Ethical Partners
FUNDS MANAGEMENT
Level 6, Johnsons Building,
36 Grosvenor Street, Sydney, NSW 2000
Ph: 02 8999 1228 www.ethicalpartners.com.au

Ethical Partners' Submission to the Australian Treasury's Consultation on Annual Superannuation Performance Test – Design Options

Superannuation Efficiency and Performance Unit
Retirement, Advice, and Investment Division
The Treasury
Via email: YFYS@treasury.gov.au

19 April 2024

To whom it may concern,

Ethical Partners Funds Management (**Ethical Partners**) thanks the Australian Treasury for the opportunity to comment on design options to improve the annual superannuation performance test (the **YFYS test**).

We welcome reforms to the YFYS test that would better enable active management and long-term, investment decisions, as well as support fund managers, like ourselves, to manage environmental, social and governance (**ESG**) risks and opportunities and invest for positive, real world sustainability outcomes in line with our clients' values.

The current YFYS test has had, in our view, clear and unintended detrimental consequences for driving capital towards a decarbonizing future, with performance tests driving investment towards the S&P/ASX 300 (the benchmark index) and those companies therein. Given that Australia's economy, in global terms, is a high per capita carbon emitter, its main listed equity market benchmark index has similar characteristics, and investment in the benchmark index therefore drives investment into potentially higher carbon emitting companies.

In our view the YFYS test has inadvertently constrained asset owners from allocating to and retaining mandates with active fund managers seeking to achieve decarbonization objectives by way of exclusions, ESG-integration, positive screening, and stewardship activities. We agree with Treasury's reflections that the YFYS test has encouraged short-term decision making, incentivised benchmark hugging, and discouraged active management. Additionally, it is clear to us that over a long-term time frame, the carbon intensive benchmark index carries an elevated level of stranded asset risk, regulatory risk, transition risk, and financial risk.

In short, our key recommendations are that:

- The reform principles be amended to better reflect the need for the YFYS test to enable and support effective values-based or ESG-focused investing that delivers positive sustainability outcomes either through broadening the meaning of member outcomes or including an additional principle;
- The YFYS test be reformed to include an alternative fossil fuel free benchmark index for listed equities that is then used to measure the performance of asset owners with a credible climate or sustainability commitment and strategy.

Our detailed feedback and recommendations are set out further below.

About Ethical Partners Funds Management

Ethical Partners Funds Management is a boutique Australian Fund Manager, managing over $1.5 billion in ASX listed equities on behalf of large Australian super funds, schools, charities, foundations, and other investors who wish to have their money managed with a deeply integrated responsible investment approach.

Ethical Partners have a dual focus on performance and investing ethically. Our approach directly manages risk and identifies opportunities, provides the ability to invest in line with our clients' values, actively assesses the

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impact of our investments and engages and advocates for change. Further details about our investment approach and team can be found on our website here.

About this Consultation

In 2021 under the Your Future, Your Super reforms, the Australian Government introduced an annual superannuation performance test to address underperformance. Subsequent reviews have raised concerns about the unintended consequences of the YFYS test. Accordingly, on 8 March 2024, Treasury released a consultation paper proposing four broad reform options to improve the operation and outcomes of the YFYS test.

If you have questions or seek further information on this submission, please contact:

Nathan Parkin
Investment Director
[redacted]

Mayleah House
Head of Stewardship
[redacted]

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36 Grosvenor Street, Sydney, NSW 2000
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Feedback and Recommendations

1. Background: Consequences of the YFYS test

Ethical Partners recognises the importance of a superannuation system that has a purpose to deliver income for a dignified retirement in an equitable and sustainable way. To achieve this purpose and deliver a sustainable future, we firmly believe that there is important role for members' investments to be managed in a manner that both achieves appropriate risk-adjusted returns (including through accounting for ESG risks, opportunities, impacts and dependencies) and pursues positive changes in investments' impacts on real-world sustainability matters.

From our experience, however, the YFYS test has inadvertently constrained asset owners from allocating to and retaining mandates with active fund managers seeking to achieve these objectives by way of exclusions, ESG-integration, positive screening, and stewardship activities. We agree with Treasury's reflections that the YFYS test has encouraged short-term decision making, incentivised benchmark hugging, and discouraged active management. We further echo concerns that the YFYS test's benchmarks are misaligned with values-based investing and do not support ESG-focused investments.

