Sustainability in investment

TOWERS WATSON

"If your plan is for one year, plant rice. If your plan is for ten years, plant trees. If your plan is for one hundred years, educate children."

Confucius

In short

Asset owners and asset managers around the world are struggling with what it means to be a sustainable investor. The theory is developing, incorporating the concepts of 'appropriately long time horizons for planning', 'capturing environmental, social and corporate governance (ESG) factors into the investment process', and 'effective ownership'. For many investors the concept of sustainability has broader meaning and the practical implication and application of sustainability is proving challenging.

This paper draws on research undertaken in collaboration with Oxford University.[1] This research was designed to help investors overcome these challenges, by exploring practical solutions and processes to enable investors to become sustainable investors. It has relevance for asset allocation, risk factor allocation and mandate allocation.

We consider sustainable investing in its broadest sense, incorporating ESG but going beyond to consider the large inter-generational issues that institutional funds need to take into account.

The Telos project has been undertaken by Towers Watson and Oxford University. The research of Oxford University was supported by 22 Industry Partners. Towers Watson also drew on the knowledge and views of eight prominent investment thinkers.

We would like to thank all contributors to the project.

Further information

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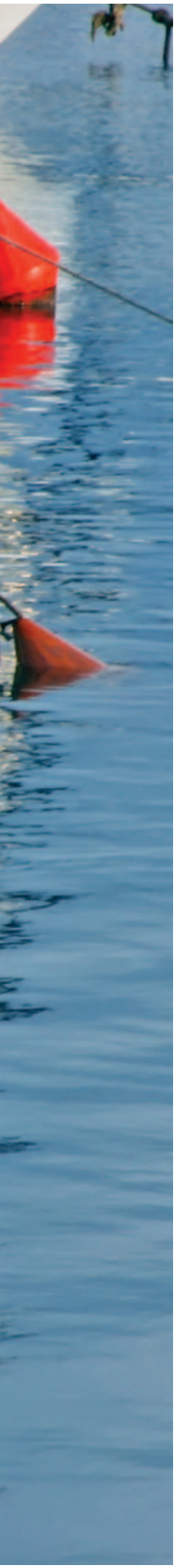


Introduction

To achieve long-term success, we need better models and tools to cope with the level of transformation anticipated.

For the asset owners, who have long-term investment funds in their care, and the asset managers who manage large segments of their assets, the challenge of meeting their performance goals has always been tough. Their purpose is to combine elements of short and long-term performance, risk control and cost control to deliver equitable results across generations of stakeholders.

We argue that their task will get more difficult because of the belief that we stand on the cusp of a period of significant transformation in world economies, politics and capital markets. We cite the cycle of deleveraging, the impacts of increasing resource scarcity and degradation, and ageing demographics as the most evident instances.

These factors introduce an extra dimension to the long-term investment challenge. We believe that the portfolios and strategies we judge as well-suited to present-day conditions will prove unsuited to future conditions. We argue that investors, who have previously been able to ignore these factors or react to changing conditions by making a series of small changes to their strategy, run a significant risk that their performance will not be sustainable into the future. This issue is emphasised for large funds with liquidity issues.

There is an alternative strategy which anticipates the direction of change and integrates the present with the future. The strategy is a more complex one to devise but, with good design, it is well-suited to securing a sustainable outcome improving long-term performance.

This research points to an important path for asset owners and asset managers to pursue in the Sustainability Roadmap, which we describe in this paper. It sets out a framework from beliefs and governance to new strategies for:

- Organisational design and the value chain.
- Risk management framework and governance.
- Factor-based, thematic and asset allocation approaches for asset owners.
- Mandate design for asset managers.

The solutions and processes proposed recognise incumbent processes. We understand that today's investor rarely starts from a blank page. The potential solutions need to be applied to their particular circumstances. They combine the disciplines of finance and investment, governance and the legal framework of funds, and the science of resource scarcity and climate change to assess the financial implications for investors.

The concept of sustainability

For many investors the concept of sustainability has broader meanings and the practical implication and application of sustainability is proving challenging. Typical impediments include issues relating to fund structures and governance, the state of knowledge (for example, the potential long-term impact of natural resource scarcity and environmental degradation on investments), fiduciary interpretation and relevance, and limited data or analytical tools.

We consider sustainable investing in its broadest sense, incorporating ESG but going beyond to consider the large inter-generational issues that institutional funds need to take into account. This is captured in the definition of sustainable investing we use, which integrates three concepts:

- Long-term investing.
- Investment efficiency (maximising returns after allowance for risk).
- Inter-generational soundness (equitable returns for each generation of stakeholder after allowing for risk).

By investing sustainably, we consciously plan for both the present and the future. Sustainable investing believes that a longer-term investment strategy will produce stronger investment performance both now and in the future.[2]

Sustainability definition

The classic reference definition of sustainability is based on the wider economic context of sustainable development from Brundtland 1987:

"Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

The concept of sustainability in investment is concerned with strategies that are designed to be effective in the short and long term, recognising linkages between the short and long term.

A *sustainable* strategy is designed to perform well in both the short and long term.

An *unsustainable* strategy or a strategy that has *poor sustainability* has a design that suggests that satisfactory short-term performance may be at the expense of long-term performance.

Transformational change

We believe that it is highly probable that the world is entering a period of significant change in world economies, politics and capital markets that will fundamentally affect the landscape facing institutional investors. Change is not unusual, but we argue that there are a number of interconnected issues arising that will converge to produce transformational change.

Typically, institutional response to change can be characterised in three ways[3]:

- Incremental *adaptation* where practices and policies shift in measured ways but without significant disruption.
- Institutional *adoption* where institutions adopt new practices and policies that have been tested in other contexts or circumstances and can be imported.
- Full-scale *innovation* where institutions make breaks with the past in their practices and policies and employ significant commitments to change management to embed lasting change.

The transformation that we anticipate suggests that the innovation model is likely to be the most effective to deliver a sustainable investment outcome.

To be successful, a more sophisticated approach to institutional investment will be required. This will involve heightened sensitivity to considerations of:

- Time horizon, in particular reconciling the requirements to meet goals over multiple time horizons.
- Externalities (spillovers and unintended consequences of investments), in particular those embedded in current investment that will have an evolving impact on a fund's financial and extra-financial position.
- Organisational design and governance and how sustainable competitive advantage can be turned into performance.
- The behavioural context of investors' goals and decision making, with respect to both the asset owners and their agents.

This has potential implications for the roles of asset owners and asset managers.

The largest mind-set change involves adapting to a different time horizon. This is not as simple as lengthening the time horizon, as every long-term investor is also a short-term investor. Most investment contexts involve multiple horizons and multiple stakeholders. There is a mix of agency issues, behavioural biases, over confidence and legal structure issues that make long-term investing exceptionally difficult. We observe that the gap between effective and current practices on this dimension alone is very considerable. The roadmap we describe sets out ways to reduce the gap and harvest the long horizon premium.

"Change is not unusual, but we argue that there are a number of interconnected issues arising that will converge to produce transformational change."

Forces of transformation

The drivers of this significant change can be divided into six broad areas (see **Figure 01**). While we describe them separately below, we are conscious that they are interconnected and consequently developments in one area have implications for others. Indeed, the level of complexity[4] in the system suggests extreme interconnectedness and a tendency for mutual reinforcement and multiplicative outcomes. In short their product is likely to be greater than the sum of considering each in isolation.

The other significant common element to these drivers is that they are long term in nature which makes their emergent pattern subject to uncertainty.

This paper does not undertake a detailed analysis of these areas, but we provide a brief summary of each below.

