Verus

Sound Thinking

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The judgmental waiter

Who decides? ESG in institutional investing

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Imagine a large family gathering. Three generations are coming together in a restaurant to celebrate a family occasion. Everyone is glad to see each other, catch up on family news, and meet the new babies that have arrived since the last gathering.

Now imagine the conversation that might ensue when they start to order from the family-style menu. The restaurant is Italian, and meat is featured prominently for the evening. This works well for most, although Cousin David has become a vegan recently (he isn't happy about the meat being cooked in the kitchen – especially the veal), while Uncle Doug is on a keto-based diet and can't have any of the carbs. Aunt Jeanne is happy to eat whatever works for everyone else, but for a whole other branch of the family, serious religious restrictions dictate what they can eat. And the children want chicken nuggets, while the grandparents have low sodium dietary requirements (there goes the dried sausage). And doesn't Zac's severe food allergy mean nuts can't be prepared in the same kitchen as the dinner?

It's not unusual to encounter such a scene in any restaurant, and we know that every family group will manage to accommodate preferences in its own way, balancing the contradictory needs and appetites around the table, and arriving at a food order that will ultimately work best for the group as a whole. Not everyone will be completely happy, of course, but at least most or all of the family will leave the table full. Each family group will have a slightly different center of gravity, based on who is at the table, what's being celebrated and what the restaurant offers.

So far so good. Now let's throw a twist into the picture. The waiter.

Imagine that the waiter doesn't just take the order. Imagine, instead, that he gets into a discussion with the family members. Let's say the waiter is a committed vegan, and tuts disapprovingly over every steak order, muttering under his breath about cholesterol and cruelty. Or let's say the waiter launches into a lecture about "how most gluten allergies aren't real" to the family member who suffers from celiac disease. Or starts to list the rights and wrongs of religious animal slaughter with the family members who can only eat ritually pure meat.

Not many people would think that was appropriate. Not because it's wrong for the waiter to have those views, but because it's the wrong forum for him to express them. It's perfectly OK for a waiter to be a passionate vegan – less so for that passionate vegan to attack carnivorous diners. The role of the waiter is to outline what's available from the restaurant, to help the diners decide what works best for them and their needs, and to make sure that they get their meal order accurately and on time.

Now let's add a final twist into the mix: Imagine that the family members being waited on aren't ordering for themselves but for another broader and more diverse group of people. Their own tastes become less important than the needs and tastes of the broader group they're ordering for.

Enough about food. You can tell that this isn't really about food and families, but about ESG, boards, and the role of the consultant in the mix. The investment board is the family doing the ordering, and the consultant is the waiter. The customization of the order represents the ESG framework that the investment board wants to implement, and the broader group they are ordering for represents the beneficiaries of the money (pensioners, grant recipients, and so on).

ESG — why now?

The topic of the environmental, social and governance components of investment has become much more important over the last 10 years. Some segments of the marketplace and certain regions of the world have focused on it more deeply than others. It has been particularly important to European investors, who share the same worldview on many of these issues, and a popular topic of conversation within the college endowment, religious, and environmental charity communities. Client demand in this space has increased significantly in the retail investment market, prompting many retail investors to take a closer look on the impact of ESG on their investments.

To understand ESG issues properly and to make sure we are addressing the literature and products in this space thoroughly, we need to carefully unbraid a number of different strands of thinking that are too often combined into a single thought.

WHAT ARE WE TALKING ABOUT?

When we talk about ESG issues we must be careful to avoid pulling ourselves up by our own shoelaces. If "ESG investment" simply means doing what investors have done all along, but sticking a different label on some parts of the process, then it is unlikely to meet the ESG goals of the investor, and will likely also fail to capitalize on the possible investment benefits they may believe are to be gained by that strategy.

The environmental, social and governance dimensions of investment have always been part of the normal investment process, and investors have always taken them into account in many ways. A company that has terrible governance is not likely to look after its shareholders: sensible investors have always been aware of that risk. A company that is habitually fined for breaching environmental laws is likely to have a higher natural earnings stability risk: sensible investors will discount the present value of the company accordingly. A company that engages in socially irresponsible behavior of the flavor that will attract regulatory, legislative or (worse) police scrutiny will probably already have that risk embedded in the normal analytical process.

For "ESG investment" to mean something, it has to be about something more than normal, prudent investor behavior. Simply passing off the typical processes you would do anyway as "ESG related" is better described as "greenwashing".

WHAT DOES THIS MEAN FOR INVESTORS?

There are two basic ways that investment managers could take ESG factors and issues into account when thinking about their investment processes[1].

The first relates to the actual investments themselves. They may choose to buy different assets, or buy assets in different weights, based on a range of ESG criteria related to the assets themselves. There are a range of different ways they can implement this – the details are beyond the scope of this piece.

