The role of asset consulting in transforming investment decision-making:
The integration of environmental, social and governance considerations into corporate valuation

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Abstract

This paper seeks to address a gap in the professional services literature around theoretical conceptualisations of the role of investment consultants in pension fund decision-making. This role is considered in light of recent moves within the finance community to integrate environmental, social and governance (ESG) considerations into corporate valuation analysis; a move which has gained momentum following the shortcomings in financial model making elucidated by the global financial crisis. Using survey data collected by the United Nations Environment Programme Finance Initiative to develop theoretical arguments, this paper portrays the consultant in a conflicted position as both thought-leader with direct access to trustee board decision-making, and as corporate follower where client demands prevail. It is suggested that higher levels of expertise and knowledge strengthen consultants' ability to take a leadership position in the adviser-client relationship. In cases where consultants have superior expertise, they are able to build more influential relationships with their clients and colleagues, and overcome systemic and cultural barriers to new investment approaches within the investment community.

Journal article

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1. Introduction

It has been argued that the sub-prime mortgage crisis of 2007 in the United States was only the trigger for a far deeper malaise in global financial markets in general and investment practice in particular. The systemic weakness in financial markets could be found in perverse incentive structures underlying financial deal making, as well as a profound inadequacy of disclosure and risk appraisal (Soros, 2008, Stiglitz, 2008). This resulted in credit rating agencies inaccurately grading the risk profile of mortgage-based financial products with high exposure to sub-prime mortgage investments. Looking to the future, some are suggesting that climate change could present another major future shock to financial markets, or as Sir Nicholas Stern suggests, potentially the greatest market failure in human history (Stern, 2007). As such, this is leading to a growing awareness of a need to expand the range of investment tools and practices employed by investors in assessing considerations material to asset pricing, if financial markets are to reflect and price more accurately systemic risks of various kinds over the long term (Forrest et al., 2006, UNEPFI, 2004).

Given their long-term time horizons and their exposure to multiple geographies and multiple sectors through global portfolio diversification, some have argued that pension funds can be described as universal owners. This, in principle, should make them conscientious participants in systemic reforms that improve the management of the global economy (Guyatt, forthcoming, Hawley and Williams, 2007), such as driving change in investment practice to include more comprehensive criteria, particularly as related to the integration of environmental, social, and governance (hereafter, ESG) considerations. Indeed, the potential influence of pension funds is large; in terms of sheer size, pension funds at the end of 2007 accounted for USD 28.2 trillion in the USD 74.3 trillion global fund management industry, effectively making them the largest single source of funds globally (IFSL, 2008).

Yet it is questionable whether most pension funds are actually capable of effectively employing their strength as universal owners, and thus the capacity to effectuate broader changes in investment practice and financial market operation. Such potential financial power is arguably limited partly by shortcomings in governance architectures (Clark and Urwin, forthcoming), and limitations of board-level competence within pension funds, as some studies suggest (Ambachtsheer et al., 2008, Clark and Urwin, 2008b, Clark et al., 2006). As a result, trustee boards widely rely on investment consultants for financial advice[1], effectively making them crucial actors in the investment decision-making process (Maatman, 2005). Yet despite such an important role, it is questionable in contrast whether investment consultants are effective at driving an investment agenda that includes ESG integration.

In this paper we examine specifically the role of the investment consultant with respect to the integration of ESG considerations in the valuation of assets and asset allocation in pension funds. On the one hand, we explore the conflicted role of the investment consultant given their position as 'thought leaders' driving innovation in investment management, but also their contractual duties to serve the requirements and wishes of the client. On the other hand, we are interested in understanding what elements of the consultant-client relationship allows such barriers to be overcome, such as a more coherent ESG consulting framework. This analysis is done in the first instance through an engagement with existing literature on the structure and function of pension fund investment decision-making. In following, we sustain this analysis utilising questionnaires collected by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative from six investment consultancies based in the UK, the US, and Japan, but with operations that spread across other markets (e.g. Canada and the Netherlands) with large funded occupational pensions[2].

Although we acknowledge that the sample size is relatively small, the overall pension fund market share of these consultancies is large. Except for one Japanese consultant with a domestic practice, these consultancies represent the world's largest and arguably the most influential global investment consulting firms with global institutional, tax-exempt assets under advisement of USD 8 trillion collectively as of June 2008. This represents approximately 30% of the world's pension funds assets. Individually, the consultancies varied in worldwide institutional tax-exempt assets under advisement of less than USD 700 million to almost USD 3.6 trillion as of 30 June 2008 (Investments, 2008). In effect, this provides scope to reflect more generally on the institutional uptake of ESG integration and related issues in developed financial markets.

This paper proceeds in the following manner. The next section brings light to the conflicted terrain around responsible investment in the academic literature over the last 25 years and situates ESG integration as a new and distinctive investment tool within this literature and in investment practice. Here we should note that this paper is not about claiming the relative merits of ESG as an investment tool; we are concerned exclusively with the issue of ESG integration. Section 3 maps out the role of investment consultants within the chain of financial advisory services available to pension funds. Section 4 discusses the dataset used in the paper and section 5 presents the results of consultants' views on ESG integration techniques and principles in detail. The final section discusses the implications of these results in terms of the difficulty of driving new alternative methods of investment analysis.

