Mercer

welcome to brighter

Investing in the future

European Asset Allocation Insights 2021

Sustainable Investment Survey

Contents

Welcome

Mercer's *European Asset Allocation Insights 2021* provides a comprehensive overview of investment strategy across the UK and European pension industry. It also identifies emerging trends in the behaviour of approximately 850 institutional investors across 12 countries, reflecting total assets of approximately €1 trillion.

Reflecting the growing importance of sustainability within portfolios, we have, for the first time, created a standalone sustainable investment survey.

COVID-19 and sustainability

2020 was a year lacking in precedents. Global economic activity had its largest fall since the Great Depression in the first half of the year but recovered much of it during the second half. The relatively brief crash in March 2020 aside, equity markets returned with a vengeance and posted strong positive returns over 2020, with the MSCI ESG Leaders index returning 5.8%.[1] However, market returns glossed over the dent in the progress to a more sustainable future caused by COVID-19 and the measures to combat it, as an estimated 71 million people joined the ranks of those in extreme poverty and school closures kept 90% of all students out of school.[2]

Sustainable funds gained large net flows over the year, with funds in Europe acquiring an extra €233 billion[3] in new money, almost double the amount in 2019, as investment in sustainability gathered momentum.

Much of the real economy still operates in a business-as-unusual environment, at least to a degree. Financial markets, however, have returned to the "old normal" of stretched valuations, for both equities and bonds. In some cases these are even more stretched than before the COVID-19 shock.

Accompanying reports

This report is accompanied by three sister reports: two on the asset allocation trends within DB and DC plans across the UK and Europe, and a further UK DB de-risking report.

[1] Source: Thomson Reuters Datastream. Total returns in euros (net).
[2] Source: The Sustainable Goals Report 2020. United Nations.
[3] Source: Morningstar.

Key findings

ESG remains the new normal

The vast majority of investors have firmly embedded environment, social and governance (ESG) considerations in their investment process, a trend that has strengthened further during the COVID-19 crisis (page 5).

E to the fore of ESG

When asked to rate the importance of environmental, social and governance considerations, respondents in all countries, except for Ireland, responded that the environment was considered the most important area of focus (page 6).

ESG broadening

Climate change and governance are becoming well trodden areas of fiduciary scrutiny. This year we asked respondents whether they were expanding the scope of their sustainability activities. A significant minority plan to focus more on social issues, other environmental issues (for example, biodiversity), and diversity, equity and inclusion (page 7).

Stewardship across the board

Stewardship is mainly thought of in relationship to equity mandates. However, increasingly it is applied across the board, to both fixed income and alternatives portfolios (page 9).

ESG risks

Figure 1. Does the plan consider ESG risks? (%)

