With great power comes great responsibility

Duty of ownership working group paper
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This document is written by members of the Thinking Ahead Group 2.0 (Roger Urwin, Tim Hodgson) following research and discussion by the Thinking Ahead Institute’s duty of ownership working group. We are grateful to the members of the group for their input and guidance as we continue to advocate for change in the investment industry to improve the value proposition for the end saver, wider society and the planet. The authors alone are responsible for any errors of omission or commission in this paper.

The members of the duty of ownership working group were as follows:

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- Tracy Burton (Coronation Fund Managers)
- Edward Evers (Ninety One)
- Adam Gillett (Willis Towers Watson)
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- Jenny Segal (Affiliated Managers Group)
- Gavin Smith (QMA, a PGIM company)
- Simon Tannett (CQS)
- Roger Urwin (Thinking Ahead Institute)
- Tim Hodgson (Thinking Ahead Institute)

The working group met (virtually) nine times between April 2020 and December 2020.

We also would like to thank Russell Picot and Stephen Miles for their inputs to working group discussions.
Executive summary

The working group considered the following areas

- How the ownership responsibility (and opportunity) that is carried by asset owners and asset managers involves a fiduciary duty of loyalty both in the financial and ESG context and in a member/stakeholder context. We considered how the changing interpretation of fiduciary duty is affecting and will affect institutional investors.

- Asset ownership involves the exercise of rights and responsibilities in voting, engagement and shareholder resolutions. We considered how effectively these functions are performed and ways for these functions to be improved.

- There is a society-wide change taking place, with the world transitioning to a low-carbon economy, while simultaneously adapting to other societal and environmental pressures. We considered what part institutional investors are playing, could be playing and should be playing in this transition. We explored the mandates that asset owners and asset managers might design and manage to produce positive impacts on the economy, the environment and society within the constraints of fiduciary duty and of maximising risk-adjusted return.

The working group wished this paper to set out the high-level principles and beliefs that cover the substantive issues set out above, provide guidance to assist organisations in their sustainable investing policies and practices and can easily be socialised in an accessible transfer of knowledge.

Core conclusions: This paper is organised around five main sections with these conclusions:

1. **The fiduciary model.** The ‘fiduciary window’ where asset owners feel comfortable with their policies remains a constraining force for progressive sustainability practice, but we suggest there is a slow but quickening shift in the direction of sustainability and wider stakeholder responsibility.

2. **The active ownership model.** The active ownership function is critical to sustainable investment practice. But it is both under-resourced and under-delivering, requiring major improvements in the people model and investment model. It should also be more focused on system-wide engagement.

3. **The asset owner investment model and 3D framework.** The asset owner (AO) should adopt an investment model that incorporates the triple materiality defined later and by doing this they can frame an investment model in three dimensions (3D) of risk, return and impact. In implementing the 3D framework AOs must be prepared for challenges in longer time horizons and reporting.

4. **The asset manager 3D mandate.** The 3D asset manager (AM) mandate – with its 3D goals, longer-term orientation, and scorecard reporting – has a significant future in both active and rules-based strategies. Paris-aligned strategies have central parts to play in this evolution.

5. **The challenges: reporting, data and ecosystem gaps.** There are gaps in our ecosystem that are compromising the effectiveness of sustainable investment practice. These gaps comprise enablers in critical infrastructure and incentives and are most evident in skills; reporting, data and technology; collaboration and culture. For these gaps to be fixed, significant change is required in public policy and organisational culture and action.
Highest level conclusions: We add a further five high level conclusions which suggest the next areas of our work:

6. **3D investing.** We highlight ‘lite 3D’ and ‘full 3D’ investing approaches, differentiated by the type of ‘impact’ sought. Both these approaches appear to have significant futures ahead. Ways to develop 3D investing practices will be part of our next phase of work.

7. **Refocusing.** We advocate for a refocusing of AO and AM activity that allocates considerably more resource to active ownership. This is consistent with a more general refocusing on positive-sum beta actions (such as collaboration on sectoral engagement) at the expense of a lower emphasis on alpha activities. Ways to improve focus will be part of our next work.

8. **Technology, data and reporting.** Success will certainly favour those organisations that manage to evolve the highly imperfect ESG data sources into decision-useful forms. The secret sauce here is a lot about governance and culture rising to the challenge of over-abundance. There are mixed signs when it comes to progress on data standardisation and streamlining. A more realistic and effective strategy is to move away from the hunt for more data and better data towards codifying the existing data by reference to its inferential quality. Ways to change this are part of our next phase of work.

9. **Sustainability success.** We believe the future will favour organisations that are:
   - collaborative – with research relationships across wider fields (like climate change)
   - at home with 3D investing – coherently able to balance risk, return and impact
   - innovative in research, thought leadership and effective engagement on ESG and impact
   - deeply endowed with talent to connect and engage key stakeholders
   - effective culturally with emphasis on purpose and people as central pillars.

   These hurdles are high, we do not believe that any asset owners or asset managers currently satisfy the complete list, but over time a relatively number of organisations (perhaps 40-50) will achieve this.

10. **Transformational change.** We do not see these sustainability challenges being met while organisations continue to evolve through incremental change processes. Instead, transformational change is needed – approaches that are more substantive, co-ordinated, agile and time-intensive. This is a new skill to acquire that combines technical excellence in project management with organisational excellence in the application of soft skills.

The current configuration of the investment ecosystem may not be sustainable in falling behind the shifting requirements of its stakeholders and failing to fulfil its social license to operate. Addressing this sustainability gap offers the chance of creating a better industry – one where there is alignment to stakeholder goals and efficiency is evident through low costs and streamlined practice.

The power of asset owners and asset managers is clear from the size of the assets they manage, variously assessed as a figure close to $100 trillion. We suggest that **with great power comes great responsibility**¹ to make the changes necessary.

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¹ “With great power comes great responsibility”, alternatively known as the Peter Parker principle, is a proverb popularized by the Spider-Man comic books written by Stan Lee, though clearly conceptually dating from (at the latest) 1793, during the French Revolution. Source Wikipedia
**Narrative and principles.** Each section of the paper starts with a ‘narrative’ that explains the working group’s overall thinking, and then provides deeper detail in the ‘principles’. *The narrative and principles can be considered as separate so duplications are intentional.*

The principles and beliefs covered across the five sections are summarised in the table below.

<table>
<thead>
<tr>
<th>High-level principles and beliefs</th>
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<tbody>
<tr>
<td>1. Fiduciary model</td>
</tr>
<tr>
<td>1. The ‘fiduciary window’ is shifting in the direction of sustainable long-term value creation and wider stakeholder interest as a result of a combination of systemic forces – social, cultural, institutional, regulatory.</td>
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<tr>
<td>2. In developing sustainability principles there is a need to work within a beliefs framework in which systems-thinking, double materiality and the potential gaming of data are central.</td>
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<td>3. Paris-aligned transition pathway strategies need to be designed and validated to ‘work’ within the fiduciary window.</td>
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<tr>
<td>2. Active ownership model</td>
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<td>4. The active ownership function is critical to sustainable investment practice and is both under-resourced and under-delivering, requiring major improvements in the people model and investment model.</td>
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<td>5. A number of practical considerations mostly related to incentives hold back active ownership from obtaining traction in particular in passive and macro investing mandates.</td>
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<td>6. System stewardship – engagement and advocacy that work on reducing system risks, particularly financial stability, climate change and social stability – is a critical activity to support sustainable investment practice.</td>
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<td>3. Asset owner (AO) investment model and 3D (three-dimensional) framework</td>
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<td>7. Sustainability factors (ESG) are material to financial factors (company performance and investment returns).</td>
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<td>8. Financial factors (those generated by company and investor actions) are material to sustainability factors (real-world impacts).</td>
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<td>9. There is a dynamic link over time between sustainability factors (real-world impacts) and financial factors (investment outcomes).</td>
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<td>10. 3D AO investment frameworks can be created that balance the risk, return and impacts of strategies. These frameworks include 3D goals, longer time horizons, total portfolio thinking, dynamic asset allocation, significant active ownership, and scorecard reporting.</td>
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1. The fiduciary model

Narrative

The ‘fiduciary window’ denotes the set of investment policies acceptable from a fiduciary duty perspective, given current interpretations. The fiduciary window is described by one spectrum stretching from short-term finance to sustainable long-term value creation; and by another from pure member financial interest to wider stakeholder interest.

The window is shifting in the direction of sustainable long-term value creation and wider stakeholder interest as a result of a combination of systemic forces – social, cultural, institutional, legal and regulatory.

The fiduciary window concept is illustrated in chart 1 below.