Economic imbalances

Much has been written on the global financial crisis and the impact of excessive debt in the system. Excessive debt is manifesting in several ways, including the eurozone crisis, political tensions and economic budget constraints. It is played out in phases of recession, private sector deleveraging and public sector deleveraging over extended periods. Imbalances can be seen on a number of levels – globally through the difference between current account surplus countries and deficit countries or nationally through the level of aggregate debt to national income. These imbalances are not likely to be sustainable. How they are resolved has significant implications for politics and markets.

> "...the emergence of change is uncertain because of the impacts of growing interconnectedness, many instances of non-linear relationships and reflexive factors."

Adverse demography

The developed world is facing pressures from an ageing workforce. Over the coming decades the proportion of over 65 year-olds will rise significantly, leading to major changes in the cost of pension and healthcare provision. The ageing profile for developing countries is more mixed, with China starting to age in the near term while India stays young into the future. From a global perspective, the growth in size of population has implications for the demand for resources, in particular energy, water and food.

Degradation of natural capital

The project undertaken by Oxford University drew on climate change and resource scarcity as prime examples of developments that may lead to unsustainable outcomes if not addressed. The effects of climate change and resource scarcity will have implications for long-term corporate profitability and investor returns and risks, as well as wider societal issues.

Innovation and technology

The current pace of change in physical technology and the impact on society in general – and markets in particular – has been likened to the Industrial Revolution. Developments have created new industries, new investment opportunities and fresh solutions to existing problems. Future progress may lead to changes in demand for energy and address some challenges arising from resource scarcity. Social technology – the rules and practices (such as governance) created to manage interactions – changes more slowly. The underlying differences in speed of change between physical and social technology creates an underlying tension in positive outcomes for innovation in the longer term.

Business nexus

We live and work in a complex environment, with the interactions between companies and their various stakeholders evolving. There is the workforce aspect of this. Historically, a 'job for life' concept created a long-term relationship between employer and employee that represented loyalty from both sides. Then there is the ownership aspect. This has been defined in largely disengaged terms, but this relationship stands to be refined as a result of attention to responsible ownership practice. Third, there is the wider societal aspect. Companies and consumers had a long-term relationship through brand loyalty and a common understanding of what that brand stood for. These relationships have changed as society has changed, resulting in different demands from stakeholders and companies alike.

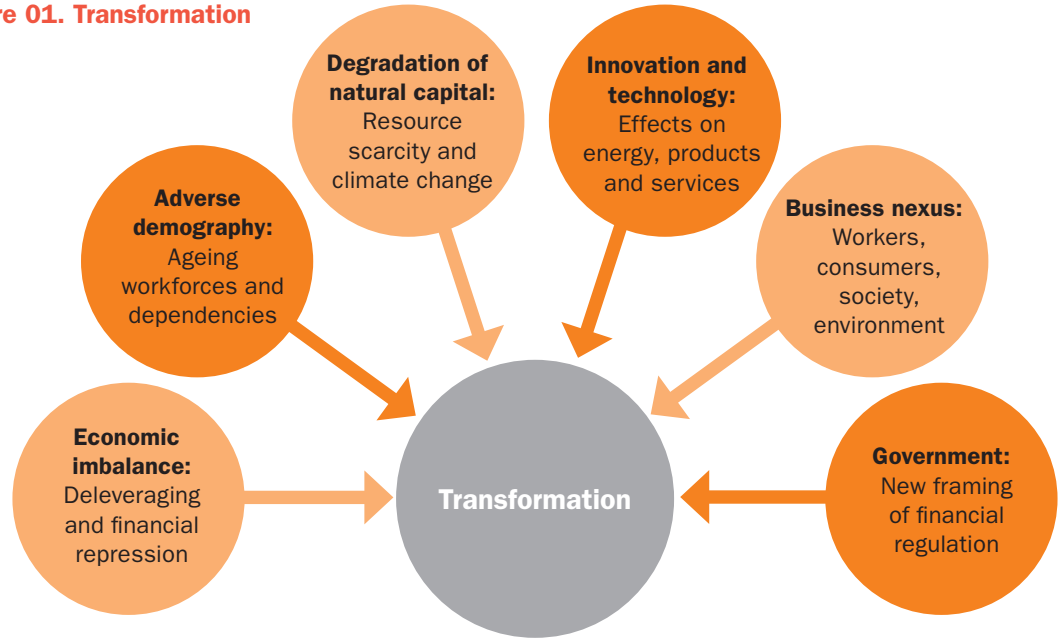
Role of government

Public policy plays a significant role in the underlying structure of interactions between market participants. In many ways, regulation is one of the hardest areas to anticipate, but the influence it can have is significant. This regulation could affect a wide range of areas such as carbon emissions, incentives for new technologies, or dealing with compensation in financial services. The messages that governments give through their policies heavily influence market behaviour. Governments are critical catalysts to set the tone and induce more action in the sustainability agenda. But governments face the challenge of setting public policy in an area where sustainability outcomes are mostly issues played out by the private sector. They also have the inherent tension with addressing very long-term issues within the political power cycles that are intrinsically short term.

We believe that the change we will experience is significantly different from what we have seen more recently. We believe that the effects will emerge over multiple time horizons. The associated complexity in these issues suggests that the future is uncertain. That is to say, the emergence of change is uncertain because of the impacts of growing interconnectedness, many instances of non-linear relationships and reflexive factors.

As is the case of any change, the ideal investment behaviours will be those that adapt to take account of the longer-term uncertainties and integrate them with shorter-term risks.

Figure 01. Transformation



Research
by Oxford University

In our contribution to the debate of 'What does it mean to be a sustainable investor?' we drew on research carried out by Oxford University. This covered the subjects of climate change and resource scarcity as examples of longer-term issues. It also considered the regulatory environment within which institutional asset owners operate and the governance structures in place to enable them to respond to the changes anticipated. Underpinning the response of institutional asset owners to the challenge is their understanding and interpretation of their fiduciary obligations. For a brief summary please refer to the Appendix (page 22).

In his report on climate change, Professor Myles Allen identified three areas that investors should be concerned about:

- The impact of long-term predictable consequences, such as rises in sea level and the intensifying hydrological cycle.
- The impact of unpredictable, global-scale climate discontinuities, such as the risk of an irreversible desiccation of the Amazon rainforest region.
- The impact of extreme weather events.

Professor Allen suggested that when investors consider the implications of climate change, they tend to focus on the likely costs of mitigation and the direct impact on certain asset classes, but underestimate the risk of companies and sectors being deemed liable for the effects of their actions on climate change under the 'polluter pays' principle. With more exact attribution of the cause of extreme weather and other environmental catastrophes, various companies stand at risk from legal claims.

Dr Dariusz Wójcik and Sarah McGill reviewed the most critical areas of likely scarcity of resources. The effects of climate change on the atmosphere (the atmospheric waste sink is limited) and water scarcity are the most urgent issues, with biodiversity, food and agricultural land on the list ahead of various metals, oil and gas. They argued that while there is more understanding of the problem of resource scarcity, there remains an early-mover advantage for sustainable investors. They highlighted revision of existing portfolios and development of new financial instruments as ways in which to capture these opportunities. But they also noted the need for a collaborative approach to address the issues.

Capturing long-term themes such as climate change and resource scarcity will require strong governance from institutional funds. Professor Gordon Clark argued that to be an effective long-term investor requires an appreciation of the relationship between the short term and the long term. The demand on governance comes from being able to manage short-term market dynamics while also devoting time and energy to considering the long-term viability of investment strategies, thereby improving decision making.

