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Sustainable investing, the asset manager and the client

The South African experience

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The annual World Economic Forum Global Risk Report has indeed become a prime document that makes for compelling compulsory reading whenever it is released. In the 2006 edition the Report alerted the world to the impact and hazard that global pandemics posed along with other health-related risks. That Report warned that “a lethal flu, its spread facilitated by global travel patterns and uncontained by insufficient warning mechanisms, would present an acute threat.”

Enter 2020 and the risk of a global pandemic became a reality. The findings of this year’s 16th edition of the Global Risk Report should then be highly instructive and prescient as we seek to orient ourselves in a world that has become increasingly complex. Prime amongst all themes and dimensions are the risks from societal fractures, social fragmentation and the consequences of widening global inequalities. There are instances where widening outcomes when it comes to health, technology and employment opportunities are directly attributed to the pandemic. In others, those outcomes have widened, placing a strain on already weak safety nets and economies. This theme should resonate strongly with all of us as South Africans. In building a more inclusive and accessible future, it is important that we appreciate that our actions as we emerge from the COVID-19 pandemic are vital, whilst also recognising that climate change remains an existential threat.

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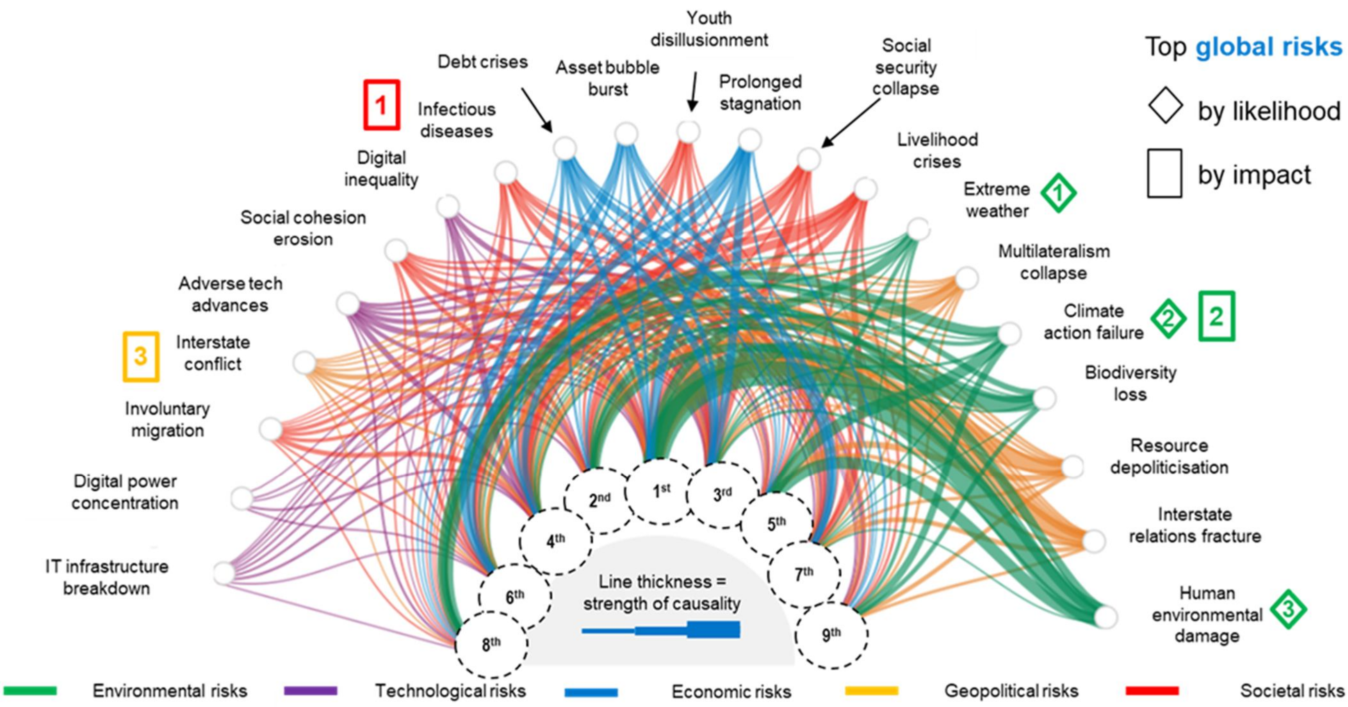
The canvas below proves very valuable as we formulate the problem statement - taking stock not only of the top global risks (by impact and likelihood) but their interconnectedness. It's clear that in navigating this new world of change where we try to create positive outcomes and mitigate or eliminate negative ones, an asset management lens needs to be more proactive and practical as we mobilise capital toward a greater purpose. As erstwhile quants and researchers we are aware of the value and insight that scenario analysis and stress testing can bring (alongside fundamental disciplines) but even we have to concede there are limits to their value given the number of six sigma events we have been experiencing of late. The futility of stress testing for unprecedented scenarios are meaning risk modelers will eventually learn valuable lessons from COVID-19, but stress tests are typically fruitless when there are no historical precedents for the never-before-seen six sigma events. Even quantitative methods are found wanting as higher order moments can't be modelled to understand interconnectedness with huge amounts of value. A more proactive approach further upstream in the asset management process is required – the implementation of robust responsible, sustainable and impact investing practices.

