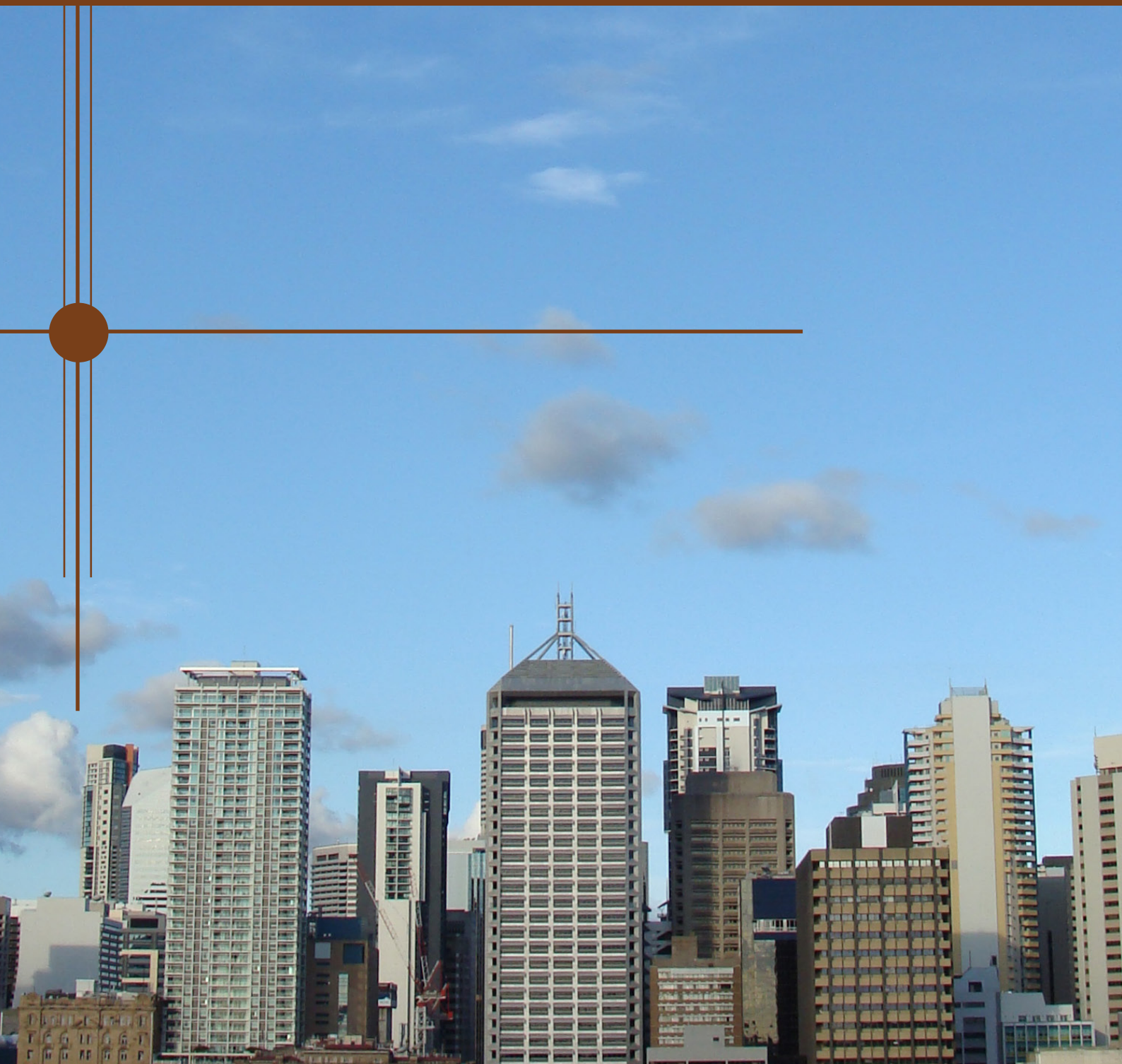


Australian Superannuation Fund Investments

A report on progress made in the implementation of ESG practices

December 2010



Executive Summary

Investment portfolios are exposed to risks and opportunities in the form of environmental, social and governance factors (ESG factors). Some investors have responded to the perceived link between ESG factors and investment returns by adopting ESG practices. These are practices that systematically embed the management of ESG-related risks and opportunities into investment processes.

Despite most investors accepting the link between ESG factors and investment returns, there has been modest progress with respect to ESG practice implementation across the broader Australian superannuation industry. This report uses extensive survey data collected in late 2009 and early 2010 to provide a view of implementation progress, the barriers that stand in the way of further progress and some measures that the authors believe would help to remove those barriers.

The survey responses show that the prioritisation of ESG practice implementation often suffers at the hands of shorter-term operating issues. The industry is dealing with a wave of regulatory reviews which is adding fuel to the consolidation trend. A regulatory issue highlighted by many in the survey is the lingering uncertainty about the scope of a trustee's duties:

- Is the trustee's duty purely to maximise risk adjusted returns?
- Should ESG factors be explicitly included in regulatory guidance?
- Should fund trustees be taking into account broader community and member attitudes when determining the appropriate investment approach?

Of most concern from the survey data was the possible misalignment between member interests and fund behaviours. While most respondents' view of 'long-term' in the context of investment performance was greater than five years, more than half placed reasonable importance on managing risks to short-term investment returns. This may be indicative of investment industry culture, where the quest for long-term returns is often compromised by persistent pressure for short-term performance.

Discussions in the industry about ESG practices contain inconsistencies and comparisons being made are often not on an 'apples with apples' basis. ESG-themed investment styles, such as negative screening, are often confused with

the consideration of ESG factors, which can be applied at the stock selection or portfolio level regardless of the investment style in question. A challenge for the industry is to establish a common platform for concepts and language used.

Despite good progress made in increasing the awareness of ESG factors, the pursuit of stronger governance standards and belief in company engagement as an effective management tool, the survey highlighted several challenges for ESG practice implementation:

- Inconsistencies in the understanding of ESG practices and language used;
- Misalignment between member interests and fund behaviours;
- Uncertainty about the extent of trustee fiduciary duty and the role that community and member attitudes play in the investment process;
- The lack of empirical evidence that ESG practices lead to superior risk adjusted returns;
- Low prioritisation for ESG practices because of ongoing structural change in the superannuation industry;
- Recognising ESG practices as a strategic issue and providing leadership;
- Resourcing and cost issues, especially for small funds;
- Improved research and information, and the need for more education about integrating ESG factors into valuation models; and
- Improving reporting and transparency of policies and processes.

We use these findings as the basis for proposing five key measures that would facilitate industry-wide implementation progress. Because of the various inconsistencies and uncertainties highlighted from the survey responses, we need to ensure the foundations are solid for building stronger practices in the future. These measures are:

1. The major superannuation investment industry bodies in Australia work together to establish a consistent understanding of the term "ESG practices" and communicate this to their constituent members and the broader industry.
2. Regulators provide clarification of trustees' duties with respect to ESG practices. Furthermore, the superannuation industry and regulators should consider the role that general community and member attitudes play in this process.

Executive Summary

3. That superannuation funds demand more transparency of process from their investment managers. As a starting point, funds can press their investment managers for examples of policy implementation and real-life examples of integrating ESG factors into investment processes.
4. Relevant industry bodies promote discussion of implementation experiences, so that certain types of investors, such as small funds for example, are able to seek guidance on best practice methodologies.
5. Funds (who have not already done so) consider elevating the issue of ESG practices to the board and management level in order to improve the effectiveness of their organisational response.

