THE SOCIAL IMPORTANCE OF SOVEREIGN WEALTH FUNDS

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Abstract

Over the past three years, more and more sovereign wealth funds have been working to integrate environmental, social and governance (ESG) considerations into their investment processes. In 2021, 71% of sovereign wealth fund respondents said they had adopted an ESG approach compared to 24% in the previous year, according to the annual climate change survey administered by the International Forum of Sovereign Wealth Funds (IFSWF) and the One Planet Sovereign Wealth Funds network.

Conceptually, the S pillar of ESG is the most challenging for many sovereign wealth funds to define and to integrate into their investment processes. Each sovereign wealth fund has a different position on the topic depending on their local culture, mandate, and maturity.

Keywords: *sovereign wealth funds, ESG, international financial markets, government policy and regulation, environmental, social, and governance policies*

To date, sovereign wealth funds have primarily focused on the environmental aspect of ESG, particularly climate change. This position partly results from the broader investment community's focus on the transition to a low carbon economy in light of an increased understanding of the financial risks and opportunities associated with climate change and the associated changes in regulation, technology, and consumer sentiment. Similarly, sovereign wealth funds have focused on decarbonization to align their portfolios with their government owners' commitments to the Paris Agreement. While it is still a complex challenge, climate change has been more straightforward for sovereign wealth funds to address than other themes within ESG, thanks to more advanced and definable metrics, standards and targets.

Consequently, the number and value of so-called "green" investments made by sovereign wealth funds have risen dramatically over the past three years from 18 investments with a value of $3.4 billion to 40 investments worth $7.9 billion, according to IFSWF proprietary data.6 Governance issues, representing the "G" in ESG, on the other hand, have regional and national variations around what constitutes “good” practices. When considering governance, investors tend to take a principles-based approach – as opposed to a rules-based approach – evaluating standards in a local context rather than by an absolute. An example of this is the 24 Generally Accepted Principles and Practices for sovereign wealth fund governance, known as the Santiago Principles. All members of the IFSWF voluntarily agree to implement these Principles and undertake a “regular review” of how they do so. The Santiago Principles are intentionally broad in order to enable an increasingly broad spectrum of sovereign wealth funds to implement them, with the goal of elevating governance standards and transparency across the sovereign wealth fund community as a whole.

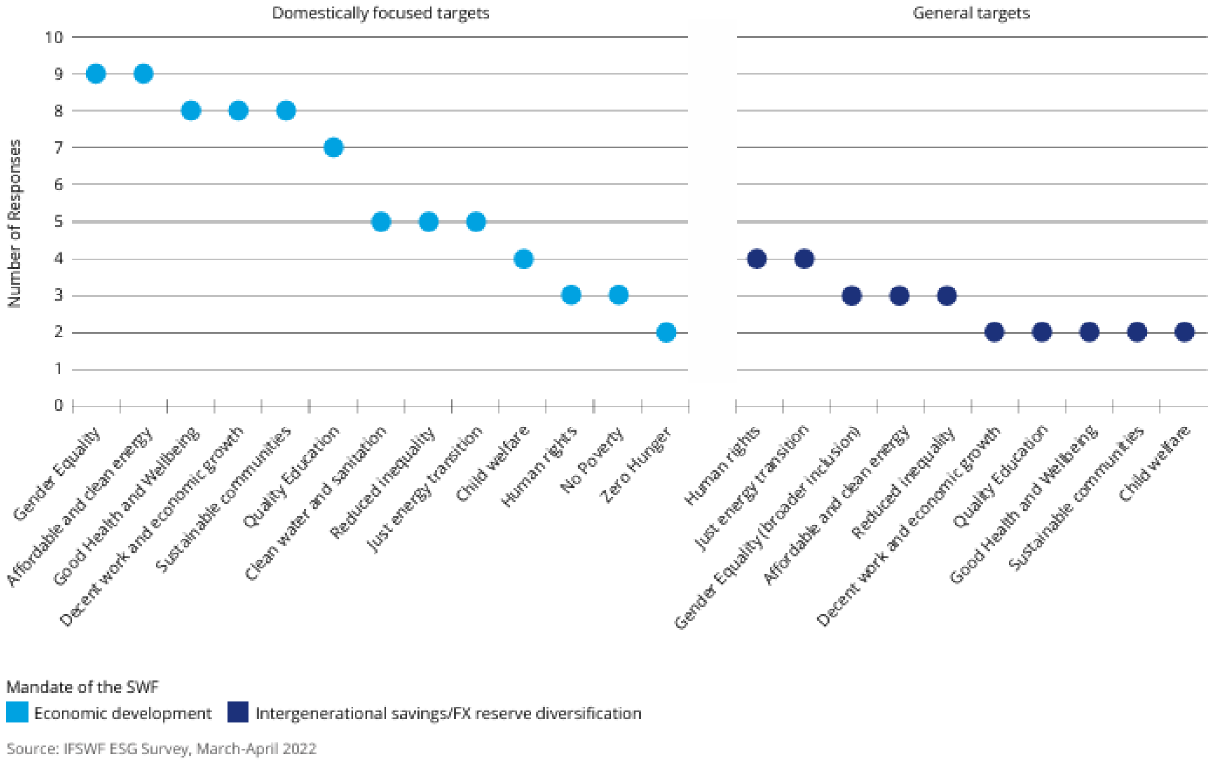
Sovereign wealth funds are also increasingly leveraging co-investments and external capital. As a result, they are now also required by their partners and stakeholders to demonstrate and disclose sound practices in E and G pillars, and increasingly S pillar. In this context, we wanted to better understand the degree to which sovereign wealth funds have taken a view on, and are considering, the S pillar in their investment processes, as well as how they may evolve their strategy and practices in the future. To do so, we surveyed sovereign wealth funds receiving a response of more than 50%. We also interviewed several sovereign wealth funds across varying stages of implementation to dig deeper into if and how they integrate social issues into their investment process. We also asked about the motivations and challenges behind their approaches. These enlightening conversations enabled us to contextualise the survey findings and more accurately describe where sovereign wealth funds currently are in their approach to the S pillar of ESG.

