encouraging fund managers to commit brokerage fees to actively encourage this. See also the Enhanced Analytics Initiative (EAI) on page 13.

31. Mark Mansley (2004) Green Pensions: Reality or Rhetoric? Claros Consulting, London.
32. Ibid.
33. Ibid.

## Collaborative Initiatives

There are various collaborative initiatives that allow pension scheme trustees to join forces with other trustees on RI issues:

### Enhanced Analytics Initiative (EAI)

Having identified poor analysis of long term and extra financial issues as a systemic weakness in the investment process, the Enhanced Analytics Initiative (EAI) has been established by a group of pension schemes and other institutional investors. EAI members have committed to allocating a minimum of 5% of their respective brokerage commission to sell-side analysts who are good at incorporating material extra-financial issues and intangibles. This is a reallocation of existing broker spend and not new money.

The EAI also includes associate members, asset owners like pension funds which do not manage their own assets internally and therefore have no direct contractual relationship with brokers (for example, the London Pensions Fund Authority – LPFA), but are committed to encouraging their external fund managers to take part in this initiative or implement similar practices. For further information, visit www.enhancedanalytics.com.

### Institutional Investors Group on Climate Change (IIGCC)

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration involving pension funds and other institutional investors on issues related to the investment implications of climate change. Climate change, and the policy response to it, could have significant implications for pension funds and other investors as it could affect returns over the medium to long term. IIGCC seeks to promote better understanding of the fiduciary implications of climate change and encourage companies and markets in which IIGCC members invest to address any material risks and opportunities to their businesses associated with climate change and a shift to a lower carbon economy. For further information, visit www.iigcc.org.

### Local Authority Pension Fund Forum (LAPFF)

The Local Authority Pension Fund Forum (LAPFF) brings together a diverse range of local authority pension funds with combined assets of over £35 billion. The LAPFF exists to promote the investment interests of local authority pension funds and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest, commensurate with statutory regulations. Formed in 1990, it provides a unique opportunity for discussion of investment issues and shareholder action by Britain's local authority pension funds. For further information, visit www.lapfforum.org.

### The Marathon Club

The Marathon Club aims to stimulate pension funds and their agents to be more long term in their thinking and actions, and place more emphasis on being responsible and active owners with a view to increasing knowledge about how their investment strategy and process can improve the long term financial and qualitative buying power of fund beneficiaries.

The Club has four core objectives:

1. Publish and disseminate a series of practical "how to" (and "why to") briefings which explain how trustees and consultants can foster a more long term and responsible approach.
2. Develop templates for mandates that encourage long term, responsible and active investment approaches.
3. Encourage real funds to award real new mandates or adapt existing mandates and reporting processes accordingly.
4. Supplement other approaches to continuous professional development of trustees, investment consultants and critical other players so they are better able to contribute to the goal.

For more information, please contact Yusuf.Samad@hewittbaconwoodrow.com.

# 6. 'How to do it' Guides to Responsible Investment

Section 6 provides 'how to do it' guides to RI. Section 6.1 to 6.3 have been designed to provide information relevant to all RI approaches (unless stated otherwise), whereas section 6.4 to 6.5 focus mainly on engagement to help enable trustees to act in line with the 2004 proposals from UK Government on Myners Principle 6 (Activism)[34].

## 6.1. Getting Started & Developing High-Level Policy

**Stage 1: Getting Started**
There are a variety of ways by which trustees can find out more and start building support for integrating RI into their pension scheme's investment strategy. See Box 7 for some basic tips on how to get started.

