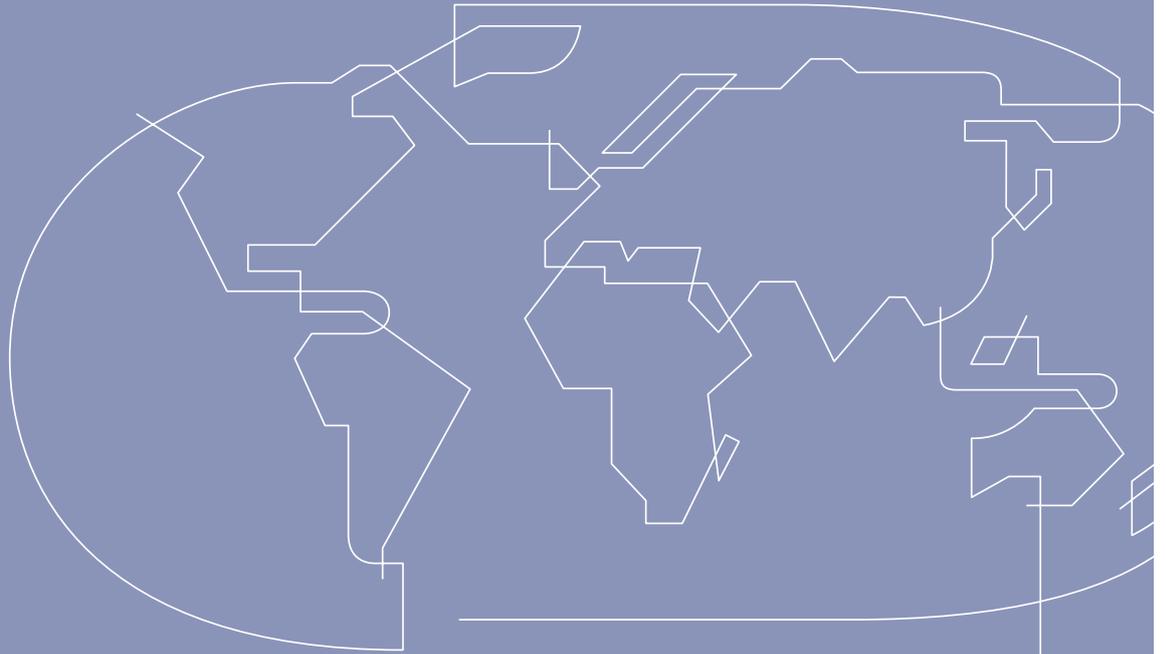


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HOW DO SOVEREIGN INVESTORS APPROACH ESG INVESTING?

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Overview

Drawing on proprietary datasets of institutional investor surveys on Environmental, Social and Governance (ESG) investing, we have sought to identify distinct features of sovereign investors. While confirming that official institutions share many features with private sector investors, the study reveals some notable differentiation. Specifically we find that public pension funds display more familiarity and commitment to ESG investing, and that sovereign wealth funds pursue divergent investment themes, methods and rationale than any other institutional group. Interestingly, discussing ESG highlights other defining characteristics, such as investment horizon and treatment of external managers.

What is ESG and How was the Study Done?

ESG investing incorporates an analysis of ESG credentials into the decision to invest – in addition to traditional financial metrics. It can also encompass efforts by investors to influence the activities of the companies within investment portfolios through voting and engagement, either directly or by an investment manager on the investor’s behalf. This style of investing is traditionally viewed as matching investors’ ethical, risk management and fiduciary preferences, but we share the growing conviction that ESG investing also offers potential to improve financial performance by focusing on long-term value creation.

For the purpose of this study, we drew on a proprietary dataset that features 291 institutional investors across 29 countries, 93 of whom were official institutions. Of this group, 65 were public pension funds and 28 were sovereign wealth funds.¹ It is important to note that the dataset contains the results of a survey conducted between November and December 2016, rather than hard data. Moreover, the dataset does not include supranational institutions and central banks. The central banks whose reserves only have a liquidity tranche have more restrictive asset allocations that would make ESG considerations of little relevance; however, anecdotally, we believe that the results of this study may be relevant to the investment tranches of central banks’ reserves.²

