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**Sustainable Investing**

**Introduction**

In determining this topic I have been asked to address a number of specific queries in regard to 'sustainable investing'.

I'm generally going to talk about processes or methodologies which look at more than standard financial parameters – a range of additional factors – sometimes referred to as non-financial or extra financial – which give a broader perspective on investment decision-making. The 3 parts:

- From global trends to the Australian perspective, how it has been accepted by investors, and the pros and cons for products providers;
- Differentiating the various complexions of ethical/sustainable/ESG investment; and to try to interpret what bearing it might have on the application of KiwiSaver.
- And along the way I'll try to comment on what works and what hasn't and the future.

This will mean a bit of a whistle stop tour.

**The World Has Changed**

It's hard to talk about ethical/sustainable investment in a vacuum. It's integrally part of a broader social issue at least somewhat reflected in green marketing issues. And as a consequence is susceptible to many of the same influences, advantages and disadvantages.

The last time I can remember a survey being conducted on the likely uptake of ethical/sustainable investment it was by Challenger, early in the decade. The outcome indicating:

- Less than 30% had ever heard of the term 'ethical/SR investment'
- Once described however, some 80% stated a preference for it

In one of Australian Ethical's early surveys one in five respondents indicated a willingness to invest 100% of their portfolio in such a manner.

Since the last millennium the world has changed, quite radically. When discussions then highlighted environmental issues (slide) such as renewable energy, uranium mining, human rights and waste management, the most dominant issue facing humanity, climate change, was barely on the horizon.

Today, documentaries such as *Inconvenient Truth* and an almost smothering media coverage (slide) have elevated environmental issues and specifically matters associated with CC to the mainstream of peoples' consciousness. So much so that despite concerns as to the cost of action – in terms of carbon taxes and emissions trading schemes, there seems sufficient consensus in Australia that petrol prices, for instance, should be allowed to rise, unadulterated, in order to expedite the pace of needed change in behaviour – to shift travel toward greater efficiency, to alternative forms of energy and public/mass transport.

We can all cite instances where we have become sensitized to environmental concerns, either directly or indirectly.

At home I see this reflected in fundamental behavioral changes in water usage, for example. The past few years have seen the worst drought in recorded history. Even with recent improvement in falls two-thirds of NSW remains 'drought-declared' today. Sydney dam levels have improved but as a national phenomenon, water usage has declined to 1960s levels. This was not, at the time, a cost driven imperative.

At another level, activist campaigns increasingly have a variety of high-emitting industries in their sights.

The Wilderness Society plans to target Australia's \$1.3 trillion superannuation pool. Next month, it will launch its online Super Activism campaign, declaring 'individuals might not want to be investing in industries that are highly exposed to impacts of climate change, such as coal companies. People will make choices as to how they want their money invested in what they see as sustainable industries.'

Others are getting into the act too. Mainstream asset consultants and research houses are putting pressure on funds to show how their environmental credentials stack up. Super Ratings, for example, has launched an assessment scheme that measures the environmental, ethical and sustainable credentials of funds.

For some time it has been noted there are legal and logistical difficulties to such advancement. The Superannuation Industry Supervision (SIS) Act requires funds to maximise returns and sections of the Corporations Act have broad definitions of 'relevant interests' and 'associate', which could stop funds acting collectively. Furthermore engagement often proves resource intensive - costly and time consuming and potentially distracting.

In the end, though, pressure may come to bear from the government. In its report handed down last month, the parliamentary joint committee on corporations and financial services indicated APRA needed to clarify aspects of the SIS Act. And the Minister for Superannuation whilst avoiding directing funds to invest in environmental or similar projects, said ‘consideration of ESG factors is so critical to the long-term financial success of super assets, that in my view it is an important part of the fiduciary responsibilities and as such, should be incorporated into the investment decisions-making process of superannuation trustees.’

## **Outline of Australian Ethical**

Because some of you may not be too familiar with where I’m from, I’d like to provide a potted history of Australian Ethical – the company, and the processes we use to create our unique investment perspective.

Australian Ethical, an ASX listed company, provides managed funds and superannuation through a dedicated approach to environmental, socially responsible and sustainable investment. In a genuine and very real sense we were doing ESG 20 years ago – before the term was ever coined.

We were a pioneer in the ethical/sustainable investment field. And still remain the most rigorous, serious and true to label participant in this market, according to research houses and rating agencies.

We are an award-winning fund manager, practicing what we preach (slide) and creating only the third 6 star green rated building in Australia, which I shall return to later (slide).

