Does "sustainable" investing compromise the obligations owed by superannuation trustees?

M Scott Donald and N.A.J. Taylor*

Trustees of Australian superannuation funds are coming under increasing public pressure to take sustainability factors into account in their investment strategies. Despite the rhetoric, trustees have been loath to incorporate what are sometimes deemed "non-financial" criteria into their decision processes. This is entirely understandable. It stems from the conventional wisdom that a range of practical and legal impediments stands in their way. This article reviews that conventional wisdom and finds that it is often superficial and ignores recent developments in the way sustainable investing is framed. This implies that the way is open for superannuation trustees to embrace a more positive approach to sustainable investing; one that is consistent with the tapestry of obligations they owe under general law as well as the legislative backdrop.

INTRODUCTION

The trustee plays a pivotal role in the management of superannuation funds in Australia. It is required to formulate an investment strategy for the investment portfolio of their fund that reflects the needs and circumstances of the fund.[1] It is required to exercise this power in the best interests of the fund's beneficiaries, and in the context of superannuation funds at least, "best interests" are universally understood to refer to the financial best interests of members.

It is in this context that calls for trustees to adopt "sustainable" investing principles must be assessed. The courts have been very circumspect in respect of two predecessors of sustainability, ethical investing and socially responsible investing (SRI). Those earlier movements exhorted trustees to consider factors in addition to the financial wellbeing of members, and as such were deemed appropriate for trustees only in the most specialised situations.[2] With respect, this must be correct. As Lord Nicholls of Birkenhead noted: "A pension fund trustee is not the guardian of the moral welfare of the fund members, and modern developments in social conditions do not compel the conclusion that he should assume this role."[3]

This aversion to non-financial criteria need not preclude trustees incorporating sustainability into the administration of the trust. Sustainability differs from both ethical investing and SRI in that it explicitly focuses on the financial consequences of the strategies it encourages. Sustainable investing is often described as being concerned with environmental, social and corporate governance (ESG)

* BEc, LLB, LLM, CFA, SFFin; Director, Capital Markets Research, Russell Investments; Doctoral Researcher in Law, UNSW.

BEc, MIntSt(Hons).

[1] The discussion in this article implicitly assumes that there is no provision in the trust deed specifically empowering (or prohibiting) trustees to consider sustainability issues, which, subject to satisfying the sole purpose test in *Superannuation Industry (Supervision) Act 1993*, s 62, would prevail over the general law principles articulated here. Similarly, no regard is had directly for the inclusion of a separate sustainable option within the menu of options offered as part of member investment choice by a fund, although some of the arguments remain pertinent.

[2] *Harries v Church Commissioners, Re Wyvern Developments* [1974] 1 WLR 1097; *Martin v City of Edinburgh District Council* [1989] 2 PBLR 8; *Cowan v Scargill* [1985] 1 Ch 270.

[3] Lord Nicholls of Birkenhead, in "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge", (1996) 70 ALJ 205.

issues, although this list is somewhat fluid.[4] Another way to characterise sustainable investing is as "an approach that recognises the financial implications of economic activity over a broader range and longer timeframe than traditional investment approaches".[5]

It is also important to establish what sustainable investing is not. Proponents of sustainable investing propose that ESG factors are material, and attempt to incorporate those factors into their investment strategies. Ethical investing and SRI can be seen to have other concerns. Ethical investors are primarily focused on pursuing investment strategies that conform to a predefined set of beliefs, which means that the financial objective is subject to other non-financial considerations. For those adopting an SRI approach, there are often no predefined requirements, except to take some account (how much varies greatly) of social, environmental *and* financial factors when making investment decisions; SRI thus serves a dual purpose: financial and social.

Sustainability's financial orientation is important because it aligns more closely with the way the courts have traditionally articulated a trustee's obligations to its beneficiaries. That does not mean that trustees are free to employ sustainable strategies, of course. There is a range of other considerations that trustees must bear in mind when formulating their investment strategy, but it starts to address what was hitherto regarded as a formidable impediment to sustainable investing by trustees.

The debate on sustainability often boils down to a question of whether the inclusion of sustainable principles is likely to undermine or enhance the investment performance achieved by the fund.[6] The research and analysis presented in this article suggests the answer lies in between. The overwhelming weight of empirical research reviewed below (and summarised in Appendix A) finds little or no necessary effect from the application of sustainable principles, when appropriate account is taken of sector, style, risk and timing effects.[7] That is not to say that a sustainable strategy that is poorly formulated or implemented sloppily won't underperform; it probably will. How you do it matters. Some of the strategies and attitudes proposed by sustainability's adherents are not appropriate for trustees of superannuation funds to incorporate into their funds. However within that broad range of possibilities there are initiatives that are prudent, practical and capable of being incorporated into a fund's strategies, given an appropriate set of circumstances. Then, and this is crucial, it is up to the trustee to determine whether they are in fact appropriate for their fund.

THE DUTY TO ACT IN THE BEST INTERESTS OF MEMBERS

The starting point for any trustee considering incorporating sustainable principles into their investment strategy is Sir Robert Megarry VC's dictum that it is "the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust".[8]

Though perhaps novel at the time,[9] Megarry VC's application of the notion "best interests" to trustees' duties in a trust has subsequently found its way into the curial vernacular.[10] Most importantly

[4] UN Global Compact, "Conference Report: Investing for Long-term Value – Integrating Environmental, Social and Governance value drivers in asset management and financial research", (UN Global Compact Conference, Zurich, 25 August 2005). In a similar vein, Gosling distilled a set of five factors; intergenerational equity, social equity, conservation of biodiversity, internalisation of externalities, and the precautionary principle; Gosling S, "Sustainability and ethical funds management" (2001) JASSA 33-36.

[5] Donald MS and Taylor N, "Sustainable Investing: Marrying sustainability concerns with the quest for financial return for superannuation trustees", (*Russell Research Report*, 2007). In the language of finance, this is equivalent to modifying the discount rate used to evaluate distant and/or risky enterprises. The effect of this is to accord greater weight to the costs and risks that threaten the sustainability of economic activity.

