

Coming Into View: Environmental, Social and Governance Sustainability for Institutional Investors

N.A.J. Taylor (with Frances Magill)

INTRODUCTION

Investment markets cause myopia; the institutional structure of the investment markets is such that many participants focus dangerously on harvesting short-term gains and managing immediate risks, whilst being guided by a narrow set of financial indicators.

That's precisely what most institutional investors are *not* supposed to be doing. Asset owners, such as superannuation funds, are established to marshal the combined retirement savings of a large number of people with a broad range of needs. For example, Statewide Superannuation Trust invests two billion dollars on behalf of 170,000 South Australians who commonly have differing levels of income, risk appetites, time horizons (e.g. the amount of time to retirement), and so on. A similar set of demands drives the actions of every superannuation fund. But one thing is certain: of Australia's 11 million or so superannuants, 43 percent will not draw down their retirement savings for more than 30 years¹ – they are long-term investors, with long-term interests.

¹ APRA (2008), 'Annual Superannuation Bulletin', *Australian Prudential Regulation Authority Statistics*, June 2007.

Thankfully, this disconnect is all about to change. Sadly, it has taken the shock of a carbon-constrained world to alert the investment industry to a set of considerations that have evaded its view for some time: environmental, social and governance sustainability.² In this chapter we discuss how an 'interrelated web' of risks and opportunities arising from climate change is compelling the investment industry to consider a broader range of factors over a longer timeframe than has traditionally been the case – which, incidentally, is precisely what they *should* be doing.

A SIMPLIFIED TAXONOMY OF THE INVESTMENT INDUSTRY

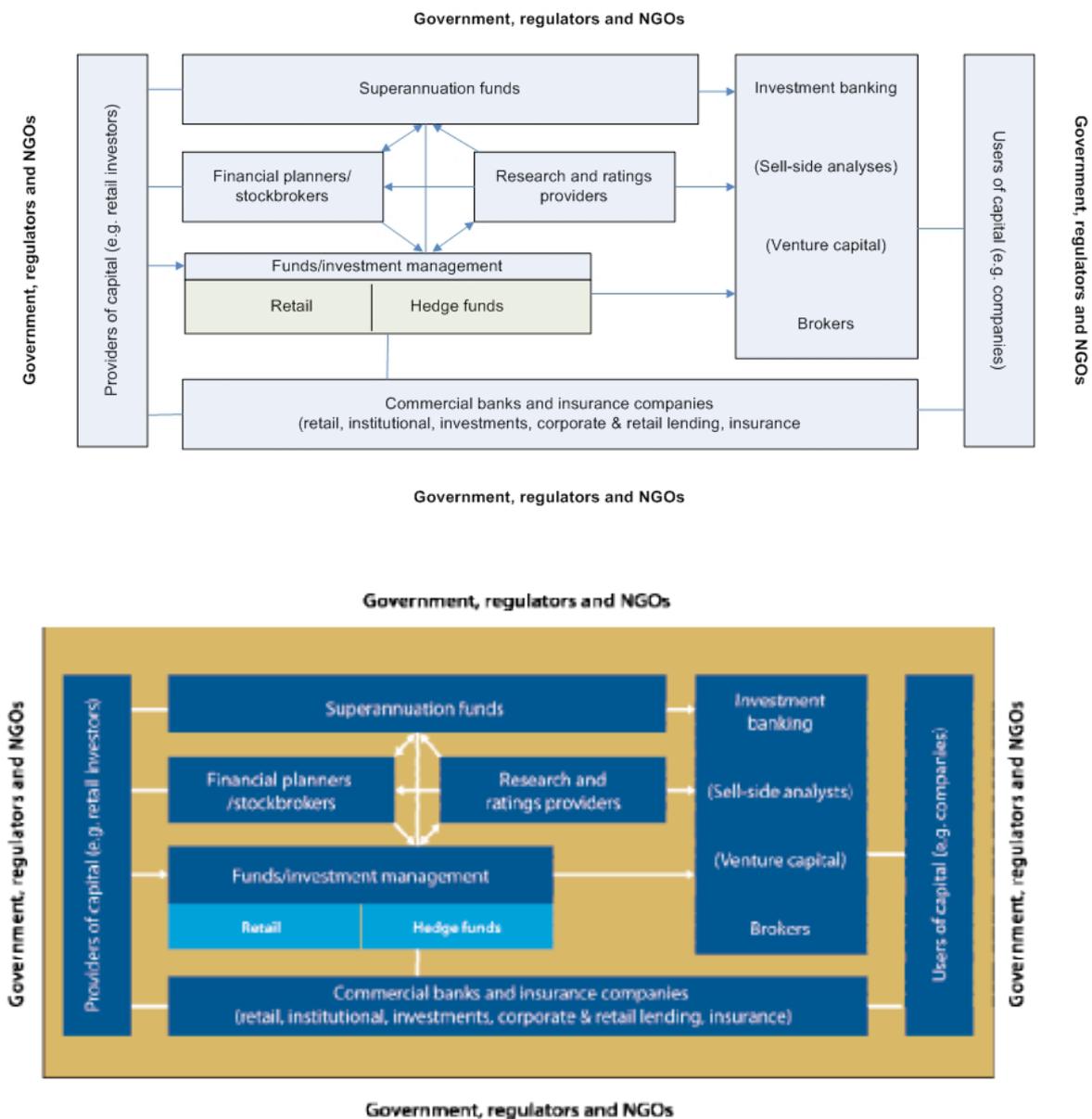
There is no single taxonomy that might accurately illustrate the operation of every institutional investor in the Australian market, since the degree to which a particular superannuation fund may delegate any number of its functions is highly individualised. For instance, some superannuation funds possess significant, internal investment teams which formulate their investment strategies and monitor performance of their investments, whereas others outsource much of their investment decision-making to external consultants. In addition, the Australian market is punctuated by collective, owner-directed organisations such as the Australian Council of Super Investors (ACSI) and Regnan, which serve functional requirements for a number of superannuation funds around corporate governance and (increasingly) sustainability. So rather than illustrate *the* exact workings of the

