



Investment Insights

Sustainable

investing in DC Master Trusts

How can trustees and sponsors really know if a Master Trust provider will stay at the front of the sustainable investing curve for decades to come? We explore the importance of both providers' *commitment* to sustainable investing as well as the actions they have *already taken*.





Individuals' retirement outcomes in the UK are increasingly dependent on the actions of DC Master Trusts. The number of active members in DC Master Trusts more than doubled between 2015 and 2019, when the figure stood at 8.3 million members¹. The trend is set to continue with increasing pressure on own-trust schemes to consolidate.

Navigating this landscape is a huge challenge for trustees and sponsors, who want to ensure the best outcomes for their members and employees. The challenge is even greater since a DC Master Trust is not just for Christmas. This is the worst kept secret in the pensions industry – everyone, from trustees to sponsors and providers, knows DC money is sticky money. In fact, the Master Trust providers are banking on it, as shown by fierce competition on costs as they battle to collect members (and more importantly assets!).

While sustainability is only one aspect to consider when choosing a master trust, it is a particularly complex one. Sustainable investing is a fast moving beast – we're learning new concepts and ideas every day. The pace of change is exciting and reassuring to those of us who are concerned by climate change, but how on earth can trustees or sponsors really know if a Master Trust provider will stay at the front of the sustainable investing curve for decades to come?

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In our view, trustees and sponsors need to understand both providers' *commitment* to sustainable investing as well as the actions they have *already taken*.

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Sustainable investing

Sustainable investing means investing for the long term. It is inextricably linked to DC pensions given the long investment horizon members have. A 25-year-old today could well be invested for 40 years before retirement and with the increasing popularity of drawdown in retirement, another 30 years after that. In fact, we believe sustainable investing is one of the key [megatrends](#) that will define the next era of financial markets.

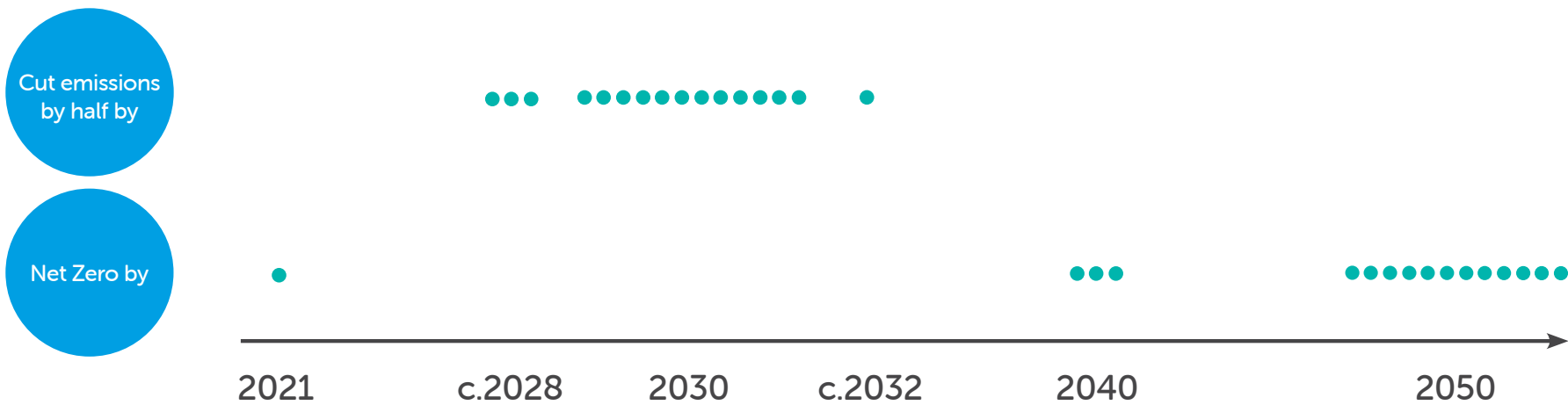
Providers' commitment to sustainable investing

Master Trust providers are demonstrating their commitment to sustainable investing in different ways:

The actual changes providers have made to their investment strategies are considered later in this paper. For the other areas, it can be difficult to spot differences between providers. For example, while participation in industry initiatives is important to drive change, deciding which initiatives are the most important can feel futile. Two areas where there are clear differences are Net Zero commitments and Stewardship activities.

