"HOW WE INVEST" WHITE PAPER

WHY WE BELIEVE RESPONSIBLE INVESTING PAYS OFF

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PREFACE

The Guardians of New Zealand Superannuation aims to be a responsible investor. We do this because we believe that responsible investing is good for the portfolio. It can be a source of opportunities and a way to control risk. Our governing legislation also requires us – amongst other things – to avoid prejudice to New Zealand's reputation as a responsible member of the world community.

This white paper explores the foundations and implications of this belief, and summarises the underlying empirical evidence.

Developing these papers has helped us provide a consistent vision to staff, to focus our time and resources appropriately and to avoid re-litigating some of the fundamental investment questions that investors deal with on an ongoing basis.

I hope they also enhance your understanding of how we go about investing the NZ Super Fund.

Matt Whineray
Chief Investment Officer

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OUR INVESTMENT BELIEFS

We have written down a number of beliefs about how we think asset markets work (these are described on our website). In our view it is important to clearly document our investment beliefs. It helps keep us disciplined, and provides the courage to stay the course when most needed.

One of our beliefs concerns responsible investment. We believe that

> ***Responsible investors must have concern for environmental, social and governance factors because they are material to long-term returns***

WHY ESG MATTERS

It is a well-established corporate belief that good management of environmental (E), social (S) and governance (G) factors – including governance, employee relations, safety, and environmental risks – is material to the long-term successful performance of any business.

Identifying and managing environmental ESG factors helps us to find new opportunities, steer our capital towards more attractive areas, and manage long-term investment risks. We expect that our returns will be higher, and downside risks lower, over the long term. These benefits arise from avoiding the poor performance and enterprise failures that can arise from lax governance, and weak environmental and social practices.

As such, we look to integrate Responsible Investment (RI) considerations all through our investment process. While ESG factors may be hard to quantify, we will benefit directly if they are taken into account in all our investment activities.

This integrated method is different to treating RI as a 'gate' or 'hurdle' for an investment proposition, or only as a way to manage risk.

Being a responsible investor implies that we must behave as the owners of assets rather than just investors in various securities. It is also important to ensure that our agents, be they fund managers, boards, or company executives, act in our interests and are seeking to maximize long term returns for the Fund.

Some examples of how the Fund's performance can improve through good ESG management include:

- Less principal-agent conflict between ourselves as the asset owner and the asset managers that we employ – including fund managers, advisors, CEOs and management teams;
- More consumer support of the businesses we invest in;
- Safeguarding a company's "social license to operate";
- General risk management and early detection of risks that could otherwise be overlooked;
- Less legal and regulatory risk (e.g. health and safety; environmental);
- More dynamic, innovative and productive companies;
- Potential returns from investing early in the life cycle of assets with ESG drivers; and
- Making best use of our long time-horizon so that we are properly responding to slow-burn global trends (See the Guardians White Paper The Advantages of Being a Long Term Investor);

Our RI belief is also why we chose to be a founding member of the UN's Principles of Responsible Investment (UNPRI). The UN principles are based on the view that "ESG issues can affect the performance of investment portfolios. Taking account of ESG issues can also align our objectives with those of society at large."

The main elements of our RI Framework

- Develop guidelines that integrate ESG considerations across our investments;
- Engage effectively with external investment managers and the companies we invest in;
- Being active, engaged, asset owners;
- Consider investments for their social returns in addition to the required financial return;
- Maintain a robust analytical and decision-making process when responding to investee companies that breach RI standards. (Our chosen standards include those of the *UNPRI*, the *UN Global Compact*, and other good practice standards issued by select industry collectives); and
- Benchmark our performance against the RI standards to which we aspire.

WHAT IS THE EVIDENCE THAT ESG MATTERS?

When we started building our Responsible Investment framework in the early days of the Fund, the academic evidence on responsible investing was thin on the ground and not particularly conclusive. We based our RI programme more on a general belief and on our own experience as investors.

Since then, the evidence has become much stronger. More than 100 academic studies on ESG have been published. They cover a wide range of markets, time periods, datasets and approaches. Not all of them have yet made their way into peer reviewed journals, and it is fair to say that some studies are better than others in terms of quality, but overall there is now a strong corpus of analysis on which to base our belief.

We find support for our belief in ESG based on the common practice of assessing the overall balance of evidence using a meta-study that reviews and collates all the individual papers. In any scientific endeavour, different studies will sometimes give different results. A meta-study is a way to average out the overall body of evidence. The advantage of this approach is that many of the flaws and limitations of individual studies cancel out, resulting in a clearer view of the evidence and more powerful statistical tests. The two most important recent meta-reviews were conducted by Deutsche Bank in 2012 and the University of Oxford in 2014.

