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Abstract

We explore whether beneficiaries of pension plans should have a voice in the fund's sustainable investments. We hypothesize that the answer to this question depends on a fund's legal and societal contexts, benchmarking pressure, and fund-specific factors such as the fund's size and the board's composition. We uncover heterogeneity in the degree to which beneficiaries are involved in decision-making. Some pension funds have started a dialogue with their participants, mainly using survey instruments. We provide an example of a fund that gave its participants a real vote, while avoiding the pitfalls that come with hypothetical surveys on individual preferences.

Keywords: pension participant survey, social preferences, socially responsible investments.

JEL Classification: G02, G20, G23, G28

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Many employees across the globe entrust their pension contributions to occupational or employment-based pension funds. Jointly, these funds hold about US \$50 trillion in assets under management (Willis Towers Watson 2020). Slightly less than half of these assets are managed in defined-benefit (DB) schemes, while the other half are managed in defined-contribution (DC) plans in which plan participants bear the investment risk. Irrespective of plan design, pension funds universally promise to deliver stable and adequate solutions for retirement incomes to participants.

In the large majority of cases, pension plan beneficiaries are not directly involved in any of the strategic choices made by these funds. This noninvolvement holds for strategic decisions on the design and governance of DB and DC plans but also for strategic choices on the funds' investment programs. Notably, beneficiaries generally are not part of the debates on sustainable investments in which nonfinancial preferences oftentimes play a prominent role. For this reason, the central question we tackle in this paper is whether pension plan participants should be involved in setting the agenda on the sustainable investments in their pension fund. If the answer to this question is affirmative, how and at what stage should they be involved in decisions?

The global financial crisis in 2008 and the subsequent market response showed that informational asymmetries, misaligned incentives, and fuzzy chains of intermediation lead to substantially lower levels of trust in the financial sector (Waitzer and Sarro 2014). This lack of trust has encouraged regulators, legislators, and courts across the globe to bend the trajectory of many relevant laws into a direction that they believed better served the public interest. Moreover, it explains why many financial institutions, and pension funds in particular, have stepped up and joined collaborative approaches (e.g., Principle for Responsible Investments (PRI) and Climate Action 100+).¹ Through these vehicles, in the interest of their beneficiaries and clients, they tackle global challenges such as climate change, inequality, and human rights' violations in the

interactions with their portfolio companies and delegated asset managers. Many pension funds now have a full-fledged sustainable investment policy that they execute and report on. They increasingly ‘walk the talk’.

Yet this proactive stance has not yet materialized as a stronger involvement of beneficiaries in the sustainable investment agenda of pension funds. Only in a very limited number of funds do the ultimate owners of the entrusted investments have direct involvement in decisions. The reasons for not ‘democratizing’ this process revolve around legal interpretations, cultural and societal perspectives, participants’ low financial literacy levels, pension funds’ capacity constraints, habit, or simply decision makers’ unwillingness.

Nevertheless, it is becoming increasingly clear that pension funds cannot simply ignore the many calls for action by substantial parts of their membership. For example, half of UK universities have now committed to divesting their fossil fuel investments (Guardian 2020). Universities have started dialogues with their individual endowments, and NGOs increasingly have engaged directly with pension funds and their participants. Fossil Free UK, for example, is in a continuous dialogue with the University Superannuation Scheme (USS) in the UK with the goal to screen for and exclude the fossil fuel industry from their investment portfolio and immediately freeze any new investment in fossil fuel companies (Fossil Free Campaign UK 2020). Another recent example of an NGO targeting pension funds directly is Tobacco Free Portfolios (Tobacco Free Portfolios, 2021). Many pension funds and asset managers, partially based on the interactions with TFP, have decided to divest from tobacco manufacturing companies. Across the globe, younger generations are calling on pension funds and other financial institutions to deploy capital in such a way that it has a positive effect on the trajectories of climate change. In some cases, pension funds proactively signal in their mission statement that they take this dialogue very

seriously. PGGM, the Dutch pension delivery organization for the health-care sector, for example states on its website: ‘Our ambition: to provide for good pensions in a livable world’ (PGGM 2020: np). Interestingly, only rarely is the direction of the sustainable investment program, including the inherent dilemmas involved, based on direct interaction with pension fund beneficiaries. In the majority of cases, pension boards alone handle the decision making.

In what follows, we first discuss the context in which pension funds decide on a sustainable investment program and how they can integrate sustainability in their investment decisions. Next, we identify key factors accounting for different ways to integrate nonfinancial preferences in pension funds’ investment processes, including the motivation to involve participants. We also largely focus on funds in the EU, the UK, and the US, and we devote special attention to the Netherlands where a pension fund gave its participants a real vote (Bauer et al. 2021). In a conclusion, we synthesize our findings and summarize our answer to our central question: How can we involve pension participants in a meaningful way when setting a pension fund’s sustainable investment agenda?

Why Measure Nonfinancial Preferences?

In a retail investment context, investors can individually choose which funds they buy or sell, and when. In the past three decades, many mutual funds have created sustainability profiles that allow individuals to choose funds that match their sustainability or nonfinancial preferences, at least to some extent.² A recent study using a natural experiment found causal evidence that market-wide, retail investors do value sustainability (Hartzmark and Sussman 2019). The authors reported that, when mutual funds were categorized by Morningstar as ‘low sustainability,’ they experienced significant net outflows. By contrast, when funds were categorized as ‘high

sustainability’, they experienced substantial net inflows. The authors concluded that their experimental evidence was consistent with positive affect influencing expectations of sustainable fund performance. Also, nonpecuniary motives influenced investment decisions. In the US context, then, nonfinancial motives do directly affect the demand for sustainable mutual funds. Earlier work (Bollen 2007; Riedl and Smeets 2017) showed that many retail investors are motivated by their strong social preferences, accepting lower expected returns on socially responsible investments and paying higher management fees.

Pension fund participants, in contrast to retail investors, generally do not have the freedom to join a plan that matches their sustainability preferences. There is no market-clearing mechanism that matches supply to demand for sustainable pension investments. In most countries, being a participant in a collective DB pension means joining the public sector, industry, or corporate plan offered by their plan sponsor; generally, they do not have an opportunity to make individual, discretionary investment choices. Here, the DB fund boards and management determine and execute strategic investment choices that include strategic decisions and directions related to sustainable investments. In a DC setting, by contrast, there are potentially more options for plan participants, which can vary from choosing the degree of risk-taking to the choice of investment funds. Nevertheless in the DC space, the menu of funds and the actual selection of delegated asset managers who supply these funds are typically set by the plan boards and managers.

Since the start of the PRI movement in 2006, there has been a considerable growth in the assets under management (AUM) of PRI signatory institutions. Asset managers and asset owners that join the PRI generally have more socially-conscious portfolio-level footprints, especially along the social and governance dimensions (Gibson et al. 2020). Nevertheless these differences are not large, which could be explained by the fact that some funds join the PRI for reputational

reasons. In addition, differentiating between US and non-US investors, the authors conclude that US signatories do not have more socially-conscious footprints, perhaps due to the different interpretation of fiduciary duties in the US market (Gibson et al. 2020).

