

Redefining performance for sustainable pension investing

PRC 2021 Symposium

Sustainable Investment in Retirement Plans: Challenges and Opportunities

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Start



Key message

ESG investing requires active investment decisions

- Pension funds are increasingly integrating sustainability and responsibility in their investments
- Wide diversity of opinions what constitutes sustainable and responsible investments
- ESG investment portfolios will be significantly different from both each other as well as from the market

This calls for a new way of performance evaluation that incorporates diffuse ownership of ESG portfolio implementation decisions and associated performance accountability

Universal benchmarking

- Performance evaluation approach within the context of sustainability choices made by the asset owner
- The universal benchmarking approach attributes performance into
 1. ESG preferences from the pension fund board
 2. Implementation decisions by the investment manager or index provider

We argue that the universal benchmarking approach could benefit pension fund boards and participants in their dialogue on the risk and return impact of ESG choices in their investments to balance ESG, return and risk.

The rise of ESG investing

Introduction

Pension funds are increasingly integrating ESG in their investments

- Growing number of asset owners starts to integrate ESG
- Further ESG integration by early adaptors
- Different maturity levels across regions

ESG does not have a universal definition

- ESG is multi-dimensional
- ESG is not uniquely defined
- Limited ESG data availability and low correlation among data vendor ratings

Fiduciary duty: What is the impact of ESG integration on the risk and return?



Exclusions



High SDG

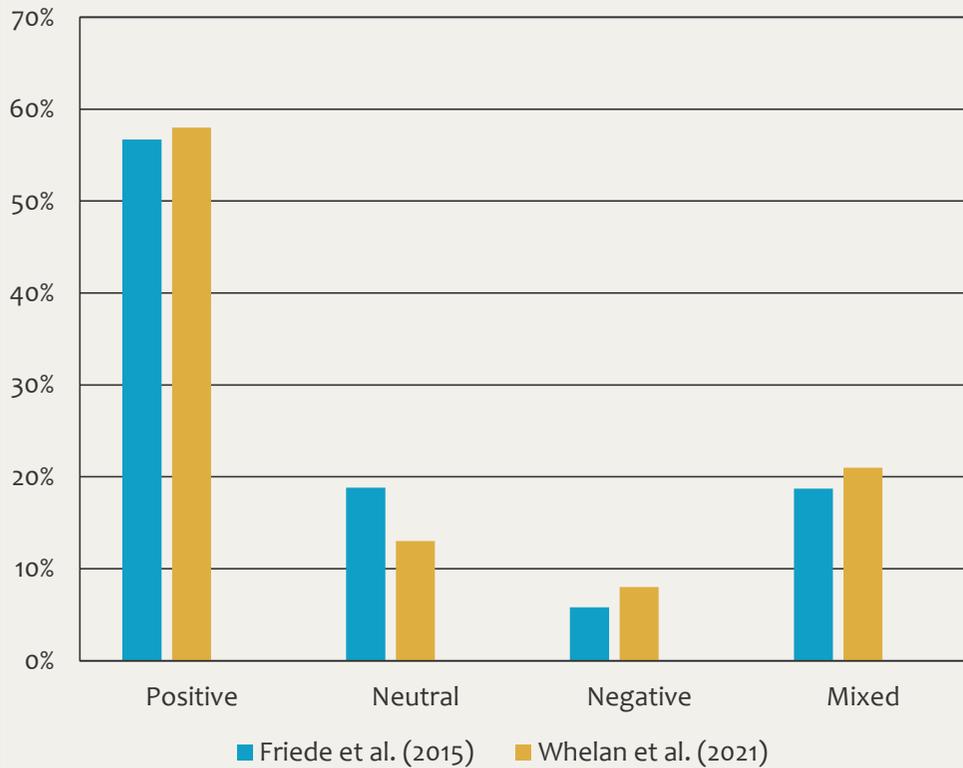


Climate risk

Literature

Relationship ESG and financial performance

Literature findings meta studies



Robustness

Friede et al. (2015) and Koedijk & Wetzels (2020) document:

