Investing in a sustainable tomorrow

ESG integration in European pensions

Building a better working world

Who should read this report, and why

Addressing environmental, social and governance issues are crucial to meeting the investment needs of current and future generations. This paper examines the use of these factors by European pension investors.

As long term investors, pension funds should be well placed to benefit from incorporating Environmental, Social and Governance (ESG) factors into their investment decisions. But in reality, many European funds – while increasingly interested in the potential of ESG – have yet to fully capture these benefits.

That is why we have produced this paper. It not only reflects the views of our own professionals but also of some of Europe's leading adopters of ESG investing – which we define, in this paper, as weighing ESG factors equally alongside financial considerations. Our goal is to help European pension funds to grasp the potential benefits of ESG investment, and to avoid the potential risks of inaction. We hope the report will be of practical use not only to pension funds, but also to the organizations that help them achieve their goals.

The methodology of our research process involved:

- Conducting a desk-based review of academic literature, commercial research, public sector reports and industry publications.
- Seeking out and analyzing the views of EY subject matter professionals on pensions, investment, ESG and sustainability from across our EMEIA member firms.
- Interviewing a number of external experts from third party organizations focusing on identifying and understanding best practice. This included representatives from several large European pension funds that already make significant use of ESG investing. The interviews took place between April and June 2017.

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1. Our focus on "sustainable performance"

Why this issue matters

Pension funds' long term horizons mean they are ideally placed to benefit from ESG investing, and a number of large European funds already find value in the use of ESG factors. However, studies suggest that many funds have so far been slower to adopt ESG investing than other institutional investors[i].

This apparent reluctance may reflect some misunderstandings about ESG. Many pension fund trustees seem to believe that ESG investing limits diversification, leads to underperformance or conflicts with their objectives. That might explain why many pension funds are yet to fully realize the potential benefits of ESG.

What this paper addresses

This paper begins by considering the arguments for European pension funds to adopt ESG investing. These include a number of industry developments and regulatory requirements. Arguably, it is the potential long term investment benefits that carry the greatest weight – both in terms of risk reduction and, potentially, of outperformance. However, we also examine the practical barriers that make it difficult for many pension funds to explore the growing business case for ESG investing.

This is followed by some recommended best practices on how European pension capital could make better use of ESG investing. Some of the most important themes are the need for understanding, clarity, logic, collaboration and co-ordination. Europe's pension funds are continually improving their understanding and management of risk and return. We see the evolution of ESG investing as an important element of this process. We also expect ESG adoption to increase.

In our view, pension funds – and other investors – should ultimately aim to integrate ESG considerations into their everyday activities. But our research suggests that that goal remains far off for many. We see many practical steps that funds of all sizes can take towards this goal. So the paper concludes with a list of suggested actions for individual funds, based on our research and drawing on the best practice of experienced ESG investors.

How we define the issue

The use of ESG factors should not be distinct from everyday investment practices. On the contrary, we believe it should ideally become "business as usual" for all investors. But for the purpose of this paper, we use the term "ESG investing" to describe the issue.

The acronym "ESG" is often confused with distinct concepts such as impact investing. In this paper, we define "ESG investing" as considering the impact of environmental, social and governance factors – including as part of a strategy of active ownership – but without prioritizing them above traditional financial goals. In our view, the ultimate rationale for ESG investing is simply to better understand investment risks and maximize long term investment returns.

We have focused on occupational "Pillar II" schemes, typically sponsored by companies, local authorities, unions or industry bodies. That includes defined benefit (DB) and collective defined contribution (DC) schemes, whether managed by trusts or administered by insurers and asset managers. Unless otherwise indicated, we exclude public schemes (Pillar I) and personal insurance products (Pillar III).

How ESG Investing varies across Europe's pension markets

Whilst this paper is not a market-by-market review, it is worth highlighting a few national variations.

For example, ESG adoption is comparatively common in the Netherlands and Nordic countries. One recent study showed that 90% of Dutch pension funds have adopted some elements of ESG investing[ii].

In contrast, ESG investing is less widespread in two of Europe's other large pension markets, the UK and Switzerland. Even so, both markets are innovative and a few individual funds stand out as ESG adopters. The use of ESG factors is also comparatively immature in countries such as France, Germany, Spain and Italy.

We see the most important drivers of these national variations as:

- **Levels of concentration:** For example, there are 20 pension providers in Denmark, but more than 40,000 schemes in the UK[iii].
- **Regulation:** Many institutional investors in Belgium, Denmark, France, the Netherlands and Sweden are required to disclose their approach to ESG investing; however those in Finland, Poland, Slovakia and Switzerland are not required to do so[iv].
- **Investment practices:** For example, professional funds in France invest relatively heavily in government bonds.
- **Structural features:** For example, many German companies hold pension liabilities on their balance sheet.
- **Legal differences:** For example, the UK system is based on common law, but many Western European countries rely on civil codes.
- **Variations:** For example, in the level of member consultation on ESG investing.

