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Structuring and Disseminating Responsible Investment Values in Wealth Funds

Helen Campbell Pickford
Saïd Business School, University of Oxford

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About the author

Helen Campbell Pickford

Postdoctoral Research Fellow

Helen comes from a background in development and education, and has an interest in learning in organisations and the creation and distribution of knowledge in policy making. Her work on the Mutuality in Business project focuses on learning and leadership, relationships between MNCs, wealth funds and local communities in developing countries, and the impact of business-led social interventions.
Introduction

Adopting Responsible Investment values in wealth funds has not restricted their practices, but has led to innovation. Analysis of innovative management in large wealth funds has shown that they offer examples of the types of mutual business relationship developed by investors with long term horizons compared to those seeking short term profits. The funds have different ownerships (pension funds, Sovereign Wealth Funds (SWFs), and privately owned asset managers), different organisational structures, and different purposes. However, their common goal, to create wealth over the long term, provides an opportunity to study those aspects which contribute to mutually beneficial relationships between investor and company, and what innovations are taking place in the investment sector to redefine these relationships away from short-term profiteering. Aspects of these longer-term relationships have the potential to demonstrate how active management practices over the long term could benefit other investors.

The study includes seven funds: three pension funds, two SWFs, and two private equity funds. They have been chosen as examples of innovation which are actively contributing to best practices in the field of Responsible Investment. The study identifies features of innovative management practices which enable them to profit, in line with their fiduciary duty, while maintaining high standards of responsibility. These funds are not philanthropic, nor aimed primarily at social impact, nor do they have separate CSR or ethical funds; responsible profit-making is at the core of their strategy. This study therefore contributes to the literature on the relationship between ownership models and Environmental, Social and Governance innovations in Responsible Investment.

The funds are compared to show what practices have been widely adopted, and where continuing innovation is driving change in the investment sector. The findings show a wide diversity of investment strategies, from small stakes in a large number of companies, to larger holdings in fewer companies, across multiple sectors and regions. Some negative screen or divest; others actively seek companies with sustainable agendas. As shareholders, they typically vote on all shares; however, some build partnerships with companies, divulge their voting strategies, and build alliances with other owners; others allow company managers greater autonomy. The funds have a variety of internal governance structures, with different approaches to appointment, tenure and including employee representatives. Although all espouse ESG principles in investee companies, few demonstrate high levels of diversity themselves. Changes in the way CEO compensation is negotiated reflect changing values in the sector.

A key finding is that fund managers perceive active management as crucial to their ability to invest responsibly, with long-term horizons. Some build active management relationships with investee companies entirely in-house; others value external managers for diversified knowledge and contacts. Where external managers are employed, they are often selected for their alignment with the investor fund’s values. However, ‘active’ engagement with companies is not always synonymous with ‘direct’; some funds claim active management of shares owned through external managers.

Many of these funds are eager to influence values and policy. They are producers of knowledge and ‘culture’, both as internal working strategy and to influence others, including the governance of businesses they invest in. Despite their active contributions to national and international regulations, there is little consensus on strategies for investment, perhaps as the practices of long term investment are still being rediscovered. In the broader field of Responsible Investment, these funds
therefore offer an opportunity to consider the connections between long-term share ownership, 
management innovation, and the drive to influence the sector towards Responsible Investment 
practices.

1.0 Rationale for the research

These funds provide potentially useful models for more sustainable and responsible investing. Like 
typical investors, they are focussed on making a profit, having a fiduciary duty to do so (compared 
with purely social impact investors). They are not primarily for ‘social impact’, nor running CSR or 
philanthropy projects separately from their main business, but combine profit making with a long 
term, stewardship approach to businesses. However, they differ in significant ways, which enable 
them to invest more responsibly: firstly, they have long term horizons for returns, typically at least 
five years, but often up to ten or twenty years.

Secondly, and crucially for their relevance to the wider investment sector, their ownership structures 
share similarities with short term shareholders, in that they are technically ‘owned’ by very large 
numbers of citizens or pension fund contributors, but are managed by intermediary companies. 
They could therefore be at risk of behaving like ‘ownerless’ (van der Velden and van Buul, 2012) 
shareholders, which buy and sell rapidly to maximise short term profit, without seeing themselves as 
investing in a company’s longer term growth.

This paper examines (i) the ownership and governance structures, and (ii) the investment 
strategies that enable the funds to obey their fiduciary duty, while resisting the short termism of 
most shareholder, profit maximisation models. The funds examined have a range of purposes in 
addition to covering costs for aging populations, including diversifying (across currencies, regions 
and away from single-resource sources of wealth), resource management, and transferring wealth 
into the future, avoiding risks of inflation, environmental destruction and short-sighted ‘windfall’
 spending. They could therefore supply strategies for enabling long term investment for funds with 
different objectives. After examining their practices in detail, the Discussion and Conclusion 
considers the implications for changes in the use of knowledge, types of relationships between 
investor and investee, and the role of innovating funds as thought leaders, disseminating changing 
values across the sector.

Comparisons can be drawn between these different types of funds – SWFs, pensions and privately 
owned –due to their shared long-term values. Having a five year (or longer) horizon requires a 
fundamentally different relationship between wealth owners, fund managers and the companies 
they invest in. It makes developing a profound knowledge of the companies, their governance 
structure and plans essential, therefore requiring a relationship to be maintained between fund 
manager and company board. Managing this kind of long-term relationship needs a skill set that is 
being developed in different ways by different funds, reflecting differences in their approaches from 
the ‘hands off’ who see their role as enabling company boards to work efficiently, to those who seek

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1 “African funds should focus on two roles, argue Anthony Venables and Samuel Wills of the Oxford Centre for 
the Analysis of Resource-Rich Economies. A sudden windfall can generate inefficient spending: it makes sense 
to "park" cash offshore until capacity is built. And a stabilisation fund, invested in liquid assets, can bolster the 
budget when oil prices fall.” “Buried treasure; African sovereign-wealth funds”: The Economist; London 
422.9032 (Mar 18, 2017): 71.

http://search.proquest.com/docview/1890481388/fulltext/D67473FDF60741DFPQ/3?accountid=13042
partners who will use their advice on working sustainably (such as Generation Investment Management). Long-term horizons are a core feature of Responsible Investment funds, as responsibility is based on an approach to ownership in which long-term value is added to the company (discussed in more detail in the following section). The ways in which the values associated with long-term investing has produced different practices across funds illustrates how they need not restrict the ways in which fund managers operate, but in fact demands innovation in making a profit responsibly, enabling a wide range of strategies.

Practices are evolving rapidly in Responsible Investment, moving on from having separate ‘Ethical funds’ to mainstreaming responsible practices across all investments, and from having CSR projects separate from mainstream management to an increasing interest in the impact on wider stakeholders of all investment. One CIO, Alex van der Velden of Ownership Capital, summed up the changing landscape:

... the 1.0 model of responsible investment is where people sign up to the UN PRI (United Nations Principles for Responsible Investment). Model 2.0 is where most people are, when they hire someone externally or internally to engage with companies when something goes wrong. Ownership Capital is ... the next step in this process.  

Whether the owners are citizens, pensioners, or private investors, changing attitudes to the ownership of shares is vital for Responsible Investment. This paper examines the ways in which innovative practices are enabling funds to comply with their fiduciary duty while creating long-term value in investee companies, and how they are using their new knowledge in attempting to change values across the investment sector.

1.1 Terms: RI and ESG
There has been a lack of clarity about the difference between different terms used in Responsible Investment. This is partly due to different agents in the processes of marketing and investing in funds labelled responsible have emphasised different aspects of their practices as ‘green’, ‘long term’, ‘ethical’, ‘sustainable’, etc. to appeal to investors with different priorities, horizons and religious or legislatory restrictions. This paper does not attempt to determine what these terms should mean, but rather to summarise how the terms are currently used in practice.

The Financial Times’ definition reflects the current state of flux of Responsible Investment, emphasising that it covers many overlapping types:

Responsible investment goes by many names - it is variously referred to as socially responsible investing (SRI), ethical investing, sustainable investing, triple-bottom-line investing, green investing - but underlying these differing names is a common theme focused on long-term value creation. Value in this context refers not only to economic value, but to the broader values of fairness, justice, and environmental sustainability.

