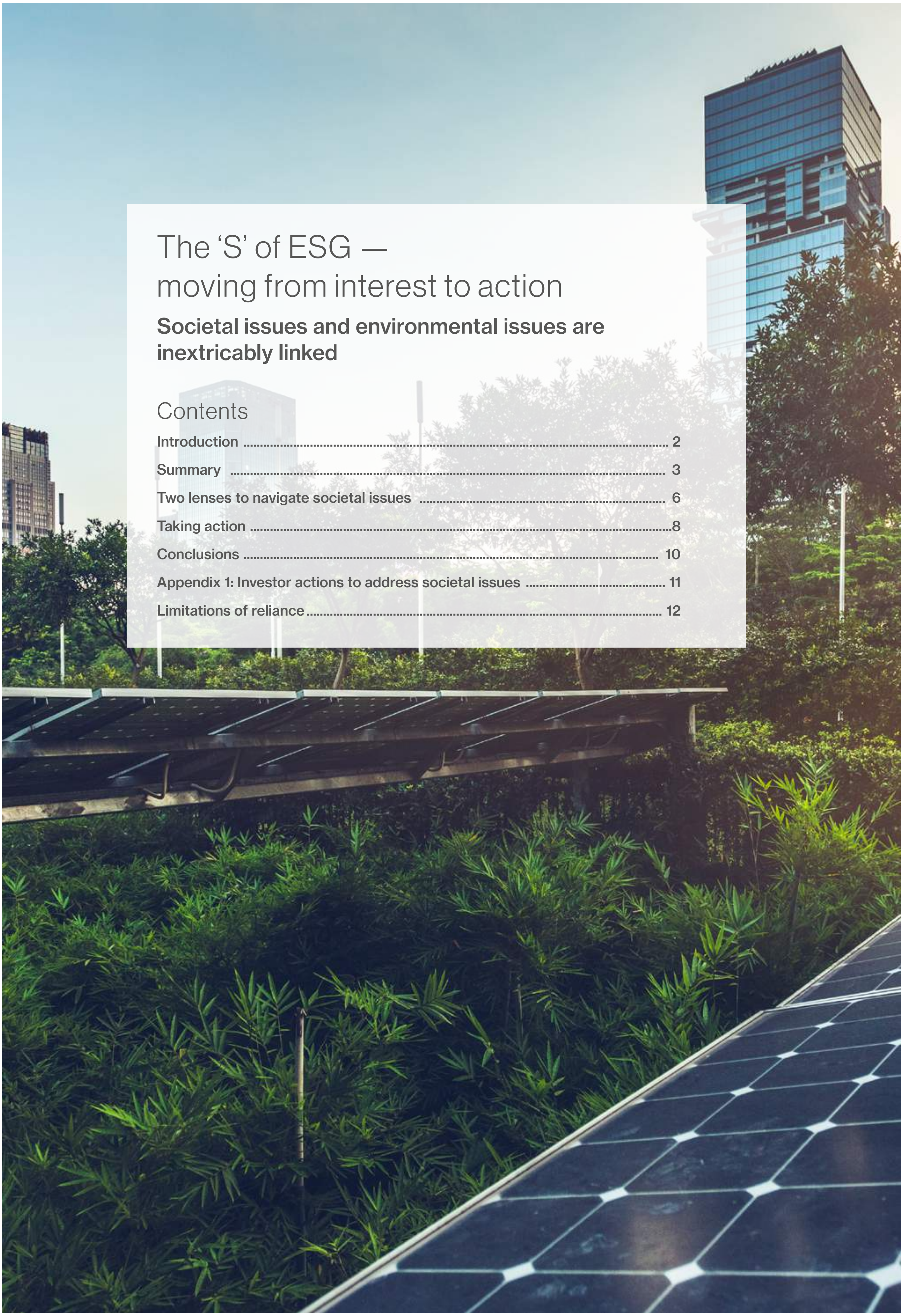
Thinking Ahead Institute
An innovation network founded by WTW

The 'S' of ESG — moving from interest to action

Societal issues and environmental issues are inextricably linked



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Introduction

This document has been written by members of Thinking Ahead (Tim Hodgson and Anastassia Johnson) following the research and discussion conducted by the Thinking Ahead Institute's investing for tomorrow (IFT) society working group. The authors are very grateful to the members of the working group for their input and guidance but stress that the authors alone are responsible for any errors of omission or commission in this paper.

