MONEY|MANAGEMENT

Guide to ESG

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ESG investing is not going anywhere but up

There is no doubt that the integration of environmental, social, and governance (ESG) investing is here to stay. General media coverage on the subject has exponentially increased in the last few years in Australia and this year's UN Climate Change Conference (COP26) has had far more coverage than ever before.

As mentioned in this *Money Management Guide to ESG*, Australian investors are increasingly demanding more from their investments and governments in light of climate change and technological acceleration.

However, funds that are able to use the Responsible Investment Association Australasia label to display their focus for ESG and responsible investing are often still investing in companies that expand fossil fuels and are incompatible with the net zero by 2050 pathway.

Not only this, they are failing to vote in favour of numerous climate-related resolutions and cite engagement with those firms as a reason. Additionally, they are failing to demonstrate that engagement is making any progress.

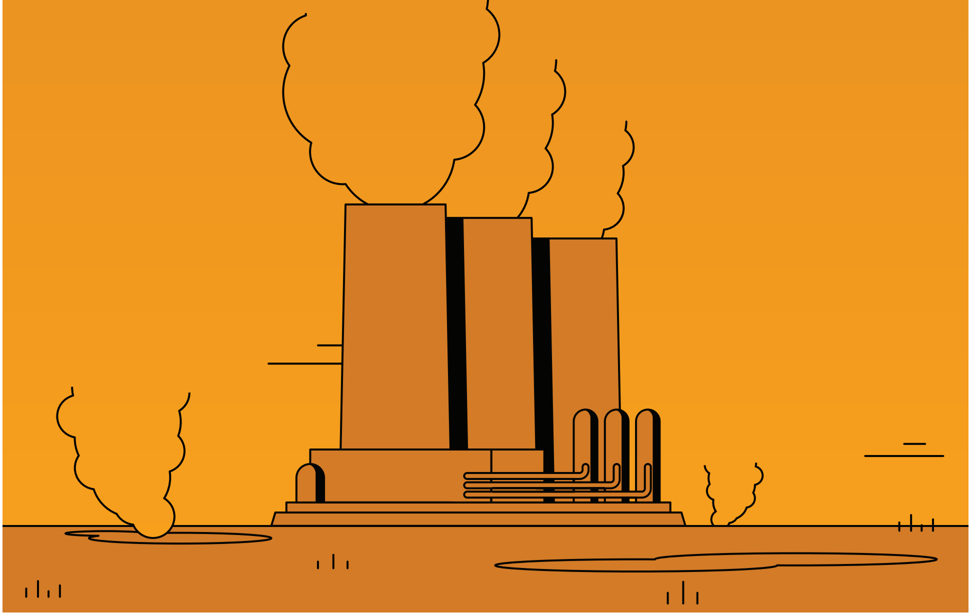
This kind of rhetoric and approach will need to change if the world truly wants to move to net zero by 2050 as investors are now more seriously pushing for this.

Advisers are already asking clients about investing ethically or including ESG factors but that may be a thing of the past as failing to consider climate change policy could affect a client's best financial interests.

It does not matter whether one believes in climate change as what is clear is that ESG is becoming part of successful investing.

I hope you find this year's *Guide to ESG* informative and useful.

Jassmyn Goh,
Editor



Are companies engaging on net zero?

With this year's United Nations Climate Change Conference now completed, Liam Cormican investigates what industry advocacy groups are addressing when it comes to moving toward net zero emissions by 2050.

In the age of climate change and technological acceleration, Australian investors are increasingly demanding more from their investments and governments.

A recent Investor Group on Climate Change (IGCC) survey of 50 Australian and New Zealand asset owners and managers, representing over $3.1 trillion in assets, found four-in-10 investors had a portfolio-wide commitment to net zero greenhouse gas emissions with another 40% planning to implement the goal.

This article focuses on the 'E' in environmental, social and governance (ESG) investing and explores the actions that Australian fiduciaries are taking to encourage sensible government policy in this space.

Policy engagement

IGCC chief executive, Rebecca Mikula-Wright, said policy engagement was a relatively newer focus of

climate risk management for its investors because of the growing recognition of the scale of risk that climate change posed on their investments.

The IGCC is an ESG-focused collaboration of some of the largest Australian and New Zealand institutional investors and superannuation funds. It represents over 7.5 million people with total funds under management of over $2 trillion.

According to Debby Blakey, chief executive of HESTA Superannuation, which is an IGCC member and signatory to the Climate League 2030, constructive collaboration between investors, business and government is vital.

