PRI | Principles for Responsible Investment

Overcoming strategic barriers to a sustainable financial system

A consultation with signatories on a new PRI work programme

Executive Summary

The Strategy agreed by the PRI Advisory Council in March 2012 gives high priority to work to address 'top-down' barriers to the development of a sustainable financial system, with a focus on capital markets. These are barriers found in current market practices, structures and regulation that undermine the interests of investors and the systems within which they operate. These factors, which include significant dimensions of the behaviour of both asset owners and investment managers, impede the integration of ESG considerations into investment processes and ownership practices, and in most cases they are not addressed directly by PRI's current work. The need for work at this strategic and systemic level has been identified as a result of PRI's experience in its first six years, and that of signatories more broadly. The financial crisis also clearly demonstrates the need for fundamental problems in the current operation of the market to be addressed. This new work will involve reviewing existing research, commissioning new research where necessary, developing proposals for practical action by investors themselves and/or by policy-makers, and facilitating collaboration by investors to pursue the changes that are identified as needed. This new work stream will be conducted in the same way as existing PRI work – by convening groups of signatories to work together to analyse and solve problems.

This consultation paper provides an overview of existing research and knowledge on some of the main obstacles to the development of a sustainable financial system and the further uptake of responsible investment. It then seeks signatories' views on a number of proposed initial project areas designed to address these challenges. These are:

- **Company short-termism and overall market returns** – to explore whether companies behave in ways that depress long-term investment returns by failing to take full account of long-term value drivers that include ESG factors; and if so, how investors should respond;
- **Investor short-termism, mandate design and alignment of interests** – to develop new

approaches to designing investment mandates, including benchmarks, performance periods, portfolio turnover and fee structures;

- **Portfolio structure and strategic asset allocation** – to explore new approaches in the light of the financial crisis, including links to sustainability issues
- **Externalities** – to identify the long-term financial implications of environmental and social externalities for portfolios, and explore the case for action by investors and policy-makers to internalize them in investors' interest;
- **Financial market stability** – to promote better risk management within financial institutions, notably those that are 'too big to fail', and regulation of these institutions and the market as a whole, that serve the interests of long-term investors;
- **Company disclosure** - to continue to promote disclosure by companies of all information relevant to long-term value creation, through voluntary and regulatory initiatives;
- **Financing the sustainable economy –** to facilitate the mobilization of capital to address some of the major challenges facing society.

The questions on which the Secretariat is inviting signatories' feedback are:

- Do you agree with the broad analysis and the identification of strategic issues set out in this paper (cf Annex)?
- Are there additional issues you wish to highlight – for example strategic barriers or challenges to a sustainable financial system in your particular market?
- Do you agree that the proposed possible projects are relevant? If not, why not?
- Do you have comments on individual proposed possible projects?
- Which of these projects do you wish to be involved in?
- Are there other projects or activities you wish to propose?
- Would you in principle be prepared to provide financial support for projects you are involved in?
- Do you have any suggestions on the way that activities in this area should be conducted?

When you have read this paper, please provide your feedback via the online survey on the PRI website. If you have any inquiries about the consultation, please e-mail strategicbarriers@unpri.org.

The deadline for responses is 8 March 2013.

Thank you.

1. Background and purpose of this paper

1.1 The PRI Strategy put in place in March 2012 renews the focus that PRI has had since its inception on long-term factors driving value creation and investment performance, the operation of the investment chain, and the policy and regulatory environment within which signatories operate. These are reflected in particular in two of the 'suggested actions' associated with Principle 4 of the PRI ('We will promote acceptance and implementation of the Principles within the investment industry'):

- 'align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate)'
- 'support regulatory or policy developments that enable implementation of the Principles'.

1.2 In its discussions leading up to the adoption of the new Strategy, the Advisory Council devoted considerable thought to the causes and continuing implications of the financial crisis. Investors' own practices and behaviours were clearly a significant factor in the loss of value to portfolios that the crisis caused - alongside failures of regulation and macroeconomic management. Short-termism, encouraging the de-linking of the financial economy from the real economy, inadequate corporate governance and ownership practices, high levels of risk and leverage, and use of certain derivatives all helped to inflate the bubble and to magnify the impacts when it burst.

1.3 Against this backdrop the Council agreed a new Mission for PRI:

'We believe that a sustainable global financial system that is efficient in economic terms is a necessity for long-term value creation, rewards long-term responsible investment and benefits the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration for their implementation; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.'