The key objective of this working group was to explore societal issues in the context of the investment industry. The exploration was motivated by a shared belief among the members that the 'S of ESG' had not received, to-date, the attention and priority it warranted. It was hoped that the exploration would uncover strong arguments for addressing the historic deficit in attention, and also practical actions that could be taken.

The members of the IFT society working group, chaired by Tim Hodgson of TAI, were as follows:

- Adam Semaine (WTW)
- Anne Lee (Commonwealth Superannuation Corporation)
- Cristina Serrano (Santander AM)
- Ed Evers (Ninety One)
- Hannah Skeates (Allspring Global Investments)
- Herschel Pant (AXA IM)
- Jeroen Rijk (PGB Pensioendiensten)
- Mirko Cardinale (USS)
- Praneel Lachman (FirstRand Bank)
- Robert Douglas (OPTrust)
- Tracy Burton (Coronation)
- Vishal Hindocha (MFS)
- Yolanda Blanch Ruiz (Pensions Caixa 30)
- Zak May (IFM Investors)

Summary

The working group set out to research and discuss the relevance, to investment and investment organisations, of significant societal issues that exist today. While what constitutes 'significant' can be debated, the working group considered two of the many potential societal issues. The first set of meetings were dedicated to inequality, which was then followed by discussions on just transition. Conclusions that the group kept coming to were echoing each other and laid bare the reality that these issues are, firstly, difficult to discuss and reach agreement on in a business environment and, secondly, they are not understood enough. There is no guide or a roadmap of how to really deal with these issues. What is the final goal of a just transition? How do we measure progress of our actions? What exactly is inequality and how much of it is too much?

We note up front that we did not follow what is arguably the definitive framing of social issues – the UN sustainable development goals (SDGs). We wished to explore, from the inside, the issues that mattered to investment, and that investment may be able to do something about, rather than start with an external framework of nationally-desirable goals. That said, we hope that the links between the ideas within this paper and some of the SDGs are self-evident.

This paper is structured as a narrative argument followed by an appendix containing practical actions. The narrative builds to a conclusion that we need a mindset shift to attach much greater importance to societal issues. Assuming the narrative is successful in making this case, the reader is strongly encouraged to spend time in the appendix considering which actions would be appropriate for their organisation to take.

Societal issues are particularly difficult

Without detracting in any way from the enormity of environmental issues, we note upfront that societal issues present their own unique difficulties. Unlike environment, where consensus points to two main issues of concern (climate change and natural resource management), society contains a multitude of topics all competing for attention. In addition, unlike climate where 'net zero' acts as a clear end-goal, there is not a clearly-defined and widely-agreed equivalent end-goal for any of the societal topics[1].

These point to difficulties in selection, implementation and assessment of societal topics. Assuming we are able to at least clear the selection hurdle, having impact on the topic will also require:

- Intentionality | we deliberately pursue actions that our theory of change suggests will have the impact we desire, AND
- Additionality | it is reasonable to expect our actions, given our size and their force, to make a noticeable difference, AND
- Agency | where we need to respect both the limits of our agency given that it isn't our money, and the opportunity provided by our agency both to act in the long-term best interests of our clients, and to proactively engage with them on that basis.

Inequality | what is it, and does it matter?

Inequality is a very big, multi-faceted and complex subject. Our working group conversations were long and deep, informed by multiple references to the work of academics and non-governmental organisations (NGOs). At the same time, this was an initial exploration of one group of societal issues and so the idea of reaching detailed and definitive conclusions was beyond our scope. Consequently, we spent some time agreeing a generic definition for any form of inequality:

Inequality is the product of a system in which the privileged minority have the power to continue the unequal access to, or distribution of, system benefits.

