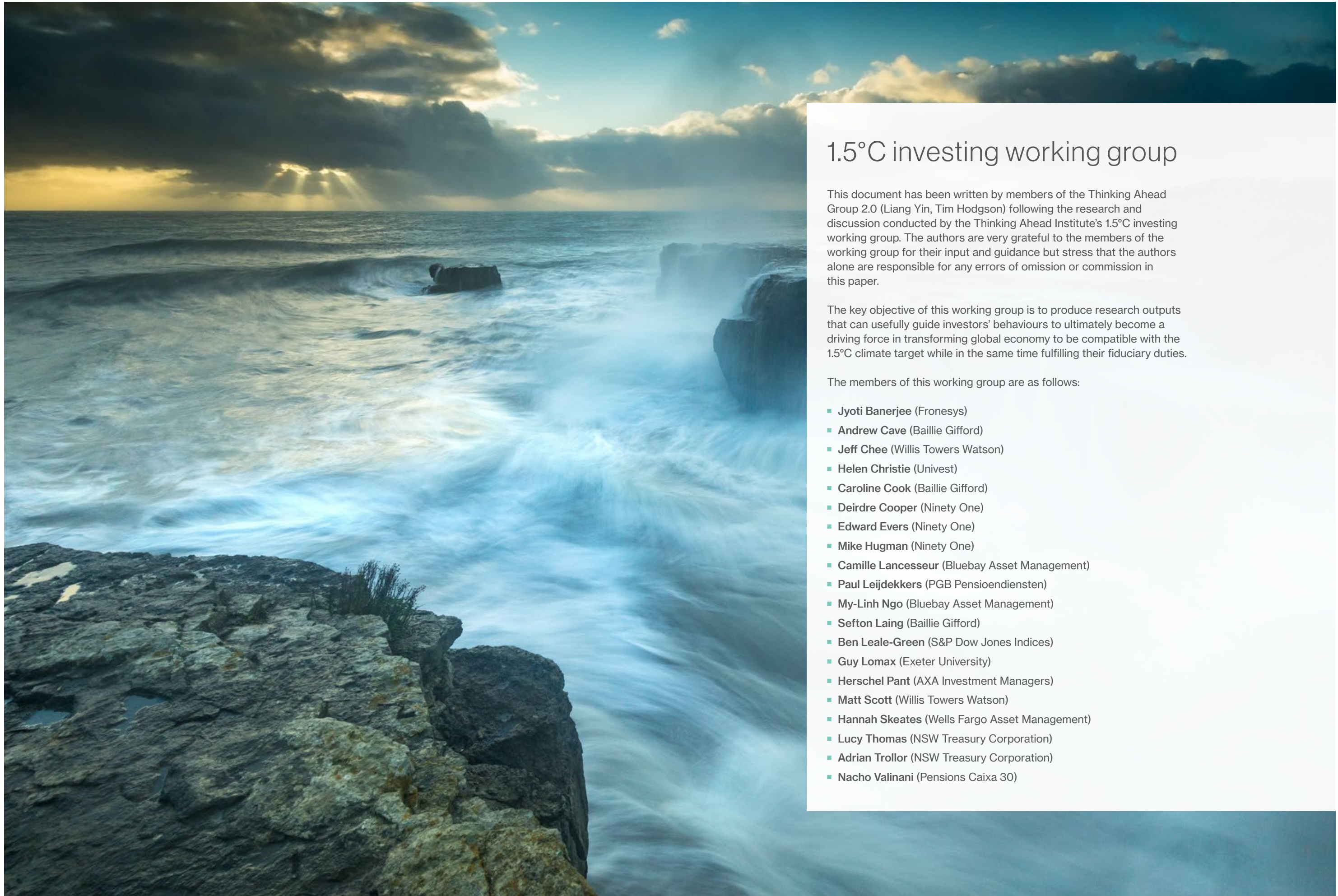


Thinking Ahead Institute

Climate actions start with beliefs

Part of a series of articles from the 1.5°C investing working group





1.5°C investing working group

This document has been written by members of the Thinking Ahead Group 2.0 (Liang Yin, Tim Hodgson) following the research and discussion conducted by the Thinking Ahead Institute's 1.5°C investing 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 is to produce research outputs that can usefully guide investors' behaviours to ultimately become a driving force in transforming global economy to be compatible with the 1.5°C climate target while in the same time fulfilling their fiduciary duties.

