STRANDED ASSETS
PROGRAMME

SMITH SCHOOL OF ENTERPRISE AND THE ENVIRONMENT

UNIVERSITY OF OXFORD

Summary of Proceedings

Investment Consultants and Green Investment, 3rd Stranded Assets Forum

Waddesdon Manor, 6th March 2015

In Partnership with:

THE ROTHSCHILD FOUNDATION

Russell Investments

Authors: Ben Caldecott | Dane Rook

About the Stranded Assets Programme

The Stranded Assets Programme at the University of Oxford's Smith School of Enterprise and the Environment was established in 2012 to understand environment-related risks driving asset stranding in different sectors and systemically. We research how environment-related risks might emerge and strand assets; how different risks might be interrelated; assess their materiality (in terms of scale, impact, timing, and likelihood); identify who will be affected; and what impacted groups can do to pre-emptively manage and monitor risk.

We recognise that the production of high-quality research on environment-related risks is a necessary, though insufficient, condition for these factors to be successfully integrated into decision-making. Consequently we also research the barriers that might prevent integration, whether in financial institutions, companies, governments, or regulators, and develop responses to address them.

The programme is based in a world leading university with a global reach and reputation. We are the only academic institution conducting work in a significant and coordinated way on stranded assets. We work with leading practitioners from across the investment chain (e.g. actuaries, asset owners, asset managers, accountants, investment consultants, lawyers), with firms and their management, and with experts from a wide range of related subject areas (e.g. finance, economics, management, geography, anthropology, climate science, law, area studies) within the University of Oxford and beyond.

We have created the Stranded Assets Research Network, which brings together researchers, research institutions, and practitioners working on these and related issues internationally to share expertise. We have also created the Stranded Assets Forums, which are a series of private workshops to explore the issues involved. The Global Stranded Assets Advisory Council that guides the programme contains many of the key individuals and organisations involved in developing the emergent stranded assets agenda. The council also has a role in helping to informally co-ordinate and share information on stranded assets work internationally.

Acknowledgements

We would like to thank the participants and speakers, as well as Russell Investments who kindly sponsored this forum. This was the third Stranded Assets Forum organised by the University of Oxford's Smith School of Enterprise and the Environment together with The Rothschild Foundation. It is part of a series that aim to bring together a select number of key people from across the financial system to better understand drivers of stranded assets, their consequences, and how to develop effective responses to the challenges they could generate.

University of Oxford Disclaimer

Table of Contents

About the Stranded Assets Programme 2
Acknowledgements 2
University of Oxford Disclaimer 2

Introduction 4
Session I: Client demand: The missing ingredient? 5
Session II: Barriers to progress: What other factors might be at work? 5

Background and preliminary findings 7
Framing the forum 7
Project aims and early results 7

Session I: Client demand: The missing ingredient? 10
Session overview 10
Awareness obligations 11
Beliefs and values 12
Hindrance of labels 13
Paradigm entrapment 14

Session II: Barriers to progress: What other factors might be at work? 15
Session overview 15
Opacity and 'safety first' 16
Confusion on duty 17
Categorisation and (mis)allocation 18
Systems appreciation 18

Annex A: Agenda 20

Annex B: Participant List 21

Annex C: Reading List 23

Introduction

The University of Oxford's Smith School of Enterprise and the Environment, in partnership with The Rothschild Foundation and Russell Investments, organised the third Stranded Assets Forum at Waddesdon Manor, Buckinghamshire, on the 6th March 2015. This forum followed on from two earlier events: 1) a general investigation of topics connected to stranded assets[1] (March 2014); and 2) a more focused event concentrating on divestment by endowments of their financial holdings in the fossil fuel industry[2] (September 2014). The third Stranded Assets Forum explored the role that investment consultants (ICs) play in promoting suitable engagement with, and action by, asset owners on matters of environment, climate, and sustainability (or, broadly: concerns over 'green investment').[3]

Investment consultants play a key role as advisers to asset owners, particularly pension funds. They provide strategic advice to pension fund trustees about asset allocation and develop plans for how pension funds can achieve the performance they need to match liabilities. The advice from investment consultants is also used to construct mandates for asset managers, and they often assess asset manager strategies and/or help pension funds to select asset managers for mandates. This means that ICs have a key role in helping to match fund demand from asset owners with fund supply from asset managers.

Nevertheless, interviews with pension fund trustees and experts suggest that there appears to be an under-provisioning of advice on green investments, environment-related risks, and stranded assets by investment consultants. This could be due to a lack of client demand, as well as the existence of barriers within the sector itself that hinder service provision, such as (to name but a few) misaligned incentives, conflicts of interest, and insufficient training. Or it could be that the industry does not consider these issues to be material for strategic asset allocation.

These and other possibilities were addressed by participants during the forum, the attendance of which included: trustees of major asset ownership organisations; investment consultants; board members; investment committee members; legal specialists; and other investment experts from both the academic and practitioner communities. (See Annex A for the full agenda and Annex B for a list of participants; participants were also provided in advance with a suggested reading list, which appears in Annex C.)

This report provides a distillation of the proceedings and deliberations from this third forum. It details key discussion points and issues that emerged during the two sessions held over the course of the afternoon. Some highlights of consensus views that emerged within both of these sessions appear below (divergent and minority perspectives are discussed in further detail within later sections of this report).

[1] A summary of the proceedings of the first forum is available at: http://www.smithschool.ox.ac.uk/research/stranded-

[2] A summary of the proceedings of the second forum is available at: http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/Stranded%20Assets%20Forum%20-%20September%202014%20-%20Summary%20of%20Proceedings%20-%20final.pdf

[3] Future instalments of the forum over 2015-2016 are likewise planned to be devoted to focussed topics.

Session I: Client demand: The missing ingredient?

