Frontier International

Perspectives from the US – Equities

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About Frontier

About us Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

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Simone Gavin re-joined Frontier Advisors in May 2020 as a Senior Consultant and is a member of the Equities Team. Simone previously worked at Lonsec for seven years where she was responsible for undertaking manager research in global and domestic equities, with lead analyst responsibilities for global equities and emerging market equities.

Prior to Lonsec, Simone spent five years at Standard & Poor's where she also undertook manager research in global and domestic equities and had lead analyst responsibilities for listed infrastructure and emerging market equities. Simone previously worked with Frontier as an analyst for two years until November 2007. Simone holds a Bachelor of Chemical Engineering (hons) and Commerce from The University of Melbourne.

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Brad joined Frontier as an Associate in March 2021 before being promoted to Consultant in August 2022.
His responsibilities include both equities research and client support.

Prior to joining Frontier, Brad worked for five years at Intrinsic Investment Management firstly as a research analyst before moving into the role of assistant equity analyst covering the industrials sector of the ASX200. Brad graduated from Monash University with a Master of Applied Finance following on from a Bachelor of Commerce from Deakin University majoring in economics, finance and quantitative business analysis.

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Introduction

In this comprehensive research paper, we delve into our insights from a recent research trip to the US. During the trip we met with 23 fund managers covering 30 strategies as well as two US-based investment consultants.

We travelled to six different cities as a part of this trip and assessed strategies currently held by clients, their ratings and explored new ideas focused on four key areas, including:

- emerging markets (with a top-down influence)
- global value (deep)
- global small or mid-caps
- climate transition/impact.

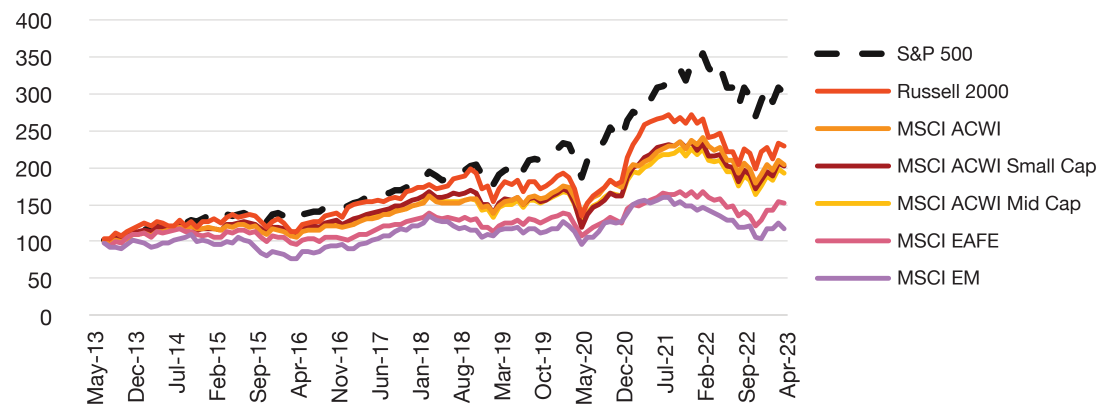
We also asked each manager and the consultants about a number of topics related to US asset owners, specifically portfolio construction including home bias and active versus passive allocations; emerging markets (China) exposure; as well as views on ESG.

Portfolio construction insights

The relative strength of US markets helps US investors with home biases

Much like Australian-based institutional investors, US-based asset owners typically invest a large portion of their equity portfolio into domestic equities and then seek diversification and return enhancing ideas outside their home market. This has typically taken shape in strategies such as international (or ex-US), global small and mid-caps and emerging markets (EM). US-based pension plans and asset allocators believe these markets are less efficient than the US market and offer fund managers greater opportunities to generate excess returns. However, despite the promise of return enhancement and diversification, any investment outside the US (and in particular US large cap) over the past ten years has resulted in substantial index headwinds for US-based investors. Given the order of magnitude of the US index level outperformance, it is unlikely US-based investors were able to compensate for this through their active management excess returns.

Chart 1: Cumulative performance of S&P 500 and various other indices since May 2013 (USD)



Source: Bloomberg, Frontier Advisors

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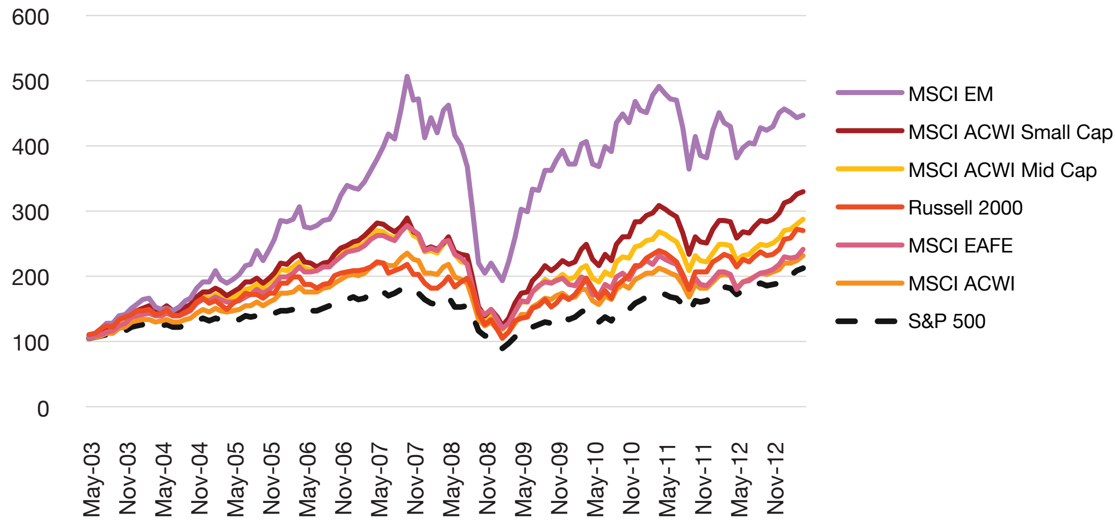
The S&P 500 has generated 12.2% p.a. returns over the ten years to 30 April 2023 as shown in Chart 1. Competing choices for US-based investors such as US small caps (7.9% p.a.), international shares (4.8% p.a.) and emerging markets (1.8% p.a.) have failed to deliver in the promise of return enhancement. Any active management program in these markets would have had to generate extremely high levels of alpha to compensate for the beta headwinds over this period.

While for many investors this market environment has felt much like a one-way bet, it stands in direct contrast to the ten-year returns to May 2013 where the S&P 500 underperformed all other markets in the sample, while EM drastically outperformed. This is shown in Chart 2.

Chart 2: Cumulative performance of the S&P 500 and various other global indices from May 2003 to May 2013 in USD



Source: Bloomberg, Frontier Advisors

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Australian investors have faced significant headwinds

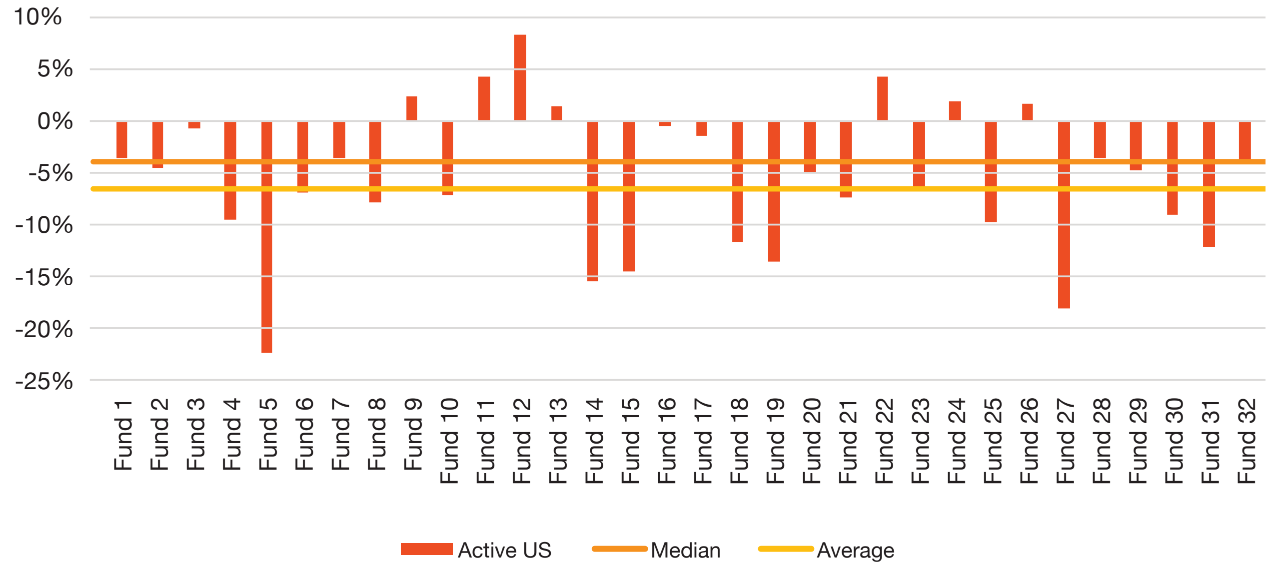
While US investors have seen this past decade of US outperformance through the lens of beta headwinds (i.e. not investing in the US hurt their overall returns), for Australian-based investors this has presented as an alpha headwind in their global equity portfolio (i.e. having less invested in the US reduced Australian investors outperformance relative to almost any global equity benchmark).

