



RESPONSIBLE INVESTMENT ANNUAL REVIEW 2016/17

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CSF Pty Limited, the Trustee of Catholic Super, has devoted considerable effort to Responsible Investment (RI) since early in the 2000s.

We have prepared this review on the main developments in the RI field at CSF Pty Limited (CSF) during the 2016/17 financial year. As this is our first review of this nature, we will also cover developments over previous years to give relevant context. You can also find our Responsible Investment Policy and Climate Change Policy, as well as more general information on our approach, at csf.com.au/responsible-investing-approach.

We intend to provide annual updates on our RI, and welcome input on the sorts of issues our members would like to see covered. Please feel free to contact us with ideas and suggestions.

This report covers eight major areas:

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1. OVERVIEW

Our RI activities have four main components:

1. **Integrating Environmental, Social and Governance (ESG) issues** into our day to day investment decision-making through our process for selection and review of our external investment managers, and engagement with them.
2. **Behaving as an 'active owner'** of the companies in which we invest by engaging with them on a range of ESG issues and through exercising our right to vote at company meetings.
3. **Collaborating with other investors and industry groups** to address systemic, industry-wide RI/ESG issues that are best addressed through joining forces with others.
4. **Investing in sustainability-themed opportunities** where they meet our usual risk/return investment criteria, and at the same time generate a positive social and/or environmental impact.



2. INTEGRATION OF ESG FACTORS

As the overwhelming majority of our investments are externally managed, the main focus of our ESG integration effort entails:

- assessing the extent to which our existing and potential external managers embrace RI thinking and incorporate it into their investment decisions, and
- encouraging our managers to enhance their performance in this area over time.



We classify our managers as Leaders, Improvers or Laggards and encourage them to move up through these categories (i.e. from Laggards to Leaders). Over the years, our main focus has been on managers of equity portfolios, as equities represent the majority of our assets. In the last year, we have been pleased to see material progress from a number of our managers. We have formally upgraded two of our listed equity managers from Laggard to Improver.

Since 2014, we have also been assessing property managers. Our assessment of property managers is greatly facilitated by our subscription to the Global Real Estate Sustainability Benchmark (GRESB), which undertakes a comprehensive assessment of more than 800 property vehicles globally (listed and unlisted), including funds offered by all but one of the unlisted property managers with which we invest. It is pleasing to report that CSF's managers, and Australian managers generally, perform extremely well in this survey relative to global peers. Indeed, CSF is invested in the property fund which achieved the highest rating of all 823 funds in the survey globally in the 2017 report. We rated two of our property managers as Leaders and two as Improvers (with one of those managers showing the potential to also be a Leader) based on a combination of the GRESB sustainability rating, the National Australian Built Environment Rating System (NABERS) energy efficiency rating and our direct engagement and meetings with fund managers.

The current ESG ratings of our listed equity and property managers are as follows:

Rating	Number of listed equity managers	Number of listed property managers
Leader	2	2
Improver	10	2
Laggard	8	0

We subscribed to the GRESB Infrastructure module, which was introduced in 2016. Infrastructure is an asset class where long-term sustainability issues are very much to the fore due to the long economic lives of the underlying assets and because the energy and transport sectors, which are strongly represented in infrastructure portfolios, have traditionally been heavy carbon emitters. Unfortunately, in the first year, the new GRESB service did not achieve very good coverage of the market, much lower than that of the property sector. Nonetheless, we expect that over time this will be addressed and that the GRESB Infrastructure service will enhance our understanding of our managers' position relative to global peers, and that pressure will be brought to bear on managers to enhance their performance on relevant ESG matters.

We note also that managers of fixed interest portfolios, particularly those with a credit orientation, have started to focus on ESG integration or, in some cases, report and communicate their long-standing efforts in this area. To date, we have not formally adopted ratings of our fixed interest managers but will do so as other priorities permit. We have invested in one credit strategy where sustainability analysis is a key part of the investment case (see section 5: Sustainability-themed investment).



