

## ***Responsible investing and investment costs***

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### 1. Executive summary

Many boards of pension funds struggle with the question as to how to implement responsible investing or an ESG (Environmental, Social, Governance) investment approach. Besides the impact on return and risk, cost considerations also play a role in board discussions. This research paper investigates whether responsible investing leads to higher asset management costs and transaction costs. I have used the VBDO report 'Benchmark Responsible Investing by Pension Funds' which covers the 50 largest Dutch pension funds to assess the extent to which each fund has managed to implement a responsible investment or ESG integration approach in its policy and organisation. The conclusion is that higher scores on responsible investing do not coincide with higher asset management costs or transaction costs. Responsible investing therefore does not necessarily require a higher cost budget than investing without regard to ESG. Pension funds can pay more attention to ESG considerations in their investment approach without increasing the overall asset management costs in three ways: 1) Shift investments from 'traditional active management' to 'ESG active management'; 2) Switch from traditional benchmarks to benchmarks with an ESG filter; and 3) Apply active engagement policy in combination with an increase in passively managed assets.

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## 2. Introduction

Responsible investing is taken as a matter of course in the investment approach of many pension funds. Some pension funds consider it to be a logical consequence of their fiduciary responsibility towards the pension scheme members. In their view, the investing of pensions provision should take into account the impact on environment and society in the long term. Also many pension scheme members are in favour of taking into account non-financial criteria into the investment approach.<sup>2</sup>

Other pension funds consider ESG (Environmental, Social, Governance) integration in the valuation and risk assessment of investments as a risk mitigating measure. The reasoning behind this approach is that investing in non-sustainable business comes with a financial risk. Reputation risk is also an important motive for a pension fund board not wanting to lag behind with respect to responsible investing. Finally, there are also pension funds which choose to stick to the bare legal minimum requirements.

Many boards of pension funds struggle with the question as to how to implement an ESG investment approach. One key question in discussions concerning responsible investing is whether it hurts the investment return. A lot of academic research has been done, mainly on equity investments, which shows that two effects play a role here. On the one hand, so called 'sin stocks' yield an above average investment return.<sup>3</sup> These are stocks in companies that produce weapons, produce tobacco, or operate casinos etc. Exclusion of those stocks or restricting the share of those investments brings opportunity costs: a lower return on investments than otherwise could have been earned. On the other hand, applying ESG criteria leads to avoiding investments with a strong downside risk. The governance factor is the most important determinant: companies that are being led by boards where board nominations are politically driven and where stockholders' rights are being curbed, tend to suffer larger losses or end up bankrupt more often. The combined effect leads to investment portfolios that earn an investment return that is similar to or somewhat higher than portfolios without exclusions policies and ESG integration.<sup>4</sup>

The question whether responsible investing itself, causes higher asset management costs is being asked less often. This research paper addresses precisely this question. In paragraph 3 I give an overview of the data sources used. Paragraph 4 describes the analyses. In

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<sup>2</sup> E.g. [Bauer, Ruof & Smeets \(2018\), "Get real! Individuals prefer more sustainable investments," working paper Universiteit Maastricht.](#)

<sup>3</sup> E.g. [Trinks, P.J.. & Scholtens, B. \(2017\), The opportunity cost of negative screening in socially responsible investing.'](#)

<sup>4</sup> E.g. the following overview papers: [Sustainable Pension Investment Lab \(2017\), 'The Financial Return of Responsible Investing.'](#), [Friede, Busch & Bassen \(2015\), "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies," Journal of Sustainable Finance & Investment, Volume 5, Issue 4, p. 210-233.](#) [Khan, Serafeim & Aaron Yoon \(2017\), "Corporate Sustainability: First Evidence on Materiality," The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.](#)

paragraph 5 I look at responsible investing from the perspective of cost efficiency and I formulate three recommendations to pension funds. All regression results are documented in the statistical appendix.

### 3. Data and methodology

The extent to which a pension fund has integrated responsible investing in its policies and investment operations is a difficult question to answer. Instead of developing my own arbitrary methodology, I have used the results derived by VBDO in its benchmark studies in 2017 and 2018.<sup>5</sup> The VBDO publishes a ranking of the 50 largest pension funds based on four criteria: governance, policy, implementation and accountability. For each of these a score between 1 and 5 is given, which is combined to an overall score in which the score for implementation counts for 50% and the other three count for 16.67% each.