We return to several of these factors later in the paper.

The European pensions landscape

Denmark
Sometimes described as the world's "best pension market", Denmark has a large, well-funded system comprised of a public pillar, a statutory occupational scheme, and a range of voluntary occupational and voluntary private schemes. The average size of voluntary occupational schemes is comparatively large, and strong member engagement is a feature of the system. These factors have helped to drive relatively widespread adoption of ESG investing.

France
The French pension system relies heavily on pay-as-you-go public provision. Some industries operate pension funds, but these are usually run by insurers. As such, the effects of Solvency II tend to discourage the large scale equity investment, limiting the adoption of ESG investing. Instead, pension assets are dominated by government bonds.

Germany
The German market features a strong public pillar but a fragmented occupational pension sector. Occupational funds may be managed on sponsor's balance sheets ("direct promise"), via insurance policies taken out on behalf of employees ("direct insurance") or via Contractual Trust Agreements. In addition, Pensionskasse and Pensionfonds are typically hosted by insurers. This complexity leads to small average fund sizes. So, despite the strength of the German Green movement, comparatively little pension capital has adopted ESG investing.

Netherlands
The Netherlands' industry-based pension funds are among the world's largest. A number of leading schemes use captive investment advisors for their consulting and management needs. Some of these advisors also oversee external funds. The overall effect is to concentrate knowledge and expertise; this, together with political and corporate support, has helped to encourage high levels of ESG investing.

Sweden
Per capita, Sweden's pension system is one of Europe's biggest. The public pension comprises a segregated pay-as-you-go scheme, a premium pension scheme and a means-tested pension. Defined benefit occupational schemes often remain on sponsor balance sheets, with or without a corresponding pension fund, but with insurance against deficits and defaults and with nationally agreed benefits. This centralization has helped to facilitate ESG adoption by pension investors.

Switzerland
The Swiss market falls outside EU regulations, although Swiss insurers and investment managers have significant international operations. Domestic occupational schemes are relatively fragmented, with large and medium-sized companies holding assets and liabilities in a subsidiary – often without professional management. Average levels of ESG adoption are low, but some funds have elected to co-operate over ESG investing.

UK
The UK's long-established pension market is large and complex, reflecting periodical reviews and actions by different governments. One recent development was the introduction of auto-enrolment for most employees. The occupational pillar is dominated by a host of DB schemes, increasingly closed to new members. Many are small and struggle to overcome the limitations of their size when trying to implement ESG. DC scheme assets are now growing rapidly and beginning to offer more flexibility for members to select ESG themed funds.

2. Key Observations: A complex, fast-changing picture

The drivers of ESG investing for European pension funds and some of the major barriers to adoption.

A combination of developments are pushing ESG investing up European pension funds' agendas. We group what we see as the most important drivers into three areas:

External requirements

Regulation addressing ESG themes has developed rapidly in recent years. There are now nearly 300 pieces of ESG-related investment regulation worldwide[v]. In the EU, the IORP II Directive[vi] requires pension schemes to consider ESG and to disclose their approach. The Non-Financial Reporting Directive puts new requirements on listed insurers and, in markets like the Netherlands, on large pension schemes. National regulators are also putting more focus on ESG investing. Regulation is rarely transformative on its own, but it is helping to increase awareness and debate around ESG investing. As Graeme Griffiths, Director of Global Networks and Outreach for UNPRI puts it: "Quite a lot of institutions find regulation ineffective, owing to different interpretations in different markets. But research we have done suggests that regulation does have a positive effect on levels of disclosure".

Recent years have also seen new **legislation**, especially in the environmental sphere. Most of this is aimed at corporations and asset managers. France's Article 173 is one example that requires specific climate change disclosures from institutional investors. Legislation outside Europe can also have an indirect effect. California's requirement for the state's public sector retirement schemes CalPERS and CalSTRS to divest companies generating half their revenue from thermal coal[vii] is a case in point.

Lastly, European pension funds are influenced by **supra-national initiatives**. One example is the Paris Agreement on climate change, agreed at the COP21 conference in 2015. Another is the set of non-binding standards created by the International Integrated Reporting Council.

Industry developments

Pension funds are sensitive to the actions of other **institutional investors,** such as Norway's oil fund divesting coal stocks in 2015, AXA withdrawing from tobacco stocks in 2016 and Swiss Re's plan to benchmark its portfolio against ESG indices[viii]. Public commitments to ESG investing by large pension funds including Unilever, BT, Philips and the UK Environment Agency have also affected thinking in the sector. The growth of the UN's Principles for Responsible Investment (PRI) to 1,500 signatories managing more than US$60tn is another influential factor.

The growing focus on stranded asset risks by a majority of institutional investors[ix] is also increasing pension funds' awareness of the potential scale of ESG risks. Commitments such as the Montreal Pledge, made by 120 institutions managing US$10tn, only serve to highlight these issues.

