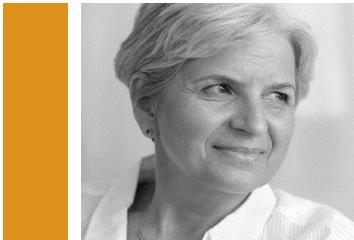
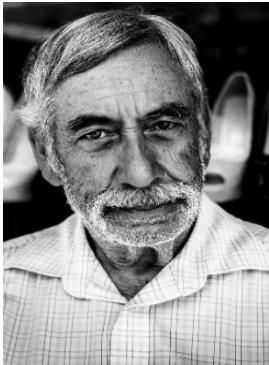


Systems Curriculum virtual event series

Principles and practical applications of systems thinking in the investment industry

Fiduciary duty. Part of the problem or part of solution?

Side-deck | June 2024



Summary: fiduciary duty issues

Issues	<ul style="list-style-type: none">▪ Fiduciary duty – a long-running foundational principle in investing - is being discussed widely, reviewed legally, and explored practically. It matters to our industry that we move it in the right direction▪ Fiduciary duty is a high-dissonance subject – the levels of misunderstanding and misrepresentations are very high reflecting its subtle characteristics. It needs the CFA I ‘touch’ with straightening out difficult things. (I think Net Zero in the Balance was in that category)▪ Fiduciary duty has arrived at a fresh place in its journey with the PRI-Freshfields-Generation work with the treatment of investing for sustainable impact. This is encouraging a 3D investing model – risk, return and real-world impact in which financial outcomes are improved through increasing resilience to systems change and real-world impact can be a parallel outcome▪ Fiduciary duty is summarised under this framing in three parts<ul style="list-style-type: none">➢ investing affordably and securely – balancing risk and return in the present➢ investing sustainably – balancing risk and return over time➢ investing systemically – securing the system health over time (particularly the combination of the social, economic, environmental and financial systems)
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Summary: fiduciary duty challenges and solutions

Challenges	<ul style="list-style-type: none">▪ Politics presents big challenges – it is casting a long shadow over the investing landscape, with differences in ethos introducing greater divisions in views, by geography, type of investor, and players' values. This is challenging the application of fiduciary duty
	<ul style="list-style-type: none">▪ Market infrastructure issues are big challenges – governance, disclosures, standards, data, incentives. We have been incentivised to manage a long-term system by concentrating on short-term factors▪ Net zero investing has been maturing slowly and incrementally while the climate change issues have been escalating substantively. We are not on track for net zero outcomes or 1.5 degrees
Solutions	<ul style="list-style-type: none">▪ Net zero investing and 3D investing are very big transitions, and will need transformational content, with a new story, theory and supporting data and narrative.▪ This will take innovation in time horizon, benchmarks, incentives, measuring and 3D investing. Innovations like <i>3D investing</i> itself, the <i>TPA</i> that supports it; the <i>balanced score cards</i> that inform it, report on it and measure it; the <i>systems thinking</i> that ties the theory and practice together

Fiduciary duties – crucial investment guardrails; Social license – increasingly relevant

Fiduciary duty

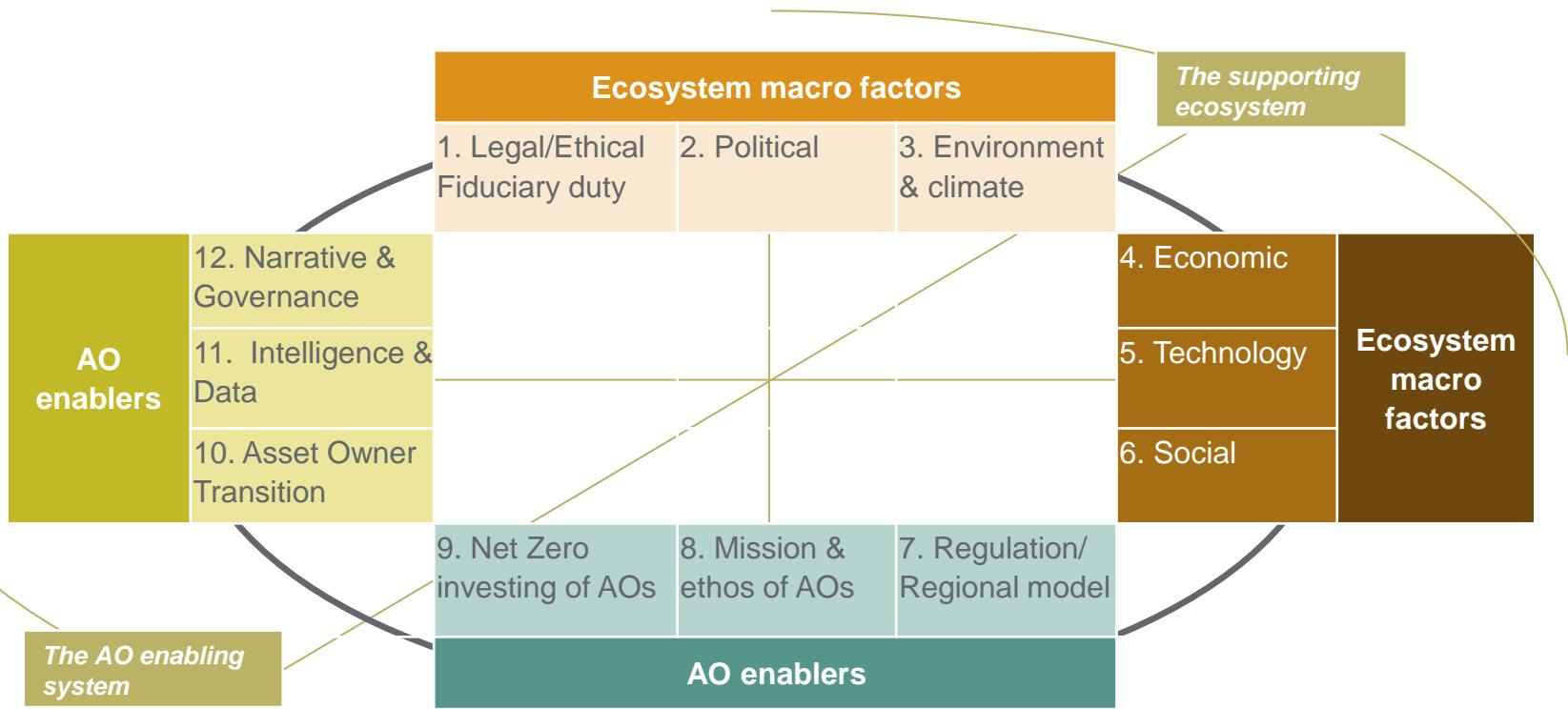
- There is no single globally consistent interpretation of fiduciary duty but most versions include:
 - Loyalty: acting in accordance with the specific power of investment by putting the interests of beneficiaries first and avoiding conflicts of interest
 - Prudence and care: investing prudently, exercising good judgement and reasonable care; diversify according to accepted investment theory
 - Impartiality: avoid favouring the interests of particular beneficiaries over others
- Interpretation will not be easy to pin down objectively, it is a window more than a precise place
- Appropriate interpretation will change as investment principles, practice and circumstances evolve
- Fiduciary duty has always put financial interests first but interests concerning well-being may be counted as well

