

Extra-financial risks & opportunities: *implications for pension funds*

OECD, Istanbul, Turkey, November 2006



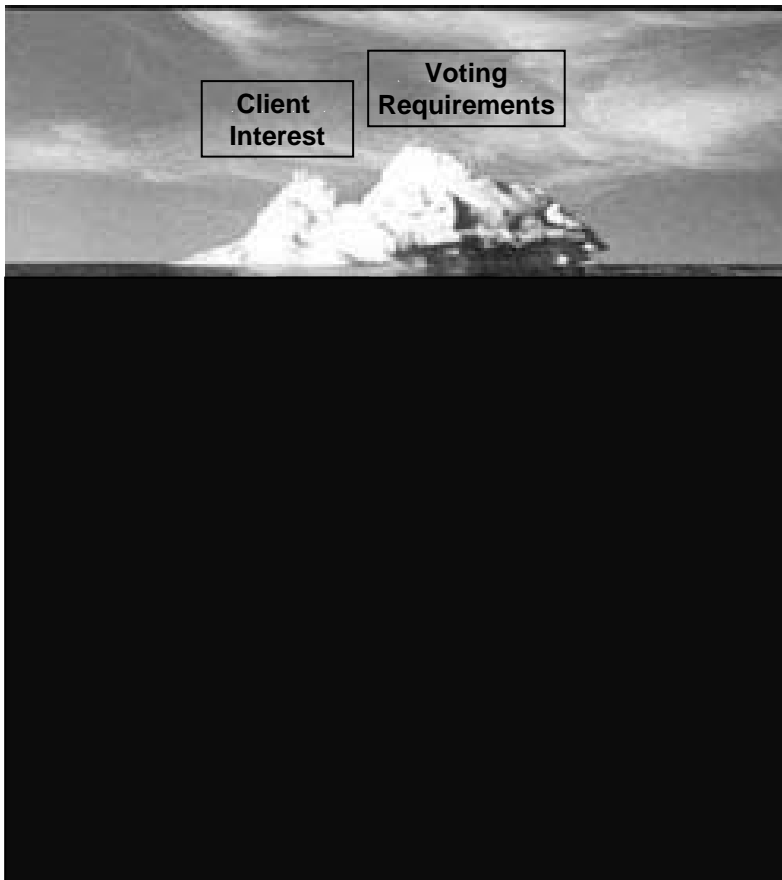


TODAY'S PRESENTATION



1. Why should pension funds care about extra-financial factors
2. What does “caring” mean for a pension fund? (How does this differ from a fund manager that offers an SRI/CG product/service?)
3. Some priorities & implications – what needs to change?
4. Conclusions

Why should pension funds care about extra-financial factors



- Today's demand
 - Voting (« a compliance matter »)
 - Client interest (« not very significant »)
- Tomorrow's demand
 - Source of competitive advantage for some & disadvantage for others
 - Alpha but also relationships
 - Essential component of what some customers expect as part of the core
 - « Licence to Operate »
 - A large market!

A CHANGING CONTEXT



“We will take economic development as our top priority, aim ourselves to the all-round development of man, and follow a development path characterized by high productivity, affluent life and sound eco-system by properly balancing urban and rural development, development among regions, economic and social development, development of man and nature, and domestic development and opening to the outside world.”

Hu Jintao, President of China

“Business . . . has a fundamental role in delivering sustainable development . . . in essence it is about enlightened self interest . . . business needs sustainable societies in order to protect its own sustainability. Very few businesses are short-term activities. Most want to do business again and again over many decades.”

