

# Responsible Investment: An Introduction

## What is Responsible Investment?

Responsible Investment (RI) involves long-term investors engaging with their investee companies about financial risks arising from environmental, social and governance (ESG) issues with the potential to affect the long-term value of investment portfolios. This is distinct from ‘ethical investment’, defined as the positive or negative screening of ‘good’ or ‘bad’ companies; nor is it about specific Socially Responsible Investment (SRI) products or funds.

Responsible Investment is concerned with helping to future-proof pension investments, investee companies and the financial services industry against factors that can reasonably be expected

to precipitate future financial or economic shocks. This is widely accepted as best practice, both by leading investors and by organisations such as the National Association of Pension Funds.

Responsible Investment involves active ownership, but not necessarily active management of a portfolio. It is equally applicable to passive investment strategies, such as tracking the FTSE All-Share Index. Indeed, engagement is arguably a more important tool for passive investors seeking to maintain the long-term value of their portfolio, since they do not have the option of disposing their assets.

## The financial crisis: irresponsible investment?

“There is need for better engagement between fund managers acting on behalf of their clients as beneficial owners, and the boards of investee companies. Experience in the recent crisis phase has forcefully illustrated that while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability. This further underlines the importance of discharge of the responsibility of shareholders as owners, which has been inadequately acknowledged in the past.”

- Sir David Walker, *Final Recommendations of the Walker Review, 2009*

It is now widely accepted that one of the causes of the financial crisis was the failure of many large institutional investors adequately to scrutinise the companies they owned. Risky business models and poor decisions went unchallenged, with devastating consequences for the economy - including for pension savers, whose funds lost an average of 17% of their value.<sup>1</sup>

In the aftermath of the financial crisis, the idea of Responsible Investment has begun to enter the mainstream. Numerous regulatory reviews, including the Walker Review,<sup>2</sup> have emphasised the role of institutional investors as ‘stewards’ of their investee companies, with a responsibility

to take an interest in factors affecting company performance, and to promote long-term value creation through engagement, not just through strategic buying and selling.

In particular, there has been a much enhanced focus on the role of investors in promoting good corporate governance - for instance, by scrutinising investee companies’ remuneration structures and risk management procedures. This has not yet been matched by an equal recognition of the materiality of environmental and social issues - although the case for such recognition is becoming just as compelling (see over).

## Myth-busting #1

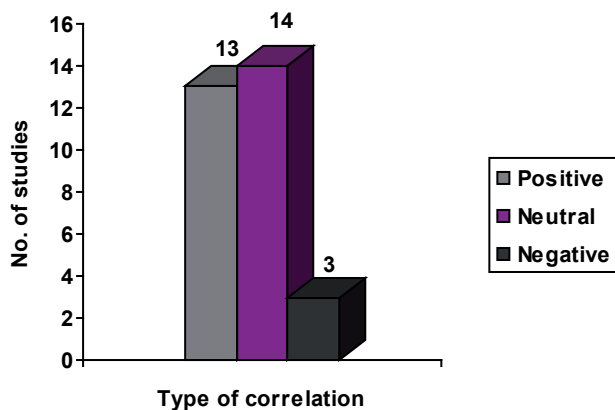
### Responsible Investment means putting principles before profit

This misconception arises principally from the confusion of Responsible Investment with screening-based ‘ethical investment’. By definition, Responsible Investment means engaging on environmental, social and governance issues where there is a business case for doing so. There is increasing evidence that adopting this approach leads to improved financial performance.

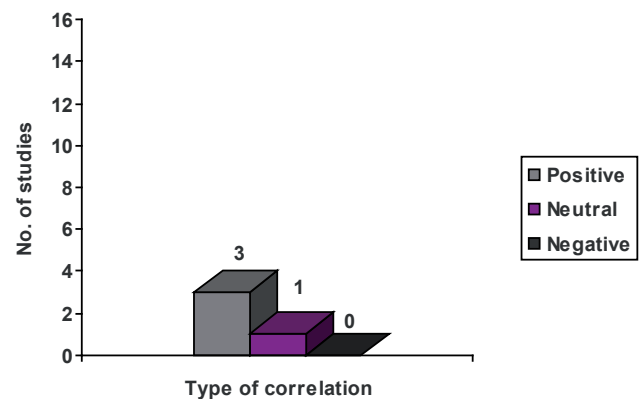
For example, a 2006 research paper by the United Nations Environment Programme (UNEP) found that “ESG issues are material - there is robust evidence that ESG issues affect shareholder value in both the short and long term” and that “the impact of ESG issues on share price can be valued and quantified.”<sup>3</sup>

Further evidence of a positive correlation between active ESG policies and performance comes from a 2007 meta-analysis by Mercer,<sup>4</sup> which finds an increased tendency towards positive correlation in instances where an engagement approach is employed:

Correlation between active ESG policies and performance (all approaches)



Correlation between active ESG policies and performance (engagement approach only)



## Myth-busting #2

### Responsible investment is legally problematic

“The fiduciary barrier to further adoption of Responsible Investment practices has been discredited.”

