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What is the point of wealth in a broken world?

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It's not a simple case of choosing between purpose and profit for asset allocators, many of whom are taking a more nuanced view as they engage with issues rather than avoiding them by disinvesting. Investors are increasingly applying non-financial factors related to Environmental, Social and Governance (ESG) issues to identify material risks and growth opportunities. Environmental relates to conservation of the natural world; Social talks largely to people and communities, including how a company manages its relationships with employees, suppliers, customers and other affected parties; and Governance relates to standards applied in running a company, including executive pay, audits and shareholder rights.

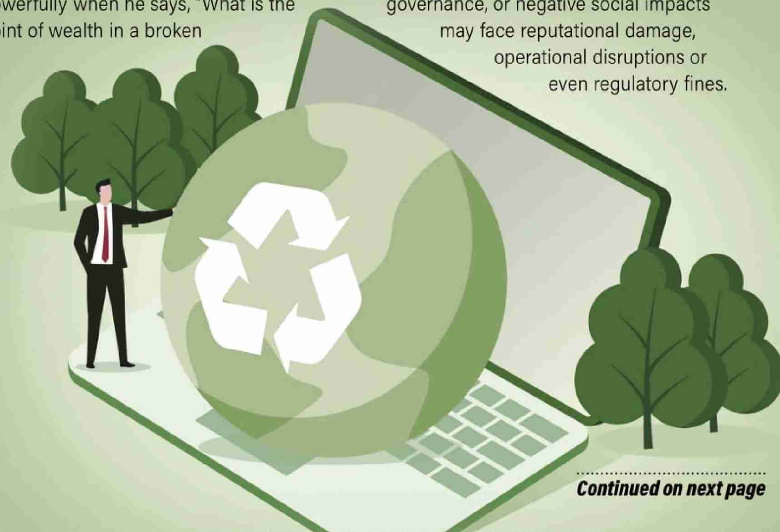
Whether an investor is worried about floods or wildfires, rising global inequality and the social unrest it threatens to unleash, the executive team pocketing all the profits, or simply beating inflation and/or the market, there is a growing consensus that everyone needs to care about where companies stand on ESG.

"Even if you don't care about the sustainability of our planet, or our species, just from a financial perspective we need to care about how companies are tackling these issues," says Linda Eedes, Investment Professional at Foord. "Understanding the risks posed by environment and social costs in the real economy is central to the practice of investment. Internalising these costs could significantly impact the costs and profits of companies' products and services, affecting their bottom line."

Companies that ignore ESG concerns risk everything from financial penalties to their assets becoming stranded or obsolete, says Eedes, who adds, "ESG factors are increasingly critical in the context of identifying material risk and growth opportunities. These things are critical in terms of the sustainability of a business, or the sustainability of business activities within the context of the greater world, or both."

Gontse Tsatsi, Head of Retail Clients at Old Mutual Investment Group, articulates it very powerfully when he says, "What is the point of wealth in a broken world?" He expands on this, "ESG is a big priority for Old Mutual Investment Group as it enables us to pursue superior, risk-adjusted returns for our clients, while also positively impacting the communities and environment in which we operate... it's about getting the returns but making sure the world (ESG) is maintained so that the wealth/goals can be enjoyed. Issues such as resource depletion, climate change, poor governance and social inequality pose both investment and systemic risks to our customers' goals."

Tanya Naidoo, ETF & Portfolio Analyst at ETFSA, adds, "Companies with poor environmental practices, weak governance, or negative social impacts may face reputational damage, operational disruptions or even regulatory fines.



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Fund managers and portfolio managers who encourage the implementation of ESG investing in their investment processes tend to avoid these risks, making them more resilient in the long term. This aligns with the goal of achieving sustainable returns for investors."

Beyond voting with their feet by disinvesting from companies that present problems in terms of ESG, shareholders can engage on various levels. They can use proxy voting to signal discontent or, as many asset managers are doing today, they can engage in a more meaningful way to try to influence the company positively.

Beyond voting on resolutions proposed by the board, shareholders can engage with companies on existing issues, or those not yet addressed. That would perhaps be "We don't think your net-zero target of 2050 is ambitious enough". Or perhaps, "When we look at your cash flows and your capex budgets etc, we don't think they align to your targets". A shareholder or investment manager can do that unilaterally, or they can rally together with others who have similar concerns.

