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welcome to brighter

becoming a future maker

From shareholder to stakeholder

Part I of the shareholder to stakeholder series (The Purpose of Corporations — Tale of Two Theories) compared the dominant theory of shareholder wealth maximization (SWM) against stakeholder theory, now explicitly endorsed by organizations as diverse as the Business Roundtable and the World Economic Forum. While these theories may appear to stand in stark opposition to each other, by looking at them across a longer timeframe we can evaluate the interim trajectory of long-term value-generative plans through including a thoughtful focus on environmental, social and governance (ESG) information.

Part II of this series (Becoming a Future Maker — From Shareholder to Stakeholder) explores the implications of a shift toward stakeholder capitalism for asset owners and how they might position their investment programs in response. Preparing for this transition has been made all the more urgent by the COVID-19 pandemic, which has shone a light on company-specific practices in relation to their non-equity stakeholders. In particular, the way companies treat their customers and workers during this time of crisis is likely to have significant implications for their businesses for years to come.

Focusing on the future

For more than a decade, Mercer has been advising asset owners on how to manage the effects on their portfolios of long-term, systemic ESG risks like climate change.[1] Managing such risks effectively requires asset owners to adopt a broader and longer-term perspective than they may do usually,[2] and the types of climate-related actions an investor will take are determined by the organization's views on the role of investors in addressing systemic risks. In this regard, asset owners generally fall into two camps:

- **Most investors** recognize ESG factors as indicators of trends that will have impacts on industries in future. However, most typically lack conviction in the importance of these trends and address ESG issues only when required by regulation. Moreover, they may treat them solely as risks rather than opportunities. Their portfolio action will reflect a compliance or risk perspective accordingly (e.g., hedging transition risk with a low-carbon equity index allocation).
- **Future Makers**[3] support sustainable outcomes (e.g., an increase in global temperatures well below 2°C) through investment decisions and engagement activities that are most likely to provide the economic and investment environment necessary to pay pensions, endowment grants and insurance claims over the timeframes required by beneficiaries. This position is typically underpinned by a belief that long-term portfolio returns are dependent upon sustainable underlying ESG systems.

In other words, if the rule of law breaks down or a natural resource runs out in a given jurisdiction, investment losses typically follow. In acknowledgment of this interdependent relationship, Future Makers strive to assess the impact of their investments on all key stakeholders, with the end goal of aligning their portfolio to sustainable systemic outcomes. Hallmarks of this approach include an emphasis on proactive engagement with portfolio companies and regulators on ESG issues and a strong commitment to impact investing.

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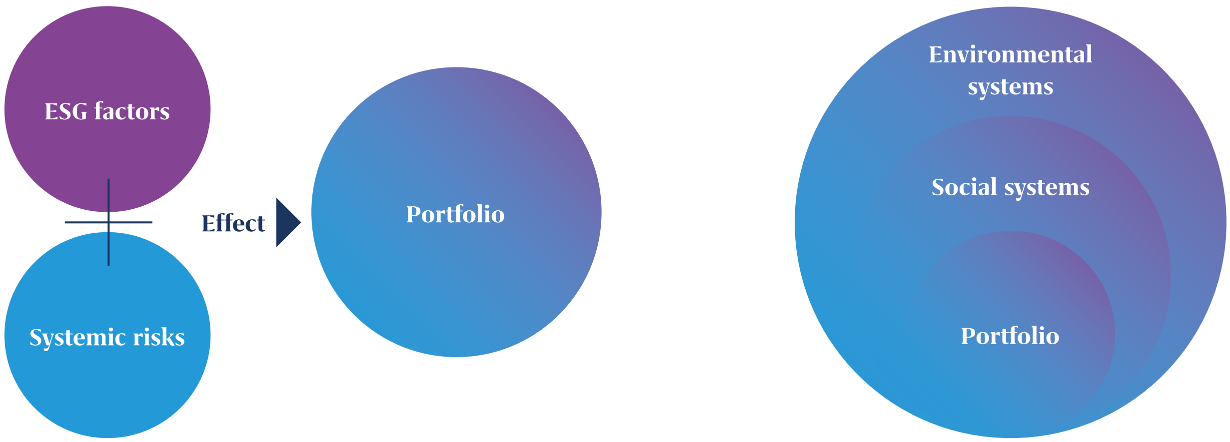
[1] http://www.mmc.com/content/dam/mmc-web/insights/publications/2019/apr/FINAL_Investing-in-a-Time-of-Climate-Change-2019-Full-Report.pdf

