The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

March 2022

PENSION ORGANIZATIONS IN THE 21ST CENTURY:

IS YOUR INVESTMENT MODEL 'FIT-FOR-PURPOSE'?

"The Responsible Investing 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."

Canadian Pensions Dashboard for Responsible Investing
November 2021

"Unilever's empire-building ambitions expose the empty rhetoric of its woke ideology."

The Telegraph
January 2022

"Canada Pension Plan Investment Board today announces that we are making a commitment for our portfolio and operations to achieve Net-Zero Green-House-Gas emissions across all scopes by 2050."

CPPIB
February 2022

Three RI Dashboard Findings

The title of last December's *Letter* was "**Now That *COP26* Has Come And Gone, What's Next For Pension Organizations?**". It featured a 'Responsible Investing Dashboard' assessment of how well Canada's 12 largest pension funds are adapting to 21st Century realities. Given that these "Canadian Pension Model" funds are generally deemed to be the best-managed in the world, the dashboard findings are of international interest. The findings led to three key conclusions:

1. Commit your organization to an effective Net-Zero 2050 investment program with explicit interim targets along the way.
2. Adopt an integrated reporting system 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.

The *Letter* went on to explore some of the implications of these findings for a pension organization's investment model and the skills required to make it work.

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A ‘Math And People’ Investments Model

Pension organizations must deliver adequate pensions at a reasonable cost. This requires an effective investment function which integrates the financial mathematics and people dimensions of investing. The math dimension can be reduced to R=Y+G , because over long investment periods R is mainly made up of the sum of the initial income yield Y plus the growth rate G of the initial income over investment period.[i] Y is known, while G must 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 risk 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-high 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 it leads to good R predictability. Good judgement about G unpredictability is also valuable. Knowledgeable investors will know to avoid totally unpredictable G stocks unless their windup value exceeds their market value.

Thus pension organizations must ask: do we have access to the requisite G assessment talent….and can those talents integrate across the relevant sustainable investment considerations? To help understand the implications of these questions, consider the case of *Unilever*.

Unilever Under Attack

We have used *Unilever* in prior issues of this *Letter* as a poster child for the transition to sustainable investing around the world. For example, supporting consideration for a move to a 100% equity investment policy for long-horizon investors, the **September 2020 *Letter*** stated:

“*Is there still a way to generate the 4% real investment return pension funds need to earn in the coming decades? Let’s use an investment in Unilever stock as a thought-experiment to address this question. Why Unilever? It is a well-known, well-managed $70B company selling a mix of well-known consumer products in the global marketplace. It has a dividend yield of 3%, paying an annual $1.83 dividend on a stock price of $60. Following the Gordon Model (R=Y+G), if we add a conservative 1% for future real dividend growth, its long-term prospective real return is 4%/yr. So with real bond yields now negative, Unilever offers a material prospective 4+% risk premium over risk-free long-term inflation-linked bonds with negative real yields. Generalizing beyond Unilever, so does a well-diversified stock portfolio made up of well-managed, sustainable companies yielding an average 3% with real dividend growth prospects averaging 1%/yr*.”

As we write this March 2022 *Letter*, *Unilever* stock is trading at $50, paying an annual dividend of $2.00, and thus now yielding 4%. This is a bad outcome for Keynes’ ‘beauty contest’ investors. The stock price is down 17% in a 17-month timeframe when most stock prices rose. Not surprisingly, old-line activists such as Nelson Peltz and the folks at Fundsmith Investments are upset, claiming ‘wokeness’ and mismanagement. What about long-term investors interested in generating that target real return of 4% over the coming decades? Should they join the old-line activists in shaking things up at *Unilever*? Or in a broader context, when, why, and how should serious long-term investors engage the Boards and C-Suites of the companies they invest in?

