NEURO-FIDUCIARY

Impact of Behavioral Governance on Trust, Implications to ESG/SRI Strategies

By Don Trone, GFS®

Maybe we’re doing it wrong. When economic, social, and governance (ESG) or sustainable responsible investing (SRI) strategies are being addressed, we often get bogged down in a heated fiduciary debate. The better approach is to begin the discussion around the new body of research associated with behavioral governance.

ESG/SRI strategies are gaining in popularity—as they should—with both wealth management clients and fiduciary trustees who are managing the assets of foundations, endowments, retirement plans, and personal trusts. Though investment consultants have been advising ESG/SRI portfolios for more than three decades, consultants still are being drawn into bristling debates associated with the implementation of such strategies.

- At one end of the spectrum are the naysayers: “ESG/SRI is a breach of your fiduciary responsibility.” With the mere mention of the word “fiduciary,” the typical investment committee meeting turns into a barroom brawl.
- At the other end of the spectrum are those pleading passionately for a particular social cause.

Any attempt by the consultant to broker a compromise often proves counter-productive because both sides typically are unwilling to give an inch.

The better approach is to start an ESG/SRI conversation in the middle of these two extremes with a discussion about “behavioral governance.”

BEHAVIORAL GOVERNANCE

Behavioral governance is a new body of research that parallels behavioral finance. The difference: With behavioral governance the lens is on the behavior of investment consultants, trustees, and investment committee members. With behavioral finance the lens is focused solely on individual investors, including pension plan participants.

Behavioral governance is directed toward understanding the interrelationships among leadership, stewardship, and governance, and how using this framework substantiates a fiduciary standard of care. Specifically, behavioral governance is best expressed in three dimensions (see figure 1):

- Governance: The fiduciary’s ability to manage the details of a prudent decision-making process (x-axis).
- Stewardship: The fiduciary’s passion and discipline to judge wisely and objectively (y-axis).
- Leadership: The fiduciary’s capacity to inspire, serve, and engage others with integrity (z-axis).
Neuroscientists have determined that certain behaviors are conducive to the building of trust (see “Behavioral Governance Framework” section).

In turn, there is a sequence. One must first demonstrate a capacity for good governance (decision-making) before one’s stewardship and leadership ability will be considered (see figure 2).

The inability of a fiduciary to demonstrate the details of a prudent decision-making process will be sufficient cause for a person not to be trusted.

Conversely, too much attention to one particular dimension—governance, stewardship, or leadership—can result in a breakdown in trust.

In the ESG/SRI community, trust often is a casualty of a barroom brawl over fiduciary responsibility (governance), or trust is never established because a presentation consists of only a passionate plea for a social cause.

To build trust, an ESG/SRI presentation should be balanced and include information on the following:

**Governance:** The details of the prudent decision-making process that will be followed.

**Stewardship:** The capacity of key decision-makers to judge wisely and objectively.

**Leadership:** The ability of key decision-makers to inspire, engage, and serve with integrity.

**BEHAVIORAL GOVERNANCE FRAMEWORK**

A key component of behavioral governance is the specific leadership and stewardship behaviors that amplify and help to improve the outcomes of a procedurally prudent decision-making process.

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**BUILDING TRUST**

![Diagram showing the relationship between trust, governance, stewardship, and leadership](image)

**Figure 3**

**Figure 4**

**BEHAVIORAL GOVERNANCE FRAMEWORK**

<table>
<thead>
<tr>
<th>GOVERNANCE (5 steps, 10 dimensions)</th>
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<tbody>
<tr>
<td><strong>Step 1. Analyze</strong></td>
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<tr>
<td>Define roles and responsibilities</td>
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<td>State goals and objectives</td>
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<td><strong>Step 2. Strategize (RATE)</strong></td>
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<td>Identify risks and assets</td>
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<td>Identify time horizons and expected outcomes</td>
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<td><strong>Step 3. Formalize</strong></td>
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<td>Define the strategy</td>
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<td><strong>Step 4. Implement</strong></td>
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<tr>
<td>Implement the strategy</td>
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<td>Formalize financial controls and procedures</td>
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<td><strong>Step 5. Monitor</strong></td>
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<td>Monitor the strategy</td>
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<td>Scrutinize for conflicts and self-dealing</td>
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**LEADERSHIP BEHAVIORS**

- Competent
- Courageous
- Collaborative
- Character-full
- Compassionate

**STEWARDSHIP BEHAVIORS**

- Aligned
- Adaptive
- Attentive
- Authentic
- Accountable

Behaviors that amplify and infuse governance, and help to predict the quality of decision-making outcomes.
process (see figure 3). If this sounds like fiduciary on steroids, it should—that’s the objective. Now everyone’s a fiduciary, and yet they’re not. Great fiduciaries are differentiated from the rest by the fact that they exhibit certain leadership and stewardship behaviors.

Consider the following behavioral governance framework (see figure 4). The left side depicts a uniform fiduciary decision-making framework. It’s “uniform” in that the same framework can be used to substantiate an ERISA, UPIA, UMPERSA, or UPMIFA fiduciary standard. The right side is a listing of the five leadership behaviors and five stewardship behaviors that amplify and infuse a prudent decision-making process.

To more effectively facilitate an ESG/SRI discussion, start by asking the question: As a trustee or investment committee member, how would you define your leadership and stewardship role?

Note: Be prepared to provide the following definitions:

- A leader has the ability to inspire and engage others.
- A steward has the passion and discipline to protect the long-term interests of others.

You will soon realize that trustees and investment committee members are far more interested in talking about leadership and stewardship than they are in talking about fiduciary.

Next, start using each of the leadership and stewardship behaviors in a question. For example:

- As an investment committee, how can we better demonstrate that we are aligned with our mission? (i.e., what specific action steps would support “alignment”?)
- As trustees, what actions or communications show that we are compassionate?

CONCLUSION
You will likely discover that the answers to these questions begin to illuminate the rationale for an ESG/SRI strategy. It’s very difficult for a trustee or investment committee member to talk about leadership and stewardship and not talk about ESG/SRI. We are conducting research with two professors from the Wake Forest University School of Business on the neurological profile of a fiduciary. We believe this research will provide us a better understanding of the decision-making process associated with ESG/SRI strategies.

The lesson: There is risk when making ESG/SRI the focal point of a discussion. The better approach is to center on behavioral governance and discuss the ways that ESG/SRI can enhance one’s leadership and stewardship role.

Don Trone, GFS®, is the founding CEO of 3ethos, which conducts original research in behavioral governance and the interrelationships between leadership, stewardship, and governance. He was the founding CEO of fi360 and the founding president of the Foundation for Fiduciary Studies. Contact him at don@3ethos.com

ENDNOTES
1. Academic research emerging from the U.S. Army, U.S. Department of Defense, and several universities regarding how adaptive leadership in group settings may be identified and incorporated for improved efficiency.