



# **Trustees: the new corporate cops?**

**By Trish Power**

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**Level 19  
Piccadilly Tower  
133 Castlereagh St  
Sydney NSW 2000**

**PO Box 1485  
Sydney NSW 1005  
Tel: (02) 9264 9300  
Fax: (02) 9264 8824**

**The Association of Superannuation Funds of Australia Limited** ABN 29 002 786 290 ACN 002 786 290  
**ASFA Website: [www.superannuation.asn.au](http://www.superannuation.asn.au)**

## **Trustees: the new corporate cops?**

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Superannuation trustees have a responsibility to their members to take an interest in the risks facing the companies they invest in. For funds like PSS and CSS, these days its all about corporate engagement.

As an individual investor, if you're not happy with a company's performance, you generally sell your shares in that company.

The decision is not as simple for major superannuation funds such as the Public Sector Scheme (PSS) and the Commonwealth Superannuation Scheme (CSS), which have more than 320,000 members and combined investment assets of approximately \$10 billion. They have a lot of money to invest and in relation to the Australian sharemarket, a relatively small number of companies to invest in, if they wish to maintain an appropriate level of diversification.

### **Engagement with companies**

The development of socially responsible investing (SRI) has seen various forms of SRI gain prominence. Interestingly, one of the most recent Australian developments is not strictly SRI, but what is better known as 'engagement with companies', or effectively a broader form of governance.

Rather than selling the shares in a company, a superannuation fund attempts to engage in dialogue with management if the company's social, environmental and governance practices fall below the fund's parameters. By monitoring investments in this way, it is hoped that the company's shareholder value will be maintained and have a favourable effect on members' returns.

In December 2001, the boards of the PSS and CSS schemes appointed Westpac Investment Management (now called Sagitta) to the role of primary governance adviser in relation to environmental, social and corporate governance, for its Australian share investments valued at \$A3 billion.

In the same announcement, the boards stated that they would systematically look at how companies within the funds' investment portfolios manage their environmental and social risks, and the effectiveness of each company's governance practices.

The trustees of PSS and CSS did not make the decision overnight. It was a thoroughly researched process over a two-year period, according to Steve Gibbs, chief executive officer of PSS and CSS. "The board first started looking at SRI about two years ago," he says. "We went through the whole process – cost versus return, fiduciary duties etc. History showed that SRI was not necessarily a cost to the fund but really depends on the style of SRI used."

Gibbs' definition of SRI is 'where social, environmental and corporate governance issues are determinative of whether an investment is made or not'

“What we’re doing is not SRI. For us it is a risk management process, not a prerequisite for selection. We think this is the best approach. Some of the things we are doing, fund managers are also doing but they are not doing it from the long-term perspective. We are hoping that what we do will become redundant because fund managers will start doing it for the long term,” he says.

### **Risk the determinant factor**

“We began with the premise that a trustee’s fiduciary duty was to maximise returns rather than investing in something that adds to costs,” Gibbs says. “Based on that premise, surely over time there is one investment strategy that all trustees will adopt. If that was the case why are there so many different strategies?”

“The missing factor was risk. Our fiduciary duty wasn’t about maximising returns at all costs; it was maximising returns with an acceptable level of risk subject to the profile of members. If you think about risk there a lot of forms – political, macro-economic, investment etc.,” he says.

“What we then said was, what about some of the other risks? For example, those normally associated with SRI. For example, potential future controls over greenhouse gas emissions, or whether a company will be subject to massive class actions, or penalties because of a mediocre occupational and safety record.”

### **Researching the risks**

Gibbs and the boards of PSS and CSS believe health, safety, environmental and community risks are bigger risks than financial risks. “We engaged Westpac Investment Management [Sagitta] to assess social, environmental and corporate governance from a risk perspective,” he says. “They have a sound understanding of governance risks, and expertise in researching the issue and the relationship between these risks and shareholder value.”