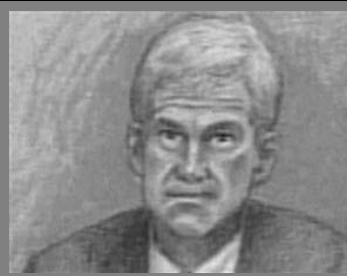
John Browne, Group Chief Executive, BP

“If unchecked, the depletion of natural resources and growing social instability will eventually have consequences for all businesses. For a reinsurer, however, . . . (there is) . . . added significance: where resources are overused and social cohesion is under threat, society will experience new kinds of risk. That is why proactively analysing and understanding any such risk, in order to develop methods of mitigating it, is a strategic task for Swiss Re.”

Bruno Porro, Chief Risk Officer, Swiss Re

**NGOs & unions: A global megaphone
shaping the debate... first
corporations...now investors in the dock**





DEBATE	PROSECUTOR	IN THE DOCK	VERDICT
Impact of Extractive Industries on Third World development	80 NGOs (incl <i>Amnesty International, Transparency International, Save the Children & Care</i>)	Oil & Gas companies and governments	Sector wide process for greater transparency supported by many institutional investors who together represent \$7 trillion
Pension funds claiming to be responsible – but what are they doing in practice?	<i>Fair Pensions</i> , a dedicated UK NGO formed by <i>Amnesty International, Oxfam & WWF</i>	UK Pension Funds	BBC Pension Fund signed up to PRI after fund members joined the campaign. (The predecessor organisation, <i>Ethics for USS</i> , was a key catalyst for USS's decision)
Should investment firms be responsible for also managing their carbon footprint?	<i>Trucost</i> , an environmental research company	44 main UK Investment and Mutual funds	Results of initial study indicate there is no gain in financial performance to be had by ignoring carbon footprint.
Some corporations are alleged to be particularly irresponsible	<i>Interfaith Center on Corporate Responsibility</i> , NGOs incl <i>Amnesty Intn</i> , Trade Unions and affiliated/ supportive funds including US State pension funds	Corporations (incl. Boeing, Halliburton, Synagro & Wal-Mart)	CSR resolutions filed and supported by shareholders, bad publicity for the company, often leading to action (eg Wal-Mart on environment & labour standards)



DEBATE	PROSECUTOR	IN THE DOCK	VERDICT
<p>Role of banks in affecting corporate action on climate change</p>	<p><i>Friends of the Earth (Netherlands)</i></p>	<p>Big Dutch Banks</p>	<p>Bad publicity for banks, resulting in new policies on climate products</p>
<p>Is Citigroup being responsible in its lending and other activities?</p>	<p><i>Rainforest Action Network</i></p>	<p>CitiGroup</p>	<p>CitiGroup has now adopted an environmental policy with new standards for finance industry: Illegal logging, ecologically sustainable development, climate change.</p>
<p>Previously, lack of sustainability principles for project finance by banks – ie lending which supports undemocratic regimes, fuels conflicts, exacerbates human rights abuses or causes environmental damage. Now, lack of implementation of these principles by some signatories</p>	<p>Key = <i>Banktrack, Netwerk Vlaanderen, Friends of the Earth.</i></p> <p>Others = <i>WWF, Bank Information center, Global Witness, MPI, International Accountability Project</i></p>	<p>Initially all financial Institutions. Now those signatories which either haven't signed or have signed and are said to be not meeting benchmark standards</p>	<p>Many banks have adopted the Equator Principles as has the IFC (part of the World Bank) – thus it is becoming a defacto norm.</p>

SECTOR LEADERS ARE MOVING



- Asset owners and fund managers representing \$4-5 trillion
- Six process principles (not content, not compliance, not prescriptive)
- Peer benchmarking and learning by doing
- www.unpri.org

- RI has and continues to evolve
 - Values (ethics) driven – negative screening & some forms of positive screening
 - Alpha seeking – integration of extra-financials – avoidance of negative alpha vs positive alpha
 - Beta enhancing – eg voting & engagement