3. ACTIVE OWNERSHIP

Engagement



Engagement involves participating in a dialogue with investee companies with a view to improving their standards of behaviour on various dimensions, often of an ESG nature.

The purpose of engagement can vary but we see it as a way to, ultimately, reduce the risk and/or enhance the return generated from an investment in the company.

Engagement can be undertaken by investors individually or in collaboration with other like-minded parties. It is generally most effective when undertaken in a non-confrontational manner and "behind the scenes". We've had a dedicated engagement effort since 2003 when we became the second client of Regnan, now widely regarded as Australia's leading specialist in the area.



Engagement is a painstaking activity and it will always be impossible to know with certainty how companies would have behaved in the absence of the engagement with shareholders. Furthermore, there is a classic "free-rider" problem because all shareholders benefit from engagement activity, not just those who pay for it. Nevertheless, we believe that there is clear evidence that engagement has, over time, resulted in substantial behavioural changes by many companies across a wide range of industries. And progress has been greater in Australia than in many other countries due to the combined efforts of Regnan, the Australian Council of Superannuation Investors (ACSI), and a number of fund managers and other institutional investors. At CSF, we believe that we have played a role due to our early support of specialist engagement activity, and are proud to have done so.

As well as our early support for Regnan and ACSI in Australia, we also use the services of a specialist engagement service globally, being Bank of Montreal's Responsible Engagement Overlay (REO) service. We are one of a very small number of Australian superannuation funds contributing to engagement overlay services both in Australia and globally.

The key engagement issues or themes focussed on during 2016/17 were:

Australia

- Climate change
- Water
- Human capital and conduct culture
- ESG disclosure
- Board diversity
- Remuneration

Overseas

- Environmental standards
- Business ethics
- Human rights
- Labour standards
- Public health
- Corporate governance
- Social and environmental governance

Voting

We again voted on all resolutions put before General Meetings of the companies in which we invest directly in Australia, except for the stocks contained in one micro cap mandate (i.e. investing in very small companies) where the voting activity is delegated to the external manager. A summary of our voting over recent years is shown in the following table.

	Management Recommendations 2016	CSF Votes 2016	CSF Votes 2015	CSF Votes 2014
For	1,593	1,492 (90.2%)	89.8%	90.1%
Against	15	135 (8.2%)	8.6%	8.0%
Abstain/ Do Not Vote	0	28 (1.8%)	1.6%	1.9%
None (or Other)*	47	0	0%	0%
TOTAL VOTES	1,655	1,655 (100%)	100%	100%

* Resolutions where there is no management recommendation usually relate to proposals for remuneration of or grants of options or shares to non-executive directors, or in some cases for remuneration reports.

In 2016, we voted against management recommendations on about 8% of resolutions, which is broadly in line with the pattern of recent years.



The issue with perhaps the highest profile at company AGMs in Australia over recent years has been remuneration. The introduction of the so-called 'two strikes' policy has given shareholders greater influence over remuneration practices at Australian companies. Under this policy, any company which receives a No vote on its remuneration policy exceeding 25% at successive AGMs is required to put a vote to spill its board to a subsequent general meeting. In 2016, some of the biggest companies listed on the Australian Stock Exchange received remuneration policy strikes from shareholders including Commonwealth Bank (51% Against) and CSL (26% Against). We were amongst the Against votes in both of these cases.

The influence of institutional shareholders was also seen in the withdrawal of contentious resolutions, including Director nominations, when it became clear that they lacked shareholder support and would be voted down.

Internationally, we note a new emergence of climate related resolutions. For international shares, our fund managers vote on our behalf because we invest via pooled or commingled funds where we do not have direct control. We review the voting behaviour of our managers and have specifically engaged with them in respect of their voting on these climate change resolutions.