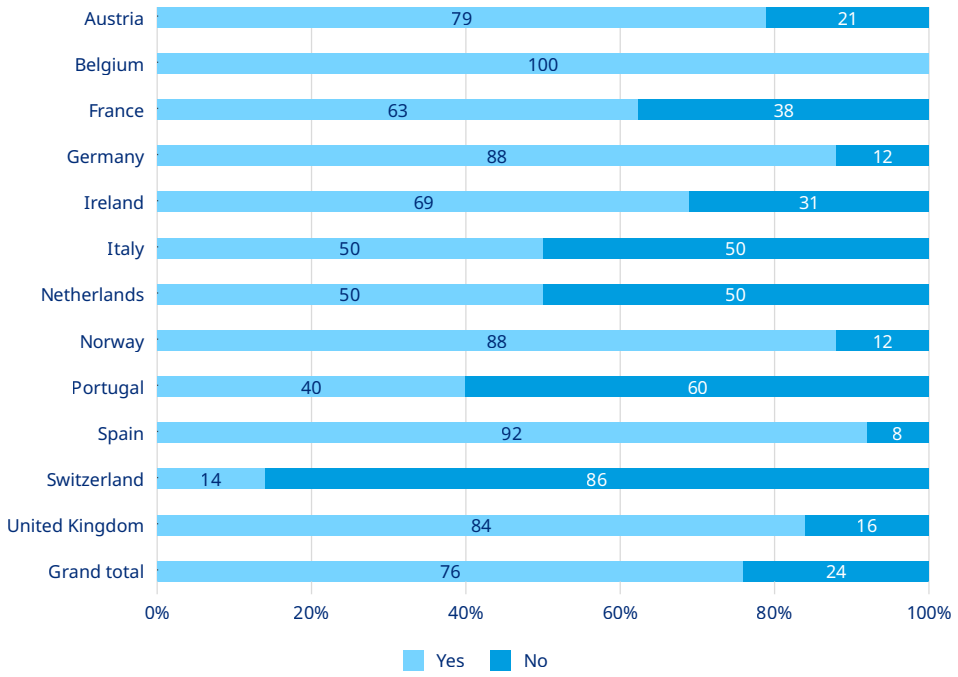
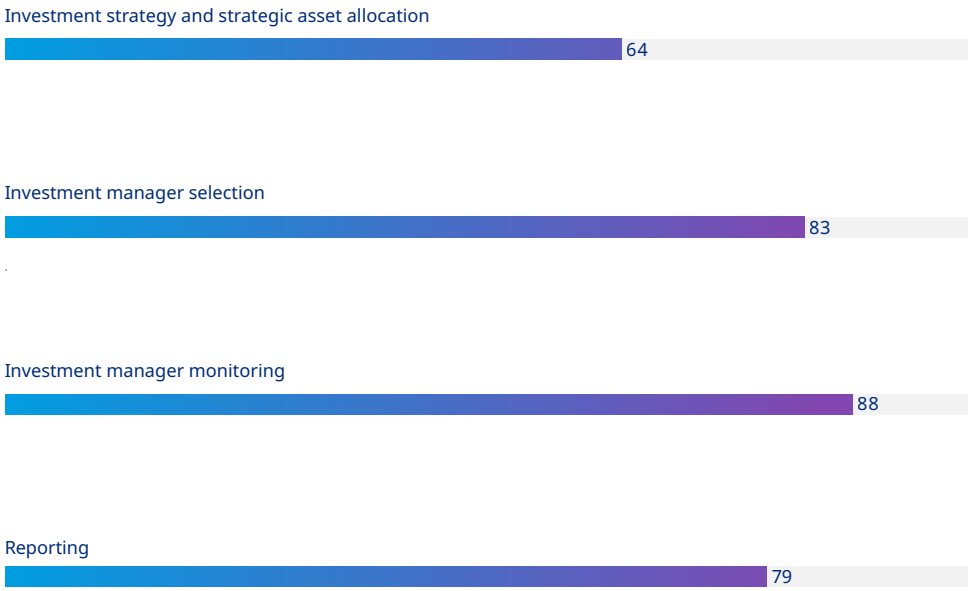


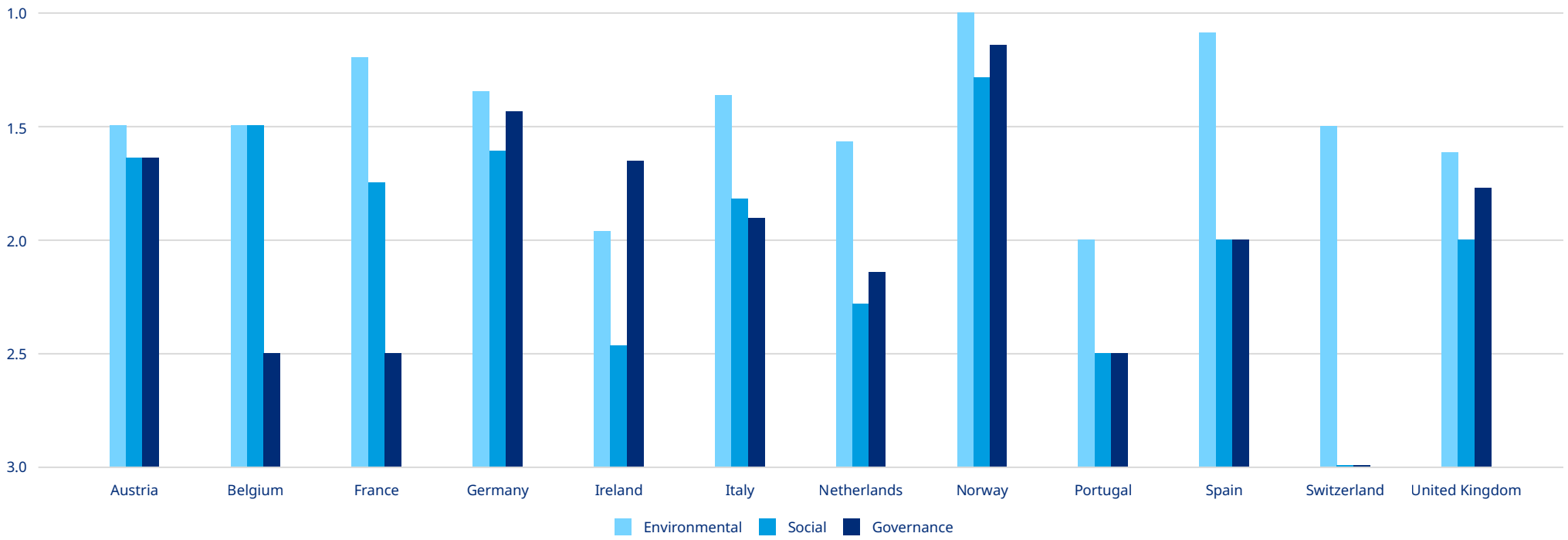
Figure 2. Are ESG issues integrated into your plan? (%)



