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How Sovereign Asset Owners Think About ESG

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- Regardless of investment horizon, sovereign asset owners question the efficiency of financial markets and their capacity to maximize social welfare
- Despite broadly subscribing to ESG's financial benefits and managing roughly two-thirds of their assets actively, less than half are adopting ESG investing in a comprehensive way
- Sovereign wealth funds lag behind other public investors in terms of ESG adoption, but also have a diverging investment philosophy
- Whatever their formal position on ESG, all types of investors consider system-wide issues behind ESG in the following order of priority: governance, environmental, social

While Environmental, Social and Governance (ESG) investing is attracting a huge amount of attention, it remains hard to determine whether this enthusiasm is being reflected in investment trends. In 2017, we drew on a unique State Street survey[1] to shed light on how sovereign investors viewed ESG. The survey highlighted that ESG adoption among official institutions was broadly similar to that of private sector asset owners, but with several key differences in the breadth and depth of adoption as well as motivations and priorities.

In this report, we draw on a new in-depth State Street survey (*The Big Shift Survey 2019, Center for Applied Research*)[2] of 427 institutional asset owner representatives (59% of whom are investment professionals) in order to form a clearer picture of sovereign ESG investing (133 of them come from sovereign institutions). The view gradually emerging from the industry is that ESG is no longer a niche topic or a set of investment strategies that are separate from overall portfolio strategy.

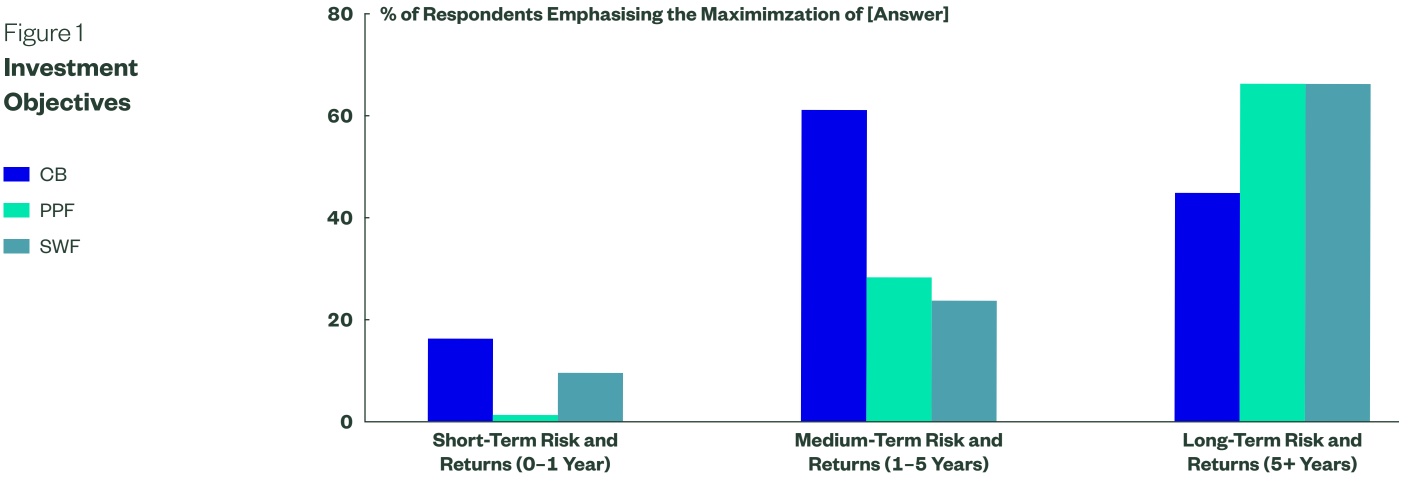
Hence, this report is split into two sections: the first examines the general investment philosophies of official institutions that frame ESG decision-making within a broader context, and the second looks specifically at ESG trends. While we are primarily focused on three main types of official institutions (central banks (CB), sovereign wealth funds (SWF) and public pension funds (PPF)), we have occasionally included other (non-sovereign) institutional types for comparative purposes.

