Sustainable Investing Principles: Models for Institutional Investors

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Abstract:
The global financial crisis is the latest event to bring the investment industry under scrutiny. The crisis has drawn attention to the question of whether the industry's priorities should be realigned to be more sustainable to better meet the long-term needs of these funds and their beneficiaries and, more broadly, society as a whole. Funds' fiduciaries have to date taken limited account of sustainability with sub-optimal performance the result. The causes of this problem are combinations of governance limitations, behavioural traps and legal framing, particularly with respect to fiduciary duty.

The sustainable investing model we advocate involves investing having regard to a broader mission, deeper thinking on investment strategy and a longer-term framework for evaluating success. We suggest that sustainable investing is mostly about investment beliefs and contrasts with responsible investing which is more about values. Sustainable investing preferably includes two elements. First, it involves a long-term investment strategy whose value creation proposition promotes current achievement without compromising future achievement (we refer to this as increased depth of strategy); such a definition of sustainable investing may be used on its own; but we advocate a second part to sustainability requiring investors to act fairly by considering the externalities created by their investments and their social responsibilities (we refer to this as increased breadth of mission). This second part of the sustainable investing model includes the integration of ESG factors and ownership responsibilities; such factors are central to responsible investing codes established to support mitigations of future societal discord from problems like climate change and natural resource degradation.

The pathway to this improved system relies on both improved governance by funds and government support. Funds must strive for improved governance along best-practice lines. Governments could improve clarity with respect to fiduciary responsibilities by introducing comply or explain codes, or safe harbour provisions. In doing so, governments would reinforce governance standards and lend support to the concept of institutional investor social responsibility. More indirectly, governments are indispensable for sending correct market signals through appropriate pricing of externalities. Sustainable investing in the model advocated is robust to legal challenge for pension and sovereign funds. Critically, it delivers fairer results in an economically efficient structure that is both economically superior to traditional investment models and positive to society.

Key words and phrases: pension fund, sovereign wealth fund, sustainable investing, investment strategy, investment beliefs, investment mission, governance, fiduciary duty, global financial crisis

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I. Introduction

The global financial crisis is the latest event to bring the investment industry under scrutiny. The crisis has drawn attention to the question of whether the industry's priorities should be realigned. As it currently stands, institutional funds' pre-occupation with short-term performance is at the expense of long-term value. This is, we suggest, out of step with the long-term needs of these funds and their beneficiaries and, more broadly, with society as a whole.

The reasons for this shortcoming lie in a combination of factors: governance limitations, behavioural biases of fiduciaries and their agents; and legal framing that is unhelpful, particularly with respect to the interpretation of fiduciary duty. Legally, while pension funds must recognise beneficiary interests as paramount, they need not be so dedicated to their current short-term, narrow focus. For their part, as state investment institutions, sovereign wealth funds have less legal constraint with respect to investment strategy and the main barrier to sustainable investing by these funds is political will and behavioural bias. We assert that by understanding the powerful effect of these problems, steps can be taken to counteract them.

Both pension and sovereign wealth funds can and should be able to move toward a more efficient investment model based on a sustainable investing model. Such a move would produce significant value for their direct beneficiaries and society generally. Moving toward this sustainable investment approach would require funds to make two fundamental shifts in the way they approach their mandate. First, funds would have to increase the *breadth* of their mandate, by taking a wider view of their investment responsibilities, including recognising stakeholders in their actions. Second, funds would need to increase the *depth* of their mandate, by advancing beyond the current investment culture that emphasises short-term risk aversion toward one that prioritises longer-term value creation influenced by many factors that are difficult to assess on strict financial terms.

The purpose of this paper is to demonstrate that an economically efficient and fair model for sustainable investing exists and can be implemented. Under this model, investment strategies use longer-term wealth creation criteria while taking into account the externalities associated with a broader range of stakeholders. We argue that while current interpretations of fiduciary duty make pension funds understandably reluctant to adopt any model of sustainable investment, certain legislative measures and improved governance solutions can overcome these impediments. Moreover, we argue that sovereign wealth funds, which as state investment vehicles have greater freedom to embrace sustainable investment, can be leaders in this area.

The principal model of 'sustainable investing' presented in the paper is of *long-term investing that is inter-generationally efficient and fair*. This involves investment strategy being simultaneously optimised in both the present and the future. This is an expansion of current thinking in two dimensions: it first involves a long-term investment strategy whose value creation proposition promotes current achievement without compromising future achievement (increased depth); such a definition of sustainable investing may be used on its own; but we advocate a second part to sustainability requiring investors to act fairly by considering the externalities created by their investments and their social responsibilities (increased breadth).

We recognise that different institutions may define sustainable investing in various ways. Most often definitions seem to focus on the second part of our model above; we see the first part (increased depth) as more critical in many respects – without increased depth, no investment model can survive over the long-term. Although we do not enter further into semantic debate here, we stress that while each fund or organisation may have its own definition of sustainable investing, it is critical to the integrity of the term that each definition is clear and suitable for the objectives of the organisation that creates it.

Terminology has caused a great deal of confusion in this area in the past. While this paper concentrates on 'sustainable investing', it is worth taking a moment to mention other terms that are used in the field. In the 1980s, the terms 'socially responsible investment' and 'ethical investment' were used to describe a wide range of investment activities that generally had to do with the promotion of certain social or ethical values. More recently, the term 'responsible investment' has appeared, largely in response to a perceived need to make socially beneficial investment more attractive to 'mainstream' investors. Responsible investment is a term most often used to consider the environmental, social and governance costs and benefits of investments in respect of investment decisions, with the view that the inclusion of these factors will not only provide a more accurate view of financial performance of investments over the long-term, but will also reduce the impact on society of negative externalities from investments. Responsible investment is therefore generally seen as providing positive social effects within a sound financial framework (and many suggest responsible investing includes a 'business-case' alongside its social justification). There are a number of organisations promoting responsible institutional investment, the most prominent of which are the Equator Principles, and the UN-sponsored Principles of Responsible Investment. Both of these sets of principles express responsible investing through a combination of environmental, social and governance (ESG) issues and active ownership of investee companies.

