STEWARDSHIP RESEARCH SERIES

INVESTING FOR A BETTER WORLD

NAVIGATING 6 PARADOXES

STEWARDSHIP ASIA

About Stewardship Asia Centre

Stewardship Asia Centre is a non-profit organisation established by Temasek Holdings, dedicated to helping business and government leaders, investors, and individuals activate stewardship practices through research, executive education and engagement. We define stewardship as creating value by integrating the needs of stakeholders, society, future generations and the environment.

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INVESTING FOR A BETTER WORLD: NAVIGATING 6 PARADOXES

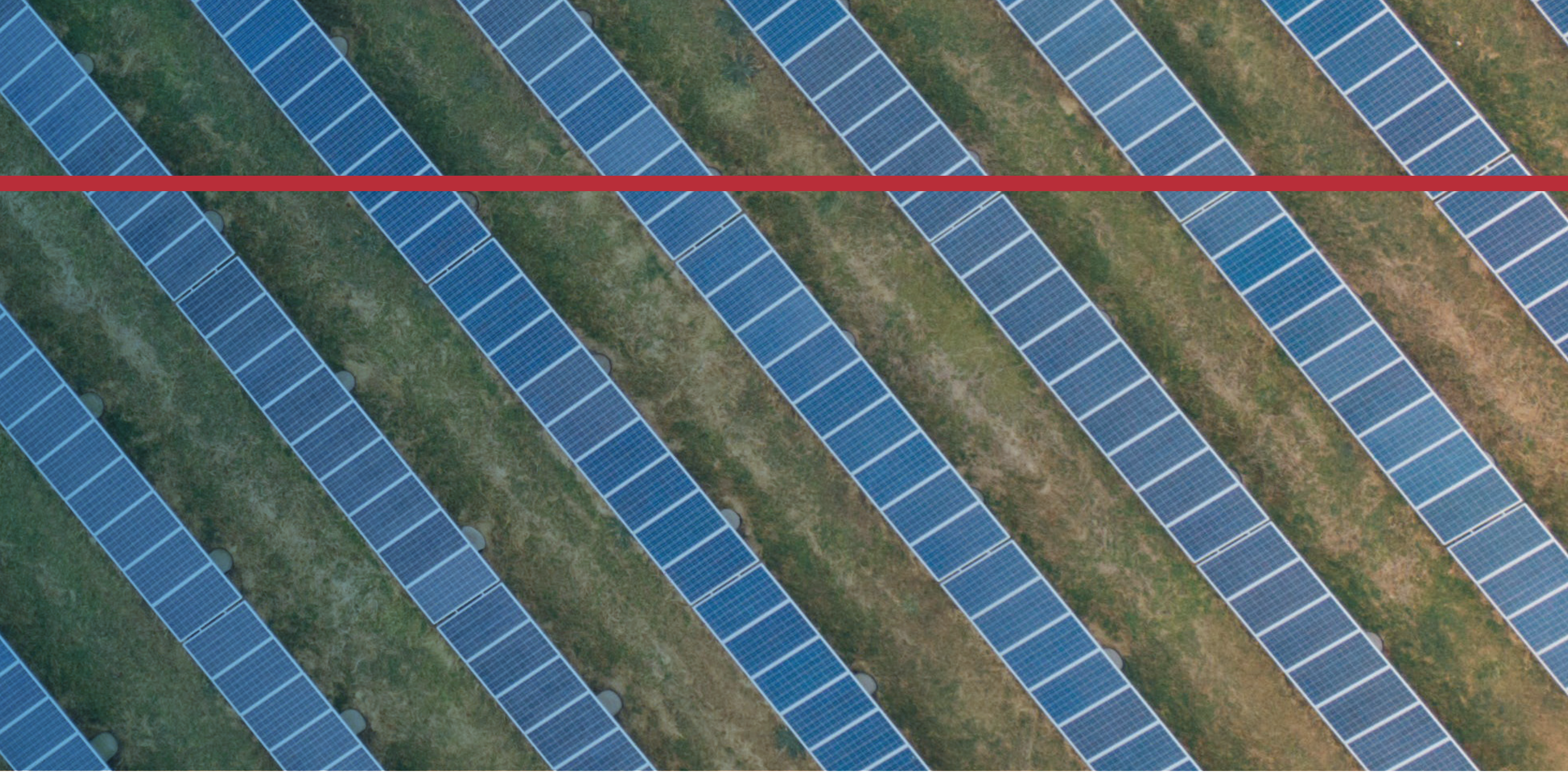
Executive Summary

I. Sustainable investing, a niche concept a decade ago, has made strong, steady progress into the mainstream of investing. The increasing demand for sustainable investments has been driven by a diverse group of stakeholders, including millennial investors, asset owners and governments seeking to effect positive social and environmental outcomes, driving investor behavioural change. However, owing to increased demand for sustainable investing, coupled with challenges around ever-evolving regulations, jurisdiction differences, and anti-ESG sentiment, investors continue to wrestle with complex dilemmas on multiple fronts.

II. The fundamental conundrum is maximising financial returns, or "value," while aligning investment decisions with ethical, environmental, and social principles, or "values." Value and values need not be at odds with each other. While it may be argued that the impact of ESG on overall performance may be hard to quantify, value-based and values-based approaches are largely complementary.

III. While positive or negative screens are commonly used by most investors, the jury is still out on the type of portfolios investors should build. Should they build one with strong ESG credentials by adhering to a strict exclusion policy or a more diverse one that allows them to enact change in investee companies? The optimal approach is about getting the right balance between exclusion and inclusion approaches and aligning these with the firm's investment beliefs.

IV. The surging anti-ESG debate is based on the premise that incorporating ESG criteria into investment analysis compromises potential investment returns and introduces an element of subjectivity into asset allocation decisions. Regardless of where the anti-ESG debate heads, investors must strive to always fulfil the fiduciary duties of prudence and loyalty simultaneously.



V. While conventional wisdom suggests that investment time horizon directly influences ESG risks and opportunities, different aspects of ESG may become prominent at different times. ESG investing and integration are therefore invaluable to all investors, irrespective of their long-term or short-term orientation.

VI. Most investors use a combination of solo and collective engagement to engage with investee companies regarding ESG issues. The mode of engagement is shaped by a multitude of factors, including, but not limited to, the gravity of the engagement issue and the leverage that individual investors can exert on corporate decisions.

VII. Owing to a lack of reach and resources, some investors may choose to outsource some or most of their stewardship activities. Given the trade-offs of outsourcing, investors have to decide if they want to entrust these responsibilities to fund managers and external entities or double down on efforts to build or enhance internal stewardship capabilities. Most investors may pursue a hybrid approach, combining elements of building internal stewardship capacity along with outsourcing.

VIII. Amidst increasing demand for sustainable investing, continuous evolution of regulations, shifting investor profile, and increasing anti-ESG sentiments, investors continue to grapple with the ultimate goal of optimising financial returns while harmonising investment choices with ethical, environmental and social principles. The resulting paradoxes extend far beyond "either/or" choices to "both/and" actions that investors must balance or execute in alternate succession.

INTRODUCTION

INVESTING FOR A BETTER WORLD

Sustainable investing, embraced only by a select few investors a decade ago, is now in the mainstream of investing activity globally.[1]

It can broadly be defined as the allocation of capital that seeks to generate a financial return while also positively contributing to environmental and social outcomes. Investors, comprising a heterogeneous group of capital providers that includes mutual funds, pensions funds, insurance funds, private equity and impact investing firms, play a pivotal role in shaping the trajectory of sustainable investing, each possessing distinct characteristics, investment philosophy and beliefs. Such investments encompass a wide range of asset classes, including stocks, bonds, mutual funds and real estate, all of which prioritise companies or projects in alignment with specific sustainability goals.

Today, many recognise that capital can be a powerful tool for shaping a better world, one that not only generates returns for investors but also contributes to a more sustainable and prosperous future. Companies are increasingly being evaluated not only on their financial performance but also on their broader impact on society and the environment. Investors are closely watching environmental, social and governance (ESG) trends and increasingly applying non-financial factors into their investment analysis and decision-making. Their objectives are multifaceted, encompassing pursuit of returns, effective risk management, and promotion of ethical business practices that resonate with their values and broader societal aspirations. Box 1 highlights the rise of ESG, especially in the recent past.

Box 1: **The Rise and Rise of ESG**

ESG is less than two decades old. The acronym dates back to 2004 when a report commissioned by the UN called for "better inclusion of environmental, social and corporate governance factors in investment decisions."[2] In the wake of corporate scandals such as Enron, WorldCom and the Exxon Valdez oil spill, financial institutions eagerly signed on to the "global compact."[3] ESG, however, had a slow start and took a few years to catch on. Between May 2005 and May 2018, ESG was mentioned in fewer than one per cent of earnings calls.[4] But once ESG became mainstream, it quickly became ubiquitous in the corporate landscape. By May 2021, it was mentioned in almost a fifth of earnings calls, after a significant surge in prominence over the pandemic.[5]

1. Bloomberg. (2019, February 21). *Sustainable investing goes mainstream: Morgan Stanley and Bloomberg Survey finds sustainable investing a business imperative among U.S. asset managers.* https://www.bloomberg.com/company/press/sustainable-investing-goes-mainstream-morgan-stanley-bloomberg-survey-finds-sustainable-investing-business-imperative-among-u-s-asset-managers/
2. Pollman, E. (2022). The Origins and Consequences of the ESG Moniker. *University of Pennsylvania Carey Law School, Institute for Law and Economics Research Paper*, 22-23.
3. Agnew, H., Klasa, A., & Mundy, S. (2022, June 6). *How ESG investing came to a reckoning.* Financial Times. https://www.ft.com/content/5ec1dfcf-eea3-42af-aea2-19d739ef8a55
4. Wang, X., & Hu, S. (2022). Can performance-based budgeting reform improve corporate environment in ESG? Evidence from Chinese-listed firms. *Frontiers in Environmental Science, 10*, 982160.
5. Agnew, H., Klasa, A., & Mundy, S. (2022, June 6). *How ESG investing came to a reckoning.* Financial Times. https://www.ft.com/content/5ec1dfcf-eea3-42af-aea2-19d739ef8a55

Investing for a Better World: Navigating 6 Paradoxes aims to unravel the relationship between the role of capital and the pursuit of a more sustainable world that generates positive economic, environmental and social impact. The Stewardship Asia Centre (SAC) research team engaged in a series of detailed conversations with industry practitioners—comprising mainly asset owners and asset managers—and thought leaders about key drivers, opportunities and challenges that define the path investors take in aligning their financial interests with broader societal and environmental goals. Here are six drivers, based on our conversations, that shape investors' motivations, strategies and priorities towards sustainable investing.

I. Increasing demand for sustainable investments. The burgeoning demands for sustainable investments, from asset owners who want to create positive social impact to millennial investors who prioritise values-based investing, have been a significant driver of change in investor behaviour. Mounting pressure from civil society, regulators and stakeholders advocating for investors to shoulder more social responsibility has also accelerated the change. ESG assets have therefore surged manifold over the past few years. In 2022, USD 35 trillion in ESG assets were recorded, representing a 15 per cent increase from the previous year.[6] According to Bloomberg Intelligence, global ESG assets may surpass USD 50 trillion by 2025, one-third of the projected total assets under management globally.[7]

II. Evolving regulatory environment.Alongside the growing ESG investments in Asia is a rapid corresponding development in ESG regulations, frameworks and standards in the region. Globally, it is estimated that there are now more than a thousand ESG regulations, including more than 200 relevant regulations in Asia, a two-fold increase since 2016.[8] Contributing to this multitude of regulations are efforts by various stakeholders. Governments have introduced policies, most notably climate agenda-driven initiatives such as net-zero commitments, carbon taxes, and taxonomies that define and assess whether an activity or investment is sustainable. At the same time, global initiatives such as the International Financial Reporting Standards (IFRS) Sustainability Disclosure Standards and the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations have been introduced to increase transparency and comparability in sustainability-related reporting. Asset managers whom we interviewed highlighted that the tightening of regulations around ESG-labelled investment funds

"THE GENERATIONAL SHIFT THAT WE'RE SEEING IN TERMS OF THE OWNERSHIP OF LONG-TERM CAPITAL IS BEGINNING TO INFLUENCE HOW ASSET OWNERS ARE DEFINING THEIR MANDATES."