Indeed, analysis by Mandala Partners has demonstrated that for ethical funds invested in Australian equities that exclude fossil fuels and gambling, their appropriate tracking error budget (i.e., 1%) is exhausted for the YFYS test's benchmark and their exclusions leave them unable to make strategic investment decisions without taking on unsustainable risks.[1]

At Ethical Partners, we actively manage mandates for asset owners and have done so both prior to and following the introduction of the YFYS test. Relevantly, we note that many of our current, former, and potential clients will set outright exclusions (e.g., tobacco production, weapons manufacturing) or revenue-based exclusions (e.g., companies with X% of revenue from fossil fuel or nuclear weapons production) on the funds we manage. In addition, clients are increasingly setting or considering setting a net zero target for their portfolio emissions.

Our investment process for mandates involves screening out companies that do not meet the relevant exclusions set by our clients and informed by our own due diligence. Additionally, to manage risk through our investment process and support our clients to achieve their targets, only ASX-listed stocks that have passed through our strict assessment of a company's balance sheet, operating cash flow and management assessment in addition to our proprietary in-house ESG assessment are selected and owned.

We undertake company based ESG assessments across our mandates to assess the level of risks and opportunities facing a company from external environmental and social factors as well as the risks and opportunities associated with a company's impacts on environmental and social matters. Often, we do not invest in certain large cap stocks by virtue of them breaching relevant standards or exclusions (e.g., Aristocrat Leisure Ltd, Woodside Petroleum Ltd).

Since inception, Ethical Partners' portfolio has broadly delivered consistently stable returns relative to benchmark. At times however, volatile cycles and economic shocks from the Ukraine-Russia war, have favoured both pure play and diversified fossil fuel companies, negatively impacting our performance relative to S&P/ASX300 Accumulation Index. We believe long-term, values-based investors who have no or limited exposure to pure play fossil fuel stocks are therefore being punished by the YFYS test, despite investing in a manner to address long-term, future risks.

The possible unintended consequence of YFYS performance tests is to limit investment managers' ability to deviate from the benchmark in constructing portfolios. Given the high weighting to fossil fuel companies in the

[1] Mandala (2023), *Superannuation and climate change: Better returns for a better climate* (p.9).

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S&P/ASX300 index (Energy is approximately a 5% weight) capital, by default, is being directed towards some companies whom we consider are still exposed to high risks given current environmental impacts, potential for stranded assets, and their lack of a credible transition plan. In our experience, the YFYS test does not assist asset owners and, therefore by extension, our ability to set science-based interim emissions reduction targets on mandates.

We firmly believe that these consequences of the YFYS test will inhibit long term, predominately superannuation capital from being invested in manner that supports Australia's economy to transition to net zero in line with the Government's own legislated targets and may undermine the purpose of the superannuation system to deliver a sustainable and dignified retirement for members within a stable financial system.

2. Reform principles

We welcome the reform options being underpinned by clear and transparent principles. Yet we are concerned that the current principles do not adequately reflect the need to address the YFYS test's constraints on benchmark hugging, short-termism, and ESG-focused investing.

Firstly, we support the principle to improve member outcomes *provided* this reflects the proposed purpose of the superannuation system. In this respect, we note that proposed principle does not reflect the full objective to achieve a dignified retirement in a "*equitable and sustainable way*." In addition, we firmly believe that a dignified retirement includes both the delivery of an adequate pension and also requires stable and healthy environmental, social, and financial systems (which in turn contributes to portfolio performance).[2] We are concerned that this is not currently reflected in the proposed principles and instead an unnecessarily narrow approach to member outcomes has been taken.

Modelling demonstrates that unmitigated climate change will have profound financial consequences that will impact today's superannuation members.[3] For example, Deloitte Access Economics estimates that a current 3°C pathway would cause a $3.4 trillion loss in GDP and 880,000 job loss by 2070.[4] Emerging research suggests these findings oversimplify the fact that commodity shocks will be simultaneously experienced regionally creating currently underestimated financial implications.[5]

Further, according to the IPCC's 6th assessment, increased changes to the climate system are expected with a continued rise in greenhouse gas emissions and this is highly likely to contribute to unprecedented extreme weather events.[6] Additional analysis has shown that by 2050, climate-induced impacts will likely cause an additional 14.5 million deaths globally (with 8.5 million attributes to floods and 3.2 million linked to droughts and extreme heat). Adverse health outcomes associated with these climate events include, for example, infectious diseases, malnutrition, mental health impacts, respiratory diseases, and cardiovascular disease.[7] These concerning environmental and social impacts may affect many of today's superannuation members that are set retire in 2050 or beyond.