Social license

- The definitions of social license are not consistent globally, but most versions include:
 - that investment industry organizations rely on a covenant from society to pursue financial goals
 - the deal is that the realisation of wider socially-valued goals legitimises the pursuit of commercial goals alongside these
 - this is a social construct that reflects a solidarity of working together when you're in it together – there are co-dependencies between society and the industry
- As for fiduciary duty, interpretation will not be easy to pin down objectively, it is a spectrum more than a precise place
- Appropriate interpretation will change as the societal zeitgeist evolves
- Societal license to operate puts non-financial interests for society alongside financial interests

Many moving parts in the system— that are all moving together

A system with a function, bringing together multiple parts and inter-connections, that is endemically changing, with growing complexity and other emergent properties. Captured in a systems map below

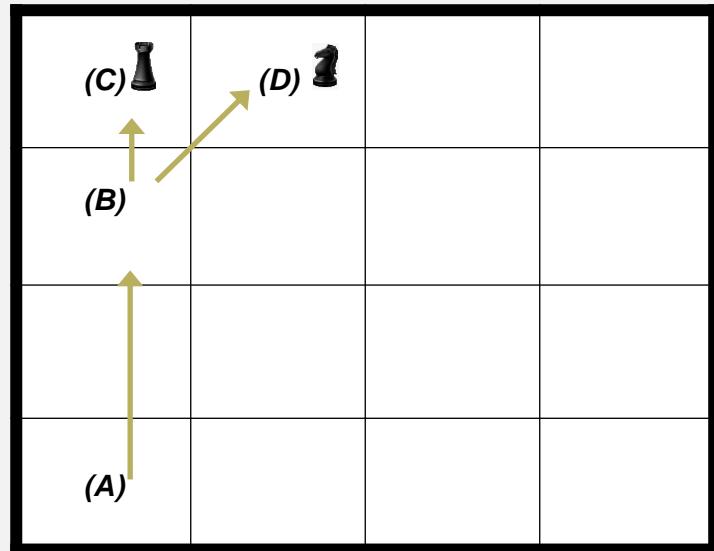


Fiduciary duty and the fiduciary window

The idea of fiduciary duty as a key influence on asset owner and asset manager policies

- The 'fiduciary window' identifies the set of acceptable investment policies given the application of fiduciary duty
- It has the vertical plane for financial materiality and motivation; and the horizontal plane for non-financial materiality and motivation
- The positioning of a fund in this window will be the result of sustainability 'rightsizing'. That is a process deciding on and acting on a particular ambition with respect to sustainability
- In the window we can characterise three relatively common sustainability positions
 - (A) is the non-ESG state, where funds started
 - (B) is the integrated ESG state with single materiality where many asset owners and asset managers are now
 - (C) is the evolving double materiality state with influence on real-world impact (*rook's move*)
 - (D) is the universal owner/ system-level investing state with intentional impact (*knight's move*)
- The window (like the [Overton window](#)) is not fixed in time and will move with various factors (societal, legal, etc)

