

A black and white photograph of a glacier landscape, showing large icebergs floating in the water and snow-covered mountains in the background. The image is partially obscured by a large orange curved shape on the right side of the page.

Delivering change 2017 report

An update on our responsible investment
activities this year



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Foreword



Mark Fawcett
Chief investment officer

This year marks an exciting new chapter in NEST's development. The initial stages of auto enrolment are nearly complete. We now have over five million members and more than 400,000 employers signed up. Our assets under management have grown to £2 billion in the first five years and are set to grow rapidly from here.

It's also been a busy year for those interested in responsible investing. We've seen a decided uptick in activity and focus on certain environmental, social and governance (ESG) issues. As we went to print, the voting season was still underway, but there'd already been some pivotal votes on a range of issues.

Support for climate change shareholder resolutions at ExxonMobil and Occidental Petroleum was significant. Shareholders also held boards to account following recent corporate scandals at companies such as Wells Fargo.

We've seen issues such as diversity and the workforce come to the fore this year. And there is a renewed focus on how investors can 'do well by doing good' through impact and social investment opportunities. We're encouraged by the positive momentum in these areas and aim to remain part of the debate and lead where we can.

Since the beginning, our approach has been to develop partnerships with our peers, fund managers, investee companies and standard setters. We want to encourage shared dialogue and a sense of common purpose to achieve a closer alignment of interests. So we're particularly pleased to see closer relationships between asset owners and managers delivering innovative and

“With auto enrolment nearly complete, we believe the next stage of development in the defined contribution (DC) landscape will be a renewed focus on members”

sustainable solutions in the interests of our members. One example is our work this year with our global equity fund manager UBS to develop a new fund to address climate change risks and opportunities in our members' portfolios.

We'd like to take this opportunity to thank UBS for its enthusiasm in working with us on an investment solution to meet our members' needs. It has also shown great commitment to developing its voting and engagement activities in this area, which we believe will be crucial to meeting the

long-term challenges and opportunities of the transition to a low carbon economy.

With auto enrolment staging nearly complete, we believe the next stage of development in the defined contribution (DC) landscape will be a renewed focus on members. As their pots grow, we expect our members will become more interested in their pension savings.

Over the next few years, we'll be exploring how we can build trust and confidence in saving by telling the story of where their money goes and the impact it is having. We hope this report will be a good foundation to build from.

Guest foreword

Managing climate change



Baroness Brown of Cambridge DBE FREng FRS, the UK's low carbon business ambassador

Climate change is happening. 2014, 2015 and 2016 have been the three hottest years on record globally. 2016 saw 1.1° of warming over pre-industrial temperatures, already over half way to the limit for 2100 agreed at the UN climate change conference in Paris. Climate change will bring not only warmer weather but more frequent extremes. This means periods of very hot weather affecting human health and productivity and increasing incidence of drought. There'll also be more short periods of very intense rainfall, leading to flooding and disruption.

Governments signed up to take action at Paris and even with the recent withdrawal of the United States government, many US states and cities have committed to

continue to support the Paris goals. Governments can, and must, set direction, in particular by providing strong policy and an appropriately stretching regulatory environment. But change will be delivered by people acting. We can be confident that we can achieve the Paris targets when action starts to run ahead of policy.

“The support of investors such as NEST, remain critical at this time of transition.”

As a non-executive director of the Green Investment Bank (GIB), I've seen attitudes change over a period of just four years. Investment in UK offshore wind was something that needed a government partner to 'crowd in' other investors. Now it's a sector where the competition to invest in operating assets is so strong that GIB has

successfully launched a £1 billion wind fund. All of this activity is driving up confidence and enabling dramatic reductions in cost. This means we're now able to talk about delivering offshore wind subsidy-free in the near future.

We're seeing a growing role for low carbon businesses in the UK economy. The low carbon sector is already comparable in size to energy intensive manufacturing, at two to three percent of GDP. It has been growing much faster than the rest of the economy over the past 10 years. The UK has started to transition to a low carbon economy, and it's encouraging to see investors, especially pension funds like NEST, becoming increasingly interested and involved in 'green' investments as an important driver of long term returns.

But there are two sorts of climate risk we need to be thinking about. One is whether a business makes its money from 'high carbon assets' or by producing products that emit carbon dioxide or other greenhouse gases. If

so, what's the strategy for changing the business model and how is the company investing its research and development? This is what we might call mitigation risk. This is the type of risk NEST is addressing directly in its new climate aware fund.

