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# What impact should ESG considerations have on trustees' investment decisions?

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The question of climate change risk and low carbon investment recently came under the spotlight when the trustee of the Environment Agency Pension Fund announced its commitment to cut coal exposure in its equity portfolio by 90% and oil and gas by 50% before 2020. Client Earth has also recently stated that asset managers and pension trustees who ignore the risks of climate change on the value of their stock may 'run the risk of legal action'. Climate change is just part of a broader banner of environmental, social and governance (ESG) issues which seem increasingly to be an important part of investment governance.

So what are trustees' duties in this area, and what can or should they take into account in their investment decision making?

In July 2014 the Law Commission published its findings on trustee fiduciary duties, making clear that a trustee's core duty is to promote the purpose for which the trust was created. For pension scheme trustees, this is usually taken to mean the best 'financial interests' of the scheme's beneficiaries.

When taking investment decisions, trustees therefore need to distinguish between:

- financially relevant factors (which they should take into account), and
- financially irrelevant factors (which they must ignore)

There is a distinction between the wider financial factors which trustees may take into account when making investment decisions (and which may specifically include ESG factors), and pure 'ethical' issues. There are of course circumstances in which 'ethical' (i.e. non-financial) factors can be taken into account, but these are outside the scope of this article.

Trustees should always take into account financially material risks. But the law does not prescribe a particular approach. It is a question of discretion for trustees, acting on proper advice, to evaluate which risks are financially material and how to take them into account.

## Stewardship and governance

Beyond the question of choosing which investments to hold (or making a conscious decision not to hold certain stocks – known as 'negative screening') trustees may wish to ask themselves how they can best engage with the companies in which they invest.

As shareholders, trustees may guide their investee companies by entering into dialogue with them and considering whether and how to exercise voting rights. Stewardship activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration.

Many trustees are signatories to the UK Stewardship Code, which encourages all institutional investors to disclose publicly how they discharge their stewardship responsibilities.

## Practical considerations

It is up to trustees to take advice and reach their own conclusions on the factors and risks they consider financially material to their investments.

The 'ESG' label can lead trustees to misconstrue it as a stand-alone issue somewhere between ethical and financial investment decision making. The reality is that ESG issues are merely a subset of wider financial factors to be borne in mind when considering the long-term sustainability of an investment. The Law Commission's guidance puts the duty succinctly: "When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability."

Taking climate change by way of example, to the extent that trustees consider its risk to be financially material to their investments (in the short or long-term), they should take steps to ensure their managers take this into account.

Beyond that, it is a matter of degree as to whether the steps trustees wish to take are proportionate to the risk posed. A different approach, for example, may be used in relation to active and passively managed funds. Where trustees are minded to take a particular view on a single issue, they should take advice and carefully consider their options within a framework of financial factors. The wider implications of a decision to impose an in-house view on the trustees' managers in relation to one particular ESG issue, while at the same time leaving all other financial decisions (including in relation to other ESG matters) to their discretion, should also be considered.

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