Thinking Ahead Institute Sustainability Summit | 1 and 2 December 2020
Post-event summary

Thinking Ahead Institute
WillisTowersWatson

Key points on the skills gap

The skills gap across sustainable investing shows up in a weak grasp of systems theory, with underdeveloped recognition of impact alongside risk and return, and a low level of ESG knowledge in parts of our industry.

Systems theory development	The investment industry is a complex system comprising participants, technologies and markets. The system is dynamic and not well understood due to a prevalence of reductionist thinking rather than systems thinking. Investment theory has over-emphasised equilibrium conditions and rational behaviours and has failed to integrate real-world conditions.	Current best practices in sustainability have involved an MPT chain of thinking from sustainability factors to investment policies and on to investment results with a weak reference to real-world outcomes. The next step is for funds to adopt a systems framework starting with investment policies that work directly on the sustainability of the system and its impacts on real-world outcomes, with links to investment results.	Investment theory and practice should integrate system-level thinking starting with its application to fiduciary duty. Systems thinking has natural connections with: ▪ Total portfolio approach ▪ Universal investor strategies ▪ ESG 3.0
ESG knowledge development	ESG knowledge and practical know-how across the investment industry is uneven. Currently, the number of ESG specialists is small on a AUM-weighted basis.	A different skill set is needed; individuals and teams should be more T-shaped (breadth and depth). Soft skills, deep-level knowledge, systems thinking, and technical proficiency allow individuals to proactively manage the complexity of ESG investing.	ESG knowledge and skills should ideally be developed to a critical threshold across the industry for all professionals. But with the investment industry taking a siloed approach to training, we are well short of this level.

Summary of discussion on the skills gap

- The ESG knowledge and skills for the whole industry have had to develop from a standing start a few years back. At entry level to the investment industry, there are reasonably strong training and credentials available to support ESG understanding. For professionals in the middle of their career, there are more friction points and knowledge remain uneven. Training programs by employers are not doing enough here. It is possible to build a much stronger learning and development program for investment professionals and all staff at investment organisations.

- The systems-theory gap in understanding is notable too. Investment grew up with a wish to be a real science like physics. The physics envy was rewarded with a bunch of solvable equations and a neatness that was completely unrealistic and unfortunate. Systems theory gradually got a look in. This is mostly about not looking at component parts but the system as a whole, reflecting multiple pulls and pushes, new shifting and shaping forces, jumps and tipping points; all reflecting messy, and hard-to-explain factors but ultimately this way of thinking explain things so much better.

- T-shaped skills are relevant to this gap, with thinking built by logic and 'always be connecting dots' ('ABCD'). This sits well with the skills that uniquely require human intelligence - judgement/empathy/intuition/communication/ethics. Here T-shaped people are particularly at home with pattern recognition and making connections; ripple effects, where one thing leads to another; and reflexivity, that people affect and are affected by the fundamentals of the systems they function in.

- Fiduciary duty is one very critical contributor to this type of thinking. The fiduciary window is the reasonable interpretation of the investment policies acceptable on the spectrums of: (a) short-term finance versus sustainable long-term value creation; and (b) member financial interest versus wider stakeholder interest. This is consistent with the idea that fiduciary duty is not set in stone and will drift with institutional, societal and government preferences. This increasingly is seen to include the sustainability preferences of beneficiaries/clients, regardless of whether these preferences are financially material - a very important idea in the context of DC pensions; and supporting the stability and resilience of the financial system.

- The integration of ESG and sustainability factors into company reporting will play a part in improving ESG understanding. The ESG world has been built up over 15 years with no mandatory requirements for disclosure. Now there are initiatives to make sure the sustainability factors (ESG) that are material to financial factors / investment returns (neat to call them pre-financial) are disclosed consistently. The financial factors (company and investor activities) that are material to sustainability factors (real-world impacts) – right to call these non-financial – are also subject to pressures for disclosures.

Skills gap session – poll results

Number of votes: 45	Not at all	Minimal	Moderate	Significant	Very Significant
How significant are second and third order effects (the consequences following the initial consequence of an action) in the consideration of your organisation's investment decisions?	2%	29%	38%	29%	2%

Number of votes: 53	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Our investment teams have the ability to both understand different fields and draw valuable connections between them (T-shaped skills).	6%	51%	26%	13%	4%

Key points on the data gap

The ESG data area has multiple limitations as described below. There is wide dissatisfaction among industry stakeholders with the present position on ESG data and reporting.

