CAMERON HUME

Corporate Governance at Rio Tinto – an ESG case study

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Executive summary

- The Juukan Gorge controversy revealed significant corporate governance failures at Rio Tinto
- ESG factors highlight that Rio Tinto was particularly weak in managing community relations, leading to the controversy
- Our risk based investment approach has fully integrated ESG factors into our portfolio analysis
- Our portfolio avoided exposure to Rio Tinto

ESG controversy - Juukan Gorge caves

In May of this year Rio Tinto destroyed two rock shelters in Western Australia which were of sacred significance to the Aboriginal community. Rio Tinto had owned the land since 2013 and had secured permission for their actions under the state's Aboriginal Heritage Act. However, there had been significant, continuing opposition to Rio's plans from indigenous leaders.

The controversy in this case is not one of the legalities of the destruction of a site of such significance. The issue for shareholders, in particular Australian superannuation funds, was of a failure of corporate governance and a failure to properly recognise the sensitivity of this project. An internal review of the incident exposed systemic flaws in the company's policies and practices: poor relations with local Aboriginal communities on heritage issues and inadequate oversight of practices, which lead to poor adherence to company policies. These findings were corroborated by an Australian parliamentary enquiry into the London-based executive management of the incident. Rio Tinto's proposed remedies and executive sanctions failed to satisfy shareholders, which subsequently led to the resignation of the group CEO and two other executives.

Rio Tinto faced no significant financial and regulatory consequence from the incident and neither its share price nor its corporate bond spreads were impacted. However, the controversy has motivated discussion around corporate ESG risks and how stakeholders can encourage better management of these risks.

Typically, clients will provide explicit policy guidelines to direct their investment managers on how best to align the portfolio with their ESG objectives. A policy may simply insist that specified controversial companies are excluded from the available investment universe. However, this is an imperfect approach, which may introduce unintended investment risk and fail to achieve the objectives that motivated the policy. We will show how an integrated and more nuanced approach to ESG analysis can improve on this approach, using Rio Tinto as a case study.

ESG ratings – corporate screens

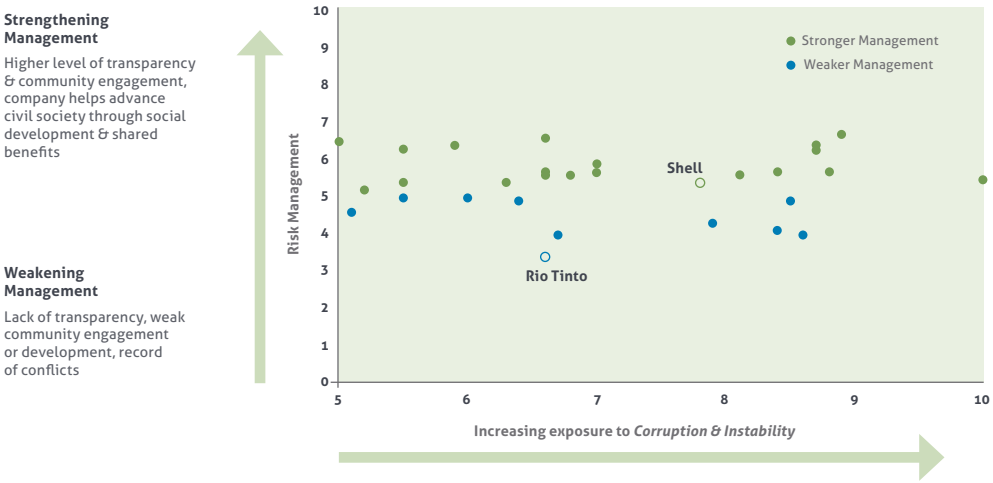
MSCI have a transparent process for providing measures of the effectiveness of the management of ESG risks. Corporate social responsibility measurements are available for a large universe of corporate and sovereign entities. Within the global industrials sector[1], our research shows that there is little correlation between corporate credit quality and MSCI ESG ratings. Thus, a fixed income ESG policy which simply screens for - with the explicit intention of avoiding - controversial industrials would not necessarily improve the credit profile of portfolio holdings and may have unintended consequences for future relative returns.

