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18 September 2019

Subject: Review of KiwiSaver default provider arrangements

Kia ora,

Mercer (N.Z.) Limited (Mercer) welcomes the opportunity to provide a submission in relation to the review of KiwiSaver default provider arrangements.

Our submission has been developed with input from Mercer colleagues along with colleagues from our sister company NERA Economic Consulting. NERA has extensive expertise in applying economic expertise to complex business and legal challenges.

In our submission, we reference relevant Mercer research including the Melbourne Mercer Global Pension Index, the lead author of which is Dr David Knox, an expert in regional and global superannuation trends. Dr Knox has also been involved in preparing this submission and is happy to provide assistance to MBIE in regard to this discussion paper.

Another key piece of research we have referred to is our 2018 research 'The ABC of ESG'. We have included this for you as an Appendix to our submission. Once again, Mercer is happy to provide further assistance in regard to ESG should that be of benefit to MBIE.

Mercer is fully supportive of KiwiSaver and thanks MBIE for the opportunity to provide our thoughts in regard to this discussion paper. Please feel free to contact Sarah Whitelock, our Consumer Wealth Leader, at sarah.whitelock@mercer.com with queries regarding our response.

Mercer looks forward to continuing to help KiwiSaver members make tomorrow today.

Ngā mihi

Martin Lewington
CEO, New Zealand

Submission template: Review of KiwiSaver default provider arrangements

Section 1: Your details

Name of contact person: Sarah Whitelock

Organisation (if applicable): Mercer (N.Z.) Limited. Input into this submission has also been provided by NERA Economic Consulting Ltd, which along with Mercer is a part of the Marsh & McLennan Companies Inc. NERA has extensive expertise in applying economic expertise to complex business and legal challenges.

Contact email address: sarah.whitelock@mercer.com

Are you requesting that any of this submission be kept confidential? No

If yes, please let us know why the information should be kept confidential in accordance with the Official Information Act. Please also send us a redacted version of your submission for publication.

Reasons for withholding:

Section 2: Feedback on discussion paper

1. What is your feedback on the proposed objective for the review?

   We support the objective of the review being to enhance the financial well-being of default members, particularly in retirement.

   We believe fulfilling this objective would assist with advancing the improvement areas reported in the 2018 Melbourne Mercer Global Pension Index (MMGPI)* in relation to New Zealand, which were:

   - Continuing to expand the coverage of KiwiSaver;
   - Increasing the level of KiwiSaver contributions;
   - Raising the level of household savings and reducing the level of household debt; and
   - Increasing the focus on income streams in place of lump sums.

   As shown in the MMGPI further strengthening KiwiSaver by expanding coverage and increasing contributions is a key pathway to increasing the Overall Index Score for the New Zealand retirement system. While effort needs to be made for all KiwiSaver members, assisting default members to increase their contributions and raising their levels of household savings most certainly has value.

*Mercer undertakes a range of research regionally and globally, including in relation to retirement savings. One such piece of research is the Melbourne Mercer Global Pension Index (MMGPI), a comprehensive annual survey of 34 countries published jointly by Mercer Australia and the Australian Centre for Financial Studies. MMGPI receives funding from the State Government of Victoria and is internationally regarded amongst global policy makers.

MMGPI provides insights into global pension trends and international comparisons and benchmarks a number of countries, with New Zealand included in the index from 2017. MMGPI methodology entails a detailed review of the core components of any sustainable retirement savings regime, namely adequacy, sustainability and integrity:

- Adequacy relates to the provision of adequate retirement incomes including the base (or safety-net) level of income provided as well as the net replacement rate for an average-income earner.

- Sustainability includes components such as the economic importance of the private pension system, the level of funding, length of expected retirement both now and in the future, labour force participation rate of the older population, current levels of government debt and the rate of real economic growth.

- Integrity is comprised of three general areas (a) regulation and governance; (b) protection and communication for members; and (c) costs. Private sector plans are noted as important components because without them the government would be the only provider. This is not a desirable or sustainable long-term outcome. They therefore represent a significant component of a well-governed and trusted pension system, which has the long-term confidence of the community.

In 2018 the countries with the highest MMGPI Overall Index Scores were Denmark and the Netherlands with index values of 80.2/100 and 80.3/100 respectively.

New Zealand was ranked 9th out of the 34 countries with an Overall Index Score of 68.5/100. In terms of the Adequacy Sub–Index however New Zealand was ranked only 16th out of 34, notwithstanding its relatively high universal pension. Hence the recommended improvements in terms of increasing both KiwiSaver contributions and coverage. The average Overall Index Score for all countries was 60.5.

MMGPI's lead author is Dr. David Knox, an expert in regional and global pension and superannuation trends with an extensive career in financial and academic sectors. Dr. Knox would be happy to talk to the MMGPI and to provide any other assistance to MBIE in regard to the Discussion Paper.

2. What is your feedback on the proposed criteria for the review? How should the criteria be weighted?

Mercer's view is that criterion 1 "Better financial position for KiwiSaver default members, particularly at retirement" and criterion 2 "Trust and Confidence in KiwiSaver" are of primary importance, are intrinsically linked and should be given the highest and equal weightings.

We believe that criterion 2 is the critical factor which drives the ongoing success of KiwiSaver, this in turn leads to the achievement of criterion 1 "Better financial position for KiwiSaver default members, particularly at retirement".

We support changes to KiwiSaver that will aid with achieving criterion 1 "Better financial position for KiwiSaver default members, particularly at retirement", but if these changes result in a converse impact on criterion 2 “Trust and Confidence in KiwiSaver” this will be counterproductive.

Since the inception of KiwiSaver there have been numerous changes and further significant change could damage trust and confidence in KiwiSaver and thus negate both criterion 1 and criterion 2.

Mercer’s view is that of the criteria listed, fulfilling criteria 1 and 2 will be of the most value in making progress on the improvement areas to the New Zealand Retirement system contained in the MMGPI, as referenced in our response to question 1 of this paper.

In regard to the remaining criteria, criterion 5 “Promote innovation, competition and value–for–money across KiwiSaver” and criterion 3 “Low Administration and compliance costs” should carry a similar but lesser weight than the criteria we have already referred to. Like criterion 1 and criterion 2, criterion 3 and criterion 5 are related. If the costs imposed on providers are reasonable and not overly burdensome this provides more ability for providers to invest in innovation and to offer default members value for money. A focus on promoting competition may also be less relevant given that the KiwiSaver market is already subject to strong competitive pressures (as we discuss in more detail later).

With regard to value for money we agree with the point made by MBIE (para 26) that value for money suggests a connection between the quality of a product and its price. Value for money is more important than a singular focus on fees and takes into account the totality of fees, quality of offering and the risk and return outcomes for members. Focusing solely on fees may reduce innovation, choice for members and total net return outcomes. It’s conceivable that the majority of product offerings would become indistinguishable from each other i.e. predominantly passive products. We believe there is a place for both active and passive management when value is the priority. A focus on fees (in isolation) ahead of value or net member outcomes may compromise the achievement of both criterion 1 and 5. Linked with that we agree with the MBIE view (para 27) that the value for money component of criterion 5 has some overlap with criterion 1.

With regard to innovation, we note that this is an ongoing process and not a one-off exercise. To continually innovate requires continual investment. If there is a disproportionate focus on fees the ability to innovate will be compromised somewhat.

While important, we see criterion 4 as being of a lower priority than the other criteria in the context of achieving the optimal default environment for KiwiSaver members. In particular, the imposition of predetermined targets may compromise the ability of KiwiSaver providers to deliver members’ retirement savings goals, in particular criteria 1, “Better financial position for KiwiSaver default members, particularly at retirement”.

3. What is your feedback on the problem definition for the investment mandate? Is a move away from a “parking space” purpose justified?

We believe that changes to the current “parking space” process are warranted and would likely assist with meeting criterion 1 of the review. KiwiSaver is primarily a long-term savings vehicle and therefore an increased allocation to growth assets is appropriate.

4. Should the investment mandate options (and other options, for example in relation to fees) apply only to default members who have not made an active choice, or should they also apply to members who have made an active choice to stay in the default fund? Why or why not?

Customers who have actively chosen the default conservative investment fund should not be moved if any changes are made in terms of investment mandate (other than a change under option 4).

As these customers have made an active choice to be in a conservative investment fund it would not be appropriate to arbitrarily move them to another fund type. We believe this does not support criterion 2 "Trust and Confidence in KiwiSaver" of this review. Those members could be presented with the option to change to the new default option, i.e. reconfirm their active choice in light of the change.

5. If a life-stages option is adopted, what "stages" should apply and to which age groups? Should there be a "nursery" period?

We believe a properly designed and managed life-stage fund is an appropriate default strategy for KiwiSaver members.

Mercer analysis shows a well designed and properly managed life-stage fund can:

- Generate returns consistent or better than balanced "static" funds over the long-term; and
- Substantially reduce sequencing risk for members approaching retirement compared to balanced funds.

Taking a life-stage approach is becoming globally recognised as the most appropriate strategy for defined contribution (DC) fund investing. A life-stages approach is widely adopted across the Tasman and further afield. For example, both the UK and the US utilise this type of strategy for DC investing. In the UK c. 90% of DC members are invested in default funds[1] which are predominantly lifecycle funds. This includes the government run pension scheme the National Employees Savings Trust (NEST) which has over 4.5 million members. NEST believes that investment risk should be taken in varying amounts throughout a member's lifetime and has adopted a series of target date funds called the 'NEST Retirement Date Funds' to deliver its default life-stage investment strategy. Each NEST Retirement Date Fund has an asset allocation that is consistent with the expected amount of risk that is appropriate for the age of a member and/or their expected retirement date. In the US, take up of the life-stage approach has been growing fast. Vanguard reported that 72% of the 4.6 million people invested in their funds and participating in company-sponsored DC plans invest in life-stage funds. This percentage has tripled over the past decade.

Generally, life-stages funds have a "growth" phase a "de-risking" phase and a "retirement" phase:

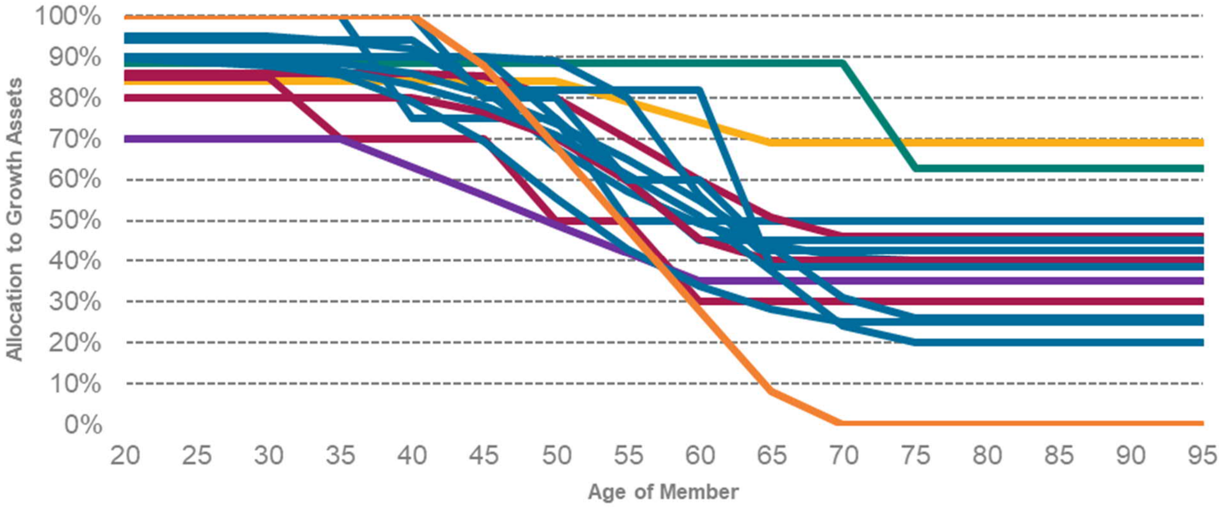
- The growth phase is to maximise growth whilst individuals have a long time horizon;
- The retirement phase is based on what retirees are doing with their money at retirement; and

1 The Pensions Regulator

- The de-risking phase is to join the above 2 phases together and should start 10-20 years prior to retirement.

To answer the question regarding what asset allocations should apply at what phases, it may be helpful to look to the Australian model in terms of life-stages, as we know Australia has a more mature superannuation environment than New Zealand and therefore can offer some insights that may be of assistance.

The graph below shows a range of 16 life-stage offerings in Australia in 2018:



It is apparent from this graph that there is diversity in the allocation to growth assets in the early years as well as how and when the different funds de-risk. However, on average this provides the following allocations at the following ages:

Average %growth asset allocation from selection of 16 Australian life-stage products							
Age	20	40	45	55	65	75	95
%Growth Assets	90%	86%	79%	60%	43%	38%	38%

Our Mercer Australia Smart Path life-stage glidepath has the following settings:

It’s also apparent that, on average Australian superannuation funds do not de-risk as early or as much as KiwiSaver funds which have a life-stages option. While this may not necessarily be appropriate for default KiwiSaver members, it does highlight that the current New Zealand setting is too conservative.

We have not performed detailed modelling for the purposes of this paper, but based on our experience we suggest commencing with an asset allocation of around 80% growth assets with de-risking commencing 10-20 years before the age of eligibility for New Zealand Superannuation. This would then reduce gradually to 30% growth assets.

Nursery periods

In regard to a “nursery” period, our view is that this is potentially confusing and may achieve little. While this approach is consistent with the UK, with NEST having a more conservative investment for the early years, not just 6 or 12 months, the concept being the provision of confidence (e.g. no negative returns early on) in the early years, it makes little difference as the account balances are small.

KiwiSaver is primarily a long-term investment and there will be fluctuations over such a horizon. Therefore, it is constructive for KiwiSaver investors to be exposed to that and become used to this from the outset, arguably when balances are lower and impact less in dollar terms. To ensure this does not erode confidence in KiwiSaver this approach needs to be supported by appropriate education, which should be shared by providers, Central Government and its various agencies and other relevant groups.