A number of points are worth making about this definition. First, it suggests that inequality is an externality thrown off by the system, rather than a designed output of the system. Second, it acknowledges that the system privileges a minority at the expense of the majority. This leads us into the uncomfortable area of values (or ethics, or morals, if you prefer that terminology). Third, by implication, the privileged minority are interested in perpetuating the inequality, otherwise they would voluntarily work towards ending it. Finally, again by implication, it shows that addressing inequality will be difficult as it will (generally) be against the interests of those with power. There is room here for enlightened self-interest, and we will see more of that below, particularly in the case studies.

[1] We could argue that the UN sustainable development goals (SDGs) are 'widely-agreed end goals'. However, the translation of the SDGs into the investment arena is far from clear. Furthermore, an SDG end goal does not necessarily solve for the societal issue. For example, the end goal of SDG number 1 is the eradication of poverty, but this gives very little insight into the stopping point for addressing inequality.

When we turned to consider whether inequality matters, we concentrated on the financial case while mindful that values-based arguments would be important outside the scope of fiduciary duty. While we did explore historical evidence for the impact of inequality on economic development and asset returns, we choose not to report it here[2]. The working group were clear in their belief that we are at a break-point in history. Whether or not inequality had affected historic returns, what mattered were future returns.

There were three key reasons for separating the past and future:

1. Historic energy transitions (coal to oil, oil to gas) were able to proceed without concerns over sustainability. The current energy transition (fossil to renewable) is likely to proceed differently, diminishing the relevance of empirical evidence from the past
2. Any financial effects on asset returns of rising inequality within the USA and UK has been masked by a rising share of national income going to capital. It was believed to be unlikely that this trend would repeat over the next three decades
3. There is likely to be a threshold to inequality, past which it will impact financial returns. In other words, a certain level of inequality may be tolerated, but a small increase could trigger social rebellion.

In conclusion, the working group came to the view that we can't rely on a continuation of past experience and that inequality will erode our system in the future. **The persistence of inequality, let alone any increase, represents a risk to asset returns over the medium to long term.**

Just transition | what is it, and does it matter?

The second big societal topic we tackled was 'just transition'. The transition part comes from the E of ESG and the necessity to transform the economy so that it operates with net-zero annual emissions. The societal part is guiding this transition so that it is compatible with the idea of justice for all. This requires that the benefits of a green economy transition are shared widely and those who are to lose economically are supported appropriately. This, of course, is easier said than done. We will unpack the issues further below, but as a taster of the complexity consider the question of scale: for whom are we seeking justice? Is it long-serving employees of our investee company, all current employees, or all current and future employees? Or is it to ensure that all citizens of our home nation are treated fairly? Or are we interested in justice for three billion people in the global south?

As for inequality, our consideration of whether justice matters acknowledged values-based perspectives, but emphasised financial considerations. The majority of the working group members agreed that a transition of some form is inevitable, but that justice is not inevitable. Arguably, the economy is already in transition and has been for some time. However, the current market system searches for the lowest cost and highest profit outcome, which does not always mean a just outcome. There was unanimous agreement among the working group members that an unjust transition would be good for short-term profits, but bad for long-term profits and long-term risk-adjusted returns. This implies that there is near-term scope for companies and their capital providers to extract financial gains at the expense of other stakeholders, but that scope is limited in size and or time-scale. It also implies that ignoring issues of justice in the short-term will raise financial risks in the longer-term.