2. ESG as investment tool

The emergence of ESG as an investment tool needs to be clearly distinguished in the academic literature from the field of socially responsible investment (SRI). The fundamental distinguishing feature between these two approaches is motivation. Whereas SRI is essentially motivated by ethical imperatives and aims to actively shape the market, ESG integration is motivated by economic imperatives and is a risk-analytics tool aimed at capturing the effects of environment, social and corporate governance considerations on the risk-adjusted return of portfolios. In this regard, ESG integration is arguably a more tangible and effective method of addressing such issues given conventional investment practice, which relies heavily on quantitative measures and standardised benchmarks (Forrest et al., 2006).

The SRI literature has a long history stretching back to the 1980s where it had strong uptake amongst European funds such as the Stewardship Fund in the United Kingdom and Varldnaturfonden in Sweden (Louche and Lydenberg, 2006). The attempt behind these early funds was to focus investment in assets that were regarded by those investors as "socially responsible". From the practitioner perspective, sell- side analysts were engaged in constructing portfolios that satisfied a particular appetite for non-financial goals. Within the academic literature, however, defining which investment goals are “socially responsible” has been contested based on different moral, ontological, ideological, and functional definitions of social responsibility (Sandberg et al., 2009). SRI has been used to describe investment portfolios that achieve a sufficient level of financial return as well as offering social, environmental and other non-financial benefits (Sparkes and Cowton, 2004). This definition of SRI is fundamentally politicised because each investor, as a consumer of financial products, demands their own mix non-financial goals and outcomes making the construction of a commonly agreed upon “SRI portfolio” practically impossible (Davis and Thompson, 1994, Hendry et al., 2007).

Separately to this prerogative, a body of literature has developed on the *economic* consequences (as opposed to the ethical consequences) of social, environmental and corporate governance variables on the financial performance of the investments. This literature has spawned many streams of academic research in finance, law (Black and Coffee, 1994) and management (Davis and Thompson, 1994). On the one hand, quantitative research has been carried out trying to use social (Orlitzky et al., 2003), environmental (Bauer et al., 2005) or governance (Bauer et al., 2008) variables to explain shareholder returns. This literature at times has faced methodological challenges by virtue of the fact that often environmental, social or corporate governance data has been located within SRI-related products, either in an aggregated fashion or in the form of self-assessed qualitative metrics. This has given reason to qualify the conclusions of much of this quantitative research. On the other hand, the literature has focussed on the ability of ownership rights and shareholder activism to change corporate management. This literature has mainly focussed on changing company's governance in light of Jensen and Meckling's (1976) agency theory (Clark and Hebb, 2004, Hebb, 2008, Neubaum and Zahra, 2006). Whatever limitations may be placed on the conclusions reached by this research, it is clear that the underlying economic motivations of this research stream fundamentally distinguish it from the ethical overtones of the SRI literature.

ESG integration has emerged as an investment tool that clearly falls within this latter economic-focussed literature. Championed to a large extent by the United Nations Environment Programme Finance Initiative and major sell-side investment houses around the world such as Goldman Sachs, UBS, and JP Morgan, ESG integration is a new investment tool which is focussed on risk analytics and identifying long-term 'alpha' drivers (above benchmark returns). In other words, it is about more precisely determining the impact of environmental, social and corporate governance considerations on asset pricing and the future cash flow of businesses. As such, it is a split from the primarily ethical/market-transforming mandate of the SRI community and as such has attracted some consternation from academics within this community (Richardson, 2009).

The importance of ESG integration in financial analysis is partly grounded in the failure of financial actors to fully price the value of quantitative data regarding a firm's environmental, social, and governance performance into asset pricing (Clark and Knight, 2009). Furthermore, it is also grounded in the shortcoming of financial valuation models, for example discounted cash flows, to capture the growing *intangible* asset base of new paradigm firms, including the effect of qualitative ESG considerations on firm valuation.[3] For instance, the book value of assets in the SandP

500 only account for 20-25% of corporate valuation (Ned Davis Research 2007). The remainder is represented in intangible assets such as future innovation, reputational value, good will, and relationships (Clark and Salo, 2008). Intangible assets have been identified as a relatively larger proportion of the asset base of ‘new paradigm’ firms as opposed to ‘classical model’ firms, which are largely reliant on physical and tangible assets (Clark and Salo, 2008).

The growth of the intangible asset base highlights the importance of continuous innovation of products, processes and organisations designs for new paradigm firms (Lev, 2001). ESG considerations share a close synergy with firms’ intangible assets especially to the extent that they encompass new product markets, for example, General Electric’s campaign to sell its ‘Eco-magination’ product line in 2008-2009 or the growth in sales for hybrid cars for the Toyota Motor Corporation in 2006-2008. Another example is the strong relationship between strong environmental performance and a firm’s reputation amongst consumers and stakeholders, as demonstrated by the losses suffered by Royal Dutch Shell following the Brent Spar incident (Esty and Winston, 2006, Gunningham et al., 2003). These serve to illustrate how the emergence of ESG integration is in close harmony with the emergence of new paradigm firms and the growing importance of intangible assets, and other factors such as reputation and legitimacy, in certain sectors and geographies.

