Thinking Ahead Institute Sustainability Summit 2020
Background reading

Thinking Ahead Institute
Willis Towers Watson

Overview

1. Skills gap
2. Data gap
3. Collaboration gap
4. Purpose gap
5. Industry roadmap

6. TAI's 2020 sustainability working groups | overview

The gaps that need closing

1. Skills gap

- Sustainable investing is missing a key building block/ thought partner. The recognition of impact alongside risk and return is limited
- ➢ **Investment theory and practice should integrate system-level thinking on top of traditional investment thinking**
- ESG knowledge and practical know-how is horribly uneven
- ➢ **ESG knowledge and skills should be developed to a critical threshold across the industry for all professionals**

2. Data gap

- Data is a legacy and co-ordination problem
- ➢ **ESG data practices should be able to support more substantial decision-useful application via improved data governance**

3. Collaboration gap

- Our industry is not joined-up and too siloed
- ➢ **Strengthened collaborations within and across organisations should be able to drive engagement and combinatorial power**

4. Purpose gap

- Purposeful and enlightened self-interest propositions are weak
- ➢ **Positive ethics and values should be martialled into purposeful organisational culture. Investment organisations should embrace the stakeholder model**
- Innovation in sustainability is slow and narrow
- ➢ **Industry commitment to innovation in sustainability needs to be far greater.**
- ➢ **Investment organisations need to be more collaborative and agile**

1. Skills gap

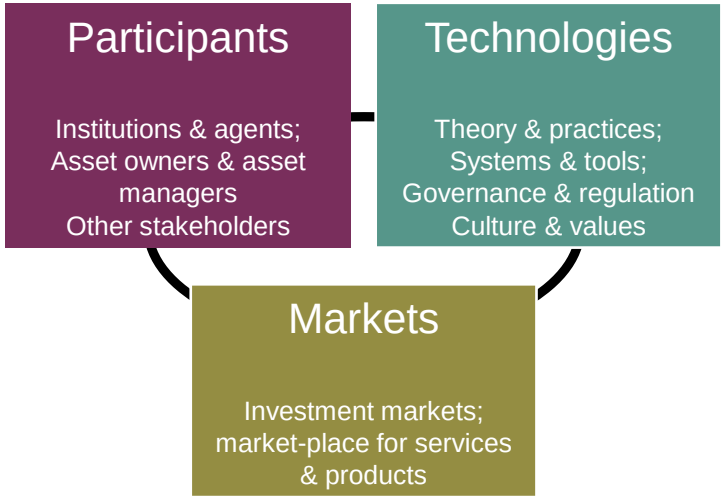
The skills gap has two main contributors:

1. a weak grasp of (a) systems theory with (b) underdeveloped recognition of impact alongside risk and return
2. a low level of ESG knowledge in parts of our industry

The investment industry defined as an ecosystem

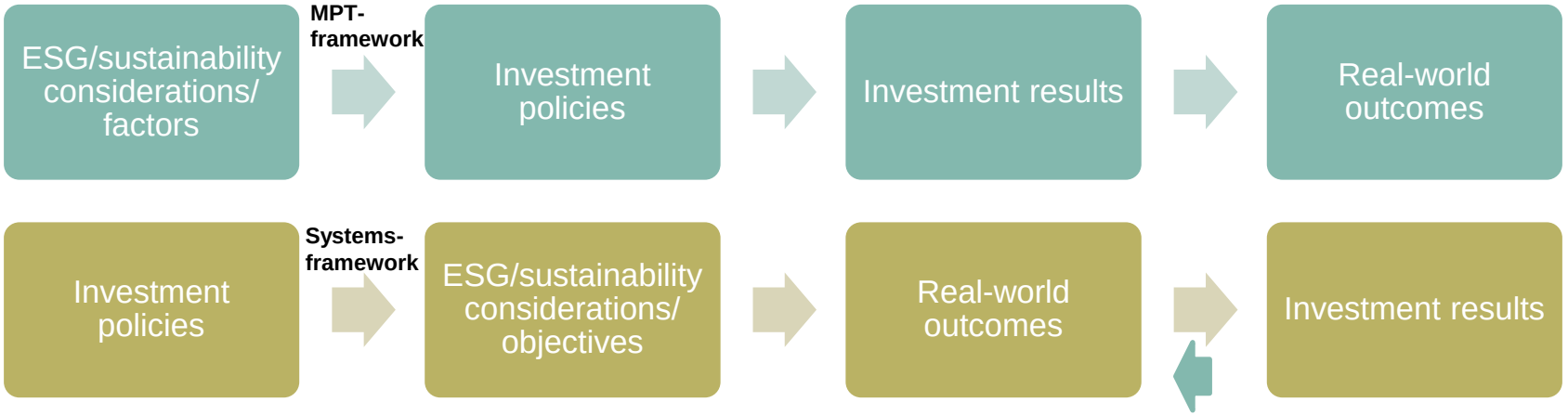
Investment-specific system features:

1. **Multiplicity:** multiple strands – participants, technologies, markets
2. **Reflexivity:** markets affect and are affected by participants and technologies
3. **Subjectivity:** no universal ‘truths’, only ‘beliefs’
4. **Theory**: critical to technologies and efficient delivery of the institution’s goals



The move to a systems-framework for investing

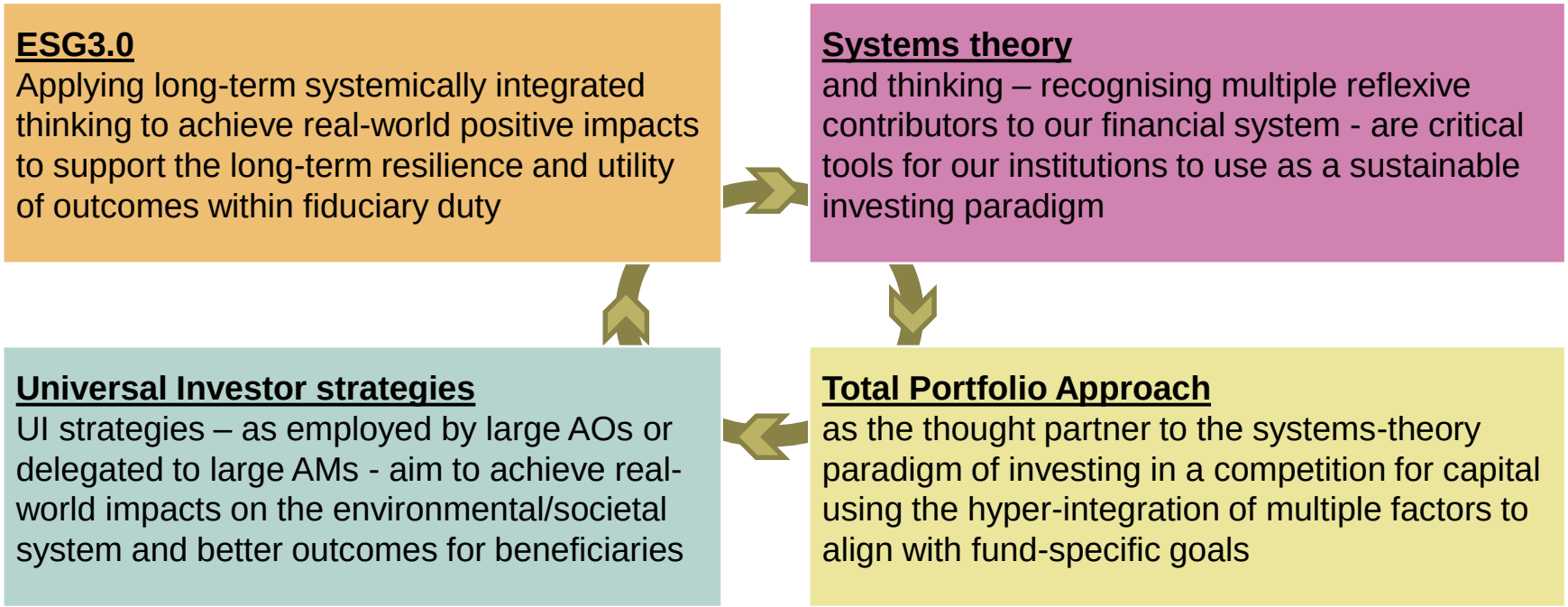
- Best practices in sustainability have involved an MPT chain of thinking from sustainability factors to investment policies and onto investment results with a weak reference to real-world outcomes.
- The next step is for some funds to adopt a systems theory chain of thinking starting with investment policies that work directly on the sustainability of the system and its impacts on real-world outcomes, which then links through to investment results.
- System focus includes both financial market issues (eg agency issues, fiduciary duty interpretation) and economy/society-wide issues (eg climate change, and wealth inequality) due to their ability to impact market risk and return.



