$uper powers

How investment funds could be driving progress in an emerging 'sustainability' economy.

Overcoming market driven short-termism in our economic framework is one of the central challenges to achieving more progress toward sustainable development. With environmental, social and governance (ESG) aligned investments now defying sceptics and proving to be a rich vein of above-average returns, heavyweight funds are buying into the notion that their investment power can achieve good things, for all stakeholders.

A number of books and reports have argued that one of the biggest barriers to corporate social responsibility, and therefore sustainability, is short-term pressures from the market forever increasing quarterly profit results.

This phenomenon forms a major chapter of discussion in the Australian-led book *The Natural Advantage of Nations*[1], and the Business Council of Australia (BCA) published a major report on the subject in 2004, arguing that market driven short-termism was threatening the long-term competitiveness of Australian firms.[2]

The BCA outlined that increasing demand from shareholders for greater quarterly profits was preventing CEOs from making the investments companies needed to position themselves for higher profitability in the medium to longer term – a timescale also needed for commitment to corporate social responsibility and wider sustainability imperatives.

Similarly, whilst the value of investing in eco-efficiencies and eco-innovation to improve long-term competitive advantage is increasingly understood by CEOs, boards and managers, the return on investment can vary from six months to four years. However, these days, it seems, this is too long a period for returns being

1 Hargroves K and Smith M (2005) Chapter 9: Accelerating the sustainability revolution: overcoming business short termism. In *The Natural Advantage of Nations: Business Opportunities, Innovation and Governance in the 21st Century* (Earthscan, London).
2 The Business Council Sustainable Growth Task Force (2004) Beyond the Horizon: Short-Termism in Australia. www.bca.com.au/content.asp?newsID=96861

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demanded by the market that wants results every three months.

As the BCA report stated, 'Australian chief executives are forced to deliver strong corporate gains within ever-diminishing time frames or face the sack.' Another BCA report on CEO turnover said Australian CEOs had an average tenure of 4.4 years – less than half that of their foreign counterparts.[3]

Significantly, the Australian Shareholders Association (ASA) supported the concerns raised in the BCA's report on performance short-termism. ASA Chairman John Curry said, 'Fund managers competed against one another for rankings – based on share price performance, and in turn profits and outlook – even over a period like a month, which is a ludicrous situation. The pressure is there to get short-term results.'

Mr Curry said that 'convincing investors to take a long-term outlook was difficult because it was necessary to change the fundamental psyche that governed investment decisions'. He said, 'Immediate commercial imperatives were often contrary to creating an environment for sustained growth, and investors liked to see strong returns – quickly.'[4]

Not surprisingly then, research with 20 leading CEOs in Australia by Professor Dexter Dunphy, of the University of Technology Sydney, found that the biggest single reason they gave for lack of progress on implementing more sustainable development/corporate social responsibility practices is the significant short-term pressures placed on them by investment houses to deliver quarterly returns.

'One of the things that quite a number of them pointed to was the difficulty of actually running organisations which are sustainable in the longer term when, in fact, they've got the analyst breathing down their necks constantly asking for short-term returns … there's an inherent conflict between managing for the short term and managing for the long term,' Professor Dunphy said.

'This is one of the things all managers face, but the emphasis has been very strongly from economic rationalism to push for the short-term return and to see [the] organisation as [being] primarily there for their shareholders.

'I guess what I see emerging is a new view that says shareholders are only one of a variety of stakeholders, and that we can in fact destroy organisations, quite effective organisations, if we only manage for the short term.

'These senior executives were saying that, until the financial analysts, the investment funds and so on actually reward us for taking a longer term and a broader view of what our responsibilities are, whatever our personal views about this, it's very hard for us to achieve this. We're sort of running up a staircase that's moving down faster than we can run up it.[5]

Super pressures

The BCA paper also identified the rise of superannuation schemes as another factor in the increasing short-term pressures on CEOs and corporate boards. It points out that super funds now constitute a major new force driving short-termism in Australia and overseas. Very soon the amount of money invested as superannuation in Australia will top $1 trillion, and the figure is growing at the staggering rate of $60 billion per annum.[6]

While superannuation investment occurs for a long period of time, on average for 20 years, fund performance is rated by the markets every quarter. As Fiona Buffini wrote in the *Australian Financial Review* recently, 'Super funds … pay their money managers to beat the market over about three years, and their brokers value companies on what they will earn in the next 12 months.'[7] And in circumstances where fund performance is below average, quarterly performance can take on a heightened significance. Hence there has been a major lack of initiative to invest in companies undergoing longer-term strategies for competitiveness by institutional super fund investors.