Chart 1

Factors in the movement of the fiduciary window

<table>
<thead>
<tr>
<th>Actor</th>
<th>Factor</th>
<th>Weighting in the past</th>
<th>Weighting in the future</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>Industry theory and practice</td>
<td>1st</td>
<td>+</td>
</tr>
<tr>
<td></td>
<td>Empirical evidence</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>State</td>
<td>Legislation and regulation</td>
<td>3</td>
<td>+</td>
</tr>
<tr>
<td>Corporation</td>
<td>Corporate reporting and alignment</td>
<td>4</td>
<td>+</td>
</tr>
<tr>
<td>People</td>
<td>Member views</td>
<td>5</td>
<td>++</td>
</tr>
<tr>
<td></td>
<td>Activism</td>
<td>6th</td>
<td>++</td>
</tr>
</tbody>
</table>

The core issues of fiduciary duty are that those who manage investments on behalf of others are bound by a number of fiduciary obligations, notably loyalty; putting the interests of beneficiaries first when determining the investment strategy, and prudence and care; investing to the standard of care of a prudent expert. The importance of loyalty makes financial factors dominant but not to the exclusion of other non-financial factors. The exact interpretation of these factors will not be black and white.

Fiduciary duty naturally evolves as circumstances evolve. But while the window has been stretched by the influences of sustainability there remains a preciousness to fiduciary practice to retain financial primacy. This means that funds in most jurisdictions and circumstances must adopt policies that maximise risk-adjusted return, and not allow concessions from other motives that may diminish risk-adjusted return.

The key test of the fiduciary window is whether – given a plausible range of scenarios for performance and changing circumstances – the trustee board can visualise themselves continuing to support (legally and practically) the policies adopted, irrespective of intermediate results. This will depend on following sound process and documentation by reference to legal and regulatory provisions.
This becomes important when policies depart from previous norms, as is likely with climate risk management strategies and climate alignment strategies. In a later section we develop how 3D mandates can work within the fiduciary window. The Paris-aligned strategies or net-zero strategies must reconcile several constraints, as well as the fiduciary standard which as discussed will mostly apply a high bar of needing to achieve at least the level of risk-adjusted returns that would have been achieved with strategies that omitted those impact elements.

The fiduciary test is interpreted differently in different jurisdictions. The US is widely referenced as a country in which fiduciary interpretation has been conservative on finance-first principles, although in practice this has followed the political cycle and so may well change with the recent changes to the administration in power.

The changes occurring in other parts of the world are substantially in the direction of more progressive practice, stretching the window in the direction of wider stakeholders. It appears that the legal framework could support clearer practice to support non-financial goals by reference to the wider economy, communities and the environment as informed by the views of beneficiaries themselves. ShareAction’s ‘Responsible Investment Bill’ is framed in this way. Legal interpretation could also potentially benefit from guardrails or safe harbour provisions that call out appropriate limits. One possible area to identify is prescribing asset owners to work within ‘do no significant harm’ principles. One example of this specified under the EU Sustainable Finance Taxonomy regulation (SFDR).

Principles

The ‘fiduciary window’ is shifting in the direction of sustainable long-term value creation and wider stakeholder interest as a result of a combination of systemic forces – social, cultural, institutional, regulatory (principle #1).

- The ‘fiduciary window’ is the set of investment policies acceptable from a fiduciary duty perspective.
- The window is described by two dimensions: one from short-term finance to sustainable long-term value creation, and the other from pure member financial interest to wider stakeholder interest.
- Appropriate interpretation of fiduciary duty should change as investment principles, theory, practice and circumstances evolve. It is reasonable to anticipate some changing context to fiduciary duty. No strict interpretation of fiduciary duty would be expected to fix the concept in time.
- The window is being shifted upward in respect of integrating ESG as financially-material; and sideways in respect of applying ESG and sustainability factors to achieve material real-world impacts.
- This could be seen as a shift or a stretch depending on whether previous models that have largely rejected ESG thinking stay within the window or are left outside it.
- The national differences in fiduciary interpretation are likely to remain. There is no lockstep of countries with respect to fiduciary duty because of cultural factors. But the direction of travel for all countries, towards ESG integration and real-world impact goals, is likely to be similar.
- Seeking regulatory clarity is important. There are benefits to providing ‘safe harbour’ provisions – reducing legal or regulatory liability if certain conditions relating to good process are met. These can reduce the difficulties the asset owner or asset manager faces with short-term monitoring milestones.

In developing sustainability principles there is a need to work within a beliefs framework in which systems thinking, double materiality and the potential gaming of data are central (principle #2).

- Beliefs are critical working assumptions that are embedded in investment processes to guide investor

1 Source: The Change We Need | ShareAction 2020
Effective beliefs require research, empirical support and reasoning.
- The most effective beliefs are aligned (they have collective support), edgy (they produce competitive advantages) and actionable (they get frequent use).
- Sustainability requires beliefs that suggest the links between ESG factors, companies, investor actions and the real-world in terms of society and environment.
- Effective beliefs incorporate a theory of change that visualises a future of both successful financial outcomes and positive real-world impacts and works backward to derive investment strategies consistent with this outcome.
- ‘Double materiality’ is explicitly allowing for both the impact of ESG on investment returns and also for the impacts of companies and investors on society and the environment.
- The gaming of data is usually evident through Goodhart’s law (measures, when they become targets, cease to be valid measures). An example here is the measurement of the implied temperature rise of portfolios (‘temperature rating’ or ‘portfolio warming metrics’), where the management of portfolios can be adapted to meet the monitoring milestones without contributing to the overall temperature goal.
- We need multiple targets, and their contexts, to guide and assess our goals, activities, accomplishments and outputs.

**Paris-aligned transition pathway strategies need to be designed and validated to ‘work’ within the fiduciary window (principle #3).**

- Paris-aligned (low-carbon) transition pathway strategies generally are framed as net-zero carbon commitments over longer-term horizons, with milestones over intermediate dates.
- Investors, in exploring their financial outcomes and intended real-world impacts, must do so satisfying the financial obligations in fiduciary duty. Essentially this commits most asset owners to achieving at least the level of risk-adjusted returns that would have been achieved with strategies that omitted those impact elements.
- Working within the fiduciary window will involve applying this high bar to financial outcomes in the monitoring process. This will involve optimising some mix of financial and non-financial (impact) goals in the strategy subject to this financial constraint.
- For example, an asset owner might pursue a strategy of underweighting carbon and engaging fossil fuel companies in the transition pathway of their strategy, but would only do so if there is a clear belief that doing so will ultimately produce better financial outcomes for the fund. The argument here is that the fund has benefited from diminished exposure to externalities that became internalised costs.
- Paris-aligned allocation strategies introduce tracking error risks relative to strategies following market-weighted benchmarks. These risks have largely produced positive alpha in recent years, but this is not necessarily supportable into the future given considerations of efficient markets and the flows of funds moving in this direction. These risks are real risks insofar as they contribute to certain counter-productive behaviours.
Duty of Ownership working group survey results

| Investment decisions should reflect the sustainability and responsibility preferences of beneficiaries, whether or not those preferences are financially material (No. of votes: 13) |
|---|---|
| Strongly agree | 15% |
| Agree | 38% |
| Neutral | 23% |
| Disagree | 15% |
| Strongly disagree | 8% |

| What degree of wider stakeholder responsibility should asset owners adopt in their purpose/mission/vision? (No. of votes: 13) |
|---|---|
| None. They should concentrate on risk-adjusted return | 0% |
| Some. They can better manage risk-adjusted return; and also, it is needed for their license to operate | 38% |
| A lot. Their beneficiaries support them doing this | 62% |

| Investment decisions should support the stability and resilience of the financial system (No. of votes: 13) |
|---|---|
| Strongly agree | 31% |
| Agree | 54% |
| Neutral | 15% |
| Disagree | 0% |
| Strongly disagree | 0% |
2. The active ownership model

Narrative

Active ownership (comprising proxy voting, engagement and shareholder resolutions) occupies an increasingly important place in the investment policy and investment arrangements. When conducted successfully it adds to the value of investee companies (which accrues to all other investors in those companies). But it remains a controversial area where efforts and capabilities seem too limited to produce the desired effects. The issues arise in respect of resourcing, the types of skills involved, and the methods applied.

We do find examples of organisations that apply active investment principles with significant engagement conducted by investment professionals alongside portfolio allocation responsibilities. Such integrated models seem to work well but they are more the exception than the rule. More often the active ownership responsibility is managed in a specialist team without significant integration. This is particularly the case where the investment approach is passive.

A recent study suggested that the level of specialist engagement resourcing at six leading providers of index tracking mandates amounts to less than 1 team member per $100bn of assets under management\(^1\). The data from this study is summarised in chart 2 below. Overall, we estimate, by sampling methods, that less than 1 per cent of the resourcing for investment management is attributable to corporate governance specialists in active ownership activities. The massive majority is attributable to allocation activities\(^2\).

Chart 2

Business model: resourcing of the six leading asset managers responsible for index tracking mandates
Source: WTW Investor stewardship study | 2019

\(^1\) Investor Stewardship - One hand on the wheel, WTW 2019

\(^2\) Of the total investment professionals employed globally (estimated at 1.05 million in 2019) we have estimated that fewer than 1% are employed in stewardship and governance specialist roles. We concede that is not possible to calculate how much time in stewardship roles is carried out by portfolio professionals whose principal role is security selection. Overall though we stand by the ‘soft data point’ that less than 1 per cent of the resourcing for investment management is attributable to specialists in active ownership activities.
System stewardship (engagement with governments, regulators and other authorities) is also ready to be elevated to a more significant level, given expectations for the net benefits that can accrue.