Source: TAI's 2020 sustainability working groups

A paradigm shift to ESG3.0

Investors more holistically targeting real-world impact to pursue better financial outcomes through enlightened self-interest



ESG1.0 – the SRI movement to 2005 | ESG2.0 – the PRI 2006-2020 | ESG3.0 – sustainability from 2020 with impact alongside risk and return

Source: TAI's 2020 sustainability working groups

Systems-theory narrative applied to our capitalist paradigm

Everything connects, behaviours matter, lattices and loops not lines

1. Reductionism and systems	The prevailing wish to reduce investment into a science has not worked well given how significant behavioural and other aspects are in reality. The need for T-shaped people and teams – capability to reconcile deep-level knowledge and understanding in one context, field or organisation with a wide perspective across many contexts, fields and organisations by employing deeper thinking and deploying wider networks
2. Loops – reinforcing and dampening	In the investment ecosystem system, the reinforcing, imbalancing forces need checks, the dampening, balancing forces are critical, there is reflexivity in two-way feedback loops
3. Loops can produce imbalanced system dynamics	*'A succession of regulatory and legal changes that has steadily bolstered corporate influence over politics and has shifted capitalism towards today's dominant corporatism'.*
4. Incomplete markets	*'In a world of very incomplete markets, the social and ecological fabric simply cannot withstand the increasingly significant maximization of such narrowly constituted profit'.*
5. In between-ness or collaborative synergy	*The persistence of unmet stakeholder needs is rooted in the relationship between corporations and government (and, indeed, between all human institutions).* *There is a need to commit to releasing government from corporate influence to begin to restore society's capacity to address social and environmental problems with public policies that are a better match for the scale and nature of those problems than piecemeal corporate initiatives*

Source & recommended reading: Duncan Austin | Milton Friedman's hazardous feedback loop
https://www.responsible-investor.com/articles/duncan-austin-milton-friedman-s-destabilising-feedback-loop

Ecosystem structural gap

- The goal we (societal 'we') want from the ecosystem is to deliver on the world's business plan = SDGs
- The part we (investment industry 'we') should want to play should be commensurate to a fair share defined by our capacity to contribute and our moral incentive to contribute

- The **ecosystem structural gap** is where the physical and social 'technologies' in the system = resourcing/infrastructure (people, process and information) and incentives/motivations (values, purpose and culture) are not sufficient to accomplish the goal that the system participants might reasonably want to fulfil.
  Technologies = ways and means of accomplishing the goal
  where means to an end = a thing that is not valued or important in itself but is useful in achieving an aim

- The investment industry/ investors part in this is as a contributor mediated by their capacity to deliver to the goal
- Its ability to do so will depend on the sufficiency/adequacies of certain enablers in:

  - Infrastructure and resources; people (and organisations), process (theory and governance) and information (data, software, AI) and its functioning via industry structure, organisational footprint, value chain and collaborations; including markets, governments
  - Incentives and motivations: intrinsic and extrinsic motivations; values, culture and purpose given regulatory and social license factors; limits of knowledge; public goods and the use of the commons

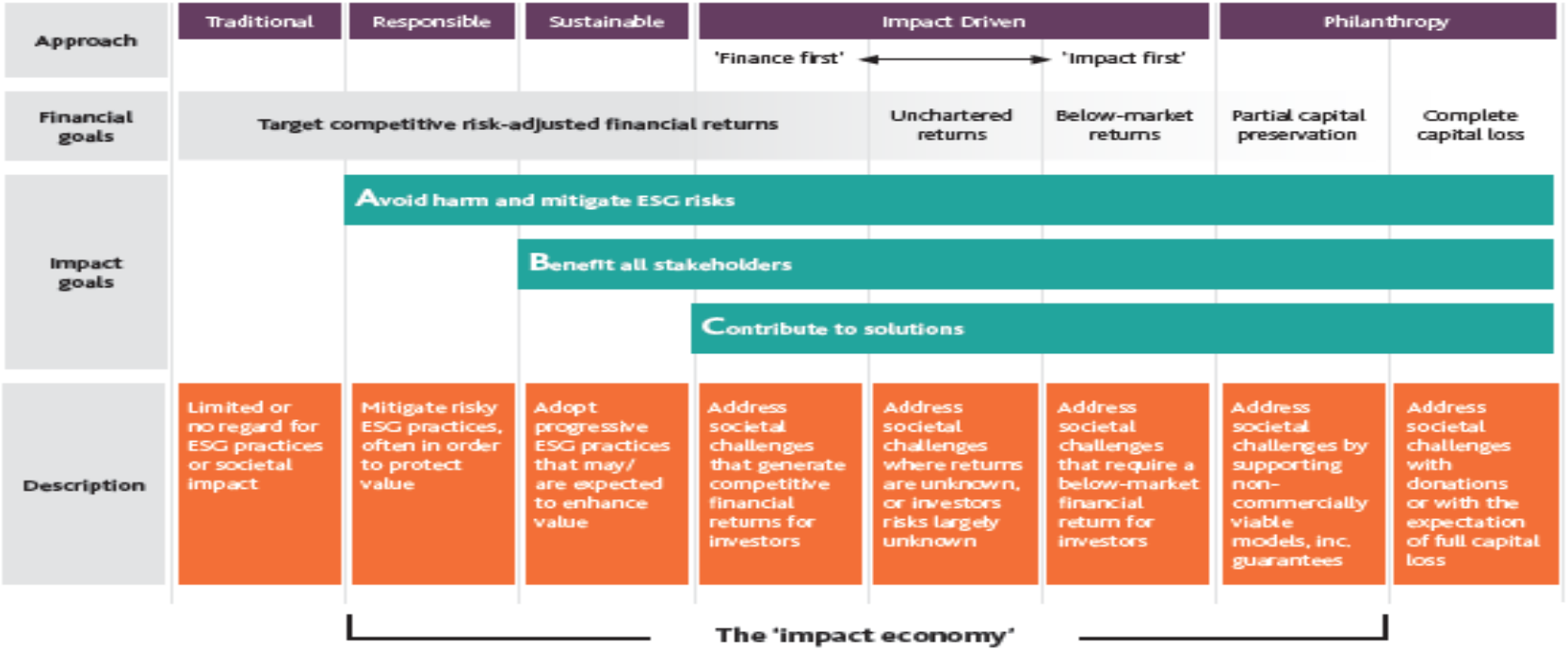
- But there are real practical issues with this in terms of aspirations running ahead of realities because of blame culture dominating a collaborative culture; and a failure to connect dots

Source: TAI's 2020 sustainability working groups

Impact Management Project

The Spectrum of Capital

Choices and strategies for investors on the 'spectrum of capital'



Source: Bridges Impact+ and the Impact Management Project.

Fiduciary responsibilities govern the system's motivations

- **The fiduciary duty window as the** reasonable interpretation of the investment policies acceptable on the spectrum of: short-term finance versus sustainable long-term value creation; and member financial interest versus wider stakeholder interest
- **Modern fiduciary duties** (source PRI)

1. Incorporate financially material ESG factors into investment decision making, consistent with the timeframe of the obligation.

2. Understand and incorporate into decision making the sustainability preferences of beneficiaries/clients, *regardless of whether these preferences are financially material*. [Our emphasis]

3. Be active owners, encouraging high standards of ESG performance in the companies or other entities in which they are invested.

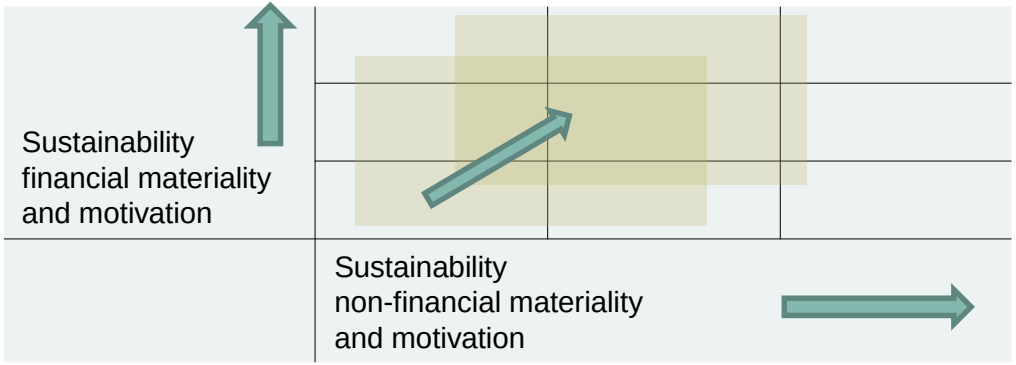
4. *Support the stability and resilience of the financial system*. [Our emphasis]

5. Disclose their investment approach in a clear and understandable manner, including how preferences are incorporated into the scheme's investment approach .

