ARE FUND MANAGERS MISSING THE TARGET ON STEWARDSHIP?
AN ASSET OWNER PERSPECTIVE
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The Local Authority Pension Fund Forum (LAPFF) is a voluntary association of 76 local government pension scheme fund members, based in the UK, with combined assets of approximately £230 billion. LAPFF exists to protect the long-term investment interests of its members and to maximise their influence as shareholders by promoting the highest standards of corporate governance and corporate responsibility amongst investee companies.

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Since LAPFF’s inception over 20 years ago, the Forum has been making the case for responsible investment and improving corporate governance in the UK. Over that time integrating environmental, social and governance aspects into investment decisions of asset owners has become more widespread with mounting evidence showing that doing ‘the right thing’ on ESG equates to the ‘right thing’ financially for beneficiaries.

However, the Forum is well aware that individual funds do not act alone. This is why LAPFF continues to push collectively as a membership organisation, as well as joining forces with other asset owners, to shift company practice and market behaviour. And it is also why the Forum recognises the critical role asset managers play in executing the mandates given by funds. Indeed, it follows that if good governance delivers better financial returns, then asset managers are performing in ensuring high environmental, social and governance standards is a matter of materiality. It is for these reasons that, over the years, the Forum has produced trustee guides which provide detailed advice on how funds can assess their asset managers’ engagement strategies, policies and activities.

On the back of this work and set against the context of pooling, this report holds a mirror up to the fund management sector with the aim of highlighting where members think it is doing well and where there is room for improvement. By doing so, the aim is to help strengthen the relationship between asset owners and asset managers, and to help ensure LAPFF members get the most out of those tasked with managing beneficiaries’ pension pots.

Based on the views of our members, the results of the survey provide a unique insight. Whilst there have been similar studies, this looks exclusively at pension fund views of asset managers and ESG and includes issues such as their reporting, effectiveness and responsiveness. The findings are encouraging in one sense as managers are not heavily criticised. However, a less generous assessment would be that they are damned with faint praise. Whichever way you interpret the results, there is certainly room for improvement. In this respect the report throws down the gauntlet for asset managers to do much more when it comes to exercising their stewardship functions.

Ian Greenwood
Chair of Local Authority Pension Fund Forum
Given the stewardship role asset managers play, LAPFF conducted a survey of its members at the end of 2017 to better understand how asset managers were meeting funds’ environmental, social and governance (ESG) needs. Based on responses from 40% of its membership, the survey found:

- Overall, LAPFF funds were underwhelmed by their asset managers. Whilst the majority felt that their ESG needs were being met ‘somewhat well’ (60%) only one in ten (8%) gave them the top score.
- The majority (63%) of respondents felt asset managers were ‘somewhat effective’ at changing ESG behaviours, but only 4% gave them top marks.
- Almost half (45%) stated that whilst asset managers assert that ESG is integral to investment processes and valuation methodologies, they provide little evidence that this was the case.
- When asked how likely funds are to recommend their asset manager to another fund in their pool based on ESG performance, funds give an average ‘net promoter score’ of under seven, suggesting significant numbers are unlikely to propose using their manager to their peers.

Mirroring priorities

- The survey also found that asset managers could do more to mirror funds’ ESG priorities.
- Four in ten (42%) said that their asset managers occasionally focus on ESG issues that mirror their funds’ priorities.
- Four in ten (40%) stated that it was not easy to get their asset manager to focus on ESG issues that mirror their funds’ priorities.
- One notable area where asset managers scored highly was over responsiveness to individual requests, with the majority (65%) stating that their asset manager was ‘very responsive’ to a specific request for ESG work.

Managing the relationship

- One in three members (29%) stated that it was not easy to work with their asset manager on ESG-centric engagements.
- The majority (86%) of funds felt resources were needed to ensure asset managers were fully discharging their ESG mandates. However, relatively few (10%) felt more resources were needed and this would represent value for money.