In proposing these measures, we are promoting the need for discussion across the broader industry. Please refer to Section 7 for more explanation.

We welcome any feedback or further suggestions with respect to this report.

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Demographics of Survey Respondents and Methodology

Fifty representatives from the superannuation industry responded to the survey. Just over half of the respondents were superannuation funds, accounting for more than \$175 billion of funds under management. Of these funds, about 40% were signatories to the PRI (Principles for Responsible Investment). The following four types of funds were well represented in the sample size: industry, government sponsored, corporate and church-based.

The remaining respondents consisted of fund managers, industry bodies, service providers and research providers. Approximately 60% of these respondents were signatories to the PRI.

The majority of respondents (63%) chose to represent the views of their respective organisations and 37% answered in a personal capacity.

Whilst the study does not claim to be representative of the entire superannuation industry, it provides enough data with which to draw some general conclusions.

The survey was conducted by way of phone calls with participants and consisted of eighteen main topics. Some questions were multiple choice or required some form of ranking and others relied on verbal comments. In many instances, respondents offered additional verbal comments to clarify or extend answers. These were recorded and analysed. The list of survey questions is available on request.

Key Definitions

ESG	Environmental, social and governance
ESG factors	Investment factors that exhibit ESG-related features
ESG practices	The consideration and integration of ESG factors into investment decisions and processes.
ESG-themed investment style	An investment style where certain ESG factors are prominent in the chosen investment criteria; typical applications include negative screening, positive screening and best-of-sector.
Ethical investing	The name used for some ESG-themed investment styles.
Mainstream ESG practices	The inclusion of ESG considerations in traditional investment styles and processes.
PRI	The “Principles for Responsible Investment”, an institutional investor and United Nations initiative that promotes ESG practices.
SRI	SRI stands for “socially responsible investing”, a name also commonly used to describe some ESG-themed investment styles.

1. Defining ESG Factors and ESG Practices

Investment portfolios are exposed to risks and opportunities in the form of environmental, social and governance factors. These factors may manifest themselves in stock valuations as the result of longer term trends, such as historically poor governance or shifting consumer preferences; or as adjustments based on specific events, such as insurers reacting to severe weather consequences that are attributed to a changing climate.

In this report, we use the term “ESG practices” to denote the process of integrating the consideration of ESG factors in an investment context. For example, an investor who takes ESG factors into account when analysing specific investment opportunities, evaluating portfolio risks, voting on company resolutions and engaging with company management, would be regarded as having integrated a range of ESG practices into their investment process.

ESG factors are a subset of all relevant investment factors that apply to an investment decision. They are often entwined with traditional factors and in many cases it is hard to separate them. Investors have historically considered ESG factors in their investment decisions. Some have done this systematically and others in an ad hoc way.

It is now widely believed¹ that a best practice approach to investing involves the systematic consideration of ESG factors across all investment processes and all asset classes, with the objective of enhancing risk-adjusted returns.

¹ As evidenced by the quantum of signatories to the UN-sponsored PRI.

2. Industry Trends and ESG Practices

2.1 The Australian superannuation sector

The superannuation sector has been constantly evolving since the introduction of the superannuation guarantee by the Keating Government in 1992. In anticipation of ballooning pension liabilities due to demographic shifts, the proposed solution consisted of three pillars: (i) a government pension safety net; (ii) a boost to private savings through compulsory contributions; and (iii) incentives to attract voluntary savings. As a result, superannuation assets in Australia now exceed one trillion dollars, with total assets nearly doubling over the six year period to 2009².

Funds are presently grappling with intense regulatory scrutiny and reform, driven partly by the severe financial crisis of 2007-2009 and partly by rapid industry growth. The investment chain has become increasingly complex and interests have not always been well-aligned. The Cooper Review was established to look at efficiencies in the superannuation system and whether it was producing the best possible outcomes for members³. The review, to date, has identified areas of market failure and sees a regulatory response as appropriate.

Funds themselves are consolidating in response to regulatory and operational pressures. The basis for competition between funds includes investment performance, service standards, product offerings and cost base / fee levels. Arguably, improvements in the latter three can be achieved through scale. Investment performance is harder to control - it requires a foundation of sensible investment principles, policies and governance. The government introduced choice of fund legislation in 2005 in a bid to spur on competition and, in conjunction with various industry review processes underway, the outlook is for further consolidation.

2.2 Why have ESG factors become prominent?

There has long been heightened awareness of ESG practices in ethical investing and socially responsible investing styles, where certain ESG factors are prominent in the chosen investment criteria. We use the term "ESG-themed" to describe these investment styles. Well known ESG-themed investment techniques include positive screening, negative screening and best-of-sector criteria.

Mainstream investors are becoming increasingly interested in ESG practices, primarily as a result of concerns expressed by many large, global institutional investors about the alignment

of interests in the investment chain. There was concern that ESG factors were being managed in an ad hoc manner (or even overlooked) by investment managers and other service providers. As agents, investment managers were often viewed as having a commercial imperative to adopt much shorter investment timeframes than their clients'.

These investors questioned the efficiency of the broader market and, as a consequence, whether capital was being allocated efficiently. This collaboration of interests led to a United Nations sponsored gathering in 2005 and in the following year the group formulated a framework for assessing and managing ESG factors in portfolios. The name of this initiative is now well known in the industry and referred to as the 'PRI'⁴.

The PRI has become an informal 'standard' in the sense that it provides a framework that funds and investment managers can use to guide their implementation of ESG practices. The majority of survey participants (59%) did not believe that the PRI would become a true market standard for reasons including: it is voluntary and 'aspirational' in nature; the likely requirement for continuous improvement; and smaller funds balking at the cost and resourcing implications.

Along with the formation of the PRI, several other factors have contributed to the rising prominence of ESG issues:

- The issue of climate change is prevalent in society which has led to a renewed focus on environmental factors;
- An ever increasing global population is pressuring natural resource availability and price;
- The standard of living in many countries has risen and consumers have become more concerned and influenced by social factors, such as manufacturing labour conditions; and
- The recent financial crisis has exposed the impact that poor governance can have on investment returns.

For all these reasons and more, ESG-related factors have become more prominent in company valuations and it is logical that investors should seek to understand and manage the associated investment risks and opportunities. However it is still early days for this investment discipline as several parts of this report will illustrate.

² APRA Statistics: Australian Superannuation Bulletin, June 2009 (issued February 2010)

³ Interview with Jeremy Cooper, "Taking super to the next level", in Finance (August 2010)

⁴ PRI stands for "Principles for Responsible Investment". Refer www.unpri.org.

2. Industry Trends and ESG Practices

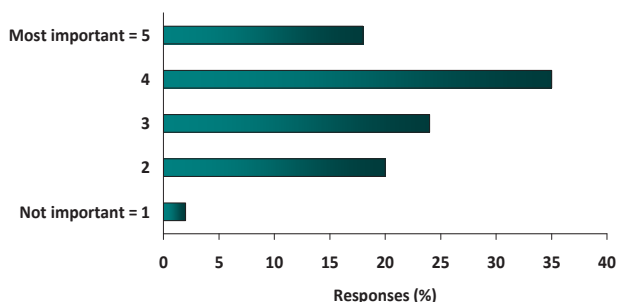
2.3 The drivers of fund interest in ESG practices

The major drivers for funds, according to the survey, include fund reputation, the pervasiveness of ESG-related themes in society, the threat of regulation, the potential impact on investment returns, industry standards and fund-specific characteristics.