[2] In sketch form, we found some evidence that inequality has adversely affected economic growth [International Monetary Fund Causes and Consequences of Income Inequality: A Global Perspective https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf; OECD Focus on Inequality and Growth https://www.oecd.org/social/Focus-Inequality-and-Growth-2014.pdf. We were unable, however, to find evidence suggesting that negatively affected growth reduced past returns. Several studies [https://site.warrington.ufl.edu/ritter/files/2015/04/Economic-growth-and-equity-returns-2005.pdf] have even suggested that sometimes the correlation between stock returns and economic growth across countries can be negative [https://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578]. We concluded that, to-date, the financial effects of rising inequality within countries have been

Two lenses to navigate societal issues

#1 Intentionality, additionality and agency

This first lens can also be thought of as a micro lens, as it relates to our individual organisation. While having the desire to see society prosper is great, having impact on our chosen topic will also require our organisation to have intentionality, additionality and agency (we define these terms in the section Societal issues are particularly difficult above).

The issue of agency leads us directly to fiduciary duty[3]. Arguably fiduciary duty was the most important component of all the working group's discussions, and is the foundation for all the other considerations. Perhaps the two most important questions for investment organisations to consider and resolve are:

1. Is pursuing societal impact consistent with fiduciary duty? and
2. Is fiduciary duty a constraint on pursuing societal impact?

Our conclusion to the first, from the perspective of long-term value creation, is that pursuing societal impact is entirely consistent with fiduciary duty. If nothing else, it is about long-term risk management. Our conclusion to the second is similar. Fiduciary duty is not a constraint on pursuing societal impact, because the inherent complexity of societal issues (lagged feedback, measurement issues, difficult trade-offs) means there is a significant opportunity for long-term investors to step in and create inter-generational value.

#2 The operation and objective of the system

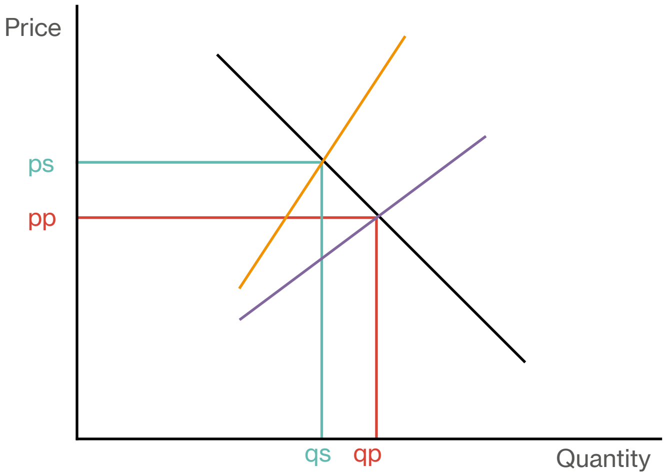
The second lens is a macro, system-wide lens. Navigating and influencing societal issues effectively will require us to understand the system which has created those issues in the first place. Ours is a market system where prices are posted to entice us to transact. It follows that there is an incentive to post the lowest price, in order to secure the greatest number of transactions. The end result of this incentive is efficiency, as all unnecessary cost (waste) is eliminated. In a sense the maximisation of efficiency can be thought of as the objective of our market system[4]. This is a desirable objective provided that two conditions are met: first, that in eliminating unnecessary costs we do not also eliminate necessary costs and, second, that the external environment is not changing faster than the system can adapt.

The first condition gets at the idea of externalities. We have suggested above that societal issues are externalities thrown off by the system. In a different phrasing, someone has decided that the cost of addressing the societal issue is an unnecessary cost, and so the cost is externalised. This means the rest of the system gets to pick up the consequences as and when they arise. This is one source of systemic risk, and is our link back to fiduciary duty and the idea of long-term risk management. Exacerbating societal issues, which essentially means injustice is being made worse, is highly likely to increase systemic risk, and therefore we should expect to see a rise in (1) litigation (eg Peruvian farmer vs RWE), (2) human rights judgements, (3) climate migration, and/or (4) repudiation of the current system by increasing numbers of citizens.

[3] We have previously written on fiduciary duty in the context of climate change, and believe the ideas are equally applicable to the societal issues we are discussing in this paper – provided that you agree with us that societal issues are also sustainability issues. The interested reader may wish to refer to pp12-13 of Investment beliefs to change the climate trajectory, Thinking Ahead Institute 2021

[4] Strictly, systems do not pursue an objective. The original architects of the system may well have had a purpose or objective in mind when establishing the system, but the organic adaptation of the system over time means that quite different outcomes can result. Instead, we look backwards at what the system has produced and infer the objective.