Reporting impact

- The majority (58%) were ‘somewhat satisfied’ with their asset manager for examining portfolio holdings to highlight and address ESG risk, but only a quarter (25%) said they were very or extremely satisfied.
- One in five members (21%) felt their asset managers were ‘not so good’ at keeping them updated on ESG risks.
- Three in ten (30%) felt managers’ reporting was not done well when it came to the impact their ESG stewardship had had on market behaviours.
- Over a third (35%) felt that asset managers were not reporting well on the progress that portfolio holdings were making in meeting ESG performance targets.
- Most funds (70%) felt work on asset managers’ reports was required before they were able to pass on information to stakeholders.

Selecting the right managers

- The vast majority (95%) of funds give some weight to ESG in the selection process.
- There appears to be noticeable divergence in the ESG scores funds gave to different asset managers, highlighting that the selection process is likely to be critical to managers meeting funds’ ESG needs.
- This divergence extends to whether funds would recommend managers to their peers.
Effective stewardship is not a ‘nice to have’, it is matter of materiality. The majority of empirical evidence shows the positive relationship between better ESG performance and better corporate financial performance.\(^2\)

As an IMF Working Paper notes: ‘the impact of improvements in corporate governance quality on traditional measures of real economic activity --- GDP growth, productivity growth, and the ratio of investment to GDP --- is positive, significant, and quantitatively relevant, and the growth effect is particularly pronounced for industries that are most dependent on external finance.’\(^3\) Hermes research has drawn similar conclusions at a firm level showing well-governed companies outperform their poorly governed competitors by an average of 30 basis points per month\(^4\) and there is also a performance premium from a credit perspective.\(^5\)

It is little wonder then that asset owners increasingly see ESG as an investment issue. The PLSA Stewardship Survey has shown that 93% of responding funds viewed ESG factors as material to their investment returns – an increase from 81% in 2013.\(^6\) And this perspective appears to be feeding through to asset managers. The Investment Association’s annual survey Asset Management in the UK found a third of asset managers stated that institutional business they manage subject to ESG requirements increased, and just 3% reported a fall.\(^7\) A survey of institutional investors in the USA, Europe and Asia commissioned by State Street Global Advisers also found that most institutions have an ESG component to their investment strategies.\(^8\)

Despite this and moves to adopt ESG policies and strategies, evidence suggests that few, as low as one in five, asset managers are fully integrating ESG into their investment decisions.\(^9\) As one observer has noted, this risks creating the worst of both worlds with investors bearing the costs of asset managers geared up for ESG without delivering the promised benefits.\(^10\)

Set against this backdrop, this report aims to look at the issue from the perspective of LAPFF members, not least because of the scale of the stewardship responsibilities asset managers have. Almost all Local Government Pension Scheme (LGPS) funds use external asset managers for some or all of their investment management strategies. Over 150 asset managers are used by LGPS funds in the UK, spread across the whole range of recognised asset classes and through a diverse range of management arrangements. These asset managers have accrued a significant amount of assets under management from the LGPS sector. Some estimates have suggested contracts are worth over £150 billion, with the top 20 asset managers managing over £100 billion.\(^11\)

To understand the nature of their role and perceived quality of performance the Forum undertook a survey of its members at the end of 2017. 29 funds responded, representing 40% of LAPFF’s membership at the time.\(^12\) The results from this survey are presented in the report with the aim of informing both asset owners and asset managers and to help strengthen the relationship between them with the ultimate focus on improving corporate ESG practices.

\(^3\) Ueda et al. ‘Corporate Governance Quality: Trends and Real Effects’, Working Paper 06/293 (IMF,2006)
\(^4\) Hermes Investment Management, ESG matters: Integrating environmental, social and governance risk analysis into our investments (2016)
\(^5\) Hermes Investment Management, Pricing ESG Risk in Credit Markets (2017)
\(^6\) Pensions and Lifetime Savings Association, Stewardship Survey 2016
\(^7\) The Investment Association, Asset Management in the UK 2015-216: The Investment Association Annual Survey (2016)
\(^8\) State Street Global Advisers, ESG Institutional Investor Survey (2017)
\(^9\) Eccles, R and Kastrupel, M The Investing Enlightenment How Principle and Pragmatism Can Create Sustainable Value through ESG (State Street, 2017)
\(^11\) Unison, Presentation for TUC Trustee Conference, LGPS Governance, Economics & Mergers (2013)
\(^12\) Responses to individual questions were slightly lower, the lowest response rate to a question was 20 answers.
At the start of the survey, funds were asked about their general views of how their asset managers were performing on ESG. As was the case throughout the survey there was a strong sense that asset managers could do better. Funds considered their asset managers were doing ‘somewhat well’, which although not an indication of failure was not a ringing endorsement of manager performance.

