How ESG is Practiced in Public Funds

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The Center on Japanese Economy and Business (CJEB) at Columbia Business School held a virtual symposium titled "How ESG is Practice in Public Funds" on April 14, 2022, as part of the Program on Public Pension and Sovereign Funds (PPPSF). David E. Weinstein, CJEB director and Carl S. Shoup Professor of the Japanese Economy at Columbia University, introduced the audience to the topic of the panel: How environmental, social, and governance (ESG) factor considerations are practiced in public pension funds. Professor Weinstein then provided a brief overview of the history and mission of CJEB before turning it over to Takatoshi Ito, professor at Columbia University's School of International and Public Affairs (SIPA) and Director of the PPPSF.

Professor Ito gave an overview of the work of the PPSF program, which is focused on researching how public pension funds and sovereign wealth funds should be organized, both in portfolio and governance matters. He introduced the panelists for the

event: Caroline Flammer, Professor of International and Public Affairs at SIPA; Pedro Antonio Guazo Alonso, Representative of the Secretary-General for the Investment of the Assets for the United Nations Joint Staff Pension Fund; and Keiko Honda, Adjunct Professor and Adjunct Senior Research Scholar at SIPA, as well as the keynote speaker, Masataka Miyazono, President of Government Pension Investment Fund (GPIF).

The first speaker explained that the main funding source of Japan's pension system is the contributions paid by participants of the plan. Japanese society is rapidly aging, so the burden on the younger generation is expected to become heavier – as a result, part of the pension funds right now is set aside so it can be, in the future, used to pay pension benefits. For the next 50 to 60 years, the pension reserve funds are expected to accumulate without being drawn down, then the tide is expected to turn, according to financial projections of the government.

Their organization is managing this reserve fund by investing it with a 50- to 100-year time horizon in mind. Their goal is to achieve stable investment returns so that those returns are able to benefit the participants of the pension scheme. In order to achieve this, their organization currently invests its funds with a portfolio that is 50-50 split between equities and bonds, with both categories also equally split between domestic and international assets. The fund's annualized investment return is 3.79%, and its total assets under management stood at $1.7tn at the end of December 2021.

The speaker then went on to explain that the legal guideline set for their fund is that the fund may only invest to achieve a return for the benefit of the pension scheme participants – no other considerations should be taken into account. They noted that

their organization doesn't hold any stocks directly but rather allocates its funds to external asset managers, who are then given the discretion to invest the money.

Because their organization is tasked with achieving a long-term return and is investing across several generations, it is important for the fund that companies' enterprise value increases and capital markets as a whole grow in a sustainable fashion over the long term. However, capital markets may be affected by environmental, social, and governance issues, and the sustainable growth they seek may be hindered by these impacts, which can be a risk for the fund's long-term investment, the speaker noted, adding that this is why their fund is engaged in ESG activities.

They then gave a quick caveat that the fund has legal constraints in how actively it can get involved in ESG, though it is still engaging to the extent possible, for instance, by sending out the message that ESG is important and joining with other entities in promoting ESG practices that it agrees with. For example, their fund became a signatory to the United Nations-supported Principles of Responsible Investment (UNPRI) in 2015. It also incorporates recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD) in its annual report. While it takes time to see the manifestations of the fund's efforts, it was still important to share its progress on ESG in its annual report with its stakeholders – the Japanese public. The report, which since 2020 also includes carbon footprint analyses of the supply chain, can be found on the pension fund's website.

On the equity investment side, their fund so far invests in eight passive indices that fall into the ESG bucket, spanning a total of $85bn in assets as of March 2020. Most recently, the fund added an investment with the FTSE Blossom Japan Sector

Relative Index. Of the eight ESG indices the fund invests with, five focus on Japanese equities and three on foreign equities. The indices include climate themes and gender-equality themes; for instance, one of the indices is the S&P/JPX Carbon Efficient Index, and another is the MSCI Japan Empowering Women Index.

From the carbon-efficient thematic investments, their organization is expecting that the emissions per revenue should be lower in this index. Overall, the speaker said that their organization wants to increase investments in such funds, as well as encourage investments with companies that are actively disclosing their climate information. According to the speaker, the philosophy behind this is, in part, that through improving their ESG practices, companies are able to improve stock market performance overall.