There is some concern amongst asset owners, however, that sustainable investing may not be aligned with their fiduciary obligation. Underlying this concern is a fear that there may be detrimental financial impact from such approaches. Dr Claire Molinari argued instead that sustainable investing, when defined and approached correctly, helps to meet the fiduciary obligations of loyalty, prudence, diversification and impartiality.

Responding to change

We believe that the forces of transformation are such that the most likely futures are at least consistent with 'business beyond usual', with change being bigger than past patterns. Dealing with such change and benefiting from it financially will require:

- Better understanding of the emerging realities associated with long-term issues such as climate change and resource scarcity.
- Innovation in investment policies and instruments to exploit these issues as opportunities.
- Evolving governance structures that support more effective decision making.

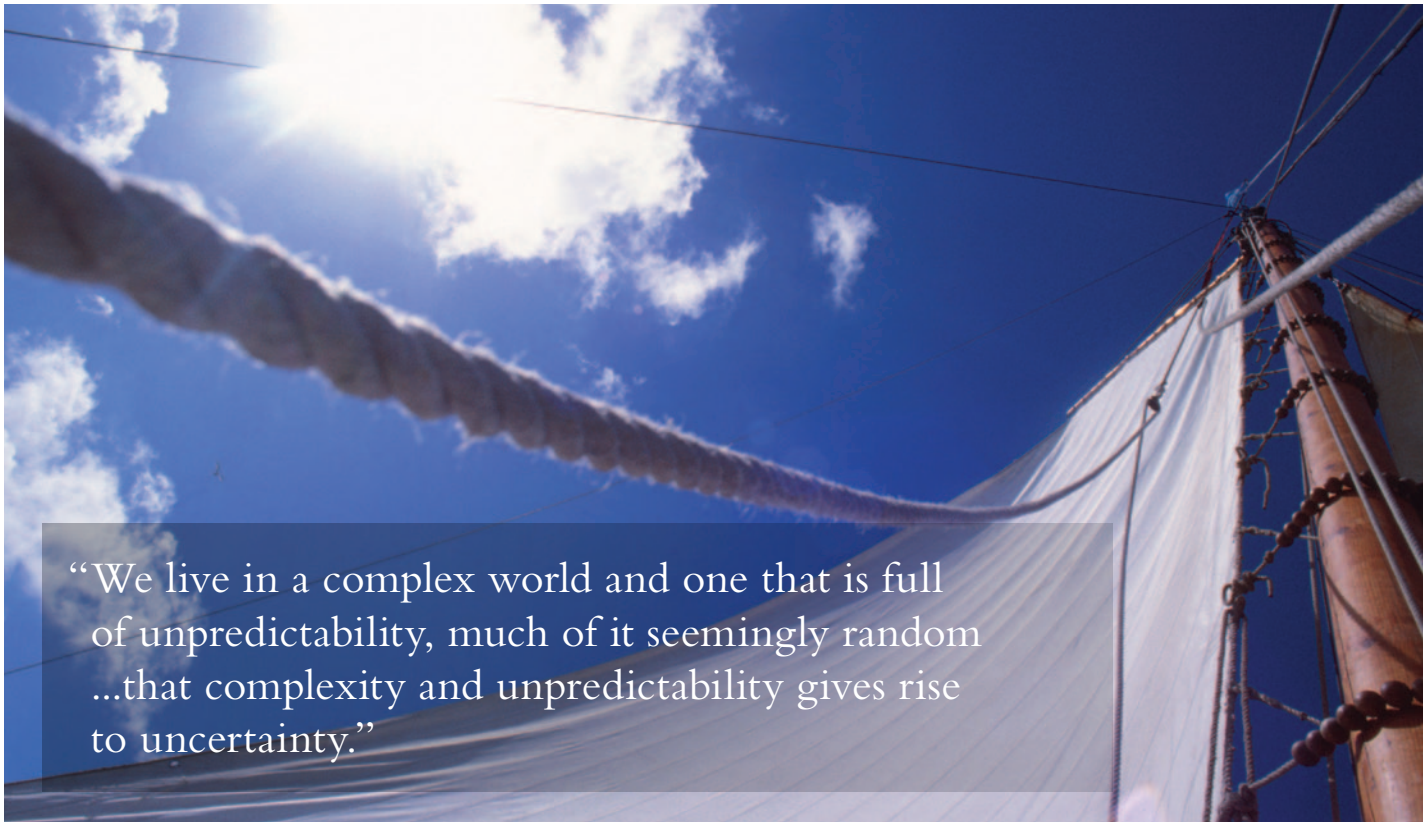
Coping with the significant change we anticipate will place strains on the governance of asset owners. These strains arise primarily from the long-term nature of the change and the associated uncertainty. This requires asset owners to anticipate change and plan for its consequences, rather than simply being reactive as events unfold. There are three key considerations: risk and uncertainty, the impact of externalities, and time horizon (short term versus long term).

Risk and uncertainty

We live in a complex world and one that is full of unpredictability, much of it seemingly random. The implications of this are important for finance and economics. That complexity and unpredictability gives rise to uncertainty.[5]

It is important to understand the difference between *risk* and *uncertainty*. It is helpful to see risk as that part of the unpredictability of future outcomes that can be captured using a probability distribution; the rest is uncertainty. This uncertainty is the natural consequence of dealing with the future, with particular respect to shifts in investors' preferences through pricing regimes and the effects of decision makers' responses to risk outcomes.

All modelling is a simplification of the truth. This simplification does not necessarily invalidate conclusions being drawn. Such simplification may yield more helpful information than using a more complex model or not using any model at all. But the limitations of the model should be recognised, including an understanding of the level of uncertainty in the system. We can model for *risk* but will almost invariably be left with some *uncertainty*.[6]



Externalities

Externalities are spill-over effects of production or consumption that produce unpriced costs or benefits to other unrelated parties, which could be other companies or society more generally. Externalities may be positive, such as social benefits of businesses in their local communities, or negative, such as poor air quality.

Some of the most important negative externalities are the environmental costs incurred by businesses due to climate change, resource depletion and pollution. The United Nations Principles for Responsible Investing (UNPRI) estimates that the total cost of such externalities for listed companies exceeded $2.5 trillion in 2008.[7] As complexity and connectivity increase in investment, so the size and impact of externalities will increase.

In a world of incremental change, the impact of externalities tends to be recognised in profit statements and balance sheets when they become internalised. One of the challenges facing asset owners (and their asset managers) of the future will be to anticipate these effects and adapt investment portfolios accordingly. Exercising ownership rights will also have an important role in dealing with externalities.[8] These rights can be used to encourage appropriate long-term behaviour from company boards. For example, there is the opportunity to discourage the use of lobbying to secure narrow benefits to one industry to the detriment of another.

UNPRI (2010) description of externalities

Externalities can affect shareholder value because they lead to a more uncertain, rapidly changing economic environment and greater systemic risks. Inefficient allocation of capital to highly polluting activities can cause a decline in asset values over time. For a diversified investor, environmental costs are unavoidable as they come back into the portfolio as insurance premiums, taxes, inflated input prices, and the physical cost associated with disasters. These costs could also reduce future cash flows and dividends. One company's externalities can damage the profitability of other portfolio companies, adversely affect other investments, and hence overall market return. Ultimately, externalities caused by companies could significantly affect the value of capital markets or their potential for growth, and with that, the value of diversified portfolios.

"Processes and practices will need to adapt, with implications for asset allocation, mandates and monitoring, as well as governance."

Time horizon

Much has been written on the detrimental effects that short-termism is having on the investment industry. This is evident in all parts of the investment chain, from company boards focusing on the quarterly earnings cycle[9] to asset owners assessing performance over short time periods. Short-term periods do not adequately allow for the possible long-term impact of externalities. By anticipating the long-term effects of externalities and positioning portfolios accordingly, asset owners can achieve better results than can be achieved through compounding short-term returns.

