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Investment

It's Red Line Day

A trigger system that alerts fund managers about a company's behaviour could empower trustees and make responsible investing more accessible

by: David Blackman

When the Institute of Directors is concerned about boardroom pay, it's a sign that the issue is getting traction.

Not too long ago, the IoD was the business world's cheerleader for Thatcherite free markets. However, in January, the institute's director-general Simon Walker added his voice to the chorus of those worried about 'runaway pay packages', that he said was fuelling a wider public distrust of business.

Combined with growing pressure on oil and gas companies to stop extracting fossil fuels from the ground, it's an opportune moment for a new trustee-led initiative to boost pension power in the boardroom.

On 10 March, Ownership Day was launched, which its backers claim heralds a revolution in investment governance. Included in the day was the start of the Association of Member Nominated Trustees (AMNT) initiative called Red Line Voting – a project to set 'red lines' for companies' environmental, social and governance performance, with corresponding voting instructions for fund managers.

It's a far cry from 30 years ago when the concept of ESG was pioneered. "It was a stark choice. You either went for a so-called ethical fund or a mainstream fund and there was nothing in between. Now there is more middle ground," says Vicki Bakhshi, head of responsible investment at F&C Asset Management. She points out that 83% of new pension fund mandates contain an ESG component.

While schemes often just used to ask fund managers to tick a box to show they had signed the UN Principles of Responsible Investment (PRI), she says they are now looking for more evidence of commitment.

Bakhshi recently saw one request for proposal (RFP) for an equity »

» mandate that contained six pages of questions designed to test prospective fund managers' responsible investment credentials.

Abigail Herron, head of responsible engagement at Aviva Investors, agrees that awareness is improving. "If you asked a question about these issues, such as carbon emissions or the number of women on the board, the chairman or finance director would be like a rabbit in the headlights. Now they are more prepared: there a definite shift to getting responsible investment topics on the agenda."

Herron is aware of an "increasing awareness among trustees about what they can and can't do, that they are asset owners and that voting and engagement is part of that".

Rob Hardy, from the corporate governance team at J.P. Morgan Asset Management, believes that for many investors, 2012's shareholder spring was a "watershed moment".

He says: "There was a collective awareness that we could unseat directors. People smelt blood. The financial crisis focused a lot of minds. We weren't holding the companies that we owned to account."

However, many trustees have been put off from undertaking responsible investment by the fear that it will not generate the returns needed to pay their members' benefits.

Last month, the London Business School fuelled the concerns with research showing that tobacco and alcohol companies had generated market-beating returns.

One of the reasons behind these returns, concluded the authors, was that such stocks had become relative bargains, due to many investors' unwillingness to buy them.

Nevertheless, at least when it comes to environmental issues, the National Association of Pension Funds' (NAPF) corporate governance policy lead, Will Pomroy, believes trustees should not be put off. "The evidence is increasingly robust: people understand that these issues can have a material impact on their performance," he says.

"The financial crisis focused a lot of minds. We weren't holding the firms we owned to account"

And trustees should be more confident about investing in what they consider to be the right things following last year's report on fiduciary duties by the Law Commission.

Herron says: "The question mark for trustees over whether responsible investment factors can be addressed has now gone."

However Steve Delo, chief executive of independent trustee firm PAN Governance, believes that pension funds boards are too busy to get involved in the nitty-gritty of responsible investment.

He says: "There is so much for trustees to do, with so many conflicting priorities, that responsible investment criteria are rather second order compared to funding deals and determining big picture investment strategy.

"I fear that the sheer volume of work and responsibilities for trustee boards is not understood by those who proclaim the need for 'more responsibility' in investing. So best practice requirements/edicts tend to result in box-ticking compliance, as opposed to behavioural change."

Addressing this lack of capacity on trustee boards is one of the drivers behind the Red Line Voting initiative.

The project is the brainchild of the Association of Member Nominated Trustees' (AMNT) co-chair Janice Turner, who is a trustee of the broadcasting union Bectu's scheme. She feels that it is unrealistic to expect smaller pension schemes to engage with the companies that they are invested in, unlike their bigger counterparts, such as the Universities Superannuation Scheme.

Turner says: "The only pension schemes able to actively participate in responsible investment have more than £1bn in assets under management."

Under the red line initiative, fund managers will be issued with voting instructions on how companies perform in relation to a set of environmental, social and governance issues. Crossing these 'red lines' should trigger a vote against the company at its annual general meeting.