Sustainability positioning in the fiduciary window

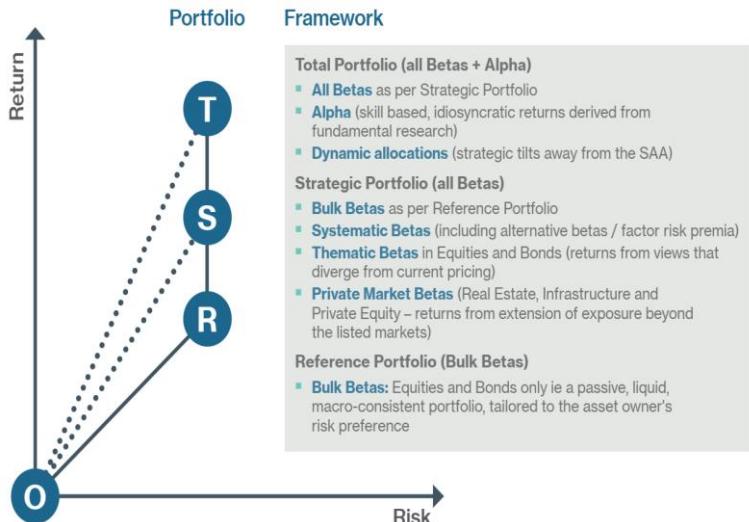


(a) The financial ambition and commitment related to sustainability factors

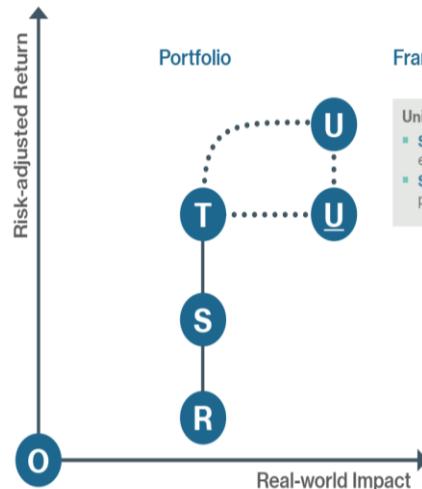
(b) The non-financial ambition & commitment related to sustainability factors

3D investing/ universal ownership theory and TPA

<p>3D investing-lite $GB_{f,esg} \times RB_{f, esg} > GB_f \times RB_f$</p> <p>Governance budget expanded to integrate ESG produces better risk-adjusted returns than the alternative</p>	<p>Governance Budget</p> <p>100% financial</p>	<p>Risk Budget</p> <p>100% financial</p>	<p>3D investing full-on $GB_{f,i} \times RB_{f,i} > GB_{f,esg} \times RB_{f, esg}$</p> <p>GB expanded to incorporate universal ownership produces better returns & real-world outcomes</p>	<p>Governance Budget</p> <p>80/20% financial/impact</p>	<p>Risk Budget</p> <p>100% financial</p>
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- In the total portfolio thinking the key is using various building blocks to produce the optimal portfolio for its overall goals.
- From reference portfolio upwards to total portfolio.
- This includes integrated ESG and active ownership and can be equivalent to a 3D lite framework.



- In the full-on 3D framework the strategy adds real-world impact but does so aiming to add to risk-adjusted return through systematic betas through high-level engagement and portfolio tilts that underweight externalities in portfolio U.
- Given the fiduciary window, the 3D framework aims at a minimum for portfolio U – adding impact but at risk-adjusted return equivalent to T.

Source: WTW Global Asset Owner Peer Study 2024

Thinking Ahead Institute
 An innovation network founded by WTW

Financial factors and real-world factors

- Enter the complication of certain factors that seem on the surface not to be ‘financial’ that we can identify as ‘real-world’. ‘Real-world’ is basically about impacts on the environment and society captured in part by well-being. Climate is our first candidate.
- The motivation to secure a better future for our climate via the decarbonisation of our economy at first blush comes across as real-world and not financial.
- But it is also financial. The evidence that adverse climate outcomes will damage future investment returns is compelling.
- This is where one of the current confusions lies – we speak as though financial and real-world impacts are binary, whereas many motivations and outcomes are both. We seek to exploit an opportunity that has both a financial and real-world impact and outcome
- This blend of financial and real-world factors comes together in two steps.
 - In step one pension funds cost-effectively contribute to a decarbonised economy and a stabilised climate, this is more real-world than financial
 - In step two and into the longer term a supportive climate secures a better long-term risk-adjusted return from the mitigation of physical climate risk and transition risk. With the collateral real-world of a better climate on top. But more financial than non-financial
- A long time horizon is crucial to this investment proposition, it has less suasion with shorter term funds whether by goals or behaviours, including funds de-risking and aiming to buy out etc

Progress in fiduciary practice in the UK on sustainability

The UK investigation into fiduciary duty under the Financial Markets Law Committee

1. *'Pension funds exist as participants in much wider financial and economic networks'*. This suggests they should be given systemic treatment because of this fact. Climate-change related risks being systemic will not be hedged by portfolio diversification the same way that non-systemic risks might be diversified. Other ways to influence the system need to be considered – like stewardship.
2. Where funds seek to make a real-world impact on climate there is the benefit of a public good, but the fund must derive its own private benefit in better risk-adjusted returns net of all costs. The test comes down to whether *'there are appropriate, lawful, cost-effective steps available to be taken in collaboration and coordination with other pension funds'*. In this test of financial primacy funds can singly employ their scale advantage, or benefit from pooling their influence. The documentation and justification of investment beliefs is a vital part of trustee process here.
3. The special factors in this uncertain system mean that *'numbers on their own will not be able to tell this story, and narrative and numbers are the way forward'....'Sometimes financial factors cannot be quantified but it does not follow that they lack weight'*. This is a very important resetting of the principle of 'what gets measured gets managed' with 'what can't be measured must still be managed'.
4. Wider factors to climate should also be seen as material systemic risk factors *'including nature, environment, community, and biodiversity'*. In each case the lens applied is that the fund's purpose is pursuing financial goals and the use of trustee powers to achieve that purpose by reference to applicable time horizons.
5. To properly integrate these four points, pension funds need perhaps to extend their golden rule to 'balancing risk and return, securely and affordably, *and sustainably and systemically*'. Using 'sustainably' downplays investing for shorter term gains when they create risks to the longer-term returns. Using 'systemically' suggests considering the interconnectedness of the investment ecosystem across a myriad of material factors – social, environmental, economic and political in particular.
6. A new step in sustainable investing is needed to advance this wider purpose. The big asset owners in owning the slice of the world economy (identified as 'universal owners' practising 3D investing) increasingly take the mindset that the returns they need will only come from a system that works; and they have the size and resources to contribute to supporting the system to secure better risk-adjusted returns. In this thinking stewardship will play a bigger part than before including systemic engagement on matters of public policy to mitigate systemic risks.