This sense was evident in responses to the initial overarching question about whether funds’ ESG needs were being met by their asset managers. The majority (60%) stated they were being met ‘somewhat well’, with one in five (20%) saying ‘very well’. Only one in ten (8%) gave the top score ‘extremely well’.

Ultimately what matters is delivering impact. With multi-billion pound mandates asset managers have a critical role in company engagement and the clout to deliver change. As the UK Stewardship Code notes ‘Asset managers, with day-to-day responsibility for managing investments, are well positioned to influence companies’ long-term performance through stewardship.’

Despite this important function there was lukewarm praise from member funds of asset managers’ activities to deliver on ESG. Just 4% gave asset managers the top score when asked whether their asset managers were effective at engaging their fund’s portfolio holdings to achieve concrete and measurable change in ESG behaviours. 21% gave the next score (very effective), with somewhat effective being the most frequently stated by members (63%).

Being effective at addressing risks first relies on identifying the threats. Yet, LAPFF members did not have full faith their asset managers were doing so. The majority of respondents (58%) stated that they were ‘somewhat satisfied’ as to whether asset managers were examining portfolio holdings to highlight and address ESG risk. 20% were ‘very satisfied’ and 4% ‘extremely satisfied’. Meanwhile one in ten (12%) gave negative responses stating they were either ‘not so satisfied’ or ‘not at all satisfied’.

Given the evidence on the link between governance and company performance, it is not surprising then that the vast majority (86%) of respondents felt that asset managers state that ESG is integral to investment processes and valuation methodologies. However, 45% stated that whilst it is asserted that it is integral, asset managers provide little evidence that this is the case. A small number (13%) stated that they were unsure of the extent to which ESG is integral to investment processes and valuation methodologies. These results would at the very least suggest there is a disclosure or communication exercise asset managers need to better inform their clients as to how ESG is being integrated into investment processes. A less generous interpretation would be that some asset managers need to go beyond the rhetoric and ensure practices live up to the warm words.

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1 DELIVERING IMPACT

13 FRC, The UK Stewardship Code, September 2012
Asset managers assert that the consideration of ESG issues is integral to their investment processes and valuation methodologies but provide little evidence that this is the case.

The consideration of ESG issues is clearly integral to the managers' investment processes and valuation methodologies.

We are unsure of the extent to which the consideration of ESG issues is integral to their investment processes and valuation methodologies.
2 MIRRORING FUND PRIORITIES

As asset owners, LAPFF members sit at the top of the investment chain. In theory this puts funds in the driving seat for promoting and advancing good ESG practices. Indeed, the Stewardship Code notes: ‘As the providers of capital, they [asset owners] set the tone for stewardship and may influence behavioural changes that lead to better stewardship by asset managers and companies.’

In practice, funds are reliant on asset managers to adapt their priorities to match those of their clients and as instructed. However, this is not always the case. The Financial Conduct Authority’s 2017 Asset Management Market Study found the market to be not fully functioning and recommendations included a strengthened duty on fund managers to act in the best interest of investors. Although the study was not focused on ESG issues, it highlights the potential for asset managers not to be aligned with funds’ stewardship priorities.

This potential misalignment was evident in the survey. Half of funds do not think asset managers regularly focus on ESG issues mirroring their funds priority ESG policies. Four in ten (42%) stated they did so occasionally and one in ten (8%) said rarely.

The survey also highlights that a number of funds felt that asset managers did not make alignment hassle free. A third of funds (36%) stated it was not so easy to get their asset managers to focus on ESG issues that mirror their fund’s priorities. A further third said that it was only somewhat easy (32%). However, one in five did state it was very easy. Whilst not a damning indictment, it does point towards a market that is not fully meeting the needs of clients.