6. Agnew, H., Klasa, A., & Mundy, S. (2022, June 6). *How ESG investing came to a reckoning.* Financial Times. https://www.ft.com/content/5ec1df-cf-eea3-42af-aea2-19d739ef8a55
7. Gunion, M. (2023, May 15). *The rise of ESG investing.* Wealth Briefing. https://www.wealthbriefing.com/html/article.php?id=197951
8. Bank Exchange (2022, January 25). *Global ESG assets to hit $50 trillion by 2025.* https://m.bankingexchange.com/recent-articles/item/9103-global-esg-assets-to-hit-50-trillion-by-2025#:~:text=Global%20ESG%20assets%20may%20surpass,-by%20Bloomberg%20Intelligence%20(BI).

has impacted their product offerings. Investment funds now must provide relevant information to better substantiate the "ESG" label. Some of the disclosures under the guidelines include details on the ESG fund's investment strategy, criteria and metrics used to select the investments, and any risks and limitations associated with the fund's strategy.[9] Overall, while regulations have helped to increase standardisation and promote sustainable investing, companies and investors have had to develop capabilities and processes to meet those rules. "Regulations are both a help and a hindrance. While they encourage transparency and disclosure, they are also potentially a bit of a hindrance if each market is doing it in their own slightly different way," explains an asset manager who participated in the research.

III. Shifting investor profile. Over the next 25 years, an estimated USD 100 trillion worth of assets will transfer from the baby boomer generation to their heirs, mainly millennials and Gen Zs,[10] and this will change the dynamics of sustainable investing. Nearly two-thirds of Gen Z investors and 59 per cent of millennials want to allocate their portfolios in a way that supports causes they care about.[11] Data further suggests that 82 per cent of Gen Z and close to two-thirds of young millennial investors have exposure to ESG investments.[12] Research also suggests that young investors are willing to give up returns to pursue their values and beliefs. More than four-fifths of Gen Zs and millennials are willing to accept underperforming the S&P 500's 10-year average return of 12 per cent to ensure that the companies where they have invested align with their values and belief systems.[13]

IV. Significant regional differences. Research participants, especially those with global presence, highlighted that the investing scene varies considerably both within Asia and when comparing Asia to other regions. According to the Organisation for Economic Cooperation and Development (OECD), while many jurisdictions in the region have issued ESG disclosure guidance to further strengthen practices and address challenges, ESG practices have developed at noticeably different speeds across Asian economies.[14] Some Asia-Pacific jurisdictions, such as Japan, have seen a strong increase in ESG coverage and investing, while other economies have progressed less quickly and are at varying stages of adoption.[15] "I think companies in Asia are very conservative, so if you are somebody they trust, then they will listen to (your) opinions, but if you are just another global investor, penetrating Asia will be harder," shares an asset manager. She adds: "Ownership structure in Asia is different; there are many 'Asias' rolled into one from a diversity standpoint, and language and cultural barriers are hard to overcome if you are a foreigner."

V. Rising anti-ESG sentiments. Recent developments in several states in the US, particularly

9. Invesco (2022, May 30). *ESG regulation in Asia.* https://www.invesco.com/apac/en/institutional/insights/esg/esg-regulation-in-asia.html
10. Zeng, Y. (2023, June 20). *ESG regulatory approaches appear to be diverging in Europe and Asia.* Thomas Reuters. https://www.thomsonreuters.com/en-us/posts/esg/esg-regulatory-approaches-europe-asia/#:~:text=The%20European%20perspective%20is%20all,bigger%20impact%2C%E2%80%9D%20she%20added.
11. Alim, A. N. (2023, August 23). *The transfer of wealth from boomers to 'zennials' will reshape the global economy.* Financial Times. https://www.ft.com/content/63027e28-724a-40bc-a929-7dec5125926c
12. Harring, A., & Kim, H. (2023, August 27). *'Not just money and math': Young people are willing to sacrifice returns for ESG.* CNBC. https://www.cnbc.com/2023/08/27/not-just-math-and-numbers-young-people-are-willing-to-sacrifice-returns-for-esg.html
13. Chan, G. (2022, June 26). *ESG investing not just for millennials and Gen Z: Survey.* The Straits Times. https://www.straitstimes.com/business/invest/esg-investing-not-just-for-millennials-and-gen-z-survey
14. Harring, A., & Kim, H. (2023, August 27). *'Not just money and math': Young people are willing to sacrifice returns for ESG.* CNBC. https://www.cnbc.com/2023/08/27/not-just-math-and-numbers-young-people-are-willing-to-sacrifice-returns-for-esg.html

after Texas passed an anti-ESG investing bill in 2021,[16] highlight the rising backlash against investing strategies that factor in ESG issues. Research participants caution that such developments are beginning to impact the way managers integrate ESG considerations into their funds. Research has shown a rise in "anti-ESG" funds.[17] Such funds include "sin" stocks like gun and tobacco makers; funds with explicitly conservative values; funds that once followed ESG principles but have since renounced them; passive funds that vote against ESG-driven shareholder proposals; and "true anti-ESG" funds that buy companies with low ESG scores on the grounds that they are undervalued.[18] In fact, Morningstar research identifies 27 investment funds as anti-ESG. Together, they manage assets worth USD 2.1 billion as of the first quarter of 2023.[19]

VI. Increasing awareness about investment stewardship. The last few years have seen a rapid rise in investment stewardship practices, a fundamental component of sustainable investing. Armed with strategies to influence companies through shareholder engagement and voting, big and small investors are claiming asset stewardship as central to their investment strategy. The uptake in investment stewardship is also fuelled by several countries introducing stewardship codes or principles. According to the Singapore Stewardship Principles for Responsible Investors, "Effective investment stewardship is investors exercising responsible allocation, management and oversight of capital, through active ownership and engagement, to create and preserve enterprise value within portfolio companies and improve long-term risk-adjusted returns for clients and beneficiaries."[20] At a high level, investors' engagement strategies can be divided into two types—one where the investment team is in charge, and the other where the mandate is split between the investment team and an ESG/stewardship team.[21] "Stewardship is a fundamental building block of any active investor. It is a mechanism to help our clients manage the money and ensure a responsible investment mindset based on inclusive capitalism," elaborates an asset manager.

14. OECD (2023). *Sustainable Finance in Asia: ESG and climate-aligned investing and policy considerations.* https://www.oecd.org/finance/Sustainable-Finance-Asia-ESG-climatealigned-investing-policy-considerations.pdf
15. OECD (2023). *Sustainable Finance in Asia: ESG and climate-aligned investing and policy considerations.* https://www.oecd.org/finance/Sustainable-Finance-Asia-ESG-climatealigned-investing-policy-considerations.pdf
16. Ahmed, A. (2023, June 12). *Lawmakers passed a bill to stop insurers from considering ESG criteria in setting rates.* The Texas Tribune. https://www.texastribune.org/2023/06/12/texas-legislature-insurance-esg-rates/
17. Wooldridge, S. (2023, July 21). *'Anti-ESG funds' are now a thing.* Treasury & Risk. https://www.treasuryandrisk.com/2023/07/21/151438-411-30189/?slreturn=20231004015833#:~:text=The%20Morningstar%20report%20notes%20that,the%20first%20quarter%20of%202021.
18. Armstrong, R. (2023, September 26). *Anti-ESG investing.* Financial Times. https://www.ft.com/content/0caf08cd-88d8-4c17-b694-b5ed757b0b47
19. Armstrong, R. (2023, September 26). *Anti-ESG investing.* Financial Times. https://www.ft.com/content/0caf08cd-88d8-4c17-b694-b5ed757b0b47
20. Singapore Stewardship Principles for Responsible Investors (2022). https://stewardshipasia.com.sg/docs/saclibraries/default-document-library/ssp_for-20responsible-20investor-202-0-1-.pdf?sfvrsn=82133969_3
21. Nilsson, R. (2023, February 10). *Stewardship: From more to better.* ESG Investor. https://www.esginvestor.net/stewardship-from-more-to-better/

Diagram 1: INVESTOR PARADOX WHEEL

Shifting Investor Profile
Regional Differences
Anti-ESG Sentiment
Investment Stewardship
Increasing Demand
Evolving Regulations

EXCLUSION Ensure capital does not support "harmful" businesses
INFLUENCE Prioritising active ownership
SOLO ENGAGEMENT Prioritising bilateral engagement
LONG-TERM Prioritising long-term value creation
DUTY OF LOYALTY Act in the sole interest of beneficiaries
VALUES Investing based on values alignment
INCLUSION Help businesses embrace positive ESG efforts
SCALABILITY Dedicating resources for engagement
COLLABORATIVE ENGAGEMENT Open to partnering with other investors
SHORT-TERM Prioritising short tern gains
DUTY OF PRUDENCE Balance risk and return objectives
VALUE Investing for returns (or alpha)

INVESTOR

STRATEGISE (Policy, strategy development)
INTEGRATE (ESG analysis and Integration)
ENGAGE (Engagement, advocacy, voting)

Source: SAC Research, 2023.

SIX PARADOXES INVESTORS MUST NAVIGATE

Amidst the backdrop of increasing demand for sustainable investing, asset managers and asset owners are grappling with multifaceted dilemmas that result from the interplay of the six key drivers mentioned above—increasing popularity of sustainable investing, continuous evolution of regulations, shifts in investor profiles, regional differences in ESG priorities, emergence of anti-ESG sentiment, and increased appreciation of investment stewardship.

In response to these six dilemmas, investors must undertake three key actions—*strategise, integrate* and *engage* (Diagram 1). Strategy development entails curating investment policies, beliefs, and guiding principles for their investment philosophy. Investors must embrace ESG analysis and sharpen processes and methodologies for ESG integration. They must invest in stewardship and other engagement activities, including but not limited to participating in dialogues with investees and proxy voting.

Beneath these three key actions lie multiple investors' uber-dilemma that revolves around optimising financial returns while harmonising investment choices with ethical, environmental and social principles. This instead presents investors with numerous paradoxes, including "value and values," "inclusion and exclusion," "duty of prudence and duty of loyalty," and others, each requiring a balanced approach to achieve effective execution, as illustrated in Diagram 1. These paradoxes extend much beyond "either/or" choices to "both/and" actions that investors must balance or execute in alternate succession.

The *Investing for a Better World: Navigating 6 Paradoxes* research delves into these six paradoxes or polarities that investors must navigate as they pursue their sustainable investing agenda. In seeking to unravel these paradoxes and complexities, the study aims to ignite a meaningful discourse on the potential of investors as agents of change to shape a better world.

The subsequent sections of this study elaborate on each of the six paradoxes.

Investment Philosophy

VALUE AND VALUES

Investor dilemma: How to deliver value, without compromising values?

The shareholder theory posits that businesses have the obligation to maximise profits and returns for their shareholders, who are seen as owners of the business.[22] Investors who subscribe to this theory aspire to extract maximum financial benefits from their investments and measure success using the rate of return achieved on capital deployed. However, in recent years, there is an increasing number of investors who are no longer content with the traditional profit motive; they want their money to do more than just multiply. Such individuals and institutions see their investments as powerful vehicles for expressing their values and enacting meaningful change. They want to align their investments with their personal or organisational beliefs. A subset of investors may even seek to generate social value through their investments by focusing on addressing societal challenges and fostering equitable growth.

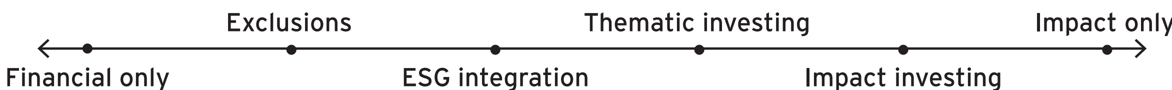
Value investing is the idea of investing in an undervalued company based on its fundamentals, motivated by an economic gain. In the context of ESG, value-based investing is concerned with how ESG factors may impact financial performance while potentially adding value for shareholders. Value-based investors integrate financially material ESG issues to understand the risk and returns on a company stock or a portfolio.

In contrast, a values-based investing approach aligns investments with environmental, political or religious beliefs, among others. Such investors own stocks only in companies whose business, strategy and operational practices align with their moral values, and exit stocks in companies that do not. Values-based investing has been adopted for decades in the form of investing practices being influenced by non-financial considerations, often relating to social or environmental issues. Quakers, for instance, were leaders in the anti-slavery movement; they decided not to engage in businesses relating to slavery.[23] In the 1980s, apartheid-dominated South Africa faced a serious investment boycott from the rest of the world.[24]

Our conversations with asset owners and asset managers reveal that it is possible to combine values-based investing with the pursuit of financial return without sacrificing one for the other. Yet, our findings also highlight challenges in quantifying the precise impact of ESG investments on overall performance. "Most investors operate along the financial value, personal or organisational values, and social value spectrum, and it is not a static position or a one-way street," shares the sustainability head at a global fund. Diagram 2 highlights key investment approaches along the value-values (capital) spectrum.

22. Smith, H. J. (2003, July 15). The Shareholders vs. Stakeholders Debate. MIT Slogan Management Review. https://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/
23. University of York (n.d.). *Quakers and slavery.* https://www.york.ac.uk/borthwick/holdings/research-guides/race/quakers-and-slavery/#:~:text=The%20Society%20of%20Friends%20(known,in%20the%20Anti%2DSlavery%20Society.
24. Counts, C. (2013, January 27). *Divestment was just one weapon in battle against apartheid.* The New York Times. https://www.nytimes.com/roomfordebate/2013/01/27/is-divestment-an-effective-means-of-protest/divestment-was-just-one-weapon-in-battle-against-apartheid

Diagram 2: The Capital Spectrum



DELIVERING FINANCIAL VALUE

FOCUSING ON VALUES AND DELIVERING SOCIETAL IMPACT

Source: Bridges Fund Management, 2015 and G8 Social Impact Investment Taskforce, Asset Allocation Working Group, 2014.[25]

As we progress along the capital spectrum, motivations for pursuing financial returns shift. At one end of the spectrum, investor interest centres on maximising financial returns. On the other, the focus is on maximising positive impact on society and the environment.