[6] See for instance, Evans J, Guido R, and Guo M, "Analysing sustainable securities", (2006) 4 JASSA 29; Ali P, Stapledon G and Gold M, *Corporate Governance and Investment Fiduciaries* (Law Book Co., 2003) and Finn FJ and Zeigler PA, "Prudence and Fiduciary Obligations in the Investment of Trust Funds", (1987) 61 ALJ 329.

[7] A recent UN study found a stronger bias towards studies reporting a positive performance impact from sustainable investing; United Nations Environment Programme Finance Initiative, *Demystifying Responsible Investment Performance*, (UNEPFI, October 2007). The analysis presented in this article is based on a longer list of academic studies and classified studies where the results were statistically insignificant as "neutral" rather than positive or negative.

[8] *Cowan v Scargill* [1985] 1 Ch 270 at 287.

for the trustees of superannuation funds in Australia, it has been codified in s 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS), the cornerstone piece of legislation governing the management and regulation of the funds they administer.[11]

The precise interpretation of the phrase "best interests of beneficiaries" is perhaps less clear than may appear on the surface. There are for instance questions around the extent to which it merely restates the fiduciary duty of loyalty (ie not to be in a position where one's duties or interests conflict with the beneficiaries') or whether it connotes something more,[12] as well as its priority in general law relative to the other obligations placed on trustees.[13]

Some things however are clear. Both the general law duty and the s 52(2)(c) duty apply to the exercise of the investment power.[14] In a trust whose purpose is to provide financial benefits to its beneficiaries (such as a superannuation fund), the best interests of members are defined in terms of their financial interests.[15] As Dal Pont concludes, this in turn implies that trustees have an obligation to attempt to maximise the return for members, subject to the risk and other constraints described below.[16] It is also clear that, the connection between the purpose and the benefit to the beneficiary must be material and direct. "Speculative and remote" benefits, such as the impact of a single superannuation fund on the economy, will not suffice.[17] Also, despite the obvious temptation to the contrary, the assessment of whether a trustee exercised a power in the best interests is taken from an *ex ante* and objective perspective. Hindsight ought not to influence that assessment, nor should the subjective beliefs of the trustee[18] (absent evidence of fraudulent intent). Finally, the court will be loathe to review the merits of a trustee's decision unless the decision is so remarkable that it amounts to "one which no reasonable trustee could make on the material which was before it".[19]

Taken together, this means that one key issue facing trustees is whether sustainable principles can be expected to have a positive or negative impact on the return earned by the fund over some foreseeable time-horizon. If the expected impact is negative, then trustees would face an uphill battle justifying the incorporation of sustainable principles. If the expected impact is positive, the arguments would be much stronger, and indeed might inspire the question to be reversed – why have sustainable

9 Frostick X, "Is there a duty to act in the best interests of beneficiaries?" (2000) 83 *Pension Lawyer* 2; Hulme SEK, "The basic duty of trustees of superannuation trusts – Fair to one, fair to all?" (2000) 14 *Trust Law International* 130.

10 See for instance, *Hillsdown Holdings v Pensions Ombudsman* [1997] 1 All ER 862; *Edge v Pensions Ombudsman* [1999] 4 All ER 546; *Alexander Forbes v Jackson* [2004] EWHC 2448 and in Australia *Asea Brown Boveri Superannuation Fund v Asea Brown Boveri* [1999] 1 VR 144; *Knudsen v Kara Kar* (2000) NSWSC 715. It has also been used in non-superannuation cases; see for instance *Fuller v Evans* [2000] 1 All ER 636.

11 Discussion in this article is focused on the law as it applies in Australia. Divergences in both the general law and statutory framework in the US, Canada and NZ make comparisons with those jurisdictions dangerous. Limited reference is made to the general law in the UK, although in time this too may be influenced by local statutory intervention in directions different from those applying in Australia.

12 See Vrisakis M, "The best test of (or the 'bestest') interests of members", (2006) 17(9) SLB 138; Vrisakis M, "Section 52 – covenants, copyright and cleanskins (not to mention doppelgangers and leviathans)", (2006) 18(2)&(3) SLB 24; Liondis E, "Errors, breaches and covenants – common threads from the s 52(2) cases" (2007) 18(7) SLB 81; and Stone M, "The Superannuation Trustee: Are Fiduciary Obligation and Standards Appropriate?", (2007) *Journal of Equity* 167.

13 Pollard D, "'Trustees'" duties to employers: The scope of the duty of pension trustees", (2006) 20 *Trust Law International* 21 at 65, fn 26.

14 Not all activities that appear under the sustainability banner are "investment" per se. However the courts are likely to regard activities such as proxy voting and encouraging enhanced carbon emissions reporting as incidental to the exercise of the investment power, so the distinction is largely ignored for the remainder of this article.

15 *Cowan v Scargill* [1985] 1 Ch 270.

16 Dal Pont GE, "Conflicting Signals for the Trustees' Duty to Invest", (1996) 24 ABLR 140.

17 *Cowan v Scargill* [1985] 1 Ch 270 at 296.

18 *Hillsdown Holdings v Pensions Ombudsman* [1997] 1 All ER 862.

19 *Maciejewski v Telstra Super Pty Ltd* [1999] NSWSC 341 at [13]; *Telstra Super v Flegeltaub* (2000) 2 VR 276; *Sayseng v Kellogg Superannuation* [2003] NSWSC at [63].

principles not been included? In fact, as the next section shows, the empirical evidence points in a different direction, towards a neutral impact (when all risks and costs are included).

The absence of a strong positive or negative finding will be troubling to some. It need not be viewed that way. The analysis points to a finding that is entirely adequate to provide a foundation from which trustees can consider sustainability. It also renders unnecessary the over-optimism seen in some analyses of sustainability. If adding sustainable elements to an investment approach is consistent with the pursuit of long term risk-adjusted returns, that is sufficient to address the concern that sustainability necessarily compromises the trustee's duty to act in the best interests of members in the exercise of its investment power. The trustee is then in a position to decide whether the specific sustainable strategies proposed for the fund are in fact appropriate for the unique needs, objectives and constraints of the fund.

