Resilience and the Long Term:

RETHINKING PORTFOLIO STRATEGY

THE PRINCE'S CHARITIES

ACCOUNTING FOR SUSTAINABILITY

BUSINESS IN THE COMMUNITY

UNIVERSITY OF CAMBRIDGE
25 YEARS PROGRAMME FOR SUSTAINABILITY LEADERSHIP

HIS ROYAL HIGHNESS THE PRINCE OF WALES

"Your sector plays a very significant role indeed in how our economic system works, both now and into the future. So it really does fall to you, I am afraid, to help shape, adapt or re-orientate a system largely devised in a very different nineteenth century context so it is actually fit for purpose and effective in what is fast becoming a very challenging twenty-first century."

PURPOSE OF THIS BOOKLET

This short booklet highlights existing research and guidance on how the inclusion of sustainability and longer term issues in investment decisions can add value for asset owners such as pension funds.

By addressing social and environmental risks, investors can create resilient, stronger and more profitable portfolios along with a more resilient underlying economy. This booklet should equip asset owners to begin speaking with fund managers about these issues and integrate environmental, social and governance considerations into investment strategy.

"Principal/agent problems and a flawed theory and understanding of finance are bringing capitalism to its knees. A new interpretation of finance points to the critical role played by those responsible for society's wealth."

DR. PAUL WOOLLEY,
CHAIRMAN OF THE PAUL WOOLLEY CENTRE FOR THE STUDY OF CAPITAL MARKET DYSFUNCTIONALITY AT THE LONDON SCHOOL OF ECONOMICS

"The integration of sustainability into business is about long-term value creation."

DAVID BLOOD,
MANAGING PARTNER OF GENERATION INVESTMENT MANAGEMENT

"Given the long term nature of our liabilities, Trustees and Beneficiaries are exposed to risks and opportunities from environmental and social changes over a long horizon. As much as possible we want to engage to obtain a positive outcome."

MICHELLE MCGREGOR SMITH,
CHIEF EXECUTIVE OF BRITISH AIRWAYS PENSION INVESTMENT MANAGEMENT

Summary

Sustainability and higher returns go hand in hand - this is about risk adjusted returns, not just ethics.

The world is entering a new economic era. Resource scarcity - exacerbated by a rapidly growing population, climate change and more affluent lifestyles - is leading to a more uncertain economic environment exposed to significant commodity and share price volatility.

Such trends have the potential to significantly affect asset values.

Companies are having to redefine their business models and supply chains to stay competitive. Opportunities for businesses that help drive a sustainable economy are also increasing.

There is mounting evidence that companies with sustainability policies (incorporating Environmental, Social and Governance factors into investment decisions) deliver improved long term returns. This in turn offers opportunities for long term investors such as pension funds.

Investment opportunities relating to assets that support the move to a sustainable economy are developing rapidly.

"The world is using up its natural resources at an alarming rate, and this has caused a permanent shift in their value. We all need to adjust our behaviour to this new environment. It would help if we did it quickly..."

Jeremy Grantham, Co-Founder GMO
(Global investment group with over US $100 billion of assets under management)

Background: A new economic era

Global trends are ushering in a new and unprecedented operating environment for businesses and investors alike. Such trends, particularly when combined, have the potential to significantly affect asset values and need to be considered by every asset owner looking to build a resilient portfolio.

RAPID POPULATION GROWTH

The world's population is predicted to rise from 7 billion in 2011 to 9.3 billion in 2050.[1] Coupled with growth of the global middle class by almost 3 billion by 2050[2], this will result in large scale increases in resource consumption.

INCREASING RESOURCE CONSTRAINTS

There are currently 700 million people who suffer water scarcity[3] and demand could outstrip supply of accessible water by 40% by 2030.[4] In order to meet global food demands by 2050, agricultural production will need to increase by 70% from 2005.[5]

CHANGING WEATHER PATTERNS

Rising global temperatures and greater volatility of weather patterns are leading to more frequent heat waves, droughts, floods and other extreme weather events. In 2011 global natural catastrophe losses cost insurers well in excess of US $100 billion.[6]

GROWING CONNECTEDNESS

The rise of Internet coverage and social media is placing organisations under increasing scrutiny from society leading to new transparency and responsibility benchmarks.