Using data obtained from the recent *Portfolio Holdings Disclosure* legislation, we have analysed the portfolio of Australia's 32 largest super funds across several different portfolio metrics. We found the median super fund has a ~5% underweight allocation to the US share market relative to the MSCI ACWI benchmark. Using this same data, we also found the median fund to have benchmark neutral allocation to emerging markets which indicates the US underweight stems from underlying manager allocations as opposed to super fund top-down decisions.

The flow on implication for Australian asset owners not represented in this data set, is that if they also employ an active management program in their global equity portfolio, they are likely to also exhibit an underweight to the US markets.

The takeaway for investors is that through their managers, Australian asset owners have both now, and in the past, been taking unintended bets against the US market and the US dollar. This is crucial in understanding both excess return patterns from the past but also the risks and opportunities to future returns relative to the benchmark.

Chart 3: Australian super fund active exposure to the US (relative to the MSCI ACWI)



Source: Super Ratings Holdings Disclosure, Style Analytics, Frontier Advisors

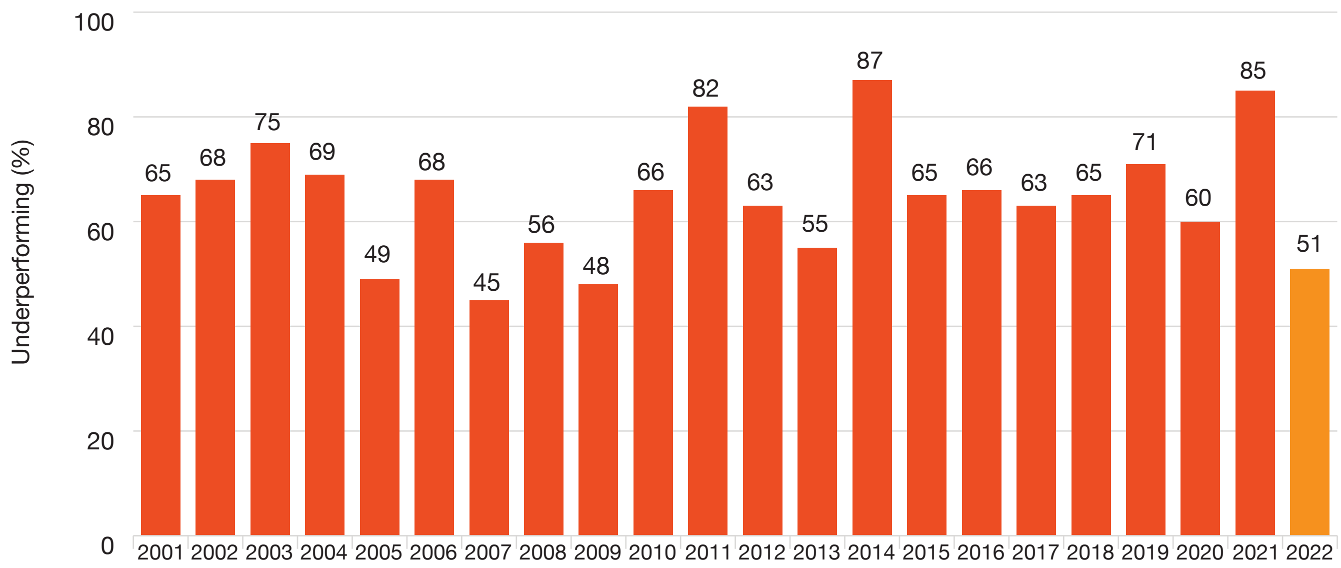
The global active management challenge

Generating excess returns within the US large cap market over the past decade has been tough for active managers. Likewise, we have seen the challenging conditions in the US producing headwinds for global active management alpha.

Given recent strong share price performance, Microsoft and Apple now make up over 13% of the S&P 500 (May 2023) and the FAAMG stocks (Facebook, Apple, Amazon, Microsoft and Google) represent more than 20% of the index.

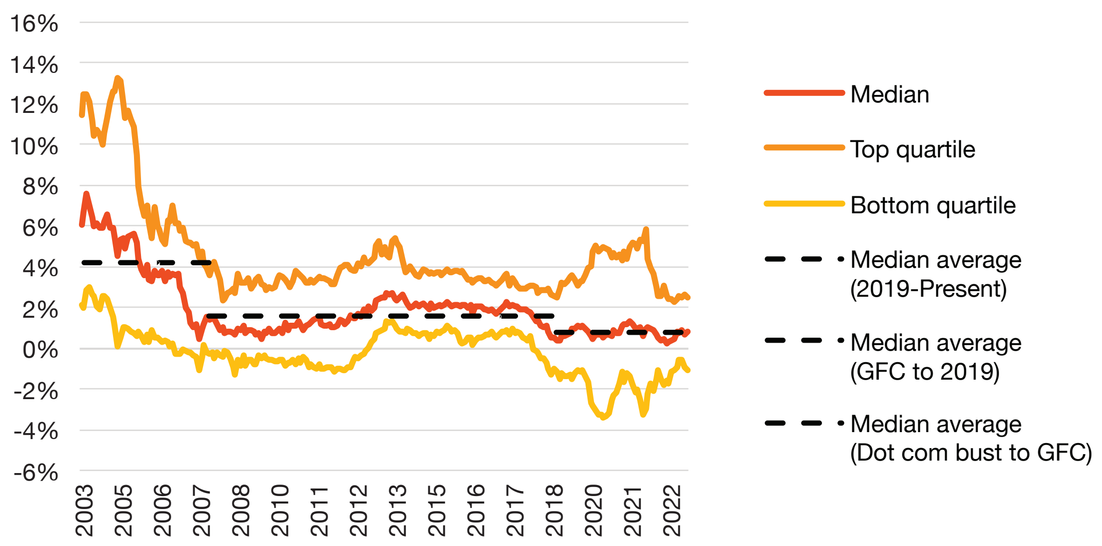
Continued ETF and passive fund flows into this cohort of stocks is one commonly cited reason as to why both domestic US and global equity managers struggle to beat the S&P 500 and MSCI ACWI index on a consistent basis. This trend is something we've previous analysed in a research paper in 2022.

Chart 4: Percentage of US large cap domestic funds underperforming the S&P 500 index



Source: SPIVA

Chart 5: Global equity manager rolling five-year excess returns against the MSCI ACWI



Source: Frontier Advisors cleansed universe, eVestment

The Frontier cleansed universe demonstrates the challenge that global active management has had over the past five years compared to the 2006-2017 period and before then in the 'dot com' unwind. While investors often question whether this decline is cyclical or structural, we contend that a large degree of this sub-par performance is a result of the underweight to US markets and US mega-caps.

Equally the challenging market conditions particularly from 2020-2022 resulted in higher levels of dispersion between top and bottom performing managers (as denoted by the spread between the top and bottom quartiles). The dispersion has since narrowed but we believe this highlights the importance of manager selection in periods of market distress.