Three ways to implement sustainable investments. Pension funds have three distinct ways that they can integrate sustainability into their investment decision-making. First, they can develop a divestment (or exclusion) policy. Globally, many examples exist of pension funds that publicly declare their divestment of certain industries, such as the tobacco industry or the nuclear weapon industry (ABP 2018). These decisions are often based on the nonfinancial preferences of pension funds (i.e., their boards), but increasingly these divestment policies are also linked to financial considerations. The USS's recent divestment from tobacco manufacturing companies and thermal coal mining companies was motivated on its website as follows: '...the traditional financial models used by the market as a whole to predict the future performance in these sectors had not taken specific risks into account. These included changing political and regulatory attitudes and increased regulation that USS Investment Management consider will damage the prospects of businesses involved in these sectors in the years to come' (USS 2020: np).

A second way of integrating sustainability into the investment process is to complement financial information with nonfinancial (sustainability) information when making strategic decisions on asset allocation or buying and selling securities in the public and private asset space.³ The key objective of these strategies is to improve the risk-adjusted returns of investments, meaning that many investors believe that financial markets have not yet fully priced material sustainability information. The jury is still out on this matter, but several excellent meta-studies and books exist on the topic (Matos 2020; Edmans 2020). Most prominent practical examples can be found in equity investments in both qualitative and quantitative strategies, but also in all other

asset classes today. The integration of sustainability information varies from slightly tilting portfolios toward certain Sustainable Development Goals (FTSE Russell 2020), to positive and negative screening of portfolios; in its most extreme form, there can be mandates with a small, selected number of highly sustainable companies that investors perceive as both positively contributing to society and the bottom line.

A third way to interact with companies and investment vehicles on sustainability issues is to engage in active ownership strategies. Many pension funds have established voting guidelines that go beyond standard shareholder-oriented governance concerns, and that are executed by professional agencies in the interest of asset owners. Also, the level and intensity of private engagement with companies by pension funds has increased steadily in the past decade. Pension funds as a group are now voicing concern and demanding action on sustainability issues such as companies' compliance with the Paris Agreement (Climate Action 100+ 2020). Many other appearances of active ownership include filing shareholder proposals, class action lawsuits, and media campaigns. In some cases, failed engagement with companies may lead to divestment of the asset altogether. A good example of the latter case is the divestment of Walmart by the largest Dutch pension fund (ABP) in 2012 because of poor labor practices.

A preference for engagement. A recent large-scale survey among institutional investors, with a substantial number of pension funds in the sample, found that respondents generally think that climate risks have important financial implications for firms they invest in (Krüger et al. 2020). The survey also showed that institutional investors consider climate risk for both financial and nonfinancial reasons; in fact, there was no single motive that explains why and how these investors incorporated these perceived risks into their investment decisions. Reputational concerns, legal considerations, and investment beliefs about the effect of climate change on risk and returns were

the key drivers of spending resources on assessing climate risks and opportunities. The survey responses also showed that most respondents favored engagement over divestment and that larger investors engaged with companies along more dimensions.

This preference for engagement relates to studies showing that engagement can have a positive effect on performance, in some cases (Dimson et al. 2015, Azar et al., 2020; Kölbel et al., 2020). Successful engagements are followed by positive abnormal returns, and engagement success is more probable if the engaged company has reputational concerns and a higher capacity to implement change. This study also showed that collaboration among engaged investors was instrumental in increasing the success rate of environmental and social engagements. A recent PRI analysis of the effectiveness of coordinated engagement activities showed that a two-tier strategy combining lead investors with supporting investors was effective in successfully achieving the stated engagement goals, and was followed by improved target performance (Dimson et al. 2021).

Initiating and executing an engagement strategy raises another set of questions for pension boards, including: Which budget should be allocated to engagement activities? Which topics are worth engaging on? How can one measure the engagement's success? Which collaborative vehicles should be joined to ensure engagement is effective? Do the benefits of engagement outweigh costs? Is it strictly about financial benefits, or also about environmental or social benefits? As pension funds do not have unlimited resources, choices need to be made regarding what topics to prioritize and what companies to target first, and through what engagement channel.

Prioritization. Pension fund boards need to prioritize sustainable investment activities spanning from divestments, to the integration of sustainability into investments, and the deployment of active ownership strategies. Subsequently, internal or external asset management organizations must execute these strategies in line with the board's priorities. Many of the decisions and priorities

can involve weighing the importance of nonfinancial preferences, yet it is complex to disentangle financial from nonfinancial preferences. Board members may hold different beliefs about the effectiveness of divestment or engagement, along with the likelihood to have successful engagements, the potential spillovers of engagement activity from one company to another, the perceived willingness of companies to contribute to the renewable energy transition, the expected financial consequences in case of divestment, and the assessment of the long-term effect of selling these shares to other owners. Pension fund boards tend to expend much energy on this topic, including preferences regarding nonfinancial as well as financial criteria.

To return to our central question, should the ultimate owners of pension funds have a voice when pension boards make strategic investment decisions of a nonfinancial nature, or when these are motivated by nonfinancial criteria? To this we turn next.

What Drives the Sustainable Investment Agenda?

In our view, there is no single response to the question of how to integrate sustainability into the investment process, and especially not how to involve the ultimate owners in this process. Market forces being absent, we first identify a set of exogenous factors that may lead to the observed heterogeneity in responses by pension funds across the globe (Krueger et al. 2020; Gibson 2020).

Legal and societal contexts. Pension funds operate in both legal and societal contexts, and these are key drivers in accounting for differences in their sustainable investment activities around the world. Laws relevant to pension funds, their interpretations and subsequent trajectories, differ markedly per jurisdiction, as do regulatory bodies' attitudes towards the sustainable investment topic. When browsing legal scholars' contributions to this discussion, references to the prudent

person rule often occur (also known as prudent man, prudent investor, or prudent expert). The prudent person rule is linked to two key principles of Anglo-American trust law: prudence and loyalty (Maatman and Huijzer 2019). According to Kuiper and Lutjens (2019), the prudence principle can be applied to a pension fund as follows: Pension funds must manage the pension capital with the care, caution, expertise, and competence that may be demanded of a reasonably competent and reasonably acting pension fund. The loyalty principle requires trustees to give priority to the beneficiaries' interests under all circumstances. If trustees fail to do so, and thereby cause harm to beneficiaries, they are liable in principle.

In the Netherlands, three initiatives exemplify the development of the prudent person rule in the context of responsible pension investments. In 2010, the Dutch Committee on Investment Policy and Risk Management devoted particular attention to pension funds' social position, and it endorsed the view that socially responsible action must be an integral part of the pension funds' risk and investment policies. This committee explicitly mentioned that the participants' preferences must be embedded in the pension fund's policies (Frijns Report 2010). To our knowledge, this is the first time that involving beneficiaries is mentioned explicitly.

