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INITIATIVE FOR RESPONSIBLE INVESTMENT

HARVARD Kennedy School THE HAUSER INSTITUTE FOR CIVIL SOCIETY at the Center for Public Leadership

Sustainable Investing in Private Wealth Management

Barriers for Sustainable Investing in the Cognition and Decision Making Processes of Private Wealth Holders and Investment Advisors

Falko Paetzold, 12.03.2015

Fellow, Initiative for Responsible Investment at Harvard University
Researcher, Dept. of Banking and Finance at University of Zurich & M-TEC at ETH Zurich
President, GreenBuzz Zurich & -Global

Phone: +1 (857) 999-5295 I +41 (0)76 521 07 21
Email: Falko_Paetzold@hks.harvard.edu I falko.paetzold@greenbuzz.ch
Skype: falkopaetzold
Web: http://hausercenter.org/iri/ I www.greenbuzz.ch

Activities Falko Paetzold

University of Zurich[UZH]

Department of Banking and Finance

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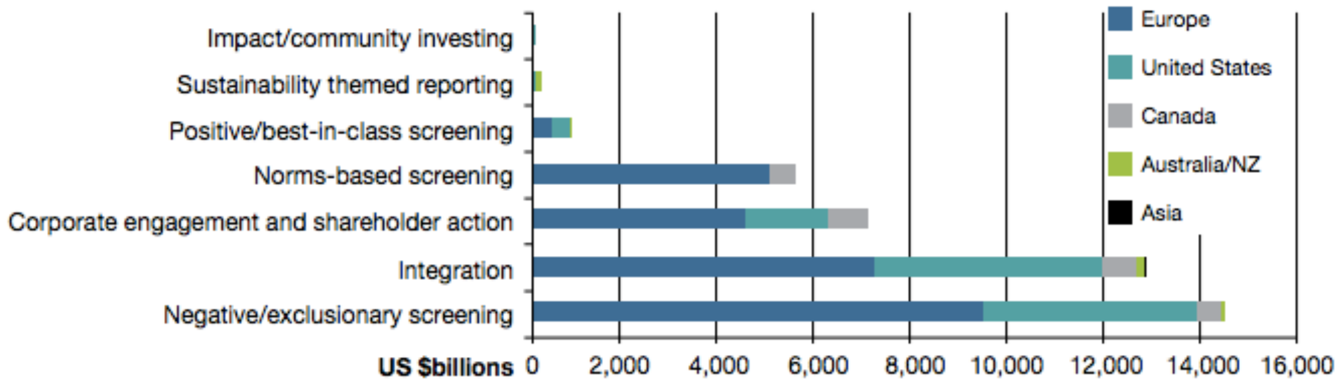
Connecting professionals for sustainability

