Perpetual Investments

THE CASE FOR RESPONSIBLE INVESTING

Strong investor interest is driving growth in responsible investment strategies. Following the increasing number of environmental, social and governance ('ESG') related scandals hitting share prices and company reputations, investors are increasingly seeking to invest their savings in companies with a demonstrated commitment to corporate responsibility. The question for advisers and their clients is: When it comes to investing in responsible investment strategies, must financial returns be sacrificed for that 'feel-good' factor?

WHAT IS RESPONSIBLE INVESTMENT?

The United Nations supported Principles for Responsible Investment define responsible investment as an approach to investment that aims to incorporate environmental, social and governance factors into investment decisions, to better manage risk and generate sustainable, long-term returns. While this definition is open to individual interpretation, in general responsible investment strategies incorporate a mix of ESG and ethical factor analysis.

OUTCOMES OF RESPONSIBLE INVESTMENT:

- Increased transparency
- Better alignment of management and shareholders
- Improved trust in the market
- Increased market efficiency
- Ultimately a more cohesive and fairer society

DEMYSTIFYING RETURNS

Despite rising popularity, responsible investments are still characterised as a niche market. Impeding growth in the industry is the long-held belief that strong financial returns are sacrificed for returns to society; that the two are mutually exclusive. Put simply, this is incorrect and this paper seeks to illustrate this misconception.

MISCONCEPTION 1:

Screening for ESG factors reduces the investable universe and eliminates highly profitable companies, leading to sub-optimal portfolios and returns.

An implicit cost to responsible investment strategies is the potential returns forgone from excluding non-complying companies or issuers from the investable universe. Investors tend to focus on this point and overlook the fact that exposure to the risks inherent in these investments is also removed.

There are a number of ESG risks that can threaten the long-term profits of a company; these risks are detailed in **Table 1**, overleaf.

Investing in companies or issuers with little exposure to these risk factors can reduce the overall risk of your portfolio, providing for higher returns over the long term. To prudent investors, responsible investment strategies provide another lever to manage and mitigate portfolio risk.

MISCONCEPTION 2:

The costs to screen, analyse and monitor company-related ESG issues can be a drag on performance.

The cost of implementing an ESG strategy can affect short-term performance. However, the monetary and non-monetary value that can be created by socially responsible investments should, over the long term, compensate for these costs.

In the Australian market there are a number of fund managers that offer responsible investment products, in both the active and passive space, with competitive fees.

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THE BOTTOM LINE

A company or issuer engaged in responsible business practices that places the welfare of its shareholders and society at the core of its business should deliver stronger returns than its peers. This is an intuitive argument supported by an ever-growing body of evidence. Of note is a Harvard Business School study that showed that high sustainability firms significantly outperformed low sustainability firms in terms of both stock market and accounting measures over the long term.[1]

> **'[Companies] continue to view value creation narrowly, optimising short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success.'[2]**

Historical fund returns support this argument, as the Responsible Investment Association Australasia reported in their 2020 Benchmarking Report[3]:

- Core responsible investment **Australian share funds** outperformed the average large cap Australian share funds over 1, 3, 5 and 10 year time horizons.
- Core responsible investment **international share funds** outperformed large cap international share funds over 3, 5 and 10 year time horizons.
- Core responsible investment **multi-sector growth funds** (balanced funds) outperformed their equivalent mainstream multi-sector growth funds over 1, 3, 5 and 10 year time horizons.