In 2018, a large number of Dutch pension funds, in cooperation with NGOs, trade unions, and government, signed the Agreement on International Responsible Investment for the Pensions Sector. It stipulated that:

The implementation of this Agreement should contribute to, and may not prejudice, the fulfillment of the pension funds' fiduciary duty arising from Article 135(1) of the Dutch Pensions Act; the pension fund's board must ensure that there is support among participants for choices made regarding responsible investment. Taking material Environment, Social and Governance (ESG) factors into account in

investment decisions is consistent with risk assessment and risk management and is in line with the fiduciary duty of pension funds. Such factors can become material in the short, medium and long term. (IRBC 2018: 5)

Signing this agreement meant that the Dutch pension regulator will check whether funds actually do comply with these promises.

In parallel, the European Union (EU) launched the EU Pension Directive (IORP II 2016) that claimed that environmental, social, and governance factors are important for pension funds' investment policy and risk management systems. Yet IORP II has no direct reference to investigating member preferences towards sustainable investments. Outside the Netherlands, very few concrete cases exist in Europe, whether in hard or soft law, where governments have requested, advised, or even proposed the involvement of beneficiaries in some stage of the setting of pension funds' sustainable investment policy. One rare example is a recent consultation document in which the EU put forward the question of whether the integration of beneficiaries' sustainability preferences in the investment strategies of occupational pension funds should be further improved. The majority of respondents (from all branches of society) answered 'don't know' (57%), about a third (32%) answer 'yes', and a smaller subset of respondents (11%) said 'no' to this question (European Commission 2020a and 2020b).

How European law develops depends on further evolution of the prudent person rule. Anglo-American law describes a pension fund trustee's fiduciary obligation in the 'Uniform Prudent Investor Act' that includes the prudent investor rule (Maatman and Huijzer 2019). The financial interests of beneficiaries, based on modern portfolio theory, are key elements of a trustee's objective function.

In the US, the prudent investor act in many states is interpreted quite narrowly. Pension fund fiduciaries are charged with maximizing financial performance in order to meet pension obligations. This focus explains why sustainability information receives little attention in the boards of many US pension funds. The US Department of Labor (DOL), the supervisor under the Employee Retirement Income Security Act of 1974 (ERISA), has demonstrated substantial ambivalence on this matter. In 2015, the DOL stated in one of its Interpretative Bulletins: ‘Environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.’ (US Department of Labor 2015: 65136)

A few years later, the DOL chose quite a different path: ‘Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary’s evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons’ (US Department of Labor 2018: 2). Beneficiaries’ sustainable investment preferences are not part of the equation, and neither is beneficiaries’ interest in building a livable world.

In 2020, the US Department of Labor adopted amendments to the ‘investment duties’ regulation under Title I of the Employee Retirement Income Security Act of 1974: ‘The amendments require plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action’ (US Department of Labor 2020: 72846). Remarkably, a few months later, the new administration announced that it will not enforce the former

administration's rules and is reviewing whether a rewrite or other action is necessary (US Department of Labor 2021).

In the UK, inspired by the Kay Review (Kay 2012), the Law Commission No. 350 foresaw an important role for sustainability information in the investment process: 'Whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: trustees should take into account financially material factors' (Law Commission 2014: 113). Interestingly, the Law Commission also hinted indirectly at involving beneficiaries' preferences in decision-making: 'Our conclusion is that quality of life factors are a subordinate objective, and are therefore subject to the two tests we set out below. Trustees should have good reason to think that beneficiaries would welcome the lifestyle benefit and there should be no risk of significant financial detriment to the scheme' (Law Commission No. 350 2014: 116).

Peer pressure and benchmarking. The level of peer pressure and benchmarking of pension funds' sustainable investments strategies also varies by region and nation, and as a result, it can determine the speed and breadth of activities in the sustainable investment domain. Every year, Dutch-based VBDO publishes the VBDO Benchmark Responsible Investment by Pension Funds in the Netherlands (VBDO 2020). This benchmarking of the 50 largest Dutch pension funds is discussed extensively, both formally and informally, around many pension board tables. International examples of benchmarking are the PRI that scores asset owners and asset managers on their sustainable investment policy, and the Global Pension Transparency Benchmark (GPTB), recently issued by CEM benchmarking and Top1000funds.com, in which responsible investments are an important factor (CEM and Top1000funds.com 2021). GPTB targets the largest pension funds in a large number of countries. These benchmarking initiatives show that funds increasingly

are being confronted with peer pressure, which includes peers' activities and advancements, when having a dialogue with pension beneficiaries.

Fund-specific factors. Next, we identify a set of fund-specific factors that may differ between individual pension funds. First, larger pension funds may allow them to set up relatively large sustainable investment teams providing the full scale of activities and necessary knowledge. By contrast, smaller funds must prioritize their activities or delegate them to external parties. Having internal investment teams also probably has a longer-lasting effect on the sustainability culture and knowledge within the pension fund, as long as it accepts the intended direction. Many European pension funds have gone through this exercise in recent years. For smaller funds, there is always the free-rider option, although EU legislation requiring European pension funds to report on their sustainable investment activities, or its absence thereof, may change this.

Independent of size, the board's investment perspectives may differ across pension plans. Beliefs about the long-term consequences of divestment, the added value of integrating sustainability into investment decisions at all levels (strategic asset allocation, timing, and security selection), and the effectiveness of active ownership strategies may differ between boards and even across board members. Moreover, board members having substantial experience and research expertise on sustainable investments may boost the execution of sustainable investment strategies.

The composition of the board may also have a significant effect on the sustainable investment agenda. Board composition varies considerably between public, industry-wide, and corporate pension plans, as well as between jurisdictions, as pension laws are often nationally or at most regionally targeted. Additionally, many pension fund boards include a mix of representatives from employers, employees, and retirees (the latter especially in the Netherlands); and in some cases, also state, political, and independent appointees. Board composition can have

a substantial effect on the strategic investment decisions of pension funds in other domains. Examples of these in the US public pension context include the amount of risk deemed acceptable (Andonov et al. 2017) and the selection of private equity investments (Andonov et al. 2018). A recent study of Dutch pension funds showed that a higher gap between the average age of board members and the average age of participants lowered the strategic allocation to equity by seven percentage points, after controlling for the fund's characteristics including the liability structure (Bauer et al. 2021). The same authors concluded that corporate pension funds having a greater representation of employers on the board allocated more to equities, which may create a classic principal-agent problem between employer trustees and beneficiaries.

These examples show that a pension board's composition affects strategic investment decisions, and it will likely also affect how pension funds shape their agenda regarding sustainable investments. For example, a US public pension fund whose board consists purely of state-appointed members may come to different conclusions than would a board comprised of a large number of public representatives (Andonov et al. 2017). Another example is a corporate pension fund that is tightly connected to a company with a high score on the sustainability scale, versus other companies in the same industry. Potentially, these pension funds will take a more positive stance on sustainability, as the board is composed of employer and employee representatives of the higher-scoring company.