Net Zero commitments

The graphic to the right summarises Net Zero commitments made by a selection of major DC Master Trusts.



There is a wide spread of commitments. The most striking observation is the one Master Trust which has committed to Net Zero *now*. This is highly unusual, with others favouring Net Zero by 2040 and 2050. It is pleasing to see that all of the Master Trusts shown have also made interim commitments. Most expect to get halfway to Net Zero by 2030, with some targeting slightly earlier or slightly later.

Why is Net Zero important? The propensity for pension schemes to support the green transition has galvanised many trustees. After all, one study suggests investing one member's pension in 'green' assets would be 21 times² more effective than that member making lifestyles changes like going vegan. There is understandably a lot of interest in Net Zero commitments as a result, but the role of a pension scheme must be understood.

2. www.makemymoneymatter.co.uk/21x/

3. www.barnett-waddingham.co.uk/comment-insight/blog/net-zero-explained/



Pension schemes don't have control over their emissions like companies do. A company can set an ambitious Net Zero target and make a concerted effort to identify, measure, understand, and most importantly *reduce* emissions throughout their value chain. A pension scheme invests in companies. While pension schemes can use stewardship to encourage change by companies, they do not have *direct* control to reduce emissions.

So what would it mean to be Net Zero today? Without due care, it can mean greatly reducing the range and breadth of investment opportunities your scheme can access. This can ultimately prove costly for members if they don't achieve meaningful diversification – the only free lunch in the investment world. What's more, there are clear opportunities to invest in 'brown' companies today and support them in becoming 'green'.

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While we absolutely support investors prioritising certain investments over others to manage *financial* risk and access *financial* opportunities in sustainability, we don't think vastly narrowing your opportunity set to reach Net Zero today should be viewed as the gold standard for 'going green'.

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From a societal point of view, investing *only* in low-emissions companies today could harm the transition to a green economy as a whole. What if the high polluting companies are all held privately by investors who prioritise short-term financial returns over long-term sustainability? What if we don't support companies in high-emitting emerging economies to move away from fossil fuels? What if we don't work towards a 'just' transition that ensures society as a whole benefits? We won't get to Net Zero until everyone gets there. So is it reasonable to target Net Zero before society as a whole?

Having said this, Master Trusts will grow significantly in the coming decades and have a pivotal role to support and encourage the green transition. Their investments and stewardship have the potential to drive significant change.

Stewardship

The majority of UK pension schemes invest via pooled funds, meaning trustees do not own the assets themselves. Trustees therefore need to make sure their fund managers' stewardship matches their own aims. This is also true for most Master Trusts. When choosing a Master Trust, you want confidence that the Master Trust is leveraging the full scale of its assets to engage its managers and drive improvements in stewardship on behalf of members.

So what does 'good' stewardship look like?

For fund managers, we want to see evidence of a clear philosophy on sustainability, with a well-resourced team responsible for stewardship. We want evidence they use voting rights and proactively engage companies and holding them to account. We want evidence that they have actually had success influencing business practices.

For Master Trusts, we also want evidence of a clear philosophy on sustainability. However, we understand they don't have direct access to the companies. Instead, we want clear evidence they proactively engage their fund managers to ensure their philosophy is known and perhaps

even reflected in fund managers' stewardship activities. It is not enough to dutifully prepare Implementation Statements and report under TCFD, especially now some fund managers are developing the infrastructure to allow schemes to choose how stewardship is carried out for their holdings.





Using responses to our questionnaire, we have put each Master Trust into one of three categories. It's clear that some are much further ahead than others.

Changes in practice

Providers are increasingly integrating sustainability into their default strategies, though it is difficult to compare providers. This challenge is reflected across the investment industry. The range of sustainable funds has evolved at pace. Investors can choose between active and passive, between tilts and exclusions, between Paris-aligned and Climate Transition Benchmarks, and plenty more. Trustees are finding they need to rely more on their advisers than ever before to keep up.

