



**THE
RISE
OF THE
S
IN ESG
AND THE
ROLE OF PUBLIC
PENSION FUNDS**

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This article explores ways in which public pension funds can respond to the broader environmental, social, and governance (ESG) concept in their investment portfolios—particularly the social, or “S,” part.

The COVID-19 pandemic has demonstrated that global health and global financial well-being are not independent; policy responses to the pandemic have had a profound impact on how we live and how businesses and societies function. In turn, global and local economies have been halted or restricted, threatening revenues and returns.

WHAT IS “S”?

Early pension fund investors that focused on “S”—or social investing—were concerned with human rights abuses in emerging markets, including sweatshops in the garment and shoe industry, and child miners in the Democratic Republic of Congo. These types of social issues usually manifested themselves as reputational risks for the corporations in the funds’ investment portfolios.

Since then, S risks have become more complex and systemic. They are no longer limited to human rights or emerging markets, and they are affecting organizations with strong positive cultures in developed markets, as these firms face difficult decisions regarding workforce management and capital allocation. Some current “S” risks include the following categories:

Human Rights

- Anti-slavery legislation
- Availability of clean drinking water and adequate food
- Access to health care

Human Capital Management

- Workers’ rights
- Diversity, equity, and inclusion
- Enforcement of harassment policies
- Compensation practices including fair pay and income inequality

Other

- Responsible firearms
- Customer service
- Supply chain transparency
- Anti-corruption
- Product quality
- Data security and digital rights
- Equitable taxes

Examples of investor value experiencing a profoundly negative impact include Volkswagen’s emissions scandal, Uber’s culture of sexism, Wells Fargo’s fake account scandal, and Equifax’s data breach, to name a few from what is now a lengthy list. For both active and passive investors, these companies’ returns were affected by “S” risks.

As institutional investors, all pension funds have investments in companies that have been affected by COVID-19 or are now facing uncertain operating environments. The COVID-19 pandemic itself has given rise to new “S” risks. For example, some companies have chosen to use funding from the federal Paycheck Protection Program to continue their share buyback programs. Others have laid off employees while at the same time rewarding executives with incentives that are significantly out of alignment with the experience of current and former employees. Investors need to be mindful about meeting their obligations while balancing the human impacts of the pandemic both in their own operations and those of their investment portfolios.

There are several ways in which public pensions can address the “S” risks in their investment portfolios. None of these activities should begin without first having a clear understanding of who the stakeholders are within the fund’s operating ecosystem, and where stakeholder interests lie. (This concept is very similar to the “know your customer” suitability requirements for financial service providers.)

Know your stakeholder

For pension funds, the concept of stakeholder suitability has traditionally been defined through actuarial demographics and metrics, and the risk profile set by the pension board. But external pressures are pushing to broaden this long-standing concept. Members and beneficiaries are more than just an age cohort—they have an important voice in optimizing the delivery of the pension fund’s mission. We first observed this in the early 2000s, when more funds began using customer satisfaction surveys to invite

member opinions about the quality of the service they were receiving. The concept of infusing the voice of the customer to create better alignment with pension fund activities is being newly tested in an environment of social unrest.

Before attempting to align their goals and activities with stakeholder interests, public pension funds need to be clear about who they perceive their stakeholders to be. At first glance this may appear to be an obvious exercise, but the picture can become rather complicated. Public pension fund stakeholders should at least include members, retirees, and beneficiaries. Some will also include those who participate in the funding of the pension fund, such as the sponsoring government or employers. Pension fund staff is another important stakeholder group that should not be overlooked, because staff members are often members of the plan, too.

Once the fund has defined who its stakeholders are, it should build capacity to interact with its

stakeholders to understand their sentiment on ESG concepts, “S” in particular. While this can be done through surveys and interviews, some non-U.S. pension funds hold roundtables with their stakeholders to enable two-way communication. There is an education component to the interaction, as well as a listening component, which helps ensure that the pension fund receives informed feedback that reflects its stakeholders’ views.

It may be the case that stakeholders have no interest in ESG concepts, or they have conflicting interests. Pension funds need to follow an appropriate process to ensure that they’ve gained sufficient clarity about their stakeholders’ concerns to move forward in identifying a strategy to address these risks. A lack of clarity is not a good enough reason to do nothing.

