

Pension Funds and Sustainable Investment

Challenges and Opportunities

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Chapter 7

Global Pensions and ESG

Is There a Better Way?

Luba Nikulina

Environmental, social, and governance (ESG) factors entered our lives in the 1960s, when investors started to exclude stocks or entire industries from their portfolios based on their business activities, such as tobacco production or involvement in the South African apartheid regime. ESG influence has been growing ever since, particularly in the last five years, as the world has faced an increasing number of societal and planetary challenges such as climate change, inequality and, more recently, the global pandemic.

The Business Roundtable (2019), whose members are CEOs of major US companies, declared that ‘companies should serve not only their shareholders, but also deliver value to their customers, invest in employees, deal fairly with suppliers and support the communities in which they operate.’ The concept of multi-stakeholder capitalism is increasingly gaining prominence in society. As Peter Drucker (1973: np) observed almost 50 years ago: ‘Any institution exists for the sake of society and within a community. It, therefore, has to have impacts; and one is responsible for one’s impacts.’

This chapter explores whether a similar logic regarding multiple stakeholders, impact responsibility, and systems-level engagement applies to global pension funds.

Scale and Influence of Global Pension Assets

Global asset owners controlled around US\$154 trillion at the end of 2020.¹ This sum includes a range of asset owners: pension funds, sovereign wealth funds, insurers, endowments, and foundations. Most of them have long-term, and often infinite, time horizons. More than 70 percent of these assets are managed via the global asset management industry. For the purposes of this chapter, we focus on pension funds, with the acknowledgment that other pools of capital will also be impacted, and hence have a role to play in the global sustainability arena.

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TABLE 7.1 Largest pension funds (in US\$ million)

Rank	Fund	Market	Total Assets
1	Government Pension Investment	Japan	\$1,555,550
2	Government Pension Fund ¹	Norway	\$1,066,380
3	National Pension	South Korea	\$637,279
4	Federal Retirement Thrift ²	US	\$601,030
5	ABP	Netherlands	\$523,310
6	California Public Employees ²	US	\$384,435
7	National Social Security ¹	China	\$361,087
8	Central Provident Fund	Singapore	\$315,857
9	Canada Pension ³	Canada	\$315,344
10	PFZW ³	Netherlands	\$243,839
11	California State Teachers ²	US	\$243,311
12	Employees Provident Fund	Malaysia	\$226,101
13	Local Government Officials	Japan	\$224,006
14	New York State Common ²	US	\$215,424
15	New York City Retirement ²	US	\$208,458
16	Florida State Board ²	US	\$173,769
17	Employees' Provident	India	\$168,095
18	Ontario Teachers	Canada	\$159,666
19	Texas Teacher	US	\$157,632
20	ATP	Denmark	\$144,983

Note: ¹ Estimate; ² as of September 30, 2019; ³ as of March 31, 2020.

Source: Thinking Ahead Institute (2021).

According to Thinking Ahead Institute's (2020a) study, pension funds are the biggest asset-owning group, representing 37 percent of the total assets or US\$57 trillion (see Table 7.1). The US is by far the largest pensions market, with around US\$32.5 trillion, followed by Japan (US\$3.6 trillion) and the UK (US\$3.5 trillion). The concentration of global pension assets is significant in developed economies, with roughly US\$43 trillion or 84 percent of global pension assets in the seven largest markets of Australia, Canada, Japan, Netherlands, Switzerland, UK, and US. To put global pension assets in perspective, in 2019 the global GDP amounted to US\$88 trillion (World Bank 2021).

