ICGN Seoul Conference – *Launch of ICGN & UN Supported GISD Alliance Model Mandate*
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Chaired by Ian Burger, Chair of the Board, ICGN

Ian Burger:
The ICGN Model Mandate is a core ICGN document, recently updated from its initial 2012 launch, a really useful guide for Asset Managers and owners. The model was led by Claudia Kruse, along with Chris Hodge, who orchestrated it, deliberated, and identified improvement areas, whilst collaborating with multiple stakeholders. It provides standard agreement terms, creating a commonality level for Managers to agree on delivery points for asset owners. There are many agreements available and there is argument for commonality, hence the Model Mandate is applicable globally. It covers systemic risk, public policy advocacy, fee structure and remuneration, stewardship, etc. This lengthy, easy to navigate, document is available on the ICGN website.

The Model Mandate includes a new section on sustainable investment, linking to SDGs. Jenn-Hui, given the new Model Mandate is heavily focused on sustainable investment, what is it and how should it be described?

Jenn-Hui Tan:
It solves two problems. Endemic to our space is that there is no clarity around what the terms used mean. ESG, sustainable or impact investing mean different things to people, which isn't helpful. What is the extent of investor fiduciary duty? We disregard differences between sustainable investing and fiduciary duty by relying on long-term, because long-term, everything converges. This may be true, but short-term, where most operate and deliver outcomes, what trade-off level will we accept between financial return and sustainable development objectives? The Model Mandate helpfully addresses and explains these issues between Asset Manager and owner. "Sustainable development investing" is "an investment that positively, intentionally contributes to sustainable development objective measured by SDGs." This is a helpful start, which clearly establishes what the asset owner wants the Manager to deliver.

From objectives, you can develop measurements, tools, expected return, turnovers, that we are familiar with. The Model Mandate provides a clear framework for those interested in this kind of investing, differing from mainstream ESG integration, principally focused on how ESG factors improve/don't improve financial performance. The Mandate clearly states that the client seeks something different and provides a delivery roadmap.

Ian Burger:
It's applicable to traditional and sustainable investing, with areas to choose from. Financial returns or sustainable returns were previously two extreme examples, are they now converging, to provide both performance and sustainability?

Jenn-Hui Tan:
I'm not sure if they're converging. More clarity might be coming around trade-offs necessary to achieve either. In marketing, it was possible to deliver both, and structural growth factors underpinned this, low interest rates, growth stocks, technology stocks, etc., factors giving a correlation between ESG investing and superior financial performance. Some factors have reversed, debatably long-term or short-term. Some traditional cyclical sectors have become popular again, challenging people's notion of ESG. It's an opportunity to mature and evolve and sustainable investing to become a distinct style, with distinct outcomes, not precluding financial performance, but more explicitly outlining the possible implicit trade-offs and timeframes of such.

Ian Burger:
Paul, do we need a model mandate?

Paul Schneider:
Yes. As investors, we are model mandate users. It provides a roadmap for engaging with external Managers, ensures all bases are covered and allows you to test to ensure Managers act in alignment to your needs. With model mandates, everything in them need not be applicable for investors or their managers, but they act as good guidance, setting frameworks to negotiate agreements suitable for both parties.

Ian Burger:
How does the Model Mandate help sustainable investment, Hiro?

Hiro Mizuno:
We absolutely need a model mandate. As a founding member of GISD, I've supported this initiative, and helped the Pension Fund Coalition for Inclusive Capitalism with creating an ESG language template for Asset Managers. This reflects my experience running GPIF. I tried to negotiate with all major Asset Managers to reflect our discussions on ESG in asset management contracts and was completely unsuccessful. They said I was the only one requesting it and I wondered why. They agreed to report on ESG and definitions of sustainable stewardship, etc., but didn't agree to add into a contract. It demonstrates the gap between talk and action. This is why I push for Asset Managers to sign new contracts reflecting sustainability and ESG developments.

The inconvenient truth of asset management is even GPIF, the biggest Asset Manager client, have difficulty changing contract languages alone, but if ten/20 clients simultaneously ask Asset Managers to use the Model Mandate, they would probably consider it. Most asset owners, institutions or retail, don't have resources to seriously negotiate the contracts. The Model Mandate can help initiate this. It bridges the gap between what Managers say and do on sustainability and ESG.