The members of this working group are as follows:

- **Jyoti Banerjee** (Fronesys)
- **Andrew Cave** (Baillie Gifford)
- **Jeff Chee** (Willis Towers Watson)
- **Helen Christie** (Uninvest)
- **Caroline Cook** (Baillie Gifford)
- **Deirdre Cooper** (Ninety One)
- **Edward Evers** (Ninety One)
- **Mike Hugman** (Ninety One)
- **Camille Lancesseur** (Bluebay Asset Management)
- **Paul Leijdekkers** (PGB Pensioendiensten)
- **My-Linh Ngo** (Bluebay Asset Management)
- **Sefton Laing** (Baillie Gifford)
- **Ben Leale-Green** (S&P Dow Jones Indices)
- **Guy Lomax** (Exeter University)
- **Herschel Pant** (AXA Investment Managers)
- **Matt Scott** (Willis Towers Watson)
- **Hannah Skeates** (Wells Fargo Asset Management)
- **Lucy Thomas** (NSW Treasury Corporation)
- **Adrian Trollor** (NSW Treasury Corporation)
- **Nacho Valinani** (Pensions Caixa 30)



Why investors need beliefs in tackling climate change

To the chagrin of the world's leading business schools, few universal investment "truths" have stood the test of time. Just as The Theory of Everything may forever elude physicists, so investing refuses to be tied down to a formula.

Instead of seeing the investment world as being machine-like that can yield to mathematical prediction, we postulate that financial markets are examples of complex systems, where "the whole is greater than the sum of the parts".

Our planet's life supporting system is the ultimate complex system that matters to every one of us. In addressing the challenge of climate change¹, investors are facing immense levels of uncertainty, compounded by a long time horizon. These include unknown unknowns that are impossible to model or measure (eg the climate technology that is yet to emerge). A set of strong investment beliefs acts as a long-term compass to guide investment decisions in such an environment.

Further, this interconnectedness in investor beliefs and actions gives rise to the phenomenon of reflexivity, which not only means that fundamentals affect asset prices, but also that asset prices – through their impact on behaviours – can change the fundamentals. Climate challenges may produce behavioural responses from asset owners, whose collective actions have the potential to change the future climate trajectory. Dealing with this combination of uncertainty, reflexivity and collective actions requires strong governance processes to achieve mission clarity in which beliefs will be a fundamental element.

There is strong practical evidence that beliefs improve investment outcomes. First, studies, such as [Best-Practice Investment Management](#) by Clark and Urwin (2007) have highlighted the importance of investment beliefs within an overall governance framework.

Second, our work with investors has shown that having structured beliefs saves time (and resources) in the decision-making process. Beliefs help us to know when to act (and when not to). And they help us avoid mistakes by introducing rigour into the investment process (which is particularly useful in times of stress).

"Instead of seeing the investment world as being machine-like that can yield to mathematical prediction, we postulate that financial markets are examples of complex systems, where "the whole is greater than the sum of the parts".

¹ The investment industry and climate change | framing the problem



The process of building strong beliefs

Investment beliefs are statements that capture our high-level understanding of how the investment world works. They guide the investment organisation to certain types of decisions and content. They normally encompass the full spectrum of investment issues: mission, goals, risk, time horizon, alpha, beta, smart beta, governance, sustainability and other areas. They should be broad in recognising multiple strands and deep in recognising complex investment features.

Effective investment beliefs are accurate, documented and validated and need to be consistently applied in the decision-making process at all levels. The best investment beliefs are smart (reflective of good insight) and edgy (reflective of competitive positioning).

Some investment beliefs are more contentious than others. The process (see Figure 1 for an example) of developing shared beliefs involves considering something inherently abstract (“soft”) and codifying it in a clear and more tangible form (“hard”).

Investment beliefs are inevitably subjective (because of the uncertainty and reflexivity discussed above) and as a result may differ across team members in the organisation. So achieving a level of alignment is key; that is, the members of the organisation need to be aligned in supporting the adoption of certain beliefs. We suggest that in practice this is more about a settlement than a consensus.

Putting beliefs into action is the acid test of course. Good belief systems will be translated into actual decisions, which feed into strategies and policies. Using them in practice requires some discipline but the outcomes of aligned and actionable beliefs are more coherent decisions.

