FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

12 March 2021
Volume 1086

How ESG is transforming investing outcomes

Written by: Kingsley Williams, Chief Investment Officer at Satrix Asset Management

Without recapping 2020, the global pandemic served, amongst other things, to accelerate many trends which arguably would have taken years to further – and put others to rest. One of the bright lights was the positive momentum behind acknowledgement of the risks of climate change and the move to sustainable investing.

Now, there is a renewed urgency for the world to work together to reverse climate change damage and move towards a net zero economy (which is supportive of keeping the average global temperature increase below 2ºC).

Whilst you may not immediately be able to replace your fossil fuel guzzling car or take your home off the grid, there are certainly opportunities in the investment world to support and encourage companies to start making the changes necessary to align with these global goals. And arguably 'encouraging' global capitalism to make these shifts will have a far greater impact than anything one individual can do – although we should never stop trying.

The decision to put your money to good work is easy. Knowing where and how to do it in a sea of jargon, misinformation and myths makes it a lot harder. The global investing fraternity acknowledges that there is much more education required to empower better decisions by investors. To this end, I will endeavour to unpack a sub-section of sustainable investing by focusing particularly on ESG.

ESG vs Sustainability

Sustainability has become a catch-all phrase for 'doing good' and investing responsibly. Under this umbrella sits ESG, which specifically focuses on how the areas of environmental, social and governance impact on a company's operational efficiency and future strategic direction.

What is ESG?

An acronym we use too easily, ESG stands for environmental, social and governance metrics as they pertain to good investment practices. These concepts, employed as metrics to measure how efficiently companies incorporate the principles, have been gaining popularity over the past few years. COVID-19 has seen these practices accelerate. Measuring data which relates to ESG, allows investors to measure intangible ESG corporate initiatives and risks which increasingly have an impact on areas such as brand value and reputation. Whilst these measures fall under the umbrella of sustainable investing they do not pertain to new modes of investing like green or impact investing. Rather they are measures to see how companies are progressing in their efforts to improve their initiatives in managing risks in these specific areas of focus.

Environmental metrics cover themes such as climate risks, natural resources scarcity, pollution and waste, and environmental opportunities. Social metrics include labour issues and product liability, risks such as data security, and stakeholder opposition. And governance encompasses items relating to corporate governance and behaviour such as board quality, diversity and effectiveness.

Why invest in ESG funds?

While there is debate on whether considering sustainability issues contributes to a company's long-term financial performance, incorporating these considerations into the investment research, portfolio construction, portfolio review and stewardship processes provides different lenses on the risks affecting these businesses. This helps to mitigate further risks and in so doing potentially enhance long-term risk-adjusted returns and portfolio resilience. Even before the COVID-19 crisis, governments, businesses and investors were beginning to reassess certain personal and community values. It is possible to measure these values and intentions by incorporating ESG metrics into the investment process. Studies are now starting to reveal that companies that exhibit characteristics of resilience have focused on things like job satisfaction, the strength of customer relations, or the effectiveness of a company's board.

Why would you invest in ESG index strategies?

Recent innovations in the ESG index construction process take explicit cognisance of the parent index from a risk perspective and aim to maximise exposure to higher-rated ESG companies within a tracking error risk budget e.g. the MSCI World ESG Enhanced Focus Index at 0.5% and 1.0% for the MSCI Emerging Markets ESG Enhanced Focus Index.

Both of these particular indices are designed to maximise their exposure to positive ESG metrics while also explicitly reducing exposure to carbon dioxide (CO^2) and other greenhouse gases (GHG) as well as their exposure to potential emissions' risk of fossil fuel reserves by at least thirty percent (30%). The indices hold no weapons or tobacco companies or companies involved in severe controversies.

There are numerous ESG indices available, each with different approaches to portfolio construction and what they try to achieve from an ESG and sustainability perspective. For investors looking to incorporate ESG into their portfolios but who are also concerned about the risk of deviating too far from their ultimate broad-market benchmark, may find a solution in the MSCI ESG Enhanced Focus indices.

Index investing in the ESG space is helping to educate and guide investors to predetermined outcomes with a greater sense of transparency and certainty. Having audited methodologies and finite rules, at this stage, may give investors more comfort in the (perceived and real) risks they may be taking whilst they gain confidence in the ESG space.

Glacier Research would like to thank Kingsley Williams for his contribution to this week's Funds on Friday.

Kingsley Williams,
Chief Investment Officer
Satrix Asset Management

Kingsley joined Satrix Asset Management in 2017. Before joining, Kingsley spent almost 10 years at Old Mutual Investment Group where he became the CIO of their indexation capability. He has vast experience in quantitative research, product development and index-tracking portfolio management, servicing South African and global institutional clients. Over his 20-year career, Kingsley has also held positions at Stanlib Asset Management and Merrill Lynch, which included positions in London and New York. In addition, Kingsley holds an MBA in Finance from Wits Business School (with electives completed at the University of Chicago Booth School of Business), a BSc Honours degree (cum laude) in Computer Science as well as a BSc degree (cum laude) with a major in Mathematical Statistics.