Terms used in Responsible Investment reflect different investor values, but is often seen as a concern with ESG factors: Environmental, Social and Governance. These terms illustrate the need to look outward towards the impact business investments can have on society and the environment,

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2 http://www.pensionfundsonline.co.uk/content/pension-funds-insider/investment-firm-sets-up-30-investment-model/831
3 http://lexicon.ft.com/Term?term=responsible-investment
and the governance structures which allow the investor to mitigate them. There is a spectrum from those RI funds which seek to minimise damage (through, for example, negative screening of investment in tobacco or pornography) to those which seek to maximise the social benefits of their investment. In balancing the need to make a profitable return and having positive social impact, those which most emphasise the latter are likely to be marketed as Impact Investment or Community Investment.

‘Sustainability’ is mentioned in some long term funds as an aim for Responsible Investment. The Brundtland Commission’s report for the UN, *Our Common Future* \(^4\) (1987) defined sustainable development as that which “meets the needs of the current generation without compromising the ability of future generations to meet their own needs”. One of the cases analysed here, Generation Investment Management, adapts the concept of stewardship for future generations to profit-making investors:

A sustainable company is:

i. one whose current earnings do not borrow from its future earnings

ii. one whose sustainability practices, products and services drive revenues, profitability and competitive positioning, and

iii. one that provides goods and services consistent with a low-carbon, prosperous, equitable, healthy and safe society. \(^5\)

The connection between developing ownership knowledge of companies to sustain long term investment, both in order to maximise profit through investment, while also balancing responsibility and sustainability, is explored in this paper through the strategies adopted by seven case studies.

This paper focusses on those funds which seek to achieve average or above-average returns by focussing on the long term ownership of shares, building relationships with companies, and maximising value creation through patient investment. \(^6\) In these funds, careful review of management and research into impact on the environment are not regarded as either ethical ‘optional extras’, or as in conflict with the need to make a profit, but as essential strategies to manage the risks over the lifetime of the investment.

1.2 Methodology

The cases in this study were chosen to cover different ownership types, different strategies in the use of in-house and external fund managers, and innovative practices in creating long term value. The funds selected represent themselves as responsible investors, deliberately innovating ways in which investors can support value creation, aiming to lead better practices in the investment sector. This paper examines these claims, the practices they use to enact responsibility, and strategies for influencing practices across the sector. It is worth remembering that the funds are representing themselves in these reports and on their websites. While their profits, management structures and policies are reported and open to public scrutiny and audit, their values are self-proclaimed and impossible to verify. This paper therefore discusses them as claims, rather than assuming all statements on values can be taken at face value.

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5 [https://www.generationim.com/generation-philosophy/](https://www.generationim.com/generation-philosophy/)
6 Of the funds included, one – Generation Investment Management – has a philanthropic branch. However, this is separate from its profit-making investment fund.
Of the funds analysed, two are SWFs, Singapore’s GIC and Norway’s NBIM. They are owned by the citizens – and future citizens – of those countries, accountable to citizens through their governments. However, they are managed independently from direct political influence by current governments. Three are pension funds, Canada’s Ontario Teachers’ Pension Fund and the Canadian Pension Plan Investment Board, and the Netherlands’ PGGM. They are ‘owned’ by the large numbers of pensioners who pay into them and managed independently of government, even when the pensioners are state employees. Two, Generation Investment Management and Ownership Capital, manage assets for private investors.

After screening approximately 15 funds which had been discussed in the press since 2008 as leading in Responsible Investment reform, these funds were selected for three criteria: innovation, to represent different ownerships, and the active promotion of best practices in Responsible Investment. In no way is this a representative sample of the entire field of Responsible Investment, but a sample selected to examine their claims of innovating best practices influential in the sector. Brief quotations from fund websites and documents are given throughout the paper to give some detail on the context of funds’ decisions, in addition to their statements of their strategies.

Screening involved searching fund websites and reports, initially for claims of being responsible investors; subsequently, in more detail to uncover what practices were used by each to screen their investments, research their governance and environmental impact, compensate CEOs, vote as shareholders, maintain high ethical standards of transparency and accountability, and influence other investors through contributing to regulatory frameworks, publications and lobbying. The results are shown in the table for comparison in Appendix I. Section 3 covers analysis of the ways responsibility values are enacted as practices, Section 4 looks at specific investment strategies across the funds, and Section 5 the governance structures and compensation policies that encourage long term horizons and allow them to innovate. Section 6 broadens the discussion from strategies of specific funds to implications of the ways in which knowledge from these innovations is being used as ‘Thought Leadership’ by funds ambitious to drive the adoption of responsible values throughout the sector.

2.0 Categories for Comparison of Case Studies

The categories include:

- **Strategies for Active/direct engagement**, including voting strategies, types dialogue and meetings, monitoring, assessment of Boards’ decision making, flags of warning, litigation and divestment.
- **Under Statements on Values and Culture**, claims of sustainable, responsible, and ethical investment are listed, with seeking to export values and Thought Leadership. Also listed are the international regulatory bodies which provide best practice frameworks which the funds have helped to develop, or with which they comply.
- **Under Statements of Investment Strategy**, there is analysis of the percentage of the portfolio which is actively managed, negative screening, screening requested by clients, the sector and region for investment, percentage of shares held in a company and duration of holding them, and which funds screen for sustainability of the companies they invest in.
- **Organisational Structures** looks at internal aspects of appointment, tenure and make-up of the fund management, but also strategies for maintaining independence from political influence. **Compensation structured to motivate long term horizons** goes into more detail.
on how Board pay is aligned with long-term values, including delayed payments, clawbacks, and Say on Pay.

For the complete table, see Appendix I.

3.0 Values as Practices

Drawing on the data on values and role in exporting cultures of responsibility, this section examines the funds’ statements on their specific values within RI, whether sustainability, ESG values, or being ‘green’. All of the funds claim to be actively involved in developing relationships with investee companies. This section identifies what organisational structures enable these funds to operate as active owners with a long term perspective. It analyses the relationship between

- Statements of values on cultures, developed within funds, and disseminated across networks constructed to share knowledge and influence practice;
- How their values are enacted in their investment strategies, including aligning values with external managers;
- How their values are shaped by national legislation, international regulation and organisational cultures.

3.1 Statements on Institutional Cultures

Corporate culture is a vitally important aspect of these funds, since it is the value they place on developing long term relationships with the companies they invest in which makes them both profitable and responsible. In addition, many of them place emphasis on exporting their values, working only with those managers who will maintain their approach to responsibility. The important role that large funds play in establishing the standards of responsibility for businesses more widely is recognised by organisations, such as the Interfaith Centre on Corporate Responsibility, campaigning for businesses to benefit a wider range of stakeholders:

As investors, few organizations have demonstrated a stronger interest in good corporate governance practices and the role governance plays in protecting shareholder democracy. Both labor organizations and pension fund members represent strong and critical voice for worker rights and greater equality both here in the U.S. and across the globe.

Canada’s Responsible Investment Association claims that values reflecting RI are becoming mainstream, whether through funds’ own policy making or their use of external managers chosen for their ability to align with these values:

Whether in-house or through external asset managers, Canadian pension funds are increasingly adopting RI policies and practices. In total, 53 of Canada’s largest pension funds and asset managers are signatories, reporting annually on their RI activities.

CRIA claimed 53 signatories to their code for Responsible Investment for Pension Funds in Canada. Across the case studies, a range of terms are used to describe their values as investors, suggesting

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that the concept is still evolving, and although values are shifting, there are still differences in focus. ‘Responsible’ is slightly more frequent, in keeping with references to UNPRI (the United Nations Principles for Responsible Investment). ‘Sustainable’ is also used, but ‘ethical’ is used only once, by Ownership Capital. However, in interviews with Alex van der Velden, he emphasises that (for example) divestment from fossil fuels is a business, not an ethical decision. “Ownership Capital has no fossil fuel investments. Less because of divestment per se, but because society will tighten regulation, making it high risk. […] Divestment is seen as being done for ethical reasons, but when you look at 30 year horizons, the financial risks are enormous. The issues are just not priced in...” (van der Velden, quoted in FT9).