1.4 This Mission builds on the original Preamble to the Principles, with its focus on long-termism and fiduciary duty:

'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.'

1.5 It is clear that PRI needs to continue to focus strongly on compiling and articulating the business case for incorporating ESG into investment strategy and processes, and on enabling and mobilising asset owners to integrate responsible investment into their relationships with their investment managers. These areas already have high priority in our work. For example, our recently published research on ESG in private equity exits shows clearly that private equity trade buyers are placing importance on the ESG characteristics of acquisition targets.[1] We will also shortly release new publications on the integration of ESG into investment research and listed company valuation, and on ESG in manager selection and monitoring. We will continue to work 'bottom-up' on the implementation of the Principles in individual asset classes and through collaborative engagement.

1.6 But quite clearly more is needed if capital markets are to become truly sustainable and PRI is to achieve its Mission. The purpose of this consultation paper is to gain signatories' input on the design of a new area of PRI work focused on 'top-down' and structural factors in the operation of the investment chain and more broadly across the market and the financial system as a whole that impede the development of this more sustainable financial system. It is important to note that the factors to be explored here include significant dimensions of asset owners' and investment managers' own behaviour. The purpose of this work will be to conduct research on these issues and formulate practical proposals at two levels:

- Action that investors themselves can take
- Action that policy-makers need to take.

The PRI Secretariat will then facilitate collaborative action by investors to implement the proposals that have been generated.

1.7 This consultation paper identifies a number of issues that the PRI Advisory Council and Secretariat believe to be important for this new area of work on the basis of existing relevant research, the lessons learned during PRI's first six years, informal discussion with signatories and consultation with a number of leading experts in this area. Possible initial project areas are set out in Section 2. A brief overview of the underlying issues and existing research, from which the potential work areas have been derived, can be found in the Annex.

1.8 The questions on which the Secretariat is seeking feedback are:

- Do you agree with the broad analysis and the identification of strategic issues set out in this paper (cf Annex)?
- Are there additional issues you wish to highlight – for example strategic barriers or challenges to responsible investment in your particular market?
- Do you agree that the proposed possible projects are relevant? If not, why not?

[1] *The integration of ESG issues in M&A transactions: Trade buyer survey results.* Available at http://www.unpri.org/wp-content/uploads/PRI_PWC_Report_FINAL.pdf

- Do you have comments on individual proposed possible projects?
- Which of these projects do you wish to be involved in?
- Are there other projects or activities you wish to propose?
- Would you in principle be prepared to provide financial support for projects you are involved in?
- Do you have any suggestions on the way that activities in this area should be conducted?

2. Possible initial project areas

2.1 A high-level analysis of strategic barriers to the achievement of a sustainable financial system is outlined in the Annex. This analysis is not intended to be comprehensive or to present new insights. It summarises existing research and knowledge, in order to provide a foundation for the development of this new area of PRI work. The range of potential projects and activities flowing from the analysis is enormous. PRI needs to prioritise clearly in order to make the most effective use of its resources (see Section 3 below for further discussion of resources). In the first instance it will be possible for us to take on only a small number of projects, each on a relatively small scale. We will not be able to take up all the proposals made during this consultation. In this section we therefore propose a small number of 'possible initial project areas'. These have been selected on the basis that the Secretariat believes they:

- Address the most significant strategic issues
- Have the greatest potential to make a significant difference to the development of a sustainable financial system
- Have the potential to deliver tangible outputs, with material benefits to investors, within a relatively short space of time
- Are particularly suited to PRI's unique characteristics – its asset owner leadership, depth of mainstream investment manager participation, its global reach and its link to the UN.

Company short-termism and overall market returns

2.2 Companies focused excessively on short-term performance – often encouraged by signals from short-term investors – are likely to disregard ESG factors that could contribute to long-term value creation, thereby depressing their financial performance. If this happens on a significant scale across the market as a whole, investment returns generally will be reduced. Moreover, underinvestment in ESG-related value drivers could undermine long-term sustainability, potentially further depressing portfolio returns. **PRI could, for example, commission new academic/industry research in this area, facilitate dialogue between investors and companies to ascertain the seriousness of the problem and devise concrete solutions. Activities of this kind might be conducted in partnership with the Global Compact, building on the existing ESG Investor Briefing project.**

Investor short-termism – mandate design and alignment of interests

2.3 The design of investment mandates is central to the long-term alignment of interests between asset owners and investment managers, and to the full incorporation of ESG-related drivers of long-term value creation into the investment chain. **Work in this area could explore performance periods, benchmarks, portfolio turnover, fee structures and the specification of overall objectives and targets.**