Note: The emphases sections are modern interpretations of fiduciary duties. PRI gives their justification in the context of global factors

Source: TAI's 2020 sustainability working groups

Factors in the movement of the fiduciary window

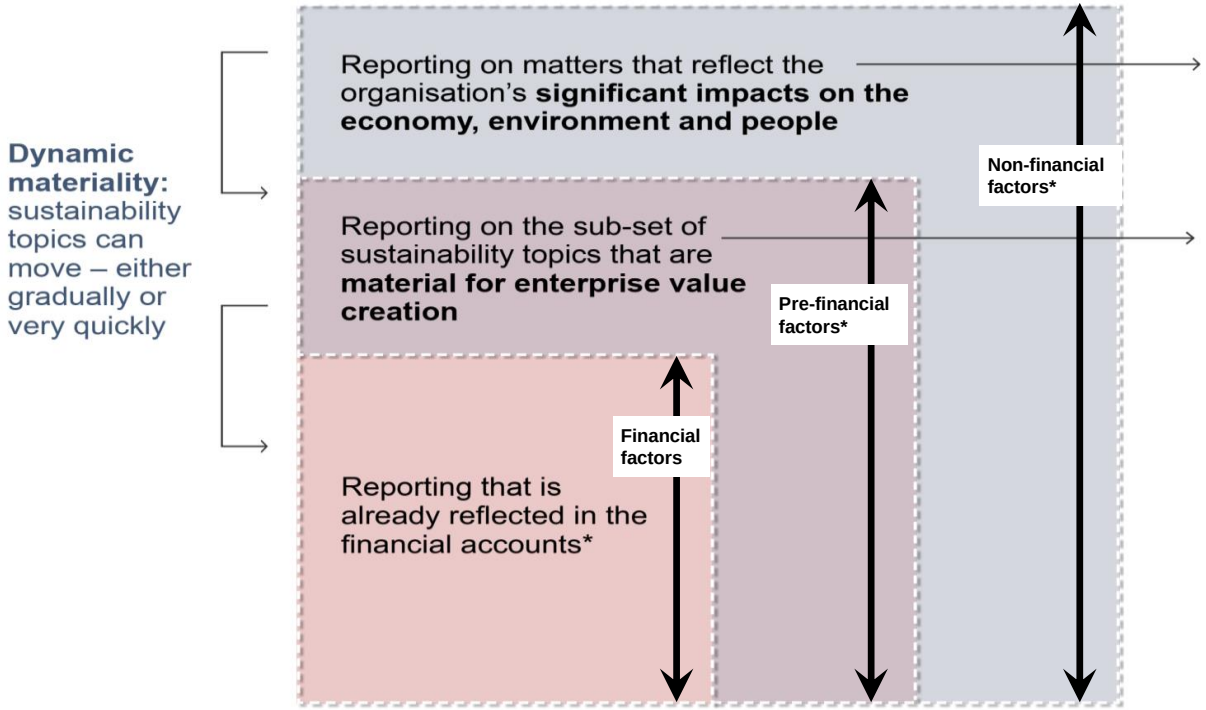


Actor	Factor	Weighting in the past	Weighting in the future
Investment industry	Industry theory and practice	1st	+
	Empirical evidence	2nd	0
State	Legislation and regulation	3rd	+
Corporation	Corporate reporting and alignment	4th	+
People	Beneficiary views	5th	++
	Activism	6th	++

Source: Future Fund and Willis Towers Watson 2017 Asset Owner Study

System issues with 'dynamic materiality'

World Economic Forum/ Big 4 paper: Toward common metrics and consistent reporting of sustainable value creation



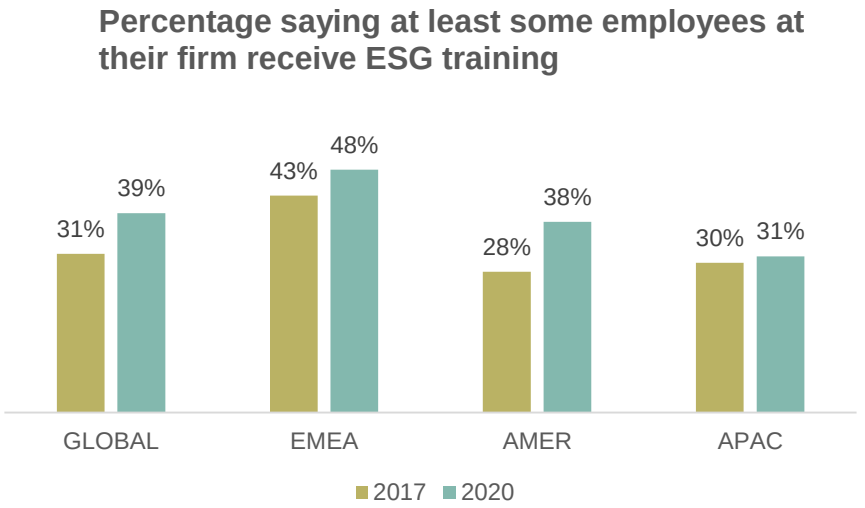
TAI Notes

- Non-financial factors are material to the achievement of non-financial objectives in real-world impacts but may also contribute to financial objectives over time
- Pre-financial factors are material to non-financial and (longer-term) financial objectives
- Together pre-and non-financial factors represent 'double materiality' and connect in a dynamic form (issues that are material from a societal perspective can become material from an enterprise or traditional perspective, either slowly or rapidly)
- Real-world impacts are impacts on society, the environment and the economy

ESG talent shortage in our industry

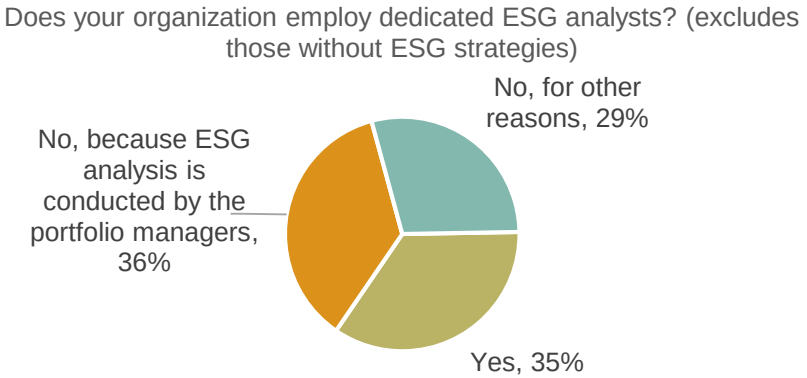
The future of sustainable investing: from ideas to reality – CFA Institute

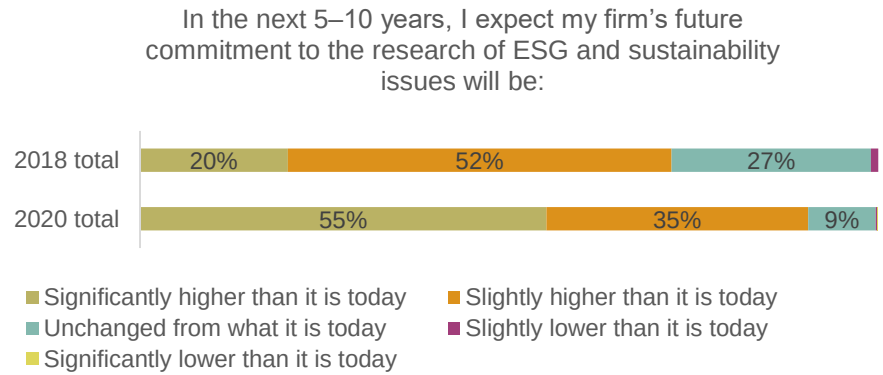
- ESG knowledge and practical know-how is very uneven
- Different skills set – a combination of technical skills, soft skills and T-shaped skills
  - Able to negotiate and convince others of the importance of ESG issues
  - Have confidence to ask tough questions to get decision-useful information, ability to analyse the softer issues (culture, integrity and attitude toward risk)
  - Can handle large amount of ESG data and distinguish the right types of metrics to use
  - Able to combine deep-level knowledge with wider connections, understanding and perspectives across the whole organisation
- The number of ESG specialist is small on a AUM-weighted basis
- Organisations to provide training to build ESG expertise (and hire new resources as needed)



Source: CFA - The future of sustainable investing: from ideas to reality

ESG training and skills supply and demand





ESG Expertise Supply and Demand
(source: LinkedIn Talent Insights)

Job title family	LinkedIn profiles	% with expertise	Expertise growth (1 yr)	% of postings seeking expertise
Portfolio Manager	146,000	1.5%	32%	18%
Chief Investment Officer	15,000	2.0%	18%	10%
Financial Advisor	630,000	0.5%	32%	5%
Analyst	180,000	0.7%	34%	2%
Chief Executive Officer	37,000	1.9%	12%	0%
Total	**1,008,000**	**0.7%**	**26%**	**6%**

Source: CFA - The future of sustainable investing: from ideas to reality

Competencies and talent model

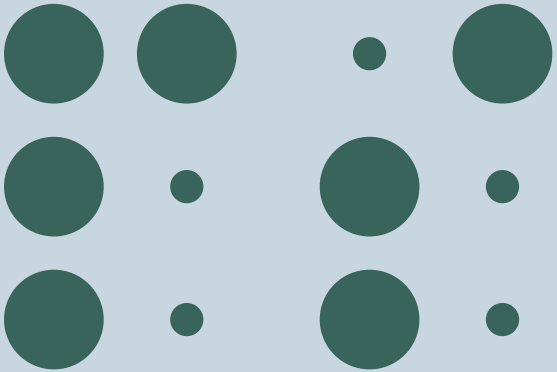
What *competencies and talent model* are needed for stewardship/active ownership/engagement roles?

