Sustainable investments as a priority for pension funds

Fourth Annual Congress IVP – Institute for Pension Education

Roger Urwin
Global Head of Investment Content, Towers Watson

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Evolved thinking among leading pension funds

- Among the world’s leading funds, new issues with governance are materialising:
  - The transformations occurring in the future investment landscape require a stronger grasp of inter-connectedness
  - Applying judgement to how externalities should be made internal to the fund’s goals and models or remain external

- Mission and beliefs clarity on integrating ESG is developing – also see the grid

- Examples include CalPERS beliefs:
  - A long time investment horizon is a responsibility and an advantage
  - Investment decisions may reflect wider stakeholder views, provided they are consistent with fiduciary duty to members and beneficiaries
The big idea – the sustainability challenge

• Asset owners need clarity on their mission reflecting its context with respect to time horizon and stakeholders

• At the same time, asset owners need their worldview perspective on the fast-moving, multi-strand framing of the investment landscape

• These complex and diverse elements are particularly difficult to integrate into a coherent strategy in the sustainability and ESG area because of conflation*
  • Financial factors (like earnings and earning multiples) and extra-financial factors (like carbon footprint and climate attribution) mix objective and subjective data
  • This also mixes values with pure financial considerations, Board decisions with staff decisions, and factors that have accepted track records with factors that don’t
  • Factors that emerge up front (for example current oil prices) or with a lag (like carbon that will take decades to settle) mix time horizons
  • The influence of agency roles – for example asset managers with relative return mandates that don’t align with the asset owner mission

* Conflation (n): The process or result of fusing items into one entity; joining up
The investment value chain

Investment chain

Investors -> Asset Owners -> Asset Managers -> Financial capital Equity & Debt & Derivatives -> Physical, Human, Natural Capital -> Investors' Returns

Wealth chain

Reputational Capital -> Regulation -> Social Capital -> Externalities
Carbon ‘Stranded Assets’

- The beliefs scenario:
  - *Politics* – The political will to contain temperature change to 2°C is captured in a ‘Carbon Budget’ that would allow burning only up to [one-third] of the current known fossil fuel reserves by 2050
  - *Science* – The scientific consensus is that global temperature needs to be kept within a 2°C increase to avoid catastrophic climate changes
  - *Finance* – The remaining fossil fuel reserves become ‘stranded’ and never generate the value corporations and investors currently ascribe to them

- A beliefs conundrum for investors:
  - Invest now with an early mover long-term thesis, using a strategic tilt or targeted divestment and/or engagement in anticipation of adaptive policy, organisational and market-pricing behaviours and pathways
  - Or ignore with a too-uncertain, wait-and-see thesis, and research new developments as they progress that reduce the uncertainty – policy, organisational, market-pricing

- But beliefs interact with values:
  - In building beliefs, can we realistically separate out any values-based preferences?
  - Do investors build their beliefs without thinking about their values?
## Positioning of ‘Top 20 Asset Owners’ on ESG grid

<table>
<thead>
<tr>
<th>B3. Targeted SI Beliefs</th>
<th>6 funds with V2 mission/B3 beliefs</th>
<th>4 funds with carbon policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>- ESG mispricing opportunities</td>
<td>- Engagement/Integrated ESG</td>
<td></td>
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<tr>
<td>- ESG mandates considered</td>
<td>- Exclusionary/Targeted Capital</td>
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<th>B2. Integrated SI Beliefs</th>
<th>10 funds with V2 mission/B2 beliefs</th>
<th>0 funds with carbon policies</th>
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<tr>
<td>- ESG risks need management</td>
<td>- Engagement/Integrated ESG</td>
<td></td>
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<tr>
<td>- Ownership needs management</td>
<td>- Exclusionary/Targeted Capital</td>
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<table>
<thead>
<tr>
<th>B1. Traditional Beliefs</th>
<th>4 funds with V1 mission/B1 beliefs</th>
<th>0 funds with carbon policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>- ESG risks unspecified</td>
<td>- No ESG policies</td>
<td></td>
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<tr>
<td>- Ownership unspecified</td>
<td>0 funds with carbon policies</td>
<td></td>
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<tbody>
<tr>
<td>Mission/Values/Goals</td>
<td>- Goals exclusively financial</td>
<td>- Goals exclusively financial but extra-financial factors considered</td>
<td>- Goals predominantly financial but extra-financial goals added</td>
</tr>
<tr>
<td></td>
<td>- Pure finance driven; non-financial factors not considered</td>
<td>- Considers wider stakeholder extra-financial factors but with no performance downside</td>
<td>- Considers wider stakeholder extra-financial factors but with limited performance downside</td>
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**Source:** Towers Watson Thinking Ahead Institute, published January 2015
Data in public domain October 2014

