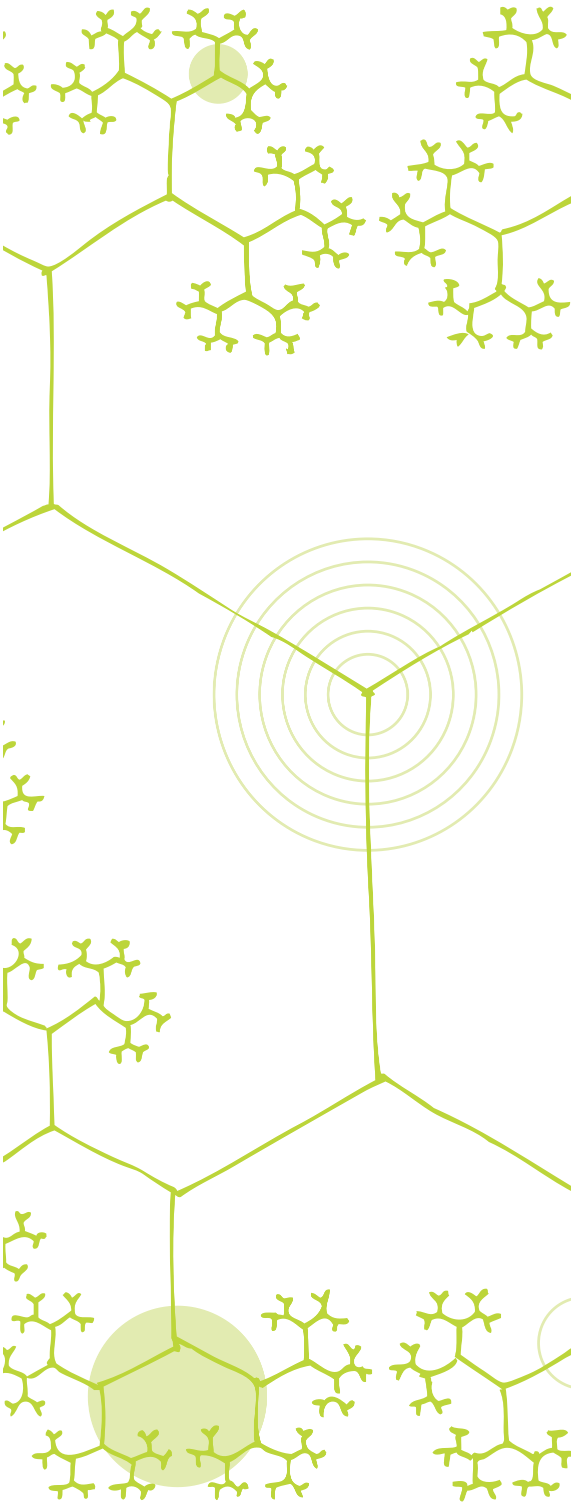
TOWERS WATSON

Investing long term

A sustainable investing roadmap



"We must adjust to changing times and still hold to unchanging principles."

Jimmy Carter

In short

This paper presents pension and other institutional funds with guidance in making allocations to sustainable investing strategies. It summarises a white paper entitled *Allocations to Sustainable Investing* by Roger Urwin[1] and prior works which focused on sustainable investing principles and practices.[2]

We outline an approach for determining allocation to sustainable investing, beginning with the establishment of beliefs in sustainable investment. Missions and values derived from that evaluation influence the focus on integrated and/or targeted investments.

Establish a starting point

The paper defines sustainable investing as encompassing long-term, finance-driven strategies that integrate environmental, social and/or governance factors in investment arrangements. The result is long-term investing that is efficient and intergenerationally fair, positioning sustainable investing in line with fiduciary principles of loyalty to all beneficiaries without undue bias to any one segment. This promotes long-term and inter-generational equity in strategy, reflects good risk management and supports a robust investment industry. There are two elements in most models of sustainability:

- A genuinely long-term strategy.
- An integration of environmental, social and governance (ESG) factors and ownership responsibilities.

As discussed previously[3], by establishing values and beliefs a clear mission of a fund can be set, determining whether the fund's goals are solely financial or include extra-financial influences. Three possible mission types are as follows:

- A **traditional mission** seeks to create value through investment activities, ensuring that present financial achievement is sustainable in the future.
- A **sustainable investment mission** incorporates additional goals which express a wider and longer-term view of responsibilities arising from ownership.
- A **dual-goal sustainable investment mission** seeks to achieve certain extra-financial goals balanced with financial targets (see **Figure 01**).

The level of conviction with which beliefs are held influences the appropriate allocation to sustainability mandates, whether integrated into traditional mandates or targeted to particular sustainable themes.