THE EMPIRICAL EVIDENCE

There are dozens of documented studies into the efficacy of ethical and SRI approaches, and an increasing number looking at sustainable investing. Rather than attempt to identify a single study whose conclusions are more robust than its peers, we have attempted to span the long list of empirical studies dealing with these types of approaches. This approach has the virtue of ensuring that the evaluation encompasses a wide range of strategies, markets and time periods. It also reflects one of the underlying themes in the recommendations that follow; trustees should not consider sustainable investing as an "all or nothing" proposition. Different combinations of sustainable strategies may be appropriate for different funds.

In the interests of brevity, the conclusion we draw from the empirical studies can be stated simply as two propositions:

1. There is no necessary performance penalty from pursuing a sustainable approach.
2. There is unlikely to be a performance premium from pursuing a sustainable approach when account is taken of appropriate risk and style effects.

Lest this be seen as merely a compromise between two intensely vocal camps, we outline below a little more of our thinking, including the implications of the conclusion we have drawn.

The 40 plus empirical studies consulted in reaching this conclusion are summarised in Appendix A.

Interpreting the empirical results

Both proponents and opponents of sustainable investing can point to studies demonstrating the cogency of their case. The reason is simple; there is considerable variety in the questions being asked and in the way the studies have been conducted. In the first place, there are material differences across the studies with respect to definition (ethical v SRI v sustainable, and all the variations in between).[20] This variation is particularly obvious when account is taken of the date of the study. Inevitably the earlier studies focused on ethical investing as SRI and sustainable investing are comparatively recent developments. As noted above, there is even a line of argument (which we have heard but do not endorse) that it was the apparent failure of ethical and SRI approaches to add value that spawned the notion of sustainable investing.

The analytical method chosen also needs to be considered when reviewing the studies. It is tempting to assume that studies using actual funds (as opposed to hypothetical portfolios) are based on more reliable data. This is a furphy. Studies based on actual funds are likely to suffer from the distortion noted above; ethical funds have a much longer history than their newer SRI and sustainable cousins. More pernicious, the study of actual funds embroils the analyst in a "dual hypothesis"

[20] This is true even within the narrow class of ethical investing, see Perks RW, Rawlinson DH and Ingram L, "An Exploration of Ethical Investment in the UK", (1992) 24(1) BAR 43.

conundrum: any finding derived from the analysis could be attributed to either the investment approach or to the active management skill of the manager responsible for the fund.[21]

There are some technical differences also. The most important is that analytical techniques have grown more sophisticated over the 30 years of the studies we reviewed. In particular, the use of econometric models that separately identify different factor effects has highlighted that the conclusions from some of the early studies (and some less rigorous recent ones) are quite unreliable. Some of the results in earlier studies have for instance been found to be driven more by market cap, style and sector biases than by ethical or sustainability factors.

Less important differences include the market investigated (usually the US, occasionally the UK and only recently other markets) and the time period observed. This is not a major issue because variety is endemic to any literature review and, in fact, is a key part of any serious research activity in the social sciences. The consistency of findings across time and different markets is a key indicator of robustness. Rather, trustees need just to be alert to the differences and attempt to see the broader pattern of results rather than focus on a small subset.

Finally, some popular commentators apply the findings from Corporate Social Responsibility (CSR) research to sustainable investing.[22] At first blush this appears reasonable, but, as numerous management gurus have discovered, well-run companies do not necessarily make good investments, nor do they necessarily sustain their commercial advantage.[23] Indeed, as Camejo points out, the ability to pursue a CSR policy may signal certain things about the company (stability, long term focus etc) that may be the actual drivers of corporate performance.[24] That is, CSR may be the result, not the cause, of any above average corporate performance.

Summing up the empirical results

What is a trustee to make of the diversity of the empirical record?

It certainly pays to view the evidence as a whole. Notwithstanding the fact that some of the studies referenced in Appendix A stand out as more sophisticated, more careful or more directly relevant to Australian trustees, the overall message is that there is no necessary performance penalty. The studies also include among their number strategies that, notwithstanding a loosening of attitudes, it would be difficult for a prudent superannuation trustee to countenance, such as heavy-handed screening of "sin stocks" and "socially-targeted" investment. If anything, this depresses the performance record (either by reducing returns or increasing risk). By how much is a matter of, often bitter, debate. However it does introduce a margin of comfort into the conclusions reached above.

The diversity also highlights that trustees should not allow themselves to be hostage to any one empirical study, however trustworthy. The sheer number of thoughtful, careful pieces of empirical research must be recognised as relevant in itself. If nothing else, the trustee's duty to exercise due care, skill and diligence requires it to be cognisant of the greater body of research, before coming to a decision.

THE THEORETICAL ARGUMENTS AGAINST SUSTAINABLE INVESTING

21 The technical solution to this problem is to adjust the benchmark to reflect the investment opportunity set of the fund manager. Few, if any, of the studies do this.

22 The repeated reference in the literature to the groundbreaking article, Moskowitz MR, "Choosing Socially Responsible Stocks", (1972) *Business and Society Review* 10, highlights this risk. The conclusions presented in this article are in any case similar to those found in the CSR space; for instance Evans et al, while not committing the solipsism of regarding CSR as synonymous with sustainability, find "no conclusive relationship between 'good' corporate behaviour and financial performance at the corporate level" from their survey of over 60 CSR studies conducted over the past 35 years. Unlike the SI literature surveyed in this article, though, the studies are more polarised, with 33 positive findings, 9 neutral findings and 20 negative findings. Evans et al, n 6.

23 The most celebrated example is the decline into financial difficulty of the one in three of the "excellent" companies identified in Peters' and Waterman's, *In Search of Excellence* within five years of the publication of the book. See Business Week, "Oops. Who's excellent now?", (5 November 1984).

24 Camejo P, *The SRI Advantage*, (New Society Publishers, 2002).

Critics of sustainability sometimes quibble about the reliability of the empirical evidence, pointing to many of the shortcomings identified above. In its place they cite the truism that investment approaches that reduce the size of the investment universe, such as screening, must be sub-optimal. In a purely mathematical sense, that must be correct since the constrained set of outcomes is merely a subset of the unconstrained set. Translated into finance-speak, subsets of the market portfolio by definition contain non-systematic risks that are not, on average, compensated.

