

Responsible Investment

The UN PRI two years on: a stock-take



Introduction

The spectacular growth in the number of signatories to the UN Principles for Responsible Investment (PRI) in only two years, now standing at over 350 asset owners and asset managers around the world, representing some US\$14 trillion in assets under management, demonstrates that responsible investment is coming to be accepted as a legitimate and, indeed, valuable element of mainstream investment.

To quote the recently-published 'PRI Report on Progress 2008' (a review by the PRI secretariat of signatories' activity), "...an increasing number of investors – including fiduciaries and their money managers – recognise that ESG issues are material to the performance of their portfolio companies and other assets they hold and, therefore, must be factored into investment analysis and decision-making".

One of the key factors underpinning the success of the Principles has been that they do not advocate one particular style or approach to responsible investment, but rather allow investment owners and managers to apply the Principles in a way that is appropriate to their standard investment processes and asset classes.

We are very encouraged by the progress that has been made, both in terms of the number of asset managers and asset owners that now support the PRI and their growing willingness to translate this support into action through, for example, supporting engagement, encouraging companies to improve their reporting on environmental and social issues and participating in collaborative initiatives. Given that we have reached a critical mass in terms of the number of organisations that have made commitments to responsible investment, we believe that there are several important issues for the PRI and its signatories to consider, which we discuss below.

The evolving engagement agenda

It is no longer controversial to suggest that companies should manage social and environmental issues in a proactive and responsible manner as an overall part of their corporate risk management. Indeed, it is a fundamental

principle of Insight's investment philosophy that companies that manage social and environmental issues well and that pay proper attention to the concerns and interests of their customers and their wider stakeholders are likely to be better investments over the longer term. Engagement directed at encouraging companies to improve their risk management systems and processes, and demonstrate good understanding and proactive management of their key environmental and social impacts is, therefore, one of the ways we believe we can contribute to generating better investment returns for our clients.

Several years ago, when Insight started engaging with companies on environmental and social issues, few companies understood the relevance of these issues to their businesses or put in place policies and practices to manage them. In contrast, today, most European-listed companies, the larger ones in particular, have assigned senior management responsibility for managing important environmental and social issues (ranging from climate change to water management, obesity and human rights – as relevant to the company and sector), established good policies and solid management systems, and report comprehensively on their progress in managing those issues.

This progress does not mean, however, that the one-to-one model of intensive engagement with companies is no longer necessary or effective. Even some large companies do not have robust management systems in place. The results of our recent climate change benchmark suggested that some 20% of a sample of 125 large UK and continental European companies do not have adequate climate change management systems in place (in terms of policies, clearly defined responsibilities etc.), with a similar proportion not providing a comprehensive inventory of their greenhouse gas emissions. Clearly, one-to-one engagement with these companies remains a priority. In addition, engagement remains necessary with smaller companies, who have perhaps received less attention from investors in the past, and on companies listed in markets outside the US and Europe, where the majority of investor engagement has been focused until now.

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The need for more public policy engagement

We also believe that investors need to broaden the scope of their one-to-one engagement. Despite the progress that has been made by larger companies in understanding and managing environmental, social and governance (ESG) risks, it is not clear whether overall corporate performance, measured in terms of the social and environmental outcomes being achieved, is improving to the extent necessary to address the key problems. For example, a consistent message that emerged from discussions with companies as part of our climate change benchmarking research was that regulatory drivers are simply not yet strong enough to force them to take action to actually reduce their overall emissions (rather than simply achieve reductions per unit of production or other metric) – which is clearly essential if we are to tackle climate change.

In the context of this type of ‘market failure’ (i.e. where the costs to a business of taking action outweigh the benefits that may accrue to the business), it is clear that investor engagement alone cannot motivate companies to significantly reduce their overall emissions. Engagement needs to be augmented with discussions with policymakers to help to identify the most effective instruments – both mandatory and voluntary – needed to address such issues.

