Financial Review Focus

ESG Investing & Sustainability

www.afr.com | Wednesday 17 November 2021

$5 trillion powers growth of global sustainable funds

Power of money

Aleks Vickovich

As eyes around the world were turning to Scotland for the 2021 United Nations Climate Change Conference (COP26), research house Morningstar revealed the extent of demand for financial products with an environmental focus.

As at September 30, "sustainable funds" around the world had a total of $US3.9 trillion ($5.3 trillion) in assets under management. In Australia, these green investment products are now worth a collective $38 billion, up 11 per cent over the September quarter.

Superannuation and investment manager Australian Ethical accounts for 18 per cent of that pool of sustainably managed assets.

It says it has seen rising demand for its funds in the lead-up to and during COP26, as climate change was thrust back onto the news agenda with the imminent summit and easing of coronavirus restrictions.

Nathan Fradley, of Lime Financial Planning, a certified ethical investment adviser, says the response to COP26 from clients and investors is not just a heightened interest in environmental, social and governance (ESG) issues but "frustration" at the lack of progress from governments.

"Investors feel it is another let-down that does not do enough," Fradley says.

"What is refreshing, though, is that the frustration is visible and widespread.

" I feel this will put further pressure on business to lead the way, with a larger focus on carbon emissions by super funds, and climate change risk as a thematic for investment."

A deal between the world's nations proved elusive in the conference's first week after big emitters China, India and Russia led efforts to oppose a hard deadline of 2050 for net zero.

The heightened focus on climate change – having been largely absent from mainstream news headlines during the pandemic – is expected to drive even further demand for ESG investments.

"COP26 will absolutely affect Australian investors because it will further enhance their confidence over the legitimacy of pursuing ESG investments and supports their existing beliefs that the whole investment community has an active role to play in its success," says Louise Watson, head of Australia and New Zealand at global investment manager Natixis.

"In this way ESG investing sets itself apart as a truly unique investment model, where the investment community works together for a desired outcome, making it particularly attractive to Australian investor."

A survey of global investors by Natixis in April, in which 400 Australians with at least $100,000 in investible assets took part, suggested 21 per cent already invest in ESG products.

A further 41 per cent said they did not invest in ESG yet but were interested in doing so. Of those that are already investing with an ESG lens, 41.7 per cent said such an approach allowed them to align their investments with their personal values, while 38.1 per cent said they did so in order to "support the environment".

More than one-third (34.5 per cent) responded that they believed ESG funds had similar or better performance than other non-ESG investment products. Half agreed with the proposition that they have a "responsibility to help fix societal issues through my investments".

"It's clear that ESG has finally moved into mainstream investment management because it is no longer possible to ignore the science of climate change, nor deny the conclusion that we are at a tipping point in terms of the global environment," says Pierre Lenders, head of ESG at Capital Fund Management in Paris.

COP26 will affect Australian investors, says Louise Watson (below), head of Australia and New Zealand at global investment manager Natixis. ILLUSTRATION: JOHN TIEDEMANN

But while more and more investors are allocating all or some of their portfolio to ESG investment products, they also increasingly expect more from their fund managers than just screening out fossil fuel companies and pocketing a performance fee.

The Natixis survey found the vast majority of Australian respondents (69.5 per cent) believed fund managers should be "actively engaging with companies they invest in".

The same number said they expected fund managers to look at "more than just the financial aspects of a company", while 67 per cent said they expected fund managers to vote on all the shares they own.

Globally, 60 per cent of the 8550 investors surveyed rejected the idea that companies were responsible only for creating shareholder value – once a widely held and uncontroversial principle of free market enterprise.

Indeed, 82 per cent of the global respondents said companies had a responsibility to address social issues – a larger cohort that the 78 per cent who said governments had such an obligation.

The findings represent a recent cultural shift whereby investors are no longer satisfied to simply deploy capital to niche investment products to satisfy their personal moral obligations.

Instead, they demand that all companies improve their ESG standing and commit to reducing carbon emissions or other environmental and social goals.

And, crucially for the financial services industry, they expect the professionals managing their money to play a role in ensuring that actually happens.

In other words, they expect investment managers to effectively become environmental activists.

Fradley agrees this is an increasing expectation of his financial planning clients and says this has only heightened since COP26. "A big issue right now is genuine engagement and voting," he says.

"Divestment-only approaches mean companies may dump assets to private equity firms, which can be mismanaged and result in worse outcomes."

