Future of ESG – in the balance

Thinking Ahead Institute
An innovation network founded by WTW

Output from the Future of ESG working group– 2023/24

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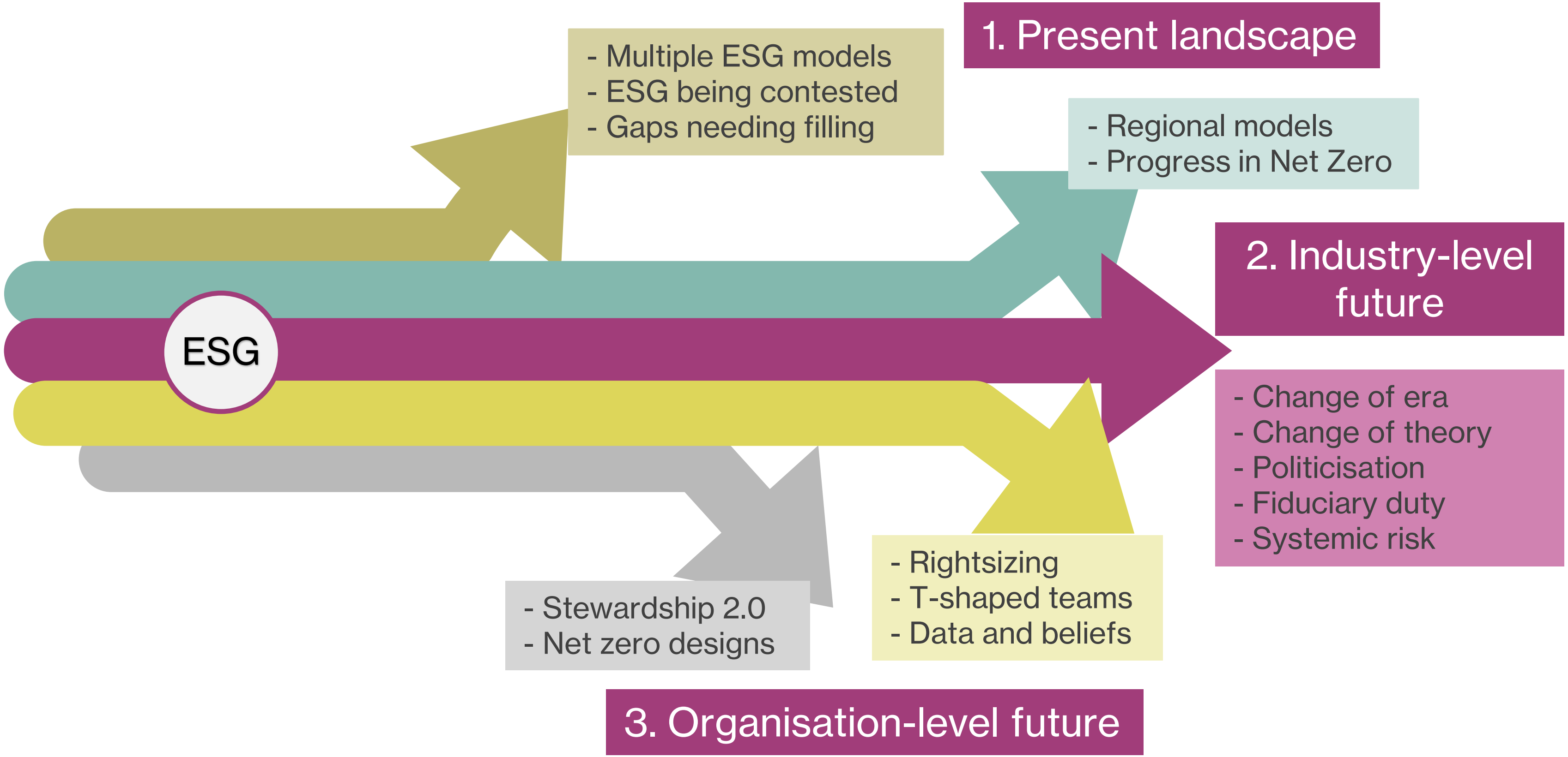
The future of ESG



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Summary: The future of ESG – *'necessary' and 'impactful'*

This paper

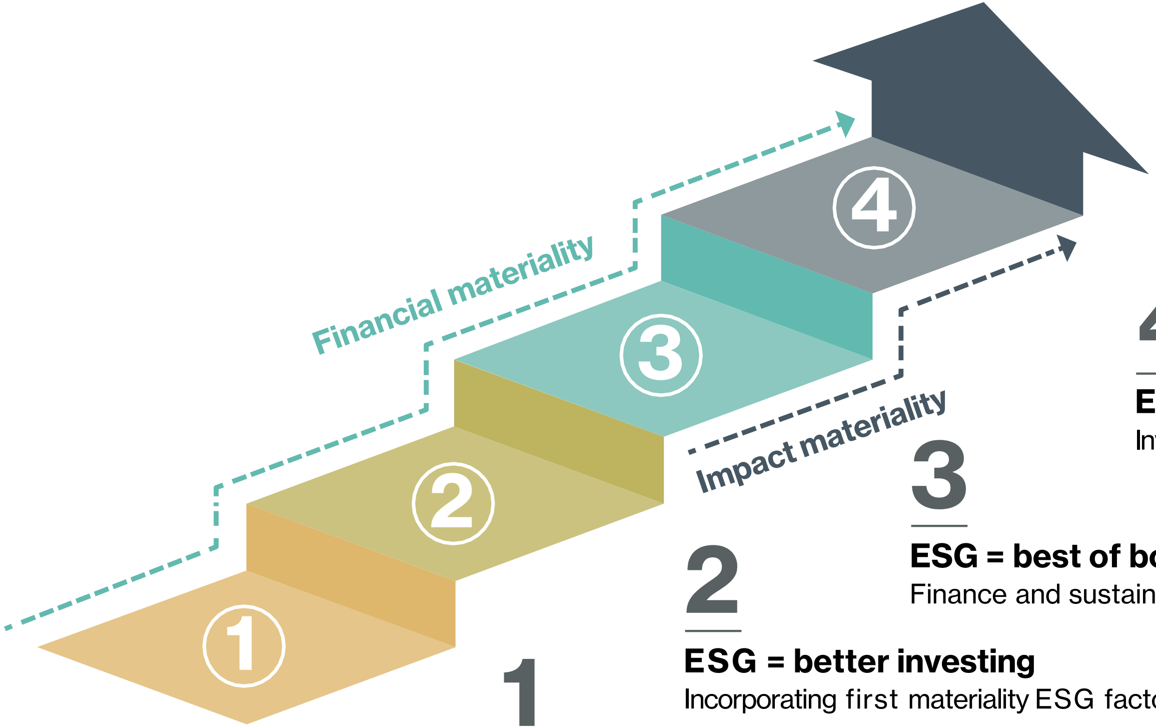
This research was conceived in 2023 as ESG entered a spectacular identity crisis with the ESG backlash in the US. In the conclusion to this research in a convened event in September 2023, TAI members put forward a robust future with key terms in a word cloud such as: 'necessary', 'impactful', and 'unstoppable'. Though 'contested' also made a notable appearance.

- This paper – Future of ESG – in the balance - is authored by Roger Urwin, Isabella Martin and Andrea Caloisi following the research and discussion by the Thinking Ahead Institute's Future of ESG working group.
- **The Future of ESG working group** met five times between March and July 2023. The full list of participants is at the back of this deck – a varied array of senior investment professionals. We are extremely grateful to the members of the group for their input and guidance. The authors alone are responsible for any errors of omission or commission in this paper.

The background

- ESG is morphing in a contest for its future. Some are sceptical it will survive. But there is so much common sense behind its principles it has very good vital signs. It is almost impossible it will do anything other than grow.
- It will surely evolve and partially converge across jurisdictions as it matures, though it will never be entirely uniform. Because it will stay different to different people - the growing will occur in distinct segments. And that is where the focus of this group has been.
- The language will change too. We have referred to 'ESG' in this paper, but sustainability and sustainable investing will be increasingly favoured.
- Time pressures for professionals have become more challenging. We have evolved a format that is easier to read in a short space of time, with considerable use of infographics.
- **Expected reading time for this paper: 20 – 25 minutes**

1.1 There are multiple ESG investment models



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ESG = better world investing
Investing incorporating explicit goals for impact

3

ESG = best of both worlds investing
Finance and sustainability integration, 3D investing

2

ESG = better investing
Incorporating first materiality ESG factors

1

No ESG = ESG is woke
Shareholder-centric narrowing of focus

1.1 There are multiple ESG investment models - *ESG means different things to different people*

The future of ESG is being contested. While backlash views have gained ground, supporters have also become more vocal. It is vital we understand how this contest is playing out. And that we emerge from it with a reset of thinking.

