Kindly hosted by

In partnership with

ICGN
International Corporate Governance Network

Kindly sponsored by

Manulife Investment Management

Governance of Sustainability Dialogue - *From Climate Change to Social Change*

23-24 June 2021
Hosted by UNCTAD World Investment Forum

Plenary 4: Aligning Accountability Across the Investment Chain

- Claudia Kruse, Managing Director Global Responsible Investment & Governance, APG Asset Management, Netherlands
- Emi Onozuka, Chief Operations Officer, Japan Catalyst, Inc, Japan
- Kevin Paul, Sustainability Research, Credit Suisse HOLT, UK
- Mirza Baig, Global Head of Governance & Stewardship, Aviva Investors, UK
- Chair, Chris Hodge, Advisor ICGN & Director, Governance Perspectives, UK

Chris Hodge:
Previous discussion has been focused on company roles on sustainability. We will focus our intention on investor contribution. These issues can't be separated, making it difficult for the panel, as we've been briefed to discuss aligning accountability along the investment chain, with many actors and intermediaries, and then investee company. The longer the chain, the greater potential for misaligned or miscommunicated incentives. Good intentions from one end do not guarantee delivery at the other end, necessitating clear expectations at each stage and accountability in the opposite direction.

Our main focus is ensuring the alignment of interests of asset owners and Investment Managers, the subject of a joint ICGN and GISD Alliance (Global Investors for Sustainable Development) project. We're developing an update of ICGN's Model Mandate Guidance, covering the issues asset owners must consider when setting mandates, with draft contract terms. The new version will focus more on sustainability, aligned with recent changes to ICGN's Global Steward Principles.

Claudia Kruse is particularly well qualified to discuss this. Alongside working at APG Asset Management, she sits on the ICGN board and is Co-Chair of GISD Working Group, developing the new guidance. Mirza Baig is Global Head of Governance and Stewardship at Aviva Investors, widely recognised as a leader in this area in investment

management. Emi Onozuka is a COO at Japan Catalyst and chairs the Japan Stewardship Initiative Steering Group, hence here involvement today. Kevin Paul from Credit Suisse is responsible for integrating sustainability research into the HOLT Evaluation Framework, which we can all learn from.

Claudia, you're ideally placed to address overall objectives and activities of the GISD Alliance, and specifically Model Mandate and its contribution to the bigger objectives.

Claudia Kruse:
The GISD Alliance was formed in 2019, is hosted by the UN Secretary-General, and is a group of 30 businesses, representing about $16 trillion. The goal is to help contribute to achieving the SDGs through three focus areas: mobilising finance and investment, scaling up investment solutions and creating impact. The companies involved are very prominent: Allianz, JSE, Aviva, CDPQ, CalPERS, GPIF, Bank of America, PIMCO, Nuveen and Infosys. A global group, with not only investors, but some big names, e.g. Citi and Santander, being represented.
The CEO is committed to making tangible impact with the various ongoing initiatives. Originally, we examined what it means to invest in SDGs, the definition was made available, which has now been progressed to examine impact metrics, currently out for consultation, alongside creating a joint investor platform with UNDP.

Why is the Model Mandate of interest? It was ICGN's seminal work. We recognise if you wish to influence the investment chain, the incentives between asset owners and Managers must be set properly and the ecosystem of standard setters in a market must accept this. Regulators and standard setters can include it in their work, as with the existing Model Mandate in South Africa and the CRISA Code.

The Working Group consults with a variety of asset owners and Managers, alongside other partners, with a view to updating the Model Mandate, with ICGN, led by Chris Hodge. There will be a much stronger focus on SDGs and, from GISD's perspective, the dimension of having impact in the developing world is very important. It is a strong collaboration. ICGN drafted the original Model Mandate, which has since influenced EU regulation, standard setters, along with very influential global businesses.

Chris Hodge:
A good introduction to the particular initiative, the broader objectives and the GISD. We're told Managers experience more client demand for responsible investment, ESG, sustainability, etc. Aviva has a well established reputation in this area. Mirza, what is your experience with clients? How well do they understand what they're asking of you? Do you get consistent requests or are wide ranging issues being raised?