ESG-related actions by large **corporations** are relevant to many pension funds. HSBC's decision to select a climate-tilted fund as the default for its UK scheme is a notable recent development in the DC space. More broadly, many listed companies are improving their disclosure to give them access to ESG investment capital.

Lastly, many **asset managers** are making transformative investments in their ESG investing capabilities, including the emergence of ESG-tilted passive products. This trend is highlighted in BlackRock CEO Larry Fink's 2017 letter to CEOs[x], not to mention the efforts of many European asset management bodies to promote ESG investing.

Fiduciary evolution

Pension funds in common law jurisdictions such as the UK and Ireland are under a fiduciary duty to prioritize the interests of beneficiaries. This has traditionally been interpreted as maximizing financial returns, encouraging some trustees to view ESG investing with skepticism. But legal definitions are evolving, especially in the UK. In 2005, a leading law firm concluded that addressing ESG risks was consistent with fiduciary duty under English law[xi]. In 2014 the Law Commission reached the same opinion[xii] and in 2016 the Pensions Regulator updated its guidance for trustees accordingly. The BT Pension Scheme responsible investment statement illustrates this thinking: "The Trustee has a fiduciary responsibility to meet the Scheme's liabilities, and as a long-term asset owner, considers sustainable factors to improve long-term risk-adjusted returns."[xiii]

There is growing evidence for the benefits of ESG Investing

Academic research indicates a link between corporate sustainability — a company integrating ESG goals into its strategy — and company financial performance. A recent meta-study found a firm empirical link (non-negative in 90% of cases) between companies' ESG ratings and financial performance[xiv].

Portfolio level studies are less conclusive, perhaps due to the impact of short term market fluctuations and transaction costs. Even so, a growing number of credible studies suggest that ESG investing can have a positive effect on risk-adjusted returns for pension funds and other investors.

The evidence on **risk reduction** is particularly strong. Several recent studies suggest that good ESG scores reduce costs of capital and volatility, increasing average returns. An investment bank that reviewed more than 10,000 mutual funds over seven years found sustainable equity funds exhibited equal or lower median volatility than traditional funds 64% of the time[xv]. Another study found that good standards of ESG can reduce a firm's cost of equity by up to 1.8%[xvi].

The Governance element of ESG appears to have the greatest impact. One asset manager finds that poorly governed companies underperform by an average of 30 basis points per month[xvii]. The last few years have shown how corporate environmental scandals – wiping out billions in market value – were in some instances foreshadowed by specialist ESG agencies downgrading their governance ratings. But governance is not the full story. Environmental risks have been found to increase credit spreads[xviii], and many investors believe that poor governance can lead to increased environmental and social risks[xix].

There is also a small but growing body of evidence suggesting that ESG investing has the potential to deliver **outperformance**. One noted academic paper found that high sustainability equities outperformed a low sustainability alternative by 46% over 17 years[xx]. More recently, a study in 2015 found that one ESG equity index outperformed a broad market index by an average of 0.45% every year for 25 years[xxi]. Looking beyond equities, a 2016 study found that a positive ESG tilt delivered a small but steady outperformance in fixed income[xxii]. And in emerging markets, Denmark's PKA pension fund has reported annual returns of 20% on its microfinance investments since 2012[xxiii].

Of course, none of these findings suggest that ESG investing will always outperform, and all studies stress the importance of manager selection and due diligence. But they clearly show that ESG investing need not be 'a noble way to lose money'.

No investment research is ever conclusive. But credible evidence (in Appendix 2 we provide a list of notable studies published between 2011 and 2016) suggests there is no financial reason for European pension funds to ignore ESG investing. It could be argued that boards and investment committees have a duty to give it active consideration. To dismiss such a large body of research out of hand does not seem consistent with good governance. As Frank Wagemans, Senior Project Manager for Responsible Investment at the VBDO puts it: "Many people's perceptions are surprisingly stuck in the past. A growing body of academic research suggests it's important for all investors to look at ESG factors."

Pension funds face obstacles to adopting ESG investing

Confusion over ESG terminology is only one challenge for pension fund investors. Many European funds also face a range of practical barriers to making greater use of ESG investing. This is particularly – although not uniquely – true for DB schemes.