TABLE 1: ESG RISKS AND OPPORTUNITIES

RISK	DESCRIPTION	EXAMPLES
ENVIRONMENTAL	The impact of a company's operations, products, services or other activities on the physical environment (air, water, etc.) creates environmental externalities (costs) for which the company is ultimately held to account.	• Climate change – companies contributing to global warming (for example fossil fuel companies) face increasing regulation, higher costs and other hurdles that will curtail growth. • Pollution – companies responsible for toxic air or water releases are subject to legal action, financial penalties or other negative consequences.
SOCIAL	The company's actions negatively impact on its 'stakeholders' – in particular its employees, customers, suppliers, government and the community at large – harming a company's reputation (or 'social license to operate'), leading to negative financial impact.	• Human capital – the human rights of people working directly for the company or in the company's supply chain are violated. For example, child labour can result in consumer boycotts. • Indigenous or local communities – company operations (e.g. mining) that ignore concerns of these groups can prove unsustainable and lead to negative financial impact.
GOVERNANCE	Weaknesses in how the company is controlled and operated can lead to poor culture and conduct and decision-making and a lack of accountability, to the detriment of shareholders.	• Board of Directors – a conflicted, inexpert or otherwise ineffective Board can mean company management are badly appointed, inappropriately remunerated and/or poorly supervised, leading to poor shareholder outcomes. • Conduct – poor culture and/or a lack of conduct policy and controls can allow bribery, corruption or other unethical behaviour to arise.

INTEGRATING ESG INTO INVESTMENTS

One of the primary goals of ESG integration is to aid long-term investment performance. It does this in a number of ways, including by:

- Acting as a proxy or indicator of sound management or the quality of a business
- Helping to identify and assess the financial and non-financial impacts of a range of ESG risks and opportunities, and
- Understanding more nuanced and less transparent drivers of investment performance like employee engagement, resource efficiency, and maintaining a social licence to operate.

CURBING 'SHORT-TERMISM'

Companies or issuers often engage in activities that maximise short-term profitability at the expense of long-term wealth creation. As the United Nations reports, short-term pressures from investors lead to companies underinvesting in sustainability related research and development, failing to develop sustainable products which could open new markets, failing to develop their human capital and not effectively managing the social and environmental risks to their businesses.

When allocating capital to companies with socially responsible practices, it is important that investment time horizons be lengthened. A company with a stable, long-term shareholder base empowers managers to invest and engage in activities that will deliver long-term returns to shareholders and society – potentially at the expense of short-term profitability.

Motivating and incentivising business managers to allocate capital to investments and projects that maximise the welfare of society is a key step towards a more sustainable form of investing, where companies do not prosper at the expense of society.

CONCLUSION

Some long-held misbeliefs prevalent in the industry could help to explain why responsible investments are still considered a niche market despite widespread interest. Overcoming these preconceptions could be the key to future growth.

In the Australian market, responsible investment strategies have delivered strong returns to both investors and society, challenging the stigma that strong financial and social returns are mutually exclusive.

For advisers, investing in funds that take a more holistic view of a company when making investment decisions can mitigate portfolio risk and boost returns. This being said, simply incorporating ESG factors into the investment process will not ensure strong returns. As with any investment, returns will be dependent on manager skill, investment style and time period.

PERPETUAL'S FRAMEWORK FOR RESPONSIBLE INVESTMENT

Perpetual Investments has a long-standing commitment to responsible investment, and in 2009 became a signatory to the United Nations supported Principles for Responsible Investment (PRI). Perpetual's Responsible Investments Team designs, implements and maintains a responsible investment framework that embeds our approach and philosophy to responsible investment within our existing investment practices, as well as working more effectively with other investors and reporting on our progress.

'RESPONSIBLE INVESTMENT IS A MORE SUSTAINABLE FORM OF INVESTING, WHERE COMPANIES DO NOT PROSPER AT THE EXPENSE OF SOCIETY.'

1 The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance – by Robert G. Eccles, Professor of Management Practice at Harvard Business School; Ioannis Ioannou, Assistant Professor of Strategic and International Management at London Business School; and George Serafeim, Assistant Professor of Business Administration at Harvard Business School.

2 Porter, Michael & Kramer, Mark. (2011). The Big Idea: Creating Shared Value. How to Reinvent Capitalism—and Unleash a Wave of Innovation and Growth. Harvard Business Review. 89. 62-77.

3 Boele, N & Bayes, S, 2020, Responsible Investment Benchmark Report 2020 Australia, Responsible Investment Association Australasia, Sydney.

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