# Working for change

NEST's activities as a responsible investor

You can use the menu at the top of the pages to go to the start of each section.

# Foreword

The launch of auto enrolment in 2012 marked the start of a revolution in share ownership and investing in the UK. Millions more people now have a stake in companies and markets around the world for the first time.

NEST (National Employment Savings Trust) believes organisations that are well-run with sound environmental and social practices have a better chance of sustaining long-term success and profitability. By focusing on sustainable practices we're looking to boost and protect our members' pots. We also want to benefit society and the environment our members live and retire in. NEST applies this approach to all our Retirement Date Funds and fund choices.

Our approach to responsible investment involves working closely with our fund managers, the responsible investment team at Royal London Asset Management (RLAM) and the voting agency Manifest. We'd like to take this opportunity to thank them for their ongoing commitment to helping NEST deliver our investment approach.

This report aims to go into more detail about our responsible investing and active ownership work and the impact it's having.

We already publish regular updates on our activities through our **quarterly investment report** and **voting reports** on our website. This document and future annual reports are part of our ongoing commitment to being transparent and accountable.

We welcome feedback on this summary of our work, particularly from our members.

Mark Fawcett
Chief investment officer

# Introduction

## What's covered in this report?

The aim of *Working for change* is to provide more detail on why and how NEST takes an active role when it comes to the investments we own on behalf of members.

We use the ownership rights associated with the investments we make on our members' behalf as a force for positive change. It's our members who benefit from companies performing well over the long term, so we take an active role in supporting companies in managing environmental, social and governance (ESG) risks and opportunities. This is often referred to as being a responsible investor.

Acting as a responsible investor is about representing our members' interests when using their ownership rights. This includes how we incorporate information on ESG issues into our assessments of the different assets we invest in. It's also about how we engage with companies and markets, including how we vote at annual general meetings (AGMs).

For NEST, investing responsibly also includes how we work with our fund managers to ensure our members' interests are being taken into account.

We want to make it easier for our members, their employers and our stakeholders to understand what drives NEST's activities as a responsible investor and to see the impact we're having.

There are four sections in this report:

**Section one** sets out:

- why NEST acts as a responsible investor
- how NEST acts as responsible investor.

**Section two** looks at four case study areas where NEST has focused some of its engagement activities. These set out how we have been working for improvements in practice. The case studies are:

- climate change
- banking culture and conduct
- the quality of company audits
- fair pay.

**Section three** looks at the partnerships, codes and networks NEST is part of.

**Section four** looks ahead to NEST's priorities for the near future.

# NEST as a responsible investor

## Why does NEST act as a responsible investor?

Like many pension schemes, NEST has a set of investment beliefs that help the organisation make better decisions about how we invest members' money. One of NEST's beliefs, developed from a significant body of evidence, sets out the importance of considering ESG risk factors.

NEST believes 'As long-term investors, incorporating ESG factors is integral to the investment management process.' In other words, we need to think about things such as how companies and markets operate and how they treat people and the environment when we make decisions on investing members' money.

This is particularly important because many of our members will be saving through NEST for decades. Many of these issues are likely to have a material impact on the performance of the companies and other assets we invest in over long timeframes.

We have four main objectives that follow from our ESG investment belief. These objectives help guide and prioritise our activities:

**Better risk adjusted return**
We want to target an improvement in ESG performance where there is evidence this can lower the risk we need to take to achieve a return.

**Better functioning markets**
We want to improve how markets operate and are regulated in jurisdictions where we invest.

**Support long-term wealth creation**
We want to encourage companies and markets we invest in to deliver sustainable and stable performance to support good returns for our members over many years.

**Manage reputational risks**
We want to protect NEST's reputation and grow trust with our members by encouraging companies to act in ways our members can feel confident about. Companies that aren't properly run, or don't consider the environment or people in a way our members would expect, damage how they are seen and how members feel about investing.

NEST has developed its approach to responsible investment through consultation with a wide variety of stakeholders, consumer groups and industry experts. We have benefitted from ongoing input from NEST member and employer panels, and our approach has been debated at length with our investment committee and trustees.

> ... we need to think about things such as how companies and markets operate and how they treat people and the environment when we make decisions on investing members' money.

Our approach and principles are set out at a high level in our governing document, the **Statement of investment principles** (SIP). Our trustees review our approach regularly as the scheme evolves and develops. Key to our ongoing development will be to increasingly involve our growing membership to understand what their expectations and needs are when investing their savings over many decades.

# NEST as a responsible investor

## How NEST acts as a responsible investor

NEST was set up to be a low cost scheme, available to any employer that wants to use us. Relative to many other pension schemes, we're still young and although our assets under management are growing rapidly, they're still modest. While there are potentially thousands of ESG investment risks or opportunities we may want to act on, our size and focus on keeping costs down mean we have to prioritise. We have to make choices on which areas to focus on, and be pragmatic on the measures we can take to support or challenge industry or company practice.

