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Sustainable investing for an aging planet

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Roger Urwin

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Sustainable investing for an aging planet

These cogs - government, company, worker, pension fund- connect better

Retirement sustainability and planet sustainability have their connections

The governance, gorilla in the room, critical to change

Defining moments: government and society; 'fair' redefined

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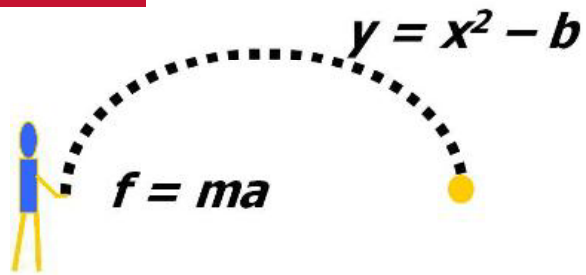
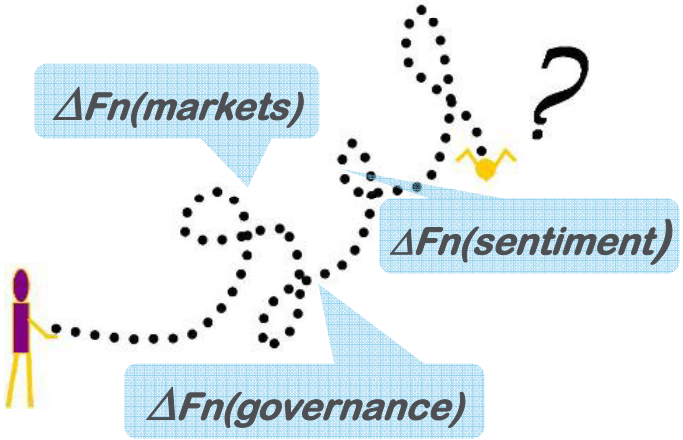
Complexity model

	General investment properties	Sustainability properties
Multi-stranded	Tentacles of the issues spread very wide	'Wicked' problems: no definition, no stopping rule, no optimal solution
Agents	Individuals and incentives and biases; game theory	Organisations and agency issues/ behavioural baggage
Multi-period evolution	Emergent change and path dependence	Adaptability/ sustainability to deal with unpredictable changes
Social technology	Governance critical to system	Governance and governments are big part of the problem

Simple



Complex



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Some simple(?) questions

	Usual answers	Better answers
Can long- term investment be seen simply as the sum of the short term?	Yes	No
Aren't sustainable investing and responsible investing for most practical purposes the same?	Yes	No
Should pension funds ignore sustainable investing because of the conflict with performance?	Yes	No
Do sustainable and responsible investment strategies underperform?	Yes	Sometimes yes, mostly no
Aren't all managers weighing ESG factors in their current decision-making?	Yes	Mostly no
Won't ESG issues fail to show in short-term performance because they are long-term factors?	Yes	No
Is sustainable investing just about ESG?	Yes	No

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Sustainable and responsible investing

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What is sustainable investing made up of?

Asset allocation

- Explicit whole fund whole life planning
- Varying asset allocation with new conditions

Managers

- Long-term mandates/ benchmarks
- Sustainable managers selected sustainably

Integrated sustainable investing

- Integrated ESG
- Active ownership

Targeted sustainable investing

- Sustainability mandates

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Choices of mission

Increased breadth of mission

1. Funds taking a traditional view of long-term liabilities/ obligations

'Traditional mission'

2. Funds taking wider and longer term view of responsibilities including ownership duties and consideration of externalities

'Sustainable investing mission'

3. Funds taking on a joint mission combining financial and defined extra-financial considerations

'Sustainable dual mission'

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Choices of strategy

A. Funds employing inactive delegations to managers without extra-financial expectations set

'Traditional strategy'

B. Funds executing long-term sustainable strategy incorporating extra-financial factors

'Sustainable investing strategy'

C. Funds executing sustainable strategy with targeted investment in sustainability mandates

'Sustainability mandates strategy'

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Poor sustainability in current model

