Money Management Institute
TIIP The Investment Integration Project

Graduating from ESG to Systems

Scenarios for Investors

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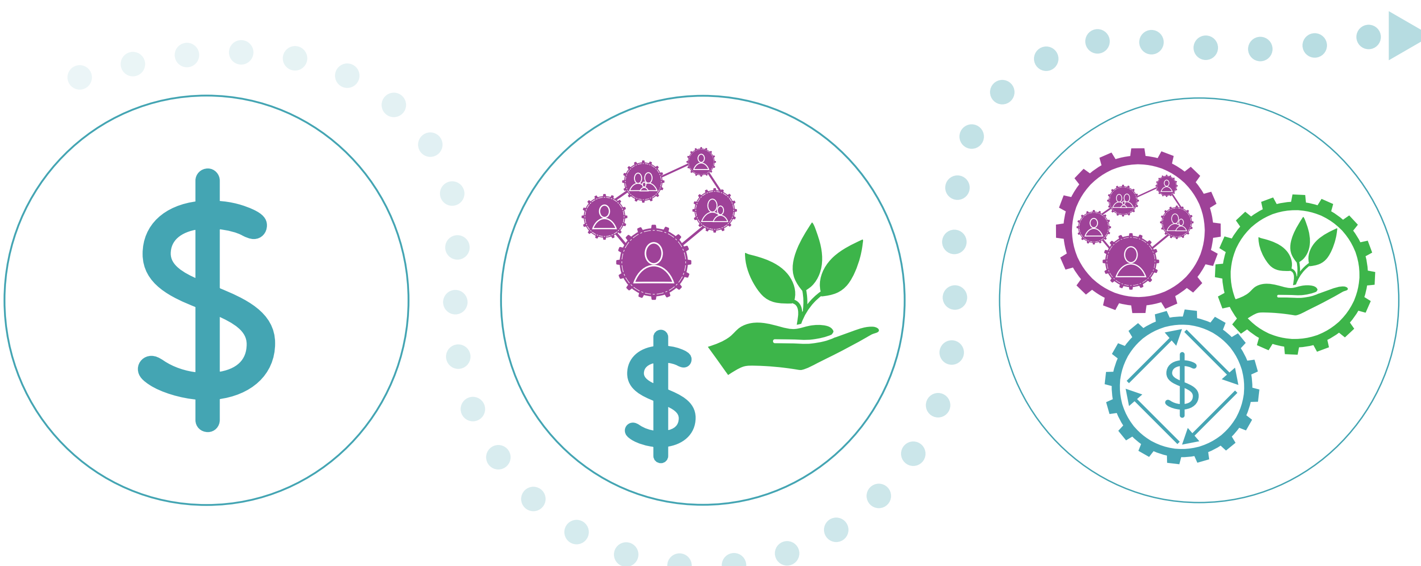

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Executive Summary

Graduating from ESG to Systems is for those investors wishing to make a transition to system-level investment, for those who see the need for this change but have difficulty imagining it in practice.

This paper uses scenarios to illustrate seven aspects of such transitions in order to give a practical embodiment to this theoretical concept.

It begins by distinguishing the conventional investors and those that integrate environmental, social, and governance (ESG) concerns from investors already convinced that managing systemic risks is essential for their long-term prosperity.

It then uses scenarios to show how long-term investors that wish to manage social, financial, and environmental systemic risks can transition their beliefs to this broad purpose; can expand their definition of risk management to encompass systemic as well as portfolio risks; and can adopt a comprehensive set of investment tools and techniques that enhance system-level influence through collaborative field building, investment enhancement, and opportunity generation.

The seven scenarios trace the progress of investors starting from an initial commitment to ESG to a more systemic approach. Each scenario describes the investor and their current status relative to conventional or sustainable investment; the catalytic moment that prompts their decision to change; the challenges in moving forward specific to their institution; their preparation for overcoming those obstacles; the actions they take to do so; and long-term management considerations necessary once the transition to system-level investment has been made.

In doing so, these scenarios illustrate the change of mindsets needed to extend today's practices into tomorrow and how to best take this step.

Introduction

It is increasingly clear that investors need to adopt system-level investment: the complex world of the 21st century demands it. Because our current social and environmental systems are inextricably interconnected and mutually interdependent, a breakdown in one can cascade throughout and disrupt others. To minimize such catastrophic risks, investors can adopt practices that create public and private goods, positive and negative externalities, and benefits for future and current generations. They can prepare for the worst while enhancing the resiliency of the best.