On the fixed-income side, the speaker explained that their fund has been promoting ESG integration for years, for instance, through a jointly published research report on the subject with the World Bank Group in 2018. Based on this study, their organization has built a platform for investment managers for opportunities such as green bonds issued by multilateral development banks and government-affiliated financial institutions in several countries. Their fund's own investments into such bonds, through the platform, stood at ¥1.1tn in March 2021.

Their organization also regularly surveys its external asset managers on which ESG issues they consider material. In the latest survey, climate change was cited as the main theme by all managers, except those in active domestic equities. Those asset managers predominantly cited corporate governance problems as material ESG issues.

Supply chain sensitivities were also mentioned by many managers, and the speaker noted that biodiversity is becoming more and more of a focal point as well.

To conclude their remarks, the speaker said they wanted to pay more attention to climate change-related disclosure criteria and, going forward, put maximum effort into securing long-term sustainable returns.

After the speaker's presentation, Professor Ito thanked them for their remarks and then presented three questions to the speaker. First, Professor Ito asked them to elaborate on what their organization is planning to work on regarding ESG aspects of the portfolio.

The speaker noted that, by now, ESG-related investments in the fund's equities portfolio were in excess of ¥10tn but added that new indices would have to be introduced to the portfolio. They said that the fund would like to shuffle around the indices it uses and invest in some active ESG funds if there are suitable ones for the portfolio on the market. As for the fixed income side, they noted that green bonds have become tremendously popular with investors, to the degree that it is now almost difficult for their organization to invest in them because of the strong demand. However, this still means that green financing is advancing smoothly.

Professor Ito then asked about their organization's perspective on one ongoing debate in the investor community: Whether in certain cases, some financial returns can or should be sacrificed because investments are benefiting society – a practice often referred to as "impact investing" – or if ESG investing should meet the same financial return expectations investors have of "regular" funds.

The speaker responded that, based on their fund's legal mandate from the government, investment for the pension scheme participants' benefits is the sole mission of the fund and its investment team. Since poorly managed ESG risk can negatively impact capital markets, reducing this risk through ESG-focused investments benefits the pension scheme participants by improving investment returns and generating a social return. When it comes to the resolution of social issues, however, the speaker said that in light of their investment principles, they wouldn't be able to promote impact investing for the time being, though the fund indirectly still contributes to sustainability and the resolution of social challenges.

Professor Ito also wanted to know whether, from the fund's experience with ESG investing so far, there could be any conclusions drawn regarding the question of whether ESG funds out or underperform "regular" funds. The speaker responded by saying that the performance of the fund's ESG indices, contrasted with major benchmarks, has been comparatively stronger in the past three to four years. They added, however, that since their organization is a long-term investor, they shouldn't become complacent or too pleased with short-term performance and instead continue to work to improve index methodologies, as well as to re-allocate and change ESG indices to enhance performance.

The next speaker began their remarks by noting that, while ESG has become quite popular, the investment style is still in a nascent stage. They said the first document referring to ESG investing was "Who Cares Wins," a 2005 report initiated by the United Nations and contributed by more than 20 financial institutions globally. While Socially Responsible investing funds – which, for instance, exclude investments in

tobacco or alcohol – have existed for a long time, the "Who Cares Wins" report explicitly recommended that private investors integrate non-financial factors such as ESG in their investment decision-making, which the speaker considers the "start" of ESG investing.

They then shared what they consider to be the definition of ESG investing: Integrate non-financial factors such as ESG factors that are important for stakeholders in investment decisions, both to mitigate risk and unlock opportunities. They added that with ESG investing, investors seek higher returns in the long term.

The speaker noted that there is still confusion among market participants when it comes to mixing up ESG and other similar but distinct investment styles, such as Social Responsible or Impact Investing. Many groups, such as government officials and retail investors, still often mix those up, even though it is important to make it clear that ESG investing is different from Impact Investing or Social Responsible Investing. The estimated amount of money in impact investments is also globally significantly lower than in ESG investments – $0.7tn compared to $31tn, according to research cited by the speaker.

They then presented a study on ESG investing, which covered a total of $24tn in assets under management among respondents, which were mostly asset managers and pension funds, and roughly split equally between the U.S., Europe, and Asia. Among the major findings was that 97% of interviewees were currently engaging in ESG investing, though the entry point for involvement was spread out over time.

