The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

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THE NEW *CFA INSTITUTE* TREATISE ON NET-ZERO INVESTING:

THE MISSING PART OF THE STORY

*"Entrenched systems and behaviours in the finance industry are hindering investors' ability to adequately consider climate risk, says Marg Franklin, chief executive of the CFA Institute, which has just launched foundational research that examines practical ways for the industry to tackle climate risk. "**Net Zero in the Balance: A Guide to Transformational Thinking**" aims to help the investment industry understand and fully implement net-zero investing."*

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"CFA Institute seeks to support those considering net-zero investing by developing more thought-leadership and educational offerings in this area. We welcome diverse perspectives….".

Marg Franklin, CEO
CFA Institute

"For generations, we have defined a corporation as a business run by a capitalist elite, which uses its accumulated wealth to own the means of production and exercise economic power. That is no longer the reality. In the 21st Century, our most desired goods and services are not stacked in warehouses or container ships: they appear on your screen, fit in your pocket, or occupy your head. But even as we consume more than ever before, big business faces a crisis of legitimacy…."

Sir John Kay, Fellow of the British Academy
Founding Dean, Said Business School, Oxford University

The New *CFA Institute* Treatise on Net-Zero Investing

The new 55-page *CFA Institute* treatise on net-zero investing authored by Roger Urwin with input from 23 expert contributors is a serious piece of work integrating climate change into the investment processes of long-term investors. Here are the key messages of "**Net Zero in the Balance: A Guide to Transformational Thinking**" as set out in its Executive Summary:

- The future impact of climate change on businesses and capital markets is likely to be material, and hence this risk must be addressed.
- Building resilience to adverse climate outcomes is possible and hence should be pursued.
- Transformational leadership and organization change will be required to make a serious commitment to the global goal of net-zero emissions.
- A key focus must be to deepen beliefs about, and understanding of, climate change. This will require attracting new expertise and talent.
- Another focus is to build collaborative networks to accelerate learning and doing.

- Key innovations will include systems thinking, balanced score cards, total portfolio thinking, universal ownership theory, and stewardship.
- Triple mandates for asset owners are to achieve the net-zero emissions goal, to meet all legislative/regulatory/coalition requirements, and to still achieve the highest possible risk-adjusted investment returns.

So what is the missing part of the "Net Zero In The Balance" treatise advertised in the title of this *Letter*? Taking *CFA Institute* CEO Marg Franklin's invitation to offer "diverse perspectives" seriously, that is the question we turn to next.

The Missing Part of the Story

In short, the missing part of the *CFA Institute*'s "Net Zero in the Balance" story is set out in Sir John Kay's new book "The Corporation in the 21st Century". Here is a brief summary of the book's key messages:

- Business has evolved, but not the language used to describe it.
- Micro economic theory throws little light on requisite business decision-making processes in the real world.
- GDP is a poor approximation of the value of economic output in developed countries today.
- We have seen a steady shift away from the large-scale production of physical 'things'. 'Value' today increasingly does not come from creating something bigger…but from creating something smarter….it is the capitalization of current and future net returns on human and social capital.
- Modern corporations are 'legal persons' with combinations of capabilities, collective intelligence, distinct cultures, and a shared sense of purpose.
- Effective management successfully mediates the desires of multiple stakeholder groups: customers, employees, suppliers, investors.
- Increasingly, the purpose of IPOs is not to attract investment money into the business but to allow founders/entrepreneurs to take money out of the business.
- There is no shortage of patient capital…but there is a shortage of intermediaries with long-term mindsets in the global financial sector.
- There is great diversity today in how global wealth is held between institutional and individual shareholders in public and private corporate entities….corporate 'ownership' is becoming an increasingly murky concept.

So if the whole investment story today is the sum of the *CFA Institute* treatise on achieving net zero emissions and the *Kay* treatise on capitalism in the 21st Century, how can we best combine these two story components into an operational framework for investment management today? That is the question we turn to next.

The Whole Investment Story

Simply put, the whole investment story goes beyond net zero investing. As we showed in the **August 2024 *Letter***, Bartley Madden captured this reality beautifully with his "*Pragmatic Theory of the Firm*". He starts with the assertion that Milton Friedman's 'maximizing shareholder value' principle is best positioned as a corporate outcome, and not as a purpose. Instead, a useful theory of the firm treats the firm as a holistic value-creation system with four key components:

1. A socio-economic vision of the firm with the power to motivate and even inspire employees.
2. A knowledge-building proficiency that provides operating returns at least equal to its cost of capital through continuous gains in efficiency and innovation.
3. Win-win relationships with all of the firm's stakeholders, both inside and outside the organization.
4. The design and manufacture of goods and services that minimize waste and pollution and thus invest in the well-being of future generations.

Note that Madden's theory encompasses both *Kay*'s and the *CFA Institute*'s insights:

- Components 1, 2, and 3 fit nicely into *Kay*'s description of the 21st Century corporation.
- At the same time, Component 4 nicely sets up the need for the *CFA Institute*'s treatise on operationalizing the net zero emissions investment constraint.

We conclude that the "*Pragmatic Theory of the Firm*" does indeed pass 'The Whole Investment Story' test.

Value-Creation in Action

The **September 2024 *Letter*** posed this question: "Pension Fund Capitalism and Ownership Investing: Are These Lofty Ideas Useful In Practice?" The *Letter* went on to describe the work of *CPP Investment*'s *Portfolio Value Creation* (*PVC*) *Group*. The mandate of the *Group* is to assess pragmatic ways in which the value-creation potential in its portfolio companies might be enhanced. Four examples showed ways in which this aspiration can be realized:

1. A new profit pool was unlocked in a mid-market private lender in the *CPP* portfolio with the design and implementation of a new line of business.
2. A priority-setting challenge in a portfolio company was addressed through a *PVC Group*-led strategic review. As a result, some business lines received additional investment while others were downplayed or even fully exited.
3. The *PVC Group* supported the management team of an infrastructure firm in designing and implementing several efficiency programs. These programs have delivered $70M/yr in run-rate savings while maintaining high asset integrity.
4. The *PVC Group* negotiated a carve-out with a global conglomerate which led to the creation of an attractive stand-alone financial services business.

Actions like these contributed to an estimated 0.9%/yr value-added to *CPP* assets over the course of the last five years, or $5.7 billion per year in dollar terms.

A recent study by four academics based on Danish experience came to a similar 'value-added' conclusion in a different way. In their 2022 paper titled "**Pension Fund Investments Raise Firm Productivity and Innovation**" authors Beetsma, Jensen, Pinkus, and Pozzoli found that firms receiving investments from pension funds experienced material increases in patent applications and worker productivity (by 3.5% to 4.9%). The authors attributed these positive results to increased capital availability, reduced capital costs, improvements in governance effectiveness, and in the lengthening of corporate planning and decision time horizons.

In Conclusion

Focused corporate narratives such as those by the *CFA Institute* (i.e., on managing climate-related risks) and by *Sir John Kay* (i.e., on the evolution of corporate purpose and structure) offer important insights into how the dynamics of investing change with the passage of time. At the same time, *Bart Madden*'s "Pragmatic Theory of the Firm" reminds us that effective 'ownership investing' requires integrating multiple focused narratives into a broader multi-dimensional balanced whole. It is only through this kind of integration that businesses become sustainable creators of value for their customers and their owners. Do your investment processes capture this reality?

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