Pensions and ESG: Institutional and Historical Perspective

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Responsible Investing, Sustainable Investing, ESG Investing, etc.

“Strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership”

Descriptive framework

• **Universal owner:** A pension or another institution that by intention or requirement invests long-term in widely diversified holdings throughout the global economy. (Urwin 2011)
  – **Externalities.** Who’s affected? What incentives to act?
  – **Agency.** Sounds good in theory, but who pays and who benefits?

• **ESG drivers**
  – Economic transformation
  – **Rise of universal owners** (new categories of large institutional investors):
  – **Stakeholder interests**, not just shareholders
  – **Improved data and analysis** of causes, effects and policies

• **Modern era evolutionary emphasis**

<table>
<thead>
<tr>
<th>1970s</th>
<th>Principles</th>
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<tr>
<td>1980s &amp; 90s</td>
<td>Products</td>
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<td>2000s</td>
<td>Processes</td>
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<td>2010s</td>
<td>Outcomes</td>
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<td>2020s</td>
<td>System</td>
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**Pre-modern era**

**Characterized by**

- Concentrated ownership of public companies
- Transformation of work and consumption
- Little to no small shareholder activism on social or environmental issues
- Little to no pension activism

**Mostly governance related**

- Policies to limit bank & family ownership and monopolies: antitrust; separate commercial and investment banking; shareclass reform.
- 2-tier board structure
- First uniform accounting, reporting, disclosure rules
- First formal recognition of stakeholder rights (Germany)
- Government ownership or control of certain industries (pre-WWII Japan, Soviet Union; post-WWII, esp U.K., France, Italy, China)

**Other:** Regulation of hours, working conditions, food quality, other products & services; environmental movement (U.S—Rachel Carson)
Dawn of the modern era of ESG (roughly 1970)

ESG vary by country,

- **G:** Governance policies and practices vary by country
  - In the U.S., company management dominant
  - In some European countries, family and/or bank control. In others, government ownership (or both)
  - In Japan, cross-holdings and bank influence

- **S:**
  - In the U.S., U.K., contention over social issues; declining influence of unions
  - In Europe, contention over social issues

- **E:**
  - In the U.S., environmental movement takes off
  - Little interest outside the U.S. in environmental issues
Share holding patterns vary by country

Source: De La Cruz et al. (2019) based on OECD Capital Markets Data Set, Thompson Reuters and Bloomberg.
Modern Era: ESG emergence as a “system”
1970s – 2020s evolution

• E, S & G initially treated separately
  – Governance: focus on principles, rules, process to produce good behavior
  – E&S: focus on reducing harm
  – E&S thought of as “complex” compared to G

• Ecosystem
  – Social movements
  – Government/regulators
  – Independent advocacy and service organizations
  – Asset owners
  – Asset managers
## Evolution of ESG Investing

<table>
<thead>
<tr>
<th>Year</th>
<th>Focus</th>
<th>Developments</th>
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<tr>
<td>1970s</td>
<td>“ESG as a principle”</td>
<td>▪ Investors align around key social concerns (i.e. South Africa, Vietnam War)</td>
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<td>▪ Pioneering institutions are created (IRRC, ICCR)</td>
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<td>1980s</td>
<td>“ESG as a product”</td>
<td>▪ Dedicated industry networks are formed (Ceres, USSIF)</td>
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<td>▪ Increased emphasis on corporate governance and the environment</td>
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<td>1990s</td>
<td>“RI as a product”</td>
<td>▪ First social indices launched and universe of Socially Responsible Investing (SRI) funds expands</td>
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<td>▪ Advance business case for sustainability and reporting (i.e. GRI)</td>
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<td>2000s</td>
<td>“ESG as a process”</td>
<td>▪ Investor convergence on climate issues</td>
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<td>▪ Global investor networks formed (i.e. PRI, Global Impact Investing Network)</td>
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<td>2010s</td>
<td>“ESG as an outcome”</td>
<td>▪ RI approaches expand across asset classes</td>
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<td>▪ Expansion of ESG data and reporting to better quantify ESG factors</td>
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<td>▪ Greater focus on outcomes (i.e. UN SDGs)</td>
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<td>2020s</td>
<td>“ESG as a system”</td>
<td>▪ Institutional investors go “all-ESG”</td>
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<td>▪ Attention to S from COVID and equality issues</td>
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<td>▪ Scrutiny and regulation to combat greenwashing</td>
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<td>▪ Heightened urgency around climate change</td>
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E & S issues are joining the mainstream among shareholders

Percentage of shareholder proposals by category receiving >30% of votes cast

Median support for E & S shareholder proposals (left scale) and # of UN PRI signatories in the U.S. (right scale)

Notes:
1. Does not measure # or growth of shareholder initiatives
2. Scales in two figures are different
Continuing Challenges

- Does further ESG progress require all investors to be on the same page?
  - Motivations for investors’ participation in ESG are quite diverse

- Who will make decisions about:
  - Prioritizing stakeholders and beneficial real-world outcomes
  - What ESG data companies should be required to disclose;
  - How investors analyze ESG data (e.g., what makes a company an ESG leader or laggard);
  - Investment and engagement decisions

- Who “owns” the big picture?
  - UN PRI; E.U.; SEC/DoL; rating “agencies”; pensions; other institutional investors
  - Is the creation of an effective (& global) investment industry ESG ecosystem our only hope for continued evolution?
  - Which market participants (and stakeholders) win and which lose in that future state?

- What’s the next unifying issue after climate change?
  - Equality?