The other area, which NEST and other investors should also interrogate, is adaptation risk. How will a business be affected by the changing climate itself? Are the company's assets or facilities at risk from flooding or heatwaves? Does it have a critical supply chain in an area of the world likely to experience significant climate change impacts such as drought?

“It's encouraging to see investors, especially pension funds like NEST, becoming increasingly interested and involved in 'green' investments as an important driver of long term returns ”

These are just the sort of issues which the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) has been considering. At the end of June this year it was encouraging to see over 100 businesses supporting the TCFD's

recommendations on voluntary disclosure of climate change risk.

We need a resilient economy, resilient investments and resilient pensions. This needs resilient companies. Ones where leadership is thinking about and addressing both the risks and the opportunities that decarbonisation and adapting to the changing climate are bringing.

There are positive signs that businesses are recognising the need to address climate change, but strong signals from government, as well as the support of investors such as NEST, remain critical at this time of transition.

Baroness Brown is a member of the Committee on Climate Change (CCC), chair of the Adaptation Sub-Committee (ASC) and a non-executive director of the Green Investment Bank and the Offshore Renewable Energy Catapult. She writes here in a personal capacity.



Introduction

What's covered in this report?

Last year we published our first Responsible Investment report **Working for change**. This provided our stakeholders with detail on why and how we take an active and responsible role when it comes to the investments we own on behalf of our members.

This year's report focuses on what we've been doing throughout the year and looks at some of our key future priorities. We want to keep our members, their employers and our stakeholders updated about how we act as a responsible investor and report the impact our activities are having.

Over the past year we've made real progress across a range of areas of our investment approach. These include fund manager selection, active ownership, risk monitoring and the direct management of environmental, social and governance (ESG) risk factors and opportunities in asset allocation. As ever, collaboration is key to our approach. We've worked with an array of people across industry. They've helped

us advance our agenda and deliver solutions to issues we believe will make a material difference to outcomes for our members.

There are four sections in this report:

Section one looks at how we've been addressing risks and opportunities in the asset classes we choose. We present a case study of our work in developing a new global equity fund that manages climate change risks and opportunities.

Section two reports on the progress of our active ownership approach, including case studies of how our corporate voting and engagement is supporting better corporate performance.

Section three looks at our relationship with others in the investment industry and how we're trying to align their interests with those of our members.

Section four looks ahead to our priorities over the next few years.



Managing risks and opportunities in our asset allocation

Our new climate aware fund

Over the past year we've made real progress in addressing specific investment risks and seeking new return opportunities by investing in a climate aware fund. We've focused on climate change because it has the potential for a clear financial effect on our members' investments.

We spent a year working closely with our developed global equities fund manager UBS on an innovative solution to the challenge we faced. In February 2017, we launched the UBS Life Climate Aware World Equity Fund together, seeded with £130 million from us. It now makes up a key building block in our default strategy.

This is an important step to prepare members' investments for a lower-carbon global economy. It seeks to mitigate climate related risks and give members access to the opportunities of the transition away from fossil fuels. We helped design the fund to be flexible and

adaptable. Its approach recognises that movement towards a low carbon world will occur over many years rather than immediately and will likely proceed at different paces at different times.

The new fund dials up or down investments in companies based on evidence of what they're doing and planning to do to mitigate the impact of climate change. As a result, we aim to send a strong signal to businesses we invest in. We're saying that we expect to see measurable progress towards positioning their companies for a future that is no longer reliant on fossil fuels.

Some of our youngest members will be saving with us for the next 40 to 50 years and are most likely to be financially impacted by climate related risks and opportunities. We've therefore assigned a larger slice of the equities in our foundation phase, where our youngest members' money is invested, to this fund.

As responsible long-term investors on behalf of our members, we can't afford to ignore climate change risks and we've committed to being part of the solution.

The case for a climate aware approach

It's generally accepted that the world's climate is changing due to rising man-made emissions of greenhouse gases, particularly carbon dioxide (CO₂). The largest single source of CO₂ emissions is the combustion of fossil fuels – coal, oil and gas. The investment challenge is that some of the largest companies that our members invest in are also some of the largest emitters of CO₂. Companies in sectors that are particularly sensitive to the impacts of climate change make up around a third of the global market. As the world embarks on a transition to a low carbon economy, if companies don't adapt accordingly, we could see their value fall dramatically. We need to plan for this scenario right now and work with companies, regulators and other investors to reduce the impact on climate change risk on our members' savings.

Case study

Our climate aware fund in more detail

Based on evidence and research from our work on climate change, the UBS Life Climate Aware World Equity Fund was developed with a specific concept at its heart.

