Aon Investment Research 2020

Covid, climate and compliance– are you ready for the new investment challenges?

Focus on responsible investment

Aon
Empower Results®

Contents

Foreword

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2020 has been a year of significant change for UK pension schemes' investment strategies — even before we take the effects of the COVID-19 pandemic into account. Governance has come under ever-greater scrutiny from The Pensions Regulator, responsible investment is rising rapidly up the trustee agenda, and pension schemes are demanding ever greater cost transparency from their providers.

Over the summer, we set out to listen and to understand how investment decision-makers were responding to all these changes and accompanying challenges. Through a series of in-depth interviews, we were able to gain real-world insights into key trends, common approaches — and differences – to paint a picture of current thinking in pensions investment.

Inevitably, the pandemic was a common thread running through all the discussions. And, while it's still too early to understand its longer-term effect on schemes and markets, the crisis has already started to reshape investment strategy decisions and the way these are made.

Now, more than ever, investors need support to continue to protect the retirement income for their members and to manage the increased pressure and demands on their investment governance and operational strategies. We have specialist teams and deep expertise to help you to rise to all these challenges — from governance, responsible investment and investing for the endgame to costs and transparency and the DB funding code of practice.

We look forward to continuing the discussion with you.

About the research

In July and August 2020, Maggie Williams, an experienced pensions commentator, writer and editor, carried out in-depth interviews with 20 pension scheme decision-makers on behalf of Aon. Interviewees were drawn from a wide range of disciplines — professional, independent and member-nominated trustees, third party evaluators and pensions managers — representing both defined benefit (DB) and defined contribution (DC) schemes. DB scheme sizes ranged from £10 million to over £10 billion.

The interviews focused on five key areas:

- Investment governance
- Responsible investment
- Investing for the DB endgame
- Costs and transparency
- Investment implications of the DB funding code of practice

Our thanks go to everyone who took the time, during very difficult and challenging circumstances, to participate in this research and to provide valuable insights.

Read all reports

Aon insight
Responsible investment

The world is facing a barrage of profound challenges: climate change, declining biodiversity, social inequality, rising populism — and a global pandemic. These create both risks and opportunities for investors.

Responsible investment is not a 'magic bullet' for solving these issues, but it does have the potential to play a powerful role in helping address them. No surprise then that there has been an increase in positive sentiment towards responsible investing in recent years.

Regulation is also accelerating the integration and adoption of responsible investing. Simultaneously, a growing body of research — and a broadening and deepening of market practice — is illuminating the investment case for it. However, more regulation, more information and more choice do not always lead to more progress.

As our interviewees highlight, there is work to be done to turn sentiment into policy and practice — but many investors lack the detail they need to adopt responsible investment in a way that is right for their schemes. This matches our own experience with the wide range of UK schemes with which we work. DB & DC schemes, large and small — all have unique circumstances and beliefs. As a result, investors need a lot of support to navigate this complex, multi-stage journey of integrating responsible investment into their portfolios.

We are working tirelessly to provide this support for our clients, drawing on our decades of combined experience and breadth of expertise. We are also innovating to help bring clarity to our clients' responsible investment journey. For example, we have developed the unique *Responsible Investment ViewPoints* methodology, which draws on behavioural science to establish and understand scheme-specific beliefs around ESG opportunities and risks. This has been used by over 70 of our clients to support the development of their responsible investment policies and strategies. For clients ready to implement responsible investment strategies, we offer a wide range of services to do this — from one-off and stand-alone exercises to comprehensive advisory partnerships, as well as our delegated investment and single-strategy solutions, which include Aon's Global Impact Fund. You can learn more about all the ways in which we can support you here and we look forward to continuing the journey with you.

Tim Manuel
Head of Responsible Investment, UK
Aon

"I have left trustees in no doubt about their responsibilities and legal obligations to protect people's pension pots from climate change risks,"

Guy Opperman, MP
Minister for Pensions and Financial Inclusion
March 2020

Responsible investment regulation: moving from 'must do' to 'want to do'

By October 2020

All trustees of both DB and DC schemes must include in their Statement of Investment Principles (SIP) their policy on:

- how financially material considerations including, but not limited to, ESG factors are taken into account in trustee investment decisions;
- the extent (if at all) non-financial matters such as member views are taken into account in trustee investment decisions;
- how they reflect their stewardship policy (eg. how rights relating to investments, including voting rights, are exercised)

The SIP must include details of trustees' arrangements with asset managers on these three points, and both DB and DC schemes must publish the scheme's SIP on a publicly available website.

From October 2020

Trustees of DB and DC schemes must publish an Implementation Statement in their first Annual Report published after that date, and no later than October 2021.

In the case of DC trustees, this must set out how the SIP has been followed and acted on during the scheme year. It must also include a description of the voting behaviour by or on behalf of the trustees, including the use of proxies.

For DB trustees, the Implementation Statement must now include information on the scheme's stewardship policy and trustee voting behaviour.

The Implementation Statements for both DB and DC schemes must be available online, free of charge.

By October 2021

Both DB and DC schemes must publish their Implementation Statement online.