76% of plans in our survey consider ESG risks. There was considerable variation by country though: whilst Swiss plans in our survey are laggards in terms of considering ESG risks, all of our Belgian participants considered ESG risks in their plans.

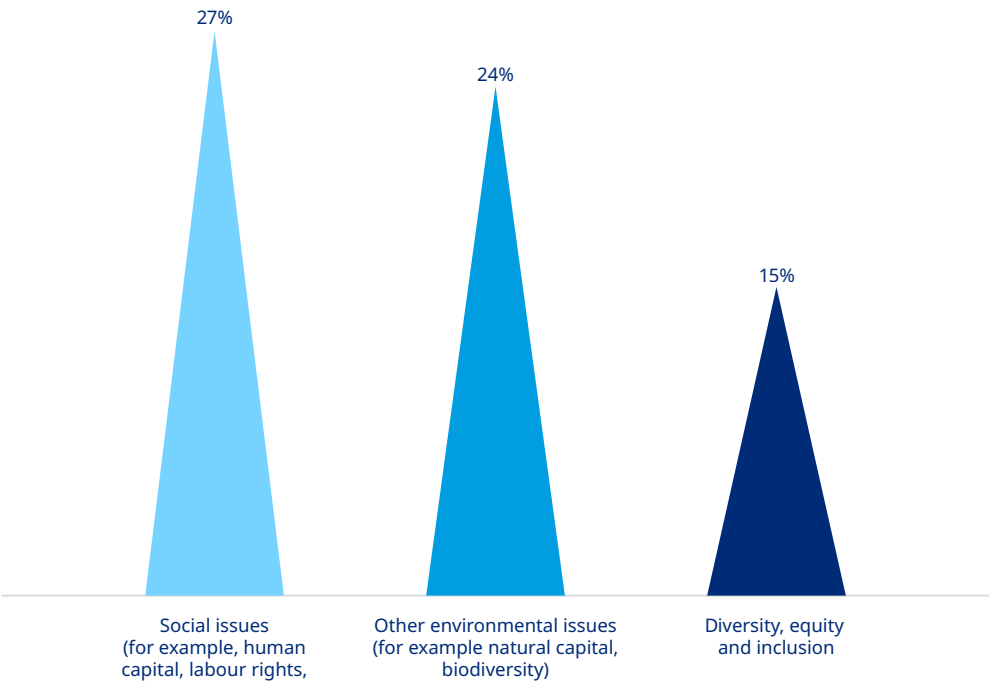
For plans that/which do consider ESG risks, they are integrated across many of the key pillars of the investment arrangements. The majority of these plans factor ESG into investment manager appointment, monitoring and retention.