It invests in line with international scientific climate models and globally agreed fossil fuel emission-reduction targets. This makes it a forward-looking investment proposition that can flexibly cater for developments in the portfolio, developments in international commitments and developments in consumer and business sentiment. We believe it's one of the first funds to do this.

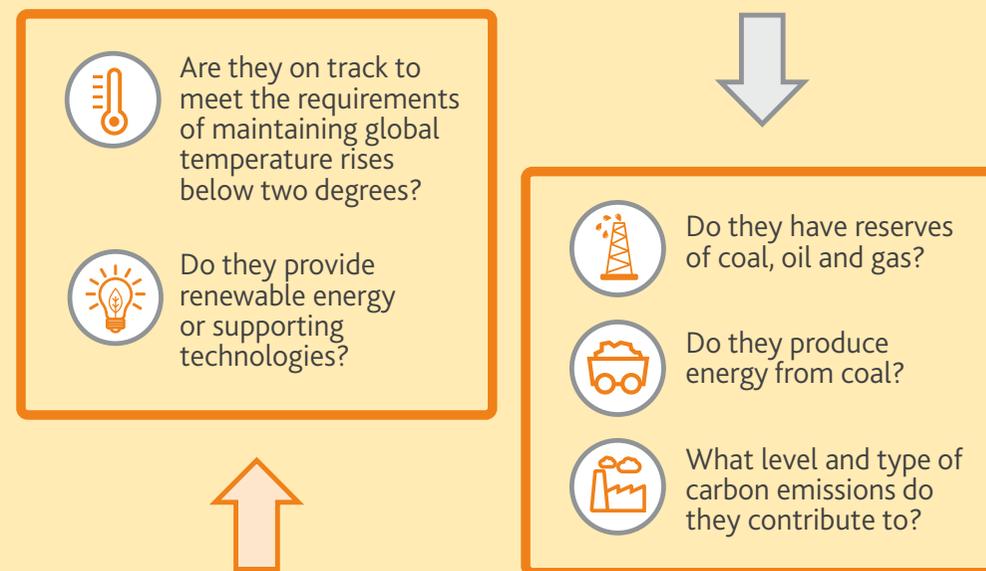
The fund aims to deliver investment returns broadly in line with the FTSE Developed Index. It is positively biased towards green and renewable energy companies.

The fund increases investment in companies adapting to combat climate change in line with, or better than, the Paris Agreement. At the same time it reduces investment in certain companies. These are companies within key sectors that appear not to be adapting in ways required by change climate models and agreed emission reduction targets.

There's no exclusion policy. Selling out of a company is unlikely to change what the company does and won't alter the course of physical climate change. We invest less in companies not responding appropriately to the risks of climate change than the FTSE Developed Index. But by staying invested, the fund can continue to influence the company and encourage positive change through ongoing stewardship.

Weighting criteria

The fund dials up or down investment in companies based on how they score against the following criteria:



Case study continued

Stewardship

The fund pursues a climate aware voting and engagement policy that focuses on companies where we've identified particular issues.

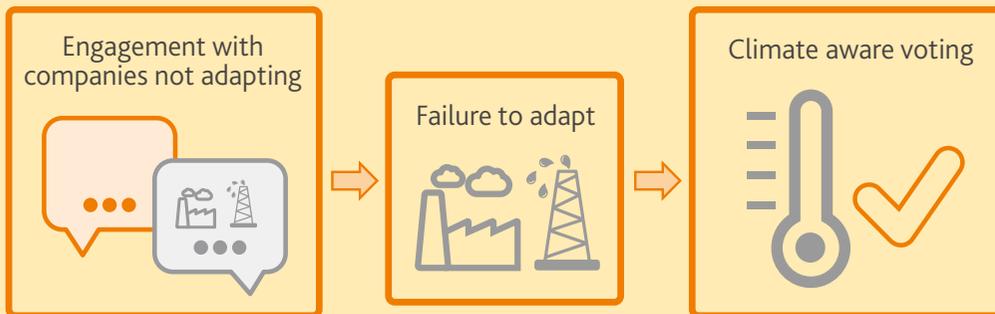
It aims to engage companies that most need to adapt their business models in order to meet globally agreed climate change targets. The fund's climate aware voting policy includes climate-specific guidelines on voting shareholder

resolutions, director elections, political and lobbying expenditure, the report and accounts and the audit committee report. Where companies don't show improvement after a period of engagement, we may vote against them.

By voting and engaging with companies in a climate aware manner, the fund supports and encourages the transition to a low-carbon economy.