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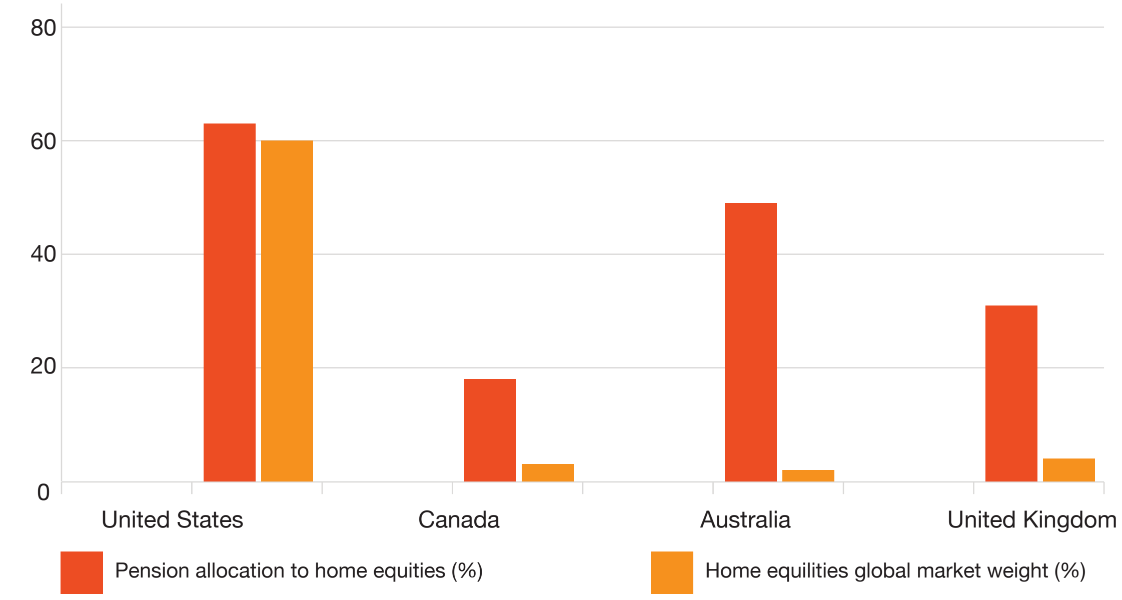
The current state of US investors' equity portfolios

As a result of the market dynamics that have played out over the past ten years, we find US asset owners still exhibit a home bias despite the already large representation of US markets in global indices. According to Northern Trust, since 2001, US pension plans have been steadily reducing their allocation to US equities from ~85% to ~63% today. Though our conversations with Segal Marco (Frontier's global research alliance partner) indicated that public pension plans allocations to US equities was closer to 70-75% of their total equity portfolio. This is even higher for the Taft-Hartley (employer sponsored) plans which currently allocate 80% of their equities' portfolio to US equities.

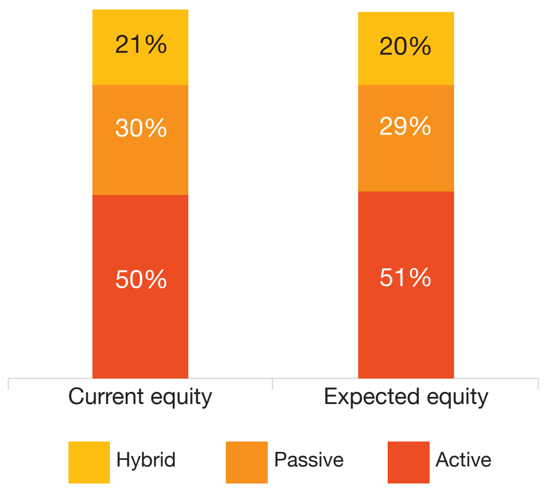
Chart 6: Home bias of global pension systems as at December 2021



Source: Northern Trust

We have also found passive investing has risen from low levels of use in institutional equity portfolios to now stand at 30%. Interestingly, our discussions indicated retail investors were allocating more to passive investments than institutional investors.

Chart 7: Active/passive allocations of US pension plans



Source: Cerulli Associates

While the home bias of US investors has reduced over the past decade, our discussions with Segal Marco indicated the overall rise of passive investing and reduction in the overall weight of equities in US investors' portfolios in favour of other asset classes had squeezed out other areas such as mid and small-caps and emerging markets. In effect, we have seen large pools of capital from US pension funds being drawn away from international equity managers and toward other asset classes and passive equity investments.

Emerging themes

We have witnessed a major shift in world financial markets following the pandemic with inflation proving to be far more persistent than first thought by central banks which has resulted in sharp tightening of monetary policy almost everywhere in the world. This has led many financial commentators to declare that the world of easy money is now over. Higher for longer was a much-discussed point in many meetings with this belief by investors having an emerging influence on portfolio construction.

The following paragraphs represent a summary of the discussions we had with US-based consultants, asset allocators and fund managers regarding emerging areas of interest for US pension plans and asset owners. However, the areas of interest were underpinned by three key common beliefs held by many consultants and asset owners:

- Record levels of index concentration within the S&P 500, which has created hidden risks for headline index level returns.
- A potential end to the US dollar strength that has acted as a significant headwind for international equities since 2008.
- A more normalised level of interest rates going forward which may reduce or even reverse passive fund flows into mega-cap stocks.

Given the US pension market is the largest in the world, the direction of travel of fund flows has the potential to shape future returns in various sub-asset groups. This growing interest in international (or ex-US) strategies represents an opportunity for Australian-based investors to get ahead of this trend and deploy capital into return enhancing strategies.

Emerging concentration risks

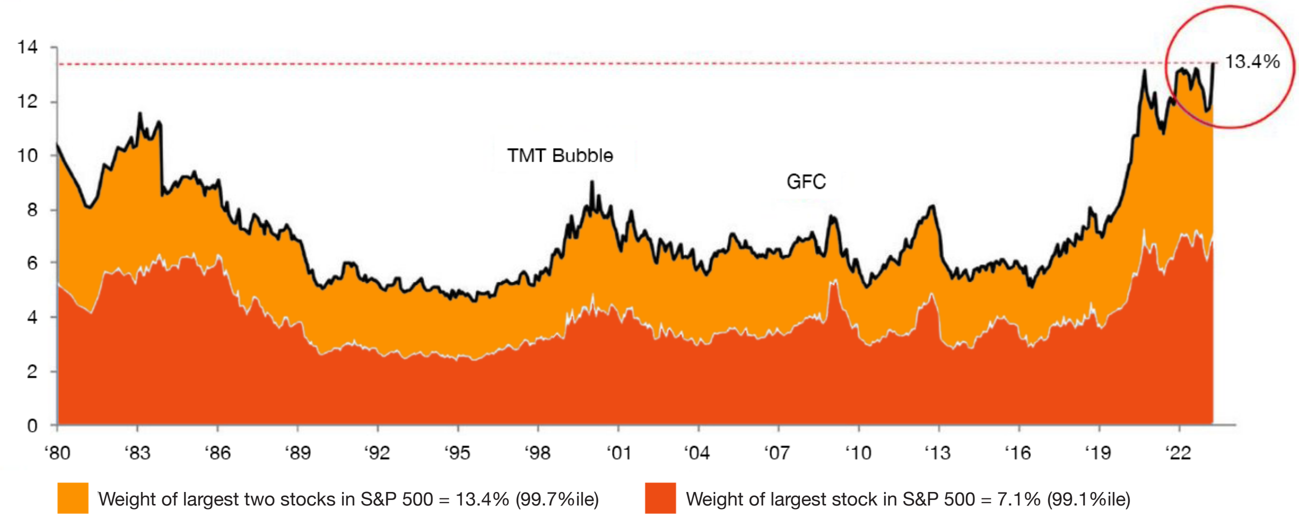
US and global investors have been increasing allocations to passive strategies over the past decade owing to their low-cost nature, simplicity in terms of implementation and recent challenges in performance of active management. Despite this, our discussions in the US indicated there was a growing weariness of index strategies given the level of concentration that has built up in recent years. Many investors also believe a more uncertain, volatile world with higher dispersion across stocks may create better opportunities for excess returns (alpha) and notably even Australia's Future Fund recently amended a historical model of passive to more active management[1].

The market environment that has prevailed in 2023 has been much like what we witnessed in 2020, with a small number of stocks proving much of the index's overall gains. For example, taking a basket of stocks linked to AI (Meta, Apple, Amazon, Microsoft, Google, Nvidia, AMD, Broadcom, Micron, Arista, and Seagate Technology), their YTD returns to May 25 of 15.5% has largely driven the S&P 500's overall return of 8.9%. The other 489 stocks have contributed -6.7% over the same period. While there is no doubt that AI is a significant technological development for humanity, we found there was a range of responses from managers we spoke to regarding where, or to which companies, the ultimate benefits would accrue. Ultimately while new developments in AI will benefit some of these businesses, it also stands as an existential risk to others.