- PRI describes the engagement value proposition model between companies and investors in three parts:
- (a) communicative dynamics – engagement enables the exchange of information between corporations and investors creating 'communicative value';
- (b) learning dynamics – engagement helps to produce and diffuse new ESG knowledge amongst companies and investors, creating 'learning value';
- and (c) political dynamics – engagement facilitates diverse internal and external relationships for companies and investors, creating 'political value'

- The experience and competencies sought to provide these propositions come from diverse functional experiences – including but not limited to risk, audit, human capital, finance, legal and investments
- The competencies model for the stewardship role is not clearly described in public sources and has limited recognition in asset management taxonomy of roles – see CFA for example. This is because the role is still relatively unusual, by our conservative estimates we believe well below 1% of investment professionals are stewardship/corporate governance specialists
- The metrics for stewardship success tend to be focused on activity and do not align to the precepts of: consistency with purpose, effectiveness of actions, progress with outcomes versus goals. This makes assessments of individuals and groups much harder

Source: TAI's 2020 sustainability working groups

2. Data gap



There are multiple issues to address to solve the data gap:

Legacy problems	Insourcing/outsourcing
Costs	Soft data
Talent	Culture
Governance	
Reporting and transparency	

Technology notes

Goal

- We can characterise the technology and data challenge generally for investment firms as creating a technology system (data and knowledge management platform and infrastructure) that aims to process and channel relevant high-quality information adaptably, cheaply, and efficiently into the investment process, with security and resilience
- We can position the range of <Data –Information – Knowledge --Insight – Wisdom> to represent the meta-cognition spectrum to cover intellectual capital

Structure

- Data and information sits alongside people and process as the key resources used by investment organisations as enabled by culture and governance as reflected by values and incentives.
- Data is positioned in insourced or outsourced models influencing the accessibility and assurances attaching to data

Data assurance

- Most data quality will be gauged through a combination of materiality and validity which will reflect soft and hard and other considerations. The costs and benefits of data quality need to be assessed on joined–up terms by adopting a complete picture on data quality, thinking about it in terms of fundamental organizational resources and incentives in the context of all stakeholders and the value chain
- Full data assurance will reflect legacy, model, costs, culture, competencies, governance

Source: TAI's 2020 sustainability working groups

Data problems

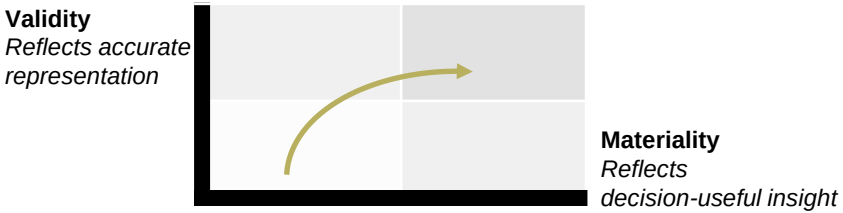
- **Data assurance issues**
- Legacy – systems are not that adaptable; there are zombie issues, there are resilience issues
- Model – insourcing/outsourcing of data; who has the data; how self-service the use of the data is
- Costs – IT spends are uneven; and value is hard to gauge; insourced/outsourced spending is thought of differently
- Culture – communication, co-operation; incentives are not joined-up; goals are different
- Talent – IT specialists; and generalists that oversee technology; language and understanding; T-shapedness
- Governance – collaboration; project design in big change areas, agile design issues, management of innovation

- **Success**
- The ultimate test of quality in data and technology will be related to the quality of decision-useful information generated (about investment-relevant questions) and the connected insights, judgements, processes, heuristics and algorithms that can be applied to it
- The quality of data is substantially about materiality and validity, conditional on availability and latency
  - Materiality is the degree to which the target form of a measure provides decision-useful insight about investment-relevant questions.
  - Validity is the degree to which the actual form of a measure provides an accurate representation of the target measure in question, where validity is reduced by subjectivity and various problems of accuracy, timeliness, granularity and transparency.

Source: TAI's 2020 sustainability working groups

Materiality and validity; and soft data versus hard data

- There is considerable soft data in ESG areas that is strong on materiality but has validity issues. Some of that validity reflects the limited observability of soft concepts, some of it reflects the nature of the system in being gameable
- Soft data is data that is subjective and hard to measure and express, contrasting with hard data that is the objective traditional form and the opposite of this. Soft data generally comes from assessment, opinion, experience or interpretation or through modelling and proxying.
- Most data quality will be gauged through a combination of **materiality and validity**.



- For example: diversity data is material for identifying good corporate culture and effective decision-making but data on racial background can only be estimated, and diversity practice is only captured by engagements survey that are subjective in being opinion-based
- Three data principles which we should carry forward into the reporting and accountability model
- **Report on data quality**. By scoring materiality and validity as part of a joined-up view of data provenance
- **Judge data in context**. Most data users evaluate benefits of a given level of data quality too narrowly - they often over-emphasise the simple facets of data quality like objectivity and accuracy; and they do not usually sufficiently consider the full data quality, in terms of the materiality and the natural scarcity of good quality data in complex systems where simple causality is not present.
- **Handle soft data 'softly'**. If soft data is made a hard target you will have gaming and other governance difficulties. Instead use reference targets and narrative alongside other KPIs to build a more-rounded picture

Source: TAI's 2020 sustainability working groups

Movements in sustainability reporting

Investors

- PRI: Active ownership 2.0
- IIGCC response to DWP consultation climate risk disclosure
- TCFD 2019 status report – climate-related financial disclosures
- Stewardship and stakeholder working group of the asset management task force - Putting stewardship at the heart of the investment industry to deliver for savers and to support the rebuilding of our economy (end of October)

Corporate accounting:

- CDP, CDSB, GRI, IIRC and SASB (The Five): Statement of intent to work together towards comprehensive corporate reporting (published in September 2020)
- IFRS - Consultation Paper on Sustainability Reporting (published in September, comments to be received by 31 Dec 2020)
- World Economic Forum/ Big 4 paper: Toward common metrics and consistent reporting of sustainable value creation (published in September 2020)

Public policy:

- European Commission: Public consultation - Non-financial reporting by large companies (closed)
- DWP UK: Consultation - Proposed requirements for larger pension schemes to publish climate risk disclosures (closed)

Our take on the ESG reporting landscape

Inputs

Transition Pathway Initiative · TruValue Labs · Trucost ESG Analysis · S&P Global · MSCI · SUSTAINALYTICS · RepRisk · FAIRR

Reporting on organisation's impacts on the economy, environment and people

Reporting on ESG factors that are material for enterprise value creation

Reporting that is already reflected in the financial accounts

Source: Bob Eccles

Corporate ESG reporting – rising hope of global standards

WORLD ECONOMIC FORUM · IOSCO · FASB · IASB · CDSB Climate Disclosure Standards Board · GRI · CDP · SASB · INTEGRATED REPORTING <IR>

Formation of "The Five"

