



## Summary Report

### Key Trends from Analyzing the 2021 Responsible Asset Allocator Initiative Index and How Benchmarks Can Help Asset Owners Deliver on ESG

Two Roundtables Co-hosted by

The Responsible Asset Allocator Initiative (RAAI) and the  
Predistribution Initiative (PDI)

Americas and EMEA Session: December 2, 2021

APAC Session: February 8, 2022

*Note: This report combines and summarizes key discussion points from the two roundtables co-hosted by the RAAI and PDI on December 2 and February 8, 2022. Each program featured a different line-up of speakers and participants. Chatham House Rule was in effect at both roundtables, and as a result all information in this report that is provided for attribution received explicit consent from the speaker.*

## Part I: Key Trends from Analyzing the 2021 Responsible Asset Allocator Initiative Index

### **Speakers Included:**

- **Scott Kalb**, *Director, Responsible Asset Allocator Initiative; Chairman, Sovereign Investor Institute; Former CIO and Deputy CEO, KIC*
- **Patrick Schena**, *Adjunct Assistant Professor, Fletcher School, Tufts University*
- **Amit Prakash**, *Chief Investment Strategy Officer, Alberta Investment Management Corp (AIMCo) (RAAI score 100%, Leaders List)*
- **Anne Simpson**, *Managing Investment Director, Board Governance and Sustainability, California Public Employees' Retirement System (CalPERS) (RAAI score 97%, Leaders List)*
- **Chandra Gopinathan**, *Senior Investment Manager, Sustainability, Railpen (RAAI score 96%, Leaders List)*
- **Elizabeth Gordon**, *Executive Director of Corporate Governance, New York State Common Retirement Fund (NYSCRF) (RAAI Score 100%, Leaders List)*
- **Emma-Jane Joyce**, *Investment Director, Head of Responsible Investment, Ireland Strategic Investment Fund (ISIF) (RAAI score 97%, Leaders List)*
- **Matt Whineray**, *CEO, New Zealand Super Fund (RAAI score 100%, Leaders List)*
- **Andrew Gray**, *Director, ESG and Stewardship, Australian Super (RAAI score 98%, Leaders List)*
- **Liza McDonald**, *Head of Responsible Investment, Aware Super (RAAI Score 100%, Leaders List)*

### **RAAI Index Overview:**

The Responsible Asset Allocator Initiative (RAAI) at New America is focused on mobilizing capital from the world's largest institutions, sovereign wealth, and public pension funds, to solve the world's greatest challenges. In partnership with the Fletcher School at Tufts University, the RAAI publishes the [RAAI Index and Leaders List Report](#). The report rates and ranks the world's largest 251 asset allocators, with total assets under management of over US\$26 trillion, and it identifies the 50 best performers that set a global standard for leadership in responsible investing. This is the third iteration of the Index, which is published every two years.

The process behind the ranking system is driven around empirical analysis of publicly available data, which is generally regulated and audited, versus survey data and subjective judgements. RAAI and the Fletcher School consistently review, evolve, and strengthen the methodology and criteria over time to recognize leaders but also leave room for improvement.

The RAAI also provides programming that supports investors as they think through the next phases and frontiers of responsible investing. The RAAI's core belief is that global asset allocators have the capacity to make a significant difference, and by working together, the RAAI seeks to advance systemic change for a more sustainable world.

The purpose of the RAAI rating system is to 1) inspire a “race to the top quintile;” 2) create a baseline of current activity to compare progress; 3) hold asset allocators accountable for their responsible investing practices; and, 4) encourage more focus and recognition to mobilize capital toward responsible investing goals such as renewable energy, affordable housing, healthcare, and education.

***Highlighted features of the ranking include:***

- Ten principles and thirty criteria with over 10,000 data points, which can be downloaded.
- Interactive data that can be organized by fund name, country, designation, score / ranking, and which includes charts.
- A “Leaders List” comprised of the thirty most responsible asset allocators as determined by the ranking, including some of the speakers at the Roundtable, and the “Finalists” comprised of the next twenty highest ranked asset allocators. Together the Leaders and Finalists comprise the Top Quintile.
- Downloadable Scorecards that individual allocators can use to evaluate their performance.

***Key findings and notable observations of the ranking include:***

- Larger asset allocators are demonstrating leadership: Leaders comprise 13% of coverage of the Index, but 31% of AUM. They have the clout and resources to drive change in responsible investing.
- The world is (gradually) becoming more responsible: The average world RAAI score (based on 251 rated entities), increased to 52% from 44% two years ago. However, the low base indicates room for improvement. By comparison, the top quintile has an average score of 96%.
- Geographic trends are notable and challenge the ability to address systemic risks: Europe, Canada and Australasia are regional leaders, setting a high bar for responsible investing, while the two largest economies globally, China and the US, are lagging dangerously behind, with average scores of 25% and 34%, respectively. Without leadership from the US and China, it will be much more difficult to address systemic risks, such as climate change, and other emerging issues that require a global macro-level approach.
- Positive regulation and disclosure rules make a difference: Countries that have better regulations on disclosure tend to have more highly rated allocators on responsible investing. For example, the UK saw a big increase in the number of top quintile rated asset allocators in the 2021 RAAI Index, corresponding with strengthened regulations, increased reporting requirements and more supportive government policies in the UK for responsible investing.

