A REFRESHING LOOK AT FIDUCIARY DUTIES

Significant New Report Shows that All Institutional Investing Must Be Responsible Investing

In 2005, powerhouse law firm Freshfields Bruckhaus Deringer shook up the investment world with A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (*Freshfields I*), which explained the need for fiduciaries to integrate social and environmental concerns into their analyses of company performance. Their new report, A Legal Framework for Impact (*Freshfields II*), should have even greater seismic effect.

The new report shows why investment professionals around the world are legally compelled to prioritize systemic issues such as climate change, inequality, and biodiversity loss over the financial performance of individual companies. For the diversified investors they serve, ESG engagement focused on individual company financial performance is less important than efforts to preserve important social and environmental systems. Fiduciaries have a duty to mitigate systemic sustainability risks using stewardship powers, even when doing so will not cause a particular company to gain in value—and even if it might cause the individual company to lose long-term value—if the potential for positive portfolio value outweighs the risk of loss to the particular investee.

Fiduciaries who fail to absorb the lessons of *Freshfields II* face considerable legal risk as these principles become understood and as the systemic impacts of irresponsible corporate behaviors mature.

FRESHFIELDS I: ESG INTEGRATION

Once upon a time, fiduciaries who managed other people's money were told that they should not consider "non-financial" issues—such as society or the environment—because their sole obligation was to optimize financial returns. *Freshfields I* exposed the ludicrous nature of this "rule" in 2005. The report explained that the effect a company has on society and the environment is often closely tied to its financial performance, and that therefore fiduciaries are permitted—even required—to pay attention to a company's social and environmental performance.

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Since the publication of *Freshfields I,* investment professionals have come to better understand the interaction between a company's impact on society and the environment and its financial performance. Investment management that leverages this connection his is often called "ESG integration," and it has emerged as an important facet of investing. Yet companies continue to harm society and the environment in pursuit of profit, often to the detriment of financial markets.

THE REMAINING GAP: ESG INTEGRATION V. SYSTEMS-FIRST INVESTMENT

Despite its success in focusing fiduciaries on social and environmental issues, ESG integration has failed to adequately address the impacts that individual companies may have on critical systems that undergird the economy, and correspondingly on the financial results of other companies in an investment portfolio. The systemic impact of an individual company decision on overall portfolio performance can far outweigh the impact of the decision on the financial performance of the company itself.

Yet many investment professionals believe that the ideas behind *Freshfields I* did not support investment decision-making that accounted for system-wide effects on portfolios. The trustees of fiduciary institutions have been told that it is a breach of fiduciary duty to give greater weight to the health of the environment than to the financial performance of a single company threatening that health. This narrow view has restricted shareholder stewardship to social and environmental issues where the financial performance of an engaged company can be improved. It has left shareholders to permit or even encourage corporate conduct that is financially beneficial to an individual company, but harmful to broad portfolio returns. In economic terms, ESG integration forces companies to ignores externalities, which Duncan Austin has called "the dropped stitch" of 20th Century economics.

> "[T]he failure of economics to fully incorporate externalities in its 20th-century theorizing now appears to be the dropped stitch that defines the whole discipline. For a long time, this was a tolerable neglect as… the environment was able to absorb the fewer demands of a smaller, less consumptive population. But, with the cultural ascendancy of market forces and the onset of a climate emergency, the context has changed considerably. It matters more and more that we might not have slightly incomplete markets, but very incomplete markets."
>
> **Duncan Austin**
> ***Pigou and the Dropped Stitch of Economics***

FRESHFIELDS II: SYSTEMS-FIRST INVESTING

Freshfields II addresses this gap. The main portion of the document summarizes the law of eleven critical jurisdictions respecting the duties of institutional investors to address sustainability concerns. It explains that under the law of each of these jurisdictions, fiduciaries can and should steward companies to ensure that social and environmental systems are maintained in order to protect portfolio value. The document makes it clear that such stewardship may result in engagements that reduce long-term financial return at one or more individual companies. In short, just as *Freshfields I* triggered the era of ESG integration, *Freshfields II* foreshadows the era of systems-first investment.

INVESTING FOR SUSTAINABILITY IMPACT

Freshfields II calls responsible investment "Investing for Sustainability Impact" (IFSI) and breaks it into two categories:

- ***Instrumental IFSI*** *is where achieving the relevant sustainability impact goal is 'instrumental' in realising the investor's financial return goals.*

- ***Ultimate ends IFSI*** *is where achieving the relevant sustainability impact goal, and the associated overarching sustainability outcome, is a distinct goal, pursued alongside the investor's financial return goals, but not wholly as a means to achieving them.*

Freshfields II explains that the purpose of instrumental IFSI (but not ultimate ends IFSI) tracks the universal obligation of fiduciaries to protect the financial value of managed assets, by addressing system-wide concerns to optimize financial performance:

> *One reason [for instrumental IFSI] will be protecting or enhancing the financial performance of the investor's portfolio. In particular, targeting sustainability impact goals might be intended to help support the sustainability of economic, environmental and social systems on which financial value depends, the declining sustainability of which could (as with climate change) create systemic risks to investors' ability to achieve their financial goals.*

This language from the Executive Summary signals that investors must move beyond ESG integration; irresponsible activity by a company activity is a threat to the financial sustainability of entire portfolios and not just to the return of the company itself.