TCFD · IBC INTERNATIONAL BUSINESS COUNCIL · Deloitte. · EY · KPMG · pwc

Source: TAI's 2020 sustainability working groups

Reporting issues in ESG

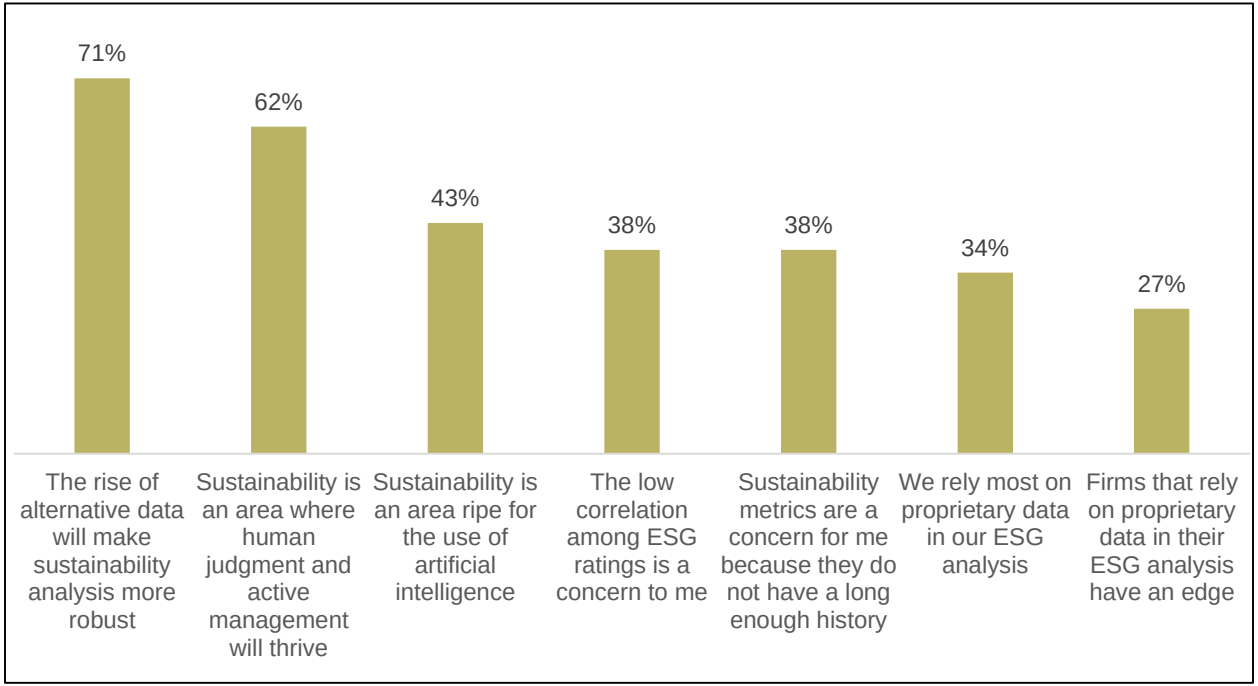
There is a wide base of dissatisfaction among investment industry stakeholders with the present position on data and reporting.

- **Analysis and data on ESG are critical at three points in the investment ecosystem:**
  - Company reporting
    - companies' obligations to report on ESG factors in their financial and statutory reporting are relatively light
    - the SASB, GRI and TCFD initiatives are setting standards that extend these obligations
  - Investor analysis and decisions
    - investors rely on a mix of internal and external resources for their analysis
    - ESG ratings by organizations such as MSCI and Sustainalytics are used widely as inputs to analysis
    - the ESG analysis is turned into active portfolios and via rules-based methods into ESG indices
  - Investor reporting
    - asset managers reporting on their ESG-related products with product disclosures being subject to industry standards in future (we have previously highlighting the forthcoming CFA Institute standards)
    - asset owners reporting on their portfolios, subject to increased regulation in certain jurisdictions, particularly in Europe

- **The World Economic Forum (WEF) suggested the following fixes:**
  - Improved transparency of the entire ecosystem (such as alleviating duplication of activity and unintentional conflicts)
  - Effective and active cross-system interactions (such as incorporating more of the end user's needs).
  - Stricter harmonization of methodologies for measuring KPIs related to ESG (such as enhancing the comparability of KPIs to help the decision making of investors and others).

Data issues

- Data issues have technical, governance and cultural sources
- The fragmented sources of data create issues
- Industry ability to manage these issues is very limited
- Data abundance and AI applications make the issues greater on balance
- Data management can be seen as a source of competitive opportunity



Source: CFA Institute: Future of Sustainability in Investment Management

Climate risk measurement

Climate risk challenged by inherent complexity and uncertainty and issues of comparability

Materiality, client demand, and regulation are the primary drivers, though lack of measurement tools is a barrier

Do you and/or your organization currently incorporate climate risk into your analysis?

Yes 40%	No 60%

Why?
N = 968

It is material	75%
Client demand	47%
Regulatory requirements	20%
Other reason	13%

Among ESG specialists, 87% say the motivation is materiality

Why not?
N = 1,478

Lack of measurement tools	57%
No client demand	31%
Not required by regulation	26%
Climate risks are not a priority for my investments	25%
Other reason	18%
Climate related risks are too far in the future to be material	10%

N = 2,497, including 250 ESG specialists

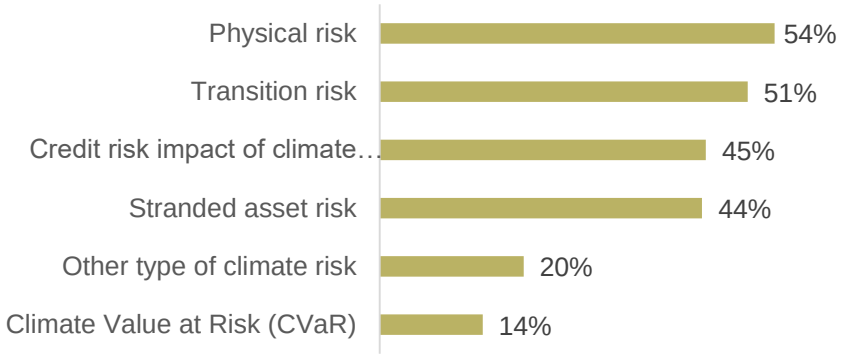
ESG specialists were defined as those who claimed proficiency in the subject and/or spend >50% of their daily work on ESG analysis

Source: CFA Institute: Future of Sustainability in Investment Management

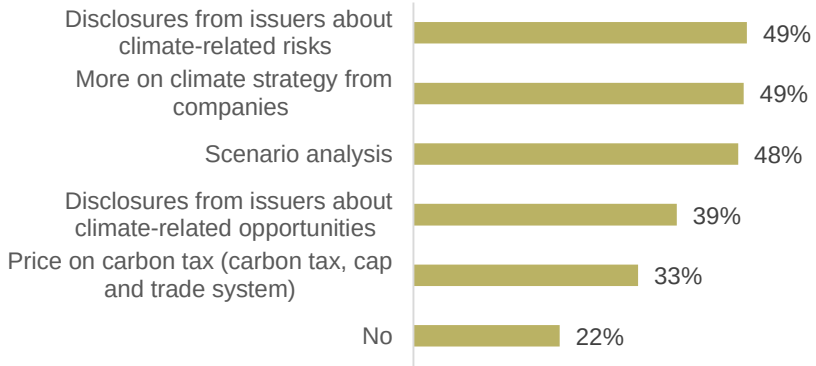
Climate risk – current practice

Sophistication in risk practices varies widely. Limitations from consistency in data

What type of climate risk do you include in your analysis? (select all that apply)
N = 940



Is there climate information you don't currently have, that you want? (select all that apply)



Source: CFA Institute: Future of Sustainability in Investment Management

The concept of temperature rating portfolios has enormous appeal as a communications device but it hides layers of assumptions, uncertainties and trade-offs

- A temperature rating is a very intuitive concept, particularly compared to other widely-used metrics such as carbon footprinting. It is something that not only professional investors but also end savers can immediately relate to. That makes it a very powerful communications device. From an asset owner perspective, an instinctively understandable metric to communicate to end savers can be very valuable.

- Temperature ratings can be beneficial for engagement practices, providing teams with an easy comparator of corporate carbon targets. In this regard, it is used as a behavioural change tool.

- However it faces multiple challenges in reality:

    - Because of lack of comparability across different methodologies temperate rating is useful to indicate the relative climate performance of two companies or two portfolios only if the same methodology has been used for both assessments. In practice, because temperature rating is such an intuitive concept and appears easy to understand even for non-experts, it can give the false impression that the results from different methodologies are comparable.
    - Seemingly-sophisticated modelling behind an intuitively-expressed temperature rating might create a perception of knowledge and precision that is illusory. Even worse, it might trick investors and end savers into thinking that the forecasts these models generated have some kind of scientific legitimacy that disguises the compounding of many poorly constrained uncertainties, assumptions and implicit value judgements.