The stronger view of fiduciary duty 'dual mandate'

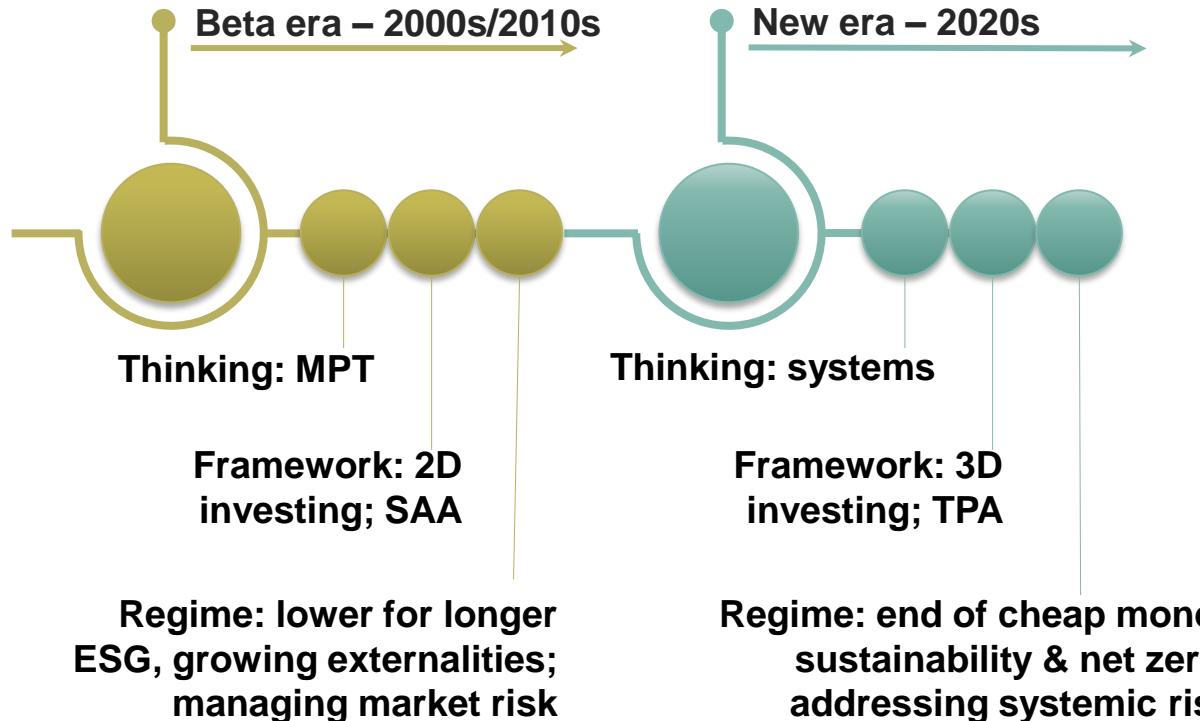
But careful what you wish for

- A new version of fiduciary duty that permits a small concession to performance goals in return for larger non-financial goals would involve a very considerable change in alignment of various stakeholders.
- It would open a more complex world in which the exercise of trustee powers would undoubtedly have large consequences with no doubt some of them unintended.
- Widening fiduciary duty to align more to a best-interests standard could be considered
- There is huge devil in the detail in how this might work but it might for example involve trustee discretion to trade long-term value versus certain limited short-term concessions to return.
- This would be more consistent with the world as it has become or is becoming where value is more than just financial value. And it would put pension funds closer to corporate practice where the UK Companies Act allows companies latitude to factor in wider relationships.
- And it would also allow the responsible practice of UK pension funds to be more highly valued and more valuable.

Supporting materials

Investment industry era change – thinking, frameworks and regimes

Change on multiple fronts. Legal change is generally slow and sticky



The purpose(s) of the investment industry

Asset owners have followed the lead of other institutions towards greater stakeholder orientation.

But staying very conscious of the financial primacy in fiduciary duty

Fundamental purpose

Contributing to society through increases in
societal wealth and well-being

Intrinsic purpose

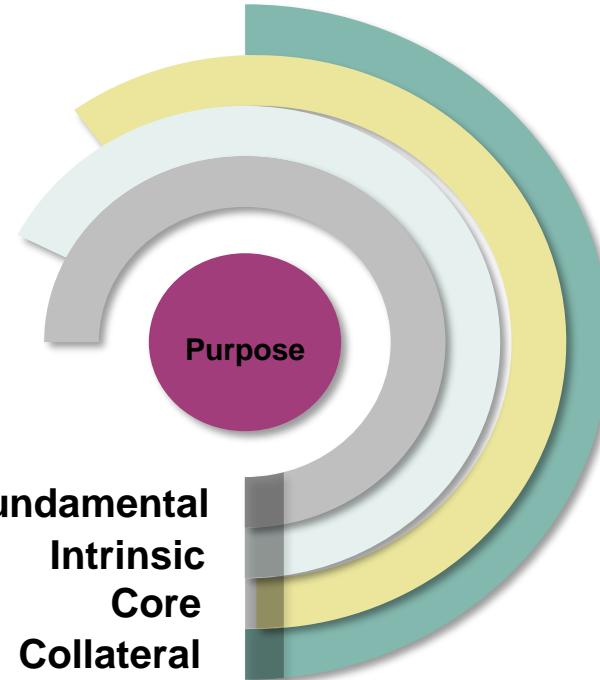
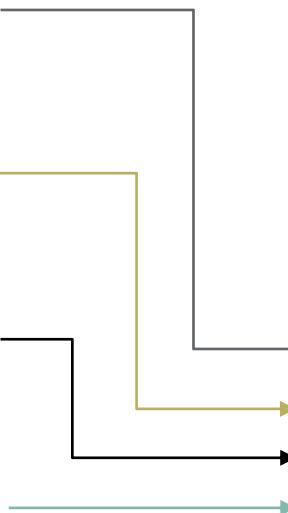
Mobilising the sourcing and
allocation of capital

