The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

July 2021

PENSION FUNDS AND ORGANIZATIONAL REPORTING FRAMEWORKS:

AFTER A YEAR OF GOOD PROGRESS…..WHAT'S NEXT?

*"At a time when innovation is urgently needed in the global asset owner community, adopting the **Integrated Reporting Framework** could be the highest return investment opportunity available today."*

The Ambachtsheer Letter
July 2020

A Year of Good Progress

Last year's July *Letter* on organizational reporting for pension funds asserted the time had come "to consolidate, simplify, and innovate", and concluded that adopting the *Integrated Reporting Framework* would be a high-return investment. Happily, this year's July *Letter* reports good progress on three related fronts:

1. <u>Consolidations</u>: responding to the demands of corporations and asset owner/managers 'for more clarity and simplicity', the *International Integrated Reporting Council* (*IIRC*) and the *Sustainable Accounting Standards Board* (*SASB*) announced their intent to merge their operations last Fall and together, they are now the *Value Reporting Foundation*. In a separate development, to improve pension fund transparency around the world, *Top1000Funds* and *CEM Benchmarking* joined together to launch the *Global Pension Transparency Benchmark* earlier this year.
2. <u>The *<IR> Dialogue for Pension Organizations*</u>: the July 2020 *Letter* sparked a pension fund collaboration to explore how to best use the *Integrated Reporting Framework* to tell their organizational stories. The group has held four webinars thus far to share their experiences.
3. <u>The shift to 'Net-Zero' Investing</u>: this accelerating movement to net-zero (NZ) GHG emissions is placing greater demands on asset owner/manager organizations to explain what 'NZ' means, what it implies for their investment policies, and the actual progress on NZ they are making.

This *Letter* examines these three developments from a "consolidate, simplify, and innovate' perspective, and ends with five concrete ideas for making further progress on these fronts in the year ahead.

Consolidations

The July 2020 *Letter* noted major concerns by both businesses and investors about the proliferation of initiatives intended to modernize corporate reporting requirements. Thus the announcement by *IIRC* and *SASB* last Fall that they would merge was well-received. Subsequently, the two organizations announced that *SASB* CEO Janine Guillot would become CEO of the new *Value Reporting Foundation* (*VRF*).

In a recent email CEO Guillot said a key goal for *VRF* is to support the *International Financial Reporting Standards* (*IFRS*) *Foundation* to develop a comprehensive global corporate reporting system. *VRF* will also offer a comprehensive suite of resources to help businesses and investors develop shared understandings of enterprise value and its creation. The resources include 1. *Integrated Thinking Principles*, 2. *The Integrated Reporting Framework*, and 3. *SASB Standards*. These resources can be used alone or in combination. Together, they constitute the infrastructure needed for organizations to develop, manage, and communicate strategies that create long-term value.

Turning to the launch of the *Global Pension Transparency Benchmark* (*GPTB*), spokespersons Amanda White (*Top1000Funds*) and Mike Heale (*CEM Benchmarking*) said: "*The Global Pension Transparency Benchmark is a world-first global benchmark for the transparency of pension disclosure. It ranks 15 countries on public disclosure of 4 key value-generation elements for the 5 largest pension fund organizations in each country.*" The four value-generating elements of the *GPTB* are: 1. Governance/ Organization Design, 2. Organizational Performance, 3. Operating Costs, and 4. Responsible Investing.

Overall, the top three pension transparency countries in the initial *GPTB* rankings were Canada, Netherlands, and Sweden. However, the rankings displayed material variance at both the individual element and the within-country levels. The launch of the *GPTB* has already sparked an encouraging development: individual pension funds are contacting *CEM* to request joining the 75 funds currently being benchmarked. And how to improve your *GPTB* score? Logically, by checking the *GPTB* description on the *Top1000Funds* website, and adopting the *Integrated Reporting Framework*![i]

<IR> Dialogue for Pension Organizations

The primary attention of organizations like *IFRS*, as well as *IIRC* and *SASB* (now *VRF*) has been on the effective reporting of value-creation in the corporate sector, keeping the needs of investors in mind. However, *KPA Advisory* has been making the case that pension organizations deserve special attention in the sense that they are value-creators for their stakeholders, as well as major investors. As value-creators, they have reporting obligations to their own stakeholders, and as investors, they need a steady flow of reliable, comparable, useful financial and non-financial information about the corporations they invest in.

With this dual focus in mind, *KPA Advisory*, in concert with *IIRC*, launched the *<IR> Dialogue for Pension Organizations* last Fall. Through four webinars thus far, *Dialogue* participants have been able to share their challenges and ideas on using the *<IR> Framework* to better tell their organizations' stories. The ideal <IR> narrative is strategic, future-oriented, multi-dimensional, complete, concise, materiality-focused, and accuracy-assured. It also follows a logical sequence from purpose of the organization, to governance/organization design, to how the organization creates value, to performance, to risks and opportunities, to future strategy.

There are powerful learning opportunities in taking actual Annual Reports and benchmarking them against these 'ideal' standards. Three 'lessons learned' thus far are:

1. The non-financial sections of actual Reports tend to be twice as long as the *IIRC*-recommended 40 pages. This problem can be addressed through a combination of tighter editing and greater use of Report appendixes.
2. The flow and sequencing of the organization story narrative can be improved in many cases. The *<IR> Framework* provides good guidance on flow and sequence.
3. Too much dwelling on the past…..and not enough on the future risks and opportunities the organization faces, and the strategies intended to address them.

