

Integration of PRI into investment decision making

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Executive Summary

Environmental, Social and Governance (ESG) issues are material, mainstream investment issues that need to be considered at each point of the investment decision making process. The development of the United Nations Principles for Responsible Investment (PRI) is recognition of this sentiment.

Institutional investors need to first understand the potential risks and opportunities in their portfolios, and then engage their underlying investment managers before they can be comfortable that the risks are being managed and all opportunities being realised.

Once the institutional investor has looked across their traditional investments to ensure the implicit ESG risks and opportunities are being managed they can then look to other thematic styles of investing that may help them generate alpha over the longer term. The emergence of the supposed 'green bubble' that refers to green infrastructure, green property, clean tech funds and carbon funds demonstrates the developments that have been made in the space.

In the end the key point remains simple: there are ESG risks and opportunities across all asset classes – the astute institutional investor can generate out-performance by having a systematic process for considering and managing the risks and opportunities across all investments. This process is known as *Mainstreaming ESG*.

Mainstreaming the consideration of ESG issues

To mainstream Environmental, Social and Governance (ESG) issues is to systematically consider, understand and manage the ESG issues that have the potential to impact the financial performance of your investments.

To understand mainstreaming ESG, it is useful to understand what it is not. Mainstreaming ESG does not simply mean applying Socially Responsible Investment (SRI) or ethical investment methodologies. SRI and ethical investment strategies typically 'screen in' or 'screen out' companies or sectors based on their activities, the moral or ethical view of those activities, or the nature of their business. Mainstreaming ESG provides better investment decisions through more detailed investment analysis.

The opportunity for superannuation funds lies in developing their investment strategy to systematically consider ESG issues, with the objective being to better manage long-term risks and maximise investment opportunities.

Defining the scope of ESG issues

There is by no means an exact list of ESG issues that investors can 'tick the box' against. ESG issues are continually changing and often reflect the perceptions of the community at a point in time. For example, environmental regulations are in a continual state of flux and often develop out of community expectations. Carbon trading is an example of this. Five years ago, few people had even heard of a carbon trading scheme, let alone believed it was an investment issue. However, as a starting point, some ESG issues include (but are not limited to):

- Human capital
- Workplace health and safety
- Human rights
- Industrial relations
- Business ethics
- Geo-political risks
- Climate change
- Water use
- Land rights/indigenous issues
- Site contamination
- Executive remuneration
- Board structure

ESG issues are typically not addressed by mainstream investment managers in a systematic way. This is starting to change, but generally investment decisions and recommendations are made by looking back in time. For example, investment managers tend to look at past financial statements as opposed to looking forward at lead indicators such as how a company is managing its staff. This has just been the nature of the industry to date. Looking at ESG issues is just not what traditional financial managers have been trained to do.

The key point is that ESG issues are issues that have the potential to impact financial performance. Some issues that are more moral or ethical views do not always impact financial performance. For example, an ethical fund manager may screen out the alcohol industry because of the impact alcohol abuse may have in certain parts of the community. The ethical argument made is that it is wrong to invest in such companies.

From a mainstreaming ESG perspective, the investor would recognise that alcohol does have some negative impacts on society. However, companies can manage this risk by adopting responsible sale of alcohol measures, supporting independent research and education into the effects of alcohol, and ensuring they don't market to minors. It is such measures that have been adopted by Australian brewers and wine producers. These mitigation measures have meant that the alcohol industry in Australia has had little interference from regulators on its 'license to operate' in recent times. They have managed their 'social license to operate' to create sustainable businesses, and have thereby protected their financial returns.

An ESG aware-investor would consider this risk and monitor the extent to which the company was continuing to manage that 'social license to operate' risk, but would not just screen the company out of its investments.

ESG often gets confused with Corporate Social Responsibility or philanthropy. A superannuation fund that looks to address ESG issues needs to be confident that it understands this distinction. Even some of the issues listed above as examples of ESG issues may not be material in all instances. The point is that investors need to understand them, assess their materiality and respond accordingly. For a superannuation fund looking to develop an ESG strategy, it is not about setting in stone the ESG issues that will be considered; it's about building a governance framework for addressing the issues. Mainstreaming ESG really is about managing risks and identifying opportunities.

The Evidence: business case for ESG

There is mounting quantitative evidence to show that ESG issues present both risks and opportunities to investors. The basic theory is that in considering ESG issues an investment manager can better understand the risks of an investment, but also identify potential investment opportunities.

