IFM Investors Chief Executive David Neal's speech to the National Conference of the Governance Institute of Australia

TUESDAY 13 SEPTEMBER 2022

I'd like to begin by acknowledging the Wurundjeri people of the Kulin nation, Traditional Custodians of the land on which we meet today and pay my respects to their Elders past, present and emerging.

I extend that respect to Aboriginal and Torres Strait Islander people here today.

I also acknowledge:

- Pauline Vamos, President and Chair of the Governance Institute of Australia;
- And Megan Motto, Chief Executive, of the Governance Institute of Australia.

It's a privilege to be able to speak to the GIA. The work you do in supporting and training governance and risk management professionals is perhaps more important than ever.

It's also great to be here in-person addressing people here in the room. It's a sign that we are beginning to emerge from the pandemic. Much of the world has endured an incredibly difficult two years. I certainly don't class myself in that group – at worst I had to bear some inconvenience, but my job was secure, I was able to keep performing it, I had a comfortable home from which to perform it and I didn't have to home school young children at the same time. I was fortunate that I and my family have experienced nothing worse than bad flu symptoms. But this has not by any stretch been everyone's experience.

It was noticeable that through the pandemic there was a global sense of priorities being readjusted to bring health, social connections, and community wellbeing to the forefront of people's thinking. Themes such as the Great Resignation emphasised this. But in recent months if feels we have received a jolt back, with a greater focus again on the economic side of our daily lives.

Far-reaching effects of the pandemic on our economy remain – from the distant impact of continued lock-downs in China where so many supply chains are exposed, to the acute shortage of workers across our economy.

These issues with our supply chains are further compounded by the new geo-political era of strategic competition we now find ourselves in. The business calculus of long-term risk appetite and risk/return trade-offs has got a lot more complicated – what price do we put on reliability and resilience?

Global business has already been trying to assimilate the impact of the competition between China and the West in the context of relationships that, whilst they perhaps had a new edge to them, were nevertheless cast in a stable and somewhat predictable light.

And then Russia invades Ukraine. Quite apart from the awful, unnecessary and unwarranted human cost this has created, the large, and largely unified response from the West in terms of widespread sanctions, consumer boycotts and business withdrawals has highlighted to everyone the risks of doing business in certain countries.

What risk premium do you build into a business proposition that may be set to zero in no time? How much of your supply chain can you expose to this risk? I have heard stories about Australian

manufacturers who had 98% of their product assembled and ready to go, but it's effectively worthless because the componentry for the last 2% is undeliverable.

Once the near term economic volatility has settled, and we've navigated back down from the massive pandemic stimulus, this global supply-chain re-configuration will I suspect linger as an inflationary pulse.

That's not to say high inflation is here to stay – there remain powerful disinflationary forces in the world, not least of which is technology development, but it's an inflationary impulse we were not thinking much about several years ago and does change the long term picture.

In short, it's complicated and volatile out there – and it's a difficult time to be a central banker or a politician. Or indeed a governance and risk management professional, like yourselves.

We could talk at great length about these immediate issues confronting the global economy. But instead, I'd like to take some time to discuss some of the longer-term systemic risks that we are facing globally and are likely to face in the years and decades ahead.

And as you might expect given my background, I want to highlight how pension funds and fund managers working together are well placed to tackle these risks, and indeed take advantage of the opportunities they present as well.

Fiduciary duty

Most recently, the national debate in Australia has turned to superannuation.

The Treasurer outlined his vision for how our national savings pool could be harnessed to address some of the big challenges facing the country, such as the energy transition and social housing.

Understandably, this led to commentary about the role of superannuation funds in pursuing so called "national interest" projects and what that would mean for returns.

I must say that I believe it is extremely unlikely that the Government will in some way try to compel super funds to invest in specific asset classes or projects.

It is also simply nonsense to think that major industry superannuation funds or IFM would make an investment that was not in the best financial interests of members.

We all have fiduciary obligations to investors.