While ‘Responsible’ and ‘Sustainable’ are the terms most likely to be used by the funds themselves, reports produced within the sector also emphasize ‘long-term’ investing. BlackRock, CPPIB, Dow Chemicals, Tata Sons, and McKinsey founded the organization Focusing Capital Long Term (FCLT) whose members include PGGM, New Zealand Superannuation, GIC, and other SWF and pension funds. The focus on long term horizons allows the funds to think of their impact not only across global networks in the present, but into the future. PGGM envisages an ‘ideal’ future, achievable only through influencing a network of partnerships:

A good pension is more than just having the finances in order. Our ideal future - the valuable future - is also characterised by a pleasant living environment, well-organised healthcare and facilities to help people work longer. PGGM not only wants to do its bit towards this, it wants to really work towards helping realise this future. […] we seek to cooperate with organisations that are as socially committed as we are. From our vision to our approach: you can follow our efforts towards a valuable future here.10

Partnerships with socially committed organizations working on improving the environment and healthcare may sound more characteristic of social impact investment than a pension fund, but this is not the term used. ‘Impact Investing’ is more likely to be used by academic departments and business schools, such as Columbia University’s CI3 – Impact Investing Initiative and the MIINT network – MBA Impact Investment Network and Training.

All of the funds have statements of their values or culture prominent on their websites. CIG list their values as Prudence, Respect, Integrity, Merit, and Excellent, or PRIME11. CIG’s reporting is typical in emphasizing the advantages of its long-term aims:

A long-term investment approach offers several advantages. It allows GIC to be contrarian in the face of short-term market movement and so reap higher long-term returns. For example, during market downturns, our active strategy teams are able to capitalize on our extensive networks, internal capabilities, collaboration and deal execution abilities to seize idiosyncratic investment opportunities with the potential for attractive returns. The illiquid

9 Financial Times Jan 5th, 2015 Steve Johnson: ‘Here be modern-day fossil fuel dragons’
10 Wherever italics are used in quotations, these are added to the original source.
and long-term nature of private equity and real estate investments also allows GIC to extract returns for bearing the illiquidity risk.12

GIC has a confidential platform for whistle blowers, in order to maintain integrity, and employees take an annual quiz on ethics.13 They state on their website that they were among the ‘architects’ of the Santiago Principles, the regulations on responsibility for Sovereign Wealth Funds14. Similarly, many of the funds claim not only to comply with international regulatory standards, but to have contributed to establishing them, and to uphold standards of ethical behaviour. Of these regulatory bodies, some are international, others national. They operate on multiple levels, constructing and sharing knowledge across networks in which individual actors often hold multiple roles simultaneously, disseminating knowledge and cultural values across institutional boundaries. For example, the Ontario Teachers’ Pension Fund contributes to the Canadian Coalition for Good Governance, widening their influence beyond pension funds to public companies. The organisations perceive partnerships as both extending their sphere of influence and increasing their potential impact beyond what they could achieve individually:

Alongside like-minded organizations, we can collectively use our influence to seek improvements in transparency and standards on ESG, conduct research and advocacy, and provide input to legislation. We join and actively contribute to initiatives that focus on specific subject matters, such as governance practices, and others that advocate for broader factors, such as fostering more long-term thinking in the investment and corporate worlds. All of these efforts further our ability as an investor to enhance the long-term performance of CPP Fund investments.15

The Canadian Coalition for Good Governance then lobbies more broadly on legislation and publishes guidelines (for example of ‘Stewardship principles’ and director compensation) which are aimed at business practices more widely:

The Canadian Coalition for Good Governance (CCGG) is the pre-eminent corporate governance organization in Canada and is uniquely positioned to effect change as the voice of Canadian institutional shareholders.

Representing the interests of institutional investors, CCGG promotes good governance practices in Canadian public companies and the improvement of the regulatory environment to best align the interests of boards and management with those of their shareholders, and to promote the efficiency and effectiveness of the Canadian capital markets.16

The Board includes directors from Ontario Teachers’ Pension Plan and CPPIB (discussed in section 4.1 below). Such an organisation provides the structure for co-ordinating the work of individual funds’ managers to spread a culture enabling ethical business practices. These organisations aim to influence the national legislation which determines much of the structure in which they operate, but

16 https://www.cccg.ca/
also international regulations and guidelines. In the case of the Santiago Principles which Sovereign Wealth Funds sign up to, the guidelines emerged from a working party first, including GIC, before the International Forum of SWFs was set up to help member funds to implement the guidelines. The IFSWF lists its main functions as setting standards, knowledge sharing and representation. For these organisations, producing and exporting knowledge and a cultural framework which makes it meaningful to practitioners is vital work. I argue below (Section 6, Discussion and Conclusions) that the values which drive active management of investment are also enacted through actively seeking to influence the investment sector towards responsible practices.

4.0 Investment strategies
There is a wide range of strategies for investment in these funds, produced by their organisational setup, including structures of decision making within boards and division of responsibility for assessing risk. (Other factors also influence investment strategies, including patterns of cross-border investment, cultural and regional affiliations, degree of transparency, and the level of independence from political control within the country where the fund is based.) For this paper, the aspect I focus on is the use of external managers for their investments. Fotak, Gao and Megginson (2016) discuss how the need to diversify, the need for investment models, and to achieve more active management means SWFs are seeking expert staff. However, while some seek to recruit staff and retain expertise in house (such as Ownership Capital, which manages all of its investments directly), others, such as GIC, perceive multiple partnerships with external managers as a source of local expertise and flexibility. I argue that both strategies require significant research capacity and learning from the organisation, either to develop expertise within the fund management, or to identify managers whose values align with their own. For this reason, these relationships also tend to be comparatively long term (as discussed below with reference to GIC).

One of the most important differences between the cases is the percentage of the fund managed directly. This varies between 6% in the Norwegian SWF, to the Ontario Teachers’ Pension Fund actively managing 80% of their Canadian dollar fund, and 100% of their infrastructure investment fund, while also holding their infrastructure investments ‘for life’. They may engage actively with working on around 20 companies. Despite this, all of the cases described themselves as ‘active managers’. For the Norwegian SWF, active ownership can also be exercised through using external managers to vote at shareholder meetings:

We are a minority shareholder in almost 9,000 companies. As part of our ownership work, we vote at general meetings and engage directly with companies’ boards and management. We have to make priorities so that our efforts have the greatest possible impact. This means that we focus on the companies where the fund has its largest investments by market value, and on companies that operate in particularly high-risk sectors.

Our active ownership is to pave the way for long-term profitable business practices and safeguard the fund’s investments. Our work is therefore dependent on good knowledge of the companies, sectors and markets we invest in. As well as engaging in dialogue, we conduct financial analyses and monitor companies’ performance.

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17 http://www.ifswf.org/about-us
18 https://www.NBIM.no/en/responsibility/ownership/
By contrast with the Norwegian SWF, Ownership Capital (as mentioned above) directly manages 100% of its investments; however, they typically hold only about 1% of the stock of the 20 – 25 companies they invest in. Their website makes it clear that this is at least partly because building detailed knowledge of the companies is demanding, though engagement with managers is an investment in learning:

Our portfolio is comprised of 20-25 high-quality companies. This focused approach allows us to gain a deeper understanding of investee companies and engage with some of the world’s leading management teams.\(^{19}\)

*Being an owner means knowing what you own.* Our specialist investment teams are dedicated to understanding every facet of each portfolio company’s business through an in-depth, hands-on research process. This means face-to-face meetings with management and visits to the stores, factories, and offices where their business is done.

Active engagement: *We actively engage with all portfolio companies on a continuous basis.* Working together with management, we encourage our companies to invest in the future to achieve the sustainable growth and business durability that is at the foundation of long-term success.\(^{20}\)

The Canadian Pension Plan Investment Board also claims to work closely with other investors, including private equity and hedge funds. Their understanding of active ownership extends beyond employing external managers to influencing networks of industry regulators:

Whether on our own or alongside other investors, we are committed to driving proactive dialogues with senior executives, board members, regulators, industry associations and other stakeholders.\(^{21}\)

CPPiB was instrumental in starting the Canadian Coalition for Good Governance, and maintains strong connections within it; as one example, Barbara Zvan,\(^{22}\) Chief Risk and Strategy Officer of the CPPiB, is also on the board of CCGG. CPPiB’s influence also extends into UNPRI and ICGN (the International Corporate Governance Network).\(^{23}\) I discuss in section 6 how such networks suggest that the principles behind active management of shares in investee companies are also enacted through active influence of others’ practices.