Figure 3. Please rank in order of emphasis — E vs S vs G



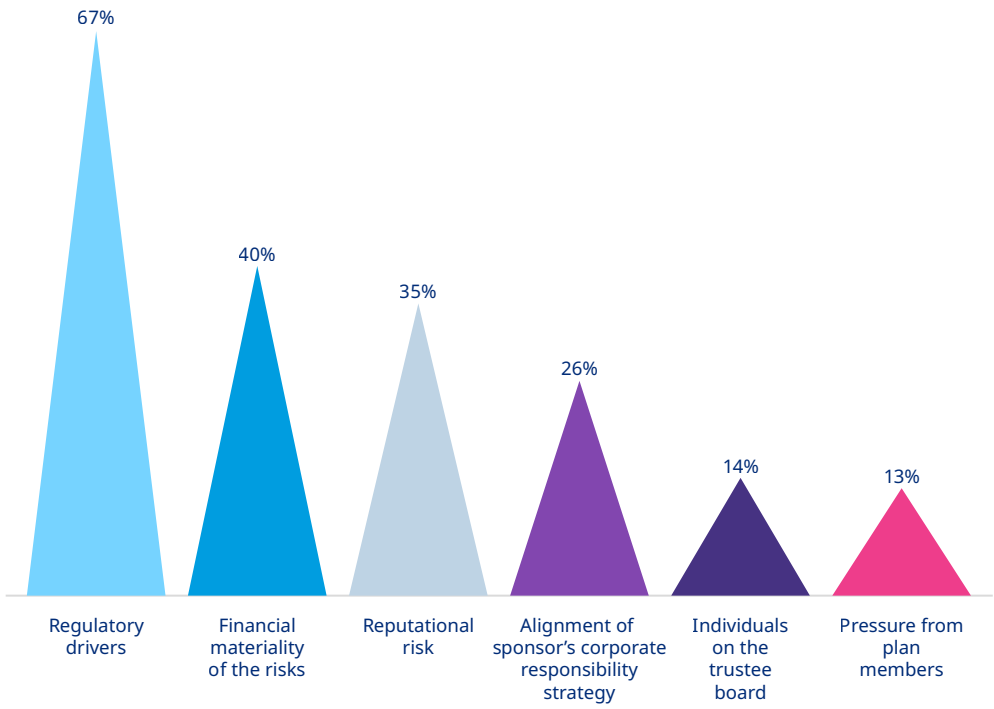
We asked participants to rank the E, S and G elements in order of emphasis, with 1 being the most important and 3 the least. With the exception of Ireland, all countries ranked environmental factors as the most important of the ESG factors. In general, participants put a greater emphasis on social factors over governance, although Ireland was again a notable exception. For some countries (Austria, Germany, Norway and the UK), the emphasis was pretty even across all three factors; in France, the Netherlands, Spain and Switzerland, the environmental factor dominated.

Figure 4. What other areas of ESG do you plan to focus on, in the next year? (%)



Early areas of focus for sustainable investors has been climate change and engagement, but investors are now broadening out into other important areas; social issues, other environmental issues and diversity, equity and inclusion will get more committee focus over the coming year.

Figure 5. In your view, what/who is the key driver behind the consideration of ESG risks? (%)

