June 2015

Asset owners and responsible investment – reconnecting with the fundamentals

This article was first published as a Foreword to the report on the Responsible Investor Asset Owner Survey, June 2015

An inflection point

The results of the Responsible Investor asset owner survey are intriguing – encouraging and slightly disturbing in equal measure. Let's take the glass half full perspective first. Those who took part in the survey are a self-selecting sample, of course – but commitment to responsible investment (RI) remains strong. About half of those responding expect their RI budget to increase between now and the end of 2016; many expect the influence of RI staff within their organisation to grow; and many funds are planning to step up their 'ESG' oversight of external managers and to increase the incorporation of 'ESG' into investment management agreements.

But for those with a glass-half-empty view of the world, some of the foundations that have been laid appear fragile. Expectations on 'ESG' are far from being perfectly aligned among the various stakeholders: beneficiaries, asset owner (AO) board members, fund executive staff, investment staff, RI staff and external managers. The most frequently reported misalignments are between beneficiaries and investment staff; investment staff and external managers; and RI staff and investment staff. The degree to which RI staff are embedded within their organisations' routine processes remains limited. At about a quarter of the responding funds, RI staff have only an occasional advisory role or no formal role at all in the approval of new investments. Clear evidence on links between 'ESG' and investment performance remains elusive, and manager reporting on 'ESG' is widely considered to be inadequate.

Against this backdrop, two comments in response to the question 'What do you expect will be your biggest challenge in 'ESG' integration between now and end 2016?' stand out:

- 'Less 'ESG' and more real sustainable long-term value creation'
- 'Having an understanding of 'ESG' risks and opportunities from a total portfolio level'.

There is a sense here that for some AOs, despite all the 'ESG' policies, processes, teams and budgets, there is something missing; that although 'ESG' has become relatively highly developed in organisational terms, it is sometimes still marginalised from a fund's 'core business' and core processes. A lot is being done. But have we forgotten why we're doing it?

(Re-)connecting with the fundamentals

There is a growing realisation that what is missing is a clear articulation of how 'ESG' is linked to the fundamental purpose and mission of the organisation; and to its beliefs about how to generate the returns it needs, over the timescales that are relevant to it, in the context of the expectations of its beneficiaries (for a pension fund); a government (for a state pension fund, buffer fund or sovereign wealth fund); customers (e.g. for an insurance company); and other stakeholders.

This incomplete integration of RI with the fundamentals of the institution can give rise to, or exacerbate, the challenges revealed in the survey results. For example, AOs express great frustration with their external managers – e.g. on poor reporting and reluctance to engage meaningfully with their clients' objectives. RI staff at large funds often express similar frustrations with their in-house investment colleagues. Stronger foundations for RI in an AO's vision and purpose, its investment beliefs and its overall strategy will help to alleviate these frictions.

Instead of seeing 'ESG' as a 'thing' to be 'integrated' – an alien concept to be forced into a reluctant and resistant investment process (and organisation) from the outside – we need to turn things around. We should start by asking what the organisation's real objectives are, and what capabilities – knowledge, processes, governance – it needs to achieve them. This will elucidate the relevance of sustainability trends to long-term returns, the AO's relationship with investee companies, its role as a responsible market participant, and its relationship with beneficiaries and the wider world around it. Policies, processes, organisational structures, internal incentives and governance arrangements can then be designed to support the conclusions of this discussion.

A next generation approach

So what are the characteristics of a 'next generation' approach to RI? I suggest that it needs to be embedded within:

- Clear statement of the organisation's purpose, mission and identity
- Well-founded investment beliefs
- Clear objectives and ambition levels
- Consistent processes and appropriate structures to translate investment beliefs and objectives into investment decisions
- Focus on priorities
- Culture and communication – internal and external
- Strong, high-skill governance

This framework is set out in the diagram below. The elements within the framework are in principle relevant to funds of all sizes; the way they are implemented will inevitably vary according to the size of the organisation (in terms of staff and other resources) and the particular priorities it selects. Let's look at each element in more detail.