The most "straightforward" form of sustainable investing involves the exclusionary screening of "sin stocks" or investment in controversial industries such as tobacco, gambling, guns and adult entertainment. This was traditionally the investing strategy of choice for religious-leaning pension funds and university endowments. As climate concerns become a big issue, some investors have also phased out coal or other fossil fuel investments in favour of companies that generate and rely on renewable resources. Most asset managers offer positive and negative screens based on their own investment beliefs that may align with the values of asset owners, especially for specific mandates.

Other investors may apply ESG integration, which involves considering environmental, social and corporate governance information along with traditional fundamentals in stock selection, mainly to evaluate outside-in risks and enhance risk-adjusted returns. According to interviewees, ESG integration is a norm amongst investment managers as they make it part of their fundamental analysis process.

As the trend of values-based investing gains prominence, more investors pursue sustainable investments aligned with specific thematic areas such as clean energy, food security and waste management. Changing investor demographics is one key driver of values-based investing. According to an Ernst & Young report, investors in their 20s and 30s are twice as likely to invest in companies or funds that target positive environmental or social outcomes.[26]

As investors progress along the capital spectrum, they tend to focus more on the inside-out impact of their investments. First introduced in 2007, "impact investing" takes a more proactive approach to ensure a measurable positive impact on society and the environment.[27] These investments aim to promote sustainable and ethical practices and focus on projects that address pressing social and environmental challenges such as climate change, financial inclusion, and accessibility to basic services including housing, healthcare and education.[28] Impact investing is primarily practised by private equity firms and family offices.

At the far right of the spectrum, investors are focused on creating the maximum possible impact, even if it does not generate financial returns. This type of investing is often referred to as "philanthropic capital."

25. Bridges Fund Management (2015). *The Bridges Spectrum of Capital: how we define the sustainable and impact investment market.* https://www.bridgesfundmanagement.com/wp-content/uploads/2017/08/Bridges-Spectrum-of-Capital-screen.pdf; G8 Social Impact Investment Taskforce, Asset Allocation Working Group (2014).https://thegiin.org/assets/documents/Webinar%20Slides/GIIN%20Webinar%20%20-%20%20G8%20Asset%20Allocation%20Working%20Group%20Presentation.pdf
26. EY (2017). *Sustainable investing: The millenial investor.* https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/financial-services/ey-sustainable-investing-the-millennial-investor.pdf
27. Madsbjerg, S. (2018, August 15). *Bringing scale to the impact investing industry.* The Rockefeller Foundation. https://www.rockefellerfoundation.org/blog/bringing-scale-impact-investing-industry/
28. Global Impact Investing Network (n.d.). *What you need to know about impact investing.* https://thegiin.org/impact-investing/need-to-know/#:~:text=The%20growing%20impact%20investment%20market,housing%2C%20healthcare%2C%20and%20education.

KEY MESSAGES

I. Values-based investing may or may not require sacrificing financial returns. Practitioners' opinions are somewhat split on the impact of investment approaches on financial returns. While some practitioners share that investors seeking values alignment and those seeking to create social value (impact investing) may have to tolerate some sacrifice on financial returns, others disagree. "I think it is a very big misconception in Asia that you have to sacrifice your financial return to achieve ESG or impact investing," shares a research participant. He adds: "We only invest in those companies because we feel they are giving us a better return in the long term and as an investor, financial return is always our priority." Some asset managers claim to provide their investors values alignment with no financial concession, while others also promise "excess financial return" or "alpha." A subset of the asset manager community is also quite confident of social value creation without sacrificing financial return, even delivering social value through non-concessionary investments. However, some interviewees underscore the limits in striking this balance. "While it seems possible to achieve values alignment with limited financial concessions if the investors are patient and think long-term, it is much harder to create social value while earning full risk-adjusted financial returns," cautions an asset manager.

"WHILE IT SEEMS POSSIBLE TO ACHIEVE VALUES ALIGNMENT WITH LIMITED FINANCIAL CONCESSIONS IF THE INVESTORS ARE PATIENT AND THINK LONG-TERM, IT IS MUCH HARDER TO CREATE SOCIAL VALUE WHILE EARNING FULL RISK-ADJUSTED FINANCIAL RETURNS."

II. Pursuing social values and impact may be easier in private equity markets. Socially responsible or ethical investments take place in public equity markets through public mutual funds that screen their portfolios to exclude companies whose activities may be considered unethical by investors. Such funds hold themselves out to investors as being capable of earning non-concessionary returns; they are expected to earn at least risk-adjusted market returns. However, while there are public market options for impact investing, it is most commonly done through private market limited partnership structures like private equity and venture capital funds.

One of the impact investors we interviewed shares the key reason for this divide. He explains that impact investing needs three conditions—intentionality, measurement and additionality. While the first two can be met while investing in listed companies, including indexed funds or exchange traded funds, additionality is hard to establish. "Additionality is doable when

you're in an unlisted private equity. You own 80 per cent of the firm and can tell the board what to do," he explains. Another interviewee explains the concept of additionality using an example of a telephone company. If an impact investor believes that mobile telephony can create tremendous social and economic benefits in an underdeveloped country, the investor might invest in a start-up instead of a global telecom corporation. Unlike the global telecom corporation with possible access to additional capital for expansion through public equity space, the start-up may not have access to capital. By investing in the start-up, the investor action can result in more mobile phone access in the underdeveloped country. Private equity investments allow greater control over assets and are generally subject to less public scrutiny, enabling investors to work with investee companies' management teams and boards to align specific values and long-term objectives.

III. Beneficiaries drive values commitment. While most investors speak effusively about values in their investment approach, they may vary in their authenticity. How asset owners balance value and values are driven by various factors. Pension funds, for instance, usually have a long-term investment horizon, since their commitments to their beneficiaries can span decades. "Pension funds need to safeguard the portion of money that everybody puts into their pension and ensure that there is sufficient money to return, so they are concerned about long-term value in driving sustainability," explains a regional sustainability lead. Their investment behaviour will be driven by the prevailing government's view on sustainability, she adds, explaining that some countries inherently embrace a more values-driven approach than others. "Swedish pension funds are different from Asian ones because the stakeholders that put money in the Swedish pension system believe in long term climate sustainability." Sovereign funds in countries that are at the forefront of environmental sustainability may also have a values-heavy stance since they cannot contradict the government's mandate. Some pension funds that are dedicated to a special community—for instance, Stichting Pensioenfonds Medisch Specialisten (SPMS), the Dutch pension fund for self-employed medical specialists, and the HESTA Super Fund, an Australian industry superannuation fund for people working in health and community services—demonstrate a values-driven approach towards specialised themes like antimicrobial resistance or global health issues because of the demands of underlying beneficiaries. Another practitioner, the chief investment officer at a private equity firm, highlights that family offices may have a more values-driven approach since they often don't deal with fiduciary capital. "We've seen situations where families are happy with 5 per cent returns or they just want to match inflation, with other objectives of pursuing a gender, education or renewable energy agenda," he adds.

Managing the Value-Values Paradox

Is there a choice that investors need to make on value- or values-based investing? Perhaps not. When considering values-based investing, one cannot disregard value. "Value is a given," shares an academic in a European finance institute. He adds: "We are talking about three zones: 'green zone' of financial returns, 'red zone' of purely non-financial returns, and then a 'grey zone' with an overlap; even so-called responsible investors will never operate in the 'red zone.'" "I think majority of this transition is happening because of the value it creates, not because people are applying some kind of values system," concurs the managing director at an impact investment firm. An Asia-Pacific (APAC) leader of a global asset management company primarily in the Exchange-Traded Fund (ETF) space further clarifies: "The purpose of our stewardship activities is to make sure that at the end of the day, we are generating financial returns for our clients over the longer term. We're not here to get the world to a greener place, we're not here to achieve some social justice; we're here to make sure that these companies we're invested in, that our clients are invested in through us, are generating value over the long term, because we're permanently locked in for the long term."

"I THINK MAJORITY OF THIS TRANSITION IS HAPPENING BECAUSE OF THE VALUE IT CREATES, NOT BECAUSE PEOPLE ARE APPLYING SOME KIND OF VALUES SYSTEM."

Value and values do not sit on the opposite side of the scale and should not be seen as mutually exclusive. "Value-values choice is like managing the affairs of your family; you don't see a compromise between the well-being of your family and the values that you embrace to conduct your family affairs," explains the managing director at a global asset management company. So, it is about finding the right balance to deliver on both fronts—financial returns and values-driven outcomes. Some investors view values as "additional constraints" that investment managers need to work with. Investors need to find a solution to outperform the benchmark returns and integrate sustainability characteristics, without compromising their investment beliefs or values.

Peer Advice

BE AWARE OF YOUR INVESTMENT BELIEFS

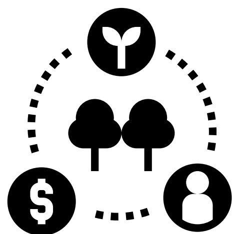
"Understand where you stand on the values spectrum; are you about investing in companies that do no harm, or companies dedicated to doing good, or will you focus on financial materiality, or impact materiality?"

BE AUTHENTIC AND WALK THE TALK

"Authenticity is the key driver; many banks are trying to promote the (values) narrative and promising concession-free returns, but hardly any are putting their own capital where their mouth is."

MANAGE TONE AT THE TOP

"While the analyst on the ground has some leeway on what is important, how far we go on value and values is driven by whoever calls the shots within the senior leadership team."



Responsible Investing

EXCLUSION AND INCLUSION

Investor dilemma: How to balance "doing more good" with "doing less harm"?

Asset managers take varying approaches when shaping their investment portfolios. Some asset managers adopt firmwide exclusionary mandates while others offer funds that screen certain exposures, typically based on industry products or percentage of revenue earned from an activity or product. The most common exclusions include "sin" stocks such as pornography, alcohol, gambling, tobacco and weapons. Some firms also embrace climate and fuel-based exclusions for coal and nuclear energy. Inclusive investing, on the other hand, involves investing in firms that are making consistent efforts in managing and promoting social and environmental issues. For example, ESG investing, particularly transition financing, is an inclusive approach. It aims to encourage firms that engage in positive environmental, social and governance efforts.

While most investors will have positive or negative screens in place, some are stricter than others. For instance, Quebec-based pension fund Caisse de depot et placement du Quebec (CDPQ),[29] California Public Employees' Retirement System (CalPERS),[30] Nippon Life[31] and Pensioenfonds ING[32] consider fossil fuels-based screens and exclusions. On the other end of the spectrum, Japan's Government Pension Investment Fund and Prudential, Inc., like most investors, have a strong leaning towards transition financing.

A fundamental question that investors are often presented with is the following: Do exclusionary policies encourage or hinder efficient market allocations towards long-term value creation and sustainability? Should investors build a portfolio with strong ESG credentials by adhering to a strict exclusionary policy, or should they have a more diverse portfolio of green and brown companies and try to enact change in these companies? Our conversations with experts and stakeholders reveal that many investors combine both exclusionary and inclusionary approaches. However, they highlight that the decision is often not straightforward as there are costs for pursuing exclusionary policies. Moreover, current policies to reduce brown investments and accelerate green investments are hindering capital allocations to a just transition.[35]

29. Keidan, M. (2021, September 29). *Canada's second-largest pension fund says first to exit oil assets.* Reuters. https://www.reuters.com/business/sustainable-business/canadas-second-largest-pension-fund-caisse-reveals-new-climate-targets-2021-09-28/
30. Callahan, M. (2023, May 26). *The Press Democrat: California State Senate passes CalPERS/CalSTRS fossil fuel divestment bill.* California State Senate. https://sd33.senate.ca.gov/news/2023-05-26-press-democrat-california-state-senate-passes-calperscalstrs-fossil-fuel-divestment
31. Uranaka, T. (2018, July 23). *Japan's Nippon Life to stop financing coal-fired power.* Reuters. https://www.reuters.com/article/us-japan-coal-divestment-idUSKBN1KD08P
32. Hoekstra, T. (2023, July 3). *Pensioenfonds ING anticipates 20% benefits increase in new DC system.* IPE. https://www.ipe.com/pensioenfonds-ing-anticipates-20-benefits-increase-in-new-dc-system/10067530.article#:~:text=Fossil%20fuel%20divestment,removed%20from%20the%20investment%20portfolios
33. Government Pensions Investment Fund (2023). *Operation Policy.* https://www.gpif.go.jp/en/info/operation_policy_20230117.pdf
34. Prudential plc (2022). *Supporting a just and inclusive transition.* https://www.prudentialplc.com/~/media/Files/P/Prudential-V13/content-pdf/prudential-plc-just-and-inclusive-transition-white-paper.pdf
35. Fanizza, M. D., & Cerami, L. (2023). *A Market for Brown Assets To Make Finance Green.* International Monetary Fund.