Norges Bank Investment Management seeks companies where the board managers have industry expertise. Although NBiM own minority holdings in each of the companies they invest in, they are able to influence them through their size and long term strategy:

As a large, long-term investor, we engage in dialogue with companies. *Our holding size gives us access to senior management and specialists at the companies we invest in.* These

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\(^{19}\) [https://www.ownershipcapital.com/investment-philosophy](https://www.ownershipcapital.com/investment-philosophy)

\(^{20}\) [https://www.ownershipcapital.com/](https://www.ownershipcapital.com/)


meetings give us an opportunity to learn about companies' operations, governance and prospects, and also to present our views on ownership, sustainable business practices and reporting.

We encourage the companies we invest in to be open in their public disclosures, because this contributes to efficient markets and equal treatment of shareholders. We believe it is important for companies that shareholders have insight into a company’s operations and can communicate their views based on their own analyses.²⁴

NBIM also attend AGMs and conduct site visits. Direct engagement strategies, including attending meetings, clearly require an investment of time. Van der Velden and van Buul (2012)²⁵ make explicit the connection between time spent learning about the investee company and the profitability of the relationship, linking the cost of time invested in building relationships with companies to increasing their holdings in them:

ESG analysis takes a substantial amount of time, not just to understand the specific facts but, more importantly, to understand their financial relevance. All this implies PGGM had to pursue an active and concentrated approach. Our strategy needed to incorporate ESG holistically within a fundamental financial framework to which active ownership activities could be added as necessary. Scarcity to a meaningful percentage of assets under management required taking larger stakes in the invested companies, something we would feel comfortable with only if we had in-depth knowledge of and strong relationships with investee companies. Active management would also allow for strategic increases or decreases in the stake of a company to stimulate ESG advancements, actions that could substantially leverage the credibility effectiveness of active ownership in a way that external ownership services cannot. Thus, the strategic objective of ESG integration and active ownership resulted in a three-pronged analytical approach involving (1) fundamental financial analysis, (2) ESG integration, and (3) active ownership.

Their focus on ESG factors as crucial to the profitability of investee companies is shared by the other investors, and is discussed in more detail below. ESG factors are also analysed by funds which use external managers. At the opposite end of the spectrum from Ownership Capital, rather than building relationships from within the fund management, GIC views partnerships with external managers as advantageous, bringing in local expertise and flexibility:

GIC employs external fund managers to access investment capabilities and opportunities. External managers enable GIC to gain exposure across both public and private markets. In particular, they offer us specialised and local expertise in various geographies. They also provide us with valuable investment insights.²⁶

Using external managers diversifies the government’s portfolio, expands the range of investment opportunities available, and helps us deepen our understanding of financial

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²⁴ https://www.NBIM.no/en/responsibility/ownership/
markets. We also look to such managers to outperform benchmark indices, taking an active investment approach and accepting higher levels of risk in search of higher rates of return\textsuperscript{27}.

GIC’s use of external fund managers varies greatly between asset classes. For public markets, external managers have at times been responsible for as much as 20% of the portfolio.\textsuperscript{28} What is interesting about these relationships is that although they remain as external managers, they are regarded as long term partnerships which provide expert knowledge and learning opportunities for GIC:

Most of the external managers we use have been investing for us for many years, in partnerships that have not only generated above average investment returns, but also given us insight into high-quality investment ideas and research, and industry best practice in both investments and operations.\textsuperscript{29}

GIC employs external managers around the globe: 9% in Australasia, 11% in Singapore, 22% in Europe, and 58% in North America. They handle 10% Fixed Income Alternatives, 36% Equities, and 54% Marketable Alternatives. It is notable that GIC’s relationship with its external managers bears comparison with the long term relationships direct investors form with companies; they provide a breakdown of length of mandate for external investors, with approximately 25% lasting up to three years; approximately 39% lasting 3 - 6 years; approximately 21% lasting 6 – 9 years; and approximately 10% lasting more than 9 years. It would be instructive to see if longer relationships with external managers become increasingly profitable as knowledge sharing is streamlined and values aligned. More data would be needed to compare the efficiency of entirely in-house expertise (as in Ownership Capital) and the use of external sources of knowledge, which GIC perceives as a source of strength.

One interpretation is that where investors have direct relationships with the companies they invest in, they develop their knowledge of those companies and develop their capacity as experts internally; in the GIC model, the expertise is distributed across partnerships. Where Ownership Capital insist that 100% direct management gives them competitive advantage, based on their knowledge enabled by long-term ownership, GIC also insist that external managers give them competitive advantage:

We look for external managers who can maximize a portfolio’s total market value over market cycles while controlling the interim risks. Our external managers complement GIC’s internal capabilities in their respective asset classes. As \textit{GIC has upgraded our internal management capabilities, the role of external managers has become more nuanced.} In general, we apply the principle of best sourcing, where we appoint external managers in equities and fixed income only if they augment the overall performance of the Government’s portfolio. External managers have to justify their management fees by delivering superior performance net of fees. Additionally, \textit{some of our external managers operate in niche markets or employ an investment style or strategy beyond GIC’s current capabilities.}\textsuperscript{30}

\textsuperscript{27}http://www.gic.com.sg/faq
\textsuperscript{28}http://www.gic.com.sg/faq
\textsuperscript{29}http://www.gic.com.sg/images/gic/Newsroom/External_fund_manager.pdf
GIC’s picture of evolving relationships between internal and external managers, added to their use of external managers to compensate for limitations in their own capacity, suggests that even where external managers are used, developing knowledge within the organisation is still vital. The factor in common between those funds which manage entirely in-house, and those using external managers, is the knowledge built through enduring partnerships. As with all the funds, GIC emphasise that external managers are selected to maintain similar values:

Our external managers must share our core investment philosophy that taking a long-term perspective enables an investor to earn superior risk-adjusted returns.\(^{31}\)

CPPIB make a very similar statement, also linking long term partnerships which allow the opportunity for knowledge and capacity building from the alignment of values:

It’s through our strategic partners that we’re able to access key opportunities. It’s through top-performing investment managers and specialized investment expertise that we’re able to gain access to markets around the world. And because we believe that our relationships are founded on trust, respect and mutual benefit, we routinely enjoy longstanding, established relationships that transcend typical client-supplier dynamics.

CPPIB emphasizes that maintaining partnerships over the long term requires them to respond to feedback from their external managers, as well as ensuring that their values are aligned at the outset. Values are not only imposed top-down, but feedback is used as guidance for developing CPPIB’s capabilities.\(^{32}\) The aspects of research and knowledge exchange within the partnership are emphasized:

Investment Partnerships (“IP”) maintains relationships with over 150 private equity and public market fund managers around the globe. IP leverages CPPIB’s scale, long investment horizon and certainty of assets to access top-tier external partners that are not available to most investors. We benefit from their expertise, which complements our internal capabilities. They offer access to well-researched investment opportunities and provide in-depth analysis, experience and ongoing management services. In turn, they value us as a highly knowledgeable investor and a trusted financial partner.\(^{33}\)

In effect, there are two strategies in use: either building expertise in investment opportunities in terms of sector, region and level of risk through developing direct relationships with companies, thereby maintaining knowledge in house; or distributing the same types of expertise across external fund managers. An important aspect of these relationships for our research is how the funds identify managers who will align with their long term approach to investing, and how they monitor the relationships to ensure that their partners maintain the values and culture they wish to propagate.

