Fiduciary: The secret sauce to achieve your sustainability goals

Philippa Allen and Sam Segameglio at Aon discuss why a fiduciary management approach to responsible investment can help trustees achieve their sustainable investment goals

Environmental, social, and governance (ESG) factors have become increasingly important for pension schemes, which have had to find their feet in the rapidly developing world of responsible investment (RI). Arguably, RI has already become the norm for UK defined benefit schemes. The positive responses to Aon's forthcoming 2021 RI survey, show the importance of RI considerations to UK schemes.

What's driving these trends?

Changing pension charters, strategy reviews and member feedback have all played their part. The government's Investing in a Better World Survey showed that 57 per cent of UK investors would like their pension to be invested responsibly and 47 per cent would want it switched if it was not invested in line with their beliefs. The increase in RI options in the market has created awareness, interest and discussion, and made implementing more sophisticated RI solutions possible for schemes of any size.

These factors have contributed to the trend, but it is hard to find a more powerful driver than regulation.

Reducing the governance burden is a key tenet of fiduciary management and that extends to the increasing level around RI. A fiduciary manager with well-resourced RI expertise will assist schemes with regulatory activities, such as preparing engagement policy implementation statements, or taking action on their behalf, such as engagement and stewardship. These activities require time and expertise to do effectively, so delegating these to a fiduciary manager can be beneficial.

We see more trustees wanting to better understand their RI beliefs and to get advice on implementing a solution in line with those. Again, fiduciary management can help. We use proprietary tools and processes, such as our viewpoints exercise, to help trustees formulate their beliefs and a plan to action them.

With better understanding of beliefs has come a shift away from trustees simply wanting to be assured that RI is being considered. Trustees now want a deeper understanding of what is happening in portfolios.

Putting it into practice

Once trustees have a coherent set of beliefs, it is the fiduciary manager's role to implement them. The focus should be on helping schemes of any size to create a solution that fits their RI needs, whether driven by regulation or beliefs. This requires flexible portfolio construction, effective stewardship and insightful reporting.

With portfolio construction, we offer

a range of ‘building block’ funds that have different RI focuses. We then use a flexible framework to slot the building blocks together in different ways for different schemes.

When considering building block funds, ESG integration is a critical starting point and the baseline that investors expect. In 2019, c.55 per cent of investors approached RI through ESG integration. This has increased considerably in 2021.

Integration makes investment sense and ensures that ESG risks and opportunities are robustly incorporated into investment decisions – and so deliver better risk-adjusted returns. There are more details on this in Aon’s paper: *The Benefits of ESG Integration*. Integration also ensures that managers are responsible stewards of capital and use voting and engagement to drive positive change.

Increasingly, investors expect fiduciary managers to engage with underlying managers on ESG. We believe engagement is an effective way to improve investment outcomes. We dedicate around 80 hours per week engaging with managers in our fiduciary portfolios, which our clients would otherwise need to do themselves.

The strong relationships between fiduciaries and managers and the large investment amounts at stake, mean fiduciary engagement causes action. We set a high ESG bar for managers to enter our portfolios, but there is always room for improvement. Key themes on which we have engaged include formalising ESG processes and better discussion with companies on environmental and social issues. Our managers have improved their ESG practices, including formalising ESG frameworks, providing more and better ESG data and working with companies on topics such as board diversity and carbon emissions.

The average ESG rating across several of Aon’s funds has improved as a result of our engagement activities. This includes our hedge fund portfolio, where 92 per cent of managers are rated integrated or advanced on ESG. We expect this to be 100 per cent within a year. This progress highlights the value that fiduciary managers can add through ESG expertise and industry influence.

Aligning to beliefs

Moving beyond integration, demand for investments that align to specific beliefs has increased. This may mean excluding sectors, decreasing carbon footprint, or investing in companies providing solutions to environmental and social challenges. Managers and fiduciaries have responded with innovative solutions.

Within our own solutions, our equity building block funds include a low carbon fund and an impact fund. Our low carbon fund has c.50 per cent less carbon than the broad equity market. Our impact fund invests to contribute positively to the United Nations Sustainable Development Goals (UN SDGs). For example, over the past year, c.26 per cent of the fund has contributed positively to good health and wellbeing via holdings in companies such as Moderna. This means investors have had a positive impact on global Covid-19 efforts. To further meet schemes’ needs, we are also launching a sustainable multi-asset credit fund, which will invest in strategies aligned with the UN SDGs and climate objectives.

Working with underlying managers to design solutions is another way fiduciary managers can meet schemes’ beliefs. We recently partnered with a leading manager to create a direct lending fund in which all loans have specific key performance indicators that encourage companies to make a positive change on ESG issues. We believe this is the first solution of its kind in which these clauses are in 100 per cent of loans.

Many schemes wish to include more than one RI approach in their portfolio. A flexible portfolio construction framework allows this. For example, several of the schemes we work with allocate half their equity exposure to our ESG integrated funds and half to our impact equity option.

A transparent approach

Beliefs, strong integration, and innovative solutions are only part of the picture. Reporting is the element that completes the feedback loop, keeps fiduciary managers accountable and allows schemes to meet their regulatory obligations. Our approach is to provide investors with an interactive online ESG dashboard and an annual stewardship report. The dashboard provides granular detail on ESG ratings, carbon metrics, and much more. The stewardship report explains the engagement we do on behalf of investors.

The bottom line

It is clear to us that RI is a theme that is here to stay. While the number and sophistication of solutions in the market has grown significantly, there is still work to be done. With fiduciary management, trustees can benefit from a holistic approach to RI and ESG which is based on their individual beliefs and can improve the likelihood of achieving their overall objectives – both across performance and sustainability.

There is no better time than now to seek expert advice on what is right for your scheme and to chart your own path towards a more sustainable future.

Written by Aon senior portfolio manager, Philippa Allen and RI portfolio specialist, Sam Segameglio