Principles for Responsible Investment

UNEP Finance Initiative — Changing finance, financing change | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

LOCAL GOVERNMENT SUPER

COUNTRY
Australia

TYPE OF FUND/ORGANISATION
Local government pension fund

TOTAL ASSETS
A$ 7.1 billion (US$ 6.5 billion) as of 30 June 2013[1]

> "LGS demonstrates how pension funds can use thematic investments both to generate good risk-adjusted returns in several asset classes while also providing an effective hedge to ESG risks across the portfolio."

INTRODUCTION

As a manager of retirement savings for around 90,000 current and former local government employees in New South Wales, Local Government Super (LGS) has a long-term investment horizon. LGS is guided by a sustainable and responsible investment policy that applies to all asset classes. The policy commits the fund to implementing exclusionary screens; engaging; voting; integrating ESG factors; and environmental and social themed investing.

LGS currently invests more than A$ 3.7 billion (US$ 3.5 billion) through external managers in 'defined and intentional' responsible investment strategies. Among those are environmental and social themed investments within four asset classes: international listed equities, private equity, sovereign bonds and absolute return strategies.

This case study describes these investments, their performance to date and how LGS identifies and executes them. It is one of a series of case studies produced by the PRI Initiative's Environmental and Social Themed Investing Work Stream.

KEY POINTS

- As a universal owner[2] with a long-term investment horizon and investments spread across many asset classes and regions, LGS recognises that it is exposed to many 'macro' or systemic ESG risks, such as climate change and resource scarcity. The fund believes that measuring, managing and hedging these risks is a fundamental aspect of its fiduciary duty.
- LGS uses a framework to analyse the relevance and significance of ESG risks to different asset classes and to determine which responsible investment strategy to adopt to respond to them.
- LGS has invested in environmental and social themed funds in four asset classes to date. In some cases, these funds provide a specific hedge to an ESG risk, while others balance out environmental and social risks elsewhere in the portfolio more broadly. One challenge LGS faces is quantifying ESG risks accurately. To overcome this, it dedicates internal resources to calculating ESG risks and allocates a budget to buy relevant research.
- The fund's environmental and social themed investments must meet all standard return and diligence thresholds – there is no question of trading off environmental or social return against financial return. Overall, LGS's environmental themed investments are fulfilling their investment objectives and have performed satisfactorily, but as with all active strategies some have performed better than others.

1 All AUM figures are as of 30 June 2013 unless otherwise stated.
2 Large institutional investors have highly-diversified and long-term portfolios that are representative of global capital markets, which, in effect, makes them 'universal owners'.

RATIONALE

LGS takes the view that the continuing prosperity of the economy and the wellbeing of its members depend on a healthy environment, social cohesion and good governance of the companies in which it invests. It believes that wherever practicable its investments should contribute to achieving these outcomes.

As a long-term, broadly-invested universal owner, LGS recognises that it is exposed to 'macro' or systemic environmental and social risks such as climate change. These risks affect different asset classes to varying extents at different times, and may not be fully recognised and priced-in by external managers.

LGS believes that by developing strategies to measure, manage and respond to or hedge these risks is critical to fulfilling its fiduciary duty and is a fundamental role of the internal LGS investment team. It also recognises and aims to capitalise on the investment opportunities that global environmental and social trends present. In response to these two drivers, LGS has made environmental and social themed investments in four asset classes.[3] These investments provide LGS's investment team with valuable insights into these complex macro issues which it sees as increasingly material and permanent considerations in long-term investment decision-making.

TYPE AND STRUCTURE OF INVESTMENTS

While the overall investment strategy is determined in-house by LGS, external managers undertake on-going stock selection and portfolio management. How this approach plays out in four asset classes is described below.

SOVEREIGN BONDS

LGS has around A$ 1.9 billion (US$ 1.7 billion) invested in fixed income and cash. Of this, around A$ 170 million (US$ 159 million) is invested in an innovative active Sustainable International Government Bond mandate currently managed by Omega Global Investors. While ESG factors are explicitly integrated into the rating and selection of all the bonds, up to 15% or A$ 25.5 million (US$ 23 million) is allocated specifically to environmental bonds issued by supranational agencies such as the World Bank, European Investment Bank and Asian Development Bank. These bonds have the same credit rating (usually AAA) and yield as other bonds issued by these agencies but act as a hedge or response to macro themes such as climate change, resource scarcity and rising populations. They do this by specifically funding independently certified investments in environmental or low-carbon infrastructure such as wind farms in China, Turkey, Egypt and Austria, Thailand's first major solar power project, and Colombia's sustainable urban transport system.

Since inception in March 2012 to July 2013, the green bonds have outperformed their benchmark by 36 basis points (before fees) – an acceptable result in a low tracking error portfolio.

INTERNATIONAL LISTED EQUITIES

LGS has around A$ 1.5 billion (US$ 1.4 billion) invested in international equities (i.e. to regions outside Australia). Around half of this amount is actively managed by six investment managers.