Once stakeholder views are known, some pension funds use advisory groups to incorporate expert views on wider ESG issues and their implementation. This is one way





Five years after Volkswagen AG admitted that 11 million of its vehicles were rigged with software that cheated on emissions tests, the company has lost more than \$30 billion dollars and stock is still 35% below its pre-scandal price. Beyond the financial repercussions, the scandal damaged the public's trust and caused incalculable harm to the brand's reputation.

to introduce the diversity of views and expertise that the pension fund staff itself might lack. Others might participate in coalitions formed by peer pension funds such as the Human Capital Management Coalition.

Once the process is underway, the pension fund should build a competency in communicating ESG issues to inform stakeholders about the fund's progress against its pre-established definition of success. It can take years for the outcomes of these initiatives to become apparent. While this timeframe is appropriate for public pension funds as long-horizon investors, it is not necessarily convenient for the immediacy of the

modern-day news cycle. Failure to communicate proactively creates the opportunity for others with different interests to take advantage of that void in a way that may not reflect the pension fund's progress or consideration of the issues. In a worst-case scenario, it can create misinformation that will take the pension's time, effort, and resources to correct.

Ongoing communication about these issues will ensure that pension funds can manage their stakeholders more effectively, providing a continuous source of diverse feedback to inform policymakers as fiduciaries.

Develop a "house view"

ESG issues present both financial risks and financial opportunities. Since situations can change rapidly, as we have seen this year, pension funds need a thoughtful approach to identifying the issues that: resonate with stakeholders; share a nexus with the pension fund's investment objectives and the risks it faces; and can realistically be addressed in the investment process, given available resources. Developing a "house view" that includes the pension fund's investment beliefs, along with an implementation plan, can help build an organized approach to addressing ESG issues.

Progressive pension funds have developed investment beliefs that serve as the foundational framing for all investment activity, including ESG. These investment beliefs have historically been referred to in a fund's investment policy statement as its investment philosophy and have captured the agreed-to sentiment about how the portfolio would be invested. Whether beliefs are expressly stated or not, they drive

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daily decision-making, which means they should be aligned with the long-term vision of the investment program. This includes identifying focus and resource allocation priorities. The expansive list of "S" issues alone can be daunting in any prioritization exercise, let alone the broader suite of ESG issues.

The pension fund's implementation plan aligns its investment staff and external investment parties such as investment managers and consultants, around activities in support of the stated investment beliefs. It provides common definitions and expectations, including roles, authority, and activities in the investment process. Specific examples of activities include responding to stakeholder inquiries, gathering data during manager due diligence, implementing new terms as contracts are initiated or renewed, and getting the types of reporting that will be provided to help with ongoing oversight.



Above, activists gather outside the New York State Supreme Court on October 22, 2019, the first day of the Exxon Mobil trial. The oil giant was accused of misleading investors on the financial risks of climate change. A New York state judge ruled in Exxon Mobil's favor, but the lawsuit was one of many the company faces involving corporate responsibility for global warming.

Know your portfolio

Pension funds often use a bottom-up approach to determine which "E," "S," or "G" issues to which an investor will allocate resources in the implementation and risk management process. This typically occurs when staff determines which issues and risks they will dedicate resources toward without being informed by the input of stakeholders or direction from the board. While the bottom-up approach can have the advantage of expediency, the problem is that stakeholder views are not taken into consideration, and boards are only peripherally mindful of the efforts being undertaken.

In some situations, pension board trustees have been surprised to learn the extent of ESG activities, even risk management, being undertaken on their fund's behalf. This most often occurs when pension assets are managed by external investment managers. The pension fund may already be receiving some level of ESG-related service from its investment managers, having offered limited or no policy guidance as to how they wish to vote their proxies, for example. Because many external investment management firms have developed their own firmwide ESG policies and activities, there has been limited visibility or routine reporting to help the fund oversee these activities in light of its own policies.

Every pension fund is responsible for setting standards of expectations for how its assets will be managed, including how their proxies, which are considered to be assets of the plan, will be voted in respect of ESG matters. ESG should not be an exception to this or an afterthought. Indeed, any ESG activities that a

pension fund's external investment managers undertake should be consistent with pension board policies and appropriately overseen by management. Just as it is important to know your stakeholder, it is critical to know your portfolio.

Conclusion

It is increasingly important that "S" issues be taken into consideration by public pensions. The processes, tools, and strategies that are available to effect consideration of "S" risks and opportunities are becoming more sophisticated and mainstream. Long-term performance outcomes are being affected by today's actions or lack thereof. Waiting on the sidelines is no longer a prudent option for pension governance, given the nexus between financial and "S" considerations. ■

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