GLOBAL ECONOMY CONTINUES TO FALTER

Many economies are struggling with low growth rates, high borrowing costs or restricted capital flows. Youth unemployment coupled with an ageing population remains a pressing global challenge. Between 2000 and 2050, the proportion of the world's population over 60 years will double from around 11% to 22% with significant consequences for pensions and healthcare costs.[7]

These trends are increasingly impacting on business's bottom line

Background: Business is responding

Many companies are adapting to the changing landscape and developing more sustainable, resilient business models. However, awareness and response rates from investors have been slow.

"People always think that to do the right thing costs you more. That is not true at all. It can actually ignite innovation and lower your costs. The alternative of not having sustainable sourcing, of having to deal with the effects of climate change, is a much higher cost on business. It is time to change...".

Paul Polman, CEO, Unilever

93%

of global CEOs see sustainability as important to their company's future success[8]

49%

of CFOs see a 'significant' link between sustainability performance and financial performance[9]

There is a disconnect between how investors and companies view the centrality and materiality of Environmental, Social and Governance issues to a business's long term prospects

Only

12%

of CEOs say pressure from investors drove them to take action on sustainability issues[8]

1

WHY is this important to you?

There is a growing acknowledgment that ‘quarterly capitalism’ is no longer fit for purpose in our changing economic environment.

Sustainable assets yield superior returns

Taking a longer term view of investment strategies can provide more profitable and resilient portfolios and achieve enhanced long term returns. There is a growing body of evidence to show that assets which exhibit better Environmental, Social and Governance (ESG) credentials result in:

OUTPERFORMANCE AGAINST PEERS

A May 2012 Harvard Business School study found that ‘High Sustainability’ companies significantly outperform their peers over the long term, in both stock market and accounting performance.[10]

A LOWER COST OF CAPITAL

A Deutsche Bank study found that 100% of over 100 academic studies reviewed agreed that companies with high ratings for Corporate Social Responsibility and Environmental, Social and Governance factors have a lower cost of capital in terms of debt (loans and bonds) and equity.[11]

REDUCED SHARE PRICE VOLATILITY

A recent study by BITC and Legal & General found that businesses that consider Environmental, Social and Governance factors show reduced share price volatility against the FTSE 350.[12]

Assets that are inconsistent with a sustainable economy risk reduced returns

Assets and companies whose business models are not compatible with a sustainable economy risk reduced returns through changing regulations, operating environment or consumer demand.
For example, if we are to keep within the two degree global temperature rise agreed by global leaders to avoid 'dangerous' climate change, it is estimated that only 20% of total current fossil fuel reserves can be burnt by 2050, even with carbon capture and storage technology.[13] The subsequent risk to the economy of these stranded assets should be balanced with the economic, political and security consequences of significant climate change.

> *"Infinite high resource intensity growth is simply not possible, and we are already living off our future capital. It may be gradual but most businesses will have to adjust to a very different reality."*
>
> Ian Cheshire, CEO, Kingfisher

A study with some of the world's largest pension funds with US$2 trillion of assets under management, led by Mercer Consulting[14] concluded that:

Climate change could contribute as much as **10%** to portfolio risk over the next 20 years

Investors could benefit from increasing the level of investment in infrastructure, real estate, private equity, agriculture land, timberland and sustainable assets

Investment opportunities in low-carbon technology could reach **$5trn** by 2030

Pension funds will benefit from a sustainable resilient economy

Given their universal ownership and long term liabilities, pension funds are both more vulnerable to the changing economic climate and better able to prosper, as long term investment strategies are able to play out.

By contributing to a long term, sustainable economy, pension funds can also help to preserve the real value of your beneficiaries' retirement income through a functioning environment and society.

"Many investors believe that doing good and making money are polar opposites, but our active pension fund shows that's not the case. In a tough market the fund is succeeding in both generating returns and in encouraging businesses to act responsibly. We are proving that investors can have a positive role in fighting the growing pressures of climate change and environmental degradation."

