ESG integration in the long-term investment process

Speech to *Kanga News* conference

by

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[SLIDE 1: cover page]

Introduction and background.

Kia ora tatou.

First, a little background on the superfund, if only to head off the inevitable question about kiwisaver – you'd be surprised

[SLIDE 2: mission, mandate etc]

The New Zealand Superannuation Fund was set up to help meet the costs of universal super for future generations of New Zealanders.

We are focused on the long term, looking for investments that will deliver the best outcomes in 20 years and beyond.

Our legislative mandate requires us to use best practice portfolio management and to maximise the Fund's return over the long term, without undue risk.

The third leg of our mandate is to avoid prejudice to New Zealand's reputation as a responsible member of the world community.

In the 15 years since it was set up the Fund has returned more than 10% a year. That's a world class performance.

Our active investment strategies have beaten the market, adding $7.6 billion in value to the Fund beyond what a purely passive approach would have provided.

While we invest globally, as you'd expect, the Fund's presence here in New Zealand is substantial.

Over the past seven years the dollar value of our investments here in New Zealand has increased from $2.4 billion to over $6 billion – that's out of a total Fund size of $39billion.

The Fund's founding legislation has given us some significant advantages as an investor.

[SLIDE 3: advantages]

The Fund's outlook stretches well beyond the next political cycle, and the one after that, and the one after that.

We are operationally independent and commercial.

We have a known cash flow profile. We generally know how much the government will contribute, even though we have been through a period when contributions were suspended.

Most importantly, we know when the government will need to begin to draw on the Fund.

It is at mid-century that the demographic impost on New Zealand's superannuation payments will be at its heaviest. So not until the 2050's will we see sustained withdrawals from the fund.

These advantages give us the ability to hold our course, even when markets are down and times are challenging, where we have confidence that we will be paid for that over the long run

These advantages are highly relevant to the topic I'm focusing on today – *ESG integration in the long-term investment process.*

ESG and the Fund

So where does ESG fit in to how we think and act at the Fund?

How is it integrated in the investment process at the NZSF?

What have we learned in our first fifteen years?

Who, does this approach link us to? And why does that matter?

In my time today I won't exactly be skimming the surface of what is a very large topic, but neither will I have time to dive deeply into it.

We *will* have time for questions and answers, and for those of you wanting more detailed information I commend to you the Fund's recently published annual report, along with the wealth of speeches, white papers and other material freely available through the Fund's website – in those, we talk about things such as the empirical basis for our ESG belief, the framework we use to make responsible investment decisions, the activity we undertake in the responsible investment area, the discussions we've had with the Board on climate change, among many other topics.

This material is as insightful as it is voluminous.

Our beliefs

You have to start with what you care about.

The Fund's activity is deeply grounded in our beliefs, and in our long-term focus.

Our investment beliefs give us a bedrock, they give us discipline, and they give us fortitude in uncertain times – such as the global financial crisis of 10 years ago.

We believe that responsible investing is good for the portfolio. It can be a source of opportunities and a way to control risk.

RI is relevant to all three legs of our mandate, and we look to integrate RI considerations throughout our investment process.

Responsible investment means we must have concern for environmental, social and governance factors *because they are material to long-term returns*.

That's what we believe.

While ESG factors may be hard to quantify, we will benefit directly if they are considered in all our investment activities. But just because they are hard to quantify – sometimes you'll hear people call them "non-financial" factors – I don't buy that, by the way – doesn't make them any less relevant to investment outcomes.

We think about ESG factors when we consider portfolio construction, when we define investment opportunities, when we make decisions on which manager to use or stock to buy.

This integrated method is different from treating RI as an add-on that is factored in only after an investment decision is made, or included as a risk or as some separate piece of asset allocation.

At the Fund, it's built into our investment framework.

This view on ESG is not a radical one, but the understanding, application and importance of it here in New Zealand and around the world has grown hugely in the 15 years the Fund has existed.