While industry efforts to elevate these activities are progressing, there are clear-cut reasons for the current limits. These are because these activities are tricky to measure, they are difficult for asset managers to monetise, and there is a free-rider problem given ownership fragmentation.

Effective stewardship practice

Stewardship has been very weak in its reporting and accountability (too anecdotal, too inconsistent, weak oversight, etc), this needs to change for its value to increase. Stewardship, through greater use of shareholder resolutions, more collaboration, and applied theory of change, could contribute substantially more to investment results. The activities will respond to better scrutiny and more systematic reporting and assessment.

When we consider the challenge for asset managers to monetise these areas, we observe the paradox that the value add from the area is believed to be quite large, and significantly greater than the costs involved. The difficulty lies with the limitations on measurement that make it hard to make strong claims on its success.

Free riders are a problem to the investment industry because they result in under-producing or degrading the ‘public good’ from the active ownership activity. For example, in the global financial crisis weak active ownership allowed massive corporate governance failures to occur across the banking sector. Free riding is more likely the more fragmented the ownership structure (a large numbers of owners with small stakes).

The size of the free riding problem in the investment ecosystem is a contested question. To many it is a big problem, but an alternative view often expressed is that free riding is not the cause of the active ownership dysfunction. That cause emanates from the fragmented ownership and scale difficulties involved.

Scale advantages can be constructed by specialised services. Engagement platforms (e.g. Federated Hermes EOS and Regnum), proxy advisory services and OCIO platforms provide scaled up active ownership functions so reducing costs. This diminishes the incentive to be free riders. But there will always be a case for free-rider actions arising from strict application of fiduciary duty and without appeal to the social license to operate that asset owners work within.

The critical issue of whether divestment or engagement should be favoured by investors has been treated with an excess of simplicity. It surely needs care to resolve taking full account of context. As a reasonable summary of normative principles, we suggest that, on a standalone basis, divestment and exclusions have little impact; on a collaborative basis, with an amplified voice, exclusions can produce signalling impacts, social shaming and prompt more sustainable corporate actions. The investment world has substantially adopted a stance that prefers engagement to divestment, substantially because of the forward-looking considerations given that engagement has the most opportunity to develop targeted and more forward-thinking impacts.

Of course, more specific responses and strategies need to reflect the context of scale, mission, skill and comparative advantage. There can be no one size fits all answer to this question.
Principles

The active ownership function is critical to sustainable investment practice and is both under-resourced and under-delivering requiring major improvements in the people model and investment model (principle #4).

- Active ownership is the combination of voting, engagement and shareholder resolutions. It uses rights and position of ownership to influence issuers’ or companies’ activities or behaviours related to ESG matters and other business practices. Ownership rights are exercised differently depending on the asset class.
- Most investors believe the benefits of successful active ownership exceed the costs. This cannot be proved with existing hard data. But the activities suffer from being tricky to measure, difficult for asset managers to monetise, and the free-rider problem given ownership fragmentation.
- Both active and passive investors treat active ownership with lower priority and manage it as a low cost activity. This reflects the limited appreciation of the ability of this activity to deliver both private value and a ‘public good’ that all investors can benefit from. This results in the limited resources applied to active ownership (estimated by TAI to be less than 1% of total front-line investment expenses).
- The benefits of collaboration represent one source of opportunity where partners are, ideally, seen as extensions of the organisation. Collaboration partnerships with high levels of trust and mutual dependence give the opportunity for each partner to focus on what it does best.
- The accountability of industry participants for their active ownership is weak, reflecting the inconsistencies and lack of focus in reporting, and relatively high degrees of opaqueness.
- The delegation to asset managers, the use of engagement overlay approaches and proxy advisors, and improvements in the strength of these collaborative activities, all represent methods that may help the effectiveness of the active ownership activity.

A number of practical considerations mostly related to incentives hold back active ownership from obtaining traction in particular in passive and macro investing mandates (principle #5).

- The ‘voice vs exit’ (or engage versus divest) debate needs portfolio and investor context to settle. The generalised conclusion is that both have merit and both may be appropriate, depending on context.
- The divest proposition is weakened when you consider who is likely to buy the divested stock; this is generally investors putting less emphasis on the ESG factors.
- The engage proposition has its practical difficulties with addressing externalities on a firm-by-firm basis in a competitive market without collective action across competitors (a sectoral approach to engagement).
- In addition, it is difficult for governments to serve their role protecting public goods when firms engage in regulatory arbitrage – again this may argue for systemic engagement in which collective investor action can fill this gap.
- Stewardship has been very weak in its reporting and accountability, this needs to change for its value to increase, the higher standards expected under the enhanced UK Stewardship Code provides a benchmark.
- Active ownership has been neglected within index-tracking mandates because of market forces. The arguments to drive more engagement into index-tracking are strong.
- Active ownership has practical challenges for investors with shorter term mandates and long/short trading positions.
System stewardship – engagement and advocacy that work on reducing system risks, particularly financial stability, climate change and social stability – is also a critical activity to support sustainable investment practice (principle #6).

- System stewardship is engagement aimed at reducing the systemic risk in portfolios, with the specific goal of improving the overall risk-adjusted returns.
- The specific goals of system stewardship are to improve the overall returns (better beta) and to reduce systemic risk.
- The main methods of reducing systemic risks available to investors are responding to regulators’ consultations, and advocacy to governments, NGO’s, and industry bodies. Engagement with leading companies may also be involved with the aim of creating trickle-down benefits throughout an industry.
- The main systemic risks that funds would wish to reduce are climate risk, financial stability risk and social stability risk.

Duty of Ownership working group survey results

<table>
<thead>
<tr>
<th>The quality of resources (talent, systems, etc) applied to stewardship in the investment industry is adequate/fit-for-purpose (No. of votes: 10)</th>
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<tbody>
<tr>
<td>Strongly agree</td>
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<td>Agree</td>
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<td>0%</td>
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<table>
<thead>
<tr>
<th>Outsourced stewardship resources (engagement overlay, proxy advisors) offer certain advantages with respect to economies of scale, and specialised expertise (No. of votes: 10)</th>
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<td>Strongly agree</td>
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<tr>
<td>Agree</td>
<td>70%</td>
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<td>Neutral</td>
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<tr>
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<tr>
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<tr>
<td>Disagree</td>
<td>80%</td>
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<tr>
<td>Strongly disagree</td>
<td>20%</td>
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</table>
3. The asset owner investment model and 3D framework

Narrative

Double materiality

The development of the ‘double materiality’ principle is a central consideration. First, ESG and other sustainability factors can be demonstrated to be material to financial outcomes. The materiality will vary by sector, but any fund considering long-term sustainable value should be interested in ESG as a financial factor with relevance to future outcomes (and we can describe this as ‘pre-financial’ or simply ‘financial’).

Secondly, investors’ actions and those of the companies they invest in can produce material real-world impacts (impacts on environmental or social factors). So, it follows that reporting of ESG factors should reveal as much as possible about what these impacts are for the scrutiny of wider stakeholders.

The third aspect of double materiality is that it can be dynamic; real-world impacts ripple through the economy to the financial outcome of the investor. Put in other words, issues that are material from a societal perspective (such as climate change) can become material from an enterprise perspective, either slowly or rapidly. This is often denoted as ‘triple materiality’ as illustrated in chart 3 below.

The aim is to allow the company’s shareholders and other stakeholders to make informed investment and engagement decisions. In recognising these issues, accounting standards must tread a pathway to balance what is material for different audiences with “interoperability” – structural connectivity between standards that companies use to report to different audiences.

Chart 3

Reporting factors in fiduciary window - dynamic materiality

World Economic Forum/Big 4 paper: Toward common metrics and consistent reporting of sustainable value creation

脚注1 World Economic Forum/Big 4 paper: Toward common metrics and consistent reporting of sustainable value creation
These issues are actively being progressed within accounting bodies. IFRS has issued a consultation on global sustainability standards, and a cooperative effort was announced by SASB, IIRC, GRI, CDP and CDSB – with the first two organisations subsequently announcing a merger. The TCFD reporting framework is being increasingly adopted and, in some jurisdictions, being made mandatory.

3D investing

Asset owner policies are a parallel development here. The choices over managing ESG factors cover a spectrum from improving performance to, in some cases, creating impacts.

The impact strategies we term three-dimensional approaches (‘3D’ for short) where the dimension of impact is put alongside risk and return. Investors can in practice choose from one of two 3D approaches:
- core sustainability strategies that exploit ESG issues through integrated ESG portfolio construction and active ownership; here the impact is ‘lite’ in that it arises from collateral influences and is generally second order
- universal investor strategies that utilise additional strategies in systematic engagement and more significant ESG allocation strategies on top of ESG core strategies; here the sustainability impact is more ‘full’ being directly targeted and accounted for.