Various governments have pledged to spend on a wide range of environmental, 'green' initiatives, which in total amount to more than US\$4 trillion. Assuming they are implemented, this level of spending is more than double the size of every other major human endeavor ever undertaken.² Moreover, global pension assets have been growing faster than the global economy, in that pension assets grew at 15 percent in 2019 and 11 percent in 2020. In addition, there has been a consistent shift from defined-benefit (DB) to defined-contribution (DC) plans, with DC accounts currently representing 53 percent of total pension assets in the seven largest pensions markets. The

key implication of this shift for ESG investing is that the fundamental time horizon of pension assets is increasing toward infinite (setting aside, for the moment, regulatory and governance constraints on DC funds). Lastly, asset allocations for global pension assets have changed significantly, with a reduction in public equity allocations and consequent home bias. This has been offset by an increase in the global scale of investing and alternatives allocations, such as real estate, private equity, and infrastructure, which almost reached 23 percent of total pension assets at the end of 2020. Global alternatives have been attractive for return reasons, offsetting some of their governance difficulties. Many new ESG investments will be global in nature, and they will be channeled through alternative investment channels. This trend in asset allocation, lengthening time horizons, and experience in global investing and alternatives, makes the global pension assets pool a valid and potentially active contributor to the unfolding theme of new large-scale ESG investments.

Why Pension Funds Invest in ESG

For many years, ESG investing was characterized, as Roger Urwin, global head of investment content at consultancy Willis Towers Watson, put it, as a ‘very slow moving but unstoppable train’ (cited by Rust 2018: np). Somewhat surprisingly, and despite significant economic challenges, this focus on ESG has accelerated from 2020, as the global pandemic brought to the forefront of investors’ attention the importance of global health and safety, and how interconnected our world has become. In addition, unrest over racial inequality in the US has increased the focus on social responsibility. As a result, the ‘slow-moving train’ of ESG investing has been gaining significant momentum more recently.

A first consideration for pension funds’ ESG investing must be financial, in line with the most common definition of pension fund fiduciary duty to the members. Embedding ESG into investment decision-making allows better risk management and identification of investment opportunities. The performance of highly rated ESG stocks in 2020 put them in the spotlight, perhaps unsurprisingly, considering the negative impact of the coronavirus crisis on the financial performance of the fossil fuel industries. Inevitably and perhaps for the wrong reasons, this recent short-term performance differential has caught investors’ attention and prompted the flow of capital into ESG funds. While there may be some short-term bounce-back as the global economy reopens, highly rated ESG stocks are likely still at the very early stages of their long-term rise.

It is possible that companies which move away from a short-term shareholder-centric approach to a longer-term perspective can create value

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for all stakeholders and will significantly outperform their peers. The performance differential between highest and lowest ESG rated stocks was more than 23 percent in 2020 according to Fidelity International (Tan and Moshinsky 2020). Hale (2021) estimates that sustainable equity funds finished 2020 with a clear performance advantage relative to traditional equity funds, with three out of four sustainable equity funds beating their Morningstar Category average.

Reputational considerations also drive pension funds' increasing attention to ESG investing. For many pension funds, especially the larger ones, it is important to be considered leaders rather than laggards in this area. There are also risks of legal action, as demonstrated in the recent case brought against the trustees of the Rest pension fund in Australia by one of its members on the grounds of the failure to adequately consider climate change risks. Rest agreed to an out-of-court settlement in their dispute, admitted that climate change represents a 'material, direct and current financial risk' to the fund, and committed to a range of actions to address that risk (Angwin and Edwards 2021).

Last but not least, increasing regulatory pressure is being brought to bear on pension funds to consider ESG factors in their investment policies and decisions, especially as the number of ESG-related policies and regulations has accelerated (PRI 2021b). The Principles for Responsible Investments (PRI) estimates that 95 percent of all ESG regulations were developed since 2000 (see Figure 7.1), and 2020 saw 124 new or revised policy instruments or 32 more than the previous year. Very few of those regulations are truly global in scope, underscoring how challenging it is to come up

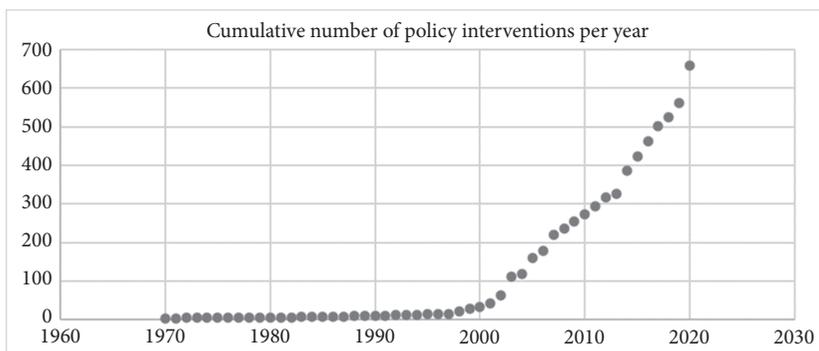


Figure 7.1 Cumulative number of policy interventions per year

Note: 'Policy interventions' are new financial policies and regulations or updates of the existing policies and regulations by governments and regulatory bodies around the world.