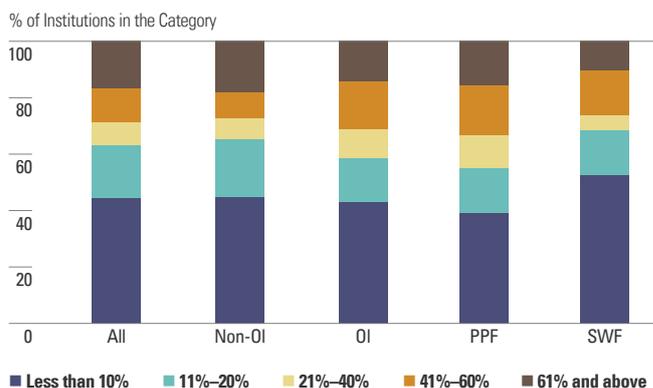
Key inferences on the difference between and within classes of assets owners are drawn from a mix of *z* and *t* statistical tests done at 90% confidence level. In some cases, we report results where the significance is marginal, if we believe that they are consistent with a strong theoretical argument.

For the rest of the text, we will refer to Sovereign Wealth Funds as SWFs and to Public Pension Funds as PPFs; the combined group is referred to as Official Institutions (OIs) versus non-OIs, while the total sample of asset owners is analysed as All Asset Owners (AAOs). All data here in is drawn from that survey sample.

1. Major Asset Owners Share Common ESG Approaches

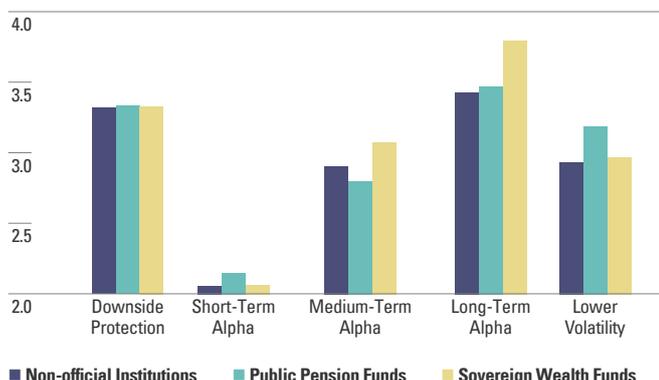
The survey data suggests that the starting point for sovereign investors is similar to other investors in their embrace of ESG investing. Whilst the adoption of this style of investing has been rapid, it is a recent phenomenon, with only one in eight investors pursuing ESG approaches for longer than six years. In this regard, it is perhaps surprising that the patterns of ESG investing among official and non-official investors are so similar, given that the former are more subject to policy influence. In particular, 75.3% of OIs implement ESG, the exact same percentage as non-OIs. Moreover, the share of assets under ESG is also very close, with an average of 26.8% of OI assets versus an average 25.8% of non-OI assets implemented under ESG.³ When looking at a more detailed breakdown of the ranges provided in Figure 1, the similarities are apparent across all institutional types. In fact, the Figure confirms that the penetration of ESG is relatively shallow across most institutions, with close to half of ESG adopters only implementing it across less than 10% of their assets.

Figure 1: Share of Assets under ESG among Investors who use ESG



In a similar vein, official institutions approach ESG with comparable expectations to other investors. Asked to rank expectation from 1–5 with 5 being highest, Figure 2 illustrates that all investors share the same relative expectation regarding ESG, namely boosting long-term performance and limiting risks in the process. On the former, views are broadly similar on the potential of ESG to deliver outperformance, with SWFs having a slightly higher expectation of medium- and long-term alpha. There is a broad consensus among the groups on the expected protection against downside risks, but public pension funds attach marginally greater importance to the protection which ESG may provide against volatility. A possible reason for this is that PPFs are particularly keen to avoid single-company tail risks from regulatory breaches or public criticism. All in all, these differences are minute and speak to investor cohesion on the topic of expectations.

Figure 2: Investors' Expectations from ESG



2. Experience, Motivation and approach differentiate Official Investors not only from other Investors but also from each other

There is a bit less cohesion when looking at the underlying forces pushing these institutions into ESG investing. Let us revisit the reasons why investors turn to ESG consideration in the first place. ESG is an umbrella concept actually covering a variety of different instruments and approaches; however, most ESG frameworks typically add an extra aspect to the inclusion, exclusion or weighting of certain securities in investment portfolios. Different institutions may have different views of ESG's desirability, for example, due to different opinions of beneficiaries or managers. Those which look on ESG favourably may do so for different reasons (e.g. following the practice of peers or as a component of the institution's core values), and may have different institutional frameworks which could help or hinder ESG implementation.

