The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary

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Outline

(1) From SRI to ESG

Transformation of SRI to ESG

Collateral benefits ESG versus *risk-return* ESG

(2) Duty of Loyalty

The “sole interest” rule

Sole interest rule applied to ESG investing

Motives Matter

(3) Duty of Care (Prudence)

The “prudent investor rule”

Theory and evidence for ESG

Risk-return ESG cannot be mandatory, it may be permissible

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From SRI to ESG

The Rise of SRI

Roots in avoiding antisocial businesses (18th Century)

Salience from South Africa divestment (1970s and 1980s)

From SRI to ESG (1990s-present)

Proliferation of funds, reflecting demand for SRI

Expansion to include governance factors (Enron, WorldCom)

Shift to risk-adjusted return from collateral or ethical motives

Rebranding as “ESG investing”

► Challenge in taxonomy is that “ESG investing” captures both collateral and return motives

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Collateral Benefits versus Risk and Return

Collateral Benefits ESG

ESG factors to achieve a collateral benefit to a third party

In effect “Classic SRI” for moral or ethical reasons

Risk-Return ESG

Can Environmental, Social, and Governance factors predict firm performance?

Can they be traded on for a profit?

ESG factors to improve risk-adjusted returns

- ► Seeking profit from mispricing of factors that affect firm value
- ► Screens
- ► Risk measures
- ► ESG considerations as factors or metrics in an asset-pricing model or in shareholder voting

Fiduciary Law and Economics

Fiduciary Law and Economics

Principles-based, after-the-fact review

Common structure across fiduciary fields

- ► Duty of loyalty – conflicts of interest
- ► Duty of care or prudence – objective standard of care similar to negligence
- ► Implementing rules – e.g., prudent investor rule for fiduciary investment

Trust Law as Source of Fiduciary Investment Law

Trusts – directly

ERISA – federal statute and Supreme Court precedent

Charitable endowments – directly, common law, and UPMIFA

Duty of Loyalty

Sole Interest Rule

RST Trusts: “administer the trust solely in the interest of the beneficiaries”

ERISA: ”solely in the interest … exclusive purpose”

Motive Maters, Mixed Motive Prohibited

RST Trusts: “the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust”

Policy Value

Prohibitory & prophylactic, infer disloyalty from any mixed-motive

Avoids difficult counterfactual disputes about relative influence of mixed motives and fairness

Compels trustee to seek authorization from court or beneficiaries

Sole Interest Rule Applied to ESG Investing

Collateral Benefit ESG Investing

By definition, violation of default sole interest rule

RST Trusts agrees as does prior literature about SRI

Risk-Return ESG Investing

Can be consistent with sole interest rule, but

Only if “sole” or “exclusive” motive is benefiting the beneficiary

Must also satisfy the duty of care/prudence

Motives Matter

Motive is highly relevant to the fiduciary analysis

The resistance to ESG by trustees reflects a kind of SRI hangover

Sole interest rule is default for personal trusts, charities have greater leeway. Mandatory rule under ERISA.

Duty of Prudence

Prudent Investor Rule

Points to portfolio efficiency in MPT sense:

- ► Market risk - “an overall investment strategy” with “risk and return objectives reasonably suited to the” account
- ► Idiosyncratic risk - must “diversify the investments”

Active investing

“Prudent investment principles … allow the use of … active management strategies,” but

Documented analysis of expected returns versus transaction and diversification costs, and

Duty of ongoing monitoring and making adjustments as appropriate

Defining ESG

What qualifies as an "ESG" factor?

Abstract consensus

- Unhealthy products, poor labor practices, strong environmental compliance, poorly incentivized management

Lack of consensus in execution

- Natural gas? Different kinds of fossil fuels? Nuclear power?
- Evolving views on alcohol and gambling
- BlackRock: "two women directors on every board"—what of three?
- Staggered boards?

How to weigh different ESG factors?

What among E, S, and G are most important?

What if they point in different directions?

- E.g., firm with strong environmental compliance but poor governance?

Theory and evidence for ESG investing as an active strategy

Relationship to firm performance?

Profit opportunity from that relationship?