There are four elements to how NEST works to invest responsibly: manager selection, active ownership, risk monitoring and risk derived asset allocation.

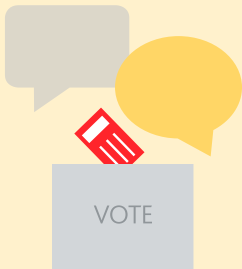
**NEST believes that as long term investors, incorporating ESG factors is integral to the investment management process.**

### Manager selection

We select and build relationships with fund managers who incorporate ESG factors across their investment approach and whose principles are aligned with ours.

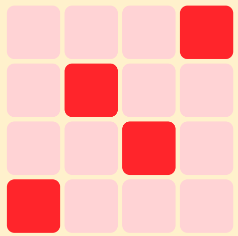
### Active ownership

We address certain ESG risks and opportunities in our portfolio by voting and engaging on issues with companies and standard setters.



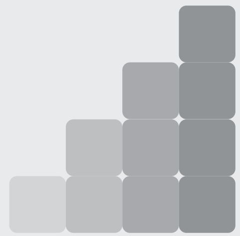

### Risk monitoring

We monitor, prioritise and manage ESG risks alongside other financial risks and opportunities across our investment portfolios. We do this with the help of our responsible investment partners and ESG databases.



### Risk derived asset allocation

We endeavour to invest in ESG focused investment strategies where we can. We plan to do more of this in the future.



# NEST as a responsible investor

## Manager selection

Appointing the right people and companies to invest and manage our members' money is an especially important part of our investment approach at this stage of NEST's development.

When we look for fund managers to run our mandates, our requirements cover what we expect from them in managing ESG risks and opportunities. This includes how they assess and include ESG factors in their investment process and their voting and engagement activities. We expect our fund managers to demonstrate how both managing the risks and harnessing the opportunities can enhance the long-term risk and return of our investments.

Where appropriate we can award focused ESG mandates that remove high risk investments prevalent in a certain asset class. For example, we **procured an emerging markets fund** that doesn't invest in companies with the largest ESG risks.

Building strong relationships with our managers gives us the tools to effectively monitor and challenge how they implement their ESG and active ownership responsibilities. Our fund managers regularly report progress on their activities and we report this via our website and quarterly investment reports. We frequently meet with our fund managers to discuss their approach. Our fund managers also regularly attend meetings of NEST's investment committee to discuss their approach and debate issues where our approach differs from their own.

**Example of how our managers include ESG considerations**

Legal & General Investment Management (LGIM), which won the mandate to run our UK property fund, places an emphasis on its role in owning and developing properties in a sustainable way. It has a target of a 20 per cent reduction in energy, carbon and water by 2020. In the last financial year it has reduced the carbon emissions across all properties by 17 per cent. It has also reduced electricity and fuel use by 15 per cent and 23 per cent respectively and cut overall water use by 7 per cent. In 2015, the UK property fund that NEST uses as one of our building blocks for our default strategy and for our Ethical Fund (the Managed Property Fund) achieved a Green Star from the Global Real Estate Sustainability Benchmark (GRESB). The fund was also awarded the accolade of world leader in its sustainability credentials amongst the diversified fund sector.

# NEST as a responsible investor

## Active ownership

One of NEST's investment beliefs is that indexed investment - sometimes referred to as 'passive management' - where available, is often more efficient than active management. The majority of NEST's equity investments are currently made via passive or indexed funds. Index investment involves holding investments in the same proportion as a chosen benchmark or index, such as the FTSE All Share. This is instead of actively choosing investments that are hoped to perform better than a given benchmark.

NEST invests in global equities through an indexed fund, but this does not mean we're 'passive'. Active managers can sell their investments if a company is performing poorly, but indexed investors like NEST can't do this. This means it's in our members' interests to help the companies we're invested in behave in a way that generates sustainable returns over many decades.

Equity index investors like NEST can be especially effective because we can engage with a number of companies in a sector and feed back our findings industry-wide. Our aim is to raise standards across the whole industry.

Owning shares in a company means you own some of that company. Most shares give their owners a right to vote on some company decisions. This includes taking decisions around such things as merging with or taking over another company, approving senior executive pay, and electing or removing board directors. Voting usually takes place at each company's AGM.

As a low cost scheme which invests in thousands of companies globally, we need to prioritise our voting work. We want to make the most of rights we exercise on behalf of our members using the resources we have.