Without externalities impacting share prices, the sum of short-term results is the same as the long term. The issue arises when externalities are internalised. Many investors claim an adaptive strategy, aligned with the short-term conditions, and being responsive to new long-term conditions when they materialise. This presents issues for responding before price changes, particularly for large portfolios. These strategies are often unrealistic for large investors.

To be successful, long-term asset owners and their asset managers will:

- Be balanced in their views of risk and uncertainty.
- Anticipate externalities and their implications for future costs before they are internalised.
- Focus on the long term, as described in their mission and mandate.

Processes and practices will need to adapt, with implications for asset allocation, mandates and monitoring, as well as governance. This calls for a road map to help us navigate from where we are to where we want and need to be.

Road map
for sustainable investing

Attributes of a road map are shown in the panel opposite. First and foremost, it must be achievable. It must also be able to respond to changing conditions over time. The primary user of a road map is the decision maker, but it is also useful for stakeholders to identify and track progress.

Our target destination is a framework that supports decision making under uncertainty. The starting point recognises that there is essential work to be done in clarifying mission and goals before being able to consider the implications for investment portfolios. The road map is a multi-year plan, recognising that the steps that asset owners need to take are not straightforward.

The sustainable model is based on principles which seek a broader mission, deeper thinking on investment, and a longer-term framework for evaluating success.[10] This approach incorporates the opportunities in the traditional areas of asset allocation and manager selection. It would also include consideration of extra-financial factors and ESG issues as these are elements of risk and reward. The goal of this is for the long-term outcome to be better financial performance, adjusted for risks and costs. It will also provide inter-generational fairness.

Road map attributes

- An achievable plan that meets the needs of all stakeholders.
- Starting position.
- Target destination.
- A plan for how to get from the start to the destination.
- What 'tools' will be needed.
- How to adapt to events along the way.
- Milestones, ways for stakeholders to measure progress.

"...there is essential work to be done in clarifying mission and goals before being able to consider the implications for investment portfolios."

Mission

Sustainable investing requires an evaluation of a fund's values and investment beliefs. It is values that distinguish the investment mission and goals of a fund; it is beliefs that distinguish the investment strategy.

Figure 02 describes the link between three possible missions and investment strategy.

A *traditional* mission of an institutional fund focuses on financial aspects. In the case of a pension fund this is likely to be based on an objective of meeting the liabilities associated with paying pensions, whereas for a foundation it may focus on meeting certain income objectives. Often the investment strategy associated with this mission would tend to focus on relatively short-term investment targets.

Sustainable investing calls for a broader mission which incorporates inter-generational equity. A *sustainable investment mission* incorporates additional goals which express a wider and longer-term view of responsibilities arising from ownership. This may be from a perspective of 'do no harm' or 'consistent with international standards or conventions' relating to corporate and investor responsibility. It may also explicitly emphasise the belief in the financial opportunities that arise from being long term. Investment strategies will tend to be longer term in nature and more specific sustainability-related instructions given in delegation of mandates to managers.

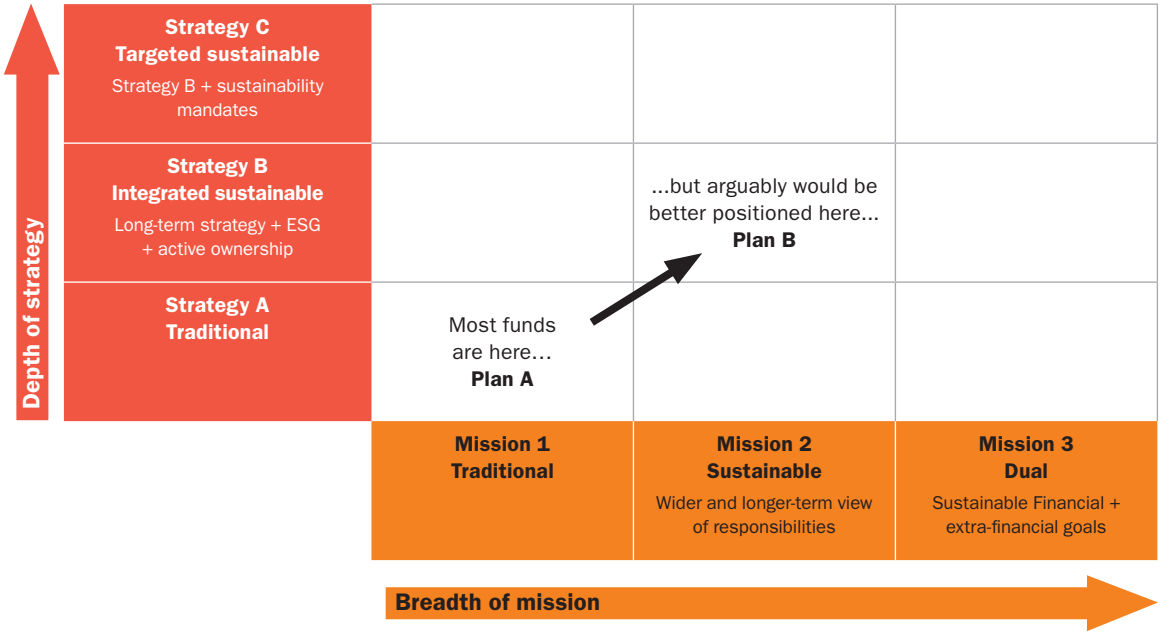
A *dual-goal sustainable investment mission* is even broader, seeking to achieve certain extra-financial goals balanced with financial targets. Investment strategy in this case may include more specific mandates with direct connection to sustainability themes. Delegation to managers may be more specialised and directive.

Universal owners may factor in a desire to effect change for a broader society. This mission will be both financial and extra-financial. The idea of universal ownership is particularly relevant in a scenario of longer-term resource scarcity and climate change. Many institutional funds' holdings are highly diversified across the global market and the global economy. Such funds' performance is more heavily dependent on the long-term progress of the economy than on individual companies. Given the potential influence of ESG factors on the long-term health of the economy, it follows that such funds should recognise the importance of sustainability to their funds' ultimate fortunes and the opportunity to influence through their strategies and actions as owners.

Sustainable investment missions

- Preserve fund's reputation/satisfy beneficiaries' requirements.
- Consider the responsibilities associated with company ownership, especially externalities.
- Ensuring that investments do no harm supports giving attention to ESG factors because of the associated reputational risks.
- Ensure value is sustained for current and future generations of beneficiaries by investment practices and decisions that focus on planning ahead.
- Create value by exploiting the long time horizon of the fund and avoiding the inefficiencies of short-term behaviours.

Figure 02. Mission and strategy matrix



Beliefs

Investment is essentially about making judgements and decisions in the present, typically with reference to the past, to cope with or exploit an uncertain future.[11] Investors do this by using their underlying beliefs about how the world works. The quality of those underlying beliefs is a major determinant of success in investment and was highlighted by Clark and Urwin[12] as a key attribute of well-governed funds.