The *<IR> Dialogue* collaboration will continue to exchange implementation ideas in the months ahead.

The Shift to 'Net-Zero' Investing

The term 'Net-Zero' is being used with increasing frequency in sustainable/ESG investing discussions around the world. It reflects a recognition that environmental considerations increasingly rank #1 in setting out the conditions for a livable planet in the decades ahead. That means getting to the state of global net-zero GHG emissions sooner rather than later….and that in turn means getting investment portfolios of asset owners/managers to reflect that reality sooner rather than later.

Three elements must work in concert to effectively insert 'net-zero' into portfolio management processes:

1. 'Net-Zero' Investment Analytics: projected investment returns are based on the sum of cashflows now plus cashflows later. The Gordon Model expresses this simply as R=Y+G, where Y is the current income yield of the investment and G the growth in current income. Y is observable, G is not. 'Net-Zero' says G projections need to incorporate the potential impact of each investment position on the global economy moving to net-zero GHG emissions by at least 2050.[ii]
2. 'Net-Zero' Governance and Org Capability: it is no simple matter to pivot investment organizations to a 'Net-Zero' investment regime. Boards of Trustees must 'get' both the need to do so and understand the 'how' to get there. Management must take that understanding of 'how' and convert it into a functional investment organization that actually 'does'. This includes holistically integrating ESG throughout the end-to-end investment and risk governance and management processes. New portfolio measurement and management metrics (e.g., Carbon Adjusted Return projections and risk budgets) will help investment organizations understand their net-zero risks. Organizational capability for "strategic engagement" for 'Net-Zero' alignment with investee companies is also necessary. All this may require an upward shift in organizational strategic thinking and execution capacity of asset owner/manager organizations.[iii]
3. 'Net-Zero' Reporting: the organization is capable of explaining the importance of 'Net-Zero' to its stakeholders as well as the progress it is making to achieve it, and does so regularly in its Annual Reports employing the *<IR> Framework*.

For most asset owners/managers to successfully transition to this new 3-element 'Net-Zero' Investing world will be a major undertaking. Readers looking for a plan to address the transition challenge should read *Wellcome Trust*'s "**The Pathway to Net-Zero for our Investment Portfolio**". In a clear, well-written and illustrated 24 pages, the paper takes the reader from *Wellcome*'s 'why Net-Zero', to its goals, strategy, timelines, and reporting commitments. Truly an inspirational document!

Australia Needs an Innovation Boost

Speaking of inspiration, Australia could use some as it contemplates the implications of *Bill 2021-Your Future, Your Super*, which is intended to positively impact the future direction of its superannuation system. Specifically, the Bill has four goals: 1. Resolve the multiple accounts problem, 2. Foster greater accountability for investment performance, 3. Improve organizational transparency, and 4. Encourage greater member engagement. The proposed 'past sins' investment performance test is seen to be especially troublesome, with its potential for false signals and fostering investment behavior not in the best interest of members.

To this outsider looking in, and in the context of this *Letter*, the Australian legislative approach being taken seems myopic. Would a broader, more strategic solution be to require all Australian super funds to produce independently-assured Annual Reports using the *<IR> Framework*? Properly constructed, such Reports would provide readable narratives about a super fund's value-creating purpose, governance, business model, performance, and strategy for the years ahead.

They set out an integrated story that starts in the past and coherently carries forward into the future. We know this can be done, as previous *Letters* have featured *CBUS Super*'s Annual Reports using the *<IR> Framework*.[iv] This seems a more promising, forward-looking approach to providing members the information they need about their own super fund, and possible alternatives to it. At the same time, requiring such Reports would improve super fund business processes, including their transition to 'Net-Zero' investing..

In Conclusion

Looking ahead, this *Letter* identifies five action steps for readers and their organizations to consider:

1. Support the new *Value Reporting Foundation* as it continues to build the infrastructure for organizations to communicate their strategies designed to create long-term value.
2. Request your own *Global Pension Transparency Benchmark* score from *CEM Benchmarking*.[v]
3. Join the *<IR> Dialogue for Pension Organizations*.
4. Use the *Wellcome Trust* document to plan your organization's approach to 'Net-Zero'.[vi]
5. Regulators should require pension organizations to use the *<IR> Framework* to tell their value-creating stories.

Over to you!

Keith Ambachtsheer

Endnotes:

i. *See our **March 2021** Letter for more on the GPTB.*
ii. *The resulting implications are no new coal fired power plants as of today, no new ICE (internal combustion engine) vehicles as of 2035, and zero fossil fuel electric power generation for the world by 2040, according to the International Energy Agency in their recently released a report "**Net Zero by 2050 – A Roadmap for the Global Energy Sector**".*
iii. *Next month's Letter will cover the technical and organizational challenges of moving to a 'Net-Zero' investment regime in greater detail. It will in part be based on new work by Mark van Clieaf, Tamara Close, and colleagues in a detailed submission on 'Net-Zero' investing they are preparing for US and Canadian financial regulators.*
iv. *See our **July 2020** and **April 2019** Letters for more on the CBUS Super using the <IR> Framework.*
v. *I am a co-founder and co-owner of CEM Benchmarking.*
vi. *A reviewer of a draft of this Letter commented that the 'Net' in 'Net-Zero' is problematic due to likely material timing mismatches between carbon emissions now and possible offsets to those emissions (e.g., by tree planting) decades later. He suggests replacing the 'Net-Zero' emissions target with just 'Zero' emissions, or even better 'Negative' emissions.*

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
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