Proponents of sustainable investing cannot fault that logic. They may however baulk at the materiality of the effect given research demonstrates that in most cases "systematic" risk is effectively diversified with relatively few holdings.[25] In any case, the logic is becoming increasingly irrelevant. Unlike Ethical investing (and sometimes, SRI) sustainable investing is not about screening naughty stocks out of the investible universe. It is primarily about recognising the cost of the externalities generated by corporate activity (be they environmental or social) more explicitly in the investment process and promoting strategies for addressing them. As noted below, this can include a range of direct (such as proxy voting and informal shareholder pressure) and indirect strategies (such as carbon emissions reporting) that have little to do with the Wall Street Walk, except in extremis.

The second theoretical argument proposed by critics of sustainable investing takes aim at the idea that attention to sustainability issues needs to be mandated. The market, they argue, will accurately price the environmental, social and governance risks currently scrutinised by proponents of sustainability. Again the argument is flawed, this time because it fails to recognise that the principle/agent relationship between superannuation fund members and the investment managers appointed on their behalf itself has institutional factors that distort the price mechanism. Commentators have in particular identified the short contracting horizon and even shorter monitoring horizon in which investment managers operate as distortive.[26] The short time horizons inspire a focus on short-term performance and minimisation of peer-relative performance risk. Some of the sustainable investing strategies described below aim specifically to address this distortion.

This second argument is, in any case somewhat toothless. What if the argument is true and the market does already factor in the risks? Then requiring investment managers and others to attend to sustainability issues will not change their decisions. So long as the exercise has not been unduly costly,[27] nothing will have been lost. Indeed, as outlined below, at least this will ensure that the focus on sustainable issues does not wane at some point in the future.

THE THEORETICAL ARGUMENT IN FAVOUR OF SUSTAINABLE INVESTING

There is also a flaw in the theory of the argument of those who would suggest a positive performance advantage from sustainable investing. Debunking this line of reasoning is a little more complex, and requires recourse to finance theory.

Suppose for a moment that empirical research showed there was consistently higher performance to be earned from sustainable investing. Finance theory would suggest that the "sustainable effect" would suffer the same fate as other efficient market hypothesis (EMH) "anomalies". Markets that are even weakly efficient would quickly impound such information in stock and bond prices, eroding any

[25] Statman M, "How many stocks make a diversified portfolio" (1987) *Journal of Financial and Quantitative Analysis* 22. The courts have flirted with the idea that the materiality of the investment constraints may be relevant. See for instance Nicholls VC in *Harries v Church Commissioners, Re Wyvern Developments* [1974] 1 WLR 1097 at 1250-1251.

[26] Benartzi S and Thaler RH, "Myopic Loss Aversion and the Equity Premium Puzzle" (1995) 110 (1) *The Quarterly Journal of Economics* 73. Also Lakonishok J, Schleifer A and Vishny R, "The Structure and Performance of the Money Management Industry", *Brookings Papers, Microeconomics*, (1992), and, in Australia, Drew ME and Stanford JD "Principal and Agent Problems in Superannuation Funds" (2003) 1 (1) *Australian Economic Review* 98.

[27] The size of the cost will of course depend on the precise mix of strategies and, in time, the number of adherents. Peculiar strategies with low participation (and hence fewer economies of scale) will tend to be relatively more expensive. Thus, for instance, the finding by Ali et al that managers offering SRI-oriented products charged higher fees is most likely an artifact of the immature stage of the market for those services. Ali et al, n 6.

systematic performance advantage.[28] One of two things would then happen: either sustainability would become a "style factor" or it would be competed away entirely.

Sustainability becomes a style factor

The sustainable effect might become a style effect, in the sense of the Fama/French risk factors.[29] The small cap effect "discovered" in the early 1980s[30] provides a useful illustration of what this would mean. The persistently large performance premium earned by small cap stocks observed by Banz in the early 1980s was quickly eroded to the point where small cap out-performance is now episodic and unpredictable. For the sustainability effect to follow this example, there would need to be something about it that was itself episodic (analogous to the fluctuations in investor risk appetite and/or liquidity preference that appear to affect small cap stocks). It is not clear what that might be in the case of Sustainability.

Sustainability gets impounded completely

On balance, it is more likely that any sustainability effect would disappear altogether, being subsumed into the melange of publicly available information routinely and continuously impounded into stock prices. That would mean that the sustainability effect would become invisible at a macro level. That doesn't mean it would be unimportant, just that the ability to generate excess returns by focusing on it as a factor across the market would have gone. If investors stopped paying attention to sustainability for a while, the effect would reappear until the excess returns from exploiting it were competed away again.[31] The sustainability traits of individual stocks would continue to be recognised by the market. For instance, companies with operations that posed high long term environmental risks would find their share price discounting that possibility, companies with sustainable HR practices would be rewarded, and so on. But those attributes would be "priced" in the market price for the company's securities. Continuous disclosure would reinforce the market discipline. So, for instance, companies failing to disclose foreseeable environmental or other risks would suffer a strong market reaction if the risk eventuated, and a track record of such negative "surprises" would encourage investors to apply a heavier discount to the value of the share.

Implications

Paradoxically, the analysis just presented would suggest that sustainable investments ought to earn a lower return than other companies. This is precisely the opposite of what many proponents of sustainable investing might expect. This should not be a surprise; it is merely a restatement of the idea that lower risk equates to lower expected return. If sustainable companies are inherently more careful about long-term risks, make better use of their human and other resources and are more financially stable than others on the market, that "quality" factor ought to see them command a premium price in the market. The flipside of the premium price is of course a lower expected rate of return to shareholders.

That is where the logic of the sustainable investment argument takes you in an efficient market. Happily it coincides with the overall picture to be drawn from the documented empirical studies in the area. So both empirical research and finance theory (properly understood) suggest that shares in companies pursuing sustainable business practices are unlikely to generate returns statistically different from any other shares when account is taken of different operational risk levels, different industries, capital structure and so on. That seems a solid foundation from which trustees can make their own, independent assessments of the relevance of sustainability to the trusts they administer.