[2] *ibid*; see also: https://www.mercer.com/our-thinking/wealth/responsible-investment.html

[3] https://www.brinknews.com/the-future-makers-long-term-investors-as-climate-change-cops/

Figure 1: Distinguishing Future Makers

Most investors | **Future Makers**



View ESG factors and systemic risk as existing outside of the portfolio, creating a defensive positioning typified by an ESG compliance mindset or risk hedging.

View the portfolio as existing within environmental and social systems, creating an offensive positioning typified by investee and policymaker engagement and impact investing.

Source: Mercer

In order to potentially take advantage of or maintain a stakeholder orientation in business and investment management, investors will need to adopt a Future Maker approach. However, overall asset owner practice is significantly out of step with this mindset.

Common practice

While the asset owner community is diverse — with sizeable differences in common practice across investor types and jurisdictions it is possible to draw some generalizations about the state of play today.

By and large, asset owners have broadened their perspective on risk to include consideration of ESG factors and climate change risks in investment decisions as indicated by the size of the Principles for Responsible Investment (PRI) signatory base[4] and the TCFD signatory base.[5]

Similarly, many asset owners are formalizing their commitments to long-termism via membership of groups like FCLTGlobal[6] and the Long-Term Infrastructure Investor Association.[7] Furthermore, a growing number of asset owners believe they have a duty to maximize capital returns *and* capital utility[8] for beneficiaries positioning themselves clearly as stakeholder-oriented Future Makers (see Figure 2 for leading examples).

Figure 2: Examples of Future Maker beliefs

PGGM Vermogensbeheer B.V. and PGGM Strategic Advisory Services (PSAS) B.V. (hereinafter PGGM)[9]

1. Responsible investment pays off: PGGM firmly believes that sustainability factors materially influence the risk-return profile of investments, and that this influence will steadily increase in the future.
2. The link between healthy returns and sustainable development: PGGM is convinced that sustainable development is necessary in order to generate good — and, crucially, stable — investment returns for our clients in the long term.
3. The driving force of capital: PGGM firmly believes that by leveraging the driving force of investments for our clients it can and must make a positive contribution to sustainable development through its investment decisions.

California Public Employees Retirement System (CalPERS)[10]

Investment Belief 2

A long time investment horizon is a responsibility and an advantage. It requires CalPERS to:

- Consider the impact of its actions on future generations of members and taxpayers
- Encourage investee companies and external managers to consider the long-term impact of their actions
- Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives
- Advocate for public policies that promote fair, orderly and effectively regulated capital markets

Investment Belief 3

CalPERS' investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

Investment Belief 9

Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error. As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

[4] https://www.unpri.org/pri/about-the-pri — over $86T in AUM in 2019.

[5] https://www.fsb-tcfd.org/wp-content/uploads/2019/06/2019-TCFD-Status-Report-FINAL-053119.pdf — "Nearly 800 public- and private-sector organizations have announced their support for the TCFD and its work, including global financial firms responsible for assets in excess of $118 trillion."

[6] https://www.fcltglobal.org/our-members/members

[7] http://www.ltiia.org/

[8] Meant here in the economic sense of the term to describe the satisfaction derived from a good or service.

[9] https://www.pggm.nl/english/what-we-do/Pages/Beliefs.aspx

[10] https://www.calpers.ca.gov/docs/board-agendas/201702/pension/item7-01.pdf

These notable initiatives and commitments aside, only a small number of investors have adopted a Future Maker stance to date. Some of the reluctance to adopt a long-term, stakeholder orientation may result from the following:

