INITIATIVE FOR RESPONSIBLE INVESTMENT AT HARVARD UNIVERSITY

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Public Pension Fund Trustees and Fund Culture: Responsible Investment and the Trustee Leadership Forum

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Abstract:

In the context of responsible investment, the role of the pension fund trustee within fund culture is a particularly intriguing area of inquiry. In many respects the ultimate responsibility for the integration of environmental, social, and governance information into investment decision-making lies with fund trustees, whose duty it is to manage funds for the long-term interests of current and future beneficiaries. What follows below is an overview of preliminary insights from a research project we are conducting at the Initiative for Responsible Investment (IRI) at Harvard University. The project, framed in the context of leadership and organizational studies, focuses on the role of pension fund trustees in designing, implementing, and overseeing the development of responsible investment strategies at their funds.

Introduction

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The role of pension fund trustees has received increasing attention in recent years, part of the generally increased interest in pension fund governance. Key issues for research include best practices in board terms and structures, the most important skills for trustees at funds of different types and sizes, and the relationship between trustees and fund staff. These take their place within broader questions about the proper role of trustees in determining investment strategy and overseeing performance.[1]

Relatively less attention has been paid to pension fund culture and the ways in which information flows, institutional norms, investment theory and beliefs, legal opinions, and power relationships among trustees and with other stakeholders shape the way in which trustee decisions get made.[2] We believe that a close scrutiny of what we might call the political culture of pension fund governance can contribute important insights both into the theory of pension fund stewardship and to the identification of best practices that can be adopted by trustees themselves.

In the context of responsible investment, the role of the pension fund trustee within fund culture is a particularly intriguing area of inquiry. In many respects the ultimate responsibility for the integration of environmental, social, and governance information into investment decision-making lies with fund trustees, whose duty it is to manage funds for the long-term interests of current and future beneficiaries.[3] Advocates for ESG integration often argue that, as stated in the preamble to the Principles of Responsible Investment, "applying these Principles may better align investors with broader objectives of society." Fund trustees are often represented as an ideal point of influence to bring this alignment about because the long-term time horizons and outsized influence of large funds in the investment marketplace can help mitigate the agency issues often thought to reinforce myopic short-term practices in the market.[4] But unless we understand better how trustees actually make decisions in context and use this information to inform the provision of necessary decision-making tools, the role of trustees in promoting a more resilient responsible investment ecosystem will likely remain as much ideal as actual.

What follows below is an overview of preliminary insights from a research project we are conducting at the Initiative for Responsible Investment (IRI) at Harvard University. The project, framed in the context of leadership and organizational studies, focuses on the role of pension fund trustees in designing, implementing, and overseeing the development of responsible investment strategies at their funds.[5] As part of this project we are conducting participatory action research with a self-defined group of labor-affiliated public and Taft-Hartley pension fund trustees, as well as trustees from labor-affiliated asset owners including, for

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[1] See for instance Gordon Clark and Roger Urwin, "Best practice pension fund governance," *Journal of Asset Management* (2008) **9,** 2–21.

[2] Cultural approaches to institutional investment can take many forms – for one productive avenue related to ours see William Barr, John Conley, and Carolyn Kay Brancato, *Fortune and Folly: the Wealth and Power of Institutional Investing*, (Irwin Professional Publications 1992).

[3] As will be discussed later, the issue of the primary legal duty of the Trustees is an important one for the implementation of ESG strategies, as well as with issues of the relationship of Trustees, staff, and professional advisors.

[4] Thus the role of the trustee is crucial to the sorts of perspectives associated with universal ownership and responsible investment set out in James Hawley and Andy Williams' account in *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate Governance More Democratic* (University of Pennsylvania Press, 2000). Our thinking on these matters resonates with the application of universal ownership ideas to the financial crisis found in the chapters in the eds. James Hawley, Shyam Kamath, and Andrew Williams, *Corporate Governance Failures: the Role of Institutional Investors in the Global Financial Crisis* (University of Pennsylvania Press, 2011).

