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FINANCIAL SERVICES INSTITUTE *of Australasia*

IMPLEMENTING ENVIRONMENTAL, SOCIAL & GOVERNANCE PRINCIPLES IN *investment decisions*

GUIDELINES FOR SUPERANNUATION PROFESSIONALS – JANUARY 2012

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Implementing Environmental, Social & Governance Principles in Investment Decisions — Guidelines for Superannuation Professionals

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SPECIAL THANKS
Finsia would like to thank the many contributors to this paper, including members of the Managed Funds and Superannuation Advisory Group (membership details are available at www.finsia.com), as well as the providers of the material in Appendix B (which has been reproduced in its entirety).

Finsia also thanks Dr Richard Fuller of Mercer (Australia) Pty Ltd for his insightful and valuable contribution. Mercer is an operating company of Marsh & McLennan Companies, Inc.

MEANING OF TERMS
For the purpose of this paper, the word 'fund' refers to any mainstream fund unless otherwise specified. Furthermore, the initialism 'ESG' is used all inclusively and, unless otherwise provided, does not distinguish between socially responsible investing, corporate social responsibility, responsible investment or other terms used to outline similar investment philosophies.

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FOREWORD

More and more, environmental, social and governance (ESG) principles are being implemented in investment decisions. A growing number of investing entities are signatories to the United Nations Principles for Responsible Investment (UNPRI), which is a set of six aspirational and voluntary guidelines. An increasing number of investing entities that are implementing ESG principles in investment decisions are superannuation funds.

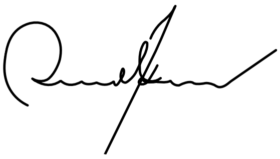
Superannuation funds have become significant market participants in Australia and influence the economy as a whole. As noted in the Australian Prudential Regulation Authority's latest annual superannuation bulletin, total superannuation assets increased by 13.9% during the year to 30 June 2010 to $1.23 trillion. Of this total, $722.6 billion are held by APRA-regulated superannuation entities. Superannuation funds have an important influence over the sustainable business practices of the companies in which they invest.

The very nature of superannuation investment is long term. Superannuation funds are well placed to take advantage of long-term opportunities and to implement ESG principles in investment decisions. Hence, guidance for superannuation funds in relation to such implementation will be of value. In addition, the guidance set out in this paper is likely to be relevant to others involved in the asset management industry, particularly those acting in a fiduciary relationship with their clients and investors, such as investment managers and fund managers.

Conventional investment analysis focuses on value in relation to financial performance per se. Yet the link between implementing ESG principles in investment decisions and financial performance is being recognised. As public awareness of the ESG impacts of corporate activity has grown, the attitude of capital markets to implementing ESG principles in investment decisions has evolved. Accordingly, investment having regard to ESG performance is becoming mainstream.

With the above factors in mind, Finsia developed these easy-to-read yet comprehensive guidelines for superannuation professionals. These guidelines outline the key issues to be considered before and during implementation. They also contain a practical step-by-step guide to implementation and consider the relationship between implementing ESG principles and a trustee's fiduciary duty.

Finsia is most grateful for the input of the members of its Managed Funds and Superannuation Advisory Group (see www.finsia.com for a list of current members) in developing these guidelines. Finsia also appreciates the insightful and valuable contribution of Mercer's Dr Richard Fuller.



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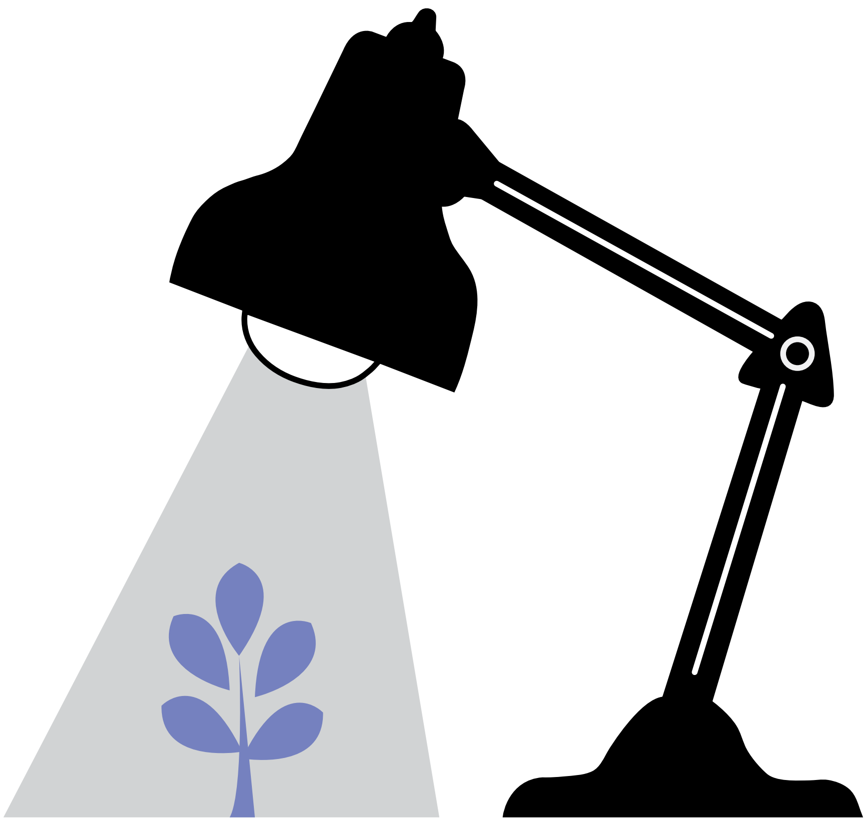
CONTENTS