Core purpose

Providing wealth management and
risk management for end savers
within fiduciary duty

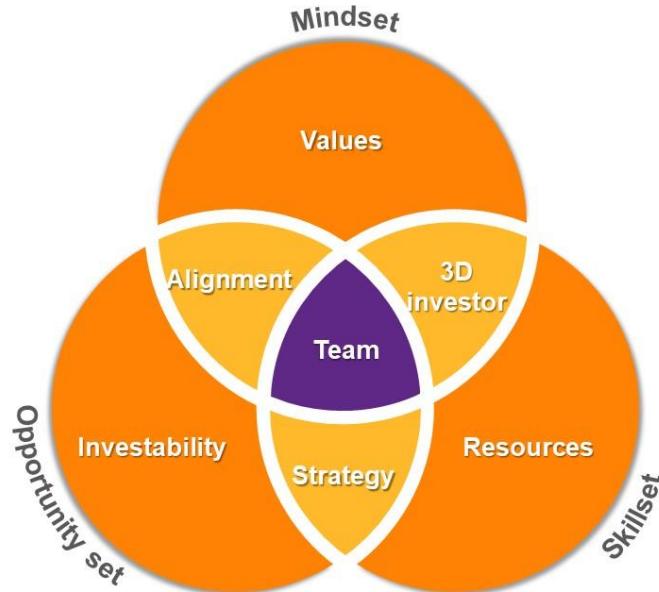
Collateral purpose

Providing opportunities and rewards for
investment professionals and organizations



Rightsizing sustainability – general framework

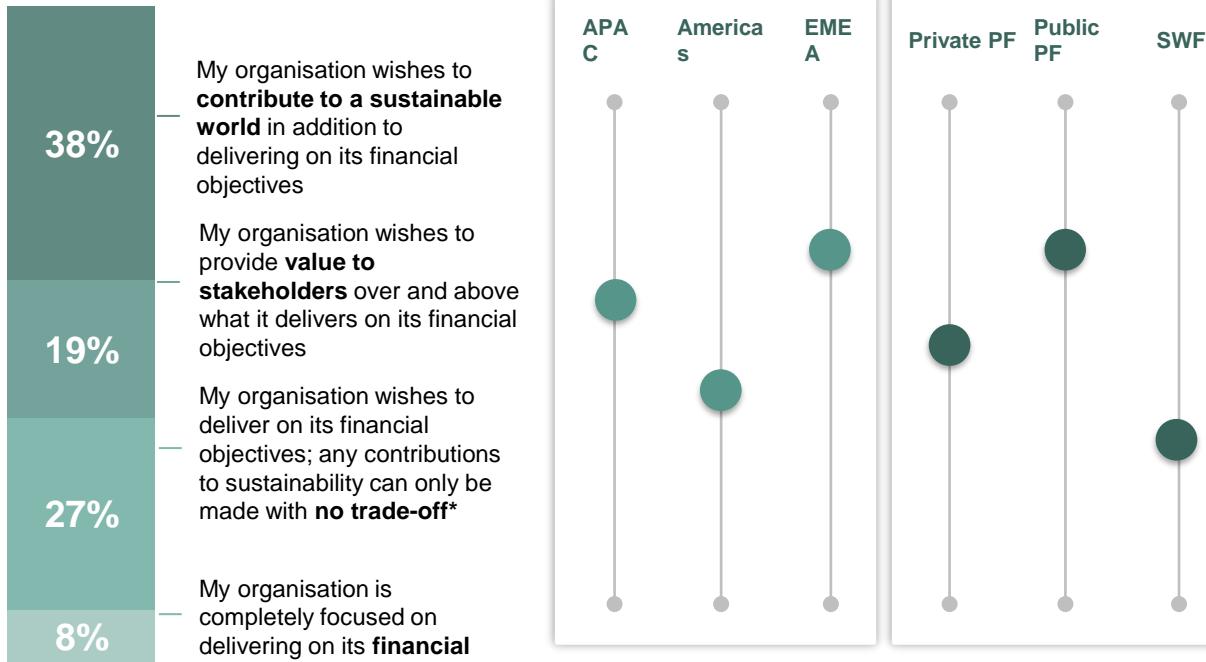
- Deciding on and acting on a particular ambition and commitment with respect to sustainability/ impact reflecting mindset and skillset of the organisation and opportunity set to do what is intended
- Not overdoing it and compromising legitimacy
- Not underdoing it and foregoing the opportunity
- Rightsizing the role to play, in contributing to society's toughest challenges, while not trying to be the solution when government has to be in that seat
- Need for purpose and vision to be clear and aligned with strategy. Vision informs strategy. Strategy grounds vision in reality
- Rightsizing brings together
 - mindset model – what net positive impacts are valued
 - skillset model – what is the unique investment edge, what is special about the people - passion, attraction, retention
 - opportunity set model - what is viable, commercial and deliverable via investing and stewarding
- Need to stress test various scenarios to check whether goals and intentions line up with realistic expectations for outcomes.
- Various challenges including measurement and communications and need for enabling



Data from TAI Asset Owner Peer Study (1): Organisational purpose

Majority of asset owners aim for sustainability alongside primacy of financial goals

- Societal stresses are arguing for changes to business models that make them more purpose-centred
- A new balance in the organisational mix: societal contribution, employee experience and client value proposition, propelled forward by supportive culture
- Putting value in a new light in which well-being ranks alongside wealth creation
- Issues with fiduciary duty where 'best interests' has been interpreted as 'best financial interests' in many jurisdictions
- Issue of presentation and performativity