Similar literature findings across asset classes

- Equities
- Bonds
- Real Estate

Similar literature findings across ESG dimensions

- Environment
- Social
- Governance

Design choices ESG portfolio implementation

ESG portfolio implementation menu

1. Passive

- Index provided by index provider
- Customized index compiled by index provider

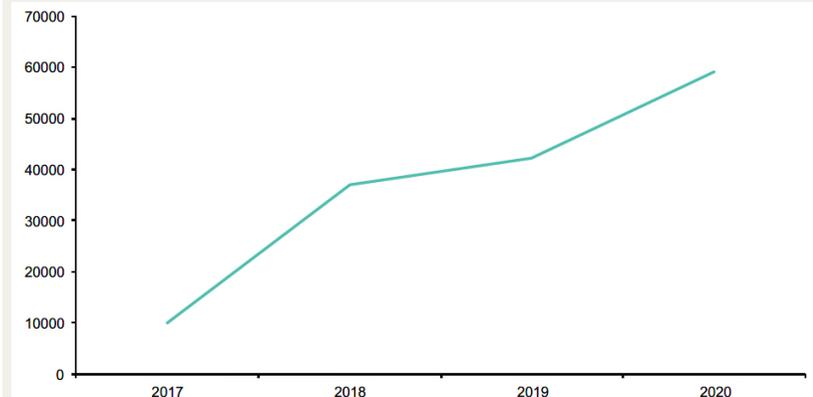
2. Active

- Investment manager

An index implementation involves active decisions

- ESG indices are active portfolios that deviate from market cap weights
- ESG indices are constructed by index providers in order to have specific ESG exposures

The number of ESG indices is growing fast
- at 60,000 already



Source: Fraser-Jenkins et al. (2020)

Research question

ESG Investment portfolios could differ widely

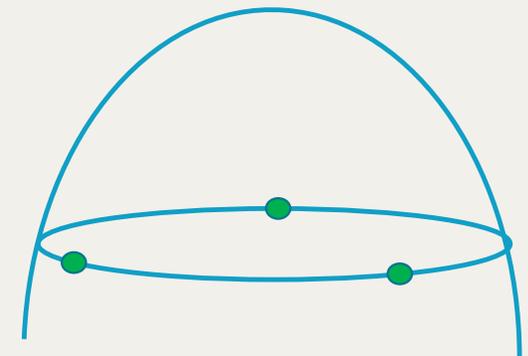
- Wide diversity of asset owner ESG preferences
- Lack of standardized ESG data
- Varied approaches in portfolio construction

Investment returns will differ accordingly

Central research question

How to attribute investment performance into ESG choices by the pension fund and into implementation choices by the active manager or index provider?

The unique 'market' ESG index does not exist

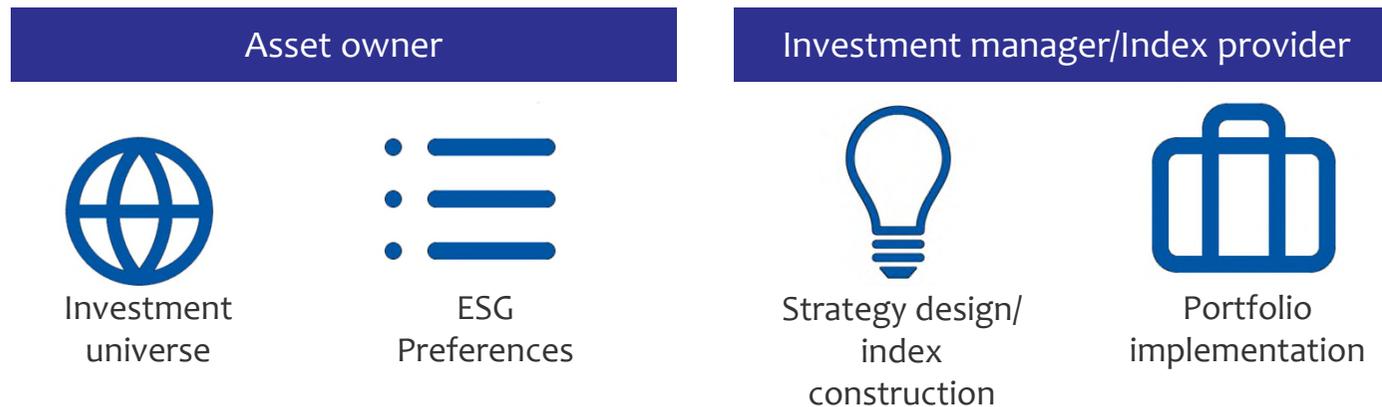


● = Portfolios that comply with ESG preferences

Universal benchmarking

An performance dialogue framework dealing with dual ownership of portfolio decisions between asset owners and investment managers/index providers