The idea that ESG information can actually help analysts make better investment decisions was also demonstrated by a research project undertaken in 2005 by PriceWaterhouse Coopers and Schroders in Europe. Company analysts were split into two groups - one set of analysts was given standard financial information alone; the other groups were given financial as well as 'extra financial' or sustainability information. The group of analysts that had both sets of information were able to make much more accurate investment forecasts and had a much lower spread of earnings forecasts than the analysts that only had the financial information.

This study demonstrates the crux of the mainstreaming ESG argument; by supplementing traditional financial analysis with a consideration of ESG issues, investors are able to make better investment decisions.

There is also now considerable analysis that shows a direct correlation or potential attribution of ESG issues to financial performance. The most compelling research in Australia has been done by Andrew Gray from Goldman Sachs JBWere (GSJBW).

GSJBW has been tracking the corporate governance performance of companies for a number of years and has undertaken statistical analysis to test the extent to which corporate governance indicators are 'lead indicators' of financial performance.

In its research entitled Good Governance = Good Returns, published in 2008, GSJBW found that companies that have poor Board skills are more likely to have negative earnings surprises. They also found that company performance is actually more highly correlated to corporate governance than to many other traditional financial metrics (that are currently widely used by investment managers), as shown in the table below. For example, Board skills, remuneration, audit and overall Board composition were more insightful as lead indicators of financial performance than Discounted Cash Flow (DCF) strength and dividend yield.

What is so significant about GSJBW's work is that it demonstrates corporate governance factors are as important as these traditional factors, therefore challenging the view that there is no investment signal from ESG issues. GSJBW has also made similar findings in relation to workplace health and safety performance.

The key point of the GSJBW analysis is not that equities portfolios should be screened to 'overweight' or 'underweight' companies identified as good or poor governance performers; rather that investors in listed equities should consider the governance issues as part of the company valuation and investment implementation process. It's about asking how the company rates on governance factors and, if it rates poorly, why, and if the reason is potentially material, adjusting the investment decision accordingly.

Summary

ESG issues are relevant for superannuation investors because they have the potential to impact members' returns. Mainstreaming ESG is not about taking a moral or ethical view in relation to a company sector or asset class. It is about systematically considering the ESG issues that could impact performance and managing them accordingly. The inherently short term nature of the Australian finance market, the size of the Australian superannuation industry and the effective permanent share ownership presents the industry with challenges. By mainstreaming the consideration of ESG issues, the risks and opportunities can start to be managed and maximised.

Strategy	Long short return (%)	
	30/09/06 – 28/02/07	31/08/01 – 28/02/07
HIGH BETA	16.4	14.2
ROFE PEG	12.1	-2.0
PE RELATIVE	11.0	71.7
EPS MOMENTUM – 3 MTH CHANGE IN MEAN EPS	7.0	28.1
HIGH EPS GROWTH	6.5	-17.6
LOW PRICE/BOOK VALUE	4.9	41.3
Board skills	4.2	21.6
Remuneration	4.1	32.1
Audit	3.8	29.4
Overall governance	3.5	2.9
EVA COMPOSITE	3.3	23.0
HIGH ROE	2.6	22.3
LOW PER	2.1	59.3
Board	2.1	11.5
DCF strength	0.7	6.0
Accounting	0.7	-20.7
HIGH DIVIDEND YIELD	-4.9	46.6
EPS MOMENTUM – 1 MTH CHANGE IN MEAN EPS	-5.1	26.1
PRICE MOMENTUM	-12.8	18.9

Source: Goldman Sachs JB Were, Andrew Gray, 2 April 2007.

There is now more than adequate evidence that ESG issues are potentially material to the investment performance of superannuation fund portfolios. It is therefore reasonable for fund trustees to ask their managers to consider the ESG risks for their portfolios. This ought not to be seen as imposing greater complexity on the investment process, rather as a way of making better investment decisions.

First steps for funds looking to mainstream

Once a superannuation fund has decided to mainstream a consideration of ESG issues, there are some first steps they can take towards embedding ESG considerations throughout the supply chain:

- Understand the nature of their supply chain influence.
- Engage that supply chain to find out to what extent ESG issues are already being considered.
- Prioritise asset classes based on potential risks and opportunity.
- Consider collaborative initiatives.
- Consider the superannuation fund's objectives.

This is by no means an exhaustive list. It is provided as a starting point.

Understanding the supply chain influence

ESG risks need to be understood and addressed through the whole investment supply chain. The superannuation fund is effectively the top of the supply chain, and by engaging the service providers it can drive the industry's approach to ESG.