- A major function served by investment consultants (ICs) is to inform and educate asset owner trustees about risk factors and opportunities; yet trustees rarely demand solutions that address risks and opportunities about which they are: 1) unaware; or 2) aware but cannot clearly act on.
- Asset owners often face issues of misaligned beliefs, values, and investment pursuits; while an obligation of ICs is to help asset owners address these misalignments, yet it may not be the place of ICs to dictate what the specific beliefs and values of asset owners should be in the first place.
- Demand by asset owners for green investment advice and solutions from ICs may be considerably depressed by inappropriate reliance on labels, and a desire by ICs to deliver products and services that fit with labels used by asset owner clients (particularly in mandates).
- A focus on labels is exacerbated by strict adherence to the 'risk as volatility' paradigm, which may be stifling demand for new forms of advice and products connected with threats and opportunities that concern climate, environment, and sustainability (i.e., green investment).
- Although some asset owners may be reluctant to pay higher fees to ICs, the relatively small margins (as compared to asset managers) faced by ICs means that customised solutions are not as commonplace as they could be; and a lack of fees linked specifically to green investment might be behind the fact that most ICs have shown less innovation there than they have on other issues.
- The scarcity of step changes among asset owners and preference instead for incremental changes limits the extent to, and pace at which, ICs can drive transformation; government interventions may be one recourse for accelerating change, but pose significant challenges and no guarantees.

Session II: Barriers to progress: What other factors might be at work?

- Confusion by asset owners over the boundaries of fiduciary duty may be one major barrier slowing progress on green investment uptake and innovation (by ICs and others); plenty of myths seem to exist about what fiduciary duty requires and allows regarding incorporating environmental, climatic, or sustainability factors in investment decisions, and many of these falsities stem from misunderstanding by asset owners themselves on the scope of fiduciary duty.
- Some of the greatest risks, as well as some of the largest opportunities, connected with climate change involve significant opacity, and this lack of concreteness introduces prohibitive difficulties for ICs in convincing some asset owners about merits of green investment solutions.
- The dominant portfolio-construction paradigm based on fixed asset classes (e.g., equities, bonds) may be seriously impeding the expansion of green investment due to overly-restrictive categories; by focusing on risk factors rather than asset classes ICs could achieve more progress.
- Much of the value in pension schemes is located with near-term claimants (i.e., those nearing retirement), whereas many of the largest liabilities to both those schemes and society with respect to green investment issues sit with long-term claimants (i.e., younger or future

members of schemes and/or society); when they offer solutions to clients that prioritise value over liabilities, ICs may be missing a significant opportunity to advance green investment objectives.

- Finding more effective ways for ICs to promote green investment possibilities will require a wider appreciation of the investment ecosystem as a whole, and should not be restricted to considering only ICs' relationships with asset owners, but also those with asset managers, policymakers, lawyers, and pension beneficiaries, plus those with other stakeholders.

Background and preliminary findings

Framing the forum

The third Stranded Assets Forum opened with a recognition that the timeframes concerned for investment issues related to climate change, the environment, and sustainability often stretch many decades into the future, and that considering these long horizons gives one an immediate impression that many things could conceivably "go wrong" in the intervening time between the present and far future. Moreover, much on the list of things that may possibly go wrong over such timescales, due to climate or environmental hazards, departs substantially from most people's lived experiences. This divergence between experience and possibility was suggested as a root cause, as well as chief opportunity, for the subject matter of the forum: the role that investment consultants (ICs) not only have been playing, but also could come to play, in advancing green investment practices and products.

But it was also asserted that these long-term possibilities must be balanced against immediate and short-term realities for many asset owners (such as pension funds, endowments, and other stewards of large pools of financial capital), which include (among other concerns): scarce resources in terms of asset owners' financial and governance budgets (the latter involving such assets as time, expertise, and leadership); a need to deliver suitable returns to present and near-term claimants, despite a challenging economic outlook and investment environment; tightening demands and scrutiny from many regulators; and a need to cope with the growing complexity in the world's financial system in general.

Taken together, this tension between addressing long-term possibilities and coping with immediate challenges was suggested as a primary frame through which to investigate not only the difficulties facing investment consultants and their clients, but also for appreciating the necessary role that ICs play in the financial ecosystem. In light of this frame, forum participants were encouraged in the course of the day's discussions to take a nuanced view on the roles and responsibilities of ICs. Moreover, they were asked to (re)consider critically not only how ICs presently go about the work of providing the advice and solutions that they do, but also to ponder how ICs might more effectively assume positions of leadership in engaging (even reluctant) asset owner clients in conversations about material risks and opportunities over long as well as short horizons.

Project aims and early results

The forum's opening was followed by a brief presentation about the in-process research project (of the same title as the forum) being undertaken by the Stranded Assets Programme at the University of Oxford's Smith School of Enterprise and the Environment (SSEE). Reasons for interest by the Stranded Assets Programme in the role that ICs currently do, as well as potentially might, play in the financial ecosystem were stated, and include the facts that investment consultants:

- Provide strategic advice to trustees about asset allocation and develop plans for how pension funds can achieve the necessary performance to match their liabilities;
- Construct mandates for asset managers;

- Assess asset manager strategies and/or help pension funds select asset managers for mandates;
- Match fund demand from asset owners with fund supply from asset managers;
- Play an essential advisory role for many pension funds that have few in-house staff and layperson trustees

These and other factors give investment consultants a crucially important position in the investment chain, and could prospectively make them a conduit for transformative change within the investment industry with respect to green investment. Consequently, the research project seeks to pursue the following six research objectives:

1. Examine to what extent the under-provisioning of advice on sustainable investment is a material issue for pension funds and the investment consultant industry;
2. Investigate the scale of the challenge, its potential causes, and where it manifests itself most acutely;
3. Explore the processes that pension funds use for selecting investment consultants and managing investment consultant relationships over time;
4. Uncover more precisely how the trend to delegate asset owner duties to investment consultants could affect the consideration of sustainable investment;
5. Identify and assess criteria to rate investment consultants with regards to sustainable investment; and
6. Generate other actionable recommendations for how to address the identified problems.

