NAPF

Securing the future of pensions

NAPF Engagement Survey:
pension funds' engagement with investee companies

NAPF Research Report

November 2014

Contents

Executive summary

This report presents the findings of the NAPF's tenth annual survey of pension funds' engagement with investee companies. The NAPF believes that engagement with investee companies is a vital part of the investment management process, and our Engagement Survey continues to illustrate that UK pension funds have growing expectations and are challenging their asset managers to meet these in an increasingly transparent manner.

It is evident that UK pension funds are continuing to get to grips with their stewardship responsibilities as set out under the Stewardship Code. More funds are committing to Code and to its Principles and are pressing their managers to deliver effectively in the interest of their beneficiaries. However, it is also clear that for many pension funds, due to limited resources, and the many other significant pensions reforms with which they have had to manage, this agenda remains a difficult one to devote significant time too.

Given the above context, the NAPF last year launched its Stewardship Disclosure Frameworks to enable funds more easily to compare and contrast the approaches of the asset manager signatories to the Stewardship Code. Building on this well received transparency initiative the NAPF is now hosting a regular series of Stewardship Accountability Forums to provide pension funds of all sizes with the opportunity to question and press the senior figures within the largest asset managers for the highest standards of stewardship.

We hope that the enhanced transparency and accountability which the NAPF's Stewardship Disclosure Frameworks and Accountability Forums provide will ensure that in 2015 we see continued progress. With the expectations of pension funds and their underlying members continuing to increase there is an opportunity for those asset managers which are most committed to delivering the long-term returns required by pension funds to differentiate themselves and in turn to be recognised and rewarded.

The core findings of this year's Engagement Survey are:

- There is a near consensus from pension funds that they have stewardship responsibilities.
- The vast majority (80%) of respondents are taking the stewardship activities and policies of managers into account when selecting managers.
- Over a quarter of respondents have active equity mandates which stretch beyond a decade and indeed over two thirds of passive equity mandates exceed a decade.
- Not a single respondent disagreed with the assertion that consideration of risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors) is compatible with a pension fund's fiduciary duty.

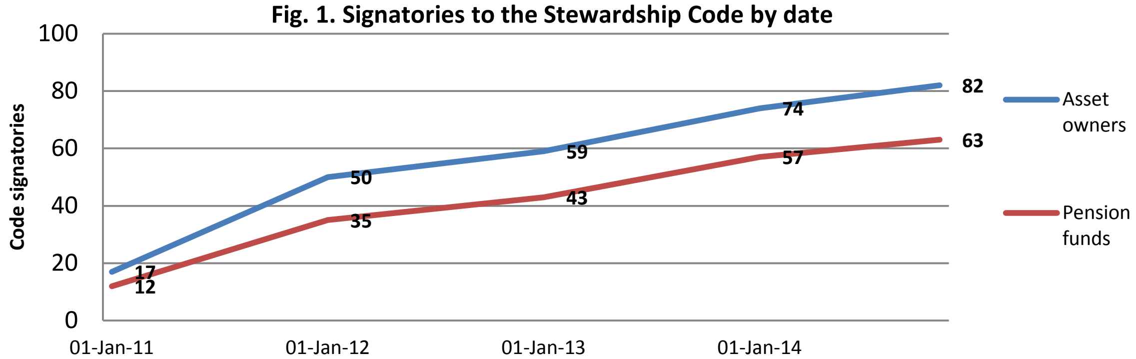
NAPF review of 2014

Bringing the spirit of the Stewardship Code to life

The UK's pioneering Stewardship Code continues to be seen as a model for others to follow. This year we have seen similar Codes being introduced in countries such as Japan in an effort to promote stronger corporate governance by calling on shareholders to engage more actively with the companies they invest in. As of September 160 institutional investors had signed up to the Japanese Code including a large number of UK asset managers.

The model of complying-or-explaining against a set of Code principles is also the approach being advanced in Europe through the proposed revisions to the European Shareholder Rights Directive. In this respect it is encouraging to see that the number of signatories to the UK Code continues to increase – there are now 82 asset owner signatories including 63 pension funds. Additionally a number of large pension funds which have in-house asset management arms such Tesco and BP are signed-up as one-client asset managers. The NAPF has long believed that a greater weight of pension fund signatories to the Code is important to give a clear signal to the market and in turn influence behavioural changes that lead to better stewardship by asset managers and companies.

Fig. 1. Signatories to the Stewardship Code by date



One of the two objectives which lay behind the Code when it was formalised was to help clients of asset managers differentiate between managers by judging how they carry out their stewardship responsibilities. However, as the Chairman of the FRC Sir Win Bischoff suggested at the NAPF's September Being Responsible Owners Hot Topic Seminar there is still some way to go in this regard, in particular Sir Win commented that:

> "It's apparent that there are some organisations who are signing up to the Code, but are failing to properly comply with its requirements, or to adhere to the spirit of the principles.
>
> It is true that the Code was never intended to create an official 'ranking system' for signatories, but the market can, and should, challenge managers to follow-up on their commitment.

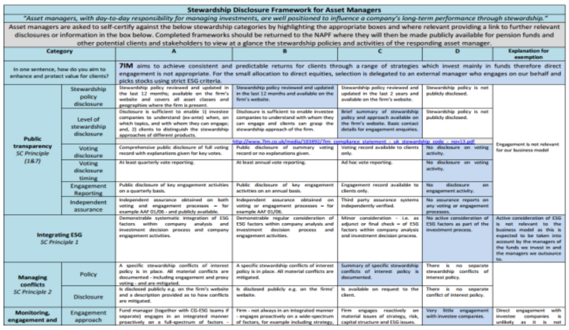
We agree, the success of the Stewardship Code requires signatories to adhere to both its letter and spirit.

It is important that asset owners are clear about their own expectations and explicitly communicate these to their asset managers. As this is something that the EU's Shareholder Rights Directive may well impose additional requirements around it is encouraging to note that a substantial majority of respondents to the NAPF survey set out their approach to stewardship within their Statement of Investment Principles; question prospective managers about their approach and an increasing number subsequently set out their expectations within the mandates they award to managers.

While there is a responsibility for pension funds and other asset owners to drive the market and challenge their managers to strive for the highest standards of stewardship, it remains difficult, especially for smaller and mid-sized funds, to efficiently compare and contrast managers and ultimately exert any real leverage within the procurement process.

In October last year the NAPF launched a new micro-site entitled Stewardship Central in order to bring together various tools to better equip pension funds in understanding the approaches of different asset managers and more effectively question them about their activities. In particular:

- The **NAPF Stewardship Disclosure Framework** provides greater transparency around the stewardship policies and activities of those asset managers who are signatories to the UK Stewardship Code. The disclosure framework does not seek to pass judgement, instead presents a clearer picture of how each firm aims to enhance and protect value for their clients.



Stewardship Disclosure Framework for Asset Managers

"Asset managers, with day-to-day responsibility for managing investments, are well positioned to influence a company's long-term performance through stewardship."

Asset managers are asked to self-certify against the below stewardship categories by highlighting the appropriate boxes and where relevant providing a link to further relevant disclosures or information in the box below. Completed frameworks should be returned to the NAPF where they will then be made publicly available for pension funds and other potential clients and stakeholders to view at a glance the stewardship policies and activities of the responding asset manager.

Category		A	B	C	D	Explanation for exemption
In one sentence, how do you aim to enhance and protect value for clients?		**7IM** aims to achieve consistent and predictable returns for clients through a range of strategies which invest mainly in funds therefore direct engagement is not appropriate. For the small allocation to direct equities, selection is delegated to an external manager who engages on our behalf and picks stocks using strict ESG criteria.				
Public transparency *SC Principle (1&7)*	Stewardship policy disclosure	Stewardship policy reviewed and updated in the last 12 months; available on the firm's website and covers all asset classes and geographies where the firm is present.	Stewardship policy reviewed and updated in the last 12 months and available on the firm's website.	Stewardship policy reviewed and updated in the last 2 years and available on the firm's website.	Stewardship policy is not publicly disclosed.	Engagement is not relevant for our business model
	Level of stewardship disclosure	Disclosure is sufficient to enable 1) investee companies to understand (ex-ante) when, on which topics, and with whom they can engage; and, 2) clients to distinguish the stewardship approaches of different products.	Disclosure is sufficient to enable investee companies to understand with whom they can engage and clients can grasp the stewardship approach of the firm.	Brief summary of stewardship policy and approach available on the firm's website. Basic contact details for engagement enquiries.	Stewardship policy is not publicly disclosed.	
		http://www.7im.co.uk/media/103892/7im_compliance_statement_-_uk_stewardship_code_-_nov13.pdf				
	Voting disclosure	Comprehensive public disclosure of full voting record with explanations given for key votes.	Public disclosure of summary voting record or no explanations given.	Voting record available to clients only.	No disclosure on voting activity.	
	Voting disclosure timing	At least quarterly vote reporting.	At least annual vote reporting.	Ad hoc vote reporting.	No disclosure on voting activity.	
	Engagement Reporting	Public disclosure of key engagement activities on a quarterly basis.	Public disclosure of key engagement activities on an annual basis.	Engagement record available to clients only.	No disclosure on engagement activity.	
	Independent assurance	Independent assurance obtained on both voting and engagement processes – for example AAF 01/06 - and publicly available.	Independent assurance obtained on voting or engagement processes – for example AAF 01/06.	Third party assurance systems independently verified.	No assurance reports on any voting or engagement processes.	
Integrating ESG *SC Principle 1*		Demonstrable systematic integration of ESG factors within company analysis and investment decision process and company engagement activities.	Demonstrable regular consideration of ESG factors within company analysis and investment decision process and engagement activities.	Minor consideration - i.e. as adjunct or final check – of ESG factors within company analysis and investment decision process.	No active consideration of ESG factors as part of the investment process.	Active consideration of ESG is not relevant to the business model as this is expected to be taken into account by the managers of the funds we invest in and the managers we outsource to.
Managing conflicts *SC Principle 2*	Policy	A specific stewardship conflicts of interest policy is in place. All material conflicts are documented - including engagement and proxy voting - and are mitigated.	A specific stewardship conflicts of interest policy is in place. All material conflicts are mitigated.	Summary of specific stewardship conflicts of interest policy is documented.	There is no separate stewardship conflicts of interest policy.	
	Disclosure	Is disclosed publicly e.g. on the firm's website and a description provided as to how conflicts are mitigated.	Is disclosed publicly e.g. on the firms' website.	Is available on request to the client.	There is no separate conflict of interest policy.	
Monitoring, engagement and	Engagement approach	Fund manager (together with CG-ESG teams if separate) engages in an integrated manner proactively on a full-spectrum of factors -	Firm - not always in an integrated manner - engages proactively on a wide-spectrum of factors, for example including strategy,	Firm engages reactively on material issues of strategy, risk, capital structure and ESG issues.	Very little engagement with investee companies.	Direct engagement with investee companies is unlikely as it is not

  - 63 firms have completed an NAPF Framework to date.

- The NAPF publishes **Monthly Topical Questions** to aid trustees in questioning the effectiveness of their managers' stewardship activity. Pension funds are encouraged to utilise these questions during their regular manager reviews in an effort to gain a greater understanding of their investment managers' approach and activity.

Building on the success of the Stewardship Disclosure Framework the NAPF has recently initiated a rolling programme of **Stewardship Accountability Forums** to bring a greater degree of accountability to the attestations made within the Frameworks and to give schemes, small and large, the opportunity to collectively question directly the figures at the top of leading asset management firms

These new Accountability Forums offer pension fund representatives the opportunity to get beneath the marketing material, ask difficult questions and test whether the practice matches the PR. In other words, allowing schemes to press for the highest stewardship standards in the interests of their members.

We hope that with the introduction of these new Accountability Forums, more pension schemes will feel equipped to engage in this agenda. We look forward to monitoring and reporting on further positive progress in 2015.

Key Findings of the 2014 Engagement Survey

Overall commitment

- **Pension funds recognise their responsibilities:** 94% agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting shares.
- **Extra-financial factors are important:** 90% also agreed that extra-financial factors – environmental, social and governance factors – can have a material impact on the fund's investments in the long-term.
- **More can be done:** Just 53% felt that institutional investors have played an active enough role as stewards of investee companies over the past year. Similarly, only 55% believed that engagement with investee companies had added (or prevented loss of) value to their fund.
- **Long-term sustainability more important than recent financial performance:** 63% of respondents believed it very important that the fund's investment managers take into account the long-term sustainability of the company strategy when making investment decisions exceeding the 55% which stressed the importance of recent financial performance.
- **Fiduciary duty is not a barrier:** Not a single respondent disagreed with the statement that active consideration of risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors) is compatible with its fiduciary duty. Furthermore, over 40% of respondents had discussed the conclusions of the Law Commission's report.

Discussion at appropriate level

- **Stewardship is increasingly discussed:** For over a third of respondents stewardship is now discussed regularly at trustee meetings – a doubling on 2013.
- **Yet stewardship continues not to be raised by consultants:** There was a slight increase in investment consultants raising stewardship with their clients (30%) but it remained more common for it not to be raised (41%).
- **Policies are commonly set out within Statements of Investment Principles:** For the majority of respondents (79%) their stewardship policy is contained within their SIP with only 5% of respondents indicating they did not have an investment policy covering these issues.

Manager selection

- **Stewardship is a factor in manager selection:** The vast majority (80%) of respondents indicated that they take the stewardship activities and policies of managers into account when selecting managers.
- **Manager selection extends beyond tick-boxing:** It is also evident that for many funds this goes beyond simply requiring managers to be a PRI signatory with over 60% actively questioning prospective managers about their approach.
- **Also extending beyond listed equities:** Over half of respondents indicated that the asset manager's approach to stewardship influences their selection of manager across all asset classes.

Fund manager mandates

- **Expectations are explicitly set out within mandates:** In just over half of cases funds explicitly set out their expectations with respect to stewardship within the mandates they award to investment managers. Approximately, a further 30% are considering doing so in future.

- **Most mandates are long-term**: For over half of respondents the average mandate awarded to their listed equity managers exceeds six years. Additionally, for more than 90% the average tenure of their active equity manger exceeds five years and for 28% it exceeds a decade. For over two thirds of passive equity mandates, the average tenure exceeds a decade.

