The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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NOW THAT *COP26* HAS COME AND GONE:

WHAT'S NEXT FOR PENSION ORGANIZATIONS?

"As COP26 came to a close on November 13, the mood was a mix of celebration and frustration. The painful reality suffusing the conference was that the world is failing to limit global warming to 1.5C above pre-industrial level…..Yet, the summit put a series of procedures in place that keep alive the possibility of reaching that goal….."

The Economist
November 20, 2021

"Many pension funds are engaging on ESG issues with the companies they invest in. They are also making efforts to improve their own internal ESG efforts. A new 'Pensions Dashboard for Responsible Investing' captures these internal efforts through ten key indicators."

Canadian Pensions Dashboard for Responsible Investing

"What is needed is an open and frank dialogue concerning ESG-related corporate policies. For example, choosing to be 'good' can increase the market value of a company during the transition period, but will often translate into a lower rate of return in the long-term, rather than a higher one."

Prof. Aswath Damodaran
Stern School of Business NYU

Back into the Trenches

The *Economist* publication tells us that instead of major breakthroughs, *COP26* ended with a long 'to do' list of procedures involving many actors to keep alive the possibility of limiting global warming to manageable levels. Some of the items on that long 'to do' list relate directly to pension organizations. The goal of this *Letter* is to assemble that list for pension organizations, and to propose a useful framework for moving from saying to doing.

That framework comes to us courtesy of a Canadian coalition of 4 not-for-profit organizations with a mutual interest in good public policy, innovation, finding practical market-based solutions, and sustainable finance. Their recent document titled a "**Canadian Pensions Dashboard for Responsible Investing**" proposes 10 key indicators to assess where any pension organization stands at a point in time on its Responsible Investing (RI) journey. Importantly, the framework is not Canada-specific, but relevant to any pension organization anywhere in the world. More on this below.

This *Letter* also introduces an 11th indicator, which is much more difficult for any external party to assess. It is the quality of the pension organization's investment model, regardless of whether investment decisions are made internally, or outsourced to external asset managers. Why is this so important? Prof. Damodaran's observation above provides an answer.

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Moving to an investment model that incorporates environmental, social, and governance (ESG) considerations does not automatically lead to higher investment returns and lower risks. Pricing still matters. It is perfectly plausible that recognized 'good' ESG companies have generally lower return prospects than recognized 'bad' ESG companies. A good investment model recognizes this reality.

Ten RI Indicators

So where does your pension organization weigh in on the RI scale? The cited Dashboard document suggest you find out by answering the following 10 questions. Helpfully, the Dashboard provides 'best practice' guidelines in italics for 7 of the questions:

1. Do you have a science-based net-zero carbon emissions commitment backed up by transparently-reported interim targets?
2. What percentage of total assets are invested in well-defined sustainable investment solutions? *(20%+ of total assets)*
3. Do you disclose total and by asset class carbon emissions and intensity, as well as annual reduction targets? *(minimum 7% reduction/yr)*
4. Do you have a publicly-disclosed E&S pay-link for your own people?
5. What is the ratio of your highest-paid employee's total comp to the medium pay employee's total comp? *(under 8:1)*
6. What percentage of the executive team and board of directors self-identify as a visible minority or indigenous person? *(27%+)*
7. What percentage of the executive team and board of directors self-identify as non-male? *(50%+)*
8. What percentage of E&S proxy resolutions did the fund support in the most recent year? *(75%+)*
9. What percentage of the board of directors has demonstrated E&S competency? *(30%+)*
10. Do you have a policy to ensure that the fund's (and its investee corporation's) political activities are aligned with your ESG priorities?

Next, the Dashboard document assessed where the 12 largest pension organizations in Canada stood in their RI journeys based on these 10 indicators. Recall that our ***March 2021 Letter*** reported that Canadian pension organizations ranked #1 out of 15 countries in transparency based on their public disclosures on governance/organization, performance, costs, and RI. The implication is that the actual Dashboard findings below likely represent the upper end of RI practices by pension organizations around the world today.

Actual RI Dashboard Findings

Here are the findings as reported in the Dashboard document for each of the 10 RI indicators listed above (best practice guidelines repeated in italics):

1. Net-Zero-related Commitments: only 2 organizations have explicit NZ by 2050 commitments with interim targets at this point. However, 6 are participating in the Climate Action 100+ initiative which focuses on corporate climate-related disclosures, 9 are committed to using the TCFD disclosure framework themselves, and 10 are PRI signatories.
2. Sustainable Investment Solutions: 9 organizations provided this information. Related to total assets, the proportions ranged from 14% to 1%, averaging 7%. *(20%+ of total assets)*
3. Carbon Footprints: 7 organization provided this information. In terms of TonsCO2/$millions invested, emissions ranged from 115 to 58, averaging 80. Percent of total assets covered ranged from 100% to 60%, averaging 74%. *(minimum 7% reduction/yr)*
4. E&S Pay-Links: only 1 organization has a direct link to compensation, while 4 others have indirect links (e.g., through integration into broader sustainability scorecard metrics).