A superannuation fund looking to mainstream ESG needs to decide how they are going to engage aspects of that supply chain; that is, how they are going to encourage and create incentives for their service providers to integrate a consideration of ESG issues. This will be different for all superannuation funds. For example, a superannuation fund that does not have an internal investment team but rather outsources all of the investment decision making to consultants will have a different 'sphere of influence' or way to influence than a superannuation fund that has a high level of in-house investment management. The role of the Trustee Board in setting the investment philosophy for the superannuation fund will also influence how a fund approaches ESG issues.

A smaller superannuation fund that is in mostly pooled investment products (as opposed to direct mandates) may also have different points of influence than a larger superannuation fund that has mostly direct and individual mandates with investment managers. This is not to say small superannuation funds cannot influence outcomes. There is a Small Funds Initiative (SFI) as part of the PRI. The SFI work stream is dedicated to assisting asset owners with less than USD 1bn funds under management in their implementation of the PRI. One of the objectives of the SFI is specifically to decrease cost of PRI implementation with economies of scale by pooling resources and establishing SFI group prices for services.

Most superannuation funds also have an existing investment strategy. Right from the outset, it is worth considering how ESG is already being articulated in the fund's investment strategy, though it may not be called ESG. For example, some superannuation funds may articulate their desire for a long-term focus in investments. Given the long-term nature of many ESG issues, it may be that mainstreaming ESG is actually already aligned with the long-term thinking and just needs to be articulated.

Regardless of size or governance structure in all scenarios, the superannuation fund is the ultimate client and can reasonably request its service providers to provide information about how ESG issues are being considered in its investment supply chain.

Engaging the supply chain

The next thing a superannuation fund may want to do is actually determine what its service providers are currently doing to integrate a consideration of ESG issues. Given the rapidly emerging prominence of the PRI in the Australian market, many managers are now accustomed to getting questions on ESG and have thought about it to some extent.

There are several ways that a superannuation fund may understand what service providers are currently doing:

- Ask if they have signed the PRI and if they have reported on implementation
- Survey managers with specific questions that consider:
 - the asset class and the associated characteristics eg liquidity and risk. A direct property mandate has very different investment characteristics to a listed equity mandate. A listed equity fund manager has much more liquidity and traditionally a shorter investment horizon than a direct property or direct infrastructure manager, who may take a 30 year or longer view on the investment.
 - the investment structure eg pooled or individual mandate.
- Have investment consultants benchmark individual managers on the mainstreaming of ESG
- Integrate ESG questions into the annual review process

Through the engagement of the supply chain, the superannuation fund will also increase their own understanding of ESG issues and be able to test their managers understanding and alignment with the superannuation fund's long-term interests.

Prioritise the asset classes to focus on

Different asset classes have different levels of ESG risk. By prioritising different asset classes, superannuation funds may be able to focus on delivering tangible outcomes from their mainstreaming ESG process.

By taking a top-down asset class view, the superannuation fund will be able to decide from the outset the ESG issues that are a priority for the fund. If most of the funds are already allocated to long-term focused mandates, it may be that they only need to do some work at the margin in the listed space and communicate to their long-term managers the ESG concerns and interests and ensure their management.

Thinking about ESG issues from an asset class perspective also enables the superannuation fund to test their own knowledge and understanding of ESG issues. Sometimes only by thinking about the application of ESG will the issues become obvious. For example, only by looking at the underlying assets in the infrastructure portfolios and thinking about them with an ESG perspective will the specific environmental issues be considered.

It may be unrealistic for a superannuation fund to address all of the ESG issues for all of their investments at once. Initially through fund manager engagement undertaken by a superannuation fund, the fund will gain an understanding of what their fund managers are already doing to address ESG issues and where the potential gaps are. This can feed into the asset class prioritisation process.

The potential risk for an asset class will also feed into that process.

Consider collaborative initiatives

There is often benefit in collaborating with other superannuation funds on ESG issues. The best example of this is with company engagement. The business case for engagement is that it is in a superannuation fund's best interests to protect the performance of the Index. Most superannuation funds are effectively permanently exposed to the S&P ASX200. Therefore, they are permanently exposed to the ESG issues that may impact financial performance. It can be a win-win scenario if superannuation funds collaborate on engaging 'recalcitrant' companies that are dismissive of ESG issues or overly short-term in focus at the expense of sustainable long-term shareholder returns.