The listed external and fund-specific factors influence the sustainable investment policy of pension funds, and are likely to explain much of the global heterogeneity in fund actions in this matter.

Examples of Member Involvement

Against the backdrop of legal contexts just described, it is no surprise that the Netherlands has the most involved pension fund members. Dutch funds pledged to integrate members' views in their investment decisions in a formal agreement (IRBC 2018), and some regularly engage their members regarding their preferences on sustainable investments. For example, ABP (civil servants) uses surveys to explore beneficiaries' preferences in all important matters in the design of the pension deal, such as risk attitude. Recently, these surveys have also contained questions regarding beneficiaries' sustainability preferences. ABP (2020) reported on that 59 percent of their participants were in favor of sustainable investments, as long as financial returns are not negatively affected.

Another example is the Philips corporate pension fund (PPF 2021). The firm conducted a large-scale survey in 2020 on sustainable investments among its participants, and found that PPF's beneficiaries overwhelmingly supported the idea of integrating sustainability into the pension fund's investments. Moreover, participants signaled that they expected this integration, as sustainability was also a cornerstone in the daily routines of the (publicly listed) companies for which they worked (Philips and Signify). Many other Dutch pension funds are in the process of preparing or executing similar interactions with their beneficiaries.

In the UK and US, there are few examples of pension funds eliciting participants' sustainability preferences. As UK pension law is flexible in relation to DC arrangements, the USS offers participants the opportunity to reflect their own ethical concerns in their DC plan, stating:

...as long as a member has a clear understanding that the investment criteria may lead to a lower return, it is acceptable to permit members to select funds reflecting their own ethical views. To provide our members with the ability to reflect their views, the USS Investment Builder offers a number of ethical fund options. The

Ethical Lifestyle and Ethical self-select funds are based upon an ethical policy which draws upon best practice and the indications of USS member preferences identified in surveys of their views. (USS 2018: 1-2)

NEST, another UK occupational DC pension scheme, recently surveyed its members on responsible investments. One of the survey's key findings was that: 'People need to understand the benefits of responsible investment for them personally, alongside any broader environmental or social benefits' (Nest Insight 2020: 5). However, NEST did not further specify how it planned to transfer these insights to its sustainable investment program.

In the US, direct engagement with beneficiaries on nonfinancial preferences is virtually non-existent.⁴ There is some indirect evidence that funds align investment strategies with beneficiaries' preferences. US public pension plans with internally managed equity departments align their investment choices with the political leanings of their beneficiaries when deciding whether to incorporate CSR in their equity allocations (Hoepner and Schopohl 2019).

These examples indicate that many funds use surveys to explore their participants' preferences. Yet the academic literature on surveys shows that eliciting true preferences requires consequential choices (Vossler et al. 2012) which satisfy a number of other criteria to ensure that the results are not biased (Carson and Groves 2007). Consequently, one must be very careful in setting up these surveys and interpreting their results.

Case Study on Involving Beneficiaries: Pensioenfonds Detailhandel (PD)

Pensioenfonds Detailhandel (PD), the Dutch pension fund for the retail sector, is probably the first pension fund in the world to have granted its participants a real vote in shaping the direction of the fund's sustainable investment agenda. PD is an industrywide defined benefit

pension fund with more than a million participants; it is a medium-sized fund with approximately \$35 billion USD assets under management. The PD board consists of representatives of employers, employees, and retirees, and it is supported by a small management team (bestuursbureau) of around 10 staff members. Jointly, the board and management prepare and execute the pension fund's main activities. Guided by realism and pragmatism, they run a relatively straightforward investment program (Pensioenfondsen Detailhandel 2020).

PD's investment beliefs. In the investment context, the board's energy is focused on making strategic decisions regarding asset liability management and strategic asset allocation. PD invests in broadly diversified passive portfolios of public assets in the global equity, fixed-income, and real estate domains. Just a small fraction of assets under management is invested in private assets, mainly in Dutch real estate. Furthermore, PD ensures that what it delegates to financial service providers is governed well. The fund spends considerable resources on communication with plan beneficiaries regarding pension and investment matters.

In its public statement of investment beliefs (Pensioenfondsen Detailhandel 2020), PD signaled that it takes sustainable investments seriously. In 2017, the fund expressed a wish to involve its participants in its sustainable investment decisions, and the PD board then initiated a joint research project with Maastricht University resulting in two large-scale field surveys of PD participants.

At the time, PD had a limited divestment policy enforced by Dutch law. Article 21a of the Market Abuse Decree of the Financial Supervision Act prohibits Dutch pension funds (and other financial institutions) from investing in companies that contribute to the production of cluster munition (Van der Zwan et al. 2019). Since PD invested the large majority of its public assets in passive or buy-and-hold mandates, it did not yet integrate sustainable information into its

investment strategies. Instead, PD started voting by proxy to cover, where possible, its equity investments guided by internal voting guidelines. To ensure that it had direct control over the voting process, PD hired a professional and independent (from PD's asset manager) agency to execute and report on the proxy voting program. Moreover, the board instructed the agency to carry out a targeted shareholder engagement program with companies based on criteria related to three prioritized Sustainable Development Goals (SDG).

A real vote. In 2018, PD decided to directly involve participants in the strategic direction and prioritization of the voting and engagement programs. With Maastricht University researchers, it granted participants a real vote through a method similar to a referendum (Bauer et al. 2021). In a survey, PD first asked participants whether it should extend and intensify the current voting and engagement program by adding a fourth SDG, and by extending the number of engagements based on these SDGs. Second, the board *ex ante* committed to execute the majority's decision. A large majority of participants voted in favor of extending and intensifying the voting and engagement program and approved the proposed fourth SDG put forward by the board. One week after the survey, the board executed the participants' vote.

In the meantime, PD further developed its sustainable investment agenda. Inspired by the overwhelming participant support, the board decided to integrate the four SDGs (Decent Work and Economic Growth (8); Climate Action (13); Peace, Justice and Strong Institutions (16); and—newly added—Responsible Consumption and Production (12) into the equity investment decision process. With FTSE Russell, the fund developed an SDG-aligned index with the objective of creating a simple, transparent way to align a broad (developed and emerging) market portfolio including specific aspects of the SDGs. This approach was based on a detailed mapping exercise of FTSE Russell's sustainable investment research and the SDG framework (FTSE Russell 2020).

The final result was a blend of PD's strong investment beliefs in holding broadly-diversified portfolios, as well as the goal of integrating participants' preferences in their portfolios. The developed market SDG-aligned index portfolio consisted of well over 1,000 different companies spread across all major industries.