² Note that by investing according to economic rationality, 'sustainable investing' markedly differs from the values-based approach of either 'ethical' or 'negatively-screened socially responsible' investing.

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investment industry, with all of its nuances, our intention is to provide a simplified taxonomy that emphasises the institutional structure of the market for those who may be unfamiliar.

Chart 1: The institutional structure of the Australian investment industry



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Source: FINSIA (2008), 'Is the Financial Services Industry ready for Climate Change?', FINSIA and Griffith Business School, May 2008.

Superannuation funds safeguard and grow the retirement savings of millions of Australians by delegating a number of responsibilities to external providers and advisers. This commonly includes seeking the advice of an *asset consultant* on where and how to invest the total pool of assets of the superannuation fund in order to meet a predetermined liability or financial return objective. Upon that advice, *investment managers* are generally employed to invest that capital in particular asset classes, assets or geographic markets, such as Australian companies or global listed property. Throughout this process, both the institutional investor and their advisers call upon the services of specialist *information providers* for investment and governance data, stock broking reports, legal advice, and so forth. It is in part because of the competitive pressure to retain the services of institutional investors, such as superannuation funds, which drives much of the focus on short-term returns and investment strategies of the major participants we explained earlier.

Superannuation funds play a central role in the institutional investment market, delegating to advisers, information providers and investment managers. Hence it is most likely that superannuation funds which drive the acceptance of sustainable investment approaches in the investment industry through client-provider relationships, formal policies, dedicated sustainability meetings with providers and/or sustainability reporting requirements, investment manager mandates, and

so on.³ As such, Statewide has made sustainability its core strategy to transform its business to the changing environment, so that it may continue to deliver high levels of services and returns to members that endure over time.⁴ As more and more superannuation funds recognise the materiality of environmental, social and governance sustainability, the investment managers and specialist service providers will be asked to build upon their 'old' way of thinking.

THE OLD VIEW: MYOPIA IS IN THE 'BEST INTERESTS' OF MEMBERS

Historically, considering the environmental, social and governance sustainability of an investment has been disregarded by superannuation fund trustees as being a 'values-based' distraction from their fiduciary duty to act in the 'best interests' of their members. Trustees are further chastened by the fundamental principle of trust law that requires trustees to exercise their powers for a 'proper purpose', which in the context of the investment power, is clearly defined to be augmenting the value of the fund according to the requirements of its beneficiary members.

With an absence of any explicit reference to environmental, social and governance sustainability in Australian investment trust law, the courts have repeatedly ruled

³ See: ACSI (2007), 'Environmental, Social and Governance Guidelines: A Guide for Superannuation Trustees to consider Environmental, Social and Governance Issues in Investing', *Australian Council of Super Investors*, November 2007.