It is important to emphasise that universal investor seeks better long-term financial outcomes and real-world impacts by undertaking actions that produce impacts and improve performance.

The summary of the 3D framework is below, drawing out the features of the lite and full versions.

| 1. 3D goals | The portfolio and strategy seeks to integrate risk, return and impact (= positive and measurable social and environmental impact) |  
| 2. Total portfolio long-term thinking | Strategy is focused on producing long-term absolute returns contributing to the total portfolio risk and return consistent with goals | ✓ | ✓ |
| 3. Strategic partnership | Adding IP to the AO outside the mandate; providing strategic input – investment strategy ideas, and reverse enquiry new mandate ideas | ✓ | ✓ |
| 4. Core sustainability strategies | Integrated ESG and active ownership adding insight and engagement to support value creation, short-term and long-term | ✓ | ✓ |
| 5. Impact strategies | Targeting and achieving real-world impact using UI strategies – portfolio and stewardship positions – including carbon management | ✓ | |
| 6. System-level engagement | Addressing the systematic risk elements in their portfolios – climate change, financial stability, social stability | ✓ | |
| 7. Scorecard monitoring | Has a long-term orientation; fulfils the impact information needed; is ‘integrated reporting’; includes TCFD compliance; narrative and data | ✓ | ✓ |
| 8. Other mandate details | External managers governance and culture | Also termination terms, could involve closed-ended structures | ✓ | ✓ |

Currently, most strategies that asset owners have committed to have fallen into the ‘lite’ area as they have focused on allocations to companies that have in the past performed well on metrics of ESG performance. This is an approach focused on secondary market exposures which can produce only modest investor real-world impact.
By contrast, the universal investor strategy gives emphasis to achieving much more significant and intentional impacts, tapping substantially more into active ownership actions to manage sustainability change.

**Universal ownership**

Universal investors (UIs or universal owners) are generally very large investors that own a slice of the world economy and world portfolio and with it a slice of all corporate externalities. Their mindset is to aim to achieve real-world impacts on the environmental/societal system and to obtain better outcomes for beneficiaries by taking a joined-up approach to managing longer-term risks, particularly externalities. The taxonomy we suggest for universal investors comes in four parts.

A small number of investors are **full UIs** – they are very large, long-term and leadership-minded asset owners (AOs) and as a consequence are deliberate in their commitment for impact (‘intentionality’) through their ability to produce positive system effects (‘additionality’) – we suggest the minimum asset size for such an AO might need to be $200bn, and we believe there are potentially about 10 AOs in this group with total assets of about $6trn.

A slightly larger group of AOs by number selectively employ UI strategies – these are large and impact-minded but not quite so large or as committed as the full UIs and so they can only be effective in some impacts and in some mandates, particularly in collaboration with larger asset pools – about 100 AOs are potentially in this group – we suggest their asset size is not the main issue, it is influencing capital sourced from financial capital and political capital; this group also totals about $6trn.

A larger group of asset managers (AMs) by number selectively employ UI strategies by delegation – these are impact-minded and can be effective in impacts through their larger asset pools – the AMs in this group are motivated by mission, values and beliefs considerations but require the AO mandates to be aligned with universal investor principles for full conviction.

All other investors, the vast majority, are **non-UlIs** – they may be deliberate in recognising and reporting on impacts, but they do not have intentionality to act to impact the system. They are free riders that benefit from UI actions.

The challenge for universal owners is integrating the management of risk, return and impact by working both within the system and on the system. The challenges introduce considerable practical difficulties. Issues like the treatment of externalities, the consideration of both short- and long-term horizons, the potential inter-actions between impacts and returns and the application of stewardship and allocation strategies are all complex.

The focus on two goals implied in this challenge (risk-adjusted returns and impacts) is akin to working on two objective functions and calls for joint and separate organising principles. We mean by this that each goal needs some separate attention, but attention must also be paid to considering them together. While some universal owners might wish to manage one process that manages an optimisation across risk, return and impact, it is doubtful that this is practicable given the distinctly different nature of financial risk and impact.

In practice, most large asset owners currently find reasons not to manage their funds in line with universal ownership principles by either not seeing themselves as large enough; not having the long-term orientation; or not having the leadership mind-set, buy-in or resources to operate this way.
Universal ownership is not widely practiced or understood. But we suggest that this mind-set and context can be changed and is likely to change to be a central growth element to the 3D investing movement which has so much current momentum.

Long horizon investing

We suggest that success with the universal investor model and the 3D arrangements will depend on successfully working with long time horizons and an extended reporting and measurement framework. As described in the triple materiality concept, ESG and impact factors emerge over extended periods and prematurely accounting for these concepts will be problematic.

A list of the factors than can produce long horizon investing success are summarised below. They combine the need for aptitudes (the skill set) with attitudes (the mind-set). These are clearly problematic for investors to master, with behavioural biases and agency issues being significant sources of friction.

We again emphasis the needs in 3D investing for mind-set shifts. These are fundamentally required if the model is to be effective.

Chart 5

Long-term orientation - asset owner checklist

Mind-set
- Consistency with liabilities/obligations/mission
- Clearly articulated rationale for long-term investing
- Documented and socialised long-horizon investment beliefs and objectives
- Board and sponsor buy-in to long-term ethos
- Willingness to tolerate short-term under-performance, low “career risk” threat

Skillset
- Skill in identifying long-term asset manager ‘edge’
- Well-framed and documented long-term decision processes
- Resources to undertake complex qualitative monitoring
- Evaluated on long-term accomplishment/success measures with progress checkpoints
- Cognitive diversity (different thinking styles and approaches)

Reporting framework

The high-level specification of the additional reporting needed by asset owners using a 3D investing framework is reporting that

- Has a long-term orientation; it focuses on long-term progress; it de-emphasises short-term data
- Fulfils the impact information needed around intentionality and additionality
- Is ‘integrated reporting’ in bringing together narrative and data on goals, actions and accomplishments, and outputs as well as outcomes
- Includes TCFD compliance.
The more complex reporting needed for 3D investing arises from adding the extra dimension of impact to the investment model. Measurement challenges arise from the difficulties in reporting that was highlighted in the triple materiality discussion. The current situation is that corporate reporting is inconsistent and lacks rigour and precise purpose. Investors as users of this reporting must come to terms with such measures having these validity issues, which standards, hard work and time can improve. But ESG and impact concepts and relationships may be fundamentally unobservable and so there are natural limits to data quality.

We can characterise the technology and data challenge generally, as creating a technology system (data and knowledge management platform and infrastructure) that can process and channel relevant high-quality information adaptably, cheaply, and efficiently into the investment process, with security and resilience. This will be judged by how much value is created through the quality of decision-useful information generated and the connected insights, judgements, processes, heuristics and algorithms applied to it.

This identifies that investors have technical, governance and cultural challenges to produce data management excellence. By these standards, the data area has very significant room for improvement, and will yield to those organisations that add significantly more resources than are currently involved. We expect scale advantages are likely to apply in meeting this challenge.

**Principles**

**Sustainability factors (ESG) are material to financial factors (company performance and investment returns) (principle #7)**

- Sustainability in investing is a broader heading than ESG, the familiar term, but they cover similar ground and are often inter-changeable. We frequently use the term “ESG investing” in our narrative.
- ESG factors – defined as affairs, situations, or topics related to the environment, society, or corporate governance – can produce material influences on an investee company’s value creation and that company’s performance.
- This is the so-called first ‘materiality’ referenced in the accounting world and is also titled a ‘pre-financial factor’ as it shows up in company performance and investor performance over time.
- Pre-financial factors are material to (longer-term) financial objectives and may overlap with non-financial objectives.
- With this materiality comes investment opportunity for idiosyncratic returns. This is why, increasingly, investors see ESG factors as a rich source of alpha.
- The investment world is progressing towards standards of reporting on ESG factors that enable investors to have the data to properly integrate them into their portfolio analysis; but this is very much work-in-progress (note the IFRS initiative to promote a standardised reporting protocol).

**Financial factors (those generated by company and investor actions) are material to sustainability factors (real-world impacts) (principle #8)**

- The activities of companies and, by extension, the activities of investors as allocators and owners of companies, have material impacts on sustainability factors – the economy, environment and society. These are often referred to as real-world impacts.
- This is the so-called second ‘materiality’ referenced in the accounting world and is often referred to as non-financial as it shows up in investors’ analysis in non-pecuniary terms.
- The investment world is progressing towards standards of reporting on these ESG factors also, but there are different stakeholders concerned about these factors (the IFRS initiative is suggesting that these factors are covered in a second phase of development).
- Non-financial factors are material to the achievement of non-financial objectives in real-world impacts but will also contribute to financial objectives over time.