Sovereigns Tend to Have Longer Time Horizons

Among sovereign investors, SWFs and PPFs have a long investment horizon, whereas CB reserve managers have a shorter term mandate. These horizons directly match the common mission statements and liability profiles of each institution, with PPFs having classic retirement liabilities and SWFs usually having very long-term or no particular liabilities.[3] As far as CBs are concerned, in this paper we are specifically talking about their foreign exchange reserve management, done to a high degree of liquidity and safety. (We have published detailed reports about the investment patterns of all three investor types.[4])

Our survey results illustrated in Figure 1 broadly confirm this matching up, with over two thirds of SWF and PPF respondents confirming that their investment processes emphasize long-term risk and returns in excess of five years. In contrast, more CBs stressed a shorter time horizon somewhere between one to five years.

Figure 1
Investment Objectives

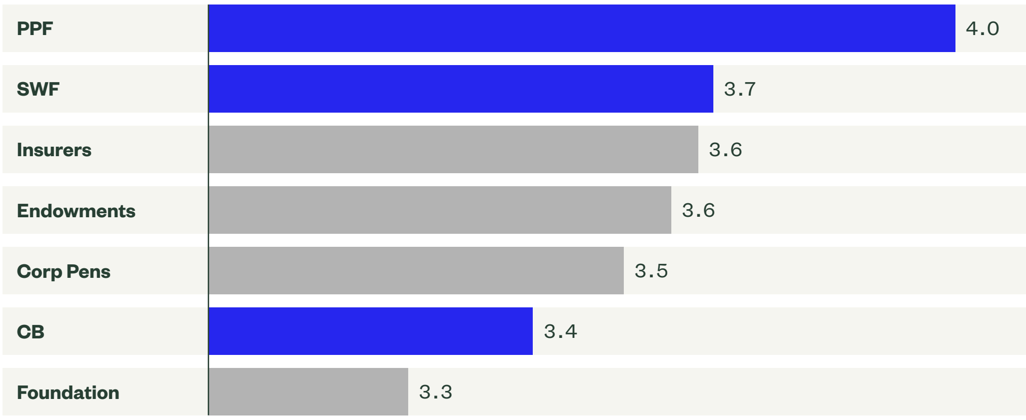


Sources: Center for Applied Research; multiple responses possible — see appendix for details.

To further illustrate the differences in investment horizons, we calculated the implicit preferred investment horizon, using the responses to how these institutions prefer to award performance-related fees. Although investment horizons have numerous drivers, such as the alignment with governments' fiscal planning, the fees appear to be a good indirect indicator: the survey indicated that 73% of all institutional investors approve of performance-related fees as an effective tool to align client and provider interests, with this number rising to 81% for CBs and SWFs.

Using these responses as a proxy, Figure 2 shows the implicit investment horizons per institutional type. Again, PPFs and SWFs emerge as the investors with the longest time horizon, with most other institutional types below these and CBs near the bottom. These results are in line with our findings in 2017, which indicated that PPFs and SWFs had considerably longer time horizons than other institutions, which is consistent with their mandates and mission statements.[5]

Figure 2
Implicit Investment Horizon (Years)

