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Public pensions forced to play defense on ESG investments

Pension plan board members are feeling squeezed between divergent opinions on whether ESG is a core part of their fiduciary duty

Dietrich Knauth | 26 Jan 2018

As environmental, social and governance (ESG) concerns become more prominent in public pension plans' strategies, sponsors sometimes struggle to justify their actions without the benefit of a clear consensus on how to measure ESG success. Board members, in particular, are feeling squeezed between divergent opinions on whether ESG is a core part of their fiduciary duty.

Different investors take different approaches to ESG and its role in a portfolio, and they use different metrics and frameworks to measure success, with competing frameworks being offered by the *Global Reporting Initiative*, the *Sustainability Accounting Standards Board*, *UN Principals for Responsible Investment*, *G20's Financial Stability Board's Task Force on Climate-Related Financial Disclosures* (TCFD), and *International Integrated Reporting Committee*, among many others. The continued debate about how to approach ESG investing leaves plans sponsors vulnerable to critics who call ESG a distraction from investors' core mission of maximizing returns.

The **California Public Employees' Retirement System** (CalPERS), which devoted a portion of its January meeting to discussing ESG strategy, is often caught in the crossfires on ESG debates.

"It's almost 'damned if you do, damned if you don't,'" CalPERS board member **Richard Costigan** said at a recent board meeting. "As a fiduciary, if I focus too much on this, I risk lower returns which opens me up to [criticism]. Now we're talking about inaction raising the risk of a fiduciary breach. As a trustee I'm sort of stuck in the middle."

CalPERS is not alone, as large plans like the **Oregon Investment Council**, **Washington State Investment Board**, and **New York City Pension Funds** have all taken recent actions that emphasize ESG concerns. Oregon has plans to hire a new ESG investment officer and is participating in the Sustainability Accounting Standards Board's effort to develop better metrics. Washington State has committed resources to several industry groups, including Embankment Project, FCLT Global, CII, Climate Action 100+, that work toward unified standards and consistent metrics related to ESG. New York City, for its part, announced a plan to divest from companies that own fossil fuel reserves, following previous divestments from coal and private prisons.

Fiduciary duty

The relationship between ESG and fiduciary duty is at the core of many debates around pension plans' ESG efforts. Many, including vocal constituencies of retirees, believe that ESG factors are a "distraction" from fiduciaries' core duty of maximizing investment returns. Others, taking a longer-term view, say that neglecting ESG factors is an abdication of fiduciary duty.

California retirees' complaints about ESG initiatives are a common occurrence at public meetings. For January's meeting, those concerns were voiced by **Al Darby** of the **Retired Public Employee Association of**

California, who said that social considerations should not justify a "drag on investment performance."

"What is the goal — lead in social issues or improve the [Public Employees' Retirement Fund]?" Darby asked at the board. "Until funded status is restored to 80% at least, we need to be focused on investment return rather than ESG and other distractions."

Whether due to its size, or its active approach to ESG issues, CalPERS' ESG returns are a frequent target for critics. In December, CalPERS found itself compelled to rebut a study by **American Council for Capital Formation** (ACCF), a think tank that argued that ESG was a drag on CalPERS' returns and that four of the nine worst-performing funds in the CalPERS portfolio focused on supporting ESG ventures. The think tank also criticized New York's divestment efforts for putting "politics over performance." CalPERS, for its part, called the ACCF report "dead wrong," "misleading" and "misinformed," saying that the think tank had cherry picked data points from funds that amounted to just over 2% of it private equity portfolio to "feebly argue its anti-ESG message."

The United Nations tracked the evolution of thinking on fiduciary duty in a 2015 report, finding that ESG efforts are stymied by "outdated perceptions about fiduciary duty and responsible investment," particularly in the U.S., where "lawyers and consultants too often characterise ESG issues as non-financial factors." Speaking at the recent CalPERS meeting, UN Assistant Secretary-General **Elliott Harris** urged CalPERS board members to recognize ESG factors' role in driving long-term investment value. As an investor with a particularly long-term horizon for investment, CalPERS should also consider how its investments shape the world that its beneficiaries will retire into, Harris said.

"I think it is becoming increasingly clear through research that these are drivers of long-term investment value. They are," Harris said. "And the question then comes, could they, should they, must they, be gradually integrated into the concept of fiduciary duty? Because if these are factors that affect macroeconomic fundamentals, which they do, then these factors will, too, affect the return on any given investment."

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A sharper focus on fiduciary duty, which CalPERS has pursued in all of its ESG efforts, has helped the UN's Principals for Responsible Investment gain broader traction in the financial markets, according to **Anne Simpson**, CalPERS Investment Director for Sustainability.

"We're not talking about 'either-or,'" Simpson said. "We're talking about 'and'. We're talking [sustainability] and how it supports our fiduciary duty."

CalPERS board member **Theresa Taylor** expressed frustration with the sometimes-circular nature of debate around ESG, saying that perhaps CalPERS should rethink its communications strategy around ESG and fiduciary duty.

"We should answer stakeholder concerns much more succinctly," she said. "I think we're kind of unclear around that, and a lot of stakeholders come and speak to us and talk about how we shouldn't involve ourselves in this, not understanding that we are not changing investment strategy entirely."

Standardized metrics remain out of reach

The staggering number of ways to measure ESG factors can be a real challenge for boards. **Margaret Brown**, a new member of CalPERS' board, admitted becoming lost in the "alphabet soup" of acronyms bandied about during the January meeting, and asked for a primer on the various ESG organizations and efforts that CalPERS supports. On a broader level, the lack of agreement among pension plans about how to measure ESG success makes it difficult for apples-to-apples comparisons.

One effort that has gained the support of large investors, including CalPERS, Washington and Oregon, is the Sustainability Accounting Standards Board, which is currently seeking public comment to refine industry-specific standards for corporate sustainability disclosures. Oregon has pointed to SASB standards as a way to cut through some of the "noise" around ESG, and better focus on sustainability concerns' impact on a business's performance, rather than focus on the business's impact on broader sustainability goals. Washington also said that it hopes that SASB will lead to more standardization and better data-driven decision-making for both companies and asset owners.

"Common ground on principles and practices in this area is needed," WSIB spokesman **Chris Phillips** told *MMR*. "The ongoing challenge for public fiduciaries is how to effectively integrate such metrics into a disciplined investment process for the long term."

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