There are a number of collaborative initiatives on ESG which complement the PRI, including the Carbon Disclosure Project, the Investor Group on Climate Change and the newly formed ESG Research Australia.

In the early stages of consideration of ESG, a superannuation fund may want to think about its receptiveness to working with other superannuation funds, and even perhaps investment managers, as this will determine the amount of resources it needs to allocate to the approach to mainstreaming ESG.

Deciding on objectives

Right from the beginning, it is worth the trustees thinking about exactly what they want to achieve from mainstreaming ESG. Some questions they may ask include:

- Is it simply that the superannuation fund wants risks to be managed?
- Does the superannuation fund want ESG investment opportunities to be actively sought as well?
- Does the superannuation fund want to participate in the policy debate on ESG issues?
- To what extent does the superannuation fund want to engage its members in the ESG discussions and debate?

By thinking about the fundamental objectives of mainstreaming ESG, the superannuation fund at early stages can set their aspirational objectives.

In discussing and thinking about the objectives, a superannuation fund needs to also recognise that ESG issues are continually evolving in line with wider community expectations and will need to have a continuous improvement and monitoring provision in their overall mainstreaming strategy.

Implementation options

Once these objectives are set, the superannuation fund can set the ESG policy. The options include:

- developing a stand-alone ESG policy
- expanding the corporate governance policy to include ESG
- developing ESG thematic policies; for example, a climate change policy
- integrating ESG into the current investment policy or statement of investment principles, or
- a combination of the above options.

Once the ESG policy has been set, and the priority areas and action items determined, the method of implementation needs to be decided. There are a few things a superannuation fund may want to consider, including:

- Governance process: The fund will want to decide if ESG ultimately sits with the Trustee board or with the executive, and the extent to which asset consultants are used in the process. This will determine the governance and reporting framework that the fund chooses. As outlined above, the PRI can act as the governance process for the overall PRI implementation.
- Level of outsourcing: This is part of the governance discussion as to whether the implementation is 100% outsourced to the asset consultant, or another expert consultancy, or done in-house.
- Level of resources allocated: The questions above will also be partly answered by the amount of resources the superannuation fund wants to allocate to ESG issues. For example, an extra person may be needed if they plan to implement their ESG policy 100% in-house.

Ways to monitor and oversee integration

The process of ongoing oversight needs to be ensured once the policy has been set, the implementation plan and priorities determined, and the reporting framework developed. The superannuation fund will need to decide:

- the type and frequency of reporting expected from managers on ESG issues
- what this reporting should include (e.g. traditional corporate governance reporting as well as engagement reporting for listed mandates), and
- the process for the manager's adherence to ESG process to be monitored (e.g. will this be done by the asset consultant or does this need to be outsourced?)

Superannuation funds may also want to consider the timeframe for reviewing their own policy and approach. For example, a superannuation fund may decide to review its own policy and approach to ESG every five years.

Initial obstacles to mainstreaming

One of the biggest obstacles to integrating ESG issues into the investment process is the perception around their materiality. There is also a persistent misunderstanding and confusion between socially responsible and ethical investing, and mainstreaming ESG. These perceptions and misunderstandings often make engagement with fund managers and asset consultants challenging.

There is also a relatively low level of fund manager and investment industry engagement and expertise on ESG issues. Very few fund managers have in-house expertise on ESG issues and provide minimal education about them. There are virtually no education programs on ESG for fund managers themselves. Until this expertise is nurtured, developing a high level of commitment to mainstreaming ESG issues into the investment supply chain will be challenging.

Mainstreaming ESG issues is also very resource intensive, especially in the early stages of integrating ESG considerations into the investment process. Finding and justifying the resources needed to effectively mainstream ESG issues can be challenging for many superannuation funds.

Summary

The most efficient way to construct a multi asset class portfolio which reflects a consideration of ESG issues is to embed a consideration of those issues into all the asset allocation and investment decisions. Only by considering ESG issues at each decision point will the potential risks be managed and opportunities realised.

Global approaches

In recognition of the importance of ESG issues globally, pension funds have started to implement a number of measures to address ESG issues. While generally the attention continues to be focused on listed markets, a number of other asset classes are starting to be addressed.¹

Listed equities

The listed equities asset class gets the most attention regarding ESG issues by superannuation funds. The UNPRI survey for 2008 found: 'The reported level of integration of RI/ESG factors into internal investment decision making is very high in the case of developed market listed equities. Many signatories are also making good progress in other mainstream asset classes and in alternative investments but more work remains to be done in these asset classes' (UNPRI Progress report 2008 pg 12).

