UK Social Investment Forum (UKSIF)
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delivered by

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Socially Responsible Investment: Should Pension Funds Care?

1. I am honoured to have been invited to deliver UKSIF's Annual Lecture this year. My subject is 'Socially Responsible Investment: Should Pension Funds Care?' Woody Allen once said 'Eighty percent of success is showing up'. On that basis, I'm home and dry with my audience tonight before even saying anything. Perhaps I should quit while I'm ahead…..

2. I suspect the reason why you have me standing before you tonight is that Helen Wildsmith and Tony Colman put me on the spot some months ago when they asked me to do this. They knew only too well that the National Association of Pension Funds did not have an explicit policy for Socially Responsible Investment, and that by inviting me to give this lecture we would jolly well have to develop one. And we will very shortly be publishing just that.

3. But first, let me tell you a bit about me and, more importantly, about the NAPF.

4. I started off life as – believe it or not – an ecologist. I was part of the first 'green revolution' of idealistic young things in the late sixties (the Beatles' apple was also green), and gained two degrees in conservation before going to work for the Countryside Commission in 1972. I was completely and utterly committed to sustainable development, biodiversity, and the like years before such terms became part of common parlance in the investment community. Certainly long before John Prescott found out what they meant! The Friends of the Earth Newsletter still thuds on my doormat every month.

5. But that's my personal politics. My job now is to run the NAPF - a not-for-profit, member-based association which represents about 90% of UK pension funds by size of assets and membership. The NAPF has around 25 staff, who carry out policy and representational work and provide services to members. We hold conferences, provide training, publish guides to legislation, and generally seek to promote good practice across the funded pensions sector.

6. Quite a chunk of our work relates to pension fund investment and related issues. Our aims here are

   1) to lobby the UK government, Brussels, regulators, accounting standard setters and others to encourage an economic, fiscal and regulatory environment which is conducive to funded pensions saving;

   2) to promote the efficient and effective investment of pension funds, in order to optimise the amount of money available to finance pensions; and

   3) to promote good practice in pension fund investment, in line with market developments.

7. The NAPF elects an Investment Council from amongst its members every year which takes the policy decisions on these issues.

8. Pension fund assets in the UK are worth around £750bn – so pension funds represent a very significant institutional investor class. Under UK law it is the trustees of schemes who are responsible for deciding how those funds should be invested. Trustees have a legal duty to act in the best financial interests of the beneficiaries of their scheme and to exercise prudence, care (the C word) and diligence in matters affecting the fund.

9. Trustees have full legal powers to invest the fund's assets but must do this in a prudent and diversified way and take expert advice where appropriate. They have, since 1997, been required to prepare a Statement of Investment Principles (SIP). Since 2000 the SIP has to include the trustees' policy, <u>if</u> they have one, on socially responsible investment and on voting their shares.

10. Around 70% of pension scheme assets are invested in companies one way or another. 66% are currently invested in equities (37% in the UK, 29% overseas). A further 5% of funds are invested in corporate bonds.

11. With equity investments – stocks and shares – the owners of the shares are the owners of the company. Shareholders, particularly institutional shareholders, can have considerable influence over the direction and oversight of the company: quite rightly, as it is their own capital that is at risk. They have voting rights at AGMs and EGMs and other rights enshrined in Company Law which, provided they exercise them wisely, can help them mitigate the risk in their investment.

12. Because of the importance of equity investments to pension funds, NAPF has for many years provided advice and guidance to its members on corporate governance matters. It is our view that good standards of corporate governance are in the interests of companies themselves: they enable them to manage their risks and make better strategic decisions in the interests of their long term success. Good corporate governance is also in the interests of their shareholders, who are more likely to see sound long-term returns on their investments if good practice is consistently applied.

13. For 15 years we have provided voting analysis and recommendations to our members. Last year, after a thorough review, we upgraded our corporate governance activity in three ways:

   1) We set up a new company – RREV – to provide research, voting recommendations and electronic voting as a one stop service to UK customers, taking over from our former Voting Issues Service;

   2) We revived our Case Committees, whereby NAPF facilitates meetings of institutional investors, and engagement with individual companies, where there is significant concern over either a corporate governance matter or the strategic direction of the company; and

3) We completely overhauled our corporate governance policies.

