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Taking A Systematic Approach to Prosocial Investment

Judging by the growth in signatories to the UN PRI in recent years, the investment management industry is largely sold on the benefits of integrating ESG issues into investment processes. Their clients, the owners of the assets for whom they invest, appear less persuaded. Is this because the managers' product offerings fail to distinguish between those who wish to invest for client gain and those who invest for general good? Or is a more cynical interpretation of managers' so-called conversion warranted?

This white paper considers not only why investors may wish to incorporate ESG issues into their investment process, but also why governments may encourage this too. The paper argues that both parties will influence the design of investment products, and that investment managers and asset owners will collaborate to change ESG policies to improve the outcomes for the ultimate investor.

As ESG issues have become more prominent in recent years it has become clear that investment managers' views are polarised: some are passionate advocates of the benefits of having an investment philosophy informed by ESG issues whereas others maintain that their first responsibility is to maximise their clients' returns. Milton Friedman sided with the latter when he argued[1]:

"*there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*"

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Seen through Friedman's prism, investors are presumed to be interested in ESG issues because they are incorrectly priced: by correctly weighing ESG implications investors can generate higher returns for comparable risk. This view implies that there is a market inefficiency, the reasons for, and persistency of which, require elucidation. On the other hand, not all investors have pursued an ESG-centred investment strategy, which suggests that they are unpersuaded by the magnitude of the opportunity. This range of views is seen, too, in the competing academic theories on how ESG issues impact valuation, which in turn reflect the absence of definitive empirical evidence.

[1] Capitalism and Freedom – Milton Friedman (1963)

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Contrary to Friedman's view, there appears to be a constituency of investors whose primary motivation is not to maximise returns, but rather is to act in a socially responsible or prosocial manner. This has attracted the attention of behavioural economists, and Bénabou and Tirole (2010)[2] propose three reasons why investors may pursue prosocial investment.

1. **Win-win ('doing well by doing good'):** This is a broader version of the view that there is a market inefficiency. In this hypothesis, investors and company management are focused on short term goals and the longer term risks encapsulated in ESG issues are unaddressed or mispriced.

   In this case there are two alternative investment strategies. First, perhaps ESG risks are wrongly priced, so avoiding them will produce better risk-adjusted returns. Alternatively, perhaps ESG risks are correctly priced, so returns can be improved by persuading companies to reduce their ESG risks. In either scenario, an investor could plausibly 'do well by doing good'.

2. **Delegated philanthropy (the firm as a channel for the expression of citizens' values):** In this case, there is stakeholder demand for companies that engage in philanthropic activity on their behalf and the companies respond by 'doing good' or by refraining from 'doing harm' and championing their stance. Examples where companies have sought to appeal to the philanthropic interests of stakeholders include the Fairtrade and Product (Red) brand campaigns, and indeed investment products that are specifically tailored to various ESG views.

   The authors argue that this poses no specific challenge to Friedman's idea of a business' social responsibility: the firm responds to customer demand and maximises profit.

3. **Insider-initiated corporate philanthropy:** Here the prosocial activities of the company reflect management's objectives and not, or at least not entirely, those of shareholders. This approach is criticised because in this case management act as principals and not as agents of the shareholders and the presumption is that profit is not maximised. For this behaviour to persist, management would need to be invulnerable to external (i.e. non–management) influences, such as from shareholders.

   In practice, this phenomenon is very difficult to identify, as management may ascribe their principal-like objectives to agent-like motives. Less cynically, it is easy to imagine circumstances where management unwittingly engage in more, or less, prosocial activity than that desired by their stakeholders.

There is some empirical evidence in the academic literature for the first two, but less so for third of these motivations[3]. Likewise, investment product providers typically market their products based on one or the other of the first two investor motivations.

The first two hypotheses focus on the actions of individual investors, but it may be that the benefits of an increased focus on ESG issues are widely dispersed and accrue to society at large, rather than to individual investors. In any event, it does not follow that investors, whether they invest for 'good' or 'gain', will necessarily promote a result that is the best one for society as a whole. David Hume, the Enlightenment philosopher and economist, termed this a fallacy of composition: it does not necessarily follow that what is good for individuals is good for the whole of society. Keynesian economists argue that is unlikely that Friedman's profit maximising markets will also produce a socially optimal outcome, hence government intervention is required to correct this 'market failure'. In other words, governments may choose to change Friedman's 'rules of the game' to encourage investors to pay more attention to ESG issues.

[2] Individual and Corporate Social Responsibility – Roland Bénabou and Jean Tirole (2010), Economica 77 1 -19

[3] See for example: Active Ownership – Dimson, Karakas and Li (2012)

Attempts to correct this market failure suggest a fourth motivating reason for prosocial investment.

4. **Remedial Intervention:** Intervention from governments or similar is necessary in order to avoid a tragedy of the commons, wherein collective self-interest can deplete or spoil a public good[4].