4. COLLABORATION



Collaboration has been an important part of our RI effort for many years, and climate change has been a key focus of our collaboration. Our Chief Executive Officer, Frank Pegan, is Chairperson of the Investors Group on Climate Change (IGCC), a position he has held since 2009. In this capacity, Frank was invited to speak at a UN-sponsored climate change conference in New York in September 2014 and at the COP21 climate conference in Paris in November 2015. The New York conference was organised in an effort to enhance dialogue and build consensus on policy targets across the globe in preparation for the Paris COP21 meeting. The latter has been acclaimed as achieving a key breakthrough in global co-operation designed to address climate change.

More information on the various collaborative initiatives in which we are involved is provided in our Responsible Investment Policy.



5. SUSTAINABILITY-THEMED INVESTMENT



In our Responsible Investment Policy we state our preparedness to undertake investments which will contribute to the social and environmental amenity of the world in which our members live and into which they will eventually retire. Any investments which we make with a sustainability theme must, however, meet standard risk/return criteria. We do not have a specific target for sustainability-themed investments as we believe that adopting such a target could lead us into investments which do not satisfy normal investment criteria, just to meet the target. Nevertheless, we have identified a number of strategies which we expect to deliver sound investment outcomes and which have a clear sustainability theme. Examples from previous years of significant unlisted investments in this category are:

- In 2013, we committed \$60 million to a global private debt fund which lends to small-to-medium-sized businesses which have a growth agenda with a clear sustainability angle. Interestingly, the second loan was to a company involved in food processing and which is based in Mill Park, a northern suburb of Melbourne. The investment period for this fund has now been completed and we are receiving distributions.
- In 2014, we made a \$60 million commitment to a fund which invests in renewable energy and energy efficiency projects in developing countries. This Global Energy Efficiency and Renewable Energy Fund (GEEREF), was raised by an arm of the European Investment Bank. A number of European governments have contributed so-called "first loss capital" which tilts the risk/return profile in our favour. During 2016/17 we received the first distributions (repayments of capital and profits) from the Fund.
- In 2016/17:
 - We committed \$60 million to a fund which is undertaking utility-scale solar PV projects in Australia. To our knowledge, this is the first fund of its type in this country. Since 30 June, we have increased the size of this commitment to \$90m.
 - We committed \$90 million to a low carbon power fund which will invest in a range of renewables technologies across the US, and potentially the UK and Australia. We previously invested in a US solar PV fund managed by the key individuals who will be managing this new fund. That fund has since returned the capital, with a satisfactory return.



It is worth noting that in all of these cases we are an important part of the overall capital of the fund. Indeed, we are by far the largest private investor in GEEREF, the dominant investor in the Australian solar PV fund, the second largest (and only Australian) investor in the global low carbon power fund, and amongst the largest (and only Australian) investor in the

global private debt fund. We see our preparedness to provide early support to strategies such as these as an important way in which we can contribute to Responsible Investment. Our early support can assist in the mainstreaming of such strategies, providing the managers with the opportunity to establish their credentials, possibly leading to larger follow-on funds. And by being early movers, we hope to achieve risk-adjusted returns exceeding those which will be available to later investors.

In the following table, we list the assets in our portfolio where:

- there is a clear sustainability angle to the strategy concerned, and the manager is a global leader in integrating sustainability into its decision-making, or
- the underlying assets generate renewable energy and therefore have inherent sustainability benefits. In some cases, the renewable energy assets form part of diversified infrastructure portfolios. In others, the strategy is dedicated solely to renewables.