[28] The assumption of a somewhat efficient market seems an uncontroversial proposition given that the vast majority of Australian superannuation fund assets are invested in large and medium cap stocks (and sovereign bonds) within the major markets of the world.

[29] See for instance Fama EF and French KR, "The cross-section of expected stock returns" (1992) *Journal of Finance* 47 at 427-465.

[30] Banz R, "The Relationship between Return and Market Value of Common Stocks" (1981) *Journal of Financial Economics* 9.

[31] This would be quite literally a microcosm of the effect of active management on market efficiency – the competition between active managers promotes efficiency, which limits each of their ability to find mispriced securities.

A POSITIVE DUTY TO CONSIDER SUSTAINABILITY?

There have been suggestions that trustees have a positive duty to consider sustainability. In Australia the most prominent among these was the Parliamentary Joint Committee on Corporations and Financial Services, which opined: "In the committee's view, consideration of social and environmental responsibility is in fact so far bound up in long term financial success that a superannuation trustee would be closer to breaching the sole purpose test by ignoring corporate responsibility."[32]

With respect, this appears to overstate the law as it currently stands.[33] The courts have been quite clear that discretions must be exercised for the purpose for which they were granted. Moreover, when exercising their discretions, trustees are to include in their considerations all relevant matters[34] and not include irrelevant matters.[35] However it would be fair to say that curial intervention has been much more attentive to the second leg of this formulation than the first, for obvious reasons. The set of relevant matters would in most cases be hard to delineate and this, when coupled with the courts' steadfast reluctance to review the basis on which trustees make decisions, makes it hard to enforce.

OTHER LEGAL ISSUES

Trustees face a range of duties, prohibitions and obligations in the exercise of their powers. The duty to act in the best interests of beneficiaries is just one. The requirements often overlap, and it is quite common to see cases argued on one basis that could easily have been argued under a different equitable head.[36] There is, moreover, no easy indicator as to which might prevail in the case of a conflict.

Fraud on the power doctrine

Trustees are required to exercise their powers for the purpose for which those powers were conferred.[37] To do otherwise is to perpetrate a "fraud on the power" or, equivalently, to act with an "improper purpose". So, for instance, the investment power is to be exercised with the objective of augmenting the value of the fund, not for the purpose of furthering ethical, charitable or social objectives.[38] The requirement for a proper purpose is given statutory backing by the "sole purpose" test present in s 62 of the SIS.[39]

What does "purpose" mean in this context? There are two strands of case law to consider. The courts have distinguished the objective notion "purpose" from the subjective "motive".[40] They are however interested in both. If the trustee is found to have been actuated by an improper motive, for

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32 Parliamentary Joint Committee on Corporations and Financial Services, *Corporation responsibility: Managing risk and creating value*, (Commonwealth of Australia, June 2006) at [5.41]. See also the UN, "Principles for Responsible Investment". Notably the UN Principles emphasise that the sustainable principles should only be applied where to do so would be consistent with the entity's fiduciary duties.

33 It also invokes the sole purpose test articulated in *Superannuation Industry (Supervision) Act 1993* (Cth), s 62, rather than the more specific (and therefore more appropriate) doctrine, namely the proper purpose of a power by a trustee.

34 *Cock v Smith* (1909) 9 CLR 773.

35 *French v Davidson* (1818) 3 Madd 396; 56 ER 550.

36 See for instance the overlap in both general law and the *Superannuation Industry (Supervision) Act 1993* (Cth) between the exercise of due care, skill and diligence and the requirement to invest prudently.

37 *Vatcher v Paul* [1915] AC 372.

38 *Cowan v Scargill* [1985] 1 Ch 270; *Harries v Church Commissioners, Re Wyvern Developments* [1974] 1 WLR 1097.

39 Although looser logic than is perhaps desirable, it seems safe to assume that the very broad requirement under s 62 that the trustee maintain the fund solely for one or more of the enumerated purposes would infuse the exercise of powers in pursuit of that purpose with a similar requirement. See for instance Leigh A, "Caveat Investor: The Ethical Investment of Superannuation in Australia", (1997) 25 ABLR 341. Also APRA, *Superannuation Circular No III.A.4; The Sole Purpose Test* (2001) at [31].

40 *Topham v Duke of Portland* (1863) 1 De GJ & S 517; 46 ER 205 at 227; *Hillsdown Holdings v Pensions Ombudsman* [1997] 1 All ER 862. The same distinction was made in Australia by Brennan J in *Magna Alloys v FCT* (1980) 49 FLR 183 at 185.

instance to benefit someone not an object of the trust, the decision will be impugned by the court.[41] The outcome will be similar if the trustee acts capriciously or for reasons foreign to the settlor's intent.[42]

The courts are also prepared to compare the purpose of the transaction (if such it be) with the settlor's intent in granting the power. Purpose in this context is an objective notion that looks to the substance of the transaction rather than the intent of the trustee. As such it can, if necessary, be inferred by the court from the circumstances of the trustee's decision and does not require enquiry into the trustee's state of mind. Not only does this reduce the evidentiary burden, it warns trustees against getting too cute about how they characterise their decisions.[43]

As always, materiality is important. The mere presence of collateral[44] benefits will not compromise an otherwise proper exercise of a power.[45] (Collateral benefits are defined here to be those too remote or else accruing to non-beneficiaries.) Only if those collateral benefits are deemed to have influenced the decision of the trustee or to have been the real purpose behind the decision will the court intervene. Similarly the courts have been realistic about the ability of trustees to divest themselves entirely of "all personal preferences, of all political beliefs, and of all moral, religious and other conscientiously held principles" and require instead a reasonable attempt at objectivity.[46]

Finally, both at general law and under the SIS, the proper purposes principle would seem to have overarching application, subordinating other "duties" owed by the trustee. This means, pertinently in the current context, that an honestly held belief that a decision was in the beneficiaries' best interests will not rectify a use of a power for an improper purpose.[47]

Due care, skill and diligence

A number of traditional trustee obligations clearly have application to a trustee considering incorporating sustainable principles into its investment strategy. So, for instance, the trustee must act prudently and with due care, skill and diligence. These general law obligations are mirrored in s 52(2) of the SIS. In the current context this means the trustee must collect and review the evidence carefully, and perhaps get independent, objective advice on its proposed course of action. The trustee must ensure the decisions it takes are implemented efficiently and also oversee a thorough monitoring process. The general law also places a higher standard of performance on professional trustees, especially those retained for their expertise.[48] This would include some (but perhaps not all) trustees of large-scale superannuation funds.