Source: TAI's 2020 sustainability working groups

Challenges also include a disconnect between temperature rating and the real-world impact as well as potentially perverse behaviours

- As the 2° Investing Initiative points out, there is no clear evidence to suggest that the actions taken to reduce the carbon exposure of investment portfolios lead to a real-world carbon reduction, as often it just results in a redistribution of emissions between investors.
- Another source of disconnect is that most carbon metrics only cover listed companies. As a result, a temperature rating based on these carbon metrics fails to take into account the emissions from privately-owned and government-owned entities, which can be substantial. We will unpack this issue in greater details in a future publication.
- Any temperature rating methodology depends on a critical, yet completely unrealistic, assumption that everyone else also plays their part for the actual temperature trajectory to be accomplished. So, an investor's claim that its portfolio is rated 2.0°C actually has very little real-world meaning. It does not at all suggest that the world is on a 2.0°C warming path, only in a hypothetical sense that if everyone else held the exact same portfolio, and the assumptions regarding future decarbonisation hold, then the world would be on the trajectory towards 2.0°C warming (and we ignore all the uncertainties around the modelling approach mentioned earlier!). In this regard, it is useful to note that the UN Emissions Gap Report 2019 suggests that the planet is on a 3.2°C trajectory, despite numerous investment portfolios rated "cooler" than that.
- Will temperature rating actually drive the right behaviours that it intends to create? "When a measure becomes a target, it ceases to be a good measure". Goodhart's law tells us that whenever a metric – by default a proxy – is used as a target, it ceases to be an effective measure. Either the metric will stop connecting to the target or people will try to game it.
- The risk of temperature rating being gamed is certainly not trivial given the lack of transparency and consistency in its methodologies as discussed above.

Source: TAI's 2020 sustainability working groups

Where does all this leave us?

- When it comes to climate reporting, a dashboard comprising multiple measures should always be used
- At this time of writing, the group's work on a climate impact dashboard continues and will be written up in a future paper.
- At this stage we can note that the group have determined that the dashboard should show 'investor contribution' and (underlying investee) 'company impact'. The choice of language is deliberate and shows that investors should not be claiming impact in terms of reducing carbon emissions or climate change.
- To claim impact there would need to be (i) intentionality to create impact, (ii) demonstrable causality between the action of the investor and the intended change, and (iii) demonstrable change as intended. In a complex, reflexive system the burden of proof to show causality is simply too high. Therefore investors can, and should, document the ways in which they have contributed towards the achievement of their intended aims.

Source: TAI's 2020 sustainability working groups

3. Collaboration gap

None of us on our own is powerful enough to change the system, but collectively we are. Collaboration opportunities lie with:

- T-shaped people and team
- NGO's like PRI
- Asset owner and asset manager
- Corporate governance relationships
- System-level engagement

Collaboration challenges and opportunities

- Strengthened collaborations within and across organisations drive engagement and combinatorial power
- Within organisations:
  - Current common configurations with specialised functions (“silos”) diminish collaborations
  - Strengthened collaborations within organisations, across groups and functions, provide a more joined-up, holistic, and teamwork-oriented approach to sustainability
- Across different organisations
  - Collaboration gap in our industry: limited interactions within our industry – peers, issuers, providers, regulators and government

- Opportunities for collaboration and creating multipliers in the stewardship and active ownership areas
  - Enable investors to play a much bigger part in corporate governance
  - Successful engagement depends on collaboration and takes extended periods of time
  - Investment organisation to put more resources to engagement and collaboration, both in the number of professionals and in their depth of skills

Being T-shaped – the combinatorial effect

T-shaped people and teams	▪ T-shaped people 'connect dots' well. They are adept at reconciling deep-level knowledge and understanding in one context, field or organisation with a wide perspective across many contexts , fields (eg anthropology and brain science) and organisations (eg think how asset managers, asset owners, consultants and third party vendors differ) by employing deeper thinking and deploying wider networks ▪ Becoming T-shaped is part talent and part training and development ▪ T-shaped teams have broad and deep collective intelligence and harness the power of a one-team culture and the benefits of cognitive diversity ▪ T-shaped teams are likely to be made up of a majority of T-shaped people, but with some specialisms
The Silicon valley link	▪ A particular example of T-shapedness is the evolution of Silicon Valley which worked because of a passion for combination within and across organisations with highly connected people and organisations
Enabling goals	▪ How can working groups be effective in engagement*, diversity**, building collective intelligence*** and achieving accuracy**** in discussions and decisions? ▪ ** Engagement – the inter-action of the group, ideally their combination being more than additive* *** Diversity – the efficient accessing of multiple values, perspectives, experiences and knowledge of the entire group* **** Collective intelligence – group effectiveness from group inter-action and collaboration - the portfolio concept, where group inter-actions (correlations) matter at least as much as the individual contributions* *****Accuracy – is degree of effectiveness in discussions (surfacing the salient issues); and decisions (resolving the trade-offs for optimal outcomes)*
Culture and process critical	▪ The culture of the team and the process adopted have to be aligned to shared goals and create the conditions for supporting engagement and collective intelligence

Our take on the NGO engagement landscape

PRI Principles for Responsible Investment and GSIA, EuroSIF, USSIF, RIAA

UNEP FINANCE INITIATIVE and Net Zero Asset Owner Alliance

Climate focused groups

IIGCC Institutional Investors Group on Climate Change

Climate Action 100+ Global Investors Driving Business Transition

and AIGCC, IGCC, Ceres ICSWG

Impact focused groups

IMPACT MANAGEMENT PROJECT

impact investing institute

Reporting disclosures and data

GRI

SASB Sustainability Accounting Standards Board

INTEGRATED REPORTING <IR>

TNFD

FAIRR A COLLER INITIATIVE

Climate specific

CDSB Climate Disclosure Standards Board

TCFD Task Force on Climate-Related Financial Disclosures

CDP Disclosure Insight Action

Transition Pathway Initiative

Corporate governance

ecgi european corporate governance institute

THE INVESTOR FORUM

ICGN International Corporate Governance Network

Professional bodies and thought leadership

CFA Institute

WORLD ECONOMIC FORUM

Institute and Faculty of Actuaries

Thinking Ahead Institute

UNIVERSITY OF CAMBRIDGE Institute for Sustainability Leadership

Advocacy groups

IM ShareAction»

THE INVESTMENT ASSOCIATION

Global groups

WWF

OECD

UN Global Compact

Note: For illustration only; not a complete list

Long-term relationships between asset owners and asset managers critical in sustainability

Principle #1

Long-term relationships need an ongoing investment of time

Principle #2

Long-term relationships need an based on mutuality of trust

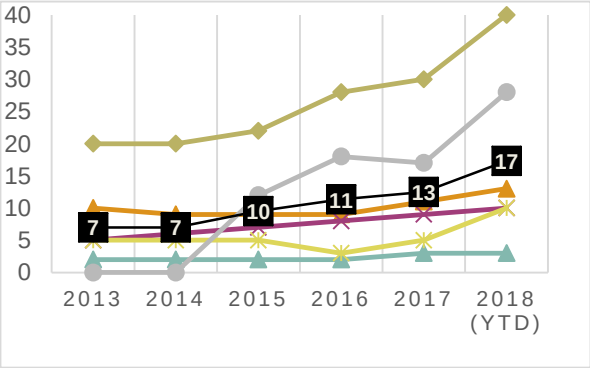
Principle #3

Long-term relationships need an ongoing exchange of value

Limited business model supporting active ownership

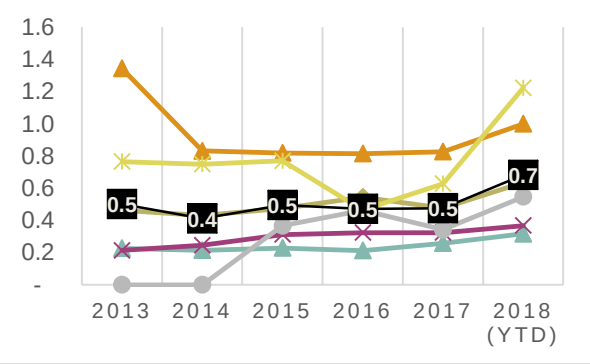
Stewardship resourcing of the six leading asset managers responsible for index tracking mandates
Source: WTW Investor stewardship study | 2019

Figure 1: Size of stewardship teams over time - the black line shows the average across the sample



Note: Figures supplied by asset managers; excludes wider firm resources that may contribute to stewardship activities such as internal active investment teams

Figure 2: Size of stewardship team per $100bn assets under management – again the black line shows the average



Note: For 2018 YTD, data is as at Q2 or Q3 depending on latest availability; assets data sourced from eVestment

Free-rider issues in sustainability

Definition	▪ The **free-rider problem** occurs when those who benefit from resources, public goods (a sustainable market economy, also things like public roads or hospitals), or services of a communal nature (‘takers’) do not pay for them/under-pay and leave others to produce or provide them (‘makers’). ▪ Free riders are a problem because while not paying for the good (either directly through fees or tolls or indirectly through taxes), they may continue to access or use it (as in funds that simply utilise the market economy). Thus, the good may be under-produced, overused or degraded, andh in the asset owner case create tension between makers and takers.
Pure public goods	▪ A pure public good exhibits the characteristics that each individual's consumption of such a good leads to no subtractions from any other individual's consumption of that good – this is called non rivalry; and non-excludability that is, it is impossible to exclude any institutions from benefiting from the good
Engagement	▪ The public good here is using engagement – security-level and system-level - to: - address ESG and value creation/strategy issues in individual entities using engagement - address the returns we need can only come from a system that works - address the benefits we pay are worth more in a world worth living in - there is a time shift (J-curve) these require, with up front investment before later pay-offs - the beliefs attaching to the pay-offs are quite ‘fragile’ and will likely be contested ▪ The business model of building an engagement platform (e.g. Federate Hermes EOS) creates a viable alternative to free riding but might need legislative or license to operate support to accomplish

Source: TAI’s 2020 sustainability working groups

PRI Active Ownership 2.0

OUTCOMES, NOT INPUTS OR PROCESSES

Active ownership 2.0 prioritises the pursuit and achievement of positive real-world goals. While resources, [12]activity metrics[13] and intermediate goals[14] are among the levers available to signatories, these are neither sufficient nor universally relevant in the delivery of outcomes.

