ON PURPOSE:

towards a unified theory of

responsible investment

Working paper

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ABSTRACT:

A functional framework for responsible investment is necessary for quality and consistency in selection, differentiation, and evaluation of varied responsible investment applications as used by investors and / or their service providers. Understanding responsible investment as an intervention aimed at correcting for gaps in conventional financial markets' recognition of real value provides such a framework. Using this framework enables universal investors and those with similar economic interests to identify offerings capable of meeting their needs.

SHIFTING FOCUS FROM WHAT RI OFFERINGS ***ARE***;

TO FOCUS ON WHAT THEY ***DO***.

The Responsible Investment (RI) field spans products and services whose diverse rationales range from religious observance to risk management. Attempts to structure the field typically focus on *describing* these varied perspectives, and the feature permutations investors encounter in investment products corresponding to each.

Such field guides are useful for newcomers, but a *principled* structure is needed for the more advanced task of designing and differentiating RI offerings for their RI quality. This becomes increasingly urgent as commercial and compliance incentives to market RI products grow.

REAL VALUE

Fundamentally, investing is about providing the capital needed to create value in the real economy, in pursuit of a commensurate financial return. 'Real value' includes traded goods and services, but also value inherent in untraded and intangible assets, like clean air, a healthy population or institutional integrity, that are fundamental to prosperity.

Investment *practice* departs frequently from this purpose, as financial activity has grown more independent of the real economy. Although beyond the scope of this paper, the following sample conveys the extent and entrenchment of the disjunctions:

- Investment markets assimilate a single (financial) measure, which ignores the multidimensional and often un-monetised 'real world value' result.

- Financial market feedback to the real economy is further distorted by the weight of non-fundamental activity that sways financial measures (e.g. indexing, low tracking error, momentum strategies affecting securities prices).

- Agency and intermediation alter incentives that would otherwise align capital flows with value creation (for instance, when an investor "must keep dancing" to remain commercial[1]).

Responsible investors recognise these shortcomings and intervene to restore this purpose to investment practice. We view this purposeful intervention as the principle underlying all intentional RI activities and offerings. This principle unifies the field; generates a coherent framework for the design of quality RI offerings; and supports meaningful evaluation and comparison of diverse RI offerings.

[1] "…as long as the music is playing, you've got to get up and dance. We're still dancing," - Chuck Prince, CEO. Citigroup, July 2007.

INTERVENTION

PORTFOLIO INTERVENTIONS

The simplest RI intervention involves voluntarily limiting exposure to opportunities the investor sees as inconsistent with creating or protecting ‘real value’ (as described above). For instance, many investors exclude the tobacco industry from their portfolios, to insulate them from risks *and returns* obtained by harming human health. By reducing their exposure to investments they see as destroying value, regardless of their financial returns, this intervention improves the portfolio’s alignment to *the purpose of investment*, described above.

Variations on this approach abound.

RI *selection* applies criteria to yield a permissible universe, and may use sustainability scores or specific industries (e.g. clean energy) as proxies for ‘real value’ creation. Impact investing is the subset that asserts the purpose of investment directly, via accountability for ‘real world’ outcomes as well as financial results.

Further variation results from differences in the scope, thresholds, or units of analysis used in portfolio interventions. For instance one portfolio may exclude exposure to thermal coal miners and their supply chains; while another restricts its carbon ‘footprint’ to half that of its benchmark but is flexible as to how that is achieved.

MARKET INTERVENTIONS

ESG integration is a more complex intervention that aims to bend *general* investment practice toward its purpose. By extending investment analysis to indirect, intangible and overlooked issues, its supporters ascertain, authenticate, and propagate relationships between real value, risk and expected returns. For example, investors whose analysis of mining companies encompasses the wellbeing of local communities may better predict *which* company's expansion plans will achieve needed approvals to proceed, and use this insight to position their portfolio for superior returns.

Whereas portfolio interventions realign a *portfolio* to the purpose of investment, ESG integration aims to align *markets*, by prompting the assimilation of real value into their financial value infrastructure. Resulting forecasts, valuations and market prices communicate investor feedback to the company, influencing corporate activities in the real economy. By design, the use of financial levers, along with its increasingly recognised benefits for investment performance, make ESG integration attractive to a wide range of investors, including many (as intended) who capitalise on its performance benefits and add their weight to its effectiveness, without any RI (purposeful intervention) goal.

REAL ECONOMY INTERVENTIONS

The influence wielded by capital allocation varies with competition for capital, and is stronger where links between funding and activities being funded are direct. Investing practice often obscures this relationship. For example equity investments are commonly on-market purchases from other investors.

Investors consequently use complementary (“stewardship”) interventions to promote their priorities through means other than capital allocation. Examples include issuer engagement, proxy voting, industry or regulatory advocacy and legal action.

Investors with RI goals and those without them use these tools, to communicate their priorities with higher fidelity than is possible through the oblique, diffuse signals conveyed through market prices. Investors with RI goals use these tools to procure (or protect) *real* value, consistent with asserting its prioritisation within the real economy.