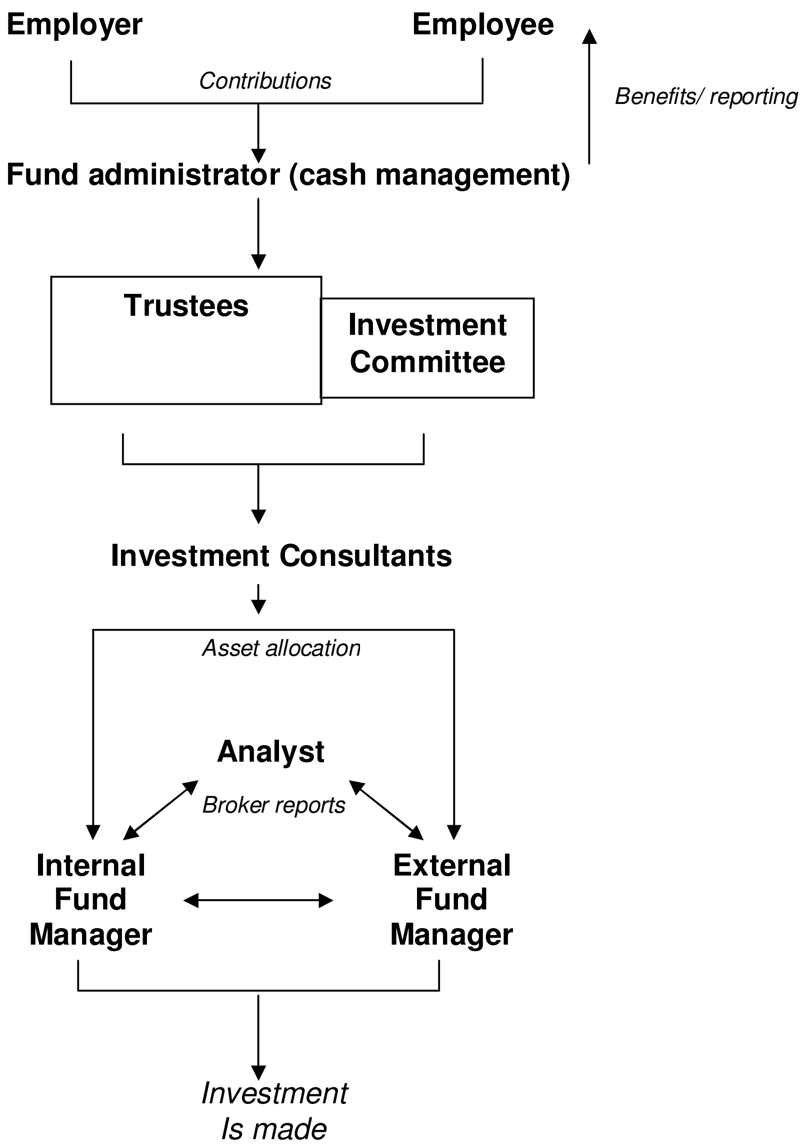
With exposure to a wide variety of asset types and geographies over a long time horizon, asset owners such as pension funds may have the potential to improve their overall returns by taking into account various considerations into their investment choices. However, given the relative novelty of ESG integration as an investment tool available in financial markets, its uptake, as we show in the following sections, is partly contingent on the willingness and ability of investment consultants to engage with ESG in advising their clients, and to convince clients of the potential merits of ESG integration. This is because investment consultants are uniquely positioned to collaborate with trustees (or investment boards) and direct the flow of pension fund assets, utilising ESG considerations.

3. The conflicted role of the investment consultant

Although the structure of pension fund investment management can vary by jurisdiction, the organisational structure of the investment process is arguably fairly standardised. For the sake of exposition, we focus primarily on illustrating the case of trust-based pension jurisdictions. In these jurisdictions—where the vast majority of global pension assets exist—employers and/or employees make contributions to a fund, which is held in a trust and overseen by a trustee board. Depending on the actual size of the pension fund, administration can be either internal or external, or various degrees thereof depending on the particular administrative task. Large pension funds, given scale effects, often have separate physical pension management organisations. Smaller funds, on the other hand, generally delegate most day-to-day management processes to external providers. These tasks range from benefits management and reporting, all the way to actual fund management (Clark, 2000).

Regardless of size, the board of trustees sits at the centre of the investment process and is ultimately responsible for the actions of the administration of the fund. Often, mainly with larger funds, members of a board will also sit on an investment committee together with other experts to make recommendations to the board on the allocation of assets, choice of investment managers, and other financial matters—with smaller funds, separate investment committees generally do not exist. In making decisions regarding the choice of investment managers and asset allocation, trustee boards often employ the advice of external investment consultants. This is particularly the case with smaller funds, given limited or non-existent internal resources for researching investment managers and devising an optimal asset allocation given the fund's risk parameters. Yet even larger funds employ outside consultants to aid in making decisions. A stylised rendition of this organisational structure is visualised in figure 1.

