In the Global Financial Crisis of 2008 – the effects of which we are still very much living with in 2015 – smart people made ‘rational’ decisions to boost financial returns while turning a blind eye to the critical **systemic risks** they were creating. Our lead article argues that it’s time for investors to start reporting on both portfolio and systems-level performance to prevent **future crises**. In our ESG interview, **Saker Nusseibeh**, Chief Executive Officer at Hermes Investment Management, concurs, adding that the crisis was a failure of governance and asset management, as he discusses Hermes’ new series of Responsible Capitalism papers.

Education is the key to learning from history, and our **academic research** digest features recent award-winning studies on sustainable finance.

The recent **forest fire** crisis (and the ones before it) in Indonesia is a recurring environmental, social and economic disaster. We look at the investor risk and responsibility angle, and ask whether **ESG disclosure in Japan**, one of the biggest financiers to SE Asia, can help prevent mass tropical deforestation in the region.

Switching to another highly topical debate, implementation of the **Dodd-Frank CEO/worker pay ratio** reporting requirement in the US, we highlight where media articles are already raising the biggest controversies.

In the **ESG Café**, we get busy with a healthier and more sustainable lifestyle, by cycling, and then recycling.

ANALYSIS

It's time for investors to start reporting on both portfolio and systems-level performance

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Balanced assets

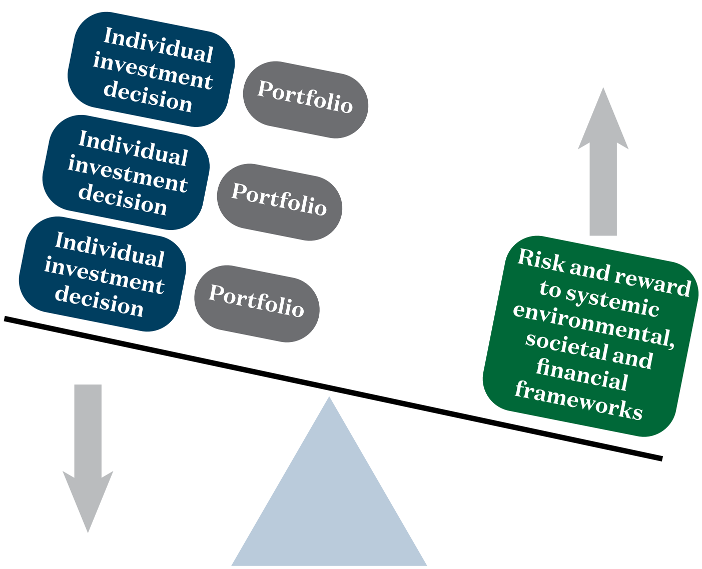
ON 18 SEPTEMBER 2008, the global financial system came within a hair's breadth of complete meltdown. This worst case was ultimately avoided, but the collapse that day of Lehman Brothers with its $600bn in assets helped trigger a worldwide economic crisis. Some 6m people lost their jobs, the Dow plunged 5,000 points, cash-strapped banks needed government bailouts, General Motors and Chrysler declared bankruptcy and the US unemployment rate skyrocketed to almost 10%. All because very smart people making rational decisions to boost portfolio returns turned a blind eye to the systemic risks they were creating.

In the seven years since, some progress in stabilising finance has been made. However, fundamental change remains elusive, despite what many would like to think. Over 1,300 institutional investors with assets under management of almost $60trn have pledged to take environmental, social and governance (ESG) factors into account in their portfolio management, in committing to the UN-backed Principles for Responsible Investment. The major pension fund California Public Employees' Retirement System recently announced that it would gradually require all of its external investment managers to identify the ESG risks in their investment processes.

These same asset owners, however, are making relatively little effort to relate their investment decisions to their impacts on global environmental, societal and financial systems that they operate within. In our new report, *Portfolios and Systemic Framework Integration: Towards a Theory and Practice*, The Investment Integration Project (TIIP) argues that investors need to acknowledge their ability to impact these systems, and that asset owners should begin asking their money managers to report on these impacts.

They should do so because, as figure 1 illustrates, the cumulative decisions of portfolio managers can disrupt these systems, making all portfolios suffer – or can strengthen and enhance them, generating gains for all. This interrelationship between portfolios and systems has all too frequently been ignored.

1. The interreaction between portfolios and systems



THE RESPONSIBLE INVESTMENT community has developed tools to help asset owners and managers integrate ESG factors into portfolio-level decision-making, and to understand and measure the ability of portfolio investments to help solve environmental and social problems. The corporate ESG guidelines developed by the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB) help investors measure risks avoided or opportunities seized at a portfolio level. The Impact Reporting and Investment Standards (IRIS) metrics help investors assess the social and environmental impacts of specific portfolios. Various other metrics such as CDP's indicators of portfolios' carbon exposure help assess specific risks.