"Investors have led the call for a net zero by 2050 target and substantive climate action, warning of the shift by leading global investors to actively manage their carbon exposures and to invest in transition opportunities," she said.

"The broad business support for a net zero target, particularly among industry bodies that previously opposed this, shows the effectiveness of this engagement and advocacy push."

She says we are seeing an inflection point in investment.

"Global investors are putting in place strategies to drive down carbon in their portfolios and looking to capitalise on opportunities arising from the transition to a low-carbon world," she said.

Blakey said this was having "a profound effect on the flow of capital globally" as countries who were establishing clear long-term policy settings would likely be at the front of the investment queue.

"It's why we have strongly advocated for the Australian government to commit to net zero by 2050 and provide greater investment certainty through clear interim targets on the path toward achieving this goal."

What does advocacy really mean?

Will van de Pol, asset management campaigner at Market Forces, an affiliate advocacy group of Friends of the Earth, said many IGCC and Responsible Investment Association Australasia (RIAA) members "talk a good game on net zero by 2050".

"But none of their portfolios are in line with that outcome because they are still investing in companies that are expanding fossil fuels and that's incompatible with the International Energy Agency net zero by 2050 pathway," he said.

"And they are failing to vote in favour of a number of key climate-related resolutions that would bring companies' behaviour into line."

In April, a Market Forces climate-related shareholder resolution was filed to Woodside, Santos and Oil Search calling for the companies to disclose how their capital expenditure and operations would be managed "in a manner consistent with the climate goals of the Paris Agreement".

Van de Pol said many of Australia's top super funds voted against the resolution, including HESTA who is mentioned in this feature.

He said all super funds, except for those set up to specifically invest ethically, were continuing to invest in fossil fuel companies, particularly in the gas sector.

"In a lot of cases they are saying they won't divest and instead engage with these companies but they're failing to demonstrate that engagement is making any progress."

According to RIAA's executive of policy and standards, Nicolette Boele, fiduciaries were putting greater focus on government policy engagement through an evolving

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implementation of the *Superannuation Industry (Supervision) Act 1993*.

Section 62 of the act requires superannuation trustees to act honestly, to properly invest funds and to "act in the best interests of the beneficiaries".

According to Boele, many of RIAA's fiduciary members were engaging in a process known as common goals and collaborative action which evolved from the need to act in the best interest of beneficiaries.

Members would engage with Australian companies they invested in to encourage them to lobby for more policy certainty around climate change – favouring the certainty of New Zealand's net zero by 2050 target, Boele said.

"They're engaging for getting some policy certainty… like 'what's going to happen at 2030?', an emissions trading scheme with a cap and trade and a price on carbon," she said.

Boele said clear policy signals would help investment managers achieve better risk-adjusted returns for their beneficiaries because systems could be developed, like the Clean Energy Finance Corporation (CEFC), which would better help funds price risk in their valuations.

The CEFC is an Australian Government-owned Green Bank responsible for investing $10 billion in clean energy projects on behalf of the Government.

Although Boele did not have a strong opinion on whether it was the role of government to create a classification system, she did say there was no clear guidance in the Australian marketplace in place.

For instance, the Australian Competition and Consumer Commission oversees a green consumer law that regulates false and misleading environmental claims. But, according to Boele, this has not been translated clearly into the finance sector.

Many members are using RIAA's certification program which checked that products were true to label under its certification requirements.

"It's all about understanding how to price risk, so we're just getting on with it and using the data we have," Boele said.

"And if we can get those parameters out of the government and not just a 2050 but a 2030 target like nearly every other country in the world has, then the investment community can put those parameters into their own pricing, and we can have better price discovery, and then the money is going to flow away from those assets that don't help us achieve it, to ones that do."

According to Mikula-Wright, the IGCC and its members are working closely with policymakers to ensure they understood the risk of capital flight and the opportunities available if they get the right policy settings.

"They are also constructively engaging with governments and regulators on more technical, but critical areas, such as driving better quality climate risk disclosure and valuing climate adaptation," she said.

"This is about engaging in the areas of climate change where it is possible, and then pushing externally where more ground needs to be made."

On that point, this year the IGCC partnered with the Global Investor Statement which saw 587 global investors representing US$46 trillion ($61.3 trillion) in assets join to call on global governments to commit to stronger climate policies.

And 21 investors, banks and insurers, have joined IGCC's Climate League 2030, which pledges support and acts towards achieving

deeper Australian emissions reductions of at least 45% below 2005 levels by 2030.

