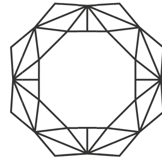

HAMILTON
wealth management

Fund Forum Asia, Hong Kong, 18th April 2016

By Will Hamilton

Responsible Investing & ESG: Overcoming The Negative Perception That Sustainability and Profitability Are Mutually Exclusive

In the past few years, we have noted increasing enquiry from clients seeking investment guidance about investing within Environmental, Social and Governance guidelines, or ESG.

Not only have not for profit clients been seeking to align their investment approach with their organisational mission, but increasingly, from families and individuals.

The level of interest highlights that many Australians want to invest to take in “values” (as opposed to value) based investing in the hope of ensuring positive ESG outcomes.

In order to establish though profitability can be augmented by a sustainability-oriented business model and countering the conventional wisdom that sustainability must come at a cost, we need put some things in context.

The western world has become wealthy exploiting empires and free natural resources like forests, ground water, wild animal stocks, etc.

However, these "free" resources are becoming depleted.

Seas are suffering from overfishing, air and water are suffering from contamination, forest depletion, etc. and, at the same time, the factors supporting our productivity gains (industrialised farming, fertiliser use, pesticides, loss of bio-diversity for example) leave us vulnerable.

Monocultures are inherently fragile; soil depletion threatens future productivity. It is broadly acknowledged we are experiencing climate change which is starting to amplify that vulnerability...loss of productive land, loss of food/water security, mass migration of population.

As a result, business models must evolve:

1. Replace the old with the new. We see it everywhere...the Internet, coal, fair trade coffee, social enterprise. If you can no longer exploit the free, how can you compete on a level playing field...that is, one that is self-sustaining.

2. Change brings challenges and risks as well as opportunity. A new regulation or legal precedent might sweep away your sources of profitability by outlawing or properly pricing what inputs or outputs you enjoy. Where are you vulnerable? What is your risk appetite? How might you improve your exposure? A model that doesn't rely on a free-kick is inherently more robust.

3. No company is an island...It cannot separate itself from its Shareholders, employees, and customers, who all have choices.

And the Internet brings transparency and ease of organisation. A business model that sits comfortably where social values are trending, can enjoy access to talent (the recent Harvard graduating class was willing to earn 17% less to work for a company in whose purpose they believe), customer loyalty (witness emergence of social enterprises in many industries), and eventually a lower cost of or certainly better access to capital…Try raising funds for a new coal mine…it is not possible in Australia today.

Well that’s how I see it!

As for overcoming the conventional wisdom.

There is a move to steer away from GDP as a measure of progress, towards indices of wellbeing. This move is underway in the UK and Sweden. Economies needs to be viewed in context with ESG. Sometimes the peace of mind from exposure to the environment is worth more than an extra $20 in the pay packet.

As Bobby Kennedy once said “it is an unfinished society that we offer the world - a society that is forever committed to change, to improvement and to growth”.

There are also moves towards raising the bar on company directors…it's not about Total Shareholder Return, it's about robust enterprises that remain strong and serve all constituencies.

Therefore, as an investment strategy, investors are balancing risk and return with ESG responsibilities.

ESG can be made across individual securities be it equities, bonds or managed funds.

It is very important to distinguish between Ethical or Responsible investing, which generally use negative screens and ESG. I would argue the better managers invest with positive screens as well as some negative screens.

A negative screen, which is most common in ethical mandates, looks specifically to exclude companies or sectors that have a negative impact on ESG outcomes. Examples of this can include sectors or companies associated with tobacco, alcohol, armaments, medical genetic modifications, pornography, animal testing, or sectors that are large in a market cap perspective in Australia, such as some mining companies exposed to excessive land degradation, or gambling companies.

On environmental factors alone, domestic Australian fund manager Perpetual estimate negative screens would eliminate 16 per cent of the S&P ASX 300 by market capitalisation.

Alternatively, positive screening, which is growing in popularity looks to identify companies or sectors selected for ESG outcomes and selection over others, and investing positively with a bias towards such companies or sectors without excluding a company on an ethical basis.

The Impact Investment Group (or IIG) based in Melbourne runs specialised single asset property syndicates. In looking at an investment not only do they look at an assets prospects for a healthy return but also at its social and environmental credentials and potential. In other words, IIG looks beyond financial returns to include off balance sheet values and risks in making an investment decision.

Specialised ESG funds have developed in the domestic Australian market such as domestic equity manager DNR Capital, who look at a combination of negative and positive screens. Likewise, Altius Asset Management in the Australian fixed interest asset class also look at a combination of negative and positive screens in portfolio construction.

There are also norms based screen approaches to ESG investing, however at Hamilton Wealth Management we have not followed any fund manager utilising this approach.

Norms based screens are not as popular as the traditional approaches, which look at a company or a sector against a minimum standard of business practice or norms. An example of which is the United Nations. This screen has found it difficult to gain traction as it is very difficult to quantify.