Survey respondents were offered to choose one or more of six reasons for adopting ESG strategies: link with better investment practices, fostering of a long-term investment mindset, example of peers, regulatory demands, beneficiary demands or the beliefs

of senior leadership. We have listed the top two reasons for each type of institution in Figure 3. While the long-term investment mind set clearly tops the poll, the secondary rationales diverge and reflect different institutional frameworks.

Figure 3: Top Two Reasons for ESG Adoption

Reasons	Public Pension Funds	Sovereign Wealth Funds	Non-Official Institutions
#1	Long-Term investment mind set		
#2	Demand from beneficiaries	Beliefs of senior leadership	Better investment practices

The considerably higher role of beneficiary demands distinguishes public pension funds and warrants separate consideration. A simple explanation could be that PPFs are better at incorporating *any* beneficiary demands. If a PPF is run on behalf of a public institution, then either the institution itself may be using the PPF to enhance and communicate its public policy goals, or the institutions' employees may be channelling their demands through available mechanisms such as trade unions that may be stronger in the public sector. Publicly funded social security institutions could be under political pressure to adopt ESG strategies. Beneficiaries of large corporate pension plans are less likely to act as a homogeneous group, and it is even more difficult for beneficiaries of insurance to do so.

"There is less cohesion when looking at the underlying forces pushing institutions into ESG investing — rationales diverge and reflect different institutional frameworks."

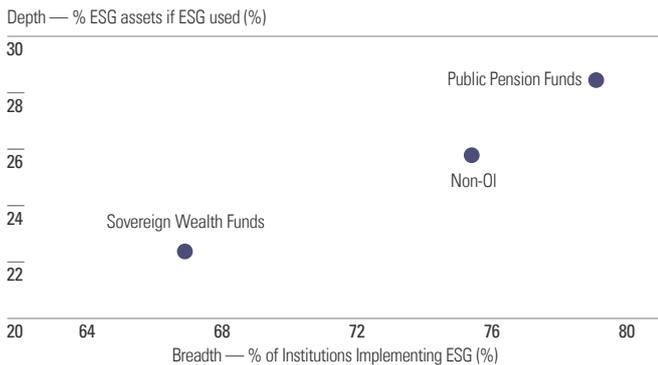
Why would beneficiary demands feature less among SWFs? In part, it would seem that the concerns of their stakeholders and the national interest at large is instead represented by the senior leadership team, often drawn from the political ranks. Such a team would make key investment decisions and would influence the adoption of ESG. However, as one of our earlier reports⁴ shows, some SWFs have an incomplete institutional structure and lack a clearly defined liability profile. Governments may change their views of SWFs, their size and purpose, and a change in political leadership may change the government's approach to SWFs. Some governments accumulate funds (e.g. proceeds of commodity exports) in SWFs as a best practice but lack clearly defined strategies for them. This results in SWFs not having full visibility of beneficiaries' preferences and therefore purely focused on proven portfolio techniques. Interestingly, sovereign wealth funds are significantly more likely than PPFs to cite peer pressure as an ESG driver; this is consistent with the hypothesis that SWFs, sometimes in absence of a clear mandate, look to other SWFs to compare and contrast their investment ideas and approaches.

How do Sovereign Investors approach ESG Investing?

“There are differences in depth and breadth of ESG usage, with PPFs exhibiting greater commitment while SWFs show less commitment than non-official institutions.”

Differential motivations for ESG adoption also consistently reflect differences in depth and breadth of ESG commitment across these groups. For depth of ESG usage, we used the share of assets under ESG (where ESG is used) while for breadth, we examined the share of institutions adopting ESG implementation. Figure 4 shows clearly the discrepancies between institutional types. Notably, this does not differentiate between official and non-official institutions, as PPFs exhibit greater commitment while SWFs show lesser commitment than non-official institutions. The latter is somewhat puzzling as Figure 2 had earlier indicated that SWFs held stronger conviction in terms of ESG outperformance capacity, but are nonetheless laggards in ESG adoption.