Reputation is a key issue for funds. A survey⁵ commissioned by ASFA in 2008 demonstrated that fund members value a fund that has 'good returns' and is a 'secure, big fund'. Reputation was identified as having relatively high importance for those funds who have adopted some form of ESG practices.

Chart 1: Survey question responses

How important is fund reputation to those trustees who have adopted ESG practices in terms of recruitment and retention of members?



Many funds feel that the expectations of the broader community are changing. This is possibly attributable to the topicality of governance and climate change issues, and concern that they could fall out of step with their members' expectations, although there was relatively little evidence of direct enquiry from members on these issues.

With respect to ESG-related themes in society, when asked about the recent financial crisis as a trigger for stricter regulatory ESG practice guidance, most responded that regulation would have only some or little effect. There was a consensus amongst this group that governance would be the main area of focus for regulation and there was a fair degree of optimism from some that market forces would produce a better quality of response. A small number of respondents thought that there would be significant regulatory guidance which would be directed mostly towards governance.

Survey quotes:

It may result in increased education but not changes in policy.

There will be some guidance, but not actual requirements.

The general sense is that governance structures got us into trouble - so now let's go forward and improve.

ESG should be mainstreamed into investment decisions, but it shouldn't be compulsory. It shouldn't be forced.

If regulation comes in, it will be more of a box ticking exercise, if left to the fund manager it will be done better.

The Cooper Review has since explored the issue and recommended⁶:

"In developing investment strategies, trustees should explicitly consider both short and long term risks, consistent with their stated investment horizon. Trustees would not be required to make decisions based on ESG issues but as ESG issues represent one type of long term risk, trustees should consider ESG issues as they think appropriate."

Whilst the Cooper Review stopped short of explicit guidance, it did link ESG factors with investment returns. We note that, because ESG factors are usually deeply entwined with general operating risks and opportunities for companies, it is difficult for any study to provide empirical evidence for the assertion that ESG practices improve risk-adjusted returns. This is discussed further in Section 6.2.

More than 85% of survey respondents believe that, for trustees who undertake ESG practices, there is a moderate to high link between ESG factors and returns. Not surprisingly, those who saw a strong link were more likely to be PRI signatories and those who saw a weak link were less likely to be so.

⁵ Matt Balogh, McNair Ingenuity Research Pty Ltd, Annual Superannuation Survey prepared for ASFA (2008)

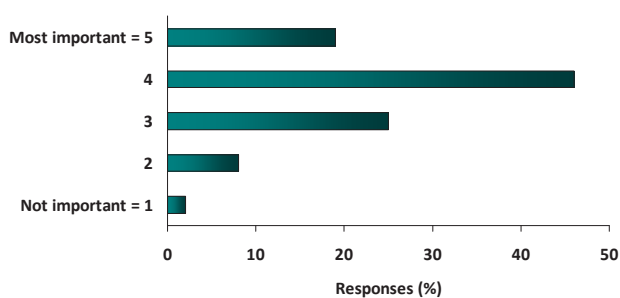
⁶ Recommendation 6.17 of the Super System Review Final Report, Commonwealth of Australia (2010)

2. Industry Trends and ESG Practices

The recognition of ESG practices as a market trend was illustrated by the response to the following question:

Chart 2: Survey question responses

To the extent that super trustees are applying ESG practices, how important is the move towards it becoming an industry standard?



Fund-specific characteristics were identified as a driver of interest. Several saw no link, but more than half of the respondents indicated that they saw influence being exerted from particular types of funds. This link was more aligned with industry funds than corporate funds. Several respondents noted that they thought this level of influence would be decreasing in the future as the implications of funds becoming 'public offer' plays out.

Survey quotes:

The ESG decision is overlayed with the investment decision and the two are not mutually exclusive. Asset consultants and board members who have particular views will influence trustees.

Industry bias will be a big determinant of behaviour.

Our fund has [a high proportion] of people in a... union and they have exerted an influence on us to pursue socially responsible investment.

There is a movement away from specific funds being linked to an industry as all funds are public offer. It will be more of a member driven thing in the future.

Some survey respondents saw the integration of ESG practices as a defensive mechanism, meaning that it would help in retaining existing members; and a few saw it as a feature for attracting new members; however one fund commented that its efforts to retain members through the adoption of ESG practices had led to those members

recruiting new ones.

2.4 An inconsistent understanding of ESG practices

A clear theme that emerged from the survey was inconsistency in the understanding of "ESG practices" across the industry. Despite there being broad acceptance of ESG factors as drivers of investment risks and opportunities, there were wide ranging views about its implications. For some it implied the integration of personal values into investment decisions; for others, it implied the pragmatic assessment of ESG factors and, subject to materiality, integration into financial models and investment decisions. This divergence in views is not necessarily surprising when we consider that the traditional champions of ESG practices have been ESG-themed investors.

In many cases, the comparisons being made are not on an 'apples with apples' basis. We find that the practice of assessing and managing ESG factors for a specific investment or portfolio often gets confused with the application of a particular investment style. For example, a mainstream investor and an ESG-themed investor may both seek to understand, assess and integrate material ESG factors into their investment analysis of a specific company; however the mainstream investor may have a broader universe of stocks from which to choose from because the ESG-themed investor screens in or out certain investments based on adopted criteria. Their stock analysis processes may be aligned, but they diverge in their approach to portfolio construction, and therefore investment style.

2. Industry Trends and ESG Practices

Based upon comments from the survey, differing views of the meaning of ESG practices was centred around investment styles as well as differing views of trustee duties with respect to managing ESG factors (refer Section 3).

Survey quotes:

[There is a] difference between SRI (values based) and ESG (risk based) [which] gets mixed up in the debate

People go off on different ESG tangents - no common standard.

How far does the responsibility go? Do you not invest in a bottle maker because they sell bottles to the alcohol industry?

[There is a] persistent misunderstanding of ethical investments and mainstream investments.

Confusion about what ESG means - is it risk management? Is it about investment?

There's a big perception that the public think that they sacrifice returns on all time horizons to invest in ESG funds.

Many respondents recognised the level of confusion in the industry. Some suggested that the mainstreaming of ESG practices is inevitable.

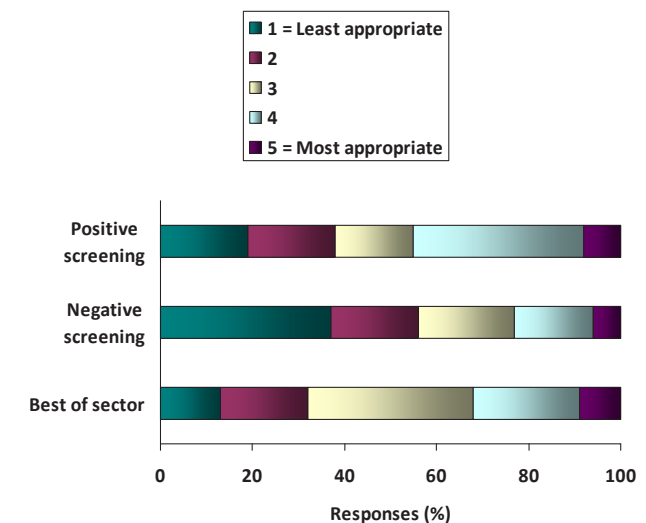
2.5 ESG practices and investment styles

Historically, mainstream investors have included elements of ESG practices in their processes, dealing with issues such as governance or factoring in the key environmental and social risks associated with an investment. However, without a systematic approach, they risk having a lack of rigour. A handful of mainstream investors have commenced the process of systematically embedding the consideration of ESG factors across all of their investment operations.