Comments on the relevance of a nursery period in regard to first home withdrawals are covered in our response to question 9.

6. If a balanced investment mandate is adopted, what range for growth assets should be applied?

The 35-63% growth assets range currently stated in the Financial Markets Authority (FMA) guidance is a very broad range. Given the broad range, this could result in a very broad spread of returns from different balanced funds - although there can be a tendency for providers to carry as high a growth weighting as possible within the allowable range which means the average weighting will be closer to 63% than 35%. We would be supportive of a tighter range for the definition.

Another consideration is that growth assets are not homogeneous, and neither are defensive assets, making the simple growth/defensive measure (which assumes assets are either 100% growth or 100% defensive) prone to inconsistencies. Some assets could be considered partly growth and partly defensive. For example, you could have a fund that holds a large portion in defensive assets, so appears defensive, but it may hold a large portion in lower grade credit. Conversely some growth assets tend to be more defensive, such as real assets (property and infrastructure) while others can more aggressive such as illiquid small cap stocks. In Australia, this has led the industry participants to apply partial growth/or defensive allocations weightings to for certain different sectors. For example, unlisted real estate and infrastructure investments could be attributed growth/defensive allocations of 60%/40%.

We advocate a similar approach be adopted, preferably with a consistent approach across the industry.

7. If a growth investment mandate is adopted, what range for growth assets should be applied?

   If a growth mandate was adopted, we believe that the 63-90% range is also quite broad. We would advocate a narrower band with similar points noted in our response to question 6.

8. If a conservative investment mandate is adopted, what range for growth assets should be applied?

   If life-stages option is not pursued we would be supportive of a higher range, making the current default funds more growth orientated. We would support the example provided of 25-35%.

9. If a life-stages, growth, or balanced option was adopted, how should we mitigate the potential issue in relation to first-home buyers and other people making early withdrawals?

   For the reasons noted below, we agree with the MBIE suggestion (para 610) that specific member communication, along with access to financial advice, to potential first-home buyers and those joining KiwiSaver is of greatest assistance for those considering a first home withdrawal.

   The risk that a member who makes a first home-withdrawal is worse off if they are in a life-stage, balanced or growth fund than the current conservative fund will depend on many variables including the allocation to growth assets, market performance and the length of time a member may be in KiwiSaver before making any first-home withdrawal.

   Although the potential outcomes are more variable, it should not be assumed that a member who makes a first-home withdrawal and is in a fund with a higher allocation to growth assets will be worse off. As we note above, this will depend on various factors. If the market fell at the time of a withdrawal the member may still be better off than if they had been invested in a more conservative fund.

   Mercer analysis of default customer first home withdrawals shows an average length of KiwiSaver membership of just over seven years prior to withdrawal. Our view is that it would most likely be preferable for customers to be invested in a higher growth option than a conservative option during this time, with the ability to choose to move to a more conservative option nearer to taking a withdrawal.

   We do not believe a nursery period as a means of protecting customers' balances in regard to first home withdrawal is valid. As noted above, we believe that most individuals using KiwiSaver for a first home deposit would be better off under a life-stages approach than under a static balanced or conservative portfolio.

   For example, under normal economic circumstances it could be expected that at younger age, the life-stages approach would earn at least 2% p.a. more than under a balanced portfolio and at least 3% p.a. than with a conservative portfolio. After a four-year period, a single investment would then be at least 8.2% or 12.6% higher. Whilst it is obviously possible for the life-stage portfolio to drop by a margin much greater than a static portfolio, history suggests that this will not occur very often. Further, under such circumstances, property prices may also fall such that the individual may be no worse off.

   Other early withdrawals are generally not foreseeable, and therefore we do not see this as something that should be provisioned for. Provisioning for this may lead to sub-optimal outcomes for the majority.

10. What would be the administrative costs to providers of choosing a life-stages option?

The cost of adding a life-stages option as the default investment option would be significant. Some of the areas that would necessitate updates include: administration platforms and system, communication and disclosure material, member web portals, underlying asset movement and associated transaction costs, training staff, retraining of chat bots, and amendments to risk profile tools. This is not an exhaustive list and all these would incur soft and hard costs. Without knowing the details of a life-stages option it is challenging to estimate these costs however, they would need to be recovered over time.

In addition, generally life-stages options will result in a higher overall allocation to growth assets and therefore overall percentage based fees will increase.

Nevertheless, notwithstanding these additional costs, a life-stages option is likely to provide a better outcome to retirees than a static balanced or conservative default option.

11. What is your feedback on the different options? Do you agree with our assessment of the costs and benefits of the option? Which option do you think is best and why? Is there another option that we have not considered that would be better than the options discussed?

We are supportive of adopting a life-stages approach. Should this not be adopted we agree with a move to a balanced approach, at a minimum there should be an increase in the allocation to growth assets within the conservative mandate.

12. What is your feedback on the level of value that KiwiSaver default members get for their fees? What are the costs that are within and outside a provider's control? To what extent are fees too high?

In its discussion on KiwiSaver fees, MBIE expresses a "problem" (para 81) that it has not seen percentage-based fees fall as overall funds under management increase. MBIE's view here is premised on the advantages that can accrue from economies of scale: when there are material fixed costs, as volumes (funds under management) increase, providers can spread their fixed costs over a larger volume-base. This leads to falling average costs, and where these average costs are recovered through a percentage-based fee, we might expect to see falling average costs being passed through to members in the form of a lower fee.

We agree with MBIE that there are economies of scale in the provision of KiwiSaver services.[2] The high fixed costs of providing these services include both the costs of initial set-up and the ongoing operation of KiwiSaver products. However, while MBIE notes that these economies of scale have not been passed through in the form of lower fees, there are two studies that suggest this may not necessarily be the case:

- In a 2015 Treasury paper, Heuser et al find that total fees as a percentage of funds under management for KiwiSaver providers fell from around 2.2% in 2009 to 1.95% in 2014;[3] and

[2] Although we note that there could be diseconomies of scale at very high levels of output. For example, Higgs and Worthington (2012) found diseconomies of scale for Australian superannuation funds beyond a certain output level – Helen Higgs and Andrew C Worthington (2012), "Economies of scale and scope in Australian superannuation (pension) funds", *Pensions: An International Journal*, 17(4), 252-259.

[3] Andreas Heuser, Jack Kwok, Daniel Snethlage and Dillon Watts (2015), "Review of KiwiSaver Fund Manager Market Dynamics and Allocation of Assets", New Zealand Treasury, September.

- A study by Auckland University of Technology economists Gilbert, Scott and Xu find that, from 2013 to 2017 total fees as a percentage of funds under management have fallen for all fund types. For Default Conservative funds in particular, these fees have fallen by nearly 30% over the period 2013 to 2017.[4]

Furthermore, there are other ways in which scale advantages can be passed through to members, rather than solely through fees. For example, providers may have passed through benefits in the form of:

- Investment in new services provided to members; one recent example for Mercer KiwiSaver scheme includes a new member website;

- Active management and increased diversification by asset class, investment manager and style leading to better risk adjusted returns;

- Offshore securities held in mandate form under NZ custody, enabling pass through of foreign tax credits to members; and

- Investment into private markets.

We may also see pass-through of economies of scale in the form of fee rebalancing in ways that are beneficial to members. Examples include Mercer's proposed reduction in the fixed monthly fee and fee exemptions for low balance members and those under 18.

Lastly, we note that the price structure that has evolved amongst KiwiSaver providers may result in less pass-through of scale economies in the percentage-based fee. That price structure is one that can best be described as a "two-part tariff". That is, providers essentially set fees to members based on two different types of prices:[5]

- A fixed fee (e.g., the fixed monthly fee), that is fixed regardless of the member's KiwiSaver balance; and

- A variable fee (the percentage-based management fee) that varies (in dollar terms) depending on the member's balance.

The idea with such a fee structure is that default providers can attempt to recover their fixed costs using the fixed fee component, while variable costs are recovered using the percentage-based fee. The economist and Nobel laureate Ronald Coase showed that, in the presence of economies of scale, such a fee structure was "optimal", in the sense that it maximises the total benefits to society.[6] As a result of this fee structure, as funds under management increase, we might not necessarily see economies of scale passed through via the percentage-based fee falling (although they may be passed through in other ways, as discussed above).[7] This is because the percentage-based fee recovers the provider's variable costs, which do not fall as volumes increase. In this context it needs to be recognised that pricing for the

[4] Aaron Gilbert, Ayesha Scott, and Shuohan Xu (undated), "Economies of Scale: The Case of KiwiSaver Fees", Auckland University of Technology, available at: https://www.nzfc.ac.nz/papers/updated/4.pdf

[5] The fee structure is slightly more complicated than this, as there are other fees that may be charged and/or fee exceptions. However, in broad terms the fee structure can best be characterised as a two-part tariff.

[6] R.H. Coase (1946), "The Marginal Cost Controversy", *Economica*, 13(51), 169-182.

[7] The fixed fee may not cover fixed costs in their entirety, meaning there can still be some pass-through. See Stephen J. Brown and David S. Sibley (1986), *The Theory of Public Utility Pricing*, Cambridge University Press, at p.67.

investment management of assets tends to be set globally and charged as a percentage of assets, certainly that is the case for outsourced international assets. Although tiers may exist there are still limits as to how far variable costs will fall. It would only be if the percentage-based fee were intended to recover both fixed and variable costs that we would see economies of scale being passed through in the form of lower percentage-based fees.

In summary, we suggest that MBIE exercise caution in basing decisions on a lack of observed reductions in percentage-based fees as funds under management rise. As noted, there is contrasting evidence suggesting that fees have in fact been falling in recent years. The (optimal) fee structure that has evolved may also mitigate the extent to which percentage-based fee reductions occur due to economies of scale, and economies of scale may be being passed through in a variety of other ways that are beneficial to members.

Furthermore, Mercer is of the view that fee levels are not a good indicator of the true quality of a product in the hands of a member. For instance, from an investment perspective, a member may benefit materially from a product that is well-diversified by asset class, has underlying investments that are structured to be tax-efficient, or have a responsible investment focus that is more extensive than a relatively simple "stock exclusions" approach. Features such as this tend to be less immediately visible, but offer real benefits and low cost products have less chance of these features being present. Accordingly, we are concerned about instances where low fees may be the sole focus.

13. Is it a problem that fees disproportionately affect those on low income and under 18s? Why/why not?

This could be considered an issue. As noted in our response to question 12, the passing through of economies of scale in the form of fee rebalancing in ways that are beneficial to members, such as these customer groups, could be of assistance.

14. If the government sets a fee, what should the fee be set at for the different investment mandate options? What considerations, methods or models could be used to determine the fee? What should be the balance between fixed and percentage fees?

In our view, having the government directly set a fee is not a viable option, for a number of reasons.

Direct government intervention in setting prices occurs very rarely in New Zealand (or indeed in other developed nations worldwide), and only in circumstances where there is limited or no competition. For example, the Commerce Commission sets regulated prices in only a very small number of industries – specifically telecommunications, electricity lines businesses, and gas pipelines – which are typically characterised by a single monopoly provider of services, with little prospect for new entry to enhance competition. The Commission also reviews and seeks to de-regulate industries as competition emerges i.e., by allowing prices to be determined by market forces, rather than being set through a regulatory process. As an example, in 2019 the Commission de-regulated the resale of voice telecommunications services by Spark because competition in the market was "well-established".[8]

It is clear that there is anything but limited competition in respect of KiwiSaver default providers, and KiwiSaver providers more generally. There are currently nine default providers,

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[8] "Commission recommends deregulating Spark's resale copper voice services", 18 July 2019, available at: https://comcom.govt.nz/news-and-media/media-releases/2019/commission-recommends-deregulating-sparks-resale-copper-voice-services2

none of whom can be considered to dominate the market (with the largest share, on MBIE's numbers, being 22% for AMP – see Table 4 of the MBIE discussion document). There are also other non-default providers which provide a competitive choice for customers, and as MBIE notes (at [76]), there has been new entry and innovation in fee models.

Members are also able to easily change scheme, and can do so at any time and as often as they like. The FMA has reported that approximately 190,000 members transferred between KiwiSaver schemes in the year to 31 March 2018, up 10% on the number transferring in the year to 31 March 2017.[9] It is important to note that, while this is only a small proportion of total KiwiSaver scheme members, there does not necessarily need to be a large number of customers that are willing to switch to provide competitive discipline. This is because a small amount of switching can constrain a provider from raising its fees, because the provider loses all its profit margin on those switching members, while only recovering a small increase in margin on its remaining customer base. In effect, these switching, or "marginal", customers provide protection for the "infra-marginal" customer base that may be less likely to switch.

Previous reviews by the New Zealand Treasury and the Commerce Commission have also found evidence of strong competition in respect of KiwiSaver providers. In a 2015 Treasury paper, Heuser et al found that the market "appears to be working in an economically efficient and competitive manner".[10] The Commerce Commission assessed the competitiveness of the market in its decision regarding the merger of AMP and AXA, and found that "competition for KiwiSaver funds is intense with a large number of other KiwiSaver providers offering consumer choice".[11] If anything, with the introduction of four new default providers in 2014 and a number of recent new entrants, the market has become more competitive since these assessments.

As well as there being no strong case for a government-set fee on the grounds of insufficient competition, such an approach also raises concerns regarding the level at which the fee is set – MBIE recognises the difficulty of this, at paragraph [100] of its Discussion Document. When the Commerce Commission directly sets the price that a regulated business may charge, it takes a lot of time to set it at the appropriate level. For example, the process that the Commission undertook to set the price that Chorus can charge for access to its copper telecommunications network spanned two years, with over 6,000 pages of submissions from industry stakeholders.[12] In that case, the Commission was also tasked with setting only a single price; in the present circumstances, the process would be made considerably more challenging if the government were to attempt to determine both a fixed fee and a percentage fee.