Engagement to prompt companies to adapt

We'll engage with companies in sectors identified by the International Energy Agency as high contributors to climate change that have no clear transition plan in place. The aim is to encourage them to adapt their business models in line with helping meet international global warming targets.



What next?

We will start measuring the impact the climate aware methodology has had on the fund. This is to see if and how much of a difference it's been making to our members' investment performance.

We'll look at climate-related news events, for example, the US announcement to withdraw from the Paris climate agreement. We'll measure the fund and benchmark performance before and after these news events and test for impacts on investment returns. By measuring this, we'll be able to determine whether we should increase our investment in the fund.

We're part of the advisory group that observes the management of the fund. The group will monitor climate-related trends and developments, political shifts and their wider potential impacts on capital markets. We'll also observe the emergence of improved data and the impact engagement has had. This will be used to determine how companies should be weighted in the fund. The group provides a forum to engage with

the fund manager and ensure the fund remains responsive to the views and judgements of its investors.

We'll update our readers next year on what new developments and judgements the group has made in relation to the fund.

Future areas of focus

Environmental, social and governance (ESG) issues in alternative investments

We're currently researching a range of new asset classes. We're considering commodities, infrastructure, global credit and private debt. Including a new investment mandate in a new area means we need to understand its ESG risks and opportunities. We also need to know how

We also want to help develop best practice in alternative asset classes as we have done with traditional asset classes. The more investors ask questions about ESG issues in alternative areas, the more fund managers will start to identify and address them as a routine part of their investment process. We'll continue pushing for higher standards regarding how our members' money is invested across all asset classes.

“Our goal is to improve our understanding of the types of issues prevalent in alternative asset classes such as commodities and infrastructure”

these might play out differently, depending on the investment approach. We want to improve our understanding of the types of issues common in these asset classes so we can put together the right questions to ask prospective fund managers.



Examples of alternative investments

1: Commodities

We're looking into commodities as a potential way to further diversify our members' portfolios. Investing in commodities may have different implications for managing ESG risks and opportunities. For example, investing in real assets like coffee or copper can create direct exposure to environmental risks, such as from mine tailings or social risks from labour conditions. However, investment can also be an important source of finance for different sectors, like the agricultural sector.

Investing in physical commodities or commodity derivatives requires investors to consider the 'systemic' impact of their actions.

Physical commodities taken away from productive use can harm growth and returns in other asset classes. Their production also often leads to environmental and social impacts and excessive speculation. Investing in commodity derivatives can lead to price volatility and ultimately harm investors' 'licence to invest' in those markets.

Our ability to manage and mitigate such risks could depend on how we access the asset class. Investing in equities, for example, may provide more possibilities to influence how companies manage ESG risks, whereas derivatives offer investors less control.

2: Infrastructure

We're currently researching infrastructure investments that would allow us to benefit from an 'illiquidity premium'. This is an extra return we'd get for not having immediate access to the money we've invested.

Infrastructure investments can also be essential to the economic health and productivity of communities. We've spoken to fund managers who are providing good financial returns from investing in renewable power generation such as solar farms and social infrastructure assets. This includes providing good financial returns from investing in schools, hospitals and courthouses that benefit the local populations and the environment.

We're interested in benefitting from the different risk and return characteristics these investments can provide. We're also keen to find out how infrastructure assets may be able to address specific environmental and social risks and opportunities.



Impact investing

Impact investing is when investors try to generate social or environmental good with their investments as well as a financial return. While the market for impact investing is no longer in its early stages, it's also far from mature. There are many different interpretations of what it means and entails. Incorporating ESG factors within a straightforward investment strategy creates some positive impact, for example. Whereas investing in a fund that exclusively addresses water risk and opportunities, say, by promoting clean water and sanitation in a specific region, creates a higher direct positive impact.

We've spent some time listening to the debate around industry and considering what impact investing means for us.

It would need to fit into our approach to seek improved risk-adjusted returns for members first and foremost.

Measuring impact

Investors increasingly want to measure and understand the impact their investments are having. Many focussed impact funds set out how they think they'll make a difference, but aren't measuring it.

Fund managers we spoke to acknowledged that this is difficult to do and they don't yet have the tools to do it effectively. Extensive measurement and monitoring also raise time and resource concerns for all involved.

What next?

We'll be observing how the market for specific impact funds develops. We're interested to know how they might be structured and priced. We also want to find out whether they'll give pension schemes like ours more opportunities for improving the risk and return profile of our members' portfolios. Where there's a clear financial case to do so, we plan to address more social and environmental issues directly in the types of investments we choose.



