Asset owners and responsible investment – it's the soft stuff that's hard
April 2016

Engineering

Some asset owners have been working on responsible investment (RI) in one form or another for over ten years – since before we started calling it 'responsible investment' in fact. In the early days we talked about 'corporate governance', 'social, environmental and ethical issues', and 'socially responsible investment'. As the terminology has stabilised, the tools and techniques to hard-wire into investment practice the relevance of sustainability and corporate governance issues to asset owners' long-term objectives have developed and – for some funds at least – matured. We now understand pretty well the 'engineering' that's needed – investment beliefs and strategy, incorporation of environmental, social and governance factors into investment manager selection and monitoring through clauses in mandates and clear communication, etc.

PRI's useful new paper *How Asset Owners Can Drive Responsible Investment* sets this machinery out very clearly. At the same time, it highlights the fact that many of PRI's 306 asset owner signatories have little of this machinery in place. PRI argues that these asset owners 'should', for example, gather their own evidence on how integrating environmental, social and governance (ESG) factors contributes to investment performance; or ensure that their approach to responsible investment is consistent with their wider investment and organisational objectives.

In principle this is good advice – and perhaps asset owners 'should' indeed follow it. But to understand how easy this might be in practice, it is useful to explore some of the characteristics shared by funds that have the most mature RI programmes, and which determine *why* they have reached this point (as distinct from the *how* of the tools and techniques they have developed). For convenience, we can cluster these factors under four interconnected headings: legal obligations; governance; purpose, identity and culture; and leadership.

Legal obligations

In some countries asset owners – and pension funds in particular – are under a legal obligation to take account of sustainability issues. These obligations take different forms – but there is a duty of this kind in (for example) France, the Netherlands, New Zealand, South Africa and Sweden. Clearly a legal obligation will drive behaviour. This behaviour may be minimalist and compliance-orientated, or creative and innovative – depending on various other circumstances, including those discussed below. Asset owners that already have a strong commitment to RI may support the introduction of legislation that reflects what they are already doing. But it would be foolish to expect turkeys to vote for Christmas (i.e. asset owners that do not currently focus strongly on ESG are unlikely to welcome regulation that requires them to do so).

Governance

Some jurisdictions prescribe a formal role for beneficiary representatives in pension fund governance. Examples here are Australia, the Netherlands, France, the UK and some US states. Fund boards may also include government representatives – e.g. state government appointees in the US. An elected public official may even be the sole trustee – as in some US states. While all board members are subject to fiduciary duty (or equivalent), employee or government representatives are likely to be particularly alive to members' and society's values, and concerns beyond just financial returns and retirement incomes. This sensitivity may well be reflected in the fund's policies and investments. Moreover, additional cognitive diversity around the board or investment committee table may also help the fund better to understand the long-term financial relevance of ESG issues, thereby enhancing returns.

Purpose, identity and culture

Every organisation created by human beings has its own distinct sense of purpose, and its own identity and culture. Pension funds and other asset owners are no exception. Purpose, identity and culture are shaped by forces that include history, the expectations of the fund's most important external stakeholders (its members), and the views and values of the organisation's board and employees. Some funds have a particularly strong identity rooted in the constituency they serve – local or national government employees, health sector workers or environmental protection officials, for example. Past reputation shocks – e.g. campaigns challenging particular investments – may make a fund more attentive to responsible investment. The internal culture within which investment professionals work is influenced by these wider factors. This may give rise to innovative investment behaviours – e.g. a greater willingness to seek out investment opportunities that meet financial return requirements while also demonstrating alignment with the fund's identity and its members' values.

Leadership

Leadership is an elusive quality. Yet we recognise it when we see it. In asset owner organisations (like others) it is found both at the top and elsewhere. There are CEOs and CIOs of asset owners in all parts of the world who stand out for their leadership in sustainability and responsible investment. They blend investment acuity; management and organisational skills; and an authenticity that reflects personal commitment and values. They are willing to do more than is strictly necessary; to be publicly visible in support of RI; and to encourage their peers to follow their example. It would be invidious to name examples; but I suspect we can all think of some.

Leadership is found too among responsible investment specialists and portfolio managers who work hard within their organisations to find new ways to integrate sustainability into investment decisions; to pursue engagement that genuinely challenges the status quo and drives forward corporate responses to tough sustainability challenges; and to press for public policy change that supports sustainability and responsible investment. These leaders are often motivated as much by their personal values as by the pursuit of financial value (even if they seldom say so openly).

Reflection

We need to continue to work on the 'hard stuff' – the 'engineering' of responsible investment, in the form of investment beliefs, policies, procedures, internal structures and reporting. This hard stuff can be hard; many asset owners still have a long way to go. But if the hard stuff is hard, the soft stuff is harder. Cultivating organisational purpose, identity and culture, and leadership throughout asset owner organisations that embeds and champions sustainability, is the next frontier for responsible investment – indeed for the investment industry as a whole.

This article first appeared at http://www.top1000funds.com/opinion/2016/04/06/its-the-soft-stuff-thats-hard-with-ri/

Rob Lake

rob.lake@roblakeadvisors.co.uk

Rob Lake

rob.lake@roblakeadvisors.co.uk