- **Limitations of data and analysis.** Pension funds are increasingly aware of how hard it can be to quantify ESG risks and opportunities. The proportion of investors seeing non-financial disclosures as inconsistent or unverified actually grew from 20% in 2013 to 42% in 2016[xxiv]. ESG **data** is often unreliable and inconsistent. Environmental disclosure can be complex and contradictory, while subjectivity makes many social factors particularly hard to quantify. There is also an absence of proven ways to incorporate ESG factors into existing **analytical and valuation models**. However, a range of commercial, academic and public bodies are making strenuous efforts to address these shortcomings. Some see this as a vital stepping stone towards wider adoption by pension funds: "We need much better data and research. Good academic research is particularly important. Luckily we are seeing a number of positive initiatives such as the Task Force on Climate-related Financial Disclosure[xxv]" says Pelle Pedersen, Head of Responsible Investment at PKA Asset Management.
- **Lack of scale and resources.** Many European pension funds are comparatively small, making it hard to formulate ESG goals or conduct their own ESG analysis. This group is also unlikely to be offered segregated accounts by asset managers, limiting their ability to tailor funds to their ESG goals. In fact, many smaller funds are unsure how to even begin tackling ESG. In the words of Frank Wagemans: "Smaller funds tend to have little influence on product development. Many boards don't have the knowledge or resources to question asset managers on ESG."
- **Co-ordination challenges.** Pension funds can struggle to communicate their ESG investment goals along what is often a lengthy value chain. In the UK for example, it can be hard to co-ordinate effectively between sponsors, consultants and external asset managers, especially when different players have different financial incentives. It is not uncommon for trustees and asset managers to each believe the other is taking responsibility for ESG. As Graeme Griffiths explains: "Smaller pension funds face real obstacles, in terms of investment skills and resourcing, and can be very dependent on investment consultants." However, not all European markets are so complex. In the Netherlands, a single fiduciary advisor often provides a pension fund with both consulting and asset management services. And as Andreas Stang, Head of ESG at PFA Asset Management says, "Here in Denmark, the value chain is a bit shorter – that can make it easier for large asset owners to engage direct with investee companies."

- **Portfolio construction.** Many pension funds are increasingly following liability-driven investment strategies, with high allocations to bonds. This can make it harder to implement ESG investing, which is often seen as specific to listed equities. The problem can be acute in markets like France, where pension funds often invest 75-80% of their portfolio in government bonds[xxvi]. Funds with heavy allocations to passive funds may also struggle to implement ESG factors. However, there are rapid developments in this area and a number of asset managers now offer thematic and tilted passive funds tracking ESG indices.
- **The low yield environment.** Low investment yields are putting exceptional pressure on many DB schemes' funding levels. This is particularly true in the UK, where benefits are rarely altered but investment policies are restricted by regulation. As a result, some DB schemes are largely focused on reducing deficits or achieving risk transfer. In these circumstances, ESG investing may seem a less pressing goal. One German pension fund association has stated that ESG factors are simply a lesser priority than managing the low interest rate environment[xxvii].
- **Confusion over ESG terminology.** In common with other investors, pension fund trustees and analysts are often confused by the absence of definitive ESG terminology. To begin with, ESG investing is easily mistaken for similar but distinct concepts such as "impact investing", that prioritize ethical factors above financial performance. (See Appendix 1 for a glossary of ESG-related terms). The confusion over terminology represents a material barrier to ESG adoption; in the view of one investment consultant, perhaps the most important of all[xxviii]. That is especially true for smaller pension funds without relevant internal expertise. The contrast with the clarity of a single, quantitative measure such as Return on Investment (RoI) may be one factor behind the relatively slow adoption of ESG investing by some pension funds.

Furthermore, "ESG" not only encompasses three key factors, but also a wide range of sub-factors. Nor are environmental, social and governance homogenous. Most companies can manage the governance factors with comparative ease, but environmental and social factors can be more difficult to quantify, assess or control.

ESG sub-factors

Environmental	Social	Governance
Climate change and carbon emissions	Labor relations	Board diversity
Energy efficiency	Diversity agenda	Auditor independence
Pollution	Employee safety	Corruption and bribery
Use of natural resources	Product safety	Anti-money laundering
Waste management	Human rights	Business ethics
Clean energy and technologies	Child labor	Cartels and price fixing
Biodiversity	Working conditions	Compensation policies

ESG investing also overlaps with other investment trends — not least, the growth of active stewardship. Given that many investors and advisors have long scrutinized the management quality of their investments, this aspect of ESG investing has arguably been going on for years under another name.

Finally, there is no single way to implement ESG investing. In the words of Pelle Pedersen: "There is no right way to execute ESG, and there is a huge variety of methods and definitions." It is not as simple as switching into a particular asset class, such as renewable infrastructure or green bonds. We explore a few of the different approaches that pension funds and their advisors can take when implementing ESG investing in our Key Recommendations.

Even the largest pension funds can face significant obstacles to adopting ESG investing. A better understanding of these challenges is essential to enabling funds to benefit from ESG considerations. This also shows the vital importance of co-ordination and co-operation across the value chain. We explore these and other themes in greater detail in the next section.

3. Key recommendations

How funds — supported by those that serve them — could adopt and benefit from ESG investing.