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Aspects of ESG are the most frequently listed where investors insist on an alignment of values. Ownership Capital sees ESG integration as a central part of the process of integrating other criteria for success in addition to the financial:

ESG integration: In a multi-stakeholder-driven society, traditional financial criteria no longer provide a full picture of business opportunities and risks. Long-term success can only be secured through proactive management of qualitative stakeholder, governance and environmental factors. To achieve investment success in this rapidly evolving landscape, we integrate advanced qualitative analytics into our fundamental, 10-year investment framework.34

Like the other funds, Ownership Capital see good management of ESG factors as managing long term risk, based on the recognition of increasing stakeholder awareness. Since poor management of these additional stakeholders is itself risky, for CPPIB, checking ESG factors is part of ‘due diligence’35 before investing. CPPIB’s statement linking ESG with risk over the long term is typical:

We believe that organizations that manage Environmental, Social and Governance (ESG) factors effectively are more likely to create sustainable value over the long-term […] Over the exceptionally long investment-horizon over which we invest, ESG factors have the potential to be significant drivers - or barriers - to profitability and shareholder value. For these reasons we refer to what many call ‘Responsible Investing’ activities simply as Sustainable Investing.36

They use questionnaires to evaluate compliance with their standards in the first instance, and then work with companies to ‘[a]ct as a long-term constructive partner to help companies meaningfully address ESG factors to the ultimate benefit of all stakeholders, instead of simply selling our shares’. Several of the funds outline highly evolved systems for assessing ESG in different sectors. PGGM describes ESG factors as ‘an integral part of the investment process’ and is amongst the most transparent about how ESG factors are applied:

The approach differs in each investment category. This difference is due to the degree of influence which PGGM can exert on the investment process, for example whether management is external or internal. In addition it makes a difference whether passive or active investment strategies are involved.37

PGGM has developed a system where there are specialised frameworks for different categories of investment, with separate sets of guidelines published for Real Estate, Infrastructure, and Private Equity. These have been developed from three stages integrated into analysing which ESG factors will affect financial performance in each sector; integrating their analysis into overall investment selection, e.g. by using them in evaluation models; and then monitoring and reporting over the long term. They publish quarterly reports on ESG factors.

34 https://www.ownershipcapital.com/
It is worth noting that although many of the funds insist on their inclusive policies, the European and North American funds are overwhelmingly male and white themselves.

4.1 Alignment of Values/Culture with External Managers

All of the funds emphasise that where they employ external managers, it is after a process of ensuring their values are aligned. CPPIB details a process of identifying and monitoring external managers who share their long-term approach, using a questionnaire to establish not only how their ESG policies compare to CPPIB’s, but what resources are committed to ESG, and how they are monitored:

Our approach to managing ESG factors with our external fund managers is firmly guided by CPPIB’s mandate to maximize returns without undue risk of loss. We evaluate how fund managers both reduce risk and increase performance in the companies in which the fund invests, which includes evaluating fund managers’ approaches to environmental, social and governance issues.38

The questionnaire extends the ‘due diligence’ of assessing ESG from CPPIB to its external managers.

Singapore GIC offers a contrast to the funds which claim to be direct or active managers, providing the most detailed, and most positive, description of its relationship with external managers. They are portrayed as active partners and sources of vital expertise, providing expertise, diversity and flexibility. Again, they are seen as sources of ‘high-quality investment ideas and research, and industry best practice’.39 As in CPPIB, feedback from external managers contributes to the fund managers’ knowledge not only of investment opportunities, but innovations and practices across the sector.

NBIM takes the alignment of values a step further, disseminating their values through discussions with other investors on adapting their compensation policies:

We will invite peer investors to consider shared principles for effective remuneration, and we look forward to discussing with boards how this general position could be applied, taking into consideration the company’s specific circumstances.40

Norway’s long term compensation strategies are discussed in more detail in section 5.2. Clearly, influencing pay for managers would be a highly effective way of influencing their attitudes towards long term investment.

In addition to investment management partnerships aligning values, in some funds they are extended into clients. PGGM describes all its clients as ‘ambassadors’41 for their ‘cooperative brand’.

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40 https://www.NBIM .no/contentassets/474d914d7b9b4e538ed2efa60e206259-ceo-remuneration---position-paper---norges-bank-investment-management.pdf
4.2 Types of Activity as Shareholder

Related to the perception of the funds as active owners, investing in the companies whose shares they buy, are the kinds of activity the funds use to initiate and maintain relationships with the companies. Across the case study funds there was again a variety of emphases on different types of activity being viewed as effective, although some strategies emerged as more frequently used than others.

One frequently mentioned aspect of relationships with investee companies is that researching them, and maintaining active relationships with them as investors, is time consuming, resource heavy and demands very high levels of skill and knowledge. (Strategies for hiring highly skilled staff are analysed in section 5.1, and the work of funds as research bases actively constructing their own knowledge is explored in 6.0.) In keeping with the findings on the diversity of approaches to investment strategies, each individual fund’s approach to active management appears to be highly evolved and the subject of continuous research and analysis within each organisation; but despite this, there are only limited areas of consensus on which strategies are consistently effective, suggesting strong cultural biases within organisations.

At time of writing, in the EU the MiFID II regulations include ‘Inducements relating to Research’ (Article 13; see Appendix 2).

Of the less frequently used strategies, only NBIM uses flags of warning, and only PGGM uses litigation. These two are also the only funds which list ‘dialogue’ with their investees as a regular strategy, though of course ‘dialogue’ covers a range of possible practices, and it is likely that the other funds maintain communication without considering it a separate strategy. Generation Investment Management is the only fund which states that it has a plan for how and when to escalate the closeness of management of investee businesses. Three funds (NBIM, CPPIB, and Ownership Capital) list sharing information with other funds.

Voting is a vital stratagem for the active management of share ownership. In addition to voting on shares they own, the funds have developed strategies for using voting to extend their knowledge or influence. GIM votes on all proxies as ‘being an engaged shareholder [is] an integral part of responsible ownership’. Voting is itself a strategy for building knowledge:

   Each analyst is responsible for reviewing the relevant corporate governance issues on a case-by-case basis and exercises their best judgment based upon their deep knowledge of the company. This is feasible because we manage concentrated portfolios, and view each proxy voting decision as an opportunity for analysts to gain additional insight into companies.

Again, strategies differ. NBIM publishes voting intentions and files shareholder proposals. GIM restrict publication to avoid influencing others:

Our proxy voting reports are available quarterly to our clients upon request. We believe this to be appropriate so as to avoid unintentionally influencing the voting decisions of others given the public nature of our holdings.\footnote{https://www.generationim.com/media/1141/generation-im-stewardship-code-october-2016.pdf p.3}

Of all the strategies used in active or direct management of investments, voting is among the most widely explored in the literature. Voting is listed as a form of active engagement by six of the seven funds, but even voting covers a range of practices. GIC is the only fund which does not mention voting at all; neither in internal elections for positions of responsibility, nor using their votes as shareholders. In terms of their internal governance structures, there is a strong emphasis on ‘culture’ and ‘leadership’ being top-down; in terms of their relationship with investees, there is emphasis on the use of external managers (see sections 4.0 and 4.1).

Among the other funds, voting strategies are highly developed. OTPP, for example, explain \footnote{https://www.otpp.com/investments/responsible-investing/governance-and-voting}

Why We Vote Every Share We Own: One of our most important rights as public company investors is the right to vote. For that reason, our objective is to vote every share of every company we own for every shareholder meeting. We ensure that our votes are cast in a manner consistent with our Corporate Governance Principles and Proxy Voting Guidelines and in the best economic interests of company shareholders over the long term.\footnote{https://www.nbim.no/en/transparency/news-list/2016/clear-expectations-towards-companies/}

This also imposes a burden of knowledge construction through their process for ‘informed share voting’, requiring OTPP to consult reports produced by the investee company itself, but also research from external providers. They emphasise voting for all decisions, avoid abstentions, and have a developed system for proxy voting, with most votes decided on a simple majority. Internally, they have say-on-pay votes (OTTP: p. 25). NBIM also aims to vote at all general meetings, and instructs external managers on how to vote.

Voting is one of the most important tools at our disposal for exercising our ownership rights. It presents an important formal opportunity to express views, influence companies and show support for the board – or hold it to account.

What is made clearer by NBIM is the use of voting as a means not only to influence individual companies, but to export their values. By publicising their votes, and voting in line with an established strategy, the fund establishes norms with which other funds and companies are invited to collaborate.

Our voting shall be predictable, transparent and in line with the fund’s long-term strategy. Norges Bank Investment Management has drawn up voting guidelines that set out our approach to voting and the overarching positions that guide our voting decisions.