   The challenge for governments is how to persuade investors to engage in activities that cost them and yet most of the benefit accrues to others. Here, the incentives to free–ride are substantial and hence participation in altruistic, prosocial behaviours is deterred. In an earlier paper the authors cited above investigated why individuals behave altruistically and suggest that rewards and punishments sometimes have an adverse effect on prosocial behaviour[5].

The framework of the United Nations Principles of Responsible Investment (UN PRI) is one such form of remedial intervention that seems designed specifically to tackle the free-rider problem and to encourage further engagement with ESG issues. Specifically, its mission statement says (our emphasis):

"The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation." [6]

The effectiveness of this remedial intervention lies in the following features:

- It is easy to sign up. Signatories' initial obligations are low and they benefit from its cachet. This has led to a large and enthusiastic response, particularly among those providing services to asset owners: investment managers who are signatories to the UN PRI manage close to three quarters of all assets under management[7].

- Expectations for implementations are progressive. The UN PRI recognises that there exists a vast range of organisations by scale, capability and asset-type, strongly impacting implementation of the Principles. Hence, the Principles are aspirational, enabling each signatory to tailor its implementation according to its own circumstances.

- Its public nature promotes healthy competition. Signatories to the UN PRI commit publicly not only to adopt the standards, but also to promote them and to make public the extent to which they have been implemented. This serves to stimulate competition between philanthropically motivated signatories, which is likely to raise standards of compliance.

In this way, the UN PRI intends to address social costs in the ESG space that result from inherently individual-focused investing: asset owners, their agents and intermediaries are encouraged to act in a way that the UN PRI hopes will 'benefit the environment and society as a whole'.

Crucially, the UN PRI's efforts to improve upon the market's response to ESG issues remain a work in progress. Indeed, Principle 5 recognises this, stating that 'we will work together to enhance our effectiveness in implementing the Principles'. Notably, increasing the participation of asset owners is one of the UN PRI's principal objectives: asset owners who are signatories have total assets of $16.6Tn[8], whereas investment managers who are signatories manage assets of $53Tn. Asset owners are strategically important to the UN PRI, because of their influence in setting policies for their investment managers to follow and in monitoring the implementation of those policies. Greater collaboration between investment managers and asset owners is likely to improve the implementation of the policies and to raise standards.

[4] The tragedy of the commons concerns the negative externalities arising from individuals sharing a common good. Individuals are compelled to act in self-interest, which leads to the depletion/exhaustion of the common good in question. This concept was made widely known by ecologist Garrett Hardin in 1968. Building from Victorian economist William Forster Lloyd, Hardin quotes: 'The tragedy of the commons develops in this way. Picture a pasture open to all. It is to be expected that each herdsman will try to keep as many cattle as possible on the commons...As a rational being, each herdsman seeks to maximise his gain...Adding together the component partial utilities, the rational herdsman concludes that the only sensible course for him to pursue is to add another animal to his herd. And another; and another...But this is the conclusion reached by each and every rational herdsman sharing a commons. Therein is the tragedy...Freedom in a common brings ruin to all'

[5] See for example: Incentives and Prosocial Behaviour - Roland Bénabou and Jean Tirole (2004)

[6] See https://www.unpri.org/about for more information.

[7] According to the UN PRI 2016 annual report: Investment managers who are signatories manage $53Tn, those who are not manage $18Tn.

[8] Ibid.

Investment managers should give careful consideration to their strategy towards ESG issues. They should consider the needs of asset owners who, if they are institutions, will have clients who are likely to be individuals. Asset owners may wish to offer ESG-tailored investment products that meet the requirements of their clients that believe in 'doing well by doing good' and to those that wish to engage in 'delegated philanthropy'. However, asset owners may also have their own prosocial policies, perhaps encouraged by the UN PRI as noted above, to which they wish all their investments to conform. Each of these three requirements will have different policies which will evolve over time and investment managers should be able to respond in kind.

Asset owners will have developed ESG policies specific to their desired corporate positions and to the various investment products offered to their clients. These are their choices and investment managers should work with them to reflect their specific investment objectives, including their ESG preferences. To accommodate asset owners' various policies, investment managers should be able to capture their ESG policies in the governing documents they use for investment policy, which means they will need to agree verifiable measures to quantify ESG exposures. Asset owners should be able to independently monitor their portfolios' exposures and those of their choice of benchmark.

Investment managers can help asset owners weigh the consequences of their policy decisions on the exposures, risks and performance of their portfolio both on an absolute basis and relative to benchmark. By doing so, they can help asset owners to understand the investment implications of their policy. In turn, this should help them not only to explain the results to their clients, but also, and perhaps as importantly, to refine their approach in the light of their investment experience.

By carefully applying a range of ESG metrics to asset owners' holdings, investment managers can tailor exposures to a particular stance on ESG issues, as well as the more traditional economic exposures in fixed income portfolios.

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