Impartiality

The trustee must also act impartially when balancing the interests of different beneficiaries. In the current context this reminds trustees that the interests of members with a short time horizon (typically those nearing retirement) and those with a long time horizon (younger and/or healthier members) may be different. Investment strategies that aim to secure outcomes for "future generations" (common

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41 *Redman v Permanent Trustee* (1916) 22 CLR 84. The influence needs to be "dominant" or "primary", making the test analogous to the "but for" test used to establish causation in common law negligence.

42 *Klug v Klug* (1918) 2 Ch 67.

43 Some commentators have argued that trustees seeking to incorporate non-financial criteria into their decision-making could do so either by "dressing up" the rationale in financial terms or by saying nothing at all (on the basis that the courts are more prone to review decisions where the trustee has disclosed its reasoning). See for instance Leigh, n 39. Notably, Leigh does not approve of the practice.

44 The courts and commentators often use the adjective "ancillary" to refer to this type of benefit. We have used the term "collateral" here to avoid confusion with the reference to "ancillary purposes" in *Superannuation Industry (Supervision) Act 1993* (Cth), s 62(b).

45 *Fuller v Evans* [2000] 1 All ER 636. Also APRA, n 39.

46 *Harries v Church Commissioners, Re Wyvern Developments* [1974] 1 WLR 1097, cited in Leigh, n 39.

47 *Hillsdown Holdings v Pensions Ombudsman* [1997] 1 All ER 862 at 884.

48 *Bartlett v Barclays Bank Trust Co* [1980] 1 All ER 139.

enough rhetoric in some parts of the sustainability movement) should be viewed cautiously.[49] In practical terms, this comes down to the trustee having a deep understanding of its member population and recognising the different needs resident therein.

Statutory investment strategy considerations

The SIS also provides some specific guidance to trustees on the exercise of their investment power. Apart from the provisions alluded to above, the SIS also requires that the trustee have regard for the need for diversification, liquidity, and an appropriate risk/return balance.[50] Each of these should be considered when sustainability principles are under consideration.

Importantly, most if not all of the sustainable investing strategies and initiatives suggested in this article operate at a level of detail below the strategic issues identified in the SIS. In particular the features of ethical investing and SRI that attract the most fervent criticism, screening of stocks and industries and socially-oriented targeting of investments, are unnecessarily heavy-handed and represent a small sub-set of available strategies. This is not to suggest that trustees should "fly under the radar", as it were, with sustainability. Rather it simply recognises that sustainable investing need not affect the decisions that most influence the performance outcomes for members; notably the asset and sector allocation decisions. Even the choice of individual investment managers, a choice whose importance is often over-emphasised, is becoming less constrained as an increasing number of mainstream investment managers are offering sustainable investing services in the marketplace. Taken together with the trend towards seeing the investment decisions of trustees in a portfolio context[51] (a move which explicitly brings issues of materiality and correlation into play), this ought to reduce substantially the threat to portfolio efficiency perceived in some quarters from sustainable investing.

PRACTICAL ISSUES

The analysis presented above emphasises that drawing general conclusions about the appropriateness of trustees adopting sustainable strategies would be a mistake. Regard must be had both for the circumstances of the trust and for the precise strategies being considered. How far a trustee wants to go will be a matter for that trustee's discretion. As such, it will not be subject to curial review simply because the court happens to disagree with the outcome, so long as the appropriate procedural elements are respected (proper purpose, prudence, due care, skill and diligence, and so on).

What sorts of strategies might a trustee consider? The obvious ones tend to involve the greatest commitment. So for instance the trustee of a superannuation fund may add a "sustainable" option to its member investment choice suite.[52] It may also (or alternatively) choose investment managers propounding sustainable investing approaches to manage its assets. These latter managers would be expected to incorporate sustainable principles directly into their investment decisions, which, given the research reviewed above, might be expected to have only marginal impact on the overall return earned by the superannuation fund.[53] Thirdly, the trustee may follow the lead of an increasing number of superannuation funds and become signatories to the United Nations Principles for Responsible Investing, the Investor Group on Climate Change or the Enhanced Analytics Initiative. Each of these initiatives encourages signatories to influence their agents (investment managers and others) to promote sustainable principles, such as environmental reporting and responsible proxy voting.

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[49] This is made particularly acute by the fact that the accumulated benefits of the older cohort are likely to be disproportionately large given their longer period of contribution to the fund.

[50] *Superannuation Industry (Supervision) Act 1993* (Cth), s 52(2).

[51] Leigh, n 39.

[52] In so doing it would sidestep some of the strictures around exercising the investment power for a proper purpose. Whether it also sidesteps the "best interests" requirement is currently under debate. APRA argues that it does not in *Superannuation Circular No II.D.1: Managing Investments and Investment Choice* (2006) but cf Australia, Parliamentary Joint Committee on Corporations and Financial Services, *The structure and operation of the superannuation industry*, (2007), recommendations 9 and 10.

[53] This is not to say that the effect on the corporate sector would be marginal, given the confluence of other pressures currently seeking to encourage corporations to act more responsibly.

Trustees may also choose to adopt less public strategies. So for instance they may engage more actively in proxy voting, especially on issues relevant to sustainability concerns, or appoint a specialist to vote on their behalf according to pre-set principles. They may encourage more detailed environmental reporting (including carbon emissions disclosure) by the companies in which they invest. There is also increasing evidence that institutional investors, perhaps at the behest of superannuation fund trustees, are engaging in informal interactions with companies to influence their behaviour.[54]

Finally trustees might consider their own operations, and identify ways in which the administration of their fund might be achieved in a more sustainable manner. This might encompass increased use of electronic delivery of reporting and disclosure, review of selection procedures for service providers and other reforms associated with the governance of the superannuation fund.