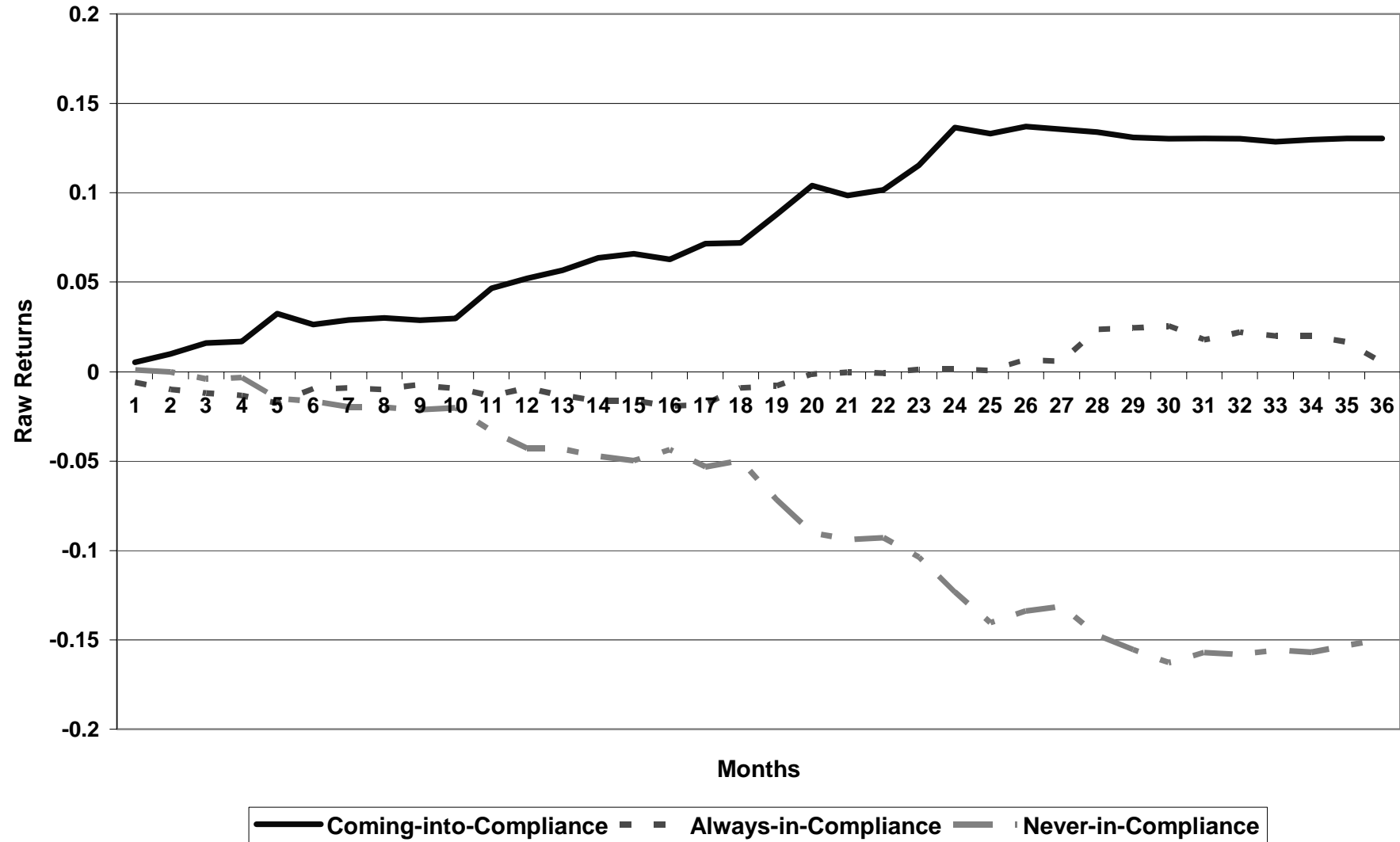
THE NEGATIVE EXCLUSION APPROACH



- « Normative »
 - Based on international norms – eg AP7, Norwegian Pension Fund
 - Linked to values of client & or end beneficiaries – eg « sin stocks »
 - Key success factor = investment beliefs and organisational values