The main research tools used in the project involve: 1) semi-structured interviews with a diverse range of industry professionals, academics, and other experts; and 2) a web-distributed survey administered to asset owners. Some preliminary results and findings from the survey were presented to forum participants so as to help situate ensuing discussions. A selection of these early findings appear below.

- *Characteristics of early responses*:
    - Initial sample of 33 asset owners collectively represent £1.4 trillion AUM;
    - Predominantly pensions and endowments based in UK (with minority located in Australia or North America);
    - Most pension respondents represent large corporate schemes (e.g., FTSE 100 members)

- *General observations*:
    - Overwhelming majority claimed "expertise" as the primary motive for hiring ICs;
    - All respondents who hire ICs to manage capital cite "enhanced access to opportunities" as the main driver for doing so (which prompts the question: do ICs have any better access to opportunities to invest in sustainable ways?);
    - More than half of respondents (55%) feel that ICs in general are too short-term-oriented in the advice they give, and nearly half (45%) say they are seeking durable relationships with ICs who they do hire (or intend to hire);
    - Half of respondents feel that there are "no meaningful differences" between top-quality ICs (i.e., top-quantile ICs are not strongly differentiated from one another);
    - one-third of respondents feel that ICs provide advice tailored to their needs, and that is non-generic;

- One-quarter of respondents do not receive, or have not been offered, sustainable investment advice from the ICs they hire;
- Less than half of those respondents that do receive sustainable investment advice from their investment consultants (three quarters) are content with the quality of such advice;
- More than half believe that there are too few top-quality ICs offering sustainable investment advice or managed products that pursue some sustainability objectives;
- Less than one-quarter believe that ICs face conflicts of interest that are of a serious nature

It was noted that, although some of these findings may sound surprising, they do not rule out the possibility that some of the difficulties raised might ultimately stem from a shortage of client demand.

Furthermore, the following issues were also raised as posing other possible barriers to green investment:

- *Methodological and proprietary problems*: How many IC tools and methodologies are 'publicly-available' versus proprietary, and how much do cost-versus-differentiation considerations drive this balance?
- *Training issues*: Does the nature and structure of consultants' training have an impact? How much topic-specific training do ICs receive, and how much do they provide to their own clients?
- *Fiduciary duty*: Trustees' (mis)interpretations of their duties might cause them to distance themselves from sustainability issues on the misunderstanding that these are not material
- *Regulation and professional practice*: Mark-to-market and other prevalent practices may make it harder for some asset owners to pursue opportunities in the sustainable investment universe
- *Remuneration, retention, and turnover problems*: Do issues of billable hours or other (dis)incentives impact the circulation and/or delivery of sustainable investment advice by ICs? Might contract structures be a significant influencing force? Does the flow (and ebb) of talent in the industry play any role?
- *Conflicts of interest*: How many ICs are engaged in both ratings provision and advisory activities?

Forum participants were informed that the event's discussion would help to advance the next stages of the research project by:

- <u>Informing the research</u> by helping to identify additional forces and effects, and suggesting promising extensions/expansions beyond the initial scope of the project;
- <u>Identifying points of consensus</u> by discussing the nature and extent of the problem, as well as some prospective solutions

Session I: Client demand: The missing ingredient?

Session overview

The first panel discussion of the forum began with the collection of expert panelists each making brief presentations on their views about factors influencing the depth of client demand for green investment advice and services from investment consultants. Although the emphases of these presentations differed, such that they covered a diverse array of causal forces and effects, a general viewpoint seemed to emerge that lack of sufficient client demand constitutes one of the strongest drivers behind investment portfolios not being as sustainable as they potentially could be.

The various presentations by panelists explored a diversity of explanations for this depressed demand, and highlighted both the contributing role that ICs are playing in perpetuating it, as well as the prospective opportunities that they face, and responsibilities which they may have, in increasing such demand for green investment advice, services, and products in the present and future. After these presentations concluded, the session was opened to discussion. The following topics largely dominated those conversations:

- *Awareness obligations*: Asset owners and other clients of ICs are unlikely to demand advice on threats and opportunities about which they are unaware or misunderstand; ICs may have an obligation, and should have a self-interest, in helping to more extensively and comprehensively educate their clients about the materiality of sustainability, environmental, and climatic issues, and do so in ways that are sensitive to and leverage value structures and beliefs of their clients.
- *Beliefs and values*: Some of the main reasons that ICs are hired is to help asset owners develop, examine, and improve their beliefs and values, as well as cultivate and execute investment strategies that align with those beliefs and values. Asset owners might, however, have beliefs and/or values that do not align with their strategies or portfolios, especially with respect to green investment; and while it is not necessarily the place of ICs to impose particular beliefs or values on their clients, it may well be among their obligations to help resolve any misalignments.
- *Hindrance of labels*: Some of the lexicon used by asset owners may be exacerbating the observed paucity of green investment activity, as well as advice. In seeking the help of ICs on investment matters – whether in conducting search processes to hire ICs, setting objectives, or discussing feasibility of proposed solutions – asset owners often draw on established sets of terms and categories that can considerably restrict the advice and services they receive; this may happen because ICs attempt to cater to the expectations of clients, and clients may resist, or not be willing to pay for, innovations that fail to fit within these established and familiar frameworks, which are dominated by labels that oftentimes are not entirely appropriate for green investing pursuits.
- *Paradigm entrapment*: As with hindering labels, many asset owners utilise the more popular financial paradigms when interacting with their investment consultants; these include, for example: the mean-variance framework for portfolio construction; a narrow definition of risk as measurable by volatility; and emphasis on choosing asset managers on the basis of past

performance and specialisation in managing portfolios structured around traditional, fixed asset classes. Framing conversations with ICs in these paradigms can be overly restrictive when considering risks and opportunities from sources (like climate change) that are not well captured by such frameworks.

The next several pages of this report encapsulate some of the additional ideas, hurdles, and solutions connected with each of the four main topics listed above.