Portfolio structure and strategic asset allocation

2.4 At a higher level than the structure of individual mandates, decisions about portfolio structure and strategic asset allocation set the framework for all other investment decisions. The financial crisis has sparked profound questioning of traditional approaches based on modern portfolio theory and diversification. **PRI could convene a group of signatories to explore new approaches to portfolio structure and strategic asset allocation, exploring issues such as the appropriate balance between real vs. financial assets, traditional definitions of asset classes vs. risk and factor-based models (including sustainability-related risk factors), active vs. passive management and short vs. long-term investment horizons.**

Externalities

2.5 There is strong evidence that the economic costs of environmental externalities are considerable and some indications that the cost of externalities associated with social and governance (both public and corporate) issues may also be substantial. It is possible that these costs depress the overall performance of the market and are therefore detrimental to long-term investors' interests. However, understanding of the implications of these impacts for long-term investors' portfolios remains limited. **PRI could commission new research on portfolio implications of externalities and develop proposals for action by investors and/or policy-makers to address them.**

Financial market stability

2.6 The importance of 'Global Systemically Important Financial Institutions'[2] – particularly the large investment banks – to the stability and functioning of the financial system as a whole means that they are central to PRI asset owner signatories' ability to fulfil their long-term fiduciary obligations, and to investment managers' ability to serve their clients successfully. Many if not most PRI signatories are shareholders of these institutions, as well as being clients, counterparties and having numerous other business relationships with them. Signatories also depend on appropriate regulation of these institutions.

2.7 **PRI could, for example, convene a group of interested signatories to explore the potential for collaboration to address risk management at financial institutions, focusing particularly on those that are 'too big to fail'. The options to be considered could include sustained collaborative engagement with a group of the large investment banks on corporate governance, risk management and executive remuneration, supported by detailed research; and dialogue with regulators.** It should be noted here that board-level issues and executive remuneration were the two

[2] As identified by the Financial Stability Board - www.financialstabilityboard.org

highest priorities for future collaborative engagement identified by signatories in the recent survey conducted by the Clearinghouse.

Company disclosure

2.8 The lack of consistent, comprehensive, comparable ESG data from companies is still a major obstacle to progress in making the financial system more sustainable. Many signatories are already involved in a variety of initiatives to standardise company reporting and/or to put it on a regulatory footing. PRI itself is involved in the International Integrated Reporting Committee [3] and has supported the Corporate Sustainability Reporting Coalition. **It would be logical for PRI to continue and expand its work on company ESG disclosure at the public policy level – for example focussing on stock exchange regulators. Dialogue with stock exchanges themselves will continue in any case through the Investor Working Group linked to the ongoing Sustainable Stock Exchanges Initiative.**

Financing a sustainable economy

2.9 Global trends such as the de-carbonisation of the economy, the expansion of finance into the 'bottom billion' and the need for affordable housing as cities grow will require very substantial allocations of capital from both the public and private sectors. Investments into these environmental and social-themed sectors are becoming more common among Asset Owner signatories – thereby driving demand for products from investment managers and for deals sourced via other intermediaries – across a range of themes and asset classes (renewable energy, clean technology, sustainable forestry and agriculture, inclusive finance, etc.). **Sharing experience among asset owners of how these investments 'fit' and 'work' within the portfolio, and deriving practical guidance from this experience, will help to increase understanding of the potential this area offers both to achieve strategic risk/return objectives and to finance the transition to a sustainable economy. PRI could also facilitate dialogue with governments and international financial institutions that are in a position to provide risk mitigation to encourage investment that supports sustainable development objectives.** PRI is already developing a work stream in this area within its Implementation Support programme. If responses to this consultation indicate particularly strong signatory interest in this area, opportunities to scale up this work faster will be explored.

3. How these projects will work

3.1 These projects will operate in the same way as existing PRI activities within Implementation Support and the Clearinghouse – by convening groups of interested signatories and facilitating collaborative activity, including commissioning research where necessary. The Secretariat will not conduct research or pursue other activities top-down without signatory involvement and support.

3.2 In general terms, in each case the Secretariat will convene a group of interested signatories, who will then develop detailed terms of reference and objectives for the

[3] The Chairman is a member of the IIRC Council and the Director of Responsible Investment is a member of the Working Group. The Secretariat is also coordinating investor input to

project, specify outputs, etc. Research could be commissioned through the PRI Academic Network or from other specialist sources. Throughout the project there will be intensive dialogue with the signatories involved in the activity, and where appropriate, with signatories more broadly.