The focus on equities seems to stem partly from the fact that corporate governance and proxy voting has long been a focus for superannuation funds and investment managers.

Some international superannuation funds have made allocations to specialist managers who have a process for considering ESG issues. Typically, this will be no more than 10% of the equities allocation. In Australia, it is very rare for a superannuation fund to make a mainstream asset allocation to a specialist ESG manager; more typically it will be offered as a member choice option and these products are usually screened or socially responsible or ethical products. The exceptions are the superannuation funds who invest with Generation Investment Management (international equities) as part of their mainstream allocation. The limited allocation to specialist managers reflects the reality that there are limited products with a proven track record, that look to mainstream the consideration of ESG issues.

The Enhanced Analytics Initiative (EAI), a sub-initiative of the PRI, is one way superannuation funds have encouraged their investment managers to better consider ESG issues. By signing the EAI, managers make a commitment to allocate 5% of brokerage to brokers that produce ESG research. While the EAI in principle is ideal,

¹ The summary on international funds and some of the discussion below is summarised from the United Nations Environment Program Finance Initiative (UNEPFI) Report: 'Responsible Investment in Focus: How leading public pension funds are meeting the challenge, 2007' and the report from the UNPRI on the implementation of the principles by signatories: 'PRI report progress on 2008'. These reports are available at www.unepfi.org and www.unpri.org respectively.

its effectiveness is dependant on the extent to which it is embraced by the underlying managers. In reality, a fund could sign up to the initiative, pay the brokers for research but not actually use it. This concern has been confirmed by the redundancies of the Citi, JPMorgan and Deutsche ESG research teams in Europe during the global financial crisis. The effectiveness of the EAI approach could be improved by consultants or funds reviewing the process as part of the standard manager review process.

It should be noted that in Australia there is an initiative called ESG Research Australia that looks to fulfil the same objectives as the EAI.

Most superannuation funds that are signatory to the PRI and that are covered in the UNEPFI report have a strategy for ESG issues and have signed the Carbon Disclosure Project (CDP). The CDP is very effective in its objective of getting better disclosure from companies on their carbon and climate change risk, but there is little evidence the information is then being used in the investment manager's decision-making processes.

Listed equity engagement

Nearly all funds interviewed for the UNEPFI paper stated that they had some form of environmental, social or governance engagement. This seems to partly arise because of the broad definitions of engagement. For example, CalPERS defines engagement as meeting with executives and directors. This is in contrast to, for example, the Thai Government Pension Fund whose definition of engagement is more about asking questions at Annual General Meetings. The PRI progress report found funds globally are becoming more active engagers.

In Australia, the engagement undertaken is more akin to the CalPERS method. Regnan and Australian Council of Superannuation Investors (ACSI) both meet with management and directors and look to change behaviour. Globally, engagement is listed equities focused. No superannuation funds outline that they engage private companies, infrastructure managers or property managers in the UNEPFI study.

Regardless of the extent to which ESG is mainstreamed, there will always be a need for some engagement with listed companies. While all investment managers may eventually factor ESG issues into all of their investment decisions, there will always be a 'price' for ESG i.e. a price at which the investment managers are willing to take the risk and buy the stock. For example, investment managers at some point buy James Hardie. As a result, there will still be companies listed in the Index that do not adequately address ESG issues, but may still be held by the superannuation fund. Funds are left with the residual risk and need to engage companies to encourage the management of that risk.

A similar logic applies to the Index investing that some superannuation funds use. ESG considerations cannot be a part of the investment decision for an Index manager, therefore there will continue to be a role for engagement to supplement Index investing.

There may also be ESG issues that are simply outside of the timeframe of typical equities mandates. Some ESG issues are much more long-term in nature and will simply not affect valuation over that 12 month timeframe. They may, however, affect the long-term

valuation of companies. The potential investment implications of the physical impacts of climate change are one example (i.e. weather risk). Some investments are already experiencing the physical impacts of climate change, eg the drought's impact on the agricultural sector with a subsequent share price impact on agricultural stocks, but other weather factors such as rising sea levels are likely to impact over the longer term and not impact the share price of listed investments for some time. It may be prudent of the superannuation investor to engage the companies that may be exposed to these long-term risks and ensure appropriate risk management systems are in place.

