

ESG'S RELATIONSHIP TO FIDUCIARY DUTY – FROM COUNTER TO CRUCIAL

For decades investors have used the justification of “fiduciary duty” to explain why they cannot participate in socially responsible investing (SRI), or use environmental, social and governance (ESG) factors as part of their investment decisions; strictly speaking this responsibility is “a legal duty to act solely in another party's interests,” which traditionally fiduciaries have taken to mean maximizing value for that party, called the principal.¹ Hence, a focus on any factors besides the bottom line could be violating that responsibility. The world of the fiduciary is being turned on its head, however, as a new wave of research, legal action, and investor behavior is pointing to a startling conclusion: perhaps considering the ESG factors of an investment is fundamental to fiduciary duty, and neglecting to do so a potential violation of that responsibility. This paper explores the possibility that it could be in the principal's best interest to incorporate ESG factors into investment analysis, hence integral to fiduciary duty.

WHAT THE RESEARCH IS SAYING

A growing body of empirical research is drawing a direct link between ESG factors and long-term value creation. Whereas traditional dogma held that SRI necessitates a sacrifice in returns in order to achieve a values-based outcome, the maturing definition of SRI and the use of ESG factors posits that for any investment certain ESG factors may be material, and where both relevant *and* material, are necessarily a part of value creation – an energy company with better environmental controls is less likely to have a major oil spill, and a garment company with a stronger commitment to human rights less likely to have tragedies like a factory collapse in its value chain.

Studies are exploring multiple facets of the environmental, social, and governance characteristics of firms, and how stronger performance in these arenas relates to long-term value creation both for the company and its investors:

E – A study in *Management Science* examined the link between strong environmental management and financial performance for firms. It found that significant positive returns were measured for firms with strong environmental management (as indicated by environmental

¹ Cornell University Law School Legal Information Institute, “Fiduciary Duty.”
https://www.law.cornell.edu/wex/Fiduciary_Duty.

performance awards). Strikingly, the reverse was also true – firms with weak environmental management (as indicated by environmental crises) displayed significant negative returns.²

S – The “S” factor of ESG refers to a range of social practices, from diversity to supply chain management to human rights. In sum, it is how a company interacts with and treats employees, customers, suppliers, and communities. Studies have also shown that good governance is correlated with higher corporate social responsibility (CSR), which in turn is associated with shareholder wealth maximization.³

G – A study by McKinsey & Co. found that companies with more executive board diversity had a 53% higher return on equity, and 14% higher EBIT margin than those with less corporate diversity.⁴

The evidence is not clear-cut across the board, however; no one is able to say that investing with a focus on ESG factors is unequivocally better than plain vanilla investing, much as one cannot unequivocally call hedge funds “sure bets” – there will always be variation in both managers and fund performance across any investment strategy. Studies are starting to demonstrate, however, that in the aggregate, SRI or ESG strategies do not necessarily mean sacrificing returns across the board. A recent TIAA-CREF study of leading SRI equity indexes found that there was no statistical difference in returns over the long term in those indexes as compared to broad market benchmarks, nor did they entail additional risk (although significant discrepancies were observed over shorter time periods).⁵

What is changing, however, is the understanding of how ESG factors play into any investment strategy. ESG factors are no longer “extra-financial” and therefore somehow extraneous to traditional investing – understanding how these different dimensions play into a company’s performance is crucial for sustainable value creation. There is a maturing understanding of fiduciary duty in academic research – to act in the best interests of a principal, it may no longer be sufficient to just study the financials of a firm. The environmental, social, and governance factors of that company, where relevant and material, may meaningfully impact long-term value creation; to ignore them, you may be leaving significant value on the table.⁶

² “The impact of environmental management on firm performance,” RD Klassen and CP McLaughlin, *Management Science* 42 (8), 1199-1214, 1996. <http://pubsonline.informs.org/doi/abs/10.1287/mnsc.42.8.1199>.

³ “Socially Responsible Firms,” Ferrell, Allen and Liang, Hao and Renneboog, Luc, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 432/2014, July 10, 2014. <http://ssrn.com/abstract=2464561>.