Figure 1: Investment Chain for Asset Allocations in Pension Funds (adapted from (Clark, 2000))



From a slightly stylized though empirically grounded perspective on best-practice investment consulting (Clark and Urwin, 2008a), the principal responsibilities which investment consultants are called on to consult encompass three overlapping areas: organisational coherence, people, and process. Regarding 'organisational coherence', investment consultants assist with the formation and clarification of a pension fund's organisational strategy and mission. This is more detailed than simply articulating the goal of maximising beneficiaries' financial returns, which is a trustee's legal obligation. It also involves clarity around the selection of benchmarks, identifying a long-term strategy, and drafting mission statements and statement of investment principles (Juravle and Lewis, 2008, Clark and Urwin, 2008a).

Consultants' responsibilities also include assisting trustees in the recruitment of competent fund managers and administrators to provide financial planning advice and advice on asset allocation. This is the 'people' aspect of the pension fund investment chain. Investment consultants facilitate the negotiation of investment policy statements between asset owners (funds) and investment managers, so that both parties to the contract have clearly mandated objectives. In this respect, the extent to which a fund has an interest in focussing on short-term or long-term investment horizons and the decision to adopt particular investment methodologies, such as ESG, is largely decided by trustees with the assistance of investment consultants (Juravle and Lewis, 2008).

In certain cases consultants may also become responsible for managing the on-going relationship between asset owners and managers and the investment 'process' broadly. They evaluate the performance of investment managers on a regular basis and make recommendations for hiring new managers based on which managers have strong performance in asset classes and methodologies, which align with trustees' mission and risk appetite. They may also be required to structure products for the pension fund to invest in directly where there is no external expertise available.

Given the intimate role investment consultants have in trustee decision-making, they have been described by some practitioners as 'the gatekeepers' of pension fund investment management (Davis et al., 2006). Although the term ‘gate keeper’ arguably overstates the ‘supervisory’ aspect and capacity of investment consultants, they still can play a pivotal role in board operations and are one of the first stops for advice and thought leadership when trustee boards need assistance. They could be more rightly characterised as sophisticated filters of information, or as one consultant suggested to us ‘important digits in the combination’ that unlocks investment management.

The flipside to the consultants’ privileged position is that they are also the subjects of client demand. The dynamics of the financial services industry are such that consultants are required to follow clients’ orders. The tension between these two positions—as adviser, and as service provider—means that consultants may find themselves in a compromising position. They may be prevented from exercising their leadership at the very moment when it is most needed because a client misunderstands them, is ignorant, or ignores the advice given to them (but likewise, it is entirely possible that consultants themselves may display irrational behaviour either because they are actively hostile, stubborn, or ignorant or because they perceive a threat to their business relationship with the client). As we demonstrate below, this fundamental characteristic is a significant barrier to ESG integration.

4. Data and Methodology

The findings in this paper draw on the responses of a number of leading international investment consultancies to a detailed questionnaire sent out by the United Nations Environment Programme Finance Initiative’s Asset Management working group in

2008. Twenty investment consulting firms were contacted in the USA, Canada, UK, France, Germany, Sweden and Japan. The recipients were asked to provide detailed responses to 19 open-ended questions. These questions covered a number of topics broadly categorised within the following topics: fiduciary duties in the management of pension fund assets; evaluation procedures for investment managers' performance; investment practices used to monitor investment managers such as requests for proposals and analysing their proxy voting track-record; attitudes towards ESG in investment research; and the legal language used to define the relationship between pension funds, consultants, and investment managers.

The response rate to the questionnaire was relatively low: responses were received from 6 of the 20 consultants contacted. Notwithstanding this low response rate (30%), those who did respond represent some of the largest and most important global investment consultants by size of assets under advisement and international reputation (see Appendix I). These responses were spread across three geographies, with response received from two offices in each of the UK, US, and Japan respectively. In each case, the questionnaires were completed by Principals (very senior consultants) within these firms and were cross-checked with team managers in international offices to ensure that they represented the general view of the consultancy as far as possible. Notwithstanding the level of global integration in each of these firms (with the exception of one Japanese firm, which is a domestic player), these responses are not intended to cover the entire field of investment consulting globally or indeed regionally. Rather they provide insight into some of the views held by consultancies engaged with the day-to-day advising of global pension funds on the issue of ESG integration in the largest pension fund markets.

The responses were received from consultants whose experience in ESG integration we evaluate fall within three distinct categories (see Appendix I). In evaluating these categorisations we took into account the number of staff employed on this issue, years of experience in advising on ESG, and the depth and breadth of the responses given. The respondents we considered to be most experienced in ESG integration (hereafter, "market leading consultants") were housed within the Responsible Investment teams of the UK and US offices respectively of two international consultancies, which were world leaders in terms of their depth of market power, geographical scope, and total world-wide, tax-exempt institutional assets under advisement as at 30 June 2008 which were in excess of USD 2 trillion. The moderately experienced respondents in ESG integration (hereafter, "moderately experienced consultants") were Principals housed in the UK and US offices respectively of two international consultancies with strong market presence predominately in Europe and the US and with total world-wide, tax-exempt institutional assets under advisement as at 30 June 2008 between USD 1 trillion and USD 2 trillion. Finally, the least experienced respondents in ESG integration (hereafter, "least experienced consultants") were Principals housed in the Japanese offices of an international and domestic consultancy respectively. These consultancies advised on total institutional assets of less than or equal to USD 1 trillion.

