How **ethical** is your investment?

Fiona Zerbst

The global trend towards responsible investment (RI) means local investors need to bring themselves up to speed. How does RI affect the investment industry, and is it good for returns?

Responsible investment (RI) and returns are viewed as polar opposites by some people. But there is no proof that RI buy-in sacrifices long-term returns. In fact, some case studies claim just the opposite. Scepticism may be a knee-jerk reaction to this poorly understood area of investment.

When it comes to investment, we all want good returns and preferably the best possible returns. But do we want them at any cost?

Cynthia Schoeman, managing director of Ethics Monitoring and Management Services, says: "We already moderate our win-at-any-cost scenarios with a measure of ethics. If we were so keen to pursue returns, we wouldn't draw any lines at all. I often ask my students why they don't work in the drug trade if money is their only aim. So what's wrong with taking that ethical stance just a little further and look at investment with environmental, social and governance (ESG) issues uppermost?"

It's easy to spurn child labour practices; less so to say you don't want your pension fund to invest in tobacco products.
What is clear, though, is legislation and investor codes are driving trustees and their service providers to pay attention to RI as never before. The Amendment of Regulation 28 of the Pensions Funds Act, 1956, states: "A fund has the fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities."

FROM SRI TO RI

Socially responsible investment (SRI) was the catch-phrase in about 2004, when it was defined by the African Institute of Corporate Citizenship as "an investment strategy that balances financial and social objectives".

As SRI matured into RI, different emphases came into play. In 2005, the United Nations invited a group of the world's largest institutional investors to develop the Principles for Responsible Investment (PRI). The PRI South Africa Network was launched in May 2009, with the support of the Government Employees Pension Fund (GEPF).

While legislation is one thing, non-mandatory codes encourage rather than force compliance. The Code for Responsible Investing in South Africa (CRISA) was launched in July 2011; largely because the King Code of Governance was lacking in guidelines for institutional shareholders. It works on an apply-or-explain principle, just like King III, and institutional investors need to fully and publicly disclose to stakeholders at least once a year to what extent CRISA is being applied.

"A company that may be a good bet over the next 12 months may be a huge environmental polluter, for example, and will have to pay carbon tax in the future, which could affect returns."

WHAT DOES ALL THIS MEAN FOR THE INVESTMENT INDUSTRY?

According to ASISA, the function of RI is to align investor objectives with stakeholders and the broader developmental needs of society. There are four broad practices we can follow:

- Engagement, whereby investors engage with management or other stakeholders to improve sustainability.
- Positive or negative screening – the inclusion or exclusion of stocks or funds that meet value requirements (the JSE's SRI Index or a faith-based Shari'ah fund would be examples).
- Integration, where ESG factors are taken into account alongside the purely financial across all asset classes.
- Targeted or impact investment – social, environmental or economic goals that benefit society, like infrastructure, SMME development, agriculture and climate change.

All well and good, but the biggest stumbling block is the practical implementation of ESG principles, says Claire Rentzke, head of manager selection and research at RisCura. She says that while fund trustees grasp the RI concept, they have a tendency to focus on minutiae rather than the big picture.

"You don't need to make a call on individual shares in a portfolio, for the sake of compliance," she says. "If long-term investment is your goal, look at sustainability. Be aware of how governance and operational issues may affect a company. Analysts should be cognisant of these factors, which means they have done a certain amount of scenario planning and can assess and quantify risk."

While governance is fairly easy to quantify, the 'E' and 'S' of ESG are perhaps less so, which is why bottom-line reporting and disclosure are going to be crucial for asset managers to scrutinise. Scenario planning will be vital, too, because of potential red flags.

A company that may be a good bet over the next 12 months may be a huge environmental polluter, for example, and will have to pay carbon tax in the future, which could affect returns. Environmental groups and ethical investment funds warned about the possibility of disaster prior to BP's Deepwater Horizon oil spill of 2010, but analysts failed to highlight the risks. This resulted in institutional investors threatening to sue, claiming BP inflated its share price by misrepresenting its safety record.

"On paper, South Africa is impressively committed to RI, but in practical terms, some investors need to be led to water to drink."

RI AND RETURNS

If the BP story hasn't served as an object lesson, it should.

"So many organisations say ethics is expensive and not good for returns," opines Schoeman. "I hear CEOs say it doesn't pay, or it doesn't make good business sense to implement RI, but in today's global village you can't hide bad business practice for long."

The recent Standard Chartered debacle is a case in point. The UK-based bank allegedly hid 60 000 transactions with the Iranian Government over 10 years, involving at least $250 billion, causing such reputational damage to the business that shares plummeted 24 per cent (its lowest level in 10 months). The New York State Department of Financial Services said that in the bank's zeal to make hundreds of millions of Dollars at almost any cost, it engaged in wilful and egregious violations of law.

This is an extreme case, but it's easy to see how reputational damage can translate to heavy losses.

Of course, there is no perfect company or industry to invest in. Schoeman suggests that conditional investing may be a good compromise, whereby you invest in a company to encourage better governance or labour practices. "Shareholder activism can drive this," she asserts. "But companies must meet the necessary criteria or lose the investment."

Sunette Mulder, senior policy adviser at ASISA, says that the GEPF has played a large role in driving fund managers to buy into RI. The biggest pension fund in Africa has assets of over R1 trillion under management and has over one million members, with active trustees making sure that development investment is top of mind. They are also quick to reject the idea that this equates to sub-optimal returns.

"People are often reluctant to buy into an idea until they see results," says Mulder. "But RI doesn't necessarily spell poor returns; in fact, over time, sustainability can come to matter very much."

Windall Bekker, partner at Rezco Investment Group responsible for retirement fund solutions, suggests another approach. "You may find that one trustee will think BEE investment in a coal-fired pit constitutes RI but another trustee wants to see investment in a wind-farm; my RI might not be your RI. To meet different needs, you could perhaps overlay an ESG score with a BEE score from a rating agency and get a median score that meets the needs of all trustees." The trick is to get trustees on the same page.

On paper, South Africa is impressively committed to RI, but in practical terms, some investors need to be led to water to drink. Nowadays, though, the question is not: can I afford to pursue RI; but rather: can I afford not to?