3.3 Numerous other organisations and networks are working on many of the issues raised in this consultation. Wherever possible and appropriate we will collaborate with others in this new work programme, in order to make the most efficient use of the resources of signatories and the Secretariat, and in order to maximise the impact of projects.

3.4 Any recommendations for changes in investor practices or public policy that are developed through projects of this kind will be supported by detailed research. It will be made clear in publications produced in these projects and in public communication about these activities that these recommendations were developed by the PRI Secretariat in a consultative process with a range of signatories and experts, but that they do not necessarily reflect the views of the signatories as a whole or any individual signatory.

3.5 In FY 2013-14 the Secretariat will have one full-time member of staff dedicated to this area, supported by a modest research budget. Clearly this means that in the first instance PRI will only be able to take on a very limited range of activities in this new area. It is important that we focus first on the highest priorities, with the strongest signatory interest – and in particular, relevance to Asset Owners, given that their place at the top of the investment chain often puts them in the best position to effect change. The purpose of this consultation is to identify those areas.

3.6 High-quality work on the challenging issues outlined in this paper will in some cases require specialist consultancy and research support, over and above what can be provided by PRI's own staff or budgets. The Secretariat therefore envisages that signatories interested in working on these issues will be invited to provide project-specific financial contributions to cover these costs. This model already operates in certain parts of PRI's work (e.g. individual collaborative engagement and Implementation Support projects) and is common in other investor networks.

3.7 In the medium term it is hoped that PRI will be able to raise additional funding from other sources to support work of this kind (as well as other parts of our work). Potential sources include governments, international organisations and charitable foundations. A fundraising manager has been recruited to explore these opportunities.

4. Next steps

4.1 Signatories are invited to provide feedback on this consultation through the online survey tool by 8 March 2013. The Secretariat plans to establish an Advisory Committee of signatories to review the feedback received and advise on priorities. Following discussion with the PRI Board and Advisory Council, the Secretariat will propose a small number of initial projects. We envisage that this will be at the end of April 2013. Working groups of signatories will then be formed to start these activities as soon as possible.

Annex

Overview of strategic barriers to a sustainable financial system

A.1 This section briefly analyses some of the barriers to the development of a sustainable financial system and the broader uptake of responsible investment from which the work areas proposed in Section 2 have been derived. Many of the issues are interrelated, and this paper does not attempt to provide an exhaustive or detailed analysis. Footnotes provide references to detailed underlying research by academics and others.

A.2 It is important to note that the PRI Initiative already works on the operation of in the investment chain. Examples include the guide to *Integrating ESG criteria in manager selection, agreements and monitoring*[4] and *Responsible Investment in Private Equity – a guide for Limited Partners (second edition)*[5] at the interface between asset owners and investment managers; and the recently published *Integrating ESG issues into executive pay*[6] at the interface between investors and companies. The objective of this existing work is to integrate ESG into the current operation of the market. The purpose of activities proposed in this new work programme is to develop recommendations and action for more fundamental changes that would have a significantly greater impact on the development of a sustainable financial system in the medium to long term.

Investors, portfolios and markets

Short-termism

A.3 Considerable progress has been made in recent years in developing investors' understanding of how ESG factors contribute to the financial performance of listed companies and other assets, and therefore of how integrating ESG into investment processes can enhance decision-making. There are strong indications that these factors can help to mitigate risk – they may contribute to alpha and improve relative performance against the market. Academic evidence of positive relationships between ESG factors and stock performance also continues to grow stronger.[7]

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[4] http://intranet.unpri.org/resources/files/PRI_Including_ESG_criteria_in_manager_selection_pilot.pdf - an updated version will be published in January 2013.
[5] http://intranet.unpri.org/resources/files/lp_guide_2.pdf
[6] http://www.unpri.org/files/Integrating%20ESG%20issues.pdf
[7] See for example:
The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance - Eccles and Serafeim, Harvard Business School, 2011. Available at http://www.hbs.edu/research/pdf/12-035.pdf
Corporate Social Responsibility and Financial Risk. Boutin-Dufresne, Francois and Patrick Savaria. The Journal of Investing, 13 (Spring 2004), pp. 57-66.
Corporate Sustainability Performance and Idiosyncratic Risk: A Global Perspective. Darren D. Lee, Robert W.Faff. The Financial Review, Vol. 44, No. 2., pp. 213-237
Employee Relations and Credit Risk. Bauer, Rob, Derwall, Jeroen and Hann, Daniel, (October 3, 2009). Available at SSRN: http://ssrn.com/abstract=1483112 or http://dx.doi.org/10.2139/ssrn.1483112
Corporate Environmental Management and Credit Risk. Bauer, Rob and Hann, Daniel, (December 23, 2010).