Figure 1: The growing interconnectedness of the global risk network



Source: World Economic Forum Risk Report 2021

While responsible, sustainable and impact investing is enjoying a lot of notoriety, the concepts are not new. In fact, there is a rich history that belies its origins and it's equally important to distinguish between them. Responsible investing mitigates risk through improved environmental, social and governance (ESG) practices, while sustainable investing both mitigates risk (protecting value) and adopts progressive ESG practices (enhancing value and performance). Impact investing addresses thematic, direct and targeted societal challenges while generating competitive financial returns for investors. The earliest forms of responsible investing can be traced back to religious communities refusing to participate in trade practices that conflicted with their values and beliefs. Locally, responsible investing gained prominence in the 1980s with boycotts against the Apartheid regime and more recently, the COVID-19 pandemic, which highlighted the need to address various social inequalities.

The first socially responsible investment fund can be credited to former World War I aviator Philip Carret, who, in 1928, launched the Fidelity Mutual Trust, now known as the Pioneer Fund. Today, ESG assets under management are valued at more than US$35 trillion according to the Global Sustainable Investment Alliance and is expected to account for roughly a third of global assets under management by 2025 according to Bloomberg.

The United Nations have developed 17 Sustainable Development Goals (SDG), which serve as a standard or guideline to implement targeted approaches towards a specific theme or objective underpinned by a robust impact measurement framework highlighting reporting requirements. The latest goals came into effect on 1 January 2016 and target various objectives such as, among others, no poverty (1), zero hunger (2), quality education (4), gender equality (5) and climate action (13).

Table 1: Mapping investment strategies on the capital spectrum

	Our strategies					
Financial-only	**Responsible**	**Sustainable**	**Impact**			**Impact-only**
Limited or no regard for environmental, social or governance practices	Mitigate risky environmental, social or governance practices in order to **protect value**	Adopt progressive environmental, social or governance practices that may **enhance value**	Address societal challenges that **generate competitive financial returns** for investors	Address societal challenges which ***may* generate a below-market financial return** for investors	Address societal challenges that **require a below-market financial return** for investors	Address societal challenges that **cannot generate financial return** for investors
Deliver competitive financial results						
Mitigating Environmental, Social and Governance risks						
	Pursuing Environmental, Social and Governance opportunities					
		Focus on measurable high-impact solutions				

Source: Lessons from the Social Impact Investment Taskforce: Asset Allocation Working Group, 12 December 2014

Debunking the myths

While there are a few leading 'think tanks' and asset managers who suggest that these forms of investing have reached a tipping point and are becoming more mainstream, there are, however, some lingering myths surrounding sustainable investing which need to be addressed.

The most glaring of these are that sustainable investing compromises performance and that the lion's share of the discipline's value originates in the avoidance or mitigation of risk. A 2015 study undertaken by Oxford University and Arabesque Partners examined more than 200 sources of academic research industry reports, articles and books and concluded that '80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance'1.

Clark, Gordon L. and Feiner, Andreas and Viehs, Michael, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance (March 5, 2015). Available at SSRN.

A separate study by Deutsche Bank and the University of Hamburg went much further examining 2 250 academic studies published since the 1970s, spanning underlying data generated over four decades until 2014. The conclusion here was that including ESG considerations made a positive contribution to corporate performance in 62.6% of meta-studies, and negative results in only 10% with the remainder being neutral[2]. Harvard Business School also linked better company performance and disclosure especially on financially material ESG issues to higher share prices in 2016 for the first time[3]. The very important mechanism of company engagement was also highlighted as an invaluable form that enhances returns in a 2017 study by three academics[4].

Other myths and perceptions that also warrant challenge are that sustainable investing is only about negative screening, that it only really works with the equity asset class, and that emerging markets pose a distinct and insurmountable set of ESG risks and challenges.

Approaches to sustainable investing

There are various approaches to sustainable investing. These include exclusions, integration (including proprietary research), impact investing, and active ownership.