Definition of Sustainable Investing: It's not all ethics, wind and solar

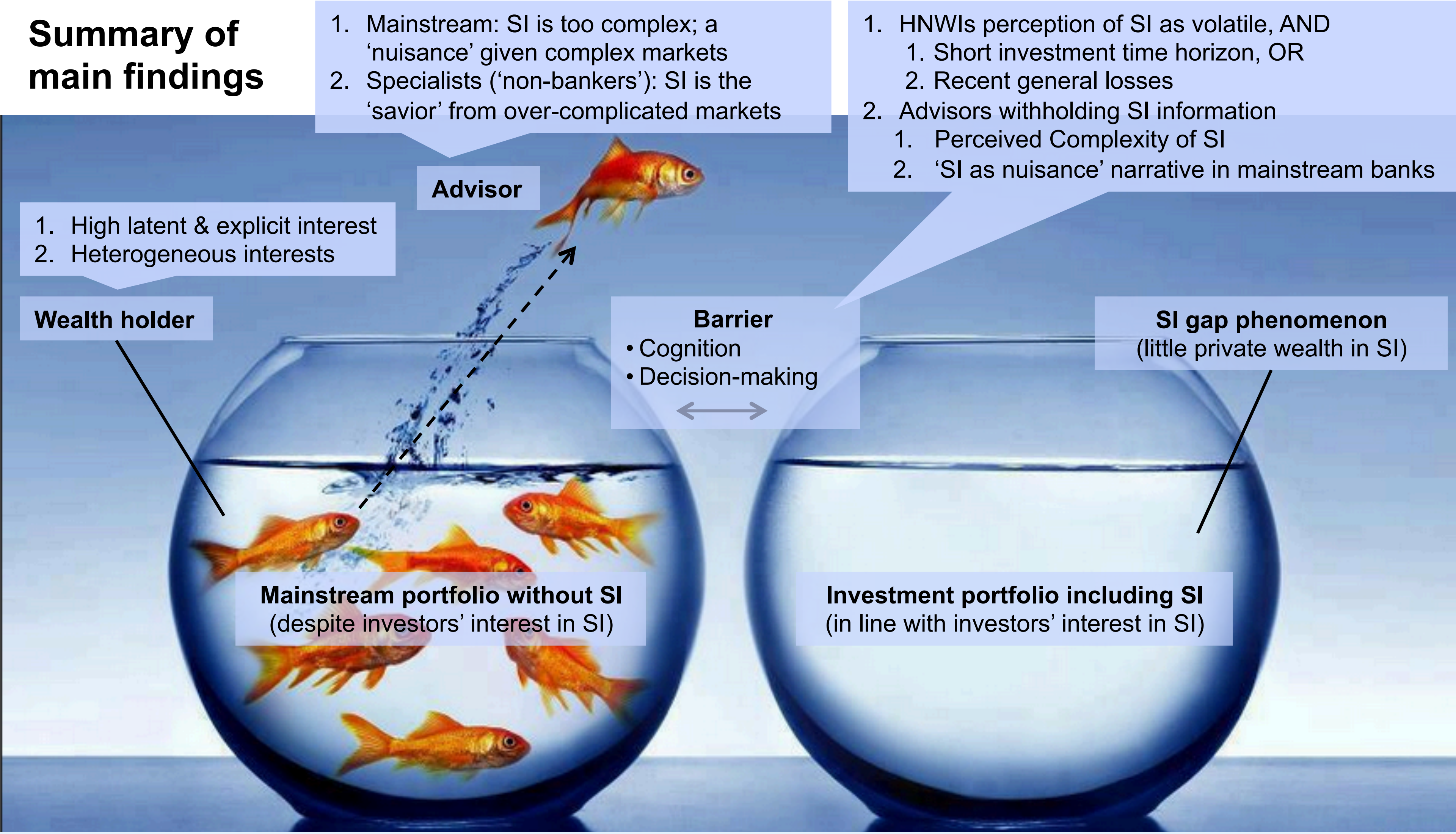
Sustainable investing (SI) is commonly understood as to "integrate certain kinds of non-financial concerns – variously called **ethical, social, environmental or corporate governance criteria** – in the otherwise strictly financials-driven investment process" (Sandberg et al., 2008).

Global sustainable investments by strategy and region, 2014, in $US Bn.



Source: GSIA. (2014). *Global Sustainable Investment Review 2014*. GSIA. Retrieved from http://www.gsi-alliance.org/

Summary of main findings



Research question: What barriers arise in the cognition and the decision-making processes of private wealth holders and their advisors in the context of sustainable investing?

"Don't worry": This research is problem-driven instead of paradigm-driven, as it starts with a phenomenon in the world that is worth explaining, instead of theoretical paradigms (Davis, forthcoming)**.**

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Summary of 3 papers covered in PhD

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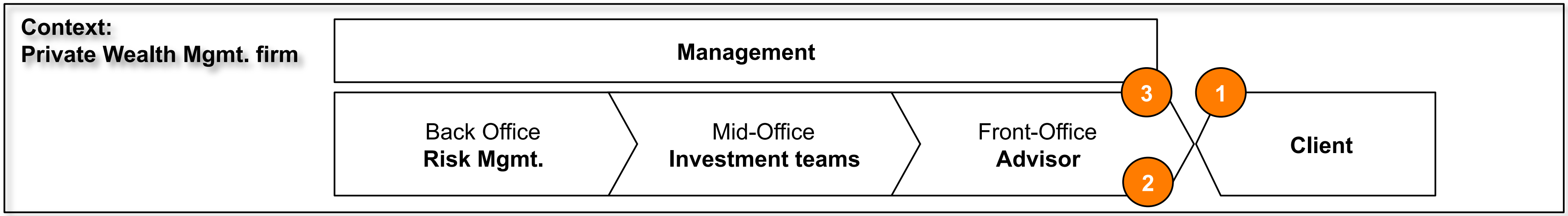