Different superannuation funds have taken a different approach to their process for prioritising engagement. For example, Australian Super prioritised which companies they would engage with on ESG issues by looking at which large Australian companies were not held by any of their active investment managers (but were still held by Australian Super as a result of their indexed equity allocation). Australian Super then spoke to their investment managers to understand why the companies were not held in their portfolios. If the decision to not hold was based on a concern around governance, these companies were prioritised for engagement by Australian Super and this engagement was outsourced to ACSI.

Proxy voting

Most Superannuation Funds have a process for proxy voting. The PRI progress report for 2008 found that the majority of investment manager and superannuation fund signatories have formal proxy voting policies, and in most cases these are disclosed publicly. Most policies apply to all voting regions where possible. There was also reported a strong degree of monitoring to ensure that voting is actually undertaken.

Internationally, there are more resolutions put to companies for environmental and social issues. In Australia they typically only relate to governance issues. There is an opportunity for Australian superannuation funds to be more active in their voting, and even look to collaboratively raise resolutions to the boards of companies that are failing to adequately address environmental and social issues (once engagement has been refused or failed).

Private equity

There is a low level of ESG consideration for private equity investments. Some have invested in specialist managers in the renewable energy space, and funds such as CalPERS invest some of their private equity in 'economically undeserved' segments of California (the investment thesis being that it helps provide economic stimulus to the Californian economy).

In Australia, there has been little attention paid to private equity and sustainability issues. There are some 'clean tech' funds on offer including the Macquarie Clean Tech fund of funds that has attracted investment from a number of Australian superannuation funds. Given many managers do not have a process for considering ESG issues, this potentially leaves a significant gap in risk management given the growing allocation to private equity.

Corporate governance in private equity has been recognised by the International Corporate Governance Network (ICGN) as a key area to be addressed.

Direct property

The UNEPFI report found that approaches to addressing ESG issues in direct property portfolios vary. CalPERS outlines that its focus is to generate returns from ‘green buildings’. The Swiss Pension fund Caisse de Prévoyance du Personnel Enseignant de l’Instruction (CIA), who manage their property portfolio internally, has invested 40% in low income housing that is energy and water efficient. The UK Environment Agency Pension Funds invest in a property fund of funds that was designed specifically for them to incorporate ESG considerations.

In Australia, it would seem the product offerors are ahead of the investors in considering ESG issues with many of the largest property managers having rigorous approaches to ESG.

In response to both the risks and opportunities presented by the property sector, the UNEPFI Property Working Group and the PRI collaborated to develop a guidance document on implementing the PRI in property portfolios. The consultation was coordinated through the PRI Clearinghouse and involved a small questionnaire, followed by a number of consultation calls, involving PRI signatories. The guidance note entitled ‘Building responsible property portfolios: A review of current practice by UNEP FI and PRI signatories’ was launched at the June 2008 PRI in Person event in Seoul and can be found at www.unpri.org

Direct infrastructure

Like direct property, few superannuation funds have specified their approach to ESG issues in infrastructure investments. The superannuation funds have tended to invest in specialist managers, in particular the Climate Change Capital Carbon Fund that invests in projects in developing countries that reduce greenhouse emissions.

In Australia, there has been some interest in environmental infrastructure, notably Industry Fund Management’s investment in Pacific Hydro, Hasting’s investment in Global Renewables waste to energy projects and Colonial First State Global Asset Management’s investment in Anglian Water in the UK.

Hedge funds

Very few superannuation funds have started to address the potential ESG issues in their hedge fund investments. The investment strategies are very broad but most strategies apply to listed assets (equities, bonds, currencies, hybrids, commodities etc). In listed equities, while engagement is occurring in many instances, the investment strategies of the hedge funds may be contradictory to the engagement that is occurring, sending a mixed signal to the investee companies.

Bonds and fixed interest

The PRI progress report outlined that among mainstream asset classes, signatories to the PRI appear to be making the least progress in integration in fixed income, where ‘Not at all’ was the most common response to the question on the level of integration of ESG considerations to portfolios. This was the same response in both developed and emerging markets.

The UNEPFI report stated a number of funds globally screen their bond portfolios on issues like human rights abuses and freedom of rights, freedom of association, freedom of press, and similar issues. While political risk may be material, this is typically already priced

by managers. Freedom of rights and freedom of speech type issues are more ‘ethical’ in nature and would require a ‘screen’. Likewise climate change is an issue for some managers.