**Box 7: Getting Started – Basic Tips for Trustees**

- Educate yourself about key RI issues. See section 7 for Useful Resources & Links. If you don't understand the jargon, consult the Glossary in Appendix C.
- Complete the self-assessment questionnaire in Appendix A to understand whether your pension scheme meets best practice.
- Encourage other trustees in your pension scheme to read this toolkit and then discuss RI at your next trustee meeting. Discuss the results of the self-assessment questionnaire and discuss whether the scheme should adopt the appropriate best practice first steps outlined in section 4.
- Make allies with other trustees outside your fund about RI and exchange ideas, experience and learning. Even better, invite a trustee from a similar pension fund that has integrated RI into their own pension scheme's investment strategy to your next trustee meeting. Contact Just Pensions or the TUC for contact details of other trustees that have an interest in RI.
- There are numerous trustee networks with regional trustee groups that meet regularly (See section 7 for a list of trustee networks). Suggest that your group addresses RI as one of the topics for discussion. Additionally, your pension scheme, union, training provider and/or investment consultant should be in a position to provide training on RI. Also, ask questions about RI in general training courses on investment.
- Contact the representative at your organisation with responsibility for CSR or related issues. Make sure that they, as a pension fund member, are pushing for an investment strategy that represents the sponsoring organisation/members' values, and that the fund is managed appropriately in terms of SEE/CG risks.
- Ask your fund manager and investment consultants a range of questions on RI (See Appendix B for Questions for Trustees to Ask their Fund Manager and Investment Consultants).
- Some trustees have found that consultants' knowledge on RI varies dramatically from very poor to excellent. If you are unsatisfied with your consultant's response bring this to the attention of the Group Head of Pensions at the investment consultancy firm.
- Your fund managers should definitely have RI specialists and some investment consultants now have staff who specialise in RI too. Make links with these people and ask them to your next trustee meeting to provide advice to you and your fellow trustees. Contact Just Pensions or the TUC for contact details of investment consultants that have staff that specialise in RI. See page 20 for contact details for Just Pensions and the TUC.

**Stage 2: Developing High-Level Policy**
Pension scheme trustees must decide whether they should develop their own policies; adopt industry-wide codes (such as the ISC statement of principles[35]); adopt the fund manager's own policy on engagement and voting; and/or allocate some or all of the pension scheme's assets to specialist approaches on either a pooled or segregated basis. A good consultant will be able to help trustees with this. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

After deciding about the RI policy, trustees will then need to decide whether this should be implemented internally or delegated to a fund manager or service provider. Again, a good consultant will be able to help trustees with this. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

34. HM Treasury (2004) Myners Principles for Institutional Investment Decision-making: Review of Progress: www.hm-treasury.gov.uk/media/DCB/53/myners_principles_web.pdf.
35. Institutional Shareholders' Committee (ISC) (2002) The Responsibilities of Institutional Shareholders and Agents – Statement of Principles: www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.

### 6.2. SIPs, Implementation Policies and Mandates

**Stage 1: Disclosing the Pension Scheme's Responsible Investment Policy in the SIP**
Following the amendment to the 1995 Pensions Act, pension scheme trustees are required to disclose in their statement of investment principles (SIP):

- The extent (if at all) to which social, environmental or ethical (SEE) considerations are taken into account in the selection, retention and realisation of investments; and
- Their policy (if any) in the relation to the exercise of the rights (including voting rights) attaching to investments.

Examples of best practice pension scheme SIPs (for a range of RI approaches) can be found at www.justpensions.org.

**Stage 2: Reflecting the SIP in an Implementation Policy and/or Mandates**
As a SIP only provides the broad framework for a fund's approach(es) to RI, it is essential that trustees design an implementation policy and/or reflect their SIP in some, or all, of their mandates.

An implementation policy usually consists of:

- A more detailed interpretation of the SIP;
- A specification of the method(s) the trustees have instructed their fund manager (or service provider) to employ in implementing the SIP;
- A specification of the fund manager's (or service provider's) reporting requirements; and
- Details of the trustees' activities to monitor fund manager (or service provider) performance and ensure the effective implementation of the SIP.

A copy of a model RI implementation policy can be found at www.justpensions.org.

There are a number of important issues to consider when developing a SIP and reflecting this in an implementation policy and/or mandate. See Box 8 for issues relevant to engagement. For negative and positive screening ask your investment consultant to provide advice on the issues relevant to these approaches.

Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

**Remember: Always consult & seek professional advice**
Trustees have overall responsibility for developing the fund's SIP and associated implementation policy. In doing this, trustees should consult and seek professional advice. For example, in determining any focused areas of activity for the fund, trustees should consult with members and beneficiaries (although they cannot be bound by the results). A number of pension schemes have undertaken such exercises via questionnaires or focus groups. In addition, the scheme's professional advisers, managers and the employing body should be consulted. Several specialist advisers on RI issues are also able to provide ongoing advice or one-off consultancy on developing RI strategies.

**Box 8: Issues to Consider for an Engagement-based Implementation Policy and/or Mandate**

There are a number of important issues that must be addressed and highlighted in an implementation policy and/or mandate based on engagement:

**SIP Interpretation & Objectives**
The pension scheme's SIP must be fully interpreted in the implementation policy and/or mandate, highlighting the objectives of the RI policy. Expectations must be fully explained in order that any initial uncertainties on the part of those expected to operate the policy can be overcome. This can be particularly acute in the case of fund managers whose main business does not include engagement on SEE/CG issues.

**Scope & Process**
Trustees need to be clear about the scope of the SIP and the methods and processes to be used to implement the policy. This could include identifying:

- The criteria for selecting companies for engagement;
- The focus for engagement activities – this is usually where the pension scheme has the greatest investment exposure (i.e. UK equities);
- The scope of issues to be raised through engagement;
- The engagement strategy (letters, meetings, any escalation process), frequency of meetings and types of follow-up;
- Any exceptional strategies such as AGM attendance or shareholder resolutions;
- The types and sources of research to be used.

**Programme of Activity (General and Priority)**
If engagement has been identified as an appropriate strategy, trustees will already have decided that SEE/CG issues are relevant for the scheme. However, such discussion may only have been undertaken at a general level. In recognition that the number of potential issues is very wide, it is usual for pension schemes to identify priority areas and within these to identify particular issues they wish to pursue. For example, the environment in general may be a cause for concern, requiring reporting on the specific case of carbon emissions. Another example would be a concern for human rights issues in general, with a specific focus on how they are affected by supply chain management.

**Dealing with Conflicts of Interest**
Trustees need to recognise that their fund manager may face conflicts of interest through a variety of causes. They could find themselves engaging with a company whose pension scheme they manage or wish to manage. They could also be undertaking engagement with the management of a particular company, where their corporate finance arm provides advice. Pension schemes too may face difficult situations if they are raising an issue that has not been addressed by the scheme's own sponsoring company. A statement as to how these situations will be dealt with should be included in the implementation policy and/or mandate.

**Measuring the Success of Engagement**
Shareholder engagement strategies can often involve lengthy discussions about issues that do not have a simple resolution. Other institutions may be involved in dialogue on the same issue and companies may also be subject to pressure from NGOs, customers and the press. As the number of stakeholders undertaking engagement grows, simple causality for particular changes in company behaviour will become increasingly hard to prove. Nevertheless, the scheme must be clear about how it will assess progress and make decisions on future engagement with particular companies.

### 6.3. Fund Manager Selection

Whichever RI approach your pension scheme decides to adopt, the process of fund manager (or service provider) selection is critical. This does not necessarily mean you have to change your fund managers as they could have the ability to meet an RI policy, but it is important to assess this at the outset.

However, changing fund managers may bring more benefits in terms of choice.

**Fund Manager Selection: Engagement & Voting Approaches**
Trustees should seek professional advice from investment consultants and formally request that their consultants evaluate fund managers with respect to their engagement capability and performance. Trustees should also ask potential fund managers or service providers questions about their approach to engagement and voting (See page 22). In addition, trustees should also assess how potential fund managers (or service providers) are responding to the pilot Eurosif Transparency Guidelines for Engagement & Voting. The pilot version of these guidelines was compiled by a group of members and affiliates of Eurosif (including UKSIF members) and aims to provide a consistent framework for disclosure to trustees (See Box 9). Investment consultants could also use these guidelines as a template for comparison with their own fund manager evaluations.

**Box 9: Basic Framework for the Eurosif Transparency Guidelines on Engagement & Voting (Pilot Version)[36]**

**1. Policy**
Respondents are invited to provide information about their organisation's engagement and voting policy.

**2. Inputs**
Respondents are invited to provide information on the human and other resources used to implement their engagement and voting policy.