‘Top 20 Asset Owners’ = largest, well-governed institutional funds
Drawn from global group of 15 pension funds, 4 SWFs, 1 endowment fund; average size $320bn
Carbon stranded assets – what next?

• The pure investment (strategy) case:
  • Weak versions and stronger versions
  • Problems with ongoing policy uncertainty, current pricing uncertainty and pricing pathways

• The wider stakeholder (mission) case:
  • Spectrum from nil to strong
  • But requires great mission clarity and alignment

• The influence of leader funds and universal owners
• Regulation is mildly supportive and may strengthen (Paris?)
• The norms anchoring behaviours will move as transformative issue develop
• The trajectory will follow reflexive (feedback loop) pathways – assets that attract early mover attention will get re-priced
The new reality worldview
New world order + Economic/social reordering + Secular stress disorder

Aging demographics
- Changing balance of workers and retirees; and balance of savers and dis-savers
- Return on capital issues

Resource scarcities
- Carbon impacts
- The energy, food, water nexus
- Regulation of externalities
- Impacts of new technologies

Economic reordering
- Deleveraging, financial repression and weak growth
- Technology positive impacts, demography weak impacts

New world order
- Decentralised power drives increased uncertainty
- Issues of global agreement
- Social capital unleashed

VUCA conditions
- Faster clock-speed and greater interconnectedness
- Volatile, uncertain, complex ambiguous conditions

Social reordering
- Individual autonomy rises
- Consumer power in business/society/environment nexus
- Cities growing in significance

Evolved capitalism
- Increased financialisation
- Deeper, broader markets
- Fiduciary capitalism, touchpoint with society, ESG etc.
Controversial and transformational issues – what next?

- Key controversies will evolve in their impact on responsibility, reputational capital and longer term financial success
- A list of developing issues is here:

<table>
<thead>
<tr>
<th>Controversies and Potential Impacts on Responsibility/ Reputation</th>
<th>2005</th>
<th>2015</th>
<th>2020</th>
</tr>
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<tbody>
<tr>
<td>Carbon</td>
<td>Nil</td>
<td>Moderate</td>
<td>Large</td>
</tr>
<tr>
<td>Water</td>
<td>Nil</td>
<td>Small</td>
<td>Moderate</td>
</tr>
<tr>
<td>Supply chain/Agriculture</td>
<td>Nil</td>
<td>Small</td>
<td>Moderate</td>
</tr>
<tr>
<td>Tobacco/Armaments</td>
<td>Small</td>
<td>Small</td>
<td>Small</td>
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Assets stranded in the longer term by the unsustainability of exponential growth

- In the more distant future, the stranded assets scenario is likely to deepen
- Continuing the pursuit of exponential growth of financial capital by drawing down both social and natural capital is unsustainable
- The aggregate stock of financial capital will at some point need to pass through an inflection point to declining rates of growth, producing more stranding:
  - A declining aggregate rate of return on invested capital
  - A systematic financial asset devaluation
- The associated systemic moves to attempt to correct imbalances should include:
  - Large-scale voluntary or policy-induced reinvestment of profits by the corporate sector into natural and social capital
  - Influences through the asset owners and asset managers to adopt strategies that manage natural and social capital outputs
  - Increased private philanthropy to recycle financial capital back into social and natural capital
- The implications for asset owners, particularly universal owners, are significant
All organisations – asset owners, asset managers and corporations – have sustainability responsibilities