**Panel Discussion Topics and Answers:**

*Briefly discuss, as best you can, your firm's responsible investing strategy. What are you prioritizing? What steps are you taking to meet environmental and social goals? Are you partnering with other organizations? What actions is your firm taking that you are excited about?*

- **Ireland Strategic Investment Fund (ISIF):** We are a sovereign wealth fund based in Ireland and was a founding signatory of the Principles for Responsible Investment (PRI). ISIF sees the pace of forward change in responsible investment accelerating. As a sovereign fund, it aims to meet the investment needs of today's savers without compromising on the needs of future savers. ISIF identifies as a "Universal Owner," and it believes that taking a holistic view on responsible investing is key to achieving its mandate. ISIF has a number of priorities, but climate is high on the list, (the fund has initiated a Net Zero journey with \$1bn to be allocated to climate solutions over the next 5 years). ISIF makes use of active ownership, ESG integration, and divestment to achieve its goals. Diversity is also discussed daily.
- **Alberta Investment Management Corporation (AIMCo):** We are an institutional investor based in Alberta, Canada that invests on behalf of Alberta-based public pension plans, a sovereign wealth fund, and government funds. AIMCo believes investors must adapt as the world changes. COVID-19 served as a wake-up call on systemic risks including climate, human capital management (HCM), and diversity, equity, and inclusion (DEI). The fund has been on a responsible investment journey for 10+ years, with ESG increasingly integrated into the investment process, reflecting our overarching objective to deliver superior risk adjusted returns over the long term for clients. Activities include integrating ESG into due diligence and monitoring processes, stewardship and advocacy, and advancing the transition to a low carbon economy. AIMCo works with a number of manager partners - for instance, it is partnering with Equilibrium to advance a strategy to invest in greenhouses. AIMCo is developing a climate action plan in consultation with clients based on a common set of principles, aiming to limit longer term risks in portfolios while investing in the low carbon economy.
- **One Asset Allocator:** Responsible investing can mean many things, but we believe that thorough ESG integration throughout the investment process helps to manage risks and improve returns. Our strategy includes adoption of ESG risk assessments of all new investments based on asset classes, with a particular focus on climate and diversity, equity, and inclusion (DEI). Active stewardship and engaging with companies and managers are priorities, as well as robust proxy voting, including voting against directors when necessary. Public policy advocacy is an important tool, particularly related to addressing systemic risks. We engage in thematic non-concessionary investing. The Trustees have set a \$20bn investment goal through a sustainable investment and climate solutions program, and the goal is close to being achieved.
- **Railpen:** Our primary goal is securing members' futures, and in line with this goal and the awareness that climate risks are financial risks, Railpen believes that focusing on climate is key.

For Railpen, Net Zero, active ownership, ESG integration across asset classes, covenants and liabilities are all critical considerations. Railpen has a strong history of stewardship and corporate governance. It is a Net Zero signatory with a commitment and roadmap for 2/3 of its portfolio. Railpen's focus is on real-world decarbonization, collaboration, and engagement. We also are working on climate solutions, particularly in private markets, infrastructure, and green bonds. Emerging frameworks, including our own proprietary one, and technologies have promising potential to help organizations assess net zero alignment, and climate transition plans, making the process iterative and robust, which can feed into engagement and proxy voting.

- **One Asset Allocator:** Our responsible investment strategy was inspired by lessons learned from the Global Financial Crisis and how returns were impacted at that time. This crisis led to a greater understanding that ESG is integral to strong financial returns, rather than separate from them, and we revised our investment beliefs to reflect this principle. In particular, the firm concluded that long term sustainable value creation comes from three types of capital: financial, human, and physical, and that when these three factors are managed holistically and consistently, it leads to long-term sustainable returns. Our climate change initiatives include identifying the largest emitters in the portfolio, helping to launch Climate Action 100+, introducing a Net Zero company benchmark, and supporting the shift to new directors at Exxon. Examples of our human capital management (HCM) initiatives include co-founding the HCM Coalition, successfully engaging with 800 companies lacking diversity on their boards and helping to establish an initiative to source over 1,000 diverse directors to US and international company boards. We believe that it is critical to advocate with regulators and policy makers and to be a voice in financial markets on behalf of beneficiaries, as well as to engage as owners in public and private markets.

*Do you think asset allocators can really move the needle on critical environmental and social issues with their responsible investment practices? Can they drive companies to achieve positive environmental and social outcomes? Are you encouraged or discouraged by responsible investing trends in the asset allocator community broadly?*

- **New Zealand Super Fund (NZSF):** We believe that asset allocators can make a powerful difference in driving companies to change behaviors to achieve positive ESG outcomes. First, where investors put their money does matter. Recent research concludes that failure to address decarbonization can pressure stock prices downwards and that as a result, divested firms often reduce their emissions compared to non-divested firms. Second, engagement can make a big difference. NZSF engages through BMO and others. Most recently, NZSF led an engagement with social media companies about streaming objectionable content on their platforms, driven directly by the terrorist attack in Christchurch that was live streamed on social media platforms. In response, Facebook's audit committee changed their terms of reference to focus on this issue and demonstrated leadership at the governance level. Third, accessing information and disclosures are important for portfolio construction. For example, allocators and other market actors have leveraged information from the Carbon Disclosure Project in decision making. Such information has even informed activities related to benchmarking. Finally, more powerful

outcomes can be achieved through collaboration with other allocators than by individual actions taken by each allocator on its own.