**3. Procedures**
Respondents are invited to describe the procedures used to implement their engagement and voting policy.

**4. Outputs**
Respondents are invited to provide information on their voting and engagement activity over the reporting period.

**5. Disclosure and Reporting**
Respondents are invited to describe their engagement and voting disclosure to clients and other stakeholders.

Copies of the pilot guidelines are available at www.eurosif.org/transparency-guidelines-engage and in the pocket at the back of this toolkit.

Industry wide information is also becoming more readily available. The Trades Union Congress (TUC) has expanded the number of questions it asks fund managers on engagement in its annual Voting Survey[37] and the largest investment consultants are also starting to assess fund managers in these areas (Watson Wyatt has recently announced that they have assessed a number of leading fund managers' 'effectiveness as owners'[38] and fund manager assessments from Mercer Investment Consulting are due later this year[39]). Trustees could cross-check how proposed fund managers or service providers perform in these evaluations and surveys.

**Fund Manager Selection: Screened Funds and Specialist Mandates**
For those pension schemes that want to select a fund manager for a screened pooled fund or specialist mandate, ask your investment consultant for advice. Contact Just Pensions or the TUC for contact details of specialist consultants if your normal investment consultants are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

36. Eurosif (2004) Transparency Guidelines for Engagement and Voting in Institutional Investment – Pilot Version: www.eurosif.org/transparency-guidelines-engage.
37. Trades Union Congress (2004) TUC 2004 Fund Manager Survey: www.tuc.org.uk/economy/tuc-8098-f0.pdf.
38. Watson Wyatt (2004) Press Release: Watson Wyatt Assesses Fund Managers' 'Effectiveness as Owners', 15 December 2004: Contact Tim Currell at tim.currell@eu.watsonwyatt.com for further information.
39. Mercer Investment Consulting: Contact Claire Blackwell at claire.blackwell@mercer.com.

### 6.4. Assessment and Review

The assessment and review of a scheme's RI policy and any fund managers or service providers is essential.

**Assessment and Review of the SIP and Implementation Policy**
Trustees should formally review the scheme's SIP and its implementation policy on a regular basis in order to identify any necessary changes in approach. This would normally take place annually and/or after the occurrence of a major market development, such as the publication of new guidelines or regulations.

**Assessment and Review of Fund Managers (or Service Providers)**
Trustees should also formally review the performance of their fund manager(s) or service provider(s) on an annual basis to ensure that they are delivering on the objectives specified in the SIP and implementation policy/mandate. For engagement and voting, the Eurosif Transparency Guidelines[40] will provide useful information, as will league tables on shareholder activism such as the Watson Wyatt[41] and Mercer[42] rankings. Alternatively, trustees may wish to consider a periodic independent review of engagement and voting activity undertaken on the fund's behalf in order to ensure that activity as reported accords with that actually undertaken.

**Trustees Competencies in SEE/CG issues**
The Pensions Act 2004 requires that trustees must have sufficient knowledge and understanding of pension and trust law to run their schemes properly. For trustees to be able to confidently assess fund manager and/or service provider performance on RI, trustees dealing with corporate governance and corporate responsibility must have the relevant skills and experience to ensure that:

- the scheme complies with the provisions of its SIP and implementation policy and;
- the fund manager and/or service provider carries out its activities in compliance with the provisions of the SIP and implementation policy.

In February 2005, the Occupational Pensions Regulatory Authority (Opra) published scope guidance for both DB and DC schemes on the topic of trustee knowledge and understanding[43]. In particular, the guidance includes a specific reference to RI and CG in relation to the scheme's SIP and the scheme's statement of compliance with the Myners Principles. The Pensions Regulator, which will replace Opra on 6 April 2005, will issue a code of practice on trustee knowledge and understanding, which will set out how trustees can comply with the legislation. The scope documents will complement the code and will be published alongside it.

Investment consultants and trustee training providers should be able to provide training on RI and SEE/CG issues.

