ALTIUS
ASSET MANAGEMENT

Engagement or Divestment?

May 2023

"Divestment should be a tool of absolute last resort"

- Brynn O'Brien, Executive Director, Australasian Centre for Corporate Responsibility (ACCR).

The certainty and clarity provided by exclusion (divestment or non-investment) has often been the default position for responsible or sustainable investment managers and superannuation funds with ethical/sustainable investment options. It helped to define the responsible investment market in its early days and even now represents a clear value proposition. Investors can decide how their savings are converted into market capital (debt or equity), and where that capital is deployed (or more importantly for some, where it isn't).

In late 2022, the number of managed assets using a rigorous approach to responsible investment hit a record $1.54 trillion, accounting for 43 per cent of the total market, according to Responsible Investment Association Australasia (RIAA). RIAA also reported that 45 per cent of investment managers claim to hold companies to account on matters relating to environmental and social issues with reporting to investors on outcomes achieved up from some 20 per cent just two years ago.

Clearly, many investors are not okay with funding tobacco, casinos, or armaments. But as the list of exclusions grows, so too does the level of contention and recognition of the inherently one-sided approach that delivers influence through where your money doesn't go, but not where it does. Recent actions by the Australian Securities and Investment Commission (ASIC) also raise the stakes considerably for sustainable funds with respect to allowable claims about the sustainable nature and characteristics of some investment options.

This has given rise to fierce debate among those that would consider themselves responsible investors— indeed most allocators of capital that advocate sound risk management principles, putting aside the extreme notion that the mere contemplation of the risks and opportunities involved with environmental, social and governance (ESG) issues is "woke capitalism."

Proponents of engagement argue that a shortcoming of the exclusion approach, for equity holders at least, is that once you leave an argument, effectively agreeing to disagree, your influence on future outcomes is forfeited.

However, there is nuance to the issue.

- If engagement without consequence is just nagging, where is the line of last resort when divestment is the only alternative?
- Can engagement still be effective if an investor doesn't hold a stake but could?
- Does the equation change for debt holders (who don't vote at AGMs) compared to equity holders?
- Should engagement and/or divestment be public or private, broadcast, or discreet?

What about entities outside the listed equity markets such as governments, mutuals, universities, and supranationals?

Strengthened by
Australian Unity
Real Wellbeing

AGL Energy
A new chapter in shareholder engagement.

As Tony Boyd, from The Australian Financial Review said following Grok Ventures' resounding vote of confidence at AGL Energy's annual meeting in 2022, there is a "new benchmark for successful shareholder activism."

The investment vehicle, owned by Mike Cannon Brooks, gained overwhelming support from the 'retail heavy' AGL Energy's shareholder register to expand AGL's board. It received between 61 per cent and 98 per cent of votes cast, despite holding just 11.3 per cent of the issued capital.

The landmark result came just months after AGL scrapped its plans to demerge its coal-focused generation business following intense lobbying from Grok Ventures and other shareholders.

The Australasian Centre for Corporate Responsibility (ACCR) echoed this sentiment regarding the power of engagement.

"Climate-aware institutional investors considering divesting should be thinking very hard about what power they are giving up."

While divestment from fossil fuels stocks may be attractive to funds from a financial or marketing perspective, there is little, if any evidence that it has an impact on real world carbon emissions."

While some (Altius included) might take exception to the description of divestment as a marketing ploy, there is a strong argument that for large equity holders, including industry superannuation funds, the sheer weight of their shareholdings can provide a great deal of leverage to influence outcomes—even without impact investment activism and board spills.

ACCR has also said that company decision-making can be impacted by sustained and escalating shareholder pressure. In the case of AGL, these recent events will have only added to pressure felt by boards to heed shareholder views.

On the other hand, sustainable or ethical funds play an important role in offering choice to investors who simply don't want exposure to certain organisations or sectors. Investors should have the choice to decide that their savings are directed exclusively to entities undertaking activities that accord with their values.

In the Australian context, companies like AGL, Origin, Woodside and Santos have provided a series of litmus tests for the issue. For example, Hesta Chief Executive Officer, Debby Blakey acknowledges that the $68 billion superannuation fund for health and community service workers has had to address the issue head on.

The rubber hit the road last year when climate activist group, Market Forces, waged a high-profile divestment campaign against the super fund. Historically, the fund has been an acknowledged leader in responsible investment, but this campaign framed the fund as an alleged greenwashing bad guy.