There is also a problem of definition. For efficiency’s sake, commentators like to lump all the ethical-style funds together. But inside the industry, there are definite distinctions between ethical investing, representing the original purist or negative screen approach, and socially responsible or ESG investing, a pro-active style incorporating sustainable investing, which is evolving into a pragmatic approach that seeks to “do the right thing” for long-term growth. Unfortunately, the distinctions don’t amount to much. Everyone, it seems, has a different definition; some players even define their principles on the run.

Goldman Sachs Asset Management, recently purchased ESG manager Imprint Capital, say the issue with ESG is that there is no one right answer and many shades of grey.

GSAM goes further stating “in a world where it is hard to compartmentalise many things, it’s difficult to say I’m going to profit from owning something that’s directly against my values”. Furthermore, they expand, saying “you have to understand why you are owning things”.

Despite this, GSAM have a commercial lense which starts with the assumption that you need to achieve market or above-market returns.

There is also the problem of what contributes to a company’s earnings. Did you know that Woolworths now controls 14,000 poker machines? The supermarket company has followed the money down the street to the pub, where cash that some might say should be spent on groceries is instead being spent on the often fruitless activity of trying to get three oranges in a straight line on a screen. So, is Woolworths still a supermarket chain, or is it a gambling company? And if it’s a gambling company, should ethical investors avoid investing in this immensely popular stock?

Still, it’s surely logical that the more restricted your investment range, the less likely you are to make money. For overseas funds located in London or New York, there is no lack of choice. In fact, both the US and the UK have deep enough stock markets to maintain specialist indices such as the Dow Jones Sustainability Index and the 4Good Index, which provide a benchmark for ethical investments. But there are less opportunities for Australian Ethical or Responsible funds, investors are forced to make the best of the meagre offerings on the resource-laden Australian Stock Exchange.

Coming back to supermarkets. Woolworths is modelled on Wal-Mart in the US. In 2004, it was revealed that Wal-Mart habitually locked night-workers in its stores to protect merchandise, and that, in many cases, employees did not have access to a key. The practice came to light when an employee had his leg crushed in a Texas store and could not get out. In June 2006, the world's largest superannuation fund, Norway's state fund, sold all its Wal-Mart stock, forcing down the Wal-Mart share price. The fund, a model for the Australian Government's Future Fund, would no longer deal with the giant US retailer, citing the company's "systematic human rights abuses" as the reason for its decision.

The Norwegian state fund is not an "ethical" fund. It's just a fund run by people with ethics.

In 2014 the Rockefeller Brothers Fund divested all fossil fuel investments on what they considered ethical grounds, which created headlines in the US, given the Rockefellers own history.

In its 2015 report on the ESG sector, the Responsible Investment Association of Australasia (or RIAA) estimated that at the end of 2014, core responsible investment, or Socially Responsible Investing or SRI portfolios, exceeded $36Billion, against Morningstar's estimate of a total pool of $1.26 Trillion of investments, which means responsible investments represent just 2.51 per cent of the market (up from 2.34 per cent the year before).

SRI portfolios are estimated to be $3.7 Trillion in the United States as at the end of 2012 according to the Social Investment Forum or 11% of the market, well above that of Australia.

However, as a distinction, assets in Australia managed under responsible investment strategies are now the norm, with total assets under management of $630Bln or 50%, and investments undertaking ESG integration representing $598Bln or 47.5%.

The causes behind the large uptake in ESG in Australia, as considered by the RIAA, are as follows:

- Increasing number of examples of company's poor management of ESG impacting shareholder value;
- Growing demand by investors to align their savings with their beliefs;
- An increase in activist groups engaging with the finance sector; and
- An increasing awareness by fiduciaries that consideration of ESG issues is an important element of their responsibilities.

For instance, last month the press revealed, Australia's largest bank Commonwealth Bank just last month, that for the second time in two years they have had to confront a substantial ethical breach from within their Wealth Management Division.

In addition to the highly negative press coverage, the implications for CBA are significant. Its slippage in the ESG rankings has been extensively covered, despite the fact that the CEO on both occasions has taken personal responsibility (and in the first instance it did not occur under his watch), and the most comprehensive remediation plan ever put in place by an Australian financial institution was unveiled:

- There is an impact on staff morale, for instance when the Group Executive of Wealth went to address staff last month the day after the second ethical breach, many staff were in tears.
- Financially the implications could be greater, as there are calls as a result of two major breaches for the wealth management division of CBA to be spun off, with a view a more tightly run company with a focused and separate management team could be far more effective at delivering both an ethical culture and a sustainable business model.

The RIAA also highlights that responsible investment funds in domestic Australian equities have outperformed not only the S&P ASX300, but also the large cap Australian share fund averages as at the end of calendar year 2014 on a one, three, five and ten-year basis.

The growth of ESG factors in the investment process by fund managers, as signatories of the United Nations Global Principals of Responsible Investing, or PRI, was estimated by the RIAA to be 14.3 per cent of Assets under Management in Australia and New Zealand as a percentage of funds.

