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National Australia Bank

A world of INSIGHT

Superfunds ESG survey

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A WORLD OF INSIGHT
SUPERFUNDS ESG SURVEY

Environmental, social and governance ("ESG") considerations are fast becoming incorporated into mainstream practice across all sectors of business.

For Australia's superannuation funds, this manifests in the governance and practices of the corporate entity itself as well as the policies and practices that govern their investment portfolios, including investments that can be classified as "responsible investing". Globally, the focus on ESG and responsible investing has moved to the forefront driven by a number of factors including customer expectations, fiduciary obligations as well as regulatory guidance on matters such as climate change risk. More broadly, there is an increasing awareness of the social and environmental impact of a company's activities, with the weight of investor money behind this shift. We are witnessing this trend in Australia, with the responsible investment market growing by 13% during 2018 to AUD$980 billion, representing 44% of total professionally managed assets which total AUD$2.24 trillion.[1]

In response to the increased focus on ESG and responsible investing by Australia's superannuation funds, including in fixed income markets, NAB extended its Biennial Superannuation FX Hedging Survey to include questions on these themes. We received responses from 30 funds, representing about AUD$820 billion of assets under management, spanning the industry, corporate, government and retail sectors.

Overwhelmingly, the survey found that 90% of respondents have a policy to consider ESG factors in their investment decisions, with the most common strategy beyond ESG integration being the application of a negative screen, particularly for tobacco, cluster munitions, landmines and weapons. Interestingly, few funds cited a negative screen for fossil fuel investments. While respondents generally called for stronger ESG integration across the board, only one respondent articulated the connection to the opportunity of assessing ESG risk as a way of enhancing returns.

This paper will explore these insights across fund segments and is the first of what will be a biennial survey to gauge how Australian superannuation funds are adopting responsible investment practices.

90% of respondents **have an ESG policy** for their investment decisions

76% of respondents **apply** negative screening

30% of respondents **invest directly** in environmental or social impact related products

1. Responsible Investment Benchmark Report 2019 Australia. Responsible Investment Association Australasia (RIAA).

State of the Responsible Investment Market

The growth in ESG considerations and the responsible investment market is a global trend, driven by a number of factors. There is the impact of changing demographics with the rise of the millennial generation who often have a different set of values beyond wealth accumulation. Customer and community expectations are changing where questions about a company's practices and impact are being asked, in part attributable to social media providing a clear mechanism for making one's view known and for organising like-minded voices. Fiduciary obligations have also played a role, requiring directors to consider all factors that may influence the long term value of a company, including those of a non-financial nature. What may be non-financial today can translate into a financial risk in the future. Regulatory guidance on matters such as exposure to climate change risk has also played a role in this global trend.

The investor community has played a significant role in building awareness, improving practices and directing funds into this area. The Principles for Responsible Investment (PRI) is the world's largest responsible investing group, with about 2,500 signatories and representing almost USD$90 trillion of assets under management.[2] This independent body has established a set of six principles to help signatories understand the investment implications of ESG issues and integrate these issues into investment and ownership decisions. Locally, the Responsible Investment Association Australasia (RIAA) has 240 members who manage more than AUD$9 trillion in assets globally, and is the largest responsible investment network across Australia and New Zealand. Some of the most influential global investors such as Larry Fink, CEO of BlackRock, the world's largest asset manager with USD$6.4 trillion under management, recently commented that all passive and active investors will be using ESG to determine the value of a company within five years.[3]

How should Australian superannuation funds respond? What is responsible investing and what does it cover? Responsible investing is an umbrella term which covers the spectrum of incorporating ESG considerations into investment decisions. The Responsible Investment Association Australiasia describes responsible investing as "a holistic approach to investing, where environmental, social and corporate governance (ESG) and ethical issues are considered alongside financial performance".[4] The PRI states that "responsible investment can and should be pursued even by the investor whose sole purpose is financial return, because to ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries."

Responsible investment choices and strategies can appear complex and there isn't one approach to guide choices. Responsible investment covers a spectrum spanning basic ESG integration which considers and analyses environmental, social and governance factors as part of investment decision making, through to impact investment which actually targets positive social and environmental impact (Appendix 1).

The following section explores how our superannuation fund respondents are incorporating ESG into their investment decisions.