Another historical thread is the application of ESG-themed investment styles, where ESG factors form the foundation of the investment style. As discussed in Section 2.2, these styles have often been labelled as ethical investing or SRI and have included techniques such as positive screening, best-of-sector and negative screening. The survey questioned participants about the appropriateness of these methodologies for funds as ways of implementing ESG practices:

Chart 3: Survey question responses

How appropriate are the following methodologies for incorporating ESG practices into an investment process for a superannuation fund?



There are investment managers who take a 'product' approach to ESG-themed investment styles, in that their core operations use traditional financial techniques, and they establish satellite offerings that are ESG-themed. Likewise, many superannuation funds include an ESG-themed investment option to cater for those members who favour this investment style.

One of the survey questions explored the differences between European and Australian investment styles, given that ESG-themed investing is more prevalent in Europe. There was a strong sense that differences in cultural and social values were a factor, with Australian funds having a much stronger focus on investment and individualism compared to European institutions who take on a more critical role in maintaining social cohesion. There were also observations made that the lack of diversity in the Australian equity universe restricts the application of ESG-themed approaches. Several comments made by respondents when answering this survey question showed there was a divergence in views, with some seeing European investors being ahead of the curve and others classifying positive and negative screening as being outdated.

3. Fiduciary Responsibility

3.1 What is a trustee's fiduciary duty?

If there is one area where inconsistency in the understanding of ESG practices has had a substantial impact, it is at the fiduciary level. When asked about the possibility of a regulatory response that would give direction to trustees about ESG practices, one respondent noted that it was a priority to “clear confusion regarding fiduciary duties. [There is] confusion between ethical and responsible investing. Formal clarification needs to be given to trustees.” Another noted that uncertainty over fiduciary risk was an obstacle to their own ESG practice implementation: “We have been lobbying the government to publish guidelines on this.”

The mixed views across the industry can be drawn back to the discussion in Section 2.4. Our own interactions in the industry over time have found that, for those who equate ESG practices directly with values-based or ESG-themed investment styles, there has been some concern that trustee liability may be created. For example, if a trustee board chose to exclude investments from certain market sectors based upon their own values, then they may be liable for loss of performance in the event that their investment returns are adversely affected (relative to an unrestricted portfolio). An opposing point of view is that ESG-themed investment styles may be better suited to detecting risks and opportunities arising from ESG factors, more than offsetting the effects of, say, a restricted universe of investments.

Some mainstream investors view ESG practices as a way of enhancing a fund's ability to identify risks and opportunities and see it being well aligned with the fiduciary's role of producing good risk-adjusted returns.

When asked to choose between two descriptions of a trustee's responsibility, namely (a) to supervise investments and ensure financial obligations can be met; or (b) to provide a member-focused service, the results were mixed with 62% favouring option (a). Of note was the fact that a significant portion of respondents commented that they thought both choices were essentially the same. The responses indicate that investment returns are at the core of the trustee's responsibilities.

Survey quotes:

The regulatory framework promotes (a).

The only reason to be a superfund is to provide for their member's retirement - there is not much room to move.

It is (a) now but they are moving towards (b). Boards do change their approach as times change. There is a journey.

3.2 Legal views

The international foundations for legal views on the fiduciary requirements of trustees with respect to ESG practices are sourced from the reports known as *Fiduciary I*⁷ and *Fiduciary II*⁸. They examined the major, global common law jurisdictions and opined on the relevance of ESG factors to trustees' duties; in particular, they addressed the issue of whether integrating ESG factors into investment policy would be considered voluntary, legally required or hampered by law. The reports concluded that the integration of ESG factors was permissible and “arguably required in all jurisdictions”. There has been commentary from the Australian legal sector that supports these conclusions⁹.

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

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

The survey responses indicated that the industry is keenly awaiting more regulatory guidance on fiduciary responsibility.

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

⁸ The Asset Management Working Group of the UNEP FI, *Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment, (2009)*

⁹ For example, refer Jason Denisenko (Clayton Utz), *Managing financial risk over the long-term – ESG factors and the evolution of trustee's fiduciary duties – a legal perspective, a contribution to FINSIA report on climate change and ESG in the finance industry (2009)*

3. Fiduciary Responsibility

Survey quotes:

The law is pretty clear that the duty of trustees is to maximise returns in relevance to risk, and ESG procedures fall into risk management procedures.

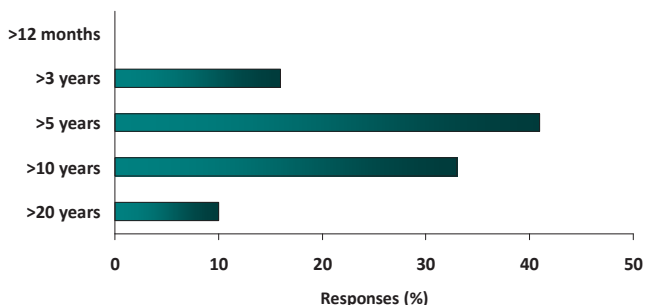
Not managing ESG risk is the risk.

3.3 Member timeframes

The survey looked in detail at the issue of timeframes used to consider member benefits and investment returns. In terms of defining the concept of 'long term' for both company performance and investment performance, more than 80% of respondents saw it as greater than five years. More than 40% used a timeframe exceeding 10 years.

Chart 4: Survey question responses

The adoption of ESG practices is frequently linked to the potential for companies managing ESG factors well to outperform their peers over the longer term. What do you consider 'long term'?



When comments about member benefits and fund behaviours are taken on board, the issue becomes far more complex. To start with, it was noted that members joining the workforce today will be investing for about 40 years. This lines up with statistics from APRA¹⁰, showing that more than 75 percent of Australian superannuants are at least 15 years from retirement age and the majority of these are more than 30 years from retirement. So there is little doubt that the average member is in the superannuation system for a long time.

The complexities come primarily in the form of ESG factor manifestation, company behaviours and the timeframes adopted by superannuation funds when it comes to

managing investment returns. One respondent captured these issues in response to a question about defining 'long term':

"ESG is issue specific. Talking from a governance perspective, 12 months can be long term; for climate change we talk 10 to 20 years. From a CEO's perspective, three years would be long term."

Somewhat surprisingly, when funds were asked to rank the general importance to trustees of the "risk to short term portfolio returns" on a scale of 1-5, with 1 being least important and 5 the most important, more than 50% of respondents ranked this 3 or higher. Not so surprising was the response to the importance of long term returns, with 90% of all respondents ranking it 3 or higher.

The finding that superannuation trustees are placing such emphasis on relatively short-term returns seems at odds with a self-perception within the industry that the trustees' primary responsibility is the long-term interests of its members. It marks a divergence between the interests of the beneficiaries and those who are managing their fund. It could also perhaps be reflecting a cultural feature of the industry – that there is pressure to perform over all time horizons – which may be compromising the primary goal of focusing on long-term returns.

Survey quotes:

Due to peer benchmarking, short termism is most important.

Funds are measured and compared on a three to five year basis – but would not call this long term.

The problem is short-termism and value chain pressure

Short term thinking was cited as a major obstacle to the adoption of ESG practices by 12% of respondents, implying that, for some, they see the investment timeframe of trustees to be misaligned with that of their fund members. This is explored further in Section 6.