But beyond that the strong member first culture and focus on member outcomes that pervades industry super funds and IFM means we are a lot less likely to be influenced by non-financial considerations than almost any other financial institution.

The out performance of industry super funds over their peers domestically goes to their singular purpose of delivering for their members and their determination to maximise risk-adjusted long-term returns to the millions of workers they invest on behalf of.

And its a key reason why they line up well against the best performing funds globally.

Systemic Risks

So funds are simply not going to make investments that don't make sense financially. And so if we extend the discussion about national interest out to the wider topic of sustainable investing, the key question, not just for us but all long-term investors, is the extent to which having regard to such factors is consistent with the fiduciary's best financial interests goal.

But at a very basic level, understanding the likely and potential impact of the environment on our investments is just a very sensible risk management exercise. And understanding the environmental and social context and thematics can allow any business to adjust the way it operates to position it for stronger value creation.

I'd highlight building inclusive cultures and diverse workforces as a great example here.

Investing in behind the meter clean energy is another key example – it can reduce costs and almost certainly improves the resilience of the asset in the long term.

Our airport assets around the world now have substantial clean energy behind the meter. Vienna Airport has Austria's biggest solar plant, and Melbourne Airport has just completed building a solar farm with 30,000 solar panels that delivers 15% of the airport's electricity needs.

We are also able to benefit from the scale of our portfolio. In Australia we have set up a renewable energy Power Purchasing Agreement program across our Australian assets.

We worked on the PPA in collaboration with another asset owner, QIC, to facilitate the supply of more than 400Gwh of renewable energy every year by 2025. It will help many of these assets achieve net zero earlier than they had planned.

And critically, all of these initiatives are accretive to the financial performance of these assets while the lack of strategic consideration for transitioning to a low carbon economy could undermine the long-term financial sustainability of any business.

This is why IFM has pledged to reach net zero on our assets by 2050, and we've set 2030 interim targets. Many other investment managers and asset owners are also working hard on these types of initiatives.

But increasingly the concern is that trying to address systemic risks without systemic changes simply won't be enough.

As we continue to understand more about the environmental and social system around us, and how it is changing, and as it becomes clearer that as a global community we are not making the progress we need to at the pace we need to, it is also becoming clear that to deliver strong long-term returns for our beneficiaries, and the generations of beneficiaries after them to whom we also owe a fiduciary responsibility, investors like ourselves need to be working to strengthen the system itself, not just individual assets within it.

This means extending our analysis beyond the footprint of the specific investments we make and understanding how our investment activity and the activity of our assets might influence the health of the economic, environmental and social system around us.

We need to orient our activity to strive for positive impact on this system. We have to do this mindful of our ability and opportunity to produce positive financial outcomes that our scale and scope can deliver, and again, critically, this is entirely consistent with fiduciary duty, and I'd even argue is required by fiduciary duty.

Healthy long term investment returns are dependent on healthy environmental and social systems, now and in the future.

The quality of investment returns in ten and twenty years' time depends on the quality of the system in ten and twenty years' time.

And also, by their nature superannuation and pension funds invest on an intergenerational basis and have a duty of impartiality to treat members of different generations fairly.

So again, we have a duty to think about the impact we are having now on the investment returns of the future.

You can't stock pick your way out of systemic risks like climate change. And risks like this are impossible to diversify away from.

They will and are impacting our entire economy. And these impacts will compound such that future market returns will deteriorate and many of the superannuation members we are investing for will have much lower retirement incomes as a result.

To put some numbers on this, scenario analysis by the European Central Bank found that under a disorderly transition to net zero, European investment funds would see losses of up to 14% of portfolio assets relative to an orderly transition through 2035.

And that analysis is a few years old and is regarded as a pretty conservative somewhat orderly version of disorderly that ignores, for example, the highly non-linear effect of tipping points. But if we take that 14% and extend it across the USD50tr of pension assets in the world, we get USD7tr of losses.