To help imagine what this transition entails in practice, this paper provides seven hypothetical, *but true to life*, examples of investors that confront and overcome obstacles as they transition to system-level investment. In these scenarios, a pension fund, diversified financial services firm, foundation, family office, insurance company, private equity firm, and investment consultant begin their journeys from disparate points of departure while pursuing the same goal: sustainable social, financial, and environmental systems that can contend with systemic challenges as diverse as climate change, income inequality, and the lack of social and environmental data in the financial markets.

The scenarios highlight diverse aspects of this transition. For asset owners and managers in different silos of the investment world, they show the obstacles that typically arise and transitions necessary to overcome them: obstacles and transitions that are common to all throughout various parts of the investment world. In each case, they also illustrate how a seemingly risky leap into the unknown can in fact be a logical outgrowth of current practice.

Investors that currently self-identify as long-term value creators, universal owners, stewards of their assets, impact investors, ESG integrators, and standard setters implicitly recognize the need to contend with systemic risks and rewards in their decision making. They understand the dangers of the 2008 financial crisis, the 2020 Covid-19 economic disaster, and the decades-long slow environmental train wreck created by climate change. As investors concerned with the health and resilience of the systems on which they depend for the long-term sustainability of their returns, they are ready to explore new pathways forward.

System-level Investors Defined

System-level investors are those who consider and act on social, financial, and environmental challenges that impact their investments across all asset classes and that they in turn can impact positively or negatively.

It can be helpful to think about system-level investors vis-à-vis conventional and sustainable investors:

Conventional investors. *Investors that* do not *consider environmental, social, and financial (ESG) factors as relevant and material in their security valuation.* Specifically, they view such factors as political issues easily abused for personal gain or subject to other conflicts of interest. Their primary goal is to maximize returns in as short a time as possible without consideration of such factors.

Sustainable investors. *Investors that consider ESG factors as potentially relevant and material in security selection and portfolio risk management.* They seek to understand, and when appropriate, improve the ESG performance of specific investments with regard to their market value. They may incorporate ESG considerations into their proxy voting and engagement with individual companies on financially material ESG issues. Their goal is to allocate assets to strong ESG performers while maximizing returns in as short a time as possible.

System-level investors. *Investors that intentionally manage the risks and rewards of the social, financial, and environmental systems that provide a stable, resilient foundation for investments across all asset classes.* They acknowledge that they have an impact, negative or positive, on systems and that systemic challenges impact their portfolios across all asset classes. They use a range of techniques to manage these risks and rewards, set explicit goals for their impact on systems, and measure their progress toward those goals. They seek to preserve and enhance foundational social, financial, and environmental systems in the long term while nevertheless achieving competitive returns in the short term.

Why make the transition to system-level investment now

The investment community is at a tipping point. If recent crises have made one thing clear it is that the 21st century is different from the 20th century: it is complex, globalized, and interconnected in ways we have never contended with before. Today's greatest challenges are of a scale previously unimaginable: polar icecaps melting, holes punched in the ozone layer. They can move with unimaginable speed: the 2008 financial system on the point of collapse seemingly within days; the 2020 global economy devastated in two months by a pandemic. Or they can be slow to unfold and irreversible in ways difficult to comprehend: species driven inexorably to extinction.

> “[T]he destruction of forests, expanding towns and cities, and industrial activities create pathways for animal microbes to adapt to the human body. The destruction and degradation of biodiverse hotspots that disturbs fragile ecosystems is an encroaching threat, exacerbated by a changing climate and unsustainable consumption patterns. Combined, these can contribute to the risks of novel deadly microbes spilling over into human population.”
>
> --A.D. McBain. “Pandemic: The inextricable link between human, animal and ecosystem health and the emergence of communicable disease” (M&G Investments: London) April 2020: 8.

Investors’ fate is now bound up with the stability of these complex social, financial, and environmental systems. They have inherited these systems along with responsibility for their stewardship. When these systems function well, they buoy the economy and investments as a whole in ways that appear simple. When disrupted, the complexity of the destruction they bring can boggle the mind. By favoring corporate business models that stress efficiency at the expense of resilience, overreliance on a single source of energy over a diversified energy portfolio, and financial innovation over investment stability, investors have helped to create a world in which a simple virus, invisible greenhouse gasses, and risky, widely distributed, securitized loans can upend entire social, environmental, and financial systems erected over decades and centuries.

The maintenance of these social, financial, and environmental systems is necessary if we are to feed, clothe, employ, transport, and connect a worldwide population of 7.8 billion, headed toward 9 billion by mid-century.