	Title	Research Question	Method & Data	Finding	Outlets
1	Unleashing the Powerful Few: Sustainable Investing Behaviour of **Wealthy Private Investors** *Paetzold & Busch*	What are the **barriers** that limit the engagement of **private investors** in Sustainable Investing?	Analytic induction, **interviews** with 14 HNWI clients at 1 bank	HNWIs are interested in SI, yet limited by perception of SI as **volatile;** and even those **advisors** that have been trained on SI actively keep SI information from their clients.	Organization & Environment (12/2014)
2	More than Money: Why **Investment Advisors** Rarely Talk About Sustainable Investing *Paetzold, Busch, Chesney*	Do investment **advisors neglect to communicate about sustainable investing** in their client discussions, and, if so, why?	Regression, **survey** with 95 HNWI investment advisors at 2 banks	**Low level of communication about SI** relates to **advisors' perception of SI** in regard to **complexity**, financial return, trust in providers, perceived consumer effectiveness, client wealth, PR stunt	Annals of Social Responsibility (1st R&R)
3	Complex Markets vs. Complex Customer Needs: How **Investment Advisors'** Narratives Enable or Constrain Sustainable Investing *Paetzold & Marti*	What **narratives** do investment advisors use in the context of sustainable investing, and how do these narratives **enable or constrain advisors to communicate with customers about sustainable investing**?	Analytic induction, **interviews** with 22 HNWI investment advisors at 3 banks	Mainstream advisors discuss SI as a **nuisance** that challenges their operational efficiency given complex markets. Specialist advisors position SI as the **savior** for conflicts of interest and **shift complexity** from markets to clients.	Journal of Business Ethics or Organization Studies

Rational for Sustainable Investing: Doing well by doing good

Financial perfor-mance	▪ Literature is focussed on **financial performance** (Gond et al., 2011) ▪ SI mutual **funds**: risk-adjusted performance "not statistically different from the performance of conventional funds" (Renneboog, Ter Horst, & Zhang, 2008, p. 1) ▪ Individual **firms**: no negative performance implications, indications for outperformance (e.g., Albertini, 2013; Orlitzky, Schmidt, & Rynes, 2003; Surroca, Tribó, & Waddock, 2010) ▪ Strong underlying trends point to financial performance argument (e.g., see IPCC reports)
Extra-financial benefits	▪ '**Warm-glow**', ethical concerns, social status (e.g., Andreoni, 1990; Statman, 2004) ▪ Avoid **Cognitive Dissonance** (Festinger, 1957) ▪ **Impact logic**: Investors are key drivers of firm behaviour and the development of society ▪ Financialization of society (Krippner, 2008), with capital markets as the "brain of the economy" (Mishkin, 2006),

The good news: Private investors including the wealthy are interested in Sustainable Investing

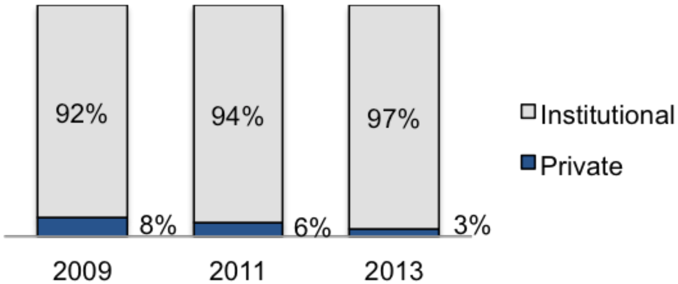
1. The **majority** of private investors consider sustainability in economical decisions (Gallup, 2009; Wins & Zwergel, 2014); basic psychology (Festinger, 1957)
2. Wealthy private investors **are particularly interested in SI** (Eurosif, 2012b):
   - **Motivation:** Families → Preserve capital for next generations
   - **Ability:** Access to solutions & freedom to act → Can move funds quickly
   - **Mindset:** Entrepreneurs, scholars, professionals → Aware of sustainability

The bad news: Private wealth is absent from Sustainable Investing

1. Phenomenon

- Privates govern USD 50 trillion in financial assets vs USD 80 trillion managed by institutions (Çelik & Isaksson, 2014; Shorrocks et al., 2013)
- Privates govern only **3%** of SI-Assets under Management in Europe (Eurosif, 2014)

SI AuM by type of investor, Europe, in % of total



2. Research gap

- "The question of "why do some [private] investors practice [sustainable] investing and others don't?" [is] still largely unanswered" (Glac, 2008, p. 41).