A key concern in determining the appropriate level of the fee is the trade-off between the fee being too low or too high. If the fee is set too high, then KiwiSaver members may pay "too much" and would be worse off. On the other hand, by setting the fee too low it can harm the ability for KiwiSaver providers to invest and innovate, and provide value-for-money services to members. For example, if the fee is set too low, it may undermine the ability for providers to offer active management services to their members. When the Commerce Commission directly regulates prices it often errs on the side of caution by setting prices on the high-side,

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[9] FMA, "KiwiSaver Annual Report", 2018.

[10] Andreas Heuser, Jack Kwok, Daniel Snethlage and Dillon Watts (2015), "Review of KiwiSaver Fund Manager Market Dynamics and Allocation of Assets", New Zealand Treasury, September, at p.76.

[11] Commerce Commission (2010), "AMP Limited and AXA Asia Pacific Holdings Limited", Decision No. 694, 18 June, at [52].

[12] "Commission releases final decision on wholesale broadband prices", 15 December 2015, available at: https://comcom.govt.nz/news-and-media/media-releases/2015/commission-releases-final-decision-on-wholesale-broadband-prices

on the basis that the consequences of setting prices too low (in terms of lost investment and innovation) generally outweigh the harm from setting prices too high.[13]

A government-set fee may also harm competition and innovation on different fee and operating models. As MBIE recognizes (at [76]), there are various new players in the market offering low-cost fee models. In addition, different providers have different operating models, ranging from lower service (e.g., online) models through to higher service models with personalised financial advice. By directly setting a fee, the risk is that these differing models would gradually be eliminated, as all providers converge on a "one size fits all" fee model based on the constraints of the government-set fee.

MBIE correctly identifies some of these trade-offs at paragraphs [112] and [113] of its Discussion Paper, and in our view the difficulties that these cause in respect of a government-set fee should not be understated. There are numerous examples of the unintended consequences arising from government-set fees in competitive markets, such as:

- In California in 2000, the electricity market suffered from soaring wholesale electricity prices, leading to the state's largest electric utility filing for bankruptcy, energy emergencies, and some rolling blackouts. A key contributing factor was government-regulated retail prices, which prevented wholesale prices from being passed on at the retail level. Such pass-through would have allowed households and businesses to cut back on their energy consumption and help alleviate the crisis;[14]
- Rent controls (i.e., government-set price caps on rents) in San Francisco, which have been in place since 1979, have been found to lead to higher demand for housing than there otherwise would be, fewer new houses being built,[15] and higher market rents in nearby areas where there are no government controls;[16] and
- In Chile, caps on interest rates charged in consumer credit markets have been found to reduce access to credit, with nearly a 20% reduction in the number of loans signed after a policy change to bring in the caps.[17]

Overall, we see very little merit in a government-set fee for default KiwiSaver providers, particularly in the current market setting where competition is vigorous.

15. What fee arrangements would best promote the objectives of the review? What is your feedback on the fee options? Do you agree with the costs and benefits identified? Which option (or the status quo) do you prefer and why? What other approaches or models could be used to reduce fees?

We prefer option 2, please also refer to our response to question 14.

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[13] See, for example, Commerce Commission (2010), "Input Methodologies (Electricity Distribution and Gas Pipeline Services)", Reasons Paper, December, at [6.7.12].
[14] See Dennis W. Carlton and Jeffrey M. Perloff (2005), *Modern Industrial Organization*, Fourth Edition, Pearson-Addison Wesley, at pp.726-727.
[15] Thomas Sewell (2009), *Applied Economics: Thinking Beyond Stage One*, Basic Books, at p.131.
[16] Rebecca Diamond, Timothy McQuade, Franklin Qian (2018), "The Effects of Rent Control Expansion on Tenants, Landlords and Inequality: Evidence from San Francisco", NBER Working Paper Series 24181, January.
[17] Jose Ignacio Cuesta and Alberto Sepulveda (2019), "Price Regulation in Credit Markets: A Trade-off between Consumer Protection and Credit Access", available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282910

16. How has the number of providers in the default market affected innovation, competition and value-for-money in the default market and in KiwiSaver more generally?

Our view is that the existing number of default providers is achieving a good balance between allowing economies of scale and ensuring sufficient competition.

There are a number of trade-offs to consider in respect of selecting the number of default providers, many of which MBIE correctly identifies in its Discussion Document.

A key consideration is economies of scale. As set out earlier, because of the relatively high fixed costs of the provision of KiwiSaver services, providers can generate economies of scale, with average costs falling as funds under management increase. There is evidence for the existence of economies of scale in superannuation funds elsewhere in the world,[18] and for KiwiSaver in particular.[19] The presence of scale economies points towards having a relatively small number of providers, so that each of those providers generates higher member and funds volumes and can achieve scale benefits.

The KiwiSaver default provider procurement process also has the feature of creating what is known as "competition for the market". In general terms, this is a setting in which potential market participants compete to obtain some form of incumbency advantage (often monopoly) in serving a market for a future time period. While the "winning" participants may face less competition "in the market" on an ongoing basis, the act of competing to become those winning participants can result in strong competitive discipline being imposed on those participants. For KiwiSaver in particular, having fewer default providers may strengthen competition for the market – that is, if KiwiSaver providers were bidding to become one of (say) only two default providers, they will compete very hard for that opportunity.

While economies of scale and stronger competition for the market point towards fewer default providers, there are some very important counter-considerations to balance against these.

First, economies of scale can often be exhausted beyond some point, and it is not clear if this is the case with KiwiSaver providers. That is, if there were very few default providers, with very high member and funds volumes, it is possible that diseconomies of scale will result i.e., average costs will rise at very high volumes.[20] This may occur because of increased costs and complexity in managing a very large KiwiSaver organisation. Unless more was known about where such diseconomies occur, we would caution against having very few (e.g., two or three) default providers.

Second, the KiwiSaver market is characterised by not only "competition for the market", but also "competition in the market". That is, once providers become default providers, they still face strong ongoing competitive pressures. This points towards having a greater number of providers, so as to strengthen those competitive pressures on an ongoing basis. The trade-off

[18] See, for example, Helen Higgs and Andrew C Worthington (2012), "Economies of scale and scope in Australian superannuation (pension) funds", *Pensions: An International Journal*, 17(4), 252-259.
[19] Andreas Heuser, Jack Kwok, Daniel Snethlage and Dillon Watts (2015), "Review of KiwiSaver Fund Manager Market Dynamics and Allocation of Assets", New Zealand Treasury, September.
[20] As noted earlier, Higgs and Worthington (2012) found diseconomies of scale for Australian superannuation funds beyond a certain output level – Helen Higgs and Andrew C Worthington (2012), "Economies of scale and scope in Australian superannuation (pension) funds", *Pensions: An International Journal*, 17(4), 252-259.

between competition for and in the market is nicely summarized by the economist Paul Geroski, who notes that it is not obvious that competition should be "front-loaded":[21]

> Hence, it would seem that one can either have vigorous competition for the market followed by little competition in it…, or less vigorous competition for the market coupled with more competition in that market when it has been established… Since it is not obvious that competition should be heavily front loaded in the period when the market is being established, it would seem to follow from all of this that there may be a limit beyond which one might want to encourage more competition for the market. [Footnote omitted]. That is, at least after a point, more competitors for a market are not a perfect substitute for less competitors in that market.

Third, having a small number of providers concentrates the operational risks, as MBIE correctly identifies.

It is difficult to know precisely how best to balance these trade-offs. However, in our view they at least suggest that having a very small number of providers (e.g., two or three) would not be appropriate. Furthermore, the evidence discussed above suggests that:

- Default providers are currently able to achieve scale economies, and pass this through to members in the form of lower fees, investment, active management and diversification; and
- Recent assessments by the Commerce Commission (in 2010) and New Zealand Treasury staff (in 2015) suggest the market is competitive, and in our view will have become more so since those assessments.

As noted above, this suggests that the existing number of default providers is achieving a good balance between allowing economies of scale and ensuring sufficient competition.

17. Do you agree with our assessment of the costs and benefits of the different approaches for the number of providers? Can you provide us with evidence that might help us quantify the size of the costs and benefits? What option do you prefer and why?

Please refer to our response to question 16.

18. If a "minimum requirements" approach is taken should this be on a period-based or rolling system, and why?

As noted above, we believe the existing number of default providers provides a good balance between scale economies and competition. We therefore believe that having an unlimited number of providers or a "minimum requirements" basis would not be appropriate.

While we do not agree with this approach, if a minimum requirements approach were taken then a rolling system would likely create further concerns.

[21] Paul Geroski (2003), "Competition in Markets and Competition for Markets", *Journal of Industry, Competition and Trade*, 3(3), 151-166, at pp.164-165.

First, it creates issues around the transfer of default members as providers enter and exit. As we discuss later, the way in which this transfer is addressed can create material risks and concerns, and this transfer would need to occur on an ongoing basis.

Second, and perhaps more importantly, having providers openly entering and exiting as default providers at any time (subject to meeting minimum requirements) would likely create considerable confusion in the market. This could risk materially undermine trust and confidence in KiwiSaver (Criterion 2).

MBIE's proposed approach of a "period-based system" (again, under an unlimited default provider approach) would mitigate these concerns to some extent, insofar as entry and exit can be more controlled and signaled to the market. However, we think some concerns will still remain because of the lack of any limit to the number of default providers. As such, we do not consider an unlimited approach is appropriate, regardless of whether a rolling or period-based system is used.

19. Are there higher investment costs for responsible investing? If so, how likely are these costs to contribute to lower net returns?

Mercer implements its responsible investment strategy through a combination of the following four approaches, integrated throughout the investment process:

1. Environmental, social and corporate governance (ESG) integration;
2. Stewardship;
3. Investment (thematic or impact); and
4. Exclusions.

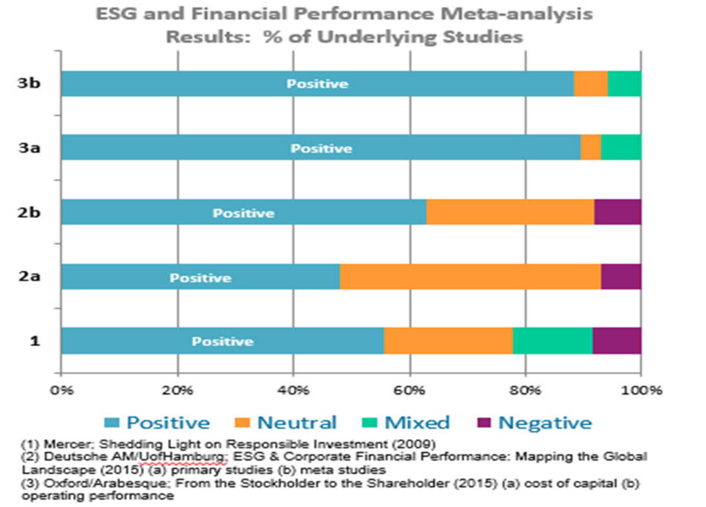
We firmly believe that focusing on exclusions alone is too narrow a definition for responsible investment and that there are a wide range of methods of implementing each of the four approaches.

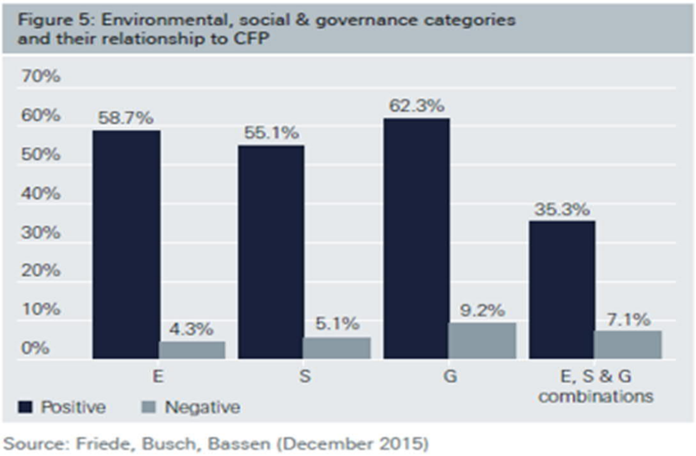
Mercer has been reviewing the research since 2007 on how integrating ESG factors and being active owners or good stewards of capital can be beneficial from a risk and return perspective across asset classes.

- Independent research on the investment benefits of ESG integration and stewardship is consistently largely favourable.

  We reference some of the latest papers in our ABC of ESG paper on pages 15 and 16 (attached in Appendix 1).

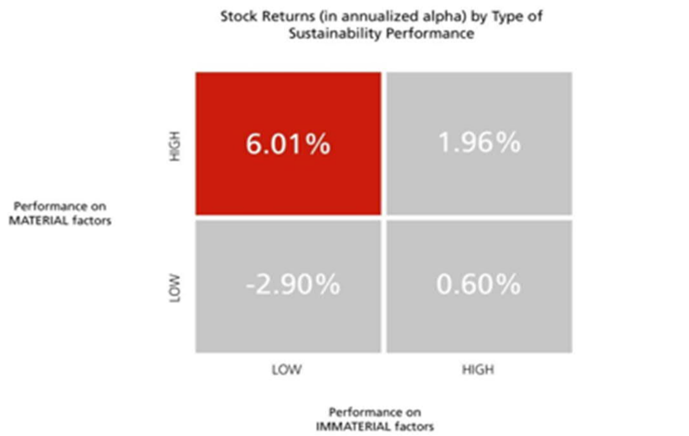
  Additionally, included below are three examples of the research results which support incorporating ESG factors in financial decisions is either positive or neutral in the vast majority of cases for performance outcomes. It is also worth noting that these are historical results and with the growth in intangible value for many companies, and the growth in environmental challenges in particular, we would only expect that to grow.





Research base favors a positive connection between ESG and corporate financial performance

Source: Deutsche Asset Management/University of Hamburg; ESG & Corporate Financial Performance: Mapping the Global Landscape; 2015.



Firms with good performance on *material* sustainability issues enjoy the strongest financial returns.