*Tariq Fancy, former CIO of sustainability at Blackrock said that companies are more likely to spend money on greenwashing than they are on responsible business practices, and that ESG investing creates a false sense of hope. Is greenwashing a serious problem? Does it distort investment decision making? Is ESG a waste of time? What can asset allocators do to avoid greenwashing and hold portfolio companies to account?*

- **Australian Super:** Greenwashing among investee companies can be a serious problem. Asset allocators can stop greenwashing practices by doing a thoughtful and careful job in ensuring that ESG factors are considered an integral part of investment decision making, and in holding companies to account for the policies they have in place and the public statements they make on their responsible business practices. For instance, a number of Climate Action 100+ companies have set net zero carbon emission targets. In response, asset allocators are identifying signposts / proof points to measure progress along the way and ensure that companies are actually delivering on their promises.

We note that some critics have expressed concern that ESG can make people complacent about critical environmental and social issues while not accomplishing much, but we have a different and more constructive view. We believe that ESG is not just a check-the-box exercise, but rather a critical component of fiduciary duty that it can actually drive better risk-adjusted returns. It is important to work not only with portfolio companies but also with external asset managers. We ask our external managers about their principles, but we also work hard to understand if they're actually doing what they say they're doing and how that is applied in their investment decision making process.

*Every one of the top 50 funds in the RAAI Index has prioritized climate change, but are we really moving the needle and making progress? Do we have a chance of meeting targets? Do net zero pledges help remove carbon from the atmosphere?*

- **Aware Super:** We believe climate will impact every investment in the portfolio in some shape or form, and we identified it as one of the most material risks of our strategy starting in 2015. Aware Super has committed to achieve net zero carbon emissions in the portfolio by 2050 and a 45% reduction in emissions by 2030, with shorter term targets for the equities portfolio of at least a 30% reduction in emissions by 2023. Commitments need to be made, otherwise investment teams won't focus on actions needed. We find that many companies are making commitments and setting targets, but investors need to assess whether these targets are aligned and how they are being met. Transparency and reporting on progress are critical. Aware Super itself is reporting annually on initiatives under its portfolio transition plan - for instance, investing in the clean energy transition across asset classes. Alliances of asset owners, managers, and consultants are important to ensure alignment. Regulation and support from various governments are also critical, but investors are often moving ahead of regulators and policy makers.

- **One Asset Allocator:** We are de-risking our portfolio on climate change by addressing systemic risks, as well as addressing transition and physical risks specific to certain assets. Advocating for policy change (e.g., carbon tax, appropriate tax incentives), as well as collaborations such as Climate Action 100+ to secure meaningful commitments to reduce emissions, are important. Investing in climate solutions also is a key part of the strategy - not just wind and solar, but also in technologies and resources for the transition period. Divestment may be appropriate when necessary – but only to protect the portfolio, never as a tool to push others to change.
- **One Asset Allocator:** There must be accountability throughout the entire value chain on climate change, including through partnership between asset allocators and asset managers. Markets need reliable information, but they also need an alignment of incentives. There has been progress at the IFRS and the SEC as investors have been calling for better rules, disclosures, and accounting standards on climate change. Now we need to make sure that accounting and audit standards are aligned with the Paris goals to avoid investors discounting these issues.
- **NZSF:** We have been working on climate change actions in the portfolio for a very long time. We started by identifying climate risks in the portfolio that were not being compensated for, and we reduced exposure in advance of what the market was doing. NZSF also recognized that decarbonizing the portfolio doesn't necessarily change real world outcomes, so we also began shifting allocations toward the clean energy transition.

*How do you feel about engagement/active stewardship versus divestment as a responsible investment strategy? Can you give some examples of engagement and voting power that have made a difference in producing positive environmental and social change? When is divestment useful and can it send an important signal to savers and stakeholders?*

- **Australian Super** is a strong believer in engagement and has seen positive results from engaging with portfolio companies. In our view, to be effective, engagement needs to be very planned and deliberate, and outcomes need to be measured carefully. For each major holding, Australian Super creates an ownership plan, which includes due diligence about which ESG issues are most relevant for that company. A plan is then developed on how to engage with the company to manage those issues during ownership. Progress is continuously measured.
- **Railpen:** We believe that shareholders have significant potential to engage invested companies and hold them accountable. For instance, Railpen is stewarding significant emitters through their transition plans. It also is identifying key voting issues and transition gaps. While the process may be slow, we feel it is necessary to take this path, and Railpen has found that having a seat at the table is more impactful than divestment. Engaging with companies starting from a low base is key to sector decarbonization and is particularly important for achieving real-world impacts.