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

- Those that see stock-specific ESG factors as essential to risk control.
- Those that identify ESG-related assets that will benefit from tail-wind effects and early mover advantages.
- Those that adopt long investment horizons and a universal owner perspective in off-setting the longer-term risks and costs of natural resource depletion with ESG-related investment.

Assessment of the beliefs helps to identify distinct views on long-term investing and ESG issues such as climate change, governance and resource depletion. The strength of the beliefs held will determine what allocation should be to sustainable investment strategies, either on an integrated or targeted basis. For example, funds that believe active ownership can influence corporate performance, and therefore the risk-return profile of investments, should engage in corporate governance activities or invest with fund managers who actively engage with corporate management.

Influence of beliefs on strategy

If there is commitment to a sustainable investing strategy, there are two distinct approaches to incorporate these strategies into a portfolio: integrated and targeted.

Integrated approach

ESG and active ownership are mainstream elements of the mandate. The manager assesses ESG factors in the investment process, takes an active ownership role and reports on those actions. The fund should describe its ESG expectations in the mandate and monitor the ESG processes and actions of the manager.

The integrated strategy focuses on ESG and active ownership mandates, taking account of extra financial ESG factors alongside mainstream financial factors. Mandates adopt an integrated

Figure 01. Sustainability missions

Wider, longer-term view of responsibilities	Extra-financial view of responsibilities
Preserve Fund's reputation/satisfy beneficiaries' requirements Consider the ownership responsibilities associated with company ownership, particularly externalities • Universal ownership • Environmental and social damage • Contribute to wider stakeholder interests (for example, community, sustainability) Do no harm (may also cover ESG factors) Explicit recognition of intergenerational equity • 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-term mandate of fund avoiding inefficiencies in short-term behaviours	Produce defined environmental outcomes • Reduce carbon footprints • Promote investment in clean technology • Contribute to biodiversity Produce particular social outcomes • Improved labour practices • Alleviation of poverty • Community interests • Biodiversity • Health Hold with defined ethical beliefs • Tobacco • Alcohol • Firearms

Beliefs and universal ownership

The idea of universal ownership is particularly relevant in a scenario of longer-term climate change and resource degradation. 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 environmental and social factors on the long-term health of the economy, it follows that such funds should recognise the importance of ESG to their funds' ultimate fortunes. Their ownership carries an opportunity to influence future outcomes. They are 'universal' in the fact that their investments and the externalities of those investments are far reaching, and they are 'owners' in the fact that their investment stakes are of sufficient size to effect change. The beliefs of universal owners comprise an interesting set of contrasting positions with those funds that position themselves more inactively in their investment actions.

approach to ESG risks and opportunities and pursue influence in relation to their investment through active ownership methods such as voting and engagement. The strengths of this approach are ease of implementation and a relatively low impact on risk and return assumptions.

In integrated mandates, managers typically overlay sustainability analysis onto existing processes. Typically, these managers incorporate macro sustainability factors into asset allocation, sector and company research.

Targeted approach

Specialist investment is concentrated on ESG-related themes such as clean technology or environmental opportunities. Funds investing in this way would typically hold a stronger conviction on the merits of sustainable investing. Estimation of risk and return assumptions may be more difficult, and the tracking error of such mandates may be greater than in general. To make an allocation to targeted mandates, the fund mission will typically have a broader objective incorporating both financial and extra-financial goals.

The mandates in a targeted approach will tend to focus on beneficiaries of ESG and sustainability trends such as the transition to low-carbon economies, increased environmental regulation, and natural resource depletion.

Screening and sustainability assessments are typically used to focus investment attention and apply ESG themes. Managers in targeted ESG tend to implement mandates in the quoted and private sectors, exploiting particular themes such as clean technology.

Monitoring

It should be noted that this is an iterative process involving a monitoring framework. This monitoring involves reviewing the experience and outcomes of the allocation process and making periodic adjustments to the investment arrangement. The influence of feedback is particularly important as the decisions need greater justification in pure financial terms. Effective monitoring would quantify both financial and extra-financial outcomes. The most critical function of monitoring is that funds assess the performance potential of an effective long-term strategy, irrespective of any possible shorter-term underperformance.

Conclusion

Sustainability will influence the shape of economic and financial markets over the coming decades. The Urwin paper suggests that there are credible arguments to support the tenet that sustainable investing will produce both better investment outcomes and better societal outcomes.

We believe the profile of sustainable investing in institutional investment will grow steadily. As knowledge and understanding of the opportunities and risks build, better measures, benchmarks and decision tools will be developed.

1 *Allocations to Sustainable Investing*, Roger Urwin, May 2010

2 *Sustainable Investing Principles: Models for Institutional Investors*, Roger Urwin and Claire Woods, October 2009 and *Sustainable Investing Practice: Simplified Complexity*, Roger Urwin, October 2009

3 *Remapping our investment world*, Watson Wyatt, October 2003

Investment

Thinking Ahead

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