Source: PRI (2021b). *Regulation Database*.

with a coordinated policy response to global challenges in an increasingly interconnected world. Instead of becoming better coordinated, however, the regulatory landscape has grown more diverse and fragmented of late. Accordingly, pension funds stand to benefit from a more coordinated global policy response to global challenges.

Insofar as ESG challenges tend to be global by nature, it will require a global effort and coordination on an unprecedented scale in order to address them. If left unresolved, some of these challenges can quickly become existential for humanity. There is a society-wide change taking place, with the world transitioning to a low-carbon economy while also addressing other social and environmental concerns, such as inequality and the loss of biodiversity. As global allocators and stewards of multigenerational capital, pension funds have a unique capacity to evaluate such challenges and to mobilize capital to address them.

A ‘Deeper Dive’ into Climate Change

Some of the most acute global ESG challenges today include climate change, inequality, and loss of planetary biodiversity. It may be instructive to look deeper into the topic of climate change, since this has attracted meaningful global policy responses. Accordingly, its implications for pension funds could be indicative of future developments.

The global challenge of making an orderly transition to a low-carbon, climate-resilient economy has brought climate to the forefront of governmental, company, and investor agendas. Climate change action is supported by the global regulatory framework via the Paris Agreement, a legally binding international treaty on climate change adopted by 190 countries (United Nations Climate Change 2015). The main catalyst for action on a global scale has been the acknowledgment that climate risk has become a financial risk as well as opportunity (in addition to regulatory nudges, in many jurisdictions).

How public and private investments are allocated in the near term will determine whether global warming can be held below two degrees Centigrade and prevent associated catastrophic climate events. As noted by PRI (2021a: np) in their ‘Inevitable Policy Response’ statement:

Financial markets today have not adequately priced-in the likely near-term policy response to climate change. The question for investors now is not if governments will act, but when they will do so, what policies they will use and where the impact will be felt . . . a response by 2025 will be forceful, abrupt, and disorderly because of the delay.

In this context, any pension fund that does not take climate change into account is likely to ignore a major risk to pension savings and miss out

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on investment opportunities. If pension managers fail to consider risks and opportunities from climate change, or fail to exercise effective stewardship, their investment performance may suffer. Their members' savings may also suffer more immediate consequences from exposure to firms that are unprepared for the low-carbon transition. These developments pose new questions to pension managers, including whether they should think exclusively in the context of their own investment portfolios, or whether they should evaluate the overall global economy and how climate change will influence their performance more broadly. As a group of institutional investors, pension funds tend to have very long time horizons. As they are expected to deliver returns over many decades, if not infinitely, the argument can be made that the returns they seek can only come from a system which supports the funds' engagement with systemic risks and challenges beyond the near term. A related point is that, if there is one institution in the investment value chain where intergenerational equity should reign, it is a pension fund.

An example of the global leadership and coordination by asset owners is the UN-convened Net-Zero Asset Owner Alliance (2021), established in 2019. The group includes asset owners from a range of developed economies, and it has set itself an ambitious public commitment to transition its investment portfolios to net-zero greenhouse gas emissions by 2050. Sixteen of the current 35 Net-Zero Alliance members are pension funds from the US, UK, Sweden, Denmark, France, and Australia (see Table 7.2).