Introduction

The material in this paper seeks to provide a framework for the implementation of environmental, social and governance (ESG) principles in investment decisions.

There are many ways to implement ESG principles in investment decisions and this paper does not seek to be prescriptive or exhaustive about how implementation should occur. Instead, this paper seeks to identify the key issues and factors that should be considered by superannuation professionals before and during implementation.

The acceptance of ESG principles by Australian superannuation funds is growing but most funds including UNPRI signatories are struggling with either developing policies or with policy implementation. In order to assist superannuation funds to develop clear and effective policies and to expedite implementation, Finsia developed these practical guidelines.



PART I
Key issues to be considered at the outset

This part of the paper outlines some of the key issues that should be considered before implementing ESG principles in investment decisions.

CLEARLY IDENTIFY GOALS

Be clear about why your organisation is undertaking an ESG approach,[1] and be clear at the highest level, including the board or trustees, the chief executive officer and the chief investment officer. This is probably the most important element affecting implementation and it is worth spending as much time as required to get it right. Why is an ESG approach in the interests of members or shareholders? What does this mean for the business? The answer to these and similar questions has an important cascade effect. Policies must be created to articulate your organisation's position. These in turn flow through to strategic plans and then to operational practices and procedures. The United Nations Principles for Responsible Investment (UNPRI)[2] are widely regarded as the pre-eminent principles and should be carefully examined at the outset.

IDENTIFY WHAT IS IMPORTANT FOR YOUR ORGANISATION

There are numerous elements to consider — the three areas themselves (environmental, social and governance), company engagement, climate change issues as a subset of environmental considerations, and the actual integration of ESG principles into investment methodologies. It is worth taking the time to consider what is of most importance to your organisation and at what it wishes to excel. This might mean communicating this focus to stakeholders and explicitly and publicly acknowledging a strategic and gradual approach; and that some actions will be prioritised over others.

HOW TO START — MAKING AN ESG APPROACH CENTRAL TO YOUR ORGANISATION

The position expressed in this paper is that, at least for the first few years, implementing ESG principles in investment decisions should be developed as a clear organisational strategy and function. This position would seem to run counter to the view that an ESG approach should be 'mainstreamed' and embedded in the general investment process. 'Mainstreaming' an ESG approach is certainly the goal; ultimately, an ESG approach should be indistinguishable from good investment practice. However, it is helpful to treat an ESG approach as a separate strategy and function in the early stages of implementation. This is to give it initial impetus. It is perfectly legitimate for organisations to take a different approach and 'mainstream' from the beginning but that may initially make implementation more challenging.

There are a number of signals that indicate that an ESG approach is of central importance to an organisation.

Three of these signals are as follows:

» The ESG approach is championed from the top of the organisation with explicit commitment from the chief executive officer and the board. In addition, standard processes reflect the centrality of an ESG approach (for example, it is incorporated in strategic and business planning decisions) and implementation progress is scheduled for regular review at the most senior level of the organisation.

» The ESG approach is explicitly referred to in important documents that govern the investment process (for example, agreements such as investment management agreements and policies such as statements of investment philosophy). Further, the ESG approach should be listed as an agenda item in all relevant discussions (for example, in performance review meetings between asset owners and fund managers).

» Consideration has been given to an implementation budget, at least in the initial stages. In addition, allocation of resources to an ESG approach is important at the outset and is also a powerful indicator within and outside the organisation. There are many ways an ESG approach can be achieved, so different levels and types of funding will be required (for example, a specific professional appointed or training for the board (if applicable) and investment team as a whole).

STRATEGIC PLANNING

Once the threshold 'why' questions in relation to an ESG approach have been determined, a strategic planning document should be prepared. This need not be an elaborate document; however, it should address the following six core issues:

» key priorities (following the identification of what is important);

» targets (process/activity moving through to quantifiable outcomes);[3]

» timeframe (usually three years);

» application to different asset classes;

» communication to stakeholders and service providers; and

» accountabilities and reporting on progress.

1. For ease of reading, throughout this paper the term 'ESG approach' is used as a shorthand expression for the phrase 'implementing ESG principles in investment decisions'.
2. The UNPRI is set out in Appendix A of this paper.
3. Targets may include process or activity-based targets and it is likely these will dominate in the early stages. As experience grows, there will be more numeric targets, which might include ratings of investment managers and companies in relation to their ESG approach.

