SWFs BEGIN TO EMBRACE THE BENEFITS OF ESG

Martin Skancke

Founder & CEO, Skancke Consulting and Chair, Principles for Responsible Investment

Investors have had no shortage of reminders of the risks posed by poor corporate governance. Shareholders in Volkswagen saw the value of their equity almost halved following the emissions scandal that engulfed the car maker last September. Corruption at Petrobras has contributed to a near 80% slide in its share price since mid-2014. Pharmaceutical giant GlaxoSmithKline has been repeatedly rocked by bribery charges. Indeed, poor governance across the finance sector contributed significantly to the 2008-09 financial crisis.

Despite the destruction of shareholder value wrought by poor governance or outright illegality, many institutional investors – and sovereign wealth funds (SWFs) in particular – have opted to remain silent in the wake of scandal. They have often failed to hold company management to account. And they have acted as passive actors when their interests, and those of their beneficiaries, would have been best served by them exercising their rights as the owners of the companies in question.

[1] I am grateful to Matthew McAdam, Athanasia Karananou and Olivia Mooney at the PRI for their help in preparing this article.

One of the six pledges that institutional investors make when they sign up to the UN-supported Principles of Responsible investment (PRI) is to become "active owners", and incorporate environmental, social and governance (ESG) issues into their ownership policies and practices. We believe that applying this principle, and the other five on which the PRI rests, can have a positive impact on investment performance, and will better align investors with the broader interests of society. Why do we believe that, and how might investors, including SWFs, best pursue active ownership?

Clearly, the most important reason is that governance failures can lead to substantial financial losses. Indeed, of the many so-called 'non-financial' factors, it is failures of governance that can most directly lead to substantial losses. Where environmental and social factors can often weigh on a company's financial performance over long time periods, governance scandals can have immediate financial impacts. Moreover, it can be argued that the majority of environmental and social impacts are themselves the result of poor governance – whether at Volkswagen, the breakdown in employee relations at South African platinum miner Lonmin that culminated in the Marikana shootings in 2012, or the safety failures that led to BP's Deepwater Horizon disaster in 2010, for example.

There is considerable empirical evidence that supports this. In a meta-analysis of some 200 high-quality academic papers, a landmark study [2] by the University of Oxford and Arabesque Partners came to the somewhat intuitive conclusion that "the majority of current studies suggest that superior governance quality leads to better financial performance." Specifically, it cites a study finding that a portfolio that goes long well-governed firms and short poorly governed firms created an annual outperformance of 10% to 15% over the period 1990 to 2001.

The analysis also found that portfolios weighted towards companies with improving ESG metrics outperform those with strategies based on static ESG criteria. "It is therefore logical for investors to seek to influence the companies into which they have invested in order to improve the company's ESG metrics," the report says.

This approach has found real-world expression in the 'CalPERS effect', where engagement by the California pension giant with companies on corporate governance has shown to be correlated with improved performance. Specifically, in 2014 CalPERS, which was also a founding signatory to the PRI, disclosed that the 188 companies it engaged outperformed the Russell 1000 index by an average of 14.4% over the five years after the engagement began. In the three years prior to engagement, they lagged the index by nearly 39%, on average.

The assumption behind these figures is that "many corporate assets are poorly managed and that resources spent on identifying and rectifying those cases can create substantial opportunity and premium returns for active shareholders," according to Andrew Junkin, Managing Director at investment advisors Wilshire Associates, who wrote the report analysing the findings for CalPERS.

There are other reasons for institutional investors to devote more attention to the governance of the companies in which they invest. The first is the 'agency problem', where company management, acting as agents to company shareholders, may seek to act in their own interests rather than those of the shareholders. Possibly the most egregious example was the collapse of Enron in 2001, when company management engaged in false accounting to inflate the value of Enron's stock.

The second is that poorly governed companies may expose their investors to indirect reputational exposures. A case in point was a Dutch TV programme in 2007 that revealed investment by

[2] Clark, G; Feiner, A; Viehs, M: From the Stockholder to the Stakeholder, How Sustainability Can Drive Financial Outperformance. University of Oxford, Arabesque Partners, 2015.

some of the country's leading pension funds in manufacturers of cluster munitions and landmines. The UK's Church of England pension fund was caught out in 2013, when it emerged that it had a small investment in Wonga, a pay-day lending firm, at the same time as the Archbishop of Canterbury was campaigning against what he argued were "unethical" practices by such firms.

SWFs are far from immune to such exposures. Norges Bank Investment Management – which manages Norway's oil fund – has faced criticism over an alleged lack of oversight at SCA. Last year, evidence emerged of corruption around expense claims and the misuse of corporate jets at the Swedish financial services group. Other investors accused NBIM, which had an 8% stake in the company, of failing to hold executives to account.

There are also reasons specific to the nature of SWFs that reinforce the case for their embrace of leading corporate governance practices. First, as significant investors, they often hold much larger stakes in individual companies than most institutional investors. Since ownership in many companies is very fragmented, even a shareholding of a few percent can make an investor one of the top 3-5 owners and ensure that an investor's voice is heard clearly at board level.

Second, SWFs also tend to be long-term investors. Again, this gives their views more weight at board level. It also means that they are able to capture the improved share price performance that follows improvements in corporate governance.