Some investors have been involved in such discussions with policymakers. The PRI Report on Progress 2008 reported that 49% of asset owner signatories and 61% of asset manager signatories claim to have engaged ‘to a large or moderate extent’ in dialogue, lobbying or initiatives pertaining to government policy and/or industry regulations relating to responsible investment and/or ESG issues.

To date, investors have been most active on climate change, emphasising the importance of governments providing appropriate long-term policy frameworks. They have also provided specific input in areas such as renewable energy and emissions trading. However, there are many other areas where the underlying cause of a social or environmental problem is market failure, and where investors have not, as yet, played as strong a role in helping to address the issue. We therefore hope to see much more investor activity in these other areas.

Helping to plug the gap

Public policy is not the only avenue for investors to influence corporate behaviour. They can also help to develop voluntary responsible business standards while regulation is being developed or in situations where the preferred public policy response has yet to be identified. An example of this is the leading role that Insight has played over the last two years in developing a set of principles relating to the governance and

management of nanotechnologies for companies involved in this exciting but controversial field. We believe that these guidelines will make a significant contribution to helping companies and other stakeholders ensure that nanotechnology-based products are developed and sold responsibly, while comprehensive regulation is developed for this field.

Delivery on PRI obligations

The PRI has been extremely successful in gathering signatories. However, with this success comes the risk that PRI as an organisation, or the signatories to PRI, are challenged on their level of commitment to responsible investment or the progress they have made in implementing the Principles.

We are of the view that the transparency of the industry as a whole is critical to the longer-term success of responsible investment. Indeed, efforts to assess and encourage greater transparency have already started to emerge. For example, a report entitled ‘UK Pension Scheme Transparency on Social, Environmental and Ethical Issues’, published in late 2006 by FairPensions, analysed the UK’s 20-largest pension schemes, finding that only five disclosed their policies on social and environmental issues and only one disclosed how shareholder votes had been cast. FairPensions argued that this lack of transparency seemed at odds with the strong commitments of many of the sponsoring organisations to social and environmental responsibility.

In this context, we think that there are three actions that are required by the PRI and/or its signatories. First, we would like to see the annual assessment by the PRI Secretariat of signatories’ performance to focus, over time, on the engagement outcomes achieved by PRI members (rather than simply reporting on the process used, numbers of companies engaged etc.).

Another valuable step the PRI could take is to define minimum commitments that signatories must meet to join the commitment or achieve within a defined period of joining (e.g. within the first year). We suggest that these should include the publication of a good responsible investment policy and meeting a set of minimum disclosure requirements. Without these checks and balances, PRI could suffer similar criticisms to similar initiatives, namely that they carry a large number of ‘free-riders’ that undermine the credibility of the initiative as a whole, with the result that the PRI is seen as a ‘lowest common denominator’ initiative rather than, as we believe it is and should be, a leadership initiative.

The third step is one that all signatories to the PRI should take. We believe they should – as required by Principle 6 – report

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publicly and comprehensively on how they comply with the various Principles, and, following a well-established tenet of corporate governance, explain where they do not yet comply and why. Paralleling the experience with corporate responsibility reporting, we believe that such reporting will help signatories demonstrate that investment risks and opportunities related to ESG issues have been identified and properly managed, enable them to respond to questions from clients and from stakeholders, provide stakeholder confidence in their approach to responsible investment, and enable them to demonstrate that their commitment to the PRI is real, and has not simply been made to 'tick the box'.

Concluding comments

In conclusion, we welcome the very substantial progress that has been made over the past two or three years in mainstreaming responsible investment and the important contribution the PRI has made. The issues raised in this article – the need for investors to think carefully about the nature of the engagement they do and the outcomes they want to achieve, and to demonstrate their true commitment to implementing the PRI – are by no means trivial. Yet, they are both critical to the longer-term legitimacy of responsible investment. Our concern at present is that responsible investment remains primarily a 'process' rather than an outcome-focused investment strategy, where ticking boxes on engagement and investment integration, and low-grade collaboration, is all that is delivered. We believe that responsible investment has great potential and strongly hope that the PRI and its signatories harness the building momentum to deliver value for shareholders as well as more prosperous and healthier societies.

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