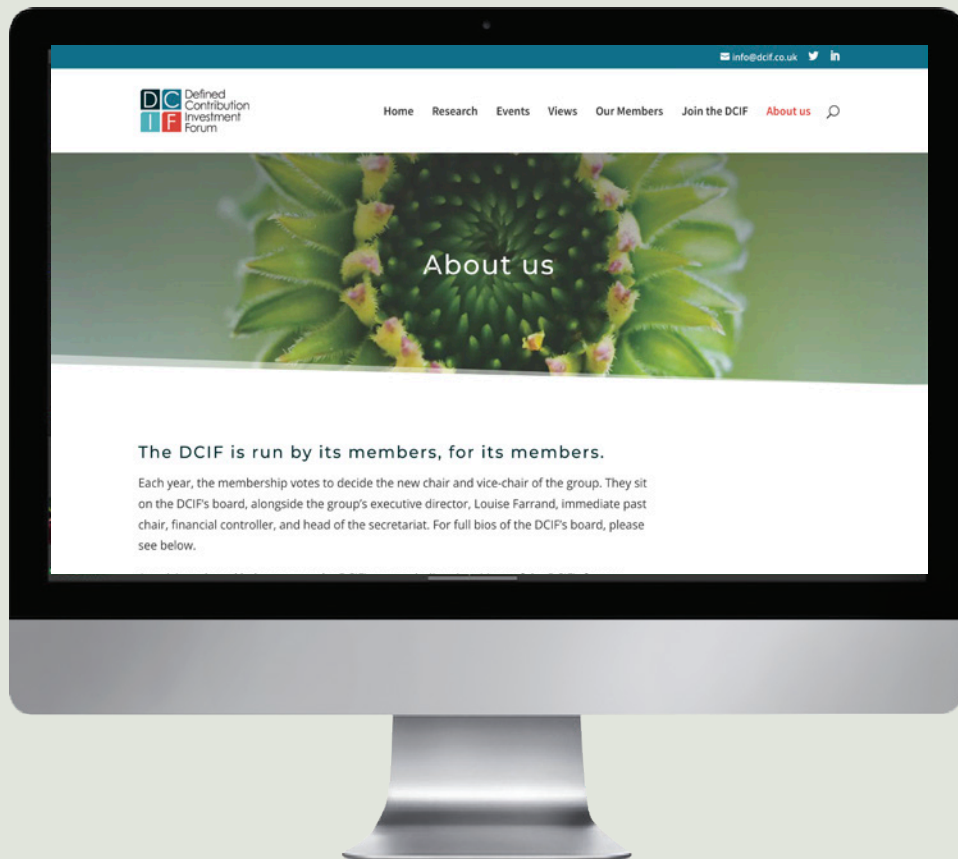


ESG 2.0 SERIES

The DCIF's guide to social factors





Who are we?

We're a group of asset managers who believe that a well-designed and diverse investment strategy has an important role in delivering a comfortable retirement for millions of DC savers.

A not-for-profit organisation, we commission and publish research which shines a spotlight on DC investment issues. We hope the people who determine DC pension schemes' investment strategies will use it to inform their work.

We also arrange events. From virtual roundtables to in person gatherings, they're a great way to learn more about DC investment issues and meet a like-minded community of trustees, pensions managers, investment consultants and more.

To find out more about our work and explore membership options, please visit: www.dcif.co.uk

Our members

Our members shape the DCIF's direction and steer research projects. They are:



Why is the ‘S’ in ESG so tricky to get to grips with? And where should DC schemes start?



When it comes to ESG, that middle child ‘S’ has always been the trickiest aspect to get to grips with for pension schemes. Recently, some excellent papers¹ have been written to define what we mean when we talk about the ‘social’ in ESG, and to explain what trustees and other pension scheme decision-makers need to do.

In this paper, we will explore why it’s challenging to pin down what we mean by social factors – and how trustees and other fiduciaries can make the ‘S’ meaningful for their own DC pension schemes.

We would add that social links to all aspects of ESG, as well as a scheme’s broader investment strategy. “Social is massively important across the board, not just within its own singular pillar,” says Nick Gaskell, senior sustainability analyst at Aberdeen. For example, in the just transition to a green economy, workers in some sectors could find themselves redundant if no plans are made to retrain them.