Insourcing vs outsourcing	Costs	Soft data vs hard data	Culture and talent	Governance
▪ Issues remain around internal development of sustainability metrics vs usage of external services to provide data ▪ Major differences in data provided by different external ESG data providers	▪ The value of IT investment is hard to gauge, limiting investment ▪ Technologies and people development suffer from uneven spend within organisations and across the industry	▪ A lot of ESG data is 'soft' (subjective; hard to measure and assess) with high materiality but limited validity ▪ The ability to handle and analyse soft data in context is key to ESG-centric decision making	▪ Incentives are not joined-up and goals are different for data providers and users ▪ Data specialists are viewed as siloed ▪ Language and understanding differs between internal groups	▪ Organisational governance can play a key role diving data performance ▪ Governance also necessary for collaboration on data across the industry

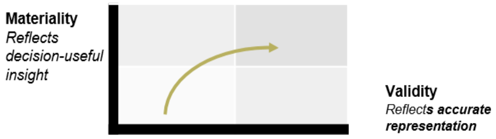
Dashboard reporting on ESG and climate

- In order to deal with these data issues, when it comes to sustainability reporting, a dashboard comprising multiple measures should always be used.
- This 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 where they only have influence.

Summary of discussion on data gap

- Covid-19 has normalised the abnormal. Investors now realise that what used to be seen as tail risks – eg climate change; a global pandemic – can have material consequences on portfolios. The pandemic has acted as a catalyst for technological innovation.
- In general, the technology and data challenge for investment firms is to create 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.
- In our work we identified multiple issues restricting us from achieving this goal: legacy problems, insourcing/outsourcing issues, costs, soft data, talent, culture and governance.

- The quality of data is substantially about materiality and validity, conditional on availability and latency:
  - **Materiality** is the degree to which the <u>target form of a measure provides decision-useful insight</u> about investment-relevant questions.
  - **Validity** is the degree to which the <u>actual form of a measure provides an accurate representation of the target measure</u> in question, where validity is reduced by subjectivity and various problems of accuracy, timeliness, granularity and transparency.



- Part of our data challenge is to develop ESG data so that it supports more substantial decision-useful application. While a lot of ESG data is highly material, it is also ‘soft’ data. The ability to handle and analyse soft data in context is key to ESG-centric decision making.
- Few investors are satisfied with the current position on ESG data and reporting. ESG analysis and data is particularly critical at three points in the investment ecosystem: (i) company reporting (ii) investor analysis and decisions (iii) investor reporting.

- **What is required to make the transformation from bulk data to decision-useful insight?**
  (Ashby Monk, Executive Director of Stanford Global Projects Center)
  i. Resources: we need rigorous delegation frameworks around data and technology and robust architecture. Technology leadership (eg CTO) is critical on boards, alongside the move from spreadsheets to software to reduce errors and improve robustness of stress testing.
  ii. Culture to support innovation: there needs to be a safe space to try technology; leaders should not need courage to innovate – processes need to be built in to allow failures in a contained way. This is necessary to drive innovation.

Key points on the collaboration gap

No single organisation within the investment industry is powerful enough to change the system, but collectively change can be achieved. Collaboration opportunities lie between individuals, within organisations, and between organisations.

T-shapedness	Non-governmental organisations	Asset owner and asset manager relationships	Corporate governance relationships	System-level engagement
▪ T-shaped people ‘connect dots’ well. They are adept at reconciling deep-level knowledge and understanding to a wider perspective ▪ T-shaped teams have broad and deep collective intelligence and harness the power of a one-team culture	▪ Non-governmental organisations can bring together individuals and organisations from across the system ▪ Global organisations from IIGCC, PRI, CFA UNEP are driving collaboration across industries	▪ The development of long-term relationships between asset owners and asset managers are crucial in integrating ESG into the investment system ▪ Long term relationships based on trust, with an ongoing exchange of value will be mutually beneficial	▪ There is limited support across the industry for stewardship, with a limited uptick in recent years in the size of teams (relative to aum) ▪ Collaboration helps address the free-rider problem – under-production of corporate governance – within the system	▪ Asset owners are subject to fiduciary duty of loyalty to beneficiaries (eg ERISA’s sole benefit rule) ▪ But engagements aimed at reducing systematic risk align with maximising risk-adjusted returns

Summary of the discussion on the collaboration gap

- Strengthened collaborations within and across organisations drive engagement and more effectively address ‘beta’ risks such as climate change:
  - Within organisations, common configurations with specialised functions (‘silos’) diminish collaboration and stifle innovation. Strengthened collaborations within organisations, across groups and functions, provide a more joined-up, holistic, and teamwork-oriented approach to sustainability. Teams can be made more effective with the following levers: (1) a strong purpose that energises collaboration; (2) a culture that allows quick adaption; (3) resources – strong need to upskill; and (4) an inclusive environment to bring together diverse perspectives.
  - Across different organisations, there remains limited interactions between investment organisations, regulators and government. We can build stronger relationships in supply chains by engaging; building trust; learning from mistakes, and creating positive feedback loops through collaborations.