Reporting requirement	Scheme type	
	DC or hybrid	DB only
Description of any review of the SIP during the period covered by the Statement including an explanation of any changes to the SIP. If the last review was not within the period covered by the statement, include the date of last SIP review.	✓	✗
Details of how and the extent to which, in the opinion of the trustees, the SIP has been followed during the year.	✓	✓ In relation to voting and engagement only
Description of voting behaviour (including 'most significant' votes by, or on behalf of, the trustee) and any use of a proxy voter during the year.	✓	✓

Source: PLSA Implementation Statement Guidance, July 2020

Current requirements from The Pensions Regulator (TPR) mean that the basics of responsible investment are now a 'must do' for all DB and DC schemes.

Our research found that decision-makers' views on adopting a responsible investment approach remain mixed. While some trustees (both member-nominated and professional) are still unconvinced about the rationale behind responsible investment, our research also found passionate advocates who are committed to pursuing and defining best practice for their schemes — and in some cases the wider industry.

"I'm wholly supportive of the ideas [of responsible investment], but what I don't like is any form of arbitrary implementation, which is political correctness, for instance. That, to me, is just silly."

Trustee, DB schemes

86%
of schemes globally consider responsible investment at least 'somewhat important'

Source: Aon Global Perspectives on Responsible Investment 2019

Only 1 in 10
DC schemes assess their default option against ESG criteria

Source: How do you Measure Up? Aon Defined Contribution Member Survey 2020

However, in general, progress towards a responsible investment approach has been slow. Even boards that are committed to embedding responsible investment throughout their investment approach admit that the process of documenting scheme beliefs, and implementing them in the portfolio, takes time.

Among respondents sceptical about responsible investment, concerns included a lack of long-term evidence on the performance of ESG funds, risk versus reward, and the cost involved in changing strategies or transitioning between managers, particularly in a de-risked portfolio.

"Legislation should be about pointing and nudging schemes in the right direction – and about disclosure. Disclosure makes trustees think harder about it. That's better than just saying, 'You have to put your investments in ESG funds.'"

Pension committee chair, DC schemes

Confusion about what is expected from schemes by TPR is also still a factor, as well as a perceived mismatch between fiduciary duty and responsible investment.

More proactive decision-makers are starting to put pressure on asset managers and consultants to improve the quality of reporting, analysis and product design, which is still perceived as variable. "Many consultants and asset managers are still in a 'greenwashing', minimum compliance place, unless you demand different. I am now demanding different," said a professional trustee.

"Trustees see the relevance of ESG. They support the principles of it, they want to be able to demonstrate they're compliant with it. But to be frank, it's not driving investment behaviour, it's not driving investment decisions. I can't think of a single situation where that has been a determining factor."

Professional trustee, DB schemes

> "What does the Regulator want? Does it want pension schemes to invest in a sustainable and responsible way, or does it want the asset managers to consider that when they're making their investment decisions? Because the two are very different. We can do the latter, to get managers to consider it. But the former, of having investment offerings that are sustainable across all asset classes? We're still a long way from that. You only really have that in the equity space at the moment."
>
> DB third party evaluator

Respondents' views on their role in responsible investment varied. Some clearly saw responsible investment as the responsibility of schemes themselves, with a strong appetite to set their own investment beliefs and hold managers to account. Others want asset managers and consultants to 'do ESG' for them, by providing ideas and recommendations that incorporate responsible investment principles.

Aon's *Global Perspectives on Responsible Investment* 2019 survey also found schemes starting to become more engaged with responsible investment. 47% believed that their own organisations had a part to play in implementing responsible investment, an increase of 11% from the previous year. However, 56% of pension scheme respondents said that they still believed investment managers were responsible for responsible investment.

The responsible investment journey

The process of defining and moving to a responsible investment portfolio takes time. One participant from a DC scheme estimated that the process had taken three years to date — and is still a work in progress.

"It's not a single decision to adopt ESG, it's lots of different decisions and a much longer process than people think. There are many component parts all the way through: what are your beliefs, how are you going to implement ESG, how does it fit into your investment strategy, how do you educate the trustees to get the best out of it?."

Pension committee chair, DC schemes

21%

leap in positive sentiment towards responsible investment in the UK

2018: **66%** | 2019: **87%**

Source: Aon Global Perspectives on Responsible Investment 2019

That journey includes trustees establishing their responsible investment beliefs, updating the SIP and other investment-related documentation to reflect those beliefs, then researching and appointing asset managers to enact the changes to the portfolio. Decision-makers and the schemes that they represent are at very different points in that process.

"The people in our business looking at sustainability haven't really engaged with us on the pensions side, even to make sure that what we're doing doesn't contradict what they're saying. I've been surprised that it hasn't been pushed up the agenda more ... I've tried to engage with them, and they've just looked a bit quizzical. Clearly, we are not quite there yet."

Employer representative, DB scheme

Both third party evaluators and professional trustees said they are seeing more commitment to responsible investment from the schemes they work with. In some instances, where a parent company has a strong belief in responsible business, there is support from the sponsor to make sure the pension scheme upholds the same values – but this is by no means universal.