Manager/Strategy	Amount invested ¹ (\$m)	Percent of total assets (%)	Total commitment where applicable ² (\$m)
Global equities			
Generation Investment Management	296.9	3.5	N/A
Stewart Investors	264.3	3.1	N/A
Property ³			
APPF Commercial	42.4	0.5	N/A
APPF Retail	59.0	0.7	N/A
APPF Industrial	97.2	1.1	N/A
GPT Office	67.1	0.8	N/A
Global Credit			
Generation Investment Management	26.3	0.3	60.0
Renewables			
Windfarms and peaking gas within Infrastructure Capital Group funds	56.2	0.7	N/A
Wind, solar and waste-to-energy within Macquarie Asia Infrastructure Fund	4.7	0.1	8.1
Lighthouse Solar Fund	36.2	0.4	60.0
Global Renewable Energy and Energy Efficiency Fund	49.4	0.6	60.0
Quinbrook Low Carbon Power Fund	0.0	0.0	88.0
All			
TOTAL	999.7	11.8	N/A

1. Value of the investment at 30 June 2017.

2. With some unlisted funds, we provide a commitment up-front. This committed amount is then drawn down progressively through an investment period as underlying investments are made. Through the life of the fund, we receive distributions of income and capital gains or losses. In this column, we show the original committed amount. It differs from the amount shown in the first column and can be higher or lower depending on where the fund is in its lifecycle. For the Macquarie Asia Infrastructure Fund, the figure shown is based on the renewables share of total assets as at 30 June 2017.

3. We have only included in this table our investment in property vehicles which achieved very high rankings in the latest GRESB report.



6. CLIMATE CHANGE



Climate change is a key investment risk and an opportunity that we seek to manage on behalf of our members. Climate change is reflected across our integration efforts, our active ownership activities, our priorities for collaborating with others, and through our investments in sustainability-themed opportunities. Over the 2016/17 year, the most obvious aspect of our climate change response was the commitment to invest an additional \$150 million into renewable energy, as discussed in section 5: Sustainability-themed investment.

More detail on our thinking on this issue is provided in our Climate Change Policy which has been approved by the Board and is overseen by the Investment Committee. Although we have been active in the area for many years, our Climate Change Policy came into force in 2016 and is reviewed on an annual basis. Some of the highlights of the policy include:

- **Beliefs:** The policy sets out in detail our investment beliefs with respect to climate change. Some key aspects of our beliefs are that:
 - climate change is already having physical impacts which are influencing investment outcomes in some areas
 - the world is at the relatively early stages of a decades-long transition to a lower carbon economy
 - as a result of mitigation efforts, some assets will become stranded (or may have already become stranded)
 - the transition to a lower carbon economy will also present investment opportunities, and
 - the integration of climate-related risks and opportunities into investment decisions is vital for enhancing our members' best interests as the low carbon transition process unfolds.
- **Engagement and Collaboration:** Engagement with companies, fund managers and policy-makers is important, and should be pursued either directly or, where this will achieve greater progress, in collaboration with like-minded parties.
- **Climate-themed investment:** We will undertake climate-themed investment which satisfies normal risk/return criteria. We will monitor investment undertaken under this banner and would like to see it increase as a proportion of total assets over time. The position as at 30 June 2017 is shown in section 5: Sustainability-themed investment.
- **Reporting:** We will report to our members on our activities in this area, and hope to refine and improve this reporting over time.



One climate change related initiative of note is our support and commitment to the Montreal Pledge. We signed this pledge in 2015 and by so doing committed to measuring and reporting the carbon emissions of our listed equity portfolio on an annual basis. To conduct the measurement, we engaged the services of an independent organisation called Trucost, an acknowledged leader in the field. To date, three such measurements have been undertaken and reported.



As stated in our Climate Change Policy, over time we would like to see a reduction in the carbon emissions from our listed equity portfolio. So far, this has been seen in our global portfolio but not our Australian equities portfolio. We could reduce the carbon footprint of our portfolio by switching part of our existing portfolio into a strategy which is specifically structured to achieve this end. At least at this stage, we are not inclined to go down that path as we believe that:

- Such strategies are generally based on unconvincing data, run the risk of building in other unintended biases to the portfolio and more generally are not well-suited to achieving the favourable long-term investment returns which are our fundamental responsibility to members.
- Climate change is best addressed by a comprehensive approach spanning a range of activities and involving governments, companies, institutional investors and individuals acting in their daily lives. We consider that we are responding to the climate change challenge in a number of meaningful ways, as shown in this review.