Contact Just Pensions or the TUC for contact details of training providers if your normal providers are unable or unwilling to help. See page 20 for contact details for Just Pensions and the TUC.

40. Eurosif (2004) Transparency Guidelines for Engagement and Voting in Institutional Investment – Pilot Version: www.eurosif.org/transparency-guidelines-engage.
41. Watson Wyatt (2004) Press Release: Watson Wyatt Assesses Fund Managers' 'Effectiveness as Owners', 15 December 2004: Contact Tim Currell at tim.currell@eu.watsonwyatt.com for further information.
42. Mercer Investment Consulting: Contact Claire Blackwell at claire.blackwell@mercer.com.
43. Opra (2005) Trustee Knowledge, Understanding and Conversance – Scope Guidance: http://www.opra.gov.uk/TrusteeKnowledge/Index.asp.

### 6.5. Reporting

**Stage 1: Reporting to Trustees**

In line with the Myners Principles[44], clear reporting mechanisms are absolutely critical. Whether by internal officers, an external agency or by fund managers, reporting on RI activity to trustees is essential for trustees to be able to satisfy themselves that their policy is being carried out consistently and rigorously.

For engagement and integration approaches trustees should be provided with reports on a regular basis or alongside performance reports, detailing aspects of SIP implementation. Again, the Eurosif Transparency Guidelines on Engagement and Voting offer a good starting point[45].

**Stage 2: Reporting to Scheme Members and Beneficiaries**

As well as making sure that the pension scheme's SIP and implementation policy are available to all members of the scheme, reporting to scheme members on performance and engagement activity is also important.

In the HM Treasury's Review of Progress on the Myners Principles[46] (December 2004), the Government proposes to amend Principle 10 (Reporting). In order to improve the quality and availability of information provided to members, the principle will state additionally that trustees should make available assessments of their own performance to the scheme membership. The Government also proposes to establish a working group, chaired by Treasury, with the NAPF and other stakeholders to develop further the practicalities of a voluntary compliance report on the implementation of the Myners Principles, which includes Principle 6 on shareholder activism and engagement. In the review, the Government stated that the reports would contribute to an informed commentary on the quality of compliance, helping establish benchmarks of good practice, providing information to members and other stakeholders, and helping trustees validate their decision-making procedures more effectively.

**Stage 3: Reporting to the Public**

In addition to reporting directly to pension scheme members, the Government states in the HM Treasury Review of Progress on the Myners Principles that reporting should be extended beyond the scheme membership to other stakeholders and the wider public. In particular, the Government proposes that trustees should post on the fund website the key information they provide annually to fund members. For funds with more than 5,000 members, it is good practice to have a website dedicated to the fund. It is considered best practice to extensively disclose the pension scheme's SIP, annual report, voting and engagement activities, as well as holdings on the web. Good practice includes disclosure of the SIP and annual report on the web and perhaps information on the top 10 holdings. The internet is generally a better means of providing information than printed material, for cost and accessibility reasons. As such, good practice is relatively easily attainable by all and best practice is not difficult to achieve[47].

44. Paul Myners (2001) Myners Review of Institutional Investment in the UK: www.hm-treasury.gov.uk.
45. Eurosif (2004) Transparency Guidelines for Engagement and Voting in Institutional Investment – Pilot Version: www.eurosif.org/transparency-guidelines-engage.
46. HM Treasury (2004) Myners Principles for Institutional Investment Decision-making: Review of Progress: www.hm-treasury.gov.uk/media/DCB/53/myners_principles_web.pdf.
47. Mark Mansley (2004) Green Pensions: Reality or Rhetoric? Claros Consulting, London.

# 7. Conclusion, Useful Networks & Resources

The investment landscape is clearly changing for long term investors, such as pension funds; changing for the better. Pension scheme trustees are increasingly recognising the importance and benefits of ensuring that investee companies manage SEE/CG risks and opportunities effectively, as this has the potential to enhance corporate performance and consequently bring substantial benefits to both shareholders and pension scheme members. This coupled with the recent RI related legislation and pressure from UK Government and the numerous codes and guidelines on active share ownership from industry bodies, such as the NAPF and the ABI, provides trustees with a compelling case to integrate RI into their pension scheme's investment strategy.