There is also a mix of member demographics within funds. For one respondent, long term "depends on the profile of the fund; most super funds have a mix of people in the 20s and 50s – different long term definition for these age groups." This adds a further layer of complexity to the issue of timeframes.

¹⁰ibid

3. Fiduciary Responsibility

3.4 Members' views

There were mixed comments about the role that members play in the debate. Many fund representatives commented on how difficult it is to engage with members on the issue of superannuation generally, let alone on ESG practices. At the other end of the scale, some funds have gained traction with their membership. One fund has members who actively canvassed for an ESG-themed investment option.

The question of member involvement provoked a variety of views. It was noted that the trustees manage the fund investments on behalf of the members and they do so under the various regulatory and legal mechanisms that they operate under. In contrast, it was also noted that members would have a degree of expectation that broad community attitudes should influence the approach that trustees take on their behalf.

Survey quotes:

Australians do not consider superannuation as their money, so do not care about their values when it comes to investment.

We work with employees to help them understand what they will need at retirement.

We believe strongly in education of members but it is not an easy task. Most members do not rank super very high in their interest even though it is probably going to be one of their largest assets they have once they retire.

It is hard to engage people on super at all – people often do not even know what their super fund is.

When asked about the industry's responsibility to educate members about the role of superannuation and its contribution to society, the majority of respondents agreed this was important. A portion of respondents saw it as government's role and some saw it as a shared responsibility.

Survey quote:

The main legal responsibility for trustees is risk and return. However, from our point of view, if you expect a license to operate from someone, you have to meet societal expectations.

There is limited obligation to educate members.

[Super funds] have a moral obligation to have a dialogue, but they also have constraints through the sole purpose test which gets funds to put financial interest of members first.

I think members would like more conversation and see more social issues addressed.

Super funds have the obligation to tell members what they are doing with their investments.

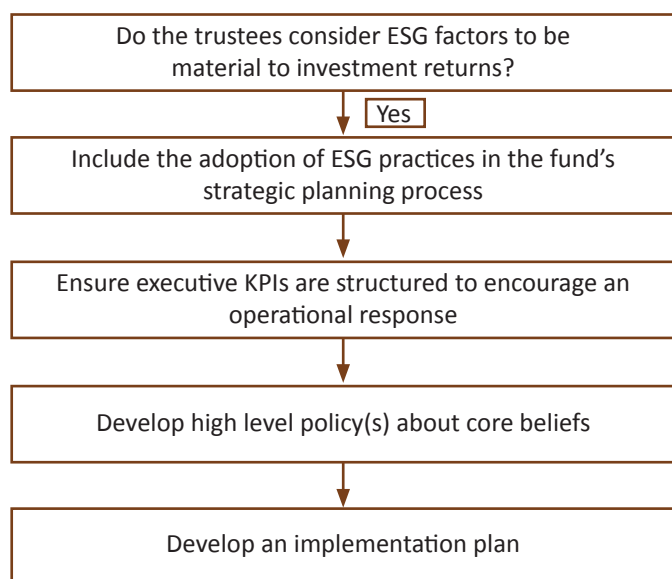
There's a lot of noise coming from members to have ESG issues looked at. Unfortunately a lot of people don't know enough to make an educated decision or believe that ESG won't support returns. Education is a big thing.

4. What Does an Implementation Plan for ESG Practices ‘Look’ Like?

4.1 A generic model for high level implementation

For the purposes of looking into industry successes and challenges later in this report, we have constructed a generic view of what an implementation process ‘looks’ like. The PRI framework is a useful tool that can be used in the implementation process, and many signatories use it to benchmark their progress both internally and externally. However there is a broader process that comes before the consideration of this or other frameworks. In our view, the key steps in the process are shown in Figure 1.

Figure 1: A generic model for high level ESG practice implementation



The characteristics of the fund in question will play a role in shaping the implementation plan. Larger funds, in theory, have more capacity to allocate resources to ESG practice implementation, so the approach taken might differ considerably from that of a small fund. Other factors that need to be taken into account include fund demographics, size of holdings / ability to influence, investment complexity, investment style, the structure of investments (mandates versus pools) and industry partnerships or affiliations.

The decision to adopt ESG practices is the commencement of a journey – not the end point. Identifying the goal, understanding what the steps are for achieving that goal and allowing a reasonable time period for full implementation

is the task. An implementation plan should include the following aspects:

- A clear internal management structure and lines of accountability;
- Cascading high level ESG-related policy into the relevant operational areas;
- Consideration of a framework, such as the PRI, for guiding and measuring progress;
- Supply chain management: aligning the timeframes and demands on asset consultants, investment managers and other service providers to those of fund members;
- Internal education;
- Transparency, disclosure and reporting;
- Communication to members; and
- A roadmap with key milestone achievements.

For further information on the broader and more practical aspects of ESG practice implementation, readers may wish to refer to the recent ASFA paper entitled “*Integration of Environmental, Social and Corporate Governance (ESG) Factors into Investment Processes for Trustees*” (May 2010). There are good resources available from ACSI¹¹ (and others) that assist with various elements of the implementation process.

4.2 Implementation according to investment style

The implementation steps and considerations that are outlined above can be applied to any fund – they are independent of investment style. Investment style is just one of the fund characteristics that will help to shape the detail of the implementation plan. Funds and investment managers who primarily use an ESG-themed investment style are generally advanced in their ESG practices.

¹¹ For example, refer http://www.acsi.org.au/images/stories/ACSIDocuments/es_guidelines_for_super_funds_final_pdf.pdf

4. What Does an Implementation Plan for ESG Practices ‘Look’ Like?

4.3 Materiality

The materiality of ESG-related investment issues is an important consideration for any investment process. Defining materiality is not easy as varying approaches can be taken and the investment style may also be an influence. At the specific investment level, materiality could be viewed as any ESG factor that is poorly managed by a company; or it could be viewed as any factor that produces a material change in an investment valuation model. Each investor will generally form its own view of materiality.

High level investment policies can be helpful tools in determining what is considered ‘material’ for a given fund or investment manager.

5. Industry Implementation Achievements

5.1 Awareness of ESG factors

Even if there is inconsistency in the understanding of ESG practices, there is little doubt that general awareness is increasing in the industry. The number of Australian asset owner and investment manager signatories to the PRI advanced from 63 to 95 over the period March 2009 to August 2010¹². Several industry bodies and service providers have been active in educating, reporting on and guiding the industry on broad ESG issues, including ACSI, AIST, ASFA, FSC (formerly IFSA), FINSIA, the PRI Australian Country Network and RIAA.

The RIAA set up an offshoot, the RI Academy, which obtained federal funding to roll out a global e-learning platform; the IGCC has been active in the area of climate change impacts and investing; and the formation of the ESG Research Australia collaboration demonstrated the interest that investors have in promoting improved broker research. An emphasis on reporting and improved disclosure by superannuation funds relating to their carbon exposure led to the launch of the Asset Owner Disclosure Project, sponsored by the Climate Institute. More recently the PRI has announced an intention to develop a standardised reporting framework for asset owners in 2011.

Coupled with these achievements, the Australian market has seen the formation of two major collectives, ACSI and Regnan, who conduct research and engagement mainly on behalf of superannuation fund sponsors and clients. There has also been an increase in demand for specialised ESG research and advisory services.

