

The UN Principles for Responsible Investment – two years on

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Recent sharemarket volatility has left many investors seeking explanations – and in need of tools to monitor company performance well ahead of troubled times. While regrets and recriminations are all that’s available for those working only from hindsight, a growing collective of institutions have been quietly incubating a brand new approach, through the UN Principles for Responsible Investment (UNPRI).

While it may be cold comfort at this time, institutional investors globally – superannuation, insurance and sovereign funds -are driving the market to a more comprehensive analysis of investment risk. As the breadth of these institutional portfolios increases with their size (the world’s pension funds are 35 percent of total global investment,^[1] Australian institutional investors are 40 percent of domestic equities^[2]) they are recognising that their obligations to their beneficiaries extend to a stewardship role in markets in which they are increasingly dominant.

Combating myopia

Institutional investment portfolios are effectively universal and permanent.

Large enough to span the entire economy, institutional investor portfolios cannot elude costs companies impose on other sectors. For example, any strong returns on greenhouse gas-intensive stocks are eroded when the portfolio’s tourism properties, mining operations, and insurance companies face climate change-related costs (for instance from increased intensity of weather events).

Similarly, since institutional portfolios need corporate performance sustained over decades and through economic cycles, short-cuts companies take today are often false economies when viewed through a longer-range lens. For instance boosting a loan book through “easy money” lending practices, or under-investing in workforce training and development, can hamper enterprise value - and even viability - in the medium to longer term.

Making sense of intangibles

The value at risk can be quantified. For every one third of enterprise value that is on the balance sheet, a further two thirds is intangible value; including intellectual capital, customer loyalty, licence to operate, internal controls and culture, continuing regulatory concessions, supply chain integrity and shareholder confidence in corporate governance. Numerous hits to company value – and ripples throughout the economy - can be traced to shortcomings in these areas, including the 2001 failure of HIH. Following the ensuing Royal Commission, Justice Neville Owen clarified the role

^[1] Watson Wyatt Worldwide , 2008 Global Pension Asset Study

^[2] ABS, Yearbook Australia 2008

shareholders play (or in this case failed to play) concluding that “if shareholders as owners are unwilling or unable to exercise their powers or make themselves heard, directors and management will lack guidance or constraint from those whose interests they are supposed to serve”.

Despite Justice Owen’s report; most companies continue to provide limited information in relation to off-balance-sheet risks because they lack demand from investment markets. At the same time, analysts have lacked the incentive to develop models that incorporate environmental, social and corporate governance (ESG) because there is insufficient data from companies to analyse. Both supply and demand sides contribute - chicken-and-egg style - to a market failure.

Framework for change

The UNPRI – two years old this month –addresses the failure head-on by providing a framework for organising and articulating investor demand. Signatories commit to seeking environmental, social and governance (ESG) information from companies; shaping corporate behaviour through activities like company engagement and proxy voting; and driving the integration of ESG factors into investment valuation and buy/sell decisions. Additional commitments to promote the Principles, collaborate with other signatories and report on progress underpin the integrity and effectiveness of the initiative.

Momentum is growing. This is aided by the fact that consistent valuation signals are emerging from ESG factors such as human capital management, ethical business practices and corporate governance integrity. A 2007 survey by the Australian Council of Super Investors (ACSI) found 71% of super fund respondents take ESG matters into consideration when selecting and approving fund managers or are likely to do so in the future. ACSI ESG guidelines and sample clauses, launched late last year, make it still easier for member funds to chart a path to UNPRI implementation.

The US \$13 Trillion invitation

The UNPRI’s infancy is nearing completion; as with most two-year olds, we should expect greater assertiveness in the next 12 months. With 300 signatories and US\$13 trillion of assets represented, the UNPRI signals significant opportunity for the investment supply chain – fund managers, analysts and corporate reporters – to tap the unmet demand.

Regnan wishes the UNPRI a happy 2nd birthday, and for signatories, many happier returns.