There is a dynamic link over time between sustainability factors (real-world impacts) and financial factors (investment outcomes) (principle #9)

- Together ESG and real-world impacts represent ‘double materiality’.
- Also, together, they can connect in a dynamic feedback form where issues that are material from a real-world impact perspective can become material from a financial perspective, either slowly or rapidly. The simple example is strategies aligned to a net zero and Paris-aligned temperature warming could be structured to produce better long-term financial outcomes to investors.
- This is sometimes referred to as the third ‘materiality’ and this enables investment organisations to arrange their ESG and impact strategies to support the highest risk-adjusted returns.
- The characteristic of this effect is more difficult to assess because it may be a second order effect (or ripple effect) and there will be leads and lags to the way it is linked to other factors.
- For example, the management of a company’s carbon footprint can produce real-world climate impacts that will affect other companies in a ripple effect over time.

3D AO frameworks can be created that balance the risk, return and impacts of strategies. These frameworks include 3D goals, longer time horizons, total portfolio thinking, dynamic asset allocation, significant active ownership, and scorecard reporting (principle #10)

- The key objective in the 3D framework is to integrate risk, return and impact. To satisfy a strict fiduciary principle it is assumed we are adding impact with no concession to the risk-adjusted return. The return should be at least as good as if the impact strategy had not been added, i.e. the strategy remains on the efficient frontier of risk and return.
- This framework will always include core sustainability and impact strategies and scorecard reporting. In its fullest form, it will include total portfolio thinking, strategic partnerships and universal investor strategies.
- Impact is not a well-defined term, but in current usage there are two versions: a ‘lite’ version that is essentially ESG-tilted and a ‘full’ version that is aiming for real-world impact and is essentially the universal investor strategy.
- The application of total portfolio thinking to the 3D framework allows for all the above features in a competition for capital that is sensitive to shorter and longer time horizons. This concept fits concisely with the 3D mandate’s needs.
- Long-horizon investing is substantially elevated in 3D mandates with greater influences attached to long-term uncertainty, both affecting the decisions and the monitoring; and in mindset via investment beliefs and investment philosophy.
- Building better beta is critical to 3D frameworks via active ownership. This implies a significant step-up from normal levels of active ownership. This may include the development of shareholder resolutions and ‘say on …’ engagements (like pay and climate) and systemic stewardship.
- The use of a scorecard for 3D mandates helps support the strategy determination and the reporting and accountability. This involves portfolio quality being assessed as a combination of (1) efficiency in expected returns and multiple risks; (2) other key factors like resilience, liquidity, costs, governance and core sustainability considerations; with (3) the addition of sustainability and impact metrics integrated into the scorecard.
- In the 3D framework, the accomplishment of two goals appears to call for joint and separate organising principles. We mean by this that the dual goals – those related to risk adjusted return and impacts achieved – will need some separate attention with additional attention given to combining them. It does not seem practicable to manage one satisfactory process in one optimisation across risk, return and sustainability, although this idea will be tested over time.
Long-horizon investing is critical to effective sustainable practice. It requires skill and mindset changes, and mandate clarity involving commitment of time, mutuality of trust and exchange of value (principle #11)

- One of the key opportunities and challenges of sustainability is the intrinsic characteristic of ESG/sustainability factors playing out over time, requiring a long-horizon investment approach.
- The long-horizon investing mind-set concerns the ingrained investment beliefs around the benefits of long-term investing, the willingness to have and act upon a long-term investment horizon (ability is assumed) and the governance, culture and internal support for long-term investing.
- It will also need regard for liabilities/obligations/mission; documented and socialised long-horizon investment beliefs and objectives; board and sponsor buy-in to long-term ethos and willingness to tolerate short-term under-performance; and an environment that carries low “career risk” threat.
- The long-horizon skill-set involves identifying long-term asset manager ‘edge’; well-framed and documented long-term decision processes; resources to undertake complex qualitative monitoring; and the evaluation of long-term accomplishment/success measures with progress checkpoints and cognitive diversity (different thinking styles and approaches).
- In the context of most mandates that generally focus on relative risk and return over a short-term (often three-year) horizon, there is a mismatch here which may be difficult to address. Ideally, mandates should be framed through total portfolio thinking and be focused most on absolute risk and returns and performance horizons of ten years and beyond.

Framing and reporting the materiality and validity of the data employed in decisions and reporting are critical to limit the hazards of gaming and greenwashing (principle #12)

- In the complex ecosystem that the investment industry exists within, we will always have attribution problems where there are multiple contributors to outcomes, making individual contributions unobservable; that is, there are no simple cause and effect results and no amount of data analysis will solve this issue.
- A similar issue is that we will act motivated by distinct going-in objectives – financial and non-financial. But we achieve conflated coming-out results. This will mean we cannot validly attribute results to objectives and may consequently blur the clarity of going-in objectives.
- Data is very difficult to interpret in the ESG and impact areas. It is necessary to report on data materiality – how useful to decisions is the data; and data validity – how much qualification should be made in the use of that data due its quality. Data quality is basically seeking objectivity, accuracy, timeliness, granularity and transparency, and where possible avoiding modelling, estimation and proxy errors.
- By scoring materiality and validity as part of a joined-up view of data provenance, we improve the use of that data; by judging data in context this is further improved. Most data users evaluate benefits of a given level of data quality too narrowly – they often over-emphasise the simple facets of data quality like objectivity and accuracy. They do not usually consider the full data quality, in terms of the materiality and the natural scarcity of good quality data in complex systems where simple causality is not present. The ecosystem complexity introduces two challenges, that there are multiple causes and multiple effects; and the system is reflexive and two-way feedback occurs, that involves effects affecting causes.
- If soft data is made a hard target you will have gaming and other governance difficulties. Instead the best practice is to use reference targets and narrative alongside other KPIs to build a more-rounded picture.
### Duty of Ownership working group survey results

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<thead>
<tr>
<th>When I think of ‘impact investing’ I think of [tick any number] (No. of votes: 11)</th>
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<tr>
<td>Non-fiduciary investing</td>
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<tr>
<td>Small scale targeted investing</td>
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<tr>
<td>Social projects</td>
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<tr>
<td>Mainstream, integrated, SDG-aware institutional investing, where impacts are considered alongside risk and return</td>
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</tr>
<tr>
<td>Investing and stewardship made with the express intention to generate positive, measurable social and environmental impact ('investor impact')</td>
<td>55%</td>
</tr>
<tr>
<td>Both of the above</td>
<td>36%</td>
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<table>
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<th>Integrating consideration of ESG issues into investment practices and processes is a necessary but insufficient condition to delivering a financial sector that serves societies and individuals (No. of votes: 13)</th>
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</tr>
</thead>
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<tr>
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</tr>
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4. The asset manager 3D mandate

Narrative

The 3D investment management mandate follows naturally from the application of the 3D investing framework. In the most common situation, the asset owner decides to adopt the 3D framework and implements this framework via the delegation of mandates to either internal teams or external firms.

Essentially the guidelines for the mandate align the asset manager to the goals, the longer-term orientation, policies and practices, impact focus and more detailed reporting. The full list is captured in the attached summary below in chart 6.

We suggest that this combination of the asset owner 3D framework and the asset manager 3D mandate is a profoundly different model for the investment industry which carries game changing implications¹.

Chart 6

3D Mandates – a straw model

| 1. 3D goals                        | The mandate seeks to integrate risk, return and impact (= positive and measurable social and environmental impact) |
| 2. Total portfolio long-term thinking | Mandate is focused on producing long-term absolute returns contributing to the total portfolio risk and return consistent with goals |
| 3. Strategic partnership            | Adding IP to the AO outside the mandate; providing strategic input – investment strategy ideas, and reverse enquiry new mandate ideas |
| 4. Core sustainability strategies  | Integrated ESG and active ownershipship adding insight and engagement to support value creation, short-term and long-term |
| 5. Impact strategies                | Targeting and achieving real-world impact using UI strategies – portfolio and stewardship positions – including climate management |
| 6. System-level engagement          | Addressing the systematic risk elements in their portfolios – climate change, financial stability, social stability |
| 7. Scorecard monitoring             | Has a long-term orientation; fulfills the impact information needed; is ‘integrated reporting’; includes TCFD compliance; narrative and data |
| 8. Other mandate details            | Includes fees; service-level agreements; collaboration terms; Also termination terms, could involve closed-ended |

3D mandates will specify their targets for impact. In some cases, the impact may be the climate outcome that is sought, but in other cases may be goals that reflect other sustainability impacts. The globally agreed taxonomy for legitimate impact targets is the UN-sponsored listing of 17 sustainable development goals (SDGs).

Funds and mandates must specify these impact goals and then manage the process of meeting them. As we described in the previous section, we suggest that the accomplishment of two goals (risk-adjusted returns and impacts) is akin to working on two objective functions and calls for joint and

¹ See the TAI blog ‘3D framework a gamechanger’. https://www.thinkingaheadinstitute.org/news/article/3d-framework-a-game-changer/

Thinking Ahead Institute
Willis Towers Watson
separate organising principles - that each goal needs some separate attention, but attention must also be paid to considering them together.