Awareness obligations

As an analogical illustration of the 'awareness obligation' that ICs may have to their clients, the early remarks by the late technologist and innovator Steve Jobs about the iPad® were paraphrased: occasionally, people are not aware that they need some drastic change to the ways in which they typically do things until they are actually *shown* that such changes are needed, and given concrete illustrations of the ways in which such changes benefit them. With respect to the revolution to personal computing which tablets like the iPad® brought, people could not simply have the need and solution described to them; doing so ultimately resulted in their claiming to be disinterested in such solutions. But when the actual solution (i.e., the iPad®) was physically placed in their hands so that they could 'see for themselves' what they had been missing, the need became immediately obvious to them. It was suggested that the demand for green investment advice and services suffers from similar problems: in many cases it is inadequate for ICs to simply inform their clients about potential risks and opportunities connected with unfamiliar, long-term phenomena like climate change and let them judge whether or not they wish to pay for advice or solutions. Instead, what is more regularly needed is the concrete presentation of why such threats and opportunities are material, and ways in which they can be directly acted upon (mere description typically is not enough).

It was suggested that one of the main ways in which such awareness could be promoted by ICs is through appeals to fiduciary duty (although some clients may still misinterpret or misunderstand what is entailed by fiduciary duty; this latter issue was discussed extensively during Session II). The basic premise of this approach is that asset owners must clearly understand that every time they accept a contribution from a beneficiary they are assuming a liability and a promise, and that for the youngest beneficiaries the obligations associated with such liabilities and promises stretch many decades into the future. Realising that such a future may have vastly different types and scales of threats is core to fiduciary duty whenever such contributions are accepted, and trustees must thus make the appropriate efforts to try to comprehend such risks and threats, even if they cannot be perfectly measured.

But, it was noted, responsibly discharging fiduciary duty does not end with simply understanding climatic, environmental, or sustainability risks that may impact investment performance well into the future; it also requires that informed and appropriate *action* be taken to manage those future hazards. And it is in proper understanding of how to best take such actions (or even go about the first steps of considering which actions to take) that investment consultants might best assist some of their clients. It was asserted, however, that making clients aware of suitable action-sets is not just an opportunity for ICs, it may also be an obligation that they have when responsibly discharging their own duties to clients.

A further point raised within this vein of discussion was that continuing failure by asset owners to be aware of and/or act appropriately on the long-term risks that are surfacing as a result of major climatic and environmental changes may cause asset owners to grossly underprice future liabilities to beneficiaries. Hence, not only does lack of awareness and suitable action on such issues cause potential concerns for asset owners with respect to fulfilling their fiduciary duties; it also may underlie valuation practices that jeopardise the very missions of such asset owners. It was therefore suggested that ICs do have an obligation to ensure that their clients fully understand and are keenly aware of these long-term concerns, and do not simply 'take their word' that clients have a sufficient grasp of the stakes at play.

Beliefs and values

The topic of asset owners' beliefs and values was raised recurrently throughout this first session (and often resurfaced in Session II). It was observed that a key force contributing to the effectiveness of investment decisions by asset owners is driven by their culture, and that beliefs and values are among the most integral building blocks of organisational culture for asset owners. Further, it was noted that many questions remain unsettled within the financial community about what beliefs and values are appropriate for any particular asset owner, and that one of the most important roles played by many ICs involves helping trustees to discover, cultivate, explore, and sharpen the beliefs and values that underpin their own organisational cultures.

Some debate developed within the session about whether or not it is appropriate for ICs to impose a specific set of beliefs or values upon their clients. One argument that was posed claimed that ICs have a duty to help clients investigate their beliefs and values, but cannot dictate these themselves. A counterargument surfaced, however, asserting that it is in many instances impossible, in discussing and exploring beliefs and values with clients, for ICs to not impose some of their own beliefs and values on clients. And although the extent to which it is appropriate for ICs to impress (at least some of) their own beliefs and values about green investment (including, e.g., threats from climate change, sustainability, and environmental responsibility) onto clients was not resolved during the session, a consensus emerged that critically discussing beliefs and values is a vital part of what ICs do for clients, and that they carry an obligation to alert clients when they detect misalignment between these and clients' investment strategies and/or practices.

It was noted that such misalignments may not be uncommon. It was asserted that there is a marked difference between holding a belief or value as an organisation and actually implementing it as an investment action. An illustrative claim was made about many corporate pension schemes improperly enacting the sustainability beliefs of their parent corporations. It was observed, for example, that while some large British and American corporations have embraced a strong sustainability ethos, and worked to make their operations and products more environmentally and socially friendly (and many have seen enhanced profits from doing so), their employees' pensions remain laggards for not carrying these sustainable values and beliefs into their investment strategies. These disconnects are very much a jeopardy to the culture and identity of the pension organisations themselves, and it was proposed that a major role for ICs lies in helping asset owners to identify and eliminate these incongruities when they arise by coaching asset owners on how to better align strategies and portfolios with beliefs and values.

Finally, it was suggested that not being overly restricted by particular labels (either in mandates or other interactions between clients and ICs) could help to make relationships between ICs and their asset owner clients both more efficient and fluid. In particular, it was noticed that, particularly when relatively unfamiliar concepts are concerned, substantial time and energy is often wasted in argumentation over semantics. It was proposed that less reliance on labels may help to reduce such unproductive exchanges.

Hindrance of labels

Another major theme of discussion elaborated on other challenges posed by ill-suited labels and terminology that are often used by asset owners and ICs alike when discussing objectives, threats, opportunities, and solutions. A main example that was treated was the issue of mandates: in fulfilling mandates which they have from asset owner clients, ICs oftentimes adopt a conservative stance of wanting to make sure that the services and advice they provide "do what they say on the tin" (i.e., explicitly fulfil the mandate). In doing so, there is a heavy reliance on existing labels and terminology, which may not comfortably accommodate advice or services connected with green investment (if at all).

Yet even when mandates do explicitly involve sustainability, they are often couched in labels such as 'ESG' or 'SRI', which do not easily accept more nuanced considerations that might actually align better with the long-term interests of asset owners, such as (but not limited to): adaptability; complexity; or flexibility. And even though both clients and ICs might understand the benefits that some of these considerations may bring, the overarching desire to explicitly discharge the mandate may cause rigid adherence to more traditional, and often less appropriate, labels and terminology.