Source: Working Paper by Mozaffar Khan, George Serafeim, and Aaron Yoon, Harvard Business School (2015)

- Integration of ESG factors in the investment process is becoming a de facto standard among institutional asset managers, with no additional fees or costs passed on to asset owners. Where additional costs may arise is around proxy voting. If funds internalise their proxy voting activities, then incumbent costs around proxy research and execution are also internalised. However, these costs are not significant enough in most cases to impact net investor returns.

- There is also evidence that supports sustainability themed investments in different asset classes as delivering consistent net of fee returns with non-thematic investments. The thematic investments have been more expensive to date, particularly fundamental equity funds, but this is shifting as the number of product opportunities is growing and sustainability data is becoming more accessible and different quant and index strategies can also be used.

- Any fund applying exclusions will introduce a management cost for sourcing an appropriate list of companies and securities to be excluded. The market for ESG research and exclusions is expanding, and as such, this cost is typically not significant but will depend on the breadth and depth of exclusions to be researched and monitored.

20. How does responsible investment affect returns? Does it increase or decrease returns, and to what extent?

    Please refer to our response to question 19.

21. Should the default provider arrangements be used to achieve objectives in relation to responsible investment?

    Yes, default funds should incorporate responsible investment as standard, particularly the ESG integration and stewardship foundations as these are expected to be beneficial for risk and return. We would also expect that some exposure to sustainability themed investments that deliver on the solutions to our environmental and social challenges should also be beneficial. However, we recognise for the purposes of comparing KiwiSaver provider default funds and enabling consumers to make distinctions in sustainability labelling, there is more to be done. We would also expect that there should be some commonality for Default Funds with respect to exclusions, to reflect legal standards in particular. However, because there are still a wide range of views amongst members, more extensive screens beyond what is legally required or that has been commonly adopted to date are better catered for through product differentiation rather than imposed on all default funds.

22. Would default members want their funds to be invested more responsibly? If yes, is the same true if responsible investment means potentially limiting future returns?

    As per previous answers, it depends on the approach taken but these should not be binary opposing statements. There are many approaches to responsible investment that are not expected to lower returns. In our experience, generally default members would want their funds to be invested more responsibly, but not if this would equate to lower returns.

23. To what extent is it a problem that default members do not have information about whether their investments are made responsibly? Would having more information make a difference to the behaviour of default members? What alternatives might there be to more/standardised information to address responsible investment concerns?

We appreciate that the responsible investment specialisation has developed somewhat difficult, jargon fuelled language which can make member communication a challenge. Clear disclosures about the different responsible investment approaches being adopted by a provider with tangible examples given, together with reasons why these approaches are expected to be beneficial to the member should be an important focus for the future.

Introducing a requirement for KiwiSaver funds to disclose their approach (if they have one) around consistent approaches, such as the four outlined above, would improve member communication and comparability.

This approach has been taken recently in the UK by the Department of Work and Pensions with the introduction of new standards around disclosures within the Statement of Investment Principles. The new standard requires default pension funds to set out:

- How they take account of financially material considerations, including (but not limited to) those arising from Environmental, Social and Governance considerations, including climate change; and

- Their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with the investment.

24. Do providers' current responsible investment exclusions meet what default members would expect?

As per the previous answers, only focusing on exclusions is too narrow a definition for responsible investment. However, for the exclusions component of a responsible investment regime, it is likely a combination of options 1 and 2, as outlined earlier, could be adopted. It may be that there are some minimum standards mandated (to be consistent with New Zealand legislation such as per the recent civilian semi-automatic/automatic weapons developments, and consistent with international treaties the New Zealand government has ratified) but others would be optional by fund and should be clearly defined and disclosed for individuals to make a decision.

Disclosure could include giving members some indication of what percentage of the index is removed by that exclusion, noting that equities and fixed income (where exclusions typically take place) are X% of their whole portfolio.

Disclosure could also include the specific technical definitions of the sub-sectors/types of companies which are being excluded.

Requiring funds to disclose a full list of excluded companies would aid comparability but could introduce commercial challenges since many contracts for exclusion lists prohibit the publication of the list. Furthermore, in some instances, disclosing a list of excluded companies can create a backlash and introduce criticism of a KiwiSaver fund or even the New Zealand government for excluding foreign companies.

25. If this option is adopted, what industries or sectors should be excluded? Should the government instead adopt an international exclusion standard or certification regime? What would be the costs associated with an exclusion or certification regime?

Please refer to our response to question 24.

26. If this option is adopted, what form should standard disclosure take? For example, should all providers be required to provide a statement listing all excluded companies by sector?

Please refer to our response to question 24.

27. What is your feedback on our assessment of the costs and benefits of the responsible investment options identified? Which option (or the status quo) do you prefer and why?

Please refer to our response to question 24.

28. What limitations or problems exist in relation to New Zealand's capital markets? How could the settings for KiwiSaver default providers be amended to support the development of New Zealand's capital markets? How do the liquidity and pricing rules affect default provider investment in alternative New Zealand investments?

Key challenges for investors in New Zealand's capital markets include the limited size and range of issuers (equity and debt) and the absence of a liquid equity derivatives market, which is an impediment to efficient portfolio management.

However, we don't believe that a lack of demand for financial assets is the problem, rather a lack of supply. Both wholesale and retail investors find it challenging to build well diversified portfolios of quality domestic securities (both equity and debt) in sufficient scale.

Demand from KiwiSaver funds for New Zealand listed equities is increasing. Reserve Bank of New Zealand data indicating New Zealand listed equities comprise ~8% of KiwiSaver assets, with listed property another ~4%. Combined, this suggests KiwiSaver funds, as at March 2019, owned approximately 6.7% of the S&P/NZX 50. This is up from ~4.3% in June 2014[22].

Domestic and international investor demand relative to the size of local markets has resulted in New Zealand assets typically being priced higher than similar international assets.

We argue that if the demand was any higher resulting from the allocation to New Zealand assets being mandatorily increased or targeted, there would be an increased risk of asset bubbles forming, which would ultimately be detrimental to members. We also have a concern that preferential treatment being given to New Zealand investment could present additional risks to KiwiSaver members whose retirement savings would otherwise be protected by asset class and country diversification. We believe that any form of prescribed or targeted investment is likely to create unintended distortions in financial markets. It may also have the potential to compromise the fiduciary duty of fund managers to act in the best interests of their customers.

Growth in KiwiSaver funds can however deliver wider indirect benefits to the New Zealand market. For example, increased scale for a KiwiSaver fund manager enables them to apply increased resource to broadening and diversifying the range of investable assets with more cost and tax effective strategies which can then also be utilised by other New Zealand funds such as workplace savings schemes, community trusts, consumer trusts, charities and private investors. In particular, increased scale would enable a fund to allocate to a wider range of alternative/private market investments including real estate and infrastructure, both domestic and overseas.

[22] Forsyth Barr NZ Equity Ownership 21 June 2019

There is strong evidence of this in the Australian superannuation market. The increased scale of Australian superannuation funds has enabled access to private investments which require scale to be successful – infrastructure is a good example. Infrastructure is in many ways well suited to investments with long time horizons such as KiwiSaver (more so than early stage venture capital) – and would also have a direct benefit to the New Zealand economy.

29. Broadly speaking however, the focus on fees over net return outcomes and the requirement for daily liquidity/switching has the opposite effect and is an impediment to KiwiSaver fund managers broadening their investment away from public markets (and passive funds). How could the default settings be used to develop New Zealand's capital markets? What parts of New Zealand's capital markets are most in need of development?

Please refer to our response to question 28.

30. Should default funds take an active role in helping develop the New Zealand capital markets? Would this support the purpose of the KiwiSaver Act and the accumulation of retirement savings by default members?

Please refer to our response to question 28.

31. To what extent is the management of default funds currently located in New Zealand or carried out by New Zealand entities?

Local Presence

As a New Zealand based business which is part of a larger global business, we strongly support the local management of Default Schemes. In regard to the management of the Mercer KiwiSaver scheme, Mercer (N.Z.) Limited is the licenced manager and has been operating in New Zealand for over 60 years.

Mercer has a staff of 100 in our Auckland and Wellington offices. Originally established in New Zealand as an actuarial practice, our activities expanded to incorporate a dedicated investment consulting business in the 1980s and investment management in the 1990s.

The Board of Mercer New Zealand comprises 5 Directors, 3 of whom are New Zealanders and New Zealand based:

- Ross Butler - New Zealand Independent Chair
- Kristen Kohere-Soutar – New Zealand Independent Director
- Martin Lewington – Mercer New Zealand Chief Executive

The New Zealand senior leadership team is New Zealand based, with the exception of the finance business partner who is based in Melbourne. The New Zealand based investment management team is led by our Chief Investment Officer Philip Houghton-Brown, based in Auckland.

The Mercer funds have appointed New Zealand fund managers, a New Zealand custodian (which is also part of a global business) and other local service providers. We also note that where shares are invested in overseas, where possible we have a preference for directly held securities over investing in overseas domiciled funds.

Global Strength

Mercer (N.Z.) Limited is a wholly-owned subsidiary of Marsh & McLennan Companies Inc., a Fortune 250 company listed on the New York (global headquarters), Chicago and London Stock Exchanges with 57,000 employees and revenues of $US13 billion. Mercer employs 20,000 people in 43 countries.

Mercer is the world's largest investment consultant with 2,600 clients and $US11 trillion of funds under advice. We also manage $NZD350 billion of funds directly on behalf of our clients and provide administration services for 9 million superannuation members around the globe.

This scale allows us to bring a wealth of experience and specialist expertise to support our New Zealand clients including the Mercer KiwiSaver scheme.

32. What is your feedback on a New Zealand-based management option? If this option is adopted, which part of the investment process do you think should be based in New Zealand to help develop New Zealand's capital markets? What type of mechanism would best give effect to this requirement?

As noted in our response to question 31, we support the local management of Default Funds but note that benefits from global presence are also of value to members.

33. What is your feedback on a targeted investment requirement? If the option is adopted, what market should be targeted by an investment requirement (eg early stage companies)?

Please refer to our response to question 28.

34. What is your feedback on our assessment of the costs and benefits of the options to develop New Zealand's capital markets? Which option (or the status quo) is best and why? Is there another option that would be better than the options discussed?

Please refer to our response to question 28.

35. What is your feedback on the problem definition for the transfer of members? What other problems are there in relation to the transfer of members?

Mercer has the following general concerns in regard to transferring default customers between providers.

Undermining criterion 1

Transferring Default KiwiSaver members has the strong potential to undermine criterion 2 "Trust and Confidence in KiwiSaver". Members have been allocated to Default Providers on the basis of Default Providers being appointed by the Crown; this provides a high level of comfort to many that should not be overlooked. Automatically moving people to other providers may undermine this. While the MBIE paper notes most of these customers are disengaged this may not be the case; customers may have chosen to stay within the bounds of the Default process (provider and investment) because it provides them a high level of trust and confidence (please refer also to our response to question 41 regarding member engagement).

As we noted in our response question 2, we support changes to KiwiSaver that aid with achieving criterion 1 “Better financial position for KiwiSaver default members, particularly at retirement”, but if these changes result in a converse impact on criterion 2 “Trust and Confidence in KiwiSaver” this will be counterproductive.

Market timing risk may undermine criterion 2

We also believe there is a serious risk in terms of market timing negatively impacting customers. An exercise of this nature and magnitude would necessitate meticulous advanced planning. Dates to transfer New Zealanders’ KiwiSaver balances would need to be established well in advance. Should the transition dates coincide with any market downturn this would potentially cause a crystallised financial loss for those KiwiSaver investors. Likewise, if there was too much time out of the market, this could directly result in a financial loss to KiwiSaver investors. If this was to occur, criterion 1 “Better financial position for KiwiSaver default members, particularly at retirement” and criterion 2 “Trust and confidence in KiwiSaver” would be jeopardised.

While there is a counter argument that investors may benefit from a market upside, this cannot be predicted or controlled and hence this risk should be avoided.

Transaction costs and liquidity concerns

Another market related concern pertains to liquidity and the transaction costs that will be incurred with any transfer of members. Moving funds results in transaction costs and this will likely ultimately be borne by KiwiSaver investors, there may also be liquidity challenges with large movement of underlying assets. We also raise the concern that a move such as this could result in default providers refusing to invest in any form of illiquid assets as there would be concerned about being able to divest from them should a wholesale reallocation of default members occur again. This may not be in those investors’ best interests.

36. If default members are transferred from providers with more members to providers with fewer members, how should we decide which members are transferred?

Please refer to our response to question 35 for our concerns in regard to reallocating default members between providers.

We are very concerned with option 1, we do not believe this can be done without causing disruption and without comprising criterion 2 “Trust and Confidence in KiwiSaver” and potentially criterion 1 “Better financial position for KiwiSaver default members, particularly at retirement” of the review.

MBIE correctly points out (para 207) that organisational capability of providers is an important consideration of option 1. We would extend this to also include capacity and resources, not only regarding providers but also others such as the central administrator, Inland Revenue.

37. If transfer option 1 or 2 were adopted, how should default members be given a choice to remain with their current provider for this option?

Existing customers should be given adequate notice and the option to stay with their current provider. We suggest that communication comes directly from the current provider, outlining the available options (including the option to remain with the current provider) to the member, who can then decide whether to remain with the current provider or to be transferred.

38. What is your feedback on the transfer options and the costs and benefits of the options? Which option (or not transferring at all) do you prefer and why? Is there another better option we have not considered?

Our preference is for option 3, followed by option 2. For the reasons previously stated option 1 is the least preferred option.

39. What factors should the review consider in deciding transition timeframes?

Any transfer of members between providers will necessitate meticulous advanced planning. Dates to transfer New Zealanders' KiwiSaver balances would need to be established well in advance.

Option 1 and then option 2 would require the longest lead time and carry the largest risk in terms of loss of confidence and risk of financial loss. Option 3 causes the least problems on all fronts.