Continued support and COVID-19. In 2020, the PD board conducted another participant survey to explore whether the board's discretionary decision to create an SDG-aligned index in developed and emerging markets was supported. Moreover, the board was interested in finding out whether members were still in favor of extending and intensifying the voting and engagement program. Additionally, as COVID-19 emerged, the board wanted to know whether participants' sustainability preferences were affected by beliefs about the perceived long-term effects of the pandemic on retirement benefits. The results of this new survey showed that a large majority of participants still supported the extended voting and engagement program, and that they also agreed with the newly created SDG-aligned index. Moreover, the support for sustainable investments was not affected by the COVID-19 crisis, despite participants' lower expected retirement benefits (Bauer et al. 2021).

Eliciting Beneficiaries' Preferences

To further describe the two field surveys in which PD granted participants a real vote on its sustainable-investment policy, we next provide additional details on what was dubbed the 'Get Real' study (Bauer et al. 2021).

The elicitation method. In the field surveys with PD participants, we used a method to elicit participant preferences truthfully and in a way that required relatively little effort. First, we conducted a field survey with n=1,669 participants (Study 1). Pension benefits and monthly

contributions of participants in the Dutch regulatory context depend on the financial health of the pension fund. If the coverage (asset/liability) ratio of the fund is poor, then pension benefits can be cut and monthly pension contributions can increase, a situation that is not new to Dutch pension participants. PD's participants have already had to pay higher pension contributions in recent years as the result of the Global Financial Crisis, continuously decreasing interest rates, and strict solvency supervision by regulatory authorities. In addition, PD has cancelled indexation (as a correction for inflation) in eight out of the last 10 years, similar to what participants of most other pension funds in the Netherlands experienced.

The academic literature on surveys has extensively addressed the so-called 'hypothetical gap,' or the gap between what people *say* they do and what they *actually* do (List and Gallet 2001). Therefore it is crucial to explore real behavior rather than hypothetical choices. As part of Study 1, therefore, the board gave its members a real vote on the fund's future sustainable investment policy. Because of the above-described features, participants' benefits were directly at stake, making the vote highly relevant to their future financial situations. We informed participants that implementing sustainable development goals meant that the financial returns were not the only factor to take into consideration. Making investments with these goals in mind meant that considering the effect of investing on the environment and wider society was important as well.⁵

To elicit truthful preferences for sustainable investments, not only are consequential choices critical (Vossler et al. 2012); four other criteria should also be satisfied if possible (Carson and Groves 2007). First, participants have to actually care about the outcome of the survey. Second, an authority can enforce payments by voters. Third, the elicitation method involves a yes or no vote on a single project. Fourth, the probability that the proposed project will be implemented is weakly and monotonically increasing with the proportion of yes votes.

PD's discrete-choice field survey satisfied all four criteria. Participants' pension savings were indeed credibly at stake, and the board guaranteed it would implement the voting outcome, which satisfied criteria one and two. Furthermore, participants were given a consequential vote with only two choices, whereby the probability that more sustainable investments would be implemented was weakly, monotonically increasing with the proportion of yes votes, which satisfied the third and fourth criterion.

Empirical results. In Study 1, we found that 67.9 percent of participants favored increasing the pension fund's engagement to boost sustainability in investments. Only 10.8 percent were against the increase, while 21.2 percent had no opinion (see Figure 1). This voting outcome gave PD a clear mandate to increase and intensify its engagement program.

Figure 1 here

In addition to engagement, another frequently-used investment strategy is screening portfolios based on sustainability criteria (EUROSIF 2018). In PD's case, portfolio screening meant that it invested more in companies that scored high on the four SDGs, and less in companies that scored low. The results from a non-consequential question in Study 1 show that 74.4 percent of respondents also favored portfolio screening based on the four SDGs (see Figure 2).

Figure 2 here

We then explored three possibilities that could explain the support for sustainable investments (Bauer et al. 2021). First, participants might have a strong belief that sustainable investments financially outperform conventional investments. Second, participants could have strong social preferences in favor of sustainable investments in which case they may support sustainable investments even when these investments were financially costly. Third, subjects might not have taken their real choice seriously, or they could have simply been confused. We

concluded that social preferences, rather than financial beliefs about sustainable investments or confusion, drove participants' choice in favor of more engagement. Moreover, a validated measure of social preferences (Falk et al. 2018a; Falk et al. 2018b) was positively related to the choice for more sustainable investments. Even among participants who expected lower returns, 58 percent chose an extension of the engagement program. Additionally, people who voted for a political party with a more sustainability-focused agenda were more likely to support the vote. Importantly, the choice for sustainable investments was not influenced by different defaults, confusion, or a lack of information.

One week after we presented the findings of our study (November 2018), the pension fund's board of trustees decided to start a voting and engagement program with a larger number of companies, by increasing the intensity of engagement interactions with these companies, and by voting more often at shareholder meetings to improve the sustainability of the companies in which it invested. Supported by a majority of 74.4 percent of PD's beneficiaries, the board began considering introducing portfolio screening as part of the sustainable investment strategy, even though the board had not *ex ante* committed to the question on portfolio screening. Several months later, PD launched the SDG-aligned index on developed equities markets.

In June 2020, a second field survey was conducted with n=3,186 respondents (Study 2), seeking to investigate whether participants supported the actual implementation of sustainable investments by PD. Study 2 helped us understand whether the support for sustainable investments would last over time. It also allows us to test whether participants agreed with the actual implementation of the extended engagement program. Study 2 also allowed us to separately address support for engagement and portfolio screening.

Figure 2 displays the results of Study 2, and results show that neither time, nor the actual implementation, nor the differentiation between engagement and portfolio screening, diminished the strong support for sustainable investments. A majority of participants (56.5%), albeit a bit smaller, still supported the intensified engagement program. The actual introduction of portfolio screening in the SDG-aligned index was supported by 77.1 percent. Participants still favored a further intensification of sustainable investments after finding out how PD implemented its previous commitment. Again, social preferences emerged as the key driver of the support.

Panel A of Figure 3 shows the distribution of participants' financial beliefs within our sample in Study 2. It documents greater heterogeneity in the beliefs about the financial consequences of more sustainable investments. Participants were slightly more positive about the financial effect of portfolio screening than about the influence of engagement for their retirement benefits. On average, return expectations were clearly not overly favorable toward sustainable investing. Panel B of Figure 3 shows that participants are generally in favor of engagement and portfolio screening, regardless of return expectations. There was a small group of individuals (under 10%) who expected engagement and screening would result in much lower pension benefits. The same held for individuals who were unsure about the effects of engagement on their retirement benefits.

Figure 3 here

These findings are fully consistent with the results of Study 1 and provide initial evidence supportive of the idea that sustainable investments are strong over time. The special circumstances during the time of the second study allowed us to go one step further. In June 2020, when the second study was run, the COVID-19 pandemic had caused a period of significant economic downturn that negatively affected Dutch pension funds' balance sheets. This environment gave us

the opportunity to investigate how beliefs about an economic crisis affected the support for more sustainable investments.