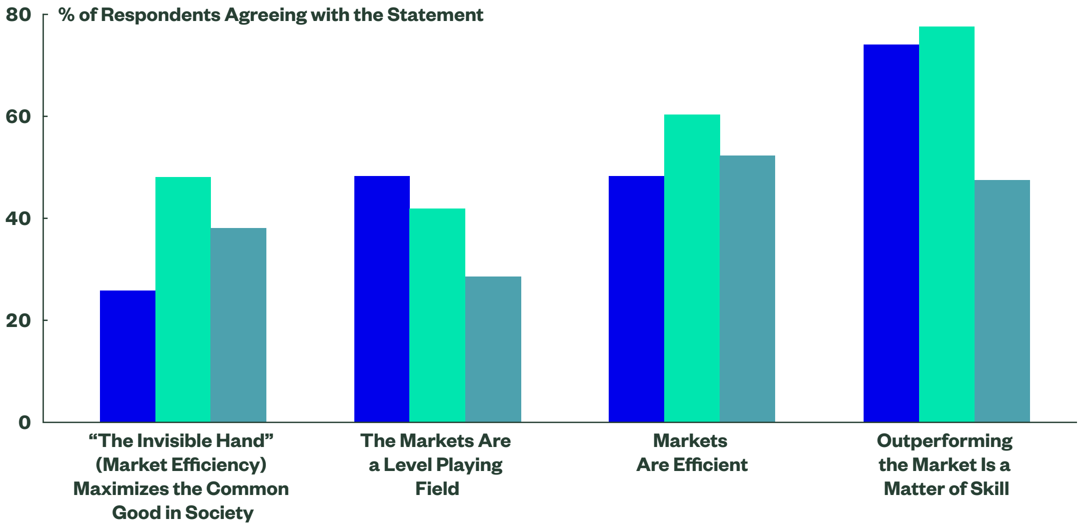


Note: Those highlighted in dark blue are official institutions.
Sources: Centre for Applied Research, Global Macro Policy Research. Corp Pens — corporate pension plans. Note that respondents could only choose between fixed options of '1 year', '3 years', '5 years' and 'Don't know', so the responses should be interpreted based on their ordinal ranking and should not be quoted as an explicit measure of the length of the investment horizon. See appendix for calculation methodology.

While the outcomes of ESG investments are best observed (and assessed) over longer time horizons, making them, in theory, more attractive to longer-term investors, it is worth examining other investment beliefs alongside the different investor approaches to ESG. In this regard, the survey reflected institutional differences in underlying investment beliefs, including attitudes toward market efficiency and investment acumen. With regard to the fair and efficient functioning of markets, scepticism seems to be widespread as per Figure 3.

Figure 3
Agreement With Core Investment Beliefs

CB
PPF
SWF



Sources: Center for Applied Research; see appendix for details.

About half believed markets were generally efficient, while only a minority agreed that markets are a level playing field and the "invisible hand" maximises the common good to society. With regard to the latter, it is noteworthy that CBs, many of which also have supervisory and regulatory functions, were particularly sceptical. SWFs were most resistant to the former, i.e. that markets represent a level playing field. However, as large long-term investors with the ability to marshal sovereign backing or governmental cooperation, SWFs may not necessarily perceive an uneven playing field as a big problem.

SWFs were also outliers with regard to whether outperformance could be attributed to investment skill. The overwhelming majority of all other institutions (on average 75%) embraced that statement, whereas just under half of SWF respondents agreed. However, as Figure 4 shows, SWFs are roughly as likely to adopt active strategies[6] as other institutions (66–73%), which is somewhat counterintuitive. One possible explanation is that SWFs attribute the success of their active investments to something other than skill (for example, scale, patience or ability to extract illiquidity premia, as their unconstrained mandates allow for higher shares of illiquid assets). In fact, 57% of SWFs believe that market participants use incorrect assumptions, which may mean that they value contrarian or out-of-the-box thinking more than traditional manager 'skills'.

It is also worth noting that there are substantial differences in the importance which different institutions attach to their benchmark. Of central banks, 65% emphasise beating the benchmark, compared to roughly half of most other investors and only 19% of SWFs. So while the share of SWFs' active strategies is similar, the strategies themselves may be very different from other investors.

Figure 4
Portfolio Breakdown Active-Passive By Institutional Type

	Active	Passive	Other
Central Banks	65.7	33.8	0.5
Public Pension Funds	66.3	33.1	0.6
Sovereign Wealth Funds	69.2	29.9	0.8
Corporate Pension Plans	68.7	30.2	1.1
Endowments	71.3	28.0	0.7
Foundations	70.0	27.2	2.8
Insurance companies	73.2	25.2	1.5

Source: Center for Applied Research.