MEASUREMENT AND BENCHMARKING

The old adage applies, 'what gets measured gets managed'. The methodology used to measure an ESG approach should be relevant and practical to ensure it happens. At least two things should occur. First, a benchmark should be established to identify what is the starting point. This might consist of a survey of fund managers to establish a qualitative view of their capacity (low, medium or high). External rating tools are available but benchmarking can be done internally and the results may be used to start a dialogue with fund managers. Second, there needs to be a regular report (at least annually) to the board and/or senior management on how the organisation is tracking against its strategic plan. Again, especially at the beginning, metrics should be limited in number and simple in nature. These can evolve over time.

VIEW AN ESG APPROACH AS A COMPETITIVE ADVANTAGE

Organisations will view an ESG approach in different ways and should do so to ensure it is aligned to specific needs. Asset owners should be careful about prescriptive approaches. One way of looking at this, from an asset owner's point of view, is that fund managers should apply critical thinking and rigour to an ESG approach. It is up to the asset owners to assess whether that thinking, and the resulting investment methodologies and processes, are of value.

SOURCES OF ADVICE

There is a great deal of expertise available to assist organisations. One of the benefits within this sector is the willingness of individuals and organisations to share their thoughts and ideas.

This can happen in the following main ways:

- Obtain insights from people who provide services such as fund managers, specialist ESG consultants, research firms and asset consultants.
- Seek out like-minded people — there will be professionals in equivalent organisations who will be willing to share their experiences.
- Sign up to or join networks or organisations (for example, the Investor Group on Climate Change Australia/New Zealand (IGCC) or others that match your organisation's priorities or strategic intent). It is worth making strategic decisions about which networks or organisations to sign up to or join as involvement can be time-consuming and potentially distracting.
- Consider specialist ESG education offered by the Responsible Investment Academy.[4]

In addition, there are many valuable articles and a wealth of reference material available, including 46 research reports listed in the 2011 Benchmarking Report produced by the Responsible Investment Association Australasia.[5]

There is significant merit in including professional advisers such as specialist ESG consultants and asset consultants as an integral part of the process.

An asset owner should ask its asset consultant (assuming it has one) the following key questions:

- what specific, usable and value-adding information can the asset consultant contribute to its understanding and processes;
- how most effectively to assess the capacity of fund managers. This should relate to assessing fund manager capacity in relation to ESG issues and overall, and should make a material change over time to fund manager review and appointment processes; and
- how existing processes should be shaped to determine outcomes. For instance, how to define and reward success by fund managers, and the applicable timeframe.

IMPACT ON FUND MANAGER SELECTION

By explicitly incorporating the importance of ESG issues into the fund manager selection process, the value the asset owner places on it is powerfully and clearly signalled. Prospective fund managers are therefore aware it is in their best interests to demonstrate a clear and well-designed process relating to ESG issues.

PROGRESSIVE IMPLEMENTATION

It should be acknowledged that implementation is a huge task. There is a danger that in trying to do it all at once, nothing at all may happen. It should also be acknowledged that an ESG approach is challenging and an organisation will learn and change its views (and possibly its strategic plan) over time. While there needs to be an overall plan, it is probably best to limit 'deliverables' or specific outcomes to a few well-defined areas (for example, share voting is a tried and true way of 'picking the low-hanging fruit' and building confidence).

INTERNAL MANAGEMENT ISSUES

ESG policies and principles are unlikely to gain traction unless they are incorporated into the key performance indicators of senior executives within a superannuation fund. Some superannuation funds have approached this issue by appointing a person who specifically is responsible for ESG policies and principles. It is important this person, together with all senior staff, is aligned to the ESG performance indicators for their specific fund.

4. See www.responsibleinvestment.org/ri-academy.
5. See www.responsibleinvestment.org. The 46 research reports are incorporated into Appendix C of this paper.

PART II
Key issues to consider during implementation

This part of the paper outlines key issues to be considered during implementation.

REASONS FOR IMPLEMENTING ESG PRINCIPLES IN INVESTMENT DECISIONS

It is important to remain mindful of why your organisation values the implementation of ESG principles in investment decisions.

Most ESG experts draw a distinction between ethical/values-based investing principles and ESG investing principles per se. One is not necessarily better than the other and they are not necessarily opposed to each other. This paper is concerned with ESG investing principles and not ethical/values-based investing principles.

For the sake of clarity, ethical/values-based investing principles often seek to promote a social good or represent the views of a particular religious or social group. Many investment funds will seek to screen out companies their investors consider to be socially undesirable (for example, companies that promote gambling or sell alcohol or armaments).

What has come to be known as ESG investing principles is more recent in origin. These principles are associated with a number of initiatives, the most recognised of which is the UNPRI formulated in 2006. ESG investing principles are not inherently based on values or ethics. Rather, they seek to improve investment decision-making by considering a broader set of long-term, extra-financial factors. ESG investing principles are based around a broad understanding of risk and opportunity and will not exclude stocks except on investment terms. This approach is entirely consistent with the UNPRI.