- Asset manager business models are still not effectively geared up to support active ownership with the size of stewardship teams per aum remaining relatively low, though there has been a small uptick in recent years. Engagement, at a security and at a system level, remains a ‘public’ good activity. Positive engagement supports the mantra that *the returns we need only come from a system that works, and the benefits we pay are worth more in a world worth living in*.

- There was a call for greater consolidation of sustainability initiatives. There are efforts towards standardisation in corporate reporting and in engagement but more work needs to be done. 80% of attendees engaged with 3 or more industry groups focused on sustainability in a way that gave them clear benefits.

- Free-rider issues in sustainability remain. Asset owners and consultants were seen as potentially playing a vital role in challenging asset managers on sustainability issues.

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

Principle #1	Principle #2	Principle #3
Long-term relationships need an ongoing investment of time	Long-term relationships based on mutuality of trust	Long-term relationships need an ongoing exchange of value

Collaboration gap session – poll results

Number of votes: 62	Absent	Minimal	Adequate	Good	Significant
The framework your organisation has in place to encourage cross-team collaboration for better decisions is...?	2%	16%	35%	34%	13%

Number of votes: 57	0	1-2	3-4	5-6	7+
How many industry groups focused on sustainability (e.g., PRI, Climate Action 100+) does your organization work with in a way that you gain clear benefits?	4%	18%	37%	11%	32%

Key points on the purpose gap

The investment industry must truly commit to the purpose of generating long-term sustainable returns, in a sustainable way.

Organisational identity	Investment organisations have so far failed to outline and commit to a long-term identity that is compatible with sustainable investing. In order to successfully integrate sustainability through the investment process, organisations should commit to stakeholder responsibility. A combination of developing a long-term vision and purpose, defining the organisation's culture and values, and strengthening strategy to include investment and organisational beliefs will help organisations advance an authentic identity around sustainability.
Climate beliefs, as example	The 1.5C investing working group considered climate beliefs. We see the settling of climate, and wider sustainability, beliefs as critical for organisations to successfully map out their organisational identity. There are three necessary components to agree for an organisation to settle on climate beliefs. The least contentious of these surrounds (a) the science of climate change. More contentious are beliefs about (b) the risks and opportunities presented by climate change. Finally the most contentious area to agree on are (c) the beliefs about the system and how it is likely to react to the climate crisis.
3-D mandates	Investment mandates, defined by asset owners, can shift the behaviours of the wider financial system. A 3D mandate is focused on integrating risk/return/impact into the portfolio construction process. A 3D mandate requires total portfolio thinking within a long-horizon and systems context, the integration of ESG and active ownership, specific targeting of real world impacts, and balanced scorecard / dashboard reporting. 3D mandates would further benefit from strategic partnerships and system-level engagement.
Innovation and transformational change	Sustainability is a confluence of significant issues – impact, systemic risk, diversity & inclusion, purposeful capitalism and cultural deepening – that creates a burning platform for big change. Big change requires a powerful vision, coalition and process that is arresting (a strong 'why'), accessible (strong 'how') and actioned (strong 'what').

Summary of the discussion on the purpose gap

- Purpose is about what is 'value', and about the stakeholders that matter. And how this may be developing over time. Organisations are not yet good with this context, but they are inching towards it; and the prizes for good work are increasing.

- This is a huge moment in time for AOs in particular with respect to their climate change policies. In the AO100 (the largest AOs by aum) we can find 15-20 funds with substantive climate policies, about half of whom are now on net-zero transition pathways.

- The problem with zero-carbon pledges is some are a lot more real than others. A net-zero target for some far-off date — say 2050 — can be meaningless if it doesn't come with nearer-term milestones for say 2025 with full accountability including through executive compensation.

- Impact is a loosely defined term with a 'lite' version as well as a 'full-on' version. ESG has become associated with the lite impact version, in which the ESG approach starts and pretty much ends with better investment outcomes. Investors get the benefit of research into the 'good' while society and the planet get only second-order gains that are very difficult to pin down. The 'full-on' version by contrast is the universal investor proposition carried from the big asset owners like GPIF through to asset management firms. This is much more an investor stewardship proposition. Here the ESG materiality maps onto society and the planet via real-world impacts. This model incorporates the combination of intentionality, additionality and measurability.

- Investment organisations have been good with product innovation (small bets, fail fast) and portfolio idea innovation, but poor with business model innovation (larger bets, succeed slow). The sustainability nexus contains five things – systemic change, diversity & inclusion, culture, purposeful capitalism and 3D investing, that together add up to a burning platform of significant issues. These five things create a tremendous agenda for asset owners and asset managers to aspire to develop.