7. DIVESTMENT/NEGATIVE SCREENING



From time-to-time, we receive requests for us to divest from our portfolio (i.e. sell our shareholdings) all stocks in companies involved in activities relating to issues such as tobacco, gambling, alcohol, fossil fuels, and the use of hydraulic fracturing (fracking) techniques in oil and gas production.

We frequently sympathise with the underlying concerns driving these requests, however we generally do not see divestment as a viable solution to the issues being raised. If we divest our holding in a particular company:

- In the absence of a concerted global campaign against the company concerned, it is likely to continue to operate in much the same way as it always has.
- The underlying consumer demand which the company is meeting will also continue unaffected by our divestment decision.
- We will have lost our opportunity as a shareholder to engage with the company to encourage it to improve its practices.
- It is likely that our shares will be acquired by another party which is less inclined to engage with the company concerned, reducing the likelihood that progress will be achieved.



With respect to fossil fuel/carbon, we strongly support a transition to a low carbon economy, but believe that it must be a gradual process extending over multiple decades. Ideally, we would have started this transition 20 years ago. As set out in our Climate Change Policy, we believe that divestment from fossil fuel assets is not an effective way to achieve positive change in this transition process for two main reasons. Firstly, investors can have more influence over companies and their behaviour if they stay invested; once an investor sells a company they lose influence. Secondly, fossil fuels will retain an important share of global energy markets at least for a number of decades. Accordingly, the prospect is for a re-pricing of some 'at risk' high carbon assets and a reduction in the proportional contribution which fossil fuels make to meeting the growing global demand for energy as renewable energy sources and new technologies continue to grow.

This thinking also underpins our strategy of seeking out and investing in climate-related opportunities that can capture this transition process while at the same time producing solid risk-adjusted returns for our members. Our portfolio will transition over time as and when the attractive investment opportunities arise.



8. OUR NEW POSITIVEIMPACT INVESTMENT OPTION



At CSF, we believe that we were an early adopter of RI thinking and behaviours. The range of activities which we undertake under the RI banner is comprehensive and appropriate given the circumstances under which we operate. Importantly, we embrace RI thinking because we believe that by doing so we will deliver enhanced investment outcomes to members over the long term.

At the same time, we are aware that some of our members would like to have their superannuation investment concentrated in assets where there is a clear and tangible social or environmental impact. Because we have embraced RI over many years, we already have a number of strategies in our portfolio where there is such a clear and tangible impact. Accordingly, we introduced our new PositiveIMPACT option on 1 November 2017. This option is diversified across asset classes, but comprises only those strategies within each asset class where there is a tangible social or environmental benefit and/or where sustainability-driven thinking is integrated into decision-making at an advanced level. A number of the strategies included in this new option are mentioned in section 5: Sustainability-themed investment.



The listed equities strategies included in the PositiveIMPACT option do not incorporate explicit screens on the various areas which are most commonly the subject of divestment or negative screening pressures. Nonetheless, due to the philosophies and process of the managers we are using for this option, it is almost inconceivable that the portfolio will contain material exposure to activities such as those listed in section 7: Divestment/negative screening. Furthermore, due to the managers' philosophies and the depth of their fundamental processes, the portfolio will be invested in companies where standards of corporate behaviour across a wide range of important dimensions, and the focus on sustainability generally, will be extremely strong. Indeed, we expect that the standard of our portfolio on these broad quality and sustainability dimensions will exceed standards achieved in typical portfolios where explicit negative screens are applied. Accordingly, the PositiveIMPACT option may also be of interest to members who do not share our thinking on divestment vs. engagement.

More information on our PositiveIMPACT option can be found at positiveimpact.com.au, and is contained in our *Product Disclosure Statement (PDS)* and *Investment guide* (available at csf.com.au/super-pds).

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