The vast majority of our service provision is in-house. And as the family photo album shows, the team has grown from 2 full-time people in 1991 to the 55 there are today. A real success story in funds management, especially in Canberra where we are based.

Australian Ethical now has around AU\$600 million in FUM. And we invest on behalf of more than 18,000 investors and superannuation members in 5 portfolios. (I should also say we have had a NZ Investment Statement for a number of years.)

## **Definitions**

Ethical/sustainable investment or the more recent variant PRI as part of a growing world-wide trend is unmistakable. Financially rewarding (in part by controlling risk), and personally fulfilling for those who see the bigger, strategic picture in issues facing society.

There are various terminologies (slide) which are different yet the same, in some ways. Essentially these may be dissected by either longevity or their market focus.

Ethical, SRI, screened, +ve/-ve, sustainable – older/retail  
Sustainable, Responsible, themed, PRI – newer/institutional

Though definitions are invariably slippery (slide) each attempts to address a broad range of environmental and social concerns, most recently and especially that of climate change. The premise of all these approaches, is 'knowing what your money is doing.'

Al Gore's Generation Investment Management's philosophy, as a case in point, has sustainable development as the 'primary driver of industrial and economic change over the next 50 years.' Where shareholders are best served by companies who maximise their financial return by strategically managing their performance in this new economic, social, environmental and ethical context. (When I visited them they were not UNPRI proponents.)

This long term focus on performance is expressed through research and responses often thematic in nature. That is they cover big picture issues which have the potential to impact (both positively and negatively) the long-term operating context for business such as: Climate Change, Demography/Urbanisation, Pandemics, Water, Poverty, Bribery/Corruption etc.

The methodology, coverage and complexion can, however, vary substantially between proponents. From avoidance of certain activities to support of others to dialogue with companies and focus on particular sectors etc. (slide)

From an institutional perspective, the usefulness of best of sector or ESG ensures little change to portfolio construction. Retail-wise, however, it's susceptible to questioning.

And the differing definitions can lead to researchers identifying vastly different levels of interest. One I know of talks about Australian SRI having \$20b vs RI/ESG's \$300b in assets. These overseas charts are in my view somewhat misleading as they lump together the genuine and the more superficial exponent. (slide)

But I don't want to get too hung-up on terminologies.

## **KiwiSaver**

Though the early stunning uptake of KiwiSaver seems in contrast to Australia's choice of super fund, the latter, and the requirement, allied to NZ, of providing a statement about their approach to RI, may offer some relevance to augmenting investor interest.

Choice of Superannuation fund in Australia had little initial impact. Early predictions of account changing behaviour, as high as half superannuation holders, proved wildly inflated. In the end the less than 10% actually moved.

And the majority of these were motivated to do so only when changing jobs. So choice of fund really didn't result in the disruption to traditional 'business as usual' that many had feared. There are two caveats, however.

In order for a change of fund to take place there has to be a compelling argument. Without this it is invariably performance and fees and perhaps levels of service (slide) that are pertinent - pretty much applicable equally to all funds, and thus insufficient to motivate a move. In other words, where everyone is vanilla, 'alternatives' aren't appealingly different. Having a product offering a unique selling proposition can be a key motivator. And at the same time imbues further loyalty within the client base.

As case in point, the uniqueness displayed within Australian Ethical Superannuation saw the number of enquiries spike in the order of a third in the early days of choice implementation. And a significant proportion of this increase was sustained, establishing a higher level of general enquiries since.

Secondly, the latest analysis shows a belated taking advantage of the 'choice of super fund' legislation introduced three years ago. In the 2008 financial year moves were up 81 per cent compared to the previous year - around 200,000 super fund members exercising choice of fund. According to SuperChoice: 'this trend is not a statistical blip. This is the future mass market forming very quickly.'

The fact that KiwiSaver will be required to state its approach to responsible investment is akin to the 2004 Australian Securities and Investments Commission (ASIC), introduction of SRI guidelines. A mandatory requirement that all products with an investment component include disclosure of 'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention and realisation of the investment'.

This could be undertaken in one of three ways:

- (a) systematically take into account these issues;
- (b) only take them into account from time to time where they have a financial impact; and
- (c) do not take into account these issues.

The vast majority conform to the latter (c). Only about 40 go down route (a).