"SI gap" – puzzling, under-researched under-representation of private wealth in SI

Source: Eurosif, 2014

Research on private wealth and advisors is called for but largely inexistent

Context:
Private Wealth Mgmt. firm

Management

Back Office
Risk Mgmt.

Mid-Office
Investment teams

Front-Office
Advisor

Client

Focus area of this study

Prior findings on client-advisor relationship

General

- **Advisors are critical in our finance-centred economy**; capital allocation & market development (Akerlof & Shiller, 2009)
- Evidence that these services, on average, **do not pay of for clients financially** (French, 2008; Malkiel, 1973)
- The **investor-advisor relationship is under-researched**
  - Especially in complex investment situations (Inderst, 2011)
  - Especially in light of deficiencies uncovered post 2008 crisis (Mullainathan et al., 2012; West, 2012)

SI Context

- **Client-advisor relationship matters in SI**: SI is multi-dimensional, too much / too little data (Hummels & Timmer, 2004; Nilsson et al., 2012)
- Micro-foundations of decision making at client and advisors level is **under-researched** (Gond, Louche, Slager, Juravle, & Yamahaki, 2011; Juravle & Lewis, 2008, 2009)

Cognition: (1) HNWIs appear very interested in SI, yet uniformed; (2) interest areas vary; (3) associate SI with volatile, thematic subsets of SI

Interest in SI

(1) High latent or explicit interest to consider sustainability aspects in investment decisions

- PRIV_08: “SI is nothing but ‘hot air’”
- PRIV_12: “SI is a fashion-word, it is useless and a bad investment strategy.”

→ Both are invested in SI, apply exclusions & consider ESG aspects → Don’t know what SI is (*latent*!)

(2) Interest areas vary substantially → related to personal background

- Africa food program manager: Reads Nestle water report; “renewables … disgrace for landscapes.”
- Energy executive: “Renewables have a great future”

→ No ‘one size fits all’ in SI → Move from *do clients care* to *who cares how;* identify individual interest

Understan-ding of SI

(3) SI is often associated with volatile, thematic sub-segments of SI (renewable energy, water)

- PRIV_10: “Sustainable firms will be the better investment in the long run. But most of them do not exist that long and are risky in the short term.”
- Q.: “What experience do you have with SI?” PRIV_03: “I had a water-fund that performed badly, a wood and a solar stock that performed miserably.”

→ Despite education, dominant limitation of SI to thematics → Stress holistic definition; concrete expls.

Barriers: SI perceived as volatile, combined with (1) a short investment time horizon or (2) losses; (3) advisors

Barrier 1: SI = above-average volatility; AND short-term investment time horizon

1. PRIV_11: "I just see the stock-price **drawdowns**. To invest in solar would respond to my **heart**. […] [But] when I think about my [investment time horizon], it is rather **short**, based on my **vintage**."
2. PRIV_06: "The investments shall serve my **children**. […] **Long term**, as that [volatile water-] fund will do well in 20, 30 or 50 years."

→ **Position SI by considering clients' investment time horizon, heirs; lengthen performance review cycles, etc.** *(prospect theory)*

Barrier 2: SI = above-average volatility; AND recent financial losses

3. Q.: "Has your investment behaviour changed due to the IT bubble and the global financial crisis? PRIV_10: Yes, definitely. […] we have invested a bit in some big [non-SI] firms as well, something stable. **We can't afford to lose half of our wealth again."**
4. PRIV_12: "[…] and **it all went down** a lot in 2008. I don't want to experience that **again** [and reduced SI]."

→ **Position SI by considering past losses; either as thematic (upside) or ESG integration/risk-mgmt. (downside protection)** *(prospect theory)*

Barrier 3: Investment-advisors that withhold relevant SI-information.

5. Q.: "After you voiced your interest, have you received information on SI products from your advisor?" PRIV_11: "I received some information on SI. But I don't know how to act on it now."

