PENSION NOTES

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The pension funds and best practices in socially responsible investment

Executive Summary

- A Socially Responsible Investment (SRI) is an investment that considers both traditional financial criteria (risk-return), and extra-financial criteria in the analysis and investment decision-making processes. These extra-financial criteria are the Environmental, Social and Governance (ESG) factors. These factors can materialize adversely, with collateral effects for returns on investments.

- The materiality of ESG factors is currently understood as a reality by several renowned international agencies. Incorporating ESG factors in the investment analysis of social security resources would appear to be essential for achieving enhanced performance and risk balance. According to the United Nations, integrating ESG factors into investment analysis, contributes to the purpose of fiduciary responsibility (Sustainalytics, 2014).

- The key question is how to integrate these factors into investment processes. There are several SRI strategies in practice: exclusion due to behavior contrary to international standards and basic rights; exclusion of activities (e.g. arms manufacture); assessment of outstanding traits (Best-in-Class), through the selection of companies that have greater ESG ratings once financial analysis has been conducted.

- The Spanish and Colombian private pension funds would appear to be the ones that have most advanced in Self-Regulation of the application of SRI concepts and ESG factors in investment decision- making.

- In addition to being excellent fund managers, seeking the best risk-return combinations, the AFPs must not lose sight of the fact that the returns of the markets in which they operate may also be affected by extra financial risks associated with ESG factors in the long term. Due to their importance for the risk-performance balance, it is perhaps time for the rest of the Latin American countries to advance further in these matters.

Introduction

There has been growing interest lately in integrating the so-called ESG factors into the analysis of social security resources investment. The main argument is that such factors can materialize adversely, with undesired collateral effects for returns on investments. Hence, these factors should be considered, at least in the field of self-regulation. This brief document defines what is understood by "responsible investment" and its relationship to ESG factors, explaining why these concepts should be considered in the analysis of social security resources investment, giving Spain and Colombia as examples.

I. Socially Responsible Investment, Environmental, Social and Corporate Governance factors and their relevance for institutional investors.

An SRI is an investment that considers traditional financial criteria (risk-return) and extra-financial criteria in the investment analysis and decision-making processes, as well as the exercising of political rights inherent to certain financial assets.

The aforementioned extra-financial criteria are the so-called Environmental, Social and Corporate Governance factors (ESG). These factors are long-term systemic aspects that contribute to the sustainability of companies and their ability to generate value. In the short term, these factors can materialize adversely, with undesired collateral effects for returns on investments.

According to Borremans (2016), companies are facing increasingly more disruptive challenges, that can be divided into four major areas: (i) financial pressure; (ii) governance concerns; (iii) social challenges; and (iv) environmental limits (see Table 1). These challenges are related to pressure from investors and financial markets to achieve short-term rather than long-term results. ESG factors can cause damage and can be lethal for institutional investors, which is why they must be duly considered when investing in companies.

Table 1.
Companies face disruptive challenges

Financial pressures	Short-termism Over-dependency on leverage Misallocation of capital to deliver fast growth
Governance concerns	Market abuse Principal-agent issues Accounting creativity and tax avoidance
Social challenges	Product health & safety concerns Poor labour standards Human rights violations
Environmental limits	Depletion of natural resources Environmental degradation Climate change

Source: Borremans (2016).

According to Sustainalytics, a leading company worldwide in research on responsible investment and the practical implementation of ESG factors for investment decision-making, expanding the information horizon with which investment decisions are taken, and incorporating ESG factors in those analyses, would appear to be essential for enhancing performance and risk balance. The materiality of ESG factors is currently understood as a reality by the US Securities and Exchange Commission (SEC), the Institute of Chartered Financial Analysts (CFA), McKinsey and Co., and the Harvard Business Review, among others. The question is no longer "Do ESG factors impact financial performance or not?" but rather "How can ESG factors be integrated into the investment processes of institutional investors, in order to avoid or minimize their negative impacts?"

The market recognizes the materiality of ESG factors. This is reflected in the strong acceptance by countries and many companies, of the Principles for Responsible Investment of the United Nations (PRI). There are currently

1,500 affiliated members (signatories) to such principles, representing assets close to US$ 62 trillion.

The Global Sustainable Investment Alliance (GSIA), also points out that about US$ 13.6 trillion in assets are managed under some ESG factor (Latin America is not considered in the study), representing 21.8% of globally managed assets. Europe, the USA and Canada account for 96% of investments involving ESG factors. Given the above, it is perhaps time for Latin America to further advance in these matters.