* Or...My organisation wishes to deliver on its financial objectives, and it can only do this **by working on the sustainability** of the economic, environmental and social system

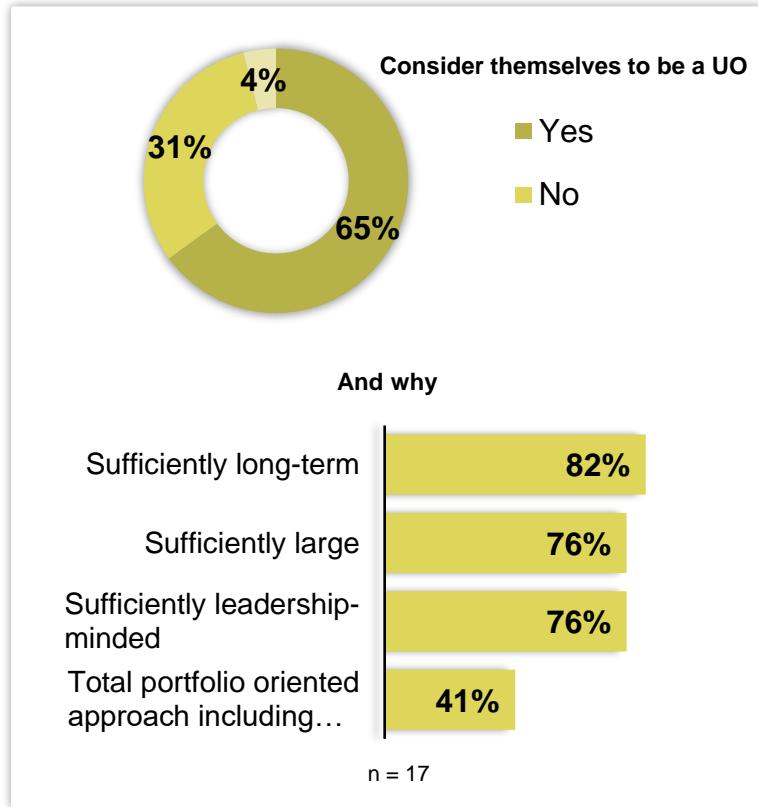
Source: WTW Global Asset Owner Peer Study 2024

Data from TAI Asset Owner Peer Study (2): Universal ownership

This is a growing feature of large fund thinking

- A universal owner (UO) / universal investor is an asset owner that
 - is large-scale, long-term and leadership-minded
 - that invests in an impact-minded way
 - to improve long-term inter-generational outcomes
 - through a total portfolio strategy managing portfolio externalities
- The proportion that considers itself a universal owner group has grown considerably
- But the group differs in the interpretation of universal ownership and intentionality* and commitment to sustainability impact
- There are large overlaps with the 69% of organisations that have made net zero pledges

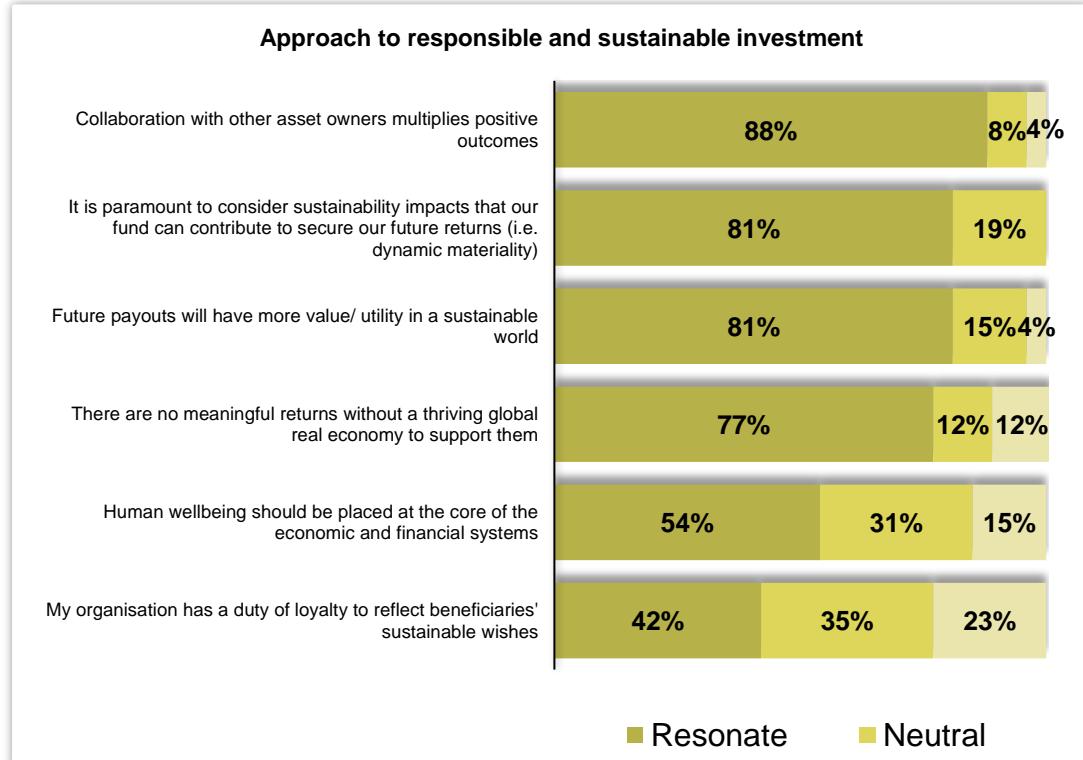
* Intentionality is when investors have a theory of change that demonstrates how their investments will create social and/or environmental impact alongside financial returns



Data from TAI Asset Owner Peer Study (3): Sustainability is key to future returns