This is reinforced by the fiduciary duty requirements of super fund managers and superannuation trustees. Fiduciary duty stipulates the responsibility of the pension fund trustees to take good care of the money that's entrusted to them and invest it so that at the end of the pension fund members' work life there will be money to pay a pension. The fiduciary duty requires the fund manager and superannuation trustee to maximise returns. This reflects the common law duty that trustees act in the best financial interests of beneficiaries of the trust.

Currently, most definitions of fiduciary duty for fund managers and superannuation trustees implicitly exclude making socially and environmentally orientated investments. The definition arose because of the belief that such investments were

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3 The Business Council Sustainable Growth Task Force (2003) CEO Turnover in 2002: Trends, Causes and Lessons Learned. www.bca.com.au/content.asp?newsID=92327
4 Quoted in Costa G (2004) Short term-ism damages Australia: BCA. *Sydney Morning Herald*, October 22. www.smh.com.au/articles/2004/10/21/1098316790416.html?from=storylhs
5 Dunphy D (2002) Interview with Peter Thompson (ABC). www.abc.net.au/rn/bigidea/stories/s519567.htm
6 Buffini F (2006) Taking responsibility for super decisions. *Australian Financial Review*, June 22.
7 Ibid.

financially less attractive. Without a screened investment methodology that can satisfy this trustee duty, superannuation trustees have been, understandably, hesitant in committing funds to unscreened investments. Hence the historical lack of initiative in this area by institutional super fund investors.

But the fact that companies that do pursue corporate social responsibility are experiencing as good or better profits, shown by studies such as those by Innovest[8], is allowing changes to these fiduciary duties of super funds and thus turning a current driver for unsustainability – super fund pressure for quarterly profit results – into a driver for sustainability.

This was the subject of Hunter Lovins and Walter Link's paper,[9] *Pension Funds: Key to Capitalizing Natural Capitalism*, and one of their contributions to the publication *The Natural Advantage of Nations* (Earthscan 2005). Lovins and Link argue that changes to fiduciary duty regulation in the US pertaining to super fund trustees has the potential to help significantly facilitate the next industry revolution towards sustainability.

In their piece in *The Natural Advantage of Nations*, Lovins and Link wrote about how now there is significant data showing that companies that invest in eco-efficiencies and eco-innovation are outperforming their competitors. They wrote about how this new data allowed Calvert Socially Responsible Investment Funds in the US to file suit against the definition of fiduciary responsibility for fund managers and superannuation trustees and win in court because it could demonstrate that there is no reason for pension funds not to invest in companies with a superior social and environmental performance.

In April 2003, after this court victory, the Global Academy's Natural Capitalism Group, led by Hunter Lovins, in partnership with Progressive Asset Management, organised a conference that brought together the trustees and managers of pension funds.[10] The goal was to raise awareness amongst super funds of the potential for them now to be able to screen and invest with a longer-term horizon. The message got through.

At the conference, Fred Buenrostro, Jr., CEO of the California Public Employees' Retirement System (CalPERS), the largest super fund in the US, stated that it really didn't matter that much to him whether he invested in a company that did really well in the next quarter as against another company. CalPERS is so big, with $160 billion in assets, that he's invested in essentially every major company in the US economy. What he cares about is whether the whole of the economy is represented, and is healthy, 20 and 50 years from now when the fund has to pay out the pensions.

Whilst pension and super funds are currently the biggest drivers for short-termism in business, in fact, as Buenrostro, Jr., said at the conference, 'Pension and superannuation funds may be the institution in society with the biggest vested interest in seeing that sustainable development is achieved'. CalPERS has committed significant funds to environmental technology companies and projects.

These efforts to address the fiduciary duty laws of super fund trustees in the US have been mirrored globally. The longstanding conventional wisdom that fiduciary duty precludes environmental, social or governance (ESG) considerations in institutional investment decisions was overturned by a report released at the United Nations Environment Programme Finance Initiative (UNEP FI) Global Roundtable in 2005[11].