Sovereign wealth funds are at varying stages of broader ESG implementation. But most, except those that have explicit social development targets embedded in the mandates, are still in the early stages of incorporating the S pillar into their investment considerations. Anecdotally, two major sovereign wealth funds we approached for interviews told us they would rather not participate because they had not yet developed sufficient understanding of the S pillar.

We did speak with institutions at the beginning of their ESG journey, who shared that the relevance of social issues to financial returns was the most challenging of the three pillars to understand. They found the complexity lay in the breadth of issues covered by the S pillar and the degree of varying standards and metrics available across them. One savings fund told us, “Social issues are a moving target because society changes continually. What may have been best practice five years ago may be standard practice today. Our views on S pillar topics and how we measure them must continue to keep up.” Indeed, as society’s standards and expectations evolve, what may be material to financial return also changes. From an outcome perspective, a development fund in an emerging market made a similar point. “We have to think of the long-term implications for society. If we look to invest in education to increase literacy rates and drive job creation, what will be the new demands and needs of a more educated workforce in the future?” The S pillar’s multifaceted and interlinked nature can, therefore, be daunting for sovereign wealth funds approaching these issues for the first time. One interviewee told us that their institution did not yet have a specific approach to S pillar “not because we don’t think the risks are there, but they’re harder to assess and define.” For the sovereign wealth funds that do have S pillar approaches, our interviews revealed the complexities of prioritising different social topics.