While many large companies can offer appealing (relatively short-term) investment returns, LGS has found that they generally have high carbon intensity. To hedge the related risks, LGS made a 5% allocation of A$ 60 million (US$ 50 million) to Impax Asset Management. Impax invests globally in high-quality companies in the renewable energy, water treatment, waste and resource management sectors and/or that are at the forefront of developing products and services to solve the world's most pressing environmental problems. Companies are eligible for investment only if they generate at least 50% of their revenue or profits in the environmental sector, or deploy at least 50% of their capital in these sectors. Given these constraints, the mandate invests predominantly in small and mid-cap companies.

The mandate is benchmarked against the FTSE Environmental Opportunities All Share. Both the environmental sector and the mandate have performed strongly in the last 12 months; as a result, it is currently one of LGS's best-performing international equities mandates.

OTHER ASSET CLASSES: PRIVATE EQUITY AND ABSOLUTE RETURN

LGS invested around A$ 369 million (US$ 345 million) in private equity. Around 10% is invested in the Macquarie Clean Technology Fund – a well-diversified private equity fund of funds managed by 12 underlying specialist managers. It focuses on technologies that seek to improve energy efficiency and reduce negative environmental impacts.

Attunga runs a similar amount on behalf of LGS. Its Power and Enviro Fund invests in the power market and related derivative products, focusing on the Australian national electricity market. The mandate can also invest in CO2 emissions, weather, gas, water and other energy- and environment-related markets.

Investments in these funds must also meet LGS's target returns and go through the standard due diligence process: there is no question of 'trading off' financial and environmental returns. LGS believes these investments help to offset the risk of punitive future emissions legislation and benefit from the financial returns available from emerging low-carbon sectors and technologies.

3 LGS places significant emphasis on retrofitting and refurbishing its direct property portfolio with a view to improving its environmental performance and reducing its exposure to rising electricity costs. It also invests in 'green' infrastructure within its infrastructure portfolio.

Attunga outperformed other investments in LGS's absolute return portfolio, which is benchmarked against the Australian bank bill rate, over the three years to the end of July 2013. However, its monthly returns have been more volatile than those of the other strategies.

APPROACH

Strong board commitment and beneficiary interest: LGS's extensive investment in responsible investment strategies stems from its strongly committed board, CEO and CIO. It also reflects the fund's beneficiaries' interest in sustainability issues, as captured through ongoing feedback.

Dedicated, in-house expert: LGS employs an experienced responsible investment professional who reports to the CIO and CEO. This specialist tracks and analyses ESG issues, oversees the implementation of the responsible investment policy and has developed an ESG and carbon risk framework.

An overarching ESG and carbon risk framework: As a long-term, broadly invested universal owner, LGS sees ESG macro risks as a primary source of investment risk that it has a responsibility to understand, measure and manage. Its ESG and carbon risk framework is a tool it uses to analyse and score the relevance and significance of ESG risks to each asset class. It then sets overall risk/return objectives for each and determines whether an ESG or responsible investment strategy, including themed investments, might improve returns or reduce risk. This is most often appropriate when there is an appetite for active management (or achieving non-beta returns). LGS then assesses the availability of themed strategies for the chosen asset class and seeks managers able to meet its objectives.

Rigorous investment-first standards applied: Every investment recommendation put to the board-level investment committee is assessed for ESG and carbon risks – including environmental and social themed investments. They are also subject to the same rigorous due diligence and approval process as all other investments. The investment committee tracks and scrutinises the performance of all ESG strategies, including themed investments.

CHALLENGES

While LGS has made good progress in identifying environmental and social themed investments within several asset classes, it has faced several challenges.

1. **A lack of investment managers with a strong track record and an insufficient choice of environmental and social themed opportunities across asset classes:** LGS seeks to meet managers to communicate its investment needs and identify – or encourage the development of – appropriate products. Once the right combination of strategy and manager is identified, LGS determines the specific risk/return objectives and ESG attributes it requires and then asks the manager to demonstrate its ability to meet those objectives.

2. **Lack of environmental and social themed investment expertise among investment consultants:** LGS also meets investment consultants to improve mutual understanding of the relevance of ESG risks to its fund and to explain its product requirements. It also provides details of attractive ESG strategies to its investment consultants to show them the types of products it is seeking.

3. **Measuring and hedging environmental and social risks:** LGS finds it challenging to quantify the risks associated with environmental and social themes. They often play out over the long term, their trajectory can be hard to predict, and they can be intangible and not fully understood. It is essential to be able to quantify risks in order to identify appropriate hedges for them. LGS has tackled this challenge by dedicating specialist internal resources to measure environmental and social risks and has committed the funds necessary to source relevant external research. To complement this quantitative approach, LGS has also developed a logical qualitative framework to evaluate ESG risks across and within asset classes. This has helped to communicate to the board and investment colleagues when themed investments and hedges are appropriate.