- Mercer Investment Consulting

There is a lingering belief in legal barriers to the adoption of RI, partly due to a misinterpretation of the 1985 Cowan v Scargill case, in which it was held that the Mineworkers’ Pension Scheme was acting outside of its powers in refusing to invest in certain assets on political or ethical grounds.

This has often been interpreted to mean that pension funds’ fiduciary duty to act in the best interests of their members is incompatible with any consideration of ESG issues. In fact, legal opinion now suggests that such an interpretation is incorrect and, indeed, that “it may be a breach of fiduciary duty to fail to take account of ESG considerations that are relevant and to give them appropriate weight” (Freshfields Bruckhaus Deringer, 2005; emphasis added).

## CASE STUDY: DEEPWATER HORIZON OIL SPILL

The recent oil spill off the Gulf of Mexico has provided a stark reminder that environmental and regulatory risks can be financial risks.

Following a massive oil well blowout at BP's deepwater drilling platform on April 20, 2010, well over \$30bn was wiped off BP's share value. At the time of writing the oil had spread to cover an area of at least 6,500 square kilometres, at a clean-up cost to BP of £523m and rising.

In the aftermath of the disaster it emerged that BP had repeatedly dismissed concerns about safety and had no risk management plan for this eventuality. More than three dozen lawsuits have already been filed against BP, and industry analysts agree that the effects of the spill will be felt by the company for years to come.

## Where next for Responsible Investment?

Although many leading investors have now adopted Responsible Investment, FairPensions' research shows that the increasing mainstream acceptance of RI principles has not yet been matched by a similar sea-change in investor behaviour.

FairPensions' ongoing work to improve pension funds' performance on RI includes:

### Research and publications

Our industry benchmarking surveys are a widely-respected guide to the leaders and laggards in the pensions and fund management industries.

We also contribute to the intellectual and policy debate, and are currently holding a seminar series on the future of fiduciary duty in partnership with the Cass Business School.

### Policymaking

We engage with a range of policymakers and regulators from across departments and across the political spectrum, as well as with industry bodies and others in the field.

We believe that there are some simple measures which could radically improve the quality of shareholder engagement at little or no cost to government or business.

### Investor engagement

We work with pension funds, their fund managers and advisors to help overcome the barriers to implementing robust responsible investment policies.

### Single-issue campaigns

We have a track record of facilitating constructive shareholder engagement with major companies.

Most recently, we co-ordinated shareholder resolutions at BP and Shell's AGMs, asking them to give investors more information about the risks associated with their tar sands projects.

These resolutions prompted significant disclosures, including the assumed carbon price used by both companies. In addition, this was the UK's biggest-ever experiment in shareholder democracy, with over 6,000 people contacting their pension funds asking them to support the resolution.

For more information about the content of this briefing, please contact:

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## ABOUT FAIRPENSIONS

FairPensions is of the operating name of the Fairshare Educational Foundation, a registered charity (no 1117244) established to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

In the case of pension funds, RI most often entails engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers. We advocate a strategy of active ownership to manage environmental, social and corporate governance (ESG) risks with the potential to affect the long-term value of investment portfolios.

FairPensions counts among its members organisations representing the beneficial owners of pension schemes, such as the National Federation of Occupational Pensioners, UNITE and Unison, as well as thousands of individual pension fund members.

Further information about FairPensions and our approach to RI can be found on our website.

**FairPensions**<sup>TM</sup>   
The campaign for **responsible** investment

[fairpensions.org.uk](http://fairpensions.org.uk)

1. OECD: <http://www.oecd.org/dataoecd/52/52/42204972.pdf>
2. See in particular Recommendations 16-22, [http://www.hm-treasury.gov.uk/d/walker\\_review\\_261109.pdf](http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf)
3. UNEP Finance Initiative Asset Management Working Group, Show Me The Money: Linking Environmental, Social And Governance Issues Into Institutional Investment (2006), 11. Available at [http://www.unepfi.org/fileadmin/documents/show\\_me\\_the\\_money.pdf](http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf)
4. Asset Management Working Group of the UNEP Finance Initiative and Mercer, Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors (2007), 13-14. Available at <http://www.mercer.com/referencecontent.htm?idContent=1332560>

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