The Climate League 2030 includes Aware Super, Cbus Super, IFM investors, QIC, Allianz, TelstraSuper, Lendlease, Pendal, Teachers Mutual Bank Limited, Pollination, UniSuper, NewForests, AustralianSuper, VFMC, U Ethical, ISPT, Active Super, Impact Investment Group, Hesta, Australian Ethical Investment and abrdn (formerly Aberdeen Standard Investments).

Mikula-Wright said portfolio alignment and traditional risk mitigation approaches alone are not enough to fully mitigate the scale of risks associated with climate change and financial organisations had a role to play by providing funding.

"Ultimately, to secure a healthy economy for Australia it will require the government to work in partnership with investors, companies and communities to unlock the private capital required to fund our inevitable transition to net zero emissions," Mikula-Wright said.

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Spotting an authentic sustainable investment product

By Emilie O'Neill

The case for ESG investment is compelling, but with the vast array of products now available, investors should be wary of 'greenwashing'. Greenwashing is when a fund is labelled as an ESG product, however the underlying holdings are not what a typical ESG investor would expect.

In recent years there has been a large increase in the number of ESG related investment products, fuelled by increasing demand from investors who are more aware of where they are investing their money.

According to the Responsible Investment Association of Australia, around 60% of Australia's $3 billion-plus investment management market is now self-declared as practicing 'responsible' investment.[1]

There is now clear evidence that responsible investments can not only keep pace with their peers but can outperform. Typically, companies performing well on ESG will be better managers of other risks.

With the rise in popularity of ESG investing, some fund managers have sought to capture flows by describing funds as an ESG or sustainable product without truly meeting the definition.

So, how should investors avoid greenwashing and what should they consider when assessing an ESG product?

Here is a checklist of issues to consider:

- **Exclusionary or "negative" screens:** Does the fund use negative screens and, if so, are the revenue thresholds that are used authentic? An exclusionary screen or negative screen is when a fund will exclude a company from its investment universe based on its exposure to a sector or industry. Examples of commonly excluded sectors are fossil fuels, gambling, adult entertainment, and alcohol. Exposure is typically measured based on revenue; however, the level of tolerance can differ between product offerings
- **Positive or thematic screens:** Does the fund target investment in certain industries through positive or thematic screens? Positive screening seeks

[1] RIAA: Responsible Investment Benchmark Report Australia 2020

companies from a universe with desirable ESG qualities. Positive screens can be implemented through a revenue threshold or a score-based system. A revenue threshold is where a fund will invest in a company that derives a certain percentage of its revenue from that sector, such as environmental services or social outcomes. A score-based system involves an internal or third-party assigning a score to a company for its ESG performance.

Investors should check that the performance metrics scored upon are sufficiently detailed and align with their beliefs.

- **Transparency:** Does the fund publish a full list of the investments in the fund? Best practice is to publish a full list of holdings, typically on a lagged basis rather than just publishing the top five or 10 holdings. This allows investors to consider whether the companies in the portfolio align with their views on sustainability.
- **Controversial companies:** Does the fund hold companies that have recently experienced ESG related controversies? This is not always a red flag as often companies that are involved in controversies seek to learn from their mistakes and greatly improve their ESG practices.
- **Proxy voting transparency:** Does the fund publish their proxy voting record, and if so, how does it align with sustainability preferences? Best practice is to disclose the proxy voting record. This allows investors to look through the record and consider whether a fund has actively used voting rights to improve outcomes where an annual general meeting of the company is considering a controversial issue.
- **ESG team integration:** Does the dedicated sustainability team sit within the investment team? An ESG team separate from the investment team may suggest that ESG considerations are less likely to be reflected in investment decisions.
- ESG publications: Does the fund publish an engagement report and/or an impact statement to detail the level of engagement the fund is having with companies and the impact of fund's ESG efforts?
- External recognition: Is the fund recognised by credible external parties focused on ESG and responsible investment? For instance, is it rated on the Responsible Investment Association of Australasia's Responsible Returns Investment Tool?

The Better Future Strategy seeks companies that are contributing to a better future. The funds use both an exclusionary and a positive screen, internal ESG scoring system and engagement to seek out companies contributing positively to society or the environment.

We believe there is a growing need for sustainability in investing, but fund managers must live up to their ESG claims. With greenwashing on the rise, investors should ensure they are armed with the right information to support their investment decisions.

Disclaimer: Please note that these are the views of the writer and not necessarily the views of Perennial Investment Management Limited. This article does not take into account your investment objectives, particular needs or financial situation.