Figure 1 – beliefs process – an example

Process stage	Core tool or action	Outcomes
1 Survey at all levels	Primary Beliefs assessed based on single factors	<ul style="list-style-type: none"> Conviction vectors
2 Develop beliefs into actionable beliefs	Working Beliefs developed by exec derived from Primary Beliefs	<ul style="list-style-type: none"> Strawman Working Beliefs
3 Settle the Working Beliefs	Adopt socialising / settlement phase. Integrate with corporate values <i>Apply triage process*</i>	<ul style="list-style-type: none"> Final Working Beliefs
4 Map Working Beliefs to Policies to Portfolios	Map Working Beliefs into investment guidelines	<ul style="list-style-type: none"> Principles and Policies Document Portfolio comply
5 Socialise more deeply	Socialise Beliefs and build out greater organisation-wide understanding	<ul style="list-style-type: none"> Organisation-wide beliefs measured in associate engagement

* Triage Process. Test strawmen beliefs under independent Agree / Can Live With / Don't Agree choices
Move to adopt belief if Agree's get 50% majority and Agrees + Can Live With's get 75% majority



“Effective investment beliefs are accurate, documented and validated and need to be consistently applied in the decision-making process at all levels. The best investment beliefs are smart (reflective of good insight) and edgy (reflective of competitive positioning).”

Three necessary components for climate beliefs

Beliefs are unique to each investor and must be developed over time, with reference to the needs of the investor and the investor's perception of the market environment.

While there are no shortcuts to the creation of useful beliefs, we offer a simple structure – think of them as scaffolding poles – you can adopt as a starting point. It can be used to frame the discussion for the climate belief building process.

In our view, climate beliefs need to cover three main areas. It is sensible to start with beliefs about the science. This is likely the least contentious area, founded on data and scientific interpretation. Climate change beliefs also need to cover investment risks as well as opportunities associated with a warming planet. This is a more contentious area for most organisations.

It concerns judgement as to what is in the price, and the unknowable path of future trends. The most contentious, and yet necessary, to cover are beliefs about the system. Beliefs in this area cover leadership, competitive positioning and responsibility, and reflexivity. In figure 2, we list example belief statements that were polled and discussed within the 1.5°C working group. While it is by no means a definitive list of questions that cover all the important aspects, we hope it is a useful starting point that can lead to further “finer-grained” beliefs. In drafting your belief statements, it is important to note that language matters. The same idea can be expressed positively or negatively, causing the reaction to differ. That said, useful climate beliefs are unlikely to be bland.

Figure 2 – belief statement examples. Unless specified otherwise, the answer options are (1) strongly agree (2) agree (3) neutral (4) disagree (5) strongly disagree.

1 Beliefs about the science

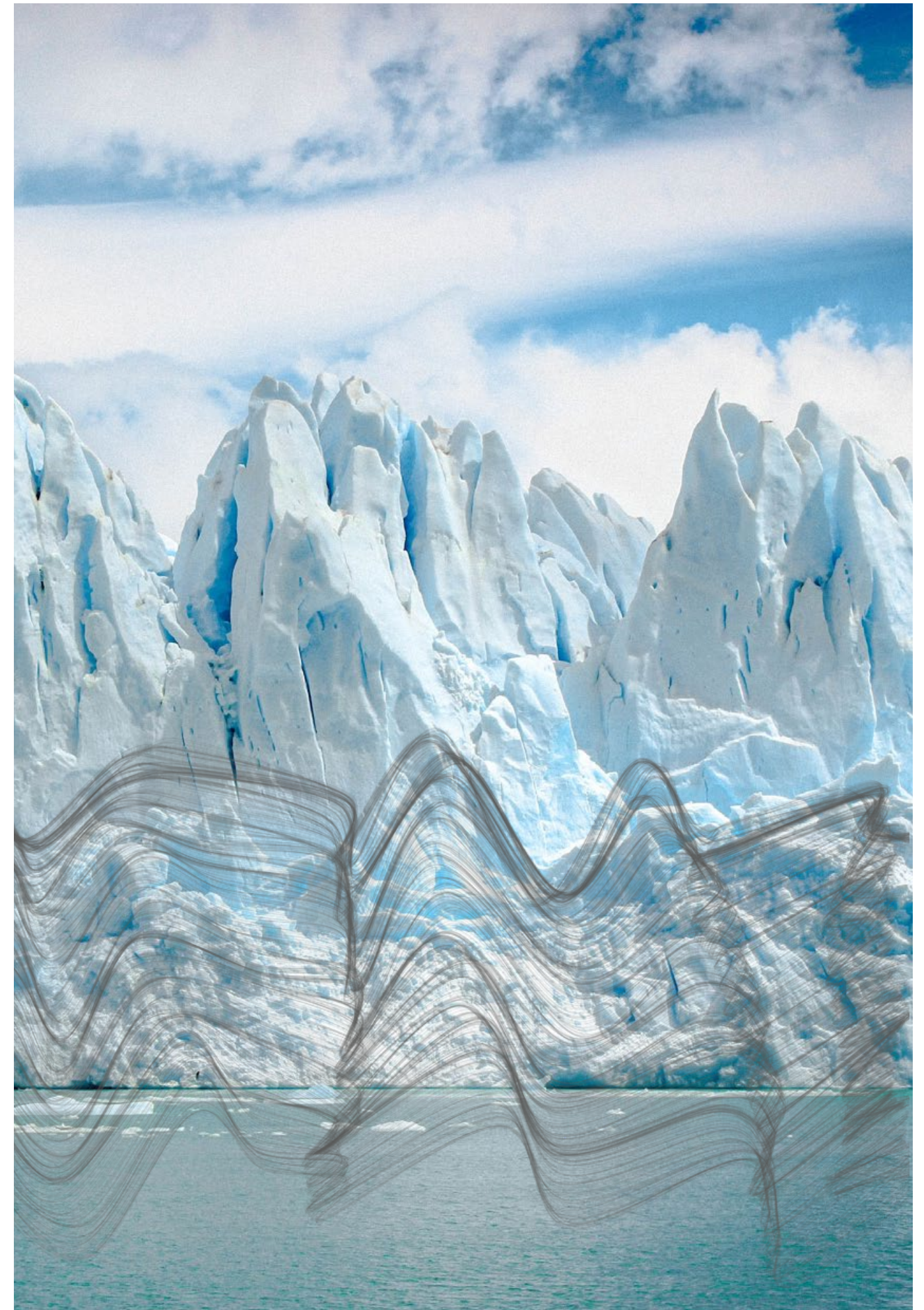
- The current and projected increase in global average temperature is predominantly due to human activity.
- Climate is a non-linear system, meaning that the risks grow ever larger with each additional increment of temperature increase.
- The climate system contains tipping points which, if triggered,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

