Appendix C

A Guide to Responsible Investment Reporting in Public Equity

January 2015
Version 1

Environment Agency Pension Fund

Kingfisher

Lothian PENSION FUND

NILGOSC

The Pensions Trust

Pension Protection Fund

SAUL

BBC Pension Trust Ltd

USS INVESTMENT MANAGEMENT LIMITED

Background

This guide was drafted following a number of roundtable meetings with pension funds and open consultation with fund managers. It is an iterative document which will be updated to reflect further feedback from fund managers and changing best practice. It should be seen in the context of our wider efforts to include responsible investment in requests for proposals, manager searches, due diligence and investment mandate terms.

Introduction

With over £200bn of assets we are a group[1] of UK asset owners committed to responsible investment (RI). We believe better reporting can help build our understanding of the extent to which RI factors and activities can help to explain both short and long-term investment risk and performance in public equity. More broadly, we believe RI reporting can help improve transparency and accountability between asset owners and fund managers.

Building on the Principles for Responsible Investment's (PRI) guidance for asset owners on including RI in manager selection and oversight[2], the aim of this document is to clarify our RI reporting expectations. We are also mindful of the NAPF's Stewardship Disclosure Framework which provides a high level reporting framework[3] reflecting the categories of the FRC's Stewardship Code. Whilst these frameworks provide guidance for reporting at the firm-wide level, this guide is intended for individual mandates.

Defining responsible investment

As long-term investors, we define RI in this guide as the integration of environmental, social and governance (ESG) factors in the investment decision-making process and stewardship activities.

An engagement and monitoring tool

The asset owners supporting this guide intend to use it to inform their engagement with, and monitoring of, both current and prospective fund managers. It is hoped the guide will be particularly useful for smaller pension funds and once a mandate has been awarded to a fund manager, where reporting will help us to monitor how well the fund manager's approach to RI is aligned to the broader investment strategy. For example, we would not necessarily expect the same approach to ESG analysis for a growth fund as a tactical opportunities fund. More broadly we intend to use managers' RI reporting to help inform our investment decision-making as well as engagement with our trustees, scheme beneficiaries and other stakeholders.

Intended fund manager audience

Where fund managers suggest that they already integrate RI in their investment processes, we expect ongoing private client reporting to help us understand in more detail how, and under which circumstances, these activities are taking place. Only through explicit RI reporting will we be able to build our understanding of the extent to which RI factors and activities can help to explain both short and long-term risk and performance. We believe better RI reporting can help fund managers to develop a more disciplined approach to explaining the rationale behind particular RI decisions.

Fund managers should regard these reporting expectations as a guide to help kick-start a process of reflection regarding their approach to RI. We do not expect managers to demonstrate best practice reporting overnight nor should managers feel compelled to deliver all the reporting expectations as a box-ticking exercise. Rather we encourage continuous improvement in RI reporting within a mutually acceptable time frame.

[1] Supportive asset owners include (as of launch): BTPS, PPF, Kingsfisher, West Midlands, Strathclyde, SAUL, Environment Agency, Merseyside, Northern Ireland Local Government Officers' Superannuation Committee, Pensions Trust, Lothian, USS, Unilever, BBC, NEST, RPMI Railpen.

[2] Aligning expectations: guidance for asset owners on incorporating ESG factors into manager selection, appointment and monitoring. UN-supported Principles for Responsible Investment, 2013.

[3] http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Stewardship/Stewardship-disclosure-framework.aspx

Improving the quality of RI reporting

The purpose of this guide is to encourage improvements in the quality of RI reporting for individual mandates. In drafting this document we have engaged with a number of managers and recognise that different investment styles and strategies will require different approaches to RI reporting. A one-size-fits-all approach would not be helpful.

A consistent and repeatable approach to generating RI reports could help to avoid adding unnecessary costs and administrative burden for our fund managers. We firmly believe that the long-term benefits that stem from greater transparency and accountability will outweigh any short term incremental reporting costs. Fund managers with high quality RI reporting may be less likely to receive more bespoke reporting requests.

We take a long-term, holistic approach to our relationships with our fund managers and are particularly interested in moving towards understanding long-term ESG trends and the development of metrics to assess long-term investment risk and performance.

RI reporting can vary in frequency and form

In this guide the term reporting is used in its widest sense, to capture all forms of communication between fund managers and their clients. Reporting can vary in frequency (daily, monthly, quarterly, annually etc.) and form (client specific reports, website portals, public reports, formal and informal verbal updates, analyst blogs etc). We do not prescribe our preferred RI reporting frequency or form.

Our primary objective is to encourage managers to clearly communicate their valuable insights. Where no material RI activity has taken place in the reporting period we encourage nil-responses. The manager is invited to demonstrate reasoning or explanation as to why they do not feel a particular reporting metric is relevant.

We would expect those involved in a specific mandate to be well-informed about the extent to which RI is integrated in the investment process. Portfolio managers in particular are expected to be able to rationalize decisions and give relevant examples of RI activities.

Clarifying RI reporting expectations

We have divided this section into the two parts of core RI reporting activity:

1. ESG integration: the transparent processes for considering environmental, social and governance factors in the manager's investment process including examples. We expect ESG integration to be applied in different ways depending on the fund manager's investment style.
2. Stewardship: the policies and processes for identifying companies for engagement and for voting stocks; voting and engagement activities, and evidence of outcomes from those activities. Building on the Financial Reporting Council's Stewardship Code[4], we regard stewardship activities as a core requirement for both passive and active public equity managers.

[4] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx

1. ESG integration

Our public equity managers might reasonably be expected to report on two areas of ESG integration in their investment process:

a) Identification of ESG risk and opportunity; and

b) Management and monitoring of ESG risks and opportunities.

1. (a) Identification of ESG risk and opportunity

- Examples of where and why the manager is prepared to take either stock or sector ESG risks or where it sees opportunities.
- Quantitative or qualitative examples of material ESG factors identified in fundamental analysis and stock valuation.[5]
- Identification of long-term ESG secular trends and themes (as potential determinants of future growth/valuation etc.) and the extent to which they have influenced portfolio construction decisions.
- Relevant information gathered from due diligence and stewardship activity which has informed the identification of ESG risks and opportunities.
- Benchmark relative, portfolio level ESG analysis (for example distribution of portfolio ESG scores relative to the benchmark, ESG scores or qualitative indicators or carbon footprinting) including specific stocks or sector decisions which drive under or over performance. Commentary on the materiality of this information to investment decision-making.
- Any changes to the ESG integration process during the period e.g. new resources, data provision.

1. (b) Management and monitoring of ESG risks and opportunities

- Examples of where the manager believes companies' management of ESG issues is a material determinant of performance e.g. lower volatility, sustainable earnings growth etc.
- Any geographic or industry allocation, or stock buying/selling decisions, that were influenced by the identification of ESG portfolio and stock risk and opportunity in the reporting period.
- Stock level ESG analysis for top risk and performance detractors/contributors in the reporting period.
- Any material changes to portfolio companies' ESG performance. Examples may include where the manager's view of ESG risk and opportunity differs from the market/rating agencies.

[5] There is a growing recognition of how ESG performance indicators can impact company value drivers. For further information on the impact of material ESG factors on sales, costs and long-term return on capital please follow this link: www.unpri.org/viewer/?file=wp-content/uploads/Integrated_Analysis_2013.pdf

2. Stewardship

Fund managers are invited to demonstrate how stewardship activities and ESG integration are connected in the investment process, and in turn, how engagement and voting activities are linked with each other as well as the link with forward-looking ESG analysis. Reporting should provide assurance that the type of engagement activity being undertaken is meaningful- not purely reactive.

The section on stewardship reporting is divided into two sections (a) Engagement and (b) Voting and for each section, where the manager is voting or engaging on behalf of the supporting asset owners, we might reasonably expect reporting on both process and outcomes.

2. (a) Engagement

Process

- Change in process for identifying engagement targets, change in list of engagement targets, portfolio weighting, engagement objectives, nature of activity (e.g. in-house or collaborative engagement), who attended meeting from company (e.g. Chair, investor relations) and investment firm, anticipated engagement timeline if applicable.
- Updates on any market-wide or public policy initiatives (engagement, consultations etc) responded to which are relevant to the strategy or the market in which it operates, and the underlying rationale for the specific activity undertaken.
- Any changes to resourcing or processes in place to engage portfolio companies (including change of proxy voting or engagement services provider).

Outcomes

- Examples of progress against engagement objectives over the reporting period.
- For completed engagements, provide any examples of how you expect engagement will enhance or avoid the destruction of long-term shareholder value or help manage risk.
- In addition to substantive engagement reporting, managers may also provide the percentage of portfolio and/or universe engaged. This may include engagement for the purpose of gathering information.
- For managers with a longer track record on stewardship, we would welcome any analysis on the degree to which engagement has contributed to portfolio level risk or return over time.

2. (b) Voting

Process

- Any changes to proxy voting policy/scope during the reporting period.
- Any changes to resourcing or processes in place to vote portfolio companies.
- Example of how proxy voting decisions are made:
  - Percentage of votes reviewed in-house (We are concerned that some managers follow external voting provider's recommendations without interrogation).
  - Examples of how conflicts of interest (if any) were managed in the reporting period.
  - Explanations for any deviations from proxy voting policy if applicable.
- A description of how and when votes were followed up or pre-empted by engagement activities (including any instances where a vote against management followed on from unsuccessful engagement).
- Information on how voting information was used to inform ESG integration and/or impacted investment decisions.
- Information on how environmental and social issues informed voting activities e.g. any votes (including rationale) on shareholder resolutions.
- Outline of changes to stock lending policies (if any) applicable:
  - Explanations for any deviations from policy; Details of events where holdings (entire or partial) could not be voted due to stock on loan over record date.
  - Any instances where lent stocks were recalled for the purposes of voting.

Outcomes

- Commentary on headline voting decisions during the reporting period and discussion of any themes/trends emerging in voting activity.
- Percentage of portfolio voted. Where less than 100%, reasons for missed/failed votes should be specified; and the steps taken to investigate and address the reasons behind failed/missed votes explained.
- A list of companies for which votes were cast during the reporting period, split by region, and all voting decisions for each; the rationale for all votes against management and abstentions; and any relevant examples of the rationale for votes in favour of management on controversial issues; explain votes cast (for or against) with respect to M&A resolutions and corporate actions.
- A breakdown of votes cast against management and abstentions by issue (e.g. remuneration, board quality etc).
- Progressive reporting: outcomes of any voting audit including the extent of the audit – which checks whether votes were cast as intended and actually reached the company; Results for key votes against the fund manager's assessment/vote cast.

Concluding remarks

We hope that this guide will stimulate discussion and facilitate constructive dialogue between asset owners and their fund managers. To reiterate, we do not expect managers to fulfil all of the reporting metrics overnight. Managers are invited to demonstrate reasoning or explanation as to why they do not feel a particular reporting metric is relevant.

We encourage continuous improvement in RI reporting and welcome further dialogue on progressive and innovative approaches to RI reporting which fund managers might work toward over the medium to long-term.

We welcome feedback on this guide including views on whether further guides might be developed for other asset classes.

The group would like to acknowledge the contributions and support from the PRI, NAPF, Ebba Schmidt at the PPF and the fund managers which provided feedback on early drafts. A copy of the paper is available on the NAPF website www.napf.co.uk/stewardship

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NILGOSC
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Merseyside PENSION FUND

nest NATIONAL EMPLOYMENT SAVINGS TRUST

SAUL

Univest Company

BBC Pension Trust Ltd

USS INVESTMENT MANAGEMENT LIMITED

RPMI RAILPEN