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Time for pension funds to adopt SRI policies

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SRI is not as prevalent among pension funds in Japan as in the US or Europe. Japanese pension funds would be well-advised formulate explicit SRI policies to expand their investment opportunities and help improve the asset management industry's SRI product offerings.

SRI has started to gain prevalence among corporate pension funds

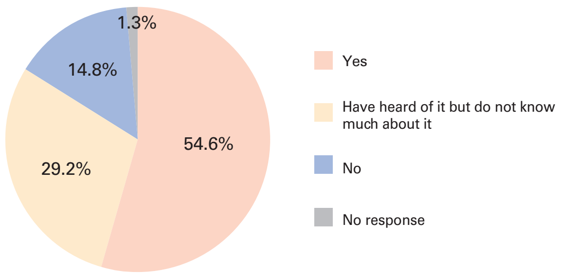
SRI (Socially Responsible Investment) is an investment approach that takes into account not only profits and other financial metrics but also prospective investee companies' policies with respect to environmental, social, and governance (ESG) issues. The most basic SRI strategy is negative screening, whereby investors exclude certain industries (e.g., tobacco, arms manufacturing) from their investment universe.

Within the pension fund sector, Europe is the global trendsetter in terms of SRI. For example, according to a 2006 survey conducted triennially by the European Social Investment Forum (Eurosif)[1], over 40% of UK occupational pension funds' equity allocation is subject to advanced SRI techniques known as engagement (attempting to persuade investee companies (e.g., by exercising proxy rights) to practice social responsibility in the aim of enhancing investment value) and integration (incorporating ESG-based risk analysis[2] into the investment decision-making process in addition to conventional financial analysis).

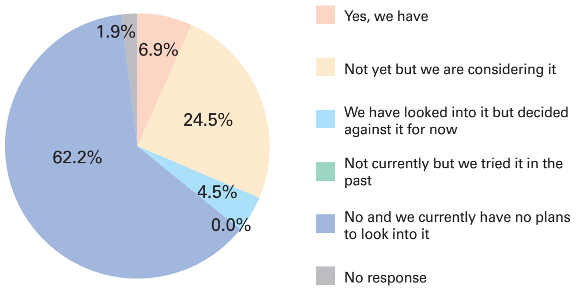
In a survey of Japanese pension funds (see exhibit), some 50% of respondents reported that they know about SRI and about 30% reported that they have heard of SRI but do not know much about it. Only 6.9% actually employ SRI practices in their investment activities (even among funds with ¥10bn or more in assets under management, this percentage was only about 10%). While these survey results indicate that further efforts are needed to promote understanding of SRI in Japan, their most striking revelation is that about half of all pension funds know about SRI but currently do not practice it. A major gap seems to exist between pension funds' knowledge and behavior.

Exhibit. Results of survey of corporate pension funds regarding SRI

Q: Do you know about SRI focused on CSR?



Q: Have you incorporated SRI into your asset management practices?



Source: NRI, based on SRI and PRI Survey Report (Research Institute for Policies on Pensions & Aging)

Gap between knowledge and behavior vis-à-vis SRI

Why do so many Japanese pension funds that know about SRI refrain from practicing it?

One conceivable factor is a perception that SRI is detrimental to investment performance. In other words, pension fund managers may feel that SRI contravenes their fiduciary responsibility to pension plan participants because ESG-conscious corporate management is disadvantageous in terms of operating efficiency and, in turn, detrimental to investment returns.

Contrary to such a perception, there is a growing body of empirical evidence that SRI is distinguished by low downside risk and favorable long-term investment performance. In 2007, the United Nations Environment Program (UNEP) published a report[3] analyzing 30 empirical studies of SRI performance. The study results suggest that SRI generally outperforms or performs equivalently to conventional investment strategies. UNEP concluded that investors do not sacrifice investment performance by adopting SRI strategies that incorporate ESG factors into the investment decision-making process. For Japanese pension funds, concerns about underperformance are no longer a rational reason for eschewing SRI.

Assuming that pension funds are aware of such research results on SRI performance, their failure to practice SRI could be attributable to a lack of internal policies regarding SRI. Pension funds that have not yet decided whether to embrace SRI or have not formulated policies regarding SRI asset allocation or product selection are unlikely to actively seek out SRI products or adequately evaluate proposals by asset managers or consultants. Absent such policies, asset managers have no mandate to engage in SRI.

Time to adopt SRI policies

Pension funds' SRI policy should be set by an entity with fiduciary responsibility to the pension plan participants, namely the pension fund or employer. In the case of multicompany Employee Pension Funds, formulating an SRI policy may of course be precluded by inability to reach a consensus among the fund's employer sponsors and/or pension plan participants. If an employer practices CSR (Corporate Social Responsibility), its SRI policy must be consistent with its CSR policies.

However, once a company has set an explicit SRI policy, it not only is able to take advantage of opportunities to invest in investment products with attributes like those discussed above, it also has a vested interest in taking the initiative to lobby asset management companies to improve their investment processes and/or develop new products. In the UK, for example, the Trades Union Congress Member Trustee Network is conducting an organized campaign to get fund managers to disclose how they vote on proxy resolutions at shareholder general meetings, hitherto a largely opaque aspect of the SRI fund management process. Some asset management companies have already started to publicize their votes in response to such pressure.

Even if a pension fund is opposed to the idea of SRI, it should have a written policy that rationally explains to pension plan participants the rationale behind its opposition. Such policy statements, if made available to not only participants but also asset management firms and consultants, would paradoxically provide the asset managers and consultants with valuable information for developing appealing SRI products more likely to win pension funds’ favor, thereby contributing to growth in SRI's prevalence among pension funds in general.

Looking ahead, asset management firms and consultants are likely to have more and more opportunities to present and recommend SRI products to pension funds. With concerns about investment performance now largely dispelled, the time is ripe for Japanese pension funds to formulate policies regarding their posture toward SRI products.

Note

1) " European SRI Study 2006", Eurosif.

2) Such analysis is called extrafinancial research because it analyzes information not directly ascertainable from financial analysis.

3) " Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors", UNEP Finance Initiative and Mercer

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