Ongoing scrutiny

- **Clients are increasing scrutiny**: More than half of funds are asking more questions on stewardship matters during manager reviews; additionally more time is spent reviewing reporting and votes cast.

- **Improving satisfaction with reporting:** Net-satisfaction with reporting from investment managers has improved although many wish to see this become more tailored and integrated.

- **More evidence being provided:** After a drop in 2013 this year more funds reported seeing evidence of engagement activities undertaken influencing changes at investee companies. In particular 76% had seen evidence of changes being brought about to executive remuneration and 54% to company strategy.

- **Funds are exercising their votes more in more jurisdictions**: While 93% of funds exercise their votes in the UK; 88% also exercise their votes in Japan (74% in 2013) and 85% in emerging markets (59% in 2013).

Introduction

About the Survey: Purpose

This report presents the findings of the NAPF's tenth annual survey of pension funds' engagement with investee companies.

The NAPF believes that pension funds as long-term investors have a clear interest in promoting the success of the companies in which they invest. As a result we have long been supportive of the UK's Stewardship Code and have consistently encouraged pension funds to become signatories to the Code in order that they demonstrate their commitment to high standards of stewardship by their asset managers and companies.

The survey is an effective means for pension funds to assess the extent to which their own stewardship practices meet the best practice of their peers as well as the increasing expectations of regulators and ultimately their scheme members.

About the Survey: Who responded?

NAPF fund members with more than £1 billion in assets under management were invited to respond. Responses were received from 50 pension funds with combined assets under management of **£419 billion.**

Of the type of funds that responded:

- There was a broad range of sizes pension funds responding with the most common having between £2bn to £5bn of assets under management.
- The majority were large private sector occupational pension schemes (78%).
- The vast majority outsourced all day-to-day investment activities to investment managers; however a small number had to varying degrees internal investment capabilities.

Fig. 2. Respondents by value of assets under management

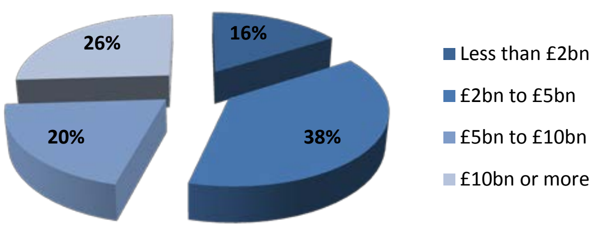
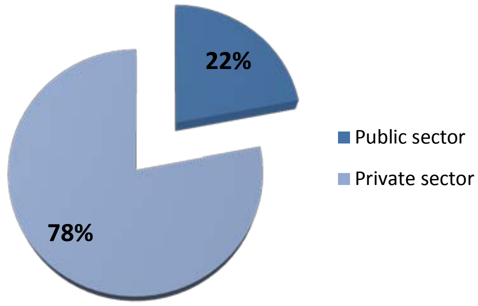


Fig. 3. Respondents broken down by public or private sector



The NAPF is extremely grateful to all funds that assisted with the survey.

Engagement survey findings

Overview

Key findings:

- 94% agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting shares.
- 90% agreed that extra-financial factors – eg environmental, social and governance factors – can have a material impact on the fund's investments in the long-term. An increase on 81% in 2013.
- 53% agreed that over the past 12 months institutional investors (including pension funds) have played an active enough role as stewards of investee companies.
- 55% agreed that over the past 12 months engagement with investee companies (by the fund or its fund manager/s) has added (or prevented loss of) value to the fund.

Do institutional investors have stewardship responsibilities?

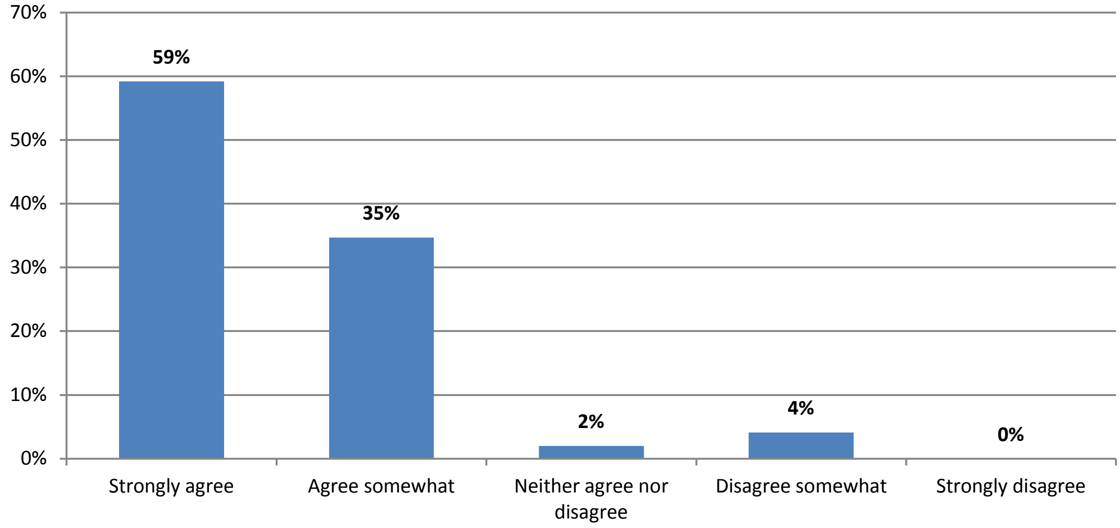
The UK Stewardship Code makes clear that in publicly listed companies responsibility for stewardship is shared. The board of the company oversees the actions of its management; and the investors in the company are expected to hold the board to account for the fulfilment of its responsibilities. It further emphasises that to this end, both asset owners and asset managers have responsibilities and goes on to describe the steps asset owners can take to protect and enhance the value that accrues to the ultimate beneficiary.

In reviewing the fiduciary duties of investment intermediaries the Law Commission recently concluded that: "at present, there is no duty on pension trustees or other investors to undertake stewardship activities." However, it went on to say: "it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest."

It is in the above context that the NAPF's Engagement Survey began by asking pension funds whether they agree that they have stewardship responsibilities.

Encouragingly, respondents were near unanimous (93%) in their view that institutional investors, including pension funds, do have stewardship responsibilities which include both engaging with companies and voting shares. This result clearly emphasises that the numbers of signatories to the Stewardship Code does not in itself give an accurate picture of the level of 'buy-in' to this agenda amongst the larger UK pension schemes, a theme which is highlighted throughout this survey.

Fig. 4. Do you agree that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting shares?

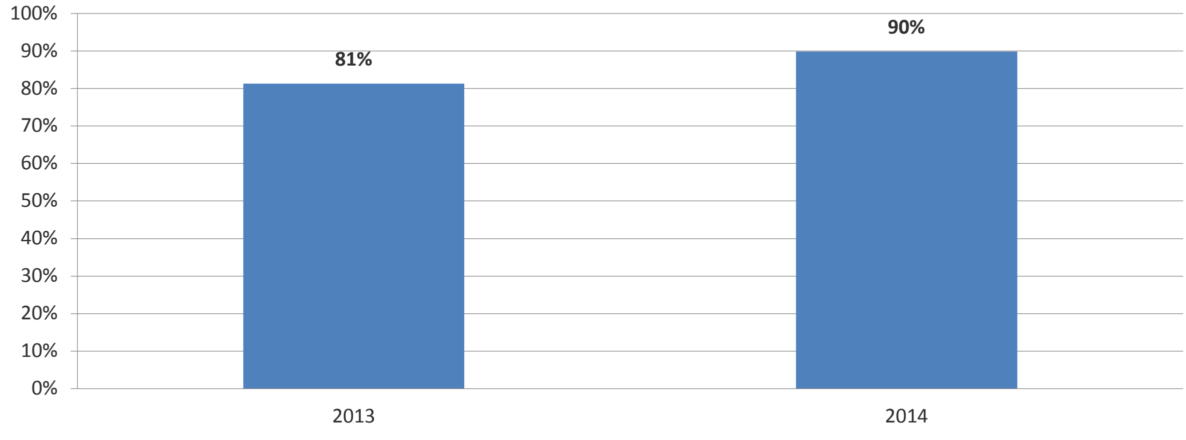


Do extra-financial factors have a material impact on investments?

A core conclusion of the Law Commission's report this year was the emphasis it placed on the importance of making investment decisions through a financial lens. In particular it clarified that over the relevant time-horizon trustees may, indeed should, take account of any factor which is relevant to the performance of an investment including those risks to a company's long-term sustainability which are commonly referred to as environmental, social or governance (ESG) factors.

Therefore, as last year, we asked whether respondents agreed that we called extra-financial factors – eg ESG factors - can have a material impact on investments in the long-term. Given that the Law Commission's conclusion that when investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks, it is encouraging to note that 90% of funds acknowledged that ESG factors may have an impact on the fund's investments in the long-term – an increase on 81% in 2013.

Fig.5. Percentage of pension funds which "agree"that extra-financial factors - e.g. environmental, social and governance factors - can have a material impact on the fund's investments in the long-term



Have institutional investors played an active enough role?

It is evident that respondents are of the view that they have stewardship responsibilities and this includes monitoring the risks posed to their investments by ESG factors. That being so, we asked whether respondents believed that over the past 12 months:

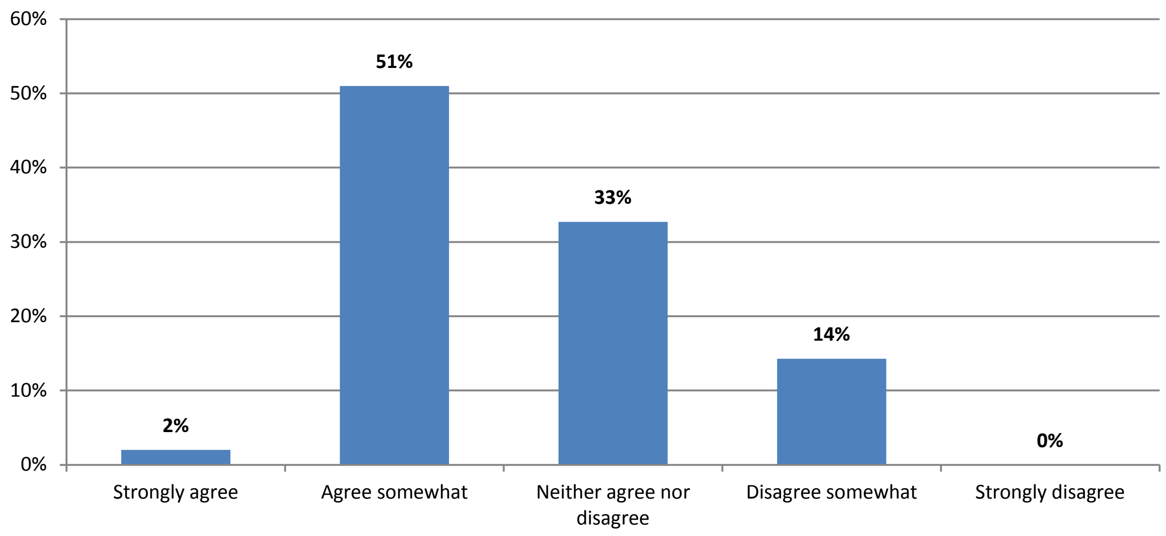
- Institutional investors (including pension funds) have played an active enough role as stewards of investee companies.

- Whether engagement with investee companies (by the fund or the fund manager/s) has added (or prevented loss of) value to the fund.

This year saw shareholder turnout at UK AGMs remain static at approx. 69% and similarly within the FTSE 350 shareholder support lingered at 97%. Behind these headline statistics however, we have acknowledged that this year has been far busier and more eventful than most for investors. The extensive reforms to corporate reporting for 2014 resulted in more information than ever being made available by issuers for investors to analyse and make use of. The scale of the additional reporting burden proved testing for investors to manage the deluge of expectant consultation requests, get themselves up to speed with the swathe of new information being sent their way and to navigate their way through to identify and subsequently engage upon the key issues of interest. That said there was much of positive to note and in general both the quantity and quality of engagement between companies and their shareholders continues to improve.

It is right to reflect on the above context when considering that just 53% of respondents to this year's survey agreed that institutional investors have played an active enough role as stewards of investee companies. With pension funds increasingly recognising and understanding the sustainability risks within their portfolios it is perhaps no surprise that in a year when investors on the whole were running just to stand that there continues to be a view that investors can and should be doing more in their role as stewards of investee companies.

Fig. 6. Over the past 12 months, do you agree that institutional investors (including pension funds) have played an active enough role as stewards of investee companies?

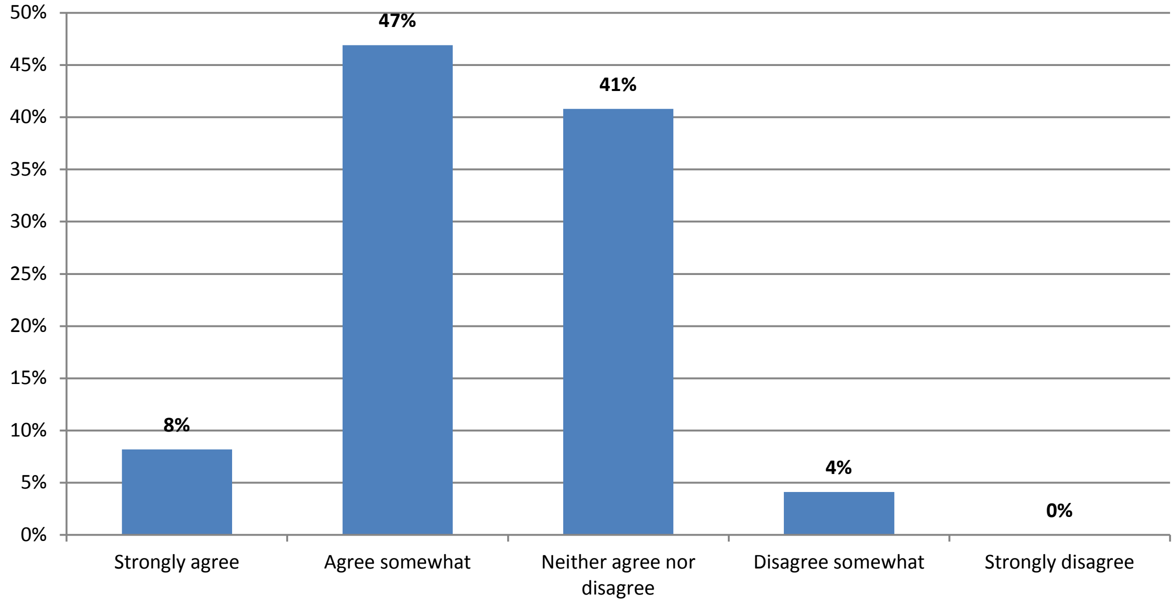


The above is also useful context when considering the response to the questions asking whether funds believed that engagement with investee companies (by the fund or fund manager/s) has added (or prevented loss of) value to the fund.