Chairman,
Environment Agency
Pensions Committee

It is part of your fiduciary duty

There is a growing consensus that where Environmental, Social and Governance factors are deemed to comprise a relevant and material systemic risk for the ultimate beneficiaries, they should form an integral part of investors' fiduciary duties.

In 2005 Freshfields produced an influential report that confirmed where Environmental, Social and Governance issues are financially relevant, that they may, and indeed should be taken into account.[15] This was a view also reflected in Professor Kay's 2012 review of the equity markets.[16]

In the UK, the Law Commission has begun a Government commissioned review to clarify the exact scope of fiduciary duty as it applies to investment intermediaries such as pension scheme trustees and investment managers. A final report is due in June 2014.

"...The links between Environmental, Social and Governance factors and financial performance are increasingly being recognised. On that basis, 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."

Freshfields Bruckhaus Deringer, A legal framework for the integration of environmental, social and governance issues into institutional investment, 2005

"...Institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities."

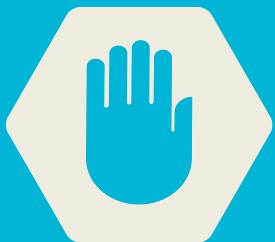
Kay Review of Equity Markets and Long-Term Decision Making, 2012

2 WHAT can you do to manage these issues?

The following outlines a set of simple non-exhaustive steps you can take to integrate Environmental, Social and Governance issues into your investment strategy to create more resilient portfolios, as well as deliver a more sustainable economy:

1. INCORPORATE INTO POLICIES AND PRINCIPLES

Engage trustee board to discuss material Environmental, Social and Governance risks within current investment decisions. Incorporate policies which support management of ESG issues and stewardship responsibilities such as engagement and voting into the statement of investment principles.



2. MANAGER AND INVESTMENT CONSULTANT SELECTION

Select fund managers and investment consultants who integrate Environmental, Social and Governance thinking into their advice and execution strategies.

It is no longer enough for a fund manager to have simply signed up to voluntary codes, pension funds should look more closely at how they implement Environmental, Social and Governance and stewardship policies. Managers should be given clear policies and instructions within Investment Management Agreements (IMA).

3. MONITORING AND REPORTING

Asset owners should scrutinise how well fund managers engage with Environmental, Social and Governance and stewardship principles in practice. Renumeration should be linked to trustees objectives for long term performance.

Pension funds should require transparency and reporting from all within the investment chain, setting out detail on engagement, voting, and identification and management of key Environmental, Social and Governance risks. Asset managers should be held to account against the fund's own policy.

4. ACTIVE OWNERSHIP

Asset owners should engage with fund managers, management teams and wider industry groups to collaborate in order to achieve change on material Environmental, Social and Governance issues. Active engagement on ESG issues has been show to increase risk-adjusted return on investment.[17]

5. BE TRANSPARENT

Disclose how the fund's investment strategies are implemented in practice.

3 HOW to progress in this area ?

Useful resources

ORGANISATIONS

National Association of Pension Funds (NAPF): An independent voice for workplace pensions.

United Nations Principles for Responsible Investment initiative (UNPRI): An international network of investors working together to put six Principles for Responsible Investment and Environmental, Social and Governance considerations into practice. The Principles have more than 1,200 signatories to date with more than US $35 trillion assets under management.

The UK Sustainable Investment and Finance Association (UKSIF): A membership network for sustainable and responsible financial services.

ShareAction: A charity that promotes incorporation of ESG issues into investment strategies by pension funds and fund managers.

TOOLS AND GUIDANCE

NAPF Stewardship Policy 2012:
Best practice guidance for pension fund trustees including guidance on the application of the UK Stewardship Code.

NAPF Responsible Investment Guide 2013:
A summary document detailing the case for incorporating extra-financial risks into pension fund investments, and how pension funds can move the market towards one where responsible investment is considered the norm.