KEY MESSAGES

I. There are implicit costs associated with exclusionary policies. Interviewees suggest that while, in some instances, exclusionary policies may be best aligned with investment beliefs, there are several insidious implications investors must consider. The underlying goal of promoting green and discouraging brown investments is to lower the cost of financing for green firms and raise it for brown firms.[36] While this strategy may seem logical, it may not be practical and can lead to counterproductive consequences.

"YOU DON'T WANT TO BLINDLY EXCLUDE THEM (BROWN INVESTMENTS) WITHOUT TRYING TO UNDERSTAND WHAT THEY ARE DOING TO CLEAN THEIR OWN EMISSIONS AND UNDERSTAND WHETHER THOSE ARE THOUGHTFUL ACTIONS ON THEIR PART THAT WE NEED TO ENCOURAGE."

For instance, emissions from excluded companies do not disappear from the environment. These companies may, at best, only disappear from the public equities market, where they are heavily scrutinised. Removing public scrutiny in fact may be counter-productive because such a move makes it easier for these companies to increase their output and emissions, extending their lifespans.[37] "You may have gotten it (brown investment) off your balance sheet, but it did not change anything for the world in general because the plant is still operating with someone else, who may not be as transparent, running it," elaborates an interviewee.

The other negative side effect of exclusion is that it starves capital from high-emitting companies, sectors, and countries that are actively trying to decarbonise. Such firms need capital to fund their decarbonisation strategies and excluding them slows down their transition. "You don't want to just blindly exclude them (brown investments) without trying to understand what they are doing to clean their own emissions and understand whether those are thoughtful actions on their part that we need to encourage," shares an interviewee.

Practitioners also caution against a highly selective investment approach, since it limits the universe of "investible" companies, thereby negatively impacting the overall risk of the portfolio. As one practitioner shares, "There is no foolproof methodology to screen out certain factors, and there are limitations to what we can exclude unless clients are willing to take the cost of an increased tracking error." Besides, exclusionary policies may

36. Allen, S. (2023, May 15). Green investing could push polluters to emit more greenhouse gases. Yale Insights. https://insights.som.yale.edu/insights/green-investing-could-push-polluters-to-emit-more-greenhouse-gases

37. Erne, B. (2018, July 21). Inclusive or exclusive approach to SRI: Which is right for you? Triple Pundit. https://www.triplepundit.com/story/2018/inclusive-or-exclusive-approach-sri-which-right-you/11491

not reduce risk or align with the investors' perception of a sustainable portfolio if the decision is purely informed by ESG ratings and scores, which are highly subjective with little or no corelation among the ratings from different agencies/sources. For instance, an exclusionary policy may have unintended consequences of omitting investments that are sustainable, when a company that promotes green solutions is ranked lower than a company operating in the brown industry. A study found that the top 20 per cent of companies in the tobacco and energy universe rank above the MSCI world average.[38]

II. "Starving" brown companies has more downside than upside. Kelly Shue of Yale School of Management and Samuel Hartzmark of the Carroll School of Management at Boston College studied emissions data from over three thousand large companies from 2002 to 2020.[39] They divided firms into five different segments based on greenhouse gas emissions (adjusting for revenue, because larger companies generally emit more than smaller ones). Then, using historical data, they analysed how the highest- and lowest-emitting groups responded to changes in their cost of capital. They concluded that when investors "punish" brown firms, they become even more short-term oriented and ultimately pollute more.

On the other hand, rewarding firms that are already green does little to improve their environmental impact since most tend to be in the insurance, healthcare and financial services industries. Besides, punishing brown firms with expensive financing discourages them from investing in green technology that could reduce emissions. The study discovered that the average brown firm has 261 times the emissions of the average green firm. So, if a brown firm changes in either direction by just one per cent, that may be way more meaningful than a typical green firm changing its emissions by 100 per cent.[40] Interviewees caution that indiscriminate ESG exclusion policies by pension trustees have the potential to hinder rather than enhance the financial performance of their funds.

III. Size, span and scope of transitioning company matters. Engaging with big companies is a crucial element in driving transitions, particularly in the context of economic, social or environmental change. A case in point is the automotive industry which accounted for 21 per cent of global emissions in 2020.[41] While Tesla may lead the way in electic vehicle (EV) production, in 2020 the company sold just 500,000 EVs—less than 1 per cent of the 70 million cars sold globally.[42] In contrast, Volkswagen, a company that was embroiled in an emissions scandal a few years ago, holds a 6.7 per cent share of the market in 2022. Therefore, car manufacturers such as Toyota, Volkswagen and Renault Nissan, which sold more than 30 million vehicles combined during the same period, could potentially play a large part in solving for limiting road transport emissions.[43] Hence, encouraging

38. Boffo, R., and R. Patalano (2020). *ESG Investing: Practices, Progress and Challenges.* OECD Paris. www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf

39. Allen, S. (2023, May 15). *Green investing could push polluters to emit more greenhouse gases.* Yale Insights. https://insights.som.yale.edu/insights/green-investing-could-push-polluters-to-emit-more-greenhouse-gases

40. Allen, S. (2023, May 15). *Green investing could push polluters to emit more greenhouse gases.* Yale Insights. https://insights.som.yale.edu/insights/green-investing-could-push-polluters-to-emit-more-greenhouse-gases

41. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

42. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

43. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

such companies to transition away from internal combustion engines to zero emissions vehicles, based on EVs or hydrogen fuel cells, has a much higher return on efforts.

While large fossil fuel companies may have a long and complex transition pathway, the impact of even a small needle movement can be sizeable. Consider the Danish utility provider Ørsted, which is one of the leading providers of offshore wind power, accounting for approximately 25 per cent of generation worldwide.[44] A decade ago, however, Ørsted, then known as Dong Energy,[45] was a traditional oil and gas company with exposure to coal powered generation. While Ørsted is still in the process of completing its transition, with approximately 11 per cent[46] of power generation still from non-renewable sources, there is a clear plan in place for a complete phase out of non-renewables. The company's transition has already led to a reduction in the level of carbon emissions of more than 72 per cent,[47] a massive positive environmental impact. Clearly, without the capital and shareholder support provided by investors during Ørsted's transition, the process would not have been possible, and the level of emissions avoided not achieved. Practitioners therefore argue that while it may seem counter-intuitive, engaging with, and supporting, companies in their transition can generate disproportionate positive social and environmental impact.

Managing the Exclusion-Inclusion Paradox

Many research participants suggest deploying "influence" or "stewardship practices," rather than just screening investments, as a more astute option. "I think there are three ways to look at it (exclusion and inclusion), and that is where stewardship comes in; I'm ready to invest in most businesses because I recognise the societal need, but I'm also mindful of the potential environmental damage some businesses may directly or indirectly cause," explains an interviewee. He adds: "So I use my position as an investor to facilitate the 'brown' to 'green' transition." He further elaborates that instead of divesting from brown firms, it may be worthwhile to try to influence such firms by gaining board seats and shifting corporate strategy in a more environmentally friendly direction. Another points out, "Doing good is about engaging over a long-term with companies that present the highest ESG risks, so I would not associate investors who have a highly exclusionary approach to be necessarily doing good."

44. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

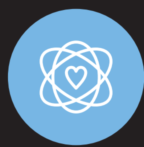
45. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

46. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

47. Jones, O. (2022, March 18). *Investing in transitioning companies is part of the ESG solution.* FT Advisor. https://www.ftadviser.com/investments/2022/03/18/investing-in-transitioning-companies-is-part-of-the-esg-solution/

Asset managers often offer a bouquet of products aligning with different strategies. They may offer closed-end mutual funds or ETFs that align with an exclusion policy based on the firm's investment beliefs. They may also have assets that are subject to client specific mandates, and such offerings offer room for customisation. "While we may not be able to go too far away from our investment beliefs, we can customise the portfolio to client's aspirations in most cases," explains an interviewee. "It's a judgement call at the end of the day," comments another practitioner. "It's our view that we are better off being a part of the transition than to simply walk away," she elaborates. Most interviewees highlight that exclusion and inclusion is all about getting the right balance and aligning that with the firm's investment beliefs. "If your investment beliefs are out of line with the rest of the market, you run the risk of underperformance against the benchmark, so you've got this very difficult balancing act," explains an interviewee, highlighting the polarity.

Peer Advice

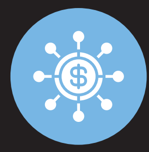


ALIGN YOUR INVESTMENT APPROACH WITH VALUES

"Be careful in applying the socially responsible filters; you want to align your investments to your values in a way that doesn't risk your performance—narrower the focus, the higher the risk of material performance deviations."

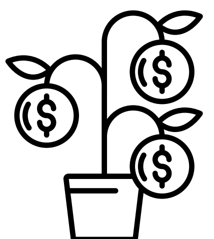
WORK TOWARDS THE RIGHT BALANCE

"If you track below the index for a year or two, you might get away with it. But anything longer and people may consider whether or not they should keep their mandate with you. So, there's an enormous pressure on asset managers on the one hand to demonstrate that they have a clear set of beliefs and a clear sort of ethical approach to what they're doing, but at the same time, not to diverge too far from the general market performance."



STRIVE FOR DIVERSIFICATION

"It's possible there may not be any socially responsible options in a specific asset class, but that absolutely doesn't mean you should weaken your portfolio by completely abandoning that asset class. Continue to incorporate both domestic and international equities, domestic and international bonds, and other alternatives, as diversification is critical to avoid materially impacting long-term returns."



Fiduciary Duty

PRUDENCE AND LOYALTY

Investor dilemma: How to fulfil the twin duties of prudence and loyalty while investing in ESG?

In recent times, particularly within the US, there has been a debate among lawmakers about ESG-related roles and obligations of pension fund managers and investment firms. The core debate revolves around whether adopting ESG practices represents a breach of fiduciary duty, which has resulted in a backlash against ESG investments. In the past few quarters, we have witnessed much lower inflow of capital into ESG funds. According to Morningstar, in the second quarter of 2023, global sustainable funds attracted USD 18 billion of new money, a significant reduction from the USD 31 billion attracted in the previous quarter.[48] A resurgence of fossil fuels and weapon stocks, owing to global conflicts and the resulting energy shortage, has only strengthened the narrative of ESG critics.[49]

The anti-ESG sentiment gained traction when Texas passed an Anti-ESG Investing Bill in 2021, banning certain government entities from transacting business with financial institutions boycotting guns and the oil and gas industry, main sources of revenue for the state.[50] By December 2022, 18 states proposed or embraced anti-ESG regulations,[51] arguing that ESG distracts firms from fulfilling their fiduciary duty. As a result, multiple states have withdrawn state funds from ESG-supporting investment firms. ESG critics argue that ESG is the pursuit of environmental or social goals without the public policymaking and elections, essentially blending moral considerations with consumerism.[52] According to such critics, investors should focus on profit generation rather than advocating social or environmental causes to conform to the trends of "woke capitalism."[53]

Opposition to the use of ESG factors also stems from confusion on how ESG performance is measured.[54] Approaches to ESG performance evaluation lack comparability and transparency, often resulting in inconsistent performance rating outputs from different sources. The fact that ESG funds have not outperformed benchmark funds also strengthens the arguments of ESG critics. According to Bloomberg, the 10 biggest ESG funds could not match the S&P 500 performance in 2022.[55]

48. Smith, O. (2003, July 27). *ESG flows stall as global headwinds hit.* Morningstar. https://www.morningstar.co.uk/uk/news/237619/esg-flows-stall-as-global-headwinds-hit.aspx
49. Rajan, A. (2023). *The future of ESG after the bear market: Passive investing 2023.* DWS. https://download.dws.com/download?elib-assetguid=d12bb36175c54d748e411f32bc11eb7d
50. Ferman, M. (2022, August 24). *Texas bans local, state government entities from doing business with firms that "boycott" fossil fuels.* The Texas Tribune. https://www.texastribune.org/2022/08/24/texas-boycott-companies-fossil-fuels/
51. Bischoff, B. (2022, December 13). *Anti-ESG legislation in the USA: Emerging risk for financial institutions?* Morningstar. https://www.ecofact.com/blog/anti-esg-legislation-in-the-usa-emerging-risk-for-financial-institutions/
52. Aschieris, S. (2023, January 31). *ESG Is 'Terrifying,' 'Problematic' Concept in Investing. Author and Entrepreneur Vivek Ramaswamy Explains Why.* Morningstar. https://www.dailysignal.com/2023/01/31/esg-is-terrifying-problematic-concept-in-investing-author-financial-adviser-vivek-ramaswamy-explains-why/
53. Tong, S., Ryan, J., & Welch, C. (2023, April 27). *Investor argues ESG investing is about measuring risk, not politics.* Wbur. https://www.wbur.org/hereandnow/2023/04/27/esg-investing-woke-vivek-ramaswamy
54. Berg, F., Koelbel, J. F., & Rigobon, R. (2022). Aggregate confusion: The divergence of ESG ratings. *Review of Finance*, 26(6), 1315-1344.
55. Quinson, T. (2022, December 7). *Big ESG funds are doing worse than the S&P 500.* Bloomberg. https://www.bloomberg.com/news/articles/2022-12-07/big-esg-funds-are-doing-worse-than-the-s-p-500-green-insight

The central question driving the anti-ESG argument is whether incorporating ESG criteria into investment analysis compromises potential investment returns and introduces an element of subjectivity into asset allocation. Investors across the globe must reflect on their role as trusted advisors and the scope and span of their commitment towards the financial success of their beneficiaries.