The results to this question remained similar to those in the past few years. Just over half agreed that engagement had added (or prevented loss of) value to the fund.

As acknowledged earlier many of the issues and risks which are being engaged upon are intangible and their impact likely to be borne in the medium to long-term. It is therefore difficult for fund managers to quantify the value added, and even more so the prevention of value lost by their engagement with investee companies. This is a particularly live challenge as the industry seeks to meet increasing client expectations by fostering a truer market for effective stewardship ensuring those managers which are actively engaged are rewarded at the expense of those which are free-riding.

Fig. 7. Over the past 12 months, do you agree that engagement with investee companies (by your fund or your fund manager/s) has added (or prevented loss of) value to the fund?



A burgeoning market

These initial results clearly indicate that there is demand amongst pension funds for stewardship and an expectation from them that their investment managers devote to it sufficient attention and resources that they are able to be effective. However, they also emphasise the difficulty being wrestled with by many firms with respect to quantifying the value add of their activities.

The market for stewardship is evolving and it is imperative that the industry is increasingly open about its activities and is more confident in demonstrating how its approach to investing is in the in the long-term interests of those whose money it is accountable for.

The NAPF's new Stewardship Accountability Forums should assist with enhancing the quality of conversation between pension funds and asset managers which will go some way to tackling the above issues.

Stewardship Code

Key findings

- Two thirds (67%) of respondents have formally committed to the Stewardship Code and a further 14% intend to do so within the coming year.
- In only 30% of cases have the fund's investment consultants raised stewardship issues in discussions with the fund. However, for 41% of funds the issues had not been discussed with their consultants at all and 13% of funds had raised it themselves with their consultants.

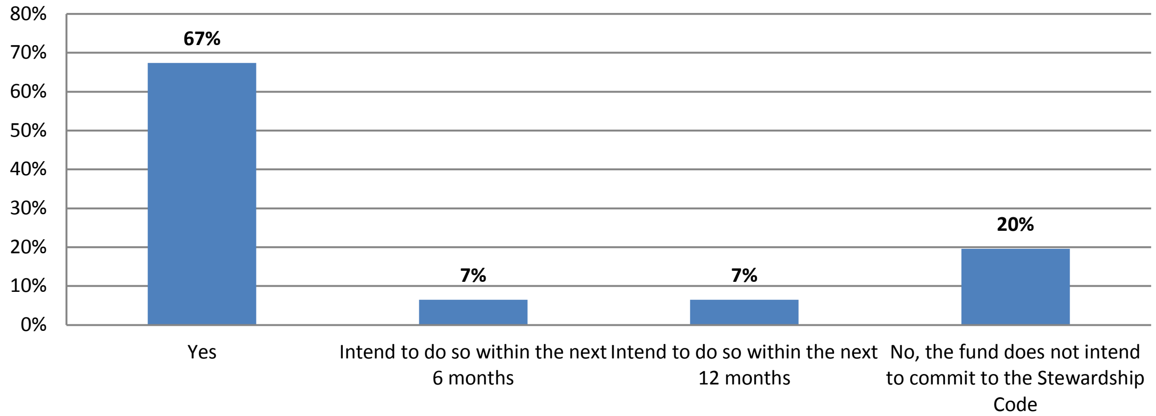
Have funds formally committed to the Stewardship Code and its principles?

The Stewardship Code aims to promote the long term success of companies in such a way that the ultimate providers of capital, such as pension funds, also prosper.

Since the Code's formal adoption by the FRC in 2010 a growing number of asset owners have signed up. As of November 2014 there were 82 asset owner signatories of which 63 are pension funds. The NAPF continues to encourage others to follow suit, as we believe that a greater weight of pension fund signatories to the Code will further influence behavioural changes that lead to better stewardship by asset managers and companies.

The Engagement Survey has consistently asked funds whether they have formally committed to the Stewardship Code. This year, despite having a record response to the survey and with a greater proportion of those respondents being private sector funds, the percentage which have formally committed to the Stewardship Code (67%) is at its highest level to date. A further 14% intend to sign up in the coming year.

Fig. 8. Has your fund formally committed to the Stewardship Code and its Principles?



The NAPF very much welcomes the continued increase in pension fund signatories to the Stewardship Code during the past 12 months. Taken together with those pension funds which are signed up to the Code through their in-house asset management arm we are reaching a point where the majority of the largest UK pension funds which have significant equity investments are now signed up to the Code or intending to do so.

We remain aware that committing to the Code may initially seem complex or not directly relevant to many smaller funds. Indeed, the barriers communicated to us through our survey which have prevented funds signing up the Code remain consistent with previous years. The most commonly cited barrier was the suggestions that other priorities have taken precedence. This is unsurprising given the raft of regulatory changes being introduced into the pension’s environment at present.. Most schemes do not have large executive teams and therefore finding the time on a hectic trustee agenda is tricky.

Other barriers cited by funds preventing sign-up to the Code included a perceived lack of ability to influence decisions as the fund is tied in to a pooled fund and noting that for many funds they already ensure that their internal and external fund managers have signed up.

The NAPF continues to believe that, for pension funds, signing up the Code need not be burdensome and in itself sends an important signal to the market. To assist pension schemes in signing up and subsequently fulfilling their core responsibility of selecting managers which are ‘good’ stewards and subsequently holding them to account the NAPF Stewardship Central website provides pension funds with a range of tools including:

- A simple implementation questionnaire to make signing up easy and straight forward;
- An aide-memoire crib-sheet setting out a range of questions to consider when selecting managers alongside the regular provision of monthly topical questions to ask fund managers;
- The NAPF Stewardship Disclosure Frameworks which enable funds to more easily compare and contrast the approaches to stewardship of different asset managers; and
- Details of the NAPF Stewardship Accountability Forums which provide pension schemes of all sizes with the opportunity to collectively question the senior figures within the leading asset management firms about the stewardship approaches and activities.

Are investment consultants raising stewardship in discussions with funds?

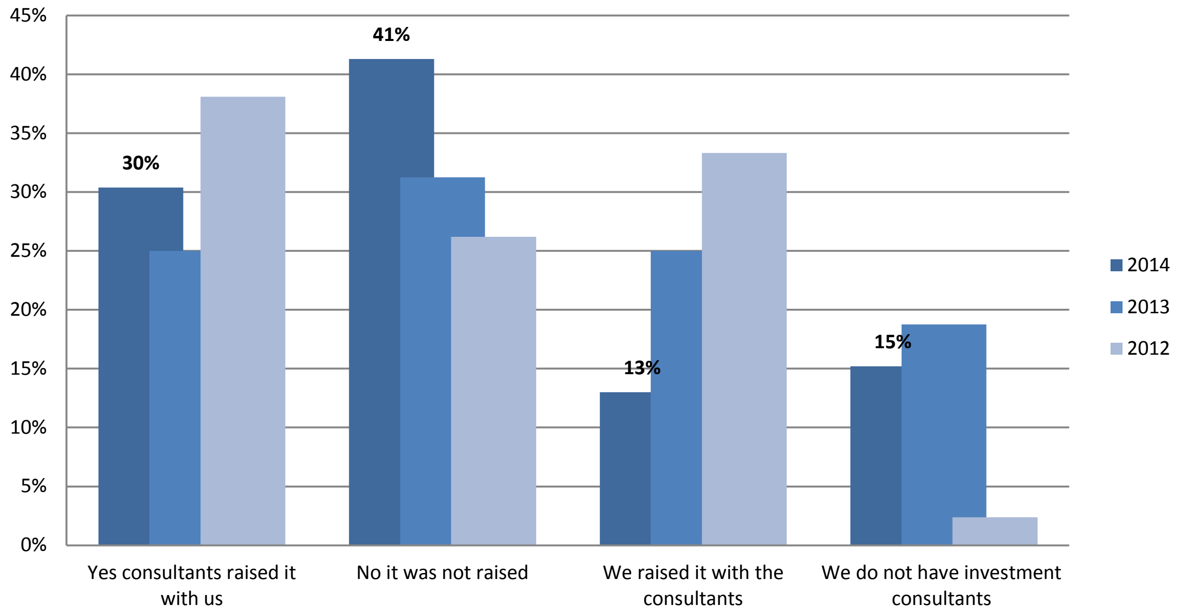
Given the vital role that funds’ investment consultants play in overcoming these barriers and managing the trustees’ agenda, we ask each year whether the investment consultants had raised the issue of stewardship in their discussions with the fund.

Despite themselves being signatories to the Code the feedback each year within our survey is that investment consultants are raising stewardship issues with their pension fund clients less and less.

There was this year a slight increase in the percentage of instances of consultants proactively raising stewardship matters with the figure increasing from 25% to 30%. However, the related figure of “No it was not raised” has continued to steadily increase; this year reaching 41% from 31% in 2013 and 26% in 2012.

The Law Commission rightly acknowledged the important role that investment consultants play in the investment chain. In this context, we continue to encourage the FRC to give appropriate attention as to how it can ensure that all those parties which have signed up the Stewardship Code are indeed committed to its Principles and intent on fulfilling its spirit.

Fig. 9. Have your investment consultants raised stewardship issues in discussions with you?



Scheme Governance - manager selection, mandates and reviews

Key findings

- Nearly 80% of respondents have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting set out within their Statement of Investment Principles.
- Stewardship and related matters are regularly discussed at trustee meetings for 35% of respondents – a doubling on the 17% last year. A further 28% discuss it on an annual basis. At only 7% of respondents are stewardship issues never formally discussed.
- For 80% of respondents the investment managers' approach to stewardship influences the selection of their investment managers – for 51% of funds this extends across all asset classes. Over 60% of respondents question prospective investment managers about their approach to stewardship.
- Over half of respondents explicitly set out their expectations with respect to stewardship within the mandates they award to investment managers. A further 29% are considering doing so in future.
- More funds are reviewing their investment managers' application of stewardship policy on a more frequent basis; 38% of respondents are doing so quarterly with in excess of 80% doing so at least annually.
- The average length of mandate awarded to listed equity managers by the respondents in over half of cases exceeded six years.
- The average tenure of their active public equity investment managers for over half of respondents exceeded seven years and for their passive equity managers exceeded a decade for 68% of respondents.

In recent times there has been a growing acceptance that, while by their nature pension funds are long-term patient investors, behavioural cues at times may unintentionally give shorter-term signals to investment managers. As a consequence there is a move, catalysed by the Kay review, to encourage pension funds to be more explicit about their investment philosophy and their understanding of their objectives and risks. The NAPF has been supportive of this principle however, we have also stressed that a balance needs to be struck between encouraging the right behaviours whilst avoiding introducing overly prescriptive measures which risk creating a compliance tick-box exercise with boiler-plate disclosures.

The NAPF's 2012 Stewardship Policy encourages pension funds to Include a section on 'stewardship' within the fund's Statement of Investment Principles. This was echoed by the Law Commission in its recent final report on the fiduciary duties of investment intermediaries. In turn, the Government have signalled their intention to consult on amending the Occupational Pension Scheme (Investment) Regulations to include, among other things, a requirement for trustees of trust-based pension schemes to state the scheme's policy (if any) on stewardship in the scheme's Statement of Investment Principles.

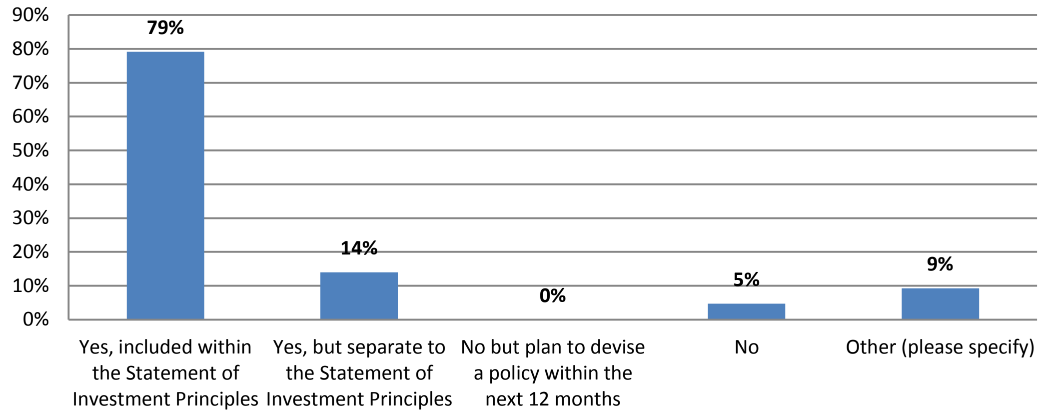
Additionally, in the background the European Commission's proposed revisions to the Shareholder Rights Directive would if implemented require pension funds to set out both their engagement policy and how their arrangements with their asset managers incentivise an investment mind-set which looks out over an appropriate time horizon and encourages engagement with investee companies.

Does your fund have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting?

Given the NAPF's recommendation that pension funds should include a section on stewardship within their Statement of Investment Principles, we asked whether funds have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting.

In light of the increasing focus by regulators and others in this area it is encouraging to note that the vast majority (79%) of respondents already set out their stewardship policy and in most cases this is contained with the fund's Statement of Investment Principles. Indeed only 5% of respondents indicated that they do not currently set out their approach within their investment policy, whether within their SIP or elsewhere.