As we’ve done in the rest of this series of papers (which you can read here), we’ll give pension schemes some practical takeaways. To bring them to life, we’ve interviewed the Tesco pension scheme, which has done some great work addressing social factors.

¹ Such as [Considering Social Factors in Pension Scheme Investments](#), the Taskforce on Social Factors, March 2024.

How do we define ‘social factors’?

For consistency, and because it’s very well expressed, we will take the UK government’s Taskforce on Social Factors’ definition, as published in their report, *Considering Social Factors in Pension Scheme Investments*:

“Social factors are considerations about an investment that relate to people – from workers and suppliers to customers and communities. This means looking at both the impact of social factors on an investment along with the social outcomes and impacts of an investment. Social factors include a wide range of topics from payment terms for suppliers, anti-microbial resistance, links to armed conflict, and vaccine fairness to the just transition, health impacts on consumers and communities and inequality.

“Social factors can manifest at the company level (e.g. a social controversy may impair an individual stock price), and can also represent systemic risks. For example, social unrest due to inequality or geopolitical stress can affect entire markets, and the systemic effects of unchecked anti-microbial resistance could have global reach. These systemic risks cannot be mitigated through diversifying an investment portfolio, nor easily through stewarding/ influencing individual companies.”

Source: [Considering Social Factors in Pension Scheme Investments](#), the Taskforce on Social Factors, March 2024.

Why are social factors so challenging to define and act on?



Siobhan Cleary, Baillie Gifford's head of ESG, explains: "I think the question is perhaps less, 'Why does S feel neglected?' and maybe more, 'Why is climate so clearly positioned and universally understood?' And I think the short answer to that is because we have a binding international agreement to take action to address climate change and we are increasingly seeing its physical impacts."

The 2015 Paris Agreement has given investment fiduciaries clarity about the direction of travel when it comes to climate change, adds Cleary. "It's something that can be quite clearly linked to fiduciary obligation, because we know that governments around the world have said that this is the direction of travel, regardless of how uneven that might be. When you add in the increasing physical manifestation of climate change, how can you not consider it in your investment decision-making or your capital allocation? It is, by definition, something you have to think about."

The same clarity does not exist when it comes to social factors, says Cleary. "We don't have that in the same way when we talk about the S, because S is everything from inequality to data privacy, to worker compensation to human rights to supply chains. S is an enormous category of things which are not framed and

"Social is an enormous category of things which are not framed and articulated in the same way that we have for climate."

articulated in the same way that we have for climate."

Climate data isn't perfect, but there is still plenty of information available which helps us to track the world's progress. This is not true of social factors, where there is both a paucity of data and a lack of consistency in reporting.

"I think the problem with S is around data. Across environmental and governance, we have data, whether it be emissions data on the E side or executive compensation on the G, whereas with the S, there is much less," says Amara Lalemi-Jacobs, sustainable investing vice president at J.P. Morgan Asset Management.

She adds: "We're increasingly getting diversity data. We can see employee turnover data, which helps to define whether it's a good working environment. But beyond that, human rights data is really hard to come by.

As a company, you may say you are exploring human rights violations in the supply chain. But where's the evidence of that? If there have been risks uncovered, what are companies doing to address those? That's not something that companies are required to disclose today consistently, and as a result, they just don't."

Inconsistent reporting also makes life more complicated. For example, gender pay reporting, employee turnover rate and lost time incident rates are calculated differently in different jurisdictions. >

> This is further complicated by the fact that you can't report on or collect on certain metrics in some jurisdictions (e.g. diversity metrics in France).

Other areas of ESG are easier to grasp for people. For example, climate change is more immediately visible, says Lalemi-Jacobs.

"I think nature is something that you can more tangibly see. People can say, 'I went to the Alps four years ago, and there was snow, and now there isn't,' or: 'There used to be this bird species every summer, and now we're not seeing it.'"

Julie Bech, portfolio manager of Nordea's Global Diversity Engagement Fund, agrees that incorporating the S requires a different focus.

Bech, who has been running Nordea's Global Diversity Engagement Fund for over five years, explains how Nordea encourages its investee companies to adopt policies that support the social characteristics they desire. Bech also explained how her team utilise a proprietary DEI tool to systematically assess workforce diversity within companies. Importantly, Nordea believes that companies which embrace strong social practices have a competitive advantage relative to peers.