Table 1 shows the characteristics of the (partial) scores in 2018. The dispersal of each of the partial scores is more or less the same. Table 2 shows the correlations of the partial scores: values of 0.7 or 0.8 are caused by a high degree of interconnectedness.

	overall	governance	policy	implementation	accountability
average	3.0	3.5	3.1	2.7	3.2
std.dev.	1.0	1.2	1.0	1.1	1.1
maximum	4.8	5.0	5.0	4.8	5.0
minimum	0.6	0.4	1.0	0.2	1.0

Table 1: Characteristics of VBDO (partial) scores 2018

correlation matrix	governance	policy	implementation	accountability
governance	1			
policy	0.8	1		
implementation	0.8	0.8	1	
accountability	0.8	0.8	0.7	1

Table 2: Correlation between VBDO partial scores 2018 (n=50)

In the ranking list of 2018 there is one incumbent pension fund, therefore 49 pension funds are in both lists. I used those 49 pension funds for the comparison of scores between 2018 and 2017, see table 3. The change in partial scores for implementation shows a somewhat lower dispersal than for the other three criteria. Table 4 shows that the changes in partial scores have low correlations.

	overall	governance	policy	implementation	accountability
average	0.1	0.1	0.1	0.1	0.1
st.dev.	0.4	0.8	0.6	0.4	0.6
maximum	0.7	1.7	1.5	1.1	1.2
minimum	-0.8	-1.9	-1.5	-0.9	-2.0

Table 3: Characteristics of changes in VBDO (partial) scores 2018 versus 2017 (n=49)

<sup>5</sup> See [VBDO Benchmark Responsible Investment by Pension Funds in the Netherlands 2017 & 2018](#).

correlation matrix	governance	policy	implementation	accountability
governance	1			
policy	0.3	1		
Implementation	0.5	0.1	1	
Accountability	0.0	0.5	0.1	1

Table 4: Correlation between changes in VBDO partial scores 2018 versus 2017 (n=49)

The Dutch Central Bank, DNB, publishes the asset management costs and transaction costs of individual pension funds annually.<sup>6</sup> I have used the data of book years 2016 and 2017. As the VBDO benchmark 2018 applies to the book year 2017, and the VBDO benchmark 2017 applies to the book year 2016, I have linked the cost data of 2017 to the VBDO scores of 2018 and the cost data of 2016 to the VBDO scores of 2017. The pension funds in the VBDO benchmark 2018 are the 50 largest Dutch pension funds, which have at least € 2.8 bn. assets under management.

Asset management costs	Book year 2017	Book year 2016	Difference from year to year
average	0.41%	0.39%	0.02%
st.dev.	0.15%	0.14%	0.05%
maximum	0.73%	0.66%	0.21%
minimum	0.09%	0.10%	-0.12%

Table 5: Asset management costs of pension funds in the VBDO Benchmark 2018 (n=50)

The asset management costs of the 50 largest funds have increased slightly, by 2 basis points. On an aggregated level, the cost increase amounts to € 5.4m. Within the group of 50 pension funds, 13 pension funds had their costs decreased, 5 kept the same cost level and 32 had their costs increased.

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<sup>6</sup> See [DNB statistics website](#).

## 4. Responsible investing and investment costs: applied analyses

The first question to be addressed is whether the level of costs depends on the VBDO score.<sup>7</sup> I conducted a regression analysis of the asset management costs in 2017 of the 49 pension funds on the VBDO overall score in 2018. There appears to be no statistically significant relation (see table 6 in the statistical appendix<sup>8</sup>). The same goes for the asset management costs in 2016 (see table 7). Pension funds with a higher VBDO score do not necessarily have higher asset management costs.

I applied the same analysis to the transaction costs. In neither of both book years is there a relation between the level of transaction costs and the VBDO score (see tables 8 and 9).

Does the change in asset management costs of pension funds depend on the change in their VBDO score (labelled as  $\Delta$  VBDO score)? There appears to be a slightly positive relation (at 5% statistical confidence level) between the increase of the overall score and the increase in asset management costs (see table 10).

This overall score is composed of the four partial scores, so we can investigate the impact of each of these partial scores separately. I conducted a regression analysis on the change in each of the partial scores (see table 11). The change in the governance score appears to be the most dominating explanatory factor. Of the cost increase of 0.02% there is 0.002% that can be statistically explained by the increase in governance score, so only one tenth. In euros this is less than € 10,000 cost increase per pension fund. The statistical relation of  $\Delta$  VBDO score however is not statistically significant at the 5% confidence level.

We can conclude that (a change in) the VBDO score has no relation with asset management costs and transaction costs. Responsible investing does not necessarily imply higher investment costs than investing without paying attention to ESG.

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<sup>7</sup> In my previous [research paper](#) (Dutch version available only) I investigated the relation between the level of asset management costs and the volume of assets under management. For pension funds on an aggregated level no economies of scale are visible.

<sup>8</sup> To enhance readability I have included the regression results in the statistical appendix.

## 5. Cost efficient investing and responsible investing: 3 recommendations for pension funds to increase their ESG integration without increasing asset management costs

What can pension fund boards do to increase the ESG integration in their investment policy and operations, without causing asset management costs to rise? I have three recommendations.

### 1) *Shift investments from 'traditional active management' to 'ESG active management'*

The pension funds' assets are to a large extent in actively managed funds or mandates. This implies that the fund manager or portfolio manager is supposed to outperform a benchmark. This involves higher asset management costs than passive management, by which I mean investing according to a benchmark without the aim of outperforming it. An investment approach that takes ESG into account in its selection and risk analysis is more labour intensive and may therefore also involve a higher asset management cost than a passive approach. However, by shifting assets from 'traditional active management' to 'ESG active management' the asset management costs do not have to increase.

