

What Difference Will It Make?

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Introduction

The UN PRI¹ was devised in 2005–2006 from a process that involved the largest institutional investors in the world. The participants of that process felt that there was insufficient integration of environmental, social and governance (ESG) risk assessment in mainstream investment practices. The term 'Responsible Investment', or 'RI' for short, describes the integration of ESG risk assessment into investment practices. It is about improving the knowledge base upon which investment decisions are made rather than screening out categories of investment opportunities based on moral or ethical grounds.

Several funds and fund managers have launched into RI implementation whilst others are still coming to terms with what it all means. There are some who, despite industry or board pressure, appear unable to align themselves with the intent of the UN PRI. One reason for this is uncertainty as to the benefits that would flow from adopting RI practices. There is demand from this market segment to have the benefits of RI expressed in a rational and non- emotive way. We use the term 'fund' to refer to pension / superannuation funds, although the discussion can easily be extended to insurance company statutory funds, investment platforms and other types of investment funds.

We examine the benefits of implementing RI practices, including investment returns, fiduciary duty and brand and reputation. The first two should encourage funds and fund managers to act with haste. The latter is also important because community awareness of ESG issues is changing with the times, and fund members expect their funds to be managing all investment risks prudently.

Investment Returns

If RI is implemented successfully – how do you prove that you have benefited from it? We take each of the key risks that fall under the RI umbrella, namely ESG, and examine their impact on investment performance.

We do not believe that ESG risks should be elevated above other investment risks. ESG risk is on the current agenda because there is growing belief that, to date, it has not been sufficiently integrated into mainstream investment practices.

Environmental Risk

In the case of environmental risk there are the 'old' risks and the 'new' risks. The investment industry is used to assessing and dealing with the 'old' risks, such as mining project sourced contamination. What has changed though is the emergence of a 'new' set of risks associated with climate change. We observe that (i) society as a whole, led by government, believes in climate change enough to propose a tax on greenhouse gas emissions; and (ii) weather related risks are likely to become more unpredictable as identified by the insurance industry².

With this in mind, is a fund or fund manager acting prudently if it has not taken account of these 'new' risks? Our own experience in the investment industry suggests that investment professionals are generally not well-equipped to fully understand or deal with this new class of risk. Like any major source of risk, it requires a framework to assess what the material risks are, how they may be managed, mitigated and even used as a source of competitive advantage.

Environmental risk is extremely relevant to asset values because the impact of climate

¹ The United Nations Principles for Responsible Investment (UN PRI) evolved out of an investor initiative in partnership with the UNEP Finance Initiative and the UN Global Compact. It outlines six key principles that can be used as a framework for adopting Responsible Investment practices. The UN PRI has become well known amongst the fund and funds management community. Refer <http://www.unpri.org/> for a thorough description.

² Dlugolecki, A. et al, *Coping with Climate Change: Risks and Opportunities for Insurers* (Chartered Insurance Institute, London (2009))

change driven events, in terms of timing and scale, is unknown. Scientists endeavour to forecast and model future climate scenarios – which are useful as a guide and provide some loose ‘data’ to work with – but, ultimately, we do not know exactly what will happen. For example, an agricultural services company would be wise to develop an understanding of predicted climate shifts rather than ignore them; and it is reasonable to expect that a fund manager would evaluate this risk in its assessment of the company’s prospects and valuation.

There are flow on effects from this ‘new’ source of environmental risk, such as the regulatory response that puts a market price on carbon production. Financial analysts are well versed in modelling company cash flows based on future scenarios for input costs; the challenge is to recognise that energy has become a **strategic** issue for many companies rather than a fairly predictable cost. Financial analysts will require sufficient expertise and discipline to take such factors into account when making investment decisions. There are good examples of energy intensive companies reaping benefits by elevating energy from an operating issue to a strategic issue³. The recurring theme from such organisations is their recognition of the link between efficiency gains and improved profitability.

If you believe that better-informed investment decisions will produce superior portfolio risk and return profiles then it follows that, overall, fund managers need to continue to develop their skill levels and investment disciplines to deal with this ‘new’ set of environmental risks.

Social Risk

Social risk came to prominence in the 1990s when several companies found that, in the eyes of their customers, their responsibility stretched further than they previously thought. A headline example was the consumer backlash felt by Nike when the media revealed poor labour and human rights practices at its Indonesian suppliers. Strategic management of social risk can provide competitive opportunity. Porter & Kramer⁴, who analyse the link between competitive

advantage and corporate social responsibility (CSR), contend that CSR presents opportunities to create shared value – a meaningful benefit for society that is also valuable to the business. In summary they conclude:

“Perceiving social responsibility as building shared value rather than as damage control or as a PR campaign will require dramatically different thinking in business. We are convinced, however, that CSR will become increasingly important to competitive success.”