CHARACTERISTICS OF ESG INVESTING PRINCIPLES

ESG investing principles are best described as fundamentals that have the potential to affect companies' financial performance in a material way, yet are generally not part of traditional financial analysis. Obviously they fall into the categories of 'environmental', 'social' or 'governance'. Further, these principles generally have the following characteristics:

- they tend to be qualitative[6] and not readily quantifiable in monetary terms (for example, corporate governance and workplace safety);
- they relate to externalities not well captured by current market mechanisms (for example, pollution);
- they relate to wider elements of the supply chain (for example, suppliers, products and services);
- they have a medium- to long-term horizon (for example, climate change, human capital/ demographics); and
- they are increasingly the subject of policy and debate by legislators and regulatory agencies.

KEY CONCEPTS

Arguably, there has been a change in how asset owners such as superannuation funds perceive their role, and this has greatly increased the importance of an ESG approach as a key consideration. Overall, asset owners are now more explicitly considering their role and responsibilities regarding the following:

- long-term investment — a commitment to an ESG approach by asset owners can influence long-term behaviour;
- universal ownership — large institutional investors are broadly diversified in global economic exposure. They are universal in the sense their investments are potentially influential to affect change and recognise both the positive and negative externalities of their investments. They thus contribute to the stability and success of the market. Universal owners focus their actions particularly on active ownership practices and active investment strategies that integrate ESG principles;[7] and
- active ownership — asset owners are now more likely to consider they have a role in share voting in equities, seeking a seat on boards where possible (for example, in private equity and infrastructure investments), and engaging with companies to protect their investments.

Beyond these immediate issues, there are other issues that also have profound implications. For example, what are the implications of being a long-term investor, concerning both manager selection and actual investments? Indeed, is the long-term simply the aggregation of short-term periods or is it something else? And what of ESG alpha and beta[8] — how should these be considered from a portfolio-wide perspective? It is important to note these fundamental issues are foundational to much of the material that follows.

6. Although this is changing and there is now clearly a much greater focus on (and capacity to) quantify these factors — see for example Mercer 2009, *Shedding light on responsible investment: Approaches, returns and impacts.*
7. For further information about how universal owners focus their actions on practices and strategies that integrate ESG principles, see Roger Unwin 2011, *Pension funds as universal owners: Opportunity beckons and leadership calls.*
8. ESG alpha are idiosyncratic impacts and ESG beta are systemic impacts.

HOW SUPERANNUATION FUNDS INCORPORATE AN ESG APPROACH

There are two main ways in which an ESG approach may be incorporated at the superannuation fund or investment option level.

First, the fund may offer to its members a specialist investment option in addition to its core fund. These specialist options can vary considerably, including screened ethical investment options and specialist ESG investment options. The latter are sometimes focused on environmental performance (an 'eco-enhanced' option), which may offer investments across a range of asset classes (for example, equities and property).

Historically, such investment options have often performed closely in line with mainstream investment options. Arguably, funds that offer such options ought to consider higher conviction strategies and communicate the expectation of performance differences compared to mainstream options. Having a standalone ESG investment option is an important strategy for superannuation funds where individual investors may seek a higher level of conviction.

Second, ESG principles can be embedded across all of a fund's investment options. This is increasingly the preferred way of incorporating ESG principles and is consistent with it being part of a standard investment practice. For example, many superannuation funds may be signatories to the UNPRI to set a framework for their approach.

Thematic products are being incorporated in both of these approaches — and climate change risks are a prominent consideration. Thus, investments may involve low carbon equity index funds, specialist clean technology funds or, more broadly, may include microfinance funds, water resource funds, or funds focused on good governance. Thematic investing may be used in specialist investment options, or may be used in core funds for diversification purposes or as a portfolio tilt.

The services of professional advisers (such as asset consultants) or the internal management team can be employed to rate fund managers on their capabilities to analyse better the potential value-add in the context of the approaches outlined above.

HOW FUND MANAGERS INTEGRATE ESG PRINCIPLES

There are numerous ways for fund managers to integrate ESG principles into investment methodologies ranging from bottom-up fundamental ESG stock research, to best-of-sector and top-down ESG-themed approaches.

For example, managers may use research that ranks companies according to ESG performance or potential, with various weights ascribed to 'environmental', 'social' and 'governance' issues, and various weights ascribed relative to traditional financial measures. This may be based on in-house research, or the services of a data provider may be used in order to rank companies on a variety of performance criteria. Often a best-of-sector approach is employed whereby sector weights are maintained but only companies that score well on their ESG performance are eligible for investment.

The ways of incorporating ESG principles into investment methodologies are too many to detail in this paper. However, there are two key points that should be kept in mind in any implementation plan.

First, diversity is appropriate. Diversity is a source of competitive advantage and differentiation. This poses a challenge for asset owners to select the right fund managers. Selecting the right fund manager requires some specialist knowledge, and the challenge of determining real fund manager capability remains.

Second, the nature of integration itself. Most asset owners will look for genuine integration, so that implementing ESG principles forms an integral and early part of the investment methodology. Thus, it is built into the process, which might be about stock selection or asset valuation. Superannuation funds should be cautious of subjective ESG overlays that fail to articulate the 'how' and 'why'.