Divestment is another strategy which illustrates the very different approaches of funds. NBIM has a system of monitoring changes in its investees which allows for them to go on a watch list, and for divestment to be used if deemed necessary. They divested from 73 companies in 2015, and from a total of 187 in the four years to 2016.\footnote{https://www.nbim.no/en/transparency/news-list/2016/clear-expectations-towards-companies/} They have expanded the criteria for divestment to ‘look
more closely at social and governance issues relating to health, safety and the environment, human capital and corruption.’ Like the other funds, they perceive ESG factors as highly significant risks (discussed below). However, their approach has been to divest after internal changes in their categorisation of ESG risks. By contrast, Ownership Capital use initial screening processes (such as no fossil fuels - see 3.1) to avoid divesting from their smaller, more focussed portfolio after initial investment, contributing to maintaining their aim for long term relationships with hand-picked companies. It is noteworthy that while Ownership Capital uses screening and NBIM uses divestment, both closely link social and governance factors with financial risk in the long term. Their strategies for dealing with risky ESG are different, but they both link poor ESG with high risk.

GIM perceive themselves as at the cutting edge of the divestment movement. Moving beyond initial negative screening or divestment reacting to involvement with fossil fuels, they build low-carbon sustainability into their search for companies with a long-term future in a world where fossil fuels have become a stranded asset. They seek to advise other investors in low-carbon sustainability through the Generation Foundation’s advocacy activities, including publications, partnerships, and funding The B Corps48 and Sustainability Accounting Standards Board (SASB)49.

There are two opposing narratives around meetings with company management. NBIM lists 3,520 meetings, including AGMs and meetings with individual investors, seeing these as a key ‘communication channel’50 for active ownership as part of responsible investing. Although attendance of meetings as a minority shareholder is time consuming, for the Norwegian SWF, they offer opportunities to communicate their values and communicate their priorities out of proportion to the size of the vote they hold. It is clear that they perceive meetings as sites of knowledge exchange; not only gathering information about the companies, but spreading their own values, based not on voting strength but the leverage their size and recognition as an international standard for governance affords them. (The role of funds as exporters of cultural values and in setting international standards is explored in more detail in the Conclusions.)

For all the talk of collaboration, being supportive and avoiding prescription, active management clearly requires being prepared to enforce decisions. Ownership Capital is prepared to propose changes in the remuneration structure or even to vote out the executive compensation committee. It is possible that only one fund uses threats of litigation (PGGM) because the majority find their ‘soft’ strategies highly effective. Both of these funds specified changing the compensation of managers of companies where they were not satisfied with progress. The vital importance of compensation strategies in setting and maintaining long-term goals have been widely explored in the literature and are discussed in 5.2 below.

5.0 Governance Structures
The funds used as case studies were selected to illustrate a range of governance structures. The ways in which the funds are governed reflect compliance with international regulatory frameworks (such as UNPRI and the Santiago Principles); national legislative environments; and organisational cultures. However, most significantly for our purposes, they reflect the range of strategies developed by the funds to respond to the needs of diverse groups of stakeholders: on the

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48 https://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps/our-funders
49 https://www.sasb.org/
50 https://www.nbim.no/en/responsibility/ownership/
ownership side, national governments, groups of contributing pensioners, and private investors; and the employees, communities and environments impacted by their activities. We examine the extent to which funds are able to innovate within their internal structures, and to drive the responsibility agenda across the sector, by adopting governance structures which embody the aspects of ESG they wish to promote.

At national level, the SWFs and pension funds must establish what degree of independence they are able to maintain from governments. CIG has the Government of Singapore as its only client, and reports to Parliament and the Minister for Finance annually. The Singapore Government states the terms of appointment, investment objectives, risk parameters, investment horizon, and guidelines for management. Appointment appears to be by top-down selection – there is no mention of elections or voting. However, the managers describe themselves as ‘Empowered and Accountable’, since the government does not directly interfere in investment decisions.

Other funds also maintain the independence of their investment strategies while answering to state authorities. CPPIB is a Crown corporation, accountable to federal and provincial finance ministers. Their sustainability monitored by the Chief Actuary of Canada. However, their independence is guaranteed by legislation, the Canada Pension Plan Investment Board Act, ensuring that their accountability is to their 20 million pension holders.

... Management is accountable to the Board of Directors of CPPIB. In the event a politician were to try to influence our investment decision making, we would remind the individual, in writing, of CPPIB's arm's-length relationship to government and the political process. Further, the incident would be reported to our Board of Directors for review and action if warranted.

CPPIB claim that their system is ‘globally recognized as a best practice for national pension plans’, and that as a result their model has been recognised by the International Monetary Fund, the World Bank, the Organisation for Economic Co-operation and Development, and the United States Congress. As with other areas in which these funds claim thought leadership, exporting their model suggests recognition of its legitimacy.

PGGM voluntarily adheres to the Code of Corporate Governance, despite not being a limited company, and therefore requires the companies it invests in to adhere to the same code. Again, this effectively makes it part of a network of organisations with shared values, while enabling it to reinforce them in practice.

We see it as our societal duty to act with care, transparency and integrity. That is why we have a code of conduct, a whistle-blower’s scheme, a PGGM Incidents Policy and a Social Integrity scheme. We also adhere to the Principles for Responsible Investment, the Global Compact, the OECD guidelines for Multinational Enterprises, the IFC Performance Standards and the Human Rights Treaties in the Netherlands. We followed the GRI G4 (Core)
international reporting guidelines, supplemented with the Financial Services Sector Supplement (FSSS), in preparing this integrated directors’ report.\(^{55}\)

It has a unique governance structure, in that it is a co-operative, and operates as a non-profit institution, with PGGM Coöperatie U.A. being the only shareholder in PGGM N.V.\(^{56}\). The employers and employees are the members. There is a profound shift in the understanding of the purpose of profit:

Making a profit is not of itself an objective, but a means employed to ensure the cooperative’s members are continually being given a better service.

The SWFs included here do not have employee representation on their boards, but the pension funds include more stakeholders. PGGM’s Members’ Council:

is the cooperative’s most important body; it has 45 members: fifteen representatives from employers’ organisations, fifteen representatives from employees’ and pensioners’ organisations and fifteen directly appointed members. The Members’ Council represents all the cooperative’s members; [...] the Members’ Council is responsible for furthering both the members’ influence and their commitment. In so doing, the Members’ Council ensures the sector exerts a direct influence on PGGM’s policy.\(^{57}\)

OTTP encourages open communication with shareholders, Evaluation of Board performance includes peer reviews and self-assessments (OTTP: p.15), and it holds say-on-pay votes (OTTP: p. 25) as ways of encouraging stakeholder engagement. The tenure of board directors is regarded as potentially a weakness (in contrast with patient investing). The governance committee decides whether

.... the length of service of a particular director has reached a point where the director’s independence may be impaired. This is best accomplished through a robust annual board and director evaluation program. (OTTP: p. 13)

As with every other aspect of innovation across these funds, their strategies for ensuring governance structures enabled stakeholders to influence decisions, maintain accountability and transparency, and uphold independence from political influence varied from enforced legislation, voluntary compliance with regulations, regular evaluation of management, and providing channels for whistle-blowers. Attitudes to shareholder democracy vary across the funds, but OTTP, CPPIB, PGGM and Norway’s SWF claim to seek ways of increasing both diversity and representation of stakeholders in the governance process.

5.1 Strategies for Hiring Skilled Staff
The lack of expertise, particularly in long term investment, is recognised as a limiting factor across the sector. According to CPPIB’s survey of public and private pension plan and SWF managers:

... while the ability to invest long term is an advantage, they do not necessarily have an effective set of implementation strategies/tools to help them realize their aspirations to be long term.\(^{58}\)

The strategies used by funds to invest are strongly influenced by whether they are able to recruit sufficient expertise to manage their ownership in-house, or employ external managers\(^{59}\). Knowledge construction requires employing staff with skills and experience, and continuing to develop sited knowledge of new companies. NBIM places strong emphasis on the ability to employ skilled staff, claiming 568 employees from 36 nationalities (Annual Report 2016). They see knowledge building as vital both to their financial success and accountability, including to future generations, with the development of knowledge essential for continuing successful long term management:

We organised four press seminars and two press conferences where we presented our reports and results. We hosted the Norwegian Finance Research Conference for a sixth time, arranged four seminars and published six publications on topics relevant to the management of the fund. [...] Our task is to manage the nation’s financial assets in a responsible, efficient and transparent manner. Openness and knowledge sharing are essential to give both current and future generations an insight into our results and how we achieve them.\(^{60}\)

Also emphasising their diversity, GIM have 93 staff of 25 nationalities, speaking 20 languages: 'The diverse nature of our team strengthens our convening power and external networks.'\(^{61}\)

At PGGM, the need to maintain the supply of knowledgeable staff is reflected in the compensation policy: 'The objective of the remuneration policy is to attract, retain and motivate qualified members to the Executive Board\(^{62}\). PGGM is the only fund in these cases to offer their expertise to other investors as consultants on asset management.\(^{63}\) However, GIM describe how their investee ‘partners’ seek ‘perspective on topics such as alignment or succession planning’. This suggests that knowledge exchange strategies can be part of highly active direct management to the point where investor and investee benefit from ‘partnerships’.

