

Responsible Investment

and

ESG risks and opportunities

Rapidly growing awareness of climate change risk has been a key driver of fund managers' need to formalise environmental, social and governance (ESG) risk assessment. Funds that enhance their processes to incorporate Responsible Investment will benefit from the increasing demand for these practices from their client base.

RESPONSIBLE INVESTMENT SEEKS to improve portfolio risk and return characteristics through a better understanding of investment risks and opportunities. The United Nations' Principles for Responsible Investment¹ (UN PRI) provide a common sense guide for fund managers interested in implementing a responsible investment approach (see box on page 36).

Why fund managers should consider Responsible Investment

The key reason is that the larger and more sophisticated funds in Australia (and globally) and their advisors increasingly believe that they will be exposed to ESG-related risks and opportunities in the future. VicSuper has gone as far as incorporating wording into legal documents governing investment management agreements that managers 'must have regard to' the UN PRI.²

There are some big picture issues that need to be contemplated by fund managers. Firstly, Responsible Investment is not the process of becoming a financial 'do-gooder' and it is far removed from traditional 'ethical' investing. It is about *enhancing* existing investment processes. To successfully lead a change management process involving the adoption of Responsible Investment, a fund manager needs leadership capable of giving strong and clear messages to its staff. The CFA Institute³ has given clarity on the approach required from analysts: '... it is as important as ever that the analyst maintain a balanced and professional

approach – factor in environmental or social issues while being careful not to distort investment decisions with political or emotional agendas that do not serve the clients' interests'.

Secondly, a fund manager also needs to decide whether it takes a mainstream or specialised approach to Responsible Investment. Mainstreaming – meaning that investment processes across the whole firm are reviewed – is the preferred approach for asset consultants who are taking the lead in the Responsible Investment space. According to Helga Birgden, who heads up the Responsible Investment activities of Mercer in the Asia Pacific region, her firm's clients are most interested in this. Mercer has developed a process to rate manager's ESG abilities according to this criteria. Based on this feedback, fund managers would be advised to concentrate on wider ranging cultural change rather than developing a specific product solution.

Thirdly, much of the dialogue to date with respect to Responsible Investment has revolved around 'stock specific' or industry sector risk. Tools exist to analyse portfolio risk but it is not always easy to draw conclusions from them. This is an area that is expected to develop further. Then there is the question as to 'how Responsible Investment can be applied to all asset classes?'. This is a separate issue and an area of expertise in itself – only listed equity will be discussed here.

Most elements of Responsible Investment are not new. For many years equity managers have been analysing social factors such as occupational health and safety records of mining companies to help form views about management ability. The formalisation



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The United Nations Principles for Responsible Investment (UN PRI):

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

of ESG risk assessment is somewhat new, though. Awareness and acceptance of climate change risk has skyrocketed in the past two years and this has been a key driver of the need for formalisation. Would you be happy if your fund manager took a large stake in an energy company without having a good process for understanding the impact of the proposed Carbon Pollution Reduction Scheme?

The first three of the six principles in the UN PRI have the biggest impact on the investment decision making process. These are:

1. **Incorporating ESG issues into investment analysis and decision making**

The firm will need to have an appropriate level of skill in understanding ESG issues. Smaller, specialised firms such as Generation Investment Management have analysts who are highly skilled in this area. Larger firms may choose to import ESG research from an external provider: this approach would help infuse an ESG culture over time. A central ESG research team is another option, but not necessarily the preferred option, as it presents the challenge of accountability and could undermine the mainstreaming goal – unless internal relationships are structured with acute skill.

Another key objective is to understand the materiality of the issues and react accordingly. There is a tension between what can be analysed and what needs to be analysed because research resources are finite. For example, the environmental issues associated with car emissions are likely to overshadow social issues for a toll road operator so, for that industry sector, a fund manager may take a policy decision to focus on the environmental aspects.

2. **Being ‘active’ owners and incorporating ESG issues into ownership practices**

Corporate governance processes are already well advanced in Australia. It is the social and environmental areas that are being developed the most. Active ownership can mean different things to different players. Fund managers who hold large stakes in companies are more likely to be able to influence outcomes compared to smaller firms who have minority positions on the share registry.

Consider the following example which helps to illustrate what Responsible Investment is all about, including active ownership. Company X may have a poor environmental track record, resulting in equity analysts factoring in a relatively high risk premium when discounting the future cash flows of the company – leading to a relatively low valuation. However, the risk may be so heavily penalised by the market that it is an attractive buying opportunity at its current price.

A sensible Responsible Investment framework would not prohibit the purchase of such a stock. Indeed there may be significant gains to be made if the fund manager actively engages with company X and, as a result, it starts managing the risk more prudently. The fund manager benefits from having a framework in place to formalise the process, a sufficiently knowledgeable analyst who could assess the risk properly and a defined process for engaging companies.

3. **Seeking appropriate disclosure on ESG issues**

This is an area in which smaller firms can perhaps have a reasonable impact, particularly considering it is a relatively low-cost activity. The fund manager needs to develop a policy that outlines how the firm will approach the issue. Pushing companies for greater disclosure on ESG issues can only help in elevating their own awareness of shareholder interest.

The discussion points above give an insight into some of the key issues for consideration by fund managers who are planning or implementing Responsible Investment. Most fund managers have already dealt with ESG issues in some form, however, by formalising the process, they and their clients gain confidence that risks and opportunities fall more into the ‘known’ category as opposed to the ‘unknown’.

Those fund managers who are able to successfully enhance their processes to incorporate Responsible Investment will be well positioned to benefit from the trend of increasing demand from a large, growing and influential part of their client base. It will also increase the sustainability of their own businesses. Differentiation is difficult to achieve in funds management – this sort of opportunity doesn’t come along very often! ●