We do not believe the suggestion staggering a transfer over a period of time (para 233) is feasible. While this may seem prudent from a project management point of view this would be very problematic in terms both criteria 1 and 2. Market risk and time in and out of the market could potentially negatively impact members' balances and result in them experiencing a financial loss. Not only that, as investors would be moving at varying times they would experience different market movements which, rightly so, could result in extreme member dissatisfaction should some investors fair worse than others. This would then compromise criterion 2 of this review. This will not only result in loss of confidence in KiwiSaver for default members, but in KiwiSaver collectively.

40. Should active defaults be considered default members for the purposes of transfers? How should active defaults be treated and notified of any changes to default provider settings?

As stated in our response to question 4, KiwiSaver investors who have made an active choice to invest in a default investment fund should not be treated in this way. These customers have made an active decision and as reported to FMA, are no longer considered Default members even though they are still invested in the default investment fund.

41. What is your feedback on the member education requirements that default providers should have in relation to default members, and how these should be enforced in the instruments of appointment?

We think the current arrangements are appropriate. However, we believe the parameters that constitute an "active" choice, which tends to be used as the proof point as to whether default providers are adequately educating default customers and whether customers are engaged, could be reconsidered and extended beyond making an active investment choice.

We observe that default customers engage in various ways including: updating communicating preferences, logging into accounts, making lump sum contributions, accessing funds for purposes of first home and advising of a change of contact details. We believe these demonstrate engagement and being “active”.

In regard to engagement there is also overseas evidence to suggest that caution is warranted in attempting to strongly regulate for greater customer engagement, as this may have unintended consequences. While this comes from the electricity market these insights, are of interest here.

Economist Stephen Littlechild (a fellow at the University of Cambridge and Emeritus Professor at the University of Birmingham), notes that certain regulator interventions in UK electricity markets to try to stimulate customer engagement were all removed due to their “unintended adverse consequences”, such as through increasing prices to some segments of the market, raising the costs of customer acquisition and thereby decreasing customer switching rates, and undermining the ability of suppliers to compete and innovate.

Similarly, in Italy there are regulated prices in place in the retail electricity market to protect disengaged customers. However, this has led to relatively low switching rates, which have been attributed to the price acting both as a focal point for suppliers, and a “feel safer” effect for consumers (that mitigates their willingness to switch suppliers).

42. What is your feedback on the other requirements that should apply to default members?

    We have no further comments.

43. Any other feedback?

    We have no further comments.

APPENDIX 1

THE ABC OF ESG

HEALTH WEALTH CAREER

THE ABC OF ESG

2018

MAKE TOMORROW, TODAY

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INTRODUCTION

1.1

At Mercer, we define responsible investment (RI) as an investment approach that includes environmental, social and corporate governance (ESG) factors and broader systemic issues — for example, climate change and sustainable development — along with active ownership (stewardship). These considerations can have a material impact on financial performance, and their inclusion is more likely to lead to sustainable investment outcomes, such as a greater ability to sustain pension payments in the future.

Mercer's own investment beliefs state that ESG factors can have a material impact on long-term risk and return outcomes. We also believe:

1. Taking a broader and longer-term perspective on risk will lead to improved risk management and new investment opportunities.

2. Climate change poses a systemic risk given the low-carbon transition and physical impacts of different climate outcomes.

3. Active ownership provides opportunities for investors to enhance the value of companies and the market.

RI is distinguished from ethical, norms-driven investing, an investment philosophy dating to the 1800s guided by moral values, ethical codes or religious beliefs and originally rooted in negative screening of investments in sensitive sectors, such as slavery-derived goods, alcohol, tobacco, pornography and firearms. Under this approach, ensuring investment was limited to companies that met the investor's moral criteria was the focus. Socially responsible investing (SRI) is another approach, intended to balance an investor's ideals with performance considerations, and typically seeks to achieve a trade-off between social and financial objectives.

That said, proponents of RI, SRI and ethical, norms-driven investment may share many underlying beliefs, and there is often overlap in the strategies implemented in pursuit of these investment approaches. Mercer's RI advice prioritizes risk and return implications, but we also help many clients balance their reputation considerations and align both *value* and *values*.

1.2

In recent years, RI has attracted significant attention among institutional investors around the world. Drivers behind this increased focus include the following:

- A general acceptance that ESG factors are relevant to companies and investors facing related risks and opportunities in aligning their capital allocations with the interests of their clients and beneficiaries is reflected in the increasing number of signatories to the UN Principles for Responsible Investment (PRI).[1] This increase represented more than US$80 trillion in 2018 — equal to the size of assets managed by the global asset management industry — compared to approximately US$12 trillion in assets 10 years earlier.

- Awareness of the growing array of social inequalities, environmental impacts and negative externalities affecting companies is increasing. Unprecedented environmental and social pressures, driven by population growth and consumption-pattern pressures on food, water and energy security; access to natural resources; climate change; human rights; and supply-chain labor standards, are creating material issues for business and the corporate world.
- The impact of poor corporate governance practices on shareholder value — accentuated by direct examples of individual company financials and the indirect impacts of the global financial crisis — has also brought issues such as transparency, corruption, board structure, shareholder rights, business ethics, risk management and executive compensation to the top of the investor agenda.

- ESG integration has increased along with the applicability of integration techniques in asset classes other than listed equity, including bonds, emerging markets and alternative asset classes.

- Changes are occurring in global legislation and legislative guidance that either require or encourage consideration of RI as part of a statement of investment principles or similar in an investor's investment strategy documentation. Changes in normative and best-practice expectations that stipulate RI considerations are also a factor.

- In some cases, stakeholders and beneficiaries are putting pressure on investment decision makers to adopt an RI investment approach or consider particular issues.

1.3

No definitive list of ESG issues exists, but they typically display one or more of the following characteristics:

- Have a medium- to long-term time horizon with a forward-looking perspective

- Are often qualitative and not always readily quantifiable in monetary terms

- Represent externalities (costs borne by other firms or by society at large) not captured by market mechanisms

- Result from normative shifts and changing regulatory or policy frameworks

- Represent former "event risks" that are becoming more predictable

The table on the next page highlights some of the issues considered as E, S or G factors, which can have financial impacts for operational and/or reputational reasons.

[1] Principles for Responsible Investment (PRI). "About the PRI," available at https://www.unpri.org/pri/about-the-pri.

WHAT IS ESG?

ESG issues to consider

ENVIRONMENTAL CONCERNS

- Climate change
- Energy efficiency
- Waste and pollution
- Water and resource scarcity

SOCIAL CONCERNS

- Health and safety
- Stakeholder concerns
- Demographics
- Labor and supply

CORPORATE GOVERNANCE CONCERNS

- Audit quality
- Board structure
- Remuneration
- Shareholder rights

1.4

This paper provides a brief introduction to RI implementation.

Section 2 discusses the four main approaches:

1. **Integration** — ESG factors incorporated into the investment process for risk/return reasons

2. **Stewardship** — voting and engagement with underlying companies and/or investment managers and engagement with policymakers for risk/return reasons

3. **Investment:**
   - Themed investing — funds that focus on the risk and return opportunities in ESG themes, typically related to sustainability solution trends
   - Impact investing — investments that seek to balance financial returns with a positive impact on society and/or the environment, including investments in companies that meet such criteria

4. **Screening** — typically implemented by excluding investments in companies that are perceived to have a negative impact on society, where investors do not want to profit from the product or activity for reputational and/or ethical reasons

Section 3 addresses historical concerns related to RI and fiduciary duty.

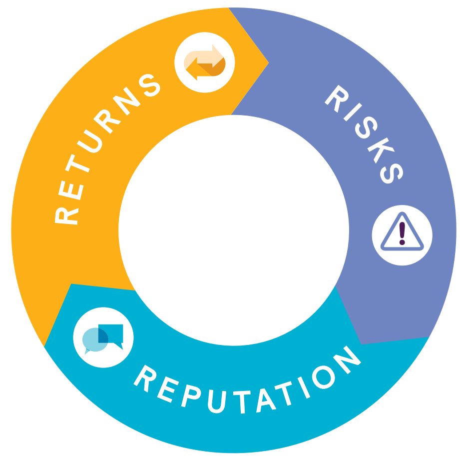
Section 4 discusses the relationship between RI and investment performance.

Section 5 provides some suggestions for next steps and a potential action plan.

INVESTMENT APPROACHES

There are many ways in which institutional investors approach RI and applicable ethical considerations — aiming to balance the risk/return requirements for investors (particularly those with fiduciary duties) and reputational considerations with the needs of beneficiaries and other stakeholders.

In this section, we describe the main approaches that can be implemented individually or in combination. The majority of investors employing a comprehensive RI program would have elements of most if not all of these.



FOUR APPROACHES TO RI

INTEGRATION

Include ESG factors in investment decisions, with an explicit approach to climate change transition and physical risks, which are portfolio-wide.

AIM:
Financial objectives
+ risk management improvement

STEWARDSHIP

Exercise active ownership/stewardship through voting and engagement with underlying companies and by engaging with policymakers.

AIM:
Financial objectives
+ financial system improvement

INVESTMENT

Allocate to sustainability themes or impact investments for new opportunities — for example, renewable energy, water and social housing.

AIM:
Financial objectives
+ positive social and environmental impact

SCREENING

Screen out sectors or companies deemed to be irresponsible or not acceptable to profit from.

AIM:
Alignment with values/reputation/risk management or longer-term financial expectations

Include ESG factors in investment decisions, with an explicit approach to climate change transition and physical risks, which are portfolio-wide.

AIM:
Financial objectives
+ risk management improvement

2.1 ESG INTEGRATION

At the forefront of recent developments in RI is an integration approach to considering ESG factors as part of the investment process. Managers adopting this approach are typically traditional fund management companies that have begun to actively take ESG issues and themes into account in their fundamental research, analysis and decision-making processes. Typically, no sector or investment opportunity is automatically excluded from a portfolio. Integration determines the ESG "traits of a security that may not have been taken into account by that security's price but which may affect its desirability"[2] as an investment.

The rationale is twofold:

1. Managers believe investors that do not consider these issues are ignoring significant extra-financial factors that may materially impact the value of their holdings, either negatively or positively.

2. Companies that ignore sustainability issues expose themselves to a range of risks, including physical, regulatory, competitive, litigation and reputational risks that will impact their long-term corporate performance, and that by ignoring these issues, they will miss out on associated opportunities.

Some investors utilize ESG indicators purely for risk-management purposes, whereas others consider these indicators fundamental to idea generation and portfolio construction for alpha generation. Some approach ESG integration with a "best in class" focus, investing in those companies that display the most positive ESG indicators within their respective sectors. Such integration considerations can typically lead investors to make buy/hold/sell or overweight/underweight decisions.

Integration can be applied, to different extents, in all asset classes. The most well-developed public market examples are found in listed equities, and, often, the private market examples with the greatest level of ESG integration can be found in real estate. Strategies are likely to share the investment characteristics of traditional strategies in the same asset class; typically, they should also be expected to display a longer-term outlook to investing and a responsible approach to stewardship. Placing financial considerations as a driver, this approach overcomes any question of whether incorporating ESG is aligned with fiduciary responsibility.

Furthermore, significant financial regulators as well as educational bodies, such as the CFA, have clarified their stances and indicated that financially material ESG factors should be considered in investment decision-making. (The global regulatory regime will be covered in more detail in section 3.) Integration is therefore being embraced by the broadest set of mainstream investors.

[2] AIMA and CAIS. *From Niche to Mainstream: Responsible Investment and Hedge Funds*, (2017).

Exercise active ownership/stewardship through voting and engagement with underlying companies and by engaging with policymakers.

AIM:
Financial objectives
+ financial system improvement

2.2 STEWARDSHIP

Also referred to as active ownership, and often interchangeably, stewardship is an approach whereby investors seek to use their positions as owners — or, lately, also as creditors — to influence the activity or behavior of investees. The aim is usually to bring a corporation in line with best practice in a particular area, to better understand fundamental business drivers related to ESG issues, and, most commonly, to improve standards of corporate governance.
In combination with other responsible investment approaches, stewardship should better align the time horizon and interests of the corporation with that of its long-term investors.

Stewardship is an integral part of RI. Tools range from using proxy-voting rights and undertaking engagement with companies (through verbal and written communication on specific topics) to collaborative engagement with other shareholders to promote systemic change within a certain sector.

For example: Climate Action 100+ is a multiyear initiative coordinated by global investors with US$30 trillion in assets under management "to engage with the world's largest corporate greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures."[3]

Stewardship is exercised differently in each asset class. For listed equities, voting and engagement are typical, whereas in asset classes where voting rights do not exist (such as fixed income), variations in engagement practices are emerging.

These tools are increasingly being pursued in an effort to reduce risk and enhance long-term financial value. Studies have shown that companies with good corporate citizenship practices on ESG issues are better-managed overall and therefore more likely to outperform in the long term. The view that stewardship is needed and legitimate[4] has been strengthened by various instances of high-profile corporate governance failings leading to disastrous investment outcomes. Active ownership is clearly encouraged by regulators, which see the systemic value of stewardship in protecting and strengthening investments.

Engagement can be on any issue the investment community believes will protect or enhance shareholder/stakeholder value. Topics may include environmental management, labor standards, director remuneration, corruption and bribery. Engagement activity is often supported by specific research and analysis. The ability to engage and/or vote will vary depending on the specific regulatory processes in place in the location of the holdings.

[3] Climate Action 100. "About Us," available at http://www.climateaction100.org.
[4] Financial Reporting Council. *The UK Stewardship Code,* 2012, available at https://www.frc.org.uk/investors/uk-stewardship-code.

Options for stewardship include the following:

- **Direct voting**: Voting can be coordinated in house by institutional investors. Typically, proxy-voting policies and procedures are developed. The development and implementation of these policies and procedures are often assisted by the use of a third-party proxy-voting researcher (as discussed below).

- **Third-party proxy voting**: If investors conduct voting in house, they may wish to use an external research firm to inform their decisions. Often, these service providers can also offer their own proxy-voting policies or customize voting policies for clients, thereby automating much of the process, including casting their votes.