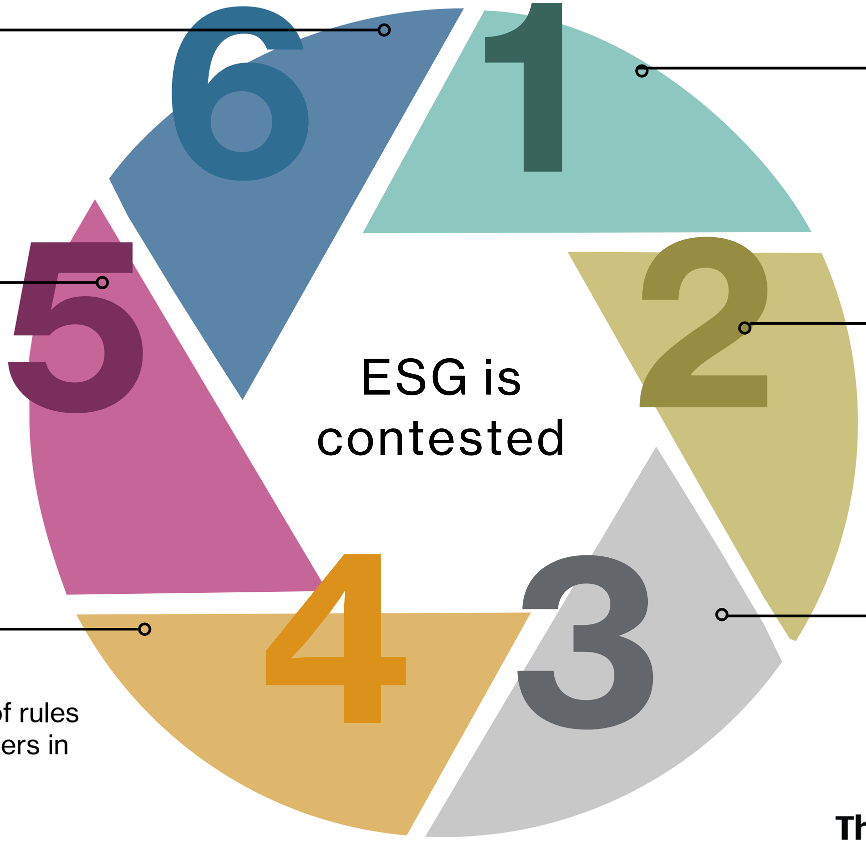
- Four distinct ESG segments are on the chart above:

1. Not doing ESG will be one model, it is a politicised version yes, but it will exist – the ESG backlash
2. ESG is simply better investing, this is integrated ESG by another name
3. The ambitious model – ESG = best of both worlds, impact alongside risk and return. This is 3D investing by another name. Net zero is in this bucket
4. There is an impact investing model – more found in family offices, and philanthropy, and charities and foundations not normally found in pensions and SWFs

Alternative models

- We will see alternative taxonomies come and go, but these four should become the foundation of ESG segmentation
- Around the four models there is a spectacular range of textures to the ESG fabric
  - Sustainability talk and sustainable investing will continue to grow as key concepts
  - Overclaiming and greenwashing will not be banished
  - There will be a bigger mix of standards, regulations, politics and controversies descending
  - Some deepening of climate consideration
  - Some widening of ESG reach into 'S'.
- Also, some widening of ESG reach into systemic risk – climate, nature, inequality, biodiversity – these are all connected.

1.2. The six dimensions to ESG being contested



Emotions
Stakeholders in the industry have varied emotions and motivations for working with sustainability and ESG factors and concepts

Taxonomy
ESG taxonomy is a classification system that defines economic activities aligned with a net zero trajectory by 2050 and other broader ESG goals

Regulation
The decisions and oversight of rules and regulations by policy-makers in various jurisdictions, in the sustainability and ESG field

Ambition
The particular commitment of the organisation with respect to sustainability and real-world impact reflecting opportunity, mindset and skillset

Materiality
A measure of the relative financial importance of a factor among a company's ESG considerations, now being reflected in financial statements

Politics
The application of political power, through government and other actors, on the sustainability and ESG elements of the industry

1.2. The six dimensions to ESG being contested – *the deepest trust comes from groups addressing and overcoming conflict*

The term 'contested' refers to issues subject to debate, where different parties present arguments to support opposing viewpoints.

- The use of the term is particularly suited to situations where there are two contrasting views on a subject and where there are significant proportions of informed professionals taking opposing views
- Are we stuck in an impasse of views? It depends whether organisations, in their multiple forms, convene the discussions that enable the adoption of aligned and accurate shared beliefs and values
- In this context, achieving lasting change necessitates both a compelling vision and a strong leadership coalition. The key rewards include galvanising groups into action with shared trust as crucial capital.

Rightsizing ESG

- Among the asset owners, ESG views are differentiated most by ambition and specifically by rightsizing:
  - Deciding on and acting on a particular ambition and commitment with respect to sustainability/impact
  - Reflecting mindset and skillset of the organisation and opportunity set to do what is intentioned
  - Not overdoing it and compromising legitimacy
  - Not underdoing it and foregoing the opportunity.

1.3 The gaps that need filling

ESG

Collaboration gap

- Strengthened collaborations within and across organisations should be able to drive engagement and combinatorial power

Skills gap

- Investment theory and practice should integrate system-level thinking on top of traditional investment thinking
- ESG knowledge and skills should be developed to a critical threshold across the industry for all professionals

Purpose gap

- Positive ethics and values should be woven into purposeful culture
- Investment organisations should embrace the stakeholder model
- Industry commitment to innovation in sustainability needs to be far greater

Data, reporting, regulation & standards gap

- ESG data practices should support a more substantial decision-useful application via improved governance
- Regulation is a huge co-ordination challenge

1.3 The gaps that need filling – *collaboration, purpose, skills and data need work*

We have the good intentions, but we are missing a lot of the soft infrastructure – skills, data, collaborative structure, clarity of purpose, that enable the system to do what is intentioned.

Collaboration

- None of us on our own is powerful enough to change the system, but collectively we are. Collaboration opportunities lie with:
  - T-shaped people and teams
  - Asset owner influences
  - Good relationships across corporate governance
  - System-level engagements
  - More collaborative and agile practices.

Purpose

- We need an investment industry that has the purpose of generating long-term sustainable returns, with purposeful and enlightened self-interest propositions
- Positive ethics and values should be the foundation to any organisation.

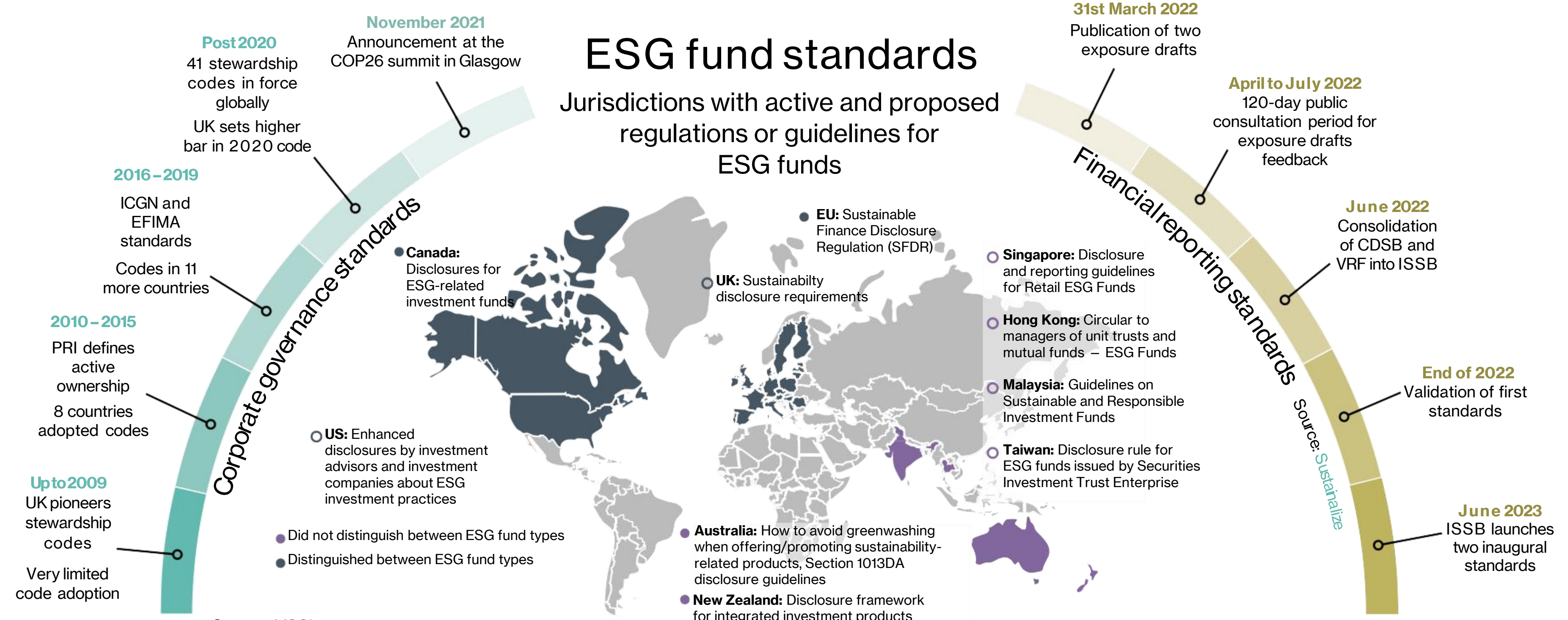
Skills

- Sustainable investing is missing a key building block / thought partner in the recognition of impact alongside risk and return in a 3-dimensional mix
- ESG knowledge and practical know-how is horribly uneven, knowledge and skills need to reach a threshold.