COVID-19. Panel A of Figure 4 shows that a substantial subset of participants expected the COVID-19 crisis would (slightly) lower their retirement benefits. Additionally, one-third of respondents felt the pandemic would eventually have no effect on their pension benefits, and 16.3 percent did not know. This belief distribution shows that, in June 2020, participants saw the economic effect of the COVID-19 pandemic as more than just a minor, temporary economic recession. Nonetheless, as shown in Panel B, the support for sustainable investments remained strong during the global pandemic.

Figure 4 here

Despite its strengths, this approach has two limitations. First, participants in Study 1 did not have a choice about whether sustainable investing should be introduced, but only had a choice on whether to increase the focus on sustainable investments. In essence, it was a conditional and restricted choice put forward by PD's board. Before the vote, the fund already engaged in sustainable investments by prioritizing three SDGs. Studying a case in which sustainable investments are introduced from scratch would give us an even richer research environment.

Second, the PD surveys had relatively low response rates of 6.7 percent and 6.3 percent, respectively. Response rates for similar surveys in the pension industry are similarly low since people rarely interact with their pension funds (Debets et al. 2018). For this reason it is important to establish the representativeness of the respondents. Since the political preferences of our sample proved to be similar to the outcome of the last Dutch national election, we believe we have little bias in our sample.

Conclusion

We have explored whether beneficiaries of DB and DC pension plans have a voice in the fund's sustainable investment agenda, and we hypothesized that the answer to this question depends on a fund's legal and societal contexts, benchmarking pressure, and fund-specific factors such as the fund's size and the board's composition. We have found great heterogeneity in the degree to which beneficiaries are engaged with or involved in their pension fund decision-making. In many cases, investment policy remains purely a board matter, and at best, most DC participants can select a sustainability fund in the fund menu. Generally, however, the features of this option are solely determined by asset managers and the asset owners that hire them. Beneficiaries do not have a vote.

In some countries, mostly in Europe and the UK, pension fund boards are increasingly being pushed to emphasize engagement with participants on strategic matters, as well on sustainable investments. Particularly in the Netherlands, a number of pension funds have started a dialogue with their participants, mainly using surveys. We also discussed a real-world example of a Dutch pension fund that gave its participants a vote in choosing the intensity and focus of the sustainable investment policy, while avoiding the pitfalls that come with hypothetical surveys on individuals' preferences.

We conclude that, irrespective of a fund's legal and board's beliefs and preferences, it is valuable to understand how participants think about the topic of sustainable investments. Trust in the financial sector, including the pension fund sector, plummeted after the Global Financial Crisis. A better understanding of the beliefs and preferences of the clients of financial services is an important tool to bring back confidence in the financial sector. Beyond this argument, earlier research shows that the clients of financial services who strongly identify with their service

provider are more likely to be loyal customers (Bauer and Smeets 2015). Since collective pension systems experience much pressure, paying attention to beneficiaries' preferences and beliefs may help the funds provide more sustainable plans in the old-fashioned meaning of the words.

Many young millennials across the globe are active in pressing decision-makers on global challenges such as climate change, inequality, and human rights violations of many kinds. This cohort will demand a voice, and if it does not feel heard, pension systems may lose the intergenerational commitment needed to provide adequate and sustainable retirement solutions for all of us. Ultimately, trustworthiness is a pension fund's most valuable asset.

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Endnotes

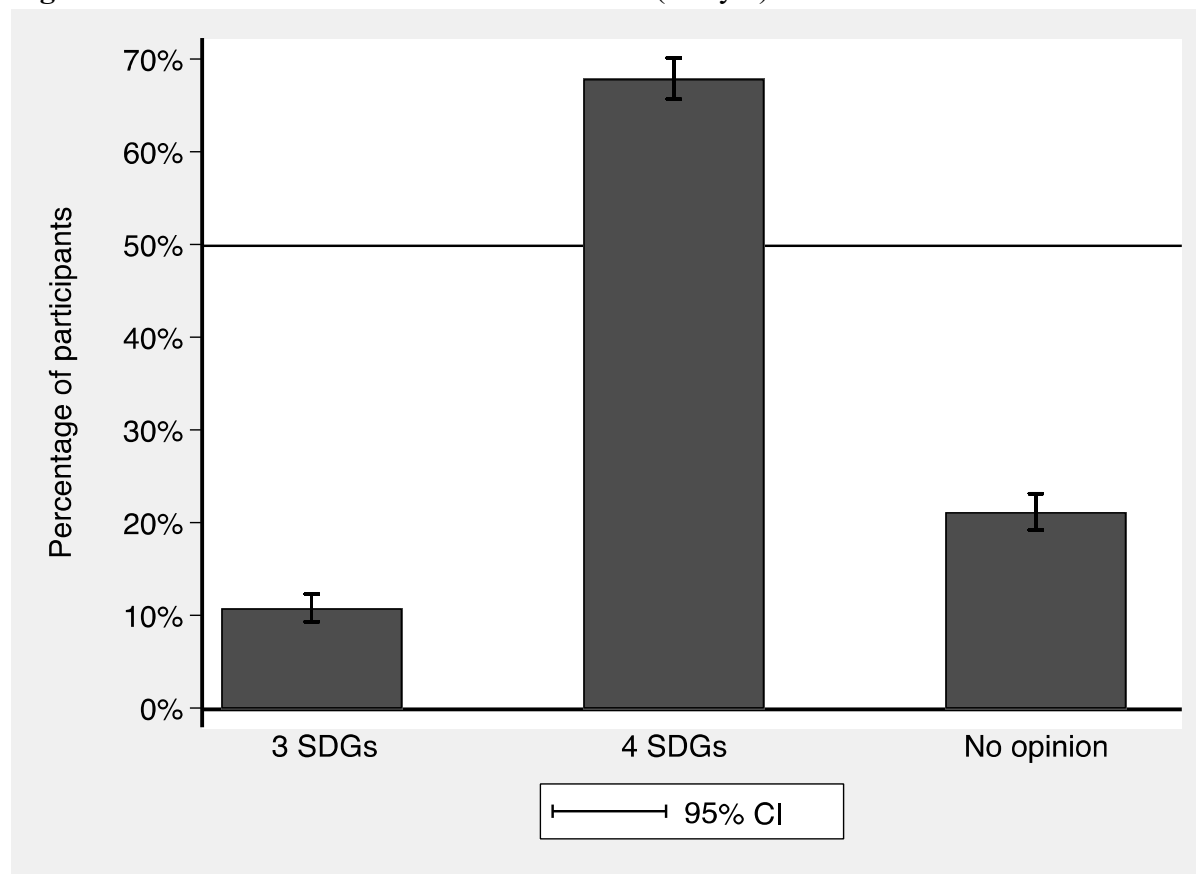
¹ More information can be found in Principles for Responsible Investment (PRI) (2021) and Climate Action 100+ (2021).

² We use these terms interchangeably, which may be up for debate.