ROLE OF THE PROFESSIONAL ADVISER

A straightforward consideration is whether a professional adviser (such as an asset consultant) is up to the task. The assistance of a professional adviser can be valuable in a number of ways, so it is worth evaluating the following:

» Does the professional adviser have the capacity to advise about ESG issues at the whole-of-fund level?

» Is there a capacity to assess and rate fund managers in relation to ESG issues?

» Is the professional adviser able to advise on how to monitor fund manager performance relating to ESG issues?

» Is the professional adviser a thought leader on key conceptual issues and able to translate this into practical investment recommendations?

» Does the professional adviser fully understand what integration of ESG principles means for the fund?

IMPACT OF CLIMATE CHANGE RISKS ON INVESTMENT DECISIONS

There is no doubting the impact of climate change risks on investment decisions. These risks have acted as a kind of litmus test to the implementation of ESG principles for asset owners interacting with fund managers.

Responses to climate change risks have generally been an accurate proxy to determine capacity and willingness to consider ESG principles.

Climate change risks are particularly interesting (and important) as an overarching theme that encompasses a wide range of ESG issues, crossing asset classes, sectors and regions. In relation to climate change risks, the approach is often to establish a benchmark, develop a strategy and a plan to improve performance, and then to take investment action against the strategy and finally to measure performance.

With climate change risks, you can begin by asking formal structured questions of fund managers such as: how do you price in carbon into corporate valuations; and how do you consider carbon at the portfolio level?

Systematisation offered by various tools[9] allows the carbon intensity of the assets managed by a particular fund manager or at the overall fund level to be established. This data enables questions to be asked that are more specific in nature (for example, questions about the portfolio's composition relative to a benchmark, or the holding of particular assets given their carbon emissions profile). Care needs to be taken to ensure that the cost involved in using these tools is justified to achieve practical outcomes. In other words, what does the fund actually do with that information, or what is it prepared to do with that information?

A more recently developed and comprehensive approach is to assess the implications of climate change risks on a 'whole of fund' or 'whole of portfolio basis' — particularly from an asset allocation perspective. Professional advisers are developing their views on how to assess climate risk in this regard. Some have focused on the inclusion of thematic investment strategies seeking to make the most of climate change opportunities.

Mercer was commissioned by a group of institutional investors to develop a comprehensive report on this issue. Mercer's *Climate change scenarios — Implications for strategic asset allocation* report[10] provides guidance on how to quantify the risk, at a whole of portfolio level, represented by the physical impacts of climate change, policy/regulatory change, and the rate of technological change in response to climate change. A key consideration is to develop a strategy to evolve the portfolio toward more climate-sensitive assets (including thematic investments such as clean technology and low carbon investments generally).

What this process yields is an 'investment ready' strategy for funds to deal with climate change risks specifically, optimal asset allocation relating to climate change risks (based on various scenarios), and a strategy to transition to climate-sensitive assets that will enable adaption to a low-carbon environment.

There are many sources of information on the financial implications of climate change. A useful place to start is with the IGCC.

LEGAL ISSUES AND FIDUCIARY DUTY

The relationship between an ESG approach and the fiduciary duty is worth considering. Trustees of superannuation funds are bound by the fiduciary duty of loyalty, by rules against self-interested profit-making and conflicted dealings, and by other general law and statutory duties.[11] Each trustee must consider all of these duties as part of its investment decision-making process.

Section 62 of the *Superannuation Industry (Supervision) Act 1993* (Cth) requires funds to be maintained solely for one or more 'core purposes' listed in the section, or for at least one core purpose and one or more prescribed or approved ancillary purpose.

It is now considered that an ESG approach, particularly a 'mainstream' ESG approach focused on improving risk-adjusted returns, is entirely consistent with the fiduciary duty — and there have been a number of studies conducted to support this view.[12] Some years ago, the concern was often expressed that there might be a potential conflict between an ESG approach and the fiduciary duty. Some funds do explicitly acknowledge the potential for conflict by making a statement, for example in publications and on websites. 'Our fiduciary duty to members is critical. Appropriate ESG investment activities will be explored, but will not be undertaken at the expense of its fiduciary duty. Usual investment criteria apply.'[13] Currently, accepted practice is to employ an approach genuinely focused on improving risk-adjusted returns which cannot, if sensibly applied, be construed to be in breach of fiduciary duties.

The current acceptance of an ESG approach being consistent with the fiduciary duty is expected to continue to be the accepted and general view.

9. For example, the tool provided by Trucost.
10. This report was released in February 2011, see www.mercer.com.
11. A note of caution is required here given the variation in legal structures for investment-related entities. Consequently, specific legal advice on fiduciary duties may need to be obtained.
12. See the report commissioned by the United Nations Environment Program Finance Initiative: UNEPFI 2005, *A legal framework for the integration of environmental, social and governance issues into institutional investment*. This report included an examination of the Australian legal framework in relation to ESG issues and fiduciary duty.
13. The statement used is that of AustralianSuper see www.australiansuper.com.