⁴ “Is There a Payoff From Top-Team Diversity?” Thomas Barta, Mark. Kleiner, and Tilo Neumann, April 2012. http://www.mckinsey.com/insights/organization/is_there_a_payoff_from_top-team_diversity

⁵ “Socially Responsible Investing: Delivering Competitive Performance,” Lei Liao, CFA and Jim Campagna, CFA, TIAA-CREF Asset Management, September 2014. https://www.tiaa-cref.org/public/pdf/C19224_SRI_White_Paper_v13.pdf

⁶ In 2013 The California Public Employees' Retirement System (CalPERS) launched a searchable database of over 700 academic studies on the impact of various ESG factors on investment risk and return. It is believed to be the most comprehensive database of current research. More information is available at: <http://www.calpers-governance.org/docs-sof/investments/siri-database-of-academic-studies.pdf>.

LEGAL DEVELOPMENTS

In parallel with developments in academic research, legal and regulatory bodies have also been expanding and refining their definitions of fiduciary duty to begin capturing the true meaning of ESG factors for fiduciaries.

In Europe, the United Kingdom Law Commission, set up in 1965 as a statutory independent body that makes recommendations to Parliament, issued a report in 2014 on the “Fiduciary Duties of Investment Intermediaries.” The report stated that the Law Commission “hoped to finally remove the misconception that trustees cannot take into account ESG considerations,” going on to assert that, “given the evidence that companies that are well governed and follow sustainable policies can produce better returns in the long run, the answer is clearly that pension trustees may consider such factors when making investment decisions.” They further assert that where ESG issues are financially material, trustees should take them into account. They cited research demonstrating that active stewardship and integration of ESG factors in investment decisions can lead to risk-adjusted outperformance, and that to the extent these factors influence financial returns, “it is in beneficiaries’ best interests for them to be taken into account.”⁷ While these recommendations have not yet been enshrined into law by Parliament, they offer important guidance to fiduciaries about the future direction of regulations. The message in the U.K. is clear: ESG factors are now part of the definition of fiduciary duty.

Across the pond, Ontario’s Ministry of Finance recently approved a slate of amendments to the Pension Benefits Act entitled “Disclosure of Environmental, Social, and Governance Factors in Statements of Investment Policies and Procedures (SIPPs).” Plan administrators are required to file SIPPs, which govern how plan assets are invested, with regulators. Now, SIPPs are required to include information about “whether, and if so, how, ESG factors are incorporated.”⁸ While the amendment stops short of requiring all pension plans to incorporate ESG factors, it does signal a growing awareness of ESG factors as material to the fiduciary duty of these plans, as well as a desire to bring Ontario pensions into compliance with the requirements mandated in the U.K. and other European countries.

Finally, inspired by the U.K. Stewardship Code Japan’s government released new binding guidelines in 2014 called “The Japanese Stewardship Code,” which are designed to improve both corporate governance and investment returns.⁹ Almost every major Japanese institutional investor has signed on to the Code, including the world’s largest pension fund, the \$1.26 trillion Government Pension Investment Fund of Japan.

⁷ “Fiduciary Duties of Investment Intermediaries,” The Law Commission (LAW COM No 350), June 30, 2014. http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf.

⁸ “Amendment to Regulation 909 under the Pension Benefits Act: Disclosure of Environmental, Social and Governance Factors in Statements of Investment Policies and Procedures,” Ontario Ministry of Finance, Regulation 235/14, October 3, 2014.

<http://www.ontariocanada.com/registry/view.do?postingId=16584&language=en>

⁹ “Principles for Responsible Institutional Investors: Japan’s Stewardship Code,” Council of Experts Concerning the Japanese Version of the Stewardship Code. April 7, 2014.

<http://www.fsa.go.jp/en/refer/councils/stewardship/20140407.html>

There are a spate of other regulations developing concurrently with those in the U.K., Ontario, and Japan, or that are already implemented (The United Nations Principles for Responsible Investment keeps a working list of ESG regulations, entitled “Global ESG Regulatory Mapping,” on their website, available at: <http://www.unpri.org/areas-of-work/policy-and-research/responsible-investment-standards-codes-and-regulation/>). Empirical research has not been mounting in a vacuum: regulators and policymakers have been taking note as well, and taking legal action to expand the definition of fiduciary duty to reflect this growing understanding of how ESG factors contribute to long-term, sustainable value.