The paradox fund managers must navigate is to play the fiduciary duty of "prudence" as well as "loyalty," two of the elements that define fiduciary duty.[56] The fiduciary duty of loyalty states that the trustee must act in the sole interest of the beneficiary, while the duty of prudence points that the trustee must construct a diversified portfolio with risk and return objectives reasonably suited to the purpose of the trust, which could in some instances be at the expense of financial returns of the beneficiary.[57]

KEY MESSAGES

I. Duty of prudence is rooted in financial materiality. Opinions across the world are clearly split on ESG investing and its interplay with fiduciary duty. While some claim that ESG investing is a breach of fiduciary duty, others strongly feel that not considering ESG is a breach of fiduciary duty. Anti-ESG groups note that investments intended to benefit third parties (e.g., society) violate the duty of loyalty. On the other hand, pro-ESG groups argue that investments that ignore material environmental, social or governance risks violate the duty of prudence.

Critics cite the decision made by CalPERS more than two decades ago, when their divestment from tobacco stocks cost the pension fund an estimated USD 3.6 billion.[58] They also often criticise ESG-minded firms that have divested from oil and gas, citing the booming oil and gas sector, which racked up record profits in 2022.[59]

Supporters, however, claim that relevant and material E, S and G issues are financial (as opposed to "non-financial"). Even if they are not immediately financial, they may well be financial in the future. They also clarify that it is a fallacy that E, S or G issues must be certain to be considered material. Just like other performance drivers, ESG outcomes are uncertain and investment managers will differ in their evaluations.

56. Record Financial Group (n.d.). *For trustees of pension funds, what does trust law say about ESG investing?*. https://recordfg.com/to-esg-or-not-to-esg-fiduciary-duty-is-the-question/
57. Schanzenbach, M. M., & Sitkoff, R. H. (2020). Reconciling fiduciary duty and social conscience: the law and economics of ESG investing by a trustee. *Stan. L. Rev.*, 72, 381.
58. Diamond, R. (2018, December 12). *CalPERS Decision to Divest from Tobacco Is Costly.* Chief Investment Officer. https://www.ai-cio.com/news/calpers-decision-divest-tobacco-costly/
59. Rives, K. (2023, March 26). *A 'fiduciary question' looms large over the ESG debate in 2023.* S&P Global Market Intelligence. https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/a-fiduciary-question-looms-large-over-the-esg-debate-in-2023-73830569#:~:text=ESG%20critics%20also%20point%20to,and%20wealthy%20endowments%2C%20they%20said.
60. PRI (n.d.). *What are the Principles for Responsible Investment?* https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment#:~:text=Principle%201%3A%20We%20will%20incorporate,entities%20in%20which%20we%20invest.

The Principles for Responsible Investment (PRI) states that the fiduciary duties of loyalty and prudence require the consideration of ESG issues.[60] Introduced in 2006, the PRI is a UN-supported network of investors aligned with responsible investment.[61] The PRI encourages the investment community to integrate all material considerations, including ESG factors, as an effective way to create wealth for investors over the long term. The network bases judgement on the fiduciary duties of loyalty and prudence on three key points: 1) ESG incorporation is an investment norm; 2) ESG concerns are financially material; and 3) policy and regulatory frameworks are changing to require ESG incorporation. In some jurisdictions, investors that fail to incorporate ESG issues are failing their fiduciary duties and are increasingly likely to be subject to legal challenge.[62] "ESG investing is not a trade-off with the fiduciary duty of an asset manager; it should in fact be seen as executing on fiduciary duty," says an asset manager.

II. There are jurisdictional differences in interpretation of fiduciary duty. What complicates this debate are jurisdictional variations as to whom a fiduciary duty is owed and what factors may be considered by directors and managers. For corporate directors, interested parties could be shareholders or stakeholders, depending on the jurisdiction. Shareholders are parties that own a piece of the company, while stakeholders have an interest in the actions of the company.[63] The exact definition of stakeholder varies by the region, but usually refers to some combination of employees, customers, suppliers, community and the government.

"IF OUR CLIENTS SO WISH TO BE ABLE TO INVEST IN A CERTAIN WAY, OUR FIDUCIARY DUTY IS TO BE ABLE TO FIND THEM THE RIGHT SOLUTION."

In jurisdictions that adopt "stakeholder theory," such as most European countries, directors owe their fiduciary duty primarily to shareholders, while they may consider the interest of other stakeholders.[64] In some states of the US, where "shareholder primacy" remains prevalent, fiduciary duty is mainly limited to shareholder accountability.[65] For fund managers, the definition of fiduciary depends on a variety of factors. For instance, in jurisdictions where a directors' fiduciary duty includes both shareholder and stakeholder, it can be argued that ESG is not in conflict with the fiduciary duty. However, in jurisdictions where fiduciary duty is extended only to shareholders, the trade-off centred on ESG factors becomes less viable.[66]

61. PRI (n.d.). *What are the Principles for Responsible Investment?* https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment#:~:text=Principle%201%3A%20We%20will%20incorporate,entities%20in%20which%20we%20invest.
62. PRI and UNEP FI (n.d.). *Fiduciary duty in the 21st century.* https://www.unpri.org/download?ac=9792
63. McGowan, J. A. (2019, September 18). *The trouble with tibble: Environmental, social and governance (ESG) and fiduciary duty.* The University of Chigago Business Law Review. https://businesslawreview.uchicago.edu/online-archive/trouble-tibble-environmental-social-and-governance-esg-and-fiduciary-duty
64. McGowan, J. A. (2019, September 18). *The trouble with tibble: Environmental, social and governance (ESG) and fiduciary duty.* The University of Chigago Business Law Review. https://businesslawreview.uchicago.edu/online-archive/trouble-tibble-environmental-social-and-governance-esg-and-fiduciary-duty
65. McGowan, J. A. (2019, September 18). *The trouble with tibble: Environmental, social and governance (ESG) and fiduciary duty.* The University of Chigago Business Law Review. https://businesslawreview.uchicago.edu/online-archive/trouble-tibble-environmental-social-and-governance-esg-and-fiduciary-duty
66. McGowan, J. A. (2019, September 18). *The trouble with tibble: Environmental, social and governance (ESG) and fiduciary duty.* The University of Chigago Business Law Review. https://businesslawreview.uchicago.edu/online-archive/trouble-tibble-environmental-social-and-governance-esg-and-fiduciary-duty

III. Fiduciary duty goes beyond ensuring financial returns. Interviewees opine that investors are increasingly seeking a comprehensive offering of financial returns and non-financial impact, and asset managers are constantly trying to align their products and services through a holistic approach to meet investors' expectations. "For us, the fiduciary duty is to deliver that total package of portfolio outcomes, which comprise financial returns and overall impact on climate for instance," explains a sustainability manager at a European fund. She adds that while the current debate is all about ESG factors, their fiduciary duty extends far beyond that. "Say there is an upcoming regulation, and you know that you have an investment in a carbon-intensive company that's emitting a lot of greenhouse gasses, so it's still part of our fiduciary duty to take into account upcoming regulations and have a view on how they may impact the businesses you're invested in, and then make an investment decision based on that," she elaborates.

One interviewee went a step further to highlight that the fiduciary duty of prudence is also about asset managers' competence and their authenticity to give their maximum effort to minimise risks and maximise returns. "There shouldn't be any doubt about the (relevance of) fiduciary duty, because your purpose or your investment goal is to manage risk and to get the best risk-adjusted returns. But the fact is, not everybody is mature enough to be able to do it the right way," he explains. He claims that if an asset manager is just plugging ESG data from a vendor the company prefers and overweighting or tilting the portfolio based on that, the manager is placing a huge bet on the fact that higher ESG score means a better investment. Nevertheless, this approach carries substantial risks to the client. "Fiduciary duty also demands that asset managers do their own in-depth analysis and identify good indicators of risk-free returns, and not depend on a mishmash of 15 indicators supplied by an intermediary or a service provider," he elaborates.

Managing the Prudence-Loyalty Paradox

How does the principles of fiduciary duty—the duty of prudence and duty of loyalty—play out for asset managers? Asset managers have a duty to invest in line with the investment mandates provided by their clients or asset owners. For instance, if the mandate requires thematic investment, then the fund manager should invest accordingly. Otherwise, the role of an asset manager is to further the pecuniary interests of the investors who entrust their money to them. "I think fiduciary duty is the primary duty. That is 100 per cent what we are focused on," shares a leader at a global asset management company. He adds: "If our clients so wish to be able to invest in a certain way, our fiduciary duty is to be able to find them the right solution to achieve that."

Most practitioners share unequivocally that as a good fiduciary, they must consider the entire spectrum of risks to their clients' assets, and that ESG risks are compatible with their existing responsibility. One interviewee aptly emphasises: "Not considering non-financial factors by

any investor that is serious about making long-term investment amounts to non-fulfilment of fiduciary duty, since neglecting such considerations is not being responsible to your client." Another interviewee summarises, "ESG is merely a collection of the risks all companies must evaluate and balance, taking into account their own specific circumstances, in seeking to achieve sustainable, long-term value." She further shares that any politicisation of ESG does not, in any possible way, either change or dilute the ability of boards and companies to consider stakeholder and ESG risks and issues. "In my view, a rigorous understanding of all the risks that a company faces—financial, environmental, social, and governance—leads to better investment decision-making, so asset owners should be encouraging those managing their money to take such holistic view on risks," she adds.

Interviewees concurred that while the ESG and fiduciary duty debate rages on, they need to be prudent about risks that may impact financial performance of investments, and they are accountable for maximising risk-adjusted returns to their clients. "If a trustee concludes that ESG investing will benefit the beneficiary directly by improving risk-adjusted return, and that the trustee has no other agenda, ESG factors must be considered," explains a senior executive at a US-based fund. He concludes that the responsibility includes considering the material E, S and G factors alongside traditional performance drivers, and failure to do so will negatively impact sustainable wealth creation for investors.

Peer Advice

BE AWARE OF YOUR CONSTRAINTS

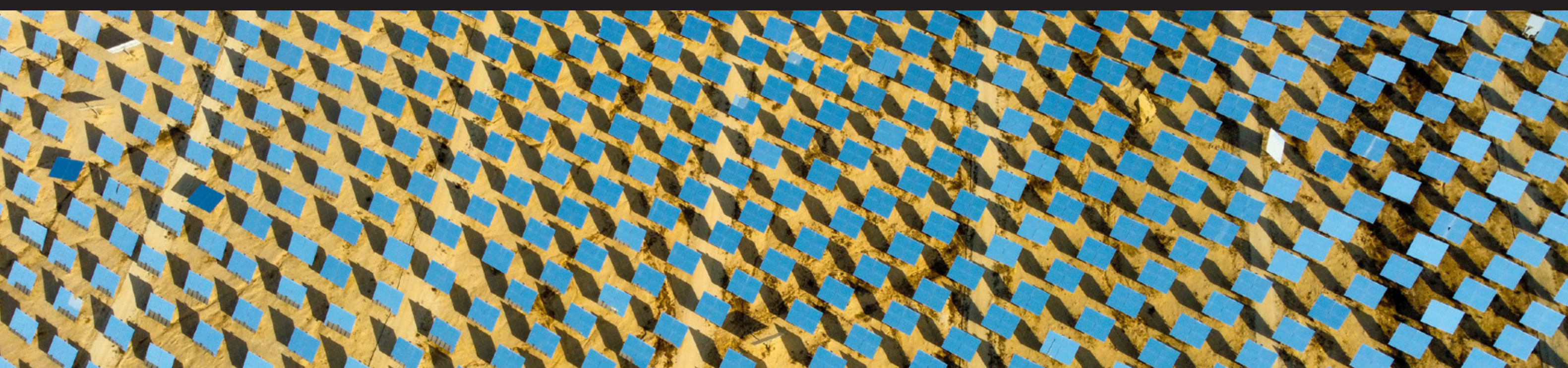
"We are intermediaries because we are managing money on behalf of our investor base; we don't actually own the money that we invest, we are just a channel to invest. So obviously, when these investors entrust their capital to us, there is upfront understanding on what we can do with the money, like how long we can hold this money, what is the kind of risk that we can take, what kind of impact we will achieve, and our duty is subject to those constraints."