Our fund managers vote the shares NEST owns on behalf of our members in line with their own firm's voting policies. However we've also developed our own **Voting policy**. This sets out a NEST viewpoint on important areas and tells our fund managers how we expect companies to consider key issues. This enables us to hold our managers to account on the voting decisions they make. It also helps us identify differences between how our fund managers may plan to vote and how we might want them to. This allows us to challenge and influence our fund managers about their decisions.

We keep a close eye on how our main equity fund manager plans to vote. Where we see key differences and strongly disagree, we look to discuss the rationale behind their vote and express our preference. From 2016, where we don't agree on issues we feel strongly about, NEST has the ability to override the voting intentions of our global equity manager.

We closely monitor a 'subset' of 100 shares to give us further insight on how our fund managers are exercising our members' share ownership rights. These shares include our largest holdings, shares in companies in high risk sectors and shares in companies identified as having governance issues in the past. Ahead of the AGMs for each of these companies, our equity fund managers send us their voting intentions. We work with our proxy voting agent Manifest which issues voting recommendations on NEST's behalf. We regularly publish **Voting summary reports** setting out how all our fund managers have voted and how this compares to NEST's voting policy.

# NEST as a responsible investor

## Active ownership continued

### How voting works for NEST

**Make contributions**

Members make contributions into their NEST pension pot. NEST then passes these on to be invested by fund managers.

**Purchase shares**

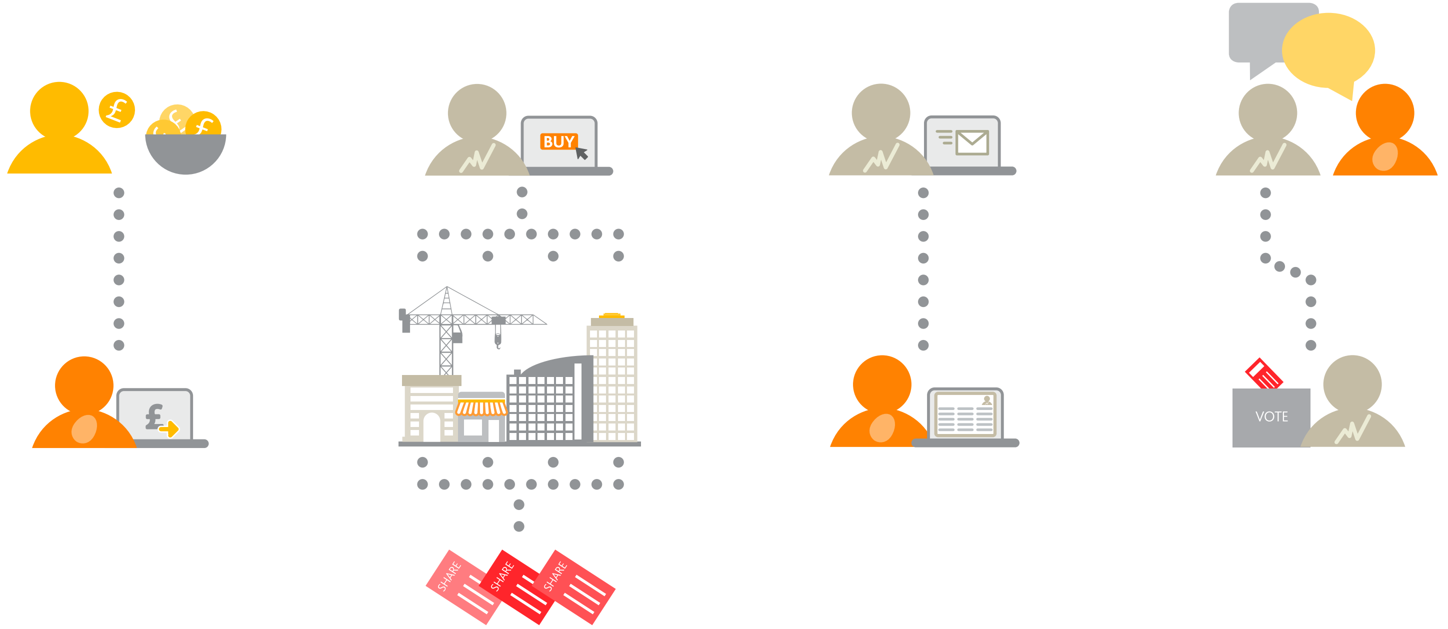
Fund managers use members' money to buy shares in companies. These come with voting rights.

**Assess voting intentions**

These companies hold annual general meetings (AGMs) where shareholders can have a say on how the company is run. Our fund managers vote on NEST's behalf, but send NEST voting intentions for select companies before the AGMs.

**Vote at AGM**

NEST has the opportunity to identify key differences in voting decisions and then discuss them with fund managers. We ask them to explain their vote rationale and take on board our view. After checking against NEST policies the fund manager casts their vote.