2. PRI website
3. Business Insider article (2 November 2018)
4. Responsible Investment Benchmark Report 2019 Australia. Responsible Investment Association Australasia (RIAA).

Survey findings

Consideration of ESG and asset class application

Respondents were asked whether they consider ESG factors in their investment decisions, and if so, are these factors applied to specific asset classes. Overwhelmingly, 90% of respondents confirmed they have a policy for their fund to consider environmental, social and governance factors in investment decisions. All of the larger funds, that is, those with more than AUD$25billion funds under management, confirmed having an ESG overlay to their investment decisions. In addition, all of the industry funds surveyed confirmed having an ESG policy and all asset classes were included. However, some industry fund respondents indicated that ESG was more easier applied for equities. One of the retail funds commented that rather than having an ESG policy in place for all investments, consideration of ESG factors is dependent on whether this is required by their client. Overall, while a small number of respondents advised they did not have an ESG policy, the survey results are consistent with broader investment trends suggesting the incorporation of ESG has become mainstream. There may be room for improvement as to how this is done and whether best practice management of long term risk as well as long term value capture is taking place. In its recent review of 120 investment managers, RIAA found just 28% are applying a leading approach to ESG integration.

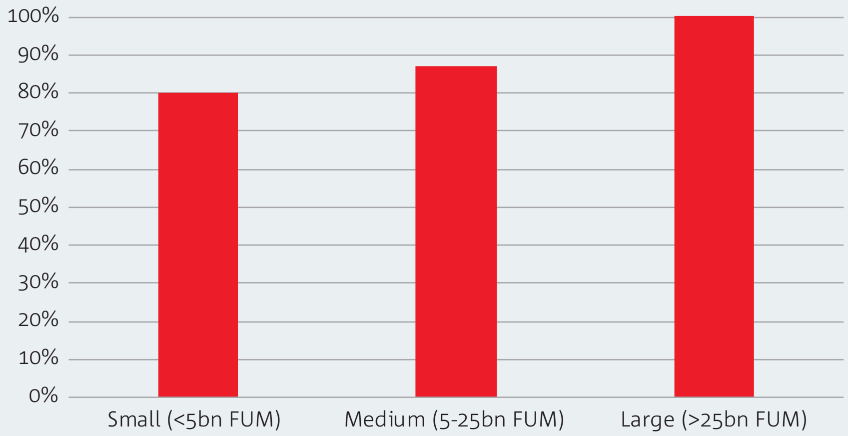
Practical application of ESG strategies

Respondents were asked how their ESG strategies were applied including negative and positive screening, direct investment in ESG products or whether other alternative strategies were applied. Unsurprisingly, 76% (totalling AUD$710billion FUM) confirmed applying a negative screen. Of the negative screens, tobacco, cluster munitions, landmines and weapons were the most commonly cited. A small number of industry funds cited fossil fuels and climate change, however, no other fund type reported a negative screen of this nature. RIAA's 2018 report reflects similar findings with controversial weapons and tobacco being the most prevalent exclusionary screens amongst Australian institutional investors, each being reported by 96% of survey respondents. However, RIAA's results differ on fossil fuels and climate change with 79% of their survey respondents reporting a negative screen of this nature.

By weighted AUM, the RIAA data tells a different story, with controversial weapons, tobacco and fossil fuels negative screens comprising 31%, 30% and just 5% respectively. Consumer expectations tell a different story again, with RIAA's consumer data finding that consumers were most keen for their funds to screen out fossil fuels followed by investments that violate human rights.[5]