Fig. 10. Does your fund have an investment policy which includes the exercising of stewardship responsibilities such as engagement and voting?

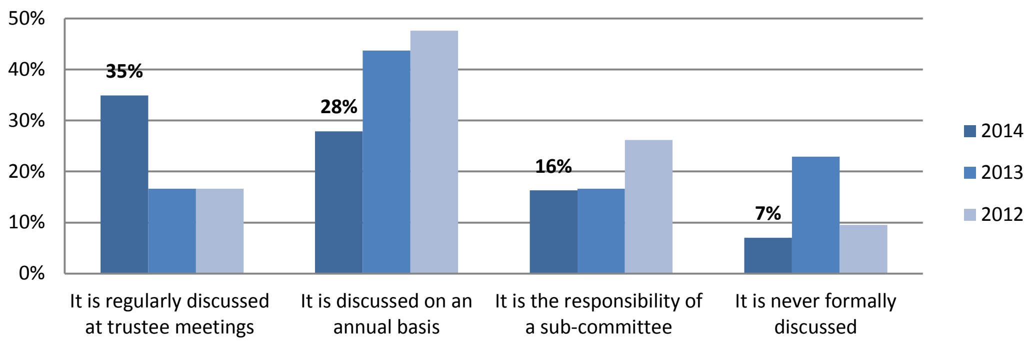


Have funds discussed the Stewardship Code?

Expanding on whether funds have formally signed up the Stewardship Code and whether they have set out their approach to stewardship within their investment policy we were keen to understand whether such issues were being actively discussed.

As we are keen that this agenda does not fall into the trap of becoming a compliance and tick-box exercise it is positive to see that discussions about stewardship and related matters are indeed occurring frequently and equally importantly only 7% of respondents suggested that they never formally discuss these issues.

Fig. 11. How often has your fund formally discussed stewardship and related matters during the past 12 months?

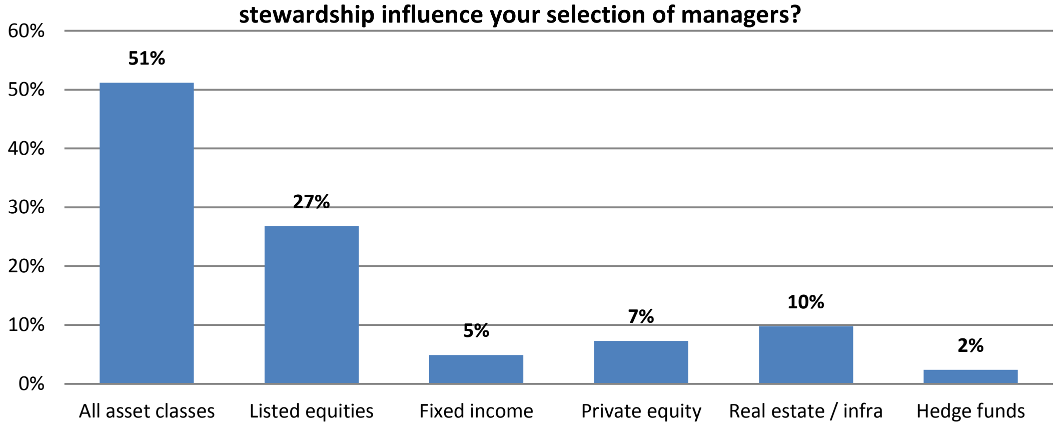


Influencing manager selection?

The first point within the NAPF's Stewardship Policy relates to trustee boards considering their approach to stewardship and subsequently setting it out within their SIP; the second aspect relates to the selection of investment managers.

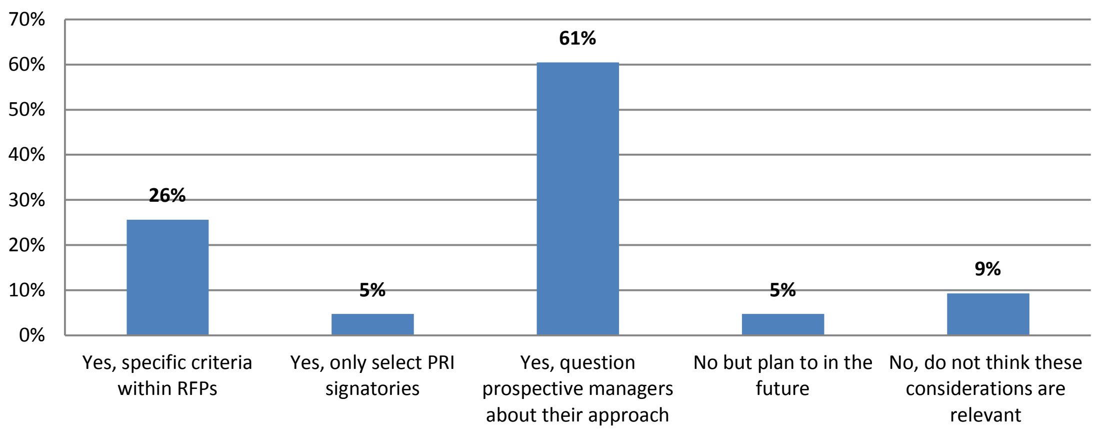
It is in relation to this second aspect of our Policy that the NAPF is continuing to focus significant attention in order that the burgeoning market for stewardship can be further fostered ensuring that firms which are most active are rewarded for their efforts at the expense of others which free-ride on their activities. It is promising therefore to note that over half of the respondents to this survey suggested that the investment manager's approach to stewardship influences their selection of managers and it was a factor in at least one asset class for 80% of respondents.

Fig. 12. Within which asset classes does the investment manager's approach to stewardship influence your selection of managers?



Perhaps most heartening in this area is the indication that the assessment of stewardship activities and policies within the manager selection process is not simply a tick-box exercise. A few years back, being a PRI signatory was advanced; it is now commonly seen as a minimum requirement of asset managers. The focus is shifting instead to measuring the effectiveness of the firm's approach and the quality of engagements with companies. Instead of simply asking whether a prospective investment manager is a PRI signatory – more than 60% of respondents are actively asking prospective managers questions about their approach.

Fig. 13. When selecting investment managers, do you take their stewardship activities and policies into account?



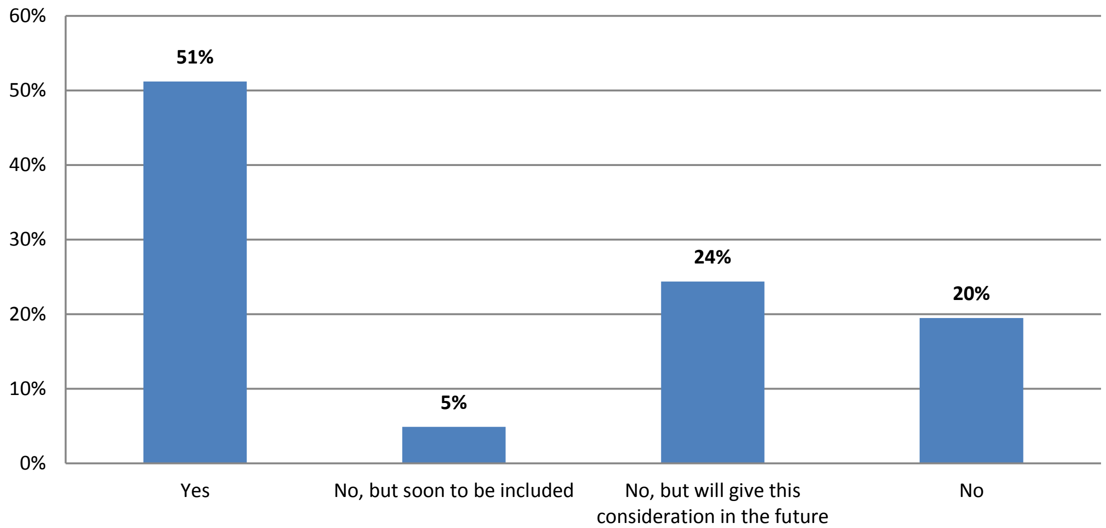
The NAPF continues to believe that it is important for pension funds to ask questions in the RFP process and during the subsequent manager presentation stage (beauty parade) to gain a greater understanding of the investment managers' stewardship approach and gauge whether they are aligned to the funds' own policy. Equally it is crucial that pension fund's key advisers, their investment consultants, proactively support their clients in these endeavours.

Are expectations set out within the mandates given to investment managers?

We have seen that pension funds appear to be giving stewardship issues more consideration and in turn are setting out their approaches within their SIPs and attempting to incorporate judgements about the appropriateness of prospective investment manager's approaches within their manager selection processes. This is very positive. However, it is often suggested that it is subsequent inadvertent behavioural cues which undermine these best intentions. This next section therefore seeks to understand whether, once selected, pension funds are becoming more explicit about their expectations.

As can be seen from the below the results here too are positive. A majority (51%) of respondents have indicated that they do set out their expectations with respect to stewardship within the mandates they award to investment managers, this compares very favourably with the results in 2013 when more than half indicated that they did not. Notably a further 29% indicated this year that may well be doing this in future.

Fig. 14. Do you set out your expectations with respect to stewardship within the mandates you give to investment managers?

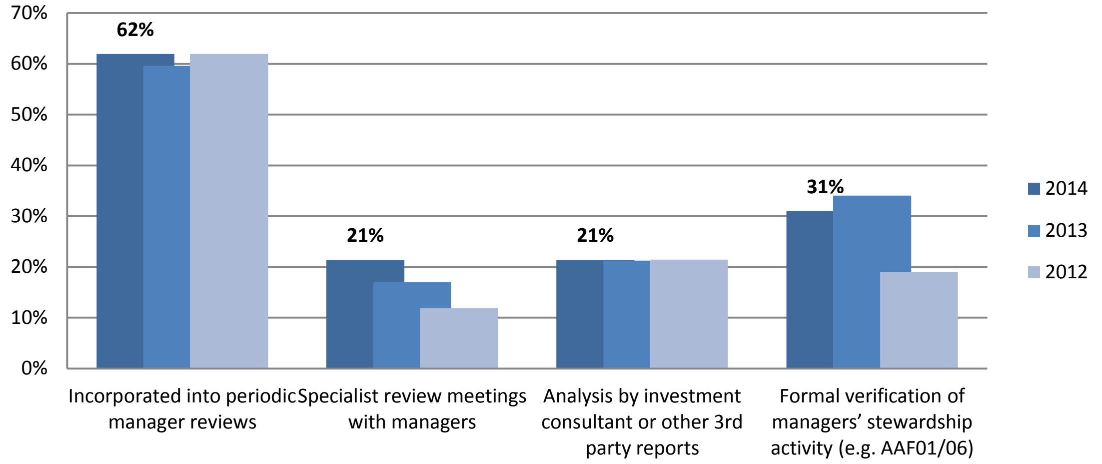


Monitoring compliance

With pension funds evidently becoming more explicit about the expectations of their investment managers there is a subsequent need to monitor compliance. As in past years we asked both how funds are monitoring the fund's investment managers' compliance with their stated policy on stewardship and how often.

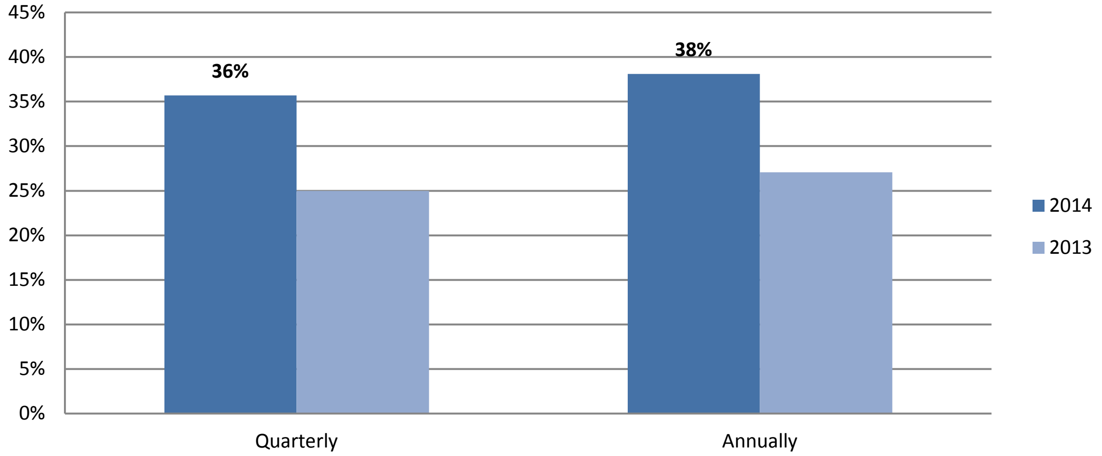
The manner of monitoring continues to remain fairly constant with 62% of respondents incorporating this within their periodic manager reviews; 21% having specialist review meetings with managers and 31% requiring formal verification of their managers' stewardship activity.

Fig. 15. How do you monitor (or intend to monitor) the fund's investment managers' compliance with their stated policy on stewardship?



Interestingly however, the frequency with which respondents are reviewing their investment managers' application of stewardship policy has increased; this year 36% indicated that they did this quarterly (25% in 2013) and 38% annually (27% in 2013) – with 7% doing so every six months. In total over 80% of respondents reviewed their fund manager's compliance at least annually.

Fig. 16. How often do you review your investment managers' application of stewardship policy?



The NAPF publishes on its website and communicates to its members, on a monthly basis, topical questions to aid trustees in questioning the effectiveness of their managers' stewardship activity. These are aimed at enabling funds to keep the conversations with their managers about these matters live.

Additionally, the NAPF is introducing a regular series of Stewardship Accountability Forums which will take place every couple of months and in which three asset management firms will make themselves available to be questioned by pension funds.

It is intended that both of these initiatives will support pension funds in incorporating assessments of both their current and prospective asset managers' stewardship approaches into a regular schedule.