⁴ Frances Magill (2008), 'Vision for the future', speech to the *Committee for Economic Development of Australia*, June 2008.

against trustees who have made decisions based on 'non-financial'⁵ criteria. The burden of proof has been on demonstrating how sustainability may have a material impact on the value of an investment portfolio – an endeavour that is somewhat different to the prudence of sustainable business practices to an individual firm which is more widely accepted.⁶

Toward that aim, previous research effectively pushed-aside five 'rocks in the road' that are frequently cited as obstructing institutional investors from considering the environmental, social and governance sustainability of their investments.⁷ Adopting a meta-analytical approach to over 35 years of empirical studies,⁸ Taylor & Donald (2007) reasoned that sustainable investment approaches need not result in lower financial returns *nor* contradict the fiduciary duties of superannuation

⁵ The term 'non-financial' is used here with some precision as it is in the language of detractors of sustainable investing approaches. Given our belief in the materiality of environmental, social and governance sustainability factors, we will use the term 'extra-financial' throughout the rest of the paper.

⁶ Previous research by Taylor & Donald clearly distinguishes between 'firm-level' and 'portfolio-level' studies into the materiality of sustainable business practices and sustainable investing approaches, respectively. For a more detailed discussion, see: Nicholas Taylor & Scott Donald (2007), 'Sustainable Investing: Marrying sustainability concerns with the quest for financial returns for superannuation trustees', *Russell Research*, August 2007; and, Scott Donald & Nicholas Taylor (2008), 'Does "sustainable" investing compromise the obligations owed by superannuation trustees?', *Australian Business Law Review*, Vol. 36 Is. 1, February 2008.

⁷ See: Nicholas Taylor & Scott Donald (2007), 'Sustainable Investing: Marrying sustainability concerns with the quest for financial returns for superannuation trustees', *Russell Research*, August 2007.

⁸ Given the recent development of sustainable investment approaches, the vast majority of studies cited by Taylor & Donald refer to 'ethical' or 'negatively-screened socially responsible' investment approaches – a point that we expect only downplays the prudence of sustainable investing approaches to the performance of an investment portfolio.

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trustees,⁹ and that ultimately "the way is open for superannuation trustees to embrace a more positive approach to sustainable investing".

THE PARADIGM SHIFT: SUSTAINABILITY IS COMING INTO VIEW

The success of this 'new' thinking has been its grounding in economic rationality; environmental, social and governance sustainability factors help better identify and manage a broader range of risks and opportunities over a longer timeframe. The consideration of sustainability factors should be seen as a complement to the current focus on short-term financial evaluation criteria, not as a process that distracts or conflicts with them.

Without question, the single issue of climate change, and in particular the pricing of carbon emissions, has resulted in a paradigm shift throughout the entire investment industry. Responding to scientific and public pressure towards climate change, there has been a recent spate of Australian broker and investment management research into the materiality of climate change and in particular carbon pricing.¹⁰

⁹ Others take this point further, arguing that investors must consider the financial return on investment *as well as* the carbon emissions (environmental) and job creation (social) that is derived from those investments. See: Pictet (2008), 'The SRI Performance Paradox', *Pictet Research*, May 2008.

¹⁰ For instance, see: AMP (2005), 'Climate Change and Company Value: A guide for company analysts', AMP Research, November 2005. Carbon Disclosure Project (2007), 'Carbon Disclosure Project Report: Australia & New Zealand', *Investor Group on Climate Change*, October 2007. Elaine Prior (2006), 'Climate Change and the ASX100: An assessment of risks and opportunities', *Citigroup Australia/NZ Equity Strategy*, November 2006. IGCC (2007), 'Potential Earnings Impacts from Climate Change: Steel Sector, Collaborative Research of IGCC, Goldman Sachs JBWere, and Monash Sustainability Enterprises, November 2007

This development is further enlightening many investment professionals to the extent to which 'extra-financial' factors such as social and governance sustainability may impact investment performance. For instance, some argue up to 75 percent of a company's value is bound-up in 'intangibles' such as corporate governance, quality of management, and reputation.¹¹ At present, some of the most pressing investment issues relating to sustainability are:

- Environmental: carbon management, climate change impacts, energy reliance and water sourcing.
- Social: lending practices, human and labour rights and human capital management.
- Governance: materiality of supply chain management, board structure, executive remuneration and shareholder rights.