The sustainability beliefs a fund may hold fall into three general types:

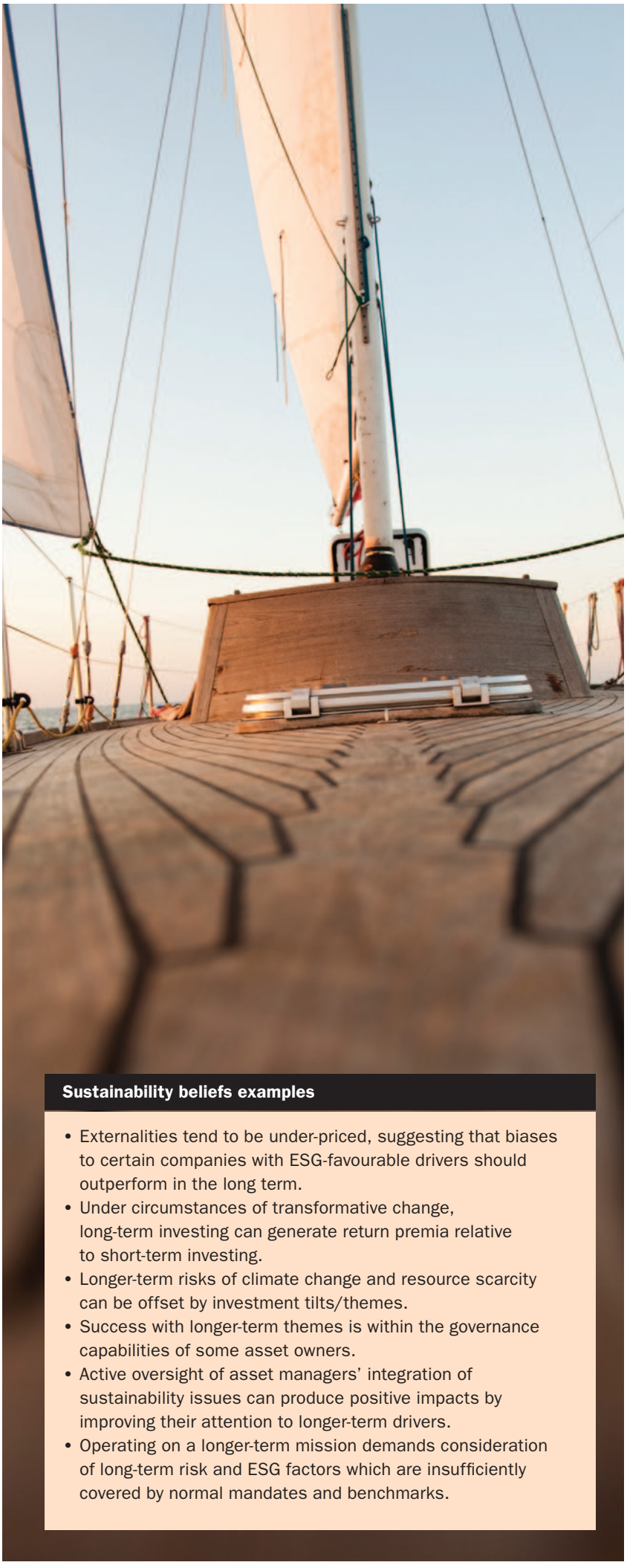
- Those that see stock-specific sustainability factors as essential to risk control.
- Those that identify sustainability-related assets that will benefit from tail wind effects.
- Those that adopt long-term investment horizons in offsetting the longer-term risks and costs associated with sustainability issues such as resource scarcity and climate change.

Examples of beliefs supporting sustainable investing are shown in the panel opposite.

Assessment of beliefs helps to identify distinct views on sustainable investing issues such as climate change and resource scarcity. The strength of the beliefs held will determine how the investment strategy can be adapted to take account of long-term factors.

In terms of fiduciary obligations there have been calls for legal clarification in terms of sustainable investing. If the belief that 'sustainable investing leads to better financial outcomes because externalities are taken into consideration' exists, then arguably the role of the fiduciary is clearer. A form of this belief or close variant seems central to most asset owners' thinking.

"Investment is essentially about making judgements and decisions in the present, typically with reference to the past, to cope with or exploit an uncertain future."



Sustainability beliefs examples

- Externalities tend to be under-priced, suggesting that biases to certain companies with ESG-favourable drivers should outperform in the long term.
- Under circumstances of transformative change, long-term investing can generate return premia relative to short-term investing.
- Longer-term risks of climate change and resource scarcity can be offset by investment tilts/themes.
- Success with longer-term themes is within the governance capabilities of some asset owners.
- Active oversight of asset managers' integration of sustainability issues can produce positive impacts by improving their attention to longer-term drivers.
- Operating on a longer-term mission demands consideration of long-term risk and ESG factors which are insufficiently covered by normal mandates and benchmarks.

"The most successful sustainable investors will utilise feedback loops that emerge over multi-year cycles to adapt their culture as well as their investment strategies."

Governance

Adopting a longer-term outlook will place additional demands on governance, which already tends to be overstretched. Clark and Urwin identified 12 attributes of well-governed funds.[13] Of these, mission clarity, a highly competent investment executive and a culture of learning are most critical in order to adapt to change.

The most successful sustainable investors will utilise feedback loops that emerge over multi-year cycles to adapt their culture as well as their investment strategies. They will be able to respond to the challenges of managing their stakeholders during difficult times.

Having the right governance also means having the right monitoring frameworks in place.

Attributes of well-governed funds

- Mission clarity.
- Effective focusing of time.
- Investment committee leadership.
- Strong beliefs.
- Risk budget framework.
- Fit for purpose tests applied rigorously to manager line-up.
- Use of highly competent investment executive team.
- High-level board competencies.
- Supportive compensation.
- Real-time decision making.
- Exploit competitive advantage.
- Learning organisation.

The road map

We summarise the road map in **Figure 03**. These are the steps that could be taken by an institutional fund wishing to consider sustainable investing. The process underlying each step would depend on the current position of a particular fund. There are three key stages for an asset owner to follow:

- Establish the strategic principles: mission, values, beliefs.
- Ensure appropriate enablers are available: governance, culture.
- Evolve investment policies: drivers, mandates, managers.

Sustainable investing has sound financial objectives at its core. When investing sustainably, investors consciously plan for both the present and the future, promoting behaviours that support positive economic and societal growth. There are areas of current practice which highlight instances of poor sustainability. In this regard, sustainable investing practices gain from an avoidance of costs. In other words, investors can benefit from the principle of not doing *unsustainable* things.

For an asset owner, sustainable investing has implications for asset allocation, manager selection, mandate design (including benchmarks and fees) and monitoring of those mandates. It brings together an appropriate mix of beta, smart beta and alpha. (See Terms panel overleaf for descriptions.)

Investment strategies

Implementing sustainable investment strategies is covered in more detail below. In developing the road map, however, we highlight the use of beta strategies over many alpha strategies as being better at delivering long-term performance adjusted for costs and risk. These take the form of long-term betas such as real estate and infrastructure or smart betas which capture an ESG beta. Alpha strategies which focus on sustainable mandates (as described overleaf) may also provide opportunities.

Figure 03. Road map

	Road map	Actions
Strategic principles	Mission, vision and goals	Explicit goals for performance over multiple horizons and sustainability Stakeholder analysis and management
	Beliefs and values	Collaborative beliefs process with macro-view and ESG factors
Enablers	Organisational design	Embed sustainable competitive advantage as central driver Rebalance mix of strategic and implementation focus and action Rebalance mix of internal and external portfolio management Rebalance mix of bulk beta, smart beta and alpha Embed fee norms tied to time horizon and value proposition
	Governance	Enhance social capital and culture Embed time horizon norms and long-term process and culture Embed investment policy templates/way of working norms Embed KPI monitoring framework
	Risk	Consider multiple risk measures including mission impairment Extend risk model to cover endogenous risks Extend risk model to integrate full risk assessment alongside risk measurement Embed risk and return dashboard
Investment policies	Higher-level strategies and return drivers	Allocations to return drivers alongside asset allocation Allocations capturing time horizon premium through thematic and systematic sources Incorporate integrated strategy on active ownership
	Lower-level implementation and alpha	Mandates aligned to mission requirements with appropriate time horizons Mandates capturing value in relationship, knowledge, sharing Mandates integrating ESG and other long-term risk factors

Asset allocation

A fund's strategic asset allocation is typically set to be in line with the mission of the fund. If that mission includes sustainability considerations, then it follows that the appropriate strategic asset allocation is adapted accordingly to factor in the needs of future generations. Static asset allocation policies are unlikely to capture these new requirements, calling for a more dynamic approach.