Though relatively small in scale, it is clear that (a) offers real differentiation. With deep green investors estimated at 10% a built-in market appears to exist. Moreover, there are certain career categories particularly attracted to the sphere – teachers, complementary therapists, scientists/engineers and social practitioners. What is obvious is these people are more discerning in their investment selection options – will revile greenwashing, and thus will demand greater transparency, more often than not expecting a wholehearted approach and an ongoing component of education.

Relatedly, as we approach the end of the decade the rate of growth in the workforce is slowing in Australia. This has implications for funds in dealing with the issue of baby boomers drawing down their retirement income and not a correlating number of people entering the workforce. Some have talked about this development as the demographic Y2K for superannuation funds. A compensating factor may be seen in the growth of ethical/sustainable investment.

Not only is such funds growth 2-3 times conventional funds but there is a cultural match, especially with Gen Y and women (and likely millennium babies).

Younger generations are savvy enough to recognise that the actions of the companies they support through their savings and superannuation have a great bearing on their ecological impact. So they do more than adjust personal actions such as conserving energy and water, they're also targeting their savings to support genuinely sustainable industries. Employers offering these sorts of superannuation alternatives will likely assist in attracting a desired pool - becoming employers' of choice.

Attracting a younger clientele and inflows which can act to balance the baby boomer outflows is perhaps the truest definition of a sustainable business.

So when done well the foresight/thought leadership inherent proves highly attractive to a new demographic, often younger, better educated with a strong female representation. (slide)

## **UNPRI**

In the past couple of years the United Nations Principles of Responsible Investment (UN PRI) has been enthusiastically embraced by many in Australia.

Many regard it as a blueprint for financial institutions wishing to incorporate 'sustainable' or environmental, social and governance (ESG) principles into the way they operate. (slide)

UN PRI signatories comprise asset owners, investment managers and professional services partners representing more than \$15 trillion in assets under management.

With around 40%, compared to a global 10%, Australia has one of the highest UN PRI participation rates.

Debate surrounds the impact that environmental, social and governance (ESG) issues can have on long-term investment returns and the widespread acknowledgement of the importance of incorporating ESG issues into mainstream investment processes. But what does this actually mean? And how can it be done? (Slide)

Obviously the action points within UNPRI set a framework. (slide) But, if I was to be harsh, it is possible to undertake much of this at a rather superficial level – translating to doing little more than chat and engage.

At the extreme, it appears that reading a company report incorporating ESG could be sufficient, or worse still the mere obtaining of such a report. And what if even such a pedestrian route was not followed? Is the UNPRI going to de-list signatories? One could rudely declare that the current level of participation is occurring simply because nothing substantive is initially required. (Are there echoes regarding the Carbon Disclosure Project?)

Certainly the RIAA explicitly acknowledges such shortcomings in its current drive to ‘develop the skills and competencies of the industry’s employees to understand, monitor and manage these ESG issues.’

Furthermore it seems several systemic impediments present themselves to a successful UNPRI despite the apparently high numbers of participants.

- General lack of active interest
- Institutional gatekeepers and asset consultants
- Short-term performance driven analysts

I believe we still have to wait and see the reality of any practical commitment.

Apart from the application of ESG potentially lacking formality or structure the failures in ESG utilisation can be seen in what is reasonable coverage of governance – with which the mainstream fund managers/brokers are comfortable, but is far less in the way of environmental and social aspects.

If evidence is needed, the fact is no environmental (E) or social (S) resolutions were put to AGM’s in Australia in either 2006 or 2007.

But there is also a way, via shareholder activism, through which individuals or groups can exert pressure on companies to affect a particular corporate practice. The method could entail anything from protests to proxy voting, from engagement/dialogue to boycotts, or letter writing to advocacy – the active putting of resolutions at AGM.

The area of shareholder advocacy is my particular interest and the focus of my recent Churchill Fellowship. Australian Ethical is currently developing a new approach, so if you are looking for a way to broadly implement ESG, we should talk.

In this context individual shareholders increasingly do not see themselves as passive participants within the corporate landscape. The growing acceptance of Climate issues within the broader population and the corporate world was expressed last year in the dozens of Climate Change related resolutions filed at company AGMs in the US.

Until the past few years the environmental and social issues focus yielded positive community outcomes, orienting corporate policies and practices to protect endangered forests, fight workplace discrimination, and end ties with repressive regimes, just to name a few.

