Institutional Investors and the Behavioral Barriers to Taking Action on Climate Change

Executive Summary
A research report for ClimateWorks Foundation, prepared by Danyelle Guyatt and Julian Poulter

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1 Executive summary

“Our conviction that we are right on climate is stronger than our fear of failure”
Quote from a CIO at an asset owner organization

This paper presents the findings of a research project funded by ClimateWorks Foundation on Institutional Investors and the Behavioral Barriers to Taking Action on Climate Change. The project focuses on the behavioral drivers that impact institutional investors’ ability and/or willingness to integrate climate-related risks and opportunities into their investment decisions.

While many investors recognize the growing need to incorporate climate change into investment decisions, it is not a straightforward task and there are a multitude of challenges that investors face that slow down the speed and scale of action required to adapt investment processes. Some of these challenges have been widely debated and often cited, such as lack of consistent signals from government policy-makers, the need to upscale new technology advances, a lack of suitable investable opportunities or lack of data, models, or suitable metrics.

However, there are additional challenges within the investment community beyond those most commonly cited (which tend to be ‘informational’ barriers), and these relate specifically to investor behavior itself (Figure 1). Moving beyond the neoclassical assumptions of rationality and perfect information as part of that philosophy’s inadequate approach to investing opens up the door to considering a number of internal behavioral conditions that might be slowing down real action by institutional investors on climate change.

Figure 1. Informational and behavioral barriers to taking action on climate change
To date, behavioral barriers are much less widely discussed in the context of investors and climate action, although the investment community is aware of some of these issues, particularly short-termism, as evidenced by the different long-term investing ‘clubs’[i] that have formed over the years. Yet at the industry-wide level – and indeed at the regulatory level – proponents of investor action on climate change tend to focus more on fulfilling ‘informational’ needs, such as best practice processes, developing new data, tools, and metrics in the hope that knowledge and information will propel investors to take action. Indeed, the Financial Stability Board’s Taskforce on Climate-related Financial Disclosure recommendations go to the heart of the lack of data and metrics and provide a useful framework for companies and investors to move forward on their actions and disclosure in relation to climate change.

However, very little attention is, in comparison, placed on how knowledge is processed by investors and interpreted through their mental models. The psychological underpinnings of investment decisions, the prevalence of cognitive biases, cultural drivers, and personal relationships (both at the individual level and inside and outside organizations), and how these influences might impact the level of action on climate change needs further attention. Putting it another way, the assumption that if decision-makers ‘have information, will act’ is still predicated on the assumption of rationality, even when there is clear evidence that this is not the case[ii].

Unless we more explicitly acknowledge the human dimension of investment decisions, the investment community will continue to perpetuate and participate in short-termism and fail to adequately manage systemic risks, such as climate change. It is for this reason that we are studying institutional investors and their response to climate change as “humans” who have bounded rationality[iii] and make decisions based on a range of influences, some of which are conscious and others unconscious or automatic.
1.1 Research objective

The aim of this research is to explore some of behavioral complexities that arise in responding to climate change, from the perspective of institutional investors themselves. Ultimately, the goal of this first phase of research was to reveal and better understand the behavioral challenges to incorporating climate change into investment processes, such that we might move closer to solutions and outcomes whereby climate change risks and opportunities are embedded into the way assets are valued and reflected in how investment decisions are made (Figure 2).

Figure 2. Behavioral barriers to taking action on climate change amongst investors

![Diagram of behavioral barriers]

1.2 Research steps

The aim was to study the institutional investment community from the inside out, to see the world through their eyes to better understand their perspective on climate change and the barriers that might be limiting wider action on climate change.
The research has been carried out through a number of stages, as set out in Figure 3. The research, data collection, and analysis of the research was conducted in six main stages:

1. Review of relevant research and evidence
2. Design and distribute a survey to institutional investors (globally, across functions)
3. Undertake interviews with CIOs, CEOs, and senior staff inside asset owner organizations[iv]
4. Examine the findings and distill key themes
5. Consider the implications for stakeholders
6. Suggest recommendations and next steps