- **One Asset Allocator:** While divestment may not be the most attractive strategy, it can help to focus public attention, spark debate, and put issues such as climate on the agenda of policy makers, thus contributing to forward looking legislative actions.

*Is responsible investment a bull market phenomenon? If we enter a recession, will the movement weaken?*

- **AIMCo:** We believe that ESG considerations are inherently long-term in nature. The economy and markets will go through cycles, but ESG will remain a critical element of investing even in a downturn. In fact, we believe downturns actually can highlight important ESG issues to pay attention to, like health and safety of workers during the COVID pandemic. We see the integration and implementation of ESG considerations into investment decision-making as likely to accelerate going forward.

*It is easy to construct a good looking ESG portfolio, for example by eliminating all fossil fuel companies, but is that the best way to combat climate change or achieve social goals? How important is it to invest in transition? What are the risks? How do you balance supporting companies through transition while deterring negative short-term ESG outcomes?*

- **NZSF:** Investing in companies transitioning to lower carbon and greenhouse gas emissions is critical to make progress. Divesting, or focusing on best-in-class, can send strong signals to the market that drive change, but they also may give more control of an asset to investors who care about short-term targets, not long-term climate transition strategies. As one allocator put it, “we are investing for a net zero world, not a net zero portfolio.” Investing in the transition includes investing in solutions, and NZSF is active in the development of low carbon energy sources. Perhaps more challenging, however, is helping currently heavy emitters to transition to a lower carbon future and this is where we as investors can have great real-world impact. The agribusiness industry provides an interesting case in point. Currently, there isn’t great technology to reduce methane gases in the cattle farming business, so NZSF, together with government agencies, research institutions and farmers, is focused on improving practices to reduce emissions. Investing in transition is critical but it can be challenging for allocators because their stakeholders may not understand why the emission profiles of certain investments aren’t improving as rapidly as they would like.

*What are allocators doing relating to the “S” in ESG? Sometimes it is harder to measure and manage social factors.*

- **Aware Super:** A lot of ESG issues are intertwined, and we can’t look at them individually. The “S” is one of the most important areas investors need to focus on, and these issues have material impacts on companies. Examples of “S” or social issues include conduct, culture, and impacts on staff. Another important issue is modern slavery and supply chains. Here, the introduction of the Modern Slavery Act has played an important role in heightening investor awareness and encouraging investors to influence companies through engagement. A number of collaborative opportunities are developing in this area including Investors Against Slavery and Trafficking.

Diversity also is an important issue and while it is improving across boardrooms, we need diversity at the next level of management as well. 40:40 Vision is a good example of collaboration relating to diversity. Collaboration is important because invested companies need to hear from multiple investors instead of just one or two.

- **Australian Super:** We have been working on gender diversity on boards for 4-5 years now. Prior to engagement, 17 of Australia's largest companies (ASX200) had no women on the board. Australian Super wrote to those companies communicating a new policy that we would vote against senior directors if there continued to be no women on the board. Today, none of those 17 companies remain without women on the board. Australian Super now has a base requirement of at least 2 women on boards, with aspirations for gender parity. In addition, Australian Super has eight priority ESG topics including diversity, which is very broadly defined. It is integral to our engagement with portfolio companies. While Australian Super's approach to racial and ethnic diversity hasn't been as structured as its work on issues such as gender diversity, climate, and workforce safety and compensation, we are currently considering projects to address this.

#### ***Audience Questions, Comments, and Panelist Responses:***

- *How should allocators think about budgeting for climate risk?*  
We do not allocate a risk budget for this purpose, since we identified and removed this risk from the reference portfolio some time ago, effectively adjusting the benchmark to remove climate risk in publicly traded securities. There is climate risk in private the markets, and it's difficult to budget for such risks because benchmarking is less efficient in the private asset space. We don't think it makes sense to try and approach all climate risks in the portfolio through benchmarking alone.
- *Are the average country and regional scores in the RAAI Index weighted by number or by AUM? If by number, would the average score increase for the USA if weighted by AUM, given the asset size of some of the leaders?*  
Average country and regional scores are weighted by number of rated asset allocators rather than by AUM. If weighted by AUM, the average score for US asset allocators would be higher at 44% versus 34%, but it would still be well below the world average score of 52%. It would not change the fact that less than 10% of total US asset allocators rated by the RAAI are in the top quintile, the lowest percentage among Western nations.
- *What are the qualifying questions in the RAAI rating system and are they self-assessed?*  
The 10 principles and 30 criteria used for the evaluation can be found in section two of the on-line report. A distinguishing feature of the RAAI is that asset allocators are rated independently by RAAI analysts and experts, based on annual reports, websites and documents in the public domain. Asset allocators are allowed to submit materials, but they do not self-assess.
- *Where can we find more information on the initiatives mentioned relating to social issues?*

The Human Capital Management Coalition is at [www.hcmcoalition.org](http://www.hcmcoalition.org) and 3D the Diverse Director DataSource is at the Equilar Diversity Network [www.equilar.com](http://www.equilar.com). More information on the Task Force on Inequality-related Financial Disclosures (TIFD) may be found at <https://thetifd.org/> and welcomes participants' involvement.