It was suggested that some of these label-based hindrances may be connected to a general lack of customised services and advice (or insufficient customisation) by ICs as a result of fee-structure norms. It was noted that, although some asset owners feel that fees charged by ICs are substantial (if not excessive), the margins under which most ICs operate are significantly (often an order of magnitude or more) tighter than those for asset managers. As a consequence, ICs are (at least implicitly) incentivised to concentrate time and resources on developing services and products that are capable of fitting the needs of multiple clients, and that is geared to satisfy needs that are clearly recognised by clients themselves. As a consequence (and particularly at smaller consultancies) there may be minimal customised advice and/or products available to any but the largest asset owners. Moreover, there may be less-than-optimal research and development resources and efforts allocated to more 'niche' concerns from the standpoints of many asset owner clients; and green investment issues may lie in this category.

These circumstances may explain the assertion leveled within the session that ICs have done far less innovating in the green investment space than in other areas. A few general suggestions were made for remedying this situation. The first involved reconsidering the formal structure of relationships between asset owners and ICs, specifically in terms of expectations on the duration for such relationships, as well as the fee structures involved. Specifically, it was suggested that if ICs are made to clearly understand when a relationship with an asset owner client is intended to be long term, as well as the specific conditions that would be required to maintain that relationship (as well as those that would cause it to end or otherwise be reconsidered), then ICs might be willing to expend more resources on less generic products and services, and also expand the time horizons along which such products and services are designed to generate results. Furthermore, it was proposed that there may be benefits from smaller (and even larger) asset owners collaborating and pooling resources to fund highly-specified services and products that meet their collective interests, with the potential for even further tailoring to their individual needs. While it was recognised that this latter idea would not be suitable in all cases, it was cited as being one interesting solution that could potentially interest many consultants.

Paradigm entrapment

Another force that was identified as potentially blocking innovation was strong adherence to dominant paradigms in financial theory. Two such paradigms and mindsets especially troubled some forum participants. Firstly, a number voiced concern over fixation by some asset owners on returns, with only secondary consideration for risk factors. Secondly, frustration by some was expressed about a continual and reductive view of risk that is concerned only with measureable (and, in particular, historical) volatility. It was posited that reliance on these paradigms promotes a relatively dangerous mindset among many asset owners: an excessive demand for, and unacceptable levels of comfort with, specific forms of 'proof' that certain risks and opportunities are material. Generally these specific forms of proof were stated to take the form of demonstrated impacts on returns. Approaches to decision making by asset owners that rely predominantly on these forms of proof were claimed as being dangerous in the face of threats like climate change, wherein the 'evidence' for impacts on returns (and volatility thereof as 'risk') is not anticipated to arrive for many years (or even decades) into the future, at which point fewer choices may be available to asset owners who adopt a strong 'wait-and-see' stance on these issues.

It was noted that such mindsets of relying on quantitative proof not only may reduce demand for green investment advice and products, but it also may underlie the difficulties that many asset owners face in implementing significant changes. It was observed that many asset owners are only capable of implementing incremental changes (and even then, some do so only with reluctance and difficulty), and that 'step changes' are not at all common among asset owners. Several participants remarked that this resistance to substantive change severely limits the range and extensiveness of green investment solutions that ICs may be able to offer to asset owner clients. While it was observed that incremental transformation at a slow pace may be better than no change at all among asset owners, it was also stated that such a tepid pace of change may be putting an unacceptable volume of financial capital at risk worldwide, and that governments may be needed to intervene in order to promote the scale of change required. An immediate reaction from many participants, however, was a voiced concern that some (and perhaps most) governments lacked the will and/or capacity to address many of these problems. Noticeably, participants in the forum were relatively split about their confidence in governments and/or regulators to supply the appropriate corrective action to force asset owners into embracing a more rapid pace of change in the face of climatic and other threats to their beneficiaries' financial capital.

Session II: Barriers to progress: What other factors might be at work?

Session overview

The second session considered further barriers to progress on improving the quality and availability of advice and services that ICs provide on green investment-related issues. The primary aim of this segment was to explore additional, and potentially more nuanced, obstacles to those that were discussed during the first session. As with Session I, Session II entailed a panel format that began with expert panelists presenting their thoughts on the subject. Panelists were encouraged to specifically focus on themes of disruption, innovation, and acceleration. And, as in the first session, panelists furnished a number of provocative and insightful explanations of other factors that may be depressing the demand for, and provision of, green investment advice and products by ICs. After these expert presentations were delivered, a wide-ranging, moderated discussion followed that raised several substantial issues and themes. A selection of some of those themes that garnered the bulk of attention appears below, and is elaborated in the remainder of this section.

- *Opacity and 'safety first'*: A significant topic discussed in this second session concerned the scale of many of the threats related to climate change; it was particularly observed that the exact scales of impact of such threats to the *specific portfolios* of asset owners is necessarily 'opaque' (i.e., not clearly visible in advance). As was noted in Session I, an absence of proof or 'hard evidence' on the exact likelihoods and outcomes of such threats can cause inertias in asset owners' decision making. Yet it was suggested that inertia (e.g., 'wait-and-see') is an inappropriate response, and that a more suitable reaction should be an agnostic, 'safety first' stance among asset owners. This safety-first position should be substantially proactive and seek to guard against worst-case threats in the absence of proof. It was suggested that ICs have a promising role to play (and responsibility) in helping communicate potential benefits of such a stance, as well as to identify and remedy areas of portfolios and investment strategies that are most exposed or vulnerable.
- *Confusion on duty*: An important observation to emerge during this session centred on the many confusions and myths that have been perpetuated about the obligations and latitudes afforded by fiduciary duty. It was noted that many asset owners misconstrue their duty to beneficiaries as preventing them from considering environmental or sustainability factors in their investment decisions. Yet, on the contrary, during this session it was demonstrated that asset owners and other trustees may instead have a strong obligation to consider such factors (and should/must be able to prove that they did so) when those factors could materially impact financial performance. It was proposed that ICs have a role to fulfil in not only helping to dispel some of the myths attached to fiduciary duty, but also to help their clients to fully and rigorously consider how factors that bear on financial performance of beneficiaries' investments, but that may not be classed as 'traditional' financial factors (i.e., climatic, sustainability, or environmental threats), can be addressed over various time horizons.
- *Categorisation and (mis)allocation*: Continuing on from ideas raised in Session I about hindrances from excessive labeling, a main theme that attracted lively discussion during Session II concerned the frictions stemming from inappropriate usage of investment categories to structure asset owners' strategies and portfolios in the face of climatic and environmental