It is that realization—that the decisions about how investors exercise the tremendous influence of their assets through their allocation decisions and access to decision-makers can enhance the resilience of these systems or cause them to bend and break—that has led the investment community to this tipping point. Investors already intuitively understand that all they do either amplifies systemic risks or contributes to their minimization. And they increasingly comprehend that in this new world they no longer have the luxury of sitting on the sidelines, assuming they are no more than spectators.

This is the crossroad at which the investment community has arrived. The path it chooses will determine the nature of investment in the 21st century—whether we live in a world in which passive investment professionals focus on wringing returns from short-term, short-sighted decisions or choose to be the strategic catalysts for sustainable systems offering long-term returns based on stable systems.

How to make the transition to system-level investment now

But how, specifically, can investors make the necessary transitions? What steps can they take to manage systemic risks and rewards? In the absence of clear ways forward, investors today all too often remain immobilized.

That need not be so. There are three relatively straightforward approaches that support such transitions. They relate to:

Purpose	Intentionally expand investment decisions to includes those that benefit both investors and public well-being.
Risk management	Consider the risks to all stakeholders posed by environmental and social risks, as well as those to stockowners and their portfolios.
Tools	Use both well-established tools (e.g. exclusion, emphasis, and engagement) and new tools (field building, investment enhancement, opportunity generation) to extend existing investment practices to a system level.

Purpose. Self-styled "impact" investors have already taken a crucial step toward system-level investment by defining the purpose of their investments as incorporating "the intention to generate positive, measurable social and environmental impact alongside a financial return."[1] Development financial institutions such as the World Bank's International Finance Corporation and related institutions with their emphasis on poverty alleviation in developing countries are explicit about their similarly dual mission.

Intention is the key. Investors can expand their investment decisions to include ones that not only benefit themselves but the broader community at the same time; that are not solely for their private gain, but that simultaneously bolster public well-being. To find an investment that accomplishes this balancing act, intention is necessary. Identifying such opportunities does not happen by accident. Accepting the need for such balance is a crucial initial step in the transition.

Risk management. The concept of ESG integration is increasingly accepted by the investment community as a tool for portfolio management. It is the fundamental commitment made by the 2,000 plus signatories of the Principles for Responsible Investment.

The Sustainability Accounting Standards Board, the Global Reporting Initiative, the Business Roundtable and others have made it clear that the materiality of social and environmental issues for stockowners and for all stakeholders in corporations needs to be taken into account.[2] Investors must consider the risks to all stakeholders posed by environmental and social risks, as well as those to stockowners and their portfolios.

This intuitive understanding explains such recent developments as the emphasis on the "stewardship" of their assets by institutional investors such as Japan's Global Pension Investment Fund and the stress the *UK Stewardship Code 2020* places on the management of systemic risks, creation of long-term value, and consideration of ESG issues. Just as a steward guards the assets of the house and those assets are no more secure than the world in which that house resides, so investors guard the value of portfolios that are no safer than the economies that support them.

Tools. Investors have at hand a set of tools that can naturally extend their current conventional practices to a system level. Some are already well-established among sustainable investors. Others involve newer techniques now being pioneered.

Among current practices are avoidance, emphasis, and engagement. Avoidance means excluding individual securities or whole industries from portfolios because of their negative externalities (e.g. divestment of coal companies). Emphasis is the flip side of avoidance: the allocation of assets to viable investments with positive externalities (e.g. inclusion of solar power firms). Similarly, sustainable investors can use engagement with specific firms in their portfolios to improve social and environmental practices (e.g. increased disclosure of carbon emissions).

Investors can intentionally adjust their practice to emphasize system-level impact. They can extend avoidance to the setting of industrywide standards and norms with implications for society as a whole (e.g. labor and human rights standards for workers throughout supply chains). They can use security selection to go beyond ESG risk management to construct portfolios that provide positive models, visions of new worlds, in which investments solve systemic challenges (e.g. portfolios of firms creating circular economies) rather than simply profit from them. And they can expand their engagements with specific companies to help to align the interests of conflicting stakeholders within a system in order to facilitate its transformation (e.g. achieving a just transition to a low-carbon economy for labor and communities).

Among the newer techniques used by forward-looking investors are ten identified by The Investment Integration Project in its recent publications.[3] They fall into three broad categories:

- ***Field building.*** These tools increase investors' capability to act collectively by: founding and leading collaborative institutions and initiatives that address systemic challenges; sharing data relevant to systemic risk management; and advocating for public policy initiatives to limit systemic risks and enhance rewards.