	Sustainability problems	**Approx leakage**
Endogenous risk and cap-weighted benchmarks	Benchmarking short-term performance relative to cap-weighted index forces managers into momentum and other non-information-based strategies with consequent price-taking and mispricing away from fundamental value ; causing suboptimal capital allocation /periodic bubbles *Avoid leakage through absolute return/ non-price benchmarks*	50 - 100 bp
Active management	Active management costs the average fund 75 bp per annum, without value being added Many products involve the application of 20% performance fees which are incorrectly specified and have excessive option values *Avoid leakage by higher passive allocations* *Avoid leakage by adopting maximum fee standards*	25 bp
Turnover	Active management involves costs around 45bp per annum without value being added Turnover in managers costs 10 – 20 bp pa without net value added *Avoid leakage with managers/ mandates with lower turnover* *Lower manager hiring and firing turnover*	25 bp

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ESG Beta

- The equity risk premium (ERP)/ equity beta is a sustainable risk return driver that are expected to be sustainably rewarded over time with a risk premium
- By sustainable we are suggesting there are no reasons why these excess returns will be arbitraged or diminished over time largely because of the factor being macro-consistent
- The equity beta is made up of many elements (value/ growth/ small cap) and ESG beta
- We view ESG beta as a macro-factor risk return driver that under certain conditions produces a premium return for the risks undertaken. It also is a long-term hedge on poor equity beta conditional on climate change escalation

	Sustainable risk return drivers	**Macro factor risk return drivers**
Categories	**Equity beta/ ERP** Also credit, illiquidity, insurance, skill	**ESG beta** Also geopolitics, public policy: finance, emerging wealth, energy, demographics,
Belief	- These are the primary sources of investment return above risk-free rate - These factors are enduring aspects of financial markets although they involve time varying premia - These are macro consistent factors, all investors can hold them without tripping up the system	- Exposures to these factors may give rise to returns over the risk free rate - These factors are medium-term aspects of financial markets reflecting current disequilibria and are time varying premia - These factors are macro inconsistent factors in which flows will affect the premia

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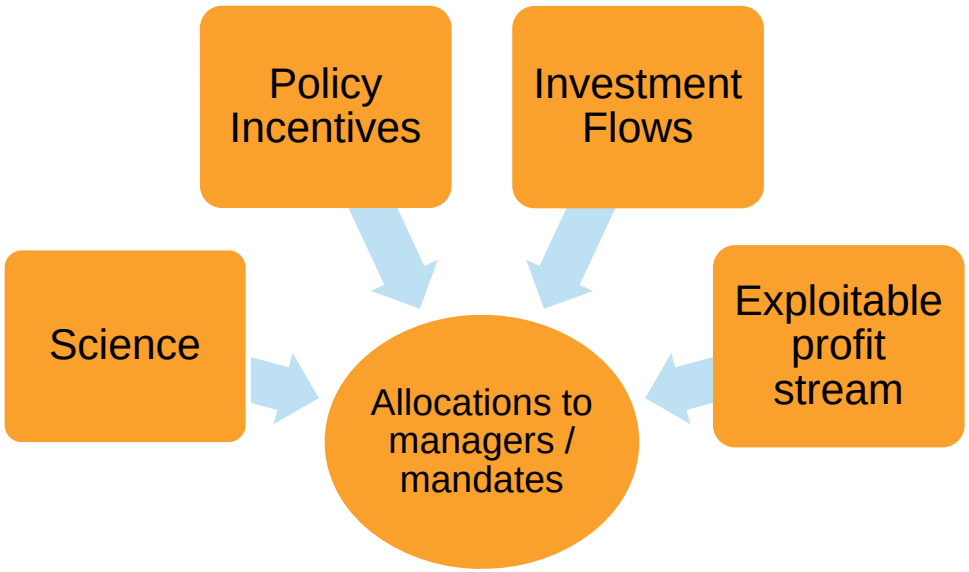
Investment case for targeted ESG



- Four strands to the investment case: science, policy, flows, profit capture
- Science: the view that climate change is occurring and measures must be taken to address it
- Policy: governments will support the science and technology and infrastructure needs with taxes/ incentives
- Flows: companies or enterprises in this space will attract growing flows and influence future prices
- Economics/ Profit capture: can investors extract an appropriate rent for their risk capital , risk exposure and endeavour; particular issues with reliable capture of returns from technology
- Size of policy measures and likely investment flows means that accepting the science not a pre-condition for investment
- Various investors will weight these blocks differently