In their Position Paper on remuneration for CEOs, NBIM builds on the idea of using remuneration to attract knowledgeable staff, to aligning their values with the long term aims of companies they invest in. They suggest that pay packages with long term rewards actually enable the company to pay more to attract talent:

There is a market for leadership talent, and every company should be free to offer the compensation structure necessary to attract the leadership it wants. Long-term incentive


\(^{59}\) As mentioned in section 4.2, the funding of research by funds is affected by MiFID II. It is possible that retaining skilled and knowledgeable staff in-house will become even more important than at present, but the full impact is yet to be seen.

\(^{60}\) [https://www.nbim.no/contentassets/41460fa6a42b4bd4a758429b90f80da2/government-pension-fund-global---annual-report-2016.pdf](https://www.nbim.no/contentassets/41460fa6a42b4bd4a758429b90f80da2/government-pension-fund-global---annual-report-2016.pdf) Knowledge Building, p. 75

\(^{61}\) [https://www.generationim.com/firm-overview/our-people/](https://www.generationim.com/firm-overview/our-people/)


\(^{63}\) [https://www.pggm.nl/english/what-we-do/Pages/Asset-Management.aspx](https://www.pggm.nl/english/what-we-do/Pages/Asset-Management.aspx)
plans with performance conditions enable companies to set pay at levels that would otherwise be hard to defend.\(^\text{64}\)

Where the supply of skilled staff is insufficient to enable the fund to employ all experts in house, funds use a similar strategy to recruit external managers, while ensuring that their values are aligned. PGGM acknowledges the difficulty in employing staff with existing skills, and therefore also has strategies in place for training or employing external managers:

\textit{ESG experience will generally have to be developed in-house or outsourced to a relatively small pool of specialized external managers, as there are few funds that integrate both financial and ESG factors.} However, given that ESG skills are relatively underdeveloped, pension funds can gain a first-mover advantage by developing them sooner rather than later. p. 56

GIM places a strong emphasis on developing knowledge within the fund through groups bringing together several sources of knowledge and perspectives:

\textit{[our] investment processes encourage rigorous research, curiosity and continuous learning. We believe inter-disciplinary, diverse teams are the most likely to yield new insights and produce the best results for our clients over the long term.}\(^\text{65}\)

Recognising the need to develop expertise in long-term investing lead to a partnership including CPPIB, OTPP, PGGM, GIC and five other institutions\(^\text{66}\) to develop knowledge and produce guidelines to Focus Capital on the Long Term:

The ‘Long-Term Portfolio Guide’ gives practical ideas for how institutional investors might reorient their portfolio strategies and management practices to emphasize long-term value creation and, in so doing, become a powerful force for promoting a long-term mindset throughout the investment value chain.\(^\text{67}\)

This collaboration shows that the funds are actively contributing to the construction of the regulatory environment in which they operate. These outputs – regulations, guidelines and codes of best practice - can be seen as strategies to export their values by collaborating with those with similar values to promote, strengthening their impact through alliance.

However, although training and retaining staff is important for developing knowledge of firms and expertise in the strategies of long term management, the funds also recognise that change is necessary to remain competitive. The following section examines how managers’ compensation can

\begin{itemize}
\item \(^\text{64}\) https://www.NBIM\_no/contentassets/474d914d7b9b4e538ed2efa60e206259/ceo-remuneration---position-paper---norges-bank-investment-management.pdf
\item \(^\text{65}\) https://www.generationim.com/generation-philosophy/
\item \(^\text{66}\) CPPIB, BlackRock, Caisse de dépôt et placement du Québec, Capital Group, GIC, New Zealand Superannuation Fund, Ontario Teachers’ Pension Plan, PGGM, and Washington State Investment Board.
\end{itemize}
be aligned with long term investment horizons, and therefore used to demonstrate the funds’ values, their effectiveness and legitimacy.

5.2 Compensation for Boards and Managers
Funds exert influence over the companies they invest in by using compensation packages in two closely related ways: structuring the packages received by their own employees in a way consistent with their values, and encouraging the companies they invest in to adopt similarly structured packages. In several cases, their own remuneration policies are transparent, which not only conforms to the values agreed across networks of institutions, but is also a stratagem for encouraging investee companies to assess their effectiveness in recruiting and retaining skilled staff. Organisations which campaign for responsibility in business are aware that large funds, particularly pension funds, set influential standards in RI. According to the Interfaith Centre on Corporate Responsibility,

From governance issues that influence compensation packages, to the provision of employer-sponsored health insurance, [...] labor unions and state/city pension funds are among the most active investors and are deeply invested in corporate responsibility.68

Compensation packages are among the most effective ways of embodying values in such a way as to demonstrate that the funds are holding their own managers to the same standards as those in whose companies they invest. Always eager to portray itself as the world leader in standards for RI, Norway lays out the arguments for aligning remuneration with long term value. Arguing that transparency gives legitimacy, while also using the transparency of their reporting to demonstrate how their pay structures work in practice, in house and for ‘peer investors’:

As a global investor, our main concern is that CEO remuneration should be value-creating for the company. We believe that most leaders have an intrinsic motivation to succeed and contribute. Substantial long-term equity exposure reinforces this motivation and removes the distractions embedded in the design of long-term incentive plans69.

The most interesting insight into NBIM’s thinking here is the notion that leaders are intrinsically motivated not only to succeed – which could be seen as purely self-interested – but to contribute to others. Remuneration becomes a way of reinforcing their ability to create value, not only for themselves, but for their clientele. If taken at face value, it runs completely counter to the popular perception of wealth fund CEOs, attests to the strength of their mission, and shows the vital importance of their values in accomplishing it.

Embedded in their position paper on CEO remuneration70 is the assumption that long term shareholding as part of CEO remuneration serves diverse stakeholders by aligning their interests. The logic is that both the CEO and ‘wider society’ benefit from longer term value creation. Portraying CEOs as benefitting from the same long term horizons as all stakeholders, and as intrinsically motivated to benefit others, shows how far NBIM have travelled from the short term profit maximisation model. Nevertheless, their requirements for investee boards of companies

68 Interfaith Centre on Corporate Responsibility: http://www.iccr.org/membership/unions-and-pension-funds
70 https://www.nbim.no/contentassets/474d914d7b9b4e538ed2efa60e206259/ceo-remuneration---position-paper---norges-bank-investment-management.pdf
show that they assume this can be achieved within a profitable business model: ‘The board should ensure that all benefits have a clear business rationale.’

PGGM explicitly treats board pay as an ESG factor, in that fair pay affects recruitment and the stability of management. (Issues around the market for skilled staff are explored in 5.1.) PGGM’s statement on remuneration also sees it as a way to demonstrate their values:

In terms of policy and implementation, our remuneration policy is consistent with our culture, our core values (decisive, open and honest, pioneering, respect for people and the environment) and our core qualities (professional, continued improvement, entice (sic), bind, account).

PGGM use ‘long-term incentive structures’, including 3, 5 and 10 year targets, which ‘could also include a multi-year lock-up period to guarantee the stability of capital’. They show that the traditional use of bonuses as an annual incentive towards profit maximisation is incompatible with maintaining good ESG, and long term value creation:

No matter how good a philosophy is, if portfolio managers are incentivized on a short-term basis, they will eventually act on a short-term basis as well. Annual bonuses can be useful motivators for shorter-term operational targets, but they do not foster a long-term approach to investment performance. When portfolio managers are subject to more typical quarterly or annual performance restrictions, it is difficult to integrate ESG factors, which are generally less relevant on a one-year timeframe.

Regarding remuneration and bonuses, OTTP requires clawback provisions, companies to state their philosophy on executive pay and how it reflects the company’s objectives, and minimum share ownership requirements for executives. They link ESG factors to risk, requiring...