Improving outcomes through active ownership

Voting

We own millions of shares in companies on behalf of our members. So it's our responsibility to help make these companies sustainable and profitable. One way we do this is by exercising our voting rights.

Engaging our fund managers on voting

We believe we can have the most impact by engaging with our fund managers about their voting policies, voting decisions and approaches to voting and engagement more generally. By engaging in dialogue with our fund managers and challenging their decisions on issues such as high executive pay, we can encourage them to hold companies to account in the way our members would expect.

Our fund managers have provided significant resource and commitment to taking on board our feedback about the particular needs of our membership. We're also pleased to have seen a step change improvement across our fund managers in their approach to voting. Over recent years they've shown a greater willingness to

challenge poor corporate behaviour and encourage a more long-term approach from investee companies. This has included taking up issues of executive pay, diversity, joint CEO/chair roles, and more.

“Our fund managers have provided significant resource and commitment to taking on board our feedback about the particular needs of our membership”

We're also pleased that more fund managers now send us their voting intentions ahead of company annual general meetings (AGMs). UBS, HSBC and BMO already do this and this year, we encouraged Northern Trust Asset Management to do so too. It has agreed to send us voting information for select companies in the Northern Trust

Emerging Market ESG fund. This is so we can assess how it will vote ahead of an AGM, identify any differences of opinion and talk to Northern Trust about them.

We're pleased to have strengthened this partnership with Northern Trust on its voting practices. It means we're more closely aligned and we can address our members' interests better.

How we monitor company votes

This year we've renewed our relationship with proxy voting research provider Manifest. It continues to play a critical role in our vote monitoring process. Manifest helps us hold our fund managers to account and be an active owner of our shares.

We also broadened the subset of companies we closely monitor to include more energy companies, tobacco companies, listed asset management companies and companies in emerging markets.

These additions reflect our focus on climate change and our increasing scrutiny of the risks tobacco stocks pose in our portfolio. We're also mindful of the prominence of ESG risks in emerging markets and the need to hold asset managers to account on their own corporate practices.

For more information on our vote monitoring process, see our 2016 responsible investment report

Working for change.

Upholding shareholder resolutions

Shareholder resolutions are vote proposals put forward by shareholders who want the board of the company to implement certain measures, for example around corporate governance, social and environmental practices. Although they're not binding, they're a powerful way to advocate publicly for change on policies such as climate change.

Since the launch of its climate aware fund early in 2017, UBS has supported almost all shareholder resolutions on climate change strategy and political donations. This involved companies in the materials (resources), oil and gas, industrial, transport and utility sectors. UBS has also supported

climate change resolutions at other asset managers. These resolutions try to make a company disclose its climate risks and policies. The company also has to show how its business strategy fits with the move to a low carbon economy.

We view shareholder resolutions as an important tool in our box. They send a strong signal to our investee companies about what we expect them to report.

At the time of writing, UBS has supported 60 environmental resolutions. We provide some examples below:

- UBS supported shareholder resolutions at asset managers BNY Mellon and T Rowe Price. These requested that the board reports on and assesses proxy voting policies in relation to their climate change position. It's important that shareholders understand that the votes they make are generally consistent with the company's climate change positions and scientific consensus.
- UBS supported a shareholder resolution at Marathon Petroleum. This was to request that the board report on business plans to align with the Paris Agreement. It also asked them to report to shareholders on environmental and human rights issues.

We expect companies such as Marathon to have a strategy for reducing greenhouse gas emissions, to be clear about goals and to report on progress.

- UBS supported shareholder resolutions at ExxonMobil requesting the board to report its climate change policies and lobbying payments and policies. We were pleased to see other large asset managers support the resolution too, which passed with 62.3 per cent of the vote. We believe that asset owners played an important part in this outcome. Prior to the AGM we joined other asset owners to meet with a number of large asset managers to let them know our expectations on voting around climate considerations.

Of course, there will be times when we think our fund managers could do more, or where we recognise that their views are not necessarily aligned with ours and our members' needs. We work closely with our fund managers and provide constructive challenge where our views differ. However, we've also secured an agreement with UBS, our global developed equities fund manager, that we can override certain votes on issues we feel are strongly at odds with our members' interests.