COMMON GOALS

Systemic issues require a deliberate focus on and prioritisation of outcomes at the economy- or society-wide scale. This means stewardship that is less focused on the risks and returns of individual holdings, and more on addressing systemic or 'beta' issues such as climate change and corruption. It means prioritising the long-term, absolute returns for universal owners, including real-term financial[15] and welfare outcomes for beneficiaries[16] more broadly.

COLLABORATIVE ACTION

Focusing on collective goals and the delivery of positive real-world outcomes is possible only through enhanced collaboration among investors and service providers.

Challenges inherent in addressing collective systemic issues, such as the free-rider problem (i.e. where some avoid the costs of addressing collective problems, while reaping the benefits), result in weaker pursuit of collective goals relative to those where the distribution of costs and benefits is more equitable.[17] This leaves collective interests comparatively under-addressed by signatories, despite their significance.

Enhanced collaboration – in a variety of forms[18] – spreads the cost of addressing collective goals and is therefore central to achieving the required evolution in stewardship practice.

References and source:
https://www.unpri.org/download?ac=9721

System-level engagement

Source: Systematic stewardship | Gordon, Columbia Law School

Fiduciary duty	Asset owners are subject to fiduciary duty of loyalty (ERISA's "sole benefit" rule) in that there can be no trade off of the economic benefits for plan beneficiaries against other social values
Systematic risk reductions is basically beta activism	"But engagements aimed at reducing systematic risk do not run afoul of the "sole benefit" criterion because they align to the objective of maximizing risk-adjusted returns"
Portfolio approach	"There is nothing new in the claim that diversified institutional investors should, and do in fact, take a portfolio approach towards their engagement activities"
Candidate systematic risks for systematic stewardship	i. *Climate change risk*. Clearly a systematically important risk (climate risk is financial risk). E.g. physical and transition risks. *ii.. Financial stability risk.* The systematic impact of the distress of systemically important financial institution. E.g. systemic failure *iii. Social stability risk.* Corporations need to be highly responsive to changes in the economic, social and environmental conditions but the resultant imposition of the adjustment costs of economic change on various stakeholders is a systematic risk. E.g. damage to license to operate
Business model implications	"Asset managers can market their systematic stewardship stance as a way of differentiating from other funds and thereby increasing AUM"

4. Purpose gap

An investment industry that is truly committed to the purpose of generating long-term sustainable returns in a sustainable way
Organisational vision, strategy and culture aligned
The innovation of 3D mandates

Organisational identity

Simplifies to vision + culture + strategy and the degree of commitment to stakeholder responsibility

1. Purpose and value | What purpose(s) we serve and what we see as the value that our organisation exists to create.
2. Mission and vision | Why we exist and what we want to be.
3. Stakeholders | What is the domain, priorities and boundaries of our reach and influence.

Vision

+

4. Values | What we believe in and how we will behave.
5. Culture | How does our organization think and behave, how does leadership behave.

Culture

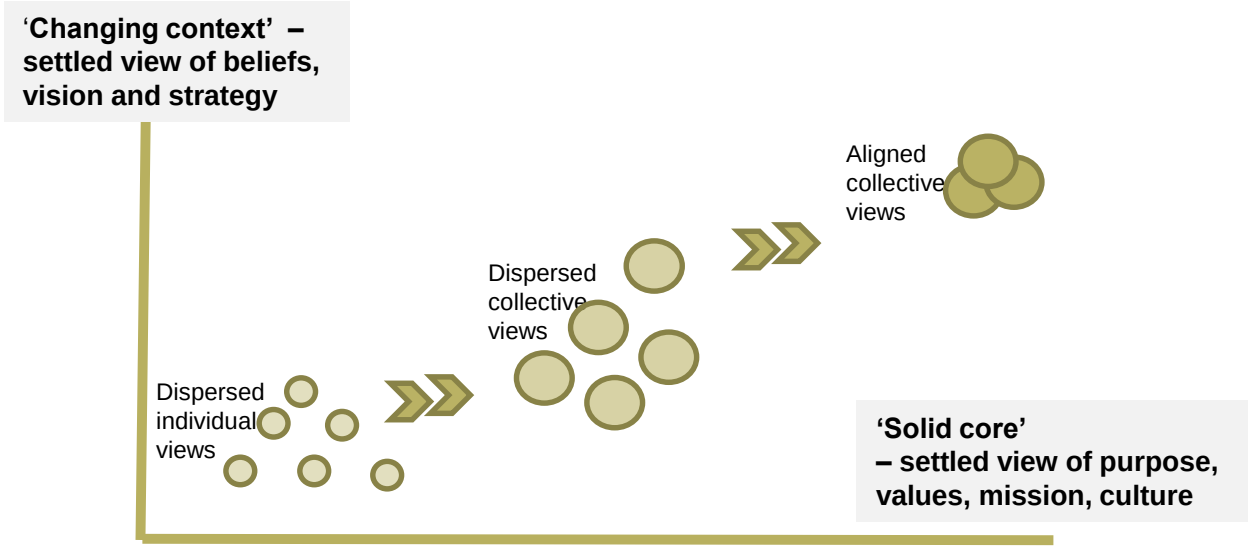
+

6. Investment beliefs | What do we believe about the investment landscape and our edge to inform our strategy.
7. Organisational beliefs | What do we believe about our organisational context (governance, stakeholders, mission, etc.) to inform our strategy including our endowments as an organisation.
8. Strategy | What is our competitive game plan – thinking ahead, employing our beliefs, reflecting uncertainty, creating value.

Strategy

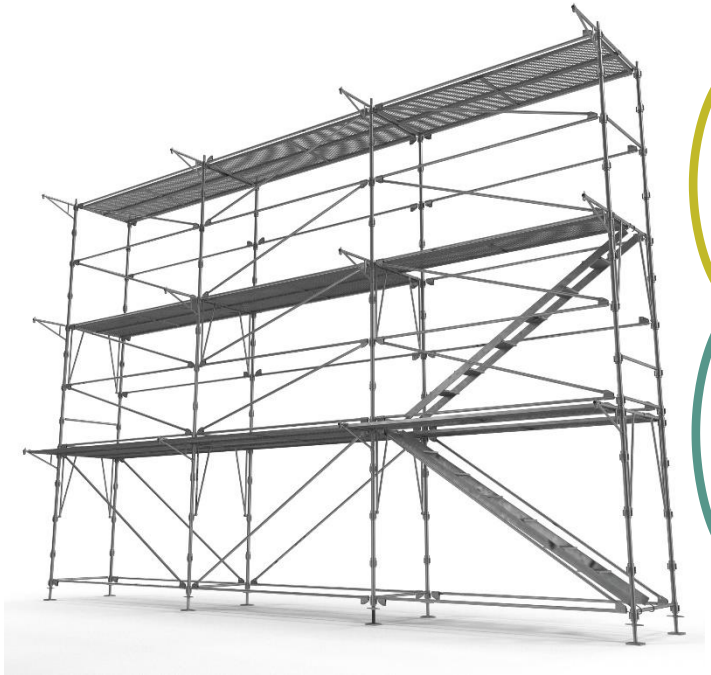
The need for vision, beliefs and strategy to align

- Asset owners have to mix a number of distinct strands to build the sustainable strategy that meets their mission
- These multi-strand elements are difficult to integrate into a coherent sustainable strategy,
- The conflation of these elements, with their mixed motives and timescales in particular, can often result in cognitive dissonance producing misalignment of mission and strategy
- Dealing with this requires strong governance processes to achieve mission clarity in which beliefs will be a fundamental element



Source: TAI's 2020 sustainability working groups

Three necessary components for climate beliefs



3. beliefs about the system(s)

The most contentious area; concerns leadership, competitive positioning, responsibility and reflexivity

2. beliefs about risks and opportunities

More contentious; concerns judgement as to what is in the price, and the unknowable path of future trends

1. beliefs about the science

The least contentious area, founded on data and scientific interpretation

Source: TAI's 2020 sustainability working groups

Example belief statements

1. Beliefs about the science
The current and projected increase in global average temperature is predominantly due to human activity.
Climate is a non-linear system, meaning that the risks grow ever larger with each additional increment of temperature increase.
The climate system contains tipping points which, if triggered, mean that changes become irreversible.