Our model for sustainable investing builds upon the content of responsible investment as defined above, in particular by introducing the concept of sustainability mandates. Nonetheless we see the rationale for the adoption of sustainable investment as differing from the rationale behind responsible investment as observed in the investment consultancy context. Investors who adopt principles of responsible investing, such as the UN PRI, express a desire to incorporate ESG issues into investment analysis and decision-making processes and to be active owners. We see sustainable investing as preceding this stage of investment value selection. Sustainable investing is an investment strategy derived predominantly from investment beliefs – investors who embrace sustainable investing believe that an investment strategy with greater breadth and depth will produce stronger investment performance both now and in the future. Sustainable investors then select their investment values according to key beliefs underlying their investment strategy. We see a beliefs-based rationale as crucial to the effectiveness and longevity of any sustainable investing strategy. This is principally because beliefs-based investment provides a strong framework for future decision-making, even where investment values change over time. While the rationales behind responsible investing and sustainable investing appear to occupy different stages of investors' strategy phases, we see grounds for reconciliation of the concepts in that responsible investing principles, as an exercise of values relating to ESG and active ownership, may be adopted on the basis of a well-founded, beliefs-based sustainable investing strategy.

This paper proceeds in five core sections. Section II demonstrates why, in our view, pension and sovereign wealth funds *should* adopt a more sustainable approach to investment. Trust funds exist to carry wealth from one generation to the next. They should do so in an economically efficient way and in a way that promotes inter-generational equity; in short, they should invest sustainably. Additionally, we argue pension and sovereign wealth funds have a responsibility to monitor the wider social and environmental impacts of their investments, given the considerable influence and financial importance of their investment activities. In an argument analogous to those made for corporate social responsibility within companies, we make a case for *institutional investor social responsibility*.

Section III outlines barriers which must be surmounted in order for pension and sovereign wealth funds to adopt a more sustainable approach to investment. Current interpretations of fiduciary duty are an impediment to change for pension funds. For sovereign wealth funds, fiduciary duty does not pose the same sort of barrier. Whether sovereign wealth funds choose to invest sustainably is more closely related to the wishes of the governments who set up these funds although we argue later that there continue to be behavioural reasons for this in addition.

In Section IV we describe a number of the behavioural biases that fiduciaries have that make change and innovation in investment strategy difficult. We describe improvements in governance that are required to mitigate these difficulties.

Section V proposes a model in which a more sustainable form of investment can be achieved. Under this new approach, funds would create more expansive investment policies in which their missions would have more breadth and their investment strategies would have more depth. By breadth of mission we are covering issues of responsible investing and potentially including combined goals – financial and mission related. By depth of investment strategy we are principally concerned with long-term sustainable investing. We also consider strategies in which funds make targeted investment in sustainability themes.

The final section describes the changes required in order to achieve a more sustainable investment culture. We recommend both top-down changes from governments and bottom-up changes in pension and sovereign wealth fund governance. We first outline a number of best practice governance approaches that can help funds to invest more sustainably. We then suggest potential legislative changes, proposing safe harbour and comply or explain provisions with respect to pension fund mandates as possible solutions.

II. The Case for Sustainable Investment

The challenges posed by climate change, environment degradation and natural resource depletion, the ageing population and the present financial crisis demand a more sophisticated approach to institutional investment. This section argues why, in our view, pension and sovereign wealth funds should expand their mandates to account for the increasing complexity and inter-connectedness of finance and society. First, these funds have a responsibility to create wealth for current and future generations over a long time horizon, and this objective cannot be sustained if the present narrow culture of short-term investing remains dominant. We argue that a sustainable approach is more efficient at wealth creation over the long term than current alternatives. Second, we argue that there is a strong ethical case for sustainable investment based on the concept of institutional investor social responsibility.

How is the sustainable investing approach more efficient than the traditional approach? The traditional approach aims to decide strategy, in terms of goals, asset allocation, mandates and managers, by optimising the risk and return trade-off over a relatively near-term horizon and review such decisions periodically.

To contrast, we put forward the sustainable investing model as differing from the traditional approach with respect to five factors:

- An explicit optimisation of risk versus return goals *over the entire life of the fund*
- Adjusting asset allocation when investment conditions change by considering endogenous factors - the limitations of markets in pricing assets at all times at fair prices, the structural changes in the investment opportunity set and the future flows of funds that are likely, given economic and geo-political developments
- Giving investment mandates to managers that make increased reference to longer-term absolute return targets and operating realistic and sustainable manager selection practices
- Using managers that are better aligned to long-term investment success
- Ensuring that managers take appropriate and effective account of extra-financial factors and use their clients' ownership interests effectively.

Table 1 overleaf summarises the differences.

The arguments for sustainable investing are centred on two factors:

- Sustainable investing will incur lower costs than the traditional strategy, and have the potential for higher returns by deploying more efficient allocations
- Sustainable investing works on the correct objective function and is more

aligned to inter-generational equity by securing value for all beneficiaries and for the whole life of the fund; the short-term approach works on a simplification of the objective function.

While this section is too brief to address how much more efficient the long-term sustainable approach is relative to the traditional short term, our assessments suggest a working assumption of an advantage of 1% per annum or more (see Urwin, 2009 and also Bird and Gray, 2009 who find evidence of a larger difference).