Ian Burger:
Jenn-Hui, why don't Asset Managers do what GPIF ask, and would collaborative engagement help?

Jenn-Hui Tan:
Hiro's criticisms are fair, and Asset Managers need to reflect on them. We should deliver a product suitable for our clients, or we won't have a business. There is more realisation now that this is not about broad integration, investing with extra stewardship. The Mandate is about investment supporting SDG development across society, which isn't our historical, or even present, experience. Fund Managers aren't currently incentivised to deliver this. We must rethink the purpose of investing, evaluating companies, and develop a robust way of evaluating company contributions to development, evidencing this, then reporting back to clients, subsequently driving incentives between owners and Managers.

In the US, collaboration is closely scrutinised by competition law, and it'll be interesting to see how far this spreads. If the largest asset owner cannot single-handedly drive this through, there's significant resistance. More Asset Managers must collectively decide if the long-term interests of the whole industry are best served by reallocating capital as the mandate envisages, rather than the traditional way.

Ian Burger:
Paul, what is the best way for asset owners to monitor Managers?

Paul Schneider:
Monitoring is ongoing from inception. We've internally developed, over recent years, our detailed ESG Maturity Matrix, to evaluate Managers and identify their position in their ESG journey and alignment with our needs. We identify potential gaps and collaborate to address these. We have internal objectives for external Managers, around climate change, Scope 1 and 2 emission disclosure, ensuring alignment with the 30% gender diversity objective, reporting to us on this. We undertake due diligence upfront to understand management approach to sustainable investing and general ESG, along with annual reviews for Managers, using the ESG Maturity Matrix, considering their progress and the need for any discussion. We ask them to report their votes quarterly, to ensure alignment with our objectives.

We have an internal controversy monitoring process, gathering reports from risk providers about the controversy index, on a scale of one to five. Any company at four or five, held by external Managers, is asked about their company engagement. There is reputational risk for us, but it's important to the Fund.

We endeavour to create alignment between Ontario Teachers' requirements and Managers' activities, through ongoing dialogue. We're closely linked with global external Managers, and have constant, two-way, dialogue. With voting, when there is ambiguity and we're aware an external Manager holds it, we'll discuss and get their viewpoint. It's an evolving robust process.

Ian Burger:
Hiro, how should success in sustainability be determined, and how does it differ from traditional investment?

Hiro Mizuno:
Sustainable investment and ESGs are separate things: integration of ESG information in investment analysis and using ESG as a KPI for company engagement. It's hard to judge success by observing only capital allocation and short-term performance. We must note engagement with other companies. ICGN is relevant for assisting GISC to help this mandate, because engagement is critical. At GPIF, over three years, we offered all Passive Managers extra fees to present other stewardship KPIs to promote ESG. Fidelity Asset Management were the only ones who proposed.

It's difficult focusing on people saying they can succeed with sustainable investment if they achieve this return. This will create a totally biased analysis of what we do. We involve the ownership side of investments to give a balanced view on progress. From that perspective, the purpose of governance, how ES is communicated through ownership is very important. A balanced view is the only way to evaluate success.

Ian Burger:
How will SDGs feature in sustainable investing portfolios, strategies or processes?

Hiro Mizuno:
On the bigger picture, the UN has passionately pushed SDGs over ESG. When advocating ESG, I had huge pushback in Japan, pressing the difference from SDGs. We developed a narrative that companies aligning business with SDGs attracts ESG money. ESG money will get the return, the company succeeds in solving SDG problems.

SDGs are not designed to be an investment tool, but it's good for corporates to set their business strategy. There are 17 goals to achieve for a sustainable world and some use them and ESGs interchangeably, but ESG is more investment tools and SDGs are business or international goals. Many SDG themed investment mandates appeared, and I advise asset owners how to interpret it into the investment strategy. Using the ESG framework is most understandable, because we are all now used to it.

Ian Burger:
In this space, we generally talk about the importance of engagement and stewardship. Paul's monitoring his Asset Managers against their agreements. In terms of stewardship and outcomes, company performance, engagement efficacy, Jenn-Hui, how do you know how effective your engagement has been and how is it evidenced?