Whilst this 'new' way of investment thinking is not yet enshrined in statute, successive governments and governmental bodies have made rather pointed public statements that broadly support sustainable investing approaches. For instance, in June 2006 a Joint Parliamentary Committee concluded that:

"In the committee's view, consideration of social and environmental responsibility is in fact so far bound up in long-term financial

¹¹ AMP Capital Investors (2006), 'SRI Managers continue to beat the benchmark', *AMP SRI Research Update*, June 2006.

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success that a superannuation trustee would be closer to breaching the sole purpose test by ignoring corporate responsibility".¹²

In July 2008, following a similar statement, Senator Nick Sherry, Minister for Superannuation & Corporate Law, left a gathering of institutional investors with little doubt as to the Labor Government's view when he declared:

"The development of carbon pricing presents a stark example of how extra-financial factors, traditionally kept off balance sheet, can become real risks for business... and investors".¹³

The recognition of environmental, social and governance sustainability by the investment industry is an important part of the overall strategy to combat climate change. With the Australian Government working towards the introduction of a national Carbon Pollution Reduction Scheme by 2010, a reconfiguration of the corporate and investment regulatory environment (sic) appears imminent; corporate environmental reporting is key to any national carbon-pricing scheme, and the investment markets would heighten any schemes effectiveness by recognising sustainability drivers in their decision-making processes, as well as further influencing corporate strategy and competitiveness.¹⁴

¹² Parliamentary Joint Committee on Corporations and Financial Services (2006), 'Corporation responsibility: managing risk and creating value', *Commonwealth of Australia*, June 2006.

¹³ Sherry, N. (2008), 'Environmental, Social and Governance Issues': *Address to the Goldman Sachs JBWere Superannuation Forum*, Melbourne, 4 July 2008.

¹⁴ For a discussion of the significant role that 'external' investment markets play in promoting competitive business practices, see: Michael Porter (1992), 'Capital Disadvantage: America's Failing Capital Investment System', *Harvard Business Review*, September/October 1992.

THE FAR-REACHING INFLUENCE OF AUSTRALIAN SUPERANNUATION FUNDS

At \$1.4 trillion, Australia's institutional investment market is the fourth largest in the world. Superannuation funds, such as Statewide Superannuation Trust, collectively marshal over \$1.1 trillion, or around 75 percent of that market. What's more, this dominance of the Australian investment industry is all but 'guaranteed'; the Reserve Bank of Australia estimates total superannuation assets to reach \$2.5 trillion by 2015 as a result of nine percent superannuation guarantee contributions and forecasted positive investment returns (which can either erode or add to the total pool).

Given the sheer quantum invested by super funds, Senator Nick Sherry, who presides over the corporate and superannuation regulatory framework that will be integral to an effective carbon pollution reduction scheme, is of the view that:

"Super funds have both the capacity and the occasion to exert direct and substantial influence over the operations of listed companies. This gives institutional investors the capacity to influence corporation's approaches to corporate social responsibility including the management of non-financial risk".¹⁵