Accordingly, we believe a dignified retirement supported by both financial and social prosperity cannot be achieved without systemic climate mitigation and adaption driven by governments and all sectors across industry, including asset owners and their investment managers. This therefore requires the superannuation

[2] Frederick Alexander, 'The Benefit Stance: Responsible Ownership in the Twenty-First Century' (2020) 36(2) *Oxford Review of Economic Policy* 341; Principles for Responsible Investment (2022), *A Legal Framework for Impact: Australia*.
[3] Climate Council (2019), *Compound Costs: How Climate Change is Damaging Australia's Economy*; University of Melbourne (2021), *Australia's Clean Economy Future: Costs and Benefits*.
[4] Deloitte (2020), *A New Choice: Australia's Climate for Growth*.
[5] Dr Timothy Neal, 'Some Economists have Severely Underestimated Financial Hit from Climate Change,' *UNSW* (2023).
[6] IPCC (2021), "Summary for Policymakers" in *Climate Change 2021: The Physical Science Basis. Contribution of Working Group I to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change*.
[7] World Economic Forum (January 2024), *Quantifying the Impact of Climate Change on Human Health*.

framework, including the YFYS test, to be underpinned by clear principles that encourage and support the superannuation system to deliver appropriate returns for members and shape sustainability outcomes.[8]

We therefore recommend that:

- **the term "*member outcomes*" reflected in the principles herein (and more broadly across the superannuation framework) include the pursuit and achievement of positive sustainability outcomes (e.g., actual reductions in stocks' emissions or improvements in their broader environmental and human rights impacts) alongside other metrics; and/or**

- **an additional principle be included that reflects the need for the YFYS test to enable and support effective values-based or ESG-focused investing across all asset classes.**

3. Reform Options

Respectfully, we believe that proposed reform options will not overcome stakeholder concerns around benchmark hugging, short-termism, and ESG constraints for listed equity investors as the options do not address the core issue contributing to these consequences: the S&P/ASX300 index.

As at 2 April, the S&P/ASX300 was comprised of 13 stocks with first derivative exposure to fossil fuel sale and production. Where this small number of volatile and cyclical stocks comprise 14.67% market weight, the YFYS test is systematically driving investment managers to buy or retain an investment in these stocks. This in turn allows fossil fuel companies virtually unfettered access to raise capital for growth strategies and projects misaligned with the Australian Government's own net zero and interim emission reduction targets.

In our view, which is shared by international pensions board the Church of England,[9] direct engagement with fossil fuel companies at this stage is insufficient to address the interests of diversified, long-term investors (i.e., achieving a 1.5 degree aligned transition) where the short-term, profits of those companies are driving decisions to expand fossil fuel projects or delay emission reduction strategies. Accordingly, capital should move away from these companies towards more sustainable stocks or those that are genuinely transitioning towards a net zero economy.

We therefore recommend that an alternative index (i.e., S&P/ASX300 excluding first derivative fossil fuel companies) be used to measure the performance of asset owners that can demonstrate a credible climate or sustainability commitment and strategy (e.g., they have an absolute financed emission reduction target and/or fossil fuel exclusions). The performance of these funds should then be compared and benchmarked against one another as opposed to those without such a commitment or strategy.

We believe that in doing so, asset owners with financed emission reduction targets will be better enabled to make strategic capital allocation decisions to achieve these targets thus minimizing the potential risk for greenwashing. Additionally, we believe these measures could enable more funds to set their own net zero or other interim emission reduction targets.

We would strongly encourage Treasury to ensure five yearly reviews of the reformed test to ensure there are no subsequent adverse consequences.

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[8] Principles for Responsible Investment, Generation Foundation, UNEP FI (2022), *Legal Framework for Impact: Australia*.
[9] Church of England (2023), *Church of England Pensions Board Disinvests from Shell and Remaining Oil and Gas Holdings*.

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Ethical Partners Funds Management sincerely thanks the Consultation for the opportunity to make a submission on this very important topic.

[redacted]

Nathan Parkin
Investment Director
Ethical Partners Funds Management