Theory and Evidence for Risk-Return ESG

Risk Return ESG Investing

There is theory and evidence for risk-return ESG

- Environmental and social factors may proxy for management quality or reveal
- Governance factors obvious importance to firm value
- Little agreement on specific factors or relative importance
- These factors are all highly contextual

Active investment strategies can be permissible, but

- Need documented analysis of reasonably anticipated benefits to offset transaction costs and diversification costs, and
- Must update the program periodically, possibly switching to anti-ESG if those factors become overvalued

Process emphasis within prudence protects against backdoor disloyalty

Prudent Investor Rule Applied to ESG Investing

Beating the Market (Active Investing)

Questioning market efficiency

- ► Multifactor asset pricing model (in vein of Fama-French)
- ► Tail risk versus standard deviation as risk measures

Screens versus stock picking

Usual caveats about stock picking

Shareholder Voting and Engagement (Active Shareholding)

Using ESG factors to guide shareholder voting

- ► Contested theory (collective action/free-rider) and empirics

Shareholder engagement

- ► Informal, coordinated with institutions, or proxy contest

ESG Investing is not Mandatory

Reasons are practical, legal, and policy-based

Conclusion

ESG for the purpose of achieving collateral benefits is not permitted by default rules of trust law

ESG for the purpose of increasing risk and return *can* be permissible

But there are many potentially prudent investment strategies (contrarian, passive).

The trustee must document and monitor its investment program and change as circumstances warrant.

ESG is simply one of many possible active investing strategies, neither favored nor disfavored under the law.

FOUR PILLARS OF SUSTAINABLE INVESTING

FI360 Conference

OUTCOME #16

Investing in a global wind turbine company, providing benefits for investors as well as the wider world.

Andrew Parry: Head of Sustainability, Hermes Investment Management

April 2019

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Our approach to holistic returns means we are committed to delivering excellent long-term investment performance and stewardship, while improving the lives of many

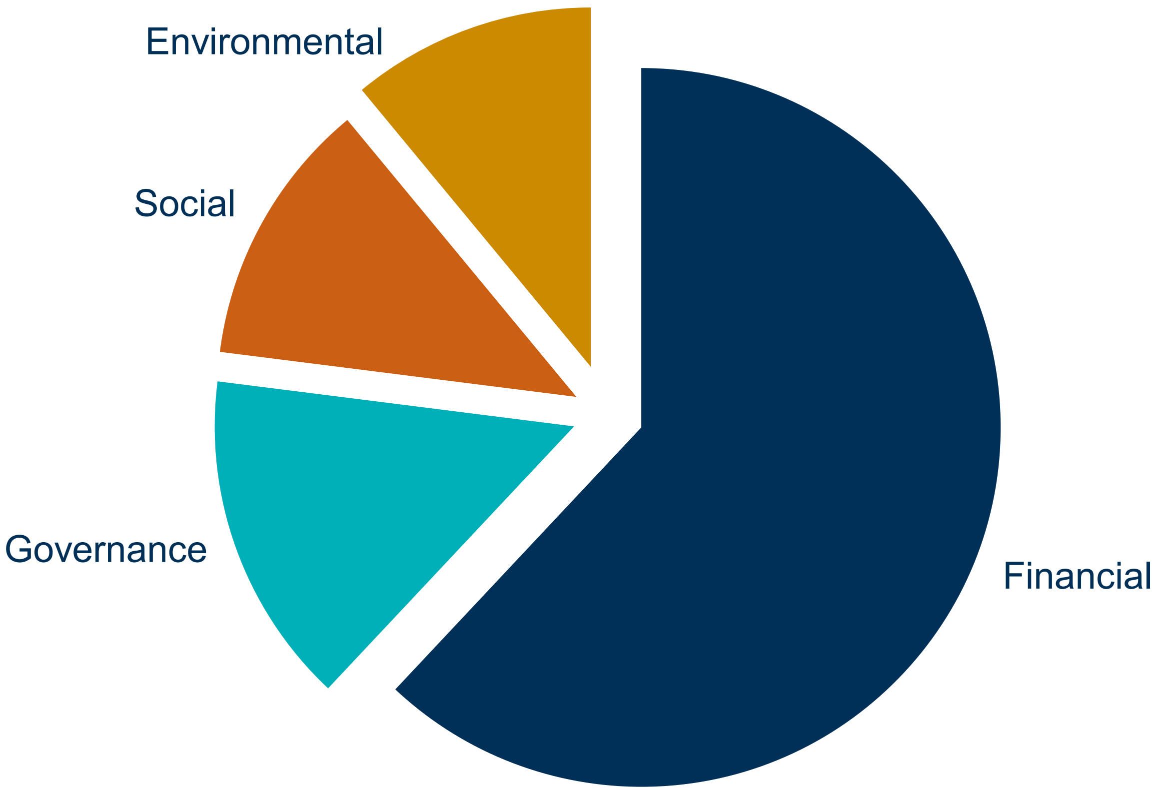
Making Sustainable Investing Accessible

Going beyond the alphabet soup

Source: Hermes as at January 2019. Note, the bigger the word, the more frequent it appeared in our research study.