Overall, there is strong evidence that companies that do well on ESG metrics tend to perform better. More specifically, companies with strong ESG or Corporate Social Responsibility (CSR) ratings tend to have some or all of the following features:

- A lower cost of equity and cheaper borrowing costs;
- Better corporate performance, for example higher profitability; and
- Better market performance, for example a higher stock price than less well-rated companies

The strength of the evidence is now quite compelling. More than 80% of studies find positive links between ESG ratings and the particular measures of performance that they are analysing.

The fact that companies with better ESG practices have a lower cost of capital suggests that the market is treating them as having lower risk. The evidence suggests that they face fewer capital constraints as well, for example with better access to bank credit lines and to bond markets.

Some of this is not surprising, as borrowing costs have always been linked to the quality of governance and management in general. Good governance mechanisms help reduce agency and monitoring tensions between the firm and the lenders. The proportion of independent directors on the Board, the degree of institutional ownership, disclosure quality, and anti-takeover measures, have all been found to affect a firm's cost of debt.

Good ESG practices reduce the cost of equity by reducing environmental and social risks, lessening information asymmetries through better disclosure from managers to owners, and keeping management aligned and motivated.

The penalty for poor governance appears to be greater in countries that have relatively weak securities regulation, such as a number of emerging markets. This suggests that corporate governance practices and legal protections supplement each other to some extent.

The evidence on environmental practices and performance shows that investors and banks add a risk premium to firms that are perceived as having a higher risk of accidents. Investors appear to be concerned not only about risks that are currently regulated, such as hazardous waste, but also about issues that may face regulation in future (climate change, for instance).

There are several reasons why companies with superior ESG practices also tend to have better stock price performance. It may be that the market is recognising improved performance over time, and pricing good ratings into the stock price. It may also be that some companies with poor ESG ratings experienced a severe negative event – an environmental spill, or a governance disaster – that severely affected the company's performance and its stock price. Lastly, cause and effect may work in both directions. Successful companies may invest more in ESG practices, which creates a positive feedback loop that makes the empirical evidence harder to read.

Our reading of the evidence, and the meta-studies mentioned earlier, shows quite mixed results when it comes to Socially Responsible (SRI) funds. On balance, they neither out-perform nor under-perform the market on average (net of fees). SRI funds typically exclude whole sectors such as tobacco or armaments for ethical reasons, rather than for financial (risk and return) reasons. This suggests that positive ESG investing may be more effective than exclusionary screening for enhancing portfolio performance.

EVIDENCE ON ENGAGEMENT AND ACTIVE OWNERSHIP

A review of the evidence on engagement and active ownership was recently prepared for the Norwegian Government Pension Fund. The report included peer and academic analysis of the role of engagement in investment strategies. Peer funds regarded monitoring their investments and exercising influence when needed as a core component of responsible investment policies, and as a means of helping to achieve financial objectives. A review of academic research found that engagement, particularly behind the scenes, can have a measurable ESG and financial impact.

Firms targeted for engagement are those that are most likely to need changes and to be changed successfully. These firms tend to exhibit poor performance, poor corporate governance, high institutional ownership, and low inside ownership. Active engagement is more likely to be able to change corporate governance when other investors join or support the process and where their insider holdings are not high, as they can be obstructions to change.

Studies of engagement by TIAA-CREF, Hermes and another institutional investor find evidence of successful changes to corporate governance and other aspects of their portfolio firms. One of these studies (Dimson et al, 2013), based on the richest database, found that ESG-related engagement delivered a one-year excess return averaging +1.8%, comprising +4.4% for successful engagements and zero for the unsuccessful ones. However, engagement is time-consuming (500 days on average) and success rates are low (around one in five engagements was considered successful).

There is also extensive evidence regarding apparently successful monitoring by institutional investors. Firms with a large number or large ownership concentration of institutional investors tend to have better corporate governance ratings and show greater improvements in governance. These impacts flow across borders, with foreign institutional ownership also being associated with improved governance.

Long-term investors can have an advantage when it comes to active ownership. Hands-on involvement with an asset requires an up-front investment of time and resources with considerable uncertainty about when efforts may bear fruit. Patient long-term capital will be more able to pursue such strategies.

SUMMARY

We are mandated to – amongst other things – manage the Fund in a manner that avoids prejudice to New Zealand's reputation as a responsible member of the world community.

In doing so, we have an investment belief that "responsible investors must have concern for environmental, social and governance factors because they are material to long-term returns."

This investment belief has been increasingly supported by empirical analysis globally over recent years, including improved investment returns and positive impact on company performance from engagement.

By identifying and managing these ESG factors, we are more confident in our ability to allocate capital towards more attractive areas, and better manage long-term investment risk.

We integrate our responsible investment activity into all of our investment activities, and operate as transparently as possible.

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