Data

- Data is a legacy and co-ordination problem:
  - Give measurement respect. Without data, you're just another person with an opinion
  - Focus on meaningfulness over measurement. We measure what we do because we can
  - Work on measuring the hard-to-measure. We can measure more than what we do
  - Set KPIs to incentivise the pursuit of goals
  - Use governance guardrails to support fair judgements
  - Use check-ins to drive goal progress
  - Add contextual narrative. Qualify data by its quality.

1.4 There are numerous regional models in regulation and standard setting



Source: MSCI

Solid dots represent regulations in force, while outlined dots represent proposed or planned regulations. List of jurisdictions with regulations or guidelines proposed or in force for ESG funds: U.S. (proposed); Canada; EU; U.K. (planned); Singapore; India (proposed); Hong Kong; Australia (including Section 1013DA); Malaysia; New Zealand; Philippines (proposed); Thailand (proposed); Taiwan. Data as of Oct 12, 2022. Source MSCI ESG Research.

1.4 There are numerous regional models in regulation and standard setting – *confusing or what?*

We face significant challenges due to the increasing breadth of regulation, which is hindering progress in both strategy and implementation. Many organisations are feeling overwhelmed by reporting obligations.

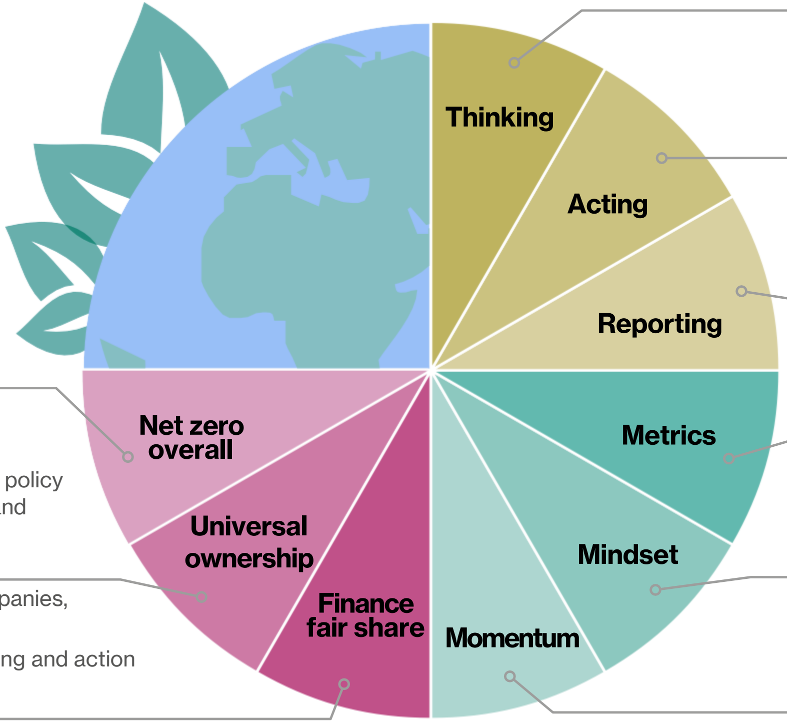
Regulation and reporting

- New regulations tend to present teething problems for the newly regulated, and that has certainly held true for the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR)
- That said the Taxonomy and SFDR together create a regulatory environment that encourages asset managers to thoroughly check their sustainability methodologies and categorisations before making sustainability claims
- In time, this should make the sustainability landscape clearer by providing end investors with a high-level understanding of asset manager intention and compliance
- This will help them make more informed choices about what firms and products align with their own sustainability preferences.

Compliance

- As a distinctive feature of this challenge, noncompliant behaviour in a setting of complex rules need not stem from wrongful actions. Instead, breaches can very often result from organisational problems that law-abiding firms acting in good faith struggle to overcome including mistakes, confusion, and misinterpretation
- You need a compliance culture that recognises this. You also need regulators that understand this.

1.5 Mapping progress in net zero investing



- TCFD origins from 2015
- Net zero investing from 2019
- GFANZ framework from 2021

Increasing:

- Net zero standardised practice of non-state actors
- Regulatory machinery

- Complex set of multiple measures for mapping progress to targets
- Many voluntary standards

- Net zero tracker suggests 19% of listed companies aligned to 1.5°C
- Emissions on sideways pathway

- Increasing diffusion and maturity
- But commitments contingent on government action to introduce policies consistent with 1.5°C

- NZAMI: 325 AMs and $57.5T AuM
- NZAOA: 89 AOs and $9.5T AuM
- TCFD adoption widespread, TNFD on point of launch

- Weak commitment to net zero
- Net zero may not align to 1.5°C
- Frictions: time horizon; fiduciary duty; policy bottlenecks; enabling infrastructure and incentives

- Soft power mix of governments, companies, finance & civil society
- Hyper-connected framework in thinking and action across the portfolio and through time

- Finance 20% of net zero change – the biggest non-state actor
- Challenge of free riding
- Investors position complicated by fiduciary duty

1.5 Mapping progress in net zero investing – *net zero is in the balance*

In the balance = will finance play its part? Will state actors play their part? Where will the acceleration come from – faster technology advancement, quicker governance improvement, inevitable policy responses or social tipping points.

Net zero features

- Net zero investing is a set of designated strategies, actions, metrics and methods through which investors can contribute to get to global net zero emissions by 2050 or sooner.
- Five features that are currently present in most cases:
  - Portfolio emissions reductions over time to net zero
  - Share of portfolio companies that are net zero aligned
  - Allocations to finance the companies and technologies essential to the net zero transition
  - Engagement targets to move portfolio companies, especially amongst higher emitters, to net zero alignment
  - Engagement with policymakers and, in some cases, commitments on ensuring aligned lobbying practices.

Net zero as a challenge

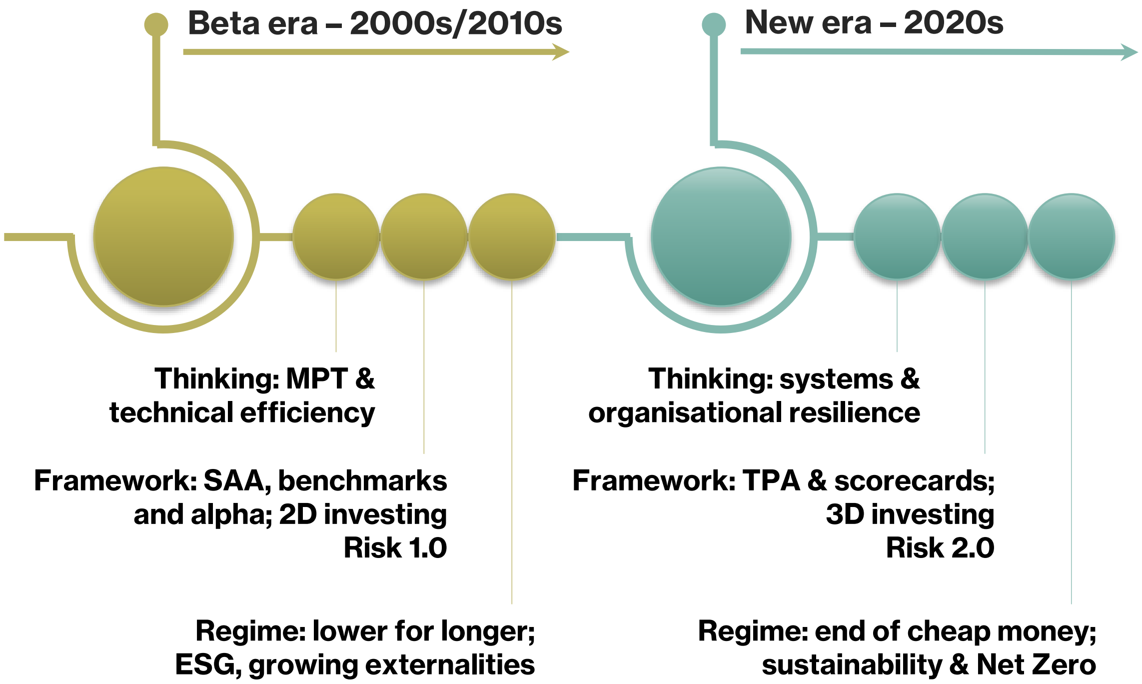
- Taking into account wider stakeholder orientation – *net zero has societal support*
- Taking more responsibility through stewardship – *stewardship has a prime role in net zero*
- Not simply accepting the systemic risks but positively affecting them – *climate risk is the main systemic risk*
- Integrating risk, return and real-world impacts – *influencing climate has real-world impact*
- Adopting a mindset of systems thinking – *which is necessary to address net zero investing.*

Hurdles

- Some hurdles are structurally connected to the external conditions of the finance sector (e.g. regulations, policies, standards, guidelines, industry norms, tools, data and information)
- Some hurdles are behavioural frictions and more relevant to the internal workings of the institutions themselves and their decision-makers (e.g. mental models, assumptions, beliefs, values, bias, worldview).