Jenn-Hui Tan:
Regarding the arrangement between Fidelity and GPIF, we're grateful for extra fees from clients, and we can quantify the monetary value of stewardship activity. Many asset owners would think it's part of what you do, etc., which is fine at a certain fee level. For passive fees, there should be more explicit acknowledgement that good stewardship is resource intensive, requiring significant expertise influencing companies and creating outcomes, which should be valued. Having the model within Fidelity has been amazingly helpful for illustrating an express dollar value clients will pay for the value of the work our team and others do.

Quantifying outcomes and value of engagement is difficult. Everyone has an anecdote about discussions with CEOs resulting in press releases giving what they asked for, which is great. These stories show that we need to show that value-add, but how do we move onto systemic quantification of impact levels? Can you show your engagement changed or influenced corporate behaviour? How do you solve the question of attribution, the linkage between what you sought? It's easy if you have a Shell proposal, but it's not always that clear. We should not overstate our influence. People do things for various reasons. Companies' explanations of their responses may not reflect their true motivations.

Often forgotten, but equally important, is showing corporate behaviour has changed to the company valuation, share price, improved financial performance, which is ultimately our delivery goal. This isn't clear. It's great to have a well-recognised ESG leading company, you can still influence their behaviour, but are you creating more value for your fundholders? Changing behaviour in a dirty, improving, company may see more change in the market view on price.

Ian Burger:
There is currently no golden answer.

Brendan Henry:
OTPP has a large private equity investment portfolio. How do you leverage that experience into stewardship of publicly listed companies, and do you demand more from external Managers of listed companies versus private equity companies?

Paul Schneider:
I'm not sure we do. Climate change expectations are fund-wide, so we expect the same from privates and publics. As a large investor, with privates we have more input, we are the owners, but expectations are the same for both. We ask for climate change strategies, Scopes 1 and 2. We report our information annually in our Responsible Investing Report, our carbon footprint. We have a Net Zero commitment and interim targets to meet.

Ian Burger:
Hiro, did GPIF have different sustainability or stewardship mandates for private and listed equity Asset Managers?

Hiro Mizuno:
We unsuccessfully tried to incorporate ESG into the contract for listed equities. For private equities, I'd push the ILPA mandate. When negotiating partnership agreements with GPs, I'd instruct my team to initially send this to the GP, rather than receive their draft to revise it. They said it was impractical, but ILPA has pushed this standard language for decades. It was unsuccessful, but I tried. Mandates only become useful when they're used, so pushing them can ultimately shift industry practice.

Ian Burger:
Paul, the onus is on you.

Kerrie Waring:
When reviewing the Model Mandate, it was meant to hardwire in SDGs and consult with all our members to get example contractual terms, but hardly anyone has anything. We approached Lawyers to obtain example contractual language. What should we do to make it more acceptable in the mainstream? Why is it difficult for Investment Consultants and asset owners to collaborate to ensure mandatory inclusion in investment management agreements?

Hiro Mizuno:
Investment Consultants said that it's "industry practice." I unsuccessfully tried to change the practice. Investment Consultants may be able to assist asset owners, not Managers, to reflect this. ESG, as a recent phenomenon, was never a market practice. Unless somebody starts using this, rather than stating it as market practice, it won't change.

Paul Schneider:
The industry incentivises on returns. I think we're improving in relation to not just having returns for returns. Managers are compensated on returns, so will they sacrifice them for sustainability? It's hard to say, but it will evolve. OTPP has recently undergone a strategy review and a big theme is impact. Our tagline is "Investing to make a mark," not necessarily returns. We want to provide 70-year pensions, but there's a concerted effort towards positive impact. Impact is important, but we're currently figuring out the how. We're slowly having more conversations like today's, so, we'll get there eventually.

Susanne Stormer:
Jenn-Hui, as you said, we used to have a conducive environment, with an opportunity for correlation. Now we talk about giving up profits for purpose. Generally, we talk about longer term profitability and value creation. Where does value creation from ESG dimensions factor in and how can it be attributed? Can we build more robust methodologies to assess the business case we urgently need, particularly in the current environment?

Jenn-Hui Tan:
This style of investing hasn't genuinely been done properly at scale in a large, diversified, public listed equity portfolio. The outcome of the return profile of this investing is, as of yet, unknown. Asset owners might be cautious about the look and timeframe of the return profile. More work is needed around this. The value creation driver of ESG is a complicated question, involving asking how companies are currently valued. What is already in the price and what do you see that others don't? Good ESG should cost company money. If it was win-win, it should've been done some time ago by mini-Management Teams. Reducing carbon emissions, protecting employees, should have cost implications.