A relatively simple joint organising framework is shown below. Here the two parts of the goals are mapped. First, the risk and return optimisation is covered. Second, there is a risk-adjusted return and impact optimisation. The fiduciary duty test is a critical consideration. The key test is whether the impact activities in the second part of the chart will reduce the risk-adjusted return. This is where the universal investor opportunity can be additive to risk-adjusted return via the better beta model using systemic engagement to derive the long-term benefits of reducing systemic risk and the systematic management of externalities.

Chart 7

There is perhaps more scope for the ‘lite’ impact version of the 3D mandate to be integrated to both the financial and impact objectives. This less challenging model may result in it being more widely adopted than the ‘full’ version, but of course the impact achieved will then be limited in scale and visibility. Many asset owners currently prefer this approach to the more complicated full-impact strategies.

Paris aligned mandates and frameworks

We have a particular illustration of the 3D ‘full’ mandate that arises in the so-called ‘race to zero’ UN-sponsored initiative. Net-zero aligned mandates that are subject to fiduciary constraints must meet two goals – the normal goal of maximising risk adjusted return and also the goal of aligning to climate outcomes in a strategy that is consistent with the transition to the zero-carbon economy. This transition is generally projected to the date 2050, and therefore represents a very long-duration journey.

For such pathway strategies to work they will need appropriate accountability, culture and reporting. Progress on these challenges has been recent but significant. We cite the work done by IIGCC (Net Zero Investment Framework for Consultation) and the Louis Bachelier Institute (The Alignment Cookbook) as practical guides to the issues facing Paris-aligned strategies.
These Paris-aligned net-zero transition pathway frameworks and strategies involve integrating the principal components in the investment toolkit – asset allocation and active ownership elements. The 3D framework can embrace both ‘active’ and ‘passive’ mandates where ‘passive’ mandates may take ‘active’ positions in engagement and use benchmarks that have strategic tilts/exclusions versus market-cap. To do this successfully within fiduciary duty constraints requires the allocation to companies on a decarbonised pathway to produce improved financial outcomes relative to strategies without this pathway. This is likely to be supported by investment beliefs that bring out the risks and return issues attached to carbon as an externality that will become internalised and timing factors where those early in the energy transition movement benefit ahead of other investors.

‘Passive’ can be a misleading description for the rules-based strategies that are represented by various indexes both in mainstream ESG mandates and in Paris-aligned strategies. These strategies are active in both their allocations versus market-cap indexes; and their ownership activities. We should see active management as central to a healthy investment ecosystem both with regards to price formation and certain forms of effective engagement (including activism).

Indexes can shape transparent strategies that simplify the complex dimensions of ‘impact’ while being managed to track within the range of diversified and ‘efficient frontier’ portfolios. These are likely to be involved in ‘lite’ impact strategies. There is a growing range of climate transition benchmarks and Paris-aligned benchmarks that can form ‘off-the-shelf’ strategies. These may be attractive where lower governance is desired.

Transition pathway frameworks and strategies are beset with reporting and data issues. To achieve appropriate standards some regulatory guardrails, standard-setting for report and third-party reporting assurance may well prove necessary. The European SFDR provisions are the first significant development in this area.

**Principles**

The 3D AM mandate – calling out 3D goals, longer-term orientation, and scorecard reporting – has a significant future in both active and rules-based strategies (principle #13)

- The key elements involve a focus on two objectives – risk-adjusted return and impact, with some communication on priorities which generally involve the primary goals being financial and not allowing concessions to return from any ancillary impact objectives.
- As for the 3D framework, the accomplishment of two goals calls for joint organising principles. We mean by this that both goals need some separate attention, as well as some joint attention. It does not seem currently practicable to manage one process that manages an optimisation across risk, return and impact.
- The lite 3D mandate appears to be an attractive part-way approach to impact that allows climate risk to be managed. The approach allows funds to apply a carbon policy, and to position a portfolio that manages climate risk exposures, both in physical and transition risks. But there is likely to be a limited degree of real-world impact and this does not correspond to the tighter definitions of ‘impact’ that the industry works with.

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1 One example of the early mover timing argument is given in the Larry Fink of BlackRock annual letter to CEOs, which discusses how issues such as purpose, and climate change would spark a fundamental reallocation of capital.
Paris-aligned net-zero transition pathway frameworks and strategies involve integrating asset allocation and active ownership elements in a multi-stakeholder context with appropriate accountability, culture and reporting (principle #14)
- Work done by IIGCC (New Zero Investment Framework for Consultation) and the Louis Bachelier Institute (The Alignment Cookbook) are guides to the issues facing Paris-aligned strategies.
- The Net-Zero Asset Owner Alliance and the Net Zero Asset Managers Initiative are organisations that are preparing net-zero strategies.
- The requirements of these strategies blend the need for real-world impact; appropriate rigour in evidence and data; practical methods and approaches; accessibility of approaches; and, ultimately, enabling the governance and accountability to work effectively within the goals of the Paris Agreement.
- The strategies call for a blend of governance and strategy; portfolio reference targets; asset allocation; portfolio construction (screening, tilts, climate solution allocations); engagement and divestment; actions for directly owned assets; and policy and stakeholder engagement.

Transition pathway frameworks and strategies are laden with complex data issues and may require new standards to work within and third-party reporting assurance (principle #15)
- Reporting issues on climate are particularly complex. Carbon intensity can only capture a historic position whereas the management has to be positioned to include some forward-looking analysis.
- There are principles that we suggest here to achieve the goals of accountability and decision-useful information, these are taken from the TAI 1.5C working group.
  ▪ The purpose of the impact report should be stated clearly
  ▪ The milestones or interim targets should be clearly defined (level and timescale)
  ▪ The actions taken to achieve the targets should be documented – investor contribution
  ▪ The metrics / evidence reported should allow a simple assessment of progress, or not, towards targets for company impact
  ▪ The complexity of the subject requires multiple, complementary metrics to be shown
  ▪ Be transparent about any limitations / challenges inherent in what is being reported upon
  ▪ Use an impact dashboard with a supporting narrative
  ▪ Be open to evolving the dashboard over time.

Duty of Ownership working group survey results
AMs are able to develop and implement universal owner strategies that would be attractive for certain clients and mandates (No. of votes: 13)

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There is an opportunity for larger AMs to adopt and be effective with universal owner strategies (No. of votes: 10)

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For mainstream investment products that target competitive returns, using the tight definition of impact investing sets a very high bar that will be problematic for the investment industry (No. of votes: 11)
5. The challenges: reporting, data and other ecosystem gaps

**Narrative**

**Ecosystem gaps**

We start with a framework. The goal we (the societal `we`) want from the economic ecosystem is to deliver on the world’s business plan as represented by the SDGs. The investment industry should contribute its fair share to the fulfilment of this goal, defined by its capacity to contribute (legal, resources, etc) and the moral incentive to contribute (values, principles, etc).

The ecosystem structural gap is where the physical and social ‘technologies’ in the system (resourcing, infrastructure, processes and incentives) are not sufficient to accomplish the goal that the system participants might reasonably want to fulfil. Technologies are the means of accomplishing the ends in the above goal. The investment industry’s (investors’) ability to play its part will depend on the sufficiency/adequacies (or gaps) in:

- **Infrastructure and resources**: people (and organisations), process (theory and governance) and information (data, software, AI) and its functioning via industry structure, organisational footprint, value chain and collaborations; including markets, governments

- **Incentives and other enablers**: intrinsic and extrinsic motivations; values, culture and purpose given regulatory and social license factors; limits of knowledge; public goods and the use of the commons.

The big gaps are summarised here in chart 8. All six areas suggest the necessary conditions by which an effective sustainable investment ecosystem can thrive.

### Chart 8

<table>
<thead>
<tr>
<th>1. ESG education</th>
<th>3. Collaboration synergy</th>
<th>5. Sustainability innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>ESG knowledge and practical know-how is horribly uneven</em></td>
<td><em>Our industry is not joined-up and too siloed</em></td>
<td><em>Innovation in sustainability is slow and narrow</em></td>
</tr>
<tr>
<td><em>ESG knowledge and skills should be developed to a critical threshold across the industry for all professionals</em></td>
<td><em>Strengthened collaborations within and across organizations should be able to drive engagement and combinatorial power</em></td>
<td><em>Organisational commitment to sustainability innovation utilising collaboration and agility should be a driving force in delivering value</em></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Systems thinking</th>
<th>4. ESG data</th>
<th>6. Purposeful culture</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Sustainable investing is missing a key building block/thought partner</em></td>
<td><em>Data is a legacy and co-ordination problem</em></td>
<td><em>Purposeful culture</em></td>
</tr>
<tr>
<td><em>Investment theory and practice should integrate system-level thinking on top of traditional investment thinking</em></td>
<td><em>ESG data practices should be able to support more substantial decision-useful application via improved data governance</em></td>
<td><em>Purposeful and enlightened self-interest proponents are weak</em></td>
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<td></td>
<td></td>
<td><em>Positive ethics and values should be married into purposeful organisational culture in a stakeholder model</em></td>
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**Investor reporting**

In the working group, our focus has been on the technology, data and reporting areas arising in 3D mandates.