2.1 Investment industry era change – *thinking, framework and regime*

Change on multiple fronts



2.1 Investment industry era change – *thinking, framework and regime*

There are always patterns that carry into the future from the past. But there are also instances where there will be big differences. At present the degree of change is particularly big reflecting a regime change in the market's driving forces and introducing greater uncertainty into the investment macro.

- Are we at a major inflexion point in terms of how the world operates? The world has several crises to wrestle with. It has geopolitics, it has climate change and the issues of inequality that could collectively challenge capitalism as we know it
- The last era had a brutally simple (and singular) version of success – **perform better than the benchmark**. The MPT investment framework elevated alpha to a highly visible target and played down the part played by beta because it was regarded as outside investors' control
- The old era story is about the tailwind – the high returns - we have had from economic integration, technology progress and demographic growth; and from the prolonged period of low interest rates.

The new era

- The new era is the sustainability era. We are now heavily invested in the sustainability era where success is producing long term sustainable value – a much more complex thing to measure and therefore to orchestrate
- The new era story is quite different. The macro has fundamentally changed and quite swiftly from lower for longer to the end of cheap money. Investment beliefs need a big makeover with rates and inflation very different going forward. We face lower real return expectations, and these new conditions will likely produce higher volatility. They move the dial from making hay while the sun shines to resilience and adapting
- And at the same time, we are transitioning in our frameworks, by moving to total portfolio arrangements that account for sustainability impacts; and by framing risk in broader ways than just volatility with a transition to recognise risk as multi-faceted and adopt more robust and resilient risk management methodology.

2.2 The evolution of investment theory towards systems thinking

		Systems thinking

Theory	▪ Maximising return relative to market return
	  ▪ *Maximising alpha*
	▪ Accepting the market and the system as an unchangeable exogenous factor
	  ▪ *Beta as a given*
		▪ Maximising absolute return relative to total portfolio goals
		  ▪ *Maximising total portfolio returns*
		▪ Working on the system to improve financial and real-world outcomes
		  ▪ *Building better beta*

Methods	▪ Modelling from past data where the issues are with its relevance. Reliance on quantitative modelling ▪ Investing portfolios under MPT precepts	▪ Modelling from future thinking and data where the issues are its reliability ▪ Quantitative models and qualitative scenario analysis ▪ Investing and stewarding more systemically
Outcomes	▪ Alpha is in total a zero sum ▪ No clear net positives to society given ESG is portfolio risk focused and externalities are not managed	▪ Outcomes are positive sum given improvements in beta ▪ Potential to achieve net positives for society given real-world outcomes are addressed

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2.2 The evolution of investment theory towards systems thinking

There is a gradual realisation of the significant limitations of mainstream modern portfolio theory and how it is used in practice.

Model change

- Investment practice. Investment decision-making relies on accepted and established practice and best practice
- Best practice relies on an **effective governance model, people model, and investment model**; all in sync; **professionalism** in their implementation; **excellence in the investment model**
- "In theory, there's no difference between theory and practice. In practice, there is." | Yogi Berra.

Model throughputs

- Investment output comes from the three model inputs: **Governance Model + People Model + Investment Model**
- Working in a joined-up way – connecting, collaborating and combining across people, teams, organisations and ideas; with co-opetition model.

Best practice investment model

- Values and beliefs processes create the foundations to investment portfolios
- Degree of insourcing and strategies in combining internal and external IP
- Risk should be seen in multiple ways particularly in mission impairment
- Risk is both an across-portfolio and across-time challenge
- Mindset is the biggest hindrance to and opportunity for long horizon investing
- Integration of ESG / extra-financial factors for sustainability and responsibility
- Portfolio construction developed by TPA and portfolio quality

Professionalism model

Purpose	+	Professionalism	+	Assurance	=	Value
• Vision and values • Stakeholder map		• Values • Competency • License to operate		• Trust • Conflicts • Track record		• Experiences • Outcomes

2.3 Politicisation is a growing factor for asset owners and asset managers

Pensions and investments grew up in an apolitical bubble
– *'I'm an investment guy not a politics guy'. Chris Ailman, CalSTRS*

Investors now cannot avoid some politics
— *'There is now a certain amount of political content in what funds do, it's small but growing'. TAI*

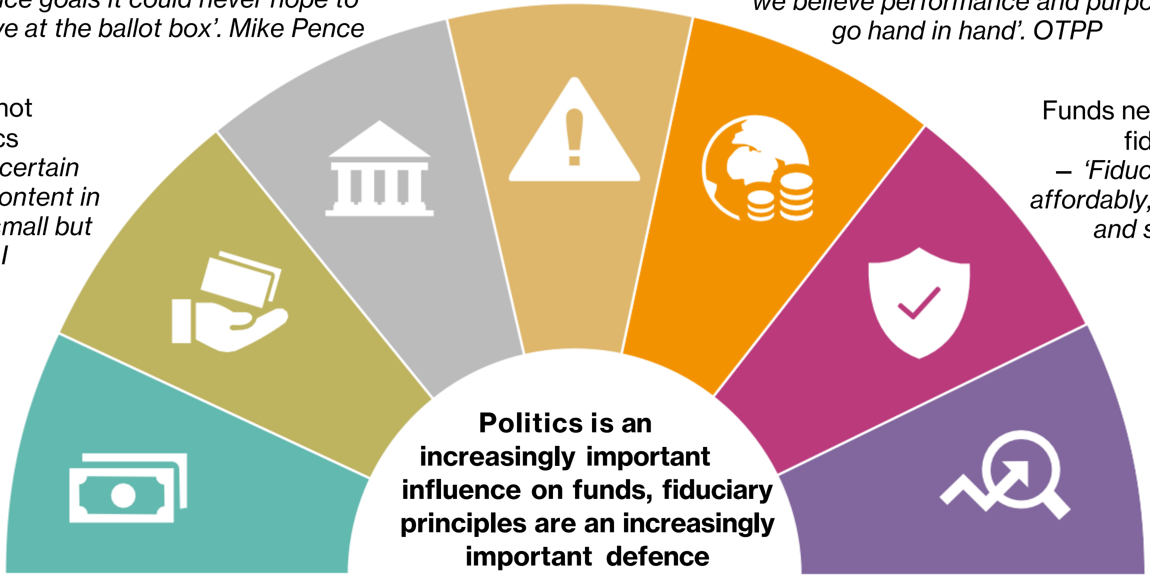
The US political backlash to ESG
– *'The progressive left is using ESG to advance goals it could never hope to achieve at the ballot box'. Mike Pence*

Funds should adapt to more political risk
– *'Politics should be accorded more importance in GPFG'. Norges*

Funds should adapt to greater democratisation
– *We invest to shape a better future, we believe performance and purpose go hand in hand'. OTPP*

Funds need the air cover of fiduciary duty
– *'Fiduciary duty = investing affordably, securely, sustainably, and systemically'. TAI*

Funds need to be transparent
– *'The ultimate protections come from exercising strong governance using fiduciary principles'. TAI.*



2.3 Politicisation is a growing factor for asset owners and asset managers

The political challenge is here to stay. But the good news is that funds can stay out of most of the mess through their commitment to fiduciary duty.