The second relates to the way that the manager votes proxies and engages with management of companies in which they invest client money. The issues they choose to engage on, the point of view that they apply, and the way in which they vote all have weight and importance; and they only have that weight and importance because of the size of client money the manager is investing. Companies care about the expressed views of a manager in direct proportion to the size of the holding in the company[2] that the manager has – but in reality, of course, it is the client's money and, therefore, the client that holds the power.

In each case, the manager is expressing views on a range of issues through actual investment actions, proxy voting, and engagement decisions. What matters, surely, is the views that are built into the purchase and sale decisions, and that are advocated by the proxy and engagement teams, are ones the investor supports.

Who decides what matters?

When we are talking about retail investment, the question of "who decides" is easy: the investor herself. She earned the money being invested, she likely has a clear idea of her values and she can, with a little help from an advisor, work out how to express those values within the context of an investment portfolio.

Things get more complicated, though, when we move into the institutional marketplace. The sums of money involved in each relationship are generally much larger, so the decisions are of more

1. *Details of different ESG approaches and how they fit into active management assessment is something we will address in detail in a Topic Of Interest publication during 2020.*
2. *Or maybe the size of potential holding in some cases.*

consequence: both from the standpoint of the effect on the supply of and demand for assets, and also in terms of the impact on the “perceived voice” of the manager who is voting proxies and engaging with companies on behalf of the investor.

The “voice”, though, is actually owned by the investor – not the manager, who simply exercises it on the investor’s behalf.[3] In the institutional space the “investor” is represented by the board, although they have to act in the best interests of the beneficiaries[4].

In other words, the board is the group that should be deciding the ways in which the assets are invested, and the ways in which votes are made and engagement pressure is applied, and they should come to the decision about how these votes should be cast on the basis of the interests of the fund as a whole, not on their personal opinions or beliefs alone.

So, for example, a personally pro-choice doctor who sits on the board of a Catholic health care institution with a strong historical and theological position against abortion is likely to feel that it is appropriate to vote in favor of a policy that embeds a pro-life viewpoint in the investment approach of the institution (at least in terms of investment approach, and possibly in terms of proxy voting and engagement). The personal views of the individual board member need to be integrated with the institutional views and interests of the organization for which they are a fiduciary.

Most important: it is neither the manager nor the consultant that needs to decide the balance of views that should drive the investment, voting, or engagement process. It is the board, acting on behalf of the organization as a whole (pensioners, donors, grant recipients, etc.)

How should the investor decide?

This is in practice often a difficult question to answer because what boards have to do in this space is in some ways quite different from what they normally do. The normal job of the board is to focus on investment questions – selecting a level of risk, worrying about asset allocation, deciding on which investment managers to use, and so on. Instead of these questions they now must focus – and worse, try to agree – on a range of topics which often take on broad social and or political dimensions. Few people hold a strong personal commitment to how to parameterize a risk model, but most people have deeply held views on the correct approach to climate change[5], wealth distribution, and union representation on corporate boards.

What this means is that the board is likely to have to spend some time assessing the issues collectively. This will involve building an understanding of how these issues impinge on investment outcomes. Unfortunately, there are few clear answers in academic literature, as the research is mixed regarding

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3. *A good parallel is the law around trading commission generated when client trades are executed by brokers – the commission is an asset of the client, not the manager, and the manager can use that commission only where it is in the interest of the client.*
4. *Apologies to all lawyers for this very approximate summary of the fiduciary obligation of boards – but the general point is, I think, accurate and clear.*
5. *And, indeed, in plenty of cases even the existence of it..*

whether the impacts of ESG decisions are positive or negative on investment performance. Investment boards will need to discuss the collective goals and beliefs of the institution itself and consider the longer term effects of each potential action on stakeholder reaction and concerns. It is possible the decision may not take much time, if the board quickly finds agreement or regard the topic as inappropriate for the institution they represent. But we believe it will require, more often than not, a significant allocation of a board's time and energy to land on the correct result that everyone would be comfortable with.

Board, manager, consultant

This then draws into sharp relief the differences in role between the investment board, the investment manager and the investment consultant.

The investment board is responsible for the investment program as a whole. If they choose to express a view on ESG issues, this should be done clearly. This view on ESG issues might range from the opinion that they have no place in the investment program, to the opinion that the entire program should be focused on ESG-targeted investment. As long as those views comply with regulatory and fiduciary policy, and the likely investment implications are understood, they should be translated into the portfolio. Correlatively, if the investment board does not express a view, then the portfolio assets should not be invested[6] in a way where they are used to express ESG views. Therefore, the ESG approach of managers hired should be clearly expressed, and the role of the clients' assets in the voting of proxies and ownership engagement should be clearly understood.

In other words, the portfolio should represent the views of the investor, properly arrived at.