[SLIDE 4: RI elements]

RI encompasses a spectrum of activity – including our approach to sustainable finance, and the practice of positive or 'impact' investment. It is not simply represented by the decisions we make on which stocks to exclude from our portfolio, although you would be excused for thinking that's it, based on the reporting those decisions generate.

The diagram on this slide depicts the various elements and interrelationships. If it looks like a somewhat crowded universe, that's because it is.

But it's one shaped by the motion of a few forces and some fundamental foundations.

The Fund's mission, mandate, endowments and beliefs are given central importance, for obvious reasons, and these elements shape the RI framework, including ESG.

These in turn link to a myriad of more detailed frameworks, policies, activities, investments, communications, and relationships, many of which I'll touch on in the time I have left today.

Let us count the ways: the benefits of ESG

It’s worth briefly thinking about the ways in which performance can improve through including ESG factors in investment and business decision making.

These are set out here and we discuss these effects, and the way in which we believe they improve corporate and investment performance in our white paper on ESG:

[SLIDE 5: ESG benefits]

The standards we apply

So, how do we take these factors and make this real in terms of how we invest?

Our approach is set out in the Fund’s RI framework, which has been an explicit part of our investment approach for many years, is published on our website and forms the basis for our RI reporting.

We are an international investor, and we need to take an international perspective.

That’s why the Fund is a founding signatory of the United Nations Principles for Responsible Investment.

The UNPRI lays out six principles of responsible investment. The core principles in terms of investment activity are ‘Integration’ – principle 1 - and ‘Ownership’, principle 2.

These principles feature prominently in the Fund’s external communications, including our latest annual report.

Integration: the Fund’s frameworks

Integration means that we incorporate responsible investment considerations in all aspects of our investment process.

We think about them when we are prioritising research into investment opportunities; we think about them when we are constructing our reference portfolio, which now includes climate change and category exclusions; we think about them when we are analysing a specific investment – what are the impacts on cash flows of ESG factors relevant to the industry we’re considering; we think about them when considering how to get exposure to a particular opportunity – doing it ourselves or through a manager; we think about them when we are choosing a manager; we think about them when we are choosing a stock or a bond and comparing price and value.

Integration of RI doesn't work if you put RI in a box – treating it as a discrete allocation or mandate, or requiring RI "sign-off" after you've chosen a manager. You'll have missed so much of the value available from RI.

'Integration' – principle one - leads naturally into 'Ownership' – Principle 2 – being an engaged owner. Under this principle, the responsible investor will consider exclusions and voting, among other activities.

We do have some ethical exclusions, and these are made in line with the laws of New Zealand, applicable international conventions and treaties and the policy of the New Zealand government. We exclude categories such as tobacco and nuclear explosive devices and some individual companies for significant breaches of standards and we have formed the view that engagement just won't be effective. These are a small, but important, part of our responsible investment activity.

Voting

Voting is an area in which we have evolved over the past year.

We reviewed our global voting policy, practice and execution. Following that review, we've taken responsibility for voting our global shares off our external investment managers, and brought the decision making in-house. How it will work is that our proxy voting agency, ISS, will manage all the votes in line with a customised voting policy that we've developed just for us.

One benefit of this is that it will ensure all our shares are being voted consistently and in line with our RI principles. In the review we saw examples where our external managers had taken different views on a vote – and so we were voting our shares against ourselves.

We continue to vote on our NZ holdings directly, as we have always done, and we will continue to engage closely with our external managers Devon and Mint, and company boards, in making our decisions here at home.

Very shortly, we plan to increase the level of information we provide about our voting activity on the Fund's website. This means people will be able to see how the Fund has voted on specific company resolutions.

Integration in practice

What does this integrated approach mean in practice?

Here are two examples, one local and one international

[SLIDE 6: farming imagery]

Farming

The Fund is a big farmer in New Zealand. We own 23 dairy farms, 2 beef farms and a vineyard.