- A lack of institutional knowledge on how to implement a stakeholder orientation among internal staff and advisors.
- Concerns regarding the costs associated with adopting a stakeholder orientation — e.g., specialized ESG data and monitoring expenses.
- Asset owners, despite generally having long time horizons, often behave differently, replacing investment managers frequently and monitoring them on short-term relative performance.[11]
- Asset managers remain focused on short-term performance by virtue of their own client reporting requirements.[12]
- Often, a disproportionate amount of board and committee time is spent evaluating recent investment manager or market performance rather than on articulating institutional investment beliefs/purpose or long-term investment strategy[13] (or, some might argue, on fund governance in general).
- Fiduciary interpretations often hinge on the presumption that consideration of ESG issues or other stakeholder impacts may result in poor financial performance and violate fiduciary duty.[14]
- Analytical frameworks rooted in modern portfolio theory (MPT) still inform (or in some cases determine) many asset owner investment decisions, but MPT is not "fit for purpose" when it comes to analyzing ESG or discontinuous systemic risks.[15]

These barriers are challenging for investors to overcome, given how engrained many related practices and beliefs are in common practice. That said, in order to be prepared for the ongoing transition toward a more stakeholder-friendly form of capital management, there are several steps asset owners can take to combat them.

[11] Ambachtsheer, J. et al; "Behaving Like An Owner: Plugging Investment Chain Leakages," *Rotman International Journal of Pension Management;* Fall 2013

[12] *Ibid*

[13] According to Vanguard's 2009 Investment Committee Decision-Maker Study, 40% of investment committee time on average is spent evaluating past performance and only 25% is spent on investment strategy. This is an area ripe for further research..

[14] https://www.unpri.org/fiduciary-duty/the-changing-landscape-of-fiduciary-duty/248.article

[15] https://www.oecd.org/finance/Investment-Governance-Integration-ESG-Factors.pdf — see Box 3 and discussion on page 49.

Becoming a Future Maker

If asset owner boards and investment committees want to become long-term, stakeholder-oriented Future Makers, we believe they need to adopt five shifts to their investment governance approach. While each shift is individually important, they are interrelated and may need to be addressed simultaneously.

Figure 3: Five shifts for Future Makers

Time horizon	From short	To long
Risk assessment	From quantitative	To qualitative
Perspective	From backward	To forward
Decision making	From passive about passive	To active about passive
Market interaction	From independent	To collaborative

Source: Mercer

1

Time horizon: Adopt a long-term perspective

Many asset owners have the advantage of a long-term perspective but do not capitalize on it. Long-term investors have the ability to conduct "time horizon arbitrage," ignoring short-term fluctuations by using illiquid vehicles or lower turnover liquid vehicles to invest in secular sustainability trends.

However, capturing value from this arbitrage strategy requires the ability to look beyond periodic strategic asset allocation exercises, supplement existing monitoring with ESG and secular trend analysis, reevaluate the way managers are benchmarked and reviewed, etc. which can be challenging given the current dominant tools and processes used.[16]

Potential key benefits: Capture premia from illiquidity and long-term thematic conviction (e.g.,. Low Carbon Transition premium)[17]; in liquid strategies, lower expenses from turnover.[18]

2

Risk assessment: Incorporate qualitative risk assessment into the investment process

Quantitative information is used to evaluate investment managers and inform many forward-looking investment decisions.[19] Most quantitative tools do not typically leave room for consideration of ESG risks except occasionally from a backward-looking viewpoint. There are clear cognitive and behavioral reasons for this quantitative bias; the past is known and numbers — even if couched in uncertainty — provide a sense of comfort in their exactitude.

Taking a broader, forward-looking and generally more qualitative perspective on risk is important to overcoming numerical bias and to ensuring "known unknowns"[20] are more accurately assessed. This can entail the adoption of a risk register and a qualitative risk ranking.[21] Alternatively, it could involve reviewing portfolios such as an assessment of exposures to investment themes and/or sectors across asset classes.

Potential key benefits: Allows for the assessment of risks and opportunities that may be missed by typical quantitative tools.

Figure 4: Short-term assets, Long-term perspective

Some asset owners have no option but to adopt a short-term investment horizon — for example, to support liquidity needs and manage cash flows against short-term liabilities — often investing primarily in short-duration fixed-income securities for which ESG factors may seem less relevant. But a robust approach to short-term investments can integrate ESG factors, acknowledging that longer-term ESG factors can influence security pricing suddenly in the short term. Short-term investment horizons do not necessarily involve short-term thinking.