Key vote overrides

Some of the votes we overrode this year that particularly stood out to us included:

- We voted AGAINST executive pay at Barclays. Our concerns were about the total level of performance-related pay granted during the year. This was 259 per cent of salary. We also objected to the high level of pension and benefit payments made to the CEO. We believe the amount was disproportionate, particularly given the CEO's reported behaviour on whistleblowing. In addition, we're concerned about the practice of increasing fixed pay in order to avoid the limits on performance related pay applied to European Banks. We also questioned the use of the same metrics for both annual pay and long-term incentives. This means executives are being rewarded twice for the same performance. We don't support this as it removes money from the company and isn't in our members' interests.
- We voted AGAINST the pay policy at Shell. We felt the company didn't fully meet the terms of the shareholder resolution it passed in 2015. This was to link key performance indicators and executive incentives to long-term strategic changes needed to keep

global temperature rises below 2°C. We didn't think the policy was forward looking enough to support. While UBS agreed that there is scope for Shell to go further, they didn't change their vote. They'll be engaging with them to make sure the next policy is more strongly aligned with the move towards a low carbon economy.

- We voted AGAINST the re-election of the chair of the Nominations Committee at Glencore. For a FTSE 100 company Glencore has made poor progress on gender diversity, with only one female director out of the eight people on the Board. The company failed to reach the 25 per cent target by 2015. It hasn't disclosed a gender diversity target, nor has the percentage of female employees in senior management positions been disclosed. This sets Glencore apart from other companies in the FTSE 100 where female board participation is on average 26 per cent. We believe the poor level of gender equality on the board at Glencore poses a long-term risk to us as investors.

Promoting gender diversity

Research and evidence collated over many years has demonstrated the positive impact that greater gender diversity in senior positions has on corporate performance.

This year we increased our commitment to gender diversity by joining the Investor Group of the 30% Club. We signed the statement of intent that commits us to use our ownership rights to encourage progress on gender diversity in companies.

Voting-led engagement

After the voting season we'll write to companies we've voted against to explain why we didn't support management. We reach out to other investors who may have opposed management for similar reasons and ask them to support our letters. This is because, although voting makes a difference, we can achieve more with a collaborative approach to engagement. It creates a higher impact and is likely to achieve more lasting change that will benefit our members.

Engagement

Last year we reported in detail on a number of our strategic engagement projects. These included improving culture and conduct in banks and reward and progression in the workforce.

Over this reporting year our focus has shifted from research and evidence gathering at a company level to conversations to help drive change at a regulatory level. Our objective is to achieve better functioning markets and sectors through collaborating with standard setters and helping drive policy improvement from the top.

Banking culture and conduct

The banking sector is an important and sizable segment of our UK equity portfolio. A strong and sustainable banking sector contributes to better financial outcomes for our members. It also generates trust among employees and customers, many of whom are also our members. A banking sector that is performing poorly and is subject to significant regulatory fines is bad news for our membership.

We've engaged extensively with some of the UK's largest banks on their culture and conduct over the past few years. This year, our peers reviewed the evidence from this work and approved it for publication.

This has appeared in the Journal of Financial Regulation and Compliance and the [Journal of Banking Regulation](#).

We're also pleased to see that the Banking Standards Board is going to focus some of its future work on themes from the evidence we presented to it. These include how banks develop their staff and have a corporate purpose that is clear to all who work in the bank.

“Our objective is to achieve better functioning markets and sectors through collaborating with standard setters and helping drive policy improvement from the top”

Another of the recommendations arising from our engagement work was to emphasise that banks have a public service duty and need to demonstrate to the wider public how they take on board the views of their customers, shareholders and wider stakeholders.

This recommendation is being taken forward by the BankingFutures Project, a group sponsored by the main UK banks that aims to create a healthy, resilient and inclusive banking sector. We've participated in the project's workshops and research gathering over the past year. Our recommendation was included in their [Pathway to Long-Term Value report](#), published earlier this year. We're also pleased to see that the new financial services industry trade association UK Finance has agreed to take forward the recommendations of the BankingFutures Project.

Working collaboratively across industries, with regulatory bodies and standard setters, is one of the best ways for us to have a significant impact on changing corporate behaviour and to improve investment returns for our members.

Workforce, pay and progression

Investing in companies with a strong commitment to their workforce is essential to building sustainable and successful businesses. It also creates opportunities to enhance risk-adjusted returns over the long term for our members. On the flipside, there are clear reputational and operational risks if companies don't motivate or reward their employees fairly.

Investors like us need robust data so we can measure and talk to our investee companies about these risks. At the moment, there are no standard metrics or comparable industry data across a range of workforce issues. Following on from our corporate engagement programme on reward and progression in the workforce last year, we approached the Financial Reporting Council (FRC) on this important issue.