5. Relative Pay Ratios: 7 organizations provided this information. The Ratios ranged from 13:1 to 4:1, averaging 10:1. *(under 8:1)*
6. Racial Diversity: 5 organizations had no racial diversity at all at the executive level, the proportion in the other 7 ranged from 11% to 23%, for an overall average of 10%. At the Board level, 6 organizations had zero diversity, with the proportion in the other 6 ranging from 7% to 22%, for an overall average of 7%. *(27%+)*
7. Gender Diversity: non-male proportions ranged from 15% to 50% at the executive level, averaging 35%. At the Board level, non-male proportions ranged from 31% to 58%, averaging 46%. *(50%+)*
8. E&S Proxy Resolutions Support: only 3 organizations provided this information. The resolution support ratios were 51%, 60%, and 76% for an average 62%. *(75%+)*
9. Board E&S Competency: the proportion of Board members in the 12 organizations with deemed E&S competency ranged from 0% to 44%, averaging 15%. *(30%+)*
10. Alignment with ESG Priorities: the RI Dashboard creators could not find any specific pension organization policies to counter inappropriate lobbying by investee companies related to a just Net-Zero transition.

What should we make of these findings? It is hard to disagree with the RI Dashboard creators when they conclude: "*The RI Dashboard findings reveal that there is progress being made in integrating sustainability and ESG considerations in Canada's pension funds, particularly in the larger ones. They also highlight that much remains to be done*."

Keeping in mind the findings likely represent the upper end of RI practices by pension organizations around the world today, they suggest a 3-point strategic 'to do' list:

1. Commit your organization to an effective Net-Zero 2050 investment program with explicit interim targets along the way.
2. Adopt an integrated reporting framework that transitions seamlessly from organization purpose, to governance/org design, to business model, to performance, to strategy.
3. Ensure you have the requisite board, executive, and professional competencies and diversities to successfully achieve items 1. and 2.

This *Letter* concludes with some thoughts on the meaning of 'business model' in a pension organization context.

'Business Models' for Pension Organizations

'Business Models' follow naturally from organization purpose. In a pensions context, 'purpose' broadly means delivering adequate pensions at a reasonable cost.[i] This in turn requires an effective investment function capable of generating a competitive risk-adjusted long-term return at a reasonable implementation cost. What does such a function look like? It has a math dimension and a people dimension. While the math dimension can be (and often is) made very complex, its essence can be reduced to R=Y+G. That is, over long investment periods, the investment return R is mainly made up of the sum of the initial income yield Y plus the growth rate G of the initial income over the investment period.[ii] Of those two R elements, Y is known, G is not. That is where the people part of investing comes in: G has to be predicted. The more predictable G is, the more predictable R becomes. The converse is also true: the less predictable G is, the less predictable R becomes.

This logic gets us to the final piece needed to complete our simplified long term investment model. The less predictable G is, the riskier the investment becomes. In a risk-averse world, that means its expected R must be high enough to be held by knowledgeable investors, and the only source of that higher expected R is a higher Y. Alternatively, if there are enough investors with too optimistic G beliefs, such investments will trade at too-high prices. The point here that the essence of any successful long term investment program is G predictability because good G predictability leads to good R predictability.

Good judgement about G unpredictability is also valuable. Knowledgeable investors will know to avoid unpredictable G stocks unless their windup value exceeds their market value. The questions for pension organizations are: do they have the requisite G assessment talent to be successful….and are those talents being used effectively?

Where Does ESG Investing Fit in to All This?

Finally, can our simplified long-term investment model throw any light on the ESG investing question? Specifically, can it explain Prof. Damodaran's earlier assertion that "*choosing to be 'good' can increase the market value of a company during the transition period, but will often translate into a lower rate of return in the long-term, rather than a higher one?*" Yes, it can.

Assume 'bad' *XCo* has poor governance, no effective long-term business plan, poor HR practices, is a habitual polluter, and has an ownership base largely unaware of these problems. Its stock has a dividend yield (i.e., Y) of 4% and a market-based real G expectation of 1%. So R=4%+1%=5%. A consortium of knowledgeable pension organizations acquire a small stake in *XCo* and initiate an intensive engagement process with *XCo*'s Board and C-Suite. After some important Board and C-Suite changes, *XCo* quickly transforms itself into an ESG super star. As the market recognizes the transformation, its market value begins to rise based on perceptions that (a) it is going to generate a higher G of 2% rather than 1%, and (b) it has become a materially less risky investment. As a result, its market value rises steadily as Y is bid down from 4% to 2%. However, once the ESG transition is complete, *XCo*'s new return prospects are R=2%+2%=4% compared to R=4%+1%=5% for the old *XCo*.

There are three important lessons in this story. First, engaging 'bad' companies and making them 'good' ones can be good investments of time and money. Second, investing in 'good' companies is not necessarily a high-return strategy. Third, successful long horizon investing requires sensible investment models and knowledgeable people with a talent for making good G assessments.

In Conclusion

In its title, this *Letter* asked what is next for pension organizations in a post-*COP26* world. It went on to propose three actions:

1. Use the RI Dashboard to assess the RI-readiness of your organization.
2. Assess the clarity of your business model for achieving organizational success in the post-*COP26* world.
3. Assess your organization's ability to make knowledgeable G judgements in an investment environment of radical uncertainty.

As the RI Dashboard creators noted…..much remains to be done.

Keith Ambachtsheer

Endnotes:

i. *There is a strong legal argument for including an 'intergenerationally-fair' constraint into the purpose statement, which raises the bar for integrating ESG considerations into the organization's investment policies.*
ii. *There is a potential third source of R if investors are willing to pay more or less for investment income at the end of the investment period than at the beginning. In that case, Y at the end of the investment period is either higher or lower than the initial Y, and the resulting change in capitalization will be a third source of R over the investment period. The longer the investment period, the less this valuation change is likely to matter.*

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