# NEST as a responsible investor

## Risk monitoring

NEST invests in thousands of companies across the globe, in all sorts of different industrial sectors. There will be times we're invested in companies we'd want to have a better track record on how they're run, or how they treat the environment or communities they work in.

As NEST is still relatively small in terms of assets under management, we need to use our resources to support companies in improving their ESG performance carefully. To help us do this in a way that gives financial value to members, we've developed a risk management model.

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The model incorporates four broad areas where we analyse company performance and score their records on:

- **Environmental issues**
  Waste management, pollution, emissions, and recycling. We group these into an overall record on environmental performance.
- **Social impact**
  Training and developing its workforce, health and safety, and how the company treats staff, customers, governments, and wider stakeholders. We group these into an overall record on social performance.
- **Governance issues**
  How the company is led, managed, kept safe, sound, and viable. We group these into an overall record on governance performance.
- **Financial performance**
  As measured by company accountants and stock markets.

The model tells us how much of each area contributes to the risk of each company. It also helps us focus on the key risks our portfolios are exposed to.

Using the model, we've identified the key ESG risks in our equity portfolio. In order of priority, these key risks are currently:

- **How companies treat the environment**
  We're addressing this through a focus on companies' greenhouse gas emissions that contribute to climate change.
- **How companies interact with others**
  We're addressing this through a focus on conduct, culture, staff reward and progression that contribute to employee well-being and productivity.
- **How companies lead and organise themselves**
  We're addressing this through a focus on audit and dividends that contribute to public and investor confidence and trust.

## Risk derived asset allocation

As we grow and our investment function evolves, we will begin to incorporate ESG risk factors into our asset allocation decisions more prominently. For example, this could include how we'll manage our exposure to carbon intensive stocks as the world moves to a low carbon economy. For the time being, our activities as a responsible investor are mostly focused on the other elements described.

# Case studies

## Helping to address climate change

### Why climate change?

Climate change is an environmental, social and economic phenomenon which will impact over many years into the future, but is already having wide-ranging effects today. A recent report from the Intergovernmental Panel on Climate Change states: 'Observed impacts of climate change have already affected agriculture, human health, ecosystems on land and in the oceans, water supplies, and some people's livelihoods.'[1]

The potentially devastating effects of climate change throughout the globe will almost certainly affect investment portfolios. This is either through the physical impact of climate change or new regulation to address it.

### How NEST is working to address climate change through its investment approach

From 2014 we embarked on a project to understand the possible capital market impacts of climate change and examine the issue of stranded assets. Stranded assets are investments that could become devalued or written-off because of things like new regulation or new technology.

We captured a wealth of evidence through meeting with government and industry experts. We also gained insight through meeting with academics such as Adrian Gault, chief economist at the Committee on Climate Change, and Timothy Lenton, professor of climate change and earth system science at the University of Exeter.

1 IPCC (2014) *Climate change 2014: impacts, adaptation and vulnerability, summary for policymakers*, available at https://ipcc-wg2.gov/AR5/images/uploads/WG2AR5_SPM_FINAL.pdf

# Case studies

## Climate change continued

Each expert we met looks at the issue from different angles. However, all agree long-term investors need to be well-prepared for the impacts of climate change and regulation on the investments they hold.

They suggested pragmatic approaches NEST could take to monitor and mitigate the potential risks arising from stranded assets. They also suggested ways for NEST to harness the potential opportunities presented by policy changes and technological advances. These have filtered through to our strategic approach to both tackling carbon risk and seeking opportunities as we move towards a low carbon world.

There are three key areas in focus for NEST:

- **Active ownership**
  We encourage our investee energy companies to diversify their energy portfolios and transition towards a low carbon economy. We're also part of collective action and networks that seek to reduce the damaging impact of climate change. For example, we co-signed a letter to the Securities Exchange Commission (SEC) around concerns US oil and gas companies are not disclosing enough information relating to carbon risk.
- **Investment and asset allocation**
  We're researching investment approaches that reduce exposure to companies with high carbon emissions and fossil fuels reserves. We also want to increase investment in companies capitalising on new regulations and technological advances to generate revenue from alternative power and energy efficient technologies.
- **Risk monitoring and measurement**
  We monitor a variety of risk factors and opportunities at different levels of the investment process.

### Engaging with utilities and energy companies

NEST has started to engage directly with a selection of utilities and energy companies in our portfolio. We want to build an in-depth picture of how they're responding to, and managing, climate risk and climate policy changes.

From our conversations so far, we've heard about a number of encouraging developments some utility companies are making in new and alternative forms of energy. Some are aiming to position themselves at the forefront of innovation and are simultaneously starting to take action on those assets that won't be viable in the long term.

We want to support our investee companies to make positive changes. We're committed to helping them become less dependent on carbon-emitting forms of energy and also invest more in renewable energy capacity and green technology.