Figure 3. Research steps

1.3 Key themes and findings

1.3.1 Aggregated survey findings

Overall our research found evidence of cognitive biases and psychological underpinnings for these, including across the areas that were the focus of this study, namely myopia, herding, and reliance on heuristics and rules of thumb. In addition, the open-ended responses to the survey and the follow-up interview process revealed the importance of other behavioral biases including cognitive dissonance, narrow framing, loss aversion, status quo bias, and overconfidence.
<table>
<thead>
<tr>
<th>THEME</th>
<th>KEY FINDINGS</th>
<th>COGNITIVE BIASES</th>
<th>PSYCHOLOGICAL UNDERPINNINGS</th>
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<tbody>
<tr>
<td>Beliefs</td>
<td>There is general acknowledgment of climate change as a systemic risk, but in practice at the day-to-day level, there is a degree of separation from the issue in terms of what that means in practice.</td>
<td>Myopia, cognitive dissonance</td>
<td>Uncertainty, denial, judgmental discounting, perceived control</td>
</tr>
<tr>
<td>Perceived Difficulty</td>
<td>There is growing effort and momentum in some areas (such as engagement with companies on climate change), yet it is still “not really incorporated into investment analysis.”</td>
<td>Narrow framing, heuristics, loss aversion</td>
<td>Habit, conflicting goals</td>
</tr>
<tr>
<td>Perceived Behavior of Peers</td>
<td>Most respondents do not think their peers are taking strong action on this issue so there is a lack of motivation to act.</td>
<td>Herding, loss aversion</td>
<td>Tokenism and rebound effect, social comparison, norms and conformity</td>
</tr>
<tr>
<td>Perceived Difficulty of Specific Actions</td>
<td>There is a degree of resistance to change to existing frameworks, it takes time, energy, and motivation to see it through, which may not be present at the individual level or across organizations.</td>
<td>Heuristics and rules of thumb, anchoring</td>
<td>Habit, perceived risk of taking action, conflicting goals, mistrust and reactance</td>
</tr>
<tr>
<td>Perceived Challenges Incorporating into Investment Decisions</td>
<td>Of the three dominant barriers that were identified by respondents, two of them relate to behavioral processes (lack of organization buy-in and perceived complexity) and the third relates to information needs (lack of data).</td>
<td>Status quo bias, cognitive dissonance</td>
<td>Habit, social comparison, norms and conformity</td>
</tr>
<tr>
<td>Perception of Risk of Taking Action</td>
<td>When it comes to taking action to try to change “the other” (external fund managers or companies), it is considered to be easier. When it comes to changing their own practices (i.e., valuation frameworks or asset allocation models), that is considered to be much more difficult.</td>
<td>Status quo bias, narrow framing</td>
<td>Denial, perceived control, perceived risk of taking action, conflicting goals</td>
</tr>
<tr>
<td>Perception of Risk of NOT Taking Action</td>
<td>Half the respondents believe that failure to act on climate change would not result in a less diversified portfolio.</td>
<td>Overconfidence effect</td>
<td>Judgmental discounting, denial, belief in solutions</td>
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1.3.2 Disaggregated survey findings, power relations

To examine the prevalence and role of power relations along the investment management chain, we divided up the sample into Group 1 ‘powerful, direct’ and Group 2 ‘less powerful, indirect’ categories to look for any differences that might emerge in terms of the role and functions within the investment community, defined as:

**Group 1 – Powerful, Direct:** Defined in this study to include Chief Investment Officers, Chief Executive Officers, asset allocation strategists, board members, trustees, general managers of investments, heads of division/department, portfolio managers.

Group 1 sample size was 42 respondents that fell into this category, representing 47% of the total sample size of 89.

**Group 2 – Less powerful, Indirect:** Defined in this study to include Environmental Social and Governance (ESG)/sustainability specialists, consultants, specialist advisors, independent researchers, data/analytics providers, industry associations, or news service providers.