An example cited by the authors is Nestlé’s track record of working with small farmers in developing countries. Over decades, the company has invested in local infrastructure and transferred world-class knowledge and technology to communities with the end result being enormous social benefit for those living in the region. From Nestlé’s perspective, they have gained direct and reliable access to the commodities they need to maintain their profitable global business. They have developed a distinctive strategy that is inseparable from its social impact.

Again, in the context of RI, social risk is not a new category of risk. Fund managers have traditionally looked at social factors such as occupational health and safety when assessing management quality. The Porter & Kramer comments are illustrative of the extension in thinking about social risk that is underway, moving it beyond the immediate sphere of risk control and into a strategic, foundation issue that can improve the sustainability of company earnings.

From a quantitative perspective, studies based on social factors are emerging. According to an ongoing global study carried out by Sustainable Asset Management⁵, based on listed equities in developed markets, there is a positive correlation between those companies who are good managers of social issues and share price performance. The study used data from annual sustainability assessments over the period from 2001 to 2008. They found that there was a positive contribution to the information ratio from five social factors examined, with ‘human capital development’ and ‘corporate citizenship’ exhibiting the strongest results.

Whilst Porter & Kramer express negative views about the distillation of CSR into factors or ratings, the findings of this study complement our assertions about the value of understanding and assessing the dimensions of social risk present in a fund’s investment universe.

Governance

Over the last ten years there has been a trend toward improved governance practices from funds in the industry. The aim of active corporate governance is to restrict key

executives and associated parties from largesse and gaining undue financial advantage at the expense of ordinary shareholders. The shareholder bases of large companies are often very fragmented which can lead to ineffective decision-making by shareholders in response to company AGM resolutions.

As was our stated case for environmental and social issues, it is reasonable to expect that fund managers, as agents for funds, have solid processes for evaluating and actioning company AGM resolutions. In the Australian market we have seen many funds take active control of the governance process by commissioning advice from specialised governance service providers such as ACSI, Regnan or Riskmetrics. Historically, funds that have relied upon external agencies to execute the voting process for them have faced issues, such as fund managers abstaining from voting or ending up with a mix of voting responses. Those funds who have re-engineered the governance process have felt the need to assert their control. This is proof that governance is very important to funds and that fund managers should be thinking strategically about the value of the services they offer.

There are quantitative results in favour of the assertion that good governance leads to superior performance. At a recent industry forum⁶, Andrew Gray of Goldman Sachs JBWere commented on the findings of his ongoing study of corporate governance data and share price performance. He found that, since 2001, portfolios of stocks selected using the governance factors of remuneration, audit and board skills, outperformed the broader market index by sizeable amounts, namely 46%, 37% and 19% respectively. While these results would have to be reviewed more deeply to explain such significant outcomes, it is hard to ignore the apparent link between good governance and share price returns.

The results suggest there is a component of the risk premium used in discounting forecast company cash flows that is inefficiently priced. For active fund managers chasing excess returns, this may be an untapped source, whilst for passive or ‘index’ managers there is incentive to see improved market practices overall.

ESG and Investment Returns

For investment activities as a whole, common sense dictates that there is a good case for ensuring that ESG risks are well managed. In the case of social and governance risks there is data emerging that supports the assertion. For environmental risk, the advent and broad acceptance of climate change risk has pushed us into uncharted waters, which is more reason to take it seriously. Companies who strategically recognise and manage ESG issues – along with all other major operating issues – are, intuitively, more likely to have resilient and

³ Australian Department of Resources, Energy and Tourism *Energy Efficiency Opportunities* workshop, Brisbane (May 2009). Organisations presenting case studies included Gold Coast City Council, Queensland Rail and Thiess.

⁴ Michael E Porter and Mark R Kramer, *Strategy & Society, The Link Between Competitive Advantage and Corporate Social Responsibility*, Harvard Business Review (2006)

⁵ Wilma de Groot, *Alpha from Sustainability? Historical performance and investment strategies based on sustainability indicators*, presentation distributed by Sustainable Asset Management Australia Limited (2009). Study includes developed countries ex-Canada.

⁶ Finsia forum, *In the long grass – leadership in adversity*, held in Sydney (7 May 2009)

sustainable businesses. Likewise, fund managers who recognise this fact and ensure that these practices should be a standard component of their mainstream investment decision-making processes will be making decisions with superior information compared to those who are not.