... incentives for performance that address both short- and long-term corporate objectives that we believe will be stable and not require alteration through the company’s business cycle...

In addition to the strategies used by the other funds, they also emphasise that say-on-pay votes are important, but recommend that they follow a three year cycle to prevent short term aims and instability. GIC provide less detail about their remuneration:

Cabinet Ministers and GIC executives on the GIC Board are not paid fees. We pay fees to directors from the private sector. The payment of director fees is as per industry practice and the amounts are reviewed regularly and take the market context into consideration.

71 https://www.nbim.no/contentassets/474d914d7b9b4e538ed2efa60e206259/ceo-remuneration---position-paper---norges-bank-investment-management.pdf
73 http://docs.otpp.com/TeachersCorpGovE.pdf p. 33
However, they specify that bonuses will only be paid when investments outperform the market. Ownership Capital use non-financial as well as financial indicators to decide on performance-related pay. OTTP also uses bonuses to reinforce long term values in a similar way to the rest of the remuneration:

We prefer to see that the exercise price or vesting schedule of the equity incentive be linked to the achievement of appropriate, company-specific performance thresholds that are explicitly linked to the strategic objectives of the company, as approved by the board of directors.  

NBIM provides figures as well as a rationale for performance related pay. Even when these are awarded, it is over a period of time, and at a fixed percentage of the salary:

Performance-based pay is calculated on the basis of the performance of the fund, group and individual measured against set targets, and is paid over a number of years. Half is paid the year after it is accrued, while half is held back and paid over the following three years. The amount held back is adjusted in line with the return on the fund. A total of 239 employees were entitled to performance-based pay in 2016. Their fixed salaries totalled 314 million kroner, while the upper limit for performance-based pay was 346 million kroner. On average, employees eligible for performance-based pay accrued 62 percent of the limit for 2016 based on multi-year performance. For 2016 in isolation, the average amount accrued was 52 percent of the upper limit. Performance-based pay may not exceed 100 percent of fixed salary, but for a limited number of employees at the international offices the limit is 200 percent.

Of all the funds, NBIM provide most detail on their policy for ensuring compensation is driven by, and drives, long term value creation. They recommend that “A substantial proportion of total annual remuneration should be provided as shares that are locked in for at least five and preferably ten years, regardless of resignation or retirement. [...] The board should commit to not offering any end-of-employment arrangements that effectively shorten or dilute the lock-in of shares. [...] The board should develop pay practices that are simple and do not put undue strain on corporate governance.” They own fund leader group receive only a fixed salary. They provide arguments for and against their position on CEO remuneration, which can be read in detail in NBIM’s CEO Remuneration – Position Paper, summarised here as an example of a highly developed compensation policy:

Arguments for the position
The performance conditions of so-called long-term incentive plans are often ineffective and may result in unbalanced outcomes. Long-term incentive plans tend to have complex and opaque metrics that are open to discretion, and boards often adjust, supplement or rebalance metrics during the measurement period.

74 http://www.gic.com.sg/faq GIC FAQ:
75 http://docs.otpp.com/TeachersCorpGovE.pdf p. 25
76 https://www.nbim.no/contentassets/49715a01ed684b1686ff3c017f1efa12/annual-report-2017---government-pension-fund-global.pdf
77 https://www.nbim.no/en/responsibility/our-voting-records/position-papers/ceo-remuneration/
The board will provide transparency by settling remuneration up front without performance conditions and disclosing a total amount of cash and shares that is not subject to later adjustments. Transparency will also limit the prospect of unanticipated and outsized awards that challenge legitimacy.

Simplicity ensures that board and CEO can focus on business. Performance conditions can encourage short-term behaviour. A simplified structure also ensures that CEO, board and shareholders can focus on the company’s strategic aims.

**Arguments against the position**

Locked-in shares may drive up total pay levels.

Settling a significant part of pay in shares locked in for several years will increase perceived remuneration risk, for which CEOs could demand compensation.

Remuneration must be tailored to the management challenge  
Boards should be able to reward strategic moves by the CEO, even if the market does not immediately appreciate their significance.

Restrictions on compensation will drive away leadership talent.

The business cycle or other external factors may drive the share price more than value creation by management. Well-calibrated performance conditions can better capture the achievements of management.  

Although CEO pay may appear to be a minor aspect of the culture of transparency and accountability for those funds which aim to set the ethical standards of the sector, by aligning their salaries with the long term values espoused by the funds, they incentivise the CEOs to practice what they preach.

**6.0 Discussion and Conclusions**

In analysing the relationship between the long term ownership of shares as an aspect of Responsible Investment, several themes emerged. The first of these is the ways in which funds are innovating, both in terms of their internal governance, and the way they build relationships with the companies they invest in, in order to adapt to long-term ownership; that, secondly, this has resulted in the move towards a model of share ownership which is closer to a partnership between investor fund and investee company.

A third theme is the constraints on funds’ ability to manage the shares they own actively and directly, currently imposed by a lack of organisational knowledge; and fourthly that the funds included in this study are responding to this lack of knowledge by restructuring their compensation to recruit managers whose values align with long-term investment.

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Finally, I argue that the move to more responsible values in investing funds is driving significant changes in the knowledge construction conducted by these funds: the need for deep knowledge of the companies they invest in, the risk factors, their governance and their environmental impact, means that the funds with the most active and direct management practices are exchanging expertise on sustainable practices with the companies whose shares they own. Knowledge of the company’s management, culture and practices are not a by-product of long association, but a precondition for investment. Poor governance and negative environmental impacts are perceived as risk factors in themselves. In some cases they are negatively screened out, while in others the investors are able to mitigate those risks through an advisory role.

The need for deep knowledge of the companies is therefore reflexively shaping the management, recruitment and compensation of the funds’ internal structures. However, I argue that it is also therefore driving the innovations that are changing the regulatory structures and organisations in the sector. The funds in this study both use the frameworks developed by IFSWF, UNPRI, CCGG, SASB, Euro SIF, US SIF, RIA, FCA, and the GSIA, and contribute to developing them. They not only undertake research into potential investees, but conduct wider research into the impact of their investments through partnerships with universities and non-profit NGOs, foundations, the UN Clearing House and other assemblies and fora. Thought leadership is a requirement not only to innovate to change their own practices and remain competitive, but to gain legitimacy for their values across the investment sector. Contributing to national and international regulatory frameworks through international organisations is a deliberate stratagem for exporting the culture driving their internal changes in order to influence others.

Although the sector is clearly in flux, demonstrated by the wide variety of internal governance structures, practices, and regulatory organisations, and by the lack of consensus in defining the meaning or implementation of such terms as ‘sustainable’, ‘green’, ‘ethical’, or ‘responsible’, these cases show that the innovations being trialled by these funds are changing the rules on investment well beyond their own organisations. How the understandings of responsibility continue to develop, how the funds manage their roles as knowledge constructors and thought leaders, and how they continue to interact with the regulatory organisations by exporting their values, will profoundly affect future models of share ownership by the world’s largest investment funds.

Appendix 1: Table for Comparison of Case Study Funds
This table lists the information publicly available on investment strategies, statements of values for Responsible Investment, and the organisational structures of the funds listed. An empty cell should not be taken as a negative, but that the information is not listed.

Appendix 2: MiFID II
The MiFID⁷⁹ (Markets in Financial Instruments Directive) legislation applies across the EU. At time of writing, additional regulations are coming into force.

⁷⁹ https://www.fca.org.uk/markets/mifid-ii/applications-notifications
Article 13 Inducements in relation to research

1. Member States shall ensure that the provision of research by third parties to investment firms providing portfolio management or other investment or ancillary services to clients shall not be regarded as an inducement if it is received in return for any of the following:
   (a) direct payments by the investment firm out of its own resources,
   (b) payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of the account are met:
      (i) the research payment account is funded by a specific research charge to the client; EN 27 EN
      (ii) as part of establishing a research payment account and agreeing the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure;
      (iii) the investment firm is held responsible for the research payment account;
   (iv) the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.
   (c) where an investment firm makes use of the research payment account, it shall provide the following information to clients:
      (i) before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for each of them.
      (ii) annual information on the total costs that each of them has incurred for third party research.

7.0 References

Where available, authors have been given. However, for the majority of webpages, no author is given, so the title of the webpage leads the entry.


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