It is important to acknowledge that there may be some scope of bias in the results. For example, larger investment consultants may have more capacity and experience to advise on ESG integration because they may have a larger budget to hire this expertise rather than a genuine commitment to the importance of the issue.

Furthermore, experienced firms may have a financial incentive to overstate the significance of ESG integration in order to attract more demand amongst the pension fund client base. The fact that these responses were provided in connection with a public UNEP FI report means that there is some scope of respondents to have a financial or marketing agenda. However, the fact the respondents were told upfront that their responses would remain anonymous helps balance this biased effect.

5. Investment consultants as agents for ESG integration in investment thinking

In this section we analyse the responses to the questions asked in the questionnaire, disaggregating them by *organisational coherence*, *people* and *process*, as per the three principle areas of the consulting relationship discussed in section 3. Although the questions were not framed along these three responsibilities in the questionnaire, we have structured our analysis using this framework, as it provides a useful tool for in-depth examination of investment consultants' behaviour and investment practices.

Our analysis of the questionnaire responses indicated that the ability of investment consultants to lead change in investment thinking around ESG integration appears to be influenced by the degree of expertise and knowledge the consultant is able to bring to the client regarding the subject. Higher levels of expertise create situations in which the consultant can take a strong position in the consultant-client relationship by providing institutional clarity to trustee boards, offering direction on the selection of the best fund manager, and lead clients out of a myopic short-term strategy and a culture of limited index-backed mandates. However, where consultants lack expertise the survey responses provide examples of how consultants can be dominated by the client and take a subservient position with respect to investment advice.

Organisational Coherence of ESG

The market leading consultants with the most specialised knowledge of ESG were confident to relate ESG to their clients in economic terms. They had the language to explain how ESG considerations can have a material impact on corporate financial performance and therefore on portfolio performance, as the following response indicates:

"An increasing body of evidence exists to show that ESG factors can impact investment performance…. We believe ESG factors fall within the purview of fiduciary duty where they are or may be material to long term capital preservation. ESG factors may also contribute to the growth of investments as related opportunities are sought."

The strength of these connections varies across sector, geography, investment strategy and asset classes and market leading consultants are able to position themselves in relation to clients as "leaders" who could guide their client through this complex terrain. For example, one market-leading consultant revealed that ESG integration was more important in asset classes exposed to long-term trends such as long-term long-only equities. As such, investment strategies that are highly geared towards short-term returns will fail to integrate these long-term dynamics into their allocations and will therefore be exposed to higher long-term risk profiles.

This leadership position and knowledge directly translated into a more active involvement in pension fund governance. For example, the two leading consultants both maintained global investment manager databases, which included information on ESG integration capacity within the investment manager community. These consultants were therefore able to provide benchmarking services to rank managers for their clients. They also had boilerplate templates for investment management contracts and investment policy statements, which could be amended to offer ESG capabilities to the client. They also expressed comfort in exercising active engagement strategies with company management as well as a variety of other tools such as voting rights and ownership strategies.

Lack of knowledge and expertise on ESG amongst moderately experienced and less experienced consultants, however, positioned these consultants as "followers" with respect to their clients. They were only willing to address ESG issues on an ad hoc basis and only when the client had raised these issues first. This placed them in a weaker position with respect to the client and meant that they were subservient to client demand, as the following response suggests:

"It is at the discretion of clients to ensure ESG criteria are relevant to their particular fund objectives, investment beliefs and governance arrangements".

This meant that they were unable to offer advice on fund managers with ESG capabilities until the client gave permission for a request for proposal to be issued.

They also expressed greater reluctance to incorporate ESG related considerations into the investment management contracts and investment policy statements

The lack of expertise not only placed the consultant in a weaker position in the client relationship, but it was also consistent with conceptual confusion about what ESG integration actually meant. Specifically, as suggested by the following response, they confused ESG with SRI, which meant that they conceived of ESG in ethical rather than economic terms:

"In terms of institutional investors, the circumstances where investment decisions are designed to be closely linked to the institutional mission and objectives are most conducive to deep consideration of ESG considerations."

Here the term "institutional mission and objectives" is a reference to mission-related investing which is a distinctive approach to ethically motivated investment decisions. This approach seeks to achieve a outcome from investment decisions other than financial return, whether this be charitable, ethical, or otherwise. The mis-categorisation of ESG as an ethical concept was most pronounced amongst the least experienced consultants in our data, who were based in Japan. For them, ESG integration was synonymous with ethical investing and was only thought to apply to environmental polluters, human rights abusers and other "antisocial forces movements (sic)". Although it is not impossible to generalize these conclusions Japan-wide, there is certainly emerging empirical evidence to suggest that meaning of terminology such as SRI, corporate social responsibility (CSR) and responsible investment (PRI) is highly conflated amongst Japanese pension funds and that there is substantive confusion on the distinction between the ethical and economic issues at play (Aging, 2008). As such, the investment cultures within the Japanese setting deserves further research (Sakuma and Louche, 2008).