[5] A number of other types of benefit funds exist in this space, including funds which provide healthcare benefits and vocational training. By far the largest funds in terms of assets, however, serve to provide pension and retirement benefits to retired employees. Thus, this paper will focus on the term "pension" with the understanding that it sometime is a stand in for other types of benefit funds with which pension funds may share common characteristics.

instance, funds that provide health benefits.[6] Input will also be solicited from a group of related stakeholders including academics, fund lawyers, investment consultants, fund managers, and others. This project, the Trustee Leadership Forum for Retirement Security, is housed at the Initiative for Responsible Investment, a project of the Hauser Center for Nonprofit Organizations at the Harvard Kennedy School. The goal of this project is to develop insights into pension fund culture and practice in support of a model of trustee leadership development that in turn supports more effective stewardship of pension funds in service of their beneficiaries.

Our goal in this paper is to introduce broad framing issues which will direct our research into pension fund culture and the role of trustees. While our cohort of fund trustees is drawn from a specific labor-affiliated subset, many of the ideas about fund governance and culture we address are generalizable across asset owner types. Here we draw on trustee and stakeholder experiences, and our work with them, to highlight some key issues that have emerged in this relatively early stage of project design.[7] We provide a provisional sketch of the role that trustees currently play, and see themselves as having the potential for playing, in the integration of responsible investment strategies into their investment decision-making. We take a rather expansive view of the definition of responsible investment.[8] It is understood here as investment that integrates ESG information and strategies in an effort to enhance the long-term sustainability and resiliency of investment portfolios, and improve the lives of generations of beneficiaries whom funds are meant to serve. We focus in this paper on outlining key issues as trustees themselves see them, rather than tying those issues to academic debates in the growing responsible investment literature – though we believe these are closely connected inquiries.

A Hard Time to Be a Trustee: The context in which this project takes shape

We began this project with a discussion of how trustees viewed the landscape in which they operate, and in particular addressed specific roadblocks that they encounter as they pursue an interest in responsible investment. A common view right now is that "this is a hard time to be a trustee," for a variety of reasons. Perhaps most obviously, the financial crisis caused real damage to fund resources, and created challenges in matching resources to liabilities. Double digit losses in assets under management necessarily create hard choices for trustees that do not have to be made in bull markets.

At the level of investments rather than strategy, the crisis has promoted a rethinking of the relationship of funds with fund managers, both in terms of the structure of payments and services rendered, and a more general sense of alignment of interests and views of the market. One labor-affiliated group, for instance, brought in their fund managers over the last few years to ask them how they had responded to the crisis and how they expected to respond in light of changed circumstances. These conversations were tied to the group's general practice of engaging fund managers on questions such as how they were positioned in relationship to the green economy, or how their work did or did not relate to the crisis of job creation in the US. More pointed issues include areas such as securities lending, a practice that has caused significant losses for a number of investors. Recent months have seen funds challenge managers

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[6] The specific composition of the benefit fund and of the Board of Trustees is an important variable in our research. However, we believe it is best examined after the common issues showcased herein are analyzed.

[7] For overviews of two meetings held by the IRI that addressed these topics, and have informed the development of the project, see the papers at the IRI's website, www.hausercenter.org/iri: hausercenter.org/iri/?page_id=287 and http://hausercenter.org/iri/wp-content/uploads/2010/05/TLF-Summary-May-17-18.pdf.

[8] For perspective from David Wood on the limitations of the "business case" defining the parameters of responsible investment, see Marina Welker and David Wood, "Shareholder Activism and Alienation," in *Current Anthropology* (Extra 1, 2011) pp. 57-69.

over practices that obscured risk-taking in ways that favored managers over the asset owners for whom they were investing, a serious issue for many trustees.

Perhaps more profoundly, the financial crisis has also called into question core beliefs about how markets function, and precisely how trustees should react to this destabilization of conventional investment wisdom. For instance, conventional notions of risk and return do not seem to match up to fund's recent experience, as diversification could not protect portfolios against the crisis, and many trustees have found the crisis leading them to revisit the role that Modern Portfolio Theory (MPT), among other theories, plays in guiding their investment strategy.[9]

One common complaint about MPT – that it views portfolios divorced from the wider world from which their investments are supposed to generate their returns – is linked to a belief among many trustees that the financialization of the economy – understood roughly as in Gerald Epstein's definition of "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies" – has not necessarily served the interests of asset owners themselves.[10] We should note that these critiques are not universally shared or fully articulated by all the trustees we have worked with. Thus, we think it is important to highlight the fact that these macro-level critiques of the way that finance works are live conversations among trustees, and that they in part explain why a self-defined cohort is engaging in the project at the moment.