1. Pensions & investments grew up in an apolitical bubble

- Politics only surfaced lightly in regulation and portfolios
- Funds were takers not makers in politics
- But we are now going into a new phase in which the political footprint is going to get bigger. For example through ISSB and SFDR, etc

2. Investors now cannot avoid some politics

- Funds' wider missions and Responsible investment (RI) objectives have added political content
- Funds are natural targets for governments that seek influence over big pools of capital

3. The US political backlash to ESG

- In the US one political theme is to characterise ESG as woke capitalism

4. Funds should adapt to more political risk

- Geopolitics is a systemic force affecting returns
- Political risk is rising with greater regulation and desire for national control

5. Funds should adapt to greater democratisation

- End investors, particularly in DC funds, will want their values expressed in the management of their funds

6. Funds need the air cover of fiduciary duty

- Fiduciary duty in putting beneficiaries interests first and with strong governance – beliefs, policies, processes – is the front-line defence in successfully managing the politics

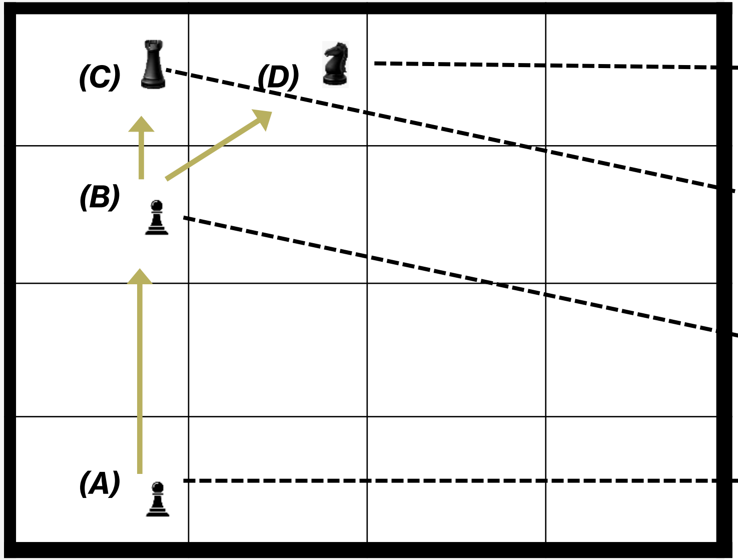
7. Funds need to be transparent

- Preparedness to speak out may risk upset in some political arenas but should still work as part of a governance strategy and collaborative principles

2.4 Fiduciary duty and the fiduciary window

The fiduciary window represents the range of acceptable policies under current interpretation of fiduciary duty

Sustainability positioning in the fiduciary window



(a) The financial ambition and commitment related to sustainability factors

(b) The real-world impact ambition & commitment related to sustainability factors

In the fiduciary window we can characterise four different sustainability positions

- (D) is the universal owner / system-level investing state with intentional impact (the *knight's move*)
- (C) is the evolving double materiality state with influence on real-world impact (the *rook's move*)
- (B) is the integrated ESG state with single materiality where many asset owners and asset managers are now
- (A) is the non-ESG state, where funds started

2.4 Fiduciary duty – *Stretching the window*

The 'fiduciary window' identifies the set of acceptable investment policies given the application of fiduciary duty.

It has the vertical plane for financial materiality and motivation; and the horizontal plane for real-world impact materiality and motivation.

- Fiduciary duty – a long-running foundational principle in investing - is being discussed widely, reviewed legally, and explored practically
- Fiduciary duty is a high-dissonance subject – the levels of misunderstanding and misrepresentations are very high reflecting its subtle characteristics
- Fiduciary duty is arriving at a fresh place in its journey with the treatment of investing for sustainable impact. This is aligning with the 3D investing model – balancing risk, return and real-world impact in which financial outcomes are improved through increasing resilience to systems change and where a positive real-world impact is a parallel outcome

- Fiduciary duty is summarised under this framing as
  - *investing affordably and securely* – balancing risk and return in the present
  - *investing sustainably* - balancing risk and return over time
  - *investing systemically* – safeguarding the health of the system over time.
- Time horizons are a big challenge. There are incentives to manage a long-term system by reference to short-term factors
- And politics is a big challenge – it is casting a long shadow over the investing landscape, with differences in ethos introducing greater divisions in views, by geography, type of investor, and values of decision-makers
- This is a very big transition, and it needs transformational content, with a new story, theory and supporting data and narrative. This will take innovation in time horizon, benchmarks, incentives, measuring and 3D investing.

2.5 Systemic risk as part of market risk

Systemic risk is the risk of malfunctions / breakdowns in an entire system, as opposed to breakdowns in individual parts or components of the system.

- Market risk is generally seen as the core risks associated with the economic machine
- Systemic risk has been small at most, with the occasional burst – at times of major conflict or financial meltdowns
- Systemic risk going forward is likely to be orders of magnitude higher than previously

Market risk

Core risks

Macro- & micro-economic risks

Systemic risks

Prime systemic risks
Escalating climate change
Biodiversity / ecosystem breakdown
Geopolitical security breakdown

Other systemic risks
Inequality / societal polarisation
Natural resource crisis
Global pandemic
Cybercrime / cybersecurity
Adverse outcomes of AI / technology
Financial system crisis

2.5 Systemic risk – *Adapting the model*

A special part of market or systematic risk arising from malfunctions in the system that cascade through the whole market.

This is very different from core market risks in term structure and path dependence and very different from classic market risk in being an addressable (endogenous) risk approached via systemic stewardship.

Systemic risks are very challenging to integrate

- Pricing this risk is near impossible (the risk has high uncertainty and irreducibility). Climate example: no past, long future; tipping points; high co-dependency; model uncertainty. Future risk distribution has limited upside and potentially severe downside
- Systemic risk historically has been about financial interdependency risks and geo-political risks
- Systemic risk downside historically has been smallish but subject to bursts and spikes

- uncertain (limited data and as a result contested);
- pervasive (undiversifiable and unhedgeable);
- inter-connected (complex reinforcing loops that domino);
- non-linear (growing, potentially spiky, even runaway);
- endogenous (can be addressed and mitigated)

- Systemic risks in the future are increasingly from climate, environmental and social sources
- Future systemic risk is likely to be orders of magnitude bigger than prior versions given the central risk – climate risk- is growing super-exponentially.

The challenge is to:

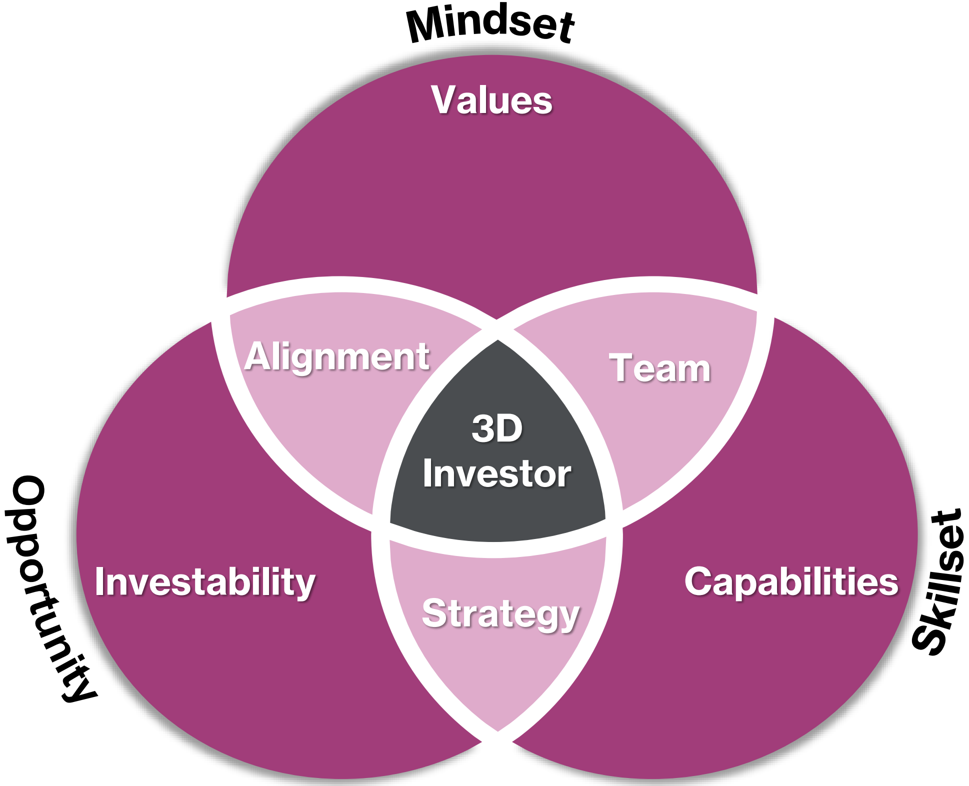
- Build an integrated joined-up process (e.g. Risk 2.0)
- To put robustness and resilience into effect
- To integrate measurement at various levels of accuracy.