We believe the valuation correction in 2022 gave investors a flavour of what index level returns could look like should the indices' largest stocks begin to underperform.

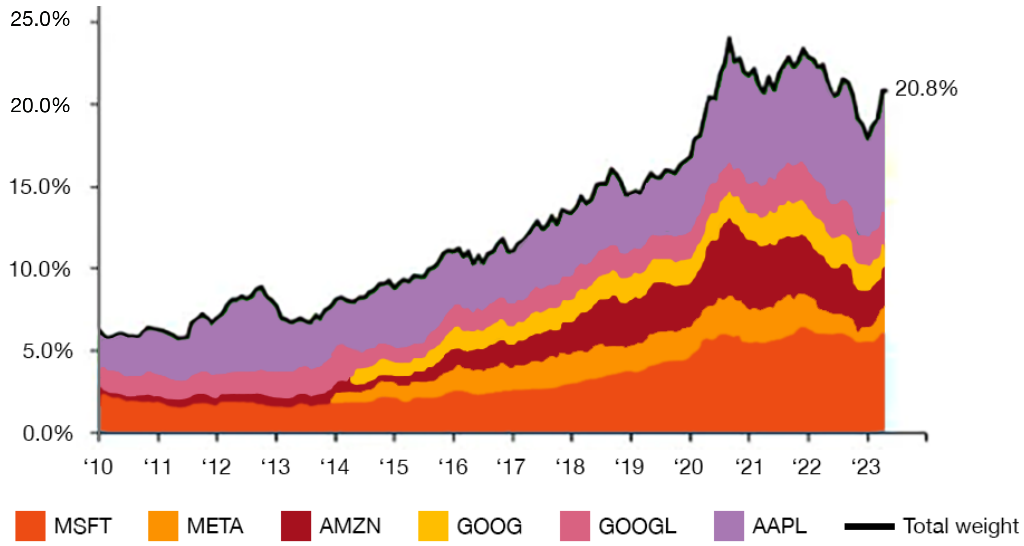
[1] https://www.afr.com/markets/equity-markets/future-fund-ready-to-embrace-stock-picking-again-20230425-p5d343

Chart 8: Weight of the two largest stocks in S&P 500 (Microsoft and Apple)



Source: Goldman Sachs

Chart 9: Weight of FAAMG in S&P 500



Source: Morgan Stanley

There was growing awareness from US-based asset allocators that at such high levels of index concentration, simply allocating additional funds into passive investments particularly within the US large cap market wasn't without its risks. We also found there to be increasing levels of activity for managers in areas such as international (or ex-US), global small and mid-caps, and global value, with managers reporting a substantial pick up in requests for proposals (RFPs) and pitches for US-based clients.

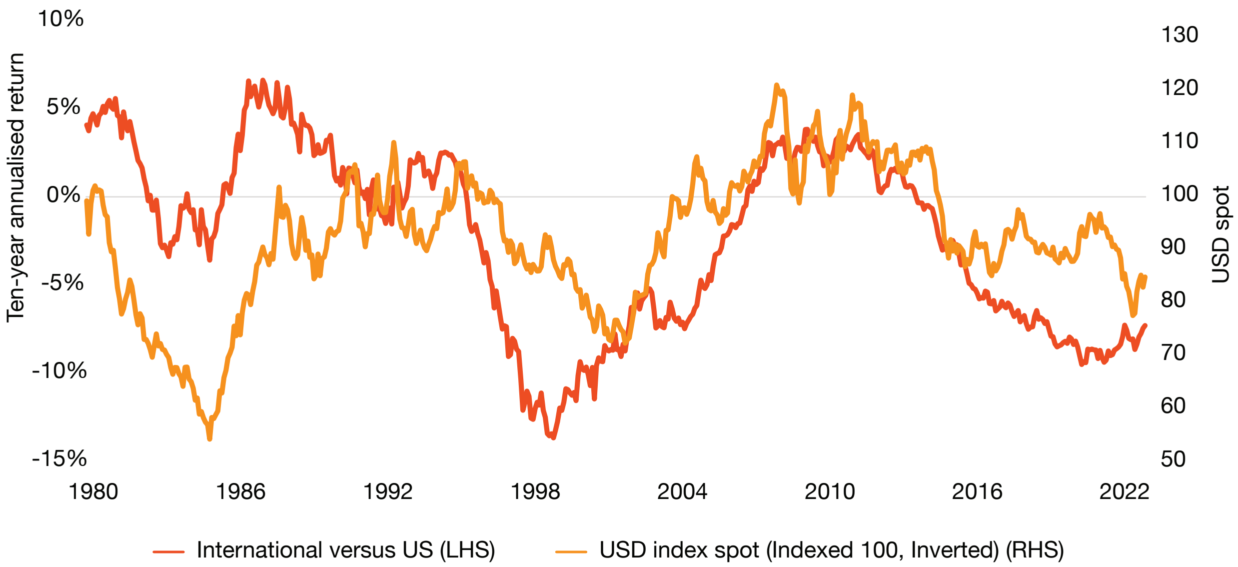
In the case of small caps, the MSCI ACWI Small Cap Index is currently trading at a discount (on a one year forward P/E basis) to the MSCI ACWI Large Cap Index. Historically this isn't typically the case and was another reason cited for the increased level of interest surrounding small cap strategies.

Interest in international strategies

The past decade has been characterised by, among other things, the continued strength of the US dollar. Over the past ten years to the end of May 2023, the USD (according to the DXY Index) has appreciated by 30% against global currencies. On an annualised basis, this has presented as a 2.5% headwind to international equity (or ex-US) returns. Despite the belief from many US investors and consultants that international and emerging markets are more conducive areas for active management, the beta headwind from both market and currency movements for US investors has generally swamped any potential alpha produced by an active management program.

While fund managers, and Frontier's equity research team, are hesitant to call a turning point in the USD, there was a general acceptance the exceptional strength over the past ten years couldn't continue to present as such a strong headwind forever. Many of the global equity managers we spoke to had reported a pick-up in interest and RFP activity from US clients. This is backed up by both the recent eVestment institutional trends survey which reported global equity strategies as one of the most viewed strategies in Q4 2022 for US investors and a Cerulli Associates survey that reported global equity among the top ten asset classes where asset owners were likely to increase allocation over the next 24 months.

Chart 10: USD weakness has in the past correlated with non-US outperformance



Source: Lizard Investors

What does this mean for Australian investors?

The past ten years has been a really tough environment for both US and Australian based investors. The outperformance of US equity markets and the US dollar has resulted in beta headwinds for US investors looking to invest offshore, while closer to home we have found Australian investors suffering from alpha headwinds in their global active management program. Despite this, over ten years the median Buy-rated manager from Frontier was able to generate 2.0% p.a. of excess returns to March 2023.

From our discussions with US based asset allocators, consultants, and fund managers we witnessed an emerging shift in the perceptions toward some of the dominant themes in portfolio construction (home equity allocation and passive investments) over the last decade.

Given the large size of the US pension market we believe this represents an opportunity for Australian investors to deploy capital toward return enhancing/opportunistic strategies (such as small caps or emerging markets) ahead of flows from US-based investors in what may be a more conducive environment for active management returns going forward.

As a result, Frontier has focused our efforts for idea generation in some of these areas including small and mid-cap equities, emerging market equities, as well as for a deep value global equity manager, which seems to be dying breed.

Emerging market equity insights

Renewed interest in EM or interest in EM ex China?