### Signing the Paris Pledge

NEST signed the Paris Pledge for Action and the Global Investor Statement on Climate Change, which sets out steps institutional investors can take to address climate change.

The Paris Pledge is about global support for a commitment to a safe and stable climate in which temperature rise is limited to less than two degrees celsius. By signing this agreement, NEST has agreed to take concrete steps to reduce greenhouse gas emissions and build resilience against climate change. We will provide updates on what the impact will mean for NEST and our investee companies.

# Case studies

## Helping banks improve their conduct and culture

### Why conduct and culture?

Share prices of UK banks plummeted in the 2008 financial crisis in part because of poor lending policy and risk management. However, behaviour or 'conduct' at these organisations was also part of the problem. Poor conduct includes things such as mis-selling products, market rigging and not having proper controls to prevent laundering criminal funds. Such issues have led to banks paying around £200 billion in fines and damages worldwide in recent years.

NEST invests in all of the large global banks. It's clearly in our members' interests to encourage all banks to work together to share good practice and help them improve their culture and conduct.

We've focused our engagement efforts in the UK first as we felt we could exert a stronger influence. We also believe engaging with UK banks would have a stronger resonance with our members. The sector constitutes a sizeable proportion of the value of the UK stock market and is economically important. When banks in the UK perform poorly, the whole economy can be dragged down.

For some years, we've been working to understand whether a permanent change in conduct and culture is underway at UK banks so we can be comfortable about our ongoing investment in the sector.

Photo credit: donsimon / Shutterstock.com

# Case studies

## Banking culture and conduct continued

### How NEST is working for change

During 2014 and 2015 we met with senior executives and members of the board of directors from major banks and officers from building societies. We also participated in policy debates at a regulatory and government level.

Our engagement aims were to:

- develop a baseline, or mid-point, from which we can measure conduct and culture change at banks
- gather examples of what was working well and what wasn't
- understand what excellent and poor practice looks like
- understand whether the indicators banks are using to measure change in conduct and culture are moving, and in which direction
- keep the pressure on banks to make lasting, positive changes to conduct and culture
- feed back our information in the form of a report to the banks so they might further improve conduct and culture.

We held additional meetings with banks that were struggling to effectively implement and get results from their conduct and culture change programmes. We also held extra meetings with those that were more successful in implementing their programmes.

### What we found

We found the conduct and culture baseline of UK banks can be thought of as encompassing five different areas:

- simplification: this refers to how active banks are across various markets and multiple products
- organisational culture: the kind of culture that is set from the top and adopted throughout the business
- customer service: assessing the bank's focus on customers rather than products
- staff: how staff are developed
- corporate purpose: how clear it is to all who work in the bank what drives the banks' activities.

We designed baselines to capture where banks are in relation to these five areas. We established which banks were above the baseline, which are on the baseline, and which were below. We then established reasons for the different positions of banks in relation to the baseline. The next step was to work with those below the baseline to increase their efforts.

We've presented our findings to the Banking Standards Board (BSB). BSB is responsible for promoting high standards of behaviour and competence across the UK banking industry. It also helps banks embed a better conduct and culture in order to improve consumer confidence and trust. BSB has used our insights to help guide its work. We also sent our findings to the banks so they can see what their peers are doing, and to share good practice.

### Our impact

In conjunction with BSB, regulators and stakeholders, we believe we're making a positive contribution to the debate about how to improve banking conduct, culture and practice. We continue to work with others to support better conduct in the banking sector for the long term.

# Case studies

## Improving our understanding of employment strategy, reward and progression in companies

### Why employment and pay?

We want to know that the companies we invest in treat their staff decently. This includes understanding how their workers are paid, their terms and conditions and how they are developed. We believe companies that invest in their staff are best placed to build long-term sustainable and successful businesses. Our members will feel more confident about investing in companies that treat their staff well.

### Understanding companies' employment models

We've carried out research to understand why companies believe their employment models are right for their business.

We chose to have a dialogue with some companies we invest in that employ a high proportion of staff through zero hours or similar contracts. These are where workers have no guarantee of work, and are paid only when they are needed by the employers, often at short notice. We also engaged with companies who pay their workers close to national minimum wage.

We asked companies why standard employment contracts aren't right for their business and asked why paying a higher rate of pay to the lowest paid workers is not appropriate.

In 2015 we met with 12 companies. Each of these public listed companies employs tens of thousands of people in retail, catering, hotel and restaurant, event and support service sectors.

Our engagement aims were to:

- develop our understanding of the different ways workers are employed and paid so we can vote in a more informed way on pay policy at company AGMs
- gain confidence that companies can continue to deliver long-term sustained performance in light of the different ways they employ and pay their workers
- hear how the benefits of company performance are shared throughout the company
- develop an understanding about a possible link between employment strategy and employee satisfaction surveys, employee well-being, and other employment metrics.