The fiduciary responsibility of institutional investors is related to materiality. According to the United Nations, integrating ESG factors in the investment analysis for achieving enhanced financial performance forecasts, is clearly permissible and contributes to the purpose of fiduciary responsibility (Sustainalytics, 2014). Eccles (2016) emphasizes that if pension funds have a long-term outlook for their beneficiaries, they would be ignoring their fiduciary duty by not considering ESG aspects in investment decision- making.

II. SRI in practice: selection and management of the different types of assets that are part of the SRI products

The identification of eligible assets for an SRI product is based on a combination of two complementary analyses:

1. **Extra-financial analysis**: Consists in identifying and assessing the good ESG practices of companies:

   ✓ Knowledge of key issues in each sector of activity (for example, the customer-supplier relationship in wholesale trade; environmental protection policies; best CG practices; decent working conditions in production/distribution chains, etc).

   ✓ Assessment within each sector of activity of the companies that best meet the ESG criteria, through regular meetings with them.

2. **Financial analysis:** To determine and assess the most attractive companies from a financial standpoint.

From this dual assessment, the product manager buys or sells shares, bonds or company debt to build the SRI products.

There are different SRI strategies that can be applied within products. The most common are:

1. Exclusion due to behavior contrary to international standards and basic rights.
2. Exclusion of activities (for example, controversial arms).
3. Assessment of outstanding traits (Best-in-Class), through the selection of companies with enhanced ESG assessment after financial analysis.
4. Dialogue with companies (aimed at improving the ESG performance of companies through processes of dialogue).
5. Integration of ESG criteria in traditional financial analysis. Consists in the assessment of investment portfolios, explicitly including ESG considerations in traditional financial analysis.
6. ESG thematic investments. This is a form of direct integration that consists in selecting companies and investments related to sustainable development issues and sectors, such as renewable energy, water, health, agriculture and forestry, or more generally climate change and eco-efficiency, among others.

The Spanish private pension funds

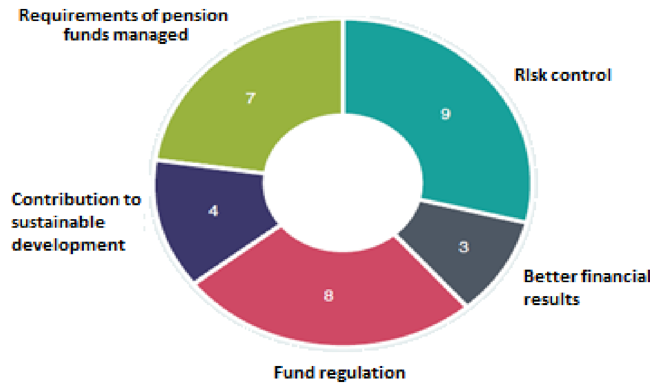
Among the Pension Funds of the FIAP member countries, the Spanish private voluntary pension funds[1] are perhaps the ones that most apply responsible investment policies and ESG factors in their investment strategies. As is apparent from a NOVASTER (2016) publication, the pension funds sector in the country has evolved significantly in the last year, in line with European trends.

Most of the Pension Fund Managers analyzed in the report, that manage assets of EUR 71,957 million (approx. US$ 77,345 million) and account for 69% of the sector, have personnel specializing in ESG, and 4 have subscribed to the Responsible Investment Principles of the United Nations (RIP).

Regarding the motivations for considering ESG issues (see Graph 1), all the fund managers understand that these factors are useful for controlling long-term risk. A second motivation is the protection of the reputation of the entity. Third is the requirement to apply ESG issues by the pension funds they manage. Fourth is contributing to sustainable development. Finally, there is the pursuit of better financial results.

Graph 1

Motivations for considering ESG issues

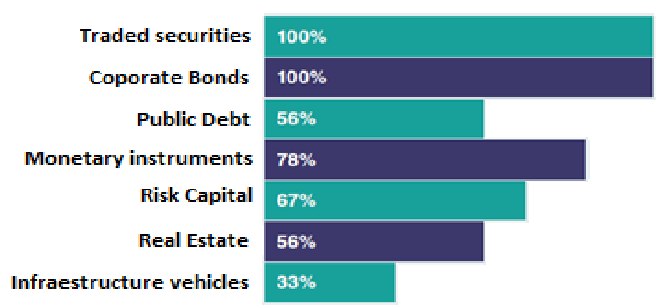


Source: NOVASTER 2016.