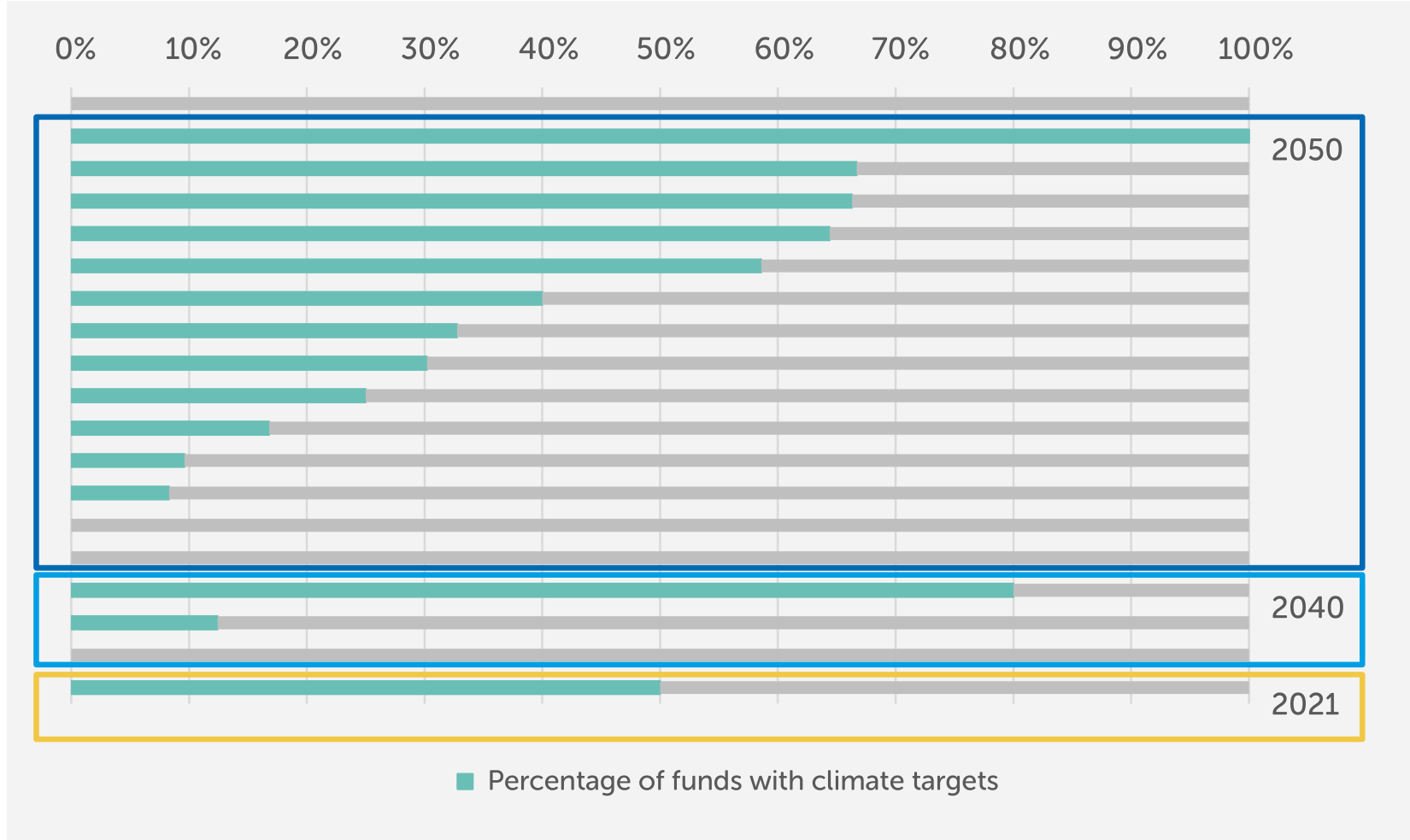
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Our analysis shows there are material differences between DC Master Trusts during the growth phase, when members are still a long way from retirement.