In addition to the fact that these entities' public commitments are quite bold, the alliance members have also set themselves ambitious interim targets to achieve these outcomes. The most common interim target is to reduce greenhouse gas emissions associated with their portfolios by half, and to double the amount of capital allocated to climate solutions by 2030. Pension funds can already invest new capital in assets and technologies that have both positive environmental impact and positive expected risk-adjusted return, such as renewable energy, transport electrification, and reforestation. There are also some promising new technologies on the horizon which still need to prove their effectiveness, both from an impact and return perspective, such as hydrogen fuel or carbon capture and storage technologies. Investment opportunities from addressing climate change will become more apparent as governments worldwide scale up their net-zero policies.

Alternatively, pension funds can divest from carbon-intensive businesses, or else engage with them to encourage their transition to carbon neutrality. While divestment is a powerful and sometimes required mechanism, it does not necessarily address the need to engage directly with non-green

TABLE 7.2 United Nations-convened Net-Zero Asset Owner Alliance members

1	Akademiker Pension (pension, Denmark)
2	Alecta (pension, Sweden)
3	Allianz (insurance, UK)
4	AMF Pension (pension, Sweden)
5	Aviva (insurance, UK)
6	AXA (insurance, France)
7	BTPS (pension, UK)
8	Cbus Super fund (pension, Australia)
9	CalPERS (pension, US)
10	Caisse des Depots (pension, Canada)
11	CDPQ (pension, Canada)
12	The Church of England (pension, UK)
13	CNP Assurances (insurance, France)
14	Dai-ichi Life Group (insurance, Japan)
15	Danica Pension (insurance, Denmark)
16	David Rockefeller Fund (foundation, US)
17	ERAFP (pension, France)
18	Folksam Group (insurance, Sweden)
19	FRR (pension, France)
20	KENFO (sovereign fund, Germany)
21	Generali (insurance, Italy)
22	Munich RE (insurance, Germany)
23	Nordea Life & Pension (insurance, Nordics)
24	P+ Pension (pension, Denmark)
25	PensionDanmark (pension, Denmark)
26	PFA (pension, Denmark)
27	PKA (pension, Denmark)
28	QBE (insurance, Australia)
29	SCOR (insurance, France)
30	St. James's Place (wealth, UK)
31	Storebrand (insurance, Norway)
32	Swiss Re (insurance, Switzerland)
33	UNJSPF (pension, US)
34	Wespath (insurance, US)
35	Zurich (insurance, Switzerland)

Note: Global asset owners setting and reporting on ambitious interim targets for net-zero emissions by 2050.

Source: Net Zero Asset Owner Alliance (2021).

firms. Moreover, divestment of carbon-intensive assets simply transitions ownership of these assets to some other, perhaps less environmentally conscientious, owners. For this reason, engagement with specific businesses becomes critical for pension funds that believe that addressing systemic challenges is part of their mission, though active engagement has not been

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at the top of most pension funds' agenda until recently. The investment value chain will need to shift so that asset owners, as providers of capital, set the tone and agenda for stewardship activities which they may delegate to asset managers for execution.

These new types of new primary investments are challenging, however, since they have been relatively small and illiquid to date, whereas the systemic challenge of transitioning the low-carbon economy requires investments on a far larger scale. Drawing parallels with investors' experiences with renewable energy, initially the scale of early private investments in wind and solar energy was very small, complex, and heavily predicated on government tariffs and subsidies. Nevertheless, for those who had the capability to be early adopters, these investments more than justified the risk and associated cost of investing. Wind and solar energy are now a common staple in pension funds' repertoires, enabling them to achieve attractive risk-adjusted returns without government support. Similarly, the public-private partnerships, such as Operation Warp Speed in the US and Project Lightspeed in Germany, have recently developed, manufactured, and distributed COVID-19 vaccines in less than 12 months. Many other industries will need to follow a similar journey, where public capital will jump-start the path toward carbon neutrality, giving private capital an opportunity to follow on acceptable risk-adjusted return terms.

It is also worth noting that the boundary between financial and nonfinancial considerations may become blurred and more challenging for pension funds to navigate in the future. For instance, setting targets for investment portfolios in terms of the reduction of carbon emissions could lead to unintended consequences, if decision makers put more weight on this target in the short-term compared to the long-run risk-return tradeoff. US public institutional investors facing strong regulatory pressure to invest more in infrastructure over time are now taking on more marginal deals in order to meet their nonfinancial objectives, which has led to underperformance (Andonov et al. 2021). In a similar vein, the use of economically targeted investments (ETIs), where fund managers take into consideration not only the investment return but also the economic benefits to the local community, was one of the most controversial issues facing public and private pension fund management in the US in the 1990s (Mitchell et al. 2008).