All the fund managers have formalized an ESG policy, which evidences the degree of development and maturity of the industry in this area. All the fund managers also apply their ESG policies to their stock market investments, and virtually all of them apply them to corporate bonds, or will do so in future. A majority of fund managers apply it, or will do so, to monetary assets (treasury bills, corporate promissory notes, etc), risk capital, public debt and real estate. They apply it to infrastructure in only three cases, mostly because four funds do not invest in these types of assets (see Graph 2).

Graph 2

Current or planned application of ESG factors per asset classes



Source: NOVASTER, 2016.

[1] The pension funds referred to here are those of the Individual, Employment and Associated systems. The Individual System includes plans promoted by one or more financial agencies, and whose participants are any individuals; the Employment System includes plans promoted by any agency, corporation or company, and whose participants are their employees; and the Associated System includes plans promoted by any association, trade union, trade association or group, whose participants are their associates or members.

All fund managers say that they perform some kind of integration in their SRI investment strategies. Five fund managers apply some kind of Best-in-Class. Two of them make thematic investments. Six of them apply pure integration, in which ESG issues are considered in financial and investment decisions, whereas two of them practice combined integration with some degree of exclusion.

The AFPs in Latin America

On reviewing the websites, annual reports and investment policies of the Latin American AFPs, it was found that there is an incipient degree of self-regulation in the industry with respect to the incorporation of ESG in decision-making regarding the investment of pension resources. Colombia was one of the leading countries in this regard, with three AFPs addressing this issue:

- ✓ **AFP Horizonte**. Following the Principle of Responsible Investment, it developed a complement to its policy for measuring the adoption of Country Code and CG practices by securities issuers in the Colombian market, which aims to extend the assessment framework to the social and environmental spheres. The implementation of these two areas was carried out through the formulation of eleven questions based on what was considered standard practice among securities issuers in the Colombian market, and they were added to the results of eighty questions of the Financial Superintendency’s survey. The result obtained was a percentage for each issuer that determines a criterion for the allocation of its credit limit. The issuers in which these policies will be evaluated are part of the real and financial sectors of the Colombian market, and they must complete the Country Code Survey and have a line of credit with AFP Horizonte.

- ✓ **AFP Old Mutual**. Among its discretional policies for assessing the CG of issuers, it states that a securities issuer must be an investment recipient, and among other criteria, must: (i) adopt rules, standards, codes of conduct or international initiatives related to ESG factors; (ii) publish reports to shareholders and/or the securities market related to ESG factors ; (iii) include in their annual reports explanations and the evolution of ESG aspects in the company; (iv) support the initiatives and resolutions of the shareholders that promote the dissemination of ESG principles.

- ✓ **AFP Protección**. Its investment policies state that it may invest in all sectors except those related to pornography, gambling or the manufacture of arms or ammunition used in wars or military conflicts. Additionally, the AFP incorporates social and environmental considerations in investment decision-making processes in those alternatives which, due to their nature, represent any kind of impact and/or risk to the environment and society.

III. Proposals and challenges for the AFPs

According to Enrione (2016), there are three proposals on how the AFPs can and must influence the quality and performance of CG in the markets in which they operate:

1. **Rigorously examine their own practices**. In order to demand improvements in the CG standards of the companies in which they invest, they must first conduct a critical self-examination. For example: Does the local market see the AFPs as examples of good CG practices? Do the AFPs comply with the same criteria that they impose or preach in the companies in which they invest? Do they really believe that their Boards of Directors are significantly better than the

market average? Do the AFP processes consider the needs of their clients?

2. **Explore a universal property perspective**. It is clear that the pension funds have a sole line of business, but given the huge amounts of the managed funds, the degrees of diversification and the long-term investment horizons, one should seriously consider the concept of "universal property." This means that the long-term value of investments will depend on country risk, the social fabric, the quality of institutions, human capital and environmental performance. Hence, the AFPs, beyond being excellent fund managers in search of the best risk-return combinations, must not lose sight of the fact that in the long term, the returns of the markets in which they operate can also be affected by these risks.

3. **That investment is perceived as a force for good**. If the AFPs, which are the largest economic investment force in the region, set high standards, at least for a portion of the local portfolio and international investments, then they must meet and disseminate these standards. Developing and disseminating local market and ESG factor rankings, and strengthening their communication areas, would appear to be key in this matter.

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