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Acting on Net Zero commitments

The chart below groups Master Trusts according to their target date for achieving Net Zero. It then shows the proportion of assets in the growth phase invested in funds with explicit targets for reducing emissions. The mechanics of the funds chosen by different Master Trusts varies, but that is not our focus here.



There are some striking observations. In particular, Master Trusts with earlier target dates for Net Zero are not always investing more in funds with climate targets than Master Trusts with later target dates. The first Master Trust in the list has no target date for Net Zero.



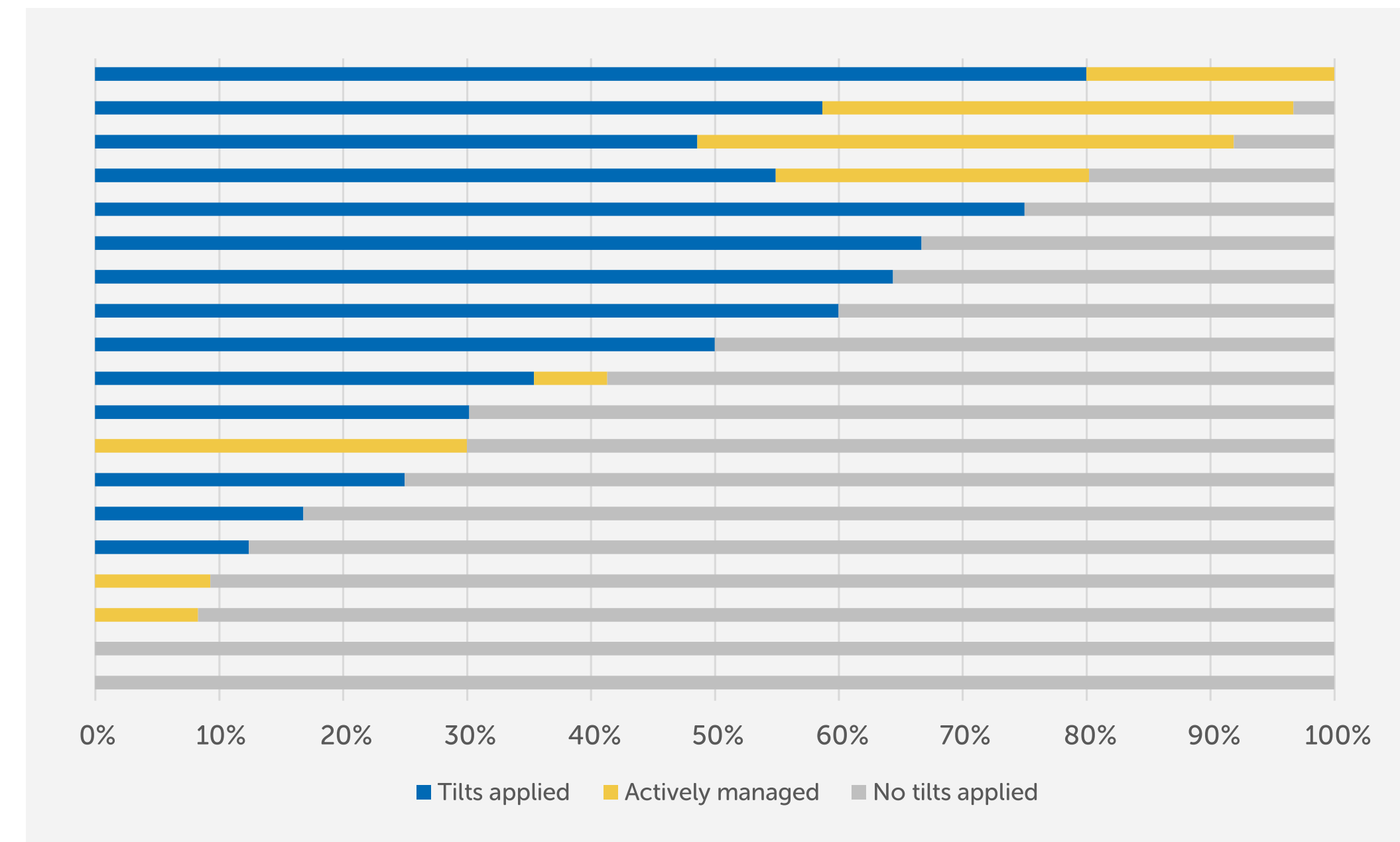
Tilts and exclusions

We often get asked whether we prefer exclusions or tilts to manage sustainability risks and opportunities. The range of approaches in the industry means this is not the straightforward question we would like it to be.