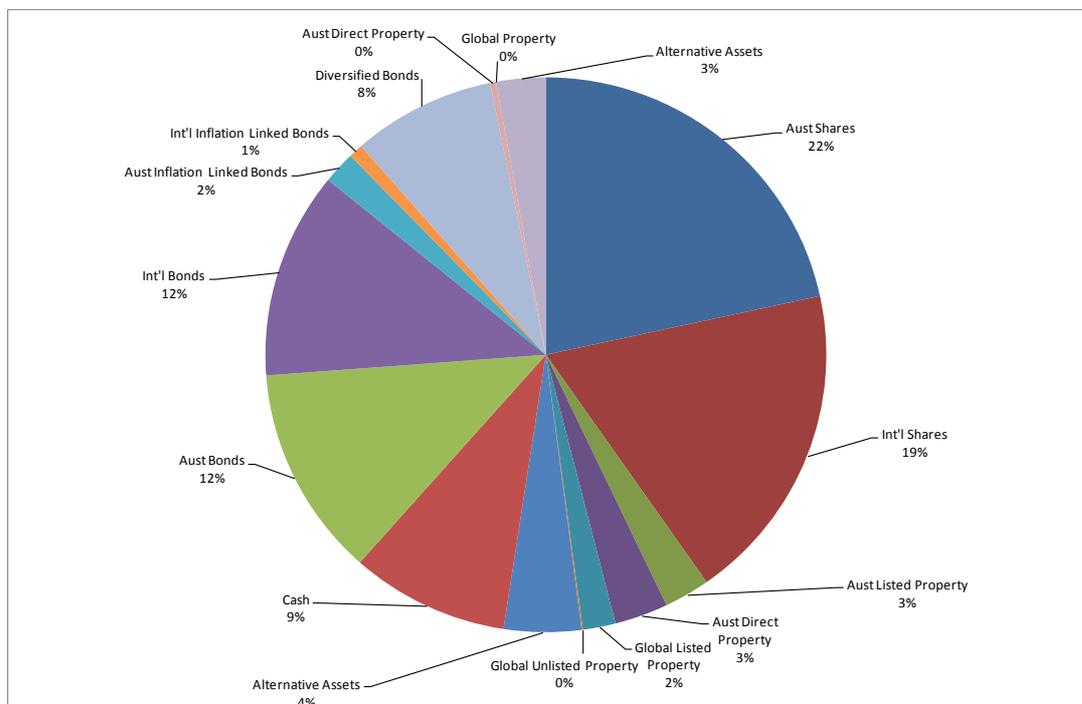
However, superannuation funds do not just invest in or influence the behaviour of listed corporations such as Westpac, Telstra and BHP Billiton. As is illustrated in

¹⁵ Senator Nick Sherry (2008), 'Environmental, Social and Governance Issues': Address to the *Goldman Sachs JBWere Superannuation Forum*, Melbourne, 4 July 2008.

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Chart 2, the average superannuation fund invests around 60 percent of its capital in other assets such as listed and unlisted property, government and corporate bonds, and infrastructure. Superannuation funds therefore have both significant *weight* of capital as well as a considerable *breadth* of influence.

Chart 2: An indicative asset allocation of Australian superannuation funds



Source: Chant West (2007), 'Strategic Asset Allocation Survey: Balanced Fund', December 2007.

A CARBON-CONSTRAINED INVESTMENT INDUSTRY: AN INTERRELATED WEB OF RISKS AND OPPORTUNITIES

With a significant range of interests comes an 'interrelated web' of considerations. The diverse range of holdings of superannuation funds greatly extends the climate-related risks and opportunities open to it, as well as adding to the complexity and

interrelationship between different assets over different time periods. For example, the construction of an airport that is funded from an institutional investor's portfolio might harm the environment to the detriment of an agricultural investment today whilst boosting the profitability of another holding which relies on regional tourism tomorrow. Others take the argument further still, believing that by holding a broad cross-section of the entire economy for long periods, superannuation funds are essentially 'universal owners'; susceptible to the financial performance of individual assets *as well as* the performance of the economy as a whole.¹⁶

Arguably no investment decisions are immune from the affects of climate change over the long-term. Whilst the impact of climate change on companies bottom-lines is most widely debated, physical assets such as property and infrastructure are significantly exposed to climate change-related risks and opportunities. For instance, the effective environmental management of property assets is becoming increasingly linked to long-term investment performance. Evidence suggests that superior environmental performance improves:

- a. Investment value: attracting and retaining key tenants and customers, preserving rent and capitalisation rates, and ensuring access to capital
- b. Investment risk: ensuring effective risk management practices around building lifecycles, energy efficiency and tenant churn.¹⁷

¹⁶ Bob Monks & Nell Minnow (1995), 'Corporate Governance', *Cambridge University Press*.

¹⁷ Drapac (2008), 'Property and the UNPRI... the emerging frontier', presentation given at the Conference of Major Super Funds, *Australian Institute of Super Trustees*, March 2008.

In addition, the exposure of institutional investors to property is unique; the risks associated with property assets not only include direct property investments, but also risk exposure to property through its reliance in the operation of almost all major businesses and facilities as well as listed property trusts in share portfolios.

In order to demonstrate the complexity and interrelated nature of climate change to an institutional investor, we now briefly introduce five core risks:¹⁸

Regulatory risk

Despite the Australian Carbon Pollution Reduction Scheme now tabled to come into effect in 2010 for most industries (agriculture will be 2012), uncertainty remains over the precise features of the scheme, which are required to model the extent to which it may impact either investment value and risk. With a global framework following the Kyoto Protocol not scheduled for discussion until late-2009, it will be some time before investors may feel comfortable with the regulatory environment covering greenhouse gas emissions.