change. Notably, it was observed that a fixation by both many asset owners and ICs on 'conventional' asset classes (e.g., listed equities, corporate bonds) and a lack of explicit consideration for some risk factors not easily dealt with by diversification strategies that rely on asset class-based allocations (e.g., political risks from climate policy, carbon price risks, geographic differences in the impacts of climate change) may be substantially impeding innovation by ICs on green investment leadership in advice and product provision.

- *Systems appreciation*: It was underscored during this session that any pragmatic attempts at removing barriers and making progress toward improving the quality and availability of IC advice and products on green investment must appreciate the fact that ICs and asset owners are not the sole inhabitants of the financial ecosystem. Participants were careful to note that other players in the system, including regulators, legal experts, asset owners, and even beneficiaries themselves all have potential roles in driving change, and that in the future ICs may be substantially benefited by working with (or at least paying close attention to) these other groups.

The remainder of this section treats these main themes in further detail and describes the solutions proposed during Session II.

Opacity and 'safety first'

A significant point of agreement during Session II was around the notion that some of the impacts from long-term climatic and environmental changes are likely to be severe, but potentially unpredictable (or else predictable only with very low levels of confidence). In short, there may be significant opacity about the particular impacts of changes to the global climate and environment *on specific investment portfolios*. As such, attempting solely 'portfolio-management' solutions to the problem is unlikely to protect asset owners, because many of the threats and opportunities stemming from such changes will be extremely difficult to quantify with any reasonable precision; there is just too much complexity involved to do so.

But perhaps one of the most insightful claims advanced by participants was that opacity would not necessarily surprise most asset owners, and that many (especially large asset owners) have conducted (or are in the process of conducting) their own attempts at quantifying the potential threats and opportunities for their investment strategies. A main assertion, however, was that the bulk of these efforts to quantify vulnerabilities from climate and environmental change fail to translate into direct action on the parts of asset owners because the action paths required may not be directly visible to them. In short, there is a tremendous opportunity not only for ICs to help asset owner clients to better comprehend and choose among possible options to take direct action to protect their organisations against threats from (and even possibly to capitalise on opportunities cause by) climate and environmental changes over the long term, but also to expand this set of potential direct actions itself.

One pragmatic route to enabling this enhanced provision of advice and service by ICs was through a promotion of a pervasive 'safety first' ethic. It was suggested that the most responsible footing that many asset owners might adopt is substantial precaution; but this precautionary stance should be one of preemptive action rather than inertia, and it should be characterised by a favoritism for considering the safest action path available (or else justifying why such a path is not the most suitable one given current information and knowledge). Appreciably, helping clients to work through the tangle of issues involved in adopting such a safety-first stance would provide substantial opportunities for leadership by ICs, and could likewise conceivably spur substantial innovation within the IC industry.

Nevertheless, a substantial barrier to widespread enactment of this stance was identified, and constituted the second main theme addressed during Session II: misinterpretations of fiduciary duties.

Confusion on duty

Substantial discussion during Session II circled around what was asserted as a widespread and lingering problem within the financial services industry: pervasive misunderstanding by many asset owners about where the boundaries of fiduciary duty lie, and what obligations that current legal views on fiduciary duty of trustees to beneficiaries means for including environmental and sustainability factors in decision making. Put simply, it was observed – through several anecdotal but poignant cases – that many asset owners (including several high-profile entities) misinterpret fiduciary duty as preventing them from weighing environmental or sustainability-related risk or return factors in their financial and investment decisions on behalf of their beneficiaries.

A key realisation advanced in this session is that such interpretations are pure mythology, and that asset owners are indeed allowed to consider environmental and sustainability factors in their investment decisions *if these factors are likely to have some potential impact – whether negatively or positively – on the expected financial returns to the asset owner's investments*. Moreover, if such potential impacts can be demonstrated as having the reasonable possibility of being material in scale, there may exist an obligation on the parts of trustees to prove that these factors were properly accounted for and considered within the investment decision process. Of course, an asset owner may still consider other factors that do not impact financial returns (such as ethical considerations, for example), but only if these non-financial factors do not interfere significantly with financial performance of beneficiaries' investments. But the crucial idea that was discussed is that considerations of environmental and sustainability risks and opportunities may be clearly linked to financial impacts, and that fiduciary duty may demand consideration of these factors over the long term.

It was further suggested that 'myth-busting' with respect to misconceptions about fiduciary duty may lie squarely in the set of responsibilities – and potentially the direct interests – of many investment consultants. More specifically, because many trustees may not have especial skill or expertise in legal matters, the possibility of engaging asset owner clients about the exact boundaries of what fiduciary duty requires and allows with respect to environmental and sustainability concerns poses a pronounced opportunity for many ICs to take a leadership position (and even create new business opportunities).

Furthermore, this opportunity for extensive engagement on fiduciary duty by ICs with their asset owner clients was cited as a possibility for extending the time horizons that are typically emphasised in relationships between asset owners and ICs. Specifically, it was discussed how trustees have an obligation to treat different classes of beneficiaries even-handedly; the long-term interests of younger trustees, therefore, must not be subjugated to the short- or near-term interests of older ones. Accentuating this need for balance across time horizons within the rubric of fiduciary duty may thus afford ICs and asset owners an expeditious way to achieve what is so often talked about, but is rarely observed in effective practice: the due consideration for long-termism.