Where the results suggest better performance by asset managers is with regard to responses to specific ESG requests. On average funds made four requests for a particular piece of ESG work in the last year. Around two thirds said their asset managers were ‘very responsive’ to requests and 20% ‘somewhat responsive’. This would suggest that funds feel that asset managers are more responsive to these specific requests than ensuring they focus on ESG issues that mirror their fund’s priority ESG policies. The results would therefore indicate that asset managers can be responsive when specifically requested to be but more needs to be done in their general approach to meeting the ESG needs and priorities of funds.
A frequent riposte from the asset management industry is that alignment and doing more comes at a price. In a study by BNP Paribas, one asset manager stated:

“I think the question on skills and capabilities can be overcome, but cost is another issue. Who is going to foot that cost? Is it going to be yet another expenditure for asset managers, who will not be able to reclaim that incremental fee from asset owners?”

Whilst cost is likely to be a factor, one reading of the FCA market study might be that the sector could be able to absorb such costs given that the report highlighted ‘considerable price clustering’ and ‘high levels of profitability’. Regardless of this, pooling could help funds. Whilst investment strategies and ESG priorities remain with the administering authorities, pools could potentially use economies of scale to ensure greater ESG alignment.

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3 MANAGING THE RELATIONSHIP

Getting the asset-owner - asset manager relationship right is important as funds remain responsible for ensuring activities undertaken by asset managers are consistent with their own approach to stewardship. However, managing this relationship effectively does not appear to be made easy by asset managers. A third felt that it was ‘somewhat easy’ to work with their manager on ESG-centric engagements. A similar number (29%) felt it was ‘not so easy’ while 17% felt it ‘very easy’. The responses are similar to how easy funds found it to ensure their policies were being matched by their asset manager.

Similar studies into the asset owner-asset manager relationship have suggested as asset owners are commissioning fund managers, their own priorities will to an extent be reflected in the actions of fund managers (and some have highlighted relatively low demand for ESG integration). This further emphasises the important role of funds and trustees. As the LAPFF policy document notes, delegation to managers still requires stewardship by trustees of their managers’ delegated responsibilities.

Managing the relationship inevitably makes calls on fund resources. In the survey, members were asked which statement best describes whether additional resources are needed to ensure that their asset managers are fully discharging their ESG mandates. The most popular response was that ‘We do not need additional resources as we already ensure our asset managers are discharging their ESG mandates’ (43%). Followed by ‘We need additional resources to ensure our asset managers are discharging their ESG mandates, but additional resources would not represent value for money’ (33%). 15% felt that asset managers met their ESG mandates, therefore no dedicated resources were needed to ensure they were being met. Just one in ten (10%) felt they needed additional resources.
Similar surveys have also highlighted some of the other challenges facing asset owners. For example, one survey found that over half (56%) said they lacked the capability to assess the performance of external managers. Follow-up interviews for that study revealed the sense that disparate sources of information made comparisons difficult. This highlights the challenge around training and perhaps the need for more standardised forms of reporting from managers. LAPFF’s policy document also gives advice, stating:

‘An important way in which trustees can become more activist, even if resources may be limited, is by regularly reviewing their fund managers’ engagement activities with a view to assessing the effectiveness of that engagement, on the basis of regular (e.g. quarterly) reports from fund managers or in meetings with them.’

*State Street Global Advisers, ESG Institutional Investor Survey (2017)*
4 REPORTING IMPACT

Just as with investee companies, assessing the ESG performance of asset managers requires appropriate disclosure. An essential component of doing so is through reporting. As agents acting on behalf of their clients, asset managers have an obligation to keep funds informed. Yet despite this, positive feedback from members was again underwhelming.

A necessary component of reporting is understanding the ESG risks asset managers are seeking to avoid and minimise. However, around half (45%) of respondents stated that their asset manager was ‘somewhat good’ at keeping them updated. Whilst a quarter (25%) said they were ‘very good’ one in five (21%) felt they were ‘not so good’.

Asset managers performed less well when it came to reporting the impact they were having on ESG risk. Around half (48%) felt their asset managers reported ‘somewhat well’ on the impact their ESG stewardship has had on market behaviours, three in ten (30%) felt it was done ‘not so well’ or ‘not at all well’ while only 13% felt it was done ‘extremely well’ or ‘very well’.