ESG: Finance 101

Getting the complete picture



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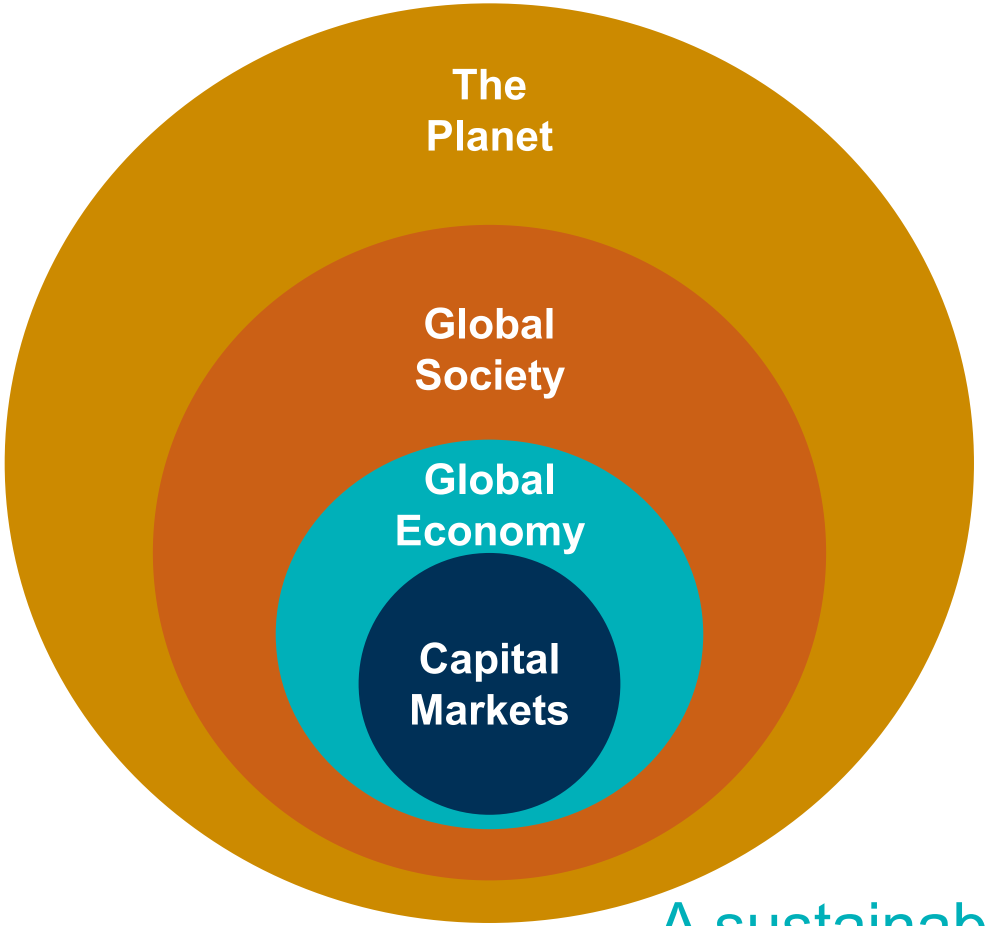
A complex, interconnected system

We are all in it together



A sustainable & resilient system

The sustainability investment case

An untapped opportunity – Beta of future growth

Opportunities

Macro ← → *Micro*

Risk

Mega trends

e.g. rising consumer awareness on healthier and more sustainable foods

Emerging growth opportunities

e.g. precision agriculture

Systemic risk

e.g. climate change effects on supply chain, physical assets and mass migration

Operational ESG risks

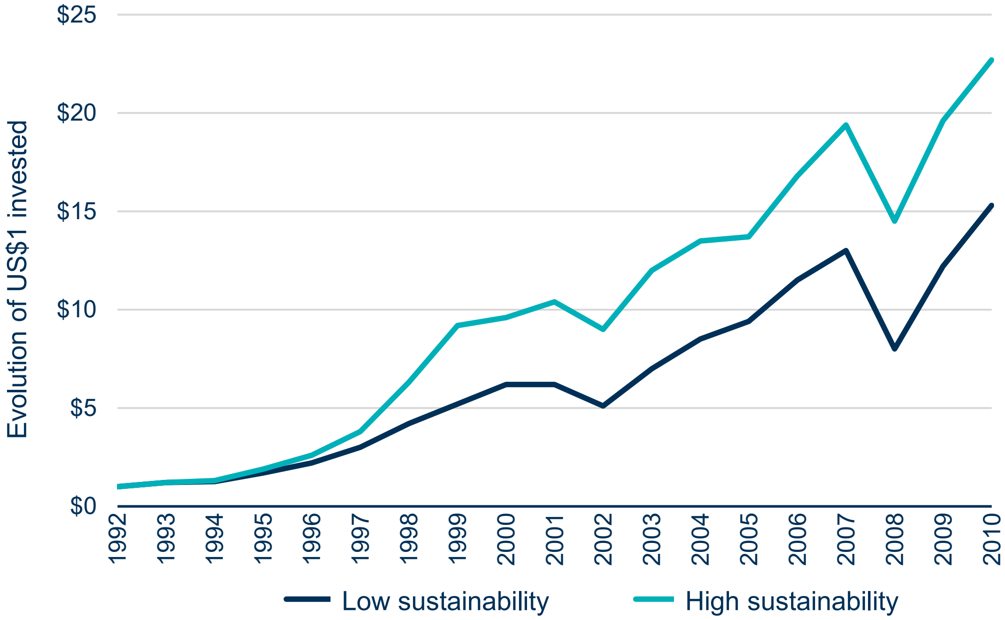
e.g. water scarcity in certain companies' locations