“The long-term aim of the project is to produce concrete metrics to measure workforce initiatives and their effectiveness”

As a result, we’ve been invited to feed into the FRC’s major work stream that will look into how companies report on value. The long-term aim of the project is to produce concrete metrics to measure workforce initiatives and their effectiveness. All companies will then disclose this as part of their reporting to shareholders. Investors, companies and standard setters are being

encouraged to join together to agree sensible, meaningful reporting standards and metrics.

Alongside discussions with the FRC, we’ve been actively involved in the Pensions and Lifetime Savings Association working group on workforce reporting. We’re also a founding signatory to ShareAction’s Workforce Disclosure Initiative. This is a new project seeking to improve company disclosure about how they manage workers they directly employ and people working in their supply chains.

Research suggests pension scheme members want to see their money invested in companies that treat people appropriately and provide good quality jobs. The evidence provided by organisations such as the Living Wage Foundation shows that employers who do so are more likely to be successful over the long term. We’ll continue to take an active role in working with standard setters and regulators to achieve those aims.



Aligning industry behaviour with our members' interests

One of our responsible investment objectives is to help create markets that support long-term wealth creation for beneficiaries. In our case these are the millions of UK workers who are saving for their pension with us.

To support this objective, we've continued to develop relationships with other pension schemes, regulators, asset managers and companies. We believe that sharing our knowledge, views and values and pushing for higher standards of practice helps create an investment chain that works for our members.

By increasing the alignment of interests of each of the participants directly involved in managing money for our members, we believe we can improve their outcomes in retirement.

Using our influence as informed buyers

At NEST, we've assets under management of £2 billion. We're due to grow to one of the largest pension schemes in the UK. These factors make us an influential buyer in the market. We use this influence when we're selecting our fund managers to ensure their interests are as close to those of our members as possible.

One way we do this is by scrutinising managers' approaches to managing ESG factors in their investment processes. By only selecting fund managers with strong ESG credentials or those who show a strong commitment to working with us to improve their approach, we can ensure that these risks are being taken seriously across our funds. The Principles for Responsible Investment (PRI) has recognised the effort we've made by rewarding us the highest rating for this area of our work in its **2017 assessment report**.

As an example, earlier this year we procured a new global high yield fund to be one of the

“By increasing the alignment of interests of each of the participants directly involved in managing money for our members, we believe we can improve their outcomes in retirement”

building blocks of our NEST Retirement Date Funds.

The aim of this mandate is to further diversify our members' money to help manage investment risk and offer attractive returns in the current low-yielding, fixed-income environment. After a high quality and competitive process that saw nearly 40 fund managers bid for the contract, we selected the J.P.Morgan Life High Yield Opportunities Fund established by J.P. Morgan Asset Management. Among the responses to our tender the fund was a strong performer on managing ESG issues.

Case study

High yield bond fund procurement

High yield bonds are issued by companies that are judged by the market to be riskier than larger and more established companies. They may be start-ups, for example, or companies that are highly leveraged.

The additional risks involved are rewarded with potential for higher returns, but require careful management. We need to think about ESG issues when we assess the suitability of these high yield bond issuers and the likelihood that they'll be able to continue servicing their debt.

Therefore, when procuring our high yield bond mandate in 2016/17, we:

- asked the potential fund managers for evidence that they considered ESG factors within their investment and risk management process
- questioned how fund managers incorporate ESG risks and opportunities in their decision-making and investment selection process

- questioned how fund managers address specific ESG risks such as operations and governance structures, bribery and corruption and climate change, which could be even more problematic for lower-rated companies
- assessed fund managers' ability to use ESG analysis effectively to add value and/or mitigate portfolio risk over the long term. We also looked at how well they report it to their clients.

The overall standard of the responses, when considering how far they addressed ESG issues, was mixed. There were some leading approaches but some failed to address the questions appropriately, showing a lack of understanding and action.

J.P. Morgan showed a clear commitment to the systematic evaluation of ESG risk factors throughout its investment process, where material and relevant. It also engaged a specialist third party ESG research and data provider to assist in

evaluating certain companies. Its analysts consider ESG issues when gauging the sustainability of the business, the quality of management and risks. These include environmental damage and corruption issues such as convictions, investigations, or regulatory actions, which can have an impact on valuations.

J.P. Morgan demonstrated a keen awareness of some of the niche ESG risks and trends in its portfolio. It has integrated a specialist ESG research dataset into its proprietary risk management system to ensure the risks are identified and regularly monitored. This includes carefully monitoring climate change risk as the world transitions to a low carbon economy.