Table 1: Comparison of traditional and sustainable models

	Traditional/ short-term approach	**New model/ long-term sustainable approach**
Investment objectives	Goals concentrate on short-term outcomes with limited attention to future generations	Goals concentrate on long-term outcomes with attention to inter-generational fairness
Asset allocation	More static model evolving as liabilities change	More dynamic model evolving with changing investment conditions presenting risks and opportunities
Mandates	Use of index benchmarks and emphasis on short-term relative return	Use of absolute return benchmarks and emphasis on long-term return
	Assessment over three year periods implies higher manager turnover	Assessment over longer periods implies lower manager turnover
Managers	Managers assessed on current indicators	Managers assessed on future indicators having regard to sustainability factors
	Managers use shorter-term evaluation of opportunities with higher turnover and costs	Managers use longer-term evaluation of opportunities with lower turnover and costs
	Fees related to a shorter-term performance metric	Fees related to a longer term sustainable performance metric
Extra-financial considerations	Extra-financial factors play a small part in investment decisions	Extra-financial factors play a more balanced part in investment decisions
	Exercise of ownership influence is limited	Exercise of ownership influence is significant

The second argument for institutional funds to invest sustainably is concerned with the negative externalities caused by their investments. These have not been accounted for adequately to date. Modern institutional investors have a large financial influence over society. We argue that this requires the exercise of ownership responsibilities analogous to the stakeholder responsibilities of modern corporations.

The primary mandate of pension funds is the creation of wealth to provide pensions for beneficiaries in the present and future. The primary mandate of sovereign wealth funds tends to be long-term wealth creation for their country's citizens to benefit at some stage in the future. However, as the providers of capital that fund a significant amount of commercial activity, these institutional investors arguably have a concomitant responsibility to people affected by externalities of this commercial activity (see Richardson, 2008).

Large pension funds are in a position to encourage companies to produce economy-wide social benefits alongside financial benefits (Hawley & Williams, 2000). Hawley and Williams argue that pension funds that are large enough to invest across all sectors of the economy (that is, universal owners), can not only derive benefit from social improvements across the economy, but are also more vulnerable to systematic financial risks (risks to which the entire economy is exposed). As such, universal owners have two broad sets of reasons for promoting social welfare as well as focusing on the growth of assets through investment. First, social improvements in any and all sectors of the economy are likely to be beneficial across their range of investee firms particularly in the longer term. One significant example is, universal owners will be better placed in the event of climate change progressing if their portfolios include specific tilts to environmental themes. Second, negative externalities created by investee companies in one industry are likely to have impacts on the assets that universal owners hold in other industries.

Company boards and management all owe some stakeholder duties in addition to their duties to shareholders. We cannot hold pension funds and sovereign wealth funds in their ownership responsibilities to a different standard. They are simply further up the investment chain. In short, it is time to develop a concept of institutional investor social responsibility. However, the recognition of this point has not yet become accepted in the institutional funds industry: institutional owners' limited engagement with bank boards during the recent global financial crisis led Lord Myners to decry the growth of 'owner-less corporations', stating that most institutional investors 'are not set up to act as owners; they don't have the mindset of owners and are not incentivised by their clients to act as owners' (see Wheelan, 2009). In this light, it will take significant changes in institutional investor beliefs in order for them to recognise a wider set of responsibilities.

The corporation has, to an extent, already undergone a parallel process of development. Companies were viewed at one stage as having no responsibilities beyond the generation of profits and shareholder value. Milton Friedman famously wrote that:

> there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud' (Friedman, 1970)

Social expectations of companies have changed since Friedman's comment. It is now generally accepted that companies have some level of responsibility toward non-shareholder stakeholders, such as workers, local communities, and, increasingly, society at large (see Metcalfe, 1998).

Pension funds have evolved more slowly than corporations in terms of stakeholder responsibility. Anglo-American pension funds are generally structured as trusts, which makes the consideration of stakeholder interests particularly difficult. The purpose of modern pension funds differs markedly from traditional family trusts, but the law that applies to them is anchored to the idea that there can be no stakeholders other than beneficiaries and the sponsor. And with this imperfect foundation comes trustees' confusion about the implications of fiduciary duty. We discuss this further in the following section.

III. Barriers to Sustainable Investing from Interpretations of Fiduciary Duty

While there has been a surge in pension funds' stated interest in responsible investing in recent years, as evidenced by increasing numbers of signatories to the Principles of Responsible Investment ('PRI')[1], there is a significant gap between interest and action (see, *eg*. FairPensions, 2009). In practice, mainstream pension funds actively pursuing a responsible or sustainable investment policy in any meaningful way are in the minority. We assert from our experience that when measured by numbers of pension funds the proportion is certainly less than 10 per cent, and probably less than five per cent.

We argue that uptake of sustainable investment strategies in pension funds remains low for two main reasons. First, most pension funds do not have clear beliefs about the investment merits of sustainable investment. We give consideration to possible beliefs with respect to sustainability in Section V. This issue has been dealt with in detail by other authors (see, *eg*, Derwall *et al.*, 2005). Second, they continue to interpret fiduciary duty as requiring good short-term financial performance and obstructing the consideration of any stakeholder interests outside the financial interests of beneficiaries. Both of these factors are exacerbated by a number of behavioural biases in fiduciaries' actions that make significant change in investment strategy fundamentally difficult.

Pension funds' current interpretations of fiduciary duty impede the broadening of the investment mandate (adopting some stakeholder responsibilities) and the deepening of investment strategies (moving toward longer-term investment) required in order to move toward sustainable investment. In our view, this conservative interpretation of fiduciary duty is incorrect, but ingrained, and may require legislative change in order to be overcome. The tendency for pension trustees to interpret fiduciary duty conservatively appears to be the legacy of case law, commentary and accepted practice dating from the 1980s. While more recent legal guidance and commentary provides support for the view that fiduciary duty allows for longer-term investment strategies and some consideration of wider stakeholder interests, this perspective has yet to be tested in court. Additionally, recent commentary from the US Department of Labor sends mixed messages about the US position. Under these conditions of uncertainty and in the absence of directly relevant recent case law, pension funds are less likely than they could be to initiate a move from the status quo toward sustainable investing.