By mis-categorising the issue as ethical rather than economic, investment consultants may lead clients away from considerations, which in fact have a very tangible impact on financial returns. Empirical research on trustee board decision-making has shown that when issues are framed in terms of ethical responsibility, trustees are less responsible than average members of the public (Caerlewy-Smith et al., 2006). The lack of knowledge around ESG integration appears to be most pronounced around environmental and social issues as opposed to corporate governance, which has a deeper history in the academic literature (Bauer et al., 2008). One comment given by a moderately experienced consultant indicated that when an ESG issue is apprehended in financial terms, then the consultant is willing to promote its importance in investment management:

"We believe that examining the corporate governance of companies is an essential aspect of investment management. However, the impact of environmental and social policies is not currently considered essential".

Knowledge and expertise therefore appear to be crucial commodities in negotiating consultants' relationship with pension fund boards. Greater levels of knowledge influence the level of leadership consultants feel comfortable to exercise over clients, and the extent to which they are able to provide more robust professional services. Lack of knowledge, by contrast, can lead to situations of active harm where conceptual confusion means that considerations material to portfolio returns are not brought to clients' attention.

People

In a professional service based industry such as investment consulting, the depth of human talent within an organisation is an important measure of the organisation's experience. This is no different for ESG integration, because firms with the most sophisticated understanding of ESG integration tools also employed the largest number of full time staff. The market leaders had full time staff focussed on ESG integration in offices around the world, primarily the UK and the US. This compared with less experienced firms in which consultants dealt with ESG considerations on an ad hoc basis depending on client demand.

As discussed above, investment consultants can play an important role in building relationships between asset owners and asset managers around areas of common interest. However, a challenge in establishing these networks has been the lack of expertise within fund managers. Market leading consultants felt that sell-side firms still had a long way to go before ESG integration services were widely available when investors needed them:

"Not all managers, across geographies, asset classes and styles have the inclination or ability to abide by such [ESG] language and it might be dangerous to include it [in investment management contracts] otherwise (sic)."

The lack of expertise at the fund manager level has been acknowledged by leading industry groups such as Fair Pensions, although they have noted improvements over the last five years (Investments, 2008). Jaworski (2007) also supports the above findings with a survey of 88 sell-side and 240 buy-side institutions in Europe, which indicate that there is weak dialogue and networking between buy-side investors and sell-side analysts around ESG considerations (Jaworski, 2007). This lack of expertise in the financial community appears to be an impediment for some investment consultants' ability to form networks of communication around ESG integration. For example, the market leading consultants indicated that they are reluctant to draft legal clauses into investment management contracts between trustees and fund managers with respect to ESG integration because there may be a lack of fund managers who would be able to carry through with this obligation.

Notwithstanding the difficulties in forming networks of communication around ESG integration, leading consultants are beginning to develop tools to assist asset owners to form and evaluate relationships with asset managers. For example, consultants have begun to rate fund managers based on their ESG competency in parallel with overall investment rating. Evaluation takes place routinely and takes into account both quantitative and qualitative data such as "idea generation, portfolio construction, management and implementation". This information is compiled into global databases about global investment managers in a manner which is comparable and standardised. Processing information and applying evaluative metrics can be understood as the first step towards taking leadership for clients on these issues (Lowenstein, 1996). This is consistent with Lowenstein's (1996) contention that financial agents are only able to manage what they can measure.

Moderately experienced consultants by contrast are to a larger extent reliant on the client to express an interest in ESG integration before expertise is forthcoming. Indeed these consultants only provide ESG integration advice on demand and have no full-time institutional capacity in this issue. The short supply of expertise may also be correlated with poor quality advice in the sense that one consultant appeared to confuse ESG integration's economic motivations with SRI's ethical motivations:

"We have an organised group of investment consultants, research consultants, and analysts who focus on the spectrum of issues in mission investing/ESG/SRI strategies"

Although they acknowledge that consultants have some role in raising the issue with clients, they are more likely to wait for trustees with the assistance of employers to take the first initiative. These insights complement the analysis on organisational coherence above but again highlighting the importance of knowledge and expertise for fostering effective relationships around ESG integration. The development by some consultants with deep knowledge to apply evaluative metrics to fund managers' performance is the first step towards building strong webs of knowledge around pension fund trustee boards.

Process

The capacity of investment consultants to transform pension fund governance through knowledge and leadership may be restricted by barriers within the investment culture of consultants themselves, which are overhangs from the client-focussed nature of the industry. One such barrier is the strong culture of short-term investing within finance. Short-termism in financial markets is a problem which has been identified amongst pension fund executives and refers to the tendency to place more weight on immediate issues instead of actively dealing with future uncertainties and opportunities (Black and Fraser, 2000). This manifests itself in quarter-to-quarter or half-yearly reporting which tracks performance over short time period rather than longer time frames, such as 5-10 years. These longer time frames are typically more suited to ESG integration because there is a significant turn around time before, for example, new strategies in green product innovations come into play and affect a company's performance.