Periodically, opportunities arise from regime shifts or from extreme valuation periods. Within a sustainable investing framework, investors invest dynamically to take advantage of these opportunities. These shifts in asset allocation are driven by longer-term anomalies rather than short-term price variations.

For example, a belief in the existence of a long-term macro theme associated with resource scarcity and climate change may be captured through thematic smart betas, focused on strategies that will be beneficiaries of the theme. Furthermore, smart beta portfolios may also be structured around indices constructed on ESG factors. These indices seek to capture an ESG beta through over-weighting companies that have high ESG ratings relative to their sector peers.

Terms

(Bulk) beta: Return drivers from macro-consistent sources derived from liquid market portfolios, captured in market capitalisation benchmarks.

Smart beta: Return drivers from non-macro-consistent sources. There are three broad types of smart beta:

- Diversifying betas (such as real estate, infrastructure, commodities).
- Thematic betas (such as emerging market currencies, clean technology).
- Systematic betas (such as value-weighted or risk-weighted indices).

Alpha: returns derived from skill achieved in excess of explicit and investible benchmarks through selective under or over-weighting of assets.

Long-term mandates

The long-term mandates designed around 10 years ago aimed to address some of the focus on the short term and over-reliance on benchmarks that was dominating the investment industry at the time.[14] We suggest that these can be refined to capture the concepts of sustainability. A long-term, integrated sustainability mandate would incorporate requirements for the underlying investment process to take ESG factors into consideration and, in particular, that the potential impact of externalities is assessed. Active ownership obligations would also be set out in terms of the policy regarding engagement. Long-term targeted sustainability mandates may focus on specific themes, such as clean technology or environmental waste services.

Monitoring of these mandates would best be done with a balanced scorecard[15] approach. These are absolute return mandates, so the primary comparator will be a version of CPI+x%, measured over rolling periods of five or more years.

Long-term equities mandate

- **Performance guidelines:** Compare with target of CPI+x% over rolling five years. Also consider target risk and return relative to benchmarks (for example, World index).
- **Fee basis:** Combination of fixed flat-rate fee and performance fees calculated over rolling five-year targets.
- **Monitoring:** Guidelines specify consideration of ESG factors being incorporated into process. Also monitor turnover, valuation metrics and ESG risks.

The International Corporate Governance Network (ICGN) has published a draft mandate which captures proposals for sustainable investment. Key features include:

- Ensuring that the timescales over which investment risk and opportunity are considered match those of the client.
- Setting out an appropriate internal risk management framework so that the risks which matter for clients are managed effectively.
- Effectively integrating relevant environmental, social and governance factors into investment decision making and ongoing management.
- Aligning interests effectively through fees, pay structures and culture; where engagement is delegated to the fund manager, ensuring adherence to the highest standards of stewardship.
- Commission processes and payments which reward appropriate research.
- Ensuring that portfolio turnover is appropriate to the mandate, in line with expectations and managed effectively.
- Providing appropriate transparency so that clients can gain confidence about all these issues.

Sustainability in asset management

If asset owners adopt sustainable investing principles, this will affect their choice of asset managers to act on their behalf. 'Sustainable managers' will demonstrate a number of features in the way they run their business and in their investment philosophy and beliefs.

Their investment philosophy and processes will factor in the issues of sustainability through an integrated process. The potential impact of externalities will be anticipated and assessed. The responsibilities of ownership will be taken seriously through an appropriate voting and engagement policy. There are several initiatives underway to challenge the corporate governance status quo, which will contribute to the sustainability debate and in which asset managers have a role to play. We note in particular the Kay Review[16] on short-termism, which noted "The long-term public goal for equity markets is in securing the public purposes of high performing companies and strong returns to savers through an effective asset management industry, and in ensuring that the profits earned by companies are as far as possible translated into returns to beneficiaries by minimising the costs of intermediation". It highlighted the role of asset managers in this regard. We also note initiatives, supported by the asset management industry, to improve the diversity of directors on corporate boards in order to reduce group thinking and improve decision making. Such change will improve the sustainability of the overall financial system.

An outcome of a sustainable investing process should be lower turnover. This reduces the total cost to the investor.

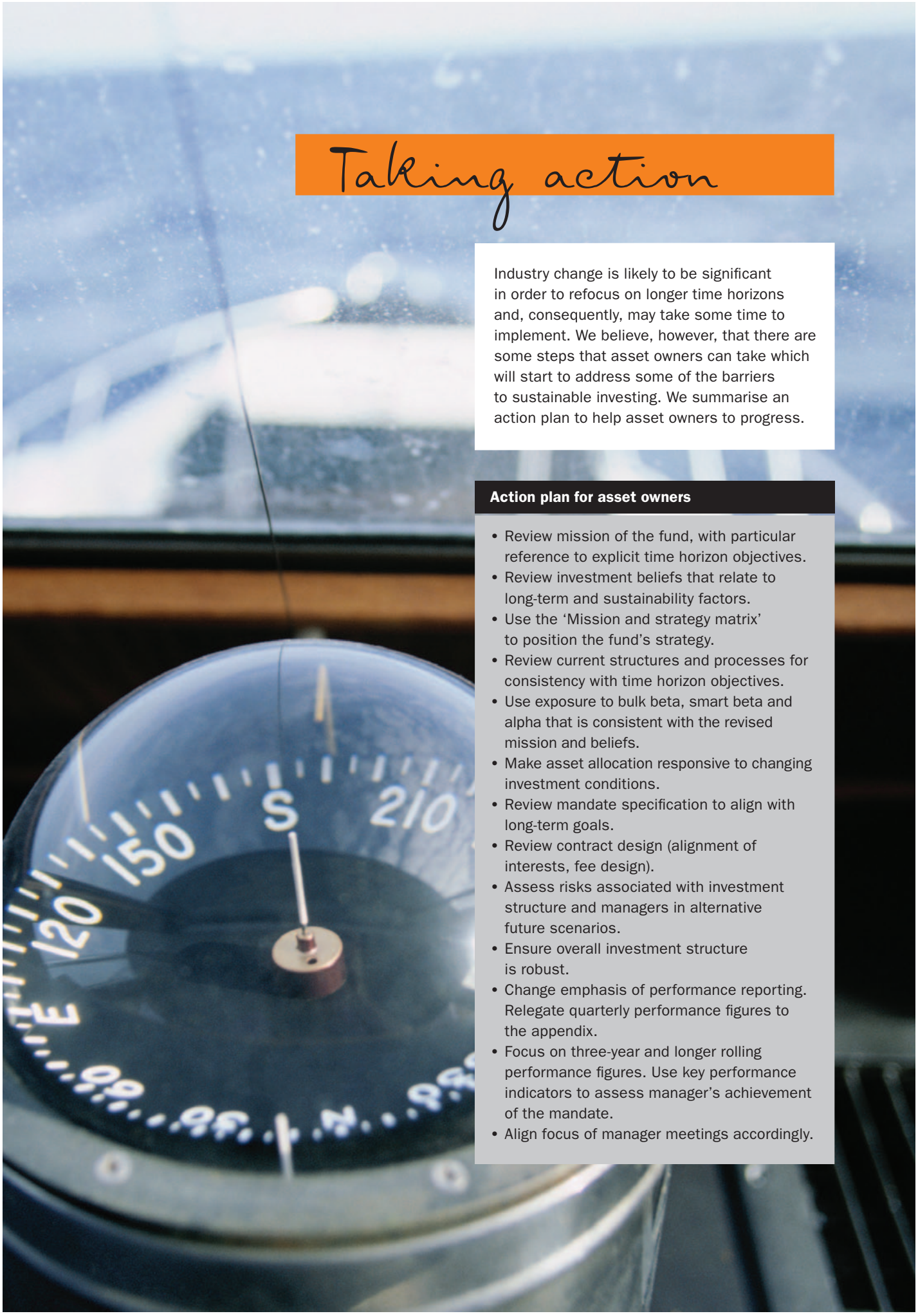
Sustainable managers will also operate their businesses in an effective way so as to be sustainable. They are committed to providing a value proposition to their clients over time. This means they do not compromise future performance for reasons of current business development. Their business has a client-centric ethos, evident in both business principles and investment decision making. Adopting practices that align the interests of asset owners and asset managers is critical.