For investors who genuinely want to make a difference to climate change, therefore, just selling stock or buying into a fund that avoids certain sectors isn't enough

Continued S7

Discover undervalued investments

Access Morningstar's top equity picks, fund and ETF ratings, and screen over 48,000 global securities inside Morningstar Premium.

Visit go.morningstar.com.au/afr to start a free 4-week trial.*

*T&Cs apply

Fear of the law to bring businesses into line

Greenwashing

Agnes King

Fear of litigation has rocketed to the top of directors' and company executives' concerns about climate-related risk amid a flurry of domestic and international lawsuits accusing corporations of "greenwashing" to conceal emissions or climate inaction, experts say.

"Litigation risk has popped right up to the top of the pile very quickly for boards. Even a few months ago, it was all about reputational damage and a little bit of financial risk – now it's all about litigation risk," says PwC environmental, social, governance leader Jon Chadwick.

This is driving calls for accelerated adoption of a single set of sustainability reporting standards and a single internationally recognised framework for reporting to reduce the risk to businesses of falling foul of rapidly evolving community expectations.

It comes as Santos faces a Federal Court challenge brought by an activist group alleging that it breached corporation and consumer laws by claiming to produce clean energy and to have a pathway to reach net zero emissions.

At the same time, in a first for climate lawfare in Australia, a Commonwealth Bank shareholder has commenced action to access documents detailing the bank's decision to finance oil and gas projects despite their potential to breach the Paris Agreement goals.

"There are variations of greenwashing resulting from this evolution of reporting that is still under way," says Dan Gocher, director of climate and environment at Australasian Centre for Corporate Responsibility, the shareholder advocacy group bringing the Santos case.

"The Taskforce on Climate-related Financial Disclosures came in about five or six years ago. It took companies a couple of years to figure out what it would mean – they're still figuring it out to a certain extent," Gocher says. "There is no real enforcement around what the minimum standard is, what your baseline should be when you set targets, or what emissions it should cover."

The absence of standards has allowed companies and investment funds to make exaggerated claims about, or "greenwash", their social or environmental impact, he says.

The law is emerging as a way to remove ambiguity. There is a growing awareness with the rollout of the European Union's taxonomy for sustainable finance that fund managers are in the crosshairs to verify the accuracy of ESG claims made by the companies in which they invest.

Paul Curnow, top, says the risk of greenwashing is lessening; Nicolette Boele.

"When Australian investors open a product labelled 'sustainable' and see a list of holdings that includes Santos and Woodside, it surprises them because they don't see these as being aligned with climate action," says Responsible Investment Association Australasia head of policy and standards Nicolette Boele.

"It's the disjunct between the promise on the label and what the investors see in the portfolio that needs to be solved."

Chadwick says: "A lot of greenwashing conversations happen as part of financing negotiations.

"As companies go, looking for capital, they want to make commitments to access funding that is being directed to green assets."

Equity Generation Lawyers partner David Barnden, who has four climate cases afoot – all started in the past 18 months – sees it as fertile ground.

"There is no shortage of corporate misconduct out there," Barnden says.

Gocher agrees that the risk is "huge" and "a systemic problem".

But Ashurst's global co-head of energy, Paul Curnow, says greenwashing was more prevalent in the past.

"The risk is getting less because of standards coming through, greater scrutiny from regulators, a clearer understanding of fiduciary obligations from directors, the risk of climate litigation and shareholder activism," Curnow says.

Boele says most investment managers don't wake up in the morning looking to intentionally mislead consumers or investors. But she says more than 80 per cent of products that come to RIAA for certification as true to label go away with substantive suggestions on how to improve their disclosures and investment processes to be more aligned with what they are promising. AFR

From S1

$5 trillion powers global green funds

because a new owner may not apply an ESG lens, allowing a high-polluting company to continue its practices.

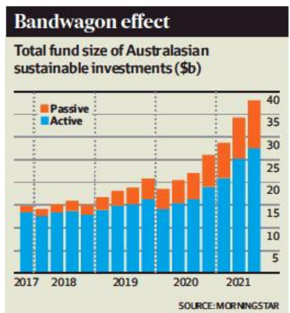
Fradley points to $100 billion-plus mega-funds AustralianSuper and Aware Super as examples of investment managers with good track records on ESG engagement.

The former has a 73 per cent voting record on ESG metrics and the latter releases a stewardship report to members demonstrating the questions on emissions reduction and gender and racial diversity it is asking companies, he says.

Australian Ethical chief executive John McMurdo is another super fund trustee who agrees divestment is not enough.

"While record amounts of money are pouring into 'sustainable' and ESG funds, capital continues to flow into companies that are harming people, planet and animals," he says.