14. The result of this latter policy review was a new statement of Principles for pension funds on corporate governance matters, published January 2004 (and reviewed a year later). We have set out 9 Principles altogether, and I will read out those most relevant to tonight's discussion.

"Shareholders in aggregate are the owners of Companies, and Boards are their agents."

"Shareholders as owners should recognise that they have responsibilities to monitor and normally support the work of the management of companies in which they invest. Good corporate governance is about dialogue and the promotion of success. Confrontation is a sign of failure by owners or Boards or, sometimes, both."

"One of the duties of owners is to allow company Boards to manage the businesses which have been entrusted to their care without excessive interference. The NAPF robustly supports the Combined Code in its entirety and wishes to add minimal requirements to that body of work."

"It is the duty of Boards, as the agents of the owners of Companies they manage, to set out their interpretation of the objectives, aspirations and culture of the Company in order that the shareholders can let it be known whether they share and accept these views."

"At all times the Board and management should be mindful of the wider perception of the Company in society, bearing in mind that maximisation of short-term gain in a manner which is deemed unacceptable by society as a whole can seriously damage the longer-term prospects of a Company."

15. So where does all of this leave Socially Responsible Investment? Some argue – quite loudly – that institutional investors, especially pension funds who are in it for the long haul, should take full account of social, environmental and ethical considerations in their investment decisions. Some would put such issues on a par with corporate governance. This is, we believe, a serious mistake. As I shall explain, we believe that Corporate Social Responsibility, to the extent that it is relevant, is an important internal company discipline which should form an integral part of investment, not governance, analysis.

16. This winter the NAPF carried out a full review of its stance towards Socially Responsible Investment and Corporate Social Responsibility. We think there is an important distinction to be made between SRI/CSR and corporate governance.

17. Corporate governance deals with an area where the agency problem clashes with conflicts of interest. Ownership of public companies, being widely dispersed, could permit (and unfortunately, in a number of high profile cases, has permitted) the managers to abuse their position as agents of the owners. The UK framework of Codes coupled with the "comply or explain" regime has, the NAPF believes, allowed UK investors to build in a framework of protection without inhibiting entrepreneurial flair.

18. This is why the NAPF has taken an active corporate governance role alongside other groups such as the ABI. In the absence of a strong stand being taken by the ABI and the NAPF, it is doubtful that a robust corporate governance framework would have developed without legislation, as this is not generally seen as a normal investment issue amongst investment analysts.

19. Corporate Social Responsibility, on the other hand relates to the notion that the Boards of companies have responsibilities to society at large and to various stakeholder groups. These responsibilities can be analysed into two distinct elements as follows:

(i) those responsibilities which constitute an integral part of the duties which a Board needs to fulfil in order to succeed in business and/or are imposed on the Board by legislation; and
(ii) those responsibilities which go beyond the duties imposed on a company by legislation and beyond the requirements for financial success.

20. As I suggested earlier, I believe that unlike Corporate Governance, which is a framework for management accountability, Corporate Social Responsibility – where actions or lack of them could have a direct impact on a company's success and so on its value for shareholders – is a fundamental part of the normal running of a business. It can and should be delegated to management, and Boards should be held accountable for their actions in this area by shareholders.

21. This is in line with the recently published Company Law White Paper which makes it clear that Directors must promote the success of the company for the benefit of its shareholders but that this can only be achieved by taking due account of both the long term and the short term, together with wider factors such as employees, effects on the environment, suppliers and customers.

22. As such, the NAPF believes that all Boards should develop their own Corporate Social Responsibility policies which they should disclose to investors. Such policies should be relevant to the business they're in. So, for example, a major oil company will consider issues such as ecological damage and pollution as a result of its exploratory, extraction and transmission activities. Investment analysts (buy-side and sell-side) should include a review of this material as part of their mainstream analysis of businesses.