The signatories of the PRI believe that as institutional investors, they have a duty to act in the best long term interests of their beneficiaries. In this fiduciary role, they believe that ESG issues can affect the performance of investment portfolios to varying degrees across companies, sectors, regions and asset classes and through time.

One of the largest issues the PRI cite for the differences, as mentioned above, is there is no universal agreement on how best to integrate or define ESG into an investment process or into decision making.

In December last year at the historic Paris climate accord, nations committed to pursue efforts to stop warming beyond 1.5 degrees centigrade. To achieve this would force businesses globally to sharply reduce the use of fossil fuels to zero.

One of the issues in Australia is that we, as a country, have an abundance of cheap coal.

To exacerbate this, until recently wind and solar power generation endured what could only be described as antagonistic government policies under former Prime Minister Tony Abbott. However, the change to Prime Minister Malcolm Turnbull is leading to more favourable environmental policy support.

There is also the concern around where you draw the line at to what is ethical and what isn't. For example, there are some that would say that uranium is more ethical or responsible than coal, yet ethical investing convention currently holds the reverse view.

Even this needs to be looked at carefully, as one such example outside of the low carbon theme is Freedom Foods, which produces nut free, gluten free and allergen free muesli bars and cereals.

Whilst Freedom Foods is targeted as an ethical investment, the question around sustainability is raised. When we wake up to that fact that they are pushing gluten free products onto people who don't need them, in which case it could be bad for their health. Yet everyone thinks they are ethical???

This is where the importance of Asset Allocation has a role to play, as clean exposure can be gained through international equites, and there are companies in New Zealand as well involved in hydroelectricity such as Mighty River Power and Meridian Energy.

There is an emerging array of companies in Australia in the small to mid-cap space, such as Energy Action, which help businesses monitor and manage energy use and Building IQ. They use software to predict temperature changes for buildings using weather projection data to ensure the most efficient operation of air conditioning systems.

There is also a shift to underweight the high carbon emitters or those exposed to the old world.

Likewise, many listed companies, such as Westpac Banking Corporation, are responding to pressure from both shareholders and activist groups, announcing that all new financing proposals will be judged against the transition to a model aligned to a 2-degree economy. As a result coal and oil and gas projects will struggle to gain support, making Westpac more accountable than their other peers on climate change.

The focus of investing must be over a market cycle or the long term. When this is done applying that test, sustainability and profitability generally go hand in hand.

If a focus though is less than a market cycle, or is a shorter term focus, it is tempting to support companies such as gambling companies, which appear to be good investments as long as governments tolerate wholesale gambling (and in fact reap many benefits from it) ……but that, in most people's minds, is not ethical or responsible hence the argument that responsible investing and profitability over the short term are mutually exclusive.

Australians are becoming increasingly concerned about where their source of food, rain water retention, renewable energy and so too they are becoming increasingly concerned that their money is invested along similar ethical or ESG lines.

Larry Swedroe published a paper in February 2016 titled *Does Ethical – Based Investing impact returns.* His study looks at the impact of negative as opposed to positive screens. He has looked into a number of studies and his conclusions are interesting for example:

- Negative screens naturally reduce the set of investment opportunities available;
- Swedroe believes negative screens come at the expense of a reduction in performance or negatively impact on a funds risk adjusted performance;
- Despite this, as mutual funds are highly correlated to past performance, this relationship is weakened, as ethical overlays are increased. In other words, investors in funds with higher ethical standards become less responsive to past performance and are anchored more through non-financial attributes, and are more reluctant to switch based on performance alone; and
- Multiple screening or integrating positive screens often eliminate poorly managed companies and is a value generating strategy.

Similarly, MSCI, in their June 2015 paper *Can ESG add Alpha*, conclude that ESG overlays do contribute to outperformance of the MSCI World Index and lead to stock specific decisions indirectly attributed to ESG signals and an increasing tilt to mid-cap companies.

On bond portfolios, Barclays in their November 2015 paper, *ESG Ratings and Performance of Corporate Bonds,* concluded that corporate bonds with high composite ESG ratings have slightly lower spreads, have modestly outperformed lower rated peers when controlling for risk exposures. However, they found that outperformance of high ESG issuers over low ESG peers has not been accompanied by increasing relative valuations therefore ESG performance gain is not a consequence of buying pressure.

Deutsche Bank in their June 2012 paper, *Sustainable Investing,* found that Sustainable investing CAN lead to superior risk adjusted returns for investors. But investors need to take the right approach towards sustainable investing to capture these, which brings us back to the view of the PRI in that there is no universal agreement on how best to integrate or define ESG into an investment process or decision making.

In concluding, I believe that when adding ESG issues into the decision making process of asset allocation and asset selection, this strategy over the long term does not necessarily mean giving up financial return while investing in companies that take these responsibilities seriously…in fact over the past decade in an Australian context I would argue it has consistently been a winning strategy.

Will Hamilton is the Managing Partner of Hamilton Wealth Management a Melbourne based independent Wealth Manager. will.hamilton@hamiltonwealth.com.au