That's a lot of pensions not paid. That's a lot of workers delaying their retirement and a lot of workers with a less dignified retirement.

It also constitutes a failure of our fiduciary obligations to investors.

My old shop the Future Fund has noted in a recent piece of research how physical climate risk has become more severe over time.

They observe that insured losses from natural disasters have increased from circa US$10 billion per annum in the 1980s to US$45 billion in the last decade (inflation adjusted), and that direct overall losses have been four times the size of insured losses and have increased approximately threefold in the last 30 years.

Beyond 2035, the physical impacts are expected to exceed the transition impacts, meaning that losses would be even higher if there is a failure to transition to net zero.

Some estimates I've seen of the impact of future physical climate shocks costs indicate a reduction in value of up to 40% of a diversified portfolio.19

And this isn't just about climate. The "S" in ESG bears similarly crucial systemic risks that we must address.

Inequality, for example, has the potential to have a very real impact on long-term returns.

Both the IMF and the OECD in separate research have found that income inequality has a negative and statistically significant impact on subsequent growth. From a pension fund's perspective this has very direct ramifications on the contributions into pension funds and the return on those pension fund members' retirement savings.

It is also an important issue from a risk perspective, as inequality could lead to social and political instability.

The widely debated crisis of democracy and rise of populism shows this spectre has arisen, and for evidence of the far-reaching potential impacts of such social instability you only have to look at the disastrous historical analogues.

Again, as a fiduciary the key is identifying the opportunity to have impacts that improve the system and also the longer term financial outcomes.

By the way, these issues are also linked - failing to address inequality and not finding a just and fair way to transition to a low carbon economy will likely stall progress on addressing climate risks.

Investment Imperatives

So as I see it, there are two investment imperatives to address the systemic risk of climate change, and one really important organising principle.

The first investment imperative is to invest in developing the new assets that our system needs if it is to be healthy.

In an infrastructure context, the most obvious example is to build clean energy, and the supporting infrastructure around it. The International Energy Agency says that by 2030, close to US$1 trillion will be needed annually for clean energy infrastructure.

This is likely to spur the creation and adoption of new technologies, products and modes of transport, which in turn create new business and investment opportunities.

At IFM we are certainly active in this space, building our skills, resources and networks to keep pace with developments, and deploying substantial capital into these new energy opportunities.

One of our funds has recently invested in ERG – one of the largest independent green power producers and developers in Europe. ERG has an established portfolio of 2.5GW and a high visibility near term pipeline of a further 3.5GW of renewable power generation.

The fossil fuel dependence of Europe is all too apparent at the moment, and businesses like ERG will be critical to the continent building both energy security and achieving net zero emissions.

This type of investment tends to get the most attention. It’s important, and a major task, and one we all need to put a lot of effort and capital behind.

The second investment imperative is just as important, but harder to execute on.

This is to drive capital into the existing stock of assets to accelerate our transition to the new clean economy, and to ensure that this transition is as smooth as possible. I noted earlier the ECB’s estimates of the difference in cost between an orderly and a disorderly transition.

My view here is that responsible investing means improving long term returns by being responsible to the society around us, and in this context it means being willing, and indeed keen, to buy assets with significant emission profiles, and investing to support a transition plan to get those emissions down.

In the case of infrastructure, by definition these are essential services. We cannot simply turn them off today.

If a district heating business runs out of power, millions of people potentially freeze. It’s crucial we recognise the urgency of the transition task, but equally we must plan and be organised about how we achieve it.

So our job is to deliver expertise and capital into those businesses to find a way to reduce emissions without jeopardising their critical service provision. All of course with the ultimate objective of delivering a great return to our investors.

One of the challenges we face as an investment manager is that in the rush to appear at the leading edge on ESG, many investors are designing their policies to screen out assets with emissions.

Investors, of course, make their own decisions.

But driving the emissions of individual portfolios down by selling emission-heavy assets won't have a systemic impact.