The trust structure used in Anglo-American pension funds has, since its inception in the UK in the middle ages, aimed to safeguard the interests of future generations (Langbein, 1995). In this limited sense, the trust was an instrument for ensuring a degree of inter-generational equity, albeit within the family unit from one generation to the next. The legacy of this history is that trustees generally must act solely in the interests of beneficiaries, precluding the explicit consideration of other stakeholder interests.

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[1] The membership of the PRI has grown from 20 asset owners in 2005 to a total of 563 PRI signatories at the time of writing. Of these, 182 are asset owners, 274 are investment managers, and 107 are professional service partners. Retrieved on 7 July 2009 from http://www.unpri.org/signatories/.

In Anglo-American trust law, fiduciary duty structures the way pension fund trustees manage fund assets for beneficiaries. It has two core components: the duty of loyalty and the duty of prudence. The duty of loyalty requires pension fund trustees to act in the sole interests, or in some circumstances, the best interests, of beneficiaries when carrying out their investment strategy.[2] While beneficiary interests must remain paramount, legal provisions do not explicitly prevent investment strategies from creating positive outcomes for non-beneficiaries.

The duty of prudence requires pension fund trustees to act with prudence, or skill, care and diligence, in managing funds for beneficiaries. In the US, the duty of prudence is contained in the modern prudent investor rule, which requires trustees to 'manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust'.[3] Similarly, all UK trustees must 'exercise such care and skill as is reasonable in the circumstances', having regard to 'any special knowledge or experience that he has or holds himself out as having'[4]. The duty of prudence does not prevent sustainable investment, provided that investment decisions are made with due skill, care and diligence and with regard to the whole portfolio of investments. Indeed, it seems evident that over the long run, prudence is better accomplished by having regard to sustainability factors (see UNEP FI, 2005; 2009). For example, it may become financially imprudent to ignore climate change impact when the externalities of climate change are internalised through carbon price or other legislative initiatives.

Despite the absence of explicit impediments to sustainable investment within fiduciary duty, however, pension fund trustees often cite the duty of loyalty as preventing any consideration of non-beneficiary stakeholder interests in investment decision-making, and the duty of prudence as preventing investment strategies that have aims beyond strong short-term financial performance. Why is this?

In the UK, the 1984 case *Cowan v. Scargill* is largely responsible for the over-emphasis of the view that trustees must focus solely on profit maximisation for beneficiaries when creating investment strategies (Scanlan, 2005). In that case, the court found that trustees had violated their fiduciary duty by making a decision about investment strategy that was predicated on their own political beliefs, rather than purely in the interests of beneficiaries.[5] The presiding judge, Megarry VC, stated that 'in considering what investments to make trustees must put on one side their own

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2 In the US, see section 5 of the *Uniform Prudent Investor Act* ('*UPIA*') for public pension funds in almost all states, and ERISA 29 USC § 1104(a) for private pension funds. In the UK, the duty is contained in clause 4(2) of the UK *Occupational Pension Schemes (Investment) Regulations* (2005), which require trustees to act in the 'best interests' of beneficiaries most of the time, and in the 'sole interest of members and beneficiaries' where a potential conflict of interest exists.

3 *UPIA*, section 2(a).

4 *Trustee Act* (2000), section 1(1)(a). UK trustee investment decisions must also accord with modern portfolio theory: decisions must be 'exercised in a manner calculated to ensure the security, quality liquidity and profitability of the portfolio as a whole': Cl 4(3), *Occupational Pension Schemes (Investment) Regulations* (2005).

5 The trustees that were in breach were mining union-appointees who had refused to ratify the investment strategy proposed by the rest of the (non-union) board unless it was amended 'so as to prohibit any increase in overseas investment, to provide for the withdrawal of existing overseas investments at the most opportune time, and to prohibit investment in energies which are in direct competition with coal': see *Cowan v. Scargill* [1985] Ch. 270 at 276-7.

personal interests and views'[6] and that 'the best interests of beneficiaries are normally their best financial interests.'[7] In our view, the *Cowan* decision has become overly influential. Megarry VC himself later commented in an academic article on the case that he had not intended his judgement to be construed as requiring profit maximisation (see Richardson, 2008). As one judge noted when reviewing the decision in a subsequent case, 'I cannot conceive that trustees have an unqualified duty simply to invest trust funds in the most profitable investment available.'[8]

In the US, case law in the 1980s did not provide a definitive answer to the law's view of fiduciary duty and 'social investing', as the results of each case turned on the specific facts at hand (see Woods, forthcoming). In 1998, the Department of Labor, which administers private pension fund law, released a letter clarifying its position on trustees' consideration of non-financial issues in decision-making. It stated that fiduciary duties under the Employee Retirement Income Security Act (ERISA) 'do not preclude consideration of collateral benefits, such as those offered by a "socially-responsible" fund, in a fiduciary's evaluation of a particular investment opportunity,' as long as the investment 'is expected to provide an investment return commensurate to alternative investments having similar risks'.[9] However, the advice provided in this letter appears to have been contradicted by two interpretive bulletins released by the Department of Labor in 2008.[10] In particular, one of these bulletins states that ERISA:

> establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investment on the basis of any factor outside the economic interest of the plan.[11]

It then goes on to say, confusingly, that where alternative investments 'are of equal economic value', fiduciaries may 'choose between the investment alternatives on the basis of a factor other than the economic interest of the plan,'[12] adding a warning that 'fiduciaries who rely on factors outside the economic interests of the plan in making investment choices and subsequently find their decision challenged will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value.[13] In our view, the 2008 interpretive bulletins from the Department of Labor do not help fiduciaries wishing to understand their legal position vis-a-vis the adoption of a sustainable investing strategy (see also SIF, 2008).