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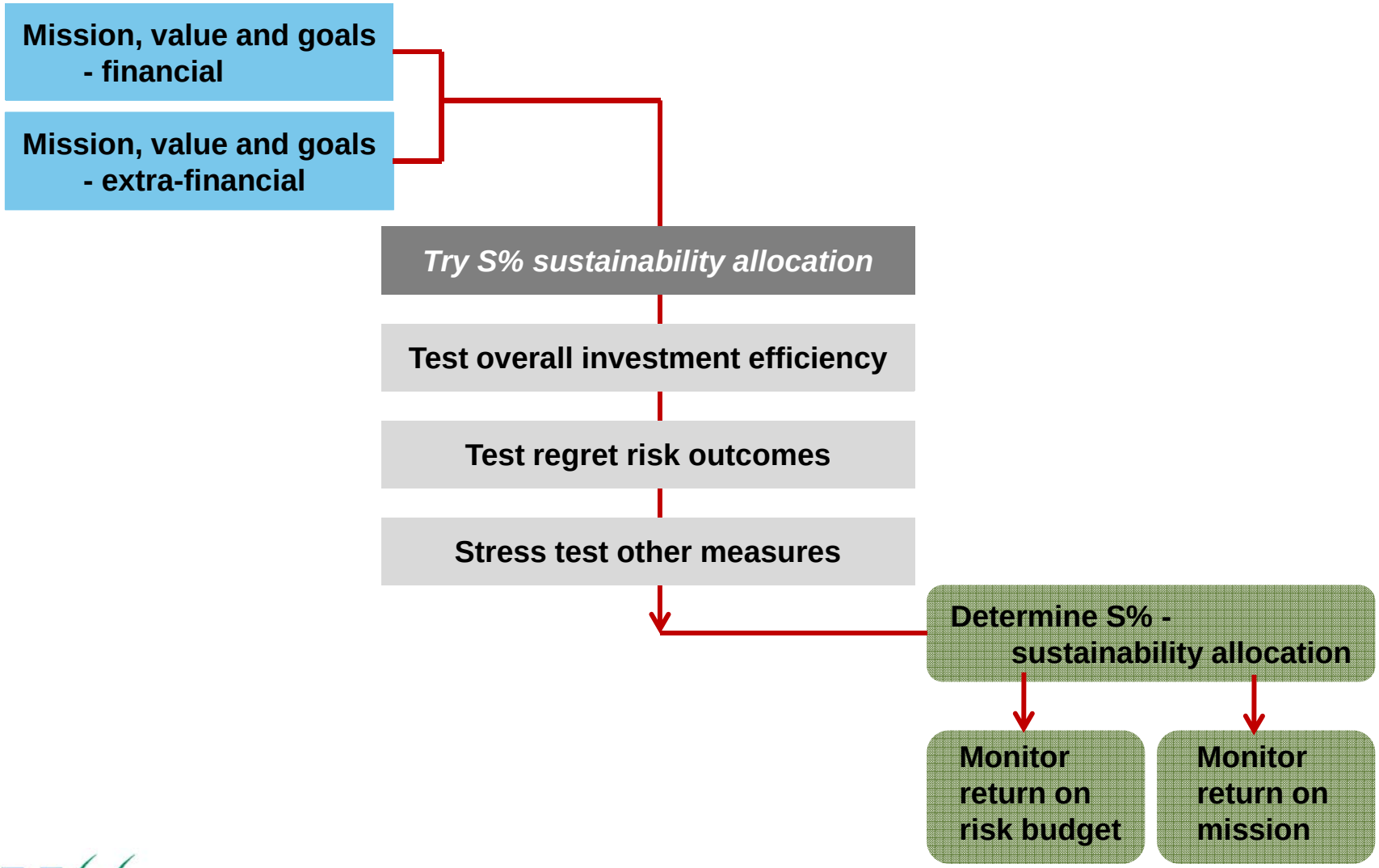
Asset allocation process for sustainability mandates



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Asset allocation examples to sustainability mandates

- Asset allocation specific to funds' exact context
- Significant subjectivity in this process
- Straw-men results of this process in most cases likely to fall in the ranges below
- For large funds such figures might represent medium-term targets given liquidity and governance considerations