A.4 Nonetheless, ESG professionals know from practical experience that in many cases ESG factors that will contribute to value creation in the long term are not financially material within the timescales on which investment mandates are commonly based. Research shows clearly that companies forego investment opportunities with positive long-term net present value in order to satisfy the market's short-term performance expectations.[8] The clear implication is that companies managed on a longer-term basis would generate superior value for their shareholders. It is likely that some of the investment opportunities that are currently discarded are strongly linked to ESG factors – such as improvements in resource efficiency, improvement of supply chain labour standards, or enhanced management of human capital within the firm. A longer-term focus by companies might therefore also contribute to sustainability goals and to the aim of greater alignment between investors and the 'broader objectives of society' set out in the Preamble to the Principles.

A.5 The behaviour of investors – both asset owners and investment managers – is also frequently short-termist. Pressures to report short-term performance to boards, beneficiaries and clients can be strong. Asset owners now also face pressures from regulators that may result in more short-termist investment strategies. These include performance requirements imposed as a result of under-funding (shortfalls against liabilities) and liquidity rules introduced in response to the financial crisis (which provide disincentives for long-term illiquid investments, including those in areas such as renewable energy infrastructure).

A.6 Even for long-term investors, some short-term strategies and practices fulfil an important function in the portfolio. In some cases, however, short-termism may undermine longer-term interests. Investment mandates – put in place by asset owners, often on the advice of investment consultants – are in many cases structured on the basis of short-term performance targets and monitoring periods. These generate incentives for asset managers to demand short-term performance of companies. Short-termism in investment management can be seen in the well documented increase in portfolio turnover that has taken place across the market as a whole in recent years. High turnover, driven in part by investment managers' incentives to deliver short-term performance to their clients relative to standard market benchmarks, is both a symptom and a cause of short-termism. It can be seen as part of the transmission mechanism between the short-termism of investors and that of companies. Yet studies show that high turnover and momentum-driven investing contribute to asset mispricing and bubbles, and the inefficient allocation of capital from a long-term perspective.[9] Empirical research shows that some front-line

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Available at SSRN: http://ssrn.com/abstract=1660470
The relationship between corporate social responsibility and shareholder value: an empirical test of the risk management hypothesis. Godfrey, P. C., Merrill, C. B. and Hansen, J. M. (2009). Strategic Management Journal. Volume 30, Issue 4, pages 425–445.
For a comprehensive review of relevant research see *Sustainable Investing: Establishing Long-Term Value and Performance* Deutsche Bank Climate Change Advisors, 2012. Available at http://www.dbcca.com/dbcca/EN/investment-research/investment_research_2413.jsp

[8] *The Economic Implications of Corporate Financial Reporting*, Graham, Harvey and Rajgopal, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=491627

[9] *An Institutional Theory of Momentum and Reversal*, Dimitri Vayanos and Paul Woolley, 3 June 2012, Paul Woolley Centre for the Study of Capital Market Dysfunctionality, London School of Economics. Available at

portfolio managers acknowledge that the way they are often incentivized to behave is not aligned with their clients' real long-term interests.[10] Nonetheless, academic research indicates that portfolio managers behaving in this way are acting rationally in response to the incentives they are given for fear of losing mandates.[11] If damaging short-termism is to be addressed, these incentives need to be restructured.

A.7 Within the investment profession, the CFA Institute's Centre for Financial Market Integrity finds that 'the obsession with short-term results by investors, asset management firms and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns and impeding efforts to strengthen corporate governance'. It therefore argues that 'compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals'.[12]

A.8 Governments too have sought ways to enhance the long-term performance of capital markets in the interest of both savers as the providers of capital and companies as its users. In the United Kingdom, the recent Kay Review of UK Equity Markets and Long-term Decision Making concluded that short-termism in the equity market undermines long-term business performance and the interests of long-term investors.[13] The European Commission has recently published an Action Plan on Company Law and Corporate Governance designed in part to promote long-term shareholder engagement with companies.[14] A Green Paper on long-term investment is also planned.