Third, SWFs are often 'universal owners', with diversified portfolios across most major equity markets. For such universal owners, many ESG-related externalities are internalized in the overall portfolio: while an individual company may prosper by tolerating worker exploitation in its supply chain, or by dumping pollution into the environment, other companies in its portfolio, and the wider society and economy, are likely to bear the costs. In corporate governance, bribery is a case in point. While one portfolio company may win a contract by paying bribes, a more ethically run company in the same portfolio loses out. Meanwhile, the corrupt payment is lost into the black economy. Finally, the counterpoint to reputational risk is reputational advantage. Since the financial crisis, the investment community has suffered from a trust deficit. SWFs in particularly – especially those outside the OECD – have been perceived as opaque and viewed with suspicion by many stakeholders. Transparent, publically communicated corporate governance policies offer SWFs the opportunity to present a different face: one of responsible investment with the best interests of their investee companies and beneficiaries (ultimately their country's citizens) at its heart.

There are, of course, countervailing pressures discouraging SWFs – as with other large investors – from stepping up their oversight of corporate governance. Some have traditionally avoided transparency, given their size and concerns they could disrupt markets by making public pronouncements. The perception that SWFs may have political, rather than purely investment objectives, has also encouraged some to take a deliberately passive approach to investment.

But, to a large degree, SWFs are no different to other classes of institutional investor: most are just beginning to appreciate the advantages of better managing ESG, while a small number have taken a lead.

Certainly, among SWFs, a handful of funds have developed market-leading responsible investment policies and procedures. One example is Norway's oil fund – the Government Pension Fund Global (GPFG). The fund has been vocal in terms of setting out the standards of corporate governance it expects from the companies in which it invests. Its manager, Norges Bank Investment Management, also a founding signatory of the PRI, publishes annual responsible investment reports on behalf of GPFG, setting out the principles to which it adheres and its activities in the previous year.

It is an active owner, using its votes to promote good corporate governance and, since last year, publishing its intentions ahead of shareholder meetings. In 2015, it voted against 9,000 company-backed resolutions. And it does not shy away from divestment: last year, it sold out of 73 companies on environmental or governance grounds.

Other funds have also developed sophisticated responsible investment policies. New Zealand Superfund, for example, has developed a comprehensive Responsible Investment Framework[3] that sets out how it integrates consideration of ESG issues into investment decision-making. That framework is based upon the PRI's six Principles, and standards such as the International Corporate Governance Network (ICGN) guidelines on proxy voting, and UN Global Compact principles for corporate responsibility.

Among other things, it stresses its active ownership of the companies in which it invests, to encourage high governance standards and to enter into dialogue with companies that significantly breach standards to encourage improved practice.

Similarly, Australia's Future Fund takes the view that "good governance (i.e. how an organization is structured, operated and controlled and how it manages environmental, social and regulatory risks and opportunities) protects and creates investment value". To that end, it has set out nine voting principles relating to, inter alia, corporate disclosure, shareholder rights, board composition, oversight, poison pills and remuneration systems.

Meanwhile, and perhaps less publicly, some of the older sovereign funds have become more active shareholders. According to a recent investor relations survey[4] by Bank of New York Mellon, 65% of 550 respondents from publicly listed companies had communicated with SWFs in 2015, up from 57% in 2013. Overall, 42% had engaged with NBIM, 38% with the Government of Singapore Investment Corporation, and 30% with the Abu Dhabi Investment Authority.

So what steps should be taken by SWFs that want to implement best practice on corporate governance? The good news is that there is a substantial body of experience, frameworks and advice available. As a starting point, there are a number of governance standards and codes aimed at institutional investors in general, and SWFs in particular, that provide an initial framework for improved corporate governance performance.

Of particular relevance are the so-called Santiago Principles. Launched in 2008 by the International Working Group of Sovereign Wealth Funds, the 24 voluntary "Generally Accepted Principles and Practices" (GAPP) cover all aspects of SWF activities. GAPP 21 directly addresses governance. It recommends that, if an SWF chooses to exercise its ownership rights, it should do so in a way that is consistent with its investment policy and protects the financial value of its investments. It should also publicly disclose its approach to voting securities.

Other standards include the UN Global Compact, stewardship codes developed by various governments, including those of the UK and Japan and, of course, those developed by the organisation that I chair, the PRI, which has a wealth of tools and resources to help signatories get started.

More generally, stewardship and corporate governance should be framed within the bigger picture of managing ESG or non-financial risk. Such risks might better be understood as 'future financial' risks – that is, risks that have not yet found expression in a company's financial performance.

We would argue that it is incumbent upon all institutional investors, including SWFs, to understand these risks (and opportunities). This requires resources: from external investment consultants and, internally, in terms of training for existing staff, and possibly hiring a dedicated internal responsible investment and corporate governance specialist.

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3 https://www.nzsuperfund.co.nz/sites/default/files/documents-sys/Responsible%20Investment%20Framework.pdf

4 BNY Mellon; Global Trends in Investor Relations 2015: A Survey Analysis of IR Practices Worldwide, 2016.

Meanwhile, all large investors should put in place policies and processes to ensure that corporate governance as well as social and environmental issues are addressed in the investment policies and process.

In conclusion, the evidence of the business case for embracing best practice corporate governance is compelling. The tools to help SWFs do so are widely available. The experience of those SWFs that have led on this issue paves the way for others. The financial benefits await.

Specifically, investors should:

Develop and publish clear responsible investment policy and investment beliefs. These are important in signaling intentions to staff, external managers, investee companies and beneficiaries.

Apply those beliefs to their investment mandates, including requiring that managers monitor and report back on implementation.

Consider the use of proxy voting firms, if they have a very large number of holdings that make active ownership challenging.

Consider the use of longer-term performance metrics for managers.[5]

Cooperate with their peers. The PRI's Clearinghouse, for example, has brought together institutional investors to engage collaboratively with companies on issues such as director nominations, anti-corruption, and integrating ESG issues into executive pay.

5 See discussion in Measurement, Governance and Long-term Investing, World Economic Forum, 2012.