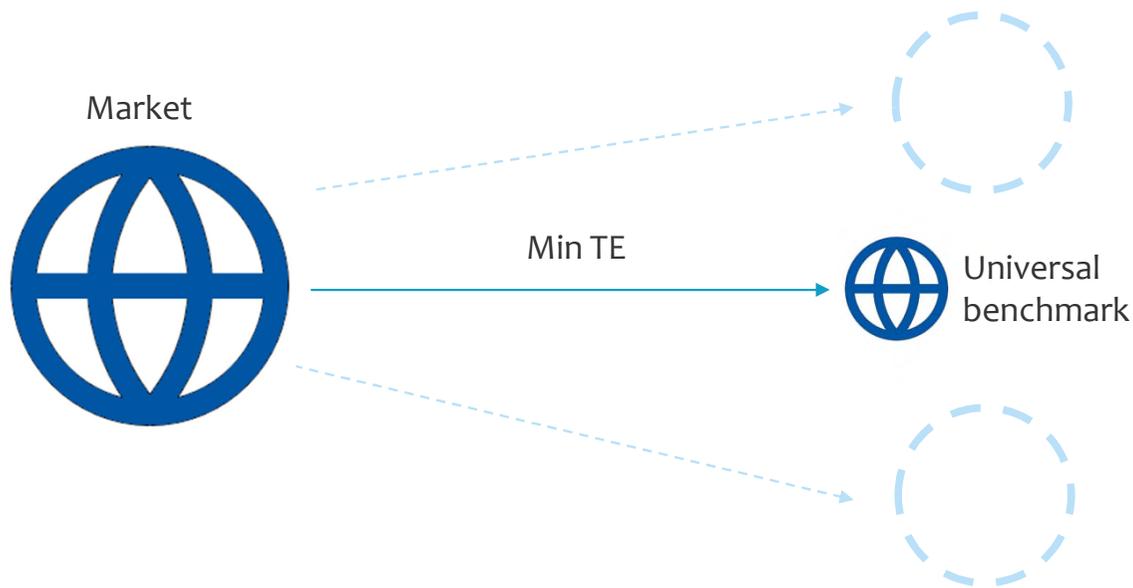
- Universal framework for each asset owner with active preferences
- Results in a customized performance assessment for each asset owner



Universal benchmark

The universal benchmark is an uniquely defined portfolio/index

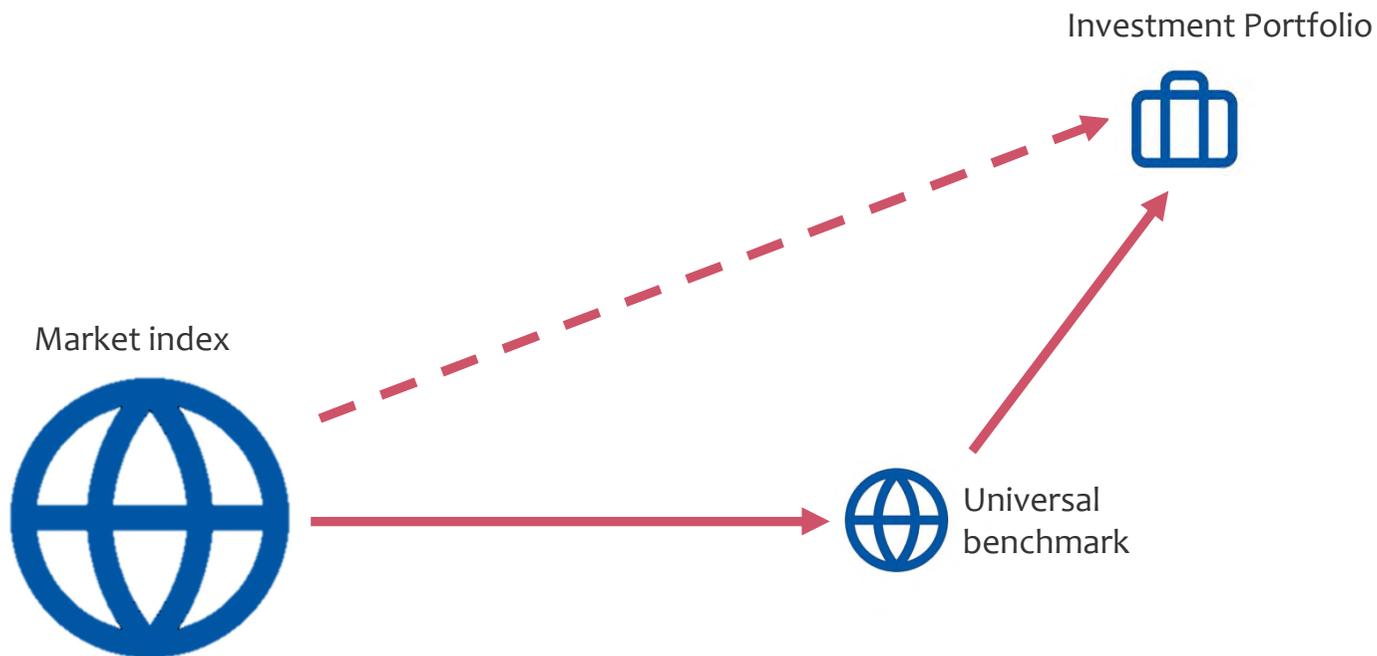
- Minimal tracking error versus the market index
- Satisfying the asset owner preferences: ESG, Universe, Risk factor exposures