5.2 Governance

The Australian investment industry has proven to be reasonably proactive in its pursuit of stronger governance. The high level of local, institutional ownership of our major companies has been a driver of governance activity, which in turn has been driven by the superannuation guarantee mechanism. The ASX Corporate Governance Council's amended principles and recommendations for listed company disclosure, released in 2007, calls on companies to develop policies for the oversight and management of a range of business risks including ESG risk.

It is fair to say that the 'G' in ESG is well managed by many funds and investment managers. The recent financial crisis and resulting governance failures added weight to the mandate that funds have in pursuing this aim and there are many research providers actively employed in this field.

In Section 2.3, we identified that survey respondents

expected any regulatory responses to the financial crisis to be centred on governance, but overall, there was a feeling that the regulatory response would be modest. This is perhaps attributable not just to the general views of regulatory direction, but also the progress made across the industry.

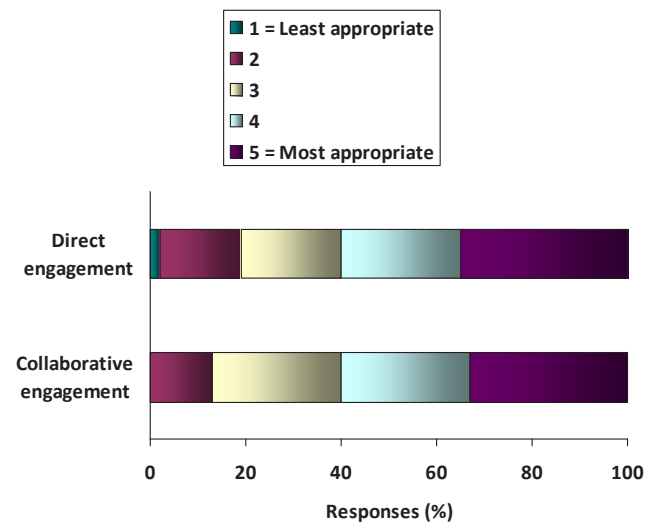
5.3 Company engagement

A positive theme that emerged from the survey was the participants' belief in the effectiveness of company engagement. With respect to the question about possible regulatory responses, those who believed a market response as more likely saw engagement as an area of increasing interest.

There was widespread acceptance of direct and collaborative company engagement as an appropriate technique for incorporating ESG practices into investment processes.

Chart 5: Survey question responses

How appropriate are the following methodologies for incorporating ESG practices into an investment process for a superannuation fund?



¹² Source: <http://www.unpri.org/signatories/index.php?country=Australia>

5. Industry Implementation Achievements

When asked about the attractiveness of high profile engagement as a way of a fund distinguishing its approach to ESG practices, the response was fairly even at 45% / 55% in favour of those who thought it was not attractive. Many commented that funds would generally avoid high profile engagement – they would prefer to “keep it under the radar” and a high profile response is usually an action of last resort. Collaboration in the engagement process was also noted as being a more effective approach for some respondents.

Survey quotes:

We are long term investors. We vote through the ballot box, engage behind the scenes and might go public if engagement fails.

Engagement is most effective if low profile, not public. We engage external people to engage with companies but would not do so in public campaigns.

6. Implementation Challenges

From the data collected and comments made in the survey it became apparent that implementation challenges occupy more airtime than success stories. In this section, we report on the key challenges facing the industry.

6.1 An inconsistent understanding of ESG practices

As discussed in Section 2.4, there is a broad range of views about the meaning of the term “ESG practices”. This is partly due to a blurring of issues associated with specific investment analysis and those pertaining to investment styles. By separating the discussion into its two component parts, a common understanding will emerge that will improve the conditions for implementation progress.

It would also be helpful to have more discussion about the role of ESG practices in passive investment styles. A respondent to the survey commented that ESG did not apply to passive portfolios. However passive approaches are still exposed to market risk and advocating stronger governance, for example, would be aligned with the investment purpose.

6.2 Linking ESG factors to investment performance

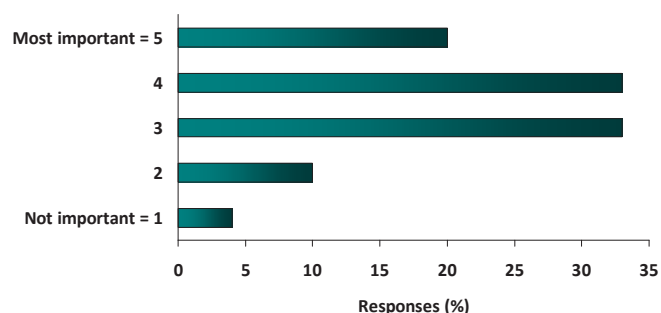
Despite general acceptance of longer term links, the lack of empirical evidence linking ESG practices with investment returns is a major barrier to implementation. Most of the studies conducted in the academic world rely on the analysis of ESG-themed funds to test this hypothesis¹³. Whilst there have been some links established in this realm, because they have been conducted with regard to a specific investment style, they are often insufficient to sway the mainstream market.

ESG factors blend in with traditional factors, making it hard to strip them out for performance attribution purposes. Consider the manufacturing sector: would the consequences of a regulatory price on carbon be considered an ESG-related risk, a standard operating risk (eg. an input price rise) or both?

As per Chart 6, respondents generally accepted that there was a link between ESG factors and returns, but there is no conclusive proof: “[The] jury [is] still out on returns; more see it as providing protection from the downside than good returns”. Another saw the challenge as “not so much demonstrating the link, but implementing ESG factors into models to determine valuations etc.”

Chart 6: Survey question responses

To the extent that super trustees are using ESG practices, how important is the belief that ESG practices support returns over time to their decisions?



Because of the practical issues that stand in the way of ESG factor attribution, the authors believe that linking ESG factors with returns requires a degree of intuitive acceptance by investors.

At the specific investment level, if it is accepted that an investment decision based on the analysis of more information is better than one based on less, then it is rational to conclude that the systematic consideration of ESG factors enhances portfolio returns. Likewise, at the portfolio level, along with stock specific benefits, a deeper and systematic understanding of the aggregation and correlation of ESG-related risks provides an avenue for enhancing risk-adjusted portfolio returns.

6.3 Fiduciary uncertainty

There is significant uncertainty over the extent of fiduciary duty, as discussed in Section 3. The industry is keenly awaiting further regulatory guidance and, should this fail to provide further clarity, it may remain a roadblock for many. In this event, trustees may look to industry bodies for stronger guidance.

This fiduciary ‘predicament’ should not prevent trustees from linking ESG factors with returns. If we first differentiate specific investment analysis from investment styles, then the proposition that ESG factor analysis provides more information from which to make investment decisions appears straightforward and consistent with trustees’ fiduciary duties.

¹³ For example, refer to the review of literature contained in Bianchi, R J et al On the Responsible Investment Disclosure Practices of the World’s Largest Pension Funds, Griffiths University (2010)

6. Implementation Challenges

6.4 Structural change is a distraction

The superannuation industry is currently subject to considerable market and regulatory change. In this environment it is not surprising that ESG practice implementation may take a back seat for some. In response to a question about regulatory responses post-financial crisis, one survey participant noted *“Financial concerns will take precedence. ESG criteria will be minor, down the pecking order.”*

In our discussion of what ESG practice implementation ‘looks’ like (Section 4), we provided a framework for high level decision making. Once the high level issues have been dealt with, the focus then shifts primarily to the investment level where, subject to resourcing, it should be able to run in parallel with other strategic initiatives.