ESG should be debated logically, not emotionally

We believe that debating ESG investing in the right way is crucial to successful adoption. Arguments in favor of ESG must emphasize logic, facts and good investment practice. The experience of pension funds that already consider ESG factors suggests that achieving the full benefits of ESG investing depends on:

- **Understanding that "values" do not outweigh "value."** ESG investing aims to make rational judgements about the financial risks and returns that flow from ESG factors, especially in the long term. As Pelle Pedersen puts it, "I try to convince people about the financial benefits of ESG by talking about deriving long term value from the world's shift towards a different kind of growth."

- **Thinking in terms of risk and return.** Focusing on risk and return not only helps to engage colleagues. It is also vital to avoiding investment errors. In the words of Graeme Griffiths: "Instead of talking about moral considerations, we make the case to value-driven investors that ESG aids risk management and can deliver better long-term investment outcomes."

- **Valuing the role of investment professionals.** Effective ESG investing depends on good portfolio management. ESG considerations should not over-ride the views of a trusted manager. Investment professionals are used to evaluating imperfect data and it is for them to judge the pros and cons of every investment. As Andreas Stang puts it, "No ESG data conveys the ultimate truth. But it would be equally wrong to assume that any non-ESG data possesses that ability."

- **Questioning myths about underperformance.** As already discussed, the notion that ESG investing leads to underperformance is not supported by research. A recent report by one asset manager claimed that 84% of institutional investors are satisfied with the financial performance of their ESG strategies[xxix].

- **Doubting exaggerated claims.** There is plenty of credible research that can be used to argue for ESG investing. Exaggerated claims based on selective interpretations of past performance are unnecessary and quickly undermine the speaker's credibility. "When arguments about performance need to be made, draw on credible academic research. You won't overcome skepticism by promising Nirvana" suggests Pelle Pedersen.

- **Resisting the temptation to search for "absolute proof".** No investment strategy performs predictably in all circumstances. Calls from doubters for ESG to "prove" its value beyond dispute are unrealistic. "Sceptics often say: 'Prove it'. We respond: 'Can you prove that considering ESG factors hurts performance?'" says Frank Wagemans.

We believe that pension funds — and other investors — should aim to incorporate ESG investing into their everyday investment practices. But for this to happen, ESG needs to be debated in the same way as any other investment issue. As Andreas Stang explains, "ESG should be a value-added function within the investment process, not separate from it. ESG factors are not supposed to go against value creation — they should go hand in hand with other financial indicators. Don't ask ESG questions for the sake of it; ask them because they're valid investment questions."

A solid understanding of ESG investing is vital

Adopting ESG investing is not as simple as switching from one asset class to another. But nor does it need to be so radical. To benefit fully from ESG investing, pension funds need to ensure they understand the variety of ways in which it can be executed. Most ESG strategies are actively managed, but the emergence of passive products is increasing the potential range of investment techniques. Some of the most important approaches include:

- **Divestment and exclusion:** Exclusionary screening remains the most popular ESG Investment technique[xxx]. It has the advantages of being cheap, easy and transparent. But it can be simplistic and removes the potential to boost returns by engaging with investee companies. Sector exclusions can also harm diversification.

- **Best in class:** Sometimes called "inclusive screening," this is where investors tilt their exposure towards strong or improving ESG performers in each sector, or set an ESG hurdle that all investments must clear.

- **Thematic investing:** A variation on impact investing that involves selecting an ESG-related theme (perhaps based on a development goal, such as clean water). This theme is then used as the basis for building a portfolio of related securities.

The desire to avoid critical ESG risks – such as asset stranding or human rights violations – means that many pension funds begin with exclusion before moving on to other techniques. As Frank Wagemans explains: "Many pension funds start defensively – typically with exclusion. They then move from a pure risk focus to using ESG data alongside financial data. Over time they may engage more closely with companies, and perhaps begin to use impact investing."

This transition is understandable, but it can create the impression of a rigid spectrum ranging from "cautious" steps like exclusion to "advanced" techniques such as thematic investing. This is misleading and implies that all ESG investors need to follow the same path.

In fact, pension funds can, and do, use a range of techniques to implement their ESG investing goals. These can be used in isolation, in combination; or as part of a broader strategy of ESG integration.

ESG integration should help to achieve the greatest benefits

There is a growing view among large institutional investors that "ESG integration" represents the optimal way to implement ESG investing[xxxi]. Integration means incorporating ESG factors into every stage of the investment process from the setting of goals, through asset allocation to the details of portfolio construction. As Kirstine Lund Christiansen, Head of ESG at P+ explains: "Our aim is to integrate ESG across as much of the portfolio as possible. That means looking beyond listed equity and considering ESG factors before investing in private equity funds, credit funds and so on."

Integration is more expensive and challenging to implement than a simple technique such as exclusion. So why are investors increasingly enthusiastic about it? The answer lies in the benefits it can deliver, which include:

- Ensuring that ESG investing is woven into the value-creation process: ESG considerations should not be separated from traditional investment techniques.
- Allowing pension funds to take a more nuanced approach than blanket exclusions: funds should use the skill of investment managers and ESG experts to extract value from every sector.
- Helping pension funds to assess the ESG risks and opportunities of diverse asset classes: these can include equities, fixed income, multi-asset funds and alternatives such as real estate, private equity and infrastructure.
- Enabling pension funds to benefit from active engagement and stewardship: rather than "leaving value on the table."