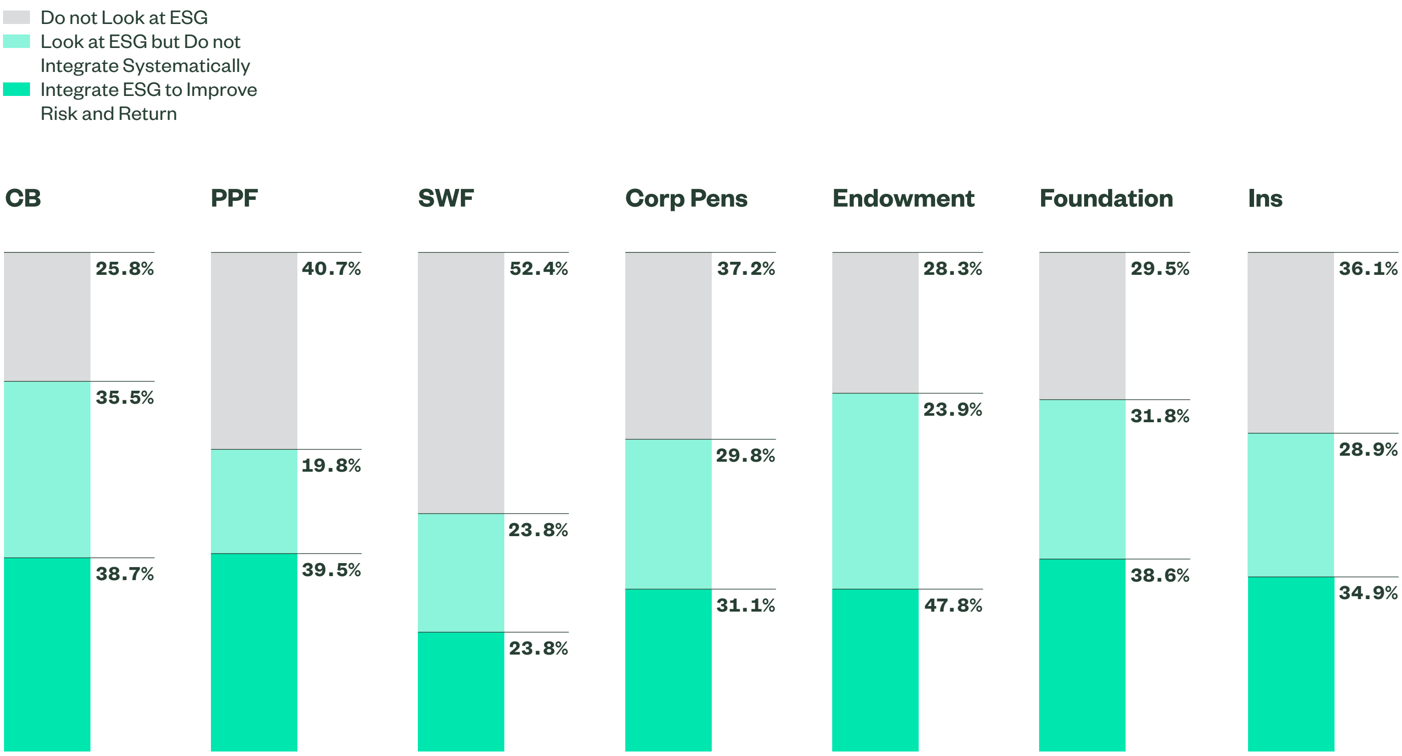
The link between the propensity to invest in active strategies and ESG is not linear. Both passive and active strategies may have ESG elements. Numerous public investors, from European central banks to East Asian public pension funds, already use various screening mechanisms in their passive equity holdings. But the high share of active strategies indicates that at least in this aspect, public investors do not have institutional constraints on implementing more high-conviction, data-driven and targeted ESG strategies.

Broad Belief in Importance Of ESG, but with Selective Implementation

Beyond broad investment philosophy, the survey included a variety of questions about the role of ESG in the investment process. Based on the answers to these, we aggregated the institutions into three broad groups — those who systematically integrate ESG to improve risk/return ratios, those who look at ESG but do not integrate it systematically, and those whose investment approach does not include it altogether.

Figure 5 illustrates our findings for official institutions alongside other asset owners. 74% of central banks look at ESG in some form, well above the private sector but in line with foundations and endowments. Public pension funds are roughly in line with their private sector peers and insurers, while sovereign wealth funds are the only category where more than 50% of investors do not incorporate ESG.