6.5 Leadership

With many of the survey questions, respondents were invited to add any additional comments they wished to make. When asked about the key obstacles to ESG practice implementation, a significant number of respondents (16%) made additional and unprompted comments about the lack of leadership within the industry. Half of these comments came from superannuation fund respondents and half from service providers, highlighting that it appears to be both an internal issue and an external perception.

Survey quotes:

Conservative culture – no one wants to be the first.

[There is a] lack of focus on [ESG] issues despite a wealth of information.

[An obstacle is] the lack of guts to make some hard ESG-related decisions.

Need a person on board who is an ESG champion; who really wants ESG methodologies adopted.

6.6 Member timeframes versus supply chain behaviour

Many respondents identified short term thinking and behaviours as barriers to ESG practice implementation (refer Section 3.3). It was significant that more than 50% of funds were quite motivated by short-term portfolio returns and there perhaps should be further investigation to determine whether the industry has a ‘perform over all time horizons’ mentality, which conflicts with the interests of fund members who desire high quality, long-term investment returns.

There were comments made about issues in various parts of the investment chain:

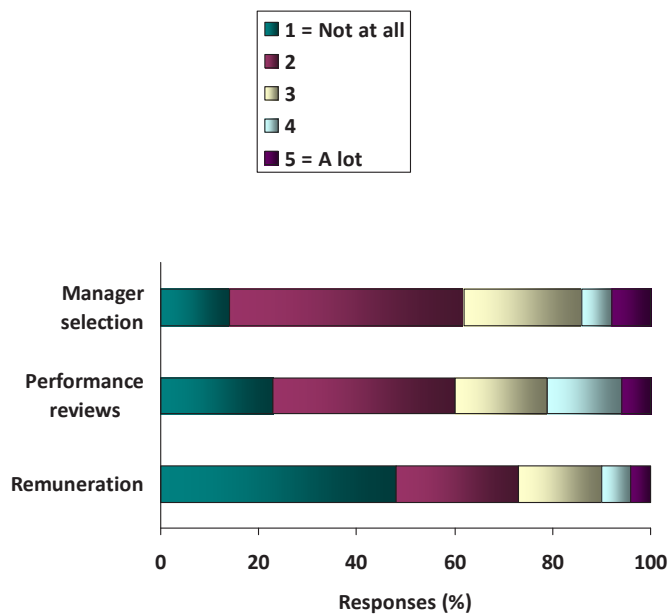
- One respondent, from an industry body, specifically commented that funds measure and compare their investment performance over 3-5 year timeframes, implying that fund officers and trustees are adopting a shorter timeframe than their members’ typical investment horizon.
- A respondent from a fund (a PRI signatory) explained that the task of developing policies and updating their investment management approach was a barrier. This was backed up by another fund respondent saying that *“Methodologies [are] not developed enough, [with the] expectations of fund managers not very clear.”*
- Asset consultants were singled out by one respondent as being an obstacle, with another noting that *“there are many intermediaries between the member (investor) and the actual manager. [It is] difficult to communicate values.”*
- Investment managers were called upon to improve the marketing of their achievements with respect to ESG practices to funds; plus there was also interest from an industry body respondent to, not so much demonstrate the link between ESG factors and returns, but to learn more about integrating ESG factors into valuation models.

Expanding further on the issue of funds dealing with the most critical part of their investment supply chain – their investment managers – one of the survey questions sought to probe the level of implementation progress in this area.

6. Implementation Challenges

Chart 7: Survey question responses

To what extent are super trustees using ESG-related processes/principles when making decisions about fund managers relating to...



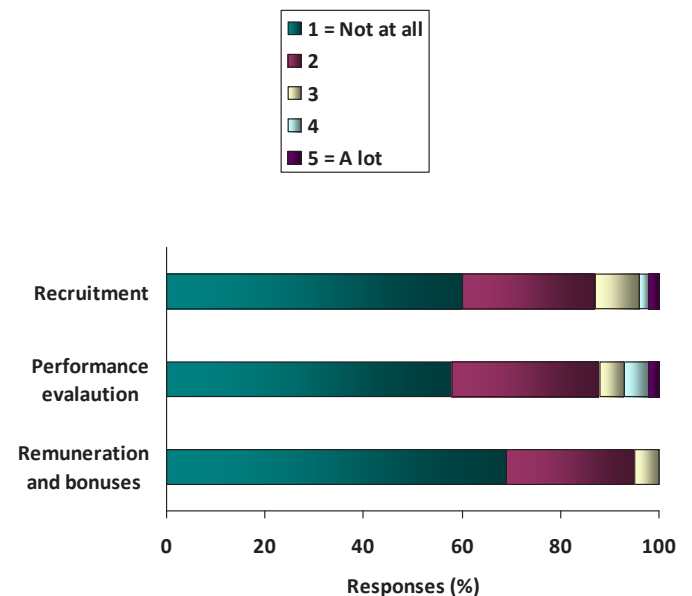
The data shows that there is only modest consideration of ESG factors when selecting, reviewing and remunerating investment managers. Whilst it may be expected that those funds who are more advanced in this area would be PRI signatories, there was in fact little correlation. The results, overall, highlight the limited progress funds have made in managing their supply chain, but this should also be balanced with the expectation that it will take time for critical mass to be achieved. What was most interesting about comments in this realm was the fact that three investment manager respondents noted that they thought stronger ESG-related criteria in mandates was imminent.

6.7 ESG practices as a strategic issue for funds

Another question in the survey honed in on the extent of the ESG practices with respect to superannuation fund management structures. The results were fairly stark and, again, perhaps reflect the relative infancy of ESG practice implementation:

Chart 8: Survey question responses

To what extent are super trustees using ESG-related processes/principles when making decisions about employees relating to...



There is scope for follow up discussion in this area along the lines of asking funds whether they consider ESG practice implementation to be a strategic issue or just an operational issue (eg. risk management / compliance)? At one extreme, if ESG practice is seen by funds purely as a compliance issue, then there is an increased risk that operational barriers will hamper implementation processes.

The high level framework suggested in Section 4 raises ESG practices to the strategic level for trustees and management. By integrating ESG practice considerations into strategic planning and executive KPIs, then implementation roadblocks should, in theory, be significantly reduced.

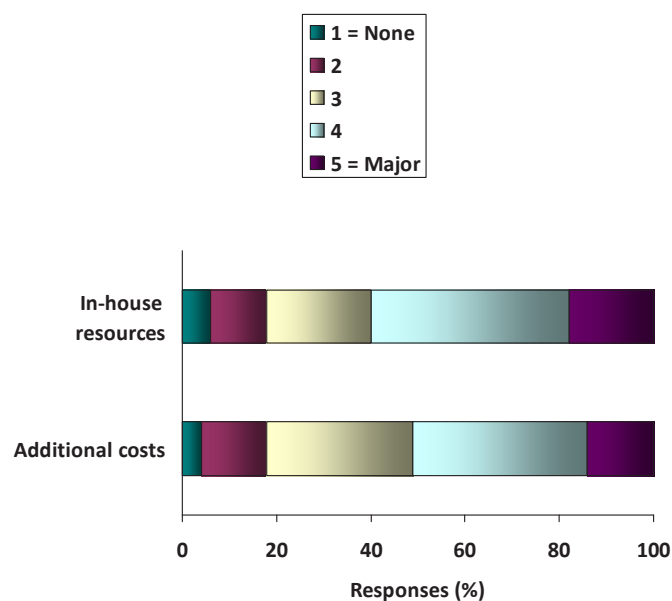
6. Implementation Challenges

6.8 Resourcing and costs

Funds are acutely aware of the costs of expanding or extending their service and skill levels. The level of structural change in the industry means there is intense competition for available resources. Management expense ratios are an indicator of fund competitiveness and efficiency, and implementing ESG practices has an impact on management time and costs. The survey respondents rated these factors fairly highly as obstacles to implementation:

Chart 9: Survey question responses

How do the following factors rate in terms of being obstacles to superannuation trustees adopting ESG practices?