Nevertheless, it was observed within the forum how a reinvigorated engagement with fiduciary duty falls well short of a panacea. Specifically, it was stated how present legal interpretations of fiduciary duty do not readily allow recourse for intergenerational equity considerations. That is, fiduciary duty applies only to those beneficiaries who are presently enrolled in a scheme, and not to those who might be so in the future (but only speculatively may be at present). Nevertheless, more encompassing interpretations do allow trustees to account for the 'type of world' that currently enrolled beneficiaries may want to live in, and could permit this consideration to enter into decision making. And although some of these advances still require thorough testing within actual case law, there exists at present substantial promise that the avenue of fiduciary duty could be an opening for innovation by ICs and others.

Categorisation and (mis)allocation

Discussion and exchange in Session I regarding labeling concerns and impediments to innovation by ICs carried over into Session II under a related guise: troubles stemming from use of overly restrictive categorisations by both asset owners and ICs during various stages of the investment planning, execution, and monitoring/oversight processes. Specifically, these concerns were claimed to emanate from steadfast adherence to traditional asset class-based approaches to capital allocation and portfolio construction. It was asserted by some forum participants that the continued practice of segmentation and analysis of risks and opportunities according to conventional asset classes (e.g., listed equities, corporate bonds) is disadvantaging asset owners by making it more difficult to identify many risks and opportunities related to long-term climate and environmental change.

An alternative that was proposed, and that could help spur innovation among ICs, instead entails allocations of capital driven primarily by diversifying exposures to various risk and/or growth factors, rather than regimented and rigid asset classes. The recommendation suggested that, in dividing their capital across investments, asset owners should be inquiring "What are we trying to achieve with this specific allocation?", and selecting the allocation on the basis of what is best-fit to promote that objective. To this end, ICs might be well positioned to advise asset owners on how to best identify those objectives that they should be pursuing (and in what relative order), as well as potentially assisting them with the search processes needed to identify the best asset managers, or else building the right in-house capacities for doing so. Furthermore, it was recommended that ICs, in offering such advice and services, should strive to keep discussions and ideas relatively 'label-lite' so as to draw clients' attentions to the relevant threats and opportunities and timescales, rather than sticking to paradigms (such as the standard mean-variance models) that might prove to be unwarranted straightjackets on productive innovation.

Nonetheless, while it was recognised that this proposed movement away from heavily asset class-based diversification may be a pragmatic way to propel innovation in green investment, several hurdles were identified. Perhaps foremost among these was the reported pushback that many ICs have received in trying to encourage this migration to 'factor-based' allocations in the past.

Systems appreciation

An idea that permeated much of Session II, and particularly spurred by one vocal member of the panel, involved the need to respect the systems-based nature of the investment industry. Participants were particularly reminded that asset owners and investment consultants are only two among an enormous number of types of entities that populate the world's financial system, and that: 1) any changes or solutions sought in reforming how asset owners and ICs engage the topic of green investment will likely additionally involve influences from other parties (and the success or failure of such initiatives will very likely be driven by whether the roles of such other parties are appropriately considered and accounted for); and 2) evolution characterizes the world's financial system over the long term, and either (or both) asset owners or ICs that fail to appreciate this dynamism will very probably find themselves losing out over long horizons.

It was therefore proposed that future efforts in exploring the relationship between investment consultants, asset owners, and green investment visit greater energy on considering the roles of other parties in the system that might bear on the problem, whether as frictions or facilitators. One matter in particular that was proposed for immediate development was improved thought leadership on how both asset owners and ICs might engage more effectively (e.g., more extensively, efficiently, or in nearer to real time) with their beneficiaries. In particular, it was observed that there is an imminent need to not only educate young people about pensions (especially in an increasingly defined-contribution setting), but also to engage with them and listen to their needs and preferences. This possibility was suggested as a deepened future possibility for ICs, although it was left an open question about how exactly this end might be best pursued.

Annex A: Agenda

Friday, 6th March 2015

12:00 – 13:00 – **Lunch and Arrival at The Archive at Windmill Hill, Waddesdon Manor**

13:00 – 13:15 – **Welcome and Opening Remarks**
Professor Gordon L. Clark, Director, Smith School, University of Oxford

13:15 – 13:30 – **Project overview and preliminary research**
Ben Caldecott, Director, Stranded Assets Programme, Smith School, University of Oxford

13:30 – 15:15 – **Session I - Client demand: the missing ingredient?**
Chair: **Professor Gordon L. Clark**, Director, Smith School, University of Oxford
Panelists:
Roger Urwin, Global Head of Investment Content, Towers Watson
Nick Sykes, Director of Manager Research, Mercer
Philippe Desfosses, CEO, ERAFP
Faith Ward, Chief Responsible Investment and Risk Officer, EAPF

15:15 – 16:00 – **Tea/Coffee**

16:00 – 17:45 – **Session II - Barriers to progress: what other factors might be at work?**
Chair: **Emma Howard Boyd**, Visiting Fellow, Smith School, University of Oxford and Adviser, Tellus Mater Foundation
Panelists:
Howard Covington, Chairman, Isaac Newton Institute and former Director of New Star Asset Management
Mike Clark, Director, Responsible Investment, Russell Investments
Elspeth Owens, Barrister, ClientEarth
Coleman Long, Managing Director, Cambridge Associates

17:45 – 18:15 – **Transfer to The Dairy at Waddesdon Manor**

18:15 – 19:00 – **Drinks Reception**

19:00 – 21:30 – **Dinner**
Keynote: Professor Elroy Dimson, Chairman, Newton Centre for Endowment Asset Management at the University of Cambridge and Chairman, Strategy Council, Norwegian Government Pension Fund

Annex B: Participant List

Lesley Alexander, Managing Director, Ferrier Pearce

Amir Amel-Zadeh, University Lecturer in Finance, University of Cambridge

Henry Boucher, Partner, Sarasin & Partners

Fabia Bromovsky, CEO, The Rothschild Foundation

Ben Caldecott, Director, Stranded Assets Programme, Smith School, University of Oxford