Group 2 sample size was 47 respondents that fell into this category, representing 52% of the total sample size of 89.

Our analysis suggested that there is a difference between those agents that have more direct responsibility for investment decisions, compared to those that have more indirect influence. This difference was not only found to be statistically significant at the total sample level, but it was also significant when some of the individual biases and drivers were examined, with Group 1 scoring lower than Group 2. The results also suggested that Group 1 was more likely to find it difficult to integrate climate change into valuations, to see how it fits into existing frameworks and investment practices, and its compatibility with fiduciary duty, compared to Group 2 respondents who scored more highly across all of these dimensions (where the differences were also found to be statistically significant).

1.3.3 Cognitive dissonance

The disaggregated analysis of the survey responses pointed to evidence of a growing dislocation within the investment community, suggesting that there is a fragmentation of culture emerging which could potentially destabilize the status quo and allow new perspectives to filter through the system. A framework is presented in this paper to support a theory of change, where the greater the divergence within the investment community, the harder it will be for resistant investors to continue responding to the prevalence of dissonance through denial or defensiveness, but rather shift more investors onto a pathway of decisive action.
1.3.4 Interview themes

There were a number of themes that emerged from the interviews in terms of how individuals in senior positions inside asset owner organizations have personally experienced the challenges with incorporating climate change into investment processes. The insights were many and various, but the highlights of these interactions revealed the following:

**Leadership success in overcoming barriers:** No matter where the inspiration for leadership within a fund came from or how it spread, the leaders displayed a surprisingly broad success rate across all types of behavioral barriers and were more than happy to live with the discomfort of potential reputational, career, and other risks.

**Information versus behavioral barriers:** No interviewees felt that the challenges with taking action on climate change was purely due to lack of data or availability of models – or even policy or technology breakthroughs – all the interviewees talked about the importance of people, trust, and personal relationships inside their organizations.

**Beliefs:** Personal belief provided a lot of the determination to do something different from their peers – not a moral or ethical belief, but one steeped in the belief that climate change is not going away, and that mitigation is the logical thing to do.

**Trust:** Strong overall fund/individual performance is a key element that allowed an individual to drive a proactive climate agenda and develop a strategy. This performance creates trust from the board that allows the board to overcome any fears about risk in being unique or proactive over climate. It also allowed leaders to ride out any difficult periods where (for example) climate-related investment decisions might generate short-term underperformance.

**Culture:** Pressure on C-suite executives from even one or two board members appears to be helpful to open up a dialogue on the issue, building a culture that embraces change and ultimately drives action.

**Perception of risk:** The interviewees all felt that the degree of financial risk to become a leader was small. This is understood by the leaders who can allocate capital to low carbon assets and still take minimal career or reputational risk.

**Finding the comfort zone:** There was some evidence of anchoring amongst the interviewees to what they feel most comfortable with. Most explained that it is far easier to expand a fund’s climate strategy and invest in low carbon opportunities if the returns from existing investments are reasonable. According to most of the interviewees, the returns don’t have to be higher than other areas, just comparable to other opportunities in similar asset classes.

**Peers:** Rather than feeling pressure to stay in the pack and not go too far from the ‘norm,’ the leaders were often disparaging of peers who had failed to see the obvious risks or who were unwilling to overcome any fears or biases in order to adjust their investment processes in view of climate-related impacts.
**External pressure:** Our discussions indicated that external pressure from beneficiaries/members, employers, regulators, NGOs, or the media to take action can be effective at overcoming behavioral barriers by (for example) helping key decision-makers to prioritize climate change internally across asset owners’ executive functions.

### 1.3.5 Leaders and biases

With acknowledgement of the inherent selection bias in the interviewees that was skewed towards the leaders versus those investors that are less progressed in terms of climate change action (as the latter is also likely to be less willing to participate in studies such as this), some of the most surprising findings concerned behavioral biases that we had anticipated in our analysis but actually didn’t shown up in interviews. The absence of many of these biases in leaders was one of the most important findings of the study because it demonstrates that with some effort and attention, these biases are not a ‘given’ and can be overcome. Indeed, these insights will help to guide further efforts to design solutions and alter the framing of climate change inside the executive of asset owner organizations as a way to overcome the biases that may prevail outside of the so-called ‘leading’ community of investors.

