Value vs. Values

The Evolution of ESG Considerations for Pension Plan Investments

www.rpia.ca

Background

Over the past several years, pension funds have been thrust into the center of the ESG debate. As large stewards of capital, they have the influence to affect the actions and practices of large corporations. However, their decision-making must balance the perception of conflicting priorities: taking a long-term approach, respecting the views of plan members, and their fiduciary obligation to generate the best risk-adjusted returns to meet their benefit obligations. This paper aims to walk through the spectrum of approaches that Plans have taken, such as delegation to their managers, ESG integration and engagement, and for some plans, a focus on specific active targets. Using a client example, we also suggest ways that Plan sponsors can move along the spectrum toward a more active approach regarding ESG factors while respecting the aforementioned priorities. Specifically, we share how ESG integration complements – rather than compromises on – investment performance.

Regulation and Legislation Imply a Fiduciary Duty

Although some Ontario-based mega-Plans started committing to a dedicated focus on ESG as early as 2003, the seeds for the momentum in the space that we continue to see today were planted by Ontario legislators in 2011. The 2011 budget was the first time the government proposed requiring Plans to explicitly disclose in their regulatory filings whether or not they address ESG factors. After its approval in late 2014, the new rules came into effect as of January 1, 2016. This kicked off a frenzy of consultation and education for Plan sponsors to determine their approach to ESG.

Ultimately, Plan sponsors had to determine whether they are upholding or violating their fiduciary duty by considering ESG factors in their investment decisions. Guidance from McCarthy Tetrault in 2019 made clear the fact that "When ESG factors inform performance assessment, sustainability, or risk, they are ipso facto financial factors and can be, and where they are known and relevant, must be taken into account by fiduciaries.[1]" The Governance factor has always been paramount in fundamental analysis across asset classes and neglecting that factor alone would be sufficient for Plan sponsors to violate their fiduciary duty.

A 2015 report from Koskie Minsky applies similar guidance but includes Climate risk as a factor that Plan sponsors must consider from a fiduciary perspective. They argue that there is scientific consensus on the causes and catastrophic consequences of climate change. These outcomes carry financial risks that Fiduciaries need to consider in their investment approach.[2]

Adding Value - Financial or Social?

Most Plan sponsors initially took a delegation approach to ESG; partly owed to the lack of time to learn and gain comfort around ESG factors before the legislation came into effect, and partly owed to a desire for verbiage that investment managers could adhere to. They signed their regulatory statements acknowledging that they do consider ESG factors and updated their Statement of Investment Policies and Procedures to state, "We delegate the decision to integrate relevant ESG factors to our respective investment fund managers."

1 Bauslaugh, Randy, Dr. Hendrik Garz. "Pension Fund Investment: Managing Environmental, Social and Governance (ESG) Factor Integration." McCarthy Tétrault, 1 May 2019, https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration.

2 Gold, Murray, and Adrian Scotchmer. Climate Change and the Fiduciary Duties of Pension Fund Trustees in Canada. 1 Sept. 2015, https://kmlaw.ca/wp-content/uploads/2015/10/KM_Climate_Change_Paper_06oct15.pdf.

This changed following guidance note by the Financial Services Commission of Ontario in 2017 that advised it is insufficient for Plan sponsors to leave the decision totally up to their underlying managers; they instead needed to either adopt their investment managers' ESG policy, describe how ESG is considered from a manager selection or review perspective, or qualify the asset classes and techniques where ESG factors should be considered.

With the benefit of time, expert consultation, and reflection, Plan sponsors have several options today to take a more refined approach to their ESG integration. To begin, Value, in the context of ESG, is the understanding that ESG factors provide both risks and opportunities to a Plan's investments. It is the concept of "ESG Analysis" or the integration of ESG factors into one's fundamental investment research. Through integration, the identification of a risk or opportunity to an investment before the market could and should deliver a financial reward. Climate risks, which are now reliably measurable,[3] are one example where integration can benefit performance. Real Estate or Infrastructure investors should be acutely aware of the financial impact that more frequent and extreme weather events are having on their assets. Public bond and equity investors need to similarly consider the financial cost that the negative externalities of climate risk can have on their holdings, as well as the risk of holding stranded assets.

This financial reward can also be obtained through engagement opportunities. While engagement opportunities seem to be better understood on the equity side of the portfolio, we, as fixed income investors, believe there to be many engagement opportunities with issuers as they frequently come to market to issue bonds. The low-hanging-fruit engagement opportunity is for better disclosure – pushing companies to report on ESG factors such as climate, diversity, compensation, etc. In the worst instance, pushing for disclosure does not lead to any change but gives the investment manager a better understanding of what they choose to hold (or not hold). If successful, conversations around disclosure can lead to improvements in the company's operations, which can in turn, improve financial performance.

Engagement with issuers in the Energy sector has recently led to the issuance of Sustainability-Linked Bonds, whereby the coupon payment can escalate if specified climate or social related goals are not achieved. While this could be viewed as social activism, it ultimately aligns with a Plan sponsor's fiduciary duty by promoting better financial performance and/or mitigating risk.