Bech also acknowledged the importance of engaging with companies to improve data availability and looking at other forms of tangible evidence for a company's social practices – examples being corporate policies and initiatives which prove their commitment to this area.



Momentum is building on social

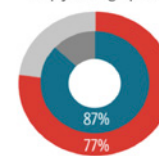
Investors may have tackled climate first, but social factors are high on the agenda. There are both solid ethical and strong financial reasons to include social factors in the investment decision-making process. Indeed, the two are often intertwined.

The Boohoo controversy is a prime example. In 2020, it was discovered that some factory workers in Leicester who were making clothes linked to the company were being paid £3.50 an hour. The modern slavery revelations created widespread outrage and caused a collapse in Boohoo's share price.²

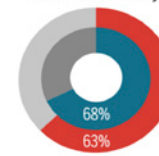
People talk about climate being easy to understand, but so are many social issues – human rights and modern slavery are great examples, which were sadly brought to life by the Boohoo situation. Indeed, investors often observe that of the three elements of ESG, getting the S wrong is the most likely to result in reputational damage, and a commensurate drop in the value and valuation of the business.

Done right, proper identification and rectification of S can improve valuations for companies, as reported in the Financial Times for Lululemon. "Lululemon disclosed markedly stronger human rights due diligence efforts to address forced labour risks in its supply chains. Its stock market performance demonstrates that a corporate strategy which embeds human rights due diligence does not have to come at the cost of investors. Lululemon's shares have surged 49% over the past 12 months – easily beating a 4.6% rise for the S&P Retail Select Industry index."³

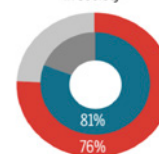
Businesses have a wider social responsibility than simply making a profit



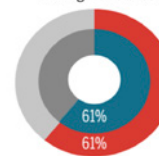
I feel strongly that businesses should control Executive Pay



It is important to me to protect the vulnerable in society



I worry about the state of the world and feel personally responsible for making a difference



● 2021 ● 2023

Question: How much do you agree or disagree with the following statements?
Base: All UK adults aged 22-65 with a DC pension (2018:1.061/ 2020:1.017/ 2021:1.000/ 2023:1.300)

Source: DCIF/Ignition House research, 2021 and 2023.

As Tim Gooding, climate investment director at Baillie Gifford observes: "The S is probably the area where companies can lose their license to operate the most quickly, because if they do something that is contrary to the interests of the customers, their suppliers, their staff, their stakeholders, very quickly, that societal license erodes."

End investors also care about social issues, as the DCIF's research found in 2023 and 2021 (see below). In the next section, we'll give you some ideas as to how to work out what matters most to them, so that you can ensure your scheme invests in a way which reflects their concerns and priorities.

As social encompasses a very broad range of factors, pension schemes are likely to have better results if they break down the issues into manageable chunks. Although it can feel like a big and elusive subject, there are ways investors can put their hands around the 'S'.

Human rights are a great example, says Cleary. "We have globally agreed frameworks that recognise what we call human rights. And so that's almost our entry point for trying to think about S-type issues. We do get into the specifics of labour rights, and then supply chains, and all the other complexities. But ultimately, it's useful to bring that back to human rights thinking. Because that is theoretically, at least, a baseline that everyone should be able to agree on."

2. Boohoo: fashion giant faces 'slavery' investigation, The Times, 5th July 2020: <https://www.thetimes.com/article/boohoo-fashion-giant-faces-slavery-investigation-57s3hxcth>

3. What's next on John Kerry's green agenda? Financial Times, 17th January 2024: <https://www.ft.com/content/277686bb-5303-4629-a8a6-2122cb59ec04>

Where should pension schemes start?



1 Understand your member base – and think about what’s important to them

Siobhan Cleary says: “I would suggest that the answer could be framed by what is important to your beneficiaries. I know some of the pension schemes I’ve dealt with have looked at compensation and inequality and how that is reflected in executive compensation. They will, for example, take quite strong action on executive pay, because for their beneficiaries, many of whom are not highly paid people, there is great concern about widening inequalities in society and so that is a social theme that they manifest in their stewardship and voting activity.”

Tim Gooding explains: “I look after a charity client and they support people who are vulnerable in society. They have a special interest in labour rights, zero hours contracts, and those sorts of features. So, they will be very forensic in looking at companies like Uber, DoorDash and Grubhub.”

