INVESTING FOR GOOD

Consideration of a company's environmental, social and governance (ESG) practices is a fast-growing trend in financial markets, being powered by the collective assertion of control by individual investors through the retirement savings industry.

By Max Cappetta

The introduction of the Superannuation Guarantee Charge (SGC) in Australia in 1991 has inextricably linked those saving for retirement with their eventual investment outcome. This is replacing taxpayer-funded pensions and corporate-defined benefit schemes, which had previously ensured that individuals were provided with fixed retirement benefits regardless of investment outcomes. Today's defined contribution world is based on individual investment choice and full ownership of the resultant specific investment outcome.

This is naturally leading to a greater focus on how investment returns are derived. Many would question the merits of earning profits from companies that knowingly pollute the environment or profit from modern slavery or other unethical activities. Such actions result in broader costs being levied across the rest of the population. Principle-based investing is supported by economic theory that points to better-managed firms being better investments in the long term.

Australia can play an important role in this phenomenon. According to the latest OECD estimates, the SGC has positioned Australia to have one of the largest retirement savings markets in the world. This positions us to drive change within investment portfolios and through to corporate behaviour. It is critical we ensure that a vision to "invest for good" also delivers strong financial outcomes.

From "agent" to "stakeholder" theories of the firm

In academia, the evolution of sustainability parallels the evolution of "theories of the firm". Historically, the "agency theory of the firm" was dominant in economics. Managers were considered agents of the shareholders, hired to manage the firm. To maximise firm value, managers focused on minimising management (or agency) costs. From this perspective, many practices aimed at improving corporate sustainability were viewed as non-essential costs that reduced shareholder value. Such thinking naturally flowed into management of pension assets, as higher investment returns meant smaller employer contributions were required to provide pension benefits to staff in retirement.

Over the last 20 years, the dominance of the "agency theory of the firm" has declined . An extensive literature now documents the importance of good corporate governance practices to maximise firm value. This literature also documents a growing list of "best practices" central to maximising profitability and firm value. This evidence has led to the emergence of a new paradigm referred to as the "stakeholder theory of the firm".

This new paradigm asserts that firm value is maximised by effectively managing the interests, concerns and incentives of all individuals who are stakeholders in a firm's success – shareholders, management, labour, the environment and society at large. Shareholder wealth is maximised by motivating all stakeholders to seek the best possible outcome. Frequently cited examples include:

- effective management of environmental impacts to mitigate costly regulatory shocks;
- safe working conditions and fair wages to improve labour productivity;
- building customer loyalty and brand value via community-wide service and engagement; and
- having effective governance structures to aid decision making and overall firm management.

From this perspective, sustainability metrics capture the degree to which a firm addresses stakeholder interests. The stakeholder view posits that good practices are ultimately reflected in superior financial performance.

The rise of member-directed superannuation funds in Australia is now converging with an appreciation of a new economic theory of the firm. There is hardly a more important engagement to be had than to ensure that individuals are aware of how their retirement incomes are being derived.

This investment thematic will become entrenched in the mainstream during the coming decade, with many implications for the professional services industries, from advice to investment management. Focusing on ESG as a stock-selection rule-of-thumb is appealing. However, experience tells us that the investment challenge is never that simple.

Incorporating sustainability within an investment approach

Many approaches to incorporating sustainability in equity portfolios are based on a process of exclusion. This stems from a principled position of not wanting to support companies involved in "unacceptable" practices or products.

When considering exclusions based on sustainability grounds, investors should be aware of the risk that such exclusions introduce to their portfolio relative to standard benchmark portfolios. In some instances, the risk may be irrelevant and, based on principle, investors should simply reset their "benchmark" to include only those companies that pass their sustainability tests. Alternatively, investors may consider a more activist approach. This could entail holding a below- benchmark position in poorer-rated companies and then using this shareholding to lobby management to change its practices.

Redpoint believes that economic, environmental, social and governance (EESG) practices of companies can provide valuable investment insight. This view is founded on our investment thesis that EESG, a measure of "sustainability," offers a new perspective on the quality of company management. Sustainability refers to "good corporate practices" regarding companies' interactions with the broader economy, the environment and society, and their approach to governance.

Whether investors exclude or downweigh, there remains ample scope for active management to be overlaid to build new investment strategies. Successfully meeting multiple investment objectives is not easy but certainly possible. Investors should clearly understand the interactions between:

- their own principled position with respect to sustainability
- their investment thesis of the return opportunity of focusing on sustainability, and
- other investment characteristics investors are seeking.

Sustainable investing towards 2030

The 2020s will usher in a massive wealth rollover from superannuation to retirement. This is a natural point for individuals to consider many aspects of their life, including legacy. It is easy to foresee that there will be a convergence across equity strategies. Socially responsible investment options remain somewhat niche at present but are likely to become mainstream as the decade unfolds. All parties need to appreciate that investing solely on the basis of sustainability criteria is insufficient. Sustainability is a necessary criteria for the long term, but it should be combined with a range of other stock-selection disciplines to deliver cost-effective and risk-efficient outcomes for investors.

The size of the Australian savings market through the next decade will provide an unprecedented opportunity for Australian investors to drive sustainability issues across the globe. Investing over $2 trillion naturally leads to having exposure to a wide range of assets in all jurisdictions. We should grasp this opportunity and strive for greater sustainability and social responsibility. This is how we can have a positive impact on our future and that of generations to come.

Max Cappetta is the CEO of Redpoint Investment Management. Prior to Redpoint, Max was a co-founding shareholder of Continuum Capital Management from 2007, and a partner, executive director and head of Australian Equities at GMO Australia Limited.