- ***Investment enhancement.*** These tools aim to strengthen social and environmental systems themselves by: investing in or otherwise funding solutions to systemic challenges; promoting and adhering to global social and environmental standards and norms; and adopting diversified approaches to the promotion of system-level change.

- ***Opportunity generation.*** These tools change the nature of how finance impacts change in systems by: channeling funds to communities lacking access to social and environmental goods and services; concentrating investments and related activities in mutually supportive clusters within local communities; incorporating the inherent worth of social and environmental systems into investment decision-making; and taking full advantage of the social purpose for which each asset class was created when identifying investment opportunities within it.

These tools expand the techniques that investors can use to increase their influence at key leverage points within social, financial, and environmental systems to better manage their potential risks and rewards.

Seven Scenarios Illustrating Transitions to System-level Investing

The remainder of this paper outlines seven hypothetical scenarios portraying investors in the midst of a transition to a system-level approach. These scenarios illustrate the nature of these transitions through such things as the re-thinking of purpose, the expansion of their risk management techniques, and the use of tools designed explicitly for system-level influence.

To illustrate these transitions, we chose three different systemic challenges: climate change, income inequality, and availability of sustainability data. Each scenario focuses on an investor from a different silo of the investment world: pensions, diversified financials, foundations, family offices, insurance, and private equity.

Each scenario describes the investor and their current status relative to conventional or sustainable investment; the catalytic moment that prompts a decision to change; the challenges in moving forward specific to their institution; their preparation for overcoming those obstacles; the actions they take to do so; and long-term management considerations necessary once that transition to system-level investment has been made.

The purpose of these scenarios is to illustrate seven of the fundamental types of transitions that will arise no matter the type of system challenge or investor.

The scenarios assume investors starting from an initial minimal commitment to ESG integration and then portray obstacles that typically stand in the way of a transition to integration of an explicitly systemic approach and steps typically useful in that transition. They are stories about turning points in the journey to fulfilling the full promise of investment: to benefit society as well as the individual. Our hope is that these scenarios help investors today as they address the twists and turns on the road to realizing that potential.

Scenario 1 - Climate Change: A Pension Fund Confronts Climate Risks Across Asset Classes

Transition from:	Attempting social, financial, and environmental risk management solely at a portfolio level.
To:	Understanding that its risks also exist at system levels and that their impact can be managed.

The large public pension fund ABC with $150 billion in assets under management has for some time directed its internal and external managers to integrate climate change risks into their security selection when financially material - with, for example, fossil-fuel extraction firms, those dependent on fossil fuels as an energy source, and those whose primary products are substantial greenhouse gas emitters.

Three ABC Trustees were surprised when its internal managers across all industries and asset classes reported that climate risks are material. They immediately understood the implication of this development: the Fund cannot diversify away its climate change risks; there is no place to hide. They therefore concluded that ABC must take all feasible steps to minimize the long-term risk of climate change itself, rather than simply manage risks for individual portfolios or asset classes.

The trio faced a substantial challenge, however: despite these findings, their fellow Trustees, as well as their in-house investment staff were not convinced of the need to change their current practice. Indeed, having integrated ESG considerations into security valuation for their specific industries, they considered their job done.

Recognizing the need for data to convince these key stakeholders that their vested interests in the current approach was misguided, they began a campaign to change this perception. They first met with ABC's Chief Investment Officer (CIO), whom they considered a key point of leverage within the organization. They requested the CIO to commission a top-notch third-party firm to assess the material, systematic—that is, non-diversifiable—risks that climate change posed for the Fund. They also asked that the study recommend steps to contend with any such risks.

Although the study took 18 months at considerable expense, these Trustees believed it a crucial step in aligning interests. The study in fact showed that about 50 percent of the Fund's climate-related risks were not diversifiable and could not be avoided through security selection, asset allocation, or hedging options. In effect, it identified climate change as a market risk tied to the economy as a whole, and hence systemic.

These Trustees reviewed the study and its recommendations with the CIO, making a case for implementation of its recommendations. Among others, these included: modifying the Fund's Investment Beliefs Statement, proxy voting policies, and engagement with portfolio companies to reflect a system-oriented approach;

joining with peers to urge public policy initiatives to minimize global warming and to prepare for foreseeable disruptions; taking a leadership role in collaborative organizations among peers to amplify the Fund's influence; and sharing data and best practices with peers to build a common understanding of most effective next steps.

Having obtained support from the CIO, the trio then presented the report to the full Board. An extended nine-month discussion overcame internal dissension and the Board agreed to adopt the study's recommendations. It imposed one condition, however: any impacts on portfolio performance and the costs of implementation should be assessed biannually to assure that they do not conflict with those anticipated. The program was phased in over two years, with the first assessment scheduled after two years of full implementation.

