

How ESG is transforming investing outcomes

By Kingsley Williams - Chief Investment Officer at Satrix Asset Management

Without recapping 2020, the global pandemic served 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 acknowledging the risk 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 2°C).



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.

How to put money to 'good' work

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.

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

What is ESG?

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. 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 (CO₂) and other greenhouse gases (GHG), as well as their exposure to potential emissions' risk of fossil fuel reserves by at least 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. 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.

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Glacier Financial Solutions (Pty) Ltd.

A member of the Sanlam Group
Private Bag X5 | Tyger Valley 7536 | Email client.services@glacier.co.za | Tel +27 21 917 9002 / 0860 452 364 | Fax +27 21 947 9210 |
Web www.glacier.co.za | Reg No 1999/025360/07
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Private Bag X8 | Tyger Valley 7536 | Tel +27 21 950 2600 | Fax +27 21 950 2126 | Web www.smmi.com *|*Reg No 2002/030939/07
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