Figure 4: Breadth and Depth of ESG Usage



A profound aspect of ESG investing is the non-trivial interaction between ESG investing and outsourcing. The survey data suggests that those types of institutions which are more likely to outsource are also more likely to adopt ESG, although the direction of the causal link is not clear.

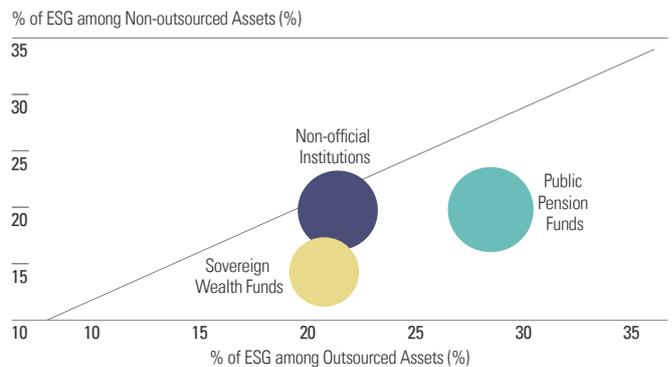
All asset owners have to balance between in-house investment management and the outsourcing to external parties; these decisions are driven by many considerations, not least the size of the asset owner.⁹ In many cases, investors outsource those components of their asset allocation where they feel they need specialised knowledge or expertise such as ESG. In that case, those institutions which have a preference for ESG may have a higher likelihood of hiring external managers to implement it. On the other hand, those who are more open to outsourcing anyway may be exposed to a greater variety of strategies and to more complex products, one of which may happen to be ESG.

Figure 5 looks at ESG adoption for outsourced and non-outsourced assets by type of institutions. As all the dots are below the 45 degree line, it shows that the proportion of ESG is greater among the outsourced assets, i.e. suggesting that the more an institution outsources, the higher its share of ESG investing will be. This clearly applies more to PPFs than other institutional types, with SWFs therefore not only have the lowest rate of ESG adoption but are also less inclined to outsource. The bubble size indicates overall propensity to outsource (i.e. not only ESG-related) which is also proportional. In any case, both types of official institutions are further from the line than non-OIs, which indicates that outsourcing is crucial to their achieving the desired rate of ESG implementation.

“Those institutions which are more likely to outsource are also more likely to adopt ESG.”

While it is possible for official institutions to adopt some ESG considerations on their own, the data seems to suggest that going beyond certain depths of ESG implementation may require specialised asset managers who can offer such products. Institutions with limited interest in ESG investing are unlikely to boost it through outsourcing, but those institutions which are interested but which have constraints on outsourcing may find it difficult to go about it on their own.

Figure 5: Outsourcing and ESG



Note: Bubble size indicates the overall % of outsourced assets.

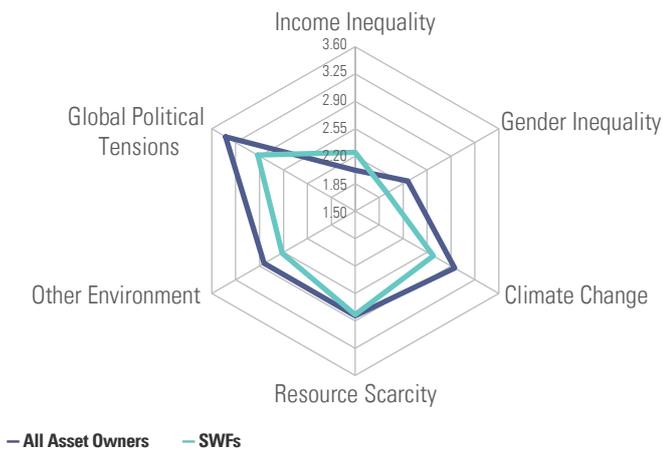
3. ESG Methods and Focus Themes Separate SWFs from the rest

Among other questions, the survey asked the respondents to state whether any of the following investment themes featured significantly in their investment process: global political tensions, income inequality, gender inequality, climate change, resource scarcity or another environmental topic.

An incorporation of a topic may be merely a reflection of the research an institution is doing, so while all of the topics are relevant to ESG, the adoption of a topic does not imply the adoption of a corresponding ESG strategy. The results are summarised in Figure 6 (where 1 stands for ‘not significantly’ and ‘5’ for ‘very significantly’). Public Pension Funds behave virtually identically to non-OIs and are aggregated with them.