The toolkit provides best practice first steps for four different types of pension scheme (outlined in section 4), highlights some potential next steps for trustees that may want to pursue RI further and 'how to do it' guides on RI. Just Pensions hopes that this toolkit will help trustees to adopt an RI policy appropriate for their scheme which will enable trustees to maximise long term shareholder value and consequently meet their fiduciary responsibilities, whilst at the same time ensuring that the values of the scheme members are reflected in their investments.

Over 2005, Just Pensions will disseminate this toolkit at a variety of events and conferences. Just Pensions will also work closely with a number of trustee networks through small roundtables, seminars and training events, encouraging trustees to use the toolkit to find out more about RI and to help integrate RI into their pension fund's investment strategy. For further information on the toolkit dissemination, please visit www.justpensions.org. If you would like to talk about Just Pensions presenting the toolkit at an event or to a sub-set of trustees, please e-mail info@justpensions.org or contact 020 7440 9712.

## Useful Networks, Resources & Links

### Useful Trustee Networks

National Association of Pension Funds Trustee Network
Website: www.napf.co.uk/membership/trnetwork.cfm

Pensions Resource Groups
Website: www.prg.org.uk

Pensions Management Institute Trustee Group
Website: http://www.pensions-pmi.org.uk/trustees/trusteegroup/index.asp

Pensions Trustee Circle
Website: www.epfif.com/Pension-committee.asp

TUC Member Trustee Network
Website: www.tuc.org.uk/trusteenetwork

### Useful Resources & Links

Eurosif (2004) SRI Toolkit: 2004-2005: www.eurosif.org

LAPFF (2004) Delegating Shareholder Engagement – Local Authority Pension Funds and Fund Managers – Best Practice Guidelines: www.lapfforum.org

Mark Mansley (2004) Green Pensions: Reality or Rhetoric? Claros Consulting, London: www.claros.co.uk

Trades Union Congress (2004) TUC Fund Manager Voting Survey 2004: www.tuc.org.uk

Trades Union Congress (2004) TUC Shareholder Voting and Engagement Guidelines: www.tuc.org.uk

Universities Superannuation Scheme (USS) How to be a Responsible Pension Fund: www.usshq.co.uk

### Useful Contact Details

If you want to find out details for specialist investment consultants, other trustees that have an interest in RI, further information about the trustee networks or specific RI resources, please contact Just Pensions or the TUC, using the following contact details:

Just Pensions
Contact: Cassie Higgs
Tel: 020 7440 9712
E-mail: cassie.higgs@justpensions.org

Trades Union Congress (TUC)
Contact: Tom Powdrill
Tel: 020 7467 1201
E-mail: tpowdrill@tuc.org.uk

# Appendix A: Self-Assessment Questionnaire for Trustees

*This self-assessment questionnaire helps trustees to determine whether their pension scheme meets best practice standards, as advocated by the Government and industry associations, such as the NAPF and the ABI (see section 2 for a summary of recent regulatory and legislative developments).*

Each question should be answered with a simple "yes" or "no". At the end of the questionnaire add up how many "yes" scores you have to see how well your pension scheme meets best practice.

1. Have you and your fellow trustees discussed the importance of SEE/CG risks and opportunities in relation to shareholder value?

2. Have SEE/CG issues been included in your scheme's SIP?

3. Have you already implemented the best practice first steps highlighted in this toolkit for your particular type of pension scheme?

4. Is your scheme's SIP reflected in your fund manager implementation policies/mandates?

5. Do you formally review the scheme's SIP and its implementation policy on a regular basis?

6. Do you disclose and report on the implementation of your RI policy?

7. Does your SIP acknowledge that the scheme complies with the ISC statement of principles?

8. Is the ISC statement of principles incorporated into fund manager mandates?

9. Do you report on the compliance and implementation of the Myners Principles?

10. Do you make performance assessments available to the scheme membership?

11. If the scheme has over 5,000 members is there a website dedicated to the fund and if so, is the information provided annually to fund members available on the scheme's website?