And taken too far, it risks starving the businesses we most need to transition of the capital they need to do so. Now of course there's a point where if a business is unwilling to engage then selling out is the appropriate thing to do – if you can't influence change then managing your portfolio risk is the only consideration left. But this should be a last resort.

Pension capital and collaboration

So those are the two investment principles, and so now to the important organising principle.

Almost by definition, the impact of a single investor or investment manager on these systemic risks is tiny. So we must organise ourselves to collaborate much more strongly to influence systemic risks.

There are many good examples of successful collaborations already across the investment world, with bodies like ICGN on governance matters and PRI and the various net zero collaborations like the Net Zero Asset Owners Alliance in the climate crisis space.

As our task becomes bigger and more urgent, I think we need to push harder on these initiatives to make them as effective as possible.

Of course, governments must play their part in addressing systemic issues.

And we are seeing significant commitments and action globally to tackle climate change.

But I think we are going to start hearing a lot more about pension capital as a class because it is ideally suited to collaboration in systemic risks, for a range of reasons.

Firstly, most large pension funds can now be considered universal owners – institutional investors that are sufficiently diversified in their investment allocations that they effectively own a slice of the whole economy.

The implications of this are that they can't avoid the effect of externalities, for example.

They might not own a company producing the externality, but they are still very likely to own the effect of the externality across their portfolio. So collaborating with other investors to engage on the issue is very much in their financial interests.

And collaborating with governments on policy responses to reduce these externalities is also in their financial interests.

Secondly, they are very long term in their outlook. Pension funds are investing for decades for their members – a horizon that comfortably encompasses the horizon for the systemic risks we are facing.

Thirdly, pension capital is huge, which gives it the weight to make a difference. The numbers are truly staggering.

At USD50tr, the retirement savings managed by pension funds are now equal to about two-thirds of the aggregate GDP of the OECD countries, and over half of global GDP.

They own a large proportion of the shares on global stock markets, as well as significant government and corporate bonds, infrastructure, real estate and private equity interests.

And pension funds continue to increase in size, with growth rates exceeding overall growth in savings and GDP growth.

Finally, they have a very simple, clear purpose in common – to protect and grow retirement savings for everyday people.

As not-for-profits (by and large) they should be focused on great absolute outcomes for their beneficiaries – the nurses, construction workers, teachers and other workers that they are investing for.

If they can improve these outcomes by working with others, they are highly motivated to do so.

This is different to typical commercial enterprise, where oftentimes competing for-profit corporations are reluctant to collaborate because the motivation is to be better, and therefore do things differently to the rest.

There are good examples of collaboration already across institutional investors, but I think we need to see much more.

Just as a footnote on this, one of the challenges to collaboration is that many pension funds operate substantially through agents, such as commercial investment managers.

These commercial investment managers are for-profit, competitive market animals – they are not naturally inclined then to want to share IP and work with a collection of their competitors.

I understand the concept of co-opetition, but I think the industry in general will need a good strong push from the pension fund clients to get collaboration to where it needs to be.

One of the privileges of working at IFM is that we are wholly owned by a collection of industry superannuation funds, which means we can bring the perspective of the pension fund, not the agent.

Pension funds I think need to be careful and engaged with their management of their agents to ensure their intentions are being realised in practice.

Because there is a lot at stake if we don’t get this right.

Conclusion

So to wrap up, strengthening the environmental, social, and economic systems on which broad prosperity depends will often directly contribute to long-term investment returns, and I’d argue that where this line of sight can be drawn, fiduciaries are duty-bound to consider how they can play a role in this strengthening process.

Sometimes the effect is clearly observable, and the decision is straightforward.

Sometimes it takes time for the effect to be felt, like water on a stone, but that doesn’t make it any less important.

By acting in collaboration with others, I believe the effect can be faster and larger.

Pension funds are well placed to influence this systemic change to the benefit of their members.

As we deal with the current economic volatility, I hope I've been able to give you a longer-term issue to ponder.

Thank you so much for having me.

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