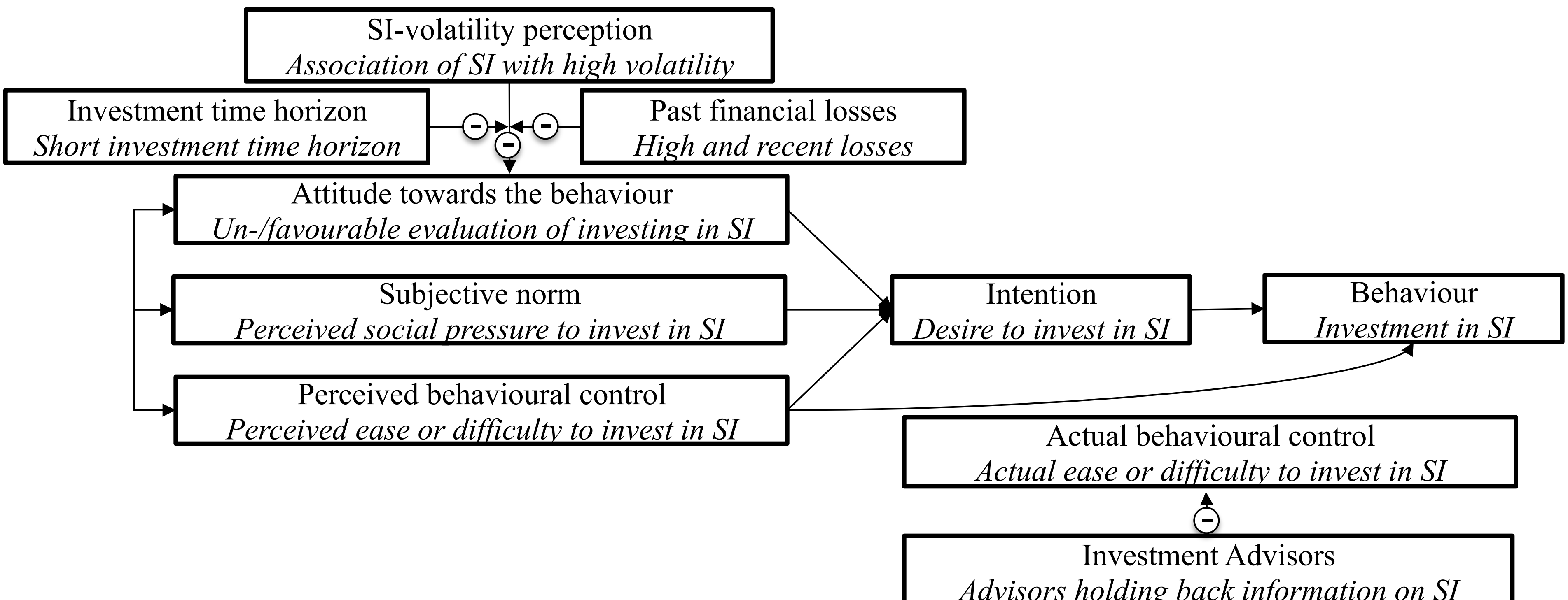
→ **Even trained and asked advisors refrain from informing about SI → Monitor and manage advisors' training, incentives and activity**

Summary of paper 1

Theory of Planned Behavior framework adapted to SI

The TPB framework can help to **understand & predict how individuals behave/act in SI**

- Model of choice in business settings, assumption of **self-interest and rational choice** (Lulfs & Hahn, 2014)
- Explains **variations in the behaviour of individuals** in, e.g., public or private equity investments (East, 1993; Maula et al, 2005), recycling (Ramayah, Leel, & Lim, 2012) or water saving (Lynne & Casey, 1995)



Source: Adapted from Ajzen & Madden, 1986; Ajzen, 1991

Summary of paper 2

Regression results

OLS values	Independent variables	Dependent variable
n.a. (7 vars., none signfict.)	Socio-demographics[1]	Advisor's level of SI communication
.23 (.10)*	**Perceived Consumer Effectiveness PCE (+)**	
.18 (.13)	Volatility (-)	
.43 (.13)***	**Return (+)**	
-.68 (.24)**	**Complexity (-)**	
-.23 (.10)*	**PR stunt (-)**	
.26 (.11)	**Trust (+)**	
.01 (.12)	Self-transcendent values (+)	
.56 (.18)**	**Client Wealth (+)**	
.08 (.13)	Client Investment Time Horizon (+)	

Note: *** $p < 0.001$, ** $p < 0.01$, * $p < 0.05$; $n = 95$; $R^2 = 0.47$; Adj. $R^2 = 0.38$
1: Gender, Kids (yes/no), Education, Bank (A/B), Language (English/German), Age, Client age