Commentators with an international perspective said that UK schemes have lagged behind other parts of Europe when it comes to responsible investment. However, there are signs that the UK is now starting to catch up. This reflects the findings from our global responsible investment survey, which showed the had the biggest gain in positive sentiment towards responsible investment.

"Trustees lagged behind their continental European counterparts quite considerably, until about two years ago. That is now changing for the better. They are starting to become a bit more demanding of their external suppliers in this area."

DB governance specialist

Taking action: implementing responsible investment

As schemes move slowly from the theory of responsible investment to making changes to their portfolios, more attention is being paid to the products available in the market, and how effectively asset managers are managing them.

"The products are improving, particularly around passive funds with tilts. I think that's a really helpful development because it's a relatively small shift in risk terms but can have quite a decent impact."

Professional trustee, DB and DC schemes

Most of the focus to date has centred on equities. Decision-makers who already take a responsible investment approach said that their scheme's beliefs can be applied to most of the equities-based products that they invest in with relative ease. That should also be good news for decision-makers concerned about the complexities of moving to a responsible investment approach, as it gives them a like-for-like replacement for equity products in their portfolio.

However, respondents admitted that there are challenges around more complex investment vehicles, such as hedge funds and also diversified growth funds, due to the range of different assets that they contain.

"I've asked my consultants to model climate change risk in the same way they model interest rates or inflation risk. Interestingly one consultant has started to go down that route. They're the only one I've come across who's really trying to quantify that risk and build it into their models."

Trustee, DB schemes

They also felt that there is still work to be done by asset managers to improve the standard of reporting on their responsible investment practices and stewardship. "Often investment managers make responsible investment too complicated. And, we've found too much 'cut and paste'. We've had to go back to them and say "No, try harder." They've got to be able to communicate with the end user," said the chair of a large DC scheme.

Investors are also starting to demand more from consultants and asset managers to provide much more detail around ESG factors, including how their products address climate change risk.

"There has been more work done proving all the various things that people are asking: 'Is flying really that bad? Is it really that bad to invest in fossil fuels? Are members really that worried about it?' Now we know, yes, they are worried about it."

Professional trustee, DB and DC schemes

Education and good quality communication both have a major role to play in helping to make responsible investment more accessible and tangible both for trustees and scheme members. A third party evaluator for DB schemes said: "The more the trustees understand about ESG, the more they can make informed decisions or have an opinion around what they want to do on behalf of the scheme. But trustees and members both struggle with tangibility — they understand the concept but the tangible point of what they can do is more difficult."

> "We are seeing more and more innovation in the market, from index providers to active managers. They are trying to... really engage with the underlying companies in which they invest and add value that way."
>
> Third party evaluator, DB schemes

Few decision-makers are directly asking members for their views on responsible investment, even though the Regulator now expects trustees to document this. Several commentators, especially trustees, also said that they are unsure how they could use the results of such an exercise in a meaningful way.

> "When we prepare our questions for our asset managers this time, we want to ask businesses how many people they've furloughed and why they furloughed those staff. I think there are some large organisations that might have used furloughing to protect the salaries of senior people."
>
> Pension committee chair, DC schemes

Heightened awareness of the importance of climate change, and high-profile industry campaigns such as Make My Money Matter, are pushing demand for greater transparency about how members' money is invested in DC schemes in particular. However, one third party evaluator expressed concerns about how members are being polled about responsible investment, and the effect that the answers might have on investment strategy:

"If you are trying to engage members, you must be very, very careful what questions you ask, how you ask them, and then quantify a potential impact. If you say 'would you prefer your pension scheme not to be invested in X, Y and Z' and we strip those investments out, it could increase our cost by 10 basis points, and it could harm return in the short-term by 50 basis points. Is that acceptable, yes or no?"

We've done that with a couple of schemes already, and we got quite a good response to, "Yes, I care about these issues, and 'yes I don't mind too much if there is additional cost'. But when we ask about the effect on returns as well, it's a different response."

> "Will awareness of these factors be enduring or just short-lived? You can almost say society is a proxy of that. You'll see some people during COVID-19 have changed their lifestyles. And you can see others that, as soon as restrictions are lifted, will go back to normality as quickly as possible."
>
> DB third party evaluator

Responsible investment and COVID-19

COVID-19 has made the 'S' and 'G' of 'ESG' front page news. The way in which businesses have treated employees during the crisis, and the quality of some corporate governance have become high profile stories in recent months. But, the extent to which these factors will make a difference to schemes' investment behaviour over time remains to be seen.

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With thanks to our researcher and author:
Maggie Williams

Maggie is an experienced pensions commentator, writer and editor with over 20 years' writing and interviewing experience. You can find out more about her through her LinkedIn profile.

Further reading and resources

Keeping pace with responsible investing – trustee essentials

Aon's Responsible Investment Services

Investing for Impact

Aon's Global Impact Fund

Aon's UK DC Pension Survey 2020

2019 Global Perspectives on Responsible Investing

Aon Investment Research 2020

This report forms part of a body of research into current thinking in pension investment.

Access all the reports in the series to discover key trends and common approaches among pension scheme decision-makers as they rise to the challenges presented by covid, climate and compliance.

Read all reports

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Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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