These risks of consequences, including potentially making suboptimal investment decisions, are substantial, and they must be acknowledged and clearly communicated. Even in the multi-stakeholder world, the primary purpose of pension funds continues to be their capacity to generate returns for their members. Finding a way to play an active role in, and deliver positive outcomes from, financing this economic transition is a key challenge for global pension funds, and addressing this challenge requires mindsets to work in ways that are not only systemic but transformational.

Universal Ownership

The concept of universal ownership can be very useful when thinking about how pension fund managers could reset their mindsets and approaches. According to the PRI (2017), universal owners are large institutional investors who own highly diversified, long-term portfolios representative of global capital markets and which effectively hold a slice of the overall market. Consequently, their investment returns depend on market performance, including the costs of externalities. A sensible approach, in this instance, is to think about the overall economic system when making investments. To be successful in the longer term, universal owners must pursue the active ownership model focusing on engagement and stewardship, and they must also give more weight to intergenerational concerns and the sustainability of the global economy as factors affecting their future risk-adjusted returns.

Current definitions of what a universal owner is focus on size, long investment horizons, and a certain mindset. In practice, most large-asset owners today do not currently manage their funds in line with universal ownership principles, in part because they do not perceive themselves as large enough, do not have the long-term orientation, or they lack leadership buy-in to operate in this way. Five asset owners among the top one hundred have been identified in the ‘universal owner’ category, all of them pension funds: the Japanese Government Pension Investment Fund (GPIF), the Government Pension Fund (Norway), ABP (Netherlands), the California Public Employees Retirement System (US), and PFZW (Netherlands).

The Japanese Government Pension Investment Fund, as the largest pension fund in the world, offers some examples of how a universal owner can behave in a way that creates a positive impact on the entire system (Henderson et al. 2019). Its creation of new ESG indices, facilitation of corporate transparency, ESG disclosures, and engagement with asset managers requiring them to integrate ESG metrics into their investment processes, not only serves as a catalyst for broader-scale improvements in the financial markets in Japan, but also provide a role model for how to influence and change the system to other large-asset owners around the world.

Another example of a pension fund that has successfully developed systems-level thinking and engagement, while not having the size for universal ownership, is New Zealand’s Super Fund. It currently holds around US\$40 billion under management, having grown at over 10 percent per year for some time. It signed the Paris Pledge for Action in 2015, affirming its commitment ‘to an emissions reduction target and regularly updating it’ (New Zealand Super Fund nd). The Super Fund states that ESG has an impact on long-term returns and accordingly, it has embedded climate change into its investment strategies and ownership practices in the belief that it will improve its portfolio.

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Ultimately, global pension funds are increasingly recognizing systemic risk as well as own portfolio risk, and they understand that their returns will be produced by a system that works, and those returns are worth more for their beneficiaries in a world worth living in. Pension funds can move from being silent and disengaged owners to active and purposeful owners, while still delivering on their key mission of securing financial futures for end savers worldwide.

Role of Asset Managers

Asset managers are a critical link in the investment value chain, as they play a substantial role in managing and stewarding underlying assets on behalf of asset owners. This segment of the value chain has grown exponentially in the last few decades, both in the amount of capital and number of people involved, and has been able to provide much higher remuneration than asset owners. At the same time, investment performance is characterized by a very low signal-to-noise ratio and very long feedback loops that link outcomes with inputs into decision-making. As a result, the asset management industry has become extremely competitive, and the relationship between asset owners and asset managers is heavily influenced by short-term results that are rarely due to skill.