Straw-men strategies ('normal circumstances')	Possible allocation
Pension fund with mainstream governance	Nil
Pension fund with stronger governance with beliefs in ESG beta	Nil – 10%
Endowment with strong ethical stance	2½% - 15%
Endowment with environmental interest	2½% - 15%
Endowment with environmental interest with beliefs in ESG beta	5% - 20%
DC participant with environmental interest	5% - 20%
Sovereign fund with dual mission	5% - 20%
Public pension fund with stronger governance, beliefs in ESG beta, and wider stakeholder responsibility	5% - 20%

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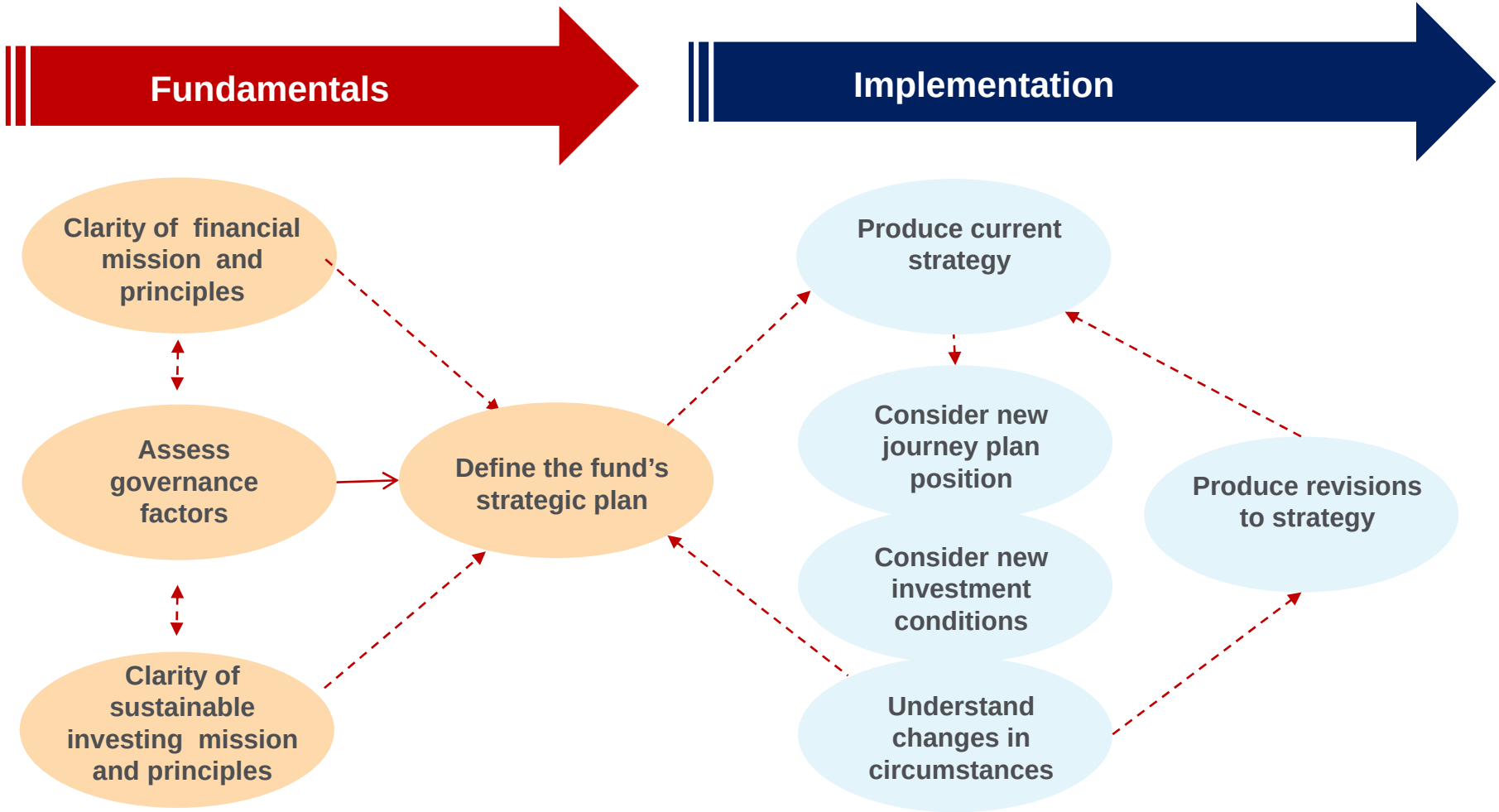
Sustainable investment route map