Similarly, a significant minority (35%) felt that asset managers were not reporting well (‘not so well’ or ‘not at all well’) on the progress that relevant portfolio holdings were making in meeting ESG performance targets. Nevertheless almost half (48%) felt they did so ‘somewhat well’.

Funds also need to keep beneficiaries and stakeholders informed. In light of the resource constraints evident in the earlier responses, the quality of reporting from asset managers could help reduce pressures if it can easily be passed on. Respondents were therefore asked a series of questions about how good asset managers were at providing reports that enable stakeholders to understand how well their fund is doing in executing its ESG policies.
The results showed:

- The majority (60%) felt that their asset managers were ‘fairly good’ (‘they provide us with the data we require to communicate the fund’s stewardship of its ESG policies effectively to stakeholders’).
- One in five (20%) said ‘very good’ (‘we can pass their reports on to our stakeholders with just a little clarifying commentary of our own’).
- Only one respondent felt they were ‘extremely good’ – ‘we can pass their reports on to our stakeholders as written’.
- Only one in ten (10%) felt they were ‘not so good’ – ‘we have to make regular requests for data to help us communicate the fund’s stewardship of its ESG policies effectively to stakeholders’.
- No one felt their asset manager was ‘not good’ – ‘they let us down when we request data to help us communicate the fund’s stewardship of its ESG policies effectively to stakeholders’.

In responses about specific managers, some scored better on this aspect of reporting than others, notably impact and progress. Nevertheless, the responses suggest they could do better to make funds’ stakeholder engagement easier.

**ESG Disclosure**

ShareAction have conducted a responsible investment benchmarking assessment of 40 largest European asset managers, based on publically available material and a questionnaire to asset managers. They found that RI performance and disclosure varies widely. While 70% of asset managers publicly disclose voting instructions, only 20% disclose a rationale for voting instructions and stated that the highest scoring asset managers also provided explanations of key votes cast. Over a half of asset managers disclose the total number of company engagements and 45% disclose engagements on ESG issues but only one in five give a full list of companies engaged with. The majority of asset managers were also found to make basic mention of impact investing (83%), 63% have information on impact measurement methodology but only 5% were deemed to provide detailed information.

In the survey response, ShareAction found that 94% monitor whether a company’s practice has changed following an engagement, 81% monitor whether a company engaged with has made progress against milestones and 74% obtain written commitment from a company to improve. The survey also looked at disclosure of engagement with policymakers and regulators, conflicts of interest policies and fees and charges. It also found that the vast majority of managers said that they provided internal employee training on ESG issues and around half included ESG in their performance assessments.19

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19 Share Action, Lifting the Lid: Responsible Investment Performance of European Asset Managers (2017)
5 SELECTING THE RIGHT MANAGERS

The asks funds make of asset managers are established in the selection process. Other surveys of pension funds have highlighted the growing expectations of asset managers to set out their approach to stewardship when they are being selected. The PLSA Stewardship Survey, for example, revealed that the majority of pension funds responding stated that they question potential managers about their approach to stewardship as part of the selection process, and around half (47%) include specific stewardship criteria in their Requests for Proposals. Indeed, over two thirds (68%) of respondents to their survey set out stewardship responsibilities in their mandates to investment managers up from 38% in 2013.

Under the Stewardship Code, funds should also ‘clearly communicate their policies on stewardship to their managers’ and ‘asset managers should be better informed, enabling them to tailor their services to meet asset owners’ requirements.’ So to understand the importance of ESG in the selection process, LAPFF members were asked how much weight they give to an asset managers ESG stewardship capabilities when they are being selected. The majority of pension funds give it ‘some weight’ (60%). Around a quarter of pension funds give it ‘significant weight’ (23%), while 14% give it ‘not much weight’ and 5% ‘no weight’. No respondent stated that they gave it ‘considerable weight’, the top answer.

The survey reveals that those who previously stated that consideration of ESG issues is clearly integral to the managers’ investment processes and valuation methodologies place stronger weight on ESG in the selection process. Those LAPFF members stating asset managers assert that consideration of ESG issues is integral to their investment processes and valuation methodologies but provide little evidence that this is the case appear to place less emphasis on ESG in the selection process. This would suggest weight given to ESG in the selection process is important either in shaping what the asset manager has to provide or which asset manager is chosen. Either way, this finding reinforces the point that demands made of asset managers drives the market and stresses the important role of asset owners.