PART III
A step-by-step guide to implementation

This part of the paper includes a sequential outline of the steps to implementing ESG principles, followed by a statement of the key principles.

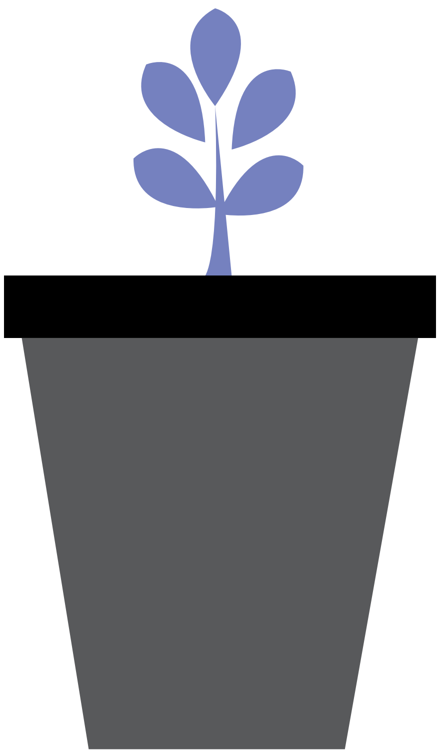
The acceptance of ESG principles by Australian superannuation funds is growing but most funds including UNPRI signatories are struggling with either developing policies or with policy implementation. In order to assist superannuation funds to develop clear and effective policies and to expedite implementation, Finsia developed these practical guidelines.

STEP 1

SETTING THE POLICY

Setting the policy is the most important part of the implementation process, as it shapes all of the steps and actions that follow. It consists of placing before the peak decision-making body in the organisation (the board of an investment entity or the trustees or board of a superannuation fund) the question of whether the organisation should adopt an ESG approach and if so, why.

It is usually the case that the board (and staff of the fund) will require some training in order to understand the concepts and principles involved. This will include training about the evolution of ESG principles (as distinct from ethical/values-based investing principles) as well as the central concepts of the universal investor, long-term investing, active ownership, and the evidentiary basis for an ESG approach.



It is important for the board to be clear on why it might adopt an ESG approach, specifically:

- Is the primary objective to improve long-term, risk-adjusted returns?
- Are there other objectives of equal importance and if so, what are these?
- Are there subsidiary objectives and if so, what are these?
- Is it clear how a conflict of objectives will be handled?
- How do the answers to these questions relate to the fiduciary duty?
- How is an ESG approach defined in the context of its own fund/investment/portfolio?

Generally there will be a board paper including:

- material about why an ESG approach should be adopted;
- an outline of the UNPRI and the pros and cons of becoming a signatory (including participation in the annual reporting and assessment tool);
- an overview of what is involved in an ESG approach (including information on policies and formal documentation and public disclosure);
- potential resourcing requirements;
- a proposed formal resolution concerning the ESG approach or an alternative approach; and
- a strategy for disclosure of the decision to stakeholders.

It is worth noting that some steps are relatively straightforward while others are more diffuse and more challenging (for example, in relation to active ownership, it is common practice to implement a share-voting policy as well as developing a company engagement program). In addition, the concept of being a long-term owner of assets has implications for performance measurement periods and structuring agreements with fund managers.

OUTCOMES TO BE ACHIEVED:

- a board resolution relating to the ESG approach; and
- the creation of a well-formulated policy to address the ESG approach. There might be a single policy (relating to say 'ESG' and 'responsible investment') or there might be a number of stand-alone policies.

STEP 2

CORE DOCUMENTS AND PROCESSES AND APPOINTMENT OF A PROFESSIONAL ADVISER

Once the board decision is made, it is necessary to begin embedding ESG principles into core documents and investment and organisational processes. These requirements will again most likely require board approval, and will flow from the policy positions noted in step 1 above.

It is also important at this point to establish the capacity of the professional adviser to assist in ESG implementation and ongoing processes, particularly the ability to assist in the evaluation of fund managers. It should be noted that this is a progressive process. It is most often a case of starting in a relatively small way and delving deeper once some experience has been gained. The inclusion of ESG principles into investment management agreements is a useful example (see Appendix B).

OUTCOMES TO BE ACHIEVED:

Incorporate ESG principles in core documents including:

» the statement of investment philosophy (or equivalent),

» investment management agreements, and

» requests for proposals documents; and

» establish capability of the professional adviser (including assessment of capability in relation to the issues outlined on page 8 under the 'Role of the professional adviser' heading).

STEP 3

STRATEGIC PLANNING AND ESTABLISHING A BENCHMARK

It is important to gain an understanding of what the fund's starting point is to establish a benchmark in relation to ESG issues. This can be achieved by an internal review of capacity, which will require some understanding, in the event of multi-asset classes, of the characteristics of different asset classes. Many superannuation funds will seek to establish a benchmark by surveying fund managers on key ESG issues (such as whether they have relevant policies, whether they train their staff about ESG issues, whether they do their own research or employ data providers, whether they include ESG principles in their portfolio construction and how they demonstrate thinking in relation to ESG principles in the stock selection process). Such a qualitative review has limitations; however, it does give some understanding of the starting point and current capacities relative to peers and good practice. The assistance of a professional adviser can be important in this process.