2. Beliefs about risks and opportunities
The financial impact of climate change over the next 20 years will be [negligible; moderate; substantial; extreme].
Over what time frame will climate change create material impacts for society [now; 10 years; 20 years; 30 years; not for the foreseeable future].
Climate change will instigate the demise of various existing business models and in the same time the birth of many new business models.
Managing an investment portfolio to address climate cannot be strategic; it must be highly dynamic.

3. Beliefs about the system
Investors can gain significant competitive advantage through their strategic response to climate change.
My organisation carries profound responsibility as a steward of existing assets, and as an allocator of new capital.
Legislation and regulation will be introduced to shift activity towards net-zero, causing interruptions and discontinuities for business models.
The investment system is non-linear, meaning that collaborations and coalitions are more likely to trigger tipping points, encoding changed behaviours.
On a standalone basis, exclusions have little impact.

Source: TAI's 2020 sustainability working groups

3D mandates – a strawman for the AO

	**1. 3D goals**	▪ The portfolio and strategy seeks to integrate risk, return and impact (= positive, measurable social, and environmental impact)
	**2. Total portfolio thinking**	▪ Strategy is focused on producing long-term absolute returns contributing to the total portfolio risk and return consistent with goals
	**3. Strategic partnership**	▪ Adding IP to the AO outside the mandate; providing strategic input – investment strategy ideas, and reverse enquiry new mandate ideas
	**4. Core sustainability strategies**	▪ Integrated ESG and active ownership adding insight and engagement to support value creation, short-term and long-term
	**5. Impact strategies**	▪ Targeting and achieving real-world impact using UI strategies – portfolio and stewardship positions – including climate management
	**6. System-level engagement**	▪ Addressing the systematic risk elements in their portfolios – climate change, financial stability, social stability
	**7. Balanced score-card monitoring**	▪ Combination of hard and soft measures ▪ TCFD reporting
	**8. Other mandate details**	▪ External managers governance and culture ▪ Also termination terms, could involve closed-ended structures

Source: TAI's 2020 sustainability working groups

Core best practices in sustainability strategies

Category	Actions	
 Capital allocation	1. Integrated ESG	▪ All equity and bond mandates specify the requirement to take account of ESG factors as financially material ▪ All private markets mandates have policies with respect to ESG exposures
	2. Strategic tilting	▪ Allocations and portfolios are strategically tilted to adopt positive ESG ratings and align with climate change/energy transitions
 Engagement	3. Bottom-up security level	▪ Stewardship activities in listed markets are aligned to stewardship codes (eg UK 2020 Code) applying policies on ESG factors ▪ Passive and active portfolios warrant different attention ▪ Ownership policies are applied to private markets ▪ Divestment is alternative to engagement
	4. Top-down system-level	▪ Influence is applied often via industry groups to support the smooth and fair functioning of the financial system and its evolution
 Governance	5. Goals and principles	▪ Specification of time horizons for strategy of at least 10 years, and often longer ▪ Commitment to long time horizons for monitoring consistent with long-term goals ▪ Governance designed expressly to manage continuity of thinking ▪ Reporting aligned to SDGs; reporting under TCFD

The TAI culture model

Many elements of the culture model are closely connected with sustainability

Core attributes

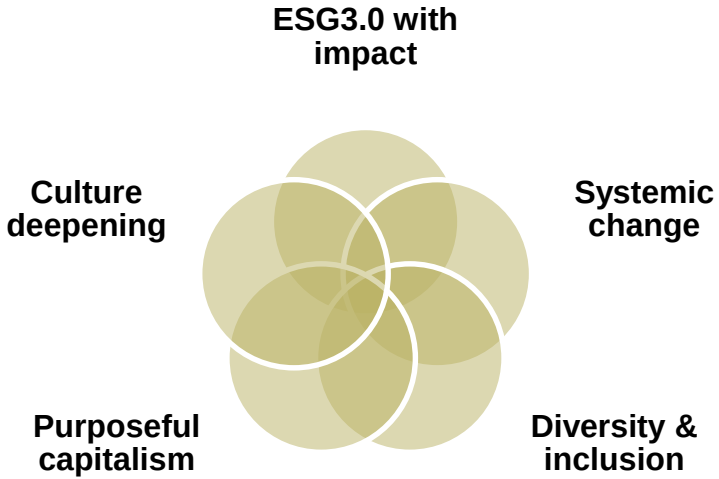
1. Client focus
2. People and teamwork ethos
3. Empowering leadership
4. High performance
5. Integrity and respect

Cultural edges

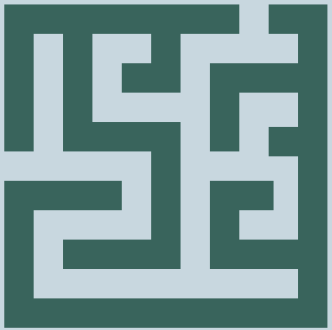
1. Diversity and inclusion
2. Innovation
3. Openness and transparency
4. Purpose
5. Staying power culture

The innovation and transformational change issue with sustainability

- Investment organisations have been good with product innovation (small bets, fail fast), but poor with business model innovation (larger bets, succeed slow)
- The sustainability nexus is a burning platform of significant issues that need big change
- Big change always needs a powerful vision, coalition and process and very strong why, how, what
  - Arresting – it draws people in, *strong why*
  - Accessible – it is well-socialised and engaging, *strong how*
  - Actioned – it is acted upon, *strong what*



5. Industry roadmap



Investment models and 3D mandates

Bridging the gaps with action

1. Skills gap

- Integrate system-level thinking on top of traditional investment thinking
- ESG knowledge and skills should be developed for all professionals
- Reallocation of professionals to sustainability roles

2. Data gap

- Focus on materiality and validity
- Focus on people issues – talent, culture, governance

3. Collaboration gap

- Strengthened collaborations within our organisations
- Strengthened collaborations across organisations

4. Purpose gap

- Purpose and culture check-in
- Commitment to sustainability innovation including 3D mandates

Are these the needed actions? What's missing?

6. TAI's 2020 sustainability working groups | overview

1.5C investing

Duty of ownership

1.5 degree portfolio working group

Research applied throughout this Summit

1. Framing the problem

This paper seeks to frame the climate change problem in a way that allows the investment industry to engage with it. It outlines the working group's position on what the task is and how investment organisations can be involved to address it. The paper also summarises two papers that are foundational for the thinking and ongoing work of the group.

2. Climate beliefs

There is a strong case for each investment organisation to develop, discuss, agree and document its climate beliefs. In our view, climate beliefs need to cover three main areas: beliefs about science; beliefs about risks and opportunities and beliefs about the system.

3. Temperature rating

The concept of temperature rating portfolios has enormous appeal as a communications device. Offsetting this attraction are a number of problems. There is a composition problem, in that what only matters is the temperature of our planet. There will be behavioural problems such as gaming and "coldwashing". And there are technical problems, ranging from the data, to the models, to the assumed relationship between the proxies and the temperature rating. That led to our conclusion: when it comes to climate reporting, a dashboard comprising multiple measures should always be used.

4. Primary investment

This paper starts by laying out an argument that the investment industry owns roughly a quarter of the climate problem by digging into the sources of emissions. Investment industry, as a result, should focus on directing and facilitating more primary investment into scaling up the mature technologies of renewable electricity generation, or investments in more speculative technologies such as negative emissions technologies.

Duty of ownership working group

Research applied throughout this Summit

1. Framing of fiduciary duty

The fiduciary window expresses a reasonable interpretation of the investment policies acceptable on the spectrum of: short-term finance versus sustainable long-term value creation; and member financial interest versus wider stakeholder interest.
The shift towards the long-term stakeholder parts supports a more expansive strategy for some funds targeting real world impacts

2. Active ownership best practices

Stewardship has been very weak in its reporting (too anecdotal, no consistency, etc); this needs to change for its value to increase.
Stewardship has been very uneven in its investment model (use of shareholder resolutions, collaboration under-played, theory of change absent, etc); this also needs to change

3. Universal investor strategies and 3D mandates

The 3D mandate integrates goals and outcomes across risk, return and impact.
This will always include core sustainability and impact strategies and balanced score-card reporting
In its fullest form this will include total portfolio thinking, strategic partnership and universal investor strategies

4. Reporting and data challenges

Reporting and targeting issues are profoundly difficult – data in particular. The data gap is one of governance and culture as well as technical issues.
The investment ecosystem has ‘structural gaps’ in thinking, technology, collaboration and culture which are critical enablers that need filling for the system to ‘work’.

Limitations of reliance

Limitations of reliance – Thinking Ahead Group 2.0
This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

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