Source: adapted from UNPRI, "The SDG Investment Case", 2017.

The investment case for both sustainable investing and engagement is compelling

Extensive research shows that both drive enhanced returns

'High Sustainability' firms generate higher returns over the long term

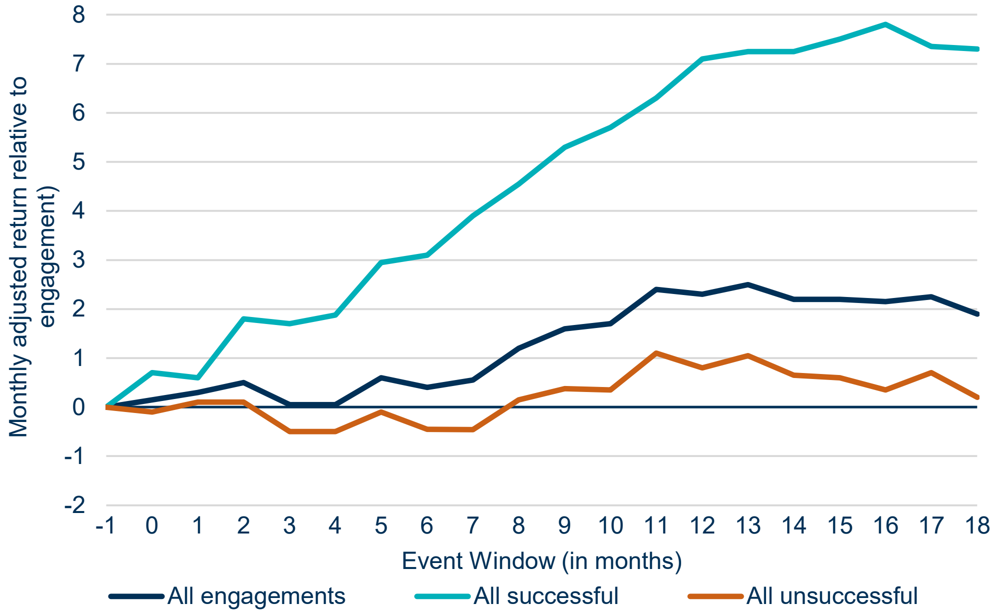


2014 study by Eccles, Ioannou, and Serafeim investigated the effect of corporate sustainability on organizational processes and performance using a matched sample of 180 US companies.

High sustainability companies = those that voluntarily adopted sustainability policies by 1993. Low sustainability companies = those that adopted almost none of these policies.

Past performance is not a reliable indicator of future results.

Engagement drives enhanced financial performance



2012 study by Elroy Dimsona, Oğuzhan Karakaşb, and Xi Lic analyses an extensive database of corporate social responsibility engagements with US public companies over 1999–2009 addressing environmental, social, and governance concerns.

Engagements are followed by a one-year abnormal return that averages +1.8%, comprising +4.4% for successful and zero for unsuccessful engagements.

Four pillars of sustainable investing

Context based approach

A lens for assessing investment opportunities:

- **Growth:** US$3-4trn of incremental capital investment represents the beta of future growth
- **Risk:** Identifying stranded assets (systemic) and stranded business models (specific)
- **Advocacy:** Corporate engagement, public policy engagement & education
- **Reporting:** Transparent disclosure of positive and negative impacts

Improving your Sharpe Ratio?

European Perspective

Sustainability is not an option: it's an imperative

- Broad acceptance that ESG should be integrated into all investment strategies – by investment managers, pension funds, insurance companies, private wealth managers and advisors
- Increasingly being backed by legislation and regulation
- Growing focus on reporting and disclosure
- "EU Action Plan for Sustainable Growth" attempting to define an overarching taxonomy

Sustainable investing

Conclusion

- ► A lens for looking at a world in transition in a more complete manner
- ► About making better capital allocation decisions
- ► Lifting our focus to the longer term
- ► A means to make us better investors

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