Length of mandates and managers' tenures

Key findings

- For more than half of respondents the average length of mandate which they award to their listed equity investment managers is in excess of six years and in excess of ten years for 31%.
- For approximately 40% of respondents the average tenure of their active public equity investment managers was 5-6 years; for the majority of respondents the average tenure extended beyond seven years and beyond ten years for 28%.
- The average tenure for passive equity managers was in excess of a decade for over two-thirds of respondents.

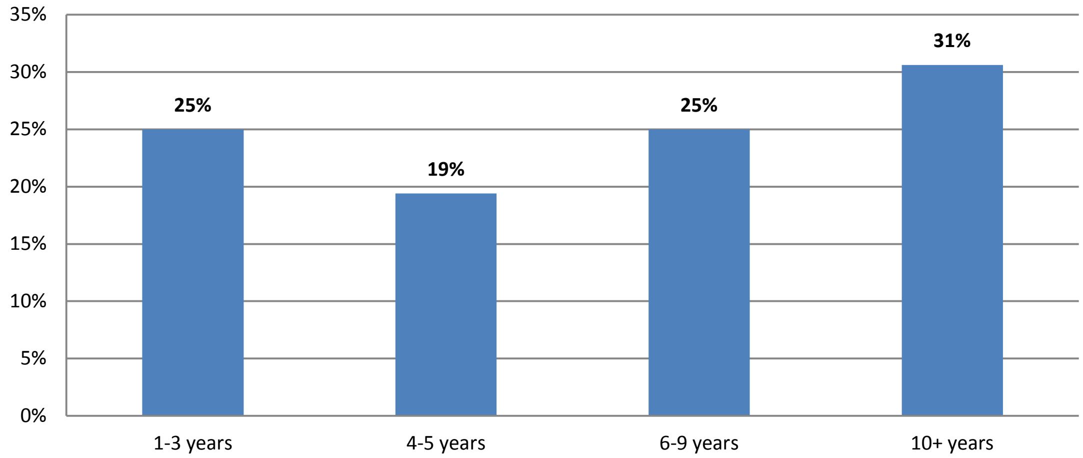
To better gauge the validity of the often cited concern amongst investment managers' about the short-term pressures arising from three year mandates and the resultant risk of being replaced we this year asked respondents a series of questions about the average length of mandates they award and the average tenure of their equity managers.

The average length of mandate awarded to listed equity investment managers

When asked about the average length of mandate awarded to their listed equity investment managers the results were broadly spread with results ranging from 1-3 years through to the most common response which was in excess of ten years.

It should be acknowledged that results towards the top end may be skewed through the inclusion of pension funds which manage equities internally with mandates which in effect operate in perpetuity. It should also equally be acknowledged however, as Professor Kay did within his 2012 report, that LGPS Investment Regulations require investment managers to be appointed on a short-term basis which may well be reflected within the results towards the shorter-end.

Fig. 17. What is the average length of mandate that you award to your listed equity investment managers?



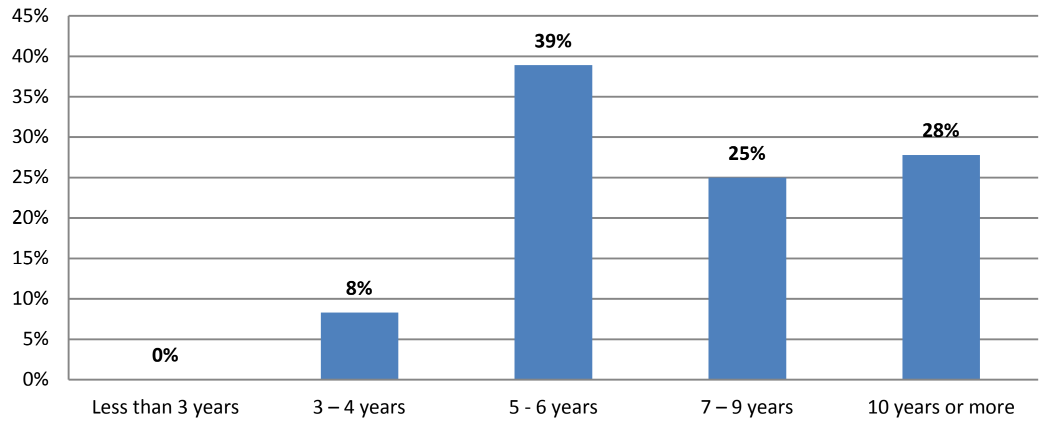
The average tenure of investment managers

The responses to the previous question suggest that many large funds are both setting out their expectations to investment managers more explicitly and empowering them with long-term mandates. In parallel we also asked respondents how long the average tenure was of both their active and passive public equity managers.

Reflecting their nature as patient long-term investors the responses clearly indicated that pension funds on the whole change managers pretty infrequently.

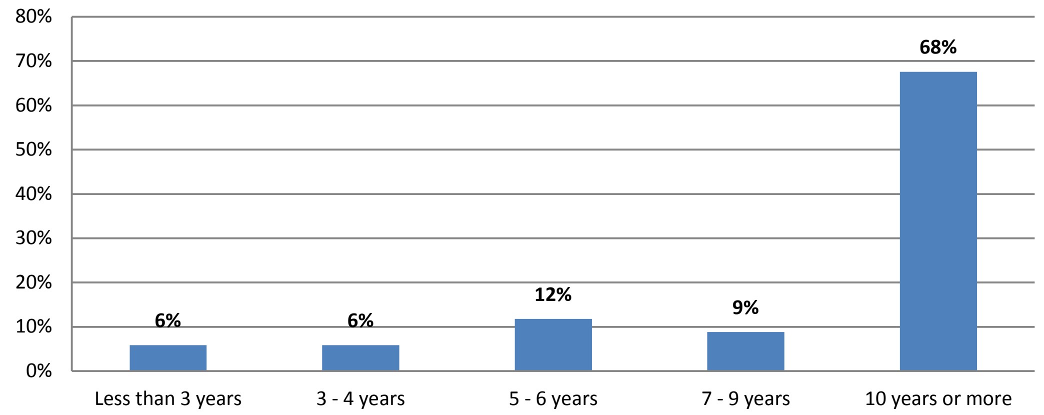
For their active equity mandates the average manager tenure was in excess of seven years for 53% of respondents.

Fig. 18. For your active public equity investment managers, how long is their average tenure?



For their passive equity mandates the average manager tenure was in excess of a decade for 68% of respondents.

Fig. 19. For your passive public equity investment managers, how long is their average tenure?



These results should provide reassurance to investment managers and highlight the desire on the part of pension funds to develop a relationship with their appointed managers whereby both are working together to achieve the stated long-term objectives.

Accountability - reporting

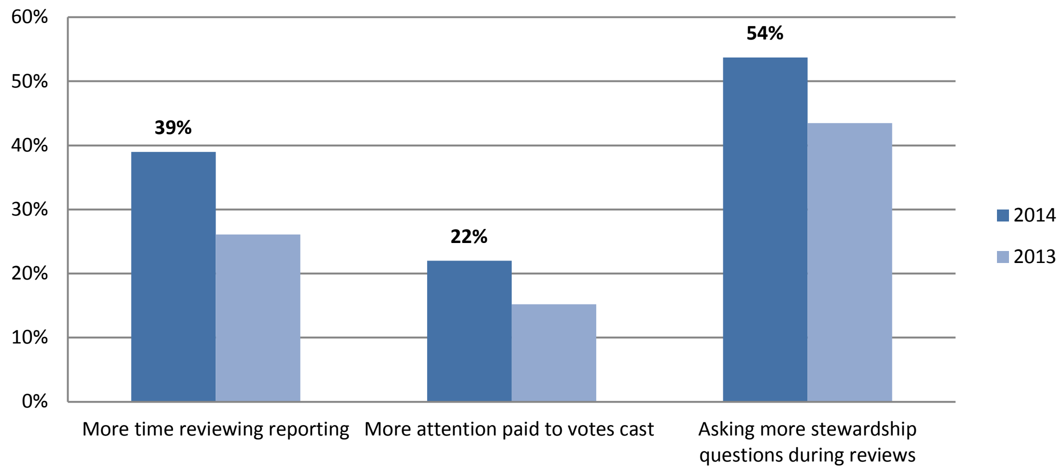
Key findings

- Respondents indicated that they are increasing scrutiny of their investment managers' stewardship activities; over half are asking more questions on stewardship matters during reviews and more time is being spent reviewing reporting and votes cast.
- The level of satisfaction with the standard of stewardship reporting from investment managers has increased. However, there remains a desire for this to become more tailored and integrated with reporting on investment matters and performance.
- The level of satisfaction with investment consultant's review of what investment managers have said about their voting and engagement activities remains unchanged.

Scrutiny of investment managers' stewardship activities

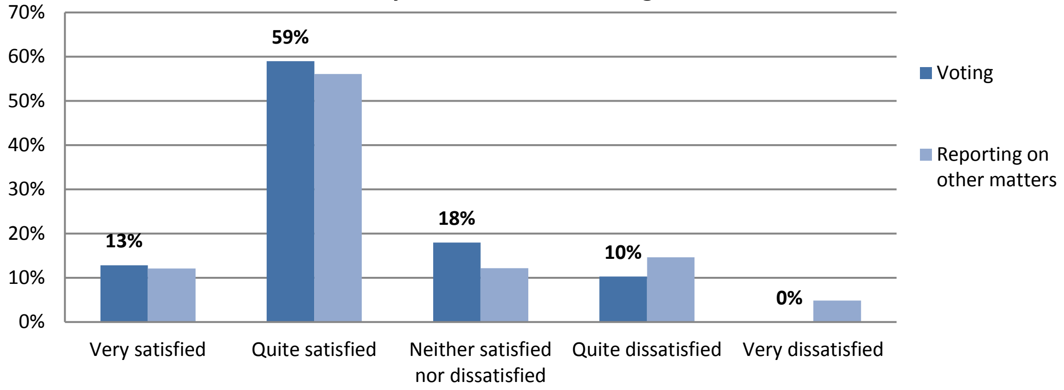
In line with answers to previous questions when asked what steps, if any, they have taken to increase the scrutiny of their investment managers' stewardship activities respondents indicated that they were spending more time reviewing reporting from investment managers and paying more attention to the votes cast. More importantly, respondents appear not to just be scrutinising the reporting they receive from their managers as 54% are also asking managers more questions on the back of this reporting.

Fig. 20. In the past year, what steps, if any, have you taken to increase scrutiny of your investment managers' stewardship activities?



It is no doubt a positive sign that with respondents indicating that they are spending more time reviewing the reports from their investment managers that the level of satisfaction with the standard of these reports has significantly increased on the level reported last year. This year the percentage of respondents indicating that they are "very" or "quite" satisfied with the standard of their stewardship reporting was 72% with respect to the reporting on votes cast and 68% with respect to the reporting on other stewardship matters. Last year the figure for satisfaction was as low as 46%.

Fig. 21. How satisfied are you with the standard of stewardship reporting from your investment managers?



Whilst levels of satisfaction are on the rise, a number of respondents suggested that there was still room for improvement. In particular, a significant number suggested that stewardship reporting should be more integrated with reporting on investment matters and performance and others wished to see it become more material and portfolio specific. Both of these echo similar aspirations contained within the reporting to clients category within the NAPF's Stewardship Disclosure Framework - the "A grade" criteria for this stipulates that:

> *Reporting includes: evidence of activities undertaken –with identified case studies - an illustration of progress against objectives; disclosure of holding periods and an analysis of ESG risks within the portfolio.*
>
> *Stewardship is integrated into broader reporting process and how activities have enhanced and protected value is explained.*

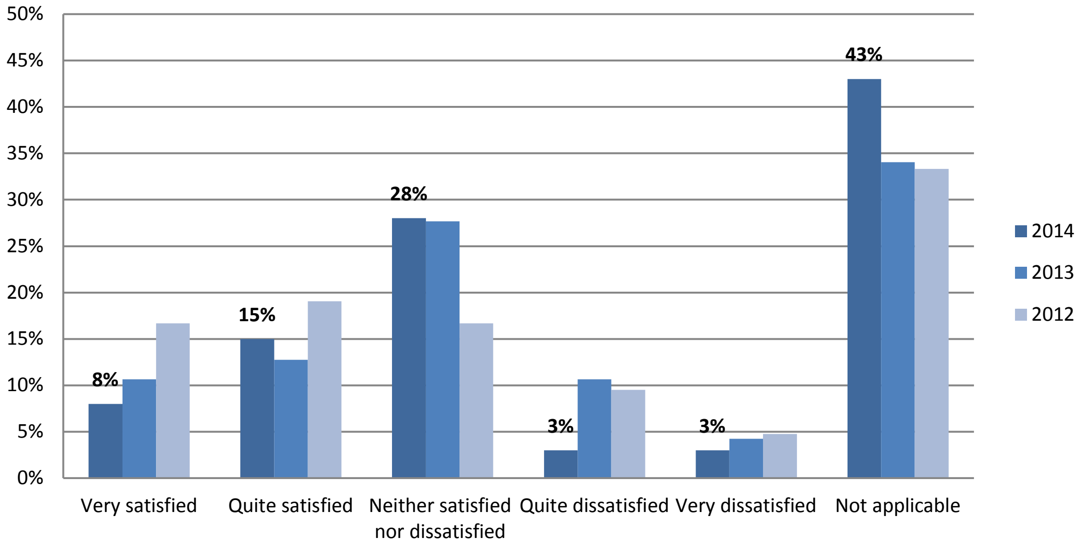
The above criteria was deliberately drafted to be stretching and indeed only 8 out of the 63 asset managers which have completed a Framework have claimed that they meet these standards.

Good quality reporting is vital to achieving a constructive relationship between the asset manager and asset owner, for this reason this is an issue on which expectations will no doubt continue to evolve. Furthermore, as per the mantra "what gets measured gets done", clearer and more thoughtful reporting should help encourage a more considered approach to explaining the rationale behind particular investment decisions within the context of the long-term objectives of the client.

As already acknowledged, investment consultants play a vital role, advising pension funds on a range of important issues, from asset allocation through to the performance of their investment managers. Given their pivotal role in the relationship between pension fund and asset manager, we again asked whether respondents are satisfied with their investment consultant's review of what their investment managers had said about their voting and engagement activities in their reports.