International Corporate Governance Network Model Mandate: A model contract designed to promote ‘optimal alignment’ between asset owners and asset managers focused on investment and risk opportunity, the integration of financial and non-financial factors, stewardship, pay structures, portfolio turnover and transparency.

UNPRI Aligning Expectations:
Guidance for Asset owners on incorporating ESG factors into manager selection, appointment and monitoring.

NAPF Corporate Governance Pensions Connection Site: Continuously updated best practice guidance and ideas targeted at helping pension funds and their investment managers address a broad range of corporate governance topics. Monthly topical questions are produced to aid trustees in questioning the effectiveness of their managers’ stewardship activity. Key questions are available on the back page of this document.

References

1. UN (2012), Department of Economic and Social Affairs ‘World Urbanisation prospects, The 2011 Revision’
2. HSBC (2012), ‘Global research, Consumer in 2050: The Rise of the EM Middle Class’
3. UN Water for Life, www.un.org/waterforlifedecade/scarcity.shtml
4. McKinsey & Company (2009), ‘2030 Water Resources Group: Charting our water future’
5. FAO (2009), ‘Global agriculture towards 2050’
6. Ceres (2011), ‘Stormy Future for US Property/ Casualty Insurers: The Growing Costs and Risks of Extreme Weather Events’
7. World Health Organisation http://www.who.int/ageing/en/
8. Accenture (2010), ‘A new Era of Sustainability, CEO Study’
9. Deloitte (2012), ‘Sustainability: CFOs are coming to the table’
10. Harvard Business School, R.G Eccles, I Ioannou and G. Serafei (2011), ‘The Impact of a Corporate Culture of Sustainability on Corporate Behaviour and Performance’
11. Deutsche Bank Group, DB Climate Change Advisors, M. Fulton, B.M. Kahn, and C. Sharples (2012), ‘Sustainable Investing - Establishing Long-Term Value and Performance’
12. Business in the Community and Legal & General (2013), ‘Conscious capital – bridging the gap between business and investors’
13. Carbon Tracker Initiative and Grantham Research Institute for Climate Change and the Environment (2013), ‘Unburnable Carbon 2013:Wasted capital and stranded assets’
14. Mercer, (2011), ‘Climate Change Scenarios: Implications for Strategic Asset Allocation’
15. Freshfields Bruckhaus Deringer (2005), ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’
16. J. Kay, (2012), ‘The Kay Review of Equity Markets and Long Term Decision Making, Final Report’

HIS ROYAL HIGHNESS THE PRINCE OF WALES

"We have to ensure that we are not battling to meet 21st century challenges with, at best, 20th century decision making and reporting systems."

Quizzing Fund Managers

During your next regular manager review, why not gain greater understanding of their approach and activities and ask your existing or prospective investment managers the following questions:

Based on questions developed by NAPF to assist pension funds in creating dialogue with investment managers around the Stewardship Code.

1. WHAT CODES OF CONDUCT OR PRINCIPLES HAVE YOU SIGNED UP TO?

The Stewardship Code and/or the United Nations Principles for Responsible Investment?

2. HOW ARE ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS INCORPORATED INTO INVESTMENT DECISIONS?

Are they built into investment research and decisions? Does the approach adopted differ across asset classes?

3. HOW DO YOU RESPOND WHEN A ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUE IS IDENTIFIED IN AN INVESTEE COMPANY?

Do they engage with the company to influence change, alter stock weighting or other? Who leads that engagement - the fund manager, corporate governance team or both?

4. ON WHAT ISSUES DO YOU ENGAGE WITH COMPANIES?

Is it in relation to both financial and Environmental, Social And Governance issues? What about the corporate culture and board leadership; executive pay; board diversity; the performance of and relationship with the auditor; and any other material factors?

5. ARE YOU ABLE TO DEMONSTRATE THE EFFECTIVENESS OF YOUR STEWARDSHIP ACTIVITIES?

Can they provide examples where they have identified issues of concern, engaged upon them and achieved appropriate positive corporate change?

6. HOW DO YOU REPORT ON YOUR STEWARDSHIP ACTIVITIES?

Do they provide clients with a voting report at least highlighting votes against management?

Printed on 100% recycled paper