Combining Values with Value

The concept of Value and ESG Analysis is contrasted with Values and "ESG Investing." The distinction being that ESG analysis considers these factors into every investment decision, while ESG investing relates to the product solution. In other words, ESG investing allows Plan sponsors to invest in line with their ethical or moral beliefs. This can include industry screening (positive or negative) or impact investments that look to directly address an issue, such as indigenous rights, housing, clean technologies, etc.

Importantly, although they can be contrasted, Value and Values are not distinct and separate. FSCO reminds Plan sponsors those best interests of beneficiaries is traditionally measured by financial interests.[4] In other words, Pension Plans cannot make investments solely to deliver on social goals unless it is legislated to do so (a pension plan of a medical company excluding tobacco investments, for example).

---

3 Various. Investing in a Time of Climate Change - International Finance Corporation. Mercer, 2015, https://www.ifc.org/wps/wcm/connect/e9bfa328-e091-465b-9da6-8fe312261b98/Investing+in+a+time+of+climate+change.pdf?MOD=AJPERES&CVID=kTFEATf.
4 "Environmental, Social and Governance (ESG) Factors ." Investment Guidance Note - 004, Financial Services Commission of Ontario - Superintendent of Financial Services, 1 Jan. 2016, https://www.fsco.gov.on.ca/en/pensions/policies/active/documents/ign-004.pdf.

Case in Point: The Relationship Between Social Values and Financial Value

A large University client of RPIA was an early adopter of ensuring that their managers integrated ESG factors into their investment process. Recognizing that carbon emissions and climate risks would have a demonstrable impact on our society and their investments as a residual of these adverse outcomes, they announced a commitment to reduce the carbon footprint of their portfolio by 40% by 2030.

We worked closely with them from an "ESG Investing" perspective to develop a corporate bond solution that aligned with their target. The strategy took our traditional investment process but added measurable risk limits to target a 30% reduction in carbon relative to the "traditional" benchmark. The intent was to further reduce carbon exposure over time. By managing the portfolio in the same manner we would any other active corporate bond strategy, albeit with carbon-measurement limits embedded in the risk policy, we were able to deliver on dual goals for the client: maintaining significant credit outperformance and a lower carbon emitting portfolio.

Although the intent was to scale down carbon emissions over time, the client was able to deliver on their climate goals roughly a decade earlier than their commitment. They decided to move further along the decarbonization spectrum to a "net-zero by 2050" approach. As such, we worked with them and a prominent Canadian fixed income index provider to develop a strategy and the relevant comparable benchmark. In doing so, investors now have the guidance of a transparent framework for negative carbon screens. Similar to the initial carbon reduced strategy, the fossil-fuel-excluded corporate bond strategy demonstrates that ESG investing does not have to compromise a traditional investment approach. It aims to maintain the same level of performance while delivering a significant reduction in a Plan's carbon footprint within their fixed income portfolio – a quick and profitable endeavour for any pension plan.

Conclusion

ESG integration has become a required component in a Plan's investment strategy – both from a fiduciary and outcome-driven perspective. However, varying beliefs, governance structures, and resources mean that every Pension Plan's approach to ESG looks a little different as sustainable investing is still evolving. In response to a changing environment and social realities, it is incumbent on Plans and investment managers to deliver on the return promise while also integrating ESG value and values.

Authors

Zachary Barsky

Vice President, Client Portfolio Management
zbarsky@rpia.ca

Zack joined RPIA in 2020 and is responsible for developing relationships with institutional investors and their consultants. In this role, he supports the Client Portfolio Management Team's sales efforts through market insights, investment strategy, and portfolio solutions.

Liam O' Sullivan

Principal, Co-Head of Client Portfolio Management
liam.osullivan@rpia.ca

As Head of Client Portfolio Management, Liam leads the team responsible for developing client relationships and developing new investment solutions. Prior to this role, Liam spent several years managing corporate bond portfolios for the firm, with a focus on the Canadian corporate bond market.

Important Information

The information herein is presented by RP Investment Advisors LP ("RPIA") and is for informational purposes only. It does not provide financial, legal, accounting, tax, investment, or other advice and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RPIA assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all information is RPIA. The information presented does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The payment of distributions is not guaranteed, may fluctuate, and does not infer performance, rate of return, or internal yield of the Fund. Always consult with your registered investment dealer before investing in mutual funds. "Forward-Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct.

RPIA aims to consider ESG factors as part of our overall investment process, but the weight and importance of it can vary across the investment funds we manage. Always refer to the relevant fund offering documents for important information on the investment objectives, strategies and associated risks of a particular fund. The consideration of ESG factors in the investment process for RP Strategic Income Plus Fund and RP Alternative Global Bond Fund plays a limited role and is weighted less than the core financial and credit analysis employed in the management of these funds.

For more information, visit www.rpia.ca/esg.

RPIA

43 Hazelton Ave.
Toronto, ON
M5R 2E3

www.rpia.ca
General Line: +1 647 776 1777
Investor Services: +1 647 776 2566