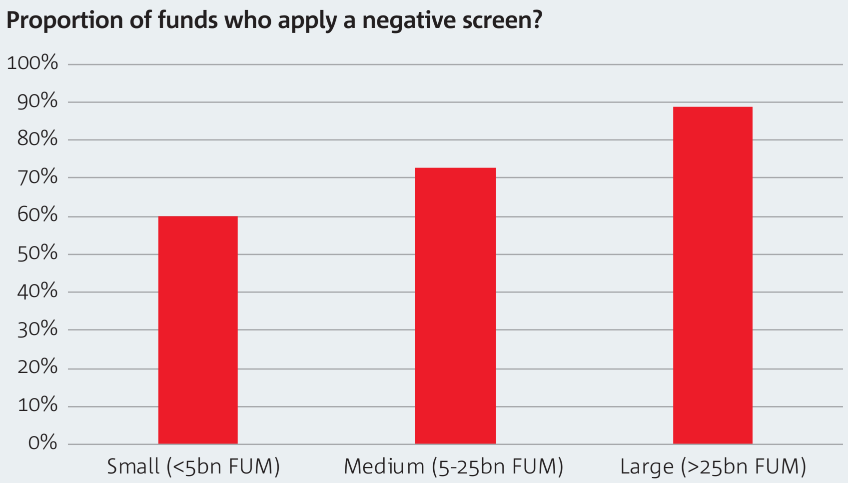
> Tobacco, cluster munitions, landmines and weapons were the most commonly cited negative screens.

Proportion of funds who consider ESG factors in their investment decisions?



Source: NAB biennial Superfund survey

5. Responsible Investment Benchmark Report 2019 Australia. Responsible Investment Association Australasia (RIAA).



Source: NAB biennial Superfund survey

Areas of opportunity include private and unlisted markets, infrastructure assets and emerging markets.

While only one respondent in the NAB survey confirmed using a positive screen, that is, it actively invests in companies or industries with better ESG performance, 30% of funds (totalling AUD$368 billion) confirmed direct investments in ESG related products. Of these responses, the most commonly cited investments across all funds types were centred on natural resources including water and timber. One industry fund reported investing in social housing. In addition, 50% of the industry funds surveyed reported active ownership and engagement as a method of applying their ESG strategies.

Future impact and responsible investment choices

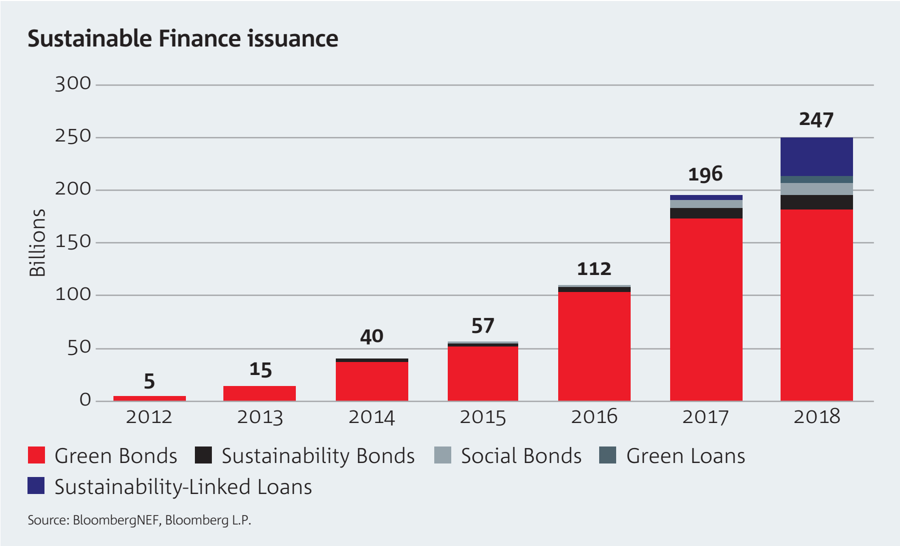
In an ideal world, what would funds like to be able to access in the future? Respondents were asked what products or asset classes with an impact or responsible investment theme would they like to see available, which aren't easily accessed today. This could include impact and sustainable themed funds or indices, bonds, direct investments in projects or companies, as well as other alternative investments.

Funds responded with a wide array of comments, however, a few themes emerged across all fund types. Most prevalent was the call for stronger ESG integration across the board, with room for improvement across all asset classes. Areas of opportunity include private and unlisted markets, infrastructure assets and emerging markets.

Some respondents expressed their desire for greater transparency and consistency of sustainable investment guidance and frameworks.

There was also a strong theme around debt markets generally needing to "lift their game" consistent with the view that equity markets have led the way and have been somewhat more advanced in integrating ESG factors.