- **Direct engagement**: Engagement can be carried out by investors directly. This can be either one-to-one (that is, the investor enters into dialogue with individual companies) or collaborative (that is, joining with other investors on a specific issue or joining investor initiatives seeking to influence public policy).

- **Third-party engagement service**: Investors can employ a third-party provider offering a standalone engagement overlay service. These providers offer long-term engagement with target companies on strategic issues to enhance shareholder value. Typically, such providers use the combined influence of assets held by several clients. The majority of engagement overlay service providers also offer a voting service.

- **Delegation of voting and engagement to fund managers**: Given its natural fit with the investment process, some investors will also delegate their stewardship and engagement activities to their fund managers as part of the investment mandate. Capacity and capabilities vary considerably between fund managers. Fund managers can then also choose to use direct or delegated routes and research provision for their engagement/stewardship activities.

Allocate to sustainability themes or impact investments for new opportunities — for example, renewable energy, water and social housing.

AIM:
Financial objectives
+ positive social and environmental impact

2.3 INVESTMENT

THEMED FUNDS

The vast majority of themed funds have a sustainability/environmental focus. These funds have proliferated in recent years with the emergence of sustainability as a key societal and investment trend driving long-term growth and returns. Focus funds or activist funds can be seen as themed funds within the governance area. Funds with a social theme can be found in microfinance, urban regeneration, property and social infrastructure projects (these could also be viewed as impact investment approaches).

Sustainability-themed funds can be found most often in:

Listed Equities

Many funds in this category may use positive/negative screening, engagement, integration or best-in-sector approaches to investment. They may also have quite wide investment universes.

As an example, one such equity fund aims to invest exclusively in global companies providing solutions to sustainability challenges in health, waste and public transport. Other, more-focused examples exist in fields such as renewable energy and water.

Fixed Income

Green-bond investment can be seen as a thematic and/or impact investment. The product was created to fund projects with positive environmental benefits with the use of proceeds linked to a specific project or asset. Green-bond funds have emerged as an option for investors to tap into the growth in this market.

Property

A smaller number of specific sustainability-themed funds are emerging in the property sector as high environmental standards become mainstream in real estate investments, reducing the ability to market specialized funds.

Alternatives

Unlisted equity funds have emerged to capture the investment opportunities associated with a broad sustainability theme. Some of these funds may have a venture-capital focus as new technologies emerge to provide solutions to the global environmental challenges. Infrastructure funds can be sustainability-themed or demonstrate a high level of understanding of ESG trends to satisfy end investors' needs. Other funds include pure-play funds focused on natural resources, such as sustainable forestry or agriculture.

IMPACT INVESTING

The meaning of this term has evolved over time; however, the Global Impact Investing Network (GIIN) defines impact investments as “investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return.” In the context of investment strategies, impact investing has historically referred to private equity, private debt and other alternatives.[5]

A wide variety of potential approaches exist, but a common “traditional” type of impact fund supports small businesses in emerging or underserved markets, either directly or through loans to intermediaries, such as microfinance institutions. Typically, funds investing directly seek companies that are solutions-oriented in terms of directly addressing environmental or social issues. Other strategies may focus on environmental or social themes, such as sustainable agricultural development or affordable housing.

As a recent development, several providers of investment products and data have also started to isolate universes of public securities that are linked to positive impacts, such as a company’s percentage of revenues that could be considered “green.” These products can also be developed with explicit references to applicable United Nations Sustainable Development Goals (SDGs) that they intend to impact.

Measuring the impacts of these investments has become increasingly important as demand from asset owners to understand the impact created by their investments has increased. The Global Impact Investing Rating System (GIIRS)[6] and IRIS[7] are prime examples of the ongoing work in this field, in which a multitude of competing methodologies exist. Mercer observes that investment managers in this space are increasingly self-reporting, as clients request detailed information on the impacts they support.

[5] Global Impact Investing Network (GIIN). “History (Global Impact Investing Initiative),” available at https://thegiin.org/impact-investing/need-to-know/.
[6] GIIN. “B Impact Assessment (and GIIRS Rating),” available at https://iris.thegiin.org/b-impact-assessment-metrics.
[7] GIIN. “IRIS Metrics,” available at https://iris.thegiin.org/metrics.

2.4 SCREENING

Screen out sectors or companies deemed to be irresponsible or not acceptable to profit from.

AIM:
Alignment with values/reputation/risk management or longer-term financial expectations

Investors that apply screening typically use one or a combination of the following screens:

Negative screen **Positive screen**

Negative screening: This refers to the exclusion of companies involved in activities or products with a perceived negative impact on society, such as armaments manufacturing, tobacco production, gambling, alcohol, and animal testing, or companies with poor records of ESG performance. Although these decisions are most often driven by ethical/ moral considerations, in some cases, a more financial perspective to exclusions is emerging. Some investors argue, for example, that the construction of coal-free and/or fossil-fuel-free portfolios — and more recently, tobacco-free portfolios — will, over the long run, deliver the best investment outcomes, due to shifts in legislative practices and technology.

Positive screening: This refers to the inclusion of stocks/ bonds based on whether the company has a positive ESG trait, such as a high overall ESG score, belonging to a certain industry sector or displaying other favorable characteristics desirable to the investor or its beneficiaries.

A screened approach can be achieved either by investing in a separate investment product or through a segregated account with a manager able to implement customized screens. Usually, the rationale for using a screened approach will be to align the portfolio with an organization's values or its views on stocks that are unacceptable (negative screening) or favored (positive screening) for ethical or reputational purposes.

Highlight on "Ethical"

Negative screening has traditionally been associated with "ethical" funds, particularly those that offer an SRI/ethical version of a mainstream investment strategy. However, even among investors that do not come from a particular ethical perspective, most would support some element of negative screening; that is, based on generally accepted behavioral and legal norms. For example, a strong normative basis exists for the exclusion of companies involved in production of cluster bombs or landmines, nuclear weapons, or the use of child labor or modern slavery. As noted, however, negative screening may also be undertaken for financial reasons. Positive screening can be implemented in a range of ways, such as passive overweighting of high-scoring stocks according to some predetermined criteria or as a defined starting point to establish a universe for themed or ESG-integrated funds.

RESPONSIBLE INVESTMENT, REGULATORY DIRECTION OF TRAVEL AND FIDUCIARY DUTY

3.1

Historically, a key barrier to broader implementation of RI was the assumption that it contradicted fiduciary responsibility, based on the belief that RI reduced the investable universe, defying a "theoretically optimal" solution. As we have outlined in this paper, that belief does not reflect modern reality. RI implementation methods do not necessarily exclude any stocks from consideration (see: integration, stewardship, investment and positive screening).

3.2

From time to time, concerns are still raised regarding the scope of fiduciaries to embrace RI. These concerns typically arise from a failure to distinguish between ethically driven investing and financially driven integration of ESG issues. In practice, RI is often simply a more-comprehensive approach to identifying investment risks and opportunities and is therefore aligned with fiduciary duty.

3.3

A key early development in establishing the legitimacy of RI from a fiduciary perspective was the "Freshfields report"[8] (2005). This report examined the legal implications of integrating ESG issues into institutional investment for those with fiduciary duty. The report found that integrating ESG considerations into investment analysis so as to more reliably predict financial performance is not only permissible but is arguably required. The legal situation continues to evolve on ESG, and key global regulators have, in turn, either regulated and/or provided guidance on the validity of the original Freshfields report. The Pensions Regulator[9] and Department of Work and Pensions[10] in the UK, the Department of Labor[11] in the US, the EU Commission[12] in the EU (with strong support from local regulators like the AMF[13] in France and the DNB[14] in Netherlands) and the APRA[15] in Australia have all actively weighed in on the dialogue. The PRI has provided global research on the fiduciary duty topics for eight jurisdictions,[16] helping to clarify the issue.

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[8] Freshfields Bruckhaus Deringer and UNEP Finance Initiative Asset Management Working Group. *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment*, 2005.

[9] The Pensions Regulator (TPR). "Investment Strategy Guidance," available at http://www.thepensionsregulator.gov.uk/guidance/db-investment-two-strategy.aspx.

[10] Department for Work and Pensions. *Government Response: Clarifying and Strengthening Trustees' Investment Duties*, 2018, available at https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties.

[11] US Department of Labor. *Field Assistance Bulletin No. 2018-01*, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

[12] EU Commission. "Sustainable Finance: Commission's Action Plan for a Greener and Cleaner Economy," available at https://ec.europa.eu/clima/news/sustainable-finance-commissions-action-plan-greener-and-cleaner-economy_en.

[13] AMF. *The AMF Affirms Its Commitment to Sustainable Finance on Climate Finance Day* [press release], 2017.

[14] De Nederlandsche Bank. "Sustainable Finance Platform," available at https://www.dnb.nl/en/about-dnb/co-operation/platform-voor-duurzame-financiering/.

[15] PRI. "Fiduciary Duty in the 21st Century: Australia Roadmap" (2016), available at https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-australia-roadmap/258.article.

[16] UNEP Finance Initiative. "Fiduciary Duty in the 21st Century," 2015–2017, available at http://www.unepfi.org/investment/fiduciary-duty/.

3.4

An increasing number of market participants (brokers, managers, consultants, investment banks) are integrating RI and evolving their processes accordingly. As a result, fiduciaries now have greater scope to ensure that ESG risks are being managed and associated opportunities pursued.

3.5

RI regulation is currently on policymakers' and civil society's agenda worldwide, and the pace of regulatory intervention is increasing. The PRI identified 300 policy instruments in its survey of the 50 largest economies in the world. All instruments supported long-term investment decision-making, including consideration of ESG factors, and more than half were created between 2013 and 2016.

[17] PRI. "Responsible Investment Regulation Map," available at https://www.unpri.org/.

RELATIONSHIP BETWEEN RESPONSIBLE INVESTMENT AND PERFORMANCE

A growing body of evidence and supporting documentation is turning the tables on common misconceptions in the industry, namely, that RI restricts the investable universe and therefore must hurt returns. More practitioners today are seeking to integrate ESG to add rigor and depth to their investment processes and risk management.

A number of ESG/sustainability indices from providers such as FTSE/Russell,[18] MSCI[19] and S&P/DJI[20] now have substantial track records. Sustainability indices cover a range of potential goals and uses. Indices range from a focus on narrow themes (for example, low carbon or climate indices, water, ESG factors, gender equality, etc.) to core allocations, such as broad ESG indices. Indices may seek to attain impact, express values, seek risk/return outperformance or track parent indices while embedding ESG considerations. In construction, screening continues to be the main method, although reweighting companies based on ESG factors has increased in recent years. Performance differs considerably, as is the case for any other index construct; however, at the broadest level, there is evidence that performance compares favorably to unconstrained portfolios.

4.1

There is now a significant body of work that supports the financial benefits of ESG integration and active ownership. Academic and practitioner research now also covers asset classes beyond listed equities.

4.2

Research into the impact of incorporating ESG factors into investment decision-making has traditionally focused on screening approaches. Although such research is not directly relevant to the merits of morebroadly focused integrated RI approaches, it does provide some insights. It is also notable that much research is carried out at a corporate level, finding links between strong ESG practices and corporate financial performance. Although informative, such research is not directly applicable at the portfolio level in all investment situations.

4.3

In general, the academic literature continues to confirm our belief that the consideration of ESG factors at the company level can lead to outperformance, especially over the longer term. ESG integration into investment decision-making and portfolios requires manager skill, a clearly defined investment style and consideration of appropriate time periods to achieve desired outcomes — as would be the case with any mainstream investment strategy.

[18] FTSE Russell. “ESG Ratings,” available at http://www.ftse.com/products/indices/f4g-esg-ratings.
[19] MSCI. “ESG Integration,” available at https://www.msci.com/esg-integration.
[20] S&P Dow Jones Indices. “ESG,” available at https://us.spindices.com/theme/esg/.

A sample of academic and practitioner research papers is included below:

Ambachtsheer J, Fuller R, Hindocha D. "Behaving Like an Owner: Plugging Investment Chain Leakages," *Rotman International Journal of Pension Management,* Volume 6, Issue 2 (Fall 2013), available at https://www.mercer.com/content/dam/mercer/attachments/global/investments/responsible-investment/Behaving-Like-an-Owner.pdf.

Dimson E, Karakaş O, Li X. "Active Ownership," *The Review of Financial Studies*, Volume 28, Issue 12 (2015), pp. 3225–3268, available at https://academic.oup.com/rfs/article/28/12/3225/1573572.

Friede G, Busch T, Bassen A. "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies," *Journal of Sustainable Finance & Investment*, Volume 5, Number 4 (2015), available at https://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917.

Khan M, Serafeim G, Yoon A. "Corporate Sustainability: First Evidence on Materiality," *The Accounting Review*, Volume 91, Number 6 (2016), pp. 1697–1724, available at https://ssrn.com/abstract=2575912.

Kiose D and Keen S. "Understanding the Relationships Between Environmental and Social Risk Factors and Financial Performance of Global Infrastructure Projects," *Scientific Research Publishing* (2017), available at http://www.scirp.org/journal/PaperInformation.aspx?paperID=80890.

Allianz Global Investors. *ESG in Investment Grade Corporate Bonds and Financial Materiality of ESG Factors for Sovereign Bond Portfolios,* 2017.

MSCI. *Foundations of ESG Investing*, 2017, available at http://info.msci.com/foundations-of-ESG-investing-part1.

CFA Institute and PRI. *ESG Integration in the Americas: Markets, Practices, and Data*, 2018, available at https://www.cfainstitute.org/en/research/survey-reports/esg-integration-americas-survey-report, and *Guidance and Case Studies for ESG Integration: Equities and Fixed Income* (2018), available at https://www.unpri.org/investor-tools/guidance-and-case-studies-for-esg-integration-equities-and-fixed-income/3622.article.

Moody's Investor Service. *Heat Map: 11 Sectors With $2.2 Trillion Debt Have Elevated Environmental Risk Exposure*, 2018.