Organisational purpose, mission and identity
There are numerous dimensions of an AO's purpose and mission, and its sense of its own identity, that may inform its approach to RI. A pension fund may have a particular alignment with its beneficiaries if they all work in a particular sector, or with a corporate sponsor. A fund may believe its purpose includes contributing to the quality of the society and the environment in which its members will spend their retirement. It will be important for the fund to ensure it understands its members' RI expectations. (CalSTRS' Sustainability Survey[1] is an interesting example of how this can be done.) An insurance company's corporate strategy may highlight sustainability or its customers' quality of life. Fiduciary duty and equivalent legal obligations that directly shape investment decision-making will of course be important. Some pension funds are subject to specific legal obligations on RI – as in Denmark, New Zealand and Sweden, for example.

A systematic process to bring these factors and the connections among them to light will help to determine what form an RI programme should take.

[1] http://www.calstrs.com/whats-new/your-input-valuable-please-complete-calstrs-sustainability-survey

Well-founded investment beliefs
Many funds refer to 'ESG' in their investment beliefs. Yet few of these statements are grounded in thorough research, or articulate *why* or *how* the fund believes 'ESG' is linked to investment risk or returns, or the fund's role as an investor or owner. What is the fund's view on sustainability-related megatrends such as climate change, resource scarcity, the demographic transition or technological innovation? How might they affect returns? Are any or all of these factors mispriced by markets? If so, over what timescale and under what circumstances might the mispricing disappear? How does this relate to the fund's investment timescale? What is the fund's role as a long-term owner and a responsible market participant?

AP2 (Sweden)[2], CalPERS (US)[3], PFZW (Netherlands)[4] and Ircantec (France)[5] are among the funds that have recently reviewed or established their investment beliefs and principles, in the context of their broader purpose, identity and values.

Clear objectives and ambition levels
RI objectives are frequently couched in terms such as 'integrating 'ESG' into our investment process', without specifying what this means for areas such as the selection of benchmarks, asset allocation, portfolio construction or stockpicking. It is helpful to clarify, for example, whether the fund views 'ESG' more from the perspective of alpha or beta – or the balance between the two. Is 'ESG' the Higgs boson of the investment process, a particle to be found by subjecting investment decisions to increasingly high levels of energy in manager monitoring (i.e. it's mainly about alpha)? Or do you expect to see 'it' more as a wave rather than a particle, interwoven with other long-term market trends and difficult to isolate from them (i.e. the focus is on beta)? What is the balance between these? Over what timescales does the fund expect to see the influence of either of these views on investment risk or return? What is the fund's approach to engagement and its role as an owner of companies, or to engagement with its external managers and with policymakers? Addressing these questions will enable a fund to set clear expectations for its managers both internally and externally, and will shape the activity and reporting it requires from them.

It is important at this stage to define the organisation's ambition level. Not everyone can be or wants to be a 'leader'. There can be legitimate reasons for pursuing RI activity to a lesser extent than other funds, including resource levels, asset allocation, beneficiary and other stakeholder expectations. However, it will always be important to set an ambition level consciously, to avoid drifting unawares into risk: financial risk in the portfolio, or reputation risk to the organisation.

Consistent processes and appropriate structures to translate investment beliefs and objectives into investment decisions
Adopting the right time horizon is crucial for aligning investment beliefs and objectives with decisions. Longer horizons are likely to make at least some 'ESG' information more valuable in the investment process. Aligning portfolio managers' (PMs) remuneration with the desired time horizons will provide incentives to incorporate information relevant to long-term value creation into research and decisions. The way 'ESG' information is provided to analysts and PMs, and the part played by any specialist RI staff needs to be clearly established. What processes are appropriate? What type of research is needed? What level of 'ESG' knowledge are PMs expected to have? Should RI expertise be centralised in a specialist team or distributed across the investment organisation? What committee structure (if any) will work best? Are there circumstances under which investment decisions should formally have to pass an 'ESG test' – e.g. with a sign-off by specialist staff for new