Figure 5
Asset Owners' Integration of ESG



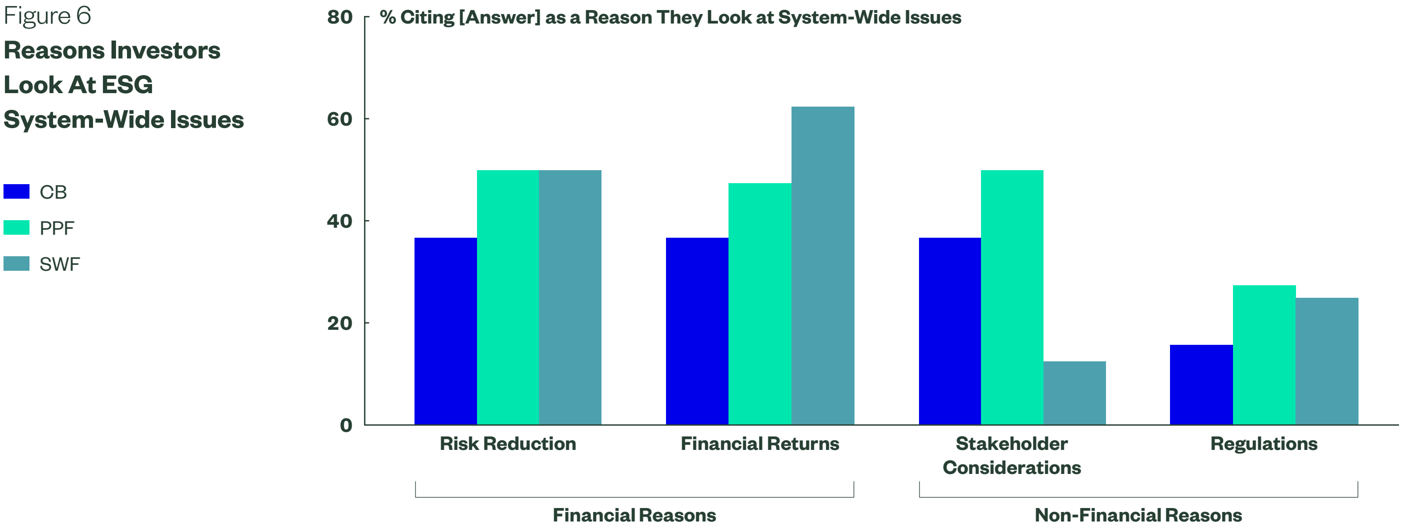
Source: Center for Applied Research, Global Macro Policy Research. Corp Pens — corporate pension plans.
See appendix for the methodology.

Our previous 2017 study (based on a different sample) showed that 78% of PPFs and 68% of SWFs implement ESG, which would suggest a decline. However, we cannot conclusively say whether this is the case, as *holding at least one ESG investment* (for example, buying an ESG-tiled index fund) is not the same *as incorporating ESG into the broader investment process* (using ESG data and analysing investments systematically for ESG risks). If we look at deeper forms of ESG implementation (for example, comprehensive portfolio analysis for social and environmental impact), it seems to have increased, even for sovereign wealth funds (24% vs 18% 'full ESG integration' in the previous study).

Equally, simple screens used by a variety of investors would not necessarily qualify as ESG integration and may not even be considered by them to be part of their *investment* process, but instead manifest themselves as an element of their *compliance* framework. Indeed, it is vital to distinguish between and within financial and non-financial drivers of ESG (Figure 6). The first point to note is the clear dominance of financial reasons (left side vs right side of the chart). This indicates that investors broadly accept that ESG investing is not merely an expression of an ethical worldview but a sound investment proposition.[7]

Second, looking specifically at the *financial* rationale behind the use of ESG, our previous study indicated that PPFs are slightly more interested in the risk mitigation aspects of ESG while SWFs view it more as way to enhance returns. The current iteration seems to confirm the pattern that financial return is the main reason why sovereign wealth funds engage with this topic — even if they do not adopt ESG formally (the 63% figure below is well above the share of SWFs who integrate ESG). PPFs are tilted towards risk reduction while central banks are even-handed, though less likely to state any particular reason at all.

Figure 6
Reasons Investors Look At ESG System-Wide Issues

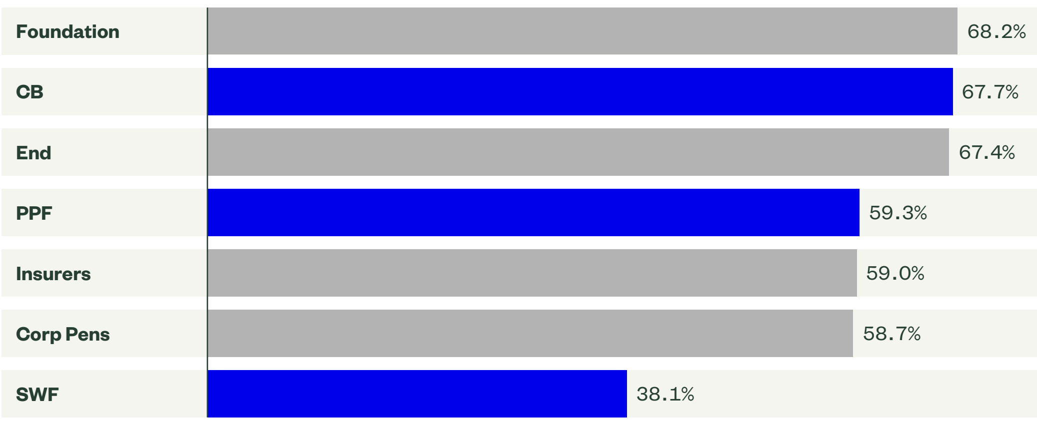


Source: Center for Applied Research.