"Ethical investing considers the impact of these investments and avoids investments in non-aligned industries, as well as actively engaging with companies to influence the shifts necessary to avoid the worst of climate change."



Bandwagon effect

Total fund size of Australasian sustainable investments ($b)

Many companies have now committed to decarbonisation or other sustainability and ESG-related outcomes.

Doug McNamee, chief executive and founder of Jolt, an electric vehicle charging network, says: "COP26 has been a catalyst for the business community in recognising the significant growth opportunities to be realised by investing in zero emissions technologies." AFR

Industry insight

Comment by

Velislava Dimitrova
Portfolio Manager
Fidelity Sustainable Water and Waste Fund

This content is produced by The Australian Financial Review in commercial partnership with Fidelity.

Perhaps the most comprehensive review on climate change is the UN's Intergovernmental Panel on Climate Change's (IPCC) August 2021 report.

It concludes that increases in GHG concentrations since 1750 are unequivocally caused by human activities and atmospheric CO2 concentrations are higher than at any time in at least two million years.

The 1.1 degree Centigrade temperature rise that has occurred as a result is already being felt. Weather extremes such as heatwaves, droughts and heavy rainfall have increased in frequency and severity. These effects will only get worse unless we take action to reduce emissions.

To limit global warming to 1.5 degree C, we need to halve greenhouse gas emissions by 2030 and reach net zero by 2050, but current country plans represent an emissions reduction of just 1 per cent in 2030 compared to 2019 levels.

Policymakers must support decarbonisation

A big part of the problem is the lack of action by policymakers.

Despite 195 countries approving the UN IPCC report and acknowledging the catastrophic consequences of climate change, we're only on course to maintain emissions by 2030 rather than cut them by 50 per cent. Why? The answer is growth. Economic development means increasing consumption of goods and services, and that requires fast and cheap forms of energy which are often carbon intensive.

And while we don't suggest inhibiting growth, governments must help transition economies to a low-carbon world.

That means converting our economic system to one that sustainably reduces, and compensates for, carbon dioxide emissions.

Fortunately, a plethora of decarbonisation solutions are available today and have the potential to cut over 80 per cent of global carbon emissions if fully adopted globally. But these innovations need policy support to scale them up quickly.

The market for decarbonisation

There are varying estimates of the cost to fully decarbonise the global economy, but the best forecast we have seen is that, at current prices, decarbonisation will cost $US4.8 trillion per year, with a total spend of $US144 trillion by 2050.[1]

The funding will need to come from both public and private sources, and one of the most efficient ways to finance the transition is to establish a price for carbon.

The current global price is too low, making the opportunity cost for businesses to emit carbon relatively easy to absorb. But that appears to be changing, with more countries adopting carbon pricing schemes domestically and as part of trading relationships.

Another policy to support decarbonisation is subsidising new technology. Subsidies for renewable energy in Germany, the US and the UK helped scale renewable power to make it the lowest cost form of energy generation in most parts of the world today. Policymakers could also restrict the use of high-emissions technology, for example by imposing low-emissions zones in cities or by cutting road taxes for electric vehicles.

The potential of green hydrogen

An area attracting a lot of interest is green hydrogen.

Most hydrogen gas used as an industrial chemical is either generated through the gasification of coal or lignite, or through steam methane reformation, which typically uses natural gas as the feedstock. Neither is carbon friendly. Green hydrogen can nearly eliminate these emissions by using renewable energy to power the electrolysis of water — the process to extract energy in the form of gas.

A plethora of decarbonisation solutions are available today and have the potential to cut over 80 per cent of global carbon emissions if fully adopted globally.

Green hydrogen has the potential to supply up to 25 per cent of the world's energy by 2050 and become a $US10 trillion market, mainly for energy storage, industrial uses and heavy transport. Its current price of $US 2.5-6 per kg has fallen some 40 per cent since 2015, but it is estimated that $US2 per kg is the tipping point to becoming competitive across multiple sectors.[2]

To get there, however, several challenges need to be overcome, including building the infrastructure required to support hydrogen production, storage, and transport. That may take time and much more policy support will be required to make this and other emerging technologies viable.

As investors, however, we already have access to opportunities in existing, cost competitive decarbonisation technologies that can drive the transition forward. These and the new technologies on the way — across every part of the economy — will help future COP conferences be even more ambitious on emissions reduction commitments and the speed at which they can occur.

References:

1 Goldman Sachs, 2020.
2 Hydrogen Council: Path to hydrogen competitiveness, January 2020.