Gordon Clark, Director, Smith School, University of Oxford

Mike Clark, Director, Responsible Investment, Russell Investment

John Clements, Partner, Lane, Clark & Peacock LLP

Leanne Clements, Responsible Investment Officer, West Midlands Pension Fund

Howard Covington, Chairman, Isaac Newton Institute and former Director of New Star Asset Management

Philippe Desfosses, CEO, ERAFP

Elroy Dimson, Chairman, Newton Centre for Endowment Asset Management, University of Cambridge and Chairman, Strategy Council, Norwegian Government Pension Fund

Charles Elworthy, Head of Research, Map Agriculture, and Visiting Fellow, Smith School, University of Oxford

Rebecca Fenton, Institutional Analyst, Alliance Trust

Nicolas Firzli, Director-General, World Pensions Council

Simon Fourmy, Head of Grants, The Rothschild Foundation

Jessica Fries, Executive Chairman, The Prince's Accounting for Sustainability Project

Matthew Gold, Actuarial and Investment Analyst, Barnett Waddingham LLP

Magnus Goodlad, Chief of Staff, Lord Rothschild

Colm Harney, Research Analyst, Equities, Hymans Robertson

Divyesh Hindocha, Global Head of Product and DC, Schroders

Fréderic Hoogveld, Investment Specialist, Amundi

Catherine Howarth, Chief Executive, ShareAction

Emma Howard Boyd, Visiting Fellow, Smith School, University of Oxford and Adviser, Tellus Mater Foundation

Terri-Ann Humphreys, Development Executive, Pensions Management Institute

Emma Hunt, Senior Investment Consultant, Towers Watson

Rob Lake, Independent Responsible Investment Advisor

Coleman Long, Managing Director, Cambridge Associates

Martina McPherson, Managing Partner, Sustainable Investment Partners

Richard Nunn, Chair, URC Ministers' Pension Trust

Will Oulton, Global Head of Responsible Investment, First State Investment

Elspeth Owens, Barrister, Climate Litigation, Client Earth

Stephanie Pfeifer, Chief Executive, Institutional Investors Group on Climate Change

Dane Rook, Research Associate, Smith School, University of Oxford

Lauren Smart, Executive Director, Trucost

Kirsten Spalding, Director, Investor Programme, Ceres

Nick Sykes, Director of Manager Research, Mercer

Roger Urwin, Global Head of Investment Content, Towers Watson

Michael Viehs, Research Fellow, Smith School, University of Oxford

Faith Ward, Chief Responsible Investment and Risk Officer, EAPF

Michael Woodmore, Independent Trustee, Agility Pension Plan

Annex C: Reading List

AICIO (2014) "Outsourced chief investment officer survey" (February).

Ambachtsheer, K., and J. McLaughlin (2015) "How effective is pension fund governance today? And do pension funds invest for the long-term? Findings from a new survey", *KPA Advisory Services*.

Clark, G.L., Feiner, A., and M. Viehs. (2014) "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance." Working Paper: Smith School of Enterprise and the Environment, University of Oxford, and Arabesque Partners. See: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281.

Ellsworth, P., and K. Spalding (2014) "The 21st century investor: CERES blueprint for sustainable investing", see: http://www.ceres.org/resources/reports/the-21st-century-investor-ceres-blueprint-for-sustainable-investing.

Eurosif (2009) "Investment consultants and responsible investment survey", see: http://issuu.com/eurosif/docs/eurosif_investment-consultants_ri_study?e=2092860/2845477.

Eurosif (2014) "European SRI study 2014", see: http://www.eurosif.org/publication/european-sri-study-2014/.

Gennaioli, N., A. Shleifer, and R. Vishny (2015) "Money doctors", *Journal of Finance*, 70(1):91-114.

Gohal, A., and S. Wahal (2008). The selection and termination of investment management firms by plan sponsors. Journal of Finance, 63(4): 1805-1847.

Hackethal, A., M. Haliassos, and T. Jappelli. (2012) "Financial advisors: A case of babysitters?", Journal of Banking and Finance, 36(2): 509-524.

Inderst, R. (2010) "Misselling (financial) products: The limits for internal compliance", *Economics Letters*, 106(1):35-37.

Inderst, R. (2011). Consumer protection and the role of advice in the market for retail financial services. Journal of Institutional and Theoretical Economics, 167(1): 4-21.

Inderst, R. and M. Ottaviani. (2012) "How (not) to pay for advice: A framework for consumer protection", Journal of Financial Economics, 105(2): 393-411.

Jenkinson, T., H. Jones, and J-V. Martinez (forthcoming) "Picking winners? Investment consultants' recommendations of fund managers", *Journal of Finance*, see: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327042.

KPMG (2014) "2014 KPMG UK fiduciary management market survey" (November), see: http://www.kpmg.com/uk/en/issuesandinsights/articlespublications/pages/fm-market-survey.aspx.

Laing, N., C. Long, A. Marcandalli, J. Matthews, A. Grahovac, J. Featherby (2012) "The U.K. social investment market: The current landscape and a framework for investor decision making", *Cambridge Associates*.

Mullainathan, S., M. Noeth, and A. Schoar (2012) "The market for financial advice: An audit study", *NBER Working Paper*, #17929.

Valor, C., M. de la Cuesta, and B. Fernandez (2009) "Understanding demand for retail socially responsible investments: A survey of individual investors and financial consultants", *Corporate Social Responsibility and Environmental Management*, 16:1-14.

STRANDED
ASSETS

PROGRAMME

Smith School of Enterprise and the Environment
University of Oxford
South Parks Road
Oxford, OX1 3QY
United Kingdom

E enquiries@smithschool.ox.ac.uk
T +44 (0)1865 614963
F +44 (0)1865 275885
www.smithschool.ox.ac.uk/research/stranded-assets/

SMITH SCHOOL OF ENTERPRISE
AND THE ENVIRONMENT

UNIVERSITY OF
OXFORD