Scenario 2 - Climate Change: A Diversified Financial Services Company Values Consistency

Transition from: Implementing sustainability products and related activities piecemeal.

To: Developing consistent principles for integration of systemic risk management into all asset classes and related investment activities.

The large diversified financial services firm DEF has a brokerage and asset management division with $500 billion in assets, commercial and retail lending operations, and an investment banking division that underwrites public equity and bond offerings.

In recent years DEF instructed its internal managers to integrate material ESG issues into their security valuation models, responded to requests from clients to screen their separately managed accounts on specific ESG factors including climate change, underwrote green bond offerings, and provided home mortgage discounts for energy efficient housing.

At last year's annual strategic management strategy retreat, DEF's top executives and leaders from the firm's three main divisions reported that market demand for climate-related products was growing rapidly.

The need to expand offerings across the board was clear. How to do so was not.

DEF's lending division was the first to see a pathway forward: it expanded its climate-risk assessment due diligence to all loans and initiated new product lines.

But they asked top management if they should refuse entirely to lend to high-risk climate-related businesses or real estate ventures, turning down otherwise potentially profitable lines.

Executives in its asset management and investment banking divisions faced a similar dilemma. Should all their investment products divest entirely from high climate-risk industries such as coal, oil, natural gas, refining, and oil-field services? Or only the most exposed?

Or should they develop a range of differentiated products to serve diverse client demand? Similarly, for investment banking: should they refuse to underwrite offerings for firms or projects with high climate risks? Should they underwrite any product that claimed to be a "green bond" or only those certified as such?

DEF's Executive Committee realized that piecemeal decision-making on such questions across divisions would lead to internal policy and public reputational confusion. Following the leadership of its CEO, DEF decided to adopt a company-wide position on climate change, a stance with political implications it previously had been reluctant to take.

Its initial investment and lending positions were limited—it would forego lending to and investments in companies substantially exposed to coal and only underwrite those green bonds that had met official Green Bond certification standards. It would continue to serve investment clients with different specific climate-change policies through products and services customized to their individual criteria. These policies were to be implemented throughout the firm's product lines in the coming year, with a review and possible expansion three years out.

In the meantime, the Executive Committee also decided to tackle a question not raised by the division heads: should DEF engage in additional activities that implied a more holistic approach? Although it recognized that the easy answer was not to go down that road, DEF's leadership decided that this more comprehensive solution to the challenge was indeed appropriate given the potential impact of climate change on the economy in coming decades. Consequently, the Executive Committee asked its division heads across the firm to devise innovative tactics in field building to position DEF as a thought leader, and its asset management group to research investment initiatives and enhancements to distinguish its product offerings.

Scenario 3 - Income Inequality: A Foundation Breaks Down Silos

Transition from: Implementing sustainability products and related activities piecemeal.

To: Developing consistent principles for integration of systemic risk management into all asset classes and related investment activities.

The $10 billion GHI foundation's primary missions are poverty alleviation, local economic development, and environmental justice, to which virtually all its grants are devoted. In the past five years, it has recognized income inequality as an exacerbating factor in each area and sought to address this challenge to accelerate progress toward its goals. Until recently, the foundation's grant-giving and investment operations have functioned separately. That has now changed. This shift was influenced by a trend in the philanthropic world toward system-oriented approaches to grant-giving.

Instead of single grants by one foundation to address an individual issue, coordinated programs among foundations have emerged, targeting systemic leverage points and collaboration with civil society and governmental agencies. The goal is to embed system-level change that can prevent undesirable outcomes, rather than fixing negative outcomes after they take place.

Cognizant of this development, the GHI Board decided to amplify its systemic influence in the area of income inequality by asking its investment team to coordinate its policies with grant-giving on this issue. When initially proposed to the investment team, the idea was met with stiff resistance. Nevertheless, the team agreed to conduct a study of best practice among foundations in similar situations. Twelve months later, the Board was pleasantly surprised with the staff's report. Although the report found little in the way of such coordinated efforts in the foundation world at the time, it did find that the global rise in income inequality was increasing the risks of political instability and hence of difficult-to-contend-with investment uncertainties.

Their report made three recommendations. The first was increased attention to labor and employee relations in security selection. Academic research showed a statistically significant positive contribution from the inclusion of this factor. Second, it recommended amending proxy voting policies to take a stronger position on excessive CEO compensation. Staff viewed this stance as unlikely to influence portfolio returns one way or the other, but as having a symbolic importance in changing cultural norms. Finally, after extensive debate, the staff decided to recommend participation in the growing calls by investors for increased transparency on corporate tax policies. Arguments that tax avoidance stood to benefit their returns were more than counterbalanced by concerns that any such short-term benefits would eventually be undermined by the long-term risks of weakening governments' resiliency because of loss of revenues.