Tilts and exclusions are often used to characterise passive (or index-tracking) funds. These funds require managers to invest in line with an index, which is created using prescribed rules. These rules can include tilts and/or exclusions to achieve specific objectives, such as improving ESG scores or limiting exposure to emissions. More often, active fund managers can invest in the companies they believe are most appealing at any given time, meaning the concept of 'tilting' is less meaningful.

This means we can't just look at the proportion of funds employing 'tilts' to understand the extent to which a Master Trust's fund managers can consider sustainability. The chart below shows some Master Trusts with a smaller proportion of funds employing tilts in the growth phase also use active management.

Arguably, those Master Trusts have *more potential* to invest sustainably, albeit there is no guarantee that active management will lead to better outcomes for returns or sustainability. Our research teams set ratings for both active and passive funds that give our view on how well they are managed *and* their sustainability, helping us to advise clients.





Both active and passive funds do set exclusions though.

Exclusions can be grouped into two categories:

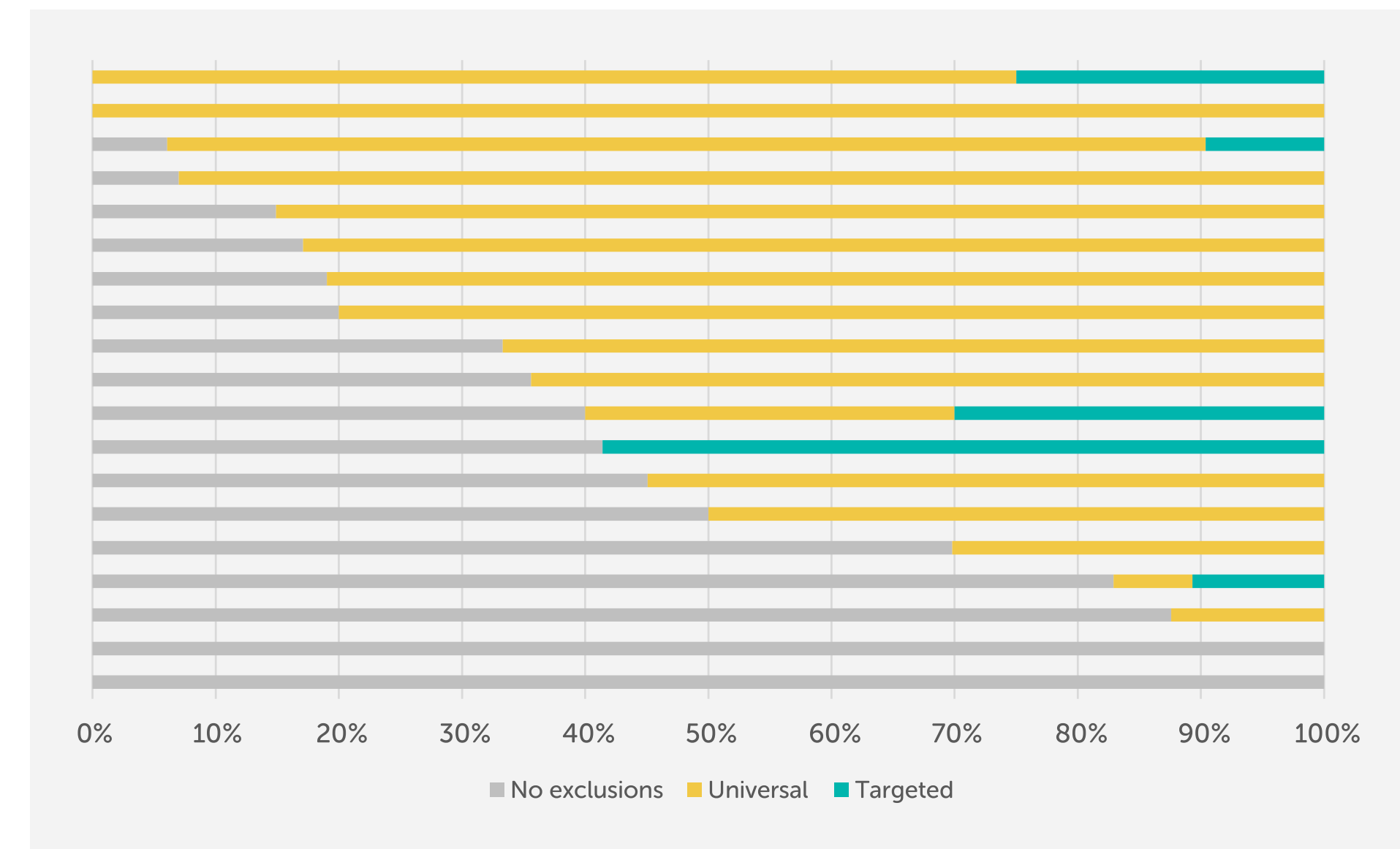
- **Universal** – this covers companies that are universally accepted as unsuitable investments, usually based on guidance from bodies like the UN or WHO. Examples include weapons, tobacco, and UN Global Compact violators.
- **Targeted** – these exclusions are designed to achieve specific objectives, like materially improving a fund's ESG credentials or reducing exposure to emissions.