Mirza Baig:
I will discuss what we see with traditional investment mandates, rather than strategies with explicit sustainability or impact objectives. The touchpoints between Asset Managers and owners break down into four key areas: RFPs, Manager selection, investment mandates and performance evaluation. The world is more complex and there are Consultants, etc., but we'll focus on those.

RFPs is probably where we see the greatest movement. We've seen a substantive increase in RFPs with responsible investment sectors, but the number of questions and level of detail has progressed materially. They no longer simply ask if we're a signatory to the PRI. They need details of integration processes, our firm's activities on diversion and inclusion, and that we can demonstrate our stewardship impact, specifically at a strategy level.

Similar performance trends are observed in frequent review meetings with clients, on dedicated ESG sessions, providing a full overview of ESG activities, priorities and achievements. The questions are increasingly more probing, with asset owners upskilling their understanding of what good looks like in ESG.

We see a wide spectrum of focus areas amongst clients, some more process driven, others interested in outcomes, some wishing to focus on their specific themes of interest, underpinned by climate. It's a welcome challenge which is required to design ESG programmes catering towards preferences of an increasingly heterogeneous client base.

The two areas with the least progress are Manager selection and explicit ESG incorporation within investment mandates. Notwithstanding a few progressive asset owners, final selection criteria is heavily weighted to fundamental investment, research, performance track record, risk management and speeds. ESG is more prominent, but remains an undefined overlay in final decision-making.

For mandates, excepting a list of ESG related exclusions, there is very little else. We've started having conversations on carbon intensity targets and how this might look. Aside from climate, there is no real conversation.

If you think we operate in a compressed fee and margin environment, if Asset Managers don't get signals on ESG's fundamentality to winning new business, this explains why the industry isn't investing at the required levels for systematic ESG integration. Without that level of focus clarity from clients, Fund Managers experience confusion for stock selection and portfolio construction, and balancing softer expectations with legally obligated financial targets. It creates inconsistent decision-making and suboptimal outcomes for everyone.

Hopefully, if we make progress with the Model Mandate, it should affect each of the four touchpoints and address the issue of revamping the ecosystem.

Chris Hodge:
You identified different impacts and differentiated the issues so clearly. Some priorities in investment objectives, you would assume will, rightly, continue to exist in the future, given owners' differing perspectives. Hopefully, there is an opportunity to address some other issues and the mandate may help towards this. As you said, a lack of clarity on the inputs and outcomes of work of individual investors may not be as effective as hoped and when addressing the SDGs, the effect of the whole industry risks being suboptimal.

The mandate could be a tool to bring greater alignment and consistency across the market. Another approach would be bringing asset owners and Managers together to identify priorities and address practical issues, as done in Japan, under Emi's leadership, through the Japan Stewardship Initiative, established 18 months ago. She's ideally placed to brief us on what it involves, how it works, any early signs of impact, and a view on whether this model is appropriate for other markets to follow.

Emi Onozuka:
The Japan Stewardship Initiative was established in November 2019. The trigger goes back longer. The Japan Governance Reform started in 2014, when the Stewardship Code came in. It has been part of the government-led growth strategy. Through investor-investee dialogue, mid to long-term return in investment is improved, ultimately, Japanese companies and entire market becoming more attractive for global investors, a big mandate and expectation.

After the 2017 revision of the code, asset owners had to take ownership of stewardship responsibility. Investors quickly realised there was an area for further collaboration, along the investment chain, to achieve this particular objective. Early in 2018, two years before launch of the GSI, a volunteer group started discussions around a smart, efficient and effective strategy of the reporting mechanism, from Asset Managers to owners.