Our balance sheet and long-term investment horizon gives us the ability to invest in top quality farm infrastructure and systems.

We use a company called FarmRight to run these operations, and FarmRight does so by adopting stringent, industry-leading, environmental, animal welfare, health and safety, and other standards that we set and monitor performance against.

We have trialed innovative approaches, such as an app called SenseMaker, to boost our understanding and management of health and safety risks, including mental health, on farms.

We've deployed significant capital for water and effluent management, fencing-off of waterways, and chemical storage and handling facilities.

These farming operations are financially sound investments too. We simply would not have taken these stakes otherwise.

A catalyst

Our ESG requirements often act as a catalyst for good practice by managers and companies. They provide a strong message of support from the asset owner to do the "right thing".

We have seen situations where managers' incentives can encourage short term thinking – reducing investment in sustainable practices to enhance short term manager returns, contrary to the interests of the ultimate owner. We can focus our managers in these operations on longer term outcomes for us as an investor, which may involve some capital investment now, to increase value in the long run.

Our farms and forests have been a powerful example of the convergence between the Fund's endowments and beliefs, our approach to Responsible Investment, and a rigorous financial assessment to making our investments.

Let me give a further example.

Lanzatech

[SLIDE 7: Lanzatech imagery]

The Fund is a cornerstone investor in Lanzatech, a carbon recycling company founded in New Zealand which is now headquartered in the US.

Lanzatech's technology uses bacteria to convert waste gases into high-value fuels and chemicals - literally turning pollution into biofuel.

The company is now operating its first commercial plant with Shougang Group in China and its jet fuel recently powered a commercial flight by Virgin Air.

Lanzatech represents integration of RI at the opportunity prioritisation stage – the positive tailwind from the global transition to a low carbon economy is a key driver of the attractiveness of the opportunity. Combined with our long horizon and ability to provide support over a long horizon, this means we can help rapidly growing companies such as Lanzatech through the challenging pre-IPO growth phase, to take advantage of that tailwind.

[SLIDE 8: Wider perspectives]

Climate change strategy and approaches

The profoundly important issue of climate change, which Mark Carney, Governor of the Bank of England, has described as "a tragedy of the horizon", certainly brings the 'E' in ESG to the fore.

It's a topic we have communicated on extensively, and again I refer you to material we've already made public on our website.

For the world, climate change represents a classic market failure – this generation is using natural capital to produce financial capital when the future generations will need both to survive and thrive.

For investors, climate change represents very real risks and opportunities as asset classes readjust to the changes in technology and regulation from a transition to a low carbon economy, overlaid with acute and chronic weather conditions creating major physical risks.

this creates many questions:

What is our exposure to these risks now?

Carbon foot-printing – where do we start? What are we comparing?

Valuations – how do we incorporate climate risk in our hurdles and risk allocation?

What do we require of our external managers?

What's the impact of climate change issues on the Fund's active investment strategies?

We have thought about this very hard. And let's not pretend it's easy. I've created a climate change decision tree which is on our website to help articulate a process investors might use to arrive at an approach on climate change. You're welcome to take a look.

Carbon footprinting is complex. We are creating the analytical tools as we go.

The Fund has a climate change investment strategy in place. The goal is to have a portfolio that's more resilient to climate-related risks, with a target of reducing the carbon emission intensity of the Fund by 20% by 2020, and reducing carbon reserves by 40% over this same period as one of four legs of the strategy

In practice, this strategy means:

- Reducing exposure to fossil fuel reserves and carbon emissions;
- Incorporating climate change into the Fund's analysis and decision-making;
- Managing climate risks by being an active owner through voting and engagement; and
- Actively seeking new investment opportunities, for example in renewable energy and related areas – some examples of which I've already given.

A year and a half ago we sold passive holdings in around 300 companies to reduce our exposure to carbon intensive companies and to carbon reserves. Since then we have moved to decarbonise other parts of the portfolio.