<table>
<thead>
<tr>
<th>Sustainability of the organisation</th>
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<tbody>
<tr>
<td><strong>Culture</strong></td>
</tr>
<tr>
<td>Culture and leadership secure the longer-term survival and growth of</td>
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<tr>
<td>corporate entities</td>
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<tr>
<td><strong>Prosocial mission</strong></td>
</tr>
<tr>
<td>Assuming wider responsibility and some prosocial commitment</td>
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<tr>
<td><strong>Environmental respect</strong></td>
</tr>
<tr>
<td>Assuming some environmental responsibility for the natural capital they</td>
</tr>
<tr>
<td>draw upon</td>
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<tr>
<td><strong>Human capital</strong></td>
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<tr>
<td>Assuming some responsibility for the human capital they draw upon, by</td>
</tr>
<tr>
<td>giving individuals respect and contributing to their personal</td>
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<tr>
<td>development</td>
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<tr>
<td><strong>Fairness in compensation</strong></td>
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<tr>
<td>Respect for individual contributions; consideration of the issue of</td>
</tr>
<tr>
<td>inequality; top earner to average earner ratio, etc.</td>
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<tr>
<td><strong>Operating fairness in diversity</strong></td>
</tr>
<tr>
<td>Contributions as individuals are mixed with diversity factors, reflecting both fairness (values) and financial outcomes (financial beliefs)</td>
</tr>
<tr>
<td><strong>Operating fairness in work-life balance</strong></td>
</tr>
<tr>
<td>Individuals are pressured in their corporate life causing balance</td>
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<tr>
<td>issues</td>
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Universal owners will play a part

- Defined by:
  - **Inter-generational fairness**
    Goal of securing fair outcomes for all stakeholders over time
    - Outcomes are financial and extra-financial
    - By another name, inclusive finance
  - **Inter-connected long-term framework and strategy**
    Framework and strategy that integrates long-term extra-financial opportunities
    - Opportunities are in asset allocation and ownership – financial and extra-financial
    - By another name, integrated finance
  - These asset owners will become more influential over time
  - Notable examples
    - ABP, PGGM, GPFG-Norway, CalPERS
References

• Bigger Boat | Towers Watson | 2012
• Universal Owners | Urwin | Rotman | 2011

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<th>Roger assumed the new post of Global Head of Investment Content at Towers Watson in July 2008 after acting as the Global Head of the investment practice from 1995 to 2008.</th>
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<tr>
<td><a href="mailto:roger.urwin@towerswatson.com">roger.urwin@towerswatson.com</a></td>
<td>Roger joined Watson Wyatt in 1989 to start the firm's investment consulting practice and under his leadership the practice grew to a global team of over 600. His prior career involved heading the Mercer investment practice and leading the business development and quantitative investment functions at Gartmore Investment Management.</td>
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<tr>
<td>Global Head of Investment Content, Towers Watson</td>
<td>Roger’s current role includes work for some of the firm’s major investment clients both in the UK and internationally. He leads the firm’s work on transformational change and has conducted major strategic reviews at a number of global leading funds.</td>
</tr>
<tr>
<td><img src="image" alt="Roger Urwin" /></td>
<td>His investment innovations include a number of global firsts: including the target fund/lifecycle framework (in 1988), the risk budget approach (in 1998) and the governance budget framework for assessing asset owner organisational effectiveness (in 2007). He is also the author of a number of papers on asset allocation policy, manager selection and governance and sustainability. He is also Advisory Director to MSCI Inc and also on the CFA Future of Finance Council and a former Board member of the CFA Institute.</td>
</tr>
<tr>
<td></td>
<td>Roger has a degree in Mathematics from Oxford University and a Masters in Applied Statistics also from Oxford. He qualified as a Fellow of the Institute of Actuaries in 1983. He is a Fellow of the Society of Investment Professionals.</td>
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