The prevailing pension fund trustee view of fiduciary duty as presenting a barrier to the inclusion of ESG factors in investment strategy was criticised by UNEP FI in a

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6 *Cowan v. Scargill* [1985] Ch. 270 at 287.
7 Ibid.
8 *Martin v. City of Edinburgh District Council* [1993] 2 All ER 300, 304 (per Murray LJ).
9 Letter from the Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (May 28,1998) (Calvert Letter).
10 Employee Benefits Security Administration, *Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments*, 29 CFR §2509.08-1 (the ETI bulletin); Employee Benefits Security Administration, *Interpretive Bulletin Relating to Exercise of Shareholder Rights*, 29 CFR §2509.08-2 (the 'shareholder rights bulletin').
11 The ETI Bulletin, *supra* note 12.
12 *Id.*
13 *Id.*

2005 report. There, UNEP FI argued that:

> it is not a breach of fiduciary duties per se [for trustees] to have regard to ESG considerations while pursuing the purposes of the trust. Rather, in our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight.

Such considerations have a material economic impact on investment decision making. We agree with part of UNEP FI's argument, namely that fiduciary duty should not act as a barrier to trustees' adoption of more sustainable investment strategies. There is nothing in the law that expressly prohibits trustees from lengthening their investment horizon, and working toward the reduction of negative externalities of their investments to the benefit of a wider group of stakeholders. However, UNEP FI's position has yet to be tested in the courts. And, if the 2008 commentary from the Department of Labor is taken into account, trustees may find the justification of a sustainable investment strategy less than straight-forward in US courts (see Kinder, 2008).

What does this law and commentary mean for sustainable investment? Under current conditions, pension funds are likely to be apprehensive about creating an investment strategy premised on long-term investment and comprising a wider stakeholder group out of concern that it may be interpreted by courts as violating fiduciary duty. This may be particularly true in the US, given the Department of Labor's 2008 interpretive bulletin. These concerns remain despite the work of UNEP FI to allay trustees' fears about fiduciary duty.

In our view, a move toward sustainable investment will require a change in trustee attitude toward fiduciary duty. While the letter of fiduciary law presents no barriers to this new sustainable vision, trustees' current interpretations of it do. We believe that trustee interpretations of fiduciary duty are unlikely to change quickly without legislative change. We discuss potential legislative solutions in section VI.

Given the impediments to sustainable investment, real or imagined, facing pension funds, sovereign wealth funds may be in a better position to become leaders in the field. These funds exist in different forms, and have different missions,[14] but their common feature is 'their origin as investment vehicles established and controlled by a sovereign political entity' (Rose, 2008, p 107). While their central mandate is often stated as long-term wealth creation, they are not subject to the same governance regimes as other institutional investors, and have the ability to make investment decisions based on wider considerations including political factors. The main barrier to sovereign wealth fund sustainable investment is therefore not fiduciary duty, but rather political will. A number of sovereign funds have taken steps in the direction of sustainable investment, a notable example being the Norway Pension Fund. For many sovereign funds, however, sustainable investment remains a missed opportunity.

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[14] Eg, the Australian Future Fund has the aim of 'accumulating financial assets sufficient to offset the Commonwealth's unfunded superannuation liabilities by 2020', The Future Fund, *Statement of Investment Principle*s, April 2009, p 3.

IV. Barriers to Sustainable Investment from Fiduciaries’ Behaviours

The investment case to adopt a particular strategy is generally based on inductive arguments supported by empirical evidence. There will never be a deductive ‘proof’ of the wisdom of a particular strategy. This leads fiduciaries increasingly to advance ‘investment beliefs’ about a subject area in order to support the adoption or rejection of a particular strategy. Investment beliefs are assertions about investments and the way the investment world works which, when developed and shared, help with investment decision making.

Various beliefs have been advanced with respect to sustainable investment. Among the more common versions are the following:

1. Sustainable investing has produced better performance than traditional investing
2. Sustainable investing has produced worse performance than traditional investing
3. Sustainable investing is likely to produce performance as least as good as traditional investing because it uses additional information that influences price and value
4. Sustainable investing is likely to produce lower performance than traditional investing because it acts as a constraint on choice
5. There is no firm evidence that sustainable investing will perform as well as traditional investing
6. There is no firm evidence that sustainable investing will perform any worse than traditional investing
7. Extra-financial factors including ESG factors influence returns and risk over extended time periods
8. The active use of ownership rights through company engagement can enhance the value of an investment if deployed in ways consistent with a manager’s investment philosophy

Statements like (1) and (2) are not definitive. Performance is always contextual to a particular set of conditions or particular period, so the statement may be true and false. In any case the inductive step that links past and future performance is relatively weak.

Qualitative arguments like (3) or (4) have greater merit but they may prove difficult to advance with high conviction. Sustainability approaches vary widely and the belief that sustainability works may be difficult to advance as a generality. This leads many fiduciaries to favour a null form of belief like (5) or (6).

The beliefs in (7) and (8) correspond to a more constructive approach. Turning such assertions into effective decision taking becomes the real challenge.

While the beliefs approach helps fiduciaries to develop strategies, it is problematic to implement and is often vulnerable to fiduciaries’ behavioural biases. These biases in pension fund boards of trustees can often make the introduction of a more sustainable approach to investment difficult. First, trustees, both as individuals and as members of committees, exhibit resistance to change. We argue that their preference for the status quo is partly psychological and partly based on an assumption that the law will be more likely to see behaviour that aligns with that of their peers as prudent, and therefore in line with fiduciary duty.

Studies in psychology and economics demonstrate that people prefer certainty to uncertainty (Zeckhauser, 1988). Moreover, people generally are loss averse, meaning that they would rather accept a higher certainty of receiving a lower reward than a lower certainty of receiving a higher reward (Kahneman and Tversky, 1979). Together, these traits present a challenge to trustee behavioural change, particularly when change involves moving toward a more complex sustainable investment model. Specifically, trustees are reluctant to create investment strategies that differ markedly from those of their peers, because they fear that the law will see unconventional investment as imprudent investment (and therefore potentially in breach of fiduciary duty). This may be reinforced by weaknesses in committee decision-making. Clark and Urwin (2008b) note that there is some evidence to indicate that trustees have only moderate confidence in the decision-making abilities of their fellow board members. A lack of confidence in group decision making on difficult questions is likely to further limit change and innovation.