This year saw the satisfaction level remain broadly similar to last year. The primary change this year was the increase in the percentage 'not applicable'; given this figure is far higher than the figure indicating that they do not use investment consultants it is perhaps a sign that consultants are increasingly not reviewing this aspect of investment management reporting.

Fig. 22. How satisfied are you with your investment consultants' review of what investment managers have said about their voting and engagement activities in these reports?



Effective engagement

Key findings

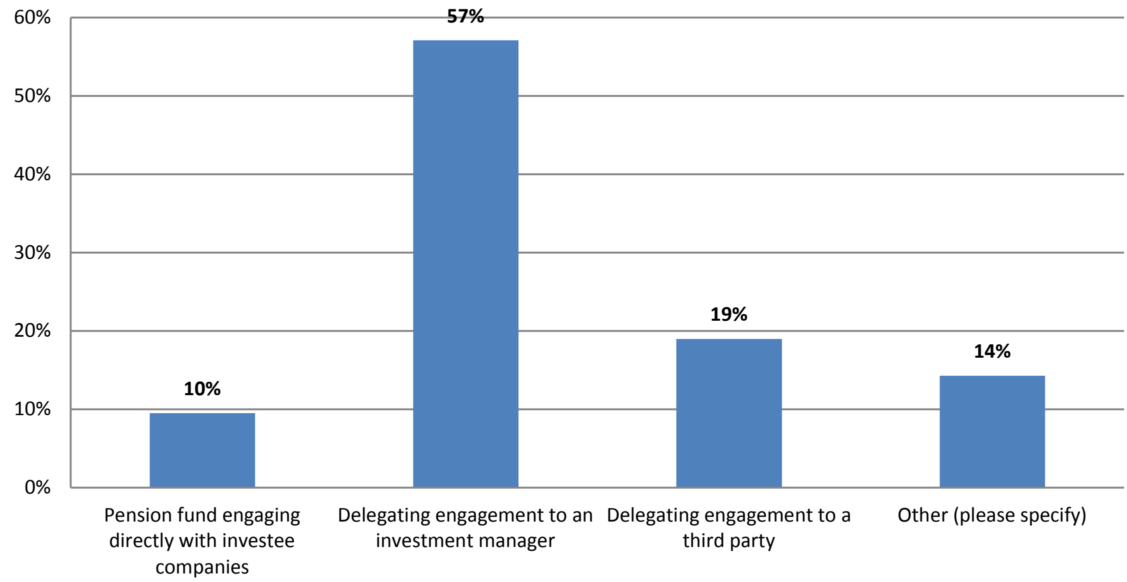
- The main approach of respondents to engagement with investee companies remains via delegation to their investment manager(s).
- The identified function at the asset management firm responsible for engagement with investee companies remains mixed although in 35% of instances engagement comes under the remit of the investment team.
- Three quarters of respondents have seen evidence of engagement activities (including voting) influencing changes to executive remuneration. More than half had also seen evidence of engagement influencing changes to company strategy.
- There was drop this year to just 40% of respondents being aware of their fund managers collaborating with other investors on their behalf.

The Engagement Survey tracks the mechanics of pension fund engagement with investee companies, including their main approach to engagement and whether they are aware of engagement influencing changes.

Approaches to engagement

As in previous years, the majority (57%) of pension funds delegate engagement activity to their investment manager, with nearly a fifth (19%) outsourcing their engagement to a third party, commonly an overlay service provider (many of those within the 'other' camp also employed an engagement overlay provider). Just 10% of funds primarily engage directly with investee companies themselves.

Fig. 23. What is your main approach to engagement with investee companies?



These results continue to reflect the acknowledgement that effective engagement requires resources along with the realisation that, with companies having increasingly dispersed share registers, greater voice can be achieved when investors pool their voices together with others.

The NAPF itself has a long history of facilitating collective engagement meetings with and for issuers on behalf of our pension fund investors, a service we are very happy to continue to provide. Alongside these traditional, more reactive, collective meetings the NAPF is also initiating a proactive set of engagement dialogues for our members with relevant companies where we believe long-term value may be at stake. As always we continue to welcome any NAPF member to get in touch if they wish to get further involved in these activities.

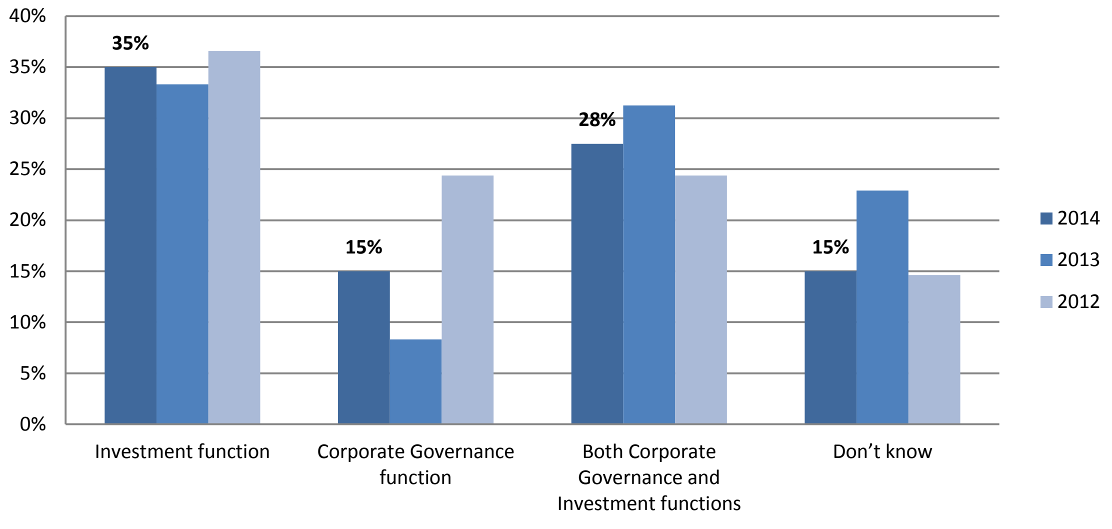
Responsibility for engagement

It is well understood that pension funds generally delegate the prime stewardship activities to their investment managers, as such it is important to understand how this is being undertaken: is it a joined up process with the fund managers involved or is it left to the corporate governance teams in isolation?

In recent years a common complaint has been that the messages conveyed by the corporate governance officer at an asset manager diverge from those expressed by the firm's fund manager. Whilst on the whole it is encouraging that only 15% of respondents believe that at their managers the corporate governance function alone is responsible for engagement with investee companies, the results overall are broadly spread.

We do encourage funds to clarify how their investment managers approach engagement to ensure that there is indeed a joined-up approach.

Fig. 24. Which function at the asset management level has responsibility for the fund's engagement with investee companies?



Is the engagement effective?

Of course what is of most interest is whether the engagement activities that are being undertaken are effective, not least when those are being undertaken by third parties such as investment managers on behalf of their pension fund clients. We therefore asked funds whether in the last year they have seen evidence of engagement activities (including voting) undertaken by the fund or its managers (on their behalf) influencing changes to a range of factors.

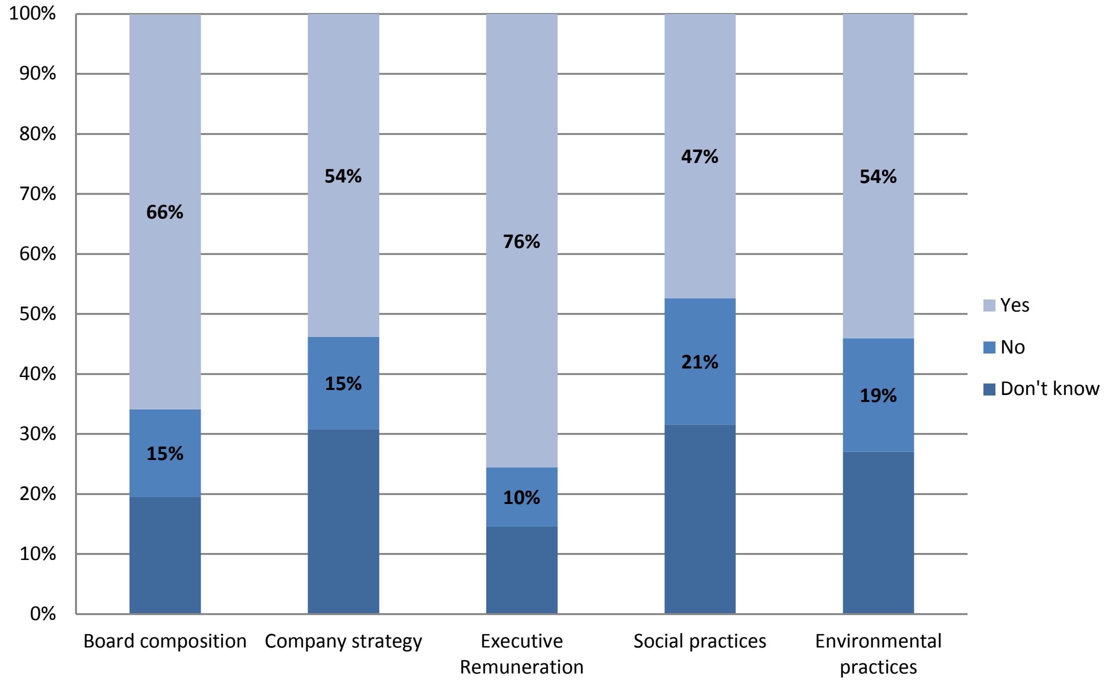
The response is broadly positive with a majority of funds reporting that they had seen evidence of influence resulting in positive changes on most issues.

Unsurprisingly, given the new binding vote on remuneration policies came into force this year and was accompanied by an tidal wave of companies consulting with their investors, over three quarters of funds reported seeing evidence of engagement resulting in changes to executive remuneration. This figure was just 60% in 2013.

Elsewhere, it is the tangible area of board composition around which 66% of funds have reported seeing evidence of effective engagement whilst other more intangible aspects or aspects such as company strategy received lower responses.

It is important of course to acknowledge that many - if not most - engagements take place over long periods of time through quiet diplomacy. Measuring influence and ultimately success can be a very tricky, if not impossible task. What funds want to see however, is reassurance that their managers are monitoring the risks, engaging upon issues once identified and where necessary and required working with others to achieve change.

Fig. 25. In the last year have you seen evidence of engagement activities (including voting) undertaken by your fund or its managers (on your behalf) influencing changes to....



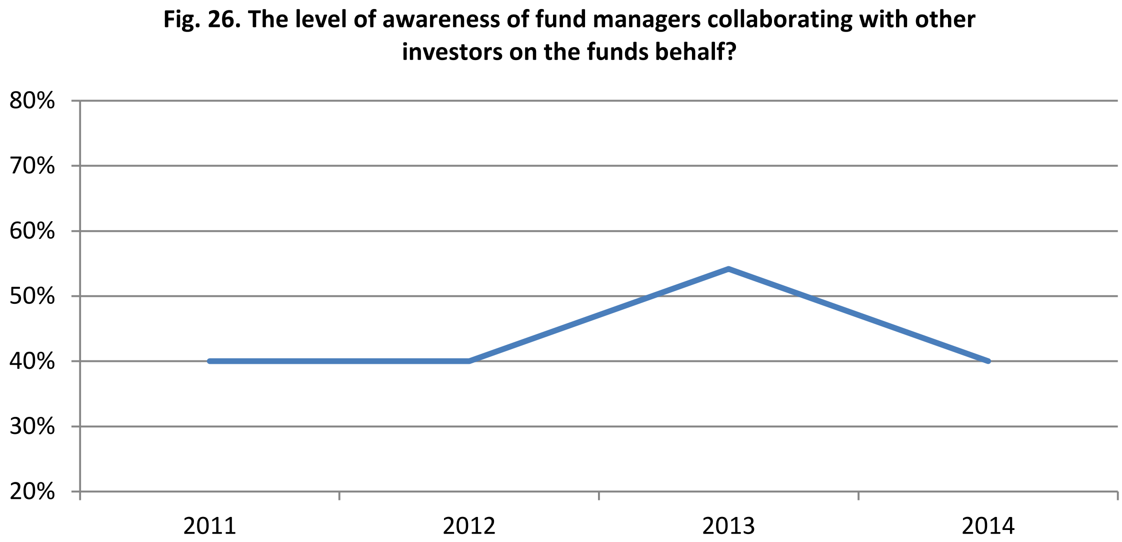
Collaboration

Coming as this report does just a short while after the new Investor Forum was formally constituted with the aim of facilitating wider and more effective collaborative engagement between issuers and investors the results to our annual question about the level of awareness of fund managers collaborating with other investors is worthy of note.

As was identified by the Kay review and others, UK companies' increasingly dispersed share registers makes the need for fund managers to collaborate on their stewardship efforts ever more important.

The Stewardship Code rightly states that investors should "be willing to act collectively with other investors where appropriate". Given that pension funds largely delegate their engagement activity to their investment manager, we have for the past few years asked funds whether they were aware of their investment managers collaborating with other investors on their behalf.

Last year the results were encouraging with an overdue uptick in responses with 54% of respondents indicating that they were aware of their fund managers collaborating with others. Disappointingly this figure has dropped back down this year to the levels recorded in 2011 and 2012 (40%).



When asked whether they would encourage more collaboration amongst their fund managers 70% of respondents suggested that they would do so.

With the Investor Forum now off the ground and with financing in place courtesy of the IMA while it builds its reputation we look forward to seeing this drop in collaborative engagement being reversed next year.