Different views on duty of loyalty. Fiduciary duty likely to be a highly influential factor in asset owner policies going forward

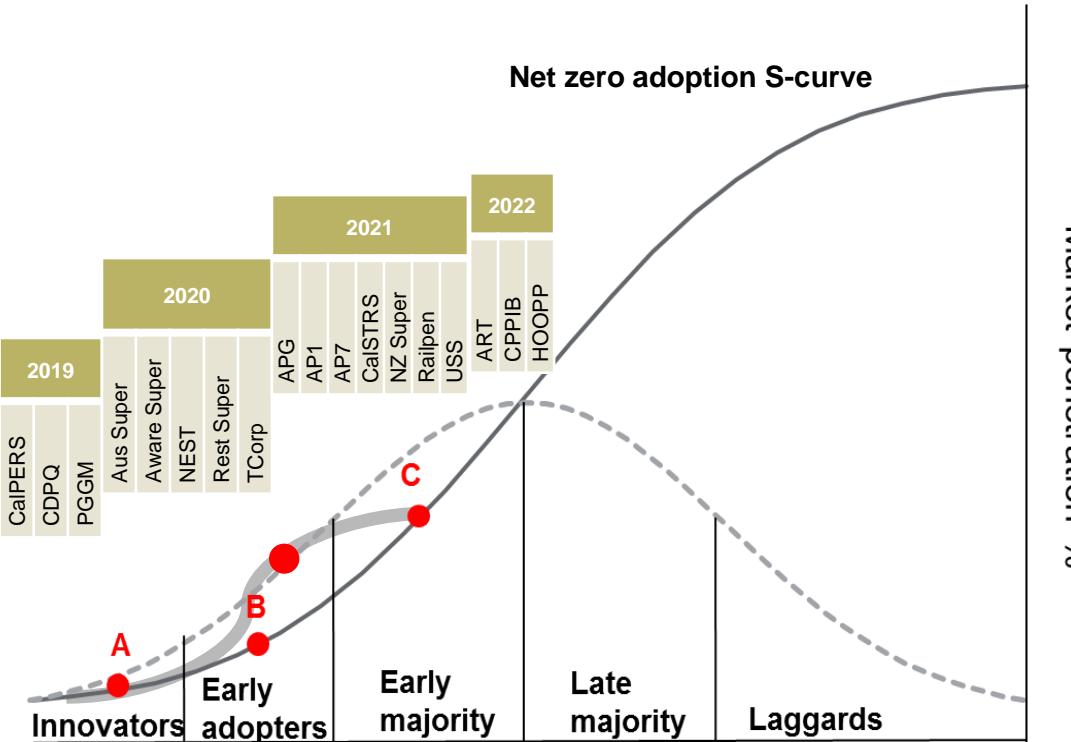
Sustainability in a maturity spectrum	
1.	ESG is a financially material factor requiring integrated ESG and stewardship (single materiality)
2.	Investing for sustainability impacts (IFSI) can be instrumental to better financial outcomes (double materiality)
3.	Investing for sustainability impacts can reduce systemic risks and improve financial outcomes (dynamic materiality)
4.	Investing for sustainability impacts (IFSI) can improve the utility of benefits (dynamic materiality)
5.	Investing can be framed with dual motivations combining financial and non-financial factors
6.	Investing can involve issues where numerical framing is not possible where narrative is critical



The evolution of net zero investing

Regulatory support for emissions reporting rather than net zero

- The S-curve is used to describe the usual shape of innovation growth
- Investment industry innovation maturity splices the faster moving physical technologies (like fintech and AI) with the slower moving social technologies (like governance)
- AO net zero adoption (thick grey line) moved extremely quickly in the run-up to COP26 in 2021(A→B) but has then slackened (B→C) with the challenge in finding the political capital and governance budget needed to implement it
- 18 peer funds out of 26 have made net zero commitments with movement peaking in 2021