In 2015 NEST was also part of a working group of pension funds that helped to produce the June 2015 publication **Where is the workforce in corporate reporting?**

Photo credit: DSBfoto / Shutterstock.com

# Case studies

## Understanding reward continued

We found employers fall into a number of different types:

- Some employers try to be **Living Wage employers** but may not be able to due to working with third-party contractors. The current UK living wage is £8.25 an hour. While all direct employees are paid well above the national minimum wage level, they believe the company should not determine the pay rates of their third-party contractors. This means they couldn't become a Living Wage accredited employer.
- Some employers work positively and quickly towards becoming a Living Wage accredited employer. In fact, one company we met in 2015 became a Living Wage Employer later that year.
- Some employers believe rewarding the lowest paid staff at a rate well above the national minimum wage isn't right for their type of business. This kind of company tends to employ many school leavers and people with little experience and qualifications. They require investment and training in the business to develop basic skills. Trainees and interns earn close to national minimum wage but they progress quickly through the company. If the company paid all new employees much more than the national minimum wage, the recruitment strategy would change so they hired more experienced and qualified staff. This would disadvantage those with no experience or qualifications.
- Some employers believe staff reward needs to be considered as part of the wider benefits, such as holiday, sick pay, pensions, life assurance and share schemes. Some additional benefits are highly valued by staff and improved their motivation, morale, as well as lowered staff turnover.
- Some employers believe zero hours or similar contracts are essential for their business. A typical business for this sort of employer type was event management companies. These employers believe in today's workforce there are large numbers of workers who want to work flexibly in a way to suit them. They believe their workers want to pick and choose the work they do.
- Some employers' pay model is dictated by a client's requirements and cost demands. Typically these are support services companies providing catering, cleaning and facilities management at client sites.The employer does not get involved in discussions about staff reward and progression. Staff often feel as though they are an employee of the client rather than an employee of the support services company. Workers often had very low levels of engagement with the support services company.
- Some employers work to be a fair employer. However, the complexity of the organisation and the number of countries in which they operate can make this hard to implement. The employer has to consider different salary levels and benefits in different countries. This type of employer often wants to approach reward and progression from a global perspective, in part driven by the need to manage the company's reputation. This employer type has worked to ensure the way they pay and develop their workers compares well to locally established Living Wage rates.

### Conclusions and next steps

We've learnt about the importance of considering a wide variety of factors when evaluating how companies reward and develop people. This engagement has made us interested in knowing more about employee satisfaction surveys and other employee well-being metrics. We're now working with the Pension and Lifetime Saving Association and other investors to try to develop this area further to develop better metrics for investors on how companies incentivise their employees.

# Case studies

## How well are audit committees adapting to new regulations?

### Why audit?

Investors rely on financial statements and reporting to tell them how companies are doing. Investors like NEST don't have as much information as those who manage and direct the company. Having an independent and unbiased audit helps us trust what we're told by the company. If we can't trust what the company is saying about how it is being run, then we cannot be confident about investing.

Auditors express an opinion on how far a company's financial statements and reporting are 'true and fair'. They also provide a view on effectiveness of the companies' internal controls and governance processes around financial reporting.

Audit committees are made up of members of a company's board and are responsible for overseeing financial reporting. This includes making sure there are appropriate checks on the financial reporting systems in place and that the appointed auditor is independent of the company's management.

In recent years there's been growing evidence audit committees have not always ensured high quality audits. There have been concerns over value for money and to what extent committees have promoted the benefits of competition and innovation within the audit market. One of the key issues identified is the length of time an auditor works with a company and the infrequency with which auditors may change.

A Lords Select Committee report found that the average auditor tenure in the FTSE 100 was 48 years. PWC was the auditor of Barclays Bank for more than 100 years. The long length of audit firm tenure and the other financial relationships the auditor often has with client companies is now widely believed to interfere with the very behaviours needed for an independent and unbiased audit.

There's a new EU requirement that FTSE 350 listed companies tender the external audit contract every ten years and rotate the external audit firm every twenty. The EU is also limiting non-audit fees, that is, fees for non-audit work like HR and management consultancy, to 70 per cent of audit fees. It's also limiting the types of advice audit firms can provide to clients, such as tax and investment advice.

We recognise the time it takes for a new audit firm to become effective can present risks for investee companies, which in turn can mean investment risk for our members. This means we need to understand how well audit committees are adapting to the new regulations. We want to be confident the UK FTSE 350 companies we invest in are prepared and equipped to ensure continuing high quality audit and value for money.