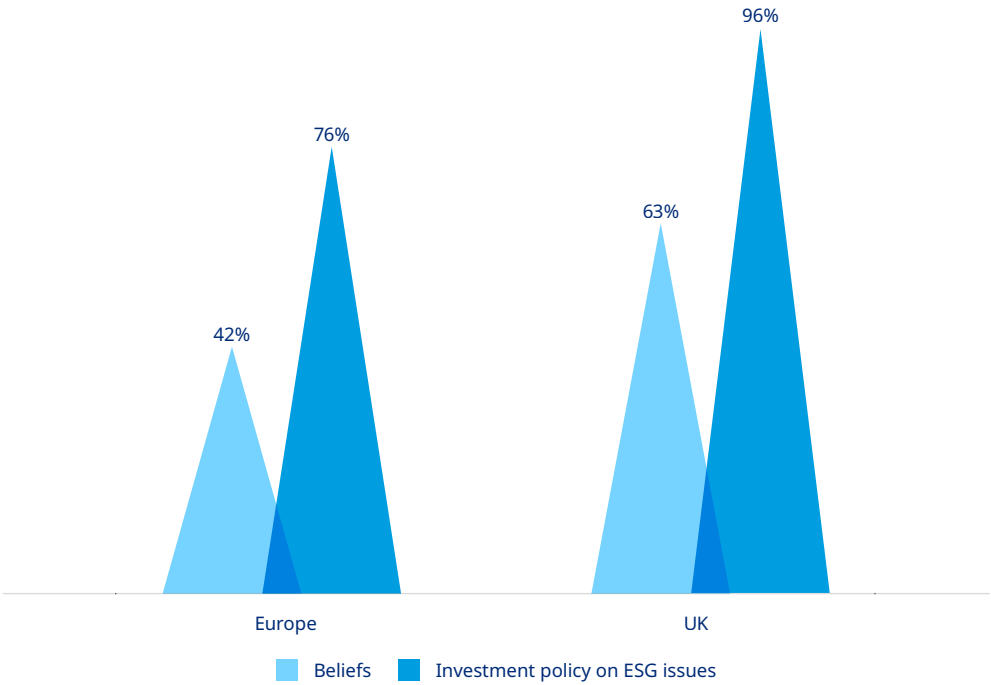


Regulation is driving most plans to consider ESG risks, but this is falling as the most dominant factor (down from 85% last year). As noted in last year's *European Asset Allocation Insights*, real positive change in any space comes when participants realise the value for themselves, rather than it being imposed upon them by regulation. Please note that respondents could pick more than one key driver.

42% of plans in Europe have developed a set of ESG/sustainable investment beliefs, whilst in the UK this is as high as 63%. Nearly all of UK respondents have an investment policy that includes details on how ESG risks are managed. This is unsurprising as UK pension plans are required by law to produce such statements, and most participants in our survey are pension plans. Having said this, the vast majority of European plans also have an investment policy on ESG issues.

One development is on the rise: 14% of the plans that we surveyed have dedicated sustainable investment resource (up from 8% last year), and of those that don't, 17% say they are likely to dedicate resources to sustainable investment this year.

Figure 6. Has the plan developed a set of investment beliefs or policy on ESG? (%)

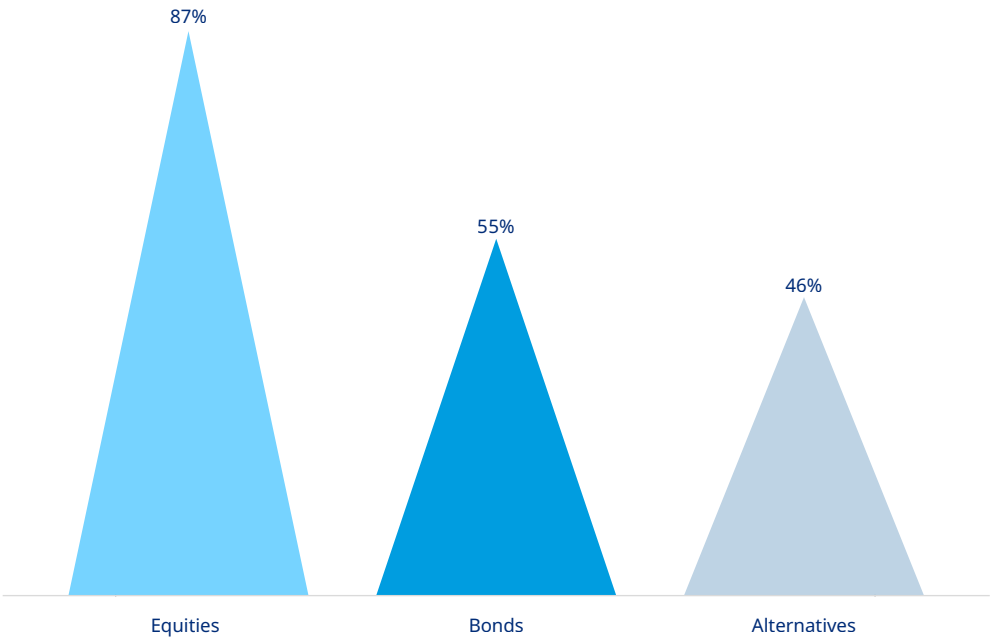


Stewardship

We surveyed plans on their approach to stewardship. Applications have now closed for the first list of signatories for asset managers and asset owners to be part of the UK Stewardship Code 2020. In the UK, 80% of plans expect their managers to be signatories. It is not surprising that the overwhelming majority of plans across the UK and Europe are applying this stewardship to their equity portfolios, but it is good to see that around half are now applying this in alternatives and fixed income.

We also asked participants for their expectations on their voting and engagement over the next year. Over a third of respondents were planning to increase their voting and engagement, with almost everyone else maintaining their commitments.