The selection process also matters because of the uneven ESG performance by asset managers. Whilst the sample size is small, responses on individual asset managers suggest divergent performance amongst the larger asset managers. Across a range of measures some fund managers used by LAPFF members scored more highly than others, including meeting the funds’ ESG needs, responsiveness to ESG objectives, and effectiveness in achieving positive ESG change. This divide was also evident in the likelihood of respondents to recommend specific asset managers to another fund within their pool for ESG service requirements.

This suggests that scrutiny of asset managers’ capabilities and emphasis of ESG in selection matters will be an important part of in delivering funds’ desired ESG outcomes. So while managing the relationship with fund managers matters, so does the initial decision about which asset manager to use. Such findings should also be of interest to asset managers trying to win contracts from investors increasingly concerned about ESG issues.

This is particularly the case given the relatively low average net promoter score, with funds scoring their managers an average 6.5 out of ten. Respondents giving a 9 or 10 are seen as ‘promoters’, loyal customers likely to recommend the company/service to others, those giving a 7 or 8 are described as passives, who are satisfied but unenthusiastic, and those scoring 6 or below are described as ‘detractors’, unhappy customers who can damage a company’s brand.

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20 Pensions and Lifetime Savings Association, Stewardship Survey 2016
CONCLUSION

As the Kay Review of UK Equity Markets and Long-term Decision Making noted, asset managers play a central ESG role by ‘exercising the attributes of share ownership.’ These stewardship attributes matter because evidence shows they are material.

Despite their important role, the survey has shown that when it comes to ESG, asset managers are not excelling in the eyes of LAPFF members. At the heart of the survey responses there was a sense that funds were underwhelmed with their asset managers; that fund managers were performing adequately but not outstandingly. Across a range of responses funds tended to see asset managers performing ‘somewhat well’ or ‘somewhat effective’ whether it was in engaging companies, examining portfolio holdings or highlighting and addressing risk. A significant number also felt that whilst fund managers stated ESG was integral to the investment process there was little evidence that this was the case.

To start to address these concerns and reports of suboptimal performance, asset managers might first look to better mirror the ESG priorities of funds. Half of members stated that asset managers do not do so regularly and there was a clear sense that more could be done to make the process of alignment easier. This said, when pressed, asset managers do appear to be willing and able but mainly when it comes to individual requests for ESG work.

Managing the relationship therefore appears to matter. Indeed, the vast majority of funds believe that they do need to manage this relationship. However, a third of members felt that it was not easy to work with asset managers on ESG engagements. And some questioned whether the additional resources required to ensure managers were discharging their ESG mandates represented value for money.

With limited budgets, efficient use of resources spent on managing the relationship could be supported not just by managers being more responsive but also through better reporting. The survey revealed that three in ten members felt that asset managers did not report well on the impact their ESG stewardship was having on market behaviours. And most stated that additional work on manager disclosure was required before they are able to pass this information on to stakeholders. Improvements in reporting could therefore be a way to free up time and enable funds to better assess how their managers are performing on ESG engagement.

On this front, the survey revealed that some fund managers may be better than others in withstanding greater scrutiny. Survey responses highlighted the gulf between managers, which emphasises the importance of the selection process. Almost all funds stated that they give some level of weight to ESG in the selection process. However, those funds who place more weight on ESG issues are more likely to have also stated that they are clearly integral to the manager’s investment processes and valuation methodologies. In this respect, the weight given by funds to ESG in selection matters as it appears to be matched in the investment processes.

Such examples show funds themselves have an important role in ensuring asset managers are exercising their stewardship duties. However, from the perspective of LAPFF members, asset managers could do much more, be it in on ESG impact, mirroring priorities or reporting.

Pension funds and asset owners are increasingly convinced that ESG performance has material impact on their investments. If it achieves nothing else, this survey should be a wake-up call for some actors in the asset manager sector that they are being judged on ESG performance and are often viewed as underperforming.