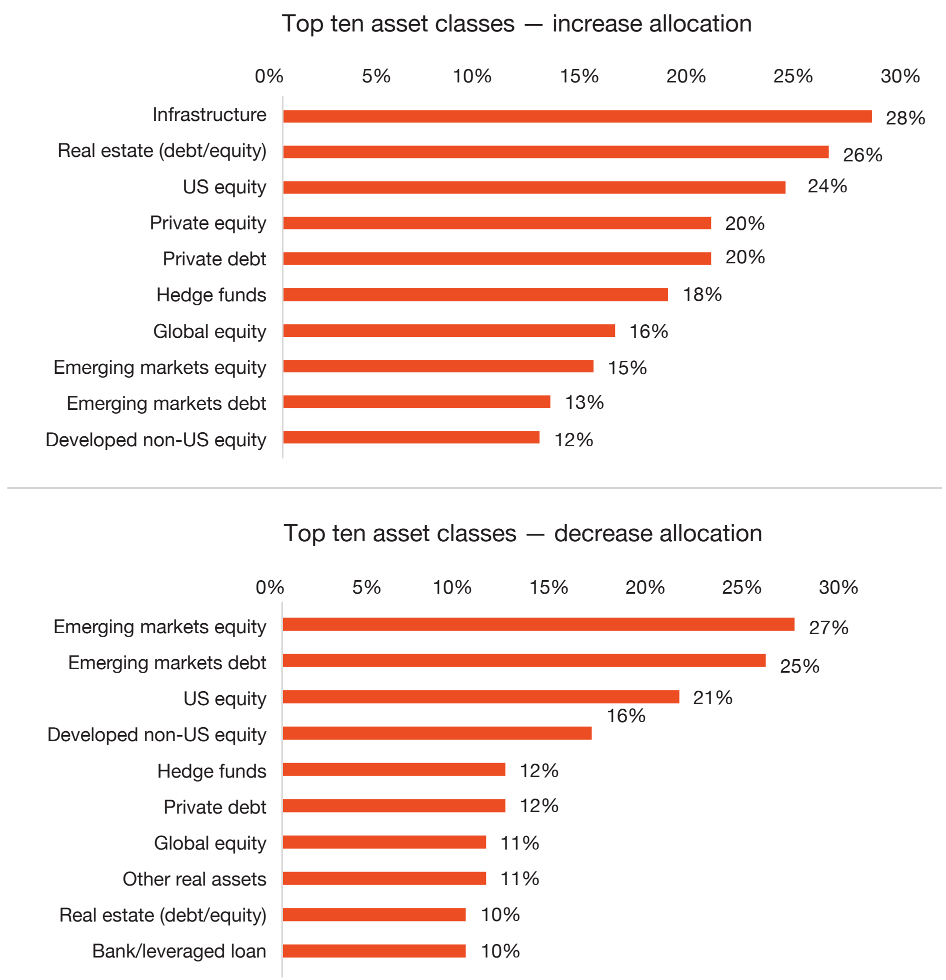
It has been a challenging decade for emerging markets amplified by the war in the Ukraine which led to concerns regarding the geopolitical tensions that surround China. This has scared investors both in the US and more broadly from investment in EM and China. We asked about more recent interest in emerging market equities given the rebound in Chinese equities following China's reopening.

Several managers noted they were receiving calls about their positions in China (including global equity managers with positions in the likes of Alibaba) with client concern heightened in 2021 and 2022 amid government regulation and post the invasion of the Ukraine. However, since the reopening of China and improved market performance, these concerned calls had stopped.

Emerging market managers observed an increase in RFPs from potential clients and interestingly noted the conversation about emerging markets ex China had also developed. This was not necessarily to divest from China completely but to control the allocation to China. However, it is worth noting that earlier this year, lawmakers in Indiana ordered their state pension fund to divest holdings closely associated with the People's Republic of China or the Chinese Communist Party. While this may be a minority case, it shows that there are instances of divestment taking place. Geopolitical tension is clearly the key reason for the reduced or zero weight to Chinese equities.

Chart 11 uses Cerulli Associates survey data from 2022 to show the most significant decrease in asset class over the next two years was expected to be from emerging markets equity with 27% of clients indicating a reduction. The timing of this chart is important because it was before the reopening when considerations of Chinese equities were more negative.

Chart 11: Asset owners: expected change in asset allocation over the next 24 months



Source: Cerulli Associates

Flows to EM and China equities

Following our discussions with consultants, including our research affiliate partner Segal Marco, on the declining allocation to emerging markets, we decided to investigate the overall net fund flows in and out of emerging markets and more specifically China.

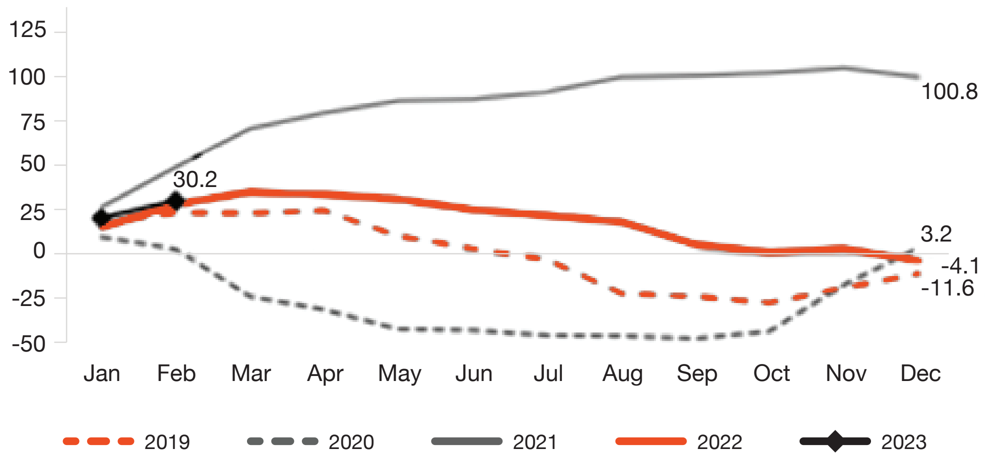
Based on EPFR data (and Goldman Sachs), mutual funds spanning emerging markets, Asia ex-Japan, global and international ex-US had on average a 7.7% weight in China as of 30 April 2023, which represents the eleventh percentile relative to exposure over the past decade (i.e. extremely low relative to the historical allocations). While not at the lowest point, it is a decline of ~50% since March 2021. Other data from Citibank corroborates this view, with global and emerging market equity funds currently 1.5% and 3.0% underweight in China respectively. We think this is particularly important for Australian investors given their China allocations are typically derived through global and emerging market manager allocations.

Chart 12: China allocations in active funds globally (includes GEM, AEJ, global and global ex-US funds)

Source: EPFR, FactSet, MSCI, Goldman Sachs Global Investment Research

The story is similar for emerging markets more broadly. US mutual fund exposure at the end of December 2022 was 6.1%, which is close to a two-decade low (5.9% in 2004) and compares to 10- and 20-year average of 7.3% and 8.5% respectively and an EM benchmark weight of 11% (MSCI ACWI). This illustrates how very light EM exposure is relative to history. Year-to-date flows to EM have been strong (US$30 billion reported by EPFR Global) although this follows a very lean 2022 (Chart 13).

Chart 13: Annual cumulative EM equity flows

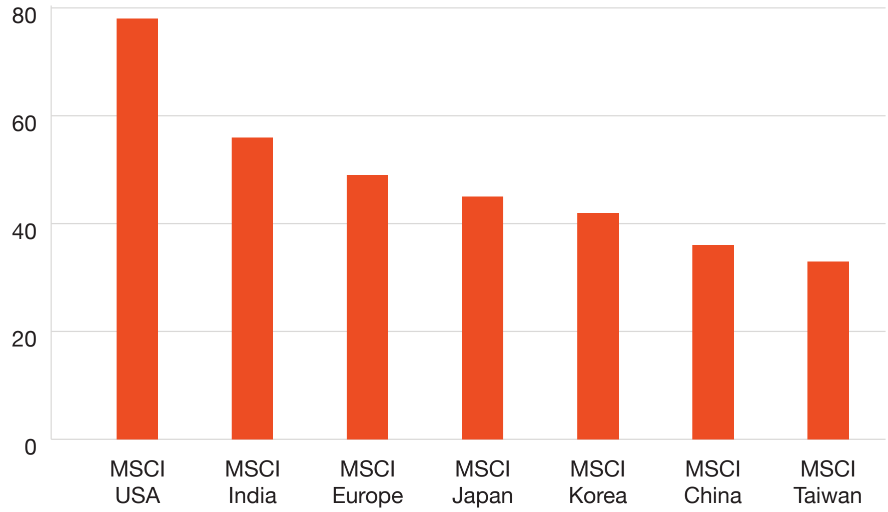


Source: EPFR Global (excludes onshore funds)

The risk of being underweight in EM/China

Given the muted flows into Chinese equities and EM more broadly over the past few years, there is significant under ownership (relative to their respective benchmarks) by global and emerging market equity funds. We found this to be particularly pronounced in the case of US asset owners. In the case of Chinese equities, the market stands at half the levels of institutional ownership when compared to the US equities market. Overall, we believe the under ownership of China/EM by institutional investors represents an opportunity for Australian investors to deploy capital ahead of a sustained economic recovery or thawing in geopolitical tensions which would likely bode well for asset flows and ultimately performance of China and emerging market equities.