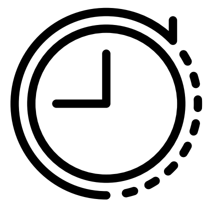
FOCUS ON YOUR INVESTMENT BELIEFS

"Fiduciary duty goes much beyond the mandate, it's also about our philosophy, or investment beliefs and what we believe will have an impact on financial returns. Think of a child that has to prepare for multiple choice questions for an exam. In order to have a good education, would you ask the child to keep drilling on the multiple choice questions, or to read around and understand the course holistically?"

EDUCATE KEY STAKEHOLDERS

"A lot of misconceptions about ESG factors and their interplay with fiduciary duty arise due to the stakeholders either being overly influenced by politically motivated media reports; lack of clarity about the fundamental definitions of ESG and related concepts; or basing their opinions on market data, more recently around ESG funds under performing; or plan lack of understanding around long term risks. Our role as a fiduciary is also to educate key stakeholders."





Time Horizon

LONG-TERM AND SHORT-TERM

Investor dilemma: How to evaluate ESG factors to balance immediate financial returns with long-term value creation?

ESG factors comprise non-financial information that can be financially material at any point in the organisations' journey, either today or in the future. Investors must carefully evaluate and understand such factors to get a better handle on risks and opportunities facing a company. The investment time horizon is a key determinant that shapes the significance of ESG factors and their impact on a firms' performance.[67] Some investors suggest that ESG factors often come into play when the time horizon is five years or more. In their opinion, traditional financial factors such as quarterly earnings, interest rates and inflation, have an overriding influence on stock prices, especially in the short term. Other immediate-term factors that may influence returns are supply and demand, market sentiment, quarterly results, broker recommendations, stability of the government, and other relevant economic indicators.

There are also observations that suggest that the shorter the time horizon, the less relevant ESG risks and opportunities become.[68] Different aspects of ESG, however, may become prominent at different times in the time horizon. For instance, in the near term, governance elements may be more relevant event risks (e.g., fraud, insider trading, bias against minority shareholders). In the long term however, environmental, and social factors may gain more prominence because issues such as carbon emissions, modern slavery, and people welfare tend to present themselves as key risks to the long-term well-being of organisations.

An alternate view is that ESG factors influence share prices and bond prices not only in the long term, but in the short term as well. ESG effects on the upside tend to materialise through a series of incremental upticks that individually contribute to long-term investment return.[69] Long-term impact, in effect, results from a series of constructive short-term decisions, not just a single mega long-term decision that is static. Therefore, irrespective of their reference time horizons, investors must embrace ESG integration since E, S and G risks are difficult to predict.

Research interviewees also reveal that the tenure of their investments is profoundly influenced by the objectives and mandates of the organisations. Therefore, while short-termism is relative to the reference time horizon of investors, holding periods have generally witnessed a trend towards reduction. The average holding period for public company shares in the New York Stock Exchange has dropped from its peak of 8 years in the late 1950s, to 5.5 months in 2020.[70] "We probably consider ourselves long-term versus say some of the investors that are looking to invest one to three years," shares the chief investment officer at an impact fund. He quickly adds: We are still

67. Dinh, M. (2023). ESG, time horizons, risks and stock returns. *Research in International Business and Finance, 65.* https://doi.org/10.1016/j.ribaf.2023.101981
68. Orsagh, M. (2019, September 18). *Are ESG factors relevant only for investors with long-term investment horizons?* CFA Institute.
69. Orsagh, M. (2019, September 18). *Are ESG factors relevant only for investors with long-term investment horizons?* CFA Institute. https://blogs.cfainstitute.org/marketintegrity/2019/09/18/are-esg-factors-relevant-only-for-investors-with-long-term-investment-horizons/
70. Lu, M. (2021, December 17). *Long-term investing: What are the reasons behind its decline?* World Economic Forum. https://www.weforum.org/agenda/2021/12/long-term-investing-decline/

considered short-term (with a five-year horizon) compared to passive funds. "A typical private equity fund is a 10-year fund, but if there is another longer-term investor, for example, looking at transitional assets like coal plants, this could be a 15- to 20-year horizon," he further explains, highlighting that investors may view time horizons differently. Diagram 3 highlights key elements of long-term and short-term approaches.

Diagram 3: **Short-term and long-term approaches**

	SHORT-TERM APPROACH	LONG-TERM APPROACH
Objective	Focused on short-term profitability and tangible financial outcomes	Focused on long-term value creation and on both financial and non-financial outcomes
Benefits	Can respond and capture short-term gains quickly	Can afford to invest in more illiquid portfolio to capture opportunities
Asset types	Active investments, mostly in equities and alternative investments	Passive investments (indexes and ETFs), equities, more illiquid asset classes like infrastructure
Stewardship/ Investor action	Exit investment	Voice and advocate change

Source: SAC Research, 2023. Adapted from multiple sources.[71]

KEY MESSAGES

I. Oversimplification of the time horizon debate can be deceptive. Interviewees cautioned that while there is a tendency to oversimplify the investment landscape by portraying short-term investment as unfavourable and long-term as a more virtuous good, the reality is more intricate. Investors, for instance, could view short-term gains as part of the capital that could be reinvested in long-term approaches. Short-term investing may lead to more agility and yield favourable outcomes, adding more complexity towards the debate surrounding the merits of long-term investing. For instance, research by Morningstar indicates that over a five-year period, active investment strategies may outperform passive ones, highlighting the potential for short-term wins.[72] Conversely, many investors who adopt ostensibly long-term index funds often replicate their portfolio with the index, lacking in-depth knowledge of the individual stocks within. Consequently, they may struggle to analyse company performance, leading them to outsource their

71. Corporate Financial Institute (n.d.). *Short-term vs long-term investors.* https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/short-term-vs-long-term-investors/; Orsagh, M., Allen, J., & Schacht, K. (2020). *Short-termism revisited.* CFA Institute. https://www.cfainstitute.org/-/media/documents/article/position-paper/Short-termism-revisted.ashx

72. Gray, W. (2015, August 17). *The Sustainable Active Investing Framework: Simple, But Not Easy.* Alpha Architect. https://alphaarchitect.com/2015/08/the-sustainable-active-investing-framework-simple-but-not-easy/

stewardship responsibilities instead of actively engaging with companies to drive positive, long-term corporate behaviour that benefits the company and its stakeholders.[73]

Long-term ESG factors can also transform into short-term issues influencing market values. Additionally, multiple ESG factors can be simultaneously at play—for example, an entity may be exposed to an ESG factor that is an underlying long-term driver of returns but another ESG factor may suddenly materialise as a low-probability, high-impact event that produces an immediate downfall in the value of the underlying asset or organisation.[74] Recent governance breakdown at Credit Suisse,[75] or other cases not too long ago, such as Volkswagen's "Dieselgate" scandal,[76] Boeing 737 Max accidents[77] and the Brumadinho dam disaster[78] had a considerable negative impact on these organisations' immediate-term value. Nevertheless, consideration of ESG factors requires a long-term perspective, irrespective of the investment timeframe. "There's no clear evidence that certain issues are financially material right now, but then things can evolve quite quickly," shares a senior leader at a global private bank. She adds: "When it comes to, say, climate change, it is not necessarily an obvious financially material topic for every single company and for every single sector, but it can be a significant reputational risk for the firm or from a fund perspective."

"WHEN WE'RE TRYING TO INVEST IN SOMETHING WE TRY TO PRICE EVERYTHING LIKE DOUBLE MATERIALITY IN THE LONG TERM, THINGS THAT ARE NOT BEING PRICED IN RIGHT NOW, AND THAT CAN BE QUITE A TASK."

II. Beneficiary objectives dictate the long- and short-term strategy decisions. Investors may have a bias towards a short-term or long-term approach. Institutional investors, particularly pension funds, sovereign funds, foundations and endowments, may often be the most patient investors as their investment horizon is based on the nature of their long-term liabilities. In fact, pension funds and foundations may have missions that stretch to perpetuity. They hold investments over an extended period to harness the benefits of long-term returns. They also serve long-term objectives, such as providing for retirees or supporting infrastructure projects. In addition, a long-term view helps such investors create a portfolio that can withstand economic downtowns and market volatility, thereby tapping into an "illiquidity premium."[79]

73. Pozen, R. C. (2015). The role of institutional investors in curbing corporate short-termism. *Financial Analysts Journal*, 71(5), 10-12.
74. Orsagh, M. (2019, September 18). *Are ESG factors relevant only for investors with long-term investment horizons?* CFA Institute. https://blogs.cfainstitute.org/marketintegrity/2019/09/18/are-esg-factors-relevant-only-for-investors-with-long-term-investment-horizons/
75. Fidelity International. (2023, April 5). *ESG Investing: Look beyond short-term factors to drive positive change.* https://www.fidelity.lu/articles/expert-opinions/2023-04-05-esg-investing-look-beyond-short-term-factors-drive-positive-change-1680702280308
76. Hotten, R. (2015, December 10). *Volkswagen: The scandal explained.* BBC. https://www.bbc.com/news/business-34324772
77. Perell, D. (n.d.). *Why did the Boeing 737 Max crash?* https://perell.com/essay/boeing-737-max/
78. IndustriALL (2022, January 25). *Three years after Brumadinho tragedy, justice and accountability still elude the victims.* https://www.industriall-union.org/three-years-after-brumadinho-tragedy-justice-and-accountability-still-elude-the-victims
79. Franklin Templeton (2023). *The cost of being too liquid.* https://www.franklintempleton.com/forms-literature/download/CBTL-WP

A potential consequence of ESG factors becoming more short-term in nature is that more investors with short-term strategies have begun to embrace ESG integration for alpha generation.[80] Some interviewees are of the opinion that using ESG as an "alpha driver" may be misleading, especially in view of the larger agenda of improving corporate ESG practices. Interviewees advise that investors may be better off asking how ESG strategies can help them to achieve objectives other than alpha, such as aligning investments with their values and beliefs, making a positive social impact, and reducing climate or litigation risk. Some interviewees suggest that applying an "improved beta" lens may be a better stance since that may nudge investors to ensure a well-constructed, future-proof portfolio that is likely to generate better, more resilient long-term returns.

III. Pricing of ESG factors is an unending guessing game. At the heart of the short-term and long-term investment philosophy is the pricing of ESG factors. For example, industries with climate-friendly operations are more likely to receive government support or tax subsidies at some point in the future. Those that do not will likely incur fines, penalties, taxes and enforcement actions that restrain future profitability. In the pursuit of risk mitigation, investors spend considerable time identifying which ESG factors are material, or predicting when they will be material—whether it be within a one-, two- or five-year period. Interviewees share that predicting and pricing these factors can be a complex and challenging task, involving deep data analysis. "When we're trying to invest in something we try to price everything like double materiality in the long term, things that are not being priced in right now, and that can be quite a task," explains the director of sustainability investing at a global asset management company. She adds: "The other decision is at what point do you incorporate that into the target price."

Managing the Long-term–Short-term Paradox

Because the timing of ESG influence is difficult to predict, ESG integration is invaluable for all investors, irrespective of their long-term or short-term orientation. Adverse events related to ESG (for example natural disasters or governance failures to prevent massive frauds) are often low-probability, large-impact events. However, ESG integration is invaluable for all investors, especially as ESG factors are considered to increasingly impact market prices in the short-term and long-term.

80. Orsagh, M. (2019, November 5). *Are investment horizons preventing integration of ESG factors?* CFA Institute. https://blogs.cfainstitute.org/marketintegrity/2019/11/05/are-investment-horizons-preventing-integration-of-esg-factors/

Peer Advice

CURATE ROBUST PROCESSES TO INTEGRATE ESG

"The questions we ask ourselves often is about robustness of ESG integration. Irrespective of time horizons, how confident are we of our understanding of ESG factor materiality and existing or future pricing of such factors?"

CONSIDER ESG FACTORS AS TIME HORIZON AGNOSTIC

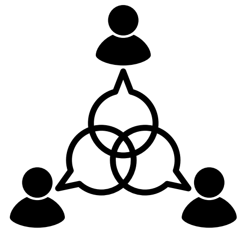
"Since ESG influence is difficult to predict, ESG integration is a must-do for all investors; such risk factors may affect market prices in the short term and long term."

THINK OF THE LONG TERM AS INTEGRATION OF SHORT-TERM ACTIONS

"Even if we have over a ten-year time horizon, we consider (the) long term as a series of short-term decisions; it helps us look at ESG integration without a time horizon bias."

Engagement

SOLO AND COLLABORATIVE



Investor dilemma: How to balance one-on-one engagement with a collective-influence approach?