NON-DIVERSIFIABLE RISK: INSTRUMENTAL IFSI REQUIRES BETA STEWARDSHIP

Freshfields II recognizes that modern investment techniques—Modern Portfolio Theory (MPT) in particular—require broad diversification of portfolios to mitigate company-specific risk, but that some risks cannot be diversified, requiring fiduciaries to reduce those risks, when possible, by other means:

> *In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore*

> *damage the performance of a portfolio as a whole and all portfolios exposed to those systems.*

Importantly, *Freshfields II* explains that such stewardship is not designed to improve "alpha," the part of a portfolio's financial return above or below a particular benchmark. Instead, it is designed to improve the return of those benchmarks, or "beta":

> *[A]ny impact from stewardship on investment performance, short-term or otherwise, in relation to a given enterprise is shared across all investors and reflected in the benchmarks against which investment performance is measured…*

A PURE MODERN PORTFOLIO THEORY APPROACH, WITHOUT MORE, IS A BREACH OF FIDUCIARY DUTY

The report then takes the logical next step, and explains why using solely MPT, which focuses on improving alpha without trying to control beta, is itself a breach because it fails to address the most important aspect of financial return—the performance of the market itself:

> *MPT helps in addressing the impact on a portfolio of risk that is idiosyncratic (i.e. specific to investment in an individual enterprise) and can be 'diversified away', but does not help in managing the risks presented by exposure to economic systems as a whole from factors like environmental and social sustainability. It essentially assumes that these are beyond the control of investors…*
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> *In consequence, it seems likely that these models and theories could result in insufficient attention to:*
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> *…systemic, non-diversifiable, risk which due to its system-wide nature could do material damage across an investment portfolio and to all portfolios invested in a given market (since the models do not address this kind of risk).*

> Large investors at insurers, pension funds, and non-ESG mutual funds are understandably very conservative when it comes to changing the way in which they invest the trillions of dollars under their control. A sober 564-page presentation from a major law firm is exactly the sort of thing to help them change their ways.
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> **Felix Salmon**
> Chief Financial Correspondent, Axios

With this in mind, it becomes clear that for diversified investors, ESG engagement focused on individual company financial performance and tracking or beating benchmarks is less important than efforts to preserve important social and environmental systems as part of a program of instrumental IFSI:

> *The more diversified a portfolio, the less logical it may be to engage in stewardship to secure enterprise specific value protection or enhancement. Diversification is specifically intended to minimise idiosyncratic impacts on portfolio performance…*
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> *Yet diversified portfolios remain exposed to nondiversifiable risks, for example where declining environmental or social sustainability undermines the performance of whole markets or sectors… Indeed, for investors who are likely to hold diversified portfolios in the long-term, the question is particularly pressing since these are likely to be the main ways in which they may be able to make a difference.*

This idea is brought home in the section of the report focused on U.S. law:

> *Pension funds will need to consider stewardship activity, including the use of voting rights, if they conclude that such stewardship activity will enable the fund to:*
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> *(a) Cause a particular investee target to achieve a given sustainability impact that will serve to maintain or enhance such target's value in the fund's portfolio… or*
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> *(b) Mitigate a systemic sustainability risk that could adversely impact the performance of its portfolio—*

The contrast between (a) and (b)—ESG integration and beta stewardship—implies that the latter is enough to require action, without any element of the former. The "or" is critical—**U.S. pensions have a duty to mitigate systemic sustainability risks using collective action even if it does not cause a particular company to gain in value—and even if it might cause the individual company to lose value over the long-term—if the potential for increasing portfolio value outweighs the risk of loss to the particular investee.**

CONCLUSION

Freshfields II provides compelling legal authority for investors to actively counter a dangerous and long-understood economic reality: companies can and do create costly externalities even while creating value and financial return for their shareholders. The risk that individual companies will maximize their own returns without regard to systemic impact renders investment professionals around the world critical gatekeepers with the voting and investment power to mitigate that risk.

With this new report in hand, fiduciaries will understand that they are legally permitted—indeed, compelled—to use this power to engage in instrumental IFSI that prioritizes systemic issues over the financial performance of individual companies. They must use their stewardship powers to oppose risky corporate behavior, even if doing so might cause the individual company to lose long-term value, keeping their eyes on the prize of optimizing overall portfolio returns and the systemic health such optimization requires.