### 1.4 Implications for stakeholders

The findings of this report have potential implications for asset owner organizations in terms of how they evaluate and conduct their investment decision-making processes, governance arrangements, and the questioning of assumptions around existing beliefs and narratives, particularly with respect to how they are managing climate change impacts. It will also have potential implications for how different industry groups and associations communicate with investors, develop guidance material, conduct workshops, design surveys, present evidence, and establish new frameworks to support investor action on climate change (Figure 5).

It is clear that leadership creates more leadership and that we have to leverage the power of the leaders and their stories and experience in a far more coordinated manner in order to shift the consensus position. The leaders can be far more influential than external experts recommending a strategy. However, experts can facilitate leadership amongst peers.

The data from the PRI’s supported Inevitable Policy Response initiative will be important to help facilitate behavioral change and the findings of this research will be immediately shared with all investment associations that can use these insights to work with investors.
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<tr>
<th>STAKEHOLDERS</th>
<th>RECOMMENDATIONS</th>
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| CIOs, CEOs, board members, trustees | • Build awareness of behavioral issues and subject matter in order to critique their own thinking and the behaviors of others  
• Review governance arrangements and seek to diversify senior layers of decision-making  
• Go beyond information and ask more challenging questions around beliefs and attitudes  
• Create an internal sponsor for behavioral issues  
• Agree on a process to address the behavioral challenges  
• Learn from leaders – or if a leader, be willing to engage with peers  
• Integrate behavioral insights into the design and implementation of climate-related investment strategies as a cross-check to decision-making processes |
| ESG/sustainability specialists    | • Build skills to interact internally and engage with CIOs, CEOs, board members, and trustees, to challenge the embedded hierarchies and power relations that may limit action  
• Champion the importance of addressing behavioral barriers to climate change internally at the organization level and also across the wider industry  
• Participate and bolster collaborative initiatives focused on improving decision-making and fostering behavior that is more closely aligned with climate-related policies and beliefs |
| Industry bodies and associations | • Widen the focus of attention from information needs to consider behavioral shortcomings through design of outreach with members, guidance documents, events  
• Embed an awareness of cognitive biases, psychology, and social and cultural influences into strategy for outreach and mobilization plans on climate action |
| Funders                         | • Reflect behavioral barriers in funding strategies  
• Help build and fund collaborative networks |
| Educators and researchers        | • Undertake more research on ‘real world’ behavioral barriers amongst investors to taking action on climate change |
| Regulators                                                                 | • Consider implications of cognitive biases and psychological, social, and cultural drivers for best practice governance standards across the financial sector  
|                                                                          | • Build standards around best practice behaviors and human relationships to foster long-termism, not only incentives but through organizational design and challenging prevailing power relations  
|                                                                          | • Build systems to identify early warning signs and remedies for short-term investor behavior  
| Service providers                                                      | • Consider the behavioral biases that may prevail within their own internal decision-making processes  
|                                                                          | • Understand the potential biases of their clients and stakeholders  
|                                                                          | • Integrate this understanding into their product and service design  
| NGOs                                                                     | • Ensure context of behavioral barriers embedded in communication and engagement strategies  

### 1.5 Recommendations and next steps

In order to convert this first phase of research into functional tools and practical guidance, a second phase of the program is required to:

- Build on the understanding of the psychological, social, and cultural barriers that are slowing down or stopping action on climate change, beyond data
- Integrate the findings into existing investor programs and outreach efforts with their members
- Design solutions to shift investor behavior on climate change to achieve desired outcomes, including challenging prevailing power relations
- Develop research, tools, and collaboration efforts, including a leadership hub
- Shift the consensus position to one of collective leadership