Corporate Purpose and Investor Engagement

In his February 17 Forbes article titled “***Unilever*’s Purpose and Sustainability Test of its Shareholders**”, *Oxford University*’s Prof. Robert Eccles weighed in on the *Unilever* controversy. His views in short:

- The combination of *Unilever*'s falling stock price over the course of 2021 and its unsuccessful effort to acquire *GSK*'s Consumer Health business have stirred up cranky traditional investors and the sensationalist British press. All that corporate purpose and sustainability stuff, they say, is obviously just a screen for incompetence and mismanagement.
- What these people refuse to understand/acknowledge is the growing global momentum towards defining corporate purpose as, in the words of his *Oxford* colleague Prof. Colin Mayer, "*to produce profitable solutions to the problems of people and the planet*".
- *Unilever* was an early adopter of this 'profitable solutions' philosophy, and has consistently shown over the years that it has walked the talk.[ii] There is no clear evidence that this choice has adversely affected its financial performance (e.g., revenues, profits, return on capital) over the course of the last 20 years.
- Its historical focus on sustainability and its steady financial performance does not mean *Unilever* is exempt from constructive investor engagement. Any corporation should be willing to engage with its investors on its purpose, governance, business model, performance, and strategy.

Returning now to the referenced commentary in the September 2020 *Letter*, with its dividend yield now 4%% rather than 3%, and continuing to believe that it can grow its dividend by at least 1% in real terms, *Unilever*'s long term real return projection has improved materially from 4% to 5% over the course of the last 17 months……or has it? Is there a flaw somewhere in *Unilever*'s business model? Could its G over the coming decades be negative rather than positive? These are the kind of judgements that will separate investment success from failure for long-term investors in the decades ahead.[iii]

***CPPIB* Goes 'Net-Zero'**

When the RI Dashboard findings were released last November, only two of the 12 largest Canadian pension funds had made 'Net-Zero' commitments.[iv] On February 10, they were joined by Canada's largest pension fund, the $550B *Canada Pension Plan Investment Board*. Specifically, it intends to do five things:

1. <u>Engagement rather than divestment</u>: continue to invest in and exert our influence in the whole economy transition as active investors, rather than through blanket divestment.
2. <u>Internal 'Net-Zero' by 2023</u>: achieve carbon neutrality for our internal operations by the end of fiscal 2023.
3. <u>Target Green Investments</u>: increase our current investments in green and transition assets from $67B to at least $130B by 2030.
4. <u>Focus on Business Transformation</u>: build on our new decarbonization investment approach that seeks attractive returns from enabling emissions reductions and business transformation in high-emitting sectors.
5. <u>Transparency</u>: report on our actions, their impact, and our portfolio emissions.

Commenting on the 'Net-Zero' announcement, *CPPIB* CEO John Graham wrote "*The impacts of climate change have fundamentally transformed the nature of business risks and opportunities……committing our portfolio and operations to Net-Zero by 2050 will help us manage the risks, capture the opportunities, and deliver on our public purpose…..to help generations of Canadians build financial security in retirement.*"

Especially noteworthy in the *CPPIB* 'Net-Zero' approach is its commitment to engage rather than divest, and to focus on business transformation in high carbon-emitting sectors such as agriculture, cement, chemicals, conventional power, oil and gas, steel, and heavy transportation. For such an investment approach to be successful, *CPPIB* will require deep knowledge and specialist skills to assess the feasibility and likelihood of success of the business transformation strategies being contemplated and implemented by investee companies in those sectors. *CPPIB* will also require strong communication skills to report on its successes (and sometimes failures) with this investment approach in the years ahead.

Strategic Investing in the 21st Century

A goal of this *Letter* has been to convey the reality that the gap between short-term 'beauty contest' trading strategies and long-term sustainable wealth-creation strategies continues to widen. This accelerating movement to long-horizon investing has important consequences for the design, implementation, and staffing of 21st Century investment models. It is increasingly less about trading skills and increasingly more about understanding the business models of investee corporations and about, when it is needed, initiating engagement with those corporations that is both knowledgeable and forceful.

Keith Ambachtsheer

Endnotes:

i. *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. The longer the investment period, the less this valuation change is likely to matter.*
ii. *A quick review of Unilever's most recent Annual Report confirms this. Following the principles of Integrated Reporting, there are detailed sections on purpose, governance, business model, performance, and strategy. On 'Net-Zero', for example, its target NZ year for Scopes 1 and 2 emissions is 2039, with serious Scope 3 work also underway to positively impact the behaviors of its suppliers and customers.*
iii. *There is a related issue here raised by NYU's Stern School of Business Prof. Aswath Damodaran. In his words….."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."*
iv. *Caisse de dépôt et placement du Québec and Ontario Teachers' Pension Plan.*

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