2021 Pension Research Council Conference

Session II: Evolution of ESG Investing in the Pension Arena

April 2021

Discussant for "The Origins of ESG in Pensions: Strategies and Outcomes" (by Stephanie Lachance and Judith C. Stroehle) and "ESG and Downside Risks: Implications for Pension Funds" (Zacharias Sautner and Laura T. Starks)

Jennifer Bender

Discussant Remarks for “The Origins of ESG in Pensions: Strategies and Outcomes” by Stephanie Lachance and Judith C. Stroehle

Discussant Remarks: Paper Summary

- On the face of it, ESG's relevance may seem to be a no brainer for pensions as intergenerational stewards of capital. However many pensions face a tension with their fiduciary duty to secure the financial returns of their beneficiaries.
- The paper reviews the historical and structural characteristics of pensions funds and attempts to pinpoint the organizational and institutional enablers and inhibiters of ESG
- The authors identify five characteristics of pension funds which have an important impact on whether and how they can integrate ESG:
  1. The historical origins of funds and their regulatory embeddedness
  2. Their mandate and legal structure
  3. The importance of corporate governance and leadership at the funds
  4. Their investment strategies and asset mix
  5. The pensions' ability to engage in collaborative and advocacy activities

Discussant Remarks: Contribution to the Literature

- Reflects the practical and real-life challenges pensions face
- Raises awareness of tension between characteristics that favor the consideration of ESG such as long-term horizon vs fiduciary responsibility
- Highlights differences in countries (US vs UK vs Canada) and the important role of government and regulatory authorities
- Makes important points about why the following are important to the discussion: (1) Pensions as Universal Owners; (2) the role pensions play between public interest and private markets; and (3) Pensions' legal structure and notion of fiduciary duty
- Stresses the importance of historical structures and organizational features that Pensions face when considering ESG
- Provides interesting case study of PSP whose framework evolved over time through interaction with market participants and investors as opposed to being mandated by the government

Discussant Remarks: Suggestions to Consider

- Data, definitions and disclosure still a major obstacle
  - How to define ESG (Sustainability)?
    - Financial materiality?
    - Climate or best in class?
    - Whose framework do you use?
  - Significant Implications for the actual execution of an ESG program:
    - What is success?
    - Reporting
    - Manager selection and monitoring
- Move from active to index has ramifications for the role of stewardship (engagement)
  - Stewardship programs at asset managers are rapidly becoming more complex, nuanced, and multi-layered
  - The definition of Activism is evolving quickly
  - Industry may be able to innovate -> dedicated stewardship practices by fund or by client?

Discussant Remarks for “ESG and Downside Risks: Implications for Pension Funds” by Zacharias Sautner and Laura T. Starks

Discussant Remarks: Paper Summary

- Synthesizes the latest research on ESG and climate risks, including a several recent papers by the authors (or subset of), focusing on downside risk
  - Krueger, Sautner, and Starks (2020): A survey among institutional investors reflecting significant interest/concerns/action when it comes to climate risk
  - Ilhan, Sautner, and Vilkov (2021): Empirical study of whether climate policy uncertainty is priced into options
  - Hoepner et al. (2021): Empirical study of whether engagement on climate issues reduces downside risk
- Makes the argument both directly and indirectly that climate risks are (should be) important to pension funds

Discussant Remarks: Contribution to the Literature

- Highlights range of ESG related risks (reputational, human capital, litigation, regulatory, corruption, climate)
- Provides overview of extant literature on risks, particularly climate-related downside risk
- Krueger, Sautner, and Starks (2020):
  - Conducted from survey of 439 institutional investors with 48 respondents from institutions with AUM > $100 bn addressing 4 key areas (role of climate risks in investment decisions; climate risk management; shareholder engagement; implications of climate risks for asset pricing)
  - Respondents generally think that climate risks have important financial implications for their portfolio firms. And climate risks, especially those related to regulation, have already started to materialize.
  - No single motive dominates the investors' explanations for why they incorporate climate risks
  - Most of the respondents have taken at least first steps toward managing climate risks, although the two most common approaches (analyses of carbon footprints and stranded asset risks) have been used by less than half of them. Divestment is the least frequently used approach overall.
  - The average respondent believes that equity valuations do not fully reflect the risks from climate change. Overvaluations are considered to be largest among oil firms, followed by traditional car manufacturers, and electric utilities, although the magnitudes of the overvaluations seem to be modest.

Discussant Remarks: Contribution to the Literature (cont.)

- Ilhan, Sautner, and Vilkov (2021):
  - Documents the impact of regulatory/political uncertainty on asset prices
    - Finds strong evidence climate policy uncertainty is priced in the option market using S&P 500 firm level options (2009-2016); finds that carbon intensity is linked to downside tail risk more when climate change attention is high
  - First to look at impact of climate change on asset prices via options
- Hoepner et al. (2021):
  - Uses unique proprietary dataset of engagements by a UK asset manager (1,712 engagements between 2005 and 2018) to understand whether engagement on ESG issues can reduce firms' downside risk. Find support for this hypothesis by testing the lower partial moment of the second order and the VaR. The investor's proprietary database, which constitutes the core of our analysis, contains 1,712
  - Across all engagements, there is no significant reductions in downside risk as a result of the engagement but this changes when conditioning on engagement milestones (specifically Milestone 2, the target management, at the minimum, acknowledged the existence of an ESG issue). The effect further increases for Milestone 3, where the target management has started to take action.
  - Engagement over environmental topics (primarily over climate change) delivers the highest benefits in terms of downside-risk reduction.

Discussant Remarks: Suggestions to Consider

- As a stand-alone piece, may benefit from some discussion of:
  - Regulatory risk and recent developments in Europe and the US
  - The impact of voluntary initiatives such as TCFD, the Net Zero Alliances, etc.
  - Stranded asset risk and the challenges of quantifying this in the context of fossil fuel reserves
  - Pricing transition and physical risk
  - Data history gaps and brevity -> the limitations of empirical analysis

Thank you