Australian National University

Guest speaker spotlight: Shaun O'Malley

Shaun O'Malley is General Manager Public and Private Markets at Spirit Super – an industry super fund. Shaun presented to the Fund about how the superannuation industry is incorporating Environmental, Social, and Governance (ESG) factors into investing. Shaun has 30 years of experience in investment markets, from working as an Equity Analyst at Investors Mutual to designing products in institutional banks such as the Commonwealth Bank of Australia. See below for a summary of the Q&A session with the SMF team.

To what extent do you expect the 'ESG-premium' on companies to continue over the short and long run?

Markets have recently priced ESG attractive companies at a price premium. A contributing factor is the unprecedented growth of IT companies and their lower inherent ESG risks that are greater in other industries. This also extends to many other growth stocks relative to their value peers, as such, investors have been rewarded for positive ESG credentials with higher returns, though is this just the value growth style rotation or something else. Whilst recent changes in market sentiment raise some doubt as to whether this pattern will persist, historical analysis nevertheless suggests that companies with a strong ESG profile have lower volatility over the long run.

As ESG risk mitigation increases and prices adjust, it will likely become harder over time to extract high returns as investors adjust to and accordingly price in ESG risks. ESG risks over time will longer be differentiable category but rather a normalised component of any investment analysis. Investors with long-term investment horizons will also have to be wary of future industry trends, changes, disruptions and changing social norms – which will inevitably reflect ESG risks.

You mentioned investing in low ESG rated companies, as long as the investor is aware of the risks. How should investors incorporate ESG risks into valuations and modelling?

One way to look at ESG is that these are simply risks that need to be considered and understood in the investment thesis. These risks can be modelled using scenario analysis, such as alternative prices for resources, and examine how these scenarios effect the valuation. As long as the ESG risks are properly understood and priced, investors can then make an informed decision as to the whether the balance of probabilities is favourable. Regarding mining, whilst everyone is moving towards a reduction in carbon footprint, there will still be a residual demand for fossil fuels where gaps in renewable technology and infrastructure remain. Investors need to form a view on how these competing issues weigh up against each other. An example would be a high quality, though short mine life, coal miner. Understanding the potential for a carbon price and the current demand profile for energy, it may actually make sense to invest.

Being cognisant of the issue of stranded assets and where potential value destruction lies is critical.

These issues will also depend on timeframes. Under dynamic asset allocation, investors have more flexibility to make asset moves to capitalise on short-term mispricing. However, longer-term investors with a set strategic position need to be aware that prices can fluctuate in either direction. Therefore, investors need to be aware of risks, but also consider the time frames over which they are expected to unfold.

Governance issues are more complicated. Consider CBA in the context of the Banking Royal Commission. The Commission showed that there are implications for misunderstanding these governance risks. Companies have lost significant value after it became public knowledge that CBA was subject to substantial fines. Nevertheless, it is difficult to predict governance failures and their outcomes. The best approach is to be cognisant of risks, price them in, and then look at the valuation. Ultimately, if you can still meet your investment hurdles, then it probably makes sense to still invest, however many investors in the ESG space, also invest with other objectives such as social or moral imperatives which would hold them back from investments.

The SMF is currently underweight resources, in part due to ESG and SRI considerations. Do you see any long-term ESG risks associated with the Australian resources sector that would warrant underweighting?

Issues relating to fossil fuels and the pricing of carbon are a major overhang for the resource sector. Investors need to measure the degree to which these issues are a risk for returns.

From a long-term perspective, metals and mining industries will have indisputable carbon issues. However, as economies become electrified, the need for green metals such as nickel, lithium and copper will continue. There are two sides to consider: the unabateable demand for resources and the environmental costs of emissions. So, whilst there are some risks in the resources sector, there are also some positives investors should be aware of. Both need to be considered in balance.

You mentioned the importance of taking 'a seat at the table' of companies to positively push them forward on ESG concerns. How successful has this been?

Having a seat at the table is very important from an ESG perspective. Spirit Super is a part of the group Climate Action 100+, an investor-led initiative that ensures the world's largest corporate greenhouse gas emitters take necessary action on climate change. The group has found collective engagement to be very important where companies are hesitant to move towards net zero or even disclose their carbon exposures. For example, BlueScope Steel initially had poor disclosure, but have since made steps in the right direction due to significant shareholder pressure. In these instances, having a 'seat at the table' can help push companies to disclose and make meaningful climate plans.

Divestment in comparison, whilst great for headlines, arguably has limited impact on the trajectory of the company. Many companies have already raised their required capital, either through equity markets or debt markets. ESG-motivated divestment merely transfers ownership to an investor that is arguably less likely to be engaged and may even support the company in avoiding climate action.

Prepared by Bella White (Relationship Officer)