Our own discussions with funds and fund managers reveal that the leading ones are working out how to manage individual company and sector exposures more effectively. In the future, they will be further challenged to develop tools and metrics to better understand the level of overall portfolio risk sourced from these factors. Concentrations of these risks – like any other risks – would be undesirable in portfolios if they were unintentional. For funds who allocate to multiple fund managers in the same asset class, the task of understanding portfolio exposure is a daunting one.

There are some clear themes that emerge from the consideration of ESG risk management:

- They are sources of investment risk and, just like any other investment risks, they need to be understood in order to be well managed;
- They should be mainstreamed in the investment decision-making process;
- Fund managers do not need to re-invent their entire investment philosophy or process; however they do need to build capacity in the area of ESG risk assessment. Starting with a clean sheet of paper may have its advantages, but is certainly not a prerequisite;
- There is quantitative data to support the benefits of managing ESG risks. Decisions made with more information rather than less should, on average, provide superior risk and return outcomes; and
- Developing a greater understanding of portfolio risk is the next major challenge for funds and fund managers.

People who live in areas that are prone to bushfire risk usually take out insurance as a way of mitigating the economic consequences of damage to their property. They can also modify their properties to reduce fire-damage potential. Incorporating ESG factors into investment decisions is akin to this process of recognising risk and implementing a process to deal with it. The end game in both cases is the same: to produce good, risk adjusted financial outcomes.

Fiduciary Duty

Given the rapid emergence of ESG risk onto the investment agenda, there is increasing awareness of the duties of fund trustees. Past debate on this topic shows there has been a level of misunderstanding of the core issue – ESG risk management has often been interpreted as the application of ethical standards to investment processes. There is a clear distinction between the two: ESG risk

management is about improving the knowledge base upon which investment decisions are made rather than screening out categories of investment opportunities based on moral or ethical grounds.

In the past, trustees have been concerned that the imposition of an ethical investment framework would not be in the best interests of fund members. We would agree with this concern on the basis that fund members may have extremely diverse views about which moral standards are applicable. Our discussion of fiduciary duty is in the context of investment risk and return – not the application of ethically-driven processes.

The Freshfields Report⁷, issued in 2005, addressed the issue of whether the integration of ESG issues into investment policy would be considered as voluntary, legally required or hampered by law with regards to pension funds, statutory insurance funds and mutual funds. The study covered major global economies, including the common law jurisdictions of the US, UK, Canada and Australia. It concluded that the integration of ESG considerations was permissible and “is arguably required in all jurisdictions”.

In Australia, superannuation fund trustees are subject to the ‘sole purpose test’, which is defined by Section 62 of the Superannuation Industry (Supervision) Act. The intent of this legislation is to ensure that the ‘fund’ is maintained solely for the purpose of generating and providing monetary benefits to members upon retirement. There is further detailed guidance for the duties of trustees in this Act, including:

“...formulate and give effect to an investment strategy that considers the whole of the circumstances of the entity, including but not limited to (1) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements; (2) the duty to diversify investments; and (3) the ability of the entity to discharge its existing and prospective liabilities to manage reserves responsibly;”⁸

Point (1) here states that it is a trustee's duty to consider the risk involved in investment decisions. This resonates with our pragmatic view that ESG risks are part of the broader set of risks to investment returns. Point (2) complements the argument, as portfolio diversification applies to all forms of investment risk concentration. Consider the counter view – would a trustee who is aware that ESG risk is not being properly managed be comfortable that their duty is being prudently discharged?

In addition to existing legislative requirements, the Australian Government is reviewing the

duties of trustees in order to address its concerns about the management of ESG risks. It is in the process of asking the relevant regulatory body, APRA, to review its guidance to funds in order to “take greater account of ESG issues in their investment practices”⁹.

This discussion is neatly rounded off with a quote from a recent paper by Jason Denisenko¹⁰ who examined the fiduciary duties of trustees in the context of the evolving regulatory, political and social environment. He concluded that “it will be necessary for them to ensure that they have considered all relevant factors, including relevant ESG factors, as part of their mainstream investment decision making process in order to satisfy their duty to act in the best interests of their beneficiaries”.

Brand and Reputation

Brand and reputation are both important for funds and fund managers. It is reasonable for members to expect a core level of competence and professionalism from the manager(s) of their fund. There is, therefore, an internally generated risk that arises if members are not happy with their experience. As is the case with any organisation experiencing a challenge to its reputation and brand, there is a cost to business in the form of inefficient resource allocation, as a disproportionate amount of time is devoted to confronting and repairing existing issues rather than preparing for and facing new ones.