INVESTOR BEHAVIOR

While research and regulation point to a growing acceptance of ESG factors in investment analysis, the real proof is in investor behavior: are investors actually changing the way they approach investment decisions? Recent actions by major institutional investors demonstrate that perhaps they are. SRI assets have grown 76% in the U.S. from 2012 to 2014, with an estimated \$6.57 trillion in assets managed with SRI strategies – or one in every six dollars under professional management in the U.S.¹⁰

Not only are investors increasingly paying attention to the ESG characteristics of their investments – a recent study found that 90% of institutional investors want fund managers to price ESG risks into investment decisions alongside financial metrics¹¹ – but investors are also making public commitments to ESG initiatives. In September, a group of major institutional investors, including two of the largest asset managers and pension funds in Europe – Amundi and AP4, respectively – committed to reduce the carbon footprint of over \$100 billion of their investments. The CEO of AP4, Mats Andersson, commented that “Climate change is more and more recognized as a financial risk and it is our duty, as trustees, to take concrete steps to reduce this risk.”¹² A second group of investors representing over \$500 billion in assets have committed to measure and disclose the carbon footprint of their investments through the Montreal Carbon Pledge.¹³

Institutional investors are also increasingly speaking out on the issue. Jane Mendillo, president and chief executive of Harvard Management Company (HMC), addressed the Fiduciary Investors Symposium at Harvard University in October 2014, stating that “we want to be forward-thinking. We want to be successful investors and sustainable investors. We are convinced that doing so will be good for our portfolio and for Harvard, and it will also be good for the world.” Mendillo added that “the definition of fiduciary duty is going to evolve even

¹⁰ “Report on U.S. Sustainable, Responsible and Impact Investing Trends 2014,” The Forum for Sustainable and Responsible Investment, 2014. http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf.

¹¹ “Responsible Capitalism Survey,” Hermes Investment Management, October 6, 2014. <http://www.hermes-investment.com/News/News/tabid/84/PostID/596/language/en-GB/Default.aspx>.

¹² “Investors Commit to Decarbonize \$100 billion in Investments,” United Nations Climate Summit, September 23, 2014. <http://www.un.org/climatechange/summit/2014/09/investors-commit-decarbonize-100-billion-investments/>

¹³ “Investors representing over U.S. \$ 500 billion take Montreal Carbon Pledge to carbon footprint their portfolios,” United Nations Principles for Responsible Investment, September 25, 2014. <http://www.unpri.org/press/investors-representing-over-us-500-billion-take-montreal-carbon-pledge-to-carbon-footprint-their-portfolios/>

further; as fiduciaries we need to think not only more broadly across our portfolios, but also more broadly through time, including consideration of environmental, governance and social factors, which I believe will lead to better long-term outcomes, and stronger, more sustainable returns.”¹⁴ This highlights an important incentive for institutional investors, particularly those such as pension plans or endowments, which have longer time horizons – these investors are particularly concerned with longer-term, sustainable value creation, which has lent itself to an increasing focus on ESG factors. While the research and regulatory action have been evolving in tandem, it is evident that this momentum has translated to the actions of actual investors as well.

CONCLUSION

While the concept of fiduciary duty has been evolving to include an increased focus on ESG factors as potentially material to investment decisions, this has not been a movement universally embraced by all. Many investors still have concerns that an activist or SRI stance could damage returns – 60% of investors surveyed by Investment & Pensions Europe said the risk of achieving lower returns as a result of ESG ethical considerations was the biggest ESG risk facing boards – and many investors remain unconvinced of the empirical case for linking ESG factors to materiality.¹⁵

Perhaps SRI's most famous critic was Milton Friedman, who argued that “the only social responsibility of corporations is to make money.” As empirical evidence, regulation, and investor behavior increasingly shifts to define the incorporation of ESG factors in investment decisions not counter to, but potentially *fundamental* to fiduciary duty, however, the investment world may be turning Friedman's argument on its head – perhaps, in order to make money, corporations must necessarily take greater environmental, social, and governance responsibility.

¹⁴ “Good for Harvard, good for the world: Why HMC embraced ESG with a passion,” Simon Hoyle, Fiduciary Investors Symposium Harvard, Harvard University, October 28, 2014. http://www.hmc.harvard.edu/docs/Good_for_Harvard.pdf.

¹⁵ “Focus Group: Contending with the ‘do-gooders’,” Dominic Gane, Investment & Pensions Europe, October 2014. <http://www.ipe.com/investment/esg/focus-group-contending-with-the-do-gooders/10003302.article>.