The market leading consultants have identified this barrier and have actively sought to advise clients to adopt long-term timeframes for their investment strategy. This means, for example, hiring and retaining managers on the basis of long-term performance rather than quarter-to-quarter benchmarks. However, some of the less experienced consultants did not believe that timeframes featured as a barrier to ESG integration into clients' portfolios. This is because manager performance was evaluated in terms of execution of a particular strategy rather than returns after a period of time. This view again reflected a perception of ESG integration as an ethical investment strategy. The key point to take away is that where asset owners are focussed on meeting short-term financial performance objectives, then their portfolios are more likely to be exposed to long-term influences of which ESG issues are some such considerations. It falls to consultants to advise asset owners away from a short-sighted view of performance such as this.

This feeds into a second barrier which is the use of tracking error limits and index-referenced mandates as benchmarks for financial performance. The use of these benchmarks as targets for fund financial performance penalizes the integration of ESG into portfolio construction. This is because the valuation of firms is based on short-term factors affecting the firm's future cash flows rather than long-term ESG drivers (Esty and Winston, 2006). ESG drivers affect the long-term valuation of a firm because they involve strategic considerations or externalities which take several years to influence the bottom line of a company. However, if firms are selected for inclusion in market indices on the basis on their short-term financial performance (for example quarterly performance) then these longer-term structural considerations are not properly reflected in the performance measures.

One strategy to overcome this barrier is for asset managers to seek absolute returns rather than market returns. This means that funds set a target for a positive financial return over a nominated time period rather than tracking the market. The market leading consultants noted that they observe a trend amongst their clients away from strict limits towards structures and policies, which are friendlier towards absolute return strategies. However, they acknowledge that tracking error will continue to be an important tool for institutional investors in order to establish their risk budgets and ensure diversification.

The hurdle that this may pose for ESG integration was highlighted by international consultancy based in the UK in the context of defined benefit pension schemes. They pointed out that if a fund with an integrated ESG policy performs more poorly than the index and that scheme enters the UK pension protection fund, then trustees might be in breach of their fiduciary duty even if the majority (but not all) of the membership are in favour of the ESG-related screen. The fundamental difficulty here is that although the ESG integration strategy is intended to lead to financial out-performance of the portfolio over the long-term, it may result in lower performance or higher volatility in the short-run as firms in the market capitalize on short-term gains. This is less of a problem in defined contribution pension schemes because policy members directly take on the investment risk for ESG integration. [4]

Finally, the incentive structure for managers can compound the barriers created by an investment focus on short-term returns and therefore penalize ESG integration. The market leading consultants argued that fee structures had a neutral effect on ESG-integration approaches whereas performance based fees can be structured to incentivize short-term gains. The grief caused by misaligned incentives is evident in the global financial crisis where investment bank executives received sizeable bonuses and remuneration notwithstanding the underlying riskiness of assets under investment.

6. Implications and Conclusions

Investment consultants have privileged positions in driving the direction of global pension fund investment. As such, investment consultants are in a position to drive the manner in which investments are made and concern is given to longer-term risks not readily priced and understood in the market. The risks of climate change to corporate profitability over the long term is one such example of an ESG consideration that large long-term investors might arguably need to consider when making investments and deciding on their asset allocation. However, our survey responses provide some examples in which profound gaps of expertise and understanding (scepticism notwithstanding) within the investment consulting community can inhibit the dissemination of ESG integration as an investment tool in financial analysis. Indeed, one potentially strong explanation for the low turn out of the questionnaire is the high degree of scepticism and/or lack of knowledge of ESG.

There may be a number of reasons why some consultants may struggle with knowledge gaps around ESG integration. For example, ESG information is often disclosed to the market in an unfamiliar manner, such as corporate sustainability reporting or qualitative judgments made by directors. This may conflict the mainstay of financial market agents who are accustomed to information that is ‘comparable’, ‘verifiable’, and ‘electronically storable and transmittable’ (Berger et al., 2002).

The accounting challenges associated with ESG integration are significant and are slowly being recognised by the academic and practitioner community. It has been suggested that it may be necessary to identify new approaches to fair accounting in order to capture these new dimensions, such as instituting wider principle-based accounting or instituting new investment procedures whereby investors and investee companies engage in deeper dialogue (UNEPFI, 2009). Novel regulatory approaches are beginning to emerge around this issue such as the new ESG reporting obligations under the UK Companies Act 2006 and the Modernisation Directive 2001 in Europe which requires greater disclosure on corporate governance, and social and environmental impacts (Clark and Knight, 2009).

However, the difficulty in understanding ESG information and deploying ESG integration as a tool is not a reason to ignore it when the cost of doing so may be great (Kiernan, 2007, Guyatt, forthcoming). Rather, investment consultants could use their position and power to build networks of collaboration and communication to bridge the knowledge gap. There is no doubt that there have been very substantial improvements in the number and scale of collaborative approaches amongst financial institutions over the last 5 years (Guyatt, 2007, Guyatt, 2008). This includes the emergence of numerous not-for-profit advocacy networks such as the Network for Sustainable Financial Markets, the UNEP FI, and the World Business Council for Sustainable Development, as well as private sector sell side advisories such as RiskMetrics, On Values, and the Enhanced Analytics Initiative (Guyatt, 2007).