Governance risk is particularly relevant to credit-based fixed interest strategies (even in short-dated cash securities) if investors are to avoid losses similar to those of Parmalat. While there are quant type tools available that provide corporate governance ratings of companies, such as the Goldman Sachs JB Were ‘cone head’ and Governance Metrics International, there is limited coverage of unlisted companies and smaller companies. As a result, few investment managers have systematically included corporate governance considerations in their investment process.

Case study on implementation: realising the ‘green opportunity’ and avoiding the ‘green bubble’

Not a day goes by that the mainstream financial press does not have some mention of climate change issues. We have heard from economists from around the world that climate change is also one of the most financially significant environmental issues facing investors today. While other environmental risks can be highly relevant to various sectors, climate risk is unique in its widespread potential for impact on individual companies, across sectors and whole economies. As Sir Nicholas Stern famously said: ‘Climate change presents a unique challenge for economics: it is the greatest and widest-ranging market failure ever seen’. (Stern Review: The Economics of Climate Change, 2007).

For investors, the impact of climate change will be felt directly (in terms of damage to agriculture, forestry, property and water), and indirectly by sectors impacted by the regulatory responses to climate change (such as carbon trading for the energy and energy intensive industries). In turn, companies with energy intensive inputs will also be impacted as their supply chains begin to price carbon.

While there are clearly risks, there are also significant investment opportunities. Companies that have technologies that reduce greenhouse emissions will benefit. Companies that are relatively less carbon intensive than their competitors may benefit. As the economy adapts to the changing weather and the physical impacts of climate change, investors that are investing in the infrastructure required for adaptation may also benefit.

The risks presented by climate change and carbon trading apply across all asset classes. The most effective way to ensure those risks are managed is to embed a consideration of carbon and climate change issues into all investment decisions in line with a broader implementation of the PRI. However, institutional investors can also potentially gain exposure to these thematic opportunities by investing in:

1. Green infrastructure,
2. Green property,
3. Clean Technology (Cleantech), and
4. Carbon funds.

These investment styles are often collectively termed the ‘green bubble’, however they are, in reality, quite different. Many of the thematic opportunities can be realised through mainstream investment portfolios, perhaps negating the risk of the ‘green bubble’. The key point is that investors need to understand the finer points of each of the opportunities.

Green infrastructure

According to the United Nations Environment Programme's Global Trends in Sustainable Energy Investment 2008, nearly US\$150 billion in new money flowed into the clean energy sector in 2007, a 60% increase over 2006 investment levels. The report goes on to state that investment levels are on track to reach US\$450 billion pa by 2012 and US\$600 billion pa by 2020. Most of the flows to date have been into wind asset financing followed by bio-fuels. The extent to which these flows are from superannuation funds is not clear.

The investment opportunity that is presented is as a result of the structural shift that is occurring in the economy through the cost of emitting carbon. In pricing infrastructure deals this carbon price has become a factor just like any traditional factor such as foreign currency and interest rates. Investors that are more across the fundamentals of the carbon markets are better able to price that aspect.

Typically institutional investors gain exposure to this clean energy market through investing directly into the infrastructure assets themselves (or direct infrastructure funds) or through listed infrastructure companies. Notable examples of direct investment are Industry Funds Management purchasing Pacific Hydro, and Perpetual's involvement with Hallet Windfarm. These investments were not made because of a moral or ethical view that was taken, rather an investment opportunity that was identified. It is true that this opportunity may be more attractive because of carbon pricing, however any risks and uncertainties around this would have been considered at the deal pricing stage.

It can be rightly argued that the 'green infrastructure' investing that has occurred to date is really just 'infrastructure investing' therefore not a function of the 'green bubble'.

Green property

Climate change and policy responses to climate change will mean that 'green buildings' may well have lower relative risks and higher relative income growth and, thereby, prove to be superior investments in the long term.

The Australian property sector has been sent regulatory signals that 'green buildings' with improved energy efficiency may become mandatory. For example, the 2004 Federal Government Energy White Paper recommended that all office and residential buildings disclose an energy performance rating at the point of lease or sale. Likewise, all office property development in the Sydney CBD already must have a 4 1/2 star 'Green Rating'.

Meeting demands for building comforts (such as increased air conditioning under warmer conditions) will complicate the situation further. These demands might have to be met through innovative building techniques and thermally efficient properties, rather than energy dependent devices such as air conditioners. As high users of energy, properties are also vulnerable to rising energy prices. All of the above should impact the evaluation of property assets both today and in the future.