Japan is very heavy in reporting. Stewardship reporting has to be bespoke for each asset owner, putting pressure on stewardship activity sustainability. With the concept of building a better, sustainable, ESG integrated world, we needed to better collaborate in the investment chain to make this a sustainable and effective activity. Through various conversations with asset owners, regulators and academics, over two years, we developed the Stewardship Initiative, to incorporate asset management participants, initially as a leading community, incorporating asset owners, supported by a mutual party. Japan Exchange Group is our Secretariat and we have supporters and observers from Japan FSA. For the investment chain, we have Keidanren, the business association of companies, in the corporate sector, and ICGN has recently become an observer. There are over 50 organisations, on a voluntary, without fee, basis, discussing the best stewardship reporting practices.
The subsequent product was the Smart Format, 150 stewardship questions, around dialogue, proxy voting, organisation setup, etc., for everyone to answer. It's used between Asset Managers and owners, not for disclosure, on a particular bilateral contract on a specific investment mandate. We agreed upon a template of the questions essential for effective industry-wide stewardship. The content is unique to each specific owner-Manager relationship. With a standard template, reporting is effective and smart, not owner specific, resulting in efficiency gain, which can be spent on company dialogue.
The format first published in 2018 and a third version was published in May. 60 asset owner organisations voluntarily use this template to ask their Asset Managers to report on a consistent format. Asset owners and Managers then compare across different Managers and report to the Board of Pensions or, ultimately, to the beneficiary. This dialogue and development continues and ultimately, we would like

to digitalise that, so the investment chain and activity is transformed into a digital transformation phase.

Chris Hodge:
The benefit depends on scale, having enough owner and Manager commitment to make it work. At such an early stage, with 60 asset owners using it, you're moving closer to achieving it.

Kevin, your focus is slightly different to the others. Your main role is developing evaluation framework for investee companies, but the issues are relevant for asset owners and Managers, your primary audience. What sustainability and SDG metrics should Managers and owners use that could form part of a reporting template or provide Manager accountability to owners, and companies to Managers?

Kevin Paul:
We're focused on integrating sustainability topics in fundamental analysis, covering a lot of ground in one conversation. To do this, you need interesting metrics, speaking to current performance and adaptation to an uncertain future, i.e., building long-term, productive and adaptive capacity. Our five focus areas encompass various aspects of the Model Mandate. Our indicators assess companies on that basis, and we turn that assessment into conversations with Asset Managers to consider how they track these indicators. Our questions to Asset Managers may be similar to those asset owners ask, albeit from a slightly different perspective.

We look to identify companies seeking to mitigate the risk of stranded assets, through capital allocation measures, maintaining flexibility on the asset and financial side, investing in long-term, productive, adaptive capacity through innovation. We track those concepts through various indicators, some reported by the company, some inferred from customers and other ecosystem participants.
In discussions with Asset Managers, we look to identify how they track stranded asset risk systematically, if possible. We look at the Asset Manager structure, defining whether teams are communicating cross-sectorally, because risk in one sector might emanate from developments further away in the ecosystem. We may seek to identify in these clients avoidance of siloes, the collaborative approach.

Materiality is a very popular word in sustainability. We're interested in the dynamic side, how materiality is evolving as companies progress through the strategic journey at various parts of the life cycle, and differences within subindustry. We think more dynamically than statically, considering the key pillars of capital a company relies on to generate value and growth. These are the KPIs we track. We define how our asset management clients track materiality and the datasets they use to identify issues not yet material, which may become so in due course. Beyond tracking news flow and media, how do they examine the fundamental dependencies of a company regarding the types of capital needed to generate value?

Investment versus maintenance is interesting and how it flows through in reported financial statements. If a company, on a headline level, appears to operate on a very high return on capital, very high margin, we need to identify those truly value creating,

generating excess returns, or those sacrificing investment in long-term productive capacity to do so. Don't rely on the return of capital metrics observed from data providers or the company, but systematically dig beneath headlines. Dig deeper into the income statement, allocating certain expenditures into the investment and some, the maintenance, bucket. This creates interesting opportunities for long-term thinking clients. If they're trading on a depressed valuation, it masks underlying investment in productive capacity. We observe how they dissect financial status, then differentiate between investment line items and maintenance expenditures, see how they track long-term opportunities, without directing resources inordinately to that effort.