Features of sustainable asset management

- Committed to delivering long-term value for clients and stakeholders.
- Strong client-centric ethos, aligning interests.
- Partner relationships with clients.
- Culture committed to investment and service excellence.
- Investment decision making based on realistic beliefs and appropriate time horizon.
- Focused product range.
- Averse to asset gathering.
- Innovation capabilities to maintain sustainable growth.
- Fees that are consistent with the value proposition and a fair deal to clients.
- Transparency.

In addition to organisational factors, sustainability is also related to the investment food chain and the fees and costs embedded in the investment proposition, which must reflect a fair deal. We have previously suggested that mandates with fees in which the manager is paid an expected fee above 50% of the expected net alpha over time have poor sustainability.

"An outcome of a sustainable investing process should be lower turnover. This reduces the total cost to the investor."



Taking action

Industry change is likely to be significant in order to refocus on longer time horizons and, consequently, may take some time to implement. We believe, however, that there are some steps that asset owners can take which will start to address some of the barriers to sustainable investing. We summarise an action plan to help asset owners to progress.

Action plan for asset owners

- Review mission of the fund, with particular reference to explicit time horizon objectives.
- Review investment beliefs that relate to long-term and sustainability factors.
- Use the 'Mission and strategy matrix' to position the fund's strategy.
- Review current structures and processes for consistency with time horizon objectives.
- Use exposure to bulk beta, smart beta and alpha that is consistent with the revised mission and beliefs.
- Make asset allocation responsive to changing investment conditions.
- Review mandate specification to align with long-term goals.
- Review contract design (alignment of interests, fee design).
- Assess risks associated with investment structure and managers in alternative future scenarios.
- Ensure overall investment structure is robust.
- Change emphasis of performance reporting. Relegate quarterly performance figures to the appendix.
- Focus on three-year and longer rolling performance figures. Use key performance indicators to assess manager's achievement of the mandate.
- Align focus of manager meetings accordingly.

The way forward

The sustainable investing debate has started to be heard more loudly over the last year. Driving such an agenda forward requires commitment and leadership. This leadership role could come from a number of areas as we describe below. The spread of the Principles for Responsible Investment where signatory numbers are rising rapidly is taken as evidence of the growing commitment to sustainable investing within the investment industry.

Some leading *asset owners* are promoting sustainable investment practices through being early adopters of missions that are aligned to long-term investing that is efficient and inter-generationally fair. In this regard we note that we believe that fiduciary obligation does not preclude such a step. This broader, deeper mission feeds through to how they interact with their agents, in particular the mandates they give to their asset managers, and the way in which they exercise their ownership rights. Sustainable investing is central to universal owners.[17] Their role in promoting sustainable investment comes from their active investment strategies integrating sustainability considerations, their active ownership practices and their collaboration with other asset owners to produce network benefits.

The leadership role of *asset managers* can be demonstrated through adopting business practices that are aligned to sustainable investing and through incorporating such thinking in their investment processes. By integrating sustainability factors into the assessment of the relative attractiveness of investments and acting as effective owners, they can influence change in corporate activity that allows for the impact of degradation of natural capital. There is significant growth in supply of investment options through expanded opportunities in environmental and energy technologies. Furthermore, there is greater application outside of quoted equity markets.

As agents of the asset owners, *consultants* can support change through promoting debate and contributing to the innovation. We note too that academics contribute through their innovation in finance theory. They also act as an independent voice on issues such as climate change and resource scarcity.

Governments are critical catalysts to set the tone and induce action. This may be through regulation associated with asset owners (such as the introduction of safe harbour principles or 'comply or explain' initiatives for sustainable investing) or through supporting investment initiatives in ESG-related industries. There have been certain government and public policy developments in this respect but the actions have so far been small-scale. One example is the UK Stewardship Code using 'comply or explain' mechanisms to institutionalise ownership best practice.

No single constituency will be able to drive change alone. Addressing the issues of sustainable investing is more likely to succeed through networked governance.[18] Governments, asset owners and corporations will need to work together in a stronger partnership to achieve a sustainable investment future. It may be increasingly expected that asset owners will care and do something about the doubtful behaviours of certain companies and industries, the environmental externalities of the corporate sector, and the social influence of the corporate sector.

The investment industry operates as part of a chain that has critical societal significance in a central function within the present capitalist system. The investment chain links savings to investments to economic growth through institutional intermediation across time horizons and geographies. A better investment chain requires investment markets to act as instruments of effective capital formation and deployment to create wealth and manage risk. It also requires investment institutions to act as instruments of effective wealth accumulation/decumulation to manage wealth and transfer risk.

Much of the investment industry is currently performance driven, with short-term behaviour leading to markets being prone to bubbles and crises. A minority of investors are driven by extra-financial objectives, providing them with a purpose that is also concerned with societal effects. We believe that sustainable investing retains financial performance as its main driver, but that the outcome is beneficial to society.

Conclusion

For asset owners who have long-term investment funds in their care and the asset managers who manage large parts of those assets, the challenge of meeting long-term investment goals is tough. The transformation we expect to occur in world economies, politics and markets adds a further dimension to this challenge. The road map we have described aims to provide a framework for developing an investment proposition that is both financially efficient and inter-generationally fair. We hope it will enable asset owners and asset managers to adopt investment strategies that both capture the opportunities and mitigate the risks that will arise.

Thinking Ahead

This publication is written by members of our Thinking Ahead Group (TAG) who are part of Investment at Towers Watson. 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 articles are therefore more likely to be the opinions of the respective author(s) rather than necessarily representing the formal view of the firm. No action should be taken on the basis of any article without seeking specific advice.