On the tenant side, Federal and State governments have made announcements that they will have minimum energy efficiency requirements for tenancies. Also, large listed companies with a position on corporate social responsibility will demand 'greener buildings'. For example, IAG, ANZ, HSBC, ABN Amro and Swiss Re have committed to making their global businesses 'carbon neutral'.

This means that they will demand more energy efficient buildings. Such companies also look to include a creative space for employees, introducing the social aspect of sustainability to building design and refurbishment.

This has already begun to translate in terms of building stock. Australian investment grade office buildings with a green rating increased to 2% of total stock in 2008 up from 0.5% in 2007.

For superannuation funds who are large investors in direct property, this is particularly significant. At July 2008, there were on average 7% of funds under management by Australian superannuation funds invested in direct property.

It is important to note that the opportunity lies not only with direct investment in new property developments, but also old stock as the payback on refurbishment improves. As energy prices increase within a carbon constrained economy, there may be more incentive for investors in direct property to upgrade their property to make it more efficient. This means that ESG is very much a mainstream investment issue for investors in direct property. It also means that investors do not necessarily need to invest in a specific 'green fund' to realise the opportunities presented in the property sector. Through active engagement of the property fund managers, institutional investors can ensure the risks and opportunities across all portfolios are managed.

Cleantech

Interest continues to grow in the clean technology (Cleantech) space as investors begin to recognise the investment opportunity in fixing environmental problems. Cleantech investing does not currently have a firm definition and covers a number of technologies including water recycling and solar, but it also includes efficiency technology and industrial process improvement technology. Cleantech is much broader than just technology that reduces greenhouse emissions or renewable energy, it is effectively any technology that has an environmental benefit. While there are some listed companies that are considered to be in the Cleantech space, they are more typically small companies or unlisted and still in the venture capital (VC) or private equity space.

An Ernst and Young study released in 2008 found that VC groups invested nearly US\$3 billion globally in Cleantech companies in 2007. A further US\$2 billion had been invested by the middle of 2008. The impact the global financial crisis has had on these flows has not been reported. In terms of performance, the US based World Cleantech Index suggests Cleantech stocks have outperformed the MSCI World Index since inception in 2004 up until late 2008.

Many believe that Cleantech investing will be a positive long-term earner for investors, as it has been for many to date. The risks however are very similar to those with any VC or private equity investment. Technology risk, key person risk, and regulatory risks are all just as real for Cleantech as they are for other alternatives.

Carbon funds

Carbon funds are funds that are set up with the explicit objective of generating returns through operating in the carbon market. They invest in technology or projects that generate carbon credits, trade credits between different markets, or both. Carbon funds are much more specific and targeted than the more broadly defined Cleantech fund. Carbon funds tend to fit in the alternatives asset allocation.

Between 2006 and 2008 the number of Carbon Funds offered rose from 30 to more than 80 and the FUM from USD4.5b to over USD80b. Investors in these funds vary and include country governments, the World Bank, European based compliance parties, speculative purchasers (particularly from the US) and primarily European pension funds.

Like Cleantech, carbon funds are more typically a private equity, venture capital or alternatives investment, Carbon and Cleantech funds carry the same level of risk for many of the same underlying reasons. Some investors have looked at investing in carbon funds as a way to hedge the carbon risk in their portfolios. Many superannuation funds will be exposed to companies that are carbon intensive and may be negatively impacted by a carbon constrained economy. By investing in Cleantech or carbon funds from an overall asset allocation perspective they are able to start hedging that risk. So while investing in Cleantech may seem to be just another version of SRI or ethical investing, it is much more than that when considered from an overall asset allocation perspective.

Conclusion

Investment opportunities that are often lumped together to describe 'the green bubble' are actually so diverse in terms of asset class coverage that it is risky to even classify them as similar investments.

Green infrastructure and green property at the end of the day should be just traditional infrastructure and property investing. Likewise, Cleantech and carbon fund investing is just like any other private equity, venture capital or alternatives investment. They carry with them a higher level of risk, most notably a very high level of regulatory risk.

Concern around the supposed 'green bubble' therefore is perhaps misguided. The risks and opportunities presented by carbon markets, climate change, and concern over the environment more broadly, are just like any other investment risk that needs to be understood and managed.

By integrating a consideration of ESG issues, including carbon and climate change issues, into the mainstream investment and asset allocation decision making process, astute investors can realise the green opportunity while avoiding the 'green bubble'. As with any investment opportunity, detailed analysis needs to be undertaken of the risks and opportunities associated with the investment, and an appropriate price paid.

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