Equity investors in particular can use their ownership stakes to positively influence company strategy. Many investors see this as one of the most financially rewarding aspects of ESG investing.

Overall, we see integration as the most intellectually coherent way to implement ESG investing. As Pelle Pedersen explains, it helps pension funds to make better long term decisions: "We view our approach to ESG as thinking about what the world will look like in 2050, and trying to get ahead of that vision in investment terms." By weaving ESG into existing processes, integration allows funds to fully leverage their own knowledge and the expertise of consultants and asset managers.

Features of an ESG integrated pension fund

Below we set out some of the potential features of a pension fund that has embraced a fully integrated approach to ESG investing. Such a fund might also be described as a "sustainable pension fund". This is not intended to be a comprehensive list or a formal blueprint, but to provide material for further debate.

Feature	Possible examples
Integration of ESG factors	▸ The use of ESG factors is considered an integral part of operations – not a distinct or separate activity ▸ The consideration of ESG factors is integrated into everyday investment decision-making
Clear mission and goals	▸ The fund's ESG investment goals and principles are clearly expressed and communicated ▸ The incorporation of ESG factors is explicitly included in investment policies and mandates
Integrated investment management	▸ The fund and its managers actively engage with investee companies on ESG-related issues ▸ Investee companies are required to provide disclosure of their own ESG policies
Strong leadership	▸ Trustees and investment committee members demonstrate collective commitment to ESG integration ▸ The fund actively encourages other pension funds to adopt ESG investing practices
Clear risk framework	▸ ESG risk factors are integrated into the fund's broader risk management framework ▸ Trustees establish formal, quantifiable and realistic limits for ESG risk factors
Effective external partnerships	▸ External investment managers are given clear guidance and instructions, and are appointed under mandates aligned with the fund's ESG goals ▸ The fund ensures that external managers have the capabilities and experience to implement the fund's ESG investing goals

Pension funds can boost their scale to take advantage of ESG investing

Many small and medium-sized pension funds would find it easier to implement ESG investing if they could overcome the limitations of their size. Greater scale helps funds to improve risk pooling, financial efficiency and, above all, their investment weight. Those factors in turn make it easier to develop internal skills and engage with external advisors. In the experience of Andreas Stang: "As a large pension fund, we have some advantages in terms of our ability to bring different stakeholders together."

On the upside, consolidation is boosting average fund size in several European markets. The number of Dutch pension funds decreased from 802 to 320 between 2005 and 2015, and UK numbers fell from 90,000+ to 40,000+ over the same period[xxxii]. However, we believe there are other scale-building options that European funds could exploit to take better advantage of ESG investing.

- **Co-operation and resource sharing:** Pension funds could combine forces to fund shared ESG research, or pool their expertise when engaging with consultants and advisors. The Dutch Pensions Federation has recently proposed such an exchange of expertise. "Asset owners are generally non-collaborative. Smaller funds could benefit further from the insights and research undertaken by larger funds, for example within the public sector" says Graeme Griffiths.
- **Pooled funds:** Many smaller pension funds do not have sufficient capital to award segregated asset management mandates. Their ESG investment options are often limited to mutual funds or exchange-traded funds (ETFs) that cannot be tailored to their requirements. Pension funds should use pooled ESG funds where available, and join together to demand greater choice from asset managers.
- **Joint ventures:** There is at least one precedent for European pension funds setting up a shared ESG investment body. A number of independent Swiss DB and DC pension funds are members of Nest (National Employment Saving Scheme), an umbrella fund that manages ESG investments on their behalf[xxxiii].
- **The use of sponsors' capabilities:** European companies such as Unilever, Ahold Delhaize and BT are often cited as achieving good alignment between their own ESG goals and those of their pension funds. However, research suggests that this group is the exception to the rule[xxxiv]. Making better use of corporations' sustainability expertise could enhance pension funds' capabilities and close the gap between the ESG policies of sponsors and funds.

Co-operation helps pension funds to follow ESG best practice

Pension funds seeking to implement ESG Investing are not alone. Co-operation with investment consultants, investment managers, ratings agencies and other advisors can help funds to overcome obstacles, learn from their peers and follow best practices.

- Other players in the value chain often have greater ESG expertise than all but the largest pension funds. And they are accustomed to making subjective decisions on the basis of imperfect financial and non-financial data. "I see the lack of definitive data on ESG issues as providing an opportunity for some active investors to express their [ESG] views through security selection. Investors that can combine ESG and other security research effectively should make better informed, more holistic investment decisions" suggests Graeme Griffiths.