A persistent theme from the study was that small funds believed they were at a distinct disadvantage because of scale.

Survey quotes:

[We] need to be already smart about recruiting and running 'slim'.

Bigger [funds] have resources – it all depends on size of fund and the scale of operation. Smaller operations have more trouble.

There's not enough interest at the moment, but if there was, cost would be a significant obstacle.

Measuring benefits from ESG – value for money is not clear; it's very expensive to implement.

A respondent made the point that there is no common standard for implementation. As we discussed in Section 4, there is unlikely to be a one-size-fits-all approach to ESG practice implementation because fund characteristics (which include issues such as scale and resourcing) will partly determine the nature of the response. However it is likely that, as ESG practices mature, templates or common approaches will emerge for funds with similar characteristics. This is already occurring to some extent with a group of PRI signatories from relatively small funds collaborating to share ideas with respect to ESG practices.

This is an area where more discussion would be beneficial, as the objectives of ESG practice implementation should include the consideration of “doing what is reasonable” for the fund in question. For example, a fund with relatively small equity holdings may have little influence using a direct corporate engagement approach; the fund may choose to focus on selected collaborative activities as an alternative strategy in order to maximise its effectiveness without over-resourcing the response.

Another consideration for funds is the use of analytical tools that help identify unwanted sources of ESG risk at the portfolio, asset class and fund level.

6.9 Research, information and education

The survey identified research, information and education needs in the areas of general ESG practices, implementation processes and linking ESG factors with investment returns.

Survey quotes:

Education is key as no one really knows what SRI/ESG really means.

[Lack of information is a] major issue – no information on how to incorporate.

[There is a] lack of clear metrics. Who knows how much value ESG actually adds, which makes it hard to argue for expenditure.

[There is] not enough research about the risks and valuations; the overall lack of research is a major barrier.

[There is a] lot of different information out there; many different issues, but there is a lack of analysis. What is the way to marry these issues with investment decisions?

The major obstacle is a lack of research and understanding about ESG valuations – how ESG relates to investment performance.

6. Implementation Challenges

6.10 Fund members

A handful of respondents saw the lack of interest from members as a barrier to ESG implementation. As alluded to in Section 3.4, there are mixed views on whether member and community attitudes should provide the lead for trustees or whether the trustee's role is solely to do what they think is best in the pursuit of good risk-adjusted returns for members.

In terms of ESG-related enquiries from members, half of the respondents had procedures in place to deal with them and of these, only about half again reported on the volume and nature of those enquiries (some do so under the PRI reporting mechanism).

6.11 Reporting and transparency

With ESG practices expanding, as evidenced by the growth of PRI signatories, the survey sought to canvas views of the reporting of ESG practices by funds. More than 85% of respondents believed this was an area in which funds would seek to distinguish their approach. Some viewed increased transparency as inevitable and others thought reporting would be tokenistic. It was also noted that some funds have produced their own sustainability reports.

7. Recommendations for Removing Roadblocks

The discussion of ESG practices has been supported by key industry bodies and comments from this survey suggest that implementation is an inevitable trend. Based on the roadblocks highlighted in Section 6, we have proposed five key measures that would assist in breaking through those roadblocks:

1. *The major superannuation investment industry bodies in Australia work together to establish a consistent understanding of the term 'ESG practices' and communicate this to their constituent members and the broader industry*

Such a process would include separating the discussion into its component parts, such as differentiating specific investment analysis from investment styles, and a review of practices across relevant offshore jurisdictions. A common understanding of ESG practices would provide a powerful platform for further implementation progress.

2. *Regulators provide clarification of trustees' duties with respect to ESG practices. Furthermore, the superannuation industry and regulators should consider the role that general community and member attitudes play in this process.*

Uncertainty in this area is a major roadblock for the implementation of ESG practices. We believe that such clarification does not necessarily need to be detailed. High level guidance could be relatively simple, such as:

- i. ESG factors, like any other factors, influence investment returns and portfolio risk profiles;
- ii. The examination of ESG practices used by investment managers should form part of any standard investment due diligence process for trustees; and
- iii. The consideration of ESG practices is consistent with the fiduciary duties of trustees.

Another area worthy of regulatory consideration is the role that broader societal trends and member interests play insofar as they should or should not influence the way trustees discharge their duties.

3. *That superannuation funds demand more transparency of process from their investment managers. As a starting point, funds can press their investment managers for examples of policy implementation and real-life examples*

of integrating ESG factors into investment processes.

Because ESG factors are heavily entwined with traditional investment factors, research has struggled to identify a definitive link between specific ESG factors and financial returns. An alternative way of evaluating the proposition is to examine real-life investment practices, both from Australia and overseas, and observe what types of informational enhancements and outcomes result from the systematic integration of ESG practices. This should be explored across a wide range of asset classes and investment styles, ranging from traditional investment approaches through to ESG-themed investment styles.

4. *Relevant industry bodies promote discussion of implementation experiences, so that certain types of investors, such as small funds for example, are able to seek guidance on best practice methodologies.*

Given that investors have varying characteristics, the implementation task becomes an investor-specific proposition. Promoting discussion about implementation practices in specific investment areas will help investors who are not currently engaged in ESG practices to become engaged. This will also address the resourcing and cost decisions that small funds, in particular, are faced with.

5. *Investors (who have not already done so) consider elevating the issue of ESG practices to the board and management level in order to improve the effectiveness of their organisational response.*

Because the implementation process has significant impacts on internal resources and the investment supply chain, starting the process at the strategic level builds organisational alignment which, in turn, assists the implementation process. The framework described in Section 4 serves as a starting point for high level guidance.

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Australian Reward Investment Alliance	Queensland Investment Corporation
CCSL	Regnan
Christian Super	Responsible Investment Association of Australasia
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HESTA Super Fund	Uniting Church in Australia Beneficiary Fund
Local Government Superannuation Scheme	Uniting Church Superannuation Plan
Nationwide Superannuation Fund	

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Glossary

ACSI	Australian Council of Superannuation Investors
AIST	Australian Institute of Superannuation Trustees
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
FINSIA	Financial Services Institute of Australasia
ESG	Environmental, social and governance
ESG factors	Investment factors that exhibit ESG-related features
ESG practices	The consideration and integration of ESG factors into investment decisions and processes.
ESG-themed investment style	An investment style where certain ESG factors are prominent in the chosen investment criteria; typical applications include negative screening, positive screening and best-of-sector.
Ethical investing	The name used for some ESG-themed investment styles.
FSC	Financial Services Council (formerly IFSA)
IGCC	Investor Group on Climate Change Australia / New Zealand
Mainstream ESG practices	The inclusion of ESG considerations in traditional investment styles and processes.
RIAA	Responsible Investment Association Australasia
RI Academy	Responsible Investment Academy
PRI	The “Principles for Responsible Investment”, an institutional investor and United Nations initiative that promotes ESG practices.
PRI Australian Country Network	A group comprising of Australian signatories to the PRI.
SRI	SRI stands for “socially responsible investing”, a name also commonly used to describe some ESG-themed investment styles.