3.1 Rightsizing sustainability – *being intentional in the outcomes sought*

- Rightsizing is deciding on and acting on a particular ambition and commitment with respect to sustainability / impact reflecting mindset and skillset of the organisation and opportunity set to do what is intentioned

- Not overdoing it and compromising legitimacy
- Not underdoing it and foregoing the opportunity

- Rightsizing brings together
  - mindset model – what is the motivation to invest sustainably; this comes from values
  - skillset model – what is the unique investment edge; this comes from skillset
  - opportunity set model - what is viable, commercial and deliverable via investing and stewarding – this comes from opportunity



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3.1 Rightsizing sustainability – *being intentional in the outcomes sought*

Like any alignment of values and vision, rightsizing sustainability is a collaborative process that integrates multiple considerations. As values come into the mix, the process needs to be as objective as possible. This calls for greater collaboration; and a mindset that recognises change and is more purpose-driven.

Rightsizing with respect to the net zero context

- Every investor will have a climate risk management policy and consider climate risk wherever there is performance materiality
- But not every investor chooses to be a net zero investor. The choice to have a net zero ambition and have a net zero commitment will reflect rightsizing given the organisation's circumstances and investment beliefs
- For example, 52 out of 100 of the Asset Owner 100 at 31 December 2022 had a net zero ambition.

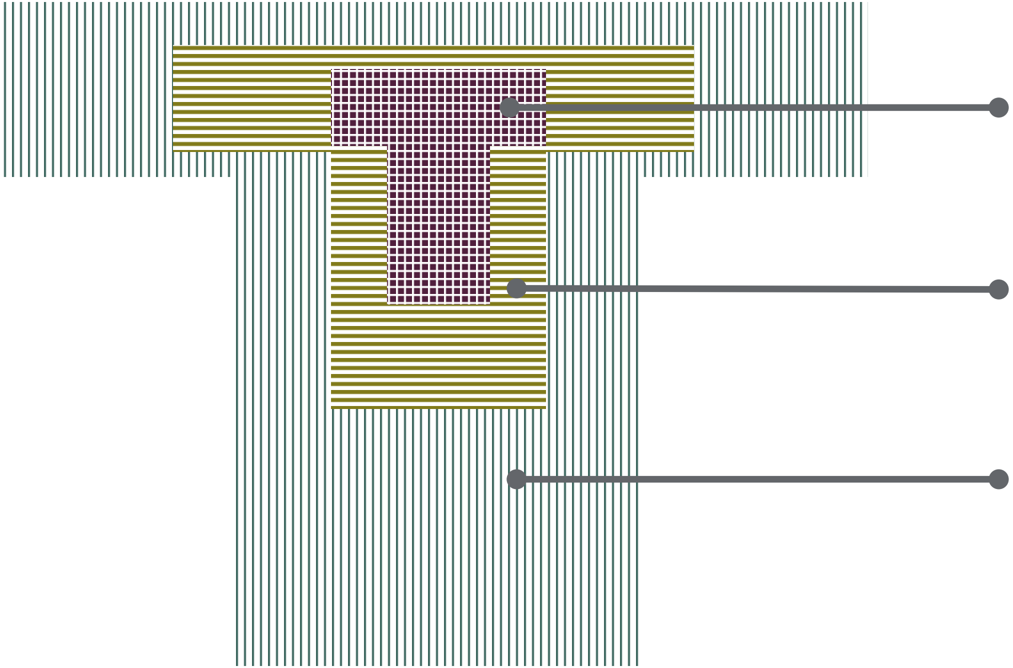
Rightsizing challenges

- The rightsizing of net zero involves deciding the role to play in climate, in contributing to society's toughest challenges, while not trying to be the solution when government has to be in that seat

- Need to make purpose and vision clear and aligned with strategy
- Vision informs strategy
- Strategy grounds vision in reality

- Need to stress test various scenarios to check whether goals and intentions line up with realistic expectations for outcomes
- This is exploration of a group's differences with a commitment to come together in a co-created conclusion
- Various challenges including measurement and communications and need for enabling

3.2 Building sustainability capability - *through T-shaped people, teams and organisational design*



The three levels of T-shapedness in the organisation

- At the organisation-level, having a dual operating model that combines hierarchical (vertical) functions with networked (horizontal) functions enables the organisation to integrate its thinking and actions
- At the team-level, in more specialised areas like technology, teams need connectors that speak fluently across the disciplines and bring more cognitive diversity into the team
- At the people-level, T-shaped professionals have a combination of deep domain skills and wide connections skills which add together the benefits of specialist and generalist skills

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3.2 Building sustainability capability - *through T-shaped people, teams and organisational design*

Sustainability skills are specialised and encroach into other disciplines like climate. This calls for greater collaboration to build rounded teams; and a mindset that is adaptable to change and more purpose-driven.

Collective effectiveness

- The key elements of collective effectiveness concern applying *inclusion*, exercising *trust*, working with a *framework* and scaffolding and fine-tuning *judgement*
- Inclusion critically involves creating a culture of identity, shared purpose and equality of voice
- Trust requires commitment as a critical value, with a focus on ways to build trust and ways to benefit from trust
- Scaffolding means using beliefs, models and principles as the fundamental frameworks for critical thinking and systems thinking, and to support decisions
- Judgement critically involves using commitments to rigour and accurate thinking from accountability, problem versatility, growth and socialising mindset.

The culture pillars of a T-shaped team

- A results-oriented culture, in which everyone pursues the common goal
- Investment professionals with deep, specialised knowledge and broad, cross-domain knowledge
- Teams are both experts in their own domain and able to make connections with other teams and domains
- Leaders build versatile, learning-oriented teams that develop cognitive diversity.

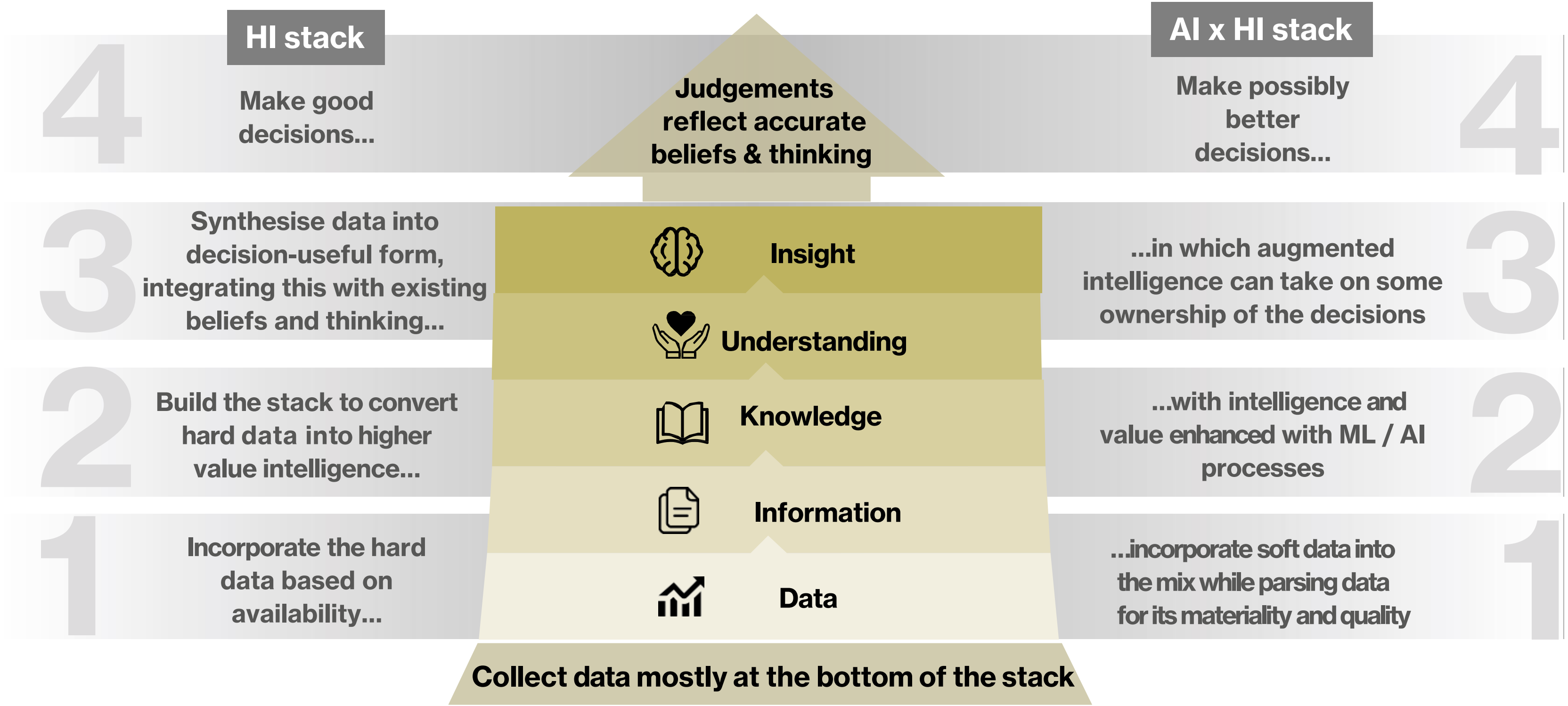
The value in T-shaped professionals

- T-shaped people have natural advantages as contributors to teams via their wider contextual perspective across many fields and disciplines combining a mix of the growth mind-set, integrated thinking and problem-solving ability
- T-shaped skills are one part inherited, one part developed through experience, one part learnt through study.