It's striking to see that very few Master Trusts actually employ *targeted* exclusions in the growth phase, despite many making *universal* exclusions.

The lack of targeted exclusions could suggest that more Master Trusts believe financial risks and opportunities are best managed using passive funds with 'tilts' and selective use of active management. This does allow Master Trusts to focus stewardship on companies which are lagging on sustainability, although we saw above that a proactive approach to stewardship is by no means guaranteed.

This touches on the broader exclusion versus engagement debate. Some trustees or sponsors may be concerned by the lack of targeted exclusions. For example, some *believe* we must exclude holdings in

oil and gas companies to limit *financial* risks, such as 'stranded assets'. With increasing pressure on own-trust schemes to evidence value for members and ultimately consolidate, designing a strategy for members that is not available from Master Trusts is a clear way to stand out.





Private markets

Private markets are a hot topic for DC schemes. They can provide much-needed diversification to improve long-term returns and, ultimately, enhance member outcomes. They offer a different range of opportunities compared to public markets. Members can also benefit from diversifying away from public markets, as many worry they are no longer an ever-green source of returns. Moreover, private markets offer clear benefits for sustainability. You can find out more [here](#).

A few Master Trusts are introducing 'true' private markets allocations. However, progress can be relatively slow as private markets do come with higher fees, which is at odds with fierce competition on costs to win business. For those choosing a Master Trust, we are monitoring developments. For own-trust schemes, the reticence of Master Trusts in this area means you have a clear opportunity to demonstrate value for members in comparison. In fact, our research [here](#) shows that larger own-trust schemes are leading the way when it comes to innovation around sustainable investing and new asset classes.

Looking forwards...

Master Trusts are exploring new ideas but these are largely confined to climate change. For instance, one has influenced the design of its own climate-aware equity index. Others have considered allocations to natural capital, such as forestry or agriculture.

However, sustainability is not just about climate risk. While headlines have been dominated by climate related developments, the DWP's call for evidence on social risks and opportunities plus efforts by the Taskforce for Nature-related Financial Disclosures highlight the broader direction of travel for sustainable investing.

While evidence of forward thinking would be fantastic, we would caution against action without sufficient research. After all, members' livelihoods are at stake. The industry at large has a long way to go. Rest assured, we'll be watching to see if Master Trusts keep up.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:



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