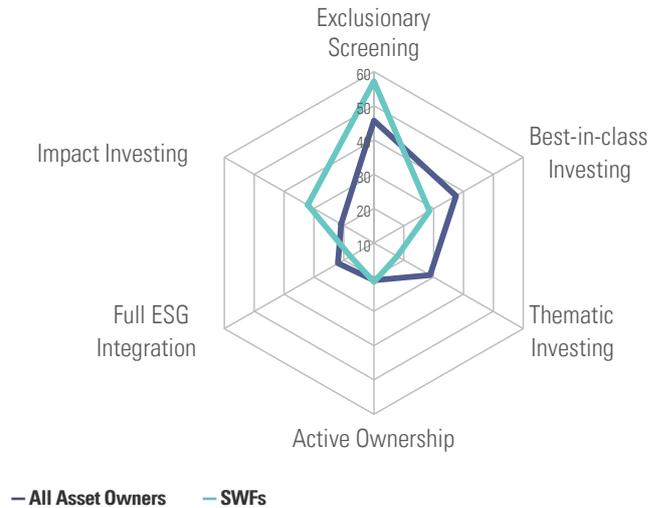
“SWFs are different from other institutions, both in thematic focus and method of ESG adoption.”

Figure 6: Emphasis of themes in Investment Process



We can note that Sovereign Wealth Funds are less likely to factor in specific investment themes. One explanation is that a focus on national wealth preservation, which to date has remained the key focus of most SWFs, preventing them from actively seeking investment topics. This is supported by the fact that they are less likely to consider ‘global political tensions’ — a wider ESG factor which all investors pay more attention to than to other factors. It is less clear, however, why SWFs take slightly more interest in income inequality than in other issues, although high income inequality in many commodity exporters may generate interest from SWFs based in them.

Figure 7: Methods of ESG Implementation



The survey also asked investors about the implementation of specific ESG methods. These methods were grouped into 6 categories (see Figure 7; the methods are not mutually exclusive).⁶ Exclusionary screening is the simplest method conceptually: it is constituted by *ex-ante* exclusion of certain companies’ securities from the portfolios; other methods are more complex. For example, active ownership requires greater interaction with investees, and thematic investing constitutes an active strategy requiring dedicated portfolio construction. Figure 7 illustrates the use specific methods of ESG implementation by different institutions. Once again, public pension funds are grouped together with non-official institutions as they are almost identical in that aspect.

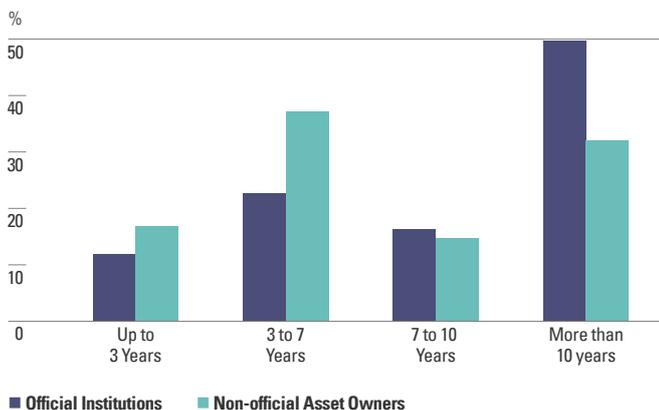
Here, SWFs are also different from other groups in their preferences. As lesser ESG adopters, we would expect them to be lesser users of each specific method, but they actually are more likely to use both exclusionary screening and impact investing. At a first glance, this seems an unlikely combination as the two methods lie at the opposite ends of ESG sophistication — exclusionary screening is the most basic method while impact investing essentially means that the whole investment strategy of the institutions embraces ESG goals. However, impact investing is a method often preferred by the largest of institutions. More importantly, those two methods are the least likely to require outsourcing. Impact investment is a high-level strategic decision which need not prejudice specific implementation tools; exclusionary screening is a tool which a large institution can implement internally. Now recall that the survey data on ESG drivers actually indicates a strong belief of SWFs’ leadership in ESG. On that basis, it is possible that to infer that SWFs have a significant willingness to strengthen their ESG credentials, but are likely prevented from doing so by institutional constraints, such as ones on outsourcing.

4. Beyond ESG: Investment Horizon

The dataset allowed us to analyse a number of further aspects of institutional investors' behaviour, which may or may not be directly relevant to ESG. One such aspect is the horizon at which different institutions invest and evaluate their investment performance.