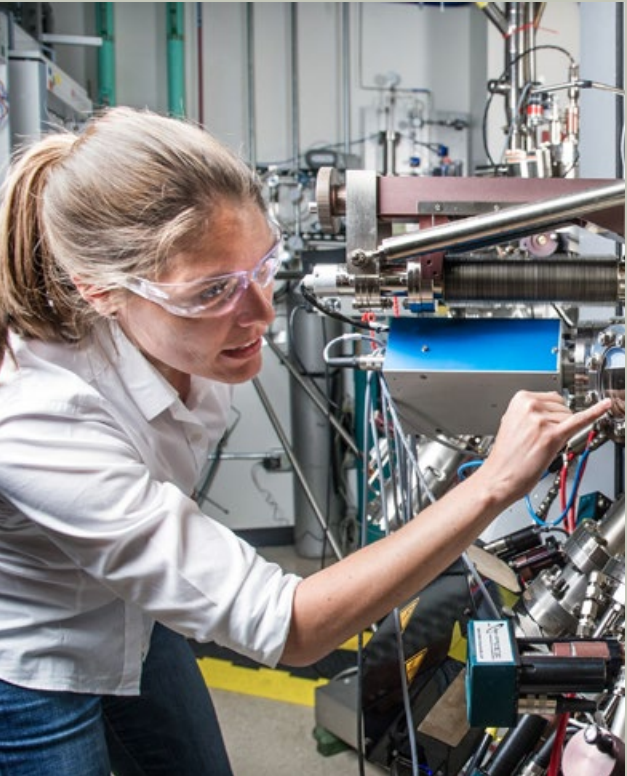
- Investors can gain significant competitive advantage through their strategic response to climate change.
- My organisation carries profound responsibility as a steward of existing assets, and as an allocator of new capital.
- Legislation and regulation will be introduced to shift activity towards net-zero, 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.



Conclusion and what's next?

We have an important message for you. There is a strong case for each investment organisation to develop, discuss, agree and document its climate beliefs. The upfront investment of time pays handsomely thereafter. And the complexity involved with climate change challenges call for strong organisational beliefs to guide actions. In the paper we have proposed three necessary "scaffolding poles" for constructing climate beliefs: these are beliefs about the science, the risk and return opportunities and about the whole system.

Now it is time for you to start laying the bricks.



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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Contact details

Tim Hodgson
+44 1737 284822
tim.hodgson@willistowerswatson.com



The Thinking Ahead Institute

About the Thinking Ahead Institute

Mobilising capital for a sustainable future.

Since establishment in 2015, over 60 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 and Marisa Hall, 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.

Join the Thinking Ahead Institute

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

Paul Deane-Williams
+44 1737 274397
paul.deane-williams@willistowerswatson.com



About the Thinking Ahead Institute

The Thinking Ahead Institute seeks to bring together the world's major investment organisations to mobilise capital for a sustainable future. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 40 members with combined responsibility for over US\$12trn.

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