- « Analytical »
 - Identify best-in-class & worst-in-class and exclude / underweight later
 - Key success factor = clarity re trade off between values & alpha
 - Choice of specialist rating agency should reflect this

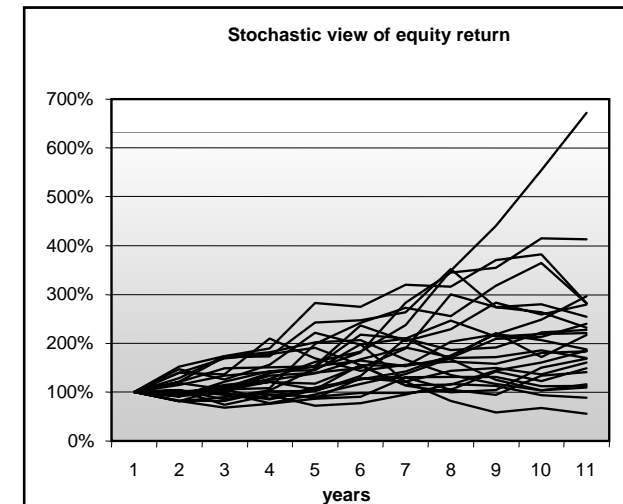
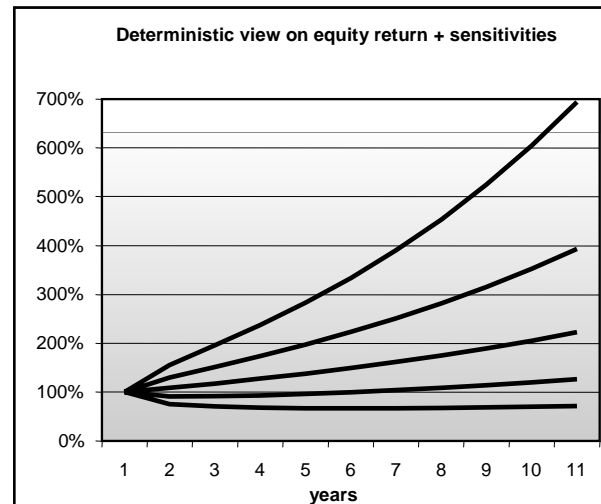
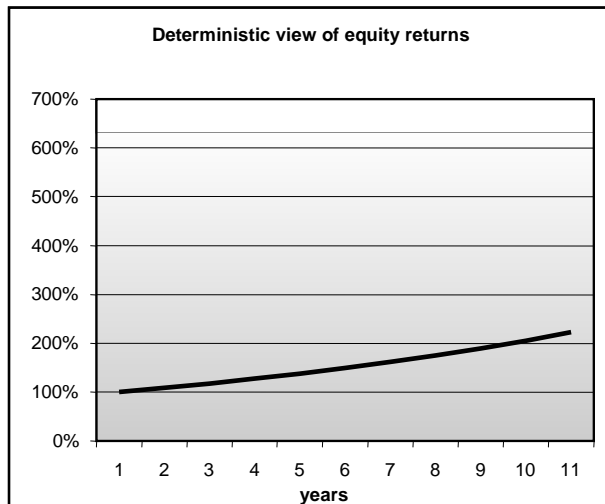
CORPORATE GOVERNANCE IS A MATERIAL INVESTMENT FACTOR



EXTRA-FINANCIAL ANALYSIS ALLOWS BETTER RISK MANAGEMENT



- In real life, our world is truly stochastic. Deterministic scenarios alone lead to irrational decision making. Stochastic modeling techniques help us make better, more appropriate decisions.
- 80% of all major value losses involve a chain of events or the simultaneous occurrence of multiple events