[16] For instance, most manager reporting is evaluated quarterly, with the most recent quarter being the focus. Simply shifting the order of performance reporting so that long-term outcomes are first in order from left to right, as Mercer has done, can be helpful toward elongating time horizon in practice.

[17] https://www.mercer.com/our-thinking/assessing-the-prospective-investment-impacts-of-a-low-carbon-economic-transition.html

[18] https://www.mercer.com/our-thinking/wealth/long-and-winding-road.html

[19] Andrew Lo and Mark Mueller; Warning: Physics Envy may be Hazardous to your Wealth!, 2010

[20] Often attributed to former US Secretary of Defense, Donald Rumsfeld, who popularized the following risk trichotomy: known risks; known unknown risks; unknown unknown risks.

[21] Mercer; Ignorance Isn't Bliss...the Risks your Portfolio may be Ignoring; 2016 — note that a qualitative risk ranking may involve quantification of a variable (e.g., carbon footprint or sea level rise), but many not be expressed in financial terms.

3

Perspective: Recognize the limits of past performance in a future that will be much different from the past.

Today, often too much emphasis is placed on historical performance evaluation in manager selection even though picking managers based primarily on past performance is unlikely to improve investment outcomes[22] — the past is not necessarily a prologue to the future. This is increasingly true in the face of widespread ongoing environmental and social change, which is not fully reflected in the historical record.

Spending more time forecasting and attempting to strategically position investment programs toward a long-term future that may entail systemic change is important to helping ensure fund resilience. This might mean stress-testing assets against the potential pricing of select externalities (e.g., carbon pricing) or broader analysis of secular shifts in industries on portfolios.[23]

Potential key benefits: Looking around corners can make for better risk management; less reactivity and more proactivity/conviction can lead to improved financial outcomes.

4

Decision making: Don't be passive about "passive" investments

An increasing number of investors are investing in low-cost index funds that track the market. The decision to invest in index funds, however, should not be done passively. Ever more ESG-oriented index funds are becoming available at low cost. Moreover, index fund managers have distinct policies on proxy voting and engagement obligations that result in very different voting outcomes.

Selecting an index fund manager that votes and proactively engages with portfolio companies on ESG issues in line with your beliefs can help to address systemic market risks over time.[24]

Potential key benefits: Reduced exposure to market risk from a low-carbon transition; alignment of outsourced voting and engagement practices with investment beliefs.

5

Market interaction: Collaborate to address collective action problems

We believe engagement that encourages the adoption of best practices by company management and which influences regulators is essential to managing long-term risk. However, independent investor engagements face a collective action problem.

Individually, investors typically lack the influence necessary to elicit change in company or industry practices and may balk at spending their time and resources on an engagement, the result of which will benefit all market participants. As such, we believe it is important for asset owners to turn some of their focus toward external and collaborative engagement with like-minded investors to share related costs and improve the chance of positive change.[25]

Potential key benefits: Better data to inform long-term investment decisions; more resilient portfolio companies; learning opportunities and network development for staff.

In our view, investors that achieve these shifts are likely to be better positioned to understand the implications of their investment decisions on their various stakeholders as well as the impact of a shift toward stakeholder theory on investment outcomes.

[22] Mercer; *Equity Manager Selection: How Relevant is Past Performance in Picking the Winners of Tomorrow?;* February 2019.

[23] Mercer has invested considerable time and resource in the development of forward-looking research to help investors to determine the impact of climate change on their portfolios. See https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html

[24] https://www.mercer.com/our-thinking/wealth/the-active-side-of-passive-management.html or https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2017-wealth-passive-managers-active-ownership-mercer.pdf

[25] Climate Action 100+ is an example of a collaborative investor engagement platform: http://www.climateaction100.org/