PURPOSE AS THE ORGANISING PRINCIPLE

EVALUATING INTERVENTION QUALITY

If the objective of all RI approaches is to realign investment practice to its purpose, then all RI offerings can be assessed against this principle. Thus the test of RI quality in a portfolio intervention is how completely the resulting portfolio holdings align with real world value; an absolute standard reflecting the possibility of perfect alignment.

In contrast, the test of quality for principled ESG integration (vs its opportunistic use by investors indifferent to real value outcomes) is whether it causes financial markets to assimilate real-world value that was previously disregarded (e.g. local community sentiment at mining companies, in the previous example). Similarly, the test of RI Stewardship is its impact on 'real world' value creation or protection.

Intervening in market conventions or the real economy is more ambitious and consequential, but also more challenging. Thus in addition to the ingenuity required to effect change at scale, quality RI ESG integration and stewardship outcomes typically require collective endeavours. Examples include collaborative funding of investment research into novel ESG risks or co-ordination of stewardship efforts. These prioritise the effectiveness of the intervention in achieving closer alignment between financial and real value.

SELECTING APPROPRIATE INTERVENTIONS

Comparisons *across* RI approaches also become significant when RI is understood as an intervention to align practice with purpose.

High quality portfolio interventions – such as impact-driven portfolios - have the potential to deliver faster, fuller alignment of investment practice with purpose; and consequently appeal to individual investors. However, for investors with more clout, interventions that address only their own portfolio(s) demonstrate more limited ambition or commitment to principled RI.

Conversely, purposeful ESG integration can nudge capital markets towards incorporating real value, so better befits institutions who influence asset transactions and their terms (including via published research or other IP).

However the scope of ESG integration extends only to aspects of real value with credible corollaries in investment risk or returns. Being anchored in existing assumptions and expectations limits both its potential and its pace in reasserting purpose within market priorities. For example, if it is possible to destroy common assets for private profits, ESG integration cannot address this.

Purposeful stewardship interventions, in contrast, can be calibrated for reach, scope and speed. Their assertion of real value priorities can nonetheless be undermined by any countervailing financial logic. For example, stewardship that drives a firm to prioritise ethical restraint instead of exploitative practices can weaken the firm relative to competitors or counterparties who lack such restraint. Disadvantage to a firm or its investors makes it unlikely that such prioritisation would prevail. Principled RI stewardship therefore prioritises intervention in the system, for instance, addressing the settings that permit value extraction (versus value creation) to be profitable. [2]

The framework of *purpose* can be applied to any RI approach or offering, to assess its potential, highlight its shortcomings, suggest its 'best practice' characteristics; and gauge the intention underlying its use by any investor type.

[2] see Peres da Costa, S. & Chandler, P. (2019) *Active Ownership 2.0: The evolution stewardship urgently needs* https://www.unpri.org/download?ac=9721

COMBINING INTERVENTIONS STRATEGICALLY

When used in isolation, even high quality RI interventions can be overwhelmed and undermined by conventional practice, outlined above. The *best* RI approaches therefore combine interventions strategically to reinforce each other.

For example, good analysis for principled ESG integration tests the limits of what real value the market will acknowledge and assimilate. In the process, it illuminates both opportunities and obstacles to realising returns from real value creation. When engagement targets these opportunities, the investment and the investor benefit. Likewise, when advocacy targets the obstacles[3] to the market recognising real value, and real-value aligned financial returns can be realised, the stewardship result is likely to be both consequential and durable.

For example, a cleaner technology innovation by a major energy generator may be commercially uncompetitive under existing government subsidies to fossil fuels. Successful engagement that encouraged the company's appetite for transformation, *together with* advocacy that successfully discontinued fossil fuel subsidies, would unleash market forces to recognise the superior 'real' value of cleaner energy, causing real and financial value to realign.

Similarly, investors whose portfolios align more completely with real value creation can pursue these stewardship objectives with vigour, being better positioned to reap the rewards. Those invested in assets whose success relies

[3] for engagement and advocacy respectively

on unfettered pollution (for example) cannot pursue its regulation without impairing their financial returns. In contrast, those aligned to reductions in pollution are not so compromised.

RI QUALITY FOR REAL WORLD RETURNS

The quality of RI activities should be assessed against its underlying principle: how well the intervention re-aligns flows of capital to real world value creation. Without reference to this principle, RI will not deliver results for those whose interests it is supposed to serve.

Effective interventions are more challenging and often more costly than superficial approaches that suffice to serve a compliance or commercial purpose. Differentiating the former from the latter necessary, as only principled and consequential RI efforts can support the real-value results that responsible investors seek.

It is only through these efforts and the signal they transmit through the investment supply chain, that the purpose of investment can be restored to its practice. This alignment is imperative for prosperity; to support real world value-creation to flourish and for the investment opportunities of the future to emerge.

ENDS

[i] FOR PROFESSIONAL INVESTORS ONLY