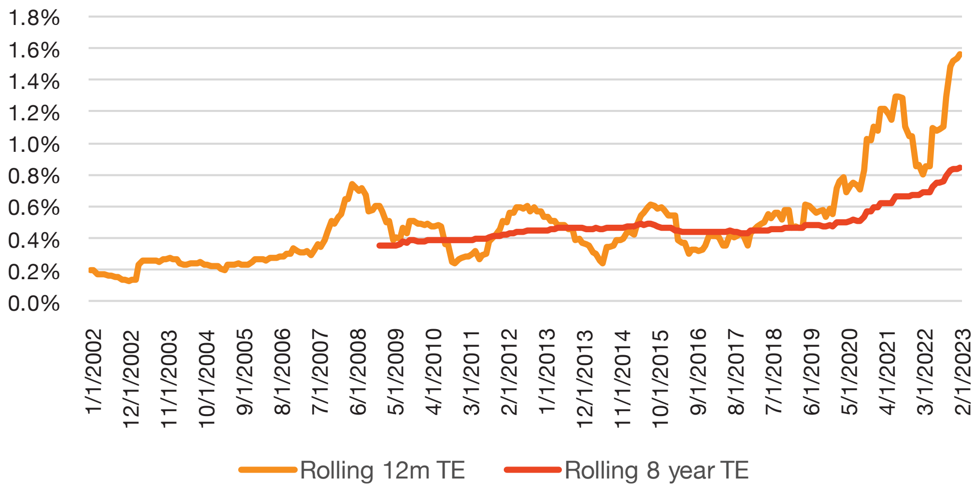
Chart 14: Estimated institutional ownership (% of float)



Source: Vinva Investment Management, FactSet, Morgan Stanley Research

Over the past three years, China has exhibited a negative correlation with global equity markets compared to a historical level of around 50%. It could be argued the last three years has been a highly 'unusual' market environment (divergence in lockdown policy, inflation and interest rates). Despite making up ~4% of the ACWI benchmark, the exclusion or large underweight allocation to China has an outsized effect on tracking error.

Chart 15: Tracking error between MSCI ACWI ex-China and MSCI ACWI



Source: Bloomberg, Frontier Advisors

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Key takeaways

We saw the initial reaction to the reopening of China from a fund flow and performance perspective. The CSI 300 rallied ~20% from its 31 October 2022 low to the end of January 2023. While the rally has since faded on concerns over the strength of the economic rebound in China, the previous strength perhaps sheds some light into the future performance of Chinese and EM equities should there be a sustained economic recovery or a thawing in geopolitical tensions.

Investors in the US have reduced their exposure to emerging markets over the past few years and while this increased with the reopening of China, it has since declined again and is very low relative to historical levels. Given the outflows from Chinese equities and EM more broadly over the past few years, we question how significant the under ownership is.

What does this mean for Australian investors?

The exclusion or under allocation to Chinese equities can have an outsized impact on the overall tracking error in Australian investors' international equity portfolios. Should there be a sustained economic recovery or thawing in geopolitical tensions, Australian investors with underweight allocations to China/EM risk getting left behind should US/global investors decide to meaningfully allocate to this area of the market again.

The landscape for ESG in the US

The politicisation of ESG

The US has come to the ESG discussion later than other regions with the UK and Europe leading the world in terms of regulation and Australia likely somewhere in between. However, following a change in administration there now appears to be efforts to catch up with regulation/rules being put in place.

Generally, governments are busy writing and implementing new regulations to help improve ESG practices including disclosures across the board while more companies and fund managers are seeking to meet those regulatory requirements and improve ESG integration.

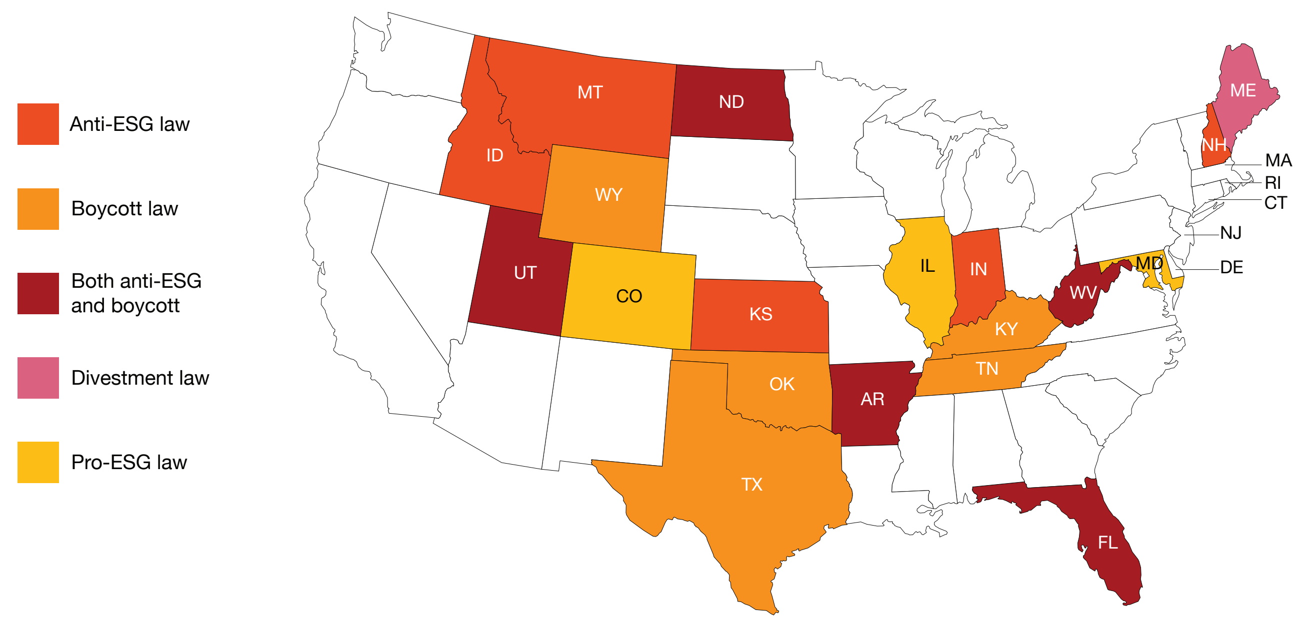
Pleasingly, throughout discussions with fund managers, we observed ESG integration continues to evolve and be enhanced including through stewardship despite the still developing political backdrop.

Reports have noted 2023 could be a watershed year for ESG-focused regulatory developments in the US with the Securities and Exchange Commission (SEC) last year detailing new climate related disclosure requirements which are to be finalised this year. This has received a lot of attention and concern surrounding the rules from various parties. In addition, an SEC taskforce was established within the Division of Enforcement[2] to specifically address climate and ESG disclosures which has pursued limited enforcement actions on greenwashing. Managers that we saw as part of this trip have had their processes reviewed and one manager noted clarification required on its references to sustainability in public communications, so the SEC is out there kicking the tyres.

The US is facing an interesting issue with how much ESG is being politicised. This is resulting in very divisive views and heterogeneous local policy development across the country. Over the course of 2021 and 2022[3], 18 mostly Republican US states passed legislation to limit ESG investing or prohibit state government departments from doing business with financial institutions that adopt certain 'pro-ESG' policies. These are broadly along political party lines although this is not always exactly aligned.

Chart 16 illustrates the current state of play (June 2023) and how the political climate is creating a minefield for investors, asset managers and companies.

Chart 16: ESG laws by US State



Source: BloombergNEF (June 2023), State Legislature

Despite all this, pleasingly there is currently momentum around US ESG regulation with the SEC expected to finalise rules pertaining to ESG this year. We will continue to monitor these developments and question managers about them. Rules made in one market can help to raise the regulatory standards in other jurisdictions and there are certainly parallels with what is happening here in Australia.

