



GAINING OUTPERFORMANCE WITH ESG

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ABOUT THE AUTHOR

Frank is a portfolio manager within Customised Solutions’ indexation team. With a strong background in mathematics and statistics, he is responsible for managing both local and international tracker funds, specialising in Africa and the emerging markets.

Historically, fund managers mainly used financial factors to determine the investment potential of a company. Now the market is increasingly also using non-financial metrics to establish the drivers of a company’s value. These include environmental,

social and governance (ESG) factors – some of which have had profound impacts on company valuations. Consider, for instance, the cost to British Petroleum (BP) of its 2010 Gulf of Mexico oil spill or the consequences of the labour unrest at Lonmin that resulted in the Marikana massacre and, more recently, the ramifications of the Steinhoff accounting scandal.

Despite the risk of investing in companies with poor ESG ratings, traditional indices have had limited scope to incorporate ESG factors into the selection processes. However, innovations in the indexation investing space in recent years have broadened the capabilities of index-tracking investment managers, enabling them to integrate ESG factors into their investment processes.

Not only can investors now access an index that offers a benchmark with meaningful exposure to ESG factors – the first of its kind in South Africa – but the returns from this index reveal the value of this approach.

KEY TAKEOUTS

- GROWING GLOBAL DEMAND FOR SUSTAINABILITY-THEMED PRODUCTS
- INVESTORS CAN NOW VOTE WITH THEIR FEET
- INDEX TRACKER DELIVERS COMPETITIVE RETURNS

EXAMPLES OF ESG ISSUES THAT IMPACT COMPANIES

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate change	Employee engagement	Board expertise/independence
Carbon emissions	Labour standards	Executive incentives
Pollution	Health and safety	Shareholder rights
Water scarcity	Diversity	Audit/accounting practices
Renewable energy	Privacy and data protection	Business ethics and fraud
Green building	Stakeholder activism	Political interference

Sources: MSCI ESG Research, UNPRI, Old Mutual

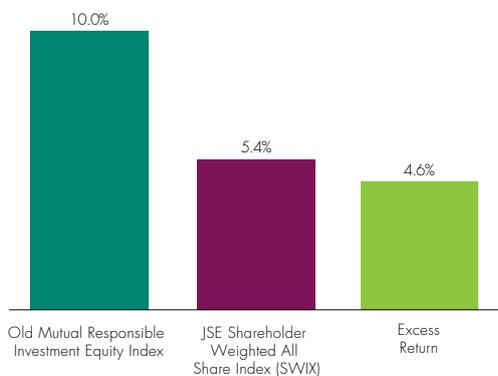
CREATING A RESPONSIBLE INVESTMENT EQUITY INDEX

This Index is made possible through the ESG-related data collected by leading index provider Morgan Stanley Capital International (MSCI). Using the data supplied by the MSCI and, through a proprietary weighting methodology, we built an index that has exposure to the most sustainable companies in South Africa.

The Old Mutual Responsible Investment Equity Index was created in April 2016. The chart illustrates the performance of this Index in relation to the JSE Shareholder Weighted All Share Index (SWIX) over the past two years. Though not a guarantee of