We have found significant differences between official and non-official investors and relatively little difference within the OI group. The most striking finding is the considerably longer investment horizon of official institutions — as shown in Figure 8, close to half of them invest on a horizon of over 10 years, compared to less than a third of non-OIs. We get similar results if we analyse the way investors link performance to compensation and the way they evaluate their in-house investment managers.

Figure 8: Investment Horizons



On a certain level, such a difference should have a profound impact on ESG usage, as ESG is often associated with longer-term investment strategies. However, a relatively large difference in ESG usage between SWFs and PPFs is juxtaposed with a very similar investment horizon. In reality, ESG strategies are multi-faceted and the interaction between the time horizon and ESG adoption is likely to be more complex and non-linear. Nonetheless, it is worth pointing out that despite the fact that SWFs and PPFs have roughly equal average investment horizons, they actually use different horizons to assess external managers, with 54% of SWFs assessing them on a timeframe under 3 years, compared to 38% of PPFs. That, once again, raises the topic of sovereign wealth funds' internal institutional constraints.

The length of OI's investment horizons, of course, has many other implications, as it may flow directly from the institutional mandate. In this regard, PPFs and SWFs also fulfil policy mandates that incorporate public finance and even macroeconomic implications that are typically longer-term than private-sector investors.

Conclusions

Our analysis of the survey data revealed a number of ESG patterns among OIs:

- Overall rate of adoption is not different from non-OIs, but both depth and breadth is greater among PPFs compared to SWFs.
- The drivers of ESG investment are somewhat different, but the expectations are the same, though SWFs are a bit more optimistic on the long-term alpha which ESG could generate.
- Institutional adoption of ESG rises with increased outsourcing. In this regard, SWFs may be constrained by the fact that they tend to outsource fewer assets.
- Compared to all other asset owners, SWFs are less likely to adopt specific themes, including ESG, in their investment approach.
- SWF's implementation of ESG is concentrated among more basic forms such as exclusionary screening.
- We have also found that all official institutions tend to have a longer investment horizon than non-OIs, but SWFs nonetheless assess the performance of outsourced assets in a shorter timeframe.

Despite shared accountability to public owners, PPFs have advanced further in the implementation of ESG than SWFs. There is no evidence in the survey to suggest that SWFs' are intrinsically more reluctant to adopt ESG — on the contrary, in SWFs respondents appeared to show considerable enthusiasm about many ESG aspects. We therefore hypothesise that, certain institutional features of SWFs, notably the extent and the mechanics of engagement with external asset managers, as well as an incomplete build-up of their mandate, may be preventing them from rolling out ESG strategies to an extent comparable to public pension funds.

¹ For details on the dataset, please see pp. 32–33 of Eccles, Robert & Kastropeli, Mirtha, "The Investing Enlightenment — How Principle and Pragmatism Can Create Sustainable Value through ESG", Center of Applied Research, available at http://statestreet.com/content/dam/statestreet/documents/Articles/The_Investing_Enlightenment.pdf

² State Street Global Advisors (SSGA) Paper: How do Central Bank Invest? A Glance at their investment Tranche by Elliot Hentov.

³ The averages are inferred from ranges which investors indicated in the survey.

⁴ SSGA paper: Nothing Lasts Forever — Imagining the Life Cycle of a Sovereign Wealth Fund, by Elliot Hentov and Jeremy De Pessemier.

⁵ The magnitude of the surveyed institutions' assets under management was within a comparable range, but perhaps there are threshold levels at which different patterns emerge.

⁶ The six methods are: 1) Full ESG integration — systemic and explicit inclusion of ESG risks and opportunities in investment analysis; 2) Best-in-class investing — preferring companies with better or improving ESG performance relative to sector peers; 3) Exclusionary screening — avoiding securities on the basis of traditional moral values, standards and norms; 4) Active ownership — practice of entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change; 5) Thematic investing — investing that is based on trends, such as social, industrial, and demographic trends, including clean tech, green real state, water supply; 6) Impact investing — investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return.

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The returns on a portfolio of securities that excludes companies that do not meet the applied ESG threshold may trail the returns on a portfolio of securities that includes companies that are not gender diverse.

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ID9758-INST-7802 0617 Exp. Date: 30/06/2018