[2] http://www.ap2.se/Global/Agarrapporter/Corporate%20Governance%20Report%202014_GB.pdf
[3] https://www.calpers.ca.gov/eip-docs/investments/policies/invo-policy-statement/investment-beliefs.pdf
[4] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2449711
[5] http://publi.caissedesdepots.fr/DRS/Ircantec/Guides/CharteISRve/

manager selection decisions or individual investments made internally? What information do senior management and the board require in order to gain assurance that the fund's high-level beliefs and strategy are being applied in practice? How formal should these assurance processes be?

Focus on priorities
The survey results show that AOs are keenly aware of the need to focus resources on the areas where 'ESG' can add the greatest value. A feature of the reviews now being conducted by some funds is a further refinement to identify priority topics that are relevant to investment research and decision-making across asset classes, company engagement and in some cases policy engagement. The most obvious of these is climate change. These efforts can help to unite RI specialists, internal investment staff and external managers around shared objectives. They can also dampen the 'tyranny of the tick-box' – the tendency for RI work to degenerate into the mechanical compilation and deployment of lists of E/S/G issues.

Culture and clear communication – internal and external
Successful implementation of an RI programme requires that all relevant staff in the organisation understand its purpose and objectives, and that these be communicated effectively to external managers, beneficiaries and other relevant stakeholders. The assumption that RI is first and foremost about exclusion and restriction of the investment universe remains strong among some investment professionals, notably in certain markets. Conceiving, designing and implementing a responsible investment programme are not often described explicitly as an exercise in change management. Yet that is what they are; communication is therefore central. Patient, repeated communication of the organisation's fundamental objectives in pursuing RI is essential. This needs to be framed in terms that are recognisable to portfolio managers and analysts, both internal and external – long-term value creation, relevance to understanding economic and social megatrends, mitigating risk, identifying investment opportunities, active ownership etc. This communication is most effective if it is led from the top of the organisation. If senior leaders do not make it clear that RI is an organisational priority, other staff, and outsiders, will draw obvious conclusions. Reporting to beneficiaries and other stakeholders is also important, to strengthen trust and the alignment of expectations that the Survey shows is often weak.

Governance
All the above activities need to be set in a strong and controlled governance framework, with high levels of skills and knowledge on the part of those in governance positions. Asset owner boards need to have a clear view of their organisation's mission and purpose and strong commitment to the investment beliefs and strategy. They need to monitor implementation of the RI programme as part of their regular process; and to review strategy on a regular basis. RI gives rise to many challenges, grey areas and dilemmas. High levels of board awareness and involvement will help to ensure that the fund remains focused on the best long-term interests of its beneficiaries when difficult decisions have to be made (for example in response to calls for fossil fuel or other divestment). All this may require focused training and awareness activities.

Conclusion

The Responsible Investor Asset Owner Survey, and my own experience working with numerous funds, suggest we are at an inflection point in 'ESG' and responsible investment. Policies are in place, systems have been built, wheels are turning. Yet amid continuing commitment, we see frustration that in many cases responsible investment, and 'ESG' issues, remain a specialist niche within asset owner organisations; almost that the organisation knows what it is doing, but has forgotten why it is doing it. The next generation of responsible investment requires a re-connection with asset owners' fundamental purpose and mission, and investment beliefs that incorporate long-term sustainability and responsible market behaviour. Supportive organisational cultures, communication and governance are also needed. All this will provide firmer foundations for AOs' expectations of their managers (internal and external) and should lead to more productive relationships along the investment chain. It will also - lest we forget - help to secure the goals of sustainable long-term financial returns and improved environmental and social quality.

Danyelle Guyatt, Howard Pearce and Simon Wong made very helpful comments on a draft of this article.

rob.lake@roblakeadvisors.co.uk