Even though there are no mandatory regulatory obligations in many jurisdictions to vote and engage with companies,[81] it is increasingly apparent that investor engagement is growing in importance, with most investors engaging in some form with their investee companies. The nature of engagement however—individual or collective, consensual or confrontational—is often shaped by an interplay of different interests and considerations. As investors tailor their engagement strategies, they may choose to engage in one-on-one dialogues with investees or to forge collaborations with like-minded investors to drive collective engagement.

Conversations with industry experts underscore the merits of both individual and collaborative engagement. The mode of engagement is influenced by the gravity of the engagement issue and leverage that individual investors can exert on corporate decisions, prompting most asset managers to engage in a combination of solo and collaborative engagement. In the case of individual or solo engagement, investors directly interact with a specific company in which they have an interest to improve financial materiality and/or environmental and social performance. This engagement typically involves multiple activities, ranging from interactions with investor relations teams all the way to engaging with board directors. Most activities aim to influence the company's behaviour and policies such that they align with investors' expectations.

Collaborative engagement, as the name suggests, involves multiple investors coming together to engage with an investee company. Other than having greater influence, collective engagement initiatives can help investors to share costs and alleviate regulatory risks.[82] However, interviewees warn of several operational and regulatory hurdles investors must navigate to ensure the effectiveness of collaborative efforts. They also highlight jurisdictional differences in how engagement is conducted, emphasising the need to consider cultural dynamics for maintaining cordial and effective relationships with investee companies. These factors collectively contribute to shaping the approach that investors choose to adopt when engaging with their portfolio companies.

Typically, investors may embrace collaborative engagement when individual engagement does not work to shape desired investee actions. One interviewee emphasised that they consider escalation only when companies refuse to act, reject shareholder initiatives, or when it becomes necessary to collaborate with other investors to explore more assertive measures. For instance, in 2021, a proxy contest at ExxonMobil led by activist investor Engine No. 1 resulted in the appointment of three directors selected by shareholders rather than management to Exxon's

81. Isaksson, M., & Celik, S. (2014). Institutional investors and ownership engagement. *OECD Journal Financial Market Trends*, 2013(2). https://doi.org/10.1787/fmt-2013-5jz734pwtrkc

82. Balp, G., & Strampelli, G. (2020). Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs. *Ohio St. Bus. LJ*, *14*, 135.

board.[83] For long-term passive index investors, the need to continually engage and escalate matters is a recurring challenge. A senior investment stewardship professional explains: "We are permanent investors in many companies, and unlike active managers we don't have the option to divest; so, if engagements don't work, we escalate matters by going public with voting decision and sharing public statements to hold directors accountable."

KEY MESSAGES

I. Engagement approach is often driven by investor and investee preferences.

Collaborative engagement helps investors amplify their influence. Given that many investors have relatively small and diversified shareholding, collective action is useful in exerting pressure on board directors and management to act. Most of the investors we spoke to engage in some form of collaborative engagement through investor collaboration platforms or investor organisations such as the UNPRI, Climate Action 100+ and Asia Investor Group on Climate Change.

"THE BASIS OF COLLABORATIVE ENGAGEMENT WOULD REQUIRE THE ISSUE TO BE SEVERE WHERE PRIVATE ENGAGEMENT DOES NOT WORK, AND ESCALATION IS NEEDED TO COLLABORATE WITH EXTERNAL INVESTORS."

Collaborative engagements allow infusion of diverse expertise. As discussions among investors evolve and mature, addressing technical and complex issues can become increasingly challenging when pursuing individual engagement strategies. One interviewee pointed out that collaborative engagement enriches the diversity of these conversations and fills the knowledge gaps individual investors may have. "Conversations with companies have matured over time, starting from generic and high-level conversations on setting net-zero targets, to more nuanced conversations like decarbonised technology and capital allocation. When engagements become increasingly complex, it requires a cohort of investors to collaborate and tap on specific investors to engage in specific topics. Sector knowledge is important and not all investors have the same level of knowledge and expertise," she elaborates.

On the other hand, a PRI report finds that investee companies often favour individual ESG engagement, allowing them to tailor engagements to further specific asks of an investor.[84] Interviewees highlight that investors that hold a sizeable stake may however accomplish much more, with fewer distractions, if they embrace the solo engagement route.

83. Stewart, L. (2023, August 3). *Two years after 'iconic' Exxon moment has engagement delivered results?* ESG Clarity. https://esgclarity.com/two-years-after-iconic-exxon-moment-has-engagement-delivered-results/

84. Gond, J. P., O'Sullivan, N., Slager, R., Homanen, M., Viehs, M., & Mosony, S. (n.d.). *How ESG engagement creates value for investors and companies.* PRI. https://www.unpri.org/download?ac=4637#:~:text=In%20general%2C%20engagement%20helps%20corporations,in%20the%20specific%20firm%20context.

II. Operational challenges and regulatory hurdles make collaborative engagement harder.

While collaborative engagement offers numerous benefits, it frequently entails additional administrative and coordination work. In some instances, a small group of investors end up shouldering bulk of the engagement efforts, leading to a free rider problem. Moreover, investors may have divergent preferences and priorities to pursue in their engagement objectives, making consensus-building a potentially challenging task. For larger institutional investors who have greater access to the management, there may be instances where they prefer to address certain issues unilaterally. "It is a nightmare just to coordinate among investors, and different working group members will have different preferences, and they can go in totally opposite directions," shares an asset manager. He adds: "So, you spend a lot of time mediating, trying to get the middle ground, pushing back, negotiating; all this is resource intensive."

Interviewees also highlight additional challenges in collaborative engagement. For instance, some jurisdictions may limit collaboration, especially requirements related to communication with fellow shareholders.[85] One of the interviewees at a US-based fund mainly in the space of ETFs, points that legal constraints may not allow them to collaborate with other investors. "The passivity law prohibits us from telling companies what they should be doing about their business; it prevents us from asking the board to fire a director or the CEO or telling them that they should be hiring certain directors to the board," he shares. "So, a lot of the things that overlap with activism that you see out there, as a passive investor, we're prohibited from doing." In some other jurisdictions, Germany for instance, investors may be apprehensive of collaborative engagement for fear of "acting in concert."[86]

III. Cultural considerations may influence the choice of engagement approach.

Besides regulations, there may also be some regional challenges, particularly as investors engage with companies in Asia. For instance, submitting shareholder proposals (individually or in collaboration with other co-investors) or even attending shareholder meetings could be perceived as adversarial in some cultures. "We often choose to submit questions in advance of the AGM (annual general meeting) to ensure that the company's face is preserved," shares an interviewee, highlighting the importance of cultural considerations in engagement strategies. "If you start practising name-and-shame in Asia, you will never ever see them (investee companies) again. They will never meet with you again. So, you are better off advocating for change, rather than playing an activist," explains one investor.

Collaborative engagement remains relatively new to many asset managers in Asia, and the approach may not enjoy widespread acceptance in the region. Lack of enough physical presence and the general level of understanding around running collaborative engagements also makes driving such initiatives much harder in the region. To mitigate

85. Balp, G., & Strampelli, G. (2020). Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs. *Ohio St. Bus. LJ*, 14, 135.

86. Schmiady, H., & Naumann, N. (2023, May 30). *Collaborative engagement and the attribution of voting rights: When can things get tricky?* BaFin. https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2023/fa_bj_2303_Collaborative_Engagement_en.html

these challenges, a senior investment stewardship professional emphasises the importance of including a local investor as part of the investor group. A co-investor who understands the local perspective can provide valuable insights into the cultural, operational and political context in which investee companies are operating, thereby aiding in the success of collaborative engagement efforts.

Managing the Solo-Collaborative Engagement Paradox

Most investors and asset managers use a combination of solo and collective engagement regarding ESG issues, choosing the appropriate route to engage with investee companies. "I think there is place for both approaches," shares an asset manager. He adds: "Larger investors may prefer to engage one-on-one, but I don't see any competitive disadvantage in doing collaborative engagement. For a relatively small asset manager of our size, we can't really expect a lot of companies to pay attention (to us) if we just directly engage with them. In collaborative approach we can at least get some attention."

Peer Advice

BUILD LOCAL PRESENCE

"To have a meaningful collaborative engagement in APAC, we need to have people on the ground. Unfortunately, we don't see many of our peers on the ground in Asia (not as much as we see in the US, Australia, Europe), engaging with companies in the language that they (companies) speak."

PRESENT A UNIFIED AND COHESIVE MESSAGE

"Effective engagement is about how best we make use of the time we have with the companies efficiently. Investors need to have a coherent structure for the meetings, be targeted in their approach, and not be seen as an assortment of investors coming in with different questions and objectives."

ENGAGE WITH ENABLING PLATFORMS

"The ideal structure of collaborative engagement would be a small set of lead investors and a very active member-based investor platform which may not necessarily lead the conversation but provide shared knowledge, best practices, and inputs on questions and topics for discussion."

Resourcing

INFLUENCE AND SCALABILITY

Investor dilemma: How to optimise resources to engage meaningfully with a larger pool of investee companies?

As responsible investment practices continue to evolve and expand, an increasing number of investment managers have embraced stewardship activities and promote positive environmental and social practices. While these efforts signify a growing commitment towards responsible investment principles, they remain significantly limited compared to the vast assets that investors hold and oversee. This incongruity gives rise to a perplexing question: How do investors balance the need to influence investee companies while scaling up their interactions and activities to increase the span of their stewardship activities?

Owing to lack of reach and resources, some investors choose to outsource some or the majority of their stewardship activities. For instance, asset owners entrust stewardship activities to fund managers, or investment managers contract third-party entities to handle stewardship responsibilities. Given the trade-offs of outsourcing, investors have to grapple with the crucial decision of whether to entrust these responsibilities to fund managers and external entities, or double down on efforts to build and enhance their internal stewardship capabilities.

KEY MESSAGES

I. Investors have mixed preference for internal stewardship capacity building.
Opinions on the relationship between resource availability and internalisation of stewardship activities vary among practitioners. While conventional wisdom suggests that having more resources leads to a preference for building internal capacity rather than outsourcing, this is not necessarily the case. "I tend to disagree that those with less resources tend to outsource, because many large asset managers outsource their engagements as well," clarifies a senior sustainable engagement professional.

As demands for investment stewardship increase, many investors are building and enhancing their internal capacities. Having a strong internal stewardship team enables investors to have a deeper understanding of their portfolio companies and have better alignment with their long-term goals. Investors, especially ones with large portfolios, must allocate their engagement efforts judiciously. There is thus a need to prioritise the investee companies they engage with. While each asset manager may have their own prioritisation model to decide the span and scope of their engagement, common decision criteria include the dollar exposure that investors have in the company, the company's controversies, sectorial risks and susceptibility to environmental and social

factors, potential impact of the engagement on the industry or sector, and the company's propensity to engage over key issues.

However, despite prioritisation models and resource availability, internalising stewardship activities may come with sizeable time investments and personnel costs. Therefore, to some investors, outsourcing stewardship activities to external entities such as proxy advisors and specialised stewardship service providers may be a more pragmatic solution. A survey done by the Investment Association found that 77 per cent of respondents that outsource engagement consider it to enhance value.[87]

II. Outsourcing stewardship may lead to overdependence on service providers.

Outsourcing can potentially lead to the unintended consequence of overdependency on external service providers. A case in point is the proxy advisory industry, which is largely dominated by two firms, Institutional Shareholder Services (ISS) and Glass Lewis. These companies control a staggering 97 per cent of the market.[88] This concentration of power means that these two firms wield significant influence in shaping the outcomes of proxy votes.[89] Research by the American Council for Capital Formation finds that institutional investors vote with ISS more than 95 per cent of the time, and smaller funds especially rely on automated voting systems.[90] This overreliance on service providers can limit the range of perspectives considered in stewardship decision-making and reduce the ability of investors to exercise independent judgment.[91]

III. There is an acute shortage of stewardship talent in the industry.

The nascency of stewardship means that some investment firms allocate limited resources and underinvest in stewardship capabilities. This is exacerbated by the lack of adequate stewardship talent in the industry. A boutique fund manager shared that he operated with a lean team and had opted for external parties to enhance their credibility, especially when managing portfolios for larger clients. "Many large fund managers use external vendors for norms-based rating," reflects an asset manager. This approach allows them to access specialised expertise and resources beyond their in-house capabilities. "Investment stewardship is not well understood in the public equity markets. It was relatively foreign to me until I was appointed to the role," shares a senior investment stewardship professional.

Several practitioners also pointed to their lack of in-house stewardship and engagement specialists within the regions where their investee companies are situated. This geographical constraint can hinder investors' familiarity with the cultural context and intricacies of local markets, making outsourcing an attractive solution to navigate such challenges.[92]

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Managing the Influence-Scalability Paradox

Interviewees shared that they are stepping up their efforts to build internal stewardship capability. While internal capability is crucial, it is noteworthy that not all investors are equipped with ESG expertise to fully internalise aspects of stewardship. Thus, investors may pursue a hybrid approach that combines elements of building internal stewardship capacity along with outsourcing.