While it is expected that issuers of fixed income debt meet minimum ESG standards at a corporate level, can investors turn to gain additional ESG insight on fixed income debt? MSCI ESG Research, the world's largest provider of ESG research and data, provides an ESG fixed income ratings process which identifies ESG-driven investment risk that may not be captured by conventional analyses. MSCI provides ESG research on a large number of corporate and financial institutions that have issued bonds into the the Australian Fixed Income Market.



A further shift seems to be required for funds to be convinced that responsible investing is not at the expense of investment returns, and that it is rather a driver of long term performance.

Moving beyond understanding ESG risk, ESG or sustainability themed fixed income investments are becoming available and are in high demand. The most significant example is the green bond market, which has grown rapidly from USD$1.8 billion in 2007 to USD$182 billion in 2018 and is expected to exceed USD$200 billion globally in 2019.

The data suggests that these bonds perform well and are generally issued in a quantum that ensures they are included in the relevant indices. The universe of these thematic bonds has broadened to include social and sustainability bonds, including bonds that are linked to the UN Sustainable Development Goals, otherwise known as SDG bonds. Loan markets are also responding, with growth in green and sustainability linked loans being issued across industries. ESG ratings impact the cost of debt on USD$32 billion of these loans worldwide, up from just USD$3 billion in 2017.[6]

How well do responsible investments perform?

Finally, funds were asked whether they believe responsible investing improves alpha outcomes, and additionally, do they benchmark their responsible investments to measure relative performance. Overall, it seems the jury is still out on whether the funds surveyed believe there is a performance uplift in responsible investing.

Time frames are important, with a large proportion of the industry funds responding that this was relevant to the assessment of performance. Some funds perceived short term costs involved in ESG investing and a negative impact on performance in the short term, whilst others noted that over the longer term, certain investments (for example, those impacted by a transition to a low carbon economy) would be affected either positively or negatively depending on the theme.

Only one respondent made the connection to the opportunity of assessing ESG risk as a way of enhancing returns. A further shift seems to be required for funds to be convinced that responsible investing is not at the expense of investment returns, and that it is rather a driver of long term performance. Two respondents reported benchmarking responsible investments to a benchmark, indicating that there is more work to be done to present a relevant benchmark to build understanding on performance.

A review of international evidence by the Australian Centre for Financial Studies[7] suggested that over the long run, responsible investment funds generally match or outperform similar conventional managed funds and that funds that engage in ESG integration have also matched or outperformed their mainstream peers.

6. BloombergNEF
7. A Review of Socially Responsible Investing in Australia. Australian Centre for Financial Studies 2017.

In their 2018 report, RIAA compared performance of responsible investment funds versus mainstream funds, net of fees, over different time horizons and found that the responsible Australian share funds performed particularly well compared to mainstream funds.

MSCI also provide guidance with research focused on understanding how ESG characteristics have led to financially significant results. The research found that ESG had an effect on valuation and performance of many of the companies in the study, with companies with high ESG ratings demonstrating higher profitability, lower tail risk and lower systematic risk.[8]

In conclusion, whilst ESG integration has definitely become mainstream, there is potential for deeper and richer performance data to be shared with our funds community so that the focus can be extended from managing long term ESG risks to actively participating in the opportunity to create even more value for their members.

Performance of responsible investment and mainstream funds[9]

Australian share funds	1 year	3 years	5 years	10 years
Average responsible investment fund (between 17 and 34 funds sampled depending on time period)	-1.24%	5.70%	6.43%	12.39%
Morningstar: Australia Fund Equity Large Blend	-5.49%	4.87%	4.42%	7.95%
S&P/ASX 300 Total Return	-3.06%	6.65%	5.60%	8.91%
International share funds	**1 year**	**3 years**	**5 years**	**10 years**
Average responsible investment fund (between 7 and 38 funds sampled depending on time period)	-0.03%	11.18%	9.48%	9.50%
Morningstar: Australia Fund Equity Large Blend	-0.68%	6.37%	8.42%	8.97%
MSCI World (Ex Australia) NR AUD	1.52%	7.49%	9.81%	9.57%
Multi-sector growth funds	**1 year**	**3 years**	**5 years**	**10 years**
Average responsible investment fund (7 funds)	-1.13%	4.75%	5.65%	7.66%
Australia Fund Multisector Growth	-2.26%	4.39%	4.92%	7.02%