The report prompted an additional unexpected result: GHI's grant-giving team decided to align its efforts with the investment staff's new initiative by supporting public policy organizations focused on workers in the gig economy and on tax justice.

The Board's five-year implementation plan for this coordinated initiative included the hiring of a developmental evaluator to guide it throughout the process and to help in the measurement of its impact, effectiveness, and progress at in attaining system-level change.

Scenario 4 - Income Inequality: A Family Office Meets a New Generation

Transition from:	Believing historical world changes will not necessitate evolutions in investment practice.
To:	Integrating practices that contend with today's emerging challenges to the stability and sustainability of fundamental social, financial, and environmental systems.

JKL Trust is a $3.5 billion family office with a single $500 million family as its principal client. In the past JKL has occasionally implemented limited social and environmental screens for its clients to accommodate one-off requests, but typically discouraged the practice.

Recently the youngest generation of their largest client assumed control of their assets. This cohort met to determine if they shared common interests. Emerging from this discussion was a consensus that the recent global upsurge in income inequality was having a deleterious impact on four pressing social and environmental concerns: climate change, labor and employee relations, human rights, and diversity. They therefore requested that JKL use the full range of the tools at its disposal to assure that their investments at a minimum were not contributing to this increasing problem and, if possible, could exercise positive influence.

JKL staff was taken aback by this request, but because it came from its largest client they did not feel it could be ignored. They conducted background research on investors addressing income inequality and discovered that financial industry compensation and tax avoidance policies were among suggested leverage points for investor action. These issues posed complications for JKL: managing clients' tax exposure is among its services. They also did not feel that it was appropriate to be raising questions about fees themselves.

Consequently, they proposed a limited approach: act on employee relations issues and, specifically, advocate for an increase in the minimum wage. Family members were disappointed and pushed JKL to expand the scope of its initiatives. After a full and frank discussion with family members, staff decided to add freedom of association, human rights, and supply chain risks to the mix, although some in the family wanted more. JKL also agreed to adjust is proxy voting policies for the family's funds to reflect these concerns.

Over the next two years, JKL's staff cautiously implemented this program. In the second year, it took the additional step of discretely joining with other investors in engagement with companies on these issues. During that time, JKL noted that the financial performance of the funds managed with these criteria did not differ significantly from that of their other portfolios. Toward the end of the second year, as JKL became more comfortable with this approach, the staff began mentioning this option to other clients and discovered unanticipated interest.

As it ramped up these initiatives, JKL encountered two obstacles. The first—the development of in-house expertise on income inequality and related issues—was resolved when it filled a newly created staff position with a specialist in these areas. The second—what metrics to use in the tracking and reporting on its impact—proved more difficult. JKL's initial step was to join the Impact Management Project, a global association of investors seeking to implement effective measurement methods.

Ultimately, its in-house specialist developed communications formats tailored to the concerns of specific family members and other clients, reporting on progress in addressing income inequality at the level of individual holdings in its portfolios as well as on positive developments at a societal level through shifts in public policy and transformations in public opinion. Throughout, it emphasized JKL's contributions to progress of these sorts.

Scenario 5 - Sustainability Data: An Insurance Company Puts Its Data to Work

Transition from: Failing to use the best scientific data available for investment purposes.

To: Adopting a unified approach to the management of social, financial, and environmental systemic risks and rewards based on comprehensive, material, scientific data.

MNO is among the largest insurance companies in the world with over $1 trillion in assets under management and $200 billion in annual revenues. Its primary business lines include life insurance, property and casualty insurance, and investment products. Its investment assets are divided evenly between its proprietary funds and those funds it manages for third parties such as public and private pension plans.

Since risk assessment is fundamental to its insurance product lines, MNO has tended to track risks of a social and environmental nature. For example, understanding the health impacts of tobacco has long been integral to its life insurance products. More recently, it has integrated analyses of the environmental impacts of climate change across its property and casualty lines.

Top management, however, has struggled with the relationship of social and environmental risks to its investment operations and, as a firm, it has not historically taken positions on the major social and environmental challenges of the day. When third-party clients instruct it to address specific issues for their accounts, MNO does so. It is less clear about what it should do with its proprietary funds and those third-party accounts silent on such issues.