Second, trustees, like most individuals, tend to focus on the short term in their investment strategies; this focus is aggravated by incentive structures and lack of confidence in the legal system to understand longer-term investment strategies. Sustainable investment, as we have defined it, includes longer-term considerations – an acceptance of these expanded investment parameters will require trustees to be more comfortable with longer periods of uncertainty about financial performance.

Despite the inherently long-term mandates of pension funds, the bias toward short-term performance is not surprising. A number of psychological and economic studies show that people tend to prefer instant and lesser gratification to distant and greater gratification (see eg, Lowenstein and Thaler, 1989). Incentive structures support short-termism: the measurement of fund performance is achieved almost exclusively through the quarterly monitoring of share prices, and asset managers are rewarded for good short-term performance rather than for long-term value creation. Finally, trustees may gain peace of mind with respect to fulfilment of their fiduciary duty from a short-term focus: good short term results are likely to demonstrate 'prudent' investments more easily in courts than longer term investments, which may fluctuate over time; trustees are wary of judges' knowledge of the subtleties of financial performance (see Perold *et al*., 2002). Given that longer-term time frames in investment strategies are integral to sustainable investing, this short-termism issue presents a further barrier to its achievement.

Third, our experience has shown that trustees are more comfortable with handling explicit concepts and measures (they are biased towards 'hard data') and struggle to adapt to incorporate inexplicit concepts and measures (they are averse to 'soft data') Sustainable investing requires trustees to incorporate soft data alongside hard data. Once again, interpretations of fiduciary duty feed into trustees' behaviour here: in our view, many fiduciaries are anxious that if a decision to favour a sustainable investment approach is ever subject to legal challenge they will only be able to advance soft data in support, rendering the outcome of the legal challenge more uncertain.

The solutions to behavioural biases lie in improved governance (see Clark and Urwin, 2008a). In particular a focus on the investment process with emphasis on the development of strong investment beliefs is the critical path to take. In practice, effective implementation of beliefs is difficult – so biases need to be directly confronted. In order for belief implementation to succeed, trustees must approach their task systematically: beliefs must be individually developed but collectively held in the trustee group, the beliefs must be reviewed regularly, and trustee decisions need to be checked for consistency with beliefs.

V. Model for a Sustainable Investment Strategy

The model we advance is based on changes to both the investment mission and investment strategy of funds. Our approach is based on the adoption of clear delineation between *values, beliefs and norms.* In the context of institutional funds:

Values are statements of preference expressing views about desirable outcomes (E.g. we prefer risk to be kept low, we prefer to invest responsibly)

Beliefs are assertions about the investment world and the way the world works that when developed and shared help make decision-making more effective (E.g. we believe that equities should outperform bonds over time)

Norms are descriptions of how a fund would operate under various conditions in the future, consistent with values and beliefs (E.g. we would change our asset allocation in a financial crisis).

The key usages of these concepts are in mission statements where values are critical and in investment strategy models where beliefs and norms are critical.

Investment missions may be adapted to allow for a more sustainable investment model. We suggest three levels of sustainable mission, ranging from the least active level of commitment (mission 1) to the most active level of commitment (mission 3) (see Table 2 below).

Table 2: Alternative missions

(1) Traditional mission	(2) Sustainable investment mission	(3) Sustainable investment mission with dual set of goals
- Create value through investment activities to meet the liabilities/ expectations	- Create sustainable financial value as in (1)	- Create sustainable financial value as in (1)
- Ensure present financial achievement is sustainable in the future	- Be responsible for externalities arising from ownership (ESG/ ownership responsibilities)	- Be responsible for externalities and consider ESG factors as in (2)
		- Aim to achieve certain extra-financial goals (eg environmental improvement) making clear the balance between the financial and extra-financial elements

The traditional mission (mission 1) is the type of mission already existing in the vast majority of pension funds. The major issue arises with how funds implement this mission. This mission is certainly consistent with their fiduciary duties but we note that many funds do not pay significant regard to whether present financial performance is sustainable over the long term and as a result may neglect inter-generational fairness.

Pension funds can also operate under mission model (2) in a manner compatible with their fiduciary duties as discussed in the prior section. The extent to which stakeholder interests can be taken into account will differ by fund. We comment in Section VI on how legislation might encourage pension funds to adopt this more sustainable investment approach, which we would regard as highly desirable from a social point of view.

Mission (3) is specialised and will rarely be consistent with pension fund fiduciary duty, because it involves a conscious compromise on a portion of financial return in exchange for an extra-financial pay-off. Only where all beneficiaries of a pension fund agreed to such a compromise would it be in keeping with fiduciary duty. Its application is more likely to be appropriate for sovereign wealth funds that might have a national or environmental goal that they might encode in their mandate; or a foundation or endowment that could expect to marry a financial purpose with some wider social agenda.

The other element of the revised model relates to investment strategy. There are three generic strategies we see as possible (see Table 3 below).

Table 3: Alternative investment strategy models

Investment Strategy Model	Model elements
A. Traditional	- Investment activities specify investment targets that are relatively short term - Wide discretion in delegations to managers - Benchmarks are generally short-term and relative return
B. Integrated Sustainable	- Investment activities incorporate long-term investing principles and integrating sustainability / extra-financial considerations - More specific instructions are likely within delegations to managers with regard to ESG and ownership - Benchmarks focus more on long-term and absolute return measures
C. Targeted Sustainable	- Investment activities as in (B) - May also include direct targeted investment in mandates with sustainability themes, environmental opportunities, etc - More specialised mandates and delegations to managers

The traditional investment strategy model (A) has significant limitations as it does not align with long-term investment principles. Its short time horizon creates potential inefficiencies, and does not contribute to inter-generational equity. It does not align that with the investment missions that we have described.

The sustainable investment strategy model (B) aligns with both traditional and sustainable investment missions.