Question assumptions

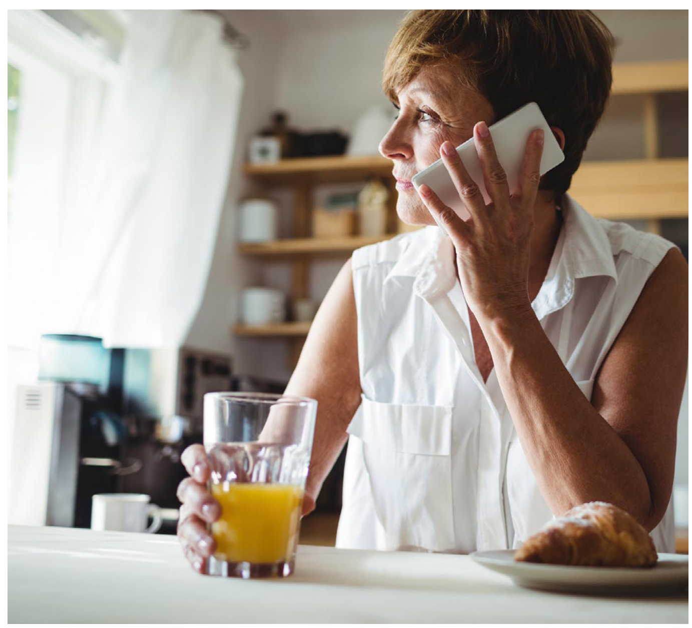
In the absence of policymakers setting laws and regulations that adequately price externalities, ensure economic resilience to catastrophes and minimize market inefficiencies, business and investment managers will need to adopt a more nuanced appreciation of stakeholder relationships to manage ESG risks.

The current global pandemic is a live and ongoing example of the importance of various stakeholders to business outcomes. Work stoppages in many industries and countries around the world, necessary to manage the growing risk of contagion to COVID-19, have brought into stark relief pre-existing financial vulnerabilities of individuals, the importance of employers as access points for many benefits (e.g., health insurance) and holes in social safety nets. It has also highlighted the extensive interconnectivity of the modern global economy and some of the foibles of pre-pandemic financial practices which favored shareholders over other stakeholders (e.g., share buybacks) leaving many companies with fewer resources to weather this downturn.

Businesses are responding to this crisis in different ways,[26] with varying types and levels of support being offered to customers (e.g., payment forbearance) and workers (e.g., extending paid sick leave). The same is true of governments.[27] While significantly more research and analysis will be required to draw any definitive conclusions, it seems that those companies with comprehensive business continuity plans, prudent cash reserves and strong stakeholder relations going into the crisis are likely to fare better thereafter, evidenced by the positive relative performance of many ESG funds and indices thus far.[28]

Indeed, this crisis may be a litmus test for the stakeholder model.[29] For some investors, it will highlight where their view has been too "short, backward and narrow," causing them to be less resilient to systemic environmental or social risks and to miss related opportunities for long-term growth, as may now accelerate in certain industries — e.g., remote work. Learnings from this pandemic can help to support the development of investor practices which better prepare portfolios to weather other systemic risks. For instance, a similar dynamic has been brewing for some time in relation to climate change.
Physical and transition risk threaten to disrupt a host of incumbent industries which will need to be supplemented or supplanted with low carbon alternatives leading to an opportunity for investors to potentially capture a low-carbon transition premium.[30]

In order to reposition themselves as Future Makers, investors need to audit current functions and question underlying assumptions to ensure multiple stakeholder perspectives and systemic risks are considered. It may mean developing new processes or tools, such as a more aggressive engagement platform, regular thematic reviews of portfolios, and likely a higher allocation to impact investments. More fundamentally, however, it will require a transformation of governance processes to align the organization with a long-term view that recognizes the importance of stakeholder relationships to achieving maximum shareholder value.[31]



[26] https://justcapital.com/reports/the-covid-19-corporate-response-tracker-how-americas-largest-employers-are-treating-stakeholders-amid-the-coronavirus-crisis/

[27] https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19

[28] https://grist.org/energy/as-coronavirus-infects-markets-sustainable-funds-prove-their-mettle/

[29] https://www.weforum.org/agenda/2020/03/covid-19-is-a-litmus-test-for-stakeholder-capitalism/

[30] https://www.mercer.com/our-thinking/assessing-the-prospective-investment-impacts-of-a-low-carbon-economic-transition.html

[31] See the companion piece to this paper — *The Purpose of Corporations:* A Tale of Two Theories https://www.mercer.com/content/dam/mercer/attachments/private/gl-2020-the-purpose-of-corporations-a-tale-of-two-theories.pdf

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