Today it is CC holding centre stage. Representing **the** issue outside established corporate governance concerns. In fact a number of sustainability commentators argue that CC has become a crossover issue. That is to say, of the environmental and social matters that are often addressed at AGMs - though traditionally receiving lesser levels of support – CC is taken as seriously and starting to attain the same level votes as the more tangible issues. It is not hard to understand why either – it can directly and dramatically affect the bottom line of almost any company.

Votes for shareholder resolutions that would force General Motors and ExxonMobil to take action on greenhouse gas emissions received record levels of support at the companies' annual meetings.

A similar resolution asking General Motors' board of directors to commit to hard goals for reducing greenhouse gases received votes representing 25.7 percent of the company's shares. The G.M. resolution showed a massive increase in support from previous votes. Since 1998, resolutions at the company that sought even simply disclosure of emissions rates received only 3 to 7 percent approval.

Whilst non-binding, resolutions receiving a quarter of shareholder votes, are enough to make management stop and think about what steps it needs to take.

In light of this it is fascinating to note this month GM reporting a loss of some US\$16B in the 2<sup>nd</sup> quarter [http://biz.yahoo.com/ap/080801/earns\\_gm.html](http://biz.yahoo.com/ap/080801/earns_gm.html). An amount potentially company destroying. Plants are to be closed, truck and SUV lines abandoned, and 'fuel-economy technology leadership [implemented] taking full advantage of global growth opportunities.' One surely has to ask whether this company 'couldn't see the writing on the wall', fairsing better had it been more strategically aware of the basic issues of peak oil and environmental matters. It was supposedly looking to the future – was it blind-sided or just unaware.

You would think that after Toyota (slide) become the largest vehicle manufacturer in 2007 – somewhat on the back of its 1 million unit sales of the hybrid Prius, the likes of Ford and GM would have been alerted to a change in market consumerism.

So does this say something about their quality of management, foresightful and strategic thinking (or lack of it), good analysis of resource depletion and pricing issues? ESG considerations certainly gave a heads-up.

## Climate Change

Climate change is the biggest issue facing this generation. Some would say it's the most important issue to face all generations.

The scope and potential of climate change – environmental, humanitarian, health, political - make it an overarching issue to rival the consequences of war in magnitude. It therefore becomes an obvious case study.

Analysts such as Citigroup's (slide) have sought to make assessments of climate change exposures for ASX 100 companies – the winners and losers.

It is true to say some sectors will be impacted more than others: front and centre (slide) will be resource companies, steel producers, oil and gas. And whilst there will be major implications for plastics manufacturers, auto, electricity generators, coal and agricultural sectors, there is a broader picture in which nothing, and no part of our economy, is likely to be left completely unaffected. From tourism to insurance to where we grow our food and how far we transport it, even to matters as to how we plan our towns and regional areas – and whether we place large DIY/department stores on the fringes of cities without adequate public transport.

The Centre for Australian Ethical Research recently replicated EIRIS' international study for industry sectors of ASX 200 companies, in order to address investor risks and the impact on shareholder value.

For companies and their investors climate change presents a number of risks and opportunities:

- Regulatory challenges
- Changing market dynamics
- Changing weather patterns
- Reputational

Figure 1 illustrates that nearly half (48%) of companies in the S&P/ASX 200 are classified as high or very high impact for climate change. (This represents over AUD 545 billion market cap.)

Figure 2 illustrates that over half (53%) of companies in the S&P/ASX 200 are considered to have unmitigated risk. (This represents over AUD 605 billion market cap.)

The Australian results appear far worse than the global 300 comparison in percentage terms – often around 50% vs 33%. In other words, Australian investors must better limit the impact of climate change so as to secure financial returns.

Most of the discussion re CC has revolved around shares. But as I've tried to indicate no sector or asset class will be immune. Out of all the asset classes,

property is the most exposed to the two primary categories of climate change risk: physical and regulatory. Moreover, it is estimated that property is the conduit for about half of total GHG emissions through its construction, use and demolition.

To date, property valuations and pricing by the market have been slow to reflect the benefits of low-energy buildings or account for the risks of accelerated obsolescence of energy-inefficient buildings. However, this is starting to change. Most buildings are being equipped with higher-efficiency fittings, and governments are beginning to enforce energy standards to reduce waste. And you know something is up when the likes of Mirvac trumpets construction of the first 6 star shopping centre in a Qantas magazine. Why is it important when mainstream companies make such overt promotions?

Part of this may be seen as having reputation/innovator benefits, but it can equally be viewed as potentially reducing costs and even more so to attract a valuation premium in a carbon constrained world.