- *Commentary on SEC proposed Rule changes*  
The RAAI and PDI note that the US SEC will come out this Spring with proposals for specific disclosure requirements regarding climate and human capital management risks, and we recommend asset allocators to respond with their comments.

***Additional Questions Posed by the Audience for Future Discussion:***

- *When it comes to outcome-oriented engagement, do you have greater expectations of active managers to influence positive change compared to ESG implemented by passive managers who can't sell the company if it is in an index?*
- *How do you collate the views/priorities of your beneficiaries/savers and how important are they in shaping your strategies?*

## Part II: How Benchmarks Can Help Asset Owners Deliver on ESG

### **Speakers Included:**<sup>1</sup>

- **Delilah Rothenberg**, *Co-Founder & Executive Director*, Predistribution Initiative (PDI)
- **Paul O'Brien**, *Trustee and Member of the Investment Committee*, Wyoming Retirement System; *former Deputy CIO*, Abu Dhabi Investment Authority (ADIA)
- **Lazaro Tiant**, *Investment Director – Sustainability*, Schroders<sup>2</sup>
- **Rob Zochowski**, *Program Director Multi-Faculty Impact Investing and Sustainability Special Projects*, Harvard Business School | Impact Weighted Accounts (IWA)
- **Andrew King**, *Co-author, “Heroic Accounting;” Allen Questrom Professor*, Boston University

### **PDI and Dr. O'Brien - Context on the Challenge of Benchmarking for Sustainable Returns:**

Benchmarks represent consensus of what “the market” is and are used by asset allocators to guide portfolios. It is important to clarify at the outset that benchmarks and indices are often used interchangeably, but a benchmark is specifically used by external parties to identify how an investment strategy is performing, define risk, and keep score. They are set by market participants and are subjective. Importantly, benchmarks reflect financial returns while excluding costs imposed by externalities. When the performance of endowments, foundations, and pension funds, are measured, it is usually against a benchmark, and therefore deviating from the benchmark is often perceived as risk. A key consideration is whether benchmarks should be adjusted to reflect sustainability goals.

The Predistribution Initiative (PDI) is focused on issues at the investor level (as opposed to portfolio companies, which are typically the focus of measurement and management). The organization supports investors in aligning their financial analysis and investment governance with their ESG and systematic risk management goals. PDI’s working paper, [ESG 2.0: Measuring & Managing Investor Risks Beyond the Enterprise Level](#), encourages investors to shift to more regenerative investment structures and asset allocation practices, but this is difficult for investors to do when using historical financial benchmarks as reference points, since newer regenerative investment structures and the emerging asset classes that represent them don’t have historical financial benchmarks. Strong benchmarks are also lacking for private assets in general, so how do we apply the concepts we are discussing to that space?

Financial benchmarks have often been criticized for not reflecting changing market structures, use of leverage, or their direct relationship to required rate of return. In the context of ESG and sustainability, it is important to consider whether historical financial benchmarks are inflated since they don’t price externalities. With many investors now seeing the value of taking a system-level investing or systematic stewardship approach, they may begin to price in

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<sup>1</sup> Mona Naqvi, Global Head of ESG Capital Markets Strategy, S&P Global | Sustainable1, was also scheduled to speak at the Americas / EMEA session, but was out sick.

<sup>2</sup> Standing in for Sarah Bratton Hughes, Global Head of Sustainability Solutions, who was out sick.

externalities moving forward, and it will be important to consider what that means when using benchmarks of the past as reference points. The comparison of returns moving forward to returns of the past will no longer be “apples-to-apples.” From an asset allocator perspective, intergenerational risks are part of the job and critical to consider in relation to fiduciary duty, so this is a central question and one that should inform activities of internal teams and external partners.

Additionally, allocators believe they need to be highly diversified, but they also know they face systematic risks. One of the problems with benchmarks is that they have thousands of securities in them, and it is not possible for investors to effectively engage with so many companies. It may be arguable that investors really shouldn’t own all the securities in the index, and they actually may be overdiversified. It is possible to have a low tracking error without owning all of the securities in the benchmark.

***Key questions on benchmarks raised at the Roundtable:***

- Are historical financial benchmarks barriers to sustainable investing, and if so, should they be adjusted? If they can be adjusted, how should this be done?
- If there is interest in adjusting benchmarks, who should be involved in that process - both within the financial system and outside of it?

***Examples of methodologies to account for externalities, and introductory remarks on the pros and cons of doing so:***

- [Schroders SustainEx](#)
  - The SustainEx tool supports clients in pricing both positive and negative externalities with a forward-looking view. The tool can be applied at the company and portfolio level and can be particularly useful in staying ahead of the curve in identifying risks that might not yet be considered material to a company’s financials but that could become material over time (the concept of “dynamic materiality”). Schroders anticipates that certain unpriced activity can eventually become financial costs to companies (e.g., policy and regulation that is emerging about sugar).
  - Schroders is focused on the largest social and environmental issues, and the tool is based on over 700 academic and industry studies of social impacts and externalities and over 70 data points for each company, covering over 16,000 global companies. Criteria for data inclusion is that information must be quantifiable, measured objectively, sensibly allocated between companies, transparent, and deliberately simple. Estimates are made where information isn’t disclosed (e.g. wages, taxes).
  - Slides used during the Schroders presentation may be found [here](#).
- [S&P Global | Sustainable 1](#)
  - While Mona Naqvi could not present due to being out sick, a slide she had planned to present may be found [here](#).