3.3. The data proposition – *building the intelligence stack and beliefs*

All data and its analysis and associated decision-making exists within an intelligence stack

And the HI x AI combination can raise the quality of that intelligence and simplify the usage of data



3.3. The data proposition – *building the intelligence stack and beliefs*

Taking beliefs further as a differentiator – opportunities in critical thinking

Data needs holistic treatment. Lots of data that is material in its decision uses has issues with its provenance – issues like subjectivity, estimation, timeliness, reliance on implicit assumptions.

In using data there needs to be the recognition of its limitations through some qualification.

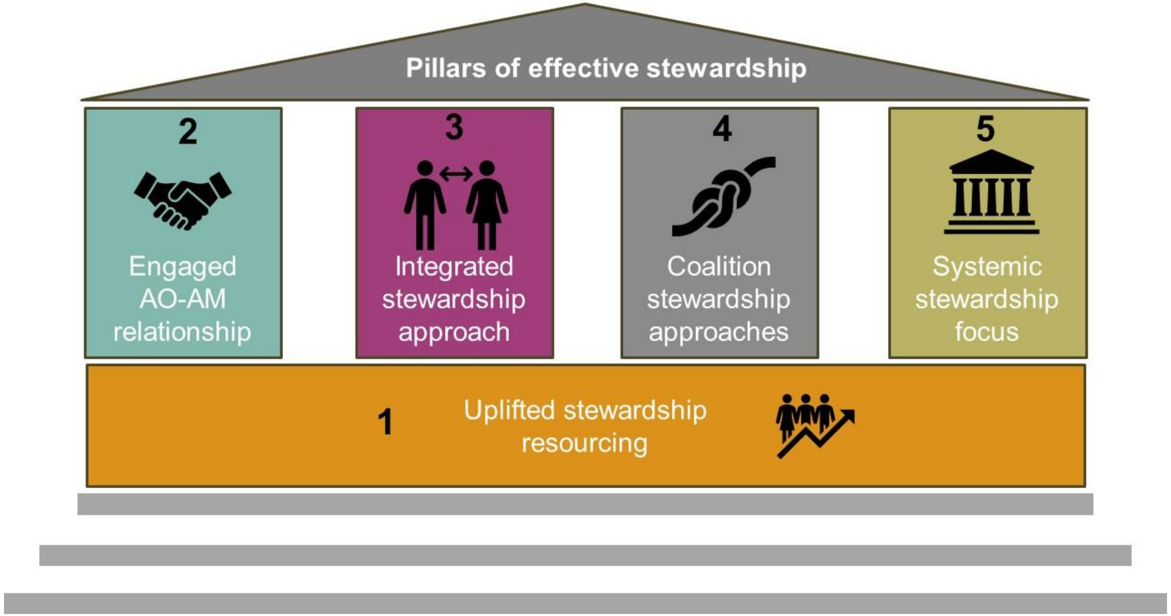
Post-truth is an issue in all worlds

- There has been a loss of integrity in institutional authority for truth-telling. This has been enabled by new social media and communication technologies, new media editing technologies and an over-claiming culture
- Truth is an accurate belief about reality – 'the essential foundation for any good outcome'
- Misinformation is triggering the vulnerable into false beliefs through the forces of their emotional stress, dissonance, cognitive biases and social / tribal behaviours and as a result creating the misinformed lens.

The key part to be played by beliefs	
Deeper situational awareness and fluency	▪ The investment landscape has got more challenging to understand ▪ Deeper investigation is necessary
Using evidence-based methods in abductive process	▪ Data supports the proposition ▪ Where data not available, strong lines of argument & judgement are applied
Ensure the behavioural biases are managed	▪ Reduce the incidence and influence of biased information / hacking, and the confirmation bias & cognitive dissonance
Strengthen the link between beliefs & decisions	▪ Build the vision of the benefits of beliefs ▪ Develop the embedding of the beliefs through socialisation

3.4 The pillars of stronger stewardship: *significant extensions to current practices*

1	▪ Resources equate to about 4% or 5% of total front-line FTEs instead of the 10% or so needed
2	▪ Asset managers need a more definitive stewardship mandate from the asset owner
3	▪ Asset managers working on allocation and stewardship in joined-up ways
4	▪ Stewardship work joined-up through coalition organisations, CA100+, etc
5	▪ Engagement with policymakers and industry groups to support the ecosystem



3.4 The pillars of stronger stewardship: *significant extensions to current practices*

The size and shape of stewardship in the current investment industry is not fully fit for purpose.
It requires some upscaling and refocusing.

The five pillars to build out

1. Uplifted stewardship resourcing
   Overall industry target to add to current resources
   But no one size fits all approach for each organisation
2. Engaged AO-AM relationship
   Builds more accountability into the relationship
   Supports the new resourcing target
3. Integrated stewardship approach
   Supports more joined-up stewardship
   Enables a cost neutral increase in resourcing
4. Coalition stewardship approaches
   Stronger proposition from collaborative approaches
   Use of coalition organisations to facilitate
5. Systemic stewardship focus
   Addressing the issues in systemic risks
   Can be approached through coalition organisations

The ask of each investment organisation

- There are always contextual differences in how investment organisations are configured and so 'no one size fits all' when it comes to the stewardship resourcing ask; and 'no one shape fits all' as well
- At the meta level, all the pillars opposite are relevant to the industry in aggregate. How can this translate to each organisation given current financial pressures with existing resources stretched? As a guide…
  - Some organisations already carry a stewardship commitment consistent with a stronger industry: for these organisations strengthening the AO-AM engagement is the priority
  - Some organisations are not carrying their stewardship responsibility; here the asset owner leads the engagement with the asset manager on what is the required commitment with measurements of resourcing included in the engagement; the integrated stewardship approach efficiently uses existing resources to adapt and might be the priority.

3.5 Net Zero in the Balance: *the system for the system*

Frameworks	1. Sustainable finance	2. Fiduciary duty	3. Transformative change		
Strategies	1. Return, risk & real-world impact	2. Alignment with policymakers & regulators	3. Engagement through coalition organisations	4. Enhanced organisational capabilities	
Innovations	1. TPA - Total Portfolio	2. Universal ownership	3. Systemic stewardship	4. Balanced scorecards	5. Theory of change
Mental models	1. Systems thinking	2. Systems leadership			

Source: Net Zero in the Balance | CFA institute

3.5 Net Zero in the Balance: *the system for the system*

There has been a very fast speed of adoption of the net zero investing model. Net zero commitments have been made by 52 out of 100 of the Thinking Ahead Institute AO 100 from its origins five years ago.

The systems map

- Starts with **frameworks**, net zero crosses the investment borders from sustainability to sustainable finance
- Builds from **strategies**: there are integration issues
- Relies on **innovations**: all five of these are developing a body of practice
- Uses **mental models**: systems thinking is critical.

Further insight...

- Under sustainable finance, investors are contributors to societal risks, under sustainable investing they are simply managing the impacts of climate change through attention to transition risks and physical risks
- Entrenched systems and behaviours in the finance industry – around benchmarks, incentives and time horizons – are hindering investors' ability to adequately consider climate risk.
- The financial ecosystem requires new thinking and tools to meet the unprecedented complexity and scale of the problem – addressing the financial and real-world impact aspects of climate change
- If we seek a more sustainable financial system, we need systems change, and to understand how to get there we need systems thinking and systems leadership.

Further momentum will come from...

1. Build deeper organisational beliefs about climate using systems thinking to explore scenarios
2. Growing understanding of net zero investing and developing the strategy to complement the vision
3. Paying regard to the changing regulatory environment and governments' commitment to net zero
4. Developing collaborative networks to support faster learning and more coordinated efforts
5. Attracting talent from diverse fields to build climate investing capability and develop T-shaped capabilities.

Source: Net Zero in the Balance | CFA institute

Thinking Ahead Institute
An innovation network founded by WTW

Conclusions – the future of ESG is in the balance

This paper

This research was undertaken in 2023 as ESG entered its identity crisis with the ESG backlash in the US. At this point we put 'contested' down as an apt description. In the conclusion to this research written with the benefit of 2024 reflection, 'in the balance' seems more apt.