Externalities

A.9 An important objective of stock-level ESG analysis is to understand the likelihood and implications of the cost of negative environmental, social and other externalities being brought into companies' accounts. The cost that a company's operations impose on other companies, the environment, individuals, communities or the economy as a whole can be internalised through government policy or regulation, changing consumer preferences, technological change, or other factors.

A.10 The Stern Review on the economics of climate change estimated that that the economic cost of climate change could equate to an average reduction in global per capita consumption of 5% at a minimum if the global temperature increase is not restricted to 2-3^{o}C.[15] The 2010 Universal Owner report by PRI and UNEP estimated that the cost of the environmental impact of human activity was $6.6 trillion, or 11% of global GDP in 2008, and that the cost of the environmental damage caused by the 3,000 largest listed companies in 2008 was $2.15 trillion.[16]

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http://personal.lse.ac.uk/vayanos/WPapers/ITMR.pdf

[10] Investment Horizons – Do managers do what they say? IIRC Institute/Mercer

[11] *The Economics of Short-term Performance Obsession*, Alfred Rappaport, Financial Analysts' Journal Vol. 63, Number 3, 2005.

[12] *Breaking the Short-term Cycle*, CFA Institute for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics, 2006. Available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2006.n1.4194

[13] *The Kay Review of UK Equity Markets and Long-term Decision Making*¸ led by Prof. John Kay. Available at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

[14] http://europa.eu/rapid/press-release_IP-12-1340_en.htm

[15] The Economics of Climate Change – The Stern Review. Nicholas Stern, 2007. Chapter 6.

[16] *Universal ownership: why externalities matter to institutional investors*, PRI and UNEP-FI, 2011. Available at

A.11 Companies that act in advance of forced internalisation of externalised costs can in some cases capture commercial advantage and benefit their investors by reducing costs, developing new generations of attractive products and services, or building a high-performing workforce. The evidence on short-termism *at the individual company level* presented above suggests that greater internalisation of externalities by companies would increase investor returns. This requires appropriate market-based incentives – for example through long-term investment mandates and changes to executive pay structures.

A.12 However, companies that move too far ahead of their competitors in taking on additional environmental and social costs that were previously externalised may place themselves at a disadvantage. Their higher costs may not be offset by higher sales and profits, or policy-makers may not force cost internalisation on the market as a whole in the way that companies anticipated.

A.13 UNEP's 2011 Green Economy Report calculates that policy changes to protect ecosystems and natural capital could *increase* global GDP from an estimated $69 trillion in 2011 to $199 trillion in 2050, compared with $151 trillion in 2050 under a business-as-usual scenario.[17] This suggests that policy change of this kind to internalise the cost of externalities across the whole of the market might be in long-term investors' financial interest *at the portfolio level*.[18]

A.14 Asset owners have begun to evaluate the implications of at least some environmental externalities for their whole portfolios. In 2010-2011 a group of large asset owners worked with Mercer Investment Consultants to assess the implications of climate change for strategic asset allocation.[19] This work concluded that uncertainty surrounding governments' policy response to climate change could account for as much as 10% of all portfolio risk, and that this could be hedged by re-allocating towards 'climate-sensitive' assets, including infrastructure, real estate, private equity, agricultural land, timberland and sustainable listed and unlisted assets.

A.15 Hedging portfolio risk and diversifying sources of return in this way might also contribute directly to addressing the sustainability problems that generate the risk in the first place. For example, investment in renewable energy, energy efficiency, clean technology or sustainable natural resource management might not only improve a portfolio's risk/return profile but also help to mitigate climate change (albeit in a very small way as far as any individual investor is concerned, and certainly without reducing the long-term impact of

http://www.unpri.org/files/6728_ES_report_environmental_externalities.pdf

[17] *Towards a Green Economy – Pathways to Sustainable Development and Poverty Eradication*, UNEP, 2011. Available at http://www.unep.org/greeneconomy/Portals/88/documents/ger/ger_final_dec_2011/Green%20EconomyReport_Final_Dec2011.pdf

[18] For a discussion of the long-term alignment between the financial interests of investors and those of society as whole in relation to environmental sustainability and social issues, see *Pension Funds, Sovereign Wealth Funds and Intergenerational* Justice, Cappelen A. and Urheim R, Norges Handeslhøyskole, September 2012. Available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2156964*

[19] Climate Change Scenarios – Implications for Strategic Asset Allocation. Mercer 2011. Available at http://www.mercer.com/attachment.dyn?idContent=1407480&filePath=/attachments/English/04028-IC_ClimateChangeAssetAllocationStudy_Report_FNL_lowres.pdf

climate change on the portfolio via reduced emissions). HSBC estimates that investment of ca. $10 trillion per year is needed between 2010 and 2020 to tackle climate change.[20] Moreover, $40 billion a year are needed to achieve universal access to modern energy for everyone in the world by 2030.[21]

A.16 For some asset owners, sustainability-driven or thematic ESG investments that satisfy portfolio risk/return requirements also contribute to broader business objectives. For example, a DC pension fund may wish to attract a particular client segment, while a DB fund may find it important to maintain strong relationships with particular stakeholders (such as government) or to demonstrate to beneficiaries that it is aligned with their values.