There is one very practical danger in all of this for trustees that has not yet been discussed (and which gets little airplay); the danger of distraction. The analysis presented above found that adopting sustainable investment practices need not adversely affect expected returns. Equally, though, trustees need to ensure that the work required to identify and then implement an appropriate sustainability strategy does not have a negative impact on their other responsibilities. Trustee time is not strictly an asset of the fund but it is certainly a constrained resource that should be applied carefully.

CONCLUSION

Trustees play a pivotal role in the management of superannuation funds in Australia. The investment decisions they make are very important to the retirement wellbeing of individuals and to the overall health of Australia's retirement income system. This article suggests that trustees can consider adopting sustainable investing practices without necessarily compromising their fiduciary duties. By ensuring that the sustainability factors they incorporate into the their fund's strategies are appropriate for the circumstances of the trust and are at least financially neutral (as the weight of empirical studies suggest) they can sidestep claims that they are in breach of their duty at general law and under s 52(2) of the SIS to act in the best interests of members. Careful attention to the way the strategies are formulated, implemented and monitored can address the requirements to be prudent and impartial and to act with due care, skill and diligence. The way is therefore open for trustees of superannuation funds to engage more actively with sustainable investing. Whether they choose to accept that invitation remains to be seen.

APPENDIX A

Paper	Strategy	Sample period	Variables	Market
Studies reporting a negative finding				
Gregory A, Matatko J and Luther R, "Ethical Unit Trust Financial Performance: Small Company Effects and Fund Size Effects" (1997) 24(5) JBFA 705.	ethical	1986-1994	ethical funds v non-ethical funds	UK
Tippett J, "Performance of Australia's Ethical Funds" (2001) 34(2) AER 170.	ethical	1991-1998	ethical funds v All Ordinaries Index	Australia
Ali PU and Gold M, "An Appraisal of Socially Responsible Investments and Implications for Trustees and Other Investment Fiduciaries" (Centre for Corporate Law and Securities	ethical	1994-2001	constructed "sinful" portfolio v S&P All Ordinaries Index	Australia

[54] See for instance Anderson K, Marshall S and Ramsay I, *Do Australian Institutional Investors Aim to Influence the Human Resources Practices of Investee Companies?* (Centre for Corporate Law and Securities Regulation, University of Melbourne, 2007).

Regulation, University of Melbourne, 2002).				
Geczy C, Stambaugh R and Levin D, "Investing in Socially Responsible Mutual Funds" (Working Paper, University of Pennsylvania, 2005).	SRI	Various starting 1963-2001	constructed SRI portfolios using a variety of screens v constructed non-SRI portfolios	US
Gold M, "Corporate governance, activism and the role of trustees" (2006) 1(2) JASSA 34.	governance	2000-2005	hypothetical portfolio v index	Australia
Jin HH, Mitchell OS and Piggott J, "Socially Responsible Investment in Japanese Pensions" (2006) 14 PBFJ 427.	SRI	1997-2005	constructed SRI portfolios v TOPPIX index; and an adjusted Nikkei 500 and FTSE Japan Index	Japan
Girard E, Rahman H and Stone B, "Socially Responsible Investments: Goody-Two-Shoes or Bad to the Bone?" (2007) JOI Spring.	SRI	1984-2003	SRI funds v matched lipper style indexes	US
Studies reporting a neutral or statistically insignificant finding				
Luther RG, Matatko J and Corner D, "The Investment Performance of UK Ethical Trusts" (1992) 5(4) AAAJ.	ethical	various starting 1972-1990	ethical funds v Financial Times All-Share Index; and MSCI World Index	UK and world
Hamilton S, Jo H and Statman M, "Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds" (1993) 49(6) FAJ 62.	SRI	1981-1990 1985-1990	SRI funds v non-SRI funds SRI funds v non-SRI funds	US
Luther RG and Matatko J, "The Performance of Ethical Unit Trusts: Choosing an Appropriate Benchmark" (1994) 26 BAR 77.	ethical	1985-1992	ethical funds v FT All-Share Index; Hoare Govett Small Companies Main Market Index	UK
Diltz JD, "The Private Cost of Socially Responsible Investing" (1995) 5(2) AFE 69.	SRI	1989-1991	universe from: Chicago Centre for Research in Security Prices constructed SRI portfolios v constructed poor-SRI ranked portfolios	US
Mallin CA, Saadouni B and Briston RJ, "The Financial Performance of Ethical Investment Funds" (1995) 22(4) JBFA 483.	ethical	1986-1993	ethical funds v matched non-ethical funds; and FT All-Share Index	UK
D'Antonio J, Johnsen T and Hutton RB, "Expanding Socially Screened Portfolios: An Attribution Analysis of	SRI	1990-1996	portfolio of corporate bonds from Domini Social	US

Bond Performance" (1997) 6(4) JOI 79.			Index v Lehman Brothers Corporate Bond Index	
Guerard Jr JB, "Additional Evidence on the Cost of Being Socially Responsible in Investing" (1997) 6(4) JOI 31.	SRI	1987-1996	universe from: Vantage Global Advisers universe constructed SRI portfolio with KLD screens v constructed non-SRI portfolio	US
Guerard Jr JB, "Is There a Cost to Being Socially Responsible in Investing?" (1997) 16 JoF 475.	SRI	1987-1994	universe from: Vantage Global Advisers universe constructed SRI portfolio with KLD screens; and DSI Index v constructed non-SRI portfolio; and S&P 500 Index	US
Sauer DA, "The Impact of Social-Responsibility Screens on Investment Performance: Evidence from the Domini 400 Social Index and Domini Equity Mutual Fund" (1997) 6(2) RFE 137.	SRI	1986-1990 (backdated) 1990-1994 (live)	Domini Social Index v series of indexes: S&P 500; and Chicago Centre for Research in Security Prices Value Weighted Market	US
Gottsman L and Kessler J, "Smart Screened Investments: Environmentally Screened Equity Funds that Perform like Conventional Funds" (1998) 7(3) JOI 15.	SRI	1992-1997	constructed SRI portfolio from S&P 500 Index with an environmental screens v S&P 500 Index	US
Reyes MG and Grieb T, "The External Performance of Socially-Responsible Mutual Funds" (1998) 16(1) ABR 1.	SRI	1986-1995	SRI funds v matched "peer group" indexes: aggressive growth funds; balanced funds; growth funds; and growth & income funds	US
Goldreyer E and Diltz JD, "The Performance of Socially Responsible Mutual Funds: Incorporating Sociopolitical Information in Portfolio Selection" (1999) 25(1) *Managerial Finance* 23.	SRI	1981-1997 1994-1997	subsets of SRI funds v random non-SRI funds subsets of SRI funds v random non-SRI fund	US
Statman M, "Socially Responsible Mutual Funds" (2000) 56(3) FAJ 30.	SRI	1990-1998	Domini Social Index v S&P 500 Index	US
Abramson L and Chung D, "Socially	SRI	1990-2000	value subset of	US