NEXT STEPS AND POTENTIAL ACTION PLAN

5.1

We trust that this paper serves as a worthwhile first step in beginning to consider responsible investment concepts and developing a position on RI. Investors should consider a number of further actions, as outlined in a separate Mercer document, *An Investment Framework for Sustainable Growth*.

A summary of the framework approach for integrating ESG considerations throughout the investment process is shown below. Different approaches can be taken for those at an initial stage of integration compared to those at an advanced stage. Mercer would be happy to discuss the most appropriate bespoke plan and approach with you.

The framework below identifies where ESG and sustainability considerations sit within the typical **"Beliefs, Policy, Process, Portfolio"** approach.

We recommend that you follow a three-step process:

1. Review and, where necessary, update your beliefs on each of the four approaches — Integration, Stewardship, Investment and Screening.

2. Update your investment policy to reflect your institution's beliefs and legal minimum requirements (in jurisdictions where ESG integration is legislated), and embed that policy within your processes.

3. Create a work plan that incorporates selected approaches into portfolio decisions, particularly research, strategy, manager selection and monitoring.

Each investor's approach will be unique, reflecting priorities based on the requirements of stakeholders (including regulators), investment structure and approach, available resources and governance budget. We can help you review your beliefs, policies and processes to capture this additional perspective and develop an implementation approach that suits your requirements.

A more-detailed reference guide on integrating ESG and sustainability-themed investment drivers and opportunities by asset class is also available. Please contact your Mercer consultant or local representative to receive a copy and to discuss how you could implement these approaches within your portfolio.

For further information, visit https://www.mercer.com/our-thinking/wealth/responsible-investment.html or contact your local Mercer representative.

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INTRODUCTION

1.1

At Mercer, we define responsible investment (RI) as an investment approach that includes environmental, social and corporate governance (ESG) factors and broader systemic issues — for example, climate change and sustainable development — along with active ownership (stewardship). These considerations can have a material impact on financial performance, and their inclusion is more likely to lead to sustainable investment outcomes, such as a greater ability to sustain pension payments in the future.

Mercer's own investment beliefs state that ESG factors can have a material impact on long-term risk and return outcomes. We also believe:

1. Taking a broader and longer-term perspective on risk will lead to improved risk management and new investment opportunities.
2. Climate change poses a systemic risk given the low-carbon transition and physical impacts of different climate outcomes.
3. Active ownership provides opportunities for investors to enhance the value of companies and the market.

RI is distinguished from ethical, norms-driven investing, an investment philosophy dating to the 1800s guided by moral values, ethical codes or religious beliefs and originally rooted in negative screening of investments in sensitive sectors, such as slavery-derived goods, alcohol, tobacco, pornography and firearms. Under this approach, ensuring investment was limited to companies that met the investor's moral criteria was the focus. Socially responsible investing (SRI) is another approach, intended to balance an investor's ideals with performance considerations, and typically seeks to achieve a trade-off between social and financial objectives.

That said, proponents of RI, SRI and ethical, norms-driven investment may share many underlying beliefs, and there is often overlap in the strategies implemented in pursuit of these investment approaches. Mercer's RI advice prioritizes risk and return implications, but we also help many clients balance their reputation considerations and align both *value* and *values*.

1.2

In recent years, RI has attracted significant attention among institutional investors around the world. Drivers behind this increased focus include the following:

- A general acceptance that ESG factors are relevant to companies and investors facing related risks and opportunities in aligning their capital allocations with the interests of their clients and beneficiaries is reflected in the increasing number of signatories to the UN Principles for Responsible Investment (PRI).[1] This increase represented more than US$80 trillion in 2018 — equal to the size of assets managed by the global asset management industry — compared to approximately US$12 trillion in assets 10 years earlier.

- Awareness of the growing array of social inequalities, environmental impacts and negative externalities affecting companies is increasing. Unprecedented environmental and social pressures, driven by population growth and consumption-pattern pressures on food, water and energy security; access to natural resources; climate change; human rights; and supply-chain labor standards, are creating material issues for business and the corporate world.
- The impact of poor corporate governance practices on shareholder value — accentuated by direct examples of individual company financials and the indirect impacts of the global financial crisis — has also brought issues such as transparency, corruption, board structure, shareholder rights, business ethics, risk management and executive compensation to the top of the investor agenda.

- ESG integration has increased along with the applicability of integration techniques in asset classes other than listed equity, including bonds, emerging markets and alternative asset classes.

- Changes are occurring in global legislation and legislative guidance that either require or encourage consideration of RI as part of a statement of investment principles or similar in an investor's investment strategy documentation. Changes in normative and best-practice expectations that stipulate RI considerations are also a factor.

- In some cases, stakeholders and beneficiaries are putting pressure on investment decision makers to adopt an RI investment approach or consider particular issues.

1.3

No definitive list of ESG issues exists, but they typically display one or more of the following characteristics:

- Have a medium- to long-term time horizon with a forward-looking perspective

- Are often qualitative and not always readily quantifiable in monetary terms

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SOCIAL CONCERNS

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- Stakeholder concerns
- Demographics
- Labor and supply

CORPORATE GOVERNANCE CONCERNS

- Audit quality
- Board structure
- Remuneration
- Shareholder rights

1.4

This paper provides a brief introduction to RI implementation.

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2. **Stewardship** — voting and engagement with underlying companies and/or investment managers and engagement with policymakers for risk/return reasons
3. **Investment:**
   - Themed investing — funds that focus on the risk and return opportunities in ESG themes, typically related to sustainability solution trends
   - Impact investing — investments that seek to balance financial returns with a positive impact on society and/or the environment, including investments in companies that meet such criteria
4. **Screening** — typically implemented by excluding investments in companies that are perceived to have a negative impact on society, where investors do not want to profit from the product or activity for reputational and/or ethical reasons

Section 3 addresses historical concerns related to RI and fiduciary duty.

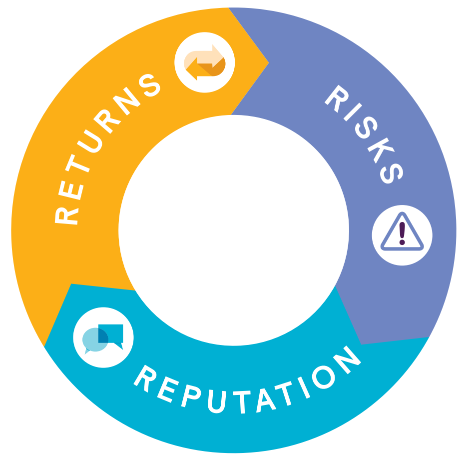
Section 4 discusses the relationship between RI and investment performance.

Section 5 provides some suggestions for next steps and a potential action plan.

INVESTMENT APPROACHES

There are many ways in which institutional investors approach RI and applicable ethical considerations — aiming to balance the risk/return requirements for investors (particularly those with fiduciary duties) and reputational considerations with the needs of beneficiaries and other stakeholders.

In this section, we describe the main approaches that can be implemented individually or in combination. The majority of investors employing a comprehensive RI program would have elements of most if not all of these.



FOUR APPROACHES TO RI

INTEGRATION	STEWARDSHIP
Include ESG factors in investment decisions, with an explicit approach to climate change transition and physical risks, which are portfolio-wide.	Exercise active ownership/stewardship through voting and engagement with underlying companies and by engaging with policymakers.
AIM: Financial objectives + risk management improvement	**AIM**: Financial objectives + financial system improvement
INVESTMENT	**SCREENING**
Allocate to sustainability themes or impact investments for new opportunities — for example, renewable energy, water and social housing.	Screen out sectors or companies deemed to be irresponsible or not acceptable to profit from.
AIM: Financial objectives + positive social and environmental impact	**AIM**: Alignment with values/reputation/risk management or longer-term financial expectations

2.1 ESG INTEGRATION

Include ESG factors in investment decisions, with an explicit approach to climate change transition and physical risks, which are portfolio-wide.

AIM:
Financial objectives
+ risk management improvement

At the forefront of recent developments in RI is an integration approach to considering ESG factors as part of the investment process. Managers adopting this approach are typically traditional fund management companies that have begun to actively take ESG issues and themes into account in their fundamental research, analysis and decision-making processes. Typically, no sector or investment opportunity is automatically excluded from a portfolio. Integration determines the ESG "traits of a security that may not have been taken into account by that security's price but which may affect its desirability"[2] as an investment.

The rationale is twofold:

1. Managers believe investors that do not consider these issues are ignoring significant extra-financial factors that may materially impact the value of their holdings, either negatively or positively.

2. Companies that ignore sustainability issues expose themselves to a range of risks, including physical, regulatory, competitive, litigation and reputational risks that will impact their long-term corporate performance, and that by ignoring these issues, they will miss out on associated opportunities.

Some investors utilize ESG indicators purely for risk-management purposes, whereas others consider these indicators fundamental to idea generation and portfolio construction for alpha generation. Some approach ESG integration with a "best in class" focus, investing in those companies that display the most positive ESG indicators within their respective sectors. Such integration considerations can typically lead investors to make buy/hold/sell or overweight/underweight decisions.

Integration can be applied, to different extents, in all asset classes. The most well-developed public market examples are found in listed equities, and, often, the private market examples with the greatest level of ESG integration can be found in real estate. Strategies are likely to share the investment characteristics of traditional strategies in the same asset class; typically, they should also be expected to display a longer-term outlook to investing and a responsible approach to stewardship. Placing financial considerations as a driver, this approach overcomes any question of whether incorporating ESG is aligned with fiduciary responsibility.

Furthermore, significant financial regulators as well as educational bodies, such as the CFA, have clarified their stances and indicated that financially material ESG factors should be considered in investment decision-making. (The global regulatory regime will be covered in more detail in section 3.) Integration is therefore being embraced by the broadest set of mainstream investors.

[2] AIMA and CAIS. *From Niche to Mainstream: Responsible Investment and Hedge Funds*, (2017).

Exercise active ownership/stewardship through voting and engagement with underlying companies and by engaging with policymakers.

AIM:
Financial objectives
+ financial system improvement

2.2 STEWARDSHIP

Also referred to as active ownership, and often interchangeably, stewardship is an approach whereby investors seek to use their positions as owners — or, lately, also as creditors — to influence the activity or behavior of investees. The aim is usually to bring a corporation in line with best practice in a particular area, to better understand fundamental business drivers related to ESG issues, and, most commonly, to improve standards of corporate governance.
In combination with other responsible investment approaches, stewardship should better align the time horizon and interests of the corporation with that of its long-term investors.

Stewardship is an integral part of RI. Tools range from using proxy-voting rights and undertaking engagement with companies (through verbal and written communication on specific topics) to collaborative engagement with other shareholders to promote systemic change within a certain sector.

For example: Climate Action 100+ is a multiyear initiative coordinated by global investors with US$30 trillion in assets under management "to engage with the world's largest corporate greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures."[3]

Stewardship is exercised differently in each asset class. For listed equities, voting and engagement are typical, whereas in asset classes where voting rights do not exist (such as fixed income), variations in engagement practices are emerging.

These tools are increasingly being pursued in an effort to reduce risk and enhance long-term financial value. Studies have shown that companies with good corporate citizenship practices on ESG issues are better-managed overall and therefore more likely to outperform in the long term. The view that stewardship is needed and legitimate[4] has been strengthened by various instances of high-profile corporate governance failings leading to disastrous investment outcomes. Active ownership is clearly encouraged by regulators, which see the systemic value of stewardship in protecting and strengthening investments.

Engagement can be on any issue the investment community believes will protect or enhance shareholder/stakeholder value. Topics may include environmental management, labor standards, director remuneration, corruption and bribery. Engagement activity is often supported by specific research and analysis. The ability to engage and/or vote will vary depending on the specific regulatory processes in place in the location of the holdings.

[3] Climate Action 100. "About Us," available at http://www.climateaction100.org.
[4] Financial Reporting Council. *The UK Stewardship Code,* 2012, available at https://www.frc.org.uk/investors/uk-stewardship-code.

Options for stewardship include the following:

- **Direct voting**: Voting can be coordinated in house by institutional investors. Typically, proxy-voting policies and procedures are developed. The development and implementation of these policies and procedures are often assisted by the use of a third-party proxy-voting researcher (as discussed below).

- **Third-party proxy voting**: If investors conduct voting in house, they may wish to use an external research firm to inform their decisions. Often, these service providers can also offer their own proxy-voting policies or customize voting policies for clients, thereby automating much of the process, including casting their votes.

- **Direct engagement**: Engagement can be carried out by investors directly. This can be either one-to-one (that is, the investor enters into dialogue with individual companies) or collaborative (that is, joining with other investors on a specific issue or joining investor initiatives seeking to influence public policy).

- **Third-party engagement service**: Investors can employ a third-party provider offering a standalone engagement overlay service. These providers offer long-term engagement with target companies on strategic issues to enhance shareholder value. Typically, such providers use the combined influence of assets held by several clients. The majority of engagement overlay service providers also offer a voting service.

- **Delegation of voting and engagement to fund managers**: Given its natural fit with the investment process, some investors will also delegate their stewardship and engagement activities to their fund managers as part of the investment mandate. Capacity and capabilities vary considerably between fund managers. Fund managers can then also choose to use direct or delegated routes and research provision for their engagement/stewardship activities.

Allocate to sustainability themes or impact investments for new opportunities — for example, renewable energy, water and social housing.

AIM:
Financial objectives
+ positive social and environmental impact

2.3 INVESTMENT

THEMED FUNDS

The vast majority of themed funds have a sustainability/environmental focus. These funds have proliferated in recent years with the emergence of sustainability as a key societal and investment trend driving long-term growth and returns. Focus funds or activist funds can be seen as themed funds within the governance area. Funds with a social theme can be found in microfinance, urban regeneration, property and social infrastructure projects (these could also be viewed as impact investment approaches).

Sustainability-themed funds can be found most often in:

Listed Equities

Many funds in this category may use positive/negative screening, engagement, integration or best-in-sector approaches to investment. They may also have quite wide investment universes.