References

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Appendix

Summary of Oxford research papers

Professor Gordon L Clark

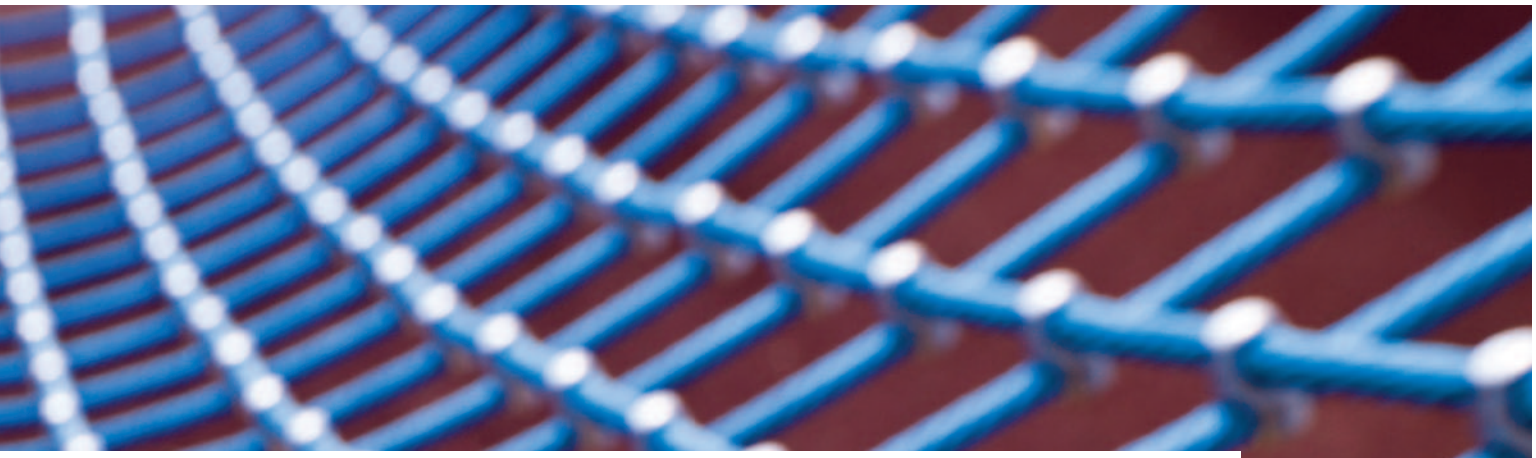
'Telos' is Greek for the aims or purposes of human endeavour. As a concept, it owes its origins to Aristotle. Even so, its significance is entirely modern. It challenges us to be deliberate about what we do and for what purpose rather than being simply responsive to events. So, in making plans for the future, we need a 'road map' or set of tools by which those plans will be realised. Having agreed on our goals and objectives and having put in place the mechanisms or means by which we will realise those goals and objectives, Telos also encourages us to carry forward ends and means in an iterative and adaptive fashion. In other words, Telos challenges us to suspend the 'automatic pilot' that typically governs actions and institutions and take charge of realising our plans for the future.

What is so special about Telos, for that matter, the idea that there is a premium on deliberation? Behavioural psychologists have a ready answer. They believe that most people, most of the time, make plans and act accordingly following what some have euphemistically termed as the 'established grooves of everyday life'. In other words, habit rules the day. Action is, more often than not, reactive to events rather than deliberative about how those events fit into or disturb past commitments. We believe that we are in a period of transformation affecting the world economy, geopolitics, and whole societies in ways that are quite unprecedented. It is time to take stock of where we are, where we might be headed, and how we might take into account scenarios for the future in ways that can benefit investment strategy and, ultimately, the welfare of those that rely upon investment management for their retirement.

Investment managers are fond of talking about the 'new realities' of capital markets. Over the past couple of decades, the industry has experienced the Asian financial crisis, the long-term capital management (LTCM) debacle, the technology bubble and bust, the sub-prime bubble, the Euro crisis and much else besides. For much of the twentieth century, financial crises flowed from the periphery of the global economy to core financial markets, disturbing equilibrium and challenging established practices (Barro 2006). More recently, we have witnessed a new phenomenon: systemic risk emanating from core financial markets of the global economy and propagated around the world. Settled expectations, the rules of investment management, and the virtues of tried-and-true recipes for asset allocation have been turned upside down. Andrew Lo (2011) has challenged the industry to adapt accordingly.

Perceptive writers about the current crisis have discerned links between financial uncertainties and twenty-first century trends. Looking forward, the growth prospects of Western economies are likely to be hampered by global macroeconomic imbalances, the ageing of Western societies and increasing dependency ratios (amplified by poor macroeconomic prospects), and a political impasse in many countries where the costs of financial instability shackle nation-states in debt while bringing forward rules and regulations that 'solve' past problems but do little to address larger, structural issues. These include the degradation of the environment, resource scarcity, and climate change. Equally, there are new relationships between companies and their workers, consumers, and society. Just as government is hemmed in by the past, expectations are growing as regards corporate social responsibility (CSR), responsible investment and sustainable investment (Urwin and Woods 2010).

A generation ago, notions of corporate social responsibility were caught up in geopolitics and much larger debates about capitalism versus communism, socialism, and so forth. As these issues have receded, a new generation has looked at CSR recognising that the reputation of the corporation is an asset in its own right and that it can be 'priced' in consumer markets. So, for example, how companies manage their supply chains, their carbon footprints, and the relationships between suppliers, intermediaries, and the final consumer have come to dominate the headlines. Business schools take these issues seriously, witness the recent papers by Michael Porter and colleagues at Harvard Business School, and financial markets have come to recognise that corporate reputation is a significant



albeit intangible asset. Media campaigns by non-government organisations, social activists and activist investors have transformed corporate reputation from 'name recognition' into a managed asset.

If once thought to be a minor issue, found amongst public sector pension funds and related investment institutions, the concept of responsible investment has been rewritten by those that contend that all kinds of institutional investors have the responsibilities of 'universal owners' (Hawley and Williams 2005). Given the significance of financial markets for Western societies, developing economies, and emerging markets, and given the significance of their investments for the long-term welfare of beneficiaries, a new generation of activists have argued that institutional investors and the investment management industry have responsibility for the integrity of the global financial system (at one level) and oversight, and engagement with the companies that are included in their investment portfolios (at another level). Governments have been studiously 'quiet' on these issues, preferring to emphasise the connections between fiduciary duty and long-term commitments.

Many institutions have signed up to the UNPRI. We recognise that many institutions are cautious about taking on these types of responsibilities, using these kinds of new institutions as listening posts for learning about the issues and the ways in which corporate social responsibility and responsible investment are being recast. Even so, this type of commitment is consistent with the Telos project. That is, many institutions have sought to reconceptualise their goals and objectives and the means by which those will be realised. Given the changing mix of social agents, global movements, and the emerging realities of the twenty-first century, the UNPRI has encouraged reflection on these issues. Equally, financial risks and uncertainties combined with the structural issues associated with global economic and environmental transformation have challenged institutional investors to place themselves in this debate.

Our contribution to this debate through the Telos project had two related parts. In the first instance, we mapped out the emerging realities associated with environmental degradation, resource scarcity and climate change. We did so as part of a larger commitment to what Urwin and Woods previously have termed as 'sustainable investment'. By their account, this is a commitment to a disciplined approach to long-term investment, taking into account both immediate investment opportunities and their currently 'unpriced' externalities so as to realise the long-term rate of return that guards against the prospect that these unpriced externalities will result in a discounted rate of return. So, for example, Myles Allen's contribution on the science of climate change and its long-term trajectory sought to convince us that the unpriced risks of climate change could be brought to the centre of financial markets through new methods of scientific endeavour that are able to link cause and effect: in his case, fossil fuel-related emissions (cause) and the frequency of large tropical storms (effect).

Mapping these emerging realities includes climate change, resource scarcity and changing public perceptions about these issues, their significance, and who is responsible for the resolution. Our colleagues Dariusz Wójcik, Sarah McGill and Myles Allen provided us with the best available scientific information and judgement about these issues. This was followed by Claire Molinari's take on how conceptions of fiduciary duty have changed and could change in the future. Just as importantly, Gordon Clark provided a governance perspective on integrating short-term with long-term investment, emphasising learning, adaptation and integration. Both governance and the concept of fiduciary duty are crucial elements in taking forward an institutional commitment to sustainable investment. In combination, our map of the emerging realities and the mechanisms or tools we might use to make good on a long-term programme of investment management was Oxford's contribution to the Telos project.

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