Tobacco was the one issue on which MNO has long been clear. As a life insurance company, it has divested from tobacco companies across all its funds, proprietary or otherwise. Debates about taking similar steps on other social and environmental issues have ended in institutional stalemates. Some at the firm argued their only obligation was to maximize returns and that investment disciplines should not be mixed with political issues. Others asserted that they could not reasonably act on the harmfulness of tobacco and not on the risks of climate change, access to water, pandemics, income inequality and other systemic issues.

After years of inaction, a new CEO broke the deadlock. If scientific data was good enough for setting their products' premiums, he argued, it was good enough for their investments as well. Moreover, challenges such as climate change would only continue to worsen until whole product lines became so risky as to be uninsurable. The company's long-term prosperity depended on addressing the causes at the heart of these issues.

The CEO pointed out that, although their peers in the insurance industry have been slow to act, institutional investors have increasingly launched comprehensive programs to address a range of systemic risks.

He ordered a top-to-bottom reassessment of investment approaches for its proprietary and third-party assets including the development of consistent companywide policies and public policy advocacy to address the root causes of these risks.

The availability of reliable data for these issues being key, MNO decided as a core strategy to take an active role in promoting ESG through a range of disclosure initiatives. It assumed a leadership role in development of standards for material ESG data by the Principles for Sustainable Insurance, a coalition of major insurance firms. It also became a supporter of the call for mandated ESG disclosure as a requirement for exchange listings around the world that is being promoted by the UN-sponsored Sustainable Stock Exchanges coalition.

Scenario 6 - Sustainability Data: A Private Equity Firm Collaborates

Transition from: Assuming that sustainability data should be kept proprietary to gain individual competitive advantage.

To: Collaborating on the development of shared knowledge that provides a beneficial basis for all and the skillful application of which can create individual competitive advantages.

PQR is a $300 million fund-of-funds private equity firm with a social and environmental mission. It uses a fund-of-funds model, investing in a wide range of private equity funds that seek this type of impact.

As part of its due diligence for potential investments, PQR gathers data on the social and environmental impacts of the funds in which it invests. Because each fund has its own idiosyncratic methods of impact reporting, PQR devised a standard questionnaire to obtain comparable data. Given the extensive number of funds PQR considers and the need to keep current on those in which it has invested, data-gathering is laborious and expensive both for the funds and for PQR. Indeed, the funds frequently complain that completing these questionnaires is excessively demanding and a distraction from their daily operations.

Consequently, PQR has a strong interest in the development of an industrywide private equity standard for impact reporting. Private equity as an asset class has generally lagged others in integration of ESG into its practice. Only a handful of large firms have made substantial advances, although a healthy cohort of smaller impact-oriented firms is gradually emerging.

PQR staff is divided on how to manage this data-gathering challenge. Some advocate continuing to expand their current proprietary database, using it to gain a competitive advantage. Others argue that their efforts would be best spent on developing an industry-wide standard that would enhance its reputation.

Still others, citing the expense of the current process, advise cutting back, gathering only a limited number of key performance indicators that can capture most, if not all, of the substantive differences among funds.

After a months-long internal debate, management decided that single-handedly creating a comprehensive impact-measurement database in an ever-expanding universe of firms would be beyond its capabilities, and that a stripped-down version of its due diligence process would not be sufficient to fulfill its mission. They opted instead to promote a collective industry data-gathering system.

To do so, in addition to allocating an in-house staff member entirely to gathering and analyzing impact data, PQR joins working groups on the integration of social and environmental principles into private equity management, such as the Principles for Responsible Investment. In addition, it commissions academic research on how impact reporting might best be tailored to private equity and joins with peers to launch an annual award for the best reporting by a private equity fund. It also proposes and then initiates the creation of a publicly-available database that would allow private equity firms to self-report on a standard set of impact metrics. In providing leadership on these initiatives, PQR hopes not only to enhance its own reputation within the industry, but also to benefit industry as a whole, improving its assessment and measurement tools and bolstering its current somewhat shaky overall reputation.

Scenario 7 - Pandemics: Investment Consultants Meet Client Demand

Transition from: A passive role in considering issues of strategic importance to multiple clients' investment success.

To: Leading development of shared knowledge of the potential investment implications of systemic issues and identifying relevant opportunities for investment and policy influence.