The second condition highlights that efficiency is only desirable in the absence of significant shocks to the system. Efficiency means that resources are highly optimised to current conditions, so if the conditions change too quickly or too dramatically we can suddenly find that the distribution of resources becomes far from optimal. In rapidly-changing conditions resilience is typically more valuable than efficiency.



We can combine these two thoughts within the notion of a socially-efficient allocation of resources. Here, externalities are fully costed and therefore prices are higher which, in turn, means a lower quantity of goods (in the diagram, the point (ps, qs)). This appears financially inefficient relative to a free market allocation (pp, qp), but is consistent with a business maximising 'fully-costed profits' and does not necessitate that 'fully-costed profits' are less than 'externality-boosted profits'.

The conclusion to these thoughts is that we probably need to intervene more heavily in the operation of our current system. Just as with COVID, where many countries quickly switched from just-in-time supply management to just-in-case, it is likely that we will need more resilience and less efficiency as we navigate the energy transition, and the working group would like to see more of the externalised costs of societal issues internalised into operating costs – for the sake of long-term value creation and risk management.

From here we can circle back to our micro lens. In the same way that we have argued that the system would be improved if it 'pursued' a modified purpose, so too can a refreshed organisational purpose counteract the pull to short-term finance-only results, and reinforce the focus on long-term inclusive value creation.

Taking action

We have already hinted above that taking action on societal topics is difficult. Which of the multiple topics do we choose? What is the route to having impact? How do we achieve the necessary scale if we are not big enough individually? What is the end goal, and how do we measure progress? To address this, a strong focus was placed on identifying tangible actions early in the discussions and members were asked to present case studies of actions their organisations were already taking. Here we discuss the case studies, while the list of actions can be found in the appendix.

Case study 1 | modern slavery regulation in Australia

Australia's Modern Slavery Act 2018 (the Act) aims to combat modern slavery in global supply chains. The Act currently applies to more than 3,000 entities which must prepare annual modern slavery statements against seven mandatory criteria. The Act requires reporting entities to explain their actions to assess and to address modern slavery risks in their operations and supply chains.

The case study organisation made an early decision to embrace the spirit of the Act, and to pursue a path that might generate genuine impact, rather than one that delivered a compliance tick-box exercise. To make the exercise practical, the organisation defined its scope as including ongoing relationships with investment managers and/or suppliers. The organisation first reviewed and enhanced its own modern slavery governance framework, before encouraging its partners to develop, review and improve their policies and processes regarding modern slavery risks. As the data began to come back up the supply chain, it then set about prioritising engagement activities, guided by the materiality of the problem, and by their likely level of influence. The level of influence can be enhanced through collaborations, including both collaborations with NGO knowledge specialists, within sectors across common suppliers, and within the UN sustainable development goals (SDG) 17 Rooms initiative (important at the design stage), leading to the development of a shared assessment tool.

While the requirements of the Act are still very new, it is already possible to point to several positive developments, including increased education, improved governance of offshore managers/suppliers, more robust tools, and notable improvement and learning on previous years – for example the use of anonymous bottom-up worker voice tools versus top-down management audits.

2 | The operation and objective of the system

The Broad-Based Black Economic Empowerment (B-BBEE) programme provides a legislative framework which aims to advance economic transformation and enhance the economic participation of Black people in the South African economy. B-BBEE compliance is measured by means of a scorecard which scores each company on a number of elements, such as its ownership, management and procurement. The score affects the willingness of government and other institutions to engage in business activities with that company.

The case study organisation was an investor in a company where the sale of shares by the original B-BBEE partners had left the company 'unempowered' in terms of ownership structure. The organisation engaged extensively with the investee company management and external advisers over six months to structure a long-term deal with an innovative funding structure that achieved genuine broad-based empowerment, while at the same time addressing the concerns of a potential dilution in value for existing shareholders.