ESG analysis – an integrated approach

Having fully integrated ESG data within our analytics suite, CaTo[2], we can see where Rio Tinto was particularly exposed to underlying governance risks. The MSCI Corruption & Instability factor quantifies 'company risk of operational disruption due to community opposition'. The Juukan Gorge controversy is clearly an example of such an ESG risk management failure.

Figure 1 illustrates that for ESG A-rated industrials, Rio Tinto has the weakest management of this risk factor. Our analysis highlights that there are multiple other industrial corporates who have similar exposure to Corruption & Instability risks, but who manage this risk better. Consequently, investors who take a risk-based approach to ESG integration could have identified alternatives to Rio Tinto in their portfolio construction.

Figure 1: MSCI *Corruption & Instability* risks



Source: CaTo

[1] We define global industrials as metals & mining; oil & gas exploration; construction & engineering; aerospace & defence; industrial conglomerates and electrical equipment sectors

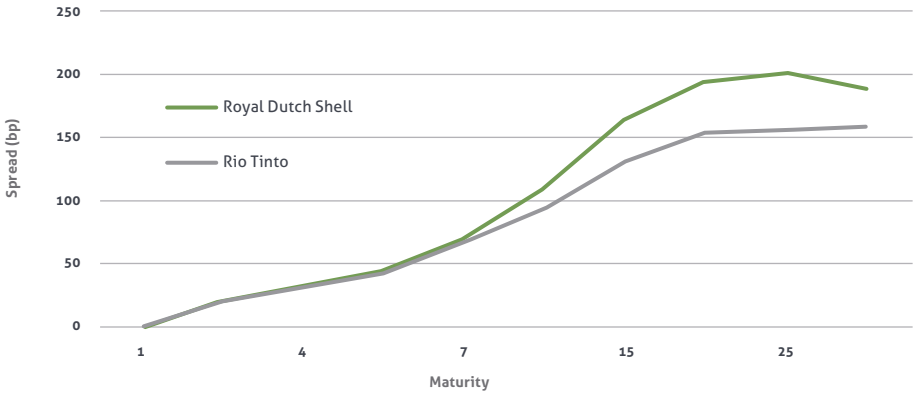
[2] We use our data analytics suite, CaTo, to enable portfolio managers to screen for investment opportunities and to support portfolio construction and credit analysis. CaTo allows us to model and understand the composition of credit spreads and interaction between credit and material ESG risk factors. Integrating material ESG risk factors in issuer selection complements our fundamental credit factor assessment.

ESG risks – quantifying price

The Juukan Gorge controversy vividly revealed Rio's inadequate management of the risk of community opposition to their corporate operations, as previously signalled by MSCI. On this occasion this governance failure did not lead to any financial or regulatory impact. This will not always be the case. Our research has previously shown that fixed income investors do not appear to receive spread compensation for taking additional ESG risk in their portfolios. We now show how a portfolio could have mitigated for specific ESG risks within the industrials sector, whilst improving credit quality and spread.

Figure 1 (above) shows that while Royal Dutch Shell ('Shell') has higher exposure to *Corruption & Instability* factor risks than Rio Tinto, the management of these risks is better. Rio Tinto has a credit rating of A while Shell is AA rated. It would therefore be reasonable to expect that market pricing of credit risk would lead to a higher spread in the US dollar bonds issued by Rio Tinto. On the contrary, Shell bonds have higher spreads for longer-dated maturities, as illustrated in Figure 2.

Figure 2: Corporate bond spread



Source: CaTo; Bloomberg

Favouring Shell 20 year bonds over Rio Tinto would pick up an additional 40bp in spread for improved credit rating, while maintaining the overall ESG A-rating of the stock selection. In a diversified fixed income portfolio such a decision within A-AA Industrials would not adversely impact risk-adjusted returns[3]. We further favour Shell in this sector given the company's commitment to the Paris Agreement on climate change and the clear corporate accountability for their energy transition strategy.

[3] As measured by MSCI BarraOne spread factor model

Conclusion

What lessons can investors learn from the Rio Tinto ESG controversy?

- Failing to manage ESG risks may not have direct financial consequences for investors, but leaves stakeholders vulnerable to public controversy
- Investors could have identified that the company had poor management of governance risks with an integrated ESG approach
- It is possible to mitigate ESG risks within global fixed income by taking a diversified, risk-based approach to portfolio construction and analysis

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