STU is an investment consulting firm with over 50 institutional clients. Most of the firm's clientele are either public retirement funds or Taft-Hartley multiemployer trusts. STU is organized with a Client Group responsible for client-facing investment advice and relationship management, and a Research Group tasked with understanding and recommending investment strategies and products for the firm's clients. At the firm's monthly update meeting between representatives of the Client Group and Research Group, two of the firm's investment consultants reported on five client meetings in the prior month. At four of those meetings, several trustees expressed concerns over their Fund's exposure to social risks that have become more prominent during the Covid-19 pandemic. The events discussed included large demonstrations across the country focused on racial equality; uneven public support of growing numbers of unemployed workers who cannot keep up with their housing rental or mortgage payments; and a syndicated article in a prominent newspaper that anticipates a sharp increase in personal bankruptcies as growing numbers of furloughed workers lose access to employer-sponsored health insurance.

In all four meetings, the investment consultants note that the Fund investment staff and Fund counsel cautioned trustees to stay within the bounds of their fiduciary duty to seek the highest risk-adjusted returns for the beneficiaries of the Fund. In the case of one Taft-Hartley Fund, the discussion amongst trustees and staff became heated, with accusations made of politicizing the Fund's activities. The investment consultants indicated that beyond discussing STU's point of view related to the pandemic on the pharmaceutical industry's prospects and exposure to biotech in a private equity fund of funds held by each of the Funds, they sought to stay neutral and relatively quiet during such polarizing debates.

A relatively new member of the Research Group suggested that while the issues have political relevance, they also have impact on portfolio returns, which prompted additional discussion of the potential performance of mortgage-backed securities and pharma and insurance stocks held in the Funds. The Research Group member interrupted this conversation after a few minutes to clarify that she had in mind more systemic effects on returns if social unrest and insecurity were to persist for more than the immediate health crisis.

The head of the Client Group stated flatly that those were concerns for the ballot box and concluded the discussion with various administrative matters.

Subsequently, the Research Group member developed a proposal for STU to lead a table-top exercise with its clients to examine the potential investment consequences of a variety of plausible scenarios related to deteriorating social systems. The head of the Client Group warmed to the proposal, noting that by approaching the issues initially with a view to exploration and education, Fund decision-makers would be well within their fiduciary responsibilities. Further, the Client Group head suggested bringing together clients for a summit meeting to conduct the table-top exercise, offering further value to clients by connecting them with their peers and enriching the scenario analysis with a variety of viewpoints.

The first such summit is held seven months later and includes presentations by several policy analysts and economists to help facilitate and frame the scenario analysis. Representatives of eight of the Funds' staff and trustees attend, and the day's discussion ends with recommendations to focus their public policy advocacy on economic resilience (including new approaches to unemployment insurance processing) and ideas for further investment research with the potential to apply catastrophe bond structures to residential rental payments.

Conclusion

For investors wishing to make the transition from conventional and sustainable investment to a rigorous system-focused approach, the seven scenarios outlined in this paper show how the challenges they will confront vary, the obstacles to implementation are substantial, and the circumstances that move them to action differ, as do the tools they can choose to overcome them. Nevertheless, these investors share common goals: minimizing the risk of social and environmental systemic crises and contributing to the health of systems that can create a rising tide of investment opportunities for all.

Long-term investors depend on the sustainability and stability in the social, financial, and environmental systems that increasingly characterize the complex and interconnected world of the 21st century. Without a reset of mindsets to transition today's practices to contend with these challenging realities, they cannot realize the full potential of investment to benefit all and one simultaneously. This is not a goal too far. Achieving it is within our reach.

Acknowledgements, Authors, Disclaimer, and About TIIP and MMI

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About TIIP and MMI

TIIP. The Investment Integration Project (TIIP), founded in 2015 by Steve Lydenberg and William Burckart, helps investors understand the impact and big picture (or "system-level") context of their portfolio-level decisions. This is important because "system-level" events, such as economic crises, ecosystems under stress, and societies in turmoil can disrupt the best-laid plans of investors and cost them dearly. Even seemingly "local" issues are now having much greater impact than they once did as the world becomes increasingly interconnected. TIIP designs, provides and maintains data, tools, and expertise that enable institutional investors to make this important connection between portfolio-level decisions and systemic considerations. Investors leverage TIIP's applied research and consulting services to solve program inefficiencies, enhance impact measurement, and boost long-term value creation. More information is available at www.tiiproject.com.

MMI. The Money Management Institute (MMI) is the industry association representing financial services firms that provide financial advice and investment advisory solutions to investors. Through conferences, educational resources, and thought leadership, MMI facilitates peer-to-peer connections, fosters industry knowledge and professionalism, and supports the development of the next generation of industry leadership. MMI member firms are dedicated to helping individual and institutional investors, at every level of assets, plan for and fulfill their financial goals. For more information, visit www.MMInst.org.

Endnotes

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