From an ex-ante perspective, we are attempting to assess the quality of the portfolio produced, without knowing the actual outcomes that will arise and through which the “success” of the portfolio will ultimately be assessed.

Even on an ex-post basis, we cannot easily determine the quality of the portfolio based on the outcomes that it delivers. The feedback arising from performance to inform on the quality of work done is limited. This is because investing is a low signal-to-noise activity (compounded by the fact that financial markets are a complex adaptive system in which multiple factors are interacting).

All of this suggests that assessing portfolio quality using just one or two metrics is very unlikely to be either accurate or helpful. Instead a scorecard approach is likely to be much more useful.

This suggests that the portfolio should be examined through a number of different lenses, considering the extent to which it demonstrates the following positive attributes:

i) Efficiency - the portfolio has a high return per unit of risk and has a high probability of meeting its overall risk and return objectives

ii) Robustness / Diversity - the portfolio has good diversification by reference to the return driver / risk factors framework, with limited overall dependency on any one source of risk

iii) Implementation – how the portfolio fares on balancing cost vs. complexity, on measures of liquidity, etc.

iv) Sustainability: - factors that need to be assessed related to sustainability in a broad sense; e.g. ESG risks, resilience to physical and transition risks, peer fund risks and intentions to produce impact (on social and environmental factors).

The portfolio quality scorecard should incorporate both shorter- and longer-term measures, as well as harder and softer indicators of success. The detailed factors to be used will be fund specific and will usually require some customisation to be relevant. An example of what could be included is shown below. In practice, separate scorecards are needed for asset owner and asset manager mandates and each should be designed to meet multiple stakeholder requirements.
Data and information sit alongside people and process as the key resources used by investment organisations. They are enabled by culture and governance as reflected by values and incentives.

Data and information challenges are more than just technology problems. There is widespread industry pressure for improvement of ESG data reporting standards and metrics. Investors and corporations have been subject to the evolving regulatory requirement and proliferation of data sources/standards that has added an extra burden to the area.

And it’s not only a technical problem, it has culture, talent and governance problems mixed in.

We can characterise the technology and data challenge generally for investment firms as creating a technology system (data and knowledge management platform and infrastructure) that aims to process and channel relevant high-quality information adaptably, cheaply, and efficiently into the investment process, with security and resilience.

Most data quality will be gauged through a combination of materiality and validity which will reflect soft and hard and other considerations. The costs and benefits of data quality need to be assessed on joined-up terms by adopting a complete picture on data quality, thinking about it in terms of fundamental organizational resources and incentives in the context of all stakeholders and the value chain. Full data assurance will reflect legacy, model, costs, culture, competencies and governance.
**Culture**

Culture remains critical to the advancement of the sustainability area. It can support stakeholder purpose and the wider impacts that are resonant. The absence of effective culture leaves organisations in a much weaker position to embrace the new principles that sustainability introduces.

Organisations that have a strong purpose-driven culture have had natural advantages in succeeding with sustainability and stewardship. It may be that the world's current vulnerable state will also work in the opposite direction and make sustainability a force for stronger culture. Either way, organisational values will reflect ownership, ancestry and leadership. We view the use of ‘enlightened self-interest’ as a rallying cry in investment to do more with sustainability.

This also connects with the issues around purpose and mission that are being considered by many industry leaders. There is a big governance challenge to create a unified perspective on the organisation’s exact purpose – what a fund exists for; and success – what measures indicate progress. This must critically examine how stakeholders rank and inter-connect and have co-dependencies. And this naturally extends to establish wider boundaries in the social license that funds operate with.

**Regulation**

Increasing numbers of asset owners and asset managers view regulation as a factor driving their ESG adoption. Domestic or local regulation combine with global forces such as the UN’s PRI or the SASB framework as a major factor shaping approaches.

The global regulatory environment is changing fast, with increasing numbers of countries putting ESG requirements into their regulations. This will only continue.

Recent examples include the SFDR provisions in the EU and DWP regulations in the UK. Both of these have supported new levels of sustainability conviction in investment arrangements and are example of regulators being more positively engaged.

The fiduciary landscape is also subject to change and taking a path in which its influence becomes clearer, effectively lightening the previous barrier to ESG uptake.

The other force is from litigation from members of funds and wider stakeholders. The Rest Super case brought in Australia, and its settlement, emphasise that climate is a very significant risk for pension funds to consider. The case may have signification ramifications in the area of how pension funds should handle climate risk relative to fiduciary duty. That is, climate risk may become a liability/litigation area for pension funds in future.

**Principles**

*There are gaps in our ecosystem that are compromising the effectiveness of sustainable investment practice. These gaps comprise enablers like critical infrastructure and incentives. They are most evident in skills; reporting, data and technology; collaboration and culture (principle #16)*

- The goal of sustainability progress correlates with progress towards achieving the UN-defined Sustainable Development Goals (SDGs). The investment industry should want to contribute towards this progress by doing its fair share, as defined by its capacity and moral incentive to contribute.
- There are enablers to accomplishing these generalised goals, namely resourcing and infrastructure (including people, process and information) and incentives and motivations (including values, purpose and culture).
- A significant majority opinion exists that progress with sustainability is being hindered by four significant gaps, that therefore warrant industry attention. The gaps are in skills (88% agreement); data (83%); collaboration (84%); and purpose (72%) [data from the TAI sustainability summit, 1 and 2 December 2020, over 100 industry participants].
- A common factor behind these gaps is organisational culture, where the organisational behaviours are overly-motivated by self-interest and not sufficiently balanced by stakeholder drivers.
- The above areas can be influenced by the industry and individual industry participants. Another area not so directly within that influencing range is regulation, covered below.

**Scorecards are needed for asset owner and asset manager 3D mandates and should be designed to meet multiple stakeholder requirements (principle #17)**

- Scorecards incorporate multiple measures that indicate material intermediate progress towards the achievement of end goals.
- In a complex system, there is a need to track goals, activities, accomplishments, outputs and outcomes. A scorecard comprises a combination of these measures with accompanying narrative.
- The measures may be in the form of calculated figures or a red-amber-green analysis.
- Current reporting is weak in having a heavy weighting towards measured outputs (like returns) and not enabling a holistic view of progress towards goals.
- Three data principles which we should carry forward into the reporting and accountability model are to: (1) report on data quality, by scoring materiality and validity as part of a joined-up view of data provenance; (2) judge data in context; and (3) handle soft data ‘softly’, which can occur through the use of reference targets and narrative alongside other KPIs to build a more-rounded picture.
- The data challenge is less about the (unrealistic) hunt for better data and more about codifying the existing data we have by reference to its inferential quality.

**Elements of organisational culture, notably purpose, innovation, collaboration, openness and respect, are critical factors in the coherence of sustainability principles and the success of sustainability practice (principle #18)**

- The link between a certain organisational culture and sustainability commitment and effective practice is strong (TAI summit participants gave this 91% agreement).
- The influence of culture on change is considerable. For incremental or transformational change to be effective, cultural factors will be dominant.
- The cultural factors that connect the strongest with making successful changes to sustainability in general and active ownership in particular are:

  ▪ Inclusion and diversity: organisations ability to deal fairly with all its people irrespective of differences and to achieve balance and equity in these regards
  ▪ Innovation: change mind-set; there is preparedness to adopt test and learn loops; the organization is OK with well-intentioned failures; there is inquisitiveness about industry landscape and nimbleness to adapt to it
  ▪ Purpose: clarity of vision and mission; purpose is focused, and expansive and exciting; employees feel their work is motivating and impactful; the organisation is not overly focused on short-term business results
  ▪ Collaboration: cultural values needed to capture the combinatorial benefits of co-operation and inter-dependence, both within organisations and across organisations in ‘co-opetition’ situations
- Resilience: the organisation is focused on the long term; risk is managed well in its multiple forms; agility in facing changing circumstances; using short-term business results to support purpose
- Integrity and respect: high ethical standards are practiced; behaviours aligned to values are highly valued
- Transparency: transparency in internal processes; transparent under external scrutiny; willingness and ability to learn from feedback and feedback loops.

Legislation, regulation, and public-private engagement are also a ‘gap’ in the ecosystem, in that they could be shaped into a more effective enabler through increased industry engagement (principle #19)

- We advance the ShareAction proposals for a Responsible Investment Bill as a good example of an improved legislative framework to enhance sustainability practice effectiveness. This proposal included key features to refocus on beneficiary interest, improve accountability and transparency, make use of a new Council for Investor Due Diligence and ensure alignment with the Paris agreement.
- We advance the proposals put forward by a group of economists led by Bob Eccles as a good model of corporate governance enhancement. Here the focus is on requiring investors to consider, identify and report on ESG risks, and corporate boards to be required to develop, disclose and implement a corporate sustainability strategy, strengthening of directors’ accountability and including non-financial reporting requirements.
- The consultation by IFRS on accounting standard development for sustainability is the culmination of a phase of progress in accounting that contrasts with the limited progress seen in previous years. Disclosures on sustainability issues have been very inconsistent between companies, and very uneven within companies. The advocacy for a much stronger shared commitment to disclosures on double materiality and dynamic materiality is a key step forward. Sustainability cannot progress satisfactorily without a stronger disclosure system.
- We note the challenge involved in infrastructure investing where models of private-public collaboration have not developed satisfactorily.
- We view the engagement models that exist between government and the investment industry through consultation as generally cumbersome.