So the question for funds, then, revolves around the benefits or otherwise of implementing RI practices? Firstly, there is the investment return aspect to brand and reputation. A recent study of fund members commissioned by ASFA¹¹ found that “good / better returns” was the one most important thing valued from their fund for 44% of respondents, far outweighing the next largest response of “secure / big fund” at 13%. Both of these responses imply that risk management is a clear expectation in the minds of fund members.

Fund members are generally forgiving of ‘events’ that are totally unexpected. The September 11, 2001, destruction of the World

⁷ Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, a report sponsored by the UNEP Finance Initiative (2005)

⁸ Ibid.

⁹ Senator the Hon Nick Sherry, Superannuation Lawyers Conference, 27 Feb 2009

¹⁰ Jason Denisenko, *Managing financial risk over the long-term – ESG factors and the evolution of trustee's fiduciary duties – a legal perspective*, contribution to finisa report (2009)

¹¹ Matt Balogh, McNair Ingenuity Research Pty Ltd, *Annual Superannuation Survey prepared for Association of Superannuation Funds* (2008)

Trade Centre buildings and resulting jolt to financial markets being a case in point. Members are unlikely to be so generous when a jolt is sourced from a risk category that has been well discussed and flagged in the investment community prior to the event. A fund that has disregard for the potential effects of climate change, for example, not only runs the risk of neglecting its fiduciary duty, but also of jeopardising its reputation. If events occur that materially affect fund returns that could have been mitigated by RI implementation then its members would have good cause to feel aggrieved. Funds that demonstrate professional risk management, both through historical performance and positioning for the future, will be well placed to enhance their brand and reputation with members and the broader industry.

Secondly, community awareness of ESG issues has increased. Regardless of our individual views on issues such as climate change, most people are aware of the issues and the uncertainty surrounding the timing and magnitude of those risks. Fund members would expect their fund to manage all major sources of risk to their investment returns. Couple this with the likelihood of greater statutory requirements¹² for trustees to consider ESG in their investment process and there is a powerful force driving the case for RI. There is also an element of fear present as funds do not want to be stranded as 'one of the few' who are not doing RI when they see take-up rates increasing around them. There is potential risk to their reputation if they do not change and fall out of sync with their members' expectations.

To date, several funds have provided SRI options in response to a level of member interest in 'ethical' investing. Whilst the addition of one or more SRI funds as an investment option has been of service to members seeking that product, it comes at a cost. From our discussions with funds who offer SRI options, many lament the low up-take of these options in proportion to the overall fund size and the additional operational costs associated with such options. Some of these funds indicate they would like to mainstream RI practices across all of their investment options which would improve both investment risk and return and their cost structure, making stand-alone SRI options redundant.

This part of our discussion has been all about funds rather than fund managers. What does brand and reputation mean for fund managers? The same issues apply to fund managers, with investment risk and return being the issue of primary importance. The behaviour of fund managers will be driven by their masters further up the supply chain, namely funds and their advisors (asset consultants). Certain asset consultants have begun mainstreaming RI into their manager review process in response to concerns expressed by funds. If the trend of improving RI practices¹³ at the fund level continues into the future then there is a strong business case for fund managers to align themselves with the requirements of their customers, otherwise, over time, they risk being screened out of the selection process because they do not measure up to the new minimum standard.

Conclusion

We have stepped through the key issues that come into play when considering the rationale for adopting RI practices. At the investment level, there is a new class of environmental risk emerging that requires pro-active management and historical data gives no insight into the magnitude or timing of its effects. Social risk should not just be considered as a 'risk' per se, but also as an opportunity for firms to create competitive advantage. Governance practices are improving, spurred on in part by the financial crisis, as funds seek to address misalignments of interest between themselves, as shareholders, and other stakeholders. The fiduciary requirement of fund trustees is in the spotlight, with legal opinion tending towards the view that the omission of a process to assess and manage ESG risk is a potential breach of fiduciary duty. Finally, community awareness of ESG issues is increasing and fund members expect their funds to manage these risks diligently, otherwise they risk damage to their reputation and brand.

With these compelling reasons for adopting RI, we believe it can only improve investment risk and return profiles. It makes sense to address risks and opportunities emerging in the investment sector. The UN PRI provides a framework that funds and fund managers can use in the implementation process and there is growing empirical evidence that it *will* 'make a difference'.

¹² Senator the Hon Nick Sherry

¹³ According to the UN PRI website, there are now 178 fund and 256 fund manager signatories, representing more than US\$18 trillion of funds under management.