Terms used in the Systems Curriculum series

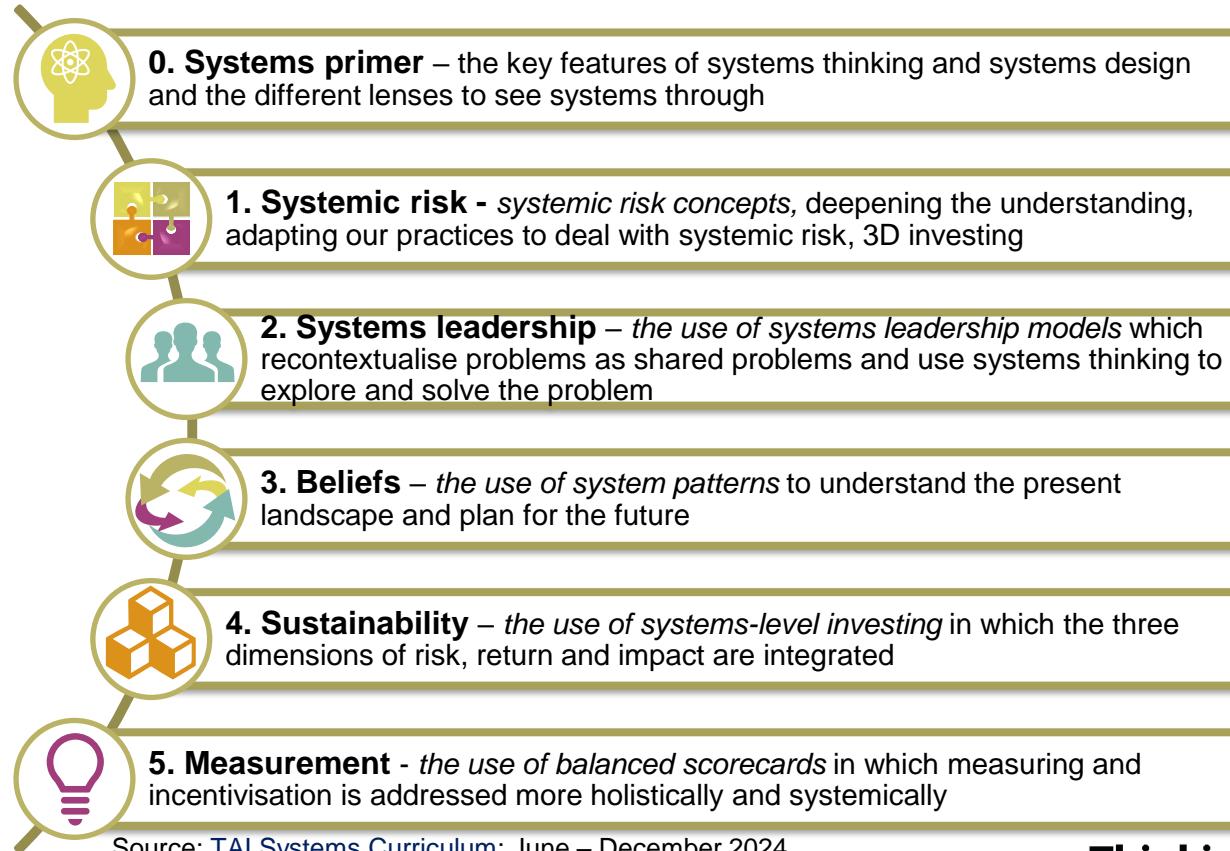
Terms used	
Systems thinking	Emphasising the whole over the parts, the collective over the individual, the inter-connectedness, the emergent properties of the system over time. Connecting dots, recognising patterns, socialising solutions
Systems leadership	A set of skills and capacities for an individual or organisation to support the process of systems-level change. It combines collaborative leadership, coalition-building and systems insight
System design	The design of the organisation with respect to various features including dealing with complexity, TPA, use of insourcing, and sustainability ambition (rightsizing)
Systemic risk	Systemic risk – with its principal examples of climate change, biodiversity and geopolitical security – is the special part of market or systematic risk arising from malfunctions in the system that cascade through the whole market.
Systems measurement	Aligning measurement to support the system in terms of high signal-to-noise measures, aligned incentives and low incentive violation. Allowance for multiple metrics, adaptive goals, reflexive feedback and transparency.
Total portfolio approach (TPA)	An approach to portfolio construction that is a “more joined up” process that starts with clearly specified investment goals, and applies a competition for capital among all investment opportunities, in a dynamic approach
Horizon scanning	The systemic analysis of potential threats and opportunities and likely future developments. Often framed over 10 years
Terms used	
Universal ownership and 3D investing	Universal investors (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; and in some cases, adapt strategy to profit from this position
Best practice	A state where the organisation functions with a margin of safety over meeting its purpose, vision and benchmarks and compares very well by reference to peers (a combination of the best asset owners globally) in strong performance and enablers of good practice
T-shaped teams	T-shaped people have natural advantages as contributors to cognitive diversity. Their mix of subject depth (the vertical bar of the ‘T’) and subject breadth (the horizontal bar of the ‘T’) suits the profile of cognitively diverse teams through their wider perspectives across many fields and disciplines
Organisational alpha	Shorthand for the level of skill generating value added through people and process
Joined-upness	Responding well to ‘integrated thinking’ based on the connectivity and interdependencies between a range of factors that affect an organisation’s ability to create value over time
Data-to-intelligence stack	How basic data including alternative data and soft data can be synthesised into more decision-useful form through a combination of human and AI process
STEEPLE factors	Social, technological, economic, environmental, political, legal and ethical factors

Terms used in the Systems Curriculum series (2)

Incentiviolation = incentivisation + violation

Incentivisation	A motivation or encouragement to someone to do something explicit
Violation	An action that acts against something, especially an agreement, principle, or goal or spirit of the game that should be treated with respect
Incentive comp	The contractual reward offered to an actor for achieving an explicit goal of an organisation (e.g. executive comp ties to achieving KPIs)
Terms for incentive comp	Contract terms between the organisation and the actor must be capable of precise measurement, or the contract will not be enforceable
The trade-off in precision	To ensure the precision of the measurement, you may need to concede some ground in the precision of fit with the true goal, you accept a proxy goal
The hazard in making this trade-off	In the actor pursuing the proxy goal to maximise their incentive, the organisation runs the risk that their true goal is missed, and the incentive produces unintended consequences
The gaming strategy	It can be one step worse. The strategy to maximise the actor's gains based on proxy goals may even involve acting opposite to the organisation's true goals. See dolphin example below
Incentiviolation	Incentiviolation is a portmanteau word (like co-opetition) derived from the violation of the incentivisation when behaviours are incentivised to act against achieving the goal or spirit of the law that it was supposed to incentivise. E.g. In net zero is being incentivised to reduce financed emissions vs financing reduced emissions
The smart dolphin example	<ol style="list-style-type: none">1. <i>The Mississippi Institute Aquarium incentivised its dolphins to clean up litter.</i>2. <i>Dolphins received as bounty one fish to eat for every piece of litter or dead seagull collected</i>3. <i>One dolphin – <u>Kelly</u> – started tearing litter into smaller pieces to game the one fish per piece of litter rule</i>4. <i>It then kept the bounty fish to lure in seagulls, killed the seagulls, and collected more bounty</i>5. <i>These are both examples of smart incentiviolations.</i>
Source: Rationally Speaking Podcast. David Manheim. Why metrics fail	

Systems curriculum: understanding the power and practice of systems thinking



Source: [TAI Systems Curriculum](#): June – December 2024