Exclusion policies (negative screening) focus on avoiding investments in companies that score extremely badly on certain ESG factors or which produce illegal or controversial products or practices. **Integration** takes financially material ESG information into account when analysing investment opportunities in order to make better-informed investment decisions, and **impact investing** aims to earn a financial return, while making a societal impact (positive screening). **Active ownership** engages with companies on various ESG issues and affects change through voting policies.

Figure 2: Industry approaches to sustainable investing

Source: RobecoSAM, Robeco

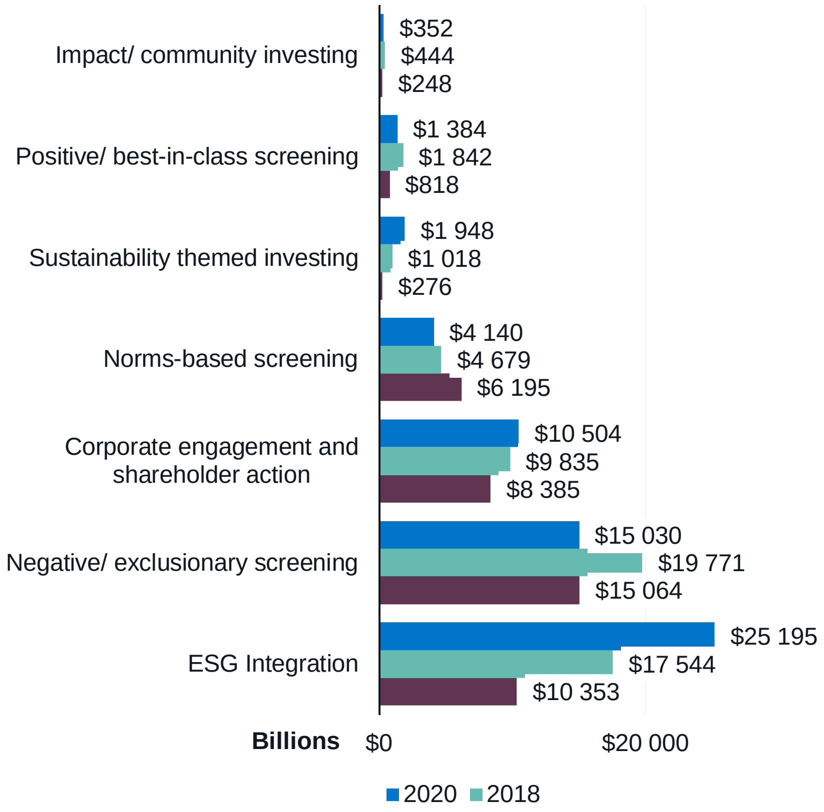
2 Deutsche Asset and Wealth management, 'ESG and corporate financial performance: mapping the global landscape', December 2015.

3 Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.

4 Tamas Barko, Martijn Cremers and Luc Renneboog, 'Shareholder Engagement on Environmental, Social, and Governance Performance', Working paper for the European Corporate Governance Institute, 2017.

Globally, ESG integration accounts for the majority of sustainable assets followed by negative screening and shareholder engagement. With most of these assets situated in developed markets, it is worth noting some important structural differences when approaching sustainable investing in emerging markets, such as South Africa.

Figure 3: Global growth of sustainable investing strategies



Source: Global Sustainable Investment Alliance

Sustainable investing in the South African landscape

Domestically, there are certain practical realities that are to be heeded. For instance, the opportunity set of our local equity market is limited with only 140 companies included in the JSE All Share Index. Compared to the US stock market of more than 4 000 listed companies, explicit and overbearing positive or negative screening may result in a portfolio with limited diversification. Furthermore, our market is very concentrated with the top ten companies accounting for almost 60% of the entire market capitalisation of the JSE All Share Index. Excluding any one of these counters will result in large unintended and magnified active positions relative to the market.

There are similar issues within our local bond market. Currently, the South African government accounts for roughly 95% of the market capitalisation of the JSE All Bond Index. When adjusting for government guaranteed debt, this increases to 99%. Blindly employing a country-based sustainability ranking of less than 5/10 (according to Robeco's Country Sustainability Rankings), would result in an underweight position in local government issues.