If the financial crisis opened the door to systemic critiques, it has also engendered political challenges to the very nature of defined benefit plans. These challenges to the current structure of vehicles for retirement security are being powerfully financed and driven. The cyclical nature of political attention, as one participant put it – in bull markets, fund investments receive little attention, while in bad times, public and corporate contributions are called into question – can lead to attacks on pension funds' financial health while they weather a down market. And fund beneficiaries themselves will suffer personal economic setbacks that reduce their own contributions.[11]

The result has been a perfect storm of financial, economic, and political challenges. Debates over the relative practicability of defined benefit plans put pension plan advocates on the defensive, and they complicate discussions over appropriate funding levels, discount rates, and benefit levels. Broader debates over the nature of retirement security, and the commitment that funds themselves represent to retirement security, have become a fundamental part of their work of financial stewardship. Trustees have repeatedly stressed to us that the challenges of pension fund stewardship and investment strategy have to be placed in this context in order to be understood and managed appropriately. If not, questions about appropriate discount rates, return targets, or asset allocation strategies can become divorced from the fundamental purpose of the funds themselves, and run the risk of placing undue burdens on investment returns to make up for shortfalls created by political decisions about funding.[12] In many ways, a focus on

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[9] For one perspective on this see Steve Lydenberg, "Beyond Risk: Notes Towards a Responsible Investment Theory", in eds. Hawley, Kamath and Williams, *Corporate Governance Failures*.

[10] Gerald Epstein, "Introduction," in ed. Epstein *Financialization and the World Economy* (Edward Elgar, 2005), p 3. On the relationship between financialization and the economic crisis see Richard Freeman, "It's Financialization," International Labour Review 149 (2010) 2 pp.163-83.

[11] The politicization of the issue of retirement security highlights the practical challenges faced by trustees. No major decisions by trustees exist in a vacuum and all must be weighed in a realtime political landscape. This is an additional reason why the success of a project like this, which can result in a transparent understanding of the forces that influence decision making, is so crucial.

[12] See Mike Musuraca, "Avoiding the Next Financial Crisis," in ed. Tessa Hebb, *The Next Generation of Responsible Investment* (Springer, 2012).

responsible investment on the part of trustees is a way to build a coherent theory that addresses current challenges, and builds capacity to better link funds' financial strategies with their long term purpose.

Trustees in Their Place: A preliminary outline of pension fund culture

Our research focuses on mapping the investment ecosystem that shapes how trustees make their decisions, and identifying particular points in the decision-making process that either create or constrain opportunities for reshaping investment practice. In particular, trustees have expressed a desire to develop tools and enhance their authority to speak on fundamental issues of concern to responsible investment, given that they bear the ultimate responsibility for the successful execution of the mandate of their funds.

To map this domain, we take as a useful starting point a view of power dynamics informed by Stephen Lukes, where "power is its most effective when it is least observable," for instance in the ability to create or enforce "social and political values and institutional practices that limit the scope of the political process to public consideration of only those issues which are comparatively innocuous" to those with whom they are in actual or potential conflict.[13] These "rules of the game," are an institutionalization of norms, including "predominant values, beliefs, rituals, and institutional procedures" that can benefit certain persons or groups – who typically occupy positions of privilege – at the expense of others. Those subject to it are led to acquire beliefs and form desires that result in their consenting or adapting to being dominated, in coercive and non-coercive settings."[14] The benefit of this approach to pension fund political culture is that it may reveal structural and ideological dynamics that shape how decisions are made by trustees, as their position of ultimate legal authority, statically defined, does not adequately represent the system in which they operate.

What follows here are several issues that surface repeatedly in discussion with trustees about the forces that shape how their ideas about pension fund stewardship and strategy are put into practice. These are recurring themes, and they are often described in discussion in terms of barriers to rethinking governance, strategy and tactics, though these issues point more generally to an understanding of the world in which trustees operate.