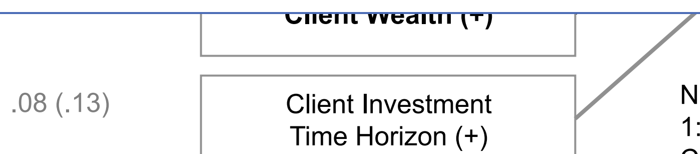
Summary of paper 2

Key findings

1. PB Advisors level of activity in communicating about SI relates to
   - **Complexity (-)**, expected financial return (+), trust in providers (+), perceived consumer effectiveness (+), client wealth (+), PR stunt (+)
2. Contrary to literature, not found related to SI communication
   - **socio-demographics,** expected **volatility (-)**, self-transcendent values (+), Client Investment Time Horizon (+)

→ Expected financial return is ***not*** the key barrier for advisors → Focus on **complexity** & **trust aspects**

→ Professionals vs privates react differently to sustainability aspects → Salespeople might **systematically deviate** from clients' interest in sustainability related product aspects



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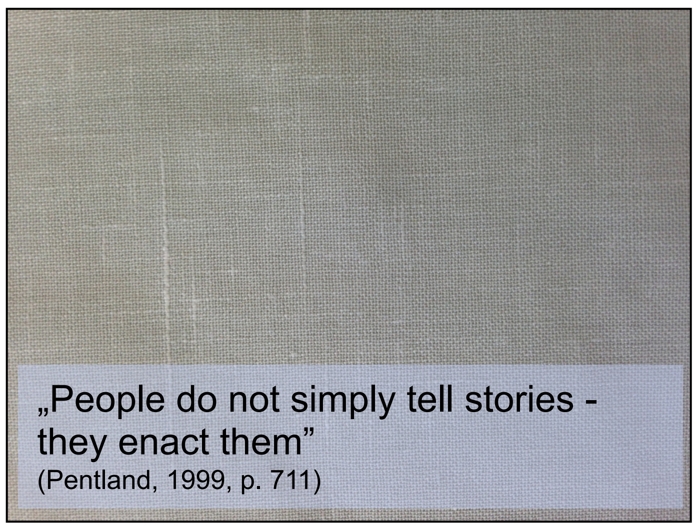
Summary of paper 3

Narratives: How actors communicate in order to understand their environment and their role within it

Definition	
	- **Conceptual models** that people tell themselves and others to make sense of the world around them and to act in it (Haack, Schoeneborn, & Wickert, 2012) - **Involve stories, a time sequence, focal actors, and "a sense of what is right and wrong"** (Pentland, 1999, p. 713)

Example



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Analysis Process

Transcripts

Lag_01	Lag_02	Lag_03	Lead_A1	Lead_A2	Lag_B1	Lag_B2
Q:… A:…	Q:… A:…	Q:… A:…	Q:… A:…	Q:… A:…	Q:… A:…	Q:… A:…

Open coding and development of a code book *(e.g., in our case 22hrs. of interviews; transcribed; ~100 codes)*

Story elements

… | … | … | … | …

Identification of clusters and patterns amongst story elements *(e.g., in our case 74 story elements)*

Surface stories

… | .. | …

Iterative identification of patterns in regard to sequence, actors and meaning

Narrative

…

Mainstream advisor narrative: SI is potentially interesting, but a **nuisance** in the face of complex markets and simplistic customers

Surface story	Story elements	Example quotes
Complex markets	1. Disruptive **regulation** **2. Erratic** market developments 3. Questioned financial perfor-mance of sustainability or SI	1. I think the challenge for an advisor today is … you are **constantly in a cover-my-ass position**. (Lag_6) 2. Since 2008 … **none of the logical models work anymore**. (Lag_1) 3. Sustainable investing just lags that development, because **these days other criteria matter**. (Lag_1)
Simplistic customers	**4. Broad** needs; Irrational **5. Delegate** wealth management 6. Expect **family** to be covered **7. Ambivalent** interest in SI	4. Customers **delegate** wealth management, "and we'll speak again in three or six months" (Lag_5) 5. Customers "are businessmen …that say **'I want profit and I don't care about sustainability' [but] we have to produce somewhat sustainable** anyways'" (Lag_2)
Trusted sales-people	8. Strategic focus on building **trust** 9. Service **across generations** **10. Salesmanship** bank-client 11. SI is interesting but **too complex,** time-consuming; a '**nuisance**'	6. I make a point of taking [the customer's] youngest daughter horse-back riding … **building a relationship** with the next generation; costs me nothing. (Lag_8) **7. We are ideas- and storytellers and story-sellers**. … We say: 'You already have a BMW, but we have got the new 5-series here. (Lag_1) 8. Stupidly, if a customer were totally interested [in SI], he would come back with a lot of **questions**. … **Pandora's Box** … Sorry, this **sustainability topic could be a big one**, no question, and personally I find it a massively good topic; **but purely as a businessman, it's a question of efficiency … so I just leave it**. (Lag_2)