UNIVERSAL OWNERS DEPEND ON MARKET RETURNS



- UO hypothesis: A large long-term investor with diverse investment portfolio can initially benefit from an investee company externalising costs but will ultimately experience a reduction in market and portfolio returns due to these externalities adversely affecting returns from other assets
- Implications?
- Reduce negative externalities (e.g. pollution and corruption) and increase positive externalities (e.g. sound corporate governance and good human capital practices)

HOW BETA IS ENHANCED



- Productivity effect - return on capital enhanced through more efficient capital allocation.
- Growth effect - higher productivity feeds through to economic growth through the reinvestment of higher corporate profits.
- Risk effect - reduction in business risk feed through to a lower cost of capital – which has associated production effects through the mobilisation of capital to productive use that would otherwise be allocated or deposited elsewhere.

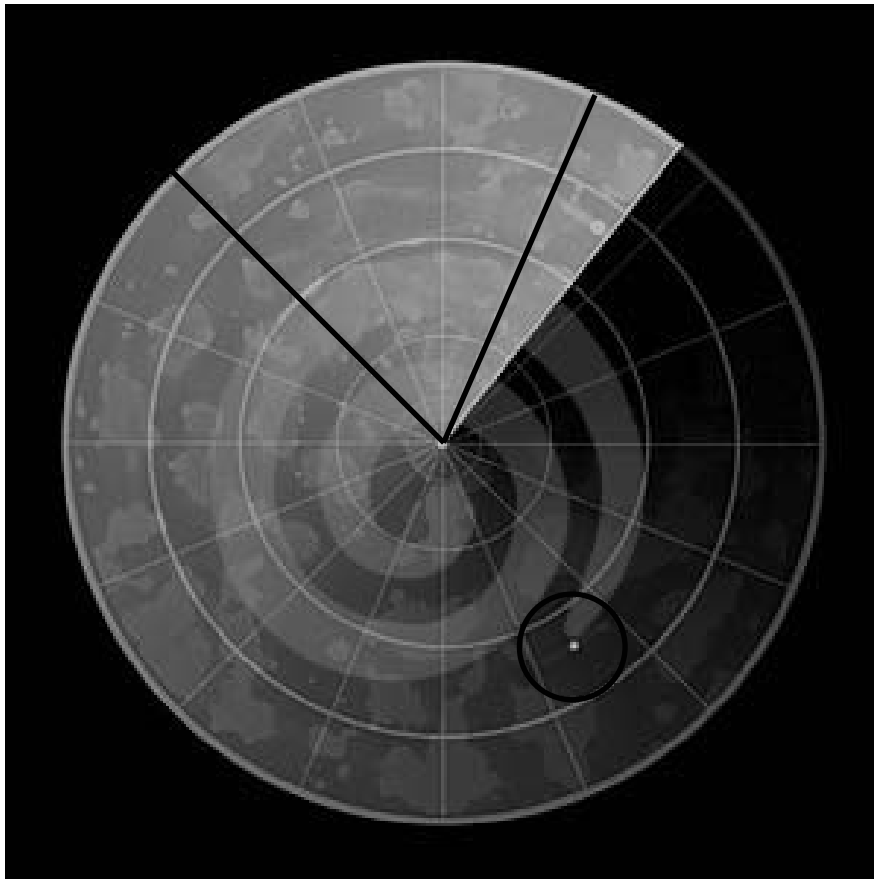
- Within each sector, however, there is wide divergence in the extent to which companies are managing these risks
- Companies that lead their peers in terms of drivers of risk & reward (and communicate this to the market) should generate higher shareholder value (lower 'risk premia') than their peers
- These companies will also
 - improve operational efficiency and reduce risk
 - potentially align and attract employees
 - more easily win new licenses to operate
 - protect and enhance brand and 'intangible' value