The legal role of the fiduciary: One issue of responsible investment trustees often raise is the uncertainty around how fiduciary duty relates to their ability to address the issues outlined above. In theory, the duties of loyalty and care define a weighty role in which trustees act to support beneficiaries past current and future, but in practice definitions of beneficiary interest, intergenerational equity, and prudent behavior may be reduced to a simplified (and, as we have seen, increasingly challenged) model of financial risk and return. One criticism that has surfaced on multiple occasions is that of conventional understandings of fiduciary duty restricting trustees' ability to question strategic allocation or fund manager selection decisions.[15] From the trustees' point of view, invocations of "fiduciary duty" can be used by stakeholders to attempt to foreshorten debate. Responsible investment offers the opportunity to rethink fiduciary duty in light of long-term fund goals, though this can challenge conventional if potentially flawed interpretations of that vital concept.

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[13] Steven Lukes, Power: A Radical View, Hampshire, England: Palgrave Macmillan (2005) (Second Edition), 10.
[14] Ibid at 13.
[15] For an elaboration of these challenges as they relate to climate change see Claire Woods, "Funding Climate Change: How Pension Fund Fiduciary Duty Masks Trustee Inertia and Short-Termism," in eds. Hawley, Kamath and Williams, *Corporate Governance Failures*.

Investment theory and beliefs: Trustees occasionally describe a climate in which beliefs about how the market functions, and in market efficiency, are taken for granted – as a counterpart, they may point to discussion on ESG topics such as increasing inequality, rapid urbanization, resource scarcity, and climate risk that are not necessarily reflected in investment practice.[16] Trustees may also believe their funds' essential purpose to their beneficiaries is not reflected in investment strategies driven by conventional portfolio theory or in relying solely on thin or short-term measures of investment performance. The question they openly face, however, is what investment theories or measures of investment performance are better suited to the task?

Access to information: Related to the issue of investment theory and beliefs, part of the role of trustees is to set strategy and review fund activity, with decisions made, for instance, about how to solicit managers via RFPs, or which managers to select in particular asset classes. But the conventions of investment practice often mean that the ultimate decisions are made from a narrowly confined pool of options, and mediated by investment consultants, fund staff, manager responses and interviews, and so on. From the trustee perspective, the goal is to develop tools and approaches that enhance their role as active agents shaping fund agendas, rather than relatively passive consumers of information rather than active agents shaping fund agendas. In practice, the trustees with whom we have engaged see their role as falling between hard questioning of information they have received and more strategic oversight of policies and practices.[17]

Agency issues and service provider relationships: Agency issues and the various potential misalignments of interests between funds and service providers are constant, well-known challenges, and trustees may confront opportunities that do not always conform the their own view of the benefits of their funds or ultimate beneficiaries.[18] Conventional benchmarks and fee structures for performance narrow the scope of engagement with service providers, and there are obvious incentives in conventional investment practice for managers and consultants to maximize their own remuneration. Available investment products may not match what trustees view as their funds' needs. The ability to see transparency in fees is a particular problem. Legal advice suffers from the same potential agency conflicts as does the relationship with fund managers. This can lead to agency issues in which the long-term interests of funds come into conflict with stakeholders' other objectives, and more generally, when conventional investment culture resists trustees' efforts to interrogate, and on occasion reformulate, investment practice.

The role of expertise: Trustees engage with their funds often on a part time basis, and may not themselves have training in finance or law apart from their work as trustees. The information they receive, and the questions they ask, are mediated through a variety of forms of expertise, which in turn can constrain trustees' ability to identify and promote change within

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[16] Trustees have been quite receptive to placing a discussion of investment beliefs in the foreground of their macro-determinations. It is our belief that more attention to this issue is warranted. See, e.g. Kees Koedijk, Alfred Slager. *Investment Beliefs: A Positive Approach to Institutional Investing* (Basingstoke, England: Palgrave Macmillan 2010).
[17] One example of this sort of questioning that resonated in our conversations comes from Margaret Blair, who in 2010 advocated a three-part test for the value of financial innovation in a short post on the Harvard Business Review blog at http://blogs.hbr.org/finance-the-way-forward/2010/06/innovation-knowing-abuse-when.html. This is the sort of hard questioning that trustees can drive.
[18] For a recent, provocative statement on agency issues that has sparked discussion in the responsible investment community, see Paul Wooley's "Why are financial remedies so inefficient and exploitative – and a suggested remedy" in *The Future of Finance: And the theory that underpins it* (London School of Economics and Political Science – Center for Economic Performance, 2010) pp. 121-43.