Investment managers play a different role. These managers build products and consider both investment outcomes and their own business and marketing strategy when they do so: quite appropriately, too. If the manager decides to offer an ESG product to clients, then the ESG views they embed in their portfolio management process and engagement and proxy-voting process will reflect that decision: partially the ESG views of the firm itself, partially the view the firm has relating to the investment opportunities generated by different ESG issues, and partially the view of the size and scale of the marketing and business opportunity offered by different levels of ESG engagement[7]. Each manager will target their approach towards a specific part of the marketplace. If a client has views that are fundamentally incompatible with the positioning of the manager and the manager's decision to offer an ESG product, then the client will likely select another manager who can better serve them. Managers state a position and then service clients that are comfortable with that position. It is completely appropriate for them to advocate for the position they have chosen, as long as they are comfortable that when they perform advocacy that they are doing so with the informed agreement of their clients.

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6. *Or, probably, proxies voted or engagement entered into.*
7. *This latter point is particularly important for managers doing business in Europe, where ESG investment approaches are almost a requirement for being hired.*

Consultants, however, are in a different role entirely, whether they are acting as a non-discretionary consultant or an OCIO provider. The consultant may have a very strong viewpoint as a specialist ESG consultant, but in most cases, they will serve clients with a broad range of social and political views. Some clients will be very liberal, others very conservative, and each one will bring that to an ESG conversation. Some will have strong religious or labor-focused views. Others will have strong environmental views in favor of climate change-oriented approaches or will be strongly opposed to the very concept of human-made climate change altogether. Yet all these different clients share one thing in common: they are the first fiduciary, and their institutional view is the one that should be implemented in their investment portfolios.

The consulting firm equally owes each of these clients a duty of neutral advice. It should be able to help each investment board discuss ESG issues without a notion that there is a pre-ordained "right" answer, and then help the investor build the resulting implementation into their portfolios with full fidelity, honesty and commitment. This implies, to the extent possible, firm-wide neutrality on the issues involved. Individual consultants may well hold deeply-held personal opinions, just like the waiter in our example. They should, indeed, be free to express them in the right context, and there will often be a close parallel between the views of the individual consultant and the clients they serve, which is right and proper.[8] But they can best do that within a framework of neutrality.

Where does Verus sit?

That position of positive neutrality describes exactly where we at Verus feel we should sit in this discussion.

As a group of individuals, we strongly encourage diversity of viewpoints because having a broad range of views and backgrounds at the table makes us stronger as a firm and helps us give better advice based on better decisions. We try to walk softly and are aware of our footprint on the world. We encourage and support the charitable activities of our colleagues. We recycle, work in efficient buildings, and use videoconferences rather than travel by air where practical.

And at the same time, we recognize that we are like most firms in today's America. Our colleagues are independent voters, Hillary voters and Trump voters[9], liberals and conservatives, environmentalists and skeptics, second amendment opponents and enthusiasts, pro-choice advocates and pro-lifers, and so on. And that's the way it should be, because that's who our clients are.

Our role in the ESG discussion isn't to take a side. We believe understanding the impact of your investments can be a sensible and laudable thing to do, and it can fit well within many investment programs. We also believe different organizations and different boards will come to different

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8. *There are likely few Taft-Hartley consultants, for example, who spend the weekend campaigning against unionization of workplaces, or consultants who have a franchise in environmental charities that protest in favor of nuclear power and widespread fracking.*
9. *Plus at least one CIO who is unable to vote at all in the United States, being a foreigner who loves living in this great country but isn't a citizen of it.*

conclusions about what that means for their organization – and that in some cases those conclusions will be the exact opposite of those drawn by others of our clients.

At the same time, we regard the rise of ESG data and expertise as an extremely important development in the marketplace, and this will continue to be an increasingly important topic for our firm and our consultants. All our consultants, consulting associates and investment staff receive full formal training in ESG issues. We are in the process of providing a formal ESG rating for all products we cover formally: this will be completed later this year. We are writing a number of papers looking at ESG issues in risk modeling, board decision making, manager selection, and portfolio construction. And we have many consultants, consulting associates, and investment professionals working in the space to support our existing ESG-focused clients and to develop further intellectual capital to help those clients.

We believe our role in this conversation is to be expert in the details, to be aware of where each of the managers we use stand regarding their roles and capabilities, to understand the issues and tools available, and to help each client construct the portfolio that's right for them. We do not believe we should be advocates, as a firm, for one particular approach. We do believe we should be advocates for each of our clients – and for their specific approach, whether they are PRI signatories or believers that ESG issues should be kept off the table altogether.

ESG, then, is important. It may even be very important. It's certainly much too important for us to want to impose one particular viewpoint on our diverse clients or our diverse employees. We will continue to work tirelessly to make sure that our clients can decide how to approach these issues, and then build their portfolio to efficiently and effectively represent that view.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for 25 years, and is the proud father of two children.

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ABOUT VERUS

Verus is an independent, employee-owned provider of non-discretionary consulting and discretionary management (i.e., OCIO) services to a wide variety of institutional investors, representing over $431 billion in assets*, including endowments and foundations, public pension plans, corporate defined benefit and defined contribution plans, and multi-employer trusts. Verus, renamed from Wurts & Associates in April 2015, has been advising institutional clients since 1986.

**Includes Verus' total assets under advisement; preliminary as of 1/1/2020.*

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