Figure 7. Which asset classes do you apply the UK Stewardship Code 2020 to? (%)



Climate change and transitioning to net zero

Figure 8. Has the plan considered the investment risks posed by climate change? (%)

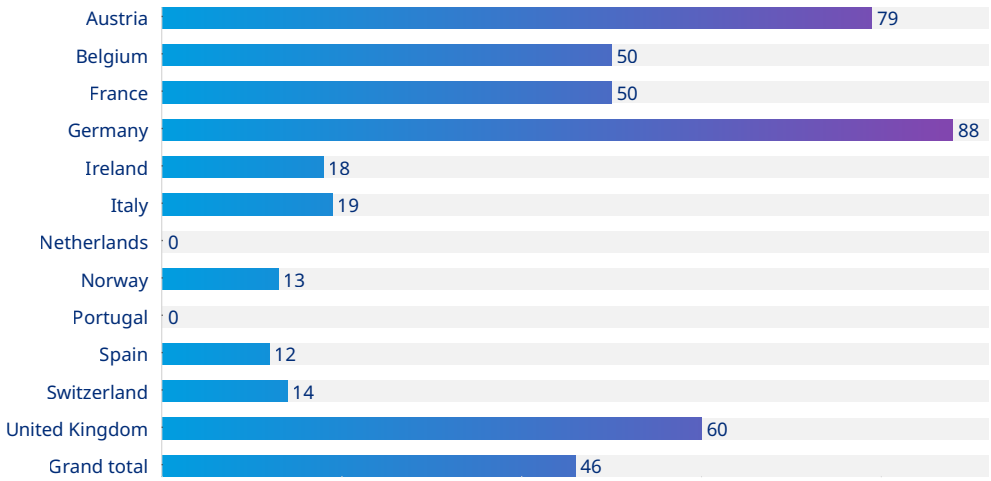
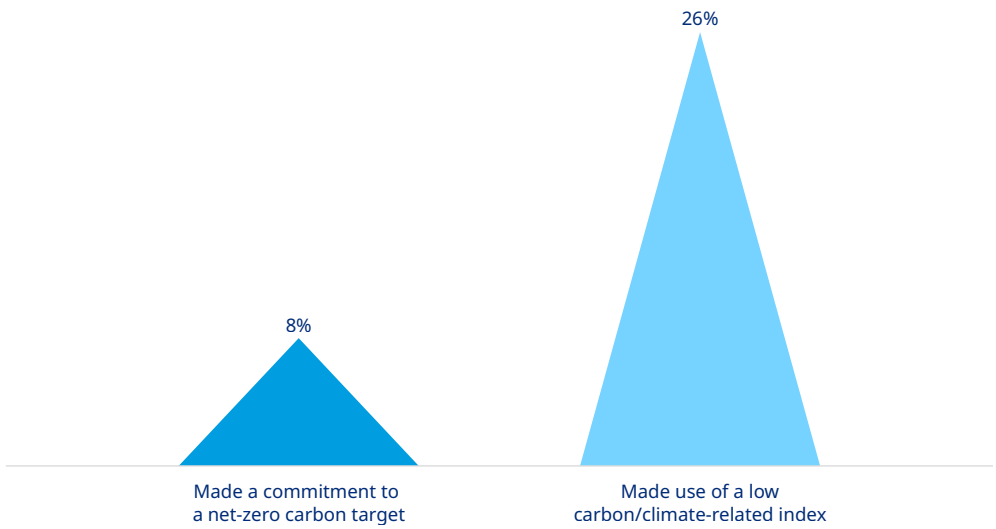


Figure 9. Has the plan made commitments to a net-zero carbon target or made use of a low carbon/climate-related index? (%)



In five of our surveyed countries, more than half of the plans are considering the investment risks posed by climate change. Of the 54% of plans across the UK and Europe who are not currently considering it, 26% plan to do so within the next year.

The UK government has introduced measures for all plans to have mandatory disclosures in line with the TCFD recommendations (starting in 2021 with the largest plans). 60% of UK plans in our survey have considered these TCFD recommendations, and despite the relative lack of regulation across Europe, 25% of plans there have also considered these recommendations.

Given the latest science on the causes of climate change, and the industry focus on transitioning to a net-zero carbon economy, we asked participants about their commitments in this area. Despite just under 8% making a commitment to net-zero carbon targets, we found that 26% of plans make use of low carbon/climate-related indices. We expect institutional investors' commitments in both areas to increase over the forthcoming months and years.