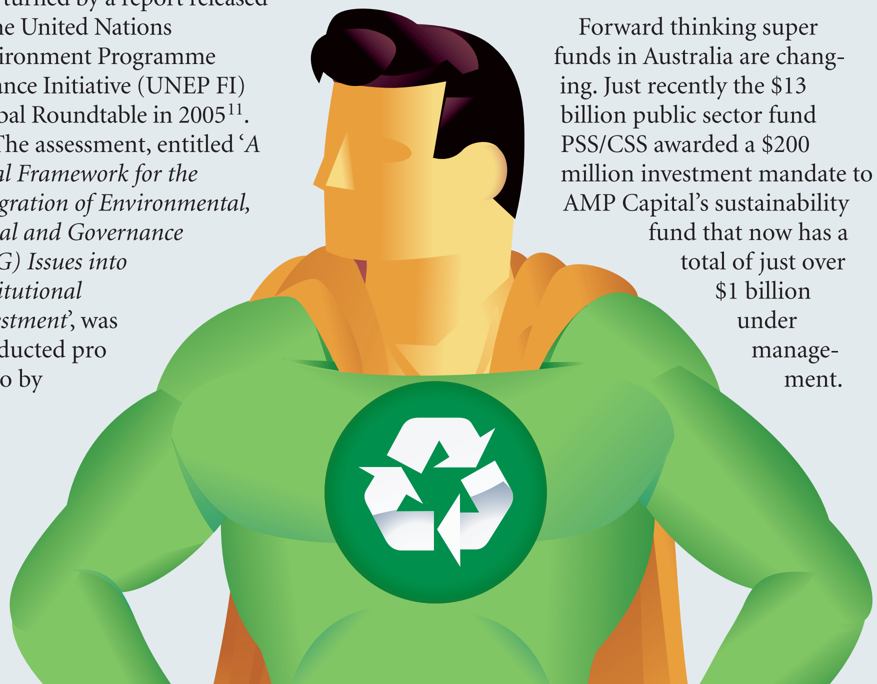
The assessment, entitled '*A Legal Framework for the Integration of Environmental, Social and Governance (ESG) Issues into Institutional Investment*', was conducted pro bono by Freshfields Bruckhaus Deringer, the third largest law firm in the world.

'A number of the perceived limitations on investment decision-making are illusory,' said Paul Watchman, a Freshfields partner and lead author of the report. 'Far from preventing the integration of ESG considerations, the law clearly permits and, in certain circumstances, requires that this be done.'

This trend is reflected in the recent findings of the Senate inquiry into corporate responsibility in Australia that super funds should be encouraged to include ESG considerations in their investments. To help this occur, the Senate inquiry report recommended that:[12]

- the Australian Prudential Regulation Authority issue detailed guidelines on the sole purpose test to clarify for superannuation trustees their position in relation to allocating investments to sustainable responsible investment fund managers;
- institutional investors in Australia seriously consider becoming signatories to the United Nations Principles for Responsible Investment; and
- the Future Fund should become a signatory to the United Nations Principles for Responsible Investment.

Forward thinking super funds in Australia are changing. Just recently the $13 billion public sector fund PSS/CSS awarded a $200 million investment mandate to AMP Capital's sustainability fund that now has a total of just over $1 billion under management.



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8 Innovest Strategic Value Advisors (2004) Corporate Environmental Governance: A Study into the Influence of Environmental Governance and Financial Performance, prepared November 2004, p. 10.
9 Lovins LH and Link W (2003) Pension Funds: Key to Capitalizing Natural Capitalism (Natural Capital Solutions and Global Academy, Colorado) www.natcapsolutions.org/publications_files/Pension_Funds.pdf
10 Ibid.
11 Freshfields Bruckhaus Deringer Law Firm (2006) *A Legal Framework for the Integration of Environmental, Social and Governance (ESG) Issues into Institutional Investment*. United Nations Environment Programme Finance Initiative (UNEP FI)
12 Parliamentary Joint Committee on Corporations and Financial Services (2006) Corporate Responsibility: Managing Risk and Creating Value. http://wopared.parl.net/senate/committee/corporations_ctte/corporate_responsibility/report/report.pdf

Similarly, VicSuper in Victoria now 'invests 10 per cent of the listed equity portfolio of VicSuper Fund's investment options in large Australian and international companies rated as having the best sustainability business strategies in their industry sector'. VicSuper also offers its members the option of investing 100 per cent of their superannuation in projects that meet set sustainability criteria.

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Generation Investment Management, headed by Al Gore, and dedicated to long-term investing around sustainability, as of July will manage $75 million of the $4.2 billion from VicSuper.

VicSuper's Chief Executive Bob Welsh has stated, 'We think over the long term this should become mainstream and the concept of having a separate option for sustainability will disappear because everyone will be managing their money this way. Super funds tend to talk long and act short but when they start to act long they will pick this up.'[13]

'We do need a cultural change,' Mr Welsh told *Ecos*, 'but what will trigger it? We need leadership from industry, but also the right legislation. We should be asked to report ten-year rather than just five-year returns, and fee disclosure should be required, in dollar amounts, to reduce competitive conditions. At present, fund performance is all that matters to everyone.