It was the same for Australian Ethical. In recently winning the prestigious Banksia Environmental Foundation award for our new environmentally friendly headquarters it was said: 'Australian Ethical Investment puts its ESG theories to practice.'

It was not solely about 'doing the right thing'. We wanted to show how it was possible to take the original, 20 years old building, and for a similar cost of a normal refurbishment to transform an ordinary suburban strata office into a state of the art sustainable office, whilst never forgetting that the productivity and comfort of the people who work there is paramount. (slide)

So it was also about savings and reducing risk. The refurbished building produces about 70 per cent fewer greenhouse emissions than an average commercial building (about a 75% energy saving) and uses about 75 per cent less water.

Features of the refurbishment include (slide) external wall insulation, solar water heating, opening, double glazed windows, and rainwater capture among others. Another important part of the refurbishment was re-use of materials. Only the third 6 green star rated building in Australia at the time, this gives a heads-up to future investment opportunities.

## **Reputation**

Much of the preceding illustrated how businesses are adjusting the way they operate to identify broader concerns and opportunities, contain risk, be better corporate citizens, or effectively differentiate themselves in a marketing dimension.

But it is not all upside. A more informed and through investor leads to greater scrutiny and a more critical consumer world.

Even when you think you're doing the right thing there can be potential downsides, in claiming to be, or going, carbon neutral. Not being sufficiently diligent can result in accusations of greenwashing. Even thinking it's being done correctly can inadvertently lead to problems.

Take for instance pitfalls inherent in carbon offsets. There are numerous issues in regards the benefit of planting tree – species, water/soil/biodiversity, location to temporal mis-alignment to the vexed food/fuel debate and energy trade-offs to the consequences for food prices and social unrest.

Thus, from a business perspective it may not necessarily be enough to want to do the right thing or think you are doing so – because more than likely you'll eventually be judged on it.

Clearly a joke site: <http://www.cheatneutral.com> parallels ways of offsetting carbon emissions with offsetting infidelity. It is well worth visiting to become versed in the emergence of possible dilemmas.

In the same vein, public consciousness about environmental issues is maturing causing the environmentally responsible 'green' factor to become a key differentiating point for brands.

A recent Corporate Watch Australia survey reveals that many so-called ethical/sustainable investment funds invest in uranium mining. Thereby generating a disconnect from what most investors would logically expect.

And the US might show us the future of failure to live up to prescribed standards. Issues related to false and misleading advertising can be equally applicable to a new order in funds management. Apart from impacting upon reputation, not being true to label can have direct financial consequences.

Instance Pax World Management, the US socially responsible mutual fund house, recent agreement to pay a \$500,000 Securities & Exchange Commission (SEC) fine to resolve charges that its funds failed to follow their own socially responsible investing rules over a five-year period. It's viewed by some as opening the way to increased regulatory oversight in the US.

### **Performance issues**

The last topic I'd like to address is that of performance. And unlike many in this field I do not intend to make the case that an ethical/ESG/sustainable investment style, by its very nature, will always outperform.

There are numerous reasons why it should do better, however: picking up on long term trends with a focus on sustainability and management quality, as well as legislative and customer demands such as recycling, smoking bans and high taxation for gambling and carbon emission trading schemes.

Returns research from the Responsible Investment Association of Australia shows that particularly over the longer term ethical/SR funds have been very competitive. As at June 2007 responsible managed funds outperformed their conventional counterparts over 1, 3 and 5 years across Australian, international and balanced categories. This obviously does not take into account the past year. As everywhere, the Australian market has been unkind. Though history has shown such funds have greater affinity with a growth style, Australian Ethical seems to perform more strongly in down markets.

Certainly there is no reason to believe returns must be sacrificed in order to invest responsibly. As a study by the United Nations Environment Program Finance Initiative and Mercer indicates, integrating ESG factors 'does not compromise investment performance, and in many cases can enhance it...'

And likewise: 'As more evidence unfolds supporting the connection between sustainability and financial performance, those who do not consider these factors in investment decisions could ultimately leave themselves open to charges of imprudence.' (The Prudent Trustee, 2005.)

In the end though, there are many and varied ways in which to implement ESG principles from responsible investment/UNPRI to ethical/sustainable practices. With or without a screening process, in a fulsome manner or superficially. Much remains dependant on the manager's capacities and will resonate differently with investor bases.

Whatever stance we choose to safeguard our ecological, financial, humanitarian and social future, it must be effective, and action is required now. The future is already here.