We believe its efforts to recognise and address these risks and other drivers of value support our objective of enhancing risk adjusted returns for members in the long term. We'll now work closely with J.P. Morgan to deliver that objective.

Case study

Working with our fund managers to exclude controversial weapons

We've committed to excluding companies involved in manufacturing controversial weapons from our portfolios in order to:

- demonstrate alignment with UK and international law in this area and the latest evidence on the role of fiduciaries in the UK
- show responsibility and alignment with our members' likely values and interests.

All of our bond and equity fund managers, both active and passive, now exclude companies involved in manufacturing controversial weapons from any of our investments. As part of our procurement approach, we also require prospective fund managers to have a policy on controversial weapons. If they don't have one, they'll need to develop one if they're going to manage money for us.

For example, when we introduced **our policy** in 2016, UBS had a policy to

exclude controversial weapons in line with the Swiss War Materials Act and international convention on cluster munitions. However, this only applied to its active investments and not to the passive fund range, which included the global developed equity index fund we're invested in.

We strongly encouraged and supported UBS to extend the application of its policy. We wanted it to exclude companies with proven involvement in manufacturing controversial weapons like cluster munitions and anti-personnel landmines from all of its global passive equity funds. It took on board our feedback and swiftly implemented a suitable policy in our interests and all other clients in the passive fund range. This means a controversial weapons exclusion policy now applies to nearly £16 billion of funds under management.

Creating a voice for members

Earlier this year, we responded to the Department for Business, Energy and Industrial Strategy Green Paper on Corporate governance reform. In our response we highlighted the continuing disconnect between companies, fund managers and beneficial owners and the

“All of our bond and equity fund managers, both active and passive, now exclude companies involved in manufacturing controversial weapons from any of our investments”

need to realign interests. We set out how we've tried to address this challenge and bridge the gap between fund managers and our members. We also set out some suggestions on how we can try to bring beneficial owners' views and needs closer to the end investee company and the role it plays in society. You can read this in full on our [website](#).

Looking ahead

Working with members

We want to continue gaining momentum with the work we're doing on member engagement. We have more than five million members saving with our scheme and auto-enrolment staging is nearly complete. So we believe the next stage of development for schemes like ours will be a renewed focus on members. It will become increasingly important to reach out to members and understand what issues they feel strongly about. In particular, we want to give members the opportunity to talk to us about how their money is invested and the impacts of their investments. That is if they're interested in doing so.

We're also participating in a research project led by the Investment Leaders Group facilitated by the Cambridge Institute for Sustainability Leadership. This is to understand how savers react to the presentation of environmental and social information with regards to their investments.

In the past three years academics from Cambridge University have been doing a lot of work on this. They've developed a framework to help investors quantify and communicate to their members the social

and environmental impact of their portfolios. They published the framework last year and are now conducting consumer research. They want to find out the most influential way to present this data to pension plan beneficiaries to help them make decisions or at least engage with their investments.

“We believe the next stage of development for schemes like ours will be a renewed focus on members.”

The research aims to enable financial institutions to better understand and reflect member interests in the design of investment strategies and financial products. For us, this research could provide an updated understanding of what's important to our members. We hope to get some insight into how interested our members are by our work on climate change, the workforce, as well as culture



and conduct in UK banks.

We want to find out whether they welcome information on these issues or if they're primarily interested in knowing about the risk-adjusted return of their investments. We hope to update readers next year with outcomes and conclusions of this project as well as progress on other member-focussed initiatives.

Tobacco

Increasingly pension funds are looking at the role of tobacco in their investment portfolios. We are analysing the impact of holding these stocks in our global equity index fund in the light of international and UK policy developments.

We recap below on what else NEST will be focussing on in the coming year.

Climate impact study

We're about to kick off work that tests for the existence of a climate driver of performance by running a climate event study on news announcements. We'll measure the fund and benchmark performance before and after these news events and test for any significant difference in impacts on investment returns.

“We want to explore how impact can be measured so we can understand the extent to which funds are meeting their social and environmental goals.”

ESG in alternative asset classes

We're researching a range of new asset classes to invest in. This means we need to understand how ESG risks and opportunities play out. Over the coming months, we'll be researching how ESG issues can affect the risk and return profile of alternative types of investment. We'll also be assessing how the investment approaches used to gain exposure to different assets may determine the level of ESG risk and opportunity.

Impact investing

We'll continue our research to evaluate viable investment opportunities across different asset classes that could generate a positive social or environmental impact in line with our risk and return requirements. We want to explore how we can measure impact so we can understand the extent to which funds are meeting their social and environmental goals.