Responsible investing: how to make it a reality that will result in strong returns for all investors

by Bradley Preston, Mergence Investment Managers
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An investment manager's role is to help provide for the future welfare of investors by striving to maximise the returns on their savings and retirement investments. It is important to remember that those savings will be enjoyed by investors within a broader environment. If a member's retirement fund is invested in companies that have a long-term negative environmental or social impact on the broader society, this could reduce the value of their retirement savings as any such negative impact needs to be seen as an indirect tax on society as a whole.

But how do we invest responsibly and still generate good financial returns?

While we believe that it is important to incorporate environmental, social and governance (ESG) considerations into the investment process in general, investment in specialist socially responsible funds is important for a number of reasons. Firstly, specialist SRI funds may often invest in unlisted securities and a broader range of securities than traditional equity or bond funds, thus broadening the universe of investments that a manager can consider. Secondly, SRI funds allow investment into funds that actively seek out and promote businesses that have an explicit positive social impact in the listed universe. For example, the Mergence High Impact Debt Fund invests in unlisted debt securities and as a result is able to invest in businesses that provide education loans, low-cost housing, entrepreneurship, job creation, and the like. It is often difficult to find investments that have a comparable social impact if one is restricted to the listed universe.

Of course a large portion of any pension fund's assets will be invested in listed securities. We believe, however, that it is also important to measure and target ESG performance in this universe. Specialist ESG funds allow asset owners to explicitly mandate ESG objectives and thus elevate them to the same level of importance as financial return within the fund. This allows asset owners to measure the ESG performance of their investments and to incentivise investment managers to take these objectives seriously. **As long as manager performance is measured and**

mandates are awarded solely on financial performance, managers will favour return considerations. Furthermore, as long as corporate management is primarily incentivised based on shareholder return, this will dominate and drive their decision making. In order to ensure that the goals of sustainability – with the emphasis on ESGhere – are realised, interests need to be aligned throughout the asset management chain, from asset owner to investment manager to corporate management.

Accordingly, investment managers' reporting role also needs to be broadened and enhanced. **Trustees need to monitor ESG performance by demanding the requisite information as part of manager reporting requirements.** Again this can be prescribed or mandated within a specialist ESG fund. Thiswill ensure that ESG matters are explicitly incorporated as part of the investment process of investment managers. With the necessary initiative and pressure from asset owners and their asset managers, this in turn will encourage corporate managers to measure and publish environmental, social and governance metrics.

An example of how direct ESG oriented investment has resulted in increased measurement and disclosure of ESG factors is seen in the work of the carbon disclosure project (CDP). The CDP is a global initiative to encourage measurement, disclosure and ultimately reduction of greenhouse gas emissions by listed companies throughout the world. When the CDP launched in SA in 2007, the top 40 largest companies on the JSE were requested to disclose information about their green house gas (GHG) emissions. That first year only 27 companies responded to the request. In the 2011 CDP report, 83 of the top 100 South African companies responded, giving South Africa the second highest response rate globally amongst the 60 countries participating in the global CDP initiative.

This clearly illustrates that the role of an asset owner and investment manager needs to be broader than merely allocating capital among different investment opportunities. Shareholder activism is also an important fiduciary role of an investment manager.

Longer-term perspective needed

It has to be recognised that the average holding period of stocks byinstitutional investment managers has tended to decline, especially due to short-term performance pressures from investors. One of the results of this higher level of turnover in portfolios is that it reduces investment manager ability and incentive to engage with company management as active shareholders. If a manager is generally holding a company for a few weeks or months, he/she is less likely to engage with management on ESG issues. Further, if corporate management presumes or knows you are not going to be around in a month's time, they are less inclined to act on your ESG recommendations or demands. **End investors can**

have a positive influence in this regard by taking a long-term view on investment managers when placing funds.

Managers who understand that their clients will afford them a longer time horizon to generate returns will be more comfortable to take longer-term views on the stocks that they invest in andwill in turn be more incentivised to play a more active role in the companies that they hold. Investments made on the basis of ESG factors in particular, often need a longer holding period to manifest. The risks and consequences of poor environmental behaviour, exploitative labour practices or weak corporate governance practices, may take years before they manifest in a company's earnings or share price performance, but when they do the impact can be significant. Another way to attack or approach the problem of short holding periods is by targeting ESG considerations and active shareholding through low tracking error funds. This means that the funds will have a lower stock turnover and longer holding periods, allowing managers to use their position as shareholders to promote ESG issues.

A final and very important requirement for the success of Responsible Investing in SA is that investment managers must demonstrate to end investors that SRI funds can outperform their benchmarks and traditional investment funds. It is a natural reaction for clients to think that they will need to give up some financial return if they are to take ESG issues seriously in their funds. Fortunately the evidence seems to indicate that this is not necessarily the case. A 2012 report by Deutsche Bank Climate Change Advisors surveyed over 100 academic studies of sustainable investing from around the world. **The report concludes that ESG factors are correlated with superior risk-adjusted returns and that 100% of the studies showed that companies with high ratings for ESG factors have a lower cost of capital.** Furthermore, 89% of the studies examined showed that companies with high ratings for ESG factors exhibit share price outperformance. Contrary to intuition or assumption, this is strong evidence that investors should actually be favouring ESG focused funds as these funds are exposed to factors that will help them generate superiorperformance over the longer term.

While Responsible Investing is still young and much work needs to be bedone, we believe that there is a strong argument from both a financial and ethical perspective for investors to consider allocating a portion of theirinvestments to products that explicitly target ESG considerations.