

Q&A

ESG integration and active stewardship: why it matters



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Stewart Brentnall, Chief Investment Officer and Alexis Cheang, Head of Investment Stewardship discuss why it is vital for all participants in the investment ecosystem to integrate a broad range of ESG factors into the decision-making process.

What has been the investment stewardship journey for TCorp?

Stewart: In 2016, during the formative stages of creating TCorp’s risk-based investment model, also known as the Total Portfolio Approach, the concept of stewarding our clients’ capital with the utmost care was already seen as a key enabler of delivering the best possible investment portfolios for our clients.

TCorp’s management and Board worked together to create 6 foundational investment beliefs, covering a broad scope of investment process and governance matters. The sixth of these states that “consideration and management of ESG factors will create more sustainable portfolio outcomes”.

What is ESG and why is it important in an investment context?

Alexis: ESG stands for environmental, social and governance. We integrate ESG factors like climate change, diversity and inclusion, and the strength of institutions into our investment model and portfolios, as they can have significant impacts on our investment returns.

At TCorp, we think deeply about climate change and what impact it will have not only on our investment risk and returns, but also the people of NSW – the recent flooding across the state is a clear example of the very real and immediate effects. Climate change presents both investment risk and opportunity as the global economy and energy system transition from fossil fuels to clean energy and a low carbon future.

In recent years, the relationship between business and the community has shifted away from the more traditional focus purely on profits to shareholders, to one that features stronger attention on broader stakeholder capital. Today, both investors and business see their role as generating genuine social value and are asking how they can create lasting value for customers, employees, the environment and communities as well as achieve profits.

Ultimately, our focus is on delivering long-term risk-adjusted returns for our clients.

What is TCorp’s approach to ESG?

Alexis: We consider ourselves stewards of the assets entrusted to us by the NSW Government and this frames our ESG thinking. The money we invest is not ours; it has been entrusted to us to invest wisely and prudently in the expectation that it will generate a given return to meet the needs of the people of NSW.

TCorp believes understanding and managing ESG issues is critical to achieving sustainable investment outcomes, and we operate under a 5 pillar Stewardship Framework as detailed in Chart 1.

Chart 1: Stewardship framework

Step 1

Integrate ESG into our investment decision-making

- Identify the ESG factors likely to have the greatest impacts on our portfolios
- Consider these factors throughout the investment decision-making process

Steps 2 & 3

Active ownership

- Encourage companies and businesses we invest in to operate responsibly and sustainably through proxy management and engagement
- Help them think ahead on how significant sustainability trends are likely to impact their businesses

Step 4

Collaboration

- Partner with our clients, investment managers, advisors, government colleagues and peers
- Seek to strengthen the whole financial and economic system by embedding good governance and sustainability

Step 5

Disclosure and transparency

- Effectively communicate the positive impact of our stewardship activities to our clients and their members or stakeholders
- Present at industry forums, roundtables and client Board/Investment Committee meetings

What are the challenges facing ESG investing?

Alexis: The biggest challenge is a lack of data to generate analysis and drive decisions and, where it does exist, incomparable data. When you manage portfolios as diversified as ours, there is a real asymmetry of ESG data available.

The International Sustainability Standards Board has recently published some draft guidelines that would set de facto global standards for ESG disclosure. These will go some way to solving the challenge, but not completely as it wouldn't apply to governments or certain other assets we might invest in.

Understanding the impact of ESG integration and getting more confidence that the way we're evaluating sustainable investment opportunities is creating financial, environmental and social value is another challenge. It is however also an opportunity for investors to look beyond the investment returns and ask, "what other positive sustainability impacts are we generating from these investments?"

How has TCorp responded to the situation in the Ukraine?

Alexis: In late March, the NSW Treasurer issued TCorp with a direction to develop a strategy to divest all holdings in Russian assets. We divested all possible directly held assets (given market constraints) and wrote down the remainder to zero.

Like most major institutional investors, TCorp held a small percentage of Russian stocks and bonds as part of its emerging markets strategy. When the Ukraine invasion began and sanctions and capital controls were introduced, those assets couldn't be sold, nor the proceeds repatriated from Russia. This led us to question where else this could happen and what more we can do to protect our clients' investments from geopolitical and stranded asset risks.

In response, TCorp has started to develop a country ESG risk framework. This will allow us to assign a country ESG risk score to every nation where we might invest and then to set some minimum standards. We can then take a well-informed decision that a certain level of risk, in a given jurisdiction, would be beyond our tolerance levels and we wouldn't invest.

The country ESG risk framework will not only allow us to identify where we have exposure to the highest risk countries but monitor changes in this risk on a regular basis that will inform whether we might decrease or increase that investment or exit the country altogether. This work will position us to minimise future risk.

Where are the opportunities in ESG?

Alexis: All kinds of new business and investment models are emerging to solve some of the world's most intractable sustainability challenges. There are opportunities now and into the future for business and investment communities to become important players in a range of areas. These include vaccine development, sustainable infrastructure and property, and water management. And, as the world transitions to a low carbon future, this includes transport such as electric vehicles.

There is the potential to turn risk into opportunity. For example, one of the most quickly emerging risks is around biodiversity loss and natural capital (natural resources) – this is closely linked to climate change. Our economy requires natural capital to exist and to provide the goods and services that all Australians rely on, but if we don't protect biodiversity, we won't have that natural capital to deliver our basic needs. Building on the learnings and experience of identifying climate change as an investment risk and opportunity, there is now a group of investors that is exploring how we could do something similar with biodiversity risk and natural capital. We're watching this area closely and are involved in thought leadership/research with WTW's Thinking Ahead Institute.

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Another risk that could be turned into an opportunity, which is not new but growing quickly, is that of diversity, equity and inclusion. Data on this risk has been somewhat lacking as well as producing unclear signals. We're now getting better data on why more diverse and inclusive businesses perform better from an investment perspective, and that allows us to integrate these factors more consistently in how we build sustainable portfolios. When we use our active ownership skills to encourage greater diversity among executive teams and boards, we do it with the expectation the companies will perform better in the long term.

How will we continue to help our clients?

Stewart: TCorp's ESG journey will continue for many years. We are working with NSW Treasury to further evolve our model, ensuring every part of our investment team integrates ESG into our processes and portfolios more seamlessly and effectively. While the investment stewardship team is only 4 people, our clients have the full Investment team building ESG-conscious portfolios. Management of ESG risks will continue to grow in importance, both to mitigate unwanted risks and to translate the desirable ones into opportunities for generating better investment returns for our clients.

About TCorp

TCorp provides best-in-class investment management, financial management, solutions and advice to the New South Wales (NSW) public sector. With A\$101 billion of assets under management, TCorp is a top 10 Australian investment manager and is the central borrowing authority of the state of NSW, with a balance sheet of A\$124 billion. It is rated Aaa (Stable) by Moody's, AAA (Stable) by Fitch, and AA+ (Stable) by S&P.

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