- [Impact Weighted Accounts \(IWA\)](#)
  - IWA is a think-tank proof-of-concept undertaking at Harvard Business School with the goal of measuring and managing externalities, with the view that economic and accounting systems are no longer fit for purpose and have resulted in a tragedy of the commons.
  - IWA recognizes that organizations may distribute value to different stakeholders in different ways. Companies that extract value from society in favor of increasing their profitability are “rent-seeking.” If accounting is designed to be focused solely on financial return, it may inadvertently incentivize companies to maximize profit at the expense of people and the environment.
  - Even though accounting was developed for the providers of capital, which arguably was the reason it is focused on the financial return of individual companies, accounting should also accommodate investors’ increasing interest in externalities and how an organization is actively managing those risks. Many issues which are now deemed immaterial represent long-term idiosyncratic or systematic risks; mismanagement of culture such as allowances for sexual misconduct or incivility have severe human capital and reputational risks. If an investor has a longer time horizon, that investor should want to integrate an analysis of these issues into its investment decision making. Additionally, the economy is increasingly knowledge and services-based, so an approach that doesn’t adequately value employees, for instance, can be problematic.
  - There is a false dichotomy between single and double materiality. Time changes that. Over time, systemic issues do become material to individual companies. For example, because the US federal minimum wage is so low, there is a huge financial benefit paired with an emerging social cost for companies. The reason for conducting accounting at a company level is to try to assign responsibility for those costs.
  - Sustainability reports do not entirely address this knowledge gap. They help investors understand the issues from a qualitative perspective, but don’t help investors integrate those issues into financial analysis and measure trade-offs. Investors need to be able to understand the *value* of reduced GHG emissions, employee health insurance, living wages and paid time off, especially if companies need to prioritize activities.
  - IWA believes that providing monetized valuation estimates based on scientific and academic (as opposed to politically salient) methodologies to identify price is a way of increasing transparency and democratizing information on organizational impacts. The IWA framework has three pillars, which includes environmental, product, and employment issues. A key benefit is that non-expert stakeholders should be able to intuitively understand the value that an organization brings without having to do hours of research. The ultimate goal is for organizations to be able to better manage their resources.
  - Several challenges to this approach include complexities around netting one value against another (transparency in methodology is important to combat this), greenwashing, and the difficulty in measuring value for things, like human well-being, clean water, clean air, or a pristine forest in the countryside. However, currently corporate managers and investors are making decisions based on accounting reports that measure only financial metrics, and using stakeholder value could be an

improvement to the status quo. IWA's approach is a starting point for quantifying impacts through each of these.

- Slides for the IWA presentation may be found [here](#).
- Dr. Andy King, Questrom Professor of Business, Boston University
  - Efforts to measure externalities are appreciated, but it is questionable whether it is possible to accurately calculate the full impact of a firm and monetize it. It is important to not just count "good" and "bad," but also to measure the marginal effect of the corporation on the system's equilibrium. These points are discussed further in the article, "[Heroic Accounting](#)."
  - The red fox is an example of how sustainability accounting as proposed by IWA may be challenging in different contexts. In its local habitat, the red fox is a great addition to the ecosystem, but in Australia, it is destructive. As another example, a gas plant in one place may provide essential energy, but in another place, it displaces renewable energy (e.g. Iceland). Regarding the growth of renewable energy, what if we end lithium mining because it has lots of externalities? Current proposals for financial sustainability accounting seem to only measure average effects, not marginal ones, use simplifications, may not account for local conditions, ignore tradeoffs among impacts, and emphasize direct effects vs. indirect effects that will likely also occur.
  - Inaccurate calculations have the potential to cause harm (potentially misdirecting investment and forestalling regulation). It may be impossible to measure the impact of everything. However, measuring eco-efficiency and engaging in policy reform and advocacy (e.g., for a carbon tax) could be a better alternative.
  - Economists have always understood externalities, but that is what policy and regulation are for. Historically when prices diverge from externalities and don't bear the full cost, government steps in and corrects this market failure. IWA's approach is concerning because it seems to suggest that private market actions will solve problems without the role of government. Business has often proposed such actions to forestall policy and regulation. Various specialists (as identified in the slides) have expressed concern that these dynamics are causing us to run out of time on key environmental and social issues as they reach tipping points.
  - Slides from Dr. King's presentation may be found [here](#).