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Further considering what would generate conditions conducive to prioritising sustainability investment criteria, Mr Welsh said, 'I'd also like to see super funds report under the Global Reporting Initiative (international corporate social responsibility reporting guidelines) the extent to which they have contributed to sustainability investing. That would be a start.'

Reinforcing the power super funds have to induce change, he said, 'There has been some encouraging recent movement on climate change related investment exposure. As significant "trustee" investors in organisations, we (super funds) now want to see the extent to which you take into account carbon impacts. But there's a long way to go before supply chain management, broader waste management and other deeper sustainability factors are generally considered, although human capital development is crucial.'

Mr Welsh pointed to the growing success of the UK-based Carbon Disclosure Project, an institutional investors' survey of 100 FT500 Global Index companies regarding risks and opportunities presented by climate change, and predicted an increased extension of that assessment to Australia.

Mechanisms and inducements

Fund managers are now grappling with how to become better long-term investors. In the UK a group of pension funds that manages $1.36 trillion now directs five per cent of commissions to brokers who best analyse extra financial factors such as corporate governance and social and environmental issues. It has contributed to a 500 per cent increase in research, and has initiated the formation of ESG teams at Goldman Sachs, Citigroup, URS and the Deutsche Bank.

To help super funds invest for the long term, better information is needed on ESG performance of companies. The Senate inquiry on 'Corporate Responsibility: Managing Risk and Creating Value' has recommended that:

- the Australian Stock Exchange Corporate Governance Council (ASX Council) provide further guidance to Principle 7 of the ASX Council's Principles of Good Corporate Governance and Best Practice Recommendations, to the effect that companies should inform investors of the material non-financial aspects of a company's risk profile by disclosing their top five sustainability risks and providing information on the strategies to manage such risks;
- the ASX Council undertake industry consultation to determine whether there are areas where companies, investors and other stakeholders believe further guidance is necessary in relation to the non-financial disclosure requirements under the ASX Council's Principles of Good Corporate Governance and Best Practice Recommendations; and
- the Australian Securities and Investments Commission revise the Section 1013DA disclosure guidelines to be relevant to mainstream fund managers rather than simply to the more limited pool of ethical investment funds.

Whilst this is commendable, it falls well short of reform efforts internationally. As reported in *The Natural Advantage of Nations*, 'the past decade has seen a marked increase in new sustainability reporting requirements around the world, with comprehensive disclosure laws or rules being enacted in France, Denmark, the Netherlands, Norway, South Africa and Sweden, among others.

'France, for example, requires detailed disclosure of water, energy and other resource consumption, greenhouse and other emissions, waste management, impacts on biodiversity, management policies and procedures, and compliance issues.

'Even more notably, the European Commission has issued a recommendation that all member states ensure environmental performance reporting in company annual reports, specifically mentioning quantitative disclosure of emissions and consumption of energy, water and materials.'[14]

The Senate inquiry missed a significant opportunity by deciding against making ESG reporting mandatory for companies above a certain size. As Charles Berger from the Australian Conservation

13 Buffini F (2006) Taking responsibility for super decisions. *Australian Financial Review*, June 22.

14 Hargroves K and Smith M (2005) Chapter 9: Accelerating the sustainability revolution: overcoming business short termism, p. 139. In *The Natural Advantage of Nations: Business Opportunities, Innovation and Governance in the 21st Century* (Earthscan, London).