Specialist advisor narrative: SI is a savior from flawed markets; banks and clients are a community in clients' complex interests

Surface story	Story elements	Example quotes
Flawed markets	1. Overly **complicated** by traditional actors 2. **Decoupled** from customers and the natural environment 3. **Conflict of interest**	1. All the energy goes into inventing new mathematical [analysis tools] … **ever farther away from the customer**; the customer doesn't want that … the purpose of the finance industry is, simplified, to **make money with money** … has become **decoupled**. (Lead_A2) 2. Conflicts of interests towards the customers are enormous. The opacity for the customer is higher than in any other industry [and advisors are] **criminals**, really, but they are not recognized as such" (Lead_A2)
Savior	4. SI is a better, **back to the roots** type of investing 5. SI includes **solving conflicts of interest**	3. I think we are going back to the roots. We can explain our client exactly what's in his portfolio; **we know what the companies do**. (Lead_A5) 4. We defend ourselves against the sustainability topic being seen only in the ethical, ecological or green corner. For us, sustainability is a **risk-tool** … allows me to build **more robust and better portfolios**. (Lead_B1) 5. We are **transparent on costs**. It's a bit **paradox** … an open business model is stuff to talk about as it does not adhere to the norm" (Lead_A5)
Commu-nity	6. **'We are not a bank / bankers'** 7. Common interest; **bank as a community** 8. **Complex client interests as main focus** 9. **Overcompensate** in terms of reporting 10. Financial return is **trivial**	6. I don't think we see ourselves as a bank. **We don't call ourselves bankers**. [We collaborate with customers] to move capital markets and sustainable development onto a sensible trajectory. (Lead_B4) 7. Q: You wouldn't work for a normal bank? A: No, never … I think the **industry needs a totally different type of advisors**. (Lead_B2) 8. Everyone has different ideas about what sustainability is, how it relates to money … **to bring that together is one of our main tasks** (Lead_B4) 9. We don't just talk about performance, but about **content**. … all these creative figures that were invented in the past 20 years, that doesn't interest the client by far … that's done in **30 seconds**. (Lead_A3)

Implications

1. A **source of complexity** appears key for mainstream & specialist advisors to justify their role
   → SI-focussed advisors **shift complexity**

2. Mainstream fund managers and advisors in their professional role **underestimate** beneficiaries' ESG interests (Jansson & Biel, 2011) – we find the same with mainstream advisors in SI
   → Note: Clients are in their private role vs advisor in professional role → **Mismatch**?

3. SI in conflict with narratives of traditional advisors, too complex, '**nuisance**'
   → Note: Complexity helps finance firms achieve higher margins (Célérier & Vallée, 2013) → Frame **opportunity**?

4. Important role of narratives – cannot be easily **transferred** (Porter, 1985)
   → Questions **mainstreaming** of SI?

Summary

1. Substantial **market potential** given HNWIs latent or explicit interest, yet individually specific interest areas
2. Key **barriers** that limit HNWIs from acting upon their interest in SI
    1. Predominant association of SI with above-average **volatility**; combined w. time horizon, losses
    2. **Advisors** that keep information on SI from their clients
3. Advisors behave **differently** than customers in regard to SI; might systematically deviate
4. **Mainstream** advisors hesitate to discuss SI with their clients as they perceive SI as **too complex**, challenges their **narrative** and **operational efficiency**
5. **Specialist** advisors employ a diametrically different narrative and **shift the focal point of complexity**
6. Narrative and complexity issue raises questions about **mainstream potential** of SI

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Outlook: Expansion of paper II and III; paper IV on management implications; synthesis in book