The idea of setting out these clear trigger points is to give pension schemes, especially small ones, the ability to meaningfully instruct fund managers on how to vote.

Turner argues that setting out a consistent set of voting instructions, which can be easily downloaded from the internet, will make life easier for fund managers, too.

Turner was inspired to mount the initiative by the shareholder spring. However, while the 2012 investor revolt focused on pay, Turner and her fellow trustees at the AMNT wanted a wider-angled approach to shareholder activism, which would also embrace the social and environment elements of ESG. "A lot of funds were doing the G but not the S and E," says Turner.

She had found no evidence of instances where fund managers had been able to use the votes they exercised on the pension funds' behalf to defeat a company.

"It doesn't say much for shareholder

ENVIRONMENTAL AND SOCIAL GOVERNANCE: A timeline

2010 – Financial Reporting Council publishes UK Stewardship Code (updated in 2012). It aims to improve the quality of engagement between asset managers and companies. A long list of pension funds, including British Airways Pensions, DMGT Pensions and the Lincolnshire Pension Fund sign up to the code

January 2012 – Business secretary Vince Cable publishes plans to make it easier for shareholders to veto executive pay packages

May 2012 – 'Shareholder spring' claims its biggest scalp. Aviva's chief executive, Andrew Moss, steps down after shareholders revolt after executive pay rises although the company's share price has fallen

July 2012 – Publication of the Kay Review, outlining a package of measures to encourage long-term investment

July 2014 – Law Commission publishes report on trustees' fiduciary responsibilities.

democracy if you can never defeat a company," she says.

Turner offers the hiring of auditors as an example of the kind of issue that the red lines could apply to. Failure to put an auditor's appointment out to tender for a certain period could trigger an instruction to vote.

"The auditor has to be able to produce an independent assessment of the company's situation – if the auditor's independence is compromised, that's a serious problem for the asset owner."

Developing red lines to cover environmental and social issues has proved harder though, Turner admits, although the UK Sustainable Investment and Finance Association is developing them.

The red line approach isn't quite as draconian as it might look at first glance.

The AMNT's proposed approach is based on the 'comply or explain' approach, which is common in regulation. Under this, a company could have up to several years to fall into line with a vote. And under the AMNT's proposal, companies will be able to explain themselves to trustees if they disregard their fund managers' instructions.

Of course, Red Line Voting is not the first initiative designed to boost investors' power (see box, left).

However, Turner argues that the red lines will be both more transparent and tougher than the NAPF's corporate governance guidelines, which were first drawn up more than 25 years ago.

"While the NAPF guidelines say consideration should be given to voting, ours are very specific and don't leave much wiggle room. If you have a red line, it doesn't allow [the fund managers] to escape their responsibility."

Pomroy says a recent update to the NAPF's guidelines, carried out in December, provides a new set of simpler frameworks that will enable schemes to more easily compare and contrast the approaches taken by different managers.

Pomroy says: "A lot of effort is needed to help small pension fund clients to understand how they can leverage any influence and communicate expectations rather than feel they are takers of whatever is given to them."

A big problem for small funds is that their stakes are hardly ever in segregated mandates but tend to be held in pooled funds instead.

Getting your fund's voice heard is trickier for schemes invested in pooled funds, says J.P. Morgan's Hardy. "The market is not structured to allow bits of voters to vote in different ways," he says. The restrictions effectively prevent funds with less than £1bn worth of assets under management from participating in responsible investing.

Turner argues that setting out a clear set of red lines will make it easy for pooled fund managers to accept voting instructions from many clients. She says: "They may receive voting instructions from a number of pension schemes, but they would all be the same instructions."

And while passive managers, which are taking a growing share of the pension scheme market, appear to possess fewer levers over companies than their active counterparts, a recent report from consultancy Mercer argues that they, too, can recoup better returns by engaging with the companies that they invest in.

However, while Hardy has no doubt that "voting is still the most immediate tool available to shareholders to implement change", it is a blunt instrument. "If we have to vote against stuff, I suspect we have failed in the engagement process."

John Nestor, an independent trustee at Law Debenture, says he would encourage trustees to exercise their voting rights as shareholders. He says: "Voting has a value and owners should give an indication to their fund managers about how they would vote if it was put in front of them."

However, he believes engagement is best done behind closed doors rather than in a public forum.

Whether engagement happens in public or in private, Red Lines Voting looks set to empower trustees to make responsible investment a reality. EI