- All this helps to inform the sustainability transition pathways of organisations. We see:
  - 20 to 25 successful 'universal investor firms' complementing the 20 to 25 universal (asset) owners
  - A group of 'truly sustainable firms' that are able to innovate successfully with 3-D mandates
  - A smouldering platform to change

1. Skills gap

An obstacle? 120% agreement*

- Mandatory training for organisation, not just ESG team
- Sustainability to become part of every decision
- Organisations commit to transformational change

The skills gap is a material obstacle preventing true adoption of sustainability in investment	1.2
To remain competitive, investment organisations will need to introduce mandatory sustainability training	1.3
The skills gap is more about current professionals keeping up with ESG developments (continuous professional development) than new professionals learning their ESG foundations	0.4

2. Data gap

An obstacle? 120% agreement*

- Focus on people issues – talent, culture, governance
- Consolidation – reporting standardisation is vital which requires better collaboration
- Real sustainability reporting (beyond greenwashing)

The data gap is a material obstacle preventing true adoption of sustainability in investment	1.2
The data challenge will be solved within five years	0.0
We don't need more data, we need to use existing data better	0.1
Bridging the data gap is as much about solving people issues (T-shaped talent, culture, governance) as it is technical issues	0.9

3. Collaboration gap

An obstacle? 110% agreement*

- Strengthened collaborations within our organisations
- Strengthened collaborations across organisations
- Consolidate sustainability initiatives and standardise frameworks

The collaboration gap is a material obstacle preventing true adoption of sustainability in investment	1.1
My organisation would benefit from greater internal collaboration	0.9
My organisation would benefit from greater external collaboration	1.1

4. Purpose gap

An obstacle? 80% agreement*

- Understand and develop purpose, and link to sustainability
- Develop culture; create psychological safe space to allow failures
- Commitment to sustainability innovation including 3-D mandates

The purpose gap is a material obstacle preventing true adoption of sustainability in investment	0.8
Investment organisations, in general, have an underdeveloped purpose	0.7
There is a significant link between quality of culture and effectiveness in sustainable investing	1.4

Other actions / issues

- Transformational change is needed
- Issues of scale for smaller asset managers
- Develop more expertise in primary investment
- Work with public sector
- Change the conversation in all board rooms
- Simplify other sustainability challenges, as we have for climate

* All questions in the two roadmap session had the same answer format – strongly agree through to strongly disagree. We have assigned a score of +2 to strongly agree, +1 to agree, 0 to neutral, -1 to disagree and -2 to strongly disagree. The aggregate score can therefore range from +2 (100% of responses for strongly agree) to -2 (100% for strongly disagree). A score of +1.0 is equivalent to 100% agree but many different distributions of responses can produce this aggregate result.

Roadmap session – poll results (1)

Number of votes: 60 - 78	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The skills gap is a material obstacle preventing true adoption of sustainability in investment	32%	56%	8%	3%	1%
To remain competitive, investment organisations will need to introduce mandatory sustainability training	40%	52%	5%	1%	1%
The skills gap is more about current professionals keeping up with ESG developments (continuous professional development) than new professionals learning their ESG foundations	16%	33%	24%	24%	3%
The data gap is a material obstacle preventing true adoption of sustainability in investment	42%	41%	12%	4%	1%
The data challenge will be solved within five years	6%	28%	33%	28%	6%
We don’t need more data, we need to use existing data better	11%	29%	27%	26%	7%
Bridging the data gap is as much about solving people issues (T-shaped talent, culture, governance) as it is technical issues	32%	38%	17%	12%	2%

Roadmap session – poll results (2)

Number of votes: 52 - 57	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The collaboration gap is a material obstacle preventing true adoption of sustainability in investment	30%	54%	11%	4%	2%
My organisation would benefit from greater internal collaboration	35%	38%	15%	8%	4%
My organisation would benefit from greater external collaboration	42%	40%	8%	8%	2%
The purpose gap is a material obstacle preventing true adoption of sustainability in investment	26%	46%	16%	11%	2%
Investment organisations, in general, have an underdeveloped purpose	24%	45%	16%	11%	4%
There is a significant link between quality of culture and effectiveness in sustainable investing	57%	34%	8%	0%	2%

Limitations of reliance and contact details

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.

The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

Limitations of reliance – Willis Towers Watson

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this material and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.

Contact Details

Paul Deane-Williams | paul.deane-williams@willistowerswatson.com

Marisa Hall | marisa.hall@willistowerswatson.com

Tim Hodgson | tim.hodgson@willistowerswatson.com

Roger Urwin | roger.urwin@willistowerswatson.com