organizations.[19] Decisions take place within the framework of the information shaped in large part by staff and external service providers. Our discussion around the "cult of expertise" with trustees has focused not on the importance of technical investment expertise – a point generally agreed to – but rather the assumption that assertions of investment expertise could mask important decisions about the careful alignment of fund objectives and investment strategies. When combined with agency issues with service providers – when, for instance, the goal of maximizing their own performance may rub against the goal of best serving the long-term interests of their pension fund clients – the assertion of expertise may disfavor productive dialogue and engagement. Some noted that investment complexity itself has been used to disguise high fees or excessive risk taking.

Strategies for operating from a minority position on the decision making bodies: Responsible investment can be seen as a challenge to conventional practice at many funds, and trustees with a desire to implement ESG strategies may occupy minority positions on their boards, and need assistance in creative ways to ensure that their positions are seriously considered by the full decision-making body. When considering responsible investment-related issues, difficulties that arise may be compounded by investment professionals' training in and disposition towards the status quo. Tendencies towards herding are a well-documented feature of the investment ecosystem, and they can work against efforts to rethink investment practice. This is true even though, as trustees frequently point out, it is their job to ask hard questions about strategy and practice.

The relative isolation of individual funds: Frequently in our engagements, trustees have emphasized the relative isolation of funds as they work through systemic issues such as fund governance, relationships with service providers, and even the overall health or relative value of the financial system in the wake of the crisis. They highlight the potential of collaborative platforms with which to engage other funds on issues of systemic importance, which might include anything from the role of public policy in shaping financial transaction taxes to the role of fund managers in lobbying against financial reform schemes. Some trustees are comfortable with the present constellation of organizations to address this issue, though concerns about the relationship between service providers and trustees exists in these organizations, as it does in individual funds. Funds might benefit from collective work to shape investment products (one live discussion at the moment is in the asset class of infrastructure) that they feel better suit their needs. Indeed, the benchmark of relative performance for funds (similar to the effects of similar benchmarks for managers) may discourage collaboration and reduce cross-pollination of and support for best practices.

What Would Superior Performance Achieve?: Trustees' goals for leadership

A map of the relationships that are embedded in pension funds' political culture can emerge from the aforementioned themes. Information flows are directed by various stakeholders, decisions enabled and constrained by identifiable legal and cultural norms. Set beliefs about market function and the place that pension funds play in the market determine to some extent the conviction with which decisions are made. We hope to make the production of such a map a central part of our work with trustees, and it is itself an important research goal of the project.

[19] This is not to say that this phenomena is solely due to self-interest of "experts." The governing legal structure in the United States provided a level of legal protection for trustees who rely on opinions of experts. See e.g., Donovan v. Bierwirth, 680 F. 2d 263 (2d Circ. 1982).

But the question remains: to what end? Topics emerged from conversations with trustees about what funds can do to rethink their governance and strategy in light of changed circumstances and new information. While no unified vision of what needs to be done for funds has emerged from our preliminary discussions – and of course unanimity is unlikely to be a goal in any case – we can highlight a set of themes that point to potential directions that trustees wish to pursue.

These are familiar topics especially in the responsible investment community, and indeed suggest how the emergence of responsible investment as a concept has begun to shape the trustee lexicon. They include:

Trustee empowerment: One immediate goal for trustees is training and education systems that tackle systemic challenges, and open the door for engagement across the range of stakeholders in the fund governance ecosystem. This is often framed in the context of "asking hard questions." What tools, information, and training would enhance trustees' ability to ask hard questions, to effectively explore the impact of investment conventions on fund governance and performance? Trustees also voice interest in developing tools and platforms that allow them to delve deeply into emerging issues, to more actively identify and research issues that do not necessarily come up in the regular course of board meetings, but which are fundamental to forward-looking oversight of fund practices. Responsible investment is a framework for enabling this work, and the RI community also serves as a point of reference for how this might be achieved.