For instance, the national Carbon Pollution Reduction Scheme will negatively impact companies reliant on industrial processes involving unavoidably high levels of greenhouse emissions (e.g. cement production) as well as those which are energy intensive (e.g. steel production) but positively impact firms able to grandfather their existing emissions and obtain large reductions (e.g. innovation and process improvements) and 'green energy' innovations (e.g. access to capital).

¹⁸ IGCC (2005), 'A climate for change: A trustee's guide to understanding and addressing climate risk', *Investor Group on Climate Change Australia/New Zealand and Carbon Trust*, October 2005.

Physical risk

Property and infrastructure investments are most susceptible to physical damage from extreme weather events. As noted above, an often forgotten exposure of nearly *all* businesses to property assets extends the issues relating to the 'property sector' to other sectors such as 'retail & consumer discretionary' which rely on factories and outlets to manufacture and trade. Additional risks associated with food shortages, urbanisation and mass human migration further add to the complexity of physical risks to investors – especially in emerging markets.

For instance, extreme weather events may negatively impact insurance companies (e.g. increased number and scale of claims) and infrastructure assets (e.g. loss of value) but positively impact construction (e.g. new facilities) and engineering services companies (e.g. mitigation planning).

Litigation risk

In time, the legal and regulatory framework is expected to ensure individual companies (and directors) and physical assets are liable for managing and reporting on their environmental performance. Litigation against non-complying or miscreant responsible entities is an imperative measure to increase investor confidence in any scheme, as well as to ensure compliance is rewarded.

For instance, penalties associated with the National Greenhouse Emissions Reporting (NGERs) framework may negatively impact engineering service companies (e.g. compliance and training) and companies with complex emissions calculations (e.g. transportation and logistics firms) but positively impact

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environmental reporting consultants (e.g. carbon baseline assessment) as well as lawyers and auditors (e.g. to fulfil regulatory and compliance requirements).

Competitiveness risk

There is already significant peer and international competitiveness implications for firms with poorly designed and implemented environmental management strategies to address climate-related risks. Any Australian-based standards and initiatives need to be constantly assessed against leading practice in order to retain competitive advantage and/or not unduly hinder local firms in competing with unconstrained imports or exploiting export markets. The key for firms using these initiatives is to measure environmental performance to ensure they remain well-placed internationally.

For instance, local firms who are unable to adequately adapt to a carbon-constrained world risk losing international competitiveness (e.g. automotive manufacturing) whereas it is the timing of any reduction scheme that is most imperative to other industries (e.g. agriculture).

Reputational risk

Public perception and communication in regard to environmental performance is becoming a significant determinant of company value. Products and processes which negatively impact on the environment, in some instances accounting for only a fraction of the global problem, are coming under increased public pressure from consumer groups, NGOs and the media. To what extent that will translate into

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shareholder value relative to the other risks is as yet uncertain, although as with competitiveness risk, it only looks set to increase over the near-term.

For instance, marketing claims of carbon neutrality might have short-term, short-lived benefits, whereas a carbon management strategy that first seeks to minimise carbon emissions is likely to be more sustainable over the long-term.

This summary is by no means exhaustive as the risks and opportunities associated with climate change are diverse and numerous. Institutional investors, with significant interests across the entire economy and in various markets, are particularly exposed to an 'interrelated web' of costs and benefits. In our view, navigating this web serves the 'best interests' of members by proactively recognising the financial implications of economic activity over a broader range of factors and longer timeframe than traditional investment approaches. Thankfully, there are an increasing number of organisations to assist institutional investors looking to implement a sustainable investing approach.

REPORT ON PROGRESS

The paradigm shift that we've been describing (and further predicting) might become more clearly evident by evaluating the investment industry's progress in considering the materiality of environmental, social and governance sustainability of their investment decisions.

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To facilitate the mainstreaming of a 'principles-based' view of sustainable investing, a small number of civil society and non-profit organisations have been established. Broadly speaking, these organisations fall into one of four categories: *frameworks, information gathering, representation & engagement, and research & development*. We now turn to profile some of the key organisations across each of these categories:

Frameworks

The United Nations Principles for Responsible Investment (UN Principles) represents signatories with over \$16 trillion in assets that publicly recognise the materiality of sustainable investing approaches. As part of the UN Principles, signatories commit to implementing a series of six aspirational principles regarding the materiality of environmental, social and governance factors.