Now we release the portfolio's carbon footprint at the end of each financial year. As at the end of June this year, carbon emissions intensity was nearly 19% lower and potential emissions from reserves were 32% lower relative to the original benchmark.

Green Bonds

Many of you will be aware from recent work published by the Climate Bonds Initiative and HSBC that this dimension of the international bond market is full of opportunity and fast-evolving.

It’s estimated the bond market for climate change solutions could be in the order of US$1 trillion. In fact, demand is outstripping supply in the green bond market but as supply grows there will be better opportunity for us to invest.

Ultimately, investment will depend on pricing and risk but green bonds are a very good fit with RI investment strategies seeking positive environmental impacts.

To the extent that they might provide a positive opportunity for the NZ Super Fund, we would be happy to invest in them and have done in a small way.

International links

The fifth of the UNPRI principles is collaboration. We all benefit when companies and investors properly account for ESG factors and we have been active in international and domestic forums on the subject.

Much has changed in the responsible investment area over the past five years. Viewpoints that might have been considered fringe have been brought to the centre – drivers have included increased awareness of the risks and effects of climate change, changes in the approach to fiduciary duty among them and increased focus on governance.

One of my colleagues has described it as a “quiet revolution” of policy, regulation, and initiatives - which in one way or another begins to address the interdependent nature of the financial, human, and natural capital systems.

At the Fund, we have collaborated in various ways to further this quiet revolution.

As I noted earlier, we are a founding signatory of the UNPRI.

We are a member of the One Planet Sovereign Wealth Fund Working Group, which has published a framework to promote the integration of climate change analysis in the management of large, long-term asset pools.

In this initiative, championed by French President Emmanuel Macron, the New Zealand Super Fund is influential. The working group members collectively manage more than $3 trillion in assets. It includes sovereign wealth funds from oil producing nations in the Middle East.

By using the Framework, SWFs and other asset owners can reinforce their long-term value creation, improve their risk-return profile, and increase long-term portfolio resilience by factoring and integrating climate issues into their decision-making.

We are very proud that the Fund's Head of RI Anne-Maree O'Connor has been appointed to the Financial Sector Commission on Modern Slavery and Human Trafficking, supported by the UN.

The Fund is one of the founders of the NZ Corporate Governance Forum, focused on lifting corporate governance standards for New Zealand issuers.

Additionally, the Fund is participating in the Aotearoa Circle, alongside a range of other private and public sector organisations. Our core belief is that sustainable prosperity comes through recognising the connection of people to nature and our responsibility to safeguard this for our *mokopuna* – our grandchildren and *their* descendants.

New Zealanders rightly treasure their natural environment and much of our economic and social well-being is connected to the land. Protection of our natural capital must become central to decision-making, whether you're running a primary sector business, a government department or a service industry.

As mentioned this morning by Westpac's Siobhan Toohill and Minister James Shaw, the Circle has formed a Sustainable Finance Forum.

I'm a co-chair of this Forum alongside Siobhan's colleague at Westpac, Karen Silk.

The aim of the forum is to identify genuine, practical ways to ensure the financial system is supporting and not hindering the very significant economic transition that will be needed if New Zealand is to meet its international commitments under the Paris Agreement and the UN's Sustainable Development Goals.

We need to reorient the New Zealand financial system so that capital flows, risk management and disclosures assimilate environmental and social factors as a means of promoting sustainable economic growth and the long-term stability of the financial system.

Summing up

It is important for the Fund to play its role in these and related areas.

Because of our core beliefs.

Because of our long-term horizon.

Because of what others can keep teaching us.

And the lessons we can share with others in turn.

And because of our commitments to New Zealand, as a very small, geographically isolated country with a huge investment (in every sense of the word) in the application of ESG and RI.

We've come a long way in 15 years, and our ESG practice and overall RI approach shows this.

This story is, I believe, an instructive one.

Thank you.