Focus

A comparison of corporate environmental disclosure requirements and practice

	Australia	France	Germany	Japan	Netherlands	Norway	South Africa	UK	USA
Compliance with Environmental Laws	Corp. Law 299(1)(f) (but widespread marginal compliance)	Damages paid for non-compliance; remediation efforts	No specific requirement	No specific requirement	Disclosure of incidents, complaints and their resolution	Major compliance orders, but only at listing of new securities	Required by JRE Listing Rules, by reference to GRI	No specific requirement; legislative proposals pending	Disclosure if liability incurred material or greater than $100K
Environmental Risks	No specific requirement	No specific requirement	No specific requirement	No specific requirement	No specific requirement	Disclosure of risk of accidents and expected 'limitations'	No specific requirement	No specific requirement; legislative proposals pending	Material environmental risks (but widespread non-compliance)
Greenhouse gas emissions	No requirement	Required by Article 148-3 of Decree 2002-221	EPER Register (EU requirement) for certain large industrial sites	No requirement	Required by Environmental Reporting Decree	Required by Law of Accounts	Required by JSE Listing Rules, by reference to Global Reporting Initiative	Pollution Inventory (EU requirement) for certain large industrial sites	No general requirement, but some states require limited disclosure
Other pollutant emissions	National Pollutant Inventory			PRTR Law					Toxic Release Inventory
Waste generation and management	No requirement		No requirement	No requirement				No requirement	No requirement
Energy Use	No requirement		No requirement	No requirement				No requirement	No requirement
Water Use	No requirement		No requirement	No requirement				No requirement	No requirement
Other Resource Use	No requirement		No requirement	No requirement	No requirement			No requirement	Some states require disclosure of raw material inputs
Product life cycle data	No requirement	No requirement	No requirement	No requirement	No requirement			No requirement	No requirement
Environmental management policies and practices	No requirement		No requirement	No requirement				No requirement	No requirement
Environmental initiatives and targets	No requirement		No requirement	No requirement				No requirement	No requirement
Applicability of specific requirements to international operations	No requirement	Decree 2002-221 may apply, but legislation lacks clarity on scope	No requirement	No requirement	Implied by Environmental Reporting Decree	Implied by Law of Accounts		No requirement	No requirement
Environmental considerations in investment product disclosures	Required for most investment products	Required for Pension Reserve Fund	Required for pension funds	No requirement	No requirement	No requirement	Fund managers must disclose their voting of equity securities	Required for pension funds	No requirement
% of top 100 companies preparing annual sustainability report (2002)	14	21	32	72	35	29	1 (2003: 20)	49	36
GRI reporting organisations (#; # per million inhabitants)	22 1.16	23 .39	19 .23	78 .61	15 .94	2 .44	19 .48	51 .86	46 .17

Source: Australian Conservation Foundation (2004) *Submission to Treasury on CLERP (Audit Reform and Corporate Disclosure) Bill 2003*

Notes:
The table compares reporting requirements for publicity listed companies. In some countries, certain requirements apply more broadly. For the Netherlands statutory reporting requirements apply to approximately 300 companies with serious impacts on the environment.

Under "Compliance with Environmental Laws" and "Environmental Risks", the table addresses the existence of specific environmental requirements in these categories; it does not reflect (1) general securities law requirements to disclose material risks and/or liabilities, or (2) accounting rules that may result in the disclosure of contingent or incurred environmental liabilities in financial statements.

Quality of regulation / practice: Good | Mediocre | Poor

Foundation outlined in ACF's submission to a separate Treasury Department inquiry, making such reporting mandatory for companies above a certain size would have achieved the following:

- It would provide more objective information. A standard reporting framework would increase the objectivity and quality of investor and community information sources, such as ratings of corporate responsibility and recommendations by ethical investment advisers.
- It would streamline analyst and community information requests. There is currently a good deal of frustration in the corporate sector regarding multiple, duplicative and sometimes voluminous requests for information. Standardised, universal reporting would lessen the number of these requests considerably.
- It could lead to better business performance. There is a growing body of evidence that public reporting improves financial performance by creating organisational structures to monitor and improve resource efficiency and waste minimisation, as well as by suggesting strategic business opportunities and raising environmental awareness overall[15].

As the table above shows, ESG reporting requirements are growing around the world. Major companies wanting to ensure ongoing super fund investment will increasingly see it as essential business practice to annually report on ESG criteria. Significant investment houses now recognise sustainability as a 'useful indicator of corporate performance and as being an important indicator of corporate risk'.

Shaun Mays, who founded the WestPac EcoFund in Australia, the first environmentally ethical mainstream banking fund, has published a major report in Australia of the business case for investment houses embracing sustainable development. [16]

One of the responses he received sums up the rationale for this shift well: 'When asked why they were willing to invest time and effort in the pursuit of greater understanding of corporate sustainability, their response was, "because the more I look at these issues, the more I get to see the operation of the company and its management in a way I would not traditionally enjoy. The deeper my knowledge of the company, the better will be my investment decisions".

In the end that is what matters.

Karlson 'Charlie' Hargroves and **Michael H. Smith,** The Natural Edge Project**.**

More information:
Hargroves K and Smith M (2005) Chapter 9: Accelerating the sustainability revolution: overcoming business short termism.
In *The Natural Advantage of Nations: Business Opportunities, Innovation and Governance in the 21st Century* (Earthscan, London)
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15 Berger C (2004) Submission to Treasury on CLERP (Audit Reform and Corporate Disclosure) Bill 2003, prepared for Emtairah T (2002) *Corporate Environmental Reporting: Review of Policy Action in Europe* (International Institute for Industrial Environmental Economics, ACF).
16 Mays S (2003) '*Corporate Sustainability: An Investor Perspective: The Mays Report*', prepared with BT Financial Group for the Department of Environment and Heritage, Australian Government.