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Advisers can't fail to act on ESG

Whether or not a client is interested in responsible investing will be moot as climate change policies by the Government and markets mean ignoring change is not in clients' best interest, Chris Dastoor finds.

Financial advisers are likely going to have to make environmental, social and governance (ESG) decisions for client portfolios whether clients express any interest, as climate change policies will ultimately affect a client's best financial interests.

Louise Watson, Natixis Investment Managers managing director, said even if an adviser or a client had no view on ESG issues, many funds were already integrating ESG into the way they manage money many funds that were integrating ESG into the way they manage money.

"What we're seeing now is that businesses have got good governance, good social practices and are doing everything across UN Sustainable Development Goals [SDGs] and ticking those ESG metrics [and] those businesses are outperforming," Watson said.

"We're seeing portfolio managers integrate UN SDGs into their portfolio, because that's leading to better business models.

"Even if you don't express a view, many of these funds are integrating ESG into the way they manage money."

Jessie Pettigrew, BT head of ESG and sustainability, said over the long-term good management of ESG factors would positively influence risk-adjusted returns.

"While it's important for advisers to understand how ESG issues are being considered in the funds and investments they recommend, they don't have to use all the tools in their kit, but they may want to make their clients aware," Pettigrew said.

"For advisers, understanding if, how and why an investment or investment manager considers ESG is important."

Pettigrew pointed to the Australian Prudential Regulation Authority as it wrote to regulated entities encouraging them to consider the impact of climate change on their operations and the Reserve Bank of Australia who described how climate change was factored into its monetary policy decisions.

But there was also the Financial Adviser Standards and Ethics Authority's (FASEA) code of ethics which meant it was part of considering clients' best interest.

Brett Jollie, abrdn Australia managing director, agreed that if advisers were not looking at ESG on behalf of their clients then they were not acting in clients' best interests.

Con Koromilas, abrdn Australia head of distribution, added that fund flows into ESG products had increased drastically in the last quarter compared to all four quarters in the previous year.

"We've been slow in this market adopting the ESG aspect in portfolio construction," Koromilas said.

"Even 12 to 24 months ago I don't think it was even on the agenda... whereas that's changed a lot and we'll see if that trend continues or if it was an aberration."

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How investors can support net zero

Divestment and engagement will be required to help steer companies towards environmental, social and governance outcomes, Chris Dastoor writes.

Government action will be needed to achieve the goal of net zero emissions by 2050, but environmental, social and governance (ESG) investors also have an important role to play.

David Sheasby, Martin Currie head of stewardship and ESG investment strategy, said capital markets and investors had a significant role to play in helping achieve net zero.

"There is a common misconception that without raising direct equity capital, the ability for secondary markets to create 'impact' in support of net zero is limited," Sheasby said.

"We strongly disagree with this assumption and see three key ways in which investors can support net zero ambitions."

Sheasby said the three ways were:

- Directing capital to finance and rewarding businesses which created solutions to the climate crisis;
- Using active engagement to push for, assess and ultimately price the presence and credibility of net zero emissions reductions targets; and
- Policy engagement, education and broadening the adoption of key tools and frameworks to aid pursuit of climate targets.

"Achieving this transformation will require a significant increase in low-carbon investment," Sheasby said.

"At the global level, the IPCC estimates an immediate investment requirement of US$2.4 trillion ($3.2 trillion) per year in the energy system until 2035."

Pablo Berrutti, an investment specialist for Stewart Investors Sustainable Funds Group, said there's no such thing as a "perfect company" and the role of long-term investors was to encourage companies to improve.

"We spend a lot of time talking about what are the priority areas that we really want to engage with companies on," Berrutti said.

"Because of the type of time horizon that we invest in we don't look at them as being a three-month engagement program – we can engage on issues for multiple years to try ensure companies are trying to progress."

Berrutti said that was the primary way investors could influence company behaviour for ESG outcomes, but there was still merit to letting capital allocation do "some of the talking".

"This idea of divestment versus engagement sort of put up as choosing one or the other, I think in reality when you're investing over the long run both are important," Berrutti said.

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Perennial Better Future is part of the next generation of authentic ESG investors. We are focused on generating strong, consistent returns while investing in companies that are making a positive contribution to society and the environment.

With a large and highly experienced team dedicated to finding opportunities, we focus on companies with sustainability tail winds and strong global growth drivers. ESG analysis and company engagement are core to our strategy and ethos. We aim to build robust and balanced investment solutions with strong risk adjusted returns, capturing the sustainability thematic and shaping a better future.

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