A.17 Understanding of the financial implications of social issues and externalities for investors is in most cases at an even earlier stage than that of environmental externalities. For example, however, the World Bank estimates that companies grow approximately 3% per year faster in countries with low levels of corruption, and that income growth is between 2% and 4% per year higher in countries that control corruption. [22] On the other hand, the financial implications, notably at the portfolio and market-wide level, of issues such as human rights and poor labour standards are relatively poorly understood. Recent work also suggests that income and wealth disparities in society as a whole depress growth economy-wide.[23] This may have implication for investors, particularly those with large highly diversified portfolios.

Financial market stability - alpha vs. beta

A.18 During PRI's first six years the bulk of the effort devoted by most ESG/RI professionals to understanding the financial implications of environmental, social and governance issues has focused on alpha generation at the stock selection level. This applies across all asset classes. As noted above, there is growing academic and empirical evidence that integrating ESG information into investment processes in the right way can improve investment outcomes.

A.19 But improving relative performance and outperforming by a small margin a market that has dropped significantly provides little comfort to a long-term asset owner with defined liabilities (such as a DB pension fund), or one seeking to maximise retirement income for its beneficiaries and remain commercially competitive (such as a DC fund). In this situation, beta – the performance of the market as a whole – is more important than alpha – the outperformance of an individual asset or part of a portfolio (an asset class or strategy within an asset class). The financial crisis demonstrated this dramatically. The

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[20] *Sizing the Climate Economy*. HSBC, September 2010.
[21] *World Energy Outlook 2011*. International Energy Agency. Available at http://www.worldenergyoutlook.org/media/weowebsite/2011/executive_summary.pdf
[22] http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20190295~menuPK:34457~pagePK:34370~piPK:34424~theSitePK:4607,00.html
[23] See for example *The Price of Inequality – How Today's Divided Society Endangers our Future,* Joseph E. Stiglitz, 2012, pub. W. W. Norton and Company; *Inequality and Unsustainable Growth: Two Sides of the Same Coin?* Andrew G. Bert and Jonathan D. Ostry, IMF Staff Discussion Note, April 8, 2011. Available at http://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf

OECD estimates that the global financial crisis had destroyed $5.4 trillion (ca. 20%) of global pension assets by the end of 2008.[24]

A.20 Within ESG, corporate governance – and in particular market-wide work on corporate governance codes and standards – has been the principal entry point so far for addressing the performance of the market as a whole. Poor corporate governance, badly designed executive remuneration and weak risk management at the 'too big to fail' investment banks and other financial institutions were clearly significant contributors to the financial crisis. Yet the crisis was at least in part a failure of governance and regulation at an even broader and deeper level – that of the market and the financial system as a whole. This failure has clearly had far-reaching consequences for PRI signatories.

A.21 Issues of great relevance to the stability and health of the market as a whole are also emerging from PRI's work in individual asset classes – most notably hedge funds. The recently published Hedge Funds Discussion Paper explores the market-wide implications of issues including shorting, leverage, the use of derivatives and high-frequency trading.[25]

Portfolio structure and strategic asset allocation

A.22 As noted above, some asset owners are starting to explore the links between sustainability and strategic asset allocation. The financial crisis showed that conventional approaches to asset allocation and portfolio structure were not capable of shielding investors from substantial losses triggered by extreme events. This has prompted a wave of discussion and reflection on new approaches, encompassing debate about the appropriate balance between real vs. financial assets, traditional definitions of asset classes vs. risk and factor-based models, active vs. passive management, short vs. long-term investment horizons, and more besides. Portfolio-level decisions on these issues will set the context for all other decisions, and will be critical in determining asset owners' relationships with investment managers and their ability to achieve their long-term objectives.