Peer Advice

STRENGTHEN INTERDEPENDENCIES WITH OTHER STAKEHOLDERS

"Stewardship is an art, and it goes beyond engaging; it is about understanding the levers that you can pull, and how to amplify the impact using platforms that are available. Asset managers should tap on external resources, such as industry associations and standard setters, to guide investee companies to help them stay aligned with industry practices."

CULTIVATE A CULTURE OF STEWARDSHIP THROUGHOUT YOUR ORGANISATION

"Whilst it is important to have a dedicated stewardship team, it is equally important for other roles in the asset management industry, for instance analysts and portfolio managers, to undertake the responsibility to contribute towards stewardship discussions."

ENSURE ALIGNMENT WITH EXTERNAL PROVIDERS

"Ensure that there is clear communication, coordination and governance between internal stewardship teams and external service providers. Investors need to select a service provider that understands and aligns with their needs and internal stewardship policy, monitoring them regularly to ensure that they are responding to their ESG concerns."

Conclusions

The *Investing for a Better World: Navigating 6 Paradoxes* research explores the intricate relationship between capital and sustainability considerations, shedding light on the paradoxes that investors grapple with the realm of stewardship and responsible investing.

Investor Action	Key Activities	Underlying Dilemma
STRATEGISE Policy and strategy development	*Develop and implement a comprehensive policy that outlines the organisation's commitment to responsible investing, including ESG integration, engagement and proxy voting.*	How to deliver value without compromising values?
		How to balance "doing more good" with "doing less harm"?
INTEGRATE ESG analysis and Integration	*Conduct robust ESG analysis to assess the materiality of ESG factors for investment decisions.* *Define clear investment guidelines that incorporate ESG factors into investment decision-making processes.*	How to fulfil the twin duties of prudence and loyalty while investing in ESG?
		How to evaluate ESG factors to balance immediate financial returns with long-term value creation?
ENGAGE Engagement, advocacy, proxy voting	*Engage with portfolio companies, regulators, and industry stakeholders to promote responsible business practices, good governance and sustainable strategies.* *Actively exercise shareholder rights, including proxy voting, to support responsible business practices.*	How to balance one-on-one engagement with collective-influence approach?
		How to optimise resources to engage meaningfully with a larger pool of investee companies?

These paradoxes are testament to the multifaceted nature of the challenges faced by investors striving to align their financial goals with sustainability objectives. As one interviewee shares: "Being a good steward is helping our clients make money with the investment return that has been agreed (upon), in a responsible manner."

Investor Paradox	Key Messages	Peer Advice
Paradox I **Investment Philosophy: Value and Values**	✓ Values-based investing may or may not require sacrificing financial returns. ✓ Pursuing social values and impact may be easier in the private equity markets. ✓ Beneficiaries drive values commitment.	✓ Be aware of your investment beliefs. ✓ Be authentic and walk the talk. ✓ Manage tone at the top.
Paradox II **Responsible Investing: Exclusion and Inclusion**	✓ There are implicit costs associated with exclusionary policies. ✓ "Starving" brown companies has more downside than upside. ✓ Size, span and scope of transitioning company matters.	✓ Align your approach with values. ✓ Work towards the right balance. ✓ Strive for diversification.
Paradox III **Fiduciary Duty: Prudence and Loyalty**	✓ Duty of prudence is rooted in financial materiality. ✓ There are jurisdictional differences in interpretation of fiduciary duty. ✓ Fiduciary duty goes beyond ensuring financial returns.	✓ Be aware of your constraints. ✓ Focus on your investment beliefs. ✓ Educate key stakeholders.
Paradox IV **Time Horizon: Long-term and Short-term**	✓ Oversimplification of the time horizon debate can be deceptive. ✓ Beneficiary objectives dictate the long- and short-term strategy decisions. ✓ Pricing of ESG factors is an unending guessing game.	✓ Curate robust processes to integrate ESG. ✓ Consider ESG factors as time-horizon agnostic. ✓ Think of the long term as integration of short-term factors.
Paradox V **Engagement: Solo and Collaborative**	✓ Engagement approach is often driven by investor and investee preferences. ✓ Operational challenges and regulatory hurdles make collaborative engagement harder. ✓ Cultural considerations may influence engagement approach.	✓ Build local presence. ✓ Present a unified and cohesive message. ✓ Engage with enabling platforms.
Paradox VI **Resourcing: Influence and Scalability**	✓ Investors have mixed preferences for internal stewardship capacity building. ✓ Outsourcing stewardship may lead to overdependence on service providers. ✓ There is an acute shortage of stewardship talent in the industry.	✓ Strengthen interdependencies with other stakeholders. ✓ Cultivate a culture of stewardship throughout your organisation. ✓ Ensure alignment with external providers.

Source: SAC Research, 2023.

Future Outlook

Amid paradoxes, complexities and challenges, a consistent message prevails among most of our interview participants—investors see themselves as stewards of the clients' capital and generally lean towards adopting sustainable investment strategies. The desire to transition towards sustainability and foster long-term value creation is not rooted in altruism but is underpinned by the understanding that sustainability makes good business sense and improves returns over the long run. It serves as a powerful strategy to mitigate risks and capture opportunities.

Research participants share the following outlook for the future of sustainable investing:

INTEREST IN SUSTAINABLE INVESTING WILL CONTINUE TO GROW.

Despite a dip in sustainable investments in 2023, there continues to be a strong and sustained global appetite for sustainable investment.[93] Interviewees share that extreme climate shifts —such as heatwaves in the US and Europe, bushfires in Australia, floods in Asia; increasing social concerns around modern slavery, socio-economic inequality, and population migration due to climate change and conflicts—will continue to drive dialogues on sustainable investing. "Unfortunately, because of global warming, you are seeing incremental physical risks play out and hence asset impairment, so whether we want it or not, whether we believe it or not, we will be forced to factor in those risks in a much more short-term time horizon, thereby the need for more ESG integration in the future," explains an asset manager.

Some interviewees highlight that while the moniker "ESG" may or may not exist in the future, the shift in allocation of assets towards creating positive environmental and social impact will continue. Another aspect that will drive more credibility to sustainable investing is the increasing availability of ESG data and tools. As more companies disclose information about their ESG performance, investors will have greater access to information that can help them make more informed investment decisions. The community of ESG data providers and ratings agencies, offering investors with a diverse array of ESG-related metrics and ratings, will continue to flourish in the future.

THE WORLD MAY BECOME EVEN MORE POLARISED AROUND ESG INVESTING.

As various forms of sustainable finance continue to grow, so does the ongoing debate surrounding ESG investing, thereby further widening the wedge between ESG investing believers and critics. "The fact that ESG debate is deeply rooted in political ideologies will make it harder to find a rational solution," shares an interviewee. While fiduciary duties have been traditionally well-defined, the advent of ESG investing means these duties could be interpreted in more ways than before. What constitutes as "material" to investment returns has become more intricate, raising more questions than ever. "Is ESG investing about managing sustainability risks? Is it about finding business opportunities? Or is it about developing a positive impact on sustainability? These are some of the questions that need to be addressed," elaborates another research participant.

93. Cheesley, A. (2023, September 18). *Sustainable investment dips in Asia in 2023, but still high - survey*. Wealth Briefing Asia. https://www.wealthbriefingasia.com/article.php?id=199084

STEWARDSHIP WILL BECOME EVEN MORE CENTRAL AND ACCEPTED IN ASIA.

Although there are limitations to implementing stewardship codes effectively, especially in Asia where the concept is comparatively new, investment stewardship will eventually become a fundamental process for asset managers as they engage with investee companies. "Investment stewardship is about where we put our money, how we put our money, and how we make sure the investment goes into not just building the business, but building it sustainably as well," shares an Asian asset manager, underlining the importance of embracing stewardship.

"WILL ESG INVESTING SAVE THE WORLD? YES, BUT IT WILL ONLY BE ONE PART OF THE PUZZLE. EVERYONE IN THE ECOSYSTEM, INCLUDING THE PUBLIC, CUSTOMERS, VENDORS AND SUPPLIERS, (AND) NGOS, HAS TO PLAY A ROLE, AND I THINK IT IS VERY IMPORTANT FOR FINANCIAL INSTITUTIONS TO PLAY THAT ROLE AS WELL."

Most global asset managers who participated in the research talked about putting "more boots on the ground" in Asia as they grow their operations in the region. Interviewees share that investee companies in Asia, which have traditionally been more conservative, may become more amenable to engagement and eager to showcase their ESG efforts. "Conversations with Asian companies were more one-sided previously, but not anymore; there are more reverse ESG roadshows initiated by companies, emphasising their commitment to ESG principles, and their willingness to engage in dialogues," adds an interviewee.

REGULATORS WILL CONTINUE TO BE IN AN "OVERDRIVE."

With the global reporting scenario becoming more complex for companies and investors, understanding what, where and how to report sustainability information while keeping up with the latest developments, is increasingly challenging and resource intensive. Practitioners share that this sharp rise in ESG regulations will persist as markets seek more effective and transparent allocation of capital to drive sustainable outcomes. For instance, practitioners anticipate that regulators in Asia will strengthen their climate disclosure mandates over the next few years and will include the IFRS standards as part of their mandatory ESG disclosure requirements for listed companies. More jurisdictions in the APAC and Southeast Asia are also mandating disclosures in alignment with TCFD recommendations. Interviewees also foresee that Asia will continue to align mandatory climate disclosure requirements with major global markets, including the UK and Europe. However, amidst these promising developments, there is a shared sentiment that there is still plenty of improvements required. A key aspect that some interviewees highlight is the need for congruence and interoperability in metrics and indicators to create systemic change in the industry. "There needs to be more information, more comparable data, and more reliable data. Ultimately, we must try to achieve a global set of reporting standards," shares a regulator.

In conclusion, the six paradoxes explored in this report highlight the dynamic and evolving nature of sustainable investing. The outlook of our interview participants is diverse, with a spectrum of optimism and caution on the role of capital towards driving societal and environmental change. Amidst these varying perspectives, what is certain is that the "train of sustainable investing" has left the station. It is imperative for industry professionals to remain adaptable and navigate the complexities brought about by changing market dynamics, regulations, and societal demands, to collectively shape the future of investing. As one real estate asset manager sums up: "Sustainable investing comes down to the core principles and beliefs of the organisation, and these beliefs will shape your ESG policies. I see work being done, but there is still a lot of work in progress."

INVESTING FOR A BETTER WORLD: NAVIGATING 6 PARADOXES

Methodology

The Stewardship Asia Centre (SAC) research team led the *Investing for a Better World: Navigating 6 Paradoxes* research with the twin objectives of understanding factors influencing sustainable investing and paradoxes investors such as asset owners and asset managers must navigate to drive the sustainable investing agenda.

The research is based on inputs from 32 practitioners (heads of stewardship, portfolio managers, regional managing directors in global funds, heads of active ownership, engagement leads, ESG practice heads, etc.) and thought leaders within the investor community, including institutional investors such as asset owners and asset managers, representatives from private equity and impacting investing firms, and esteemed academics and thought leaders.

The SAC research team conducted semi-structured interviews in two phases. The first phase collated investor views on the state of sustainable investing and the challenges they encounter during their investment stewardship and sustainability journey. Based on the inputs, the team identified key paradoxes investors must navigate to successfully drive the sustainable investing agenda. The second phase of interviews synthesised the collective wisdom of the interviewees on the top six dilemmas and paradoxes to present tools, tips, experiences and best-demonstrated practices.

Definitions

Given below is a list of some terms used throughout the key findings report:

- *ESG investing* refers to the consideration of environmental, social and governance factors when making investment decisions. Investors aim to integrate these ESG factors into the investment process to identify companies that align with ethical and sustainable values.
- *Sustainable investing* is a broader concept that encompasses ESG factors but also contributes to broader sustainability goals. It aims to generate positive social and environmental outcomes alongside financial returns. Sustainable investing can include ESG investing and integration, ethical investing and impact investing.
- *Impact investing* is a strategy designed to generate positive and measurable social and environmental impact alongside a financial return. The specific impact and financial returns achieved will depend on the investors' objectives, reflecting the diverse goals and approaches of impact investors.
- *ESG integration* is a risk management approach that involves explicit and systematic inclusion of environmental, social, and governance issues in investment analysis and investment decisions. By doing so, it aims to improve financial performance by identifying opportunities and mitigating risks associated with these factors.
- *Value investing* is the idea of investing in an undervalued company based on its fundamentals and motivated by an economic gain.
- *Values-based investing*, or ethical investing, aligns investments with environmental, social or religious beliefs, among others. Values-based/ethical investing strategies could vary from negative screening (exclusions), positive screening (active selection of companies that meet ethical criteria), and shareholder activism (engagement with companies to encourage ethical behaviour).
- *Investment stewardship* is a set of principles and practices fundamental to sustainable investing. Effective investment stewardship is investors exercising responsible allocation, management, and oversight of capital, through active ownership and engagement, to create and preserve enterprise value within portfolio companies, and improve long-term risk-adjusted returns for clients and beneficiaries.

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