12. Do all trustees of the scheme have a copy of the Opra scope guidance on the topic of trustee knowledge and understanding?

13. Do you and your fellow trustees have sufficient knowledge to understand your scheme's SIP?

14. Do you and your fellow trustees have sufficient knowledge to understand your scheme's statement of compliance with the Myners Principles?

15. Has at least one of the trustees on the board had trustee training on SEE/CG issues and RI?

16. Have you consulted with pension scheme members about the scheme's approach to RI?

17. Have you consulted with the employing body about the scheme's approach to RI?

18. Do you formally review and assess fund managers or service providers on an annual basis to ensure that they are delivering on the RI objectives specified in the SIP and implementation policy/mandate?

19. If your chosen approach is engagement, do you select and assess your fund managers using the Eurosif Transparency Guidelines for Voting and Engagement and do you and your fellow trustees regularly ask fund managers questions about their resources, procedures and reporting?

20. Do you regularly ask your investment consultants questions about the assessment and reporting of fund managers and reviewing your SIP/implementation policy?

21. Do you publicly and extensively disclose the pension scheme's SIP, annual report, voting and engagement activities, as well as holdings on the web?

22. Have all your fellow trustees read this RI trustee toolkit?

### Assessment

**15 or more "yes" scores: Congratulations** – your scheme is currently at the stage in which it meets best practice advocated by the UK Government and industry associations, such as the NAPF and the ABI. Of course, you will need to go further as best practice and the industry develop.

**8 to 14 "yes" scores: Not too bad, but could do better** – your scheme is achieving good practice, but you could make a few changes to improve and attain best practice.

**7 or fewer "yes" scores: Oh dear, you could do a lot better** – So make sure that you implement the first steps in this toolkit and use the 'how to do it' pages as a guide.

# Appendix B:
# Questions for Trustees to Ask about Engagement-based RI

Box 10 and 11 contain a list of questions for trustees to ask their fund managers, service providers and investment consultants about engagement-based RI. In addition to these questions, the TUC provides a list of questions for trustees to ask their fund manager in their quarterly TUC trustee newsletter[48] and the Just Pensions sector note series also provides a list of questions to ask fund managers[49].

To begin with, trustees might want to prepare questions on a few issues where they are sure of their ground and able to substantiate their arguments. This allows them to challenge fund managers, service providers and investment consultants if necessary. For example, this toolkit highlights that the UK Government considers it best practice for trustees to comply with the ISC statement of principles and ensure that these principles are incorporated into fund manager mandates. So trustees could ask their investment consultants and fund managers their position on this and challenge them if their answer is not in line with the UK Government's position on shareholder activism best practice. If answers are baffling and full of jargon, trustees should ask for explanations in simpler language.

**Box 10: Questions for Trustees to ask their Fund Manager (or Service Provider)**

**Policy**
- Do you have an overall policy on engagement and voting encompassing SEE/CG issues? How does it differ from the ISC statement of principles?
- How is your analysis of SEE/CG issues and the information you find out from engagement incorporated into investment decision-making?
- How do you manage conflicts of interest between client specific policies and your general engagement and voting policies?

**Resources and Procedures**
- What internal and external resources are used to implement engagement and voting policies?
- What procedures are used to implement the engagement and voting policies?

**Review and Reporting**
- What engagement and voting activities have you carried out over the last reporting period?
- How do you assess the effectiveness of your engagement and voting activities?
- How do you disclose and report on your engagement and voting activities to trustees and what issues do you generally cover?
- How frequently do you disclose and report on your engagement and voting activities to trustees?

**Box 11: Questions for Trustees to ask their Investment Consultant**

**Policy**
- As long term investors, we are interested in how we can take account of SEE/CG issues. Should we develop our own engagement policy; adopt the ISC statement of principles; or adopt the fund manager's own policy on engagement and voting?
- If we adopt an engagement and voting policy, do you think we should implement this ourselves or delegate this to a fund manager or third party?