Chart 3 illustrates

the rapid acceptance of environmental, social and governance sustainability to the investment industry, as measured by the total assets working toward sustainable investing approaches via the UN Principles.

Chart 3: Signatories to the UN Principles (by assets and number)

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The Carbon Disclosure Project (CDP) requests information on the business risks and opportunities presented by climate change and greenhouse gas emissions data from the largest 3000 listed companies around the world on behalf of institutional investors with more than \$57 trillion in assets. Signatories are then able to access company-level data as part of their investment decision-making processes, and more general information is made publicly available. Other reporting frameworks include the Global Reporting Initiative (GRI) and the UN Global Compact as well as a number of sector, national and global indexes.

Representation & Engagement

Organisations such as the Investor Group on Climate Change (Australia/New Zealand) and the Australian Council of Super Investors serve to extend the

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investment industry's knowledge and engagement on environmental, social and corporate governance (ESG) sustainability. For instance, Statewide Superannuation Trust is a member of both the IGCC and ACSI, and has a policy of actively contributing to the promotion of sustainable investing approaches, as well as industry submissions on issues pertinent to its investments such as the Garnaut Climate Change Review.

Over time various regional organisations have been established in order to represent and educate the market on sustainable investing and other extra-financial approaches. In Australia, the Responsible Investment Association of Australasia (RIAA) – to which Statewide Superannuation Trust is also a member – enables individual investors to compare the products of different investment managers and superannuation funds, offers education materials to individuals and financial advisers, and reports annually on the level of funds under management in sustainable investing approaches.

Research & Development

Other organisations and networks solely focus on uncovering the materiality of environmental, social and governance sustainability, so as to better formulate practical and regulatory solutions to assist their mainstreaming in the investment industry. Examples include the Network for Sustainable Financial Markets (NSFM) and the Enhanced Analytics Initiative (EAI), which has recently folded into the UN Principles For Responsible Investment.

CONCLUSION: A CHALLENGE TO THE INVESTMENT INDUSTRY

Grounded in previous research into the economic rationality of sustainable investing approaches, we have shown how a carbon-constrained world is resulting in a farther-reaching paradigm shift within the investment industry in which the materiality of sustainability factors are 'coming into view'. In sum, we argued that sustainable investment approaches, by recognising a broader range of factors over a longer timeframe than has traditionally been the case, promise to better equip the investment industry to navigate the 'interrelated web' of risks and opportunities presented by climate change and other environmental, social and governance issues.

Superannuation funds, perhaps more than any other group of investors, must exert their significant influence over the functioning of the investment markets, as well as the economy as a whole in order to ensure the sustainability of their investments. Quite commonly, the institutional structure of the investment markets means that superannuation funds, as the 'owners' of the capital within the system, will increasingly demand that their asset consultants, investment managers and specialist service providers are considering the materiality of environmental, social and governance sustainability of their investment decisions.

Therein lies our challenge to the investment industry: for all participants, including the Government and regulators, to foster an environment (sic) that encourages the mainstreaming of sustainable investing approaches through

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continued collaboration and engagement between every stakeholder within the institutional investment industry.

We believe if we effectively meet this challenge, that 'sustainable' investment markets and institutions will ultimately serve the 'best interests' of superannuation fund members, as well as play a central role in the overall strategy to combat climate change.

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ABOUT THE AUTHORS

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Frances Magill is Chief Executive Officer of Statewide, a leading superannuation fund. Frances' commitment to her staff and the community has seen her appointed to the Premier's Council for Women ensuring that women's issues are on the agenda for Government policy and planning.

Frances is a member of many industry associations and a Paul Harris Fellow. Frances is also the holder of the title 2000 Telstra South Australian Business Woman of the Year and was awarded the Centenary Medal for Services to the Community and Statewide. In 2006 Frances received the SA Great South Australian of the Year Business Award.

Nicholas Taylor

Nicholas formed Outcrop to offer independent advice and bespoke research on environmental, social and economic issues following more than seven years in the investment industry.

In 2007, Nicholas won the inaugural 'Environmental, Social & Governance Research' award at the Australian Sustainability Awards. He now serves as an active member of various networks and associations, including the Network for

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**Sustainable Financial Markets and the United Nations Environmental Programme
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