For example, many asset managers are investing in their ability to factor ESG risks and opportunities into their cash flows projections and valuations. Like some pension funds, a number of firms are pursuing integration programs, building ESG expertise into all their investment activities[xxxv].

- One aspect is the ability to **analyze the huge amount of external ESG data** disclosed by corporations and generated by nearly 100 commercial providers of ESG ratings. Given the limitations of this data, many firms are developing their own **in-house capabilities**. These include the building of customized databases, the recruitment of experts, and the construction of proprietary models focused on specific factors such as carbon emissions.
- Asset managers are also applying ESG factors across a **growing range of asset classes**, including fixed income, property, infrastructure and private equity. And they are working with index providers to develop new ESG-tilted **tracker funds, ETFs and smart beta products**. This makes it easier for investors to adopt ESG via passive strategies.
- Finally, several firms have developed dedicated **engagement and stewardship teams** to interact with investee companies and co-ordinate proxy voting for investors.

This rapid evolution of capabilities illustrates the potential for co-operation across the investment value chain to help pension funds benefit from ESG investing. The evolution of fiduciary management — which combines advisory services and investment management — should increase that opportunity. Fiduciary management is well established in the Netherlands and is growing fast in the UK. We believe it could become increasingly influential in other European markets.

Member consultation could help funds to implement ESG investing

European pension savers are increasingly interested in the sustainability of their own savings. This will only accelerate as the financial pull of millennials grows. This generation sees climate change and the destruction of natural resources as the world's most serious issue, even more so than war and conflict[xxxvi]. The stewards of some pension funds are coming under increasing pressure to consult beneficiaries on their approach to ESG[xxxvii].

Member engagement is an established feature of the pension landscape in markets such as the Netherlands and Denmark, where many boards include member representatives. Such consultation is far more limited in other European markets. In the UK for example, very few DB funds or DC master trusts consult beneficiaries on ESG-related matters. A recent survey found that 54% of UK funds believe good stewardship requires them to incorporate ESG factors into their decisions. However, only 20% see the need to reflect the views of beneficiaries[xxxviii].

We expect beneficiary consultation to become an increasingly common feature of pension governance in future. Educating beneficiaries about the link between their savings and the stewardship of investee companies will be an important part of this process. As Frank Wagemans explains, "When beneficiaries understand investment policy better, they tend to become more engaged on the topic."

The rationale for consultation is most apparent in the DC space. Younger employees are particularly keen to invest in accordance with their personal values. Many companies are responding by offering ESG-themed options under their DC schemes. As already mentioned, a few are even switching their default options onto an ESG footing. This improves sponsors' corporate sustainability profile, helping them to attract and retain staff.

Member consultation may also be helpful for some DB funds. One reason is to align their investment goals with the views of their members. A second, overlapping reason is to give boards a clear mandate for action on ESG. "A resolution from a member at last year's AGM formalized our approach to ESG integration" says Kirstine Lund Christiansen. Consultation can also protect trustees against accusations of fiduciary neglect. In the view of Frank Wagemans, "Engagement over ESG themes is often still limited. However the information from engagement processes can help pension funds to formulate their own policies and goals. That gives boards a basis for responding to reputational issues in their investment portfolio."

4. Conclusions: Delivering sustainable performance

A wide range of factors are driving European pension funds' increasing interest in ESG investing.

We believe many funds could find ESG investing a valuable contributor to their long term financial and fiduciary goals. And we see a number of reasons to believe that ESG investing will become an increasing priority for the sector over the next few years.

In this paper we have seen that many pension funds face a number of barriers to adopting ESG investing. But the experience of funds that already use ESG investing suggests that most barriers can be overcome. European pension funds continue to develop increasingly sophisticated views of risk, and to make innovative use of asset allocation. This environment is fertile ground in which to realize the potential benefits of ESG investing.

At an industry level, we have set out what we see as some of the keys to successful ESG investing. In our view, a deep understanding of this complex subject, and the need to focus on investment logic, are vital. So too is the importance of collaboration between funds, and of close co-operation with sponsors, advisors and other external partners. In the long term, we see the integration of ESG considerations into everyday investment decisions as crucial to deriving lasting benefits.

But what about practical steps for individual pension funds interested in the potential benefits of ESG investing? That, of course, depends on each fund's circumstances. Some are already making significant use of ESG factors, but may wish to achieve full ESG integration. Others may only be considering the subject for the first time. On the basis of our research and experience, we set out a few suggested action points for pension funds on the next page.

In summary, ESG investing is about far more than ethical considerations or regulatory requirements — important though they are. There is a growing view that ESG can make a valuable contribution to long-term investment performance. Pension funds should be aware not only of the potential opportunities, but also of the risks of inaction. Despite the complexities of the topic, there is much that European funds can do to engage with ESG investing and to benefit from it.