Market frameworks and other actors

Company disclosure

A.23 High-quality ESG information remains crucial to all responsible investment endeavours – and it is to some extent still the 'Holy Grail'. Full incorporation of value-relevant long-term sustainability factors into the operation of the market will not be possible until and unless appropriate information from companies is available. In recent years policy-makers and regulators in numerous markets have taken steps to facilitate greater capital market sustainability through mandatory ESG reporting by companies. Obligations on companies to disclose different types and levels of ESG information already exist in certain countries.[26] The PRI Initiative has supported extensive collaborative engagement to

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[24] Antolín, P. and F. Stewart (2009), "Private Pensions and Policy Responses to the Financial and Economic Crisis", *OECD Working Papers on Insurance and Private Pensions*, No. 36 Available at http://www.oecd.org/insurance/privatepensions/42601323.pdf

[25] http://www.unpri.org/files/2012.11.RI.and.HF.pdf

[26] E.g. to some extent under the EU Accounts Modernisation Directive. More specific reporting requirements

encourage stock exchanges to require ESG disclosure of listed companies, and endorsed the recent call by the Corporate Sustainability Reporting Coalition for a commitment by governments at Rio+20 to start negotiations leading to mandatory corporate sustainability disclosure.[27]

Fiduciary duty

A.24 Fiduciary duty has been the subject of intense debate in the ESG/RI world for some time. The PRI is framed very firmly in the context of investors' fiduciary and other legal obligations. The 2005 report by the international law firm Freshfield Bruckhaus Deringer for UNEP-FI concluded that 'integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions'.[28] Nonetheless, concerns over the consistency of responsible investment with fiduciary duty still arise commonly in certain markets. An active debate continues in some markets on whether the legal definition of fiduciary obligations should be changed, or whether trustees and others responsible for the governance of pension funds and other asset owner institutions should in practice interpret their legal duties in ways that take more systematic account of ESG factors, particularly from a long-term perspective.[29]

Pension fund governance

A.25 The governance structures and practices of pension funds, including the skills and knowledge of trustees and members of governing bodies, are of critical importance to the long-term success of asset owners, and to whether and how ESG/responsible investment is incorporated into an institution's operations. A number of trustees are already involved in different parts of PRI's work (e.g. as members of the Advisory Council, members of the Small and Resource-Constrained Signatories Steering Committee, through regular attendance at PRI in Person etc.) We plan to explore the potential for further activities directly focused on trustees/board members in 2013.

Sell-side research

A.26 The ESG community has devoted considerable effort in recent years to encouraging the sell side to integrate ESG factors into its research. The Enhanced Analytics Initiative and similar projects have helped to stimulate substantial progress. Recent work by the ESG Integration Working Group of PRI's Listed Equity Workstream has found that the quantity of high-quality broker research that deals in a sophisticated way with ESG factors has increased very significantly compared with the situation only a short time ago. The pilot new PRI Reporting Framework asks signatories to disclose how they incentivise brokers

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exist in countries including France and Denmark. In the US the SEC requires certain disclosures related to climate change.

[27] http://www.unpri.org/news/2012.05.21%20PRI%20Supports%20CSRC.pdf

[28] *A legal framework for the integration of environmental, social and governance issues into institutional investment.* UNEP FI 2005. Available at http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

[29] E.g. *Reclaiming Fiduciary Duty Balance*. James Hawley, Keith Johnson and Ed Waitzer. Rotman International Journal of Pension Management. Vol. 4, Issue 2, Fall 2011. Available at http://utpjournals.metapress.com/content/d78148gvh28678g3/fulltext.pdf

to integrate ESG into their research.[30]

Credit rating agencies

A.27 Credit rating agencies (CRAs) are a vitally important component of the fixed income investment chain. Both the Corporate and Sovereign working groups of the Fixed Income Work Stream are assessing the extent to which the CRAs incorporate ESG into their methodologies, research and ratings. The Sovereign Working Group responded to Standard and Poor's recent consultation on corporate governance, urging it also to take account of environmental and social factors. This work on CRAs will continue within the Fixed Income Work Stream.

Investment consultants

A.28 The extent to which investment consultants incorporate ESG/RI into their advice to clients varies very widely indeed. PRI has a small number of investment consultant signatories. Asset owner signatories frequently report that their consultants are at best neutral and at worst hostile to ESG. Investment consultants could be invited to be involved in work on the design of investment mandates. Other opportunities to work with consultants will be considered as resources permit.

[30] Direct – Listed Equity supplement, question LE04. Note that the final version of the revised Reporting Framework is currently being developed on the basis of feedback from the 2012 Pilot.