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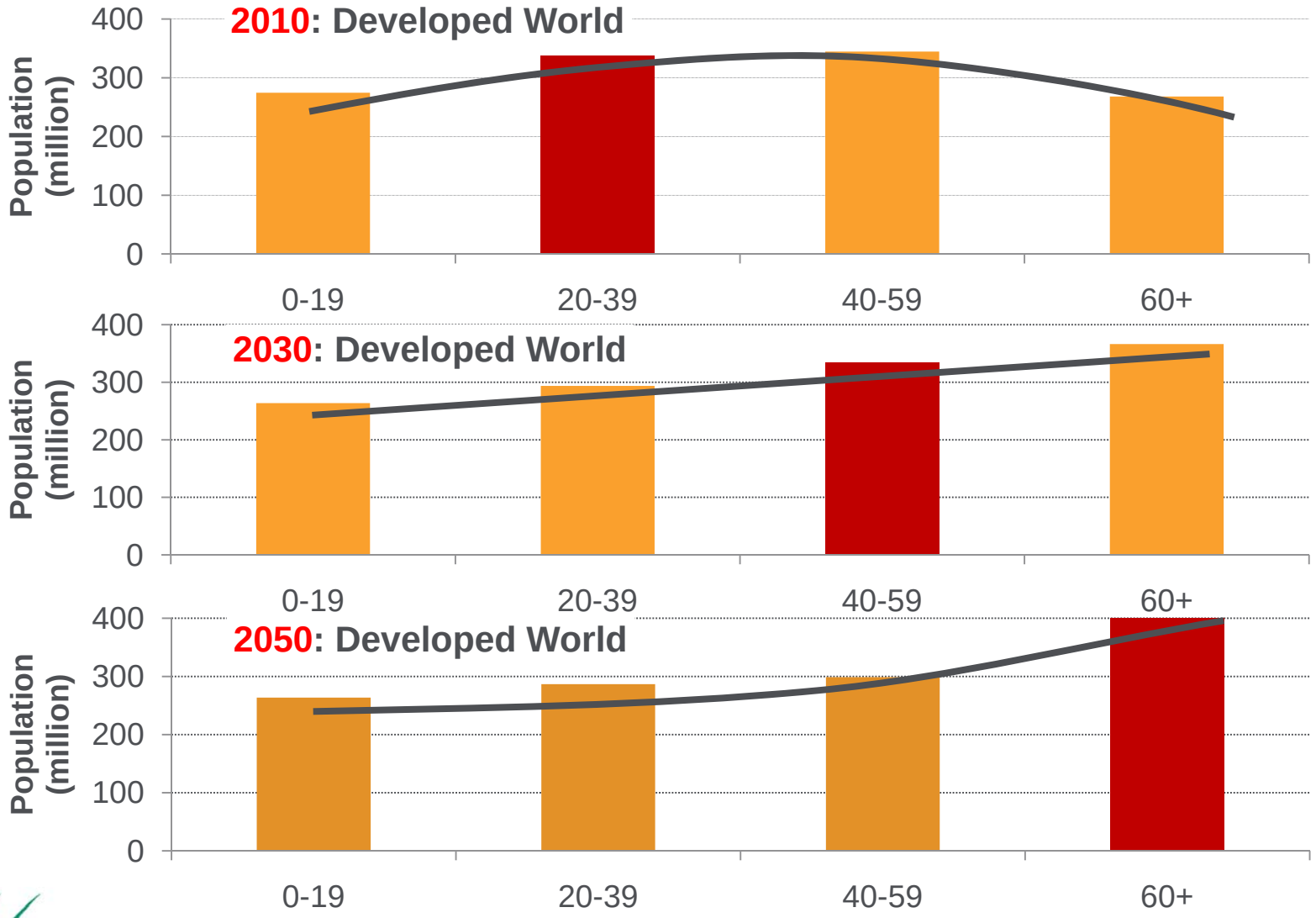
The big picture
Developed world demographic – inverting fast