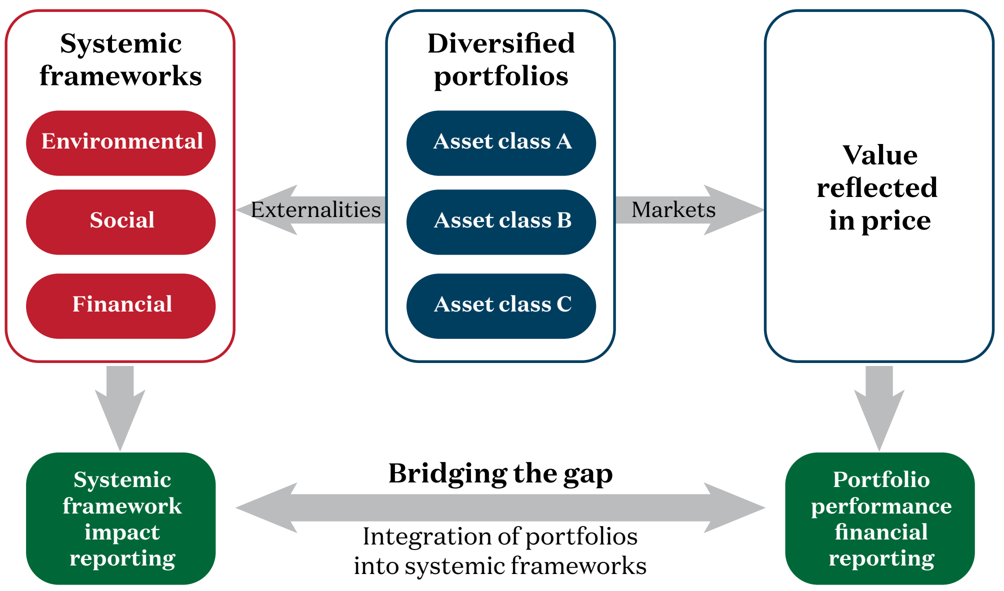
But these tools stop short of providing an understanding of the systemic influence of investors' decisions. Indeed, investment theory currently encourages, and even directs, managers to consider their portfolio-level investment decisions as if they are without impact on the environmental, societal and financial systems that provide the foundations on which their investments are built.

Managers are effectively told they should not consider the potentially globally disruptive effects of climate change unless they can demonstrate their impact on the price of specific stocks in their portfolios. The performance of the markets as a whole is not factored into measurement of managers' investment success or failure because – the assumption is – market forces are beyond their influence and control.

The problem with this assumption is that it does nothing to help protect asset owners and managers from systems-level risks or to help them enhance systems-level rewards, when in fact, the potential of asset owners and managers' portfolio-level decisions to support or undermine these systems has never been greater.

The sheer size of their assets under management tells the tale of this potential. Globally, collective assets stand at some \$250trn. It's difficult to argue that assets of \$250trn, growing daily, are without impact. And this potential influence is concentrated in remarkably few hands. Andy Haldane, executive director for financial stability at the Bank of England, has pointed out that the top 10 asset managers globally have a market share of almost 30% of the asset management sector, with assets estimated at over \$80trn in 2015 and projected to reach \$400trn by 2050.

2. Bridging the gap between portfolios and systems



A NUMBER OF OBSTACLES stand today between money managers and their ability to understand that their portfolio-level decisions can collectively create systems-level risk and rewards.

To begin with, managers – like their corporate executive peers – are told that their first duty is to generate the greatest returns in the shortest time possible: the invisible hand of the market will then guide their efficient actions to the best outcome for society with no one intending anything other than his or her own self-interest. This philosophy has led to an increasing short-termism in the markets that is "troubling both to those seeking to save for long-term goals such as retirement and for our broader economy," as Laurence Fink, the CEO of BlackRock, wrote in a letter to 500 of the US's largest companies in April of 2015.

Second, it is difficult for money managers and asset owners to see how their individual decisions can meaningfully impact these systems. What real difference does it make if one continues to profit from fossil fuels when climate change is driven by far more than any single decision? Nor will a single investment in a 'green' chemistry company make or break this emerging technology, so why make the effort to evaluate its complexities?

In addition, few tools exist that allow asset owners and money managers to evaluate their systems-level impacts. The PRI's Reporting Framework requires the reporting of much relevant information. But establishing managers' intentionality with regard to systems-level effects, and drawing lines that connect the factors reported on to those systems are the next steps on the road to a deeper understanding of this important phenomenon.

To bridge the gap between portfolios and systems, as illustrated in figure 2, asset owners will need to take three concrete steps:

- acknowledge the connection between investment decision-making and systems-level risks and rewards;
- determine which systemic frameworks they can most appropriately and usefully focus on; and
- implement investment practices that allow them to contribute to the preservation and enhancement of these system while simultaneously achieving competitive financial returns for their portfolios.

A world in which asset owners and money managers seek to enhance simultaneously the strength of systems and their relative portfolio performance will benefit all. The obstacles between us and such a world, while substantial, are not insurmountable. The first step in overcoming them is to recognise that all investments have impacts beyond the portfolio. Once we acknowledge that fact, the rest will follow.

As Mark Carney, the governor of the Bank of England, forcefully put it at the Conference on Inclusive Capitalism in London in May 2014, "We need to recognise the tension between pure free market capitalism, which reinforces the primacy of the individual at the expense of the system, and social capital, which requires from individuals a broader sense of responsibility for the system. A sense of self must be accompanied by a sense of the systemic."

Investment decisions that intentionally manage systems as well as portfolios can create a rising tide of investment opportunities – and help avoid burning down the house in which we all reside.

The report, Portfolios and Systemic Framework Integration: Towards a Theory and Practice, *can be found at: www.investmentintregrationproject.com*