Sustainability-themed and impact investing

Figure 10. What percentage of the plan's assets are aligned with the shift to a low-carbon economy? (%) (Note this question was only for those plans who are aligning at least some assets - those with zero assets aligned are excluded.)

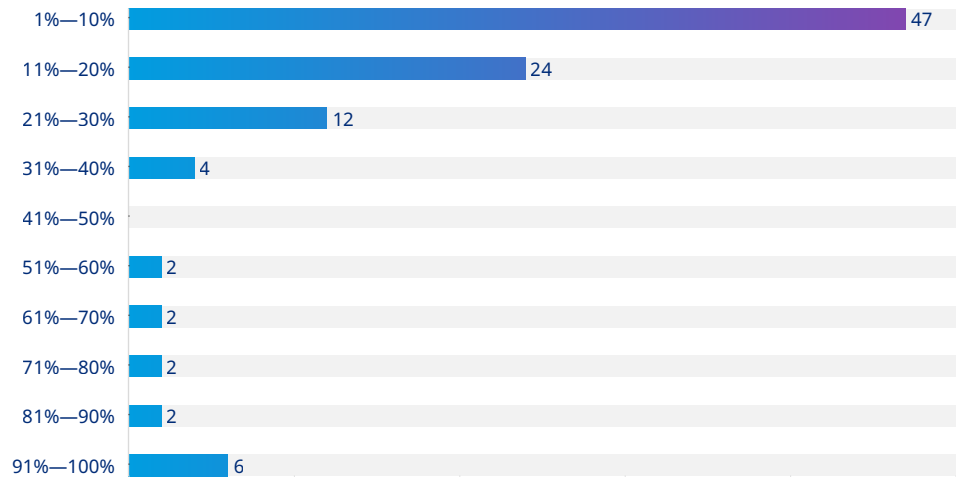
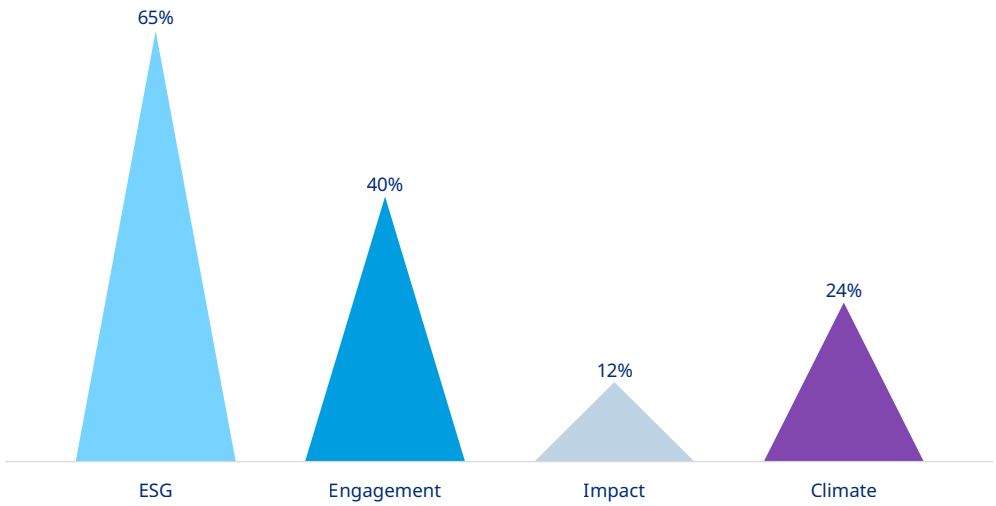


Figure 11. Does the plan report on any of the following investment outcomes? (%)



Institutional investors are increasingly focused on sustainable investing. Of those respondents who are aligning their assets to a low-carbon economy (for instance sustainable equity, sustainable infrastructure, renewable energy), over half have allocated more than 10% to their investments in this way, and almost 14% have allocated more than 50% of their assets to this shift.

Furthermore, 21% of plans have considered impact investing (investing in companies with the intention to generate a positive environmental and social impact alongside a financial return) – this is up from 18% in last year's survey.

The vast majority (81%) of plans who have allocated to impact investments have invested less than 10% of the plan assets in this way: this is clearly relatively embryonic for most plans, but we do anticipate this building over the coming years.

Reporting on ESG is becoming mainstream, and it is encouraging that more and more plans are including specific climate and impact reporting in their analytics.

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