### 2) *Switch from traditional benchmarks to benchmarks with an ESG filter*

Many pension funds use well-known benchmarks such as the MSCI indices for equity portfolios. By filtering out those companies that are exposed to a high ESG risk score, a benchmark based on a smaller universe can be composed. Such a benchmark has the advantage that ESG considerations are being taken into account in the investment portfolio, while it still leaves room for active management: the ESG filtered universe is sufficiently broad for any successful active manager to outperform such a benchmark. The cost of actively managing assets against an ESG benchmark need not be higher than against any traditional benchmark. Many ESG indices are available nowadays.<sup>9</sup>

### 3) *Apply an active engagement policy in combination with an increase in passively managed assets*

The motivation of many pension funds to adopt responsible investing is that investment choices, for equity financing of companies as well as for debt funding of companies and governmental bodies, should have a positive non-financial impact. In the case of listed stocks, this means for every sell transaction there is a buy transaction of the stock; the world does not change because of the transaction. For example, composing a "low CO<sub>2</sub> emissions"

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<sup>9</sup> E.g. the [Dow Jones Sustainability Indices](#), the [MSCI ESG Indices/MSCI Socially Responsible Investment \(SRI\) Indices](#), and the [FTSE4Good indices](#).

portfolio does not impact companies. According to some experts excluding or restricting specific investments does not really make impact.<sup>10</sup> For making real impact there are alternative approaches.

The first alternative is impact investing: investing in equity or debt aimed at a measurable positive impact on social or environmental criteria besides earning a financial return. A well-known example is microfinance. The disadvantage is lack of scalability. The management of those investments is expensive, just as with normal private debt or private equity investments. This is because it requires specialist expertise and more operational controls; it is therefore not suitable for every pension fund.

Between impact investing and traditional investing there is also the investment opportunity of green bonds and social impact bonds. Companies or organisations raise funding from capital markets through those bonds in order to fund specific projects with a measurable non-financial goal. This asset class also requires specialist expertise. This is only a suitable asset class for those pension funds that have that expertise in-house.

An alternative that can be applied by many pension funds however, is active engagement policy. This means that the pension fund actively uses its voting rights as a shareholder in companies<sup>11</sup> or its influence as funder of debt in order to impact the behaviour of the corporation or organisation that issued the shares or bonds. To do this, the pension fund should ideally be the legal owner of the shares or bonds.<sup>12</sup> The pension fund is free to pursue its own engagement policy, or to do so in coalitions with like-minded institutional investors. The board of the pension fund can also decide whether to establish an engagement policy and leave the execution of it to a specialised party. Active engagement policy as such, will require a budget; this can easily be earned by making a small shift from actively to passively managed assets in the portfolio allocation.

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<sup>10</sup> See [Brest, P. en Born, K. \(2013\), "Unpacking the impact in impact investing."](#)

<sup>11</sup> Which also comprises proxy voting: delegating its voting right to a third party.

<sup>12</sup> In case of investments in mutual funds or ETFs the fund manager is the legal owner of the underlying shares or bonds. The fund manager then decides on engagement policy, if any. When selecting a fund manager, a pension fund can indirectly use its influence by taking into account the voting policy of the fund manager in its selection criteria.

## Statistical appendix

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.003851	0.000692	5.563843	1.22E-06
VBDO score	9.42E-05	0.00022	0.428866	0.66998

Table 6: regression of asset management costs in 2017 on VBDO score 2018 (n=49)

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.003293	0.000633	5.204157	4.2E-06
VBDO score	0.000217	0.000207	1.048229	0.299894

Table 7: regression of asset management costs in 2016 on VBDO score 2017 (n=49)

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.001142	0.000202	5.642588	9.31E-07
VBDO score	-1.7E-05	6.42E-05	-0.26978	0.788513

Table 8: regression of transaction costs in 2017 on VBDO score 2018 (n=49)

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.001426	0.000218	6.547327	3.98E-08
VBDO score	-0.00013	7.12E-05	-1.77407	0.082529

Table 9: regression of transaction costs in 2016 on VBDO score 2017 (n=49)

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.000175	6.99E-05	2.505723	0.015741
$\Delta$ VBDO score	0.000400	0.000187	2.137259	0.03781

Table 10: regression of change in asset management costs on change ( $\Delta$ ) in VBDO score (n=49)

	<i>Coefficients</i>	<i>Standard error</i>	<i>T- statistic</i>	<i>P-value</i>
Intercept	0.000183	7.15E-05	2.559601	0.013992
$\Delta$ Gov	0.000201	0.000104	1.933927	0.05957
$\Delta$ Pol	0.000039	0.000134	0.294166	0.770014
$\Delta$ Impl	0.000054	0.000189	0.286335	0.775966
$\Delta$ Acc	0.000011	0.00013	0.086343	0.931585

Tabel 11: regression of change in asset management costs on change ( $\Delta$ ) in VBDO partial scores (Gov: governance. Pol: policy. Impl: implementation and Acc: accountability) (n=49)