The deal entailed the raising of fresh capital by the B-BBEE partner by way of an issue of R6.6 billion of preference shares, of which R1.6 billion (24%) was subscribed to by the case study organisation. The proceeds of the capital raised was used to invest in an issue of new ordinary shares by the investee company, which in turn was applied to growth strategies. This resulted in the new partner becoming a significant 31.4% shareholder in the company.

The case study organisation's involvement ensured that the preference shares were appropriately structured and priced to generate market support and adequate liquidity. The resulting B-BBEE ownership comfortably exceeded the minimum requirements and provides the company with a 35% empowered status, which is believed to provide a comfortable buffer against any future regulatory change.

Case study 3 | investing in social housing in North America

Approximately 33% of households in Canada live in rented accommodation. This has become a more important component of Canada's housing system as deteriorating homeownership affordability, alongside a growing young demographic and increased immigration, has led to strong demand for renting.

The case study organisation believed that unremedied, the housing situation was likely to create challenges for social justice and a reduction in economic prosperity. These challenges were expected to have a negative impact on the real estate market in Canada. As stewards of long-term capital, they were keen to explore opportunities where barriers to affordable rental housing could be reduced without negatively impacting financial returns. A solution was to leverage government incentive programs aimed at improving rental affordability. This led them to invest in building new residential properties where a proportion of units would be reserved for community housing. The organisation now has a number of new developments across North America and are delivering hundreds of rental units and community housing. It is described as a continuous learning exercise with each project developing new ways to incorporate social housing into new property development. It was interesting to note that societal issues can be combined with environment issues via a collaboration with partners on the largest net-zero carbon residential project in Canada.

Partnering with governments has been important in developing and delivering these projects. Incentives and tax exemptions help make projects happen, but so do flexible planning authorities. There is still a lot to be learned about possible ways to collaborate with policy makers to create opportunities for addressing social housing issues through regulation instead of voluntary action.

As a fiduciary, it was important to bring these projects forward thoughtfully. They considered how a strategy to create affordable rental housing could be executed while still generating attractive returns for the organisation. They started out with smaller projects and looked for opportunities to receive feedback from stakeholders and keep their Board informed to make sure objectives were aligned. As confidence grew, so did the size of the projects.

Case study 4 | supporting basic finance education in children from primary school to university

The case study organisation saw a lack of financial education as contributing to societal issues (particularly inequality) observed among adults. Consequently it sought to make financial learning more accessible through funding several programmes, and partnering with charities in different locations. Activities included:

- Providing office space and resources to a UK education charity, RedSTART, which delivers financial education to primary age children; and to a similar programme for older children in France
- Supporting the KickStart Money initiative, which calls for effective financial education to become a compulsory element of the national primary school curriculum
- Promoting finance as a career option at universities
- Creating videos to provide better access to financial education and positioning the industry to attract more motivated people and aid social mobility.

The impact of the activities is hard to measure and, for some (such as primary school education) will be only possible to measure at a much longer term than the usual cycle. As a result, the programme is subject to qualitative review.

Conclusions

The case studies above divide neatly into two groups. The first two represent 'forced' actions where the organisations needed to comply with regulations (albeit they chose to go beyond the minimum requirements to achieve greater impact), while the second two represent voluntary actions. The case studies of voluntary action shared within the group were genuinely inspiring, and yet also showed the limits of how much impact is achievable under the constraint of fiduciary duty. The housing example was a first step back from profit-driven / market-based real estate provision, but remains several steps removed from the root societal issue of homelessness. The financial education example was also admirable, but also showed how big the need is, and how many follower organisations would be needed to help share the cost. The forced actions showed the power of public policy to initiate behaviour change – and also highlighted how public policy has yet to be targeted at other significant societal issues.