Third, the *non-financial* reasons are dominated by broad stakeholder considerations rather than regulations, partly as public investors may face different regulatory restrictions from private ones. More importantly, this confirms our previous finding that public pension funds are under much greater stakeholder pressure[8] to adopt ESG — from either governments, or beneficiaries, or both — than sovereign wealth funds or central banks. This could be a geographical bias (half of PPFs in the sample are based in developed markets versus less than a tenth of SWFs), but it is also much harder for SWFs to objectively define their stakeholders, especially as governments periodically alter their mandates. Finally, it is important to note that 'supply-side' pressure on SWFs to implement ESG is much lower; with high shares of in-sourced mandates and illiquid investments, there are simply far fewer ESG strategies on offer to match their investment profile.

Further data from the survey helps put stakeholder interests into context, specifically in relation to sustainability issues (the 'E' of ESG) as Figure 7 shows. Asked whether their board and beneficiaries ask about such issues, we once again see three 'clusters' of responses: around two-thirds of central banks, foundations and endowments, just over half of both public and private liability-driven investors (including PPFs), and only 38% of sovereign wealth funds say that they do. This corresponds closely with the headline level of ESG implementation referred to above. It is also worth noting that most of the stakeholder requests are for qualitative data — less than a fifth of asset owners rely solely on quantitative information about sustainability.

Figure 7
Stakeholder Interest in Sustainability



Note: Those highlighted in dark blue are official institutions.
Source: Center for Applied Research, Global Macro Policy Research. Corp Pens — corporate pension plans.

System-Wide Issues Considered Even Where Not Labelled "ESG"

The survey data suggests that stakeholder demand is just one of several ESG drivers. Even investors who do not use the term 'ESG' do in fact consider some of the underlying ESG issues in their investment decisions. This is illustrated by the 63% of SWFs who believe that looking at system-wide issues such as climate change can enhance financial returns (see above).

In fact, the survey provided us with insights into a range of ESG-related system-wide issues that investors consider, whether or not they formally recognize them as part of an ESG framework. The survey allowed respondents to pick up to 20 issues from a pre-defined list. We categorised those issues into environmental, social and governance buckets and presented the top-ranked ones for every investor category. The resulting 'heat-map' in Figure 8 illustrates a number of important results.

Figure 8
System-Wide Issues and Their Importance to Investors

CB	PPF	SWF	Corp Pension	Endowment	Foundation	Insurers
Corporate Governance	Corporate Governance	Climate Change	Corporate Governance	Corporate Governance	Transparency	Corporate Governance
Climate Change	Corruption	Corporate Governance	Shareholder Rights	Renewable Energy	Corporate Governance	Climate Change
Shareholder Rights	Climate Change	Corruption	Climate Change	Shareholder Rights	Shareholder Rights	Renewable Energy
Renewable Energy	Shareholder Rights	Shareholder Rights	Financial Stability	Climate Change	Financial Stability	Shareholder Rights
Transparency	Renewable Energy	Transparency	Transparency	Financial Stability	Corruption	Financial Stability
Corruption	Transparency	Financial Stability	Corruption	Transparency	Climate Change	Social Equality and Diversity
Human Eights	Financial Stability	Natural Resources	Human Rights	Corruption	Renewable Energy	Transparency
Social Equality and Diversity	Human Rights	Renewable Energy	Renewable Energy	Infrastructure	Human Rights	Corruption
Infrastructure	Social Equality and Diversity	Human Rights	Social Equality and Diversity	Human Rights	Infrastructure	Human Rights
Employment	Infrastructure	Infrastructure	Waste Management and Pollution	Waste Management and Pollution	Waste Management and Pollution	Infrastructure

Governance Environmental Social "Corp pension" refers to corporate pension plans

Source: Center for Applied Research. System-wide issues are ranked in the order of likelihood of institutional types considering them as important.

First of all, governance issues tend to be prioritised over environmental and social ones. This is in part because they are less controversial (very few people would explicitly argue that governance is not important to performance) and widely recognised even outside the modern ESG framework. But it is also interesting to note that investors prioritize holistic *corporate governance* over specific negative governance *risks* (transparency, shareholder rights and corruption).