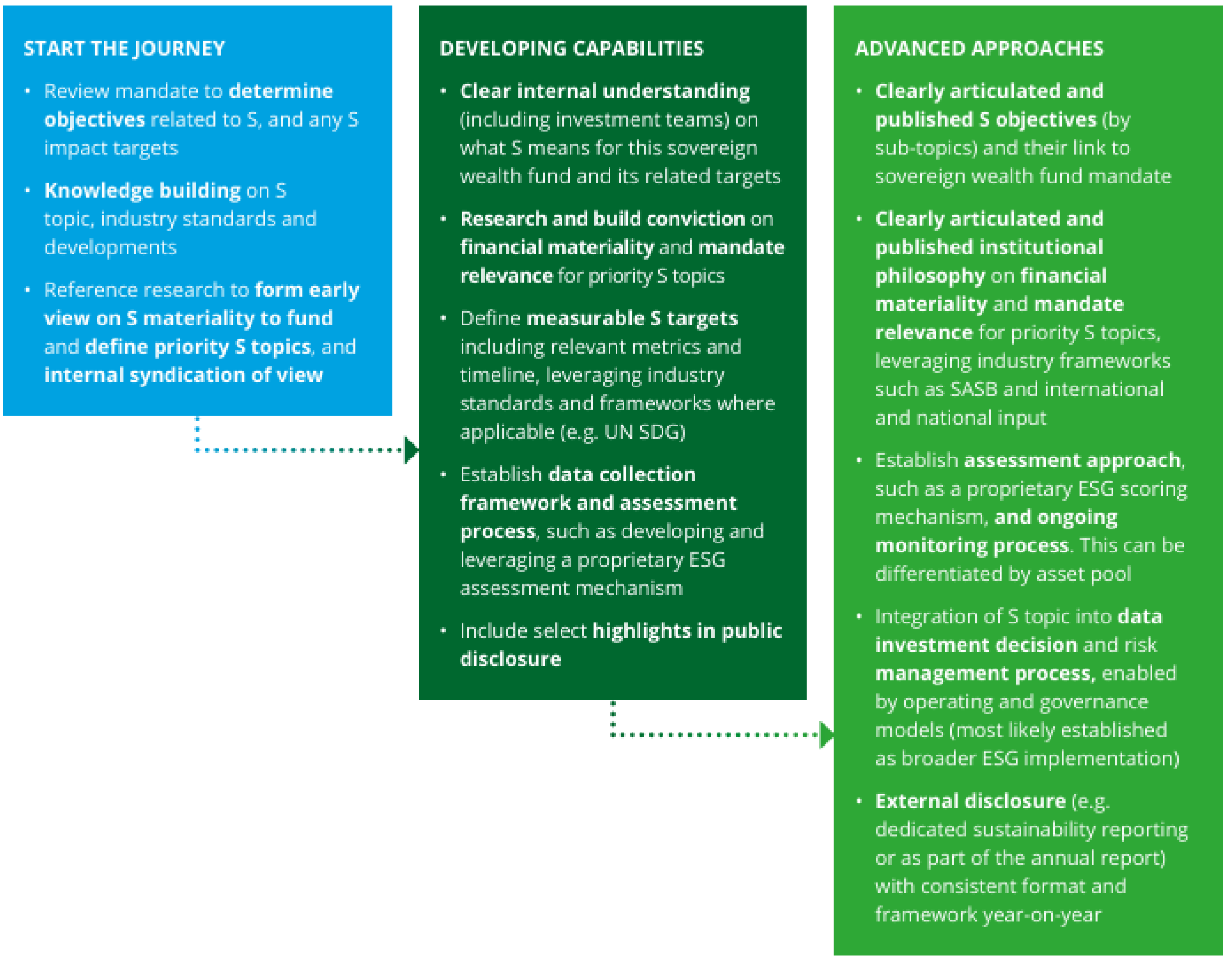
With this situation in mind, our research also revealed differences in the social factors that savings funds and development funds focus on.12 Development funds, which made up half of our respondents to this section of the survey, focus on a broader group of topics than their savings counterparts. The most common social issues prioritised by this group are “gender equality”, which enables more women to work and thus increases economic activity, and “affordable and clean energy”, which has knock-on health and educational benefits in many developing countries.13 The second group of priorities for development funds were “decent work and good health”, which enhance workforce participation, as well as “sustainable cities”, which is an essential part of sustainable economic development in the context of rapidly urbanising populations in the developing world, where many development funds are based.

Figure-1. What are the most important S pillar themes for your institution?



Savings funds' S pillar priorities focus on "human rights" and the "just energy transition", followed by "reducing inequality" and "affordable and clean energy". These issues align with the accepted priorities of the international financial markets where many savings funds invest, although these expectations and standards may differ from culture norms in their home markets. Additionally, savings funds' focus on the energy transition and clean energy suggests that their views on the S pillar appear to be influenced by their Gender Equality more advanced understanding of environmental issues. Affordable and clean energy.

Integrating social issues into the investment process is a journey that requires regular review and updating of sovereign wealth funds' approaches. As society evolves and acceptable norms change from country to country, community to community, year by year, for sovereign wealth funds, social issues are typically the most complex piece of 17 the ESG puzzle. We don't underestimate this challenge for many sovereign wealth funds, particularly those with limited resources. However, we do believe that – even within those constraints – there is a thought process that can guide sovereign wealth funds during their ESG integration process and enable them to consider these issues on their own terms.



By performing this stocktake, we observed best practices and approaches across sovereign wealth funds that are at different stages of this journey, as summarised in the following illustration. While there is no single standard, we hope these observations will assist sovereign wealth funds in understanding the most pertinent issues to them, their financial materiality and, where necessary, their real-world impact.

Conclusions

As a group, sovereign wealth funds, like many other investors, find the S pillar complex 18 and challenging to understand and measure. It is also the pillar most closely associated with the political position of their government owners, from which many savings funds have sought to maintain independence over the decades. Where they and their portfolio companies face pressure from stakeholders and partners in the international investor community to address social-related risks and opportunities, they often have the difficult task of balancing Western financial institutions' normative judgments about "good" social policies with local cultural and political norms, in addition to evaluating financial materiality of these issues.

Recently, the same has been true for development funds looking to attract foreign direct investments and partner with international institutions. In addition, development funds, which have a more direct link with social topics, find the S pillar less problematic to define. They usually have some form of social impact mandate and are aligned with national economic development targets, so they are more comfortable reporting on this topic. This advantage is amplified as they have smaller portfolios in fewer markets, making gathering data on their investee companies easier than for savings funds with globally diversified holdings.

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