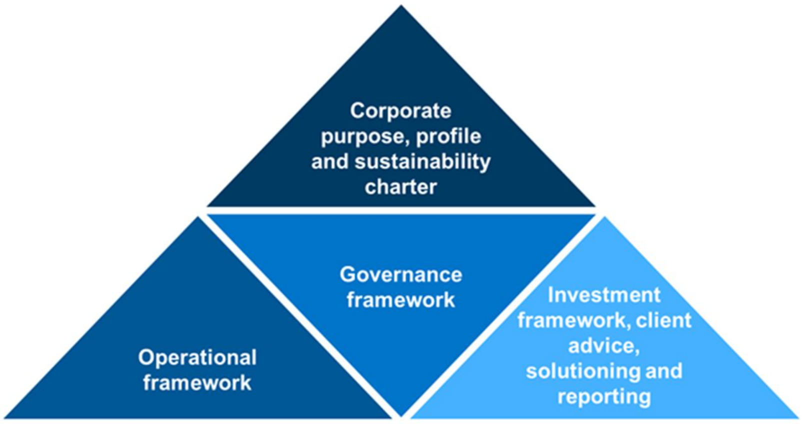
Strictly disciplined but measured approaches to exclusion may be more appropriate in a smaller capital market like our own. More extensive use of company engagement (target, measurement and reporting), integration and proprietary research may be better suited for our market. Rank exclusionary policies also have the disadvantage of investors missing out on opportunities to influence change, through disciplined engagement, at companies that do not currently rate well on ESG metrics. If there is indeed an ESG premium for sustainable opportunities, either through a lower discount rate or tighter credit spreads, only including these investments once they achieve a higher ESG score may see investors miss out on the rerating opportunity.

Choosing the right asset manager

Following on from global regulation the Financial Sector Conduct Authority (FSCA) issued Guidance Note 1 of 2019: Sustainability of Investments and Assets in the context of a Retirement Fund's Investment Policy Statement. In conjunction with Regulation 28 it states that a fund should consider all factors that may materially affect the long-term performance of any asset it invests in. As a retail investor or retirement fund member, the most important decision lies with your choice of asset manager as you embark on your journey in sustainable investing. Continuous education and skills development is also extremely important. An asset manager who meaningfully invests in its investment professionals and processes working within a replete and holistic framework should be favoured. There are many recent articles that have been published alleging that South African asset managers are falling behind global best practice. Asset managers that manifest sustainability in their approach across these key areas takes meaningful steps towards global best practice:

- A corporate identity and profile driven and reinforced by purpose, endeavouring to meaningfully contribute to shaping positive environmental and social outcomes and limiting / eliminating negative ones in an increasingly changing and complex world.
- Operationally, a credible and authentic sustainability practitioner's organisation needs to espouse sustainable business practices championed by the senior-most leadership and supported by a complementary culture (behaviours).
- A governance function and framework that provides oversight and ensures that the organisation's commitment to all stakeholders (including clients, employees, shareholders and society) complies with, and is upheld to, the standards articulated in its policies.
- A strong client-centric investment framework is necessary to effectively navigate the world of change and assist clients to reach their specific sustainability outcomes by identifying outcomes and tracking their progress with measurable targets. Replete investment decision-making (ESG integration) requires an embrace of all material risks and opportunities of any investee entity, issuer or even in the selection of an external manager/building block.

Figure 4: Sanlam Investments Sustainability Profile



Conclusion

There is no single right way to approach sustainable investing. There are important structural differences between markets that need to be accounted for and no approach should be followed blindly. What is important is the intention behind your investment decisions and, in some cases, shareholder engagement may be better suited than exclusion. At Sanlam Investments, we follow an integrated approach to sustainable investing. We integrate ESG metrics into the valuation and risk management processes and also believe that our investors are better served through robust company engagement to influence change as opposed to exclusion policies, particularly in the local capital markets. We have entered into a deep and exclusive partnership with Robeco, a market leader in sustainable investing, to formulate a robust sustainable client value proposition that subscribes to global best practices. This partnership allows us to leverage off industry leaders and experts in formulating our ESG philosophy and for idea-sharing on practical ways to implement this philosophy, given our unique market.

Over and above all of this, in rebuilding South Africa in the wake of the global pandemic toward a more inclusive and accessible society, Sanlam Investments has fully embraced its role and greater purpose in improving the lives of all South Africans.

Glacier Research would like to thank Jason Liddle FRM and Michael Badenhorst CFA, CAIA, CFP, CIPM for their contribution to this week's Funds on Friday.

Jason Liddle FRM

Head: Distribution

Jason works off an extensive 18-year career within the financial services and asset management industry. In his current role, he now heads up the Sanlam Investments distribution area (both institutional and retail), leading a team that spans our active, indexation (passive), alternative and multi-management capabilities. Jason is a certified Financial Risk Manager FRM® with the Global Association of Risk Professionals (GARP), holds a Bachelor's degree in Commerce from UCT and is extremely passionate about empowering our clients in making better decisions in pursuit of their investment, sustainability and impact objectives.

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Michael is a Client Research Analyst and Product Specialist at Sanlam Investments where he is responsible for manager research, competitor analysis and content creation. Prior to joining Sanlam Investments, he served as Head of Operations at SANNE Management Company