**Mandates & Selection**
- Fund Manager A currently has X, Y & Z mandates and has said they manage conflicts of interests between these different clients in the following ways? Does this sound sufficient to you?

**Review and Reporting**
- Have there been any major market developments, such as the publication of new guidelines or new regulations that we should incorporate into our SIP and/or implementation policy? Please incorporate these market developments as part of our next trustee training seminar.
- How are you assessing our fund managers against the ISC statement of principles?
- Have the activities and reporting of fund manager X on voting and engagement improved in line with developments in the transparency guidelines[50] and league tables[51,52].

48. Trades Union Congress (TUC) Member Trustee Newsletters: www.tuc.org.uk/trusteenetwork.
49. Just Pensions Sector Note Series: www.justpensions.org.
50. Eurosif (2004) Transparency Guidelines for Engagement and Voting in Institutional Investment – Pilot Version: www.eurosif.org/transparency-guidelines-engage.
51. Watson Wyatt (2004) Press Release: Watson Wyatt Assesses Fund Managers' 'Effectiveness as Owners', 15 December 2004: Contact Tim Currell at tim.currell@eu.watsonwyatt.com for further information.
52. Mercer Investment Consulting: Contact Claire Blackwell at claire.blackwell@mercer.com.

# Appendix C:
# Responsible Investment Glossary & List of Acronyms

## Responsible Investment Glossary:

**Avoidance**
See Negative Screening.

**Best-in-Class**
Best-in-class refers to selecting the companies that are best in their industry in relation to SEE/CG issues, whilst still meeting financial performance criteria.

**Corporate Governance**
Corporate Governance covers the accountability and control mechanisms that govern the relationships among shareholders, management and stakeholders of a company.

**Corporate Social Responsibility**
Voluntary commitments made by companies to contribute to sustainable economic development.

**Collaborative Engagement**
Engagement strategy conducted collaboratively with multiple pension funds and/or fund managers in order to gain leverage.

**Divestment**
When companies are sold from a fund portfolio because they no longer meet the Responsible Investment criteria for that fund or for purely financial reasons.

**Engagement**
Engagement also known as "shareholder activism" refers to the processes through which investors seek to improve a company's SEE/CG performance.

**Exclusion**
See Negative Screening.

**Integration**
Integration occurs when active fund managers include potentially material SEE/CG risks and opportunities into the normal investment analysis and stock selection processes.

**Negative Screening**
Negative Screening also known as "exclusion" or "avoidance" refers to the exclusion of stocks and shares from investment portfolios on SEE/CG grounds.

**Positive Screening**
See Positive Selection.

**Positive Selection**
Positive Selection also known as "positive screening" or "support" is a process by which investors select companies that have superior SEE/CG performance.

**Responsible Investment**
Responsible Investment combines investors' financial objectives with their concerns about SEE/CG issues.

**Shareholder Activism**
See Engagement.

**Socially Responsible Investment**
See Responsible Investment.

**Support**
See Positive Selection.

**Thematic Investment**
Thematic investment refers to the selection of companies with a commitment to chosen responsible business products and/or services, such as environmental technologies.

**Voting Rights**
The exercise of voting rights for investors to influence company policy. Voting is often used as an engagement mechanism.

## List of Acronyms:

| | |
|---|---|
| ABI | Association of British Insurers |
| AGM | Annual General Meeting |
| CG | Corporate Governance |
| CSR | Corporate Social Responsibility |
| DB | Defined Benefit |
| DC | Defined Contribution |
| ERISA | Employee Retirement Income Security Act |
| EUROSIF | European Social Investment Forum |
| ISC | Institutional Shareholders' Committee |
| LAPFF | Local Authority Pension Fund Forum |
| NAPF | National Association of Pension Funds |
| OPRA | Occupational Pensions Regulatory Authority |
| RI | Responsible Investment |
| SEE | Social, Environmental and Ethical |
| SEE/CG | Social, Environmental, Ethical and Corporate Governance |
| SIP | Statement of Investment Principles |
| SRI | Socially Responsible Investment |
| TUC | Trades Union Congress |
| UKSIF | UK Social Investment Forum |

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