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Making the connections
Projections over 2010 to 2050

I=PxAxT

I^E - Impact on environment

Poor quality of life if I^E too large

P - Population

P is 6.9bn on its way to 9.2bn

A – Affluence, Income per person

Current A is $10k moving to $45k

Extrapolated footprint of P x A in 2050 = $420trn, up by factor of 6

T - Technology and sustainability

T must have large sustainability element to support A extrapolation and reduce environment impact (and adverse retirement impact)

I=PxAxG

I^R - Impact on retirement

Poor quality of retirement if I^R too small

P – Population

P over 60 is 0.8bn on its way to 2.0bn

A – Pension assets per person

Current A is $3.3k moving to $22k

Extrapolated footprint of P x A in 2050 = $200trn, up by a factor of 8

G – Governance and sustainability

G must have large sustainability element to support or enhance A, reduce adverse retirement impact (and adverse environment impact)

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Where is all this going?

- Funds are pursuing investment arrangements that have poor sustainability*

  * *long-term investing that is inter-generationally efficient*

- Better sustainable investing is a strategy of investing broader, deeper, longer
  - Broader mission
  - Deeper thinking on investment strategy
  - Longer term

  Sustainable investing in this model is legally robust; superior financially; fairer

- Sustainable investing should comprise three broad areas of opportunity: asset allocation, managers and ESG all requiring governance budget to do this well

- Targeted investment in sustainability mandates will develop but it needs stronger beliefs and processes

- Longer term, we see retirement and economic sustainability are positioned at tipping points; sustainable investing provides a win-win link between these issues

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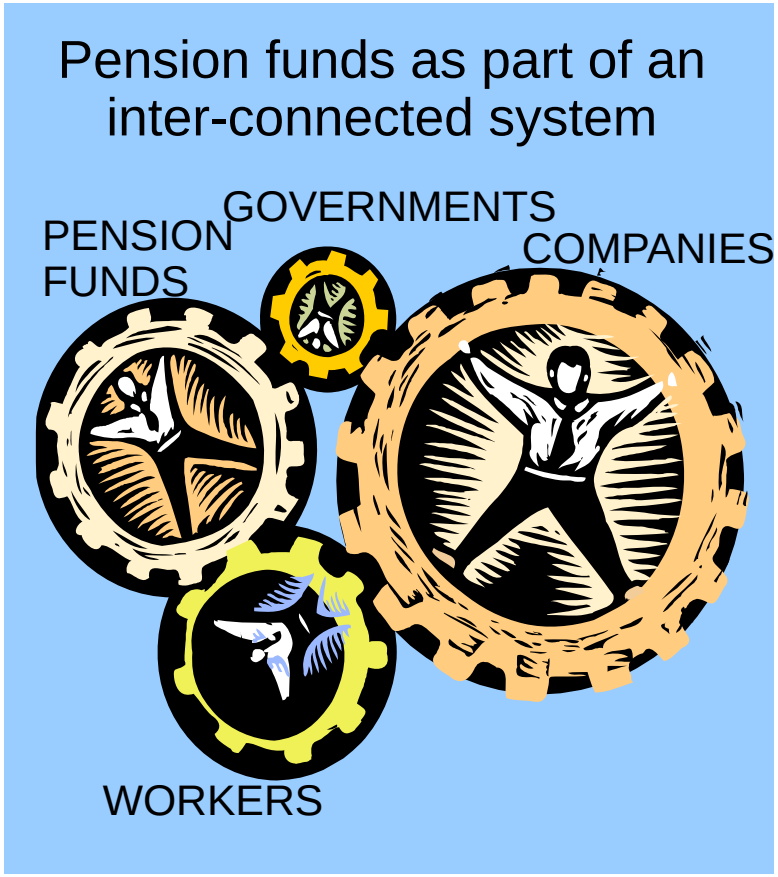
Reasons to be optimistic

- Pensions and sovereign funds can be silver bullet for nation states in addressing their demographic crunch
- They can also make a difference to our other big challenges: environment and natural resource depletion
- Institutional investment needs to raise its game to play a part in these challenges.
  It will need to strengthen its governance to do so



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Contact details, references and limitations of reliance

Roger Urwin
Watson Wyatt
roger.urwin@watsonwyatt.com

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