Pension schemes which have large memberships could consider carrying out a membership survey, as Tesco did (see case study, p7). To make it actionable, schemes could pick members’ top few priorities as starting points.

“A good manager across E, S and G is one who can articulate the approach they are taking, why they are taking it and how it fits with their investment style and approach.”

Kate Turner, global head of responsible investment, First Sentier Investors.

2 Interrogate your asset managers

Many DC schemes invest in pooled funds and will need to lean heavily on their investment managers to engage on their behalf. Different investment teams will take completely different approaches to social factors; there isn’t a single definition of excellence.

Managers should be able to explain what social issues they prioritise and why, with financial materiality and salience at the top of their minds, adds Turner. They should give clients a clear framework and plan for how they are addressing these issues, knowing the approach will differ company by company.

Get into the details and try to establish a shared starting point, suggests Alasdair Birrell, workplace investment proposition lead at Standard Life UK. “Try to get into the nitty gritty of what you’re voting on: ‘These are our beliefs. What investments of yours go against those beliefs? Can you explain to us why you voted that way? How would you do it differently?’ Having those conversations. Because stewardship is key, but it’s also the challenge of: you might vote one way, but if everyone else votes against you, then again, what difference are you making? Absolutely none. Everyone’s got to start singing off the same hymn sheet, and that’s the only way we can make a difference.”

CASE STUDY



How Tesco found out what members care about – and integrated these findings into its investment strategy

The challenge

As one of the UK's largest employers, Tesco takes its responsibilities to its people very seriously. With over half a million pension scheme members, the supermarket aimed to reflect their key investment priorities, while securing the best possible return. The first step was to ask members what matters most to them. The Tesco Retirement Savings Plan (TRSP) spoke directly to thousands of members in focus groups, member sessions and questionnaires across the course of 2019 (and which was then updated in 2023).

Members' priorities

Several priorities emerged. People wanted their money to be invested responsibly, but their main priority was that their savings grew as much as possible – without too much downside risk. As they expressed it, they wanted their money to feel safe.

Three responsible investment-related themes came through most strongly from Tesco's members. First was protecting people's rights by (for example) investing and influencing companies to treat their people well. The second was working towards a better society particularly through health and education systems. The third was protecting the planet,

ensuring that the TRSP's investments are helping to protect the world's natural resources and making a positive difference to climate change.

How Tesco took members' views into consideration

The TRSP's investment committee, alongside LCP, mapped scheme members' priorities against the UN Sustainable Development Goals. Using that information, they developed a custom index, working closely with index provider Solactive, and pension provider Legal & General. The index had customised tilts and screens which took members' priorities into account.

The portfolio is targeting to be net zero by 2050 and has made a significant initial carbon reduction. Tesco also expects it to deliver better financial outcomes, in line with members' top priority.

Lessons for other schemes

Finding out what matters to members has been vital for the TRSP, which is large enough to be able to develop a custom index. For other schemes which take a similar route, focus on the quality of the survey and seek expert help with this if needed. The TRSP developed its survey together with C Space, an insight agency.

Once you understand members' priorities, use that information. "Tesco has a great framework for thinking about any decision they make," says Steve Budge, partner at LCP and adviser to the scheme. "They play everything back to members' priorities."

As most schemes do when incorporating ESG, the TRSP asked itself some philosophical questions about aligning ESG with fiduciary duty.

One uncontroversial way to approach integrating social factors is to think about the risks of not doing it, says Budge. He explains: "The TRSP asked themselves: are we holding any stocks where, if we look back in ten years, we will not be very happy with ourselves?"

As a result, Legal and General (their master trust provider) exclude around 10-15 stocks from the TRSP index. "It doesn't do much in terms of tracking error, but it removes those high risk stocks," says Budge.

What next for Tesco?

The TRSP is considering its next steps in private markets. They have already invested in the Aviva Climate Transition Real Assets Fund, which focuses on the domestic economy.

All the TRSP's future work will be grounded in the priorities set out by its members.

'It's so important to listen to members, understand what matters most which we then integrate into our governance model and our investment, engagement and broader stewardship strategies. Critically, this clear purpose helps us to understand how

we can genuinely 'measure and increase value for members'. Our members really matter to us." says Ruston Smith, chair of the Tesco Pension Fund.