**Discussion Topics:**

*Must financial sustainability accounting and policy / regulation be mutually exclusive? Could IWA's framework support policy makers and regulators in understanding negative impacts and further incentivize them to act?*

**Mr. Zochowski:** At this stage, IWA's framework isn't ready to be in fully mandatory form. There is a need to work with stakeholders to better understand issues and nuances, such as the complexity and context matters that Dr. King raises. However, IWA has been engaged in initiatives to support policy and regulation. Regarding complexity, IWA is embracing confidence

intervals while maintaining flexibility. For instance, one might consider using values based on underlying impacts with a 90<sup>th</sup> percentile confidence interval. Given the state of the US political system, it may not be realistic to expect near-term or lasting policy change, though that may be more likely in the EU context. If governments can't agree on ways forward to address environmental and social issues, then the next best option may be to provide investors with tools that are improvements over the frameworks and ratings they are using currently.

**Across both roundtables:** There was general agreement about the importance of policy and regulation. Some highlighted that improved reporting standards, disclosure rules, and regulation are often driven by investor and public demand for better information flow as they need to price these external risks better. The corporate sector also spends significant amounts of funding on political lobbying to influence government policy. As a result, regulators tend to step in after the private sector engages on these issues, not beforehand.

*There is over US\$3 trillion in AUM in these meetings – what would you advise them to do?*

**Dr. King:** Work for a worldwide carbon tax. Empower democracy.

**Mr. Zochowski:** A carbon tax is great, but it needs to be the right price. US\$20 won't be effective. Allocators can begin pushing companies and using improved data. Currently, there are significant omitted emissions. Allocators should try to compute their own emissions estimates, and if they don't align with their portfolio companies' estimates, then the investors should engage with them.

*Are investors willing to take a loss to improve stakeholder outcomes? If so, how much are they willing to lose?*

**Allocator Participant:** The short answer is not much. Excess data is overwhelming, and Dr. King's comments resonate. Keeping it simple and focusing on things that allocators can change and where they can gain leverage are valued. Don't let best be the enemy of better. Any carbon tax is at least getting the issues on the radar of investors. Marginal performance and progress do matter.

**Another Participant:** Some companies might benefit from posturing and prioritizing policy and regulatory change as an excuse to not take voluntary action, when they know the probability of policy or regulatory action is low. Dr. King agreed that this could be an issue and noted that there is research suggesting that if there is regulation on an issue, consumers often feel that they don't need to do as much.

**Mr. Kalb:** In the US, we need a carbon tax and other government policies and regulations to govern important systemic risks, such as climate change, but it doesn't seem the US is set up to move forward on such initiatives. In fact, the poor policy environment and lack of disclosure rules and operating guidance in the US on systemic risks can be toxic, impeding progress and even allowing boards to be sued for implementing environmental or social goals. We even allow

private sector funds that incentivize companies to contribute to systemic risks – for example, a fund launched recently to invest in companies that have the highest spending on lobbying and political donations, on the theory that such companies can successfully bend the rules in their favor, at the expense of imposing greater costs on society, to increase their short-term profits. Investments might include an energy company that spends large sums to overturn environmental protections. We need a better regulatory and policy environment, and we must continue to advocate for it, but neither can we afford to sit by idly and do nothing, waiting for government agencies to step in. It may be best to take a dual track and pursue both private market solutions, as well as policy and regulatory change. In our experience, regulators tend to be reactive vs. proactive, so when there is a groundswell of support for a particular issue, they are more likely to act. Hence private market solutions may be an important means to an end.

*Is anyone worried that the IWA approach could cause net harm?*

**Another Participant:** Carbon emissions are up despite a groundswell of voluntary initiatives. Fees are higher, but sustainability isn't better. Fund managers aren't trained or designed to address these issues.

**Ms. Rothenberg:** It may be true that ESG hasn't necessarily produced the positive impacts many expected. However, ESG has been focused on what is financially material to particular companies, vs. what is financially material to investors' portfolios. Externalities aren't material risks to individual companies' financial performance, but they are material risks to large long-term diversified investors' portfolio returns. That is why the accounting that IWA is working on could be useful to quantify externalities that impact investors portfolio. Externalities aren't being captured by existing frameworks like SASB and MSCI's ESG ratings. So it is up to asset owners and allocators to hold managers and companies accountable. It isn't that investors aren't aware of the risks, but they don't have sufficient financial analysis tools and governance policies and procedures to capture systematic risk, and part of this relates to benchmarking, hence the impetus for this roundtable.

*Should we adjust historical financial benchmarks?*

**Dr. O'Brien:** We need to consider general vs. partial equilibrium. Partial equilibrium is specific to a company, while general equilibrium is specific to the aggregate economy. The latter is where the discussion about externalities and benchmarks lies. The US emits some five gigatons of carbon, costing approximately US\$500bn annually. This is a large externality that is going unrecognized. It can't all be subtracted from corporate profits or GDP, but it will eventually have a large impact on aggregate returns. It is difficult to attribute these costs to specific companies, but in general, investors know that their portfolios will be hurt by these dynamics. The top asset owners may find value in coming together to think about these dynamics and how to adjust benchmarks moving forward to drive capital in the right direction.

Allocators don't necessarily want to know what each individual company did, but in aggregate, we see that 25% of corporate profits over the last 25 years were generated by unsustainable activities. Hence, we understand that the returns on equity upon which we've based our benchmarking and asset allocation models has been exaggerated. Dr. King agreed with this point and suggested that getting into the weeds on individual companies and accounting can take away from the big picture.