Linked with this (although this may follow some time later) is a strategic plan relating to ESG issues. Essentially, this is a statement of what the end objective is at a whole-of-fund level and what to do in what order; thus setting out a prioritisation according to the agreed objectives.

OUTCOMES TO BE ACHIEVED:

» establish benchmark of current capacities via internal review and/or survey of fund managers (assistance of a professional adviser may be valuable);

» create a strategic plan (or statement of priorities); and

» consider bodies/organisations/resources that might be of assistance in achieving the strategic plan (for example, the UNPRI and the IGCC. See Appendix C for additional information).

STEP 4

CORE PROCESSES AND FUND MANAGER EVALUATION

Following the board decision and the establishment of core documents, it will be necessary to establish the key practices and processes that give meaning to these documents.

One of the most vital of these considerations from a superannuation fund's point of view, is building ESG principles into the fund manager appointment, evaluation and review processes. Clearly, ESG principles will not be the only factor in fund manager appointments; however, it should be included in the mix. Some asset consultants provide ratings of fund manager capacities and these ratings can be used in the process. Other processes will depend upon how the fund prioritises its activities relating to ESG principles.

OUTCOMES TO BE ACHIEVED:

» explicitly build ESG principles into fund manager appointment and review processes;

» request the professional adviser address the issue for use in fund manager appointment processes and capacity assessment; and

» determine the order of other processes and activities according to resource constraints (for example, climate change and emissions intensity of assets, share voting and company engagement).

STEP 5

PORTFOLIO LEVEL AND ASSET CLASS PLANS

There is a need to consider an ESG approach in a holistic manner at the portfolio level as to some extent this will have been done with the strategic plan. There will be existing reviews and mechanisms that should also consider an ESG approach: for instance, climate change in the context of asset allocation reviews. It is obvious each asset class has its own characteristics and dynamics. It is desirable to develop plans relating to an ESG approach progressively for each asset class.

OUTCOMES TO BE ACHIEVED:

» progressively incorporate an ESG approach into existing portfolio-wide reviews including asset allocation reviews; and

» according to prioritisation, progressively determine plans for an ESG approach for each asset class.

STEP 6

REPORT AND REVIEW

The board or trustees should review on a regular basis its initial decision to implement ESG principles in investment decisions. It should also review on a regular basis the strategic plan, performance against this plan, and whether any amendments are required.

OUTCOMES TO BE ACHIEVED:

» the board or trustees should schedule an annual review of its ESG approach to incorporate implementation progress, key metrics, strategic issues, resourcing and recommendations for change.

STEP 7

DISCLOSURE

In the interests of transparency, the organisation should consider disclosing key ESG policies, statements and outcomes, including as an active owner and steward of assets on behalf of beneficiaries, and publishing share-voting information.

OUTCOMES TO BE ACHIEVED:

» consideration given to publication of key policies (for example, active ownership) on the website;

» consideration given to publication of share-voting outcomes; and

» consideration given to publication of a statement of the organisation's ESG approach or sustainability including data and/or activity statements.

APPENDIX A
United Nations Principles for Responsible Investment

BACKGROUND

The United Nations Principles for Responsible Investment (UNPRI) were devised by the investment community. They reflect the view that ESG issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfil their fiduciary (or equivalent) duty. The UNPRI provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large. As of October 2011, over 915 investment institutions have become signatories, with assets under management approximately US$30 trillion.

THE UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT PROVIDE AS FOLLOWS:

'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. **We will incorporate ESG issues into investment analysis and decision-making processes.**

   Possible actions:

   » Address ESG issues in investment policy statements

   » Support development of ESG-related tools, metrics, and analyses

   » Assess the capabilities of internal investment managers to incorporate ESG issues

   » Assess the capabilities of external investment managers to incorporate ESG issues

   » Ask investment service providers (such as financial analysts, consultants, brokers, research firms, or rating companies) to integrate ESG factors into evolving research and analysis

   » Encourage academic and other research on this theme

   » Advocate ESG training for investment professionals.

2. **We will be active owners and incorporate ESG issues into our ownership policies and practices.**

   Possible actions:

   » Develop and disclose an active ownership policy consistent with the Principles

   » Exercise voting rights or monitor compliance with voting policy (if outsourced)

   » Develop an engagement capability (either directly or through outsourcing)

   » Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights)

   » File shareholder resolutions consistent with long-term ESG considerations

   » Engage with companies on ESG issues

   » Participate in collaborative engagement initiatives

   » Ask investment managers to undertake and report on ESG-related engagement.

3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Possible actions:

- Ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative)
- Ask for ESG issues to be integrated within annual financial reports
- Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact)
- Support shareholder initiatives and resolutions promoting ESG disclosure.