The devil, however, is in the detail, not least in terms of how to isolate and measure the various aspects of ESG, who measures them, and how to police implementation. You might have thought South Africa would be further along this road, considering it is "a country of activists with high social awareness", as Tsatsi put it. He adds that "investors (institutions and retirement fund members) have long demanded that their assets be invested in a sustainable manner".

He explains, "If you consider Broad Based Black Economic Empowerment and the Financial Services Charter, you could argue that ESG is part of our DNA. When one analyses the structural changes that came about since 1994, all aspects of ESG are in the South African system and we are continuously strengthening these from a government and industry perspective."

Premal Ranchod, Head of ESG Research at Alexforbes, expands on South Africa's existing regulatory and legislative environment, adding his own 'highlights', which include the King IV Code on corporate governance, which is still a feature for all JSE-listed companies through listing requirements; Regulation 28 of the Pension Funds Act, which requires ESG application; the Code for Responsible investing in SA and Principles for Responsible Investment, which have strong adoption by asset managers.

So why, then, are we lagging, especially on social issues? Eedes says the industry has long been proactive about governance "because it's far easier to see the direct impact of poor governance or remuneration policies on the value of a business... while capturing the risk of environmental damage is often difficult".

"Historically, the problem is that profits have been privatised, while the costs to the environment or the local communities has been socialised. So, the costs of producing profits have not been borne by those who participate in the profits, but by communities, or the world at large."

She adds, "As an investment team [at Foord] we spend a lot of our time trying to quantify the potential risks of doing harm, the financial impact of pursuing profits in an unsustainable manner, and the financial benefit of orienting your business towards more sustainable practices."

Eedes also says it's important for investors to understand the transition to green energy will take time. "Renewable energy sources have been growing exponentially, but over the past decade, 90% of energy demand growth has come from coal, oil and gas."

From avoidance to engagement

There's been a shift in the trend from simply avoiding companies that aren't responsible corporate citizens to actively seeking out opportunities to influence them to change course. Ranchod, of AlexForbes, agrees there are few simple 'yay or nay' decisions. He gives the example of making bold calls to decarbonise portfolios in favour of environmental risk reduction without consideration for job losses and other consequences. In contrast to a pure activist stance, Ranchod suggests a steady engagement in the short to medium term "for the benefit of additional disclosure, and effecting change".

Making the point that "non-financial risks become financial risks over time if not addressed", Angelique Kalam, Head of Sustainable Investment Practices at Futuregrowth Asset Management, says placing emphasis on partnership and engagement with investee companies "provides a pathway for these companies to commit to sustainable change".

> "Companies that ignore ESG concerns risk everything from financial penalties to their assets becoming stranded or obsolete"

Mandi Dungwa, Portfolio Manager at Camissa Asset Management, concurs. "Camissa cares about the sustainability of the businesses we invest in [but] we would not be in favour of divestments or exclusionary policies, as active engagement on these risks could result in material changes that could benefit society at large." She adds, "Excluding companies with higher sustainability risks disables our ability to engage and potentially be a change agent in such businesses."

There's growing evidence that investors don't have to sacrifice returns to do the right thing and that companies with higher ESG scores will outperform over the long term. ETFSA's Naidoo says, "By focusing on the opportunities while actively managing the risks, it's possible to build a robust, future-oriented investment portfolio that meets both financial and sustainability objectives, potentially leading to more stable long-term returns."

Old Mutual Investment Group's Tsatsi says, "According to MSCI, companies with higher ESG ratings were associated with higher profitability, lower tail risk (chance of a loss occurring due to a rare event) and lower systematic risk (risk beyond the control of a company, e.g. economic, political, social factors)."

Sustainability as a macroeconomic theme is reshaping the competitive landscape and there is a growing consensus that companies that innovate early will reap the rewards, from better growth prospects to a clearer social licence to operate, and even lower cost of capital.

As Tsatsi says, "Responsible Investing is rooted in an understanding that how we invest today determines the quality of our future... if we continue to invest in unsustainable companies that erode public trust, pollute the environment, and perpetuate inequality, we should accept that this is the kind of future we will bestow on our future generations."

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