[2] SEC.gov | SEC Announces Enforcement Task Force Focused on Climate and ESG Issues

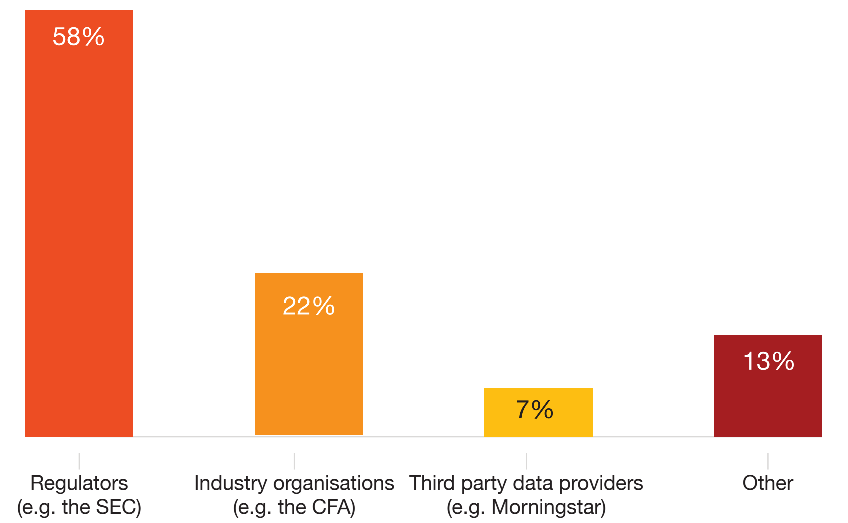
[3] ESG: Trends to Watch in 2023 (harvard.edu)

Who should lead the way?

One manager stated that it seemed like clients felt they were required to ask questions about ESG integration but there was no genuine interest. This particular manager believed ESG should be regarded as a 'value' or ideology and should be very separate to investing, although this was phrased around materiality to investment. The manager added that it should be left to governments and regulators to implement ESG considerations.

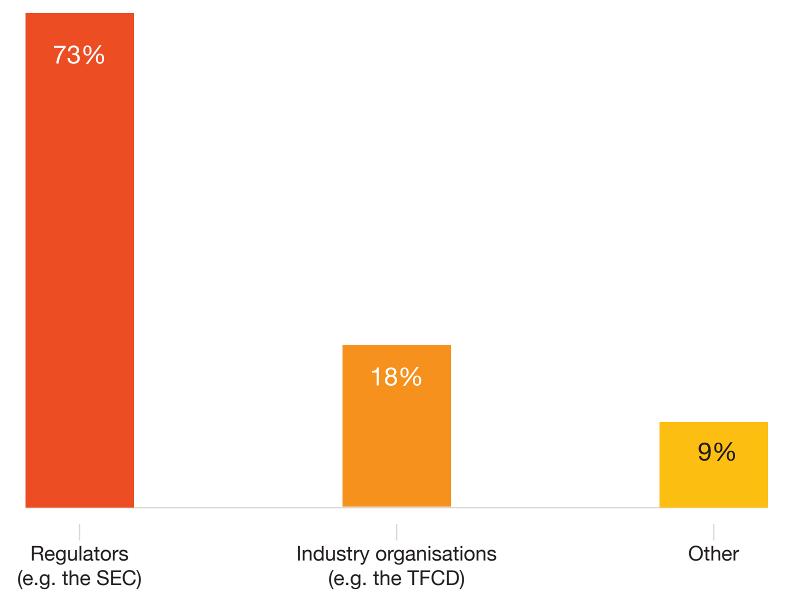
Our discussions with Cerulli Associates yielded similar responses. The research firm surveyed a number of clients in 2022 and the view was also that regulators (e.g. the SEC in the US) should be leading the way with change.

Chart 17: Which organisations should be responsible for setting ESG standards and product definitions?



Source: Cerulli Associates (Analysts notes: Other responses include ESG investment managers and clients, SASB, asset managers, all of the above, and "We do not believe there is a singular 'correct' approach to ESG management"

Chart 18: Which organisations should be responsible for setting ESG standards around ESG disclosures?

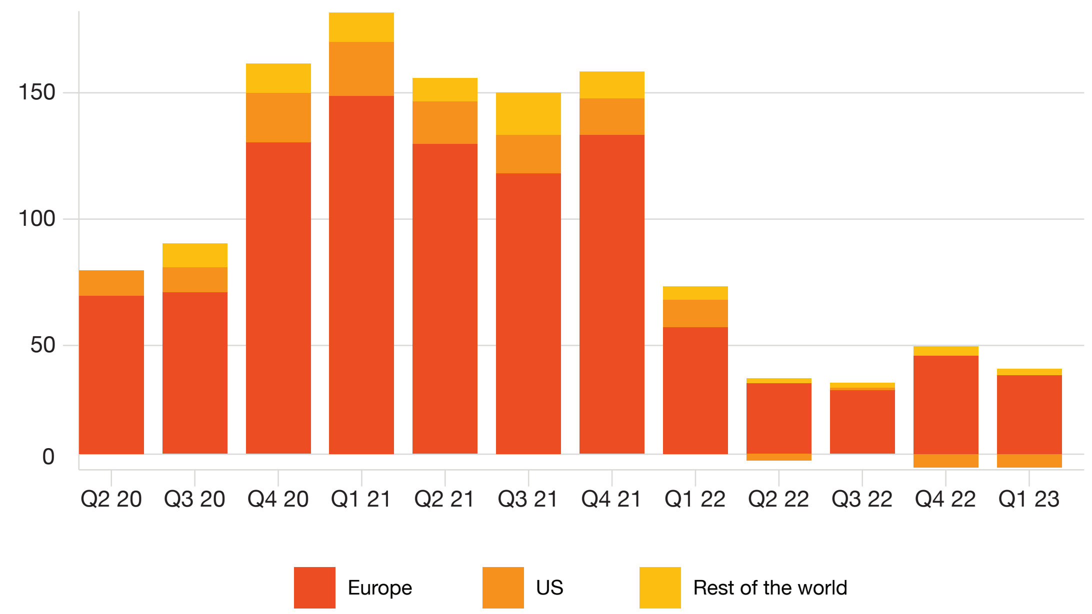


Source: Cerulli Associates (Analysts notes: Other responses include Regulators and Industry Organisations, industry organisations such as the CFA, ESG investment managers and clients, and "We do not believe there is a singular 'correct' approach to ESG management"

Interest in sustainable funds

US interest in 'green' funds has been weak as a result of the political landscape and likely because of the more challenging performance period for sustainable strategies. This has led to outflows of US$12.4 billion in the US over the 12-months to March 2023 relative to inflows of US$126.3 billion in Europe (according to Morningstar).

Chart 19: Quarterly global sustainable fund flows ($bn)

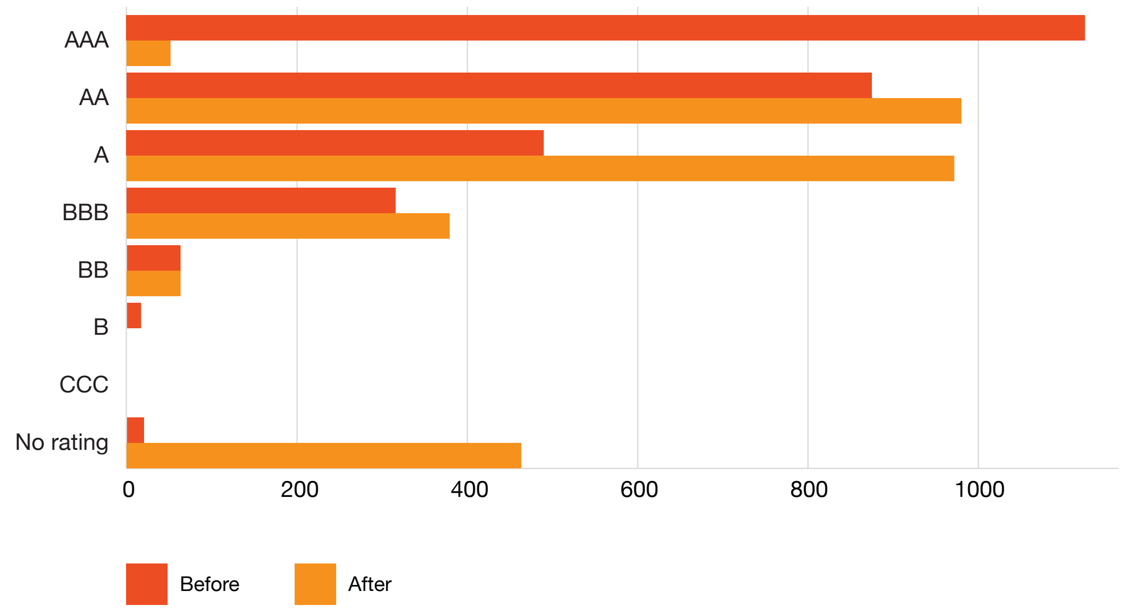


Source: Morningstar Direct, Manager Research (Data as of March 2023)

Adding to this backdrop, in March 2023, BlackRock removed iShares ESG Aware US ETF (the largest sustainable fund in the US) from its model portfolio moving to invest in the iShares MSCI USA Quality Factor ETF (QUAL) instead, which provided another headwind for 'sustainable' funds.

