EXPERT COMMENTARY

With its increase in prominence, ESG integration in pension schemes' investment strategies and practices is also facing growing complexity. Are managers doing enough to help, asks Valeria Rosati, a senior partner at Vantage Infrastructure

The partnership at the heart of ESG

Within Europe, there are a multitude of national investment regulations on ESG, climate change, stewardship policies and disclosure, in addition to the EU directives on risk control and shareholder rights. Both the European Commission's action plan on sustainable finance and the UK Government's Green Finance Taskforce are seeking to encourage ESG efforts across the wider financial markets. At the heart of these regulatory and legislative changes lie two beliefs:

- In order to promote a scheme's purpose of growing and protecting members' capital sustainably, ESG factors need to be considered; and
- The investor community and broader financial markets can drive positive societal impacts.

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These beliefs are also shared across the globe by other investors who have voluntarily chosen to adopt responsible investment policies and to integrate ESG considerations into their strategies.

Infrastructure is particularly well placed to help pension funds and insurers achieve these objectives, given its essential nature and social function.

Vantage believes that infrastructure managers should work in partnership with their clients on these issues. As solution-orientated infrastructure specialists, we have considered our clients' own journeys into ESG integration and monitoring and how we can assist through active engagement at each stage.

Looking for tailored solutions

The first stage in an investor's ESG integration is a milestone that many pension schemes have already reached: the set-up phase. The investor establishes an ESG approach through policies and weaves it into its investment strategy through asset allocations. Review of framework documents and staff training may be needed to keep abreast of regulatory developments.

A 2019 survey by Slacker & Partners indicated that a top three obstacle to pension schemes' implementation of ESG policies was the lack of products in the marketplace. Allocating capital to unlisted infrastructure debt or equity can assist. The longevity of

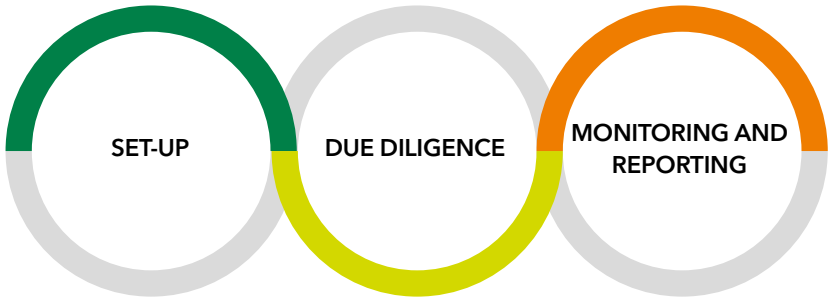
infrastructure investments supports resilient financial returns and sustainable goals for society, while also compelling careful consideration and management of long-term ESG risks. On the unlisted equity side, managers can drive responsible actions through direct governance, whereas on the debt side, managers can establish regular dialogue with borrowers to identify emerging risks and encourage best practice through benchmarking.

In this set-up phase, an infrastructure manager should:

- Work closely with the scheme to understand its ESG objectives and how to best integrate these into the investment strategy, and related governance and reporting requirements; and
- Implement the strategy taking account of market developments and the client's evolving ESG requirements.

For instance, pension trustees will need to choose the best format to hold investments, through pooled funds or separate managed accounts, and whether to delegate the stewardship of ESG issues to their managers or third-party providers. If an investor has very specific needs, a segregated account in infrastructure can provide a customised solution with mandate-specific parameters for ESG factors. For example, most of Vantage's clients have a range of sector exclusions reflected in their separate accounts with us and we also pay continued and careful consideration to non-contractual, client-specific risk tolerances, especially to identified reputational, social or environmental factors.

Investor ESG integration



Investor

- Establish and document ESG approach in policy
- Integrate ESG objectives into investment strategy
- Choose between pooled funds or separate accounts
- Perform manager due diligence and scoring
- Select manager
- Agree contractual ESG obligations
- Get involved in investment decisions (if non-discretionary)
- Receive regular ESG reporting
- Evaluate effectiveness

ACTIVE ENGAGEMENT WITH MANAGER

Manager

- Understand client ESG objectives and integrate in manager strategy, governance, reporting
- Implement investment strategy
- Offer customised ESG solutions
- Demonstrate alignment
- Conduct risk vs value due diligence
- Evidence actions
- Benchmark against peers and seek ongoing improvement
- Prepare ESG briefings on or involve client in capital deployment
- Design comprehensive ESG portfolio reporting
- Ensure Task Force on Climate-related Financial Disclosure integration and reporting

Source: Vantage Infrastructure

Favouring substance over form

The second stage of integration for a pension scheme is manager due diligence. A bfinance 2018 asset owner survey showed that 'ESG will pay a major role in future manager selection' for 58 percent of European investors and we believe this trend is likely to strengthen.

In this selection phase, investors are often assisted by asset consultants or other advisors, which provide comprehensive ESG questionnaires, due diligence support and manager scoring frameworks. With ESG labels at risk of being used as buzzwords, it is essential for an investor in its manager selection to 'look under the hood' at substance over form.