### Engaging with audit committee chairs

We met with audit committee chairs from 15 FTSE 350 companies to learn about their thinking processes and approaches to audit tenders and changing auditors. We wanted to develop a greater understanding of the work of auditors as seen through the companies' eyes. We also wanted to understand what audit committee chairs are doing to ensure high quality audit tenders and smooth transitions between auditors.

We found that audit committee chairs feel the external auditor provides trusted consultation, challenge and caution. They use the auditor's knowledge, expertise and experience to help solve complex accounting problems and provide expert advice to the finance director and audit committee chair. We found that as the auditor feeds back, companies change what they're doing. By making changes as circumstances evolve, the auditor helps companies to 'self-regulate'.

Ongoing consultation built a strong foundation of trust between auditor and audit committee. This trust relationship explained the long audit tenures found in the past.

The next step for NEST is to share the best practice examples we've found with audit chairs and the Financial Reporting Council (FRC), with a view to supporting high quality audits in the interests of investors including our members.

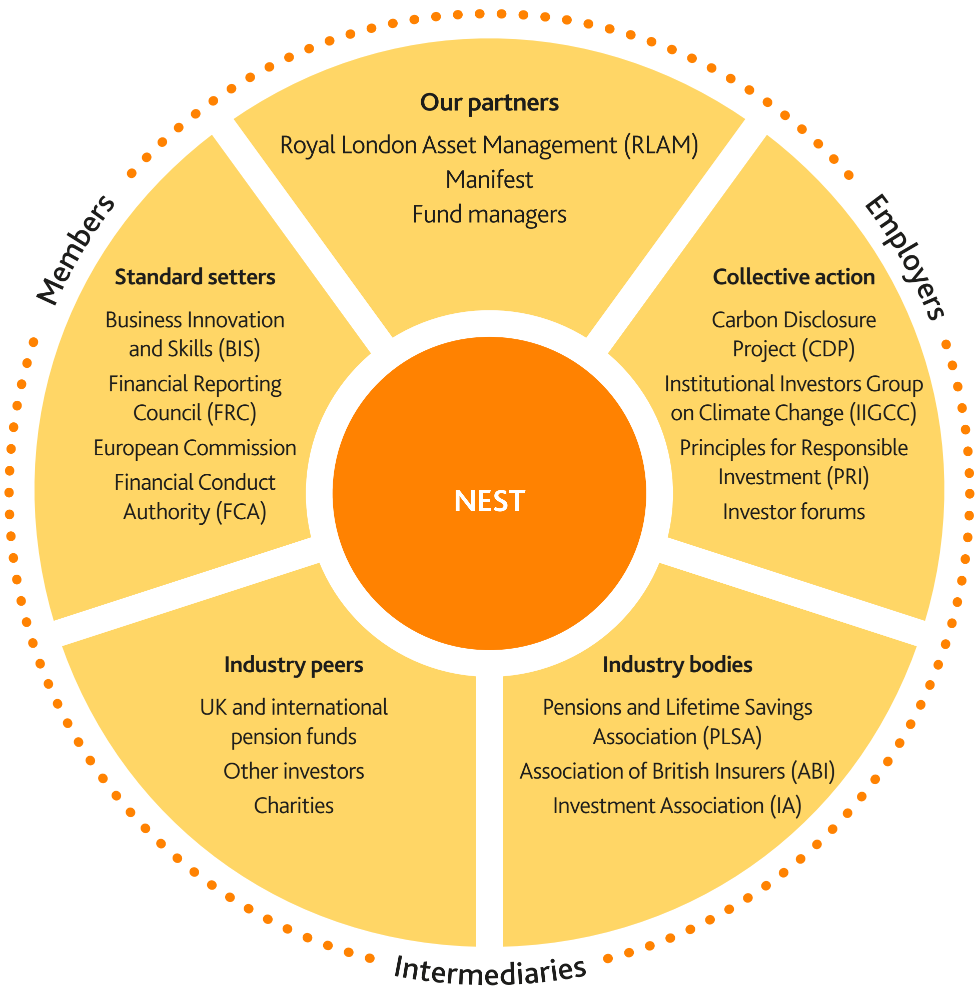
# Working with others

Maintaining relationships with others allows NEST to share resources and knowledge. Where we can speak with one voice and unite with others, we can exert stronger influence. This makes us more likely to achieve positive change across our investments and the markets and regulatory environments in which we operate.

> Where we can speak with one voice and unite with others, we can exert stronger influence.

In addition to our fund managers, NEST works with a number of partners to help us be more effective when acting on issues that matter to our members and their money.

The diagram opposite shows our key relationships.



# Working with others

## Working with RLAM

From early on in our development we've partnered with Royal London Asset Management (previously The Co-operative Asset Management) and Manifest, the proxy voting agency.