While Market Forces argued that a responsible investor cannot hold investments in fossil fuel companies, the legitimacy of this argument involves an assessment of the effectiveness of divestment and active engagement. Critically, is one so ineffective that it amounts to an invalid strategy for a responsible investor?

The UN Principles of Responsible Investment – to which most industry super funds are signatories – includes a pledge to be active owners and incorporate ESG issues into their ownership practices.

While the fracture amongst ESG advocates, ESG investors, and their fund members runs the risk of distracting from the main game of speeding decarbonisation and keeping the focus on polluters, it can also spur more muscular engagement.

In the case of AGL's demerger plan, it was largely met with dismay as shareholders and analysts described it as both "value destructive and environmentally disastrous."

HESTA stood out from its peers by voicing early public opposition to the demerger, adding to the intense media coverage of the demerger of Australia's biggest carbon emitter. Arguably, its influence on the outcome was stronger than if it had waited for the vote (it holds just 0.34 per cent of AGL's equity).

Ultimately, HESTA's support was a significant boost for Grok's bid and contributed to the groundswell that led to AGL pulling out of its demerger plans.

True to label

In a panel discussion at The Australian Financial Review Super and Wealth Summit in November last year, John McMurdo, CEO of Australian Ethical, discussed the merits of engagement and divestment approaches, noting that nothing precluded the fund from taking an active engagement approach.

"I take the example of AGL, where we have been against what they have been trying to do for some time; if there's a major change there, that will be an interesting discussion for us to have," McMurdo said.

McMurdo also said that while there are currently no legacy fossil fuel companies that have a net zero transition pathway warranting investment, there are a couple that are beginning to show the right signs.

Generally, Australian Ethical lean toward the clarity of offering products that have a harder screen on investments for investors that prefer that certainty due to the belief that the industry needs stronger labelling standards of responsible and ethical products.

Australian Ethical's recent divestment from Lendlease also shows the potential synergies between divestment and engagement. After four years of engagement and progress, the fund judged that engagement had stalled on the issue of safeguarding a koala colony at a new development. As a result, Australian Ethical divested and communicated the reason publicly – signalling to Lendlease and other developers what it considers responsible regard for nature looks like.

NGS Super Pty Ltd as Trustee of NGS Super (NGS) was another fund that divested prior to the AGL demerger vote in line with its trajectory to a carbon-neutral portfolio by 2030. The absence of these 'like-minded' responsible investors on the AGL share register added to the challenge faced by those seeking change through shareholder activism.

But the implications of managing the behaviour of problematic investments through engagement go beyond responding to public criticism from activist groups.

ASIC's recent action on greenwashing raises the stakes considerably for sustainable funds with respect to allowable claims about the sustainable nature and characteristics of some investment options.

If upheld, the action will effectively rule out active ownership and engagement for ethical/sustainable funds unless representations clearly allow for exceptions to sustainability screens—and the fund can demonstrate effective controls for determining appropriate exceptions, setting engagement objectives and timeframes for escalation, as well as periodic outcome measurement and reporting. Choosing to hold debt or equity in a company as an exception to stated screening criteria for active engagement is now much more fraught for sustainable funds.

Engagement must be effective

Digging deeper into the approach adopted by Hesta highlights the unique perspective a superannuation fund can have if it represents members sharing a sharp social focus.

As Hesta CEO, Debby Blakey reflected, "We're very blessed that our members are the frontline members of the health and community services sector. In the last few years where they've dealt with so much; bushfires, floods, the pandemic."

In terms of connecting the dots on climate change, she said, "For many of our members, in terms of health impacts, they pick up the pieces."

Therefore, for members, their investments need to provide "financial return to give them that confidence in their financial future, but also make a difference to the world that they live in, where they work, and where they retire."

Notably, Hesta also appreciate that there is a limit to engagement and agree with the notion that engagement without the potential sanction of divestment is just nagging.

"Divestment is always a tool that investors like HESTA have if you believe that you cannot make any more progress." said Blakey.

Crucially, that means recognising when time is up, and in some cases, it can be a long process, "There may be a point where investors need to divest where progress cannot be made."

As has been the experience for other responsible investors, there are often knock-on benefits where decisive action can have a galvanizing impact on other engagement activity.