Universal benchmarking

The universal benchmarking approach attributes performance into

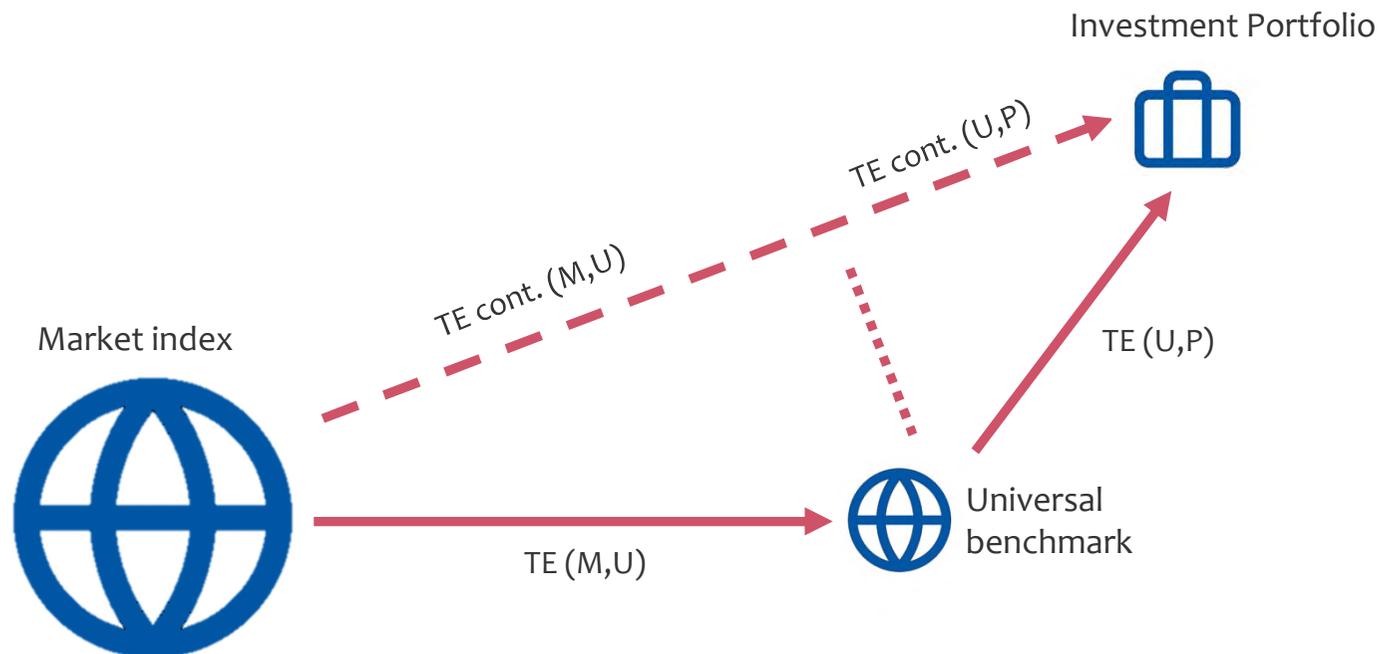
1. ESG preferences from the pension fund board
2. Implementation decisions by the investment manager or index provider



Universal risk decomposition

Decompose risk into two components

1. ESG preferences from the pension fund board
2. Implementation decisions by the investment manager or index provider



Case study

Universal benchmarking performance dialogue

| | Active portfolio | | | ESG index portfolio | |
|--------------------------------------|------------------|----------------|--|---------------------|----------------|
| | Return | Tracking error | | Return | Tracking error |
| Portfolio | 3.0% | | | 2.0% | |
| Market | 1.0% | 4% | | 1.0% | 2% |
| Universal benchmark | 1.75% | 3% | | 1.75% | 0.5% |
| ESG preferences | | | | | |
| Asset Owner | 0.75% | 2% | | 0.75% | 2% |
| Implementation Investment Manager | 1.25% | 3% | | 0.25% | 0.5% |

Stylized examples.

Conclusion and suggestions for future research

Concluding remarks

- Asset owner ESG preferences require active choices from investment managers or index providers
- Universal benchmarking provides a framework for a
 1. Accountability of ESG investment decisions between pension fund and investment manager
 2. Meaningful dialogue on those decisions
- This feedback loop gives substance to the fiduciary duty by
 1. Evaluating both the performance impact of asset owner ESG preferences
 2. Evaluating the skills of the investment manager/index provider
 3. Balancing and evaluating the Return – Risk – ESG profile of the portfolio

Suggestions for future research

- Liquid markets versus private markets
- Further refinement of accountability of ESG investment decisions into e.g. (1) pension fund, (2) regulator, (3) investment/index manager, or (4) other stakeholders

Appendix

References

References

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