What does this say about the company's long-term sustainability generation in exchange for these higher upfront costs? It depends on views on the extent to which negative externalities reflect back on the long-term company value and whether the transmission mechanism is policy and regulation or consumer demand, brand and reputation, etc., and the most conducive markets to do this. A global carbon price is a lovely idea, but not realistic. We're currently subsidising carbon, not putting a price on it. Establishing where this will happen and over what timeframe will unlock value in the ESG analysis.

Woochan Kim:
Academia, especially finance, does not view ESG integration as able to deliver excess return, because the market is efficient, E&S factors are reflected, maybe not now, but in the future. But we believe if E&S factors contribute to market value, ESG engagement can possibly deliver excess return. I feel engagement can better achieve the two things simultaneously. In the Model, is there an element emphasising engagement over passive strategies, such as ESG integration or screening?

Hiro Mizuno:
That's the exact mandate we delivered to Fidelity. The tracking index is not worth any fee and should be automated. Promoting ESG will create value, so we paid for that service. There should be a cost and benefit associated with stewardship activities. It may be true that ESG doesn't deliver excess return, but ESG is usually associated with a systemic market risk. If everyone tries to get excess return, who's responsible for systemic risk? Climate is a good example. It helps to get extra return, but it may cause a systemic market crush.

I'm visiting Harvard, Oxford and Cambridge faculties, pushing universal ownership philosophy, whereby the owner has to be responsible for their portfolio and negative externality caused by it. Without responsibility on ownership, nobody cares about the systemic risk, and everybody is doomed. The Korean University Business School should get serious around analysing systemic risk associated with ESG.

Woochan Kim:
Green grass emission could be a systemic risk, so investors require a premium. Firms vulnerable to systemic risk have a higher return and those not vulnerable have a lower return. Global academic consensus is that picking non-vulnerable firms will give negative excess return. E&S factors are important, but to make an excess return you must pressure companies to change, not passively pick overpriced firms and ignore under-priced firms.

Hiro Mizuno:
Divestment makes no difference. You're right, engagement is only one way to improve the system, but the financial faculty must expand its scope of analysis on managing systemic risk. Harvard, Oxford and Cambridge all have this view, also, so we need more discussion.

Jenn-Hui Tan:
I agree with Hiro and we're thinking extensively about system-wide stewardship, moving from individual corporate stewardship, engagement or thematic engagement in sectors, considering more of a policy, market, regulatory level and the financial industry's responsibility for creating enabling environments for invested companies to behave sustainably. There is a limit to the trade-offs people will accept.

Whether you view markets as efficiency pricing information, asymmetries can exist. Factors are anticipated to become more or less relevant and active industry should exploit that for profit, improving systemic efficiency as a result, whilst generating excess returns to individual portfolios. If you're thoughtful, you can make money from effective capital allocation decisions guided by ESG factors. It probably won't happen through buying a basket or broad-base index, which isn't too diversified to feel the effect of individual security selection.

Nana Li:
SDG, their targets and financial return abilities are often vaguely written. How should investors talk to our clients to justify alliance of SDGs to investment portfolio strategies?

Hiro Mizuno:
For the last 20 years active Managers have never beat the index, nothing to do with SDG or ESG. You must find a way to make extra returns by integrating ESG and using integration. The market is shifting towards all ESG criteria, a condition

precedent, for investors to invest. We should stop using ESG as an excuse not to make extra return. ESG will be there and must be integrated.

Jenn-Hui Tan:
Our industry loves reducing things to simple numbers, which is generally not good. It removes the complexity and understanding. It's particularly damaging with ESG, because we're only beginning to define what good looks like and devising measurements for this. Having a number with no context, whether carbon footprint of ESG rating, etc., stating this is good and that's bad, is a really a bad habit. We ran an experiment for a client to demonstrate if you halve the carbon footprint of MSCI Europe by taking out the top ten emitters, you still have a very diversified, 390 stock portfolio, but with half the carbon footprint. Many Fund Managers sell this as an ESG product, highlighting the amazing carbon stats and performance, but it's not a sustainable product in itself. Anyone who does carbon footprint analysis knows the sensitivity of the calculation to individual high emitters, so portraying half the carbon footprint, with a small tweak in the index rating or constituents, is not helpful. It's an example of negative implications of reductivism in ESG analysis.