An asset owner may feel differently to a manager about externality importance, with different timeframes and perspectives on overall systemic risk. We want to integrate the fundamental, externalities and impact discussion. Can we track hybrid metrics, e.g., economic profit per unit of value creation systematically along the SDG verticals, whilst enhancing comparability across companies? Any systematic analysis needs comparison of company performance, consistently integrating into one set of metrics value creation, process externalities and product and service impact. Similar indicators must be monitored by Asset Managers.

Slightly different is the asset management process. On capital return and economic profit, few companies have attractive capital allocation history and genuine prospects for compounding value. Is the asset process set up for very few decisions to be made annually, or many decisions, where errors creep in? Can reinvestment be outsourced to a company with genuine value compounding capabilities? We look at companies with ability to reinvest capital, but in asset management, you must know when to sell, how to deploy proceeds and whether you can minimise the periodic decisions required.

We focus on capital allocation to bring key indicators into the discussion, which exceed current performance, identify long-term productive capacity and adaptive capacity. How can we integrate capital allocation and current performance KPIs?

Chris Hodge:
So, how do you integrate the considerations into the performance metrics and mandates? The questions you ask Managers, asset owners would ask if they knew the right questions.

Claudia, what should we consider when developing the Model Mandate?

Claudia Kruse:
Very interesting perspectives on standardisation and bespoke reporting. APG offers a bespoke service for very few asset owners. Their dedicated RI policy covers stewardship, sustainability, etc., and we implement it, report on progress and targets, etc. We increasingly use external Managers, making greater use of templates, but they're not sufficient. We want to go deeper and tailor the discussion on meeting our needs as per the client's mandate.

What data you use for impact reporting is very interesting. ABP committed to invest in SDGs in 2015. How do you identify SDG contributing investments? Back then, there was no data source to track this. We developed an AI-driven data source observing positive contributions of core business, products and services. Our joint platform with British Columbia, AustralianSuper and PGGM makes the standard more broadly available. To answer asset owners' questions, we must create standards to facilitate it. The Model Mandate should identify the collaboration for this.

Chris Hodge:
That's a particular priority with the practical integration difficulties, from Asset Managers and owners. Emi's approach is one model. It's not the answer, but is intended as a framework for bespoke discussion, depending on the issues. It ensures common questions are debated, an incredibly helpful starting point.

Do you have a brief guide to key fundamentals in sustainable value creation?

Kevin Paul:
Two companies, on the surface, generating positive economic profit, one may be doing so at the expense of future investment. We must separate those from companies generating good economic profit, whilst being forward-thinking. Don't generate value today by borrowing from the future. Use your current resources productively, but consider long-term adaptation investment, ultimately remaining relevant. This incorporates impact and ESG discussion, ultimately, methods of SDG disclosure.

Capital allocation is central here. ICGN work regularly with capital allocation disclosure. We want to discover what companies deploy for replenishing existing assets and boosting capacity, going forward. The difference between innovation and maintenance must be drawn.

Mirza Baig:
It is multidimensional. The debate is sustainable value creation for who, and shareholder primacy versus multistakeholder model of value creation, how to measure it and balance stakeholder interests. We say long-term stakeholder interest alliance, which doesn't help individual business decision-making at any one time.

Investment Managers form a view, but all clients have different perspectives on evolving debates. Their needs, asks, interests and positions must be clearly articulated and bind the Investment Manager to their world view. If it's communicated softly, but performance targets are around shareholder primacy, you see investment behaviours where capital is allocated, contrary to your values and broader sustainable value creation perspectives, so you can only direct capital sustainably through clarity and a mandate. Capital distribution is still inconsistent.

Claudia Kruse:
The carbon reduction and investment targets linked to the SDGs are part of the SLA and Strategic Investment Plan. It sharpens Portfolio Managers' minds and enables you to drive the capital allocation and cultural change. Our implemented theme of

inclusion is risk, return, cost and ESG, all investments being justifiable by these, which in practice, triggers change.

Chris Hodge:
Is the use of a carbon-adjusted return metric on capital a potential key new performance metric which should be applied to the incentive design for Asset Managers and their investee companies?