23. Similarly the NAPF believes that Socially Responsible Investment should be seen as an integral part of the normal investment management process: but <u>only</u> to the extent that it encompasses matters which the Board needs to address to be a successful business and comply with the law. In this sense we fully support the proposed revisions to the Myners Principles recently proposed by the Treasury – that Trustees should ensure that the principles on Responsibilities of Institutional Shareholders and the Agents set out by the Institutional Shareholders' Committee should be incorporated into fund managers' mandates. Trustees should ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company, the approach they will use, and how they will measure the effectiveness of this strategy.

24. The NAPF recognises that there are occasionally issues relating to time-scale inasmuch as the time horizon of a mainstream analyst is often shorter than the possible adverse Corporate Social Responsibility outcomes, especially as regards environmental issues. Consequently the NAPF urges trustees to ensure that their investment managers take all of these issues into account. Trustees should find out how their investment managers do their research in <u>all</u> areas, but particularly in analysing long-term risks and opportunities for companies.

25. Trustees meet face-to-face with investment managers at least annually, sometimes more frequently. They are also advised by investment consultants and there are, thus, several opportunities to make CSR issues part of the agenda. The larger schemes also set topics for a number of managers to address at intervals, less frequently than annually, and CSR can again be considered here. Trustees should know in which companies they invest. Some pension schemes, particularly in the local government sector, can set significant CSR agendas – Lothian Pension Fund in Edinburgh, for example.

26. This stance is in line with NAPF's high level Principles for corporate governance that I alluded to earlier. NAPF also supports the introduction of OFR disclosures which will highlight more of these sorts of issues across more companies.

27. On wider issues which do <u>not</u> impact the value of a company to investors, I can do no better than quote a recent Economist leading article, with which we are in agreement.

> "The proper guardians of the public interest are governments, which are accountable to all citizens. It is the job of elected politicians to set goals for regulators, to deal with externalities, to mediate among different interests, to attend to the demands of social justice, to provide public goods and collect the taxes to pay for them, to establish collective priorities where that is necessary and appropriate, and to organise resources accordingly.
> The proper business of business is business."

28. Where does this leave us? Clearly with plenty that we still can – and should – do.

29. Firstly we welcome market initiatives like that of the Marathon Club, who are developing innovative approaches to long term pension fund investment; and the Enhanced Analytics venture, which is encouraging ways to incorporate non-financial issues into sell-side research and analysis where it is felt these could have an impact on long term investment performance.

30. Secondly, our corporate governance Principle, that companies should be mindful of the wider perception of them in society, bearing in mind that maximisation of short term gain in a in a manner deemed unacceptable longer term prospects of a company, is one we take seriously. Where appropriate, it is considered when we convene Case Committees, and when RREV applies NAPF policies in giving voting advice.

31. We do not believe it would be helpful to companies or their owners for NAPF to add to the proliferation of advisory services, codes and guidance by producing a more detailed interpretation of this Principle. Rather we will encourage RREV, our voting and corporate governance advisory service, to consider making appropriate specialised services in this area available on its website for use by professional investors and pension funds.

32. Thirdly, many consumers hold strong views about Socially Responsible Investment, and have every right to do so. In a world that is increasingly moving to defined contribution pension provision, trustees and those contracting with product providers should seriously consider the choice of investment funds available, understand the needs and wishes of members/customers, and seek to offer the option of an ethical fund where there is a demand for it.

33. I hope tonight I have been able to explain NAPF's position on this important issue to you, and convinced you that our stance is a considered and responsible one. Our main concern is – and must remain – the performance of pension fund investments, so as many people as possible can continue to benefit from well-managed, well-funded pension schemes when they retire. 'Caring' is something which I do as a private individual. Pension funds, on the other hand, have clear legal duties to discharge on behalf of their members. Political preferences, sentiment, and a desire to change the world do not sit easily with those duties. But a long term view of investment in successful businesses does.

Thank you.