Extending time horizons: There is a general (and in many cases long-held) belief that the investment ecosystem, as currently constituted, promotes short-termism through a variety of agency issues and management complexities, from quarterly benchmarking of investment performance to rewards for excessive risk taking in the near term that create long-term risks to beneficiaries. But extending time horizons also raises key questions about fund purpose, including issues of intergenerational equity among current and future beneficiaries and the proper understanding of risk over extended periods of time. ESG issues become especially relevant here, as they are seen to be measure of risk more appropriate than shorter term evaluations of standard deviation of market prices. From the perspective of trustees, the development of beliefs, strategies and processes that embed longer time horizons in fund practice becomes a key element in rethinking fund governance.

Investing in the real economy: As noted, critiques of current investment practice by trustees often focus on the topic of financialization, and the suspicion that the growth of financial products and services does not necessarily translate into robust economic activity. For trustees of funds suffering from a lack of sufficient contributions for full funding, the condition of the underlying economy is an increasing concern. In this context, trustees point to the need for tools to evaluate potential investment strategies and products as contributing to "the real economy," and so generating returns that are sustainable over the course of multiple business cycles. This interest in the real economy is typically linked with the need for longer term time horizons. But it is also closely tied with a belief about the health of funds, over the long term, being necessarily tied to the health of the economy itself (indeed, funds are drawing on ideas such as universal ownership to make this link). This may involve rethinking how funds measure their contribution to real economic activity, and how large-scale social and environmental changes will affect long-term performance. It may also encourage rethinking of the needs of beneficiaries, whose lives are of course also as affected by the state of the real economy.

Platforms for fund collaboration: If one of the barriers cited is the relative isolation of funds, one of the goals that trustees point to is naturally the development of platforms for fund collaboration. We repeat this here because of the frequency and strength with which trustees

express their support for collaboration. They tie this need to more general issues about the roles that funds play in the market. Benchmarking performance against each other may encourage short termism, and weaken efforts to support real economic activity rather than speculation. A more united voice for funds would allow more effective expression of systemic solutions, and advocacy for policies (from relationships with service providers to national and international systems of financial regulation and oversight) that individual funds may not be in a position to argue for effectively. Our point here is that this is not merely a question of aggregating funds to achieve more political effectiveness – the idea of collaboration itself is motivated by and informs a potential critique of the investment beliefs and strategy as conventionally understood. From the trustee's perspective, collaboration driven at the board level can help place funds in conversation with the collaborative activity of other stakeholders (for instance, around the conventional fee structures for alternative investments).

Together these topics suggest a model for trustee leadership in challenging times, in that they integrate systemic understandings of funds' purpose and positions with identifiable strategies for responding to changed beliefs, in service to beneficiaries' interests.

Conclusion

Trustees play a specific role in the investment decision-making process, and they are often seen as, or labeled as having, a primary role in authorizing, and reformulating, investment principles and strategies. To the extent that responsible investment is a challenge in investment orthodoxy – at the least, a claim that the various agency issues, portfolio theories, and power dynamics have led stakeholders in the financial system to undervalue ESG information – trustees are seen as playing a fundamental role at developing systems and tools that can better take into account ESG information. This, of course, in better service to multiple generations of beneficiaries, whose well-being is the purpose of fund activities.

Our preliminary work with a specific and self-selected set of trustees has revealed a group of engaged practitioners who are rethinking investment theory, portfolio management, and stakeholder relationships in light of the weaknesses in conventional theory and practice highlighted by the financial crisis. This emerging research project has to date focused on the complex culture of pension fund governance, and trustees' role within it, in an effort to more fully explore both the network of relationships that constitutes the institutional investment ecosystem, and also to help develop tools that help trustees make that ecosystem more robust in responding to current and future challenges.

Responsible investment – broadly understood to be a model for addressing the long-term needs of fund beneficiaries embedded in society – is both a frame for interpreting trustee goals for leadership, and also, in the form of the RI community, a model for how collaborative action among funds can help reshape their role in the market and society more generally. We believe that this project – an extended, close engagement with trustees on their role, in the context of current challenges, to develop models for effective trustee leadership – can help inform responsible investment research and practice, in part by more fully accounting for the map of power relationships that shape how decisions are and could be made by trustees as they do the work of positioning their funds for long-term sustainability.