Like pension funds, asset managers have been responding to the recent developments in the ESG landscape, from both regulatory and investment perspectives, and they are boosting their ESG expertise and capabilities. Seventy-three asset managers have signed onto the Net-Zero Asset Managers Alliance, including many of the largest asset managers in the world: their assets represent US\$32 trillion, more than one-third (36 percent) of the total assets under management worldwide. That said, asset managers' net-zero commitments tend to be stipulated by constraints put on them by their clients, the asset owners. This dynamic emphasizes the importance of the powerful 'voice from the top' of asset owners, yet asset owners still need support from asset managers to invest efficiently and effectively. They also need better measurement frameworks to ensure they are achieving the desired results. In any event, the current landscape reflects a work in progress rather than an endpoint.

To become more effective, the relationship between asset managers and asset owners would benefit from becoming more long-term and strategic in nature. Incentives and behaviors must be aligned across the investment value chain: for instance, asset owners need to outline investment mandates and incentives in a way that does not lead asset managers to short-term orientation in their mindsets and behaviors. Again, the Japanese GPIF provides a good example as it has completely restructured its active equity

mandates, making them longer-term, while also aligning incentives (Henderson et al. 2019). Investors must also engage more actively with underlying businesses to encourage this transition since, to date, asset managers' capabilities devoted to stewardship have been modest compared to the task at hand. Miles and Shihn (2019) have estimated that dedicated stewardship resources represent around 1 percent of the total headcount in the asset management industry, while 99 percent is focused on research, valuation, and trading. Accordingly, the asset management industry has a unique opportunity to redefine its purpose and create value for all its stakeholders, including society at large.

Finding a Better Way

A growing awareness of the need to look beyond immediate financial motives to create a sustainable future is prompting many leaders to focus more on culture, which includes multi-stakeholder capitalism and increased emphasis on purpose following the tragedy of the global pandemic. Pension funds, as the most sizable category of asset owners and ultimate allocators of capital, will therefore increasingly need to revisit their missions and beliefs to take on these wider ideals. While many expect these challenges to be longer term, there is also the risk of short-term repricing as new regulations reshape capital markets. For this reason, considering ESG factors is increasingly becoming a fiduciary duty, even in its most narrow definition.

Asset owners as a group, and pension funds in particular, often lack internal capabilities and are often under-resourced, precluding them from focusing on goals wider than immediate portfolio activities. One analysis of the investment value chain (Thinking Ahead Institute 2020b) suggested that asset owners represent only 10 percent of the total workforce employed in the investment industry, while bearing the ultimate responsibility for most of its capital. The same source noted that asset managers represent 60 percent of the total headcount, and other service providers account for around 30 percent. This allocation of resources does not appear aligned with where the ultimate power sits; to navigate the increasingly complex investment landscape and exercise genuine active ownership and stewardship rights, pension funds must devote more effort to defining their missions, beliefs, culture, and operating models.

Conclusion

We have argued in this chapter that, aside from government spending, global pension assets represent the largest pool of capital on the planet, with the longest time horizon and multiple stakeholders across different generations. Many challenges facing our society are global in nature, and they can

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only be solved with a global and intergenerational mindset. Global pensions appear to have great potential to address these critical issues, yet the global investment value chain has mostly not heard a ‘voice from the top.’ Humanity would be remiss in not harnessing the power of this capital. Yet for this to happen, pension funds as investment organizations need to go through a transformational change that requires strengthened governance, greater system-wide collaboration, and substantive innovation.

Notes

1. Unless stated otherwise, all estimates are from the research reported by the Thinking Ahead Institute, a global not-for-profit group founded by Willis Towers Watson (WTW) whose vision is to mobilize capital for a sustainable future. All numbers have been collated based on annual surveys run by TAI for the last ten years. Consequently, these numbers are more up to date compared with the estimates from OECD or World Bank.
2. The ‘current pledge’ includes spending by the US (US\$2 trillion under the Biden administration), the EU (US\$1.3 trillion from Green New Deal), and China (at least US\$800 billion during 14th five-year plan. ‘Other major human endeavours’ include US Interstate Highway System, Saudi Arabia’s NEOM, Xiongan New Area, the Apollo Program, the Great Wall of China, China Three Gorges Dam, Manhattan Project, Panama Canal, Suez Canal, and the US transcontinental railway.

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