FUND MANAGEMENT IS PATTERN RECOGNITION



- *Current* extra-financial information overlooked:
 - R&D intensity
 - Pro-shareholder corporate governance culture (eg alignment of remuneration with L/T value creation)
 - Eco-efficiency
 - Human capital management
- *New* extra-financial information priced in slowly:
 - Accruals as extra-financials
 - Corporate governance

EVOLVING PATTERN RECOGNITION

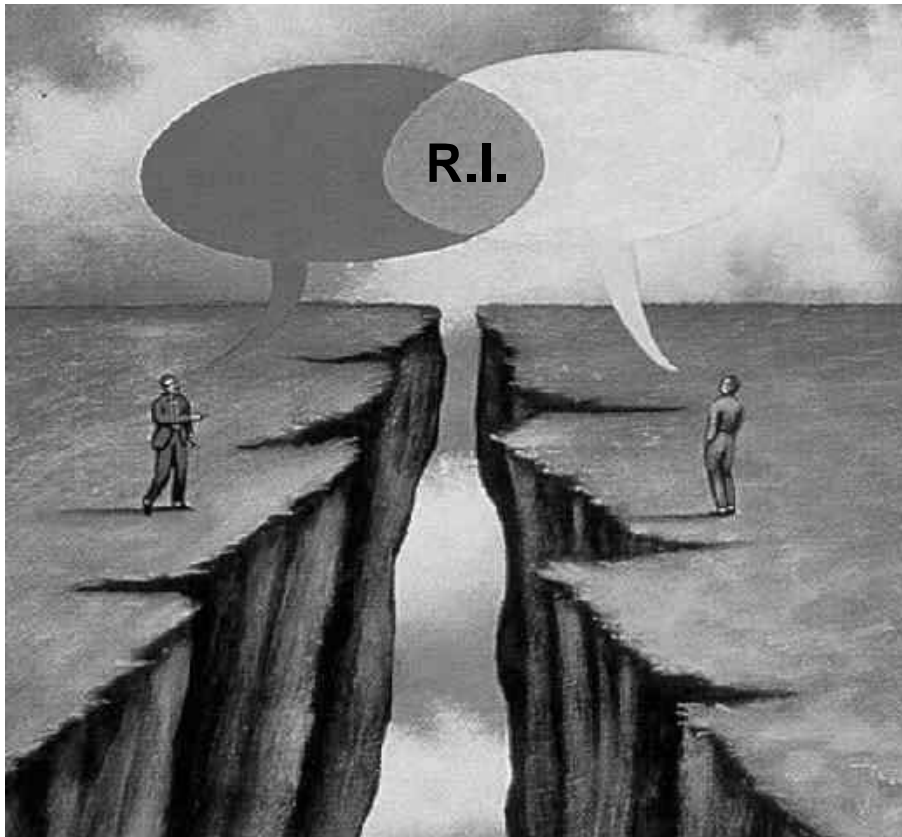


- Fund manager experience
 - Expand set of variables
 - Deliver new perspective
- Radars retuned
 - ‘New’ price and risk sensitive information grabbing their attention



- Voting
- Thematic (climate change risk)
- What happens when enough fund managers take the “extra” out of extra-financial

R.I. – THE BRIDGE BETWEEN SUSTAINABILITY & «WALL STREET»?



- Bridges the values related to sustainable development and day-to-day investment behaviour

WHERE R.I. IS TODAY? (A generalisation!)



- Small teams, junior staff, not part of real decision-making processes
- Marketing/PR function
- Niche products (vs mainstream funds)
- Asset owners trying to find alternative ways around their normal investment supply chains
- Weak client interest



Henri de Castries,
Chairman of the
Management Board

The AXA Vision

*"To help our clients be life confident:
it's our vision of the business and how
it should be done"*

"We have chosen to work in a demanding business. If we serve our customers well, we will enable them to get more out of life and feel reassured, protected and supported at the various stages in their lives, as they realise their dreams. That is the AXA vision. It gives meaning to our daily work, and human aspects of our business, which has become more necessary than ever. "