Practical steps to explore the potential benefits of ESG investing

Governance and control	‣ Consider whether your legal or fiduciary responsibilities might require you to consider ESG factors when investing. ‣ Ensure you are aware of all national and European legal and regulatory requirements relating to ESG, and the indirect effect of any requirements in other jurisdictions.
Leadership and strategy	‣ Identify your current level of ESG adoption, decide what you believe would be your best approach, and consider how to address any gaps. ‣ Review the quality and level of corporate sustainability practices by investee companies. ‣ Assess the potential benefits – and practical requirements – of pursuing ESG integration across the fund's full range of activities.
Understanding and capabilities	‣ Review your existing ESG knowledge and resources and consider how to ensure that trustees and investment committee members are informed and updated about ESG terminology, techniques and areas of debate. ‣ Keep up to date with the latest academic and commercial research on ESG investing. This not only applies to the potential benefits, as attention should also be paid to the risks that can arise from ESG factors such as climate change-related "asset stranding". ‣ Monitor the ESG experience of institutional investors at large, particularly those that are seen as leading adopters, or as having achieved particular benefits from ESG investing.
DB vs. DC	‣ DB funds should work closely with sponsors and investment consultants to consider whether ESG investing can complement their short, medium and long term investment goals. They should then assess whether, and how, they should integrate ESG factors into their overall investment strategy. ‣ DC funds should consider the potential for increasing demand for ESG investing options from current and future members. They should then take steps, in consultation with sponsors, to reflect this in the design of their default strategies and the range of self-selected funds they offer.
External partnerships and support	‣ Consider signing up to the Principles for Responsible Investment (PRI) or ESG-focused groups of institutional investors. ‣ Review and analyze the experience of close peers or affiliated funds that already make use of ESG investing. ‣ Assess the ESG expertise and experience of your fund's advisors and consultants, and consider whether you are making best use of these external relationships.
Investment management	‣ Be aware of the full range of possible techniques for implementing ESG investing. This includes both active and passive strategies and a full range of asset classes. ‣ Engage closely with investment managers to understand the range of ESG-themed products and services they offer. This could include ratings and research, segregated mandates, passive funds or ETFs and active stewardship. ‣ Challenge prospective investment managers about their ESG capabilities as part of manager selection procedures.
Co-operation and collaboration	‣ Set out a strategy to ensure clear and effective co-ordination between sponsor, fund, consultants, managers and other partners. ‣ Explore the possibility of co-operation with other pension funds, industry bodies or sponsors, taking full advantage of any shared experience and knowledge. ‣ Contribute to industry or government led initiatives aimed at improving the quantity and quality of ESG disclosure by investee companies.

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Appendix 1 — Glossary of ESG-related terms

This is an informal glossary intended to help readers avoid confusion between different ESG-related terms. It is not intended to be definitive — readers may dispute some of our definitions.

ESG factors: Environmental, Social and Governance factors.

ESG Investing: The focus of this paper. Integrating the potential financial impact of ESG factors into investment decisions, but without prioritizing non-financial goals above investment performance.

Ethical Investing: Investing in a way that puts "values before value" — often involves excluding certain sectors, such as armaments or tobacco.

Impact Investing: Investing that not only considers ESG factors, but may rank ESG goals above financial returns, or be willing to accept below-market returns in exchange for positive ESG impact.

Responsible Investing: Often used as a blanket term for investment decisions that look beyond purely financial criteria, including ESG Investing. Some consider it analogous to ESG Investing.

Socially Responsible Investing: Making investment decisions that are based on social criteria.

Sustainable Investing: Another blanket term, again often seen as a close substitute for ESG Investing.

Sustainable and Responsible Investing: Another blanket term, combining Sustainable Investing and Responsible Investing.

Appendix 2 — Relevant studies for further reading

- *ESG Investing: It still makes you feel good, it still makes you money,* Hermes Global Equities, September 2016
- *Responsible Investing: Delivering competitive performance,* TIAA Global Asset Management, April 2016
- *Sustainability and bond returns,* Barclays, 2016
- *ESG and financial performance: aggregated evidence from more than 2,000 empirical studies,* Deutsche Asset & Wealth Management Investment; School of Business, Economics and Social Science, University of Hamburg, November 2015
- *Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies,* Morgan Stanley Institute for Sustainable Investing, March 2015
- *From the Stockholder to the Stakeholder, Smith School of Enterprise and the Environment,* University of Oxford; Arabesque Asset Management, September 2014.
- *Impact of Corporate Sustainability on Organizational Processes and Performance.* Eccles, Ioannou, Serafeim — Harvard Business School, 2011.

We would refer readers looking for a comprehensive bibliography of research into the performance impact of ESG investing to EFAMA's Report on Responsible Investment, September 2016. The report's Annex 2, "Overview of Research on Responsible Investment and Performance", reproduces the abstracts or conclusions of more than 100 studies on responsible investment performance.

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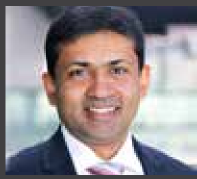

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