Erik Mather, Sagitta’s head of governance advisory, calls the PSS/CSS approach, “investment governance”. He says it has considerable correlation with SRI concepts: “Governance is the next stage in risk management and the future of investment management.”

“We have expanded our relationship with Monash University Sustainability Enterprises, which also has a long-term commitment to investment governance research. Sagitta provides an overlay service to PSS/CSS: we don’t touch the investment nor do we interfere with any fund management relationship,” says Mather.

According to Gibbs, PSS/CSS identified a list of 70 potential risks and prioritised down to an initial six. “Through Westpac and Monash we researched every company in the ASX200 and established whether each company was exposed to one or more of the six risks (see box) and if they were exposed, did they have an appropriate response to that risk?”

## **Dialogue action plan**

If a company didn't have an appropriate response, that is, there was a gap between exposure and response, PSS/CSS in conjunction with Sagitta, developed a dialogue action plan.

"We have three types of response. We respond at the policy level to government bodies, or if the sector is more exposed to the risk, we talk to the industry body, or we go directly to individual companies where it is a company-specific risk," says Mather.

"We're not about trying to run companies," says Gibbs. "We're not about micro-managing. If we think there is a risk to our investment, then we get involved. We're also not about screening and we don't eliminate the possibility of selling out of a company, but only in extreme circumstances.

"We only started in December 2001 so the process is young but the response so far has been excellent. We wrote to every company in the ASX200 to let them know about our governance initiative."

## **Audit governance**

"We have completed a dialogue action plan on audit governance and, to date, three companies will be changing their audit practices based on our dialogue with them," says Gibbs.

"Through our audit governance research we found that 14 companies in the ASX200 don't have an audit committee, while 25 companies (one-eighth of the ASX200) had an audit committee containing executives, and nine of the 200 had the chief financial officer on the audit committee! This is a real issue because the audit committee is supposed to be independently auditing the executives' work. These are serious corporate governance issues."

Gibbs believes that while there may be some concern with non-audit fees for the auditor, the biggest issue is that governance structures in place in companies are not adequate to ensure management of risk.

"Directors are ultimately responsible for the performance of the company and whether they are performing their duties and acting in the best interests of shareholders. On the other hand, superannuation trustees have a responsibility to their members to take an interest," he says.

"We have also made a commitment to vote on our shareholdings at every company's annual general meeting rather than abstaining. We have a fiduciary duty to vote our shares in the interests of our stakeholder.

"The long-term outcome we want is an overall improvement in practices and policies. Not monitoring the non-financial risks can lead to long-term deterioration of shareholder value; however, if the directors of companies aren't vigilant, there are some companies you can't prevent from falling over," says Gibbs.

## **Influence in numbers**

According to Gibbs, it is too early to tell if companies understand the process. "There does seem to be a number of companies with the view that they we are better off than

many other companies, but I don't agree. You need policies and controls in place," he says.

"We really have quite a way to go for best practice. We have taken up this process but we are open to other funds becoming part of the process. If we have ten funds involved we can do research split ten ways. We are approaching other funds and we are hopeful that by the end of the year we can announce that a number of other funds will be joining us."

### **PSS/CSS investment governance risks**

- *Audit governance* – e.g. ineffective management of conflict of interests
- *Environmental disclosure* - e.g. failure to manage environmental risks may trigger community alienation and government fines
- *Energy use* - i.e. manner in which an organisation manages its consumption of resources
- *Workplace safety* - e.g. difficulty attracting staff and negative publicity can damage the reputation of a business
- *Board composition* - i.e. board and management experience and diversity
- *Human rights in the supply chain* - mainly, clothing, footwear and textiles industries

PSS/CSS have released position papers based on research Sagitta and Monash have conducted into environmental and audit governance, with a position paper pending on workplace health and safety. These papers can be accessed on the PSS/CSS websites ([www.pss.gov.au](http://www.pss.gov.au), [www.css.gov.au](http://www.css.gov.au)).