The sustainable mandates model (C) which includes specialised mandates can be aligned with any of the missions but when aligned with the traditional or sustainable missions it requires an investment case built on beliefs that the strategy will produce a competitive advantage over the long term.

In deciding which combination to adopt, funds should consider their values, sustainability goals, fiduciary responsibilities, the resources they command and their investment beliefs.

For pension funds, either mission (1) and (2) may be appropriate. We see mission (3) in most cases as inappropriate for pension funds given current legal constraints. With mission (1) or (2), an appropriate combination can be made with either investment strategy (B) or (C). We see investment strategy (A) as limited and best avoided. While any of these four combinations might be adopted, depending on circumstance, the combination with most appeal in most circumstances is mission (2) and strategy (B).

In the cases of sovereign funds, non-financial commitments (described in mission 3) may be appropriate. Such a mission might correspond with either strategy (B) or (C).

Mission clarity and beliefs are the most critical facets of the sustainability challenge. Without a clear mission and belief structure, funds risk confusing purpose with investment content.

Examples of the mission statements that might be used are given in Table 4 below. The middle column contains sample wordings for each mission. The right hand column provides sample strategic goals for each mission. In practice, funds would choose their words to reflect their circumstances and preferences. A pension fund wishing to adopt the widest-ranging sustainable investment approach possible would need to have a mission statement with respect to financial, long-term, ESG/responsibility and ownership missions. A sovereign wealth fund wishing to go further by adopting a non-financial mission would need to have a non-financial mission statement in addition to the foregoing missions.

Table 4: Mission statements

Type of mission	Example wording	Associated view of 'value'
Financial mission	Create value for beneficiaries consistent with the fund's overall goals	Value measured by net financial returns in excess of liabilities allowing for risk
Long-term mission	Ensure the achievement of these goals in the present are sustained in the future (i.e. is not compromised by current actions)	Value measured by the positive impact on future returns
ESG mission	Ensure that the fund's investments appropriately reflect those extra-financial factors including ESG that will influence their long-term value	Value defined by the extent to which ESG impacts on future return are limited
Ownership mission	Ensure that the fund's ownership interests in its investments are responsibly applied in the interests of stakeholders	Value defined by the extent to which poor governance impacts on future returns are limited

Non-financial mission	Create value for beneficiaries/ stakeholders by supporting enterprises in environmental opportunities , etc	Value defined by non-financial return to the fund

Examples of investment beliefs that might be adopted by funds wishing to pursue a policy of sustainable investing are set out below (see Table 5). These are complementary to any mission statement and necessary for the investment arrangements to be effective internally and justifiable externally.

Table 5: Investment beliefs

Source of risk and return	Commentary on belief
Extra-financial driver	Extra-financial factors, including environment, social, governance (ESG), influence values and risk over extended time periods and should be a part of the analysis of all investments
Ownership driver	The active use of ownership rights, the value of an investment can be enhanced if deployed in ways consistent with a manager's investment philosophy
Active management	There are managers who can apply this analysis successfully on an integrated basis in combination with mainstream financial analysis to deliver the alpha proposition
Mandate design	There are mandates that can be designed to apply appropriate alignment and oversight to managers and produce better outcomes
Fee design	There are fee structures that can be developed that are appropriately structured as incentives and reinforce long-term sustainable aspects
Supportive governance	There are governance arrangements that can exploit these areas through understanding the characteristics of success including the long time horizons

These beliefs are consistent with the sustainable investment model (B). More detailed beliefs would be consistent with the targeted investment in sustainable mandates model (C) (see Urwin (2009) for more detail).

VI. Legislative and Governance Changes Required

Certain legislative and governance changes would help to facilitate the sustainable investment approaches we have described. The key parts of the fund's process that need strengthening are summarised in Table 6 below (content is adapted from the Clark Urwin best-practice governance model: Clark and Urwin 2007).

Table 6: Best-practice governance

	Core best-practice governance actions	Actions relating to sustainability
Mission clarity	Ensure clarity of the mission and the commitment of trustees and asset managers to the mission statement	Ensure complete clarity on sustainable investing mission and informed buy-in by trustees and asset managers
Effective focusing of time	Allocate time and other resources correctly to each element in the investment process based on expected impact and required capabilities	Map out the resources needed to implement sustainable policies, making full use of delegations
Leadership	Ensure strong leadership at the board/ Investment Committee (IC) and executive level, with the key role being the IC Chairman	Provide strong leadership to mediate varying opinion and mould consensus as sustainable investing is introduced
Strong beliefs	Introduce and maintain strong investment beliefs commanding fund-wide support that align with goals and inform all investment decision-making	Build a strong foundation to sustainable investing strategy and limit the possibility of later challenges
Risk budget framework	Frame the investment process by reference to a risk budget which incorporates an accurate view of alpha and beta and aligns with goals	Place quantifiable parameters on sustainable investing components
Fit-for-purpose manager line-up	Initiate an effective process for the selection of external managers, which is governed by clear mandates aligned with goals, and designed with 'fit-for-purpose' criteria	Increase focus on managers' sustainability credentials (having regard to both organisational and capability-based criteria)
Competitive positioning	Frame the investment philosophy and process by reference to the institution's comparative advantages and disadvantages	Work at creating the stronger investment capabilities and governance oversight required for dealing with sustainability issues

Previous research has demonstrated that the pension fund institutions are poor at innovating and at thinking about issues outside their current financial mandate (Clark and Urwin, 2009). A number of changes to governance are necessary for funds to be effective in the move toward sustainable investment.