	Title	Research Question	Method & Data	Finding	Outlets
1	Unleashing the Powerful Few: Sustainable Investing Behaviour of **Wealthy Private Investors** *Paetzold & Busch*	What are the **barriers** that limit the engagement of **private investors** in Sustainable Investing?	Analytic induction, **interviews** with 14	HNWIs are interested in SI, yet limited by perception of SI as **volatile;** and even those	Organization & Environment
2	More than Money: Why **Investment Advisors** Rarely Talk About Sustainable Investing *Paetzold, Busch, Chesney*	Do investment **advisors neglect to communicate about sustainable investing** in their client dis… and, if so, why?	Regression, **survey** with 95	**Low level of communication about SI** relates to **advisors' perception of SI** in regard to	Annals of Social Responsibility
3	Complex Markets vs. Complex Customer Needs: How **Investment Advisors**' Narratives Enable or Constrain Sustainable Investing *Paetzold & Marti*	What **narratives** do investment advisors use in the context of sustainable investing, and how do these narratives **enable or constrain advi… communicate with custo… sustainable investing**?	Analytic induction, **interviews** with 22 HNWI investment	Mainstream advisors discuss SI as a **nuisance** that challenges their operational efficiency given complex markets. Specialist advisors	Journal of Business Ethics or Organization
4	Biases, cognition, narratives: Implications for managers *Paetzold (& tbd)*	How can managers **adapt to and integrate behavioral aspects and cognition** into strategy development and implementation?	Diss. findings synthesis, triangulation with literature and managers	*(Specification of common challenges, and strategies to counteract and integrate these into strategy development & implementation processes)*	California Management Review
5	*Book:* Sustainable Investing in Private Wealth Management *Paetzold*	Synthesis of dissertation for practitioner audience			tbd

- **Integrate 203 responses from Q4 '14 survey at bank 3 (total n = 298)**
- **Add retail perspective & comparison**

- **Collect friendly reviews and conference feedback**
- **Decide on target journal and resulting implications for data and theory**

- **Synthesize and round-off dissertation towards managerial implications**

Papers:

Published:

- Paetzold, F., Busch, T. (2014). Unleashing the Powerful Few: Sustainable Investing Behaviour of Wealthy Private Investors. *Organization & Environment, 27*(4), 347–367.

In review processes:

- Paetzold, F., Busch, T., Chesney, M. (2014). *More than money: Why Investment Advisors Rarely Talk About Sustainable Investment*. UZH working paper. *(submitted for publication in a peer-reviewed journal).*

- Paetzold, F., Marti, E. (2014). *Complex Markets vs. Complex Customer Needs: How Investment Advisors' Narratives Enable or Constrain Sustainable Investing*. UZH working paper. *(submitted to conferences and friendly reviews).*

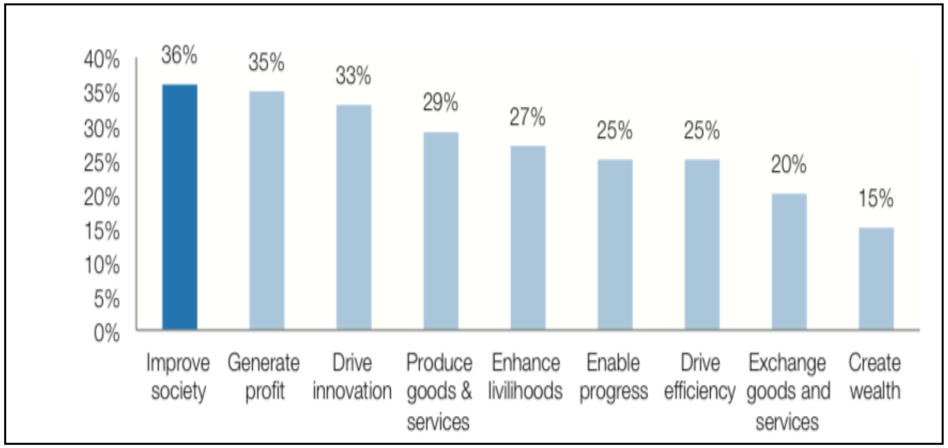
Sources: ..

Outlook:
Focus on Next Gen members of ultra affluent families

1. **Wealth transfer:** "Next Gen", i.e., 25-40 y. o. members of ultra high net worth families (>USD 60 mn.) will inherit US$41 trillion (World Economic Forum, 2013)

2. **Shift in investment paradigm:** The value systems of these inheriting Millenials and Next Gens are particularly congruent with SI (Deloitte, 2014; Morgan Stanley & Campden Wealth, 2014)

Primary purpose of business according to the Millenial Generation, 2014, in % of survey respondents (Deloitte, 2014)



3. **Identified barrier for shift to SI:** Next Gens lack skill, legitimacy, argumentation to decide on family wealth allocation

Now setting up the "Empowering the Next Generation of Family Office Impact Investors" **training program for UHNWI Next Gens**, combined with research on strategies to shift family capital, with James Gifford at Harvard University

Q&A