Most of the survey respondents – about 60% – said they participated in ESG investing to generate higher risk-adjusted returns in the long term, the single largest reason for involvement. In terms of a specific strategy, all asset owners and managers

said they employed ESG integration, which includes incorporating ESG data, alongside traditional financial metrics, into the investment process. However, survey respondents also highlighted issues facing their institutions in accessing ESG investing. Most commonly, the difficulties surrounding data availability were cited as obstacles by 81% of respondents, with 37% of interviewees also saying that the lack of a clear ESG definition was a problem. Despite these complexities, the speaker concluded by remarking that things were progressing.

The next speaker presented insights on ESG investing from an academic research perspective. They began their presentation by giving a brief overview of the pressure points that have contributed to increased interest in ESG investing, such as social activism, government regulation, and corporations' risk associated with climate change. They then presented general findings from academic research, noting that research suggests there is a positive correlation between ESG and financial performance and a negative relationship between ESG and risk. In other words, this suggests that pursuing ESG investing can be beneficial for investors.

The speaker then went on to categorize various ways of ESG investing. In equity investing, investors can pursue passive ESG investing strategies through, e.g., ESG screenings, which can come in the shape of a negative screen, excluding certain securities or entire industries, or as a thematic screen, pursuing certain industries in a heightened manner. Alternatively, investors can also apply ESG integration, considering ESG factors in portfolio construction.

In addition to passive ESG investing strategies, the speaker explained that investors can also pursue more active ESG investing strategies. This includes ESG

shareholder engagement, which is available to large investors such as public funds and other institutional investors. Or, they can engage in ESG shareholder activism, submitting (and voting on) ESG shareholder proposals. Besides aiming to improve the ESG practices of their portfolio companies, investors can also engage in stewardship, helping to foster conditions that, for instance, advance climate risk disclosure and other policies related to ESG – to trigger change at the system level.

They then dove into how ESG is typically practiced by public funds, highlighting that most of them tend to pursue passive strategies without direct engagement with portfolio companies. This is despite academic research suggesting that active ESG investing strategies would be a more effective way to trigger change in the portfolio companies.

On the debt side, the speaker highlighted various fixed-income ESG instruments, such as green and social bonds, noting that based on the insights from academic research, green bonds, in particular, seem to have real impact and are not merely a tool for so-called greenwashing. Such results are evident when it comes to certified green bonds. Green bonds that are not certified, in contrast, do not lead to improvements in environmental performance in subsequent years, suggesting that greenwashing concerns do exist for those bonds.

The speaker concluded their remarks by highlighting pension funds' unique opportunity and responsibility to actively engage with portfolio companies on ESG issues and to be stewards. Beyond that, many other investors tend to follow pension funds' lead, compounding their impact.

The next speaker presented their organization's investment approach to ESG. They highlighted the investment differences between their fund and another: Whereas the other fund works with external asset managers, their fund manages 82% of its $85bn portfolio in-house. Private investments in funds, such as private equities, real estate, and real assets, have a target allocation of 20%. About half of the fund's total assets are in public equities, and about 30% are in fixed income.

There are, however, still commonalities between their pension fund's approach and the other pension fund's approach to ESG – for instance, both asset owners are UNPRI signatories. The speaker's fund, beyond that, also works with the UN-convened Net-Zero Asset Owners Alliance to establish standardized goals to decarbonize portfolios.

In terms of its ESG approach, the speaker noted that their organization's internally managed public equity portfolio has screens applied to it, based on the team's in-house methodology, that excludes certain firms, such as tobacco companies or thermal coal companies. As of 2021, the fund also decided to exclude companies whose main revenue comes from fossil fuel exploitation, a decision that led to a $2bn divestment in its portfolio, representing more than 2% of its overall assets.

After all the panelists had presented, Professor Ito led a brief question-and-answer session with the speakers. Topics discussed included (1) Whether the explosion in green bonds could become a problem for public pension funds and if they should get priced out of the market amid the boom (2) The effects on returns from applying exclusionary screens and the difference between ESG and impact investing in this manner (3) Carbon pricing and ESG scores.

Professor Ito concluded the event by thanking attendees and panelists for joining and CJEB corporate sponsors for their continued support.