We built a system based on everyone needing a 7% required rate of return, but perhaps 2% may have come from externalities. So, we need to have conversations with beneficial owners about realistic returns moving forward. That is what the benchmark discussion can accomplish.

**Across both roundtables:** Panelists generally agreed with concerns that it may be difficult to accurately price certain externalities. However, there was a level of agreement that some externalities, like carbon, may be easier to price and a better starting point than others, and that society could potentially agree on several externalities to price moving forward. Avoided emissions are also an increasingly used metric for companies making positive impacts.

#### ***Final Question and Answers:***

*Should historical benchmarks be adjusted to account for externalities?*

- **Perhaps we should carefully consider adjusting benchmarks** as tools and consensus for pricing externalities are developed. Investors expect that portfolios will grow, but various estimates which reflect pricing for externalities suggest returns will be lower in the future. On the other hand, sustainable brands could attract more consumers, and there may be positive externalities that could help compensate for expected losses. Overall, we may be facing lower returns in the future, requiring that expectations be recalibrated. Given this scenario, it may be worthwhile to adjust historical financial benchmarks to make them consistent with forward looking changes that could occur.

Ultimately, we are a long way away from adopting widespread pricing of externalities moving forward, let alone pricing them into benchmarks. For now, the industry needs to develop the right tools and partnerships to understand where the externalities lie and then through analysis and engagement determine what to do about them.

- **No, we should not adjust historical financial benchmarks.** If we were to adjust historical financial benchmarks, some clients of money managers or financial advisors may be disappointed to know that their historical returns are being adjusted downwards. This could lead to substantial disruption of capital market and savings. Additionally, it is very hard to do. If something was more costly in the past, then a firm may not have made the same decision to act on that cost. For instance, if beef was more expensive historically, more restaurants might have served chicken or fish instead and their profits might not have changed so much.

Adjusting historical returns may place more emphasis on private market measures to address societal and environmental problems, rather than policy and regulation. Planetary boundaries were recognized in the early 1970s at the first UN conference on humans and the environment, and regulations were proposed. However, the private sector pushed the transparency-plus-private-market-action perspective, which became the accepted path. It is not clear that disclosure has an impact on behavior (see for instance, <https://www.nature.com/articles/s41558-021-01174-8.pdf>).<sup>3</sup>

There are also risks in saying good enough is better than nothing. That was the thinking that brought foxes to Australia.

- **Yes, we should begin to pursue adjustments to historical financial benchmarks.** Currently, SASB, TCFD, GRI, IFRS, and others are trying to integrate value accounting into their standards, but 1) they are not fully integrating value into financial analysis (monetization), and we must recognize that financial performance is a significant driver of incentives when investing, and 2) they focus on financial risks to portfolio companies, not the systemic risks that the portfolio companies pose to society, markets, and investors' diversified portfolios. Additionally, regulators don't typically lead on these types of issues, so investors and the public need to demand more and better information, which will then push the regulators and policy makers to change.

Moreover, while investors are the ultimate users of benchmarks, they don't typically set them. Rather, private organizations with different objectives like MSCI and S&P have usually been responsible for driving benchmarks. Since investors are the ultimate users of the benchmarks, there is a role for large institutional investors and other allies to engage in the process of adjusting benchmarks. In fact, the practice of customizing benchmarks already is well established.

Regarding concerns about the complexity of valuing systems, the goal is not to have a massive monetization spreadsheet of metrics. Rather, we need a general understanding of which risks are being priced too low (e.g., carbon currently), or on the positive side, which are priced too high. IWA is putting forth global models as a proof-of-concept to make the point that there are significant unpriced externalities. They are seeking partners to ensure the tool isn't abused and there aren't unintended negative consequences.

Participants also highlighted that standard financial accounting (non-impact) is based on estimates, and that accounting practices have become accepted by tradition and age,

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<sup>3</sup> As a counter argument, note there is evidence to support that disclosure rules, a soft form of regulation, can drive behavior and favorable outcomes. See <https://www.sec.gov/news/speech/lee-cii-2020-conference-20200922>. In addition, evidence suggests that asset allocators in countries with a higher level of ESG regulation tend to score more highly on responsible investing metrics. See <https://www.newamerica.org/responsible-asset-allocator-initiative/reports/the-2021-leaders-list-the-30-most-responsible-asset-allocators/>

which lends support to the belief that a similar evolution can happen for carbon accounting (even the AICPA has formally adopted measurement metrics).

***Additional resources shared during the panel:***

- Denise Hearn, who is PDI's Chair, co-author of *The Myth of Capitalism*, and a Senior Fellow at the American Economic Liberties Project (AELP), writes a [newsletter](#) that often covers topics relevant to this discussion.
- Beyond Alpha's [flagship research paper](#) covers the importance of system-level investing and measuring and managing systemic risks.
- Article on the [partial/general equilibrium point](#) within sustainability.
- Ms. Rothenberg also shared that the Predistribution Initiative is researching several indigenous groups who are developing methodologies to value social and environmental factors and that they expect to share more information on these initiatives in their future programming.