Second, while only sovereign wealth funds rank an environmental issue at the top (despite, or because of, the fact that over half of their wealth is generated from fossil fuels), all investors (except foundations) have it as a second or third issue. Climate change is the top green issue for most, followed by renewable energy (perhaps as the latter is a clear investment proposition as well as a system-wide issue).

Overall, it is worth noting that 'global' issues such as climate change appear to be a much higher environmental priority compared to more 'local' issues such as land use and water management, perhaps reflecting the global nature of asset owners' portfolios. Specifically, SWFs have been involved in international initiatives such as COP21 and 'One Planet' while the 'local issues', especially in emerging markets, have so far been the province of governments and multilateral institutions.

Third, social issues are a much lower priority, perhaps as they are harder to define and their transmission into risk and return is perceived to be less straightforward. Human rights are almost universally the first, followed by social equality and diversity (we also included infrastructure as a social issue though it could be assigned to any of the three categories).

Conclusion

The survey results confirm several trends. First, despite differing investment horizons, most sovereign asset owners are sceptical of market efficiency and only manage around a third of their assets under index strategies. This certainly creates room for them not to just use broad ESG-tilted strategies but to adopt more targeted ESG strategies. Second, ESG adoption has primarily been driven by financial motives, which means that successful ESG integration depends on embracing an ESG approach that matches the investment strategy, governance and framework of each institutional investor. While this may seem obvious, the practical experience of ESG adoption has not always followed that course. Therefore, ESG integration needs to be a broader conversation within each organisation and with their respective managers. Third, the clear thematic prioritisation of governance and climate change issues should guide the industry towards focusing on solutions that reflect these priorities, rather than perhaps the combined ESG format.

Appendix: Sample and Methodology

For the purposes of this study, we drew on a proprietary dataset with 427 survey responses from asset owners. Each data point is a set of survey answers from one asset owner employee, so in a small number of cases a single asset owner is represented by more than one employee.

Of the 427 responses, 133 were from sovereign investors (31 from central banks, 81 from public pension funds and 21 form sovereign wealth funds) and 294 from other assets owners: corporate pension plans (121), endowments (46), foundations (44) and insurance firms (83).

Of the employees answering questions, 59% were investment staff (including 39% with direct asset management responsibilities), 30% were from C-suite and Board level, 5% were from risk functions and 5% from other roles.

In Figure 2, we removed the 'do not know' group from the sample and re-calculated the remaining responses to get a total of 100%. From the remaining responses of '1 year', '3 years' and '5 years', we constructed the implicit horizons, but it is important to note that only these three options were given to the respondents.

In Figure 5, the respondents were given three different, non-mutually exclusive options of ESG integration as well as a 'none of the above' option. As we felt that 'Incorporate ESG considerations to improve risk and returns' is the strongest possible response, we used it along with the 'none of the above' option, while placing all other respondents into a third category of 'Look at ESG but do not integrate systematically'. The wording of the latter is ours and was not used in the survey.

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Endnotes

1 SSGA (2017) Hentov, E, Petrov, A 'How Do Sovereign Investors Approach ESG Investing?'

2 Please see appendix for methodology & details on the underlying survey data conducted by the State Street Center for Applied Research.

3 In fact, recent cross-country initiatives such as FCLT attempt to further emphasise the long-term considerations.

4 SSGA-OMFIF (2019): Hentov, E, Petrov, A, Kyriakopoulou, D, Ortlieb, P 'How do Central Banks Invest? Embracing Risk in Official Reserves'; SSGA (2018): Hentov, E, Odedra, S, Petrov, A How do Public Pensions Fund Invest? From Local To Global Assets' and SSGA (2018): Hentov, E, Petrov, A 'How Do Sovereign Wealth Funds Invest? Shift Into Private Market Continues.'

5 Note that the same institution can have multiple horizons in different portfolios/different aspects of its financial management.

6 'Active' and 'passive' are very broad terms encompassing very different strategies, and the figures were self-reported according to investors' own definitions of those terms.

7 See SSGA article: https://ssga.com/investment-topics/environmental-social-governance/2018/08/esg-institutional-investor-survey.pdf.

8 Given the lack of clarity which the term is often used, it is worth noting that the survey did not define 'stakeholders' and left the term to the interpretation of individual respondents.

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