The next major conclusion is how deeply interconnected multiple issues are. For example, climate and societal issues overlap and affect each other, but at the same time these issues run in parallel and differ significantly:

- Our understanding and level of engagement with societal issues are several years behind climate change discussions, but we believe they will mature with time
- Climate issues are governed by physical and chemical realities and are a result of our interactions with an external natural environment. Inequality is a function of human choices where our interactions with each other affect the societal outcomes
- Climate issues have a common currency of greenhouse gas emissions and have a robust science behind it. With societal issues it is harder to know what 'good' or 'better' looks like because subjective values tend to be involved.

A further example of an important intersection is between the two topics considered by the working group – just transition and inequality. The group's view is that the transition will not occur if it is inequitable. Similar to the idea that decarbonising one's own portfolio does not protect against climate risk if the rest of the world does not decarbonise, the global north may be able to afford the transition to clean energy, but will still face climate change if the global south cannot afford the transition. Regrettably, it is almost certain that the costs of climate change will fall disproportionately on those least able to bear them – further exacerbating inequality.

It is true that the members of this working group were self-selected, and so there is no surprise that it concluded that societal issues were already important, and would become more so. While the appendix contains multiple ideas for taking practical action, the really big ask is for a mindset shift. The climate problem is not a technical problem requiring a technical solution, it is a human-caused problem requiring a human-centred response. We see inequality and justice as intrinsically intertwined with climate, and therefore requiring a joint and simultaneous solution.

Appendix: Investor actions to address societal issues

Below is a list of actions investors could take to address social issues of inequality and just transition. The actions were collated from a number of sources (UNPRI[5], TIIP[6], TAI[7] and IGCC[8]).

	Macro / systems thinking actions
1	Refresh organisation's identity (culture reset)
2	Settle beliefs and level of ambition
3	Adjust internal resources (entity and sector level engagement)
4	Adjust external resources (3D mandates, strategic partnerships)
	General actions
5	Collaborate with wider group of stakeholders
6	Collaborate with other investors to create a stronger voice
7	Public policy engagement
	Employee relations and labour rights
8	Incorporate expectations of fair labour practices
9	Engage with corporations
10	Implement responsible contractor policies
11	Attribute value to income equity
12	Encourage a balance between appropriate cost controls and responsibility towards the workforce
	Corporate taxation
13	Clarification of tax expectation
14	Engagement on tax policies and practices
15	Endorsement of tax principles
16	Understanding tax as corporate social responsibility
17	Articulation of tax as social capital
	CEO compensation
18	Assessing the short and long-term effects of tying CEO compensation to stock price appreciation
19	Developing alternative models that balance the rewards to stockowners with making investments in employees and other stakeholders that enhance the value of the corporation
20	Assessing the short and long-term implications of alternative incentivisation models

[5] UNPRI report "Why and how investors can respond to income inequality" https://www.unpri.org/download?ac=5599
[6] TIIP "Confronting Income Inequality"
https://tiiproject.com/wp-content/uploads/2021/06/Confronting-Income-Inequality-Toolkit-TIIP-Updated-6-8-218575.pdf
[7] TAI "With great power comes great responsibility" https://www.thinkingaheadinstitute.org/research-papers/with-great-power-comes-great-responsibility/
[8] IGCC "How investors can support an equitable transition to net zero"
https://igcc.org.au/wp-content/uploads/2021/07/IGCC-Investors-role-in-an-Equitable-Transition-to-net-zero-emissions_FINAL-150720211-copy.pdf

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. 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.

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We seek collaboration with like-minded organisations to achieve our vision, so for more information about us please contact:

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About the Thinking Ahead Institute

Since establishment in 2015, around 100 investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies;better organisational effectiveness and strengthened stakeholder legitimacy.

Led by Tim Hodgson, Roger Urwin, Marisa Hall and Paul Deane-Williams our global not-for-profit research and innovation hub connects our members from around the investment world to harnesses the power of collective thought leadership and bring these ideas to life. Our members influence the research agenda and participate in working groups and events and have access to proprietary tools and a unique research library.

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