ESG: Towards a more purposeful capitalism and fiduciary duty

OVER THE PAST DECADE, ESG investing has become most important trend in the asset management industry.

With the likelihood of achieving the 2015 Paris Agreement target to limit global warming looking extremely challenging, asset managers have a tremendous opportunity to reshape their role and reputation. Collectively we have the power to play our part in achieving the target by allocating capital to sustainable businesses and encouraging change for the benefit of society.

Classic theory

US economist Milton Friedman, who won the 1976 Nobel Memorial Prize in Economic Sciences, devised the shareholder maximisation philosophy and believed wage and price controls will harm the economy. But does this still work in today's climate-challenged world?

I would argue his analysis has proved harmful for wider society and, in fact, for shareholders. Classical economic theory is ill-equipped to describe the interdependence of finance, business, the economy and society in broader terms. Neither does it account for multi-generational economic transfers, whereby individuals choose to forgo consumption with no recompense to benefit future generations.

The global economy is currently emerging from the Covid-19 crisis in desperate need of growth. This should not be growth at any cost but a sustainable economic expansion that minimises the risk of another major crisis.

In *Reimagining Capitalism in a World on Fire*, published in 2020, Harvard professor Rebecca Henderson discussed the need to rewire capitalism.

She gets to the heart of what is wrong with modern capitalism and lays out a roadmap for how businesses can help drive the systemic change needed to build a capitalist society that works for everyone. Asset managers are a crucial component of the solution given we can invest clients' assets to both deliver returns and support the sustainable development of our economy.

40%

Percentage of pension funds in Asia and Europe committed to reaching net zero carbon emissions by 2050 versus just 17% of North American funds

In such a world, the fiduciary duty of asset managers needs to evolve from its historic role of delivering a risk-adjusted return to also take account what we deliver to society.

Our research on the interaction between ESG criteria and its impact on returns shows that adding bottom-up and top-down ESG restrictions into the portfolio construction process does not change the efficiency of the portfolio in an economically significant way.

Instead, there is evidence of a marginal improvement to risk-adjusted performance and downside protection: investors can achieve their risk and performance objectives while incorporating ESG preferences.

Modern theory

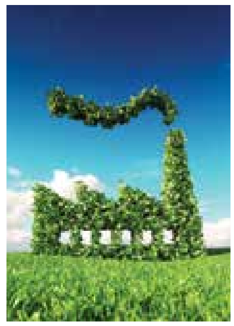
Given this, I believe portfolios will increasingly be measured not only on risk and return as per Harry Markowitz's modern portfolio theory but on risk, return and ESG. Asset managers will need to adjust to this new reality and consider every investment's ESG impact when constructing portfolios.

We are in a position to allocate capital to the right sectors and companies and engage to ensure they remain on an appropriate trajectory towards sustainability.

By doing so our industry can contribute to rebooting the global economy in a sustainable way while ensuring robust returns for investors.

However, at present, investors are not unified in this goal.

According to a 2020 study from Aviva, some 40% of pension funds in Asia and Europe have committed to reaching net zero carbon emissions by 2050 versus just 17% of North American pension funds.



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This reflects a divergence in commitment that can be partly attributed to the pace of regulatory reform and shift in the role of fiduciary duty over recent years on each side of the Atlantic.

In Europe, regulators are increasingly scrutinising the impact decisions and investments made by asset managers have on society, forcing fiduciary duty to evolve and shifting responsibility for these decisions from the underlying client onto investment managers.

The introduction of the SFDR, for example, aims to reduce greenwashing by increasing transparency and, as a by-product, will help redirect capital flows towards a more sustainable economy. This will intensify the trend towards a new definition of fiduciary duty.

The US is currently in a very different position. It withdrew from the Paris Agreement in June 2017, repealed the Clean Power Plan in 2019, and in 2020 ruled that fiduciaries have an obligation only to act in the best interests of beneficiaries, meaning that asset managers would need to prove that any ESG considerations would not damage performance objectives.

However, Europe's advantage is unlikely to last for long; change under US President Joe Biden has been encouraging and it will undoubtedly catch up with Europe. But for the time being, European asset managers have the potential to lead the pack in this very strong evolution of our industry.

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