

Perspectives

Sustainable Investing

Principles and Practices

“Our real problem, then, is not our strength today; it is rather the vital necessity of action today to ensure our strength tomorrow.”

Dwight D. Eisenhower

In Short

In this paper, we draw upon the findings of two recent works, *Sustainable Investing Principles*¹ by Roger Urwin and Claire Woods, and *Sustainable Investing Practice: Simplified Complexity*² by Urwin, in considering sustainable investing principles and practices. They observe that sustainable investing has not yet reached the top of the agenda for many institutional funds, but that opportunities exist for priorities to be realigned to better meet the long-term needs of funds and beneficiaries.

The sustainable model advocated is based on principles that seek a broader mission, deeper thinking on investment and a longer-term framework for evaluating success. This approach combines the opportunities in the traditional areas of asset allocation and manager selection with extra-financial factors, including environmental, social and governance (ESG) issues.

Defining Sustainable Investing

The primary model of “sustainable investing” presented is of **long-term investing that is intergenerationally efficient and fair**. By investing sustainably, we consciously plan for both the present and the future. The days of socially responsible investing (SRI) have given way to responsible investing (RI). The key values of RI cover the practices of integrating ESG into decision making, controlling the negative externalities of the investments. Sustainable investing promotes a long-term investment strategy with greater breadth and depth (as described below) to produce stronger investment performance both now and in the future.

There are two elements that figure in most models of sustainability:

- A long-term strategy
- An integration of ESG factors and ownership responsibilities

The long-term strategy focuses on a value creation proposition that promotes near-term achievement without compromising future achievement — referred to in the Urwin/Woods paper as “increased depth of

Complexity Theory

The basis for the sustainable investing model stems primarily from complexity theory. In the world of complexity economics, agent interactions produce complex behaviors that are nonlinear and cannot be explained by summing up the parts. Because the system now exhibits nonlinear behavior, the idea of markets finding an equilibrium goes away.

The complexity approach mixes mainstream finance theory with complexity theory: behavioral economics, agency theory, network theory and game theory.

strategy.” This definition of sustainable investing can be used on its own, but the second component of integrating ESG factors and ownership responsibilities suggest investors need to act both effectively and fairly by considering the externalities created by their investments. This is “increased breadth of mission.” This second part of the sustainable investing model includes factors central to responsible investing codes established to address climate change and natural resource depletion.

Sustainable investing relies on improved governance and government support. Urwin/Woods argue that funds must strive for improved governance along best practice lines. Governments could also improve clarity with respect to fiduciary responsibilities by introducing “comply or explain” codes or safe-harbor provisions. In doing so, governments would reinforce governance standards and lend support to the concept of institutional investor social responsibility. Urwin/Woods suggest that sustainable investing delivers fairer results in a financially efficient structure that is both economically superior to traditional investment models and positive to society.

Mission and strategy

In the paper focusing on practices, Urwin suggests that sustainable investing requires an evaluation of values and investment beliefs. Values distinguish the investment mission and goals of a fund; beliefs distinguish the investment strategy.

¹ *Sustainable Investing Principles: Models for Institutional Investors*, Roger Urwin and Claire Woods, October 2009

² *Sustainable Investing Practice: Simplified Complexity*, Roger Urwin, October 2009

Figure 1 describes the link between three possible missions and investment strategy that may be adopted.

A traditional mission seeks to create value through investment activities designed to meet the liabilities while ensuring present financial achievement is sustainable in the future. The investment strategy associated with this mission would tend to focus on relatively short-term investment targets.

A sustainable investment mission incorporates additional goals that express a wider and longer-term view of responsibilities arising from ownership. Investment strategies will tend to be longer term in nature, and more specific ESG-related instructions may be given in delegation of mandates to managers.

A dual-goal sustainable investment mission is even broader, seeking to achieve certain extra-financial goals balanced with financial targets. Such a mission is likely to be more common in sovereign funds and endowment than pension funds. Investment strategy in this case may include more specific mandates with direct connection to sustainability themes such as environmental opportunities. Delegation to managers may be more specialized and directive.

To achieve success, mission clarity and beliefs are critical facets of the sustainability challenge. The traditional mission described earlier has limitations, as it does not align with long-term investment principles. The other two forms of investment mission support an investment strategy that involves

sustainable investing initiatives, either through an integrated approach or dedicated sustainability mandates, as described below.

Sustainable investing in practice

Sustainable investing comprises three broad areas:



- Asset allocation, benchmarks and managers
- Integrated ESG approaches
- Targeted sustainability mandates

Asset allocation, benchmarks and managers

Establishing a fair deal between generations of beneficiaries, including the current generation, is critical to the sustainability of a fund's mission. To achieve this sustainability, the plan for the fund must be robust to organizational change over time so that future commitments are covered. The asset allocation should be responsive to changing investment conditions and changes to asset class expectations, and can be captured in good choices of benchmarks. Furthermore, risk management should allow for stressed investment conditions alongside normal investment conditions.