³ The term ‘nonfinancial’ may be a bit confusing as material sustainability information does provide insight into a company’s risks and opportunities beyond the regular financial information. It complements the information set for any investment decision-maker and at all levels of the investment process. It also shows that some nonfinancial information is not material for financial decisions, and some is.

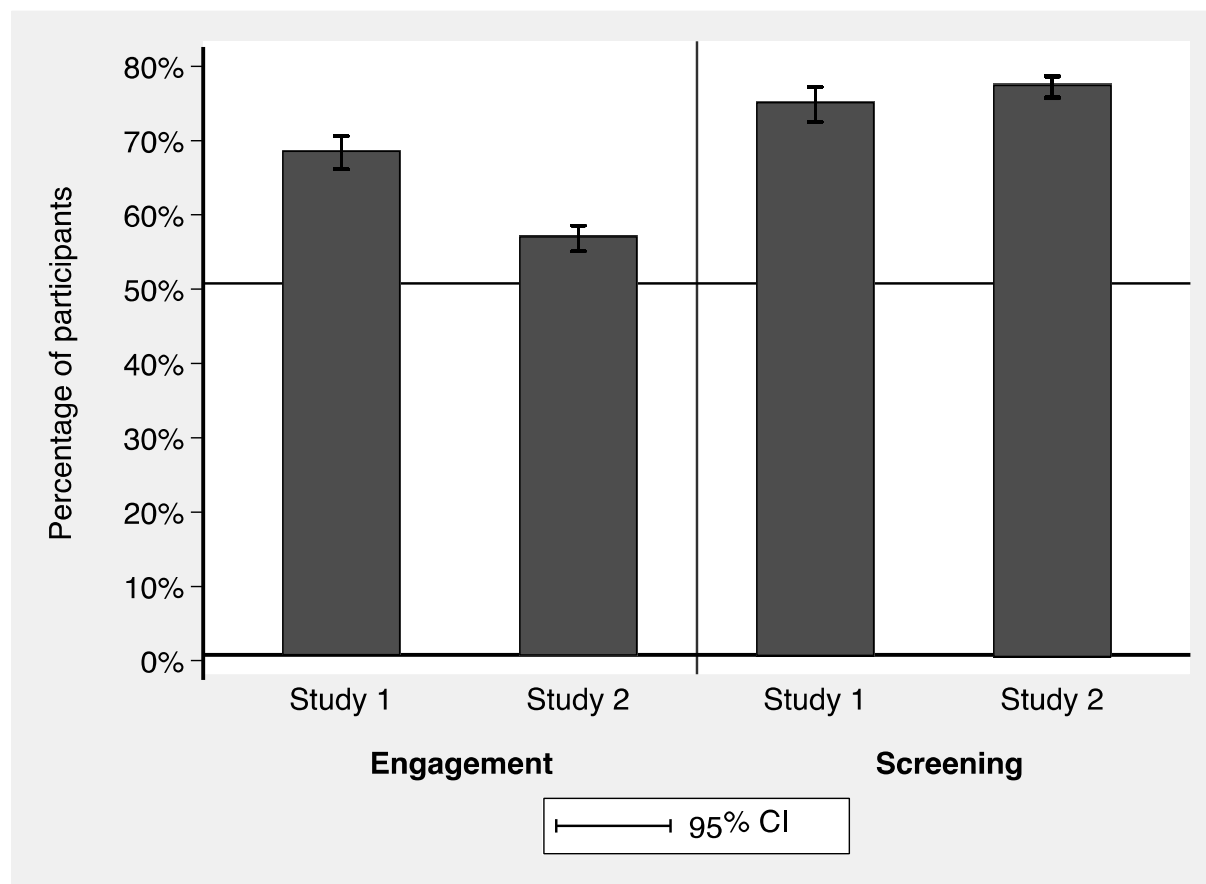
⁴ We welcome information on other examples of beneficiary involvement in the US.

⁵ Several academic papers on sustainable investment behavior have been published (e.g., Riedl and Smeets 2017; Hartzmark and Sussman 2019) focusing mainly on retail clients in the mutual fund sector. To our knowledge, very few papers have focused on eliciting the preferences for pension fund investments from the beneficiaries.

Figure 1. Preferences for sustainable investments (study 1)

Notes: The graph presents the distribution of choices for the following question: ‘Do you want Pensioenfonds Detailhandel to add the fourth sustainable development goal “Responsible consumption and production”? Yes, add; No, do not add; I have no opinion regarding this matter,’ and takes on the corresponding three values: ‘3 SDGs,’ ‘4 SDGs,’ and ‘I have no opinion regarding this matter.’ 3SDGs refers to the sustainable development goals of ‘Climate action,’ ‘Decent work and economic growth,’ and ‘Peace, justice, and strong institutions,’ which the pension fund had already focused on prior to 2018. 4 SDGs refers to the three SDGs just mentioned plus the fourth SDG, ‘Responsible consumption and production,’ which participants are introduced to during the survey. The above-stated question refers to the default treatment where participants can add the fourth SDG. The default where participants can remove the fourth SDG is treated analogously, for brevity, without providing further explanation here. Choices are guaranteed to be implemented by the pension fund if more than 50% of respondents choose in favor of three (four) SDGs. Error bars represent 95% confidence intervals.

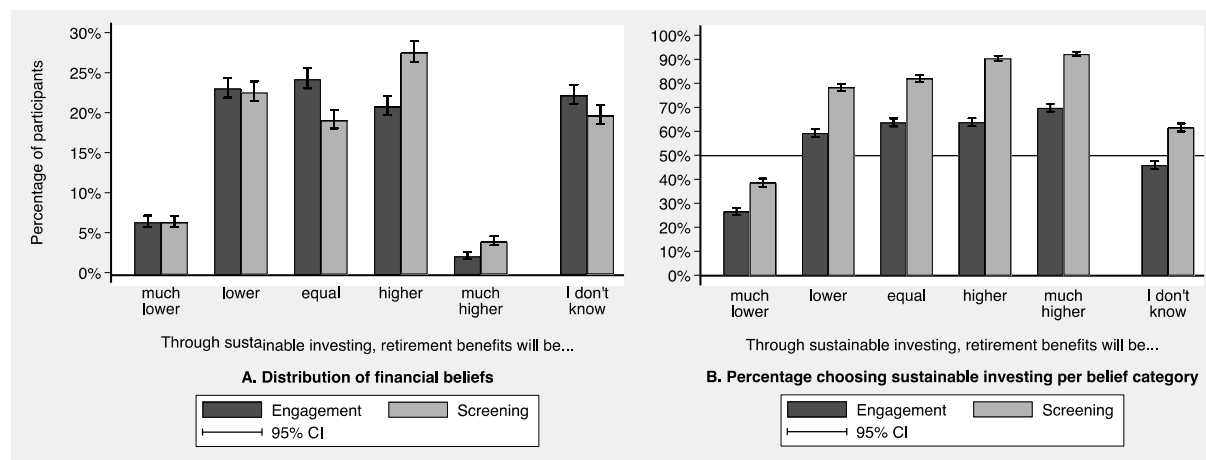
Source: Bauer et al. (2021).