For Hesta, this meant that over the six months from that previous divestment, "Our engagement with other organisations became more effective – for example, with Rio Tinto over the Juukan Gorge controversy. Past action had 'shown our metal' so we were able to get traction and engage with impact … partly because it was on the table that divestment was part of our escalation process."

Part of the challenge for asset owners is the increasing levels of complexity in ESG issues and therefore the skill required to recognise delay, deflection and greenwash. For instance, decarbonisation and transition are a massive challenge without a 'one size fits all' pathway.

Blakey noted,

"We all support this transition to a low carbon future.

We want it to be just, orderly and fair. Which means understanding the transition pathways of our assets and companies we own."

https://www.investmentmagazine.com.au/2022/06/hesta-grabs-the-green-limelight-with-opposition-to-agl-demerger/
https://www.afr.com/wealth/investing/agl-stoush-may-change-australian-ethical-s-mind-on-fossil-fuels-20221108-p5bwcx
https://www.abc.net.au/news/2023-03-13/australian-ethical-divests-lendlease-koala-corridors-gilead/102086068

Impact through direct investment

The ground-breaking ingredient in the landmark AGL shareholder activism was other impact investors taking a high-profile role in gathering capital, acquiring shares, and publicly advocating for change. A group of impact investors, with a relevant interest in more than $50m worth of AGL shares (representing around 5 per cent of AGL), released a blueprint – One AGL: From Laggard to Leader – written by energy research think tank, Climate Energy Finance (CEF) for the Sentient Impact Group led by Oliver Yates, former Chief Executive Officer of Clean Energy Finance Corporation (CEFC).

Tim Buckley, Director of CEF, nominated a range of strategic recommendations – all of which were to a large degree eventually adopted – to address AGL's declining core business and governance issues while seizing the opportunity to lead the energy transition for Australia.

Buckley also sees nuance in the engagement versus divestment dilemma for responsible investors.

"It's not just about divestment versus engagement anymore. Strategic impact investors can be pivotal. What's more, premature divestment by otherwise like-minded owners can leave you friendless amongst owners voting on a fundamental sustainability issue," he said.

Finding interested impact investment allies on a global scale isn't all that hard, it turns out. Members of the Finance Alliance for Net Zero, the industry-led, UN-convened banking alliance made up of a global group of banks representing more than 40 per cent of global banking assets, were specifically looking for this kind of opportunity.

"Members such as the World Bank and the Asian Development Bank had all been working on the idea of buying out and retiring early suitable coal fired power plants across the developing world."

The big question was, how do you prove if you go and buy and close a coal fired power plant you don't just have another one pop up next door?

One way to get confidence is to have a relevant government that is a signatory of Powering Past Coal Alliance – an initiative founded by the UK and Canadian Governments and now spanning 167 national and sub-national governments, businesses, and organisations. In the absence of that, increasingly, impact investors are prepared to back market forces. If you have firmed renewable capacity ready ahead of closure, then you don't need a formal government pledge.

The argument in this case is simple. Once renewables are operational, you're approaching zero marginal cost of operation and will always win. Who's going to build another coal fired power plant when it can't compete with a ready to deploy solar or wind project? Buckley believes state renewable energy policies are key in this regard.

"All of their renewable energy hubs, renewable energy zones and grid connectivity is key."

Given the preponderance of retail investors on the AGL share register, it was never a likely prospect that impact investors could gather a majority or even an influential holding, especially if they were bidding against each other. The mass defection of institutional investors on financial and/or ESG grounds accelerated the retail dominance in share ownership. That meant that the task for effective investor impact in this case had an even higher degree of difficulty.

For Buckley the question became how to engage with retail. "One model is to have Self-Managed Super Funds (SMSF) sign over authority and let someone use the proxy for climate engagement."

While not going as far as securing delegated authority, proxy advisors proved to be influential as ISS and Glass Lewis recommended an influx of new, independent directors.

Of course, one notable part of the shareholder register that was all but impossible to engage with was index fund managers.

Buckley noted that, "Blackrock, Vanguard and State Street each owned circa. six or seven per cent."

"You've got to have a strong ESG lens to get a public commitment through your board in advance of a vote. Someone like Hesta were willing to sign on to something like that but there was no chance of getting a Vanguard to do it."

This adds an additional dimension to the broader efficient capital allocation question that has always surrounded passive investment.