However, there is also some evidence to suggest that consultants face barriers to leading clients on the issue of ESG integration, especially where those consultants are in subservient positions with respect to their clients. Caught between their role as adviser to pension fund boards and their position as servant to the client, investment consultants can be both providers of new understanding but may find themselves ultimately led by the demands of their clients . Although consultants have a clear professional duty to raise substantive issues with their client base, they may ultimately be trapped by systemic ignorance within their client base. Amongst some least experienced consultants surveyed this leads to a problematic situation in which critical issues are only addressed if the client raises them first. This passivity with respect to the client may constitute negligence in cases where clients are shielded from widely recognised systemic issues because of consultants failing to bring these issues to their clients' attention.

An important tool for building relationships of understanding discussed in this paper is knowledge, training and expertise. We find examples where consultants with greater ESG experience and knowledge are more confident and able to take leadership positions for their clients with respect to ESG integration compared with their inexperienced counterparts. Consultants who lacked expertise on ESG integration tended to confuse it as an ethical issue rather than an economic issue. This error is highly problematic in light of the fact that trustee boards have a weak appetite for ethical considerations (Caerlewy-Smith et al., 2006). Therefore ESG integration presented to trustees in this manner is likely to be dismissed to the fund's financial disadvantage.

We also find barriers to ESG integration within the investment culture of consultants and fund managers more generally. The prevalence of myopia in investment time horizons is coupled with an incentive structure for remuneration that rewards short-term returns of asset managers. There is also a reliance on index-referenced mandates and tracking error limits which result in portfolios being tracked to short-term markers for financial success. This penalizes the use of ESG integration as an investment strategy to the extent that its dynamics play out over a longer time frame. Wider adoption of absolute return strategies may provide some relief in the future towards this structural barrier.

As the current financial model undergoes a thorough reassessment in light of the global financial crisis, investment consultants are required more than ever to be alert to developments in financial innovation. ESG integration as an investment tool aimed to capturing the effect of systemic environmental, social and governance considerations on portfolio returns is likely to feature prominently in such innovation. Yet while investment consultants command tremendous delegated authority in investment management from pension fund executives, they are also subject to the restrictions of a client-focussed industry. Nevertheless, this predicament may erode as networks of knowledge and expertise around the issue of ESG grow, particularly as advocates continue to stress their case.

APPENDIX 1

Descriptor	Consultant 1	Consultant 2	Consultant 3	Consultant 4	Consultant 5	Consultant 6
Level of ESG experience	"market leading"	"Market leading"	"moderately experienced"	"moderately experienced"	"Least experienced"	"Least experienced"
Firm Scope	Global	Global	Global	Global	Global	National
Respondent's Office	UK	US	UK	US	Japan	Japan
Seniority of respondent	Principal	Principal	Principal	Principal	Principal	Principal
Type of respondent	Specialist	Specialist	Mainstream	Specialist	Mainstream	Mainstream
Verification of survey	Cross-checked across global practice	Cross-checked across global practice	Cross-checked within national office	Cross-checked across global practice	Cross-checked within national office	Cross-checked within national office
Worldwide assets under advertisement as at June 30 2008[v]	Tier 1	Tier 1	Tier 2	Tier 1	Tier 2	Tier 3

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[1] We note that not all pension funds operate in trust-based legal environments, particularly those in civil law countries. However, other jurisdictions, such as the Netherlands, have comparable fiduciary systems of investment oversight (for the Netherlands see MAATMAN, R. 2005. Dutch pension funds - fiduciary duties and investing. Amsterdam: Kluwer Legal Publishers.). Ultimately, investment consultants are typically involved at some point during the investment decision-making process.

[2] The geography of pension funds is quite diverse. Countries with large occupational pension funds relative to GDP include the US, UK, Canada, Australia, the Netherlands, Switzerland and Japan. Although funded pension arrangements are increasing in other countries through reform of public pension systems, actual assets under management remain small.

[3] "New paradigm" firms is a term which has emerged in the management literature to describe the unique business model of numerous firms over the past 25 years. The market valuation of these firms involves intangible assets such as good will, corporate reputation and brand valuation. These assets mean that the firm's market valuation is at a significant premium to the firm's book value. This is in contrast to "classical model" firms which dominated the early 20th century. Here, market valuation is closer to book valuation because the firm's assets where primarily physical and tangible assets such as plant and equipment CLARK, G. L. and SALO, J. 2008. Corporate governance and environmental risk management: a quantitative analysis of 'New Paradigm' firms. *In:* QUARTER, J., CARMICHAEL, I. and RYAN, S. (eds.) *Pensions at Work: Socially Responsible Investment of Union-Based Pension Funds.* Toronto: University of Toronto Press..

[4] What may be needed is a change in investment culture, which allows for a greater deviation from the index for periods of time where less conventional investment strategies are adopted. In addition, it may be helpful to more widely implement specific ESG-integrated indices as benchmark for performance for the management of pension funds assets over the long term. These kinds of indices have been around for some time now with the Dow Jones Indexes, STOXX Limited and SAM Group launching the Dow Jones Sustainability Indexes (DJSI) in 1999. The real barrier is therefore translating this into investment culture.

[v] These categorisations have been used to maintain the anonymity of the respondents: (1) Tier 1 = over USD 1 trillion; (2) Tier 2 = USD 500 billion to USD 1 trillion; (3) Tier 3 = less than USD 500 billion.