4. We will promote acceptance and implementation of the Principles within the investment industry.

Possible actions:

- Include Principles-related requirements in requests for proposals (RFPs)
- Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate)
- Communicate ESG expectations to investment service providers
- Revisit relationships with service providers that fail to meet ESG expectations
- Support the development of tools for benchmarking ESG integration
- Support regulatory or policy developments that enable implementation of the Principles.

5. We will work together to enhance our effectiveness in implementing the Principles.

Possible actions:

- Support/participate in networks and information platforms to share tools, pool resources, and make use of investor reporting as a source of learning
- Collectively address relevant emerging issues
- Develop or support appropriate collaborative initiatives.

6. We will each report on our activities and progress towards implementing the Principles.

Possible actions:

- Disclose how ESG issues are integrated within investment practices
- Disclose active ownership activities (voting, engagement, and/or policy dialogue)
- Disclose what is required from service providers in relation to the Principles
- Communicate with beneficiaries about ESG issues and the Principles
- Report on progress and/or achievements relating to the Principles using a 'Comply or Explain'[1] approach
- Seek to determine the impact of the Principles
- Make use of reporting to raise awareness among a broader group of stakeholders.

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.' See www.unpri.org for further information.

1. The Comply or Explain approach requires signatories to report on how they implement the Principles, or provide an explanation where they do not comply with them.

APPENDIX B
Inclusion of ESG principles in investment management agreements

Below are some examples of wording that could be incorporated into investment management agreements (IMAs) in order specifically to address ESG integration. These samples were produced by Arnold & Porter and endorsed by Quayle Watchman Consulting.[14]

SAMPLE 1:

[Client's] investment objective is [investment objective], provided that in pursuing such investment objective, [Asset Manager] seeks to act in the best long-term interests of [Client's] investors by taking into consideration environmental, social and corporate governance ('ESG') issues, to the extent permitted by law. [Asset Manager] has signed the Principles for Responsible Investment ('PRI'). The PRI is an industry-focused initiative that promotes long-term responsible investment and share ownership, and the integration of material ESG issues into investment analysis. It is [Asset Manager's] intention to remain an active and engaged member of the PRI and meet any ongoing membership commitments (including the submission of an annual assessment questionnaire).

[Asset Manager] is willing to make available to [Client] on request a copy of each assessment questionnaire that it submits to the PRI, as well as the PRI's analysis of its relative performance. Copies of the voting and engagement work undertaken within the context of the PRI are also available, upon request.

SAMPLE 2:

[Client's] investment objective is [investment objective], provided that in pursuing such investment objective, [Asset Manager] seeks to act in the best long-term interests of [Client's] investors by taking into consideration environmental, social and corporate governance issues to the extent permitted by law.

SAMPLE 3:

Subject to compliance with applicable law, [Asset Manager] shall be authorised to, and shall, take into consideration environmental, social and corporate governance issues in making investment decisions on behalf of [Client] in furtherance of [Client's] investment objective. [Asset Manager], as a signatory to the Principles for Responsible Investment ('PRI'), shall manage the assets of [Client] in accordance therewith to the extent permitted by applicable law.

[Asset Manager] will promptly notify [Client] [Client's beneficial owners] in writing if its intention to remain engaged with PRI changes, for example, if the PRI materially changes in a way in which [Asset Manager] does not support, and will explain to [Client] [Client's beneficial owners] the rationale for withdrawing.

SAMPLE 4:

Subject to compliance with applicable law, [Asset Manager] shall be authorised to, and shall, take into consideration environmental, social and corporate governance issues in making investment decisions on behalf of [Client] in furtherance of [Client's] investment objective.

In addition to the above examples, set out below are statements given by the Environment Agency of England and Wales and VicSuper respectively on inclusion of ESG in their IMAs.

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1. Environmental Agency of England and Wales

'We will seek to engage managers using our own form of investment management agreement. This has been drafted to meet industry standards of best practice, and will ensure the use of consistent terms and conditions, fund valuation methods, manager fee calculation and payment mechanisms in respect of the various investment mandates. It will also include our corporate governance/environmental policies and disclosure and reporting requirements. External fund managers will have to agree to comply with such requirements as a condition of their appointment.'[15]

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2. VicSuper

'In appointing new fund managers or modifying existing relationships, VicSuper requests that the following clause be inserted into the legal documents that govern the investment activities: "the Manager must have regard to, and use its best endeavours to comply with, the United Nations Principles for Responsible Investment". In recognising the non-prescriptive nature of the [UNPRI] VicSuper supplemented this requirement with a brief set of sustainability covenants to guide investment behaviour in this context. In practice, the extent to which the manager implements this clause through the investment supply chain and into relevant investment decisions, legal documentation and investment analysis is still open to review. VicSuper is monitoring the investment activities of managers and engaging where appropriate.'[16]

14. UNEPFI Asset Management Working Group 2009, *Fiduciary Responsibility — Legal and practical aspects of integrating environmental, social and governance issues into institutional investment.*
15. Environment Agency Active Pension Fund 2006 — Annual report and financial statement — see www.environment-agency.gov.uk (contained in email).
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