Manager selection is an important aspect of sustainable investing. Sustainable managers are committed to maintain their performance for clients over time and do not compromise future performance through conflicted actions, such as asset gathering. Sustainable managers are characterized by a strong client-based culture committed to performance excellence.

Figure 1. The effect of sustainability criteria on investment mission and strategy

| | | Breadth of strategy  | | |
|---|--|--|---|--|
| | | Mission 1 Traditional | Mission 2 Sustainable <i>Wider and long-term view of responsibilities</i> | Mission 3 Dual Sustainable <i>Financial + extra- financial goals</i> |
| Depth of mission  | Strategy A Traditional | X | | |
| | Strategy B Integrated sustainable long-term strategy + ESG | | 0 | 0 |
| | Strategy C Targeted sustainable + sustainability mandates | | 0 | 0 |

In addition to organizational factors, sustainability in managers is related to the fees embedded in the proposition. Fees are often sized and shaped in ways that are inconsistent with a net value proposition and a fair deal. While products vary considerably, it is possible to express certain maximum levels for fees to be reasonable or sustainable. For example, it could be argued that fee propositions in which the manager is paid an expected fee above 50% of the expected net alpha³ over time has poor sustainability. Desirable features for improved sustainability would include a balance of fixed and performance fees based on longer-term performance with appropriate hurdles.

Integrated ESG approach

The discipline of ESG and ownership can be integrated with other traditional investment processes and approaches. This investment strategy contrasts with an approach that concentrates on investing directly in securities in the ESG area. The primary difference is the influence that extra-financial factors including ESG have on values and risks of companies and markets. These influences may be significant and are often difficult to measure, but should not be ignored.

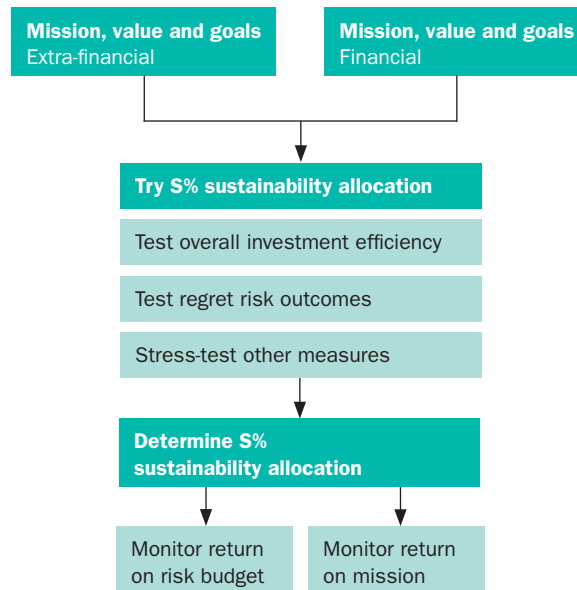
It is also reasonable to suggest that some positive effects can arise from a more effective and engaged ownership practice.⁴ Such practice covers a spectrum of activities relating to the level of engagement with companies. At one end of this spectrum there is the voting of shares and other corporate actions attaching to ownership interests, while at the other end of the spectrum there is shareholder activism, where owners or agents pursue a strategy to engineer change.

An integrated approach to sustainable investing puts ESG and ownership considerations alongside other traditional investment processes.

Targeted sustainability mandates

Funds with sophisticated ESG-based beliefs and good conviction in these beliefs may elect to make target allocations to sustainability mandates. These would involve direct investments in mandates with sustainable themes such as environmental opportunities.⁵ Although much of the return being sought might be thought of as a “green beta,”⁶ several factors point to active management in both public and private markets being the best way to access the potential of sustainable opportunities. The allocation by a fund to targeted sustainability mandates would depend on a number of factors, both financial and nonfinancial (such as peer risk and regret risk, *Figure 2*).

Figure 2. Asset allocation process for sustainability mandates



³ Manager outperformance

⁴ See *Investing for the Future*, Towers Watson, January 2008

⁵ See, for example, *Environmental Opportunities Mandates*, Towers Watson, September 2009

⁶ For more on the existence of a green beta, see Chin-Ping Chia, Lisa R. Goldberg, David T. Owyong, Peter Shepard and Tsvetan Stoyanov, “Is There a Green Factor?” *Journal of Portfolio Management*, Spring 2009

The level of allocation made by a fund would most likely be determined through an iterative process, balancing the risk/return trade-off and exposure to risk, including regret risk. Monitoring of the return on mission through both financial and extra-financial measures will be critical to the success of this process.

Conclusion

Sustainability will influence the shape of economic and financial markets over the coming decades. There are credible arguments to support the tenet that sustainable investing will produce both better investment outcomes and better societal outcomes.

Institutional investment needs to raise its game to play its part in meeting these challenges, and will need to strengthen its governance to do so. Institutional investments are part of an interconnected system with governments, companies and workers critical to the success of the system. Indeed, there have been limited moves in all of these groups toward a more sustainable investing model. We expect the pace to pick up considerably in the coming months and years.

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