Figure 2. Preferences for Engagement and Screening (studies 1 and 2)

Notes: The graph presents the share of participants in favor of engagement and screening, respectively. Results for studies 1 and 2 are shown separately. The question on engagement in study 1 is, ‘Do you want Pensioenfonds Detailhandel to add the fourth sustainable development goal “Responsible consumption and production”?’ Answer options are ‘Yes, add,’ ‘No, do not add,’ and ‘I have no opinion regarding this matter.’ The fourth SDG refers to ‘Responsible consumption and production,’ which participants are introduced to during the survey and is in addition to the SDGs ‘Climate action,’ ‘Decent work and economic growth,’ and ‘Peace, justice, and strong institutions,’ which the pension fund had already focused on prior to 2018. For a full distribution of answers, see Figure 1. The question on screening in study 1 is, ‘Do you prefer Pensioenfonds Detailhandel to invest more in companies that score high on environmental, social and governance factors and less in companies that score low?’ Answer options are ‘Yes,’ ‘No,’ and ‘I do not know.’ For a full distribution of responses, see Figure A1, panel A. The question on engagement and screening in study 2 is, ‘With which of the two parts of the sustainable investment strategy of Pensioenfonds Detailhandel do you agree?’ Answer options are (1) ‘More intensive dialogue with companies,’ (2) ‘Investing more in companies that score well on sustainability,’ (3) ‘Both,’ (4) ‘None,’ and (5) ‘I do not know.’ For a full distribution of responses, see Figure A1, panel B. The fraction that supports engagement is the sum of participants who agree only to more

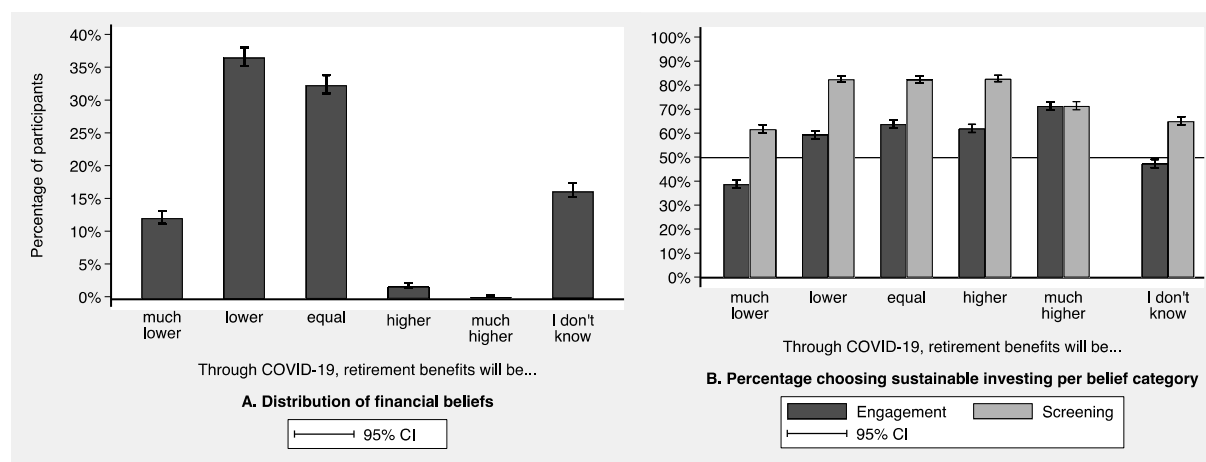
engagement and those who agree to both engagement and screening. The fraction that supports screening is the sum of participants who agree only to more screening and those who agree to both screening and engagement. Error bars represent 95% confidence intervals.

Source: Bauer et al. (2021).

Figure 3. Financial beliefs about sustainable investing (study 2)

Notes: Panel A shows the distribution of financial beliefs. Return expectations for engagement are elicited by asking participants the following questions: ‘How do you think that the dialogue that Pensioenfond Detailhandel enters into with companies to enhance their sustainability will influence your retirement benefit once you retire?’; return expectations for screening through the question ‘How do you think that the choice to invest more in companies that score well on sustainability and less in companies that score poor on sustainability will influence your retirement benefit once you retire?’ Answer options in both cases are (1) ‘lowers my retirement benefits a lot,’ (2) ‘lowers my retirement benefits a little,’ (3) ‘has no influence on my retirement benefits,’ (4) ‘increases my retirement benefits a little,’ (5) ‘increases my retirement benefits a lot,’ and (6) ‘I don’t know.’ Panel B presents the percentage of participants who agree to engagement or screening for each return expectation separately. The share of sustainable investing refers to the question, ‘With which of the two parts of the sustainable investment strategy of Pensioenfond Detailhandel do you agree?’ Answer options are (1) ‘More intensive dialogue with companies,’ (2) ‘Investing more in companies that score well on sustainability,’ (3) ‘Both,’ (4) ‘None,’ and (5) ‘I do not know.’ For a full distribution of responses, see Figure A1, panel B. The fraction that supports engagement is the sum of participants who agreed only to more engagement and those who agree to both engagement and screening. The fraction that supports screening is the sum of participants who agree only to more screening and those who agree to both screening and engagement. Error bars represent 95% confidence intervals.

Source: Bauer et al. (2021).

Figure 4. Beliefs about the influence of COVID-19 on retirement benefits (study 2)

Notes: Figure 5, panel A, shows the distribution of financial beliefs about the impact of COVID-19 on retirement benefits. Beliefs about the impact of COVID-19 on retirement benefits are elicited by asking participants the following question: ‘How do you think that the corona crisis will influence your retirement benefits once you retire?’ Answer options are (1) ‘it will lower my retirement benefits a lot,’ (2) ‘it will lower my retirement benefits a little,’ (3) ‘it eventually has no influence on my retirement benefits,’ (4) ‘it will increase my retirement benefits a little,’ (5) ‘it will increase my retirement benefits a lot,’ and (6) ‘I don’t know.’ Figure 5, panel B, presents the percentage of participants agreeing with engagement or screening for each COVID-19 belief category separately. The share of sustainable investing refers to the question, ‘With which of the two parts of the sustainable investment strategy of Pensioenfond Detailhandel do you agree?’ Answer options are (1) ‘More intensive dialogue with companies,’ (2) ‘Investing more in companies that score well on sustainability,’ (3) ‘Both,’ (4) ‘None,’ and (5) ‘I do not know.’ For a full distribution of responses, see Figure A1, panel B. The fraction that supports engagement is the sum of participants who agree only to more engagement and those who agree to both engagement and screening. The fraction that supports screening is the sum of participants who agree only to more screening and those who agree to both screening and engagement. Error bars represent 95% confidence intervals.

Source: Bauer et al. (2021).