In a situation where a company is edging towards a strategy that is widely judged to represent wanton value destruction with a climate bomb thrown in for good measure, where are passive investors (who collectively own 20 per cent of the equity)? Are they neglecting one of the obligations of active ownership? If so, does engagement compromise the idea of "neutrality" in investment decisions?

If informed engagement is a reasonable expectation, that also presents quite a challenge to the passive business model built on ultra-low fees. Having something worthwhile to contribute clearly requires a view that reflects experience, expertise, and contemporary research.

"Clearly there are a whole range of limitations with index investing when it comes to the efficiency of capital markets in general, but particularly when it comes to looking through an ESG lens," Buckley said.

"This is a constraint on the effective management of a customer's money, which I'm sure most people have never considered."

Proper engagement isn't the purview of the average portfolio manager or desk quant.

"Managers must be resourced properly so even if they cannot or will not divest, that doesn't preclude active management, active engagement and active ESG leadership."

In the case of Blackrock, when Larry Fink started to talk about this as a commitment, he had to double and then quadruple the number of relevant staff. And they need to be high quality, experienced people: hired to do that engagement, managing director level in many cases. Being listed on the New York Stock Exchange, Blackrock are answerable to their shareholders which is why they are ahead on this trend.

The Altius view

For Altius, the AGL experience really underlines our view that a 'one-size-fits-all' approach to the divest versus engage dilemma is unhelpful.

As a cash and fixed interest manager, we recognise that the equation is somewhat different for debt holders who don't get to nominate board members or vote on resolutions and remuneration recommendations. That means the bar for divestment tends to be lower for us.

Our orientation toward divestment is further reinforced by our specialisation as a sustainable investment manager. The Altius cash and fixed interest sustainability policy is integral to our responsible investment approach and is overseen by a Sustainability Advisory Committee with investor representation.

Transparency of investment holdings is also important, as is frequent reporting of engagement activities which we do by way of our annual impact report.

Risk management is another element in our considerations. In contrast to the tracking error headaches that equity managers face when excluding an industry or group of companies that are a big slice of their benchmark indices—the asymmetric risk profile of bonds supports exclusion given that investment capital is at risk and capital gains for idiosyncratic company performance are minimal.

We have also had positive experiences with engagement even when we aren't an investor. This has been the case with some of the local major trading banks, and some unlisted borrowers. As a rule, unless an organisation operates in an industry that is subject to a hard screen like gambling or fossil fuels, exclusion from a well-known sustainable fund isn't on their wish list.

Advocacy is also part of our responsibility to help the growth and development of a vibrant and trusted sustainable finance market. That includes private and public channels of feedback, through industry bodies such as Financial Services Council (FSC) and Investor Group on Climate Change (IGCC) or to regulators and government or through financial media.

Divestment is also often the only option when dealing with entities outside the listed equity markets such as governments and supranationals, although global investor demand and greater political support for dealing with ESG issues have improved engagement attitudes over recent years.

A nuanced approach to active ownership of debt and equity can be very effective in delivering leverage at multiple layers. It is entirely consistent for a responsible investment fund to seek engagement as a shareholder while simultaneously applying a divestment stance on the organisation's debt. In effect avoiding the nagging parent trap by impounding the car keys before escalating to a full grounding.

The advent of the strategic impact investor is a fascinating development and one that is sure to have alerted boards everywhere that unresolved ESG issues can be an existential threat to not only their company, their community, and their shareholder's wealth but their own tenure as well.

Bill Bovingdon, Chief Investment Officer, Cash and Fixed Interest

Bill has an enviable 33-year track record in fixed interest asset management.

Prior to co-founding Altius, Bill was the head of Australian fixed income and chief executive officer at Aberdeen Asset Management. He has also been head of fixed income for Schroder Investment Management and Deutsche Asset Management.

His achievements include building market leading fixed income businesses by overhauling investment processes and systems and developing investment staff.

Bill has a long working relationship with Senior Portfolio Managers Chris Dickman and Gavin Goodhand, formed over many years.

For more information on the Altius Green Bond Fund, please contact your financial adviser or our Investor Services Team.

australianunity.com.au/wealth
australianunitywealth@unitregistry.com.au

Investor Services
T 1300 997 774

Australian Unity
271 Spring Street,
Melbourne VIC 3000

Adviser Services
T 1300 997 774

AU0707_WC_221003