Responsible Investing: Viable for Value Investors" (2000) 9(3) JOI. 73.			Domini Social Index v series of indexes: Russell 1000 Value; S&P Barra Value; and Wilshire Large Cap Value	
Cummings L, "The Financial Performance of Ethical Investment Trusts: An Australian Perspective" (2000) 25(1) JBE 79.	ethical	1986-1996	ethical funds v series of indexes: industry average; S&P All Ordinaries; and S&P Small Companies	Australia
di Bartolomeo D and Kurtz L, "Managing Risk Exposures of Socially Screened Portfolios" (Working Paper, Northfield Information Services, Boston, 1999).	SRI	1990-1999	Domini Social 400 Index; and constructed SRI portfolio from Domini Social 400 Index v S&P 500 Index	US
Naber M, "Catholic Investing: The effects of screens on financial returns" (2001) 10(4) JOI. 58.	ethical	1991-1995	constructed ethical portfolio from KLD database v series of indexes: NYSE; ASE; and Nasdaq	US
Asmundson P and Foerster SR "Socially Responsible Investing: Better for your soul or your bottom line?" (2001) 14(4) CIR 26.	SRI	1995-1999 1990-1999	SRI funds v TSE Total Return 300 Index	Canada
Stone BK, Guerard Jr JB, Gultekin MN and Adams G, "Socially Responsible Investment Screening: Strong Evidence of No Significant Cost for Actively Managed Portfolios" (Working Paper, June 2001).	SRI	1984-1997	universe sourced from common stocks across: Chicago Centre for Research in Security Prices Value Weighted Market Index; COMPUSTAT; and I/B/E/S constructed SRI portfolio using KLD measures v constructed non-SRI portfolio	US
Bauer R, Koedijk K and Otten R, "International evidence Ethical Mutual Fund Performance and Investment Style" (2005) 29 JBF 1751.	ethical	1990-2001	ethical funds v non-ethical funds; and Matched Broad Market Index: Worldscope World; Worldscope UK; Fama & French Market	UK, US and world
Kreander N, Gray RH, Power DM and	ethical	1995-2001	ethical funds v	UK,

Sinclair CD, "Evaluating the Performance of Ethical and Non-ethical Funds: A Matched Pair Analysis" (2005) 32(7)&(8) JBFA 1465.			matched non-ethical funds; and a series of indexes: FT World; and FT All-Share	Sweden, and world
Shank TM, Manullang DK and Hill RP, "Is it Better to be Naughty or Nice?" (2005) 14(3) JOI. 82.	SRI	1993-2003	constructed SRI portfolio v constructed "sin stock" portfolio from S&P 500 Index	US
Vermier W, Van de Velde E and Corten F, "Sustainable and Responsible Performance" (2005) 14(3) JOI 94.	SRI	1998-2004	series of SRI indexes: ASPI Index; ESIE, ESIG, DJ Sustainability Index; DSI; FTSE4Good v series of matched broad market indexes: Stoxx-Euro Zone; MSCI Europe; DJ Global; and FTSE Europe	Europe, US and world
Bello ZY, "Socially Responsible Investing and Portfolio Diversification" (2005) XXVIII(1) JFR 41.	SRI	1994-2001	SRI funds; and DSI 400 Index v matched non-SRI funds; and S&P 500 Index	US
Evans J, Guido R and Guo M, "Analysing sustainable securities" (2006) 1 JASSA 27.	ethical	1998-2003	hypothetical portfolio v index	global
Bauer R, Otten R and Rad AT, "Ethical Investing in Australia: Is there a Financial Penalty?" (2006) 14(1) PBFJ 33.	ethical	1992-2003	ethical funds v matched index: Worldscope Australia Index; or Worldscope Global Index	Australia and global
Statman M, "Socially Responsible Indexes: Composition, Performance and Tracking Error" (2006) 32(3) JPM 100.	SRI	various starting 1990-2004	series of indexes: DSI 400 Index, Dow Jones Sustainability Index (US), Calvert Index; Citizens Index v S&P 500 Index	US
Bauer R, Derwall J and Otten R, "The Ethical Mutual Fund Performance Debate: New Evidence from Canada" (2007) 70 JBE 111.	ethical	1994-2003	equally weighted SRI portfolio v equally weighted non-SRI portfolio	Canada
Gregory A and Whittaker J, "Performance and Performance Persistence of 'Ethical' Unit Trusts in the UK" (2007) 34 (7)&(8) JBFA 1327.	ethical	1989-2002	ethical funds v matched non-ethical funds	UK and world

Studies reporting a positive finding				
Kumar R, Lamb WB and Wokutch RE, "The End of South African Sanctions, Institutional Ownership, and the Stock Price Performance of Boycotted Firms" (2002) 41(2) *Business and Society* 133.	ethical	1993	constructed Ethical Portfolio from KLD database v S&P 500 Index	US
Edwards E and Samant A, "Investing with a Conscience: An Evaluation of the Risk-adjusted Performance of Social-responsible Mutual Funds" (2003) 18(1) MAJB 51.	SRI	1991-2000	SRI funds v S&P 500 Index	US
Hussein K and Omran M, "Ethical Investment Revisited: Evidence from Dow Jones Islamic Indexes" (2005) 14(3) JOI 105.	ethical	1996-2003	series of classifications of: DJ Islamic Market Index v MSCI World Index	global