Voting

Key findings

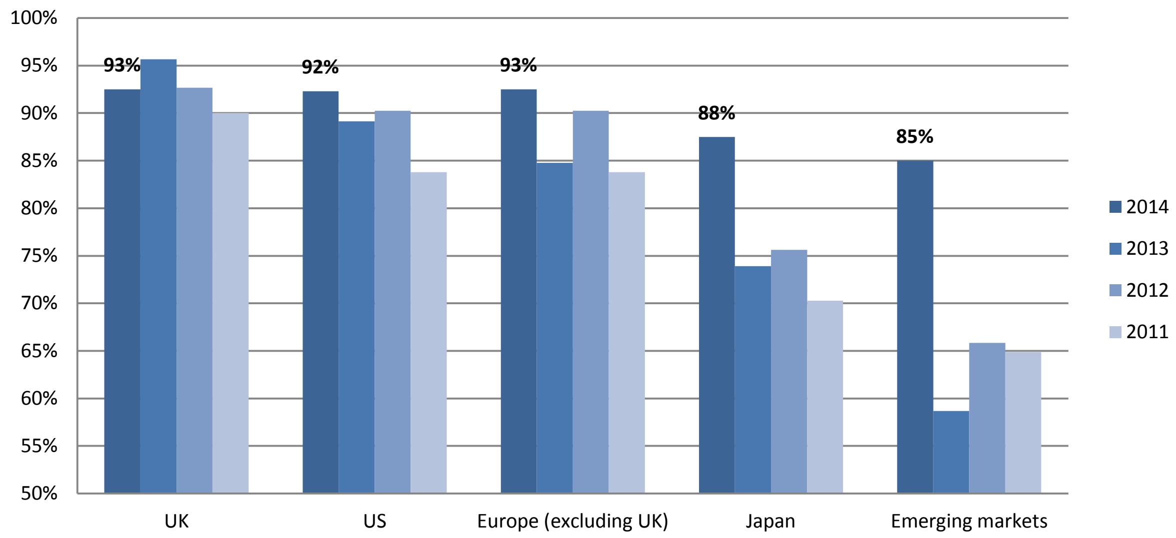
- Respondents are exercising their voting rights more and in more jurisdictions.
- Two thirds of respondents disclose voting information to scheme members and for 62% this constitutes both the voting policy and voting records.
- There was a significant decrease in the percentage of respondents which do not lend stock and 44% of respondents indicated that they recall lent stock in order to vote for at least contentious resolutions.

Voting rights

The NAPF believes that the considered exercise of voting rights, while not a legal duty, is a responsibility of owners and an implicit fiduciary duty of pension fund trustees and the investment managers to whom they delegate this function. Therefore, the Engagement Survey has consistently tracked the extent to which pension funds exercise their voting rights in the UK and in overseas markets.

This year's survey found that, as in past years, voting rights are consistently being exercised within the UK. With pension schemes increasingly diversifying their equity investments outside of the UK it is striking that the reported percentage of voting rights being exercised in overseas markets has increased significantly this year. For the developed markets the figures have increased to 92% from 89% in the US, to 93% from 85% in Europe and to 88% from 74% in Japan. More striking still, the reported figure for emerging markets has soared to 85% from just 59% in 2013.

Fig. 27. In the past twelve months, have your voting rights been exercised in the following markets?



It is not immediately clear what may have prompted this sudden rise in voting rights being exercised in overseas markets. While in part it may be attributed to pension funds themselves continuing to diversify their equity portfolios with more investment going into emerging markets. In these markets governance risks can often be more stark and material; equally engagement can often be more difficult and therefore utilising voting rights can be important.

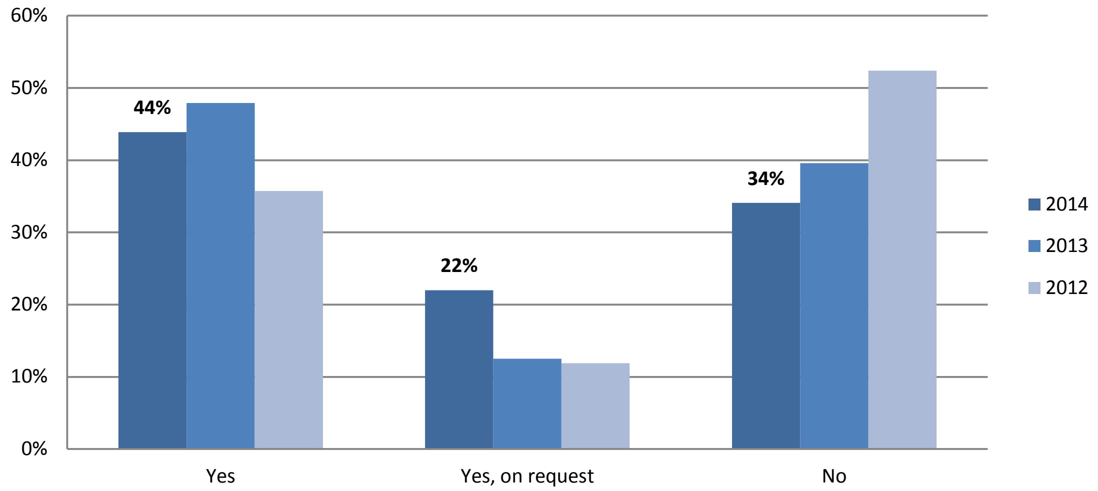
A core aspect of the trend of voting rights being used more and in more jurisdiction is undoubtedly the general positive momentum which continues to be generated by the Stewardship Code and the accompanying greater emphasis being given to translating the best practice adopted for home market stocks to those from further afield. This momentum has been helped further by the introduction of similar Codes such as that in Japan. Additionally, in addition to the NAPF's own Disclosure Framework, this year has been the first in which UN PRI signatories have been required to complete the organisation's new Reporting Framework. As this Framework extensively covers voting this may well have prompted more attention to voting across portfolios.

Voting disclosure

Principle 6 of the UK Stewardship Code states that "institutional investors should have a clear policy on voting and disclosure of voting activity" and Principle 7 states that "institutional investors should report periodically on their stewardship and voting activities" and goes on to say that "asset owners should report at least annually to those to whom they are accountable on their stewardship policy and its execution". Requirements with respect to these disclosures also feature within the proposed revisions to the Shareholder Rights Directive.

The NAPF believes that transparency is important. In particular we believe that in the interests of transparency towards investee companies asset manager's voting policies should be both publicly available and also easily findable. Additionally, in the interests of accountability, the subsequent voting records should be made publicly available, ideally in a consistent and user friendly format. Furthermore, pension funds, as fiduciaries of members' savings should endeavour to be transparent about how voting rights are to be and have been exercised, linking where feasible to the disclosures made by their asset managers. As non-commercial entities however, many pensions commonly do not have public websites. In these circumstances it is right that efforts are made to make the information available to interested members.

Fig. 28. Do you disclose information on voting to scheme members?



In line with improving level disclosures across the industry with respect to voting records the responses from respondents continues the trend observed last year with 66% of respondents disclosing information on voting to scheme members at least on request, up from 61% last year and 48% the year before. Those disclosing information also in most cases (62%) disclose both the voting policies and voting records. Additionally, 44% of respondents indicated that they disclose information on voting to the general public.

Voting on loaned stock

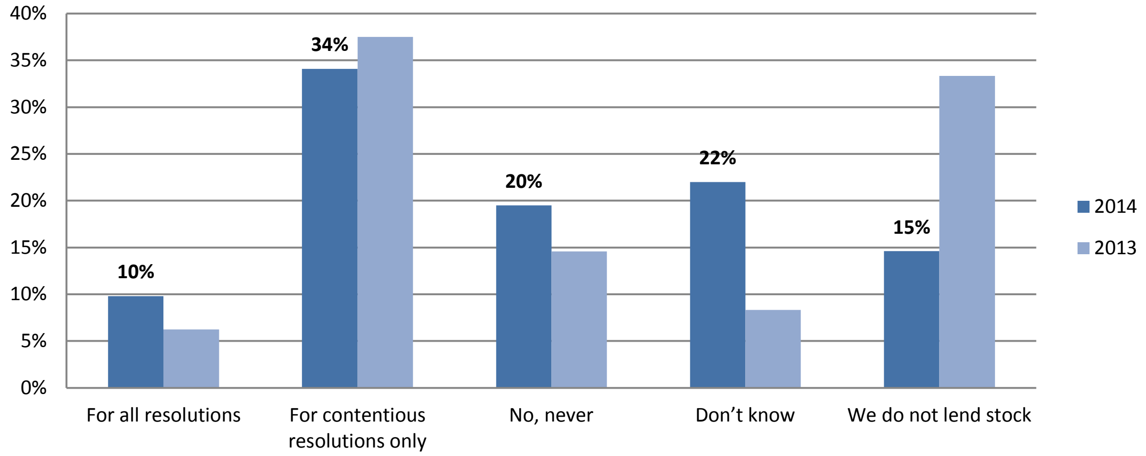
Principle 6 of the Stewardship Code states that "institutional investors should disclose their approach to stock lending and recalling lent stock". As stock 'lending is actually a sale with an agreement to return, the "owner" no longer possess the securities and so cannot vote them. Thus, if a fund wishes its voting rights to be exercised it needs to recall these securities in advance of the company meeting.

It is argued in some quarters that there is a conflict between stock lending and the ability to fulfil stewardship responsibilities, specifically the responsibility to exercise rights as shareholders. However, stock lending aids market liquidity, reduces the cost of trading and provides a steady additional income stream to many funds. What is important is that funds do discuss their policy in this area and explicitly communicate it to their agents, as well as being clear what lending activity is conducted both by their fund managers and their custodian.

As in past years, we asked funds whether they (or their investment managers) recall stock that is out on loan in order to regain control over the voting rights.

Whilst the percentage of respondents whom reported that they recall stock out on loan for at least contentious resolutions remained steady at 44% the proportion of respondents which do engage in stock lending has begun to decrease after rising for the past few years – this year the figure was 15% as compared to 33% for 2013 and 2012.

Fig. 29. Do you (or your investment managers) recall stock that is on loan in order to regain control of the voting rights?



Approach to responsible investment (RI)

Key findings

- Nearly two thirds of respondents had reviewed their responsible investment policy within the past year.
- Over 60% of respondents feel it extremely important that their investment managers take into account the long-term sustainability of the company strategy when making investment decisions.
- At odds with the broader focus on executive pay this factor was considered the least important of those suggested when making investment decisions.
- No respondents disagreed with the assertion that "active consideration of risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors) is compatible with its fiduciary duty" and a majority strongly agreed.
- Over 40% of respondents had discussed the conclusions of the Law Commission's final report published in June 2014 into the Fiduciary Duties of Investment Intermediaries at a trustee meeting. For none of the respondents had these conclusions been raised by their investment consultants.

The NAPF published a Responsible Investment Guide in May 2013 and which defined 'responsible investing' as: *"An investment approach in which investors recognise the importance of the long-term health and stability of the market as a whole; seeking to incorporate material extra-financial factors alongside other financial performance and strategic assessments within investment decisions; and utilise ownership rights and responsibilities attached to assets to protect and enhance shareholder value over the long term – primarily through voting and engagement."*

The NAPF believes that the long-term investment horizon of pension funds fits well with the growing evidence that responsible investment approaches can lead to enhanced long-term risk-adjusted returns. Implementing a responsible investment policy also helps pension funds to adhere to codes such as the UK Stewardship Code.

In addition, pension funds are often thought of as universal owners - long-term owners of a diversified investment portfolio that is spread across the entire market or markets – and as such they collectively own a significant share of the economy and are effectively tied into this share in the longer term. Given this, it is necessary to manage the longer term risk within portfolios through both asset allocations and active ownership practices that are sensitive to longer term factors.

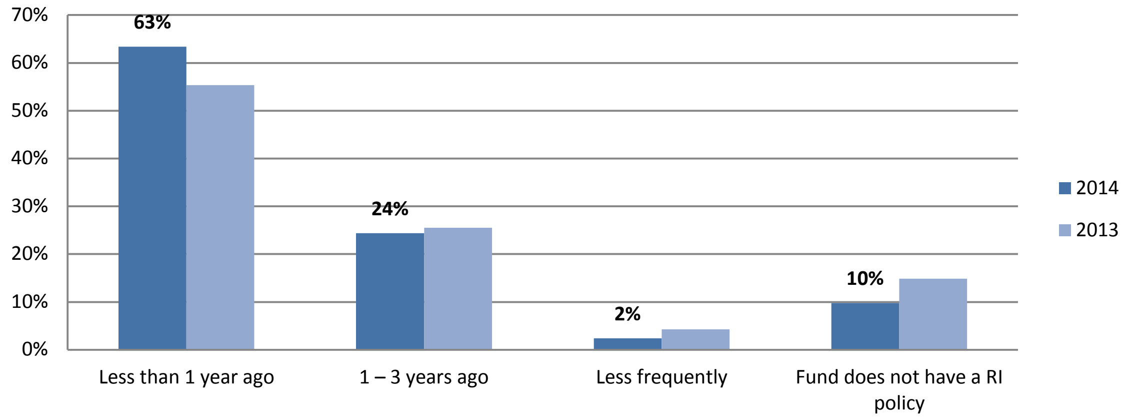
Responsible Investment Policy

The SRI Pensions Disclosure Regulation 2000 requires "that trustees of occupational pension funds disclose in the Statement of Investment Principles the extent (if at all) to which social, environmental and ethical (SEE) considerations are taken into account in their investment strategies".

The language within the regulations is now out of step with common terminology a point accepted by government. As such the government intends to consult on changes to the Investment Regulations to ensure that they more clearly reflect the distinction between financial factors and non-financial factors. In turn the distinction between a fund's general investment beliefs, including how it seeks to ensure material ESG factors are incorporated within investment decisions and exercises its stewardship responsibilities, and whether or how it takes into account non-financial factors, will become clearer.

Despite the continued ambiguity as to what is interpreted to be meant by a responsible investment policy we, as in past years, asked respondents when the fund had last reviewed its responsible investment policy. 63% of respondents had reviewed their policy within the past year and close to a quarter had done so within the past few years.

Fig. 30. When did the fund last review its Responsible Investment (RI) policy?



Factors influencing investment decisions

Exploring the impacts of funds' responsible investment policies and expanding on the earlier question which asked respondents whether they accepted that ESG factors can have a material impact on the fund's investments in the long-term (90% of respondents agreed) we asked funds to rate the relative importance of a range of factors for fund managers' to consider when making investment decisions.