Duty of Ownership working group survey results

<table>
<thead>
<tr>
<th>The reporting of stewardship activity and outcomes is adequate/fit-for-purpose (No. of votes: 10)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly agree</td>
<td>0%</td>
</tr>
<tr>
<td>Agree</td>
<td>10%</td>
</tr>
<tr>
<td>Neutral</td>
<td>40%</td>
</tr>
<tr>
<td>Disagree</td>
<td>50%</td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>0%</td>
</tr>
</tbody>
</table>
AOs will increasingly report their impact(s) on the SDGs (No. of votes: 12)

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly agree</td>
<td>33%</td>
</tr>
<tr>
<td>Agree</td>
<td>59%</td>
</tr>
<tr>
<td>Neutral</td>
<td>0%</td>
</tr>
<tr>
<td>Disagree</td>
<td>8%</td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>0%</td>
</tr>
</tbody>
</table>

Which of the following areas do you believe requires attention for sustainable investing to succeed. Choose top three. (No of votes: 11)

<table>
<thead>
<tr>
<th>Area</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. ESG professional education. ESG knowledge and skills are</td>
<td>18%</td>
</tr>
<tr>
<td>developed to a critical threshold across the industry</td>
<td></td>
</tr>
<tr>
<td>2. System-level thinking. Theory and practice should integrate</td>
<td>55%</td>
</tr>
<tr>
<td>system-level thinking on top of traditional investment thinking</td>
<td></td>
</tr>
<tr>
<td>3. Collaboration synergy. Strengthened collaborations within and</td>
<td>55%</td>
</tr>
<tr>
<td>across organisations should drive engagement and combinatorial</td>
<td></td>
</tr>
<tr>
<td>excellence</td>
<td></td>
</tr>
<tr>
<td>4. ESG data. ESG data practices should be developed to support</td>
<td>64%</td>
</tr>
<tr>
<td>more effective decision-useful application</td>
<td></td>
</tr>
<tr>
<td>5. Sustainability innovation. Organisational commitment to</td>
<td>9%</td>
</tr>
<tr>
<td>sustainability innovation should be made incorporating agility and</td>
<td></td>
</tr>
<tr>
<td>incremental iteration</td>
<td></td>
</tr>
<tr>
<td>6. Purposeful culture. Positive ethics and values should be</td>
<td>73%</td>
</tr>
<tr>
<td>martialled into a purposeful organisational culture and mission</td>
<td></td>
</tr>
</tbody>
</table>

Other suggestions include: advances and standardisation of measurement to demonstrate value-add; regulatory incentives; common goals
6. Conclusions

The issues in the duty of ownership are multi-faceted and tangled. The working group coverage of these issues was broad and deep, and we greatly appreciate the perspectives they brought to the discussions and conclusions.

The circumstances surrounding these issues are changing relatively fast. As we set out in earlier narrative, the most fundamental change we have previously experienced is the rise of ESG as a key factor in sustainable long-term value creation. And the most fundamental change that we are presently is the incorporation of wider stakeholder influences (particularly in net zero ambitions). This is happening as a result of a combination of systemic forces – social, cultural, institutional, legal and regulatory. Together, these two shifts represent a movement in the fiduciary window.

How will the duty of ownership area progress? We have five high-level points to conclude with.

Transformational change
The current configuration of the investment ecosystem may not be sustainable. By inadequately incorporating sustainability issues, the industry risks falling behind the shifting requirements of its stakeholders, particularly the end savers. Closing this sustainability gap offers the chance of creating a better industry – one where there is alignment to stakeholder goals and efficiency is evident through low costs and streamlined practice. We identified ecosystem gaps in skills, data, collaboration and culture. We observe that these gaps significantly limit the present-day success of sustainable investment. We suggest that this is because organisations are attempting to manage these gaps using forms of incremental change. Instead, transformational change is needed.

This provides us with one final principle in our list as follows:

To address the limitations in the ecosystem, particularly skills, data and technology, collaboration, innovation and culture, we suggest will require the commitment of investment organisations to transformational change processes (principle #20)

Transformational change simply defined is ‘a complete change in an organisation designed to bring big improvements’ (source: Cambridge dictionary). Common features of transformational change are approaches that are more substantive, innovative, time-intensive, agile and multi-strand. Success with transformational change often involves a higher purpose and compelling vision; attention to leadership alignment and socialisation; and excellence in project and program management.

Ways to introduce transformational change into the industry and ways to be successful with transformational change will form part of our next phase of work.

3D investing
The investment framework and mandates that we term 3D approaches put the objective of achieving certain impacts alongside risk and return. This implies a competition for capital that must satisfy two goals – maximising risk-adjusted return and aligning to certain impact outcomes. Investors can choose from one of two 3D approaches:

- core sustainability strategies that manage impacts and risk and return through integrating ESG into portfolio construction, and through engagement and divestment actions. Here the impact is ‘lite’, in that it arises from the collateral influences on the portfolio and is generally second order and hard to account for
• *universal investor strategies* that aim for real-world impacts and better long-term financial outcomes, through systematic engagement and more significant ESG allocation strategies on top of ESG core strategies. Here the sustainability impact is 'full' being directly targeted and accounted for. The most significant current example is the net zero investment ambition.

Both these approaches appear to have significant futures ahead. Ways to develop 3D investing practices will be part of our next phase of work.

**Refocusing**
Investment industry focus has emphasised portfolio construction and not been that attentive to active ownership. This latter area has had limited resources committed so far, and while talent is growing, the systems and processes have been weak and inconsistent across the whole industry. It is telling that we don’t yet have an effective or workable measurement system when evaluating the impact of active ownership activities. We therefore advocate for a refocusing that allocates considerably more resource to active ownership. This is consistent with a more general refocusing that would also be welcome; a greater emphasis on positive-sum beta actions (such as collaboration on sectoral engagement) at the expense of a lower emphasis on zero-sum alpha activities.

Ways to change this focus will be part of our next phase of work.

**Data**
Success will certainly favour those organisations that manage to evolve the highly imperfect ESG data sources into decision-useful forms via effective data governance and culture. There are good signs that data standardisation will progress further. But we believe some aspects of the data challenges will remain: attributing cause and effect ‘correctly’ in a complex system with multiple causes and multiple effects and two-way feedback (reflexivity) will be difficult and inaccurate, at best; standardisation of data methods can progress only so far; and modelled estimates will continue to fill data gaps. More rational expectations and more realistic strategies need to be set for dealing with data, moving emphasis away from the hunt for more data and better data towards codifying the existing data by reference to its inferential quality. The secret sauce is a lot about governance and culture, and industry organisations rising to the challenge of over-abundance.

Ways to change this are part of our next phase of work.

**Success**
Which will be the truly sustainable investment organisations of the future? We believe the future will favour organisations that are:

- collaborative – with research relationships across wider fields (like climate change)
- at home with 3D investing – coherently able to balance risk, return and impact
- innovative in research, thought leadership and effective engagement on ESG and impact
- deeply endowed with talent to connect and engage key stakeholders
- effective culturally with emphasis on purpose and people as central pillars.

We do not believe that any asset owners or asset managers currently satisfy the complete list. These hurdles are high. But we believe progress can be made on each criterion, benefiting both the organisation and facilitating a better industry. The ways to transition to become *truly successful sustainable organisations* will be part of our next phase of work. We repeat that we see this as likely to involve transformational change methods¹.

¹ See the TAI blog ‘3D framework a gamechanger’ for further narrative on truly sustainable investment organisations. [https://www.thinkingaheadinstitute.org/news/article/3d-framework-a-game-changer/](https://www.thinkingaheadinstitute.org/news/article/3d-framework-a-game-changer/)
In conclusion

Through the skill and diligence of the working group through 2020, we have progressed forward and laid out the foundations of future work that needs to be undertaken in 2021.

The roadmap created in the DOO working group follows the key steps of developing (1) narrative and (2) principles. We believe narrative supports the socialising of the thinking of the working group, principles support the enabling of the thinking. The roadmap contains the further steps into new content in (3). Member organisations can use working group outputs in many ways but the A-B-C steps in the roadmap suggested are reasonably generic.
Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients.

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*Mobilising capital for a sustainable future.*

Since establishment in 2015, over [60] investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies; better organisational effectiveness and strengthened stakeholder legitimacy.

Led by Tim Hodgson, Roger Urwin and Marisa Hall, our global not-for-profit research and innovation hub connects our members from around the investment world to harnesses the power of collective thought leadership and bring these ideas to life. Our members influence the research agenda and participate in working groups and events and have access to proprietary tools and a unique research library.

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We seek collaboration with like-minded organisations to achieve our vision, so for more information about us please contact:

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