As an example, one such equity fund aims to invest exclusively in global companies providing solutions to sustainability challenges in health, waste and public transport. Other, more-focused examples exist in fields such as renewable energy and water.

Fixed Income

Green-bond investment can be seen as a thematic and/or impact investment. The product was created to fund projects with positive environmental benefits with the use of proceeds linked to a specific project or asset. Green-bond funds have emerged as an option for investors to tap into the growth in this market.

Property

A smaller number of specific sustainability-themed funds are emerging in the property sector as high environmental standards become mainstream in real estate investments, reducing the ability to market specialized funds.

Alternatives

Unlisted equity funds have emerged to capture the investment opportunities associated with a broad sustainability theme. Some of these funds may have a venture-capital focus as new technologies emerge to provide solutions to the global environmental challenges. Infrastructure funds can be sustainability-themed or demonstrate a high level of understanding of ESG trends to satisfy end investors' needs. Other funds include pure-play funds focused on natural resources, such as sustainable forestry or agriculture.

IMPACT INVESTING

The meaning of this term has evolved over time; however, the Global Impact Investing Network (GIIN) defines impact investments as “investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return.” In the context of investment strategies, impact investing has historically referred to private equity, private debt and other alternatives.[5]

A wide variety of potential approaches exist, but a common “traditional” type of impact fund supports small businesses in emerging or underserved markets, either directly or through loans to intermediaries, such as microfinance institutions. Typically, funds investing directly seek companies that are solutions-oriented in terms of directly addressing environmental or social issues. Other strategies may focus on environmental or social themes, such as sustainable agricultural development or affordable housing.

As a recent development, several providers of investment products and data have also started to isolate universes of public securities that are linked to positive impacts, such as a company’s percentage of revenues that could be considered “green.” These products can also be developed with explicit references to applicable United Nations Sustainable Development Goals (SDGs) that they intend to impact.

Measuring the impacts of these investments has become increasingly important as demand from asset owners to understand the impact created by their investments has increased. The Global Impact Investing Rating System (GIIRS)[6] and IRIS[7] are prime examples of the ongoing work in this field, in which a multitude of competing methodologies exist. Mercer observes that investment managers in this space are increasingly self-reporting, as clients request detailed information on the impacts they support.

[5] Global Impact Investing Network (GIIN). “History (Global Impact Investing Initiative),” available at https://thegiin.org/impact-investing/need-to-know/.
[6] GIIN. “B Impact Assessment (and GIIRS Rating),” available at https://iris.thegiin.org/b-impact-assessment-metrics.
[7] GIIN. “IRIS Metrics,” available at https://iris.thegiin.org/metrics.

Screen out sectors or companies deemed to be irresponsible or not acceptable to profit from.

AIM:
Alignment with values/reputation/risk management or longer-term financial expectations

2.4 SCREENING

Investors that apply screening typically use one or a combination of the following screens:

Negative screen **Positive screen**

Negative screening: This refers to the exclusion of companies involved in activities or products with a perceived negative impact on society, such as armaments manufacturing, tobacco production, gambling, alcohol, and animal testing, or companies with poor records of ESG performance. Although these decisions are most often driven by ethical/ moral considerations, in some cases, a more financial perspective to exclusions is emerging. Some investors argue, for example, that the construction of coal-free and/or fossil-fuel-free portfolios — and more recently, tobacco-free portfolios — will, over the long run, deliver the best investment outcomes, due to shifts in legislative practices and technology.

Positive screening: This refers to the inclusion of stocks/ bonds based on whether the company has a positive ESG trait, such as a high overall ESG score, belonging to a certain industry sector or displaying other favorable characteristics desirable to the investor or its beneficiaries.

A screened approach can be achieved either by investing in a separate investment product or through a segregated account with a manager able to implement customized screens. Usually, the rationale for using a screened approach will be to align the portfolio with an organization's values or its views on stocks that are unacceptable (negative screening) or favored (positive screening) for ethical or reputational purposes.

Highlight on "Ethical"

Negative screening has traditionally been associated with "ethical" funds, particularly those that offer an SRI/ethical version of a mainstream investment strategy. However, even among investors that do not come from a particular ethical perspective, most would support some element of negative screening; that is, based on generally accepted behavioral and legal norms. For example, a strong normative basis exists for the exclusion of companies involved in production of cluster bombs or landmines, nuclear weapons, or the use of child labor or modern slavery. As noted, however, negative screening may also be undertaken for financial reasons. Positive screening can be implemented in a range of ways, such as passive overweighting of high-scoring stocks according to some predetermined criteria or as a defined starting point to establish a universe for themed or ESG-integrated funds.

RESPONSIBLE INVESTMENT, REGULATORY DIRECTION OF TRAVEL AND FIDUCIARY DUTY

3.1

Historically, a key barrier to broader implementation of RI was the assumption that it contradicted fiduciary responsibility, based on the belief that RI reduced the investable universe, defying a "theoretically optimal" solution. As we have outlined in this paper, that belief does not reflect modern reality. RI implementation methods do not necessarily exclude any stocks from consideration (see: integration, stewardship, investment and positive screening).

3.2

From time to time, concerns are still raised regarding the scope of fiduciaries to embrace RI. These concerns typically arise from a failure to distinguish between ethically driven investing and financially driven integration of ESG issues. In practice, RI is often simply a more-comprehensive approach to identifying investment risks and opportunities and is therefore aligned with fiduciary duty.

3.3

A key early development in establishing the legitimacy of RI from a fiduciary perspective was the "Freshfields report"[8] (2005). This report examined the legal implications of integrating ESG issues into institutional investment for those with fiduciary duty. The report found that integrating ESG considerations into investment analysis so as to more reliably predict financial performance is not only permissible but is arguably required. The legal situation continues to evolve on ESG, and key global regulators have, in turn, either regulated and/or provided guidance on the validity of the original Freshfields report. The Pensions Regulator[9] and Department of Work and Pensions[10] in the UK, the Department of Labor[11] in the US, the EU Commission[12] in the EU (with strong support from local regulators like the AMF[13] in France and the DNB[14] in Netherlands) and the APRA[15] in Australia have all actively weighed in on the dialogue. The PRI has provided global research on the fiduciary duty topics for eight jurisdictions,[16] helping to clarify the issue.

[8] Freshfields Bruckhaus Deringer and UNEP Finance Initiative Asset Management Working Group. *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment*, 2005.
[9] The Pensions Regulator (TPR). "Investment Strategy Guidance," available at http://www.thepensionsregulator.gov.uk/guidance/db-investment-two-strategy.aspx.
[10] Department for Work and Pensions. *Government Response: Clarifying and Strengthening Trustees' Investment Duties*, 2018, available at https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties.
[11] US Department of Labor. *Field Assistance Bulletin No. 2018-01*, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.
[12] EU Commission. "Sustainable Finance: Commission's Action Plan for a Greener and Cleaner Economy," available at https://ec.europa.eu/clima/news/sustainable-finance-commissions-action-plan-greener-and-cleaner-economy_en.
[13] AMF. *The AMF Affirms Its Commitment to Sustainable Finance on Climate Finance Day* [press release], 2017.
[14] De Nederlandsche Bank. "Sustainable Finance Platform," available at https://www.dnb.nl/en/about-dnb/co-operation/platform-voor-duurzame-financiering/.
[15] PRI. "Fiduciary Duty in the 21st Century: Australia Roadmap" (2016), available at https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-australia-roadmap/258.article.
[16] UNEP Finance Initiative. "Fiduciary Duty in the 21st Century," 2015–2017, available at http://www.unepfi.org/investment/fiduciary-duty/.

3.4

An increasing number of market participants (brokers, managers, consultants, investment banks) are integrating RI and evolving their processes accordingly. As a result, fiduciaries now have greater scope to ensure that ESG risks are being managed and associated opportunities pursued.

3.5

RI regulation is currently on policymakers' and civil society's agenda worldwide, and the pace of regulatory intervention is increasing. The PRI identified 300 policy instruments in its survey of the 50 largest economies in the world. All instruments supported long-term investment decision-making, including consideration of ESG factors, and more than half were created between 2013 and 2016.

[17] PRI. "Responsible Investment Regulation Map," available at https://www.unpri.org/.

RELATIONSHIP BETWEEN RESPONSIBLE INVESTMENT AND PERFORMANCE

A growing body of evidence and supporting documentation is turning the tables on common misconceptions in the industry, namely, that RI restricts the investable universe and therefore must hurt returns. More practitioners today are seeking to integrate ESG to add rigor and depth to their investment processes and risk management.

A number of ESG/sustainability indices from providers such as FTSE/Russell,[18] MSCI[19] and S&P/DJI[20] now have substantial track records. Sustainability indices cover a range of potential goals and uses. Indices range from a focus on narrow themes (for example, low carbon or climate indices, water, ESG factors, gender equality, etc.) to core allocations, such as broad ESG indices. Indices may seek to attain impact, express values, seek risk/return outperformance or track parent indices while embedding ESG considerations. In construction, screening continues to be the main method, although reweighting companies based on ESG factors has increased in recent years. Performance differs considerably, as is the case for any other index construct; however, at the broadest level, there is evidence that performance compares favorably to unconstrained portfolios.

4.1

There is now a significant body of work that supports the financial benefits of ESG integration and active ownership. Academic and practitioner research now also covers asset classes beyond listed equities.

4.2

Research into the impact of incorporating ESG factors into investment decision-making has traditionally focused on screening approaches. Although such research is not directly relevant to the merits of morebroadly focused integrated RI approaches, it does provide some insights. It is also notable that much research is carried out at a corporate level, finding links between strong ESG practices and corporate financial performance. Although informative, such research is not directly applicable at the portfolio level in all investment situations.

4.3

In general, the academic literature continues to confirm our belief that the consideration of ESG factors at the company level can lead to outperformance, especially over the longer term. ESG integration into investment decision-making and portfolios requires manager skill, a clearly defined investment style and consideration of appropriate time periods to achieve desired outcomes — as would be the case with any mainstream investment strategy.

[18] FTSE Russell. “ESG Ratings,” available at http://www.ftse.com/products/indices/f4g-esg-ratings.
[19] MSCI. “ESG Integration,” available at https://www.msci.com/esg-integration.
[20] S&P Dow Jones Indices. “ESG,” available at https://us.spindices.com/theme/esg/.

A sample of academic and practitioner research papers is included below:

Ambachtsheer J, Fuller R, Hindocha D. “Behaving Like an Owner: Plugging Investment Chain Leakages,” *Rotman International Journal of Pension Management,* Volume 6, Issue 2 (Fall 2013), available at https://www.mercer.com/content/dam/mercer/attachments/global/investments/responsible-investment/Behaving-Like-an-Owner.pdf.

Dimson E, Karakaş O, Li X. “Active Ownership,” *The Review of Financial Studies*, Volume 28, Issue 12 (2015), pp. 3225–3268, available at https://academic.oup.com/rfs/article/28/12/3225/1573572.

Friede G, Busch T, Bassen A. “ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies,” *Journal of Sustainable Finance & Investment*, Volume 5, Number 4 (2015), available at https://www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917.

Khan M, Serafeim G, Yoon A. “Corporate Sustainability: First Evidence on Materiality,” *The Accounting Review*, Volume 91, Number 6 (2016), pp. 1697–1724, available at https://ssrn.com/abstract=2575912.

Kiose D and Keen S. “Understanding the Relationships Between Environmental and Social Risk Factors and Financial Performance of Global Infrastructure Projects,” *Scientific Research Publishing* (2017), available at http://www.scirp.org/journal/PaperInformation.aspx?paperID=80890.

Allianz Global Investors. *ESG in Investment Grade Corporate Bonds and Financial Materiality of ESG Factors for Sovereign Bond Portfolios,* 2017.

MSCI. *Foundations of ESG Investing*, 2017, available at http://info.msci.com/foundations-of-ESG-investing-part1.

CFA Institute and PRI. *ESG Integration in the Americas: Markets, Practices, and Data*, 2018, available at https://www.cfainstitute.org/en/research/survey-reports/esg-integration-americas-survey-report, and *Guidance and Case Studies for ESG Integration: Equities and Fixed Income* (2018), available at https://www.unpri.org/investor-tools/guidance-and-case-studies-for-esg-integration-equities-and-fixed-income/3622.article.

Moody’s Investor Service. *Heat Map: 11 Sectors With $2.2 Trillion Debt Have Elevated Environmental Risk Exposure*, 2018.

NEXT STEPS AND POTENTIAL ACTION PLAN

5.1

We trust that this paper serves as a worthwhile first step in beginning to consider responsible investment concepts and developing a position on RI. Investors should consider a number of further actions, as outlined in a separate Mercer document, *An Investment Framework for Sustainable Growth*.

A summary of the framework approach for integrating ESG considerations throughout the investment process is shown below. Different approaches can be taken for those at an initial stage of integration compared to those at an advanced stage. Mercer would be happy to discuss the most appropriate bespoke plan and approach with you.

The framework below identifies where ESG and sustainability considerations sit within the typical **"Beliefs, Policy, Process, Portfolio"** approach.

We recommend that you follow a three-step process:

1. Review and, where necessary, update your beliefs on each of the four approaches — Integration, Stewardship, Investment and Screening.

2. Update your investment policy to reflect your institution's beliefs and legal minimum requirements (in jurisdictions where ESG integration is legislated), and embed that policy within your processes.

3. Create a work plan that incorporates selected approaches into portfolio decisions, particularly research, strategy, manager selection and monitoring.

Each investor's approach will be unique, reflecting priorities based on the requirements of stakeholders (including regulators), investment structure and approach, available resources and governance budget. We can help you review your beliefs, policies and processes to capture this additional perspective and develop an implementation approach that suits your requirements.

A more-detailed reference guide on integrating ESG and sustainability-themed investment drivers and opportunities by asset class is also available. Please contact your Mercer consultant or local representative to receive a copy and to discuss how you could implement these approaches within your portfolio.

For further information, visit https://www.mercer.com/our-thinking/wealth/responsible-investment.html or contact your local Mercer representative.

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