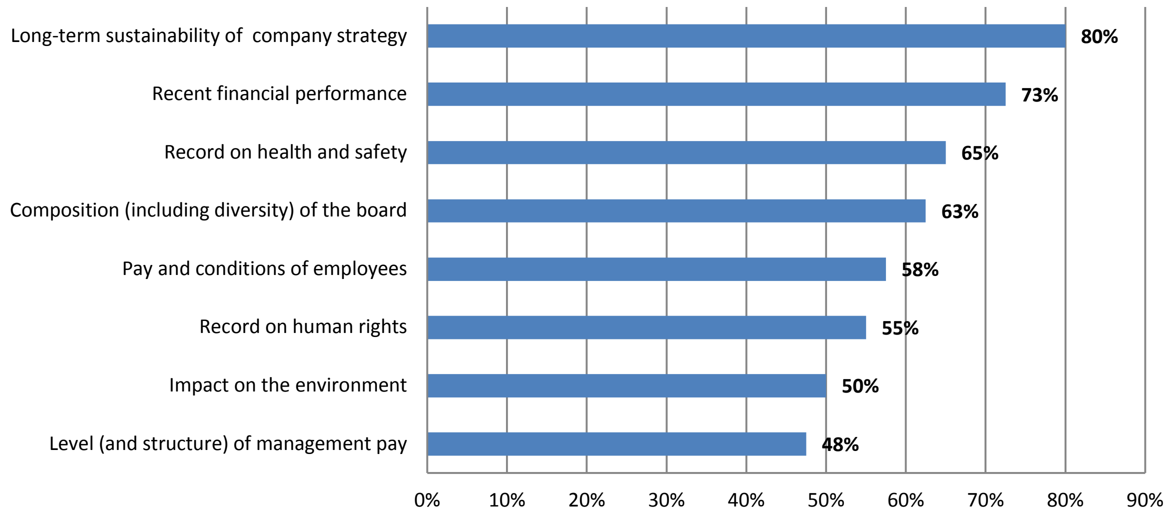
This year the range of factors that we presented reflected those factors which were included in a survey we commissioned of pension scheme members earlier this year in which we asked what they considered are the most important issues for their pension provider to consider.

The notable results from the survey of scheme members was that despite the significant attention given to issues of executive pay, diversity and environmental impacts – all of which the NAPF agrees are important and material issues for many companies – these did not on the whole feature as very important for the respondents. The issue considered most important was the recent financial performance of the company (57%) with pay and conditions of employees (36%) and level executive pay (30%) a distance behind. Interestingly amongst 18-34 year olds the issue of pay and conditions of employees is considered on a par with the company's recent financial performance (44%).

For the pension fund respondents to our Engagement Survey the factor considered most important for investment managers to take into consideration when making investment decisions is the long-term sustainability of the company strategy – assessments of this should in itself include assessments of the sustainability of the company's approach to its workforce, its environment and broader strategy.

While scheme members in our previous survey suggested that diversity on company boards was the least important factor on which providers should engage, closely followed by the company's record on health and safety; the pension fund respondents to this survey promoted both much higher up the list. Similarly, whilst the level (and structure) of management pay was considered third most important by scheme members for engagement it was rated the least important factor to incorporate into investment decisions by pension funds.

Fig. 31. How important is it that the fund's investment managers take the following factors into consideration when making investment decisions: (percentages choosing "4" or "5")



These results overall strongly support the view that pension funds increasingly understand the importance of considering the risks to an investee company's long-term sustainability. With corporates globally increasingly being required by regulators and stock exchanges to disclose more non-financial information it is encouraging to note that there is a desire for investment managers to make use of this data, incorporating it where relevant into their analyses and in turn directing capital towards those companies which are most sustainable.

A fiduciary duty

Since we conducted this survey last year, the Law Commission has concluded its review of Fiduciary Duties of Investment Intermediaries. This review was prompted by the Kay review which highlighted a concern that trustees of occupational pension schemes were taking an unnecessarily restrictive view of what they were allowed to consider as fiduciaries.

As has already been referenced within this report, the Law Commission concluded that:

- *Trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors).*

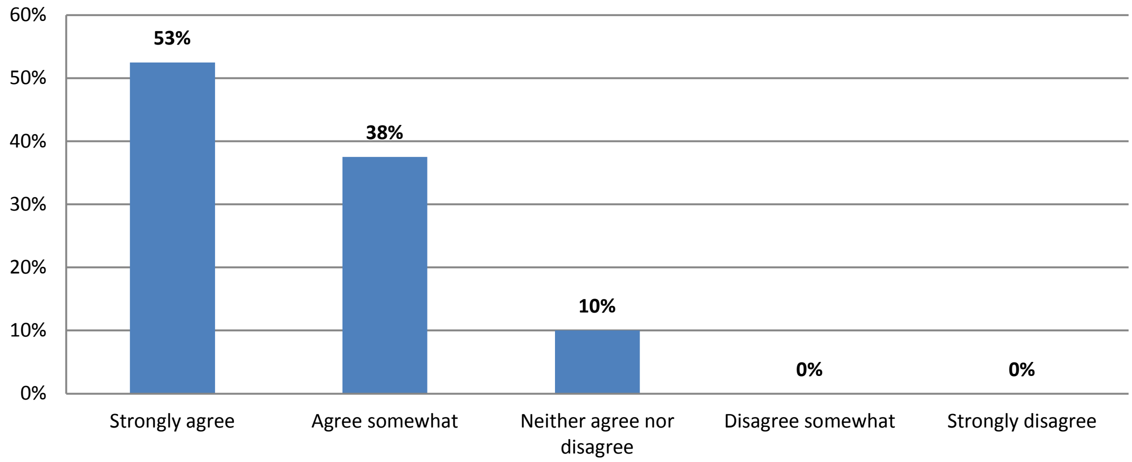
- *The Law Commission's conclusion is that there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.*

The NAPF fully agrees with the Law Commission's conclusions.

Given trustees' purported confusion around the remit of their fiduciary duties we asked whether pension funds agree that active consideration of risks to a company's long-term sustainability, such as ESG factors is compatible with its fiduciary duty. We subsequently also asked whether trustee boards had discussed or noted the recent conclusions of the Law Commission.

To the first question the response was pretty clear. Not a single respondent disagreed with the assertion that active consideration of ESG factors is compatible with a fund's fiduciary duty.

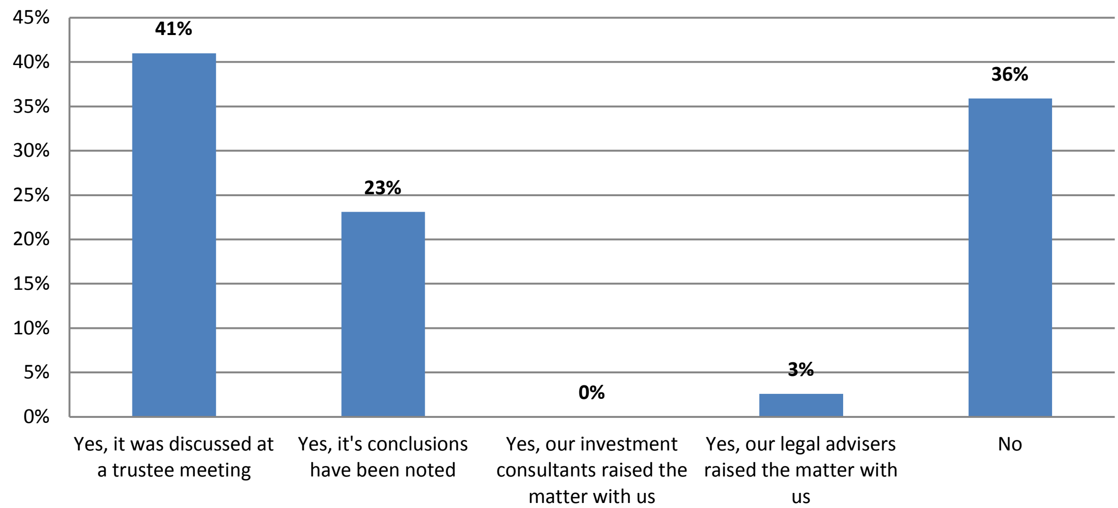
Fig. 32. Does your fund agree that active consideration of risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors) is compatible with its fiduciary duty?



With respect to whether trustee boards had discussed or noted the Law Commission's conclusions over 40% had formally discussed these at a trustee meeting and a further 23% had noted them. Given that this survey was conducted only three months after the report's publication this is reassuring.

What is disappointing however, is that the feedback in the survey suggests that no investment consultant had raised the matter with their pension fund clients and indeed only 3% of legal advisers had done so.

Fig. 33. Is your trustee board aware of the conclusions of the Law Commission's final report published in June 2014 into the Fiduciary Duties of Investment Intermediaries?



Securities Litigation

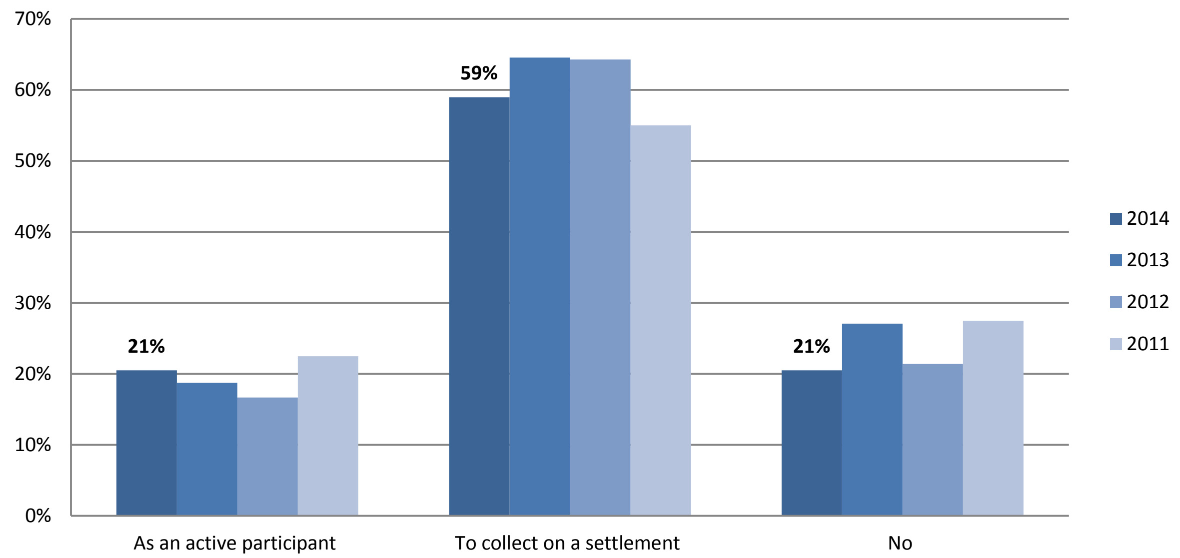
Key findings

- 79% of respondents had participated in a class action settled either actively or to collect on a settlement.

This year's Engagement Survey continues to show that a significant majority of pension funds are participating in class actions – 79% of funds either participated in a class action to collect on a settlement or as an active participant. Only 21% reported that they had not participated in a class action within the past 12 months.

Some respondents suggested that they routinely collect on settled class actions through their custodian and indeed are active participants in current cases in the UK, France and Japan. Equally however, a number of pension funds feel uneasy about participating in a class action where they remain invested in the company, a common situation in many of the major litigations. It is one matter to collect money owing through a settlement and quite another to actively participate in a case against a company that is an ongoing investment.

Fig. 34. In the past twelve months have you participated in a class action settlement?



With many schemes adversely affected by the recent economic crisis, it remains important that institutional investors continue to consider opportunities to recover any available proportion of their losses. However, this of course needs to be balanced against their ongoing interests in the company's future financial sustainability. Our survey suggests that UK pension funds are endeavouring to do just that.

Conclusion

One of the charges often levelled at the investment industry is that it does not operate in the long-term interest of savers; if you're going to give someone your money to look after you need to be able to trust them to do it properly. To that end, a trusted and effective pensions system requires all those in the pensions investment chain to act as good stewards – in this case of the hard-earned savings of millions of people.

Since 2010 there have rightly been widespread efforts to encourage investors to adopt a more long-term mind-set and to engage with the companies in which they invest. The UK Stewardship Code, the first of its kind in the world, was introduced to encourage this approach.

Encouragingly, the NAPF's 2014 Engagement Survey demonstrates that the UK's largest pension funds well understand that they have stewardship responsibilities and these involve considering the long-term sustainability of their investments in the best interests of their beneficiaries.

Whilst it positive that more funds are committing to the Stewardship Code it is most encouraging that the underlying principles are being brought to life by pension funds through their regular interactions with their investment managers. The survey's findings suggest that discussions about stewardship are more regularly a feature of manager selections and much more attention is being paid to the substance of the stewardship activities within regular manager reviews. As such the burgeoning stewardship market is beginning to gain momentum.

Given that the FRC is rightly focusing on signatories' adherence to the spirit of the Code and the European Commission is seeking to introduce additional transparency requirements upon asset owners and asset managers these results are positive.

However, the Survey again highlights areas for improvement, not least in the commitment to the Code from investment consultants. Whilst the larger funds are getting to grips with their responsibilities and seeking to drive the market in the interests of their members, the long tail of smaller pension funds require the support of their key advisers, an expectation that should be rightly met.

Time constraints also remain a core challenge for many funds, in particular for small and medium sized pension funds not least because the number of 'signatories' to the various stewardship initiatives such as the Stewardship Code and UN PRI makes it difficult to easily differentiate between firms and reward those most committed to being good stewards of client money.

It is with this in mind that the NAPF has sought over the past couple of years to develop tools to assist pension funds fulfil their stewardship responsibilities in an effective but efficient manner. The NAPF's new Stewardship Accountability Forums, alongside our existing Stewardship Disclosure Framework, we hope now enable pension schemes, whether DB or DC and whether large or small to fulfil their responsibilities.

Pension schemes recognise that the assets they own and have oversight of can play an important role in determining the future society their member's face and thus, the real value of their retirement income. Equally, scheme members themselves express a strong desire to see their savings invested in a manner which is in their long-term interests. Rightly many asset managers are responding. We look forward to seeing all parties maintaining the momentum over the coming year.

APPENDIX 1: List of figures

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