This was at the same time as MSCI's methodology changes where the firm removed the so-called adjustment factors (ESG momentum and ESG tail risk) from the calculation of its ESG Quality Score, which led to hundreds of funds/ ETFs being stripped of the ESG ratings and thousands more downgraded (Chart 20 shows the number of European ETFs downgraded). MSCI tightening its own ESG-compliant criteria is thought to be due to pressure from regulators and concerns over 'greenwashing'.

Chart 20: European-listed ETFs



Source: BlackRock

With this backdrop, investment managers have to perform a delicate balancing act to avoid alienating either the pro- or anti-ESG camps. We were interested to know whether the managers communicate differently to clients depending on which side they sat. We heard examples of clients wanting ESG to be integrated from the basis of better long-term risk-adjusted returns rather than being 'values' based. Interestingly, one manager stated the focus on impact resonates with the middle of the country which is much more interested in new technologies and financing and likes the idea of being part of it and innovation. In contrast, the West Coast and East Coast were noted to be much more open to discussions on net zero and stewardship. Anecdotally it sounds like many clients want to understand how components of ESG have added value and are trying to work out what it means for them.

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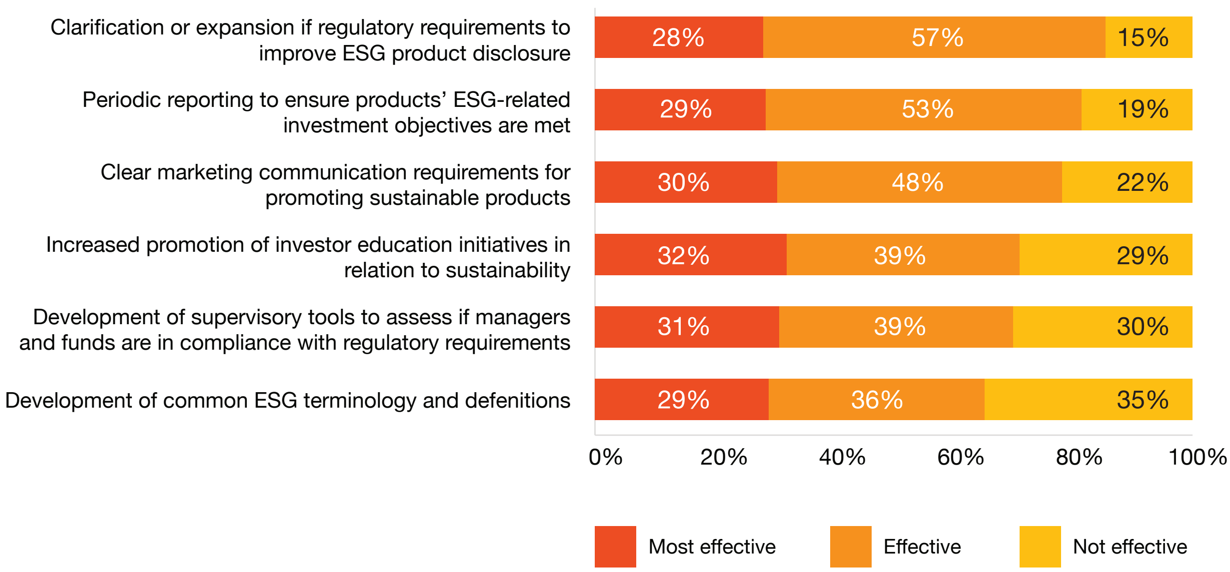
Greenwashing

In terms of greenwashing concerns, we have seen examples being made of a number of fund managers in Australia, and the US has been no different. Goldman Sachs was charged last year and settled with the SEC in November 2022[4]. BNY Mellon was also charged last year for misstatements of omissions[5] concerning ESG considerations.

We discussed greenwashing concerns and what it actually means with Cerulli Associates. A survey conducted in 2022, found clients considered the most effective way to curb greenwashing was through increased promotion of investor education initiatives in relation to sustainability and the development of common ESG terminology. Definitions was found to be the least effective in this survey. Perhaps more interesting is how close the six options are on 'effectiveness', indicating uncertainty in the market.

Chart 21: Asset owners: views on the most effective ways to curb greenwashing, 2022



Source: Cerulli Associates

We met with another US-based consultant, Segal Marco who noted it didn't believe its clients were concerned about greenwashing and instead discussions were more around engagement versus divestment as part of the solution.

As fund managers step back from ESG or sustainable claims as we've seen in the European regulation, 'greenhushing' (publicly downplaying one's sustainability credentials even while seeking to be progressive behind the scenes) will be an issue to watch out for.

[4] SEC.gov | SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments

[5] SEC.gov | SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations

The Inflation Reduction Act (IRA)

The US Inflation Reduction Act (IRA), while an unfortunate name, is an important move by the current federal government in helping to tackle climate change and is a significant investment, said to be worth about US$400 billion over ten years.

Through our discussions with managers, it was clear many were pleasingly across the IRA legislation and the opportunities in the energy sector, and more broadly, that will benefit. For example, companies with a focus on solar, hydrogen power, energy storage and domestic manufacturing as well as electric car companies along with companies through this supply chain. That said, the detail in responses differed. Those managers with particular experience investing in commodities were able to provide very clear intelligence on the companies that were benefitting.

Some managers see beneficiaries outside the US including supply chains or the picks and shovels supplying to the market leaders like Tesla, so it was not just US equities doing well from the subsidies. There may be beneficiaries in Australia, specifically Australian mining and energy companies, that could benefit from special access to US subsidies as noted in reports[6] following the G7 meeting in Japan.

[6] G7 summit in Hiroshima, Japan: Australia to get a bigger slice of IRA billions for rare earth mining and energy companies (afr.com)

The final word

- While Europe has long been leading regulation, the US regulator is stepping up its efforts and there is currently momentum around US ESG regulation. The SEC has proposed three rules pertaining to ESG, which are expected to be finalised this year. Specifically, the rules include:
  - A climate change disclosure rule requiring registrants to disclose Scope 1 and Scope 2 Greenhouse Gas (GHG) emissions and information on climate related risks, impact of climate related events and publicly set climate targets as well as enhanced reporting requirements.
  - An investment company 'names rule' affecting investment companies and business development companies given the important role that the name of a fund plays in marketing.
  - An ESG disclosure and reporting proposal for investment advisers and investment companies aimed to increase transparency.
- The political backdrop and wave of anti-ESG legislation in Republican states has been a headwind for sustainable funds but managers we met continue to evolve and improve their ESG position indicating they continue to believe this provides them with a competitive edge.
- The importance of strong ESG credentials for Australian investors is clearly well understood by the US-based managers we met with, and they continue to evolve and build on their knowledge. Marketing and communication may vary depending on the client but ultimately all are seeking long-term risk-adjusted returns.
- The SEC is reviewing fund manager policies and procedures and there has been a couple of high-profile charges related to greenwashing. Standardisation would help fund managers to meet criteria, for example, reporting standards and disclosure.
- Efforts being made such as by the International Sustainability Standards Board (ISSB) will advance the cause to get to some form of global standardisation.

What does this mean for Australian investors?

- Clients with ambitions to enhance their ESG approach should seek out fund managers that have a strong alignment with their own values and beliefs around sustainability. While we are not specifically concerned about any rated managers changing their ways on ESG, we expect there may be greater dispersion in the future between those managers that incorporate ESG and those that don't, and we will continue to test managers on ESG. Refer to Frontier's research piece for more information on the ESG assessment of managers (June 2022).
- Frontier's ESG scorecards on managers help clients better understand a manager's integration of ESG and focus on engagement as well as its disclosure. As part of this, we will monitor the managers' efforts in keeping up to date with regulation and the resulting risk and opportunities these present.
- Frontier will continue to stay abreast of upcoming disclosure requirements and seek to ensure managers are doing the same.

Want to learn more?

We hope this paper has generated ideas for your own portfolios. If you are interested in learning more, please reach out to your consultant or a member of the Equities Team.

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