Outperformed by the average RI fund   Underperformed by the average RI fund

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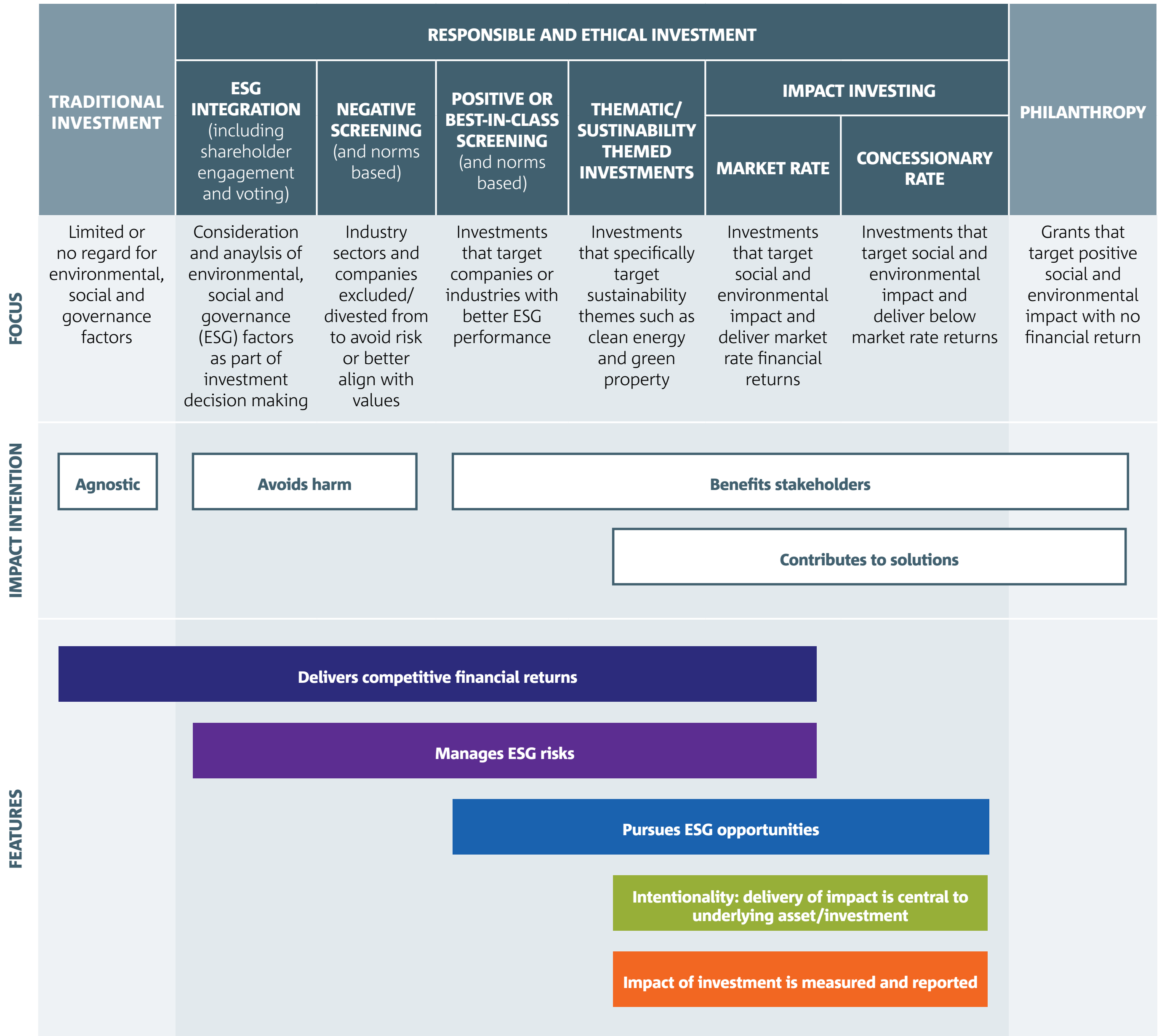
8. MSCI 'Has ESG affected stock performance?' (November 2017)
9. Responsible Investment Benchmark Report 2019 Australia. Responsible Investment Association. Australasia (RIAA).

Appendix 1

Responsible Investment Association Australasia
Responsible and ethical investment spectrum



Source: Responsible Investment Association Australasia (RIAA)