They've helped us develop our approach and policies around responsible investment and active ownership. The partnerships have evolved and now focus on executing and delivering these policies in the form of direct corporate engagements and voting. We also work with RLAM and Manifest to share information and knowledge on industry developments.

## Financial Reporting Council (FRC) UK Stewardship Code

This code looks to support better quality engagement between companies and their investors in order to help improve long-term returns. There are seven principles that set out a benchmark for good practice for owners of shares, like NEST, should aspire to.

NEST has been a supporter of the FRC UK Stewardship Code since it began. We participated in the further development of the Stewardship Code in 2012 through written submissions and meetings with the FRC.

As part of NEST's commitment to the code we publish a **Statement of Compliance with the UK Stewardship Code**. This explains the steps we take to meet the seven principles.

## United Nations-backed Principles for Responsible Investment (PRI)

NEST is a signatory to the **PRI**. These are a further set of principles for investors. The principles look to encourage consistent standards for responsible investment around the world. One of the aims is to incorporate sustainability issues into investors' decision-making and ownership practices.

In implementing the principles it's hoped that signatories, like NEST, will be contributing to developing a more sustainable global financial system.

## Carbon Disclosure Project (CDP)

The CDP collates carbon data on thousands of companies globally and holds the largest collection of self-reported climate change, water and forest-risk data. It measures carbon impacts and shares this information to help drive change.

NEST uses CDP data to evaluate climate risks as well as the opportunities. These could impact companies' operations and financial performances and therefore our members' returns. CDP's data can help us to identify the largest carbon risks in our portfolio across various sectors. It also provides some focus for our engagement.

# Working with others

## Institutional Investors Group on Climate Change (IIGCC)

IIGCC is an investor forum that encourages public policies, investment practices and corporate behaviour to address the long-term risks and opportunities associated with climate change.

Being part of the IIGCC keeps NEST updated on the developments in EU and international climate and energy policy. It also supports our work on climate risk and engagement. In 2015 we co-signed a letter to 60 high risk companies, asking them to disclose their positions on climate and energy policy and their lobbying activities.

> One way of supporting good corporate behaviour is working with regulators and standard setters. Better standards across markets mean our members can benefit from higher standards in all the companies we invest in on their behalf.

## Working with standard setters

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Over recent years we have engaged with regulators including the FRC, the Department for Business Innovation and Skills (BIS) and the Department for Work and Pensions (DWP). We've engaged on matters of audit, investor codes, accounting standards and gender equality.

You can read NEST's responses to various consultations with standard setters and regulators on **our website**.

# Looking ahead

As we're still a young scheme, our approach to investing responsibly will continue to evolve. In this section we provide a flavour of where NEST is heading in the near future.

> Climate change remains one of our key priorities and we will be taking a number of steps reflecting this.

## Continued focus on climate change

Climate change remains one of our key priorities and we will be taking a number of steps reflecting this.

We'll be engaging with some of the major oil and gas companies whose revenues are heavily linked to oil and gas exploration. We want to hear their perspective on the implications of a below two degree celsius limit established by the Paris Agreement in 2015 and how they plan to make transition to the low carbon economy.

In our revised voting policy we set out new guidelines on climate change reporting. The policy also details our expectations on performance for companies and sectors where carbon risk is deemed to have a material impact.

We're also researching low carbon solutions that can effectively hedge, or off-set, carbon risk. In addition we're looking into how we might benefit from opportunities by investing in companies positioning themselves for a low carbon economy consistent with our indexed approach to investing.

In doing all of this, we're mindful NEST is designed to serve members at reasonable cost. We have to be practical and carry out change in stages as our assets under management grow.

For our members, this means we're likely to build portfolios that directly address climate change risks and opportunities, and other sustainability factors, incrementally over time.

Looking into the more immediate future, we'll be taking a deeper look at issues affected by the physical impacts of climate change, beginning with research into water. This will include gathering evidence from various experts across government, academia and investment. A number of reports suggest water risk and water scarcity are on the increase. This means some of the assumptions about the availability of water that underpin the value of some investments in financial markets may not be realistic into the future.

We want to understand where there are material risks and what they might look like if they occur. We want to start to get an understanding of the potential impact on capital markets and therefore our members' investments.

## Working with members

Auto enrolment is still in its early days and many of NEST's members are new to investing. They may not always understand they are effectively owners of companies and other assets and the rights this provides.

As NEST grows and our members' understanding of pension saving increases, we'll be looking to understand what issues members feel strongly about and how they want us to act. In particular, we also want to develop a two-way dialogue with our members about how their money is invested and the impact this can have. This is not only in terms of the long-term financial security of their investment, but also the short-term impacts on their environment and communities. We believe this will be a key element of promoting a genuine shareholder democracy to improve markets, long-term sustainability and company behaviour and conduct.





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