Kevin Paul:
We're developing a carbon-adjusted suite of metrics. Our flagship return on capital metric is CFROI (cashflow return on investment). We're now calculating a carbon-adjusted CFROI. You can incorporate carbon intensity, apply different carbon prices, reflecting transition towards 1.5 Net Zero, consider abatements related expenditure and a company's ability to pass costs to customers. Wrapped up in this metric, comparing to an as reported ROC metric, you see divergence in performance, with improvement in operating returns, not carbon intensity. Comparing the measures gives different perspectives of a company's performance.

You could say KPIs for the CEO should incorporate a ROC metric adjusted for externalities. Many plans plainly incorporate ROC. One incorporating externalities may address the growth and footprint trade-off.

Chris Hodge:
Emi, the guidance should be capable of being applied in many different countries, circumstances, etc. A challenge is to develop a framework that works everywhere, and it's challenging in one market, Japan. Are there any tips on how to do this broadly, but not broad enough to have no practical value?

Emi Onozuka:
It is challenging to agree on common ground globally. When developing the format, we tried to distinguish common area from bespoke area. We drew a doughnut, the central hole being common, with best practice to leverage and educate ourselves to expectation, and the doughnut more creative for Asset Managers and owners.

We encompassed different perspectives. Initially, Asset Managers, Heads of the Stewardship Group, then with my global knowledge, consultation with asset owners, incorporating regulators and academics to agree a common approach. Since 2018, we've had yearly updates, it's an evolving ground for our education, steering stewardship in an aspiring, not complacent, direction, with commonalities, but realistic enough for the investment chain to appreciate.

Chris Hodge:
It's finding the appropriate middle ground, avoiding box ticking, whilst helping to resolve the practical issues.

Claudia Kruse:
We have a European Sustainable Finance Disclosure Regulation (SFDR), with remit not limited to Europe. Kevin, how do you integrate SFDR disclosures into your framework?

Kevin Paul:
Currently, we're in early stages of integrating the SFDR articles. We're establishing tools for Asset Managers to demonstrate systematic sustainability assessment and companies' possible, and potential, contributions to various sustainability initiatives. With carbon, we're developing a tool enabling clients to systematically stress test portfolio cashflows in different scenarios, the implications for costs taken through cashflows, etc., run them for different scenarios, assessing portfolio impact, drilling down into subindustries and further, into companies, identifying the risks systematically.

How do you do it systematically with your current disclosure? For various externalities analysis, we can do it within this framework: carbon, water, waste, footprint related measures. With Article 8/9 considerations, we demonstrate companies have a positive impact or potential by focusing on metrics we currently have access to: innovation, R&B driven, patent disclosure. Incorporating these into a systematic assessment of contribution towards SDGs, is a work in progress, incorporating various workstreams, but we'll update you.

Chris Hodge:
Asset owners have upskilled in ESG knowledge but are still learning. Are there any examples of companies supporting their pension funds with internal ESG expertise or relevant assistance, to help them tackle issues?

Mirza Baig:
Not structurally, as companies must keep pension funds at arm's length. Aviva are involved in educating pension fund trustees, along with only a few others, but the number is growing.

Chris Hodge:
Even if it's not typical, it's encouraging to hear. What one action would you like to see that would have the biggest impact on achieving the objectives?

Claudia Kruse:
Clear incorporation into investment agreements. I would encourage everyone to share their Model Mandate ideas with Chris.

Mirza Baig:
To revolutionise the ecosystem, we must invest in technology to create dynamic communication. We must bring beneficiaries to the forefront of Managers' thinking.

Emi Onozuka:
For a sustainable future, we need to be sustainable. In Japan, we're focused on how investment chain participants and initiatives like ours can be sustainable, to lead by example in this context.

Kevin Paul:
I'd appeal to investee companies for better disclosure on capital allocation for stakeholders, to observe priorities of different types of capital, incorporating in a way to drive their competitive advantage.

Chris Hodge:
Excellent final points and fascinating conversation.