Critically, funds must cope with greater depth to their investment strategy in a sustainable investing mode. This will only be accomplished successfully if funds can expand their ability to deal with complex investment and longer time horizons. The requirements are magnified with respect to direct investment in mandates with sustainable themes. This area is likely to involve allocations outside quoted equities and bonds in areas like venture capital, private equity, real estate and infrastructure. The typical pension fund employs external managers to cover these areas; the fund's responsibilities hinge on being able to select these managers successfully, draw up appropriate mandates governing their actions and targets and apply effective oversight. Overall, a move toward sustainable investment will require pension funds to improve their capacity to innovate and to think outside their current financial mandate. How can this come about? We suggest that these changes to pension fund governance would help:

- The establishment of executive in-house sustainability teams: adding capability in the sustainability field is the single most important factor in achieving stronger results from these activities; relevant skills would include financial, legal and scientific perspectives on sustainability – a more lateral range of skills than institutions have retained in the past
- The introduction of independent expert chairs: strong leadership is essential for building consensus within the organisation, and will increase both clarity of and commitment to the sustainable investing mission
- The use of delegations to fiduciary managers: this will streamline governance; while delegation may also increase agency conflicts, overall this structure may help the implementation of sustainability principles by using a scale factor to ensure that the requisite specialist skills are in place
- The use of best-practice governance models: in short, this requires a specification of what in principle is most effective and what might be done in practice.

Governance improvements form only part of the challenge. As we have argued, current interpretations of fiduciary duty appear to discourage pension funds from adopting a more sustainable approach to investing. Prevailing pension fund views of fiduciary duty have led to an over-emphasis on maximisation of financial returns without regard to externalities. This need not be the case, but fiduciaries are unlikely to change their ingrained behaviour without legislative signalling from governments. We suggest that nudge principles (Thaler and Sunstein, 2008) give guidance on more effective means of engineering change in areas of social technology like pension fund governance. In addition, here we suggest briefly two potential legislative changes that could encourage pension funds to invest more sustainably:

- The introduction of 'safe harbour principles': this approach would incentivise sustainable investing by disallowing litigation against fiduciaries with respect to practices covered by safe harbour clauses (where fiduciaries have followed due process and acted in good faith). The safe harbour clauses could be designed to protect from litigation fiduciaries that choose to broaden and deepen their investment mandates in the way we have described in this paper. Of course, any safe harbour provision would have to be designed carefully to ensure that it achieved the desired outcome. Safe harbour legislation was effective in helping defined contribution default plans in the US to attain better structure.
- The introduction of a comply or explain process with respect to sustainable

investing: under this approach, legislators would encourage pension funds to think of sustainable investment as a norm, by requiring them to either comply and adopt aspects of sustainable investment (‘comply’) or provide a written explanation detailing why they have chosen not to comply and for what time period (‘explain’). This approach incentivises sustainable investment, by portraying it as legislatively sanctioned, while allowing an alternative line of action to be pursued subject to explanation. Similar legislation has been effective in raising governance standards in the UK with respect to corporate governance (*Combined Code on Corporate Governance 2003*) and pension investment governance (‘Myners Principles’: see Myners, 2001), and has already appeared to a limited extent for UK pension funds with respect to ESG issues. Under the *Pensions Act* (1995), pension funds must produce a written statement of investment principles (‘SIP’).[15] The SIP must cover ‘the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments’[16]. This regulation stops short of being a comply or explain approach because it merely requires pension funds to state *whether* they take social, environmental and ethical considerations into account, but not *why* they choose not to do so. This approach, while accommodating very limited response by many funds, is still productive in that it is sufficiently flexible to allow pension funds to adjust their strategies at their own pace, while gradually contributing to a change in expectations about sustainable investment (see Thaler and Sunstein, 2008).

[15] See *Pensions Act* (1995) ss 35-36.

[16] *Occupational Pension Schemes (Investment) Regulations* 2005 cl 3(b)(vi). Similarly, it must cover the fund’s ‘policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments’: cl 3(c).

VII. Conclusion

The biggest challenges of the 21st century include addressing climate change and natural resource depletion; managing ageing populations; facilitating effective globalisation; and alleviating poverty. Pension funds and sovereign funds connect significantly with all of these.

Given these connections, it follows that institutional investors have great potential to act as a force for good by deploying their capital in environmentally supportive ways; contributing to retirement affluence; strengthening the force of global capital; being part of the supporting financial apparatus by which poverty is alleviated.

Our vision is that the current assets of pension funds and sovereign funds which currently stand at around $25 trillion should be focused on a wider agenda than previously. As it currently stands, the focus of these funds is too often distracted by short-term performance at the expense of long-term value. This is, we suggest, out of step with the long-term needs of these funds and their beneficiaries and, more broadly, with society as a whole.

The legal and regulatory framework is unhelpful, particularly for pension funds. It permits funds and managers protection in risk minimisation standards that are far easier and less risky to enforce than optimisation standards that require more difficult judgements. There is no reason in law for pension funds to be so dedicated to this current short-term, narrow focus. Shifting the underlying paradigm to a standard of conduct that looks to expertise and judges governance in the context of the capacity to optimise value within a defined risk budget is not only acceptable but advisable. As sovereign wealth funds are subject to different, and generally less restrictive, legal regimes, these funds may be able to provide leadership in sustainable investing for other institutional investors.

Moving toward a more long-term and sustainable investing approach requires funds to make two fundamental shifts in the way they approach their mandate. First, funds must increase the breadth of their mandate, by taking a wider view of their investment responsibilities, including recognising more stakeholders in their actions. Second, funds must increase the depth of their mandate toward one that optimises longer-term value creation influenced by many financial and extra-financial factors.

The pathway to this improved system relies on both improved governance by funds and government support. Funds must strive for improved governance along best practice lines. Governments could improve clarity with respect to fiduciary responsibilities by introducing comply or explain codes, or safe harbour provisions. In doing so, governments would reinforce governance standards and lend support to the concept of institutional investor social responsibility. More indirectly, governments are indispensable for sending correct market signals through appropriate pricing of externalities.

Pension funds and other asset owners have very large responsibilities to their beneficiaries and to society. They carry a lot of the responsibility for addressing the coming demographic crunch. They will be most capable of meeting these responsibilities if they adopt a broader, deeper sustainable investing model.

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