Meeting the following challenges is critical

- **On talent**, there is no argument. We have the talent. Can it adapt in mindset and skillset. We are optimistic
- **On collaboration**, there is a track record of the industry raising its game through collective action, PRI, TCFD, have made their mark. Can it take bigger steps in the critical stewardship and systemic stewardship areas. It's close, but on balance we are optimistic
- **On data**, recent progress has seemed difficult. But there are indications that this is all part of a complex phase of realigning data to new realities. On balance, a new data era is likely to emerge that will surpass the present one for enabling effective analysis and accountability
- **On purpose,** it is in the balance. Finance and investment has the opportunity to use its influence inclusively and beneficially or self-servingly and superficially. It will take something of a mindset shift to get to the place it needs to be. How well will it adapt? We can be optimistic, but we should allow for some disappointment
- **On naming,** we should largely bury the term ESG. The term we should be working with is sustainable investing
- **On governance attention,** a typical sophisticated asset owner commits about 20% of its governance budget (time and capabilities) to sustainability issues. In the next 5 to 10-years we are optimistic that the same funds will step up to a figure more like 25%
- **On organisational alpha,** a typical sophisticated asset owner expects about 10% of organisational alpha (value-adding skill captured in soft data) to come from sustainability. The future of sustainability in org-alpha is likely to step up (perhaps to around 20%). The rise of systemic risk and the arrival of a risk 2.0 era produces this bigger opportunity to create value.

Future of ESG working group

The members of the working group, chaired by Roger Urwin of TAI, were as follows:

- Herschel Pant, AXA Investment Managers
- Praneel Lachman, FirstRand Bank
- Linda Colwell, Goldman Sachs
- Emma Hunt, HSBC Bank Pension Trust (UK) Limited
- Amanda Latham, IFM Investors
- Michael Jabs, Kraft Heinz
- George Beesley, MFS Investment Management
- Ed Evers, Ninety One
- Alison Loat, OPTrust
- Nacho Hernández, Pensions Caixa 30
- My-Linh Ngo, RBC BlueBay
- Leilani Weier, Rest Super
- Augusto Caro, Santander Asset Management
- Isaac Ré Delgado, Santander Asset Management
- Jaspreet Duhra, S&P Dow Jones Indices
- Anna West, S&P Global
- Alexis Cheang, New South Wales Treasury Corporation (TCorp)
- Adrian Troller, New South Wales Treasury Corporation (TCorp)
- Adam Gillett, WTW
- Tim Unger, WTW

Terms used in this report

Terms used	What is it
Systems thinking	Emphasising the whole over the parts, the collective over the individual, the inter-connectedness, the emergent properties of the system. Connecting dots, recognising patterns, socialising solutions
Systems leadership	A set of skills and capacities for an individual or organisation to support the process of systems-level change. It combines collaborative leadership, coalition-building and systems insight
System design	The design of the organisation with respect to various features including dealing with complexity, TPA, use of insourcing, and sustainability ambition (rightsizing)
Systemic risk	Systemic risk – with its principal examples of climate change, biodiversity and geopolitical security – is the special part of market or systematic risk arising from malfunctions in the system that cascade through the whole market
Total portfolio approach (TPA)	An approach to portfolio construction that is a "more joined up" process that starts with clearly specified investment goals, and applies a competition for capital among all investment opportunities, in a dynamic approach
Horizon scanning	The systemic analysis of potential threats and opportunities and likely future developments
Universal ownership / 3D investing principles	Universal owners are generally very large investors that own a slice of the world economy and world portfolio and with it a slice of all corporate externalities; and in many cases are adapting their strategy to improve or indeed exploit their position. 3D investing principles align with universal ownership in managing funds to balance risks, returns and real-world impacts

Terms used	What is it
Best practice	A state where the organisation functions with a margin of safety over meeting its purpose, vision and benchmarks and compares very well by reference to peers (a combination of the best asset owners globally) in strong performance and enablers of good practice
Fit-for-purpose	A fit-for-purpose organisation functions in line with meeting its purpose, vision and benchmarks and compares adequately by reference to peers
Fiduciary duty	Investing having regard to principles of: ▪ loyalty: *acting in accordance with the specific power of investment by putting the interests of beneficiaries first and* ▪ prudence and care: *investing prudently, exercising good judgement and reasonable care; diversify according to theory*
Culture	The collective influence from shared values and beliefs on the way the organisation thinks and behaves (Urwin, TAI, 2019)
T-shaped teams	T-shaped people have natural advantages as contributors to cognitive diversity. Their mix of subject depth (the vertical bar of the 'T') and subject breadth (the horizontal bar of the 'T') suits the profile of cognitively diverse teams through their wider perspectives across many fields and disciplines
Governance budget	The time and capabilities of the governing and leadership function of an asset owner or asset manager
Organisational alpha	Shorthand for the level of skill generating value added through people and process

Limitations of reliance and contact details

Limitations of reliance – Thinking Ahead Group 2.0
This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

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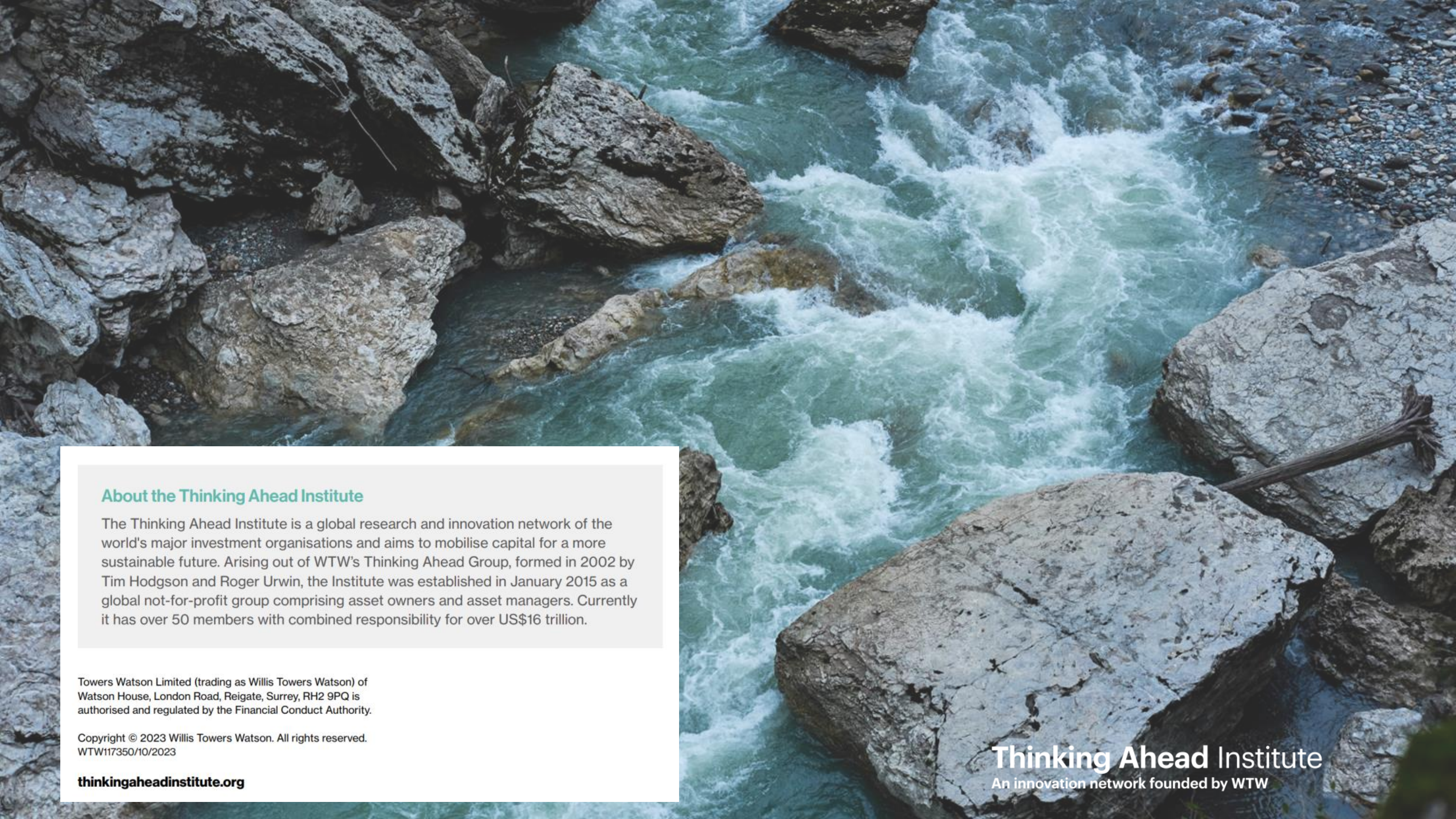

About the Thinking Ahead Institute

The Thinking Ahead Institute is a global research and innovation network of the world's major investment organisations and aims to mobilise capital for a more sustainable future. Arising out of WTW's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners and asset managers. Currently it has over 50 members with combined responsibility for over US$16 trillion.

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