We have set out a few ESG considerations for infrastructure:

1. **Alignment.** It is crucial to understand a manager's true aspirations in ESG, whether its ethos aligns with the investor's and its plan to close the gap between aspirations and outcomes. In addition, alignment in values and investment practices does not exclude room for service customisation.
2. **Risk vs value diligence.** Due diligence performed by both investors and managers often focuses on what can go wrong. Particularly for infrastructure equity, a manager selection would benefit from two types of ESG reviews: risk due diligence and value due diligence. A manager should be able to demonstrate how their approach and practices mitigate ESG risk and how potential value opportunities can be systematically captured.
3. **Evidence.** It is easy, especially for large organisations with established brands and large marketing departments, to produce glossy documents celebrating their ESG strategy or integration framework. While those are useful, it is important to focus more closely on the manager's actual processes, actions in the day to day and results at the portfolio and asset levels. How have the manager's asset management programmes in ESG produced impacts and outcomes? For instance, priority should be given to reviewing a manager's ESG report produced for its clients over that posted on its website, particularly as disclosure in the latter will be limited by confidentiality restrictions applying to unlisted investments. Past investment papers, case

studies and periodic asset reviews are also helpful documents of actual practices and results.

4. **Benchmarking.** Nobody ever regrets raising the bar. So, should an investor be wary of managers that do not undergo benchmarking? Evidence should be requested on how a manager's tools, practices, achievements and innovations benchmark against peers. Vantage's participation in PRI and GRESB surveys is not driven by a thirst for third party accolades, but a desire to deliver best in class client outcomes in sustainability.
5. **Continuous improvement.** To turn good intentions into good results, we would expect any infrastructure manager to be able to provide past and future ESG action plans, targets and project trackers. Sustainable improvement is a marathon, not a sprint.

Expecting excellence

The third stage of ESG integration for a pension scheme involves monitoring and reporting.

This is where infrastructure managers can provide investors with a superior and differentiated service in ESG.

In connection with capital deployment, an investor with an infrastructure manager appointed on a discretionary basis should expect as a minimum manager surveys and portfolio review meetings covering:

- Examples of pursued or declined investments whereby ESG considerations have affected the manager's ultimate decision; and
- Examples of manager engagement with issuers on new and existing investments.

On the non-discretionary mandate side, an investor should see the manager's ESG assessment frameworks and tools clearly deployed and incorporated in its own client investment papers.

In connection with portfolio reporting, at Vantage we believe best in class service in ESG should include three components.

1. **Transparent fact-based outputs.** A pension fund should expect its infrastructure manager to report on ESG matters regularly. Action programmes and continuous monitoring should be included in quarterly updates, ranging from reporting internal ESG assessment scores alongside traditional credit ratings for debt investments to highlights and updates for equity investments. On the unlisted equity side, where substantial access to ESG information typically exists, comprehensive and quantitatively focused annual ESG reports should be delivered to clients to share perspectives on investee companies' material ESG risks and opportunities, achievements to date, action plans and, where possible, targets. At Vantage we now prepare an extensive annual ESG report on our managed equity portfolio collecting, analysing and comparing a broad range of quantitative ESG measures asset-by-asset.
2. **Impact quantification.** A comprehensive ESG client report should also cover environmental impacts, such as carbon emissions and abatement and resource management metrics, and social impacts. It can also be useful to classify a portfolio company's ESG contribution mapping results to recognised sustainability frameworks or targets, like the Sustainable Development Goals or the EU Principles for Taxonomy Development.
3. **Value-orientated assessments.** Periodic reports should also incorporate ESG risk assessments for both debt and equity assets. At Vantage, we have also developed an in-house ESG 'risk to value' system, which sits alongside our managed assets' GRESB sector benchmarking reports. While the latter benchmarks investee companies within their peer groups, our tools look at ESG risks to shareholder value, thus providing clients with a different comparative dimension.

There is no denying that the level of reporting activity described above is time- and resource-intensive. However, it is essential to both engage transparently with our investors and set internal and portfolio company ESG strategies and targets. We have found that, in ESG, there is no substitute to rolling up your sleeves.

As active asset managers, our purpose is to use ESG assessment tools and data analysis to drive disciplined actions and make an impact on each investee company.

However, our actions and outcomes also need to be communicated transparently and comprehensively to the investors for their mapping of ESG across asset classes. This is valuable in tackling the lack of standardisation, which can make manager benchmarking challenging in ESG.

Finally, at Vantage we regard the above reporting as necessary but still not sufficient to fulfil an investor's monitoring and reporting needs.

Climate change in its own right is increasingly being recognised by multiple regulators as paramount to investment decisions and the bar for climate-related disclosures from investors continues to rise. Many organisations across the world will be reporting climate related disclosures under the Task Force on Climate-related Financial Disclosures by 2022, with initial evidence for UN PRI signatories needed to be submitted in 2020.

While the TCFD is nascent, a prudent infrastructure manager should already have a plan in place to tackle its incorporation and to report on it incrementally over time.

At Vantage, we have started working on this project, with indicative risk assessments already performed for unlisted equity investments under the TCFD framework.

The next phase involves deeper dives and quantitative analyses driven by materiality.

These assessments will improve an infrastructure manager's ability to exercise stewardship of climate-related investment decisions at the portfolio companies' level. In addition, our own climate assessments have been giving more prominence to risks than opportunities. Going forward, a more balanced look at both has been identified as an action item.

So, are infrastructure managers doing enough to assist investors' own ESG integration? In this rapidly shifting field, many investors are probably still working through their ESG needs. We believe that the right infrastructure manager can certainly assist this journey.

A year ago in this publication, we said our ESG ambition was to elevate Vantage's ESG strategy and practices above market standard.

Our new tools and outputs since then have been client-centric but there is still more we can do to push the frontier. As Zig Ziglar would say: "There are no traffic jams on the extra mile." ■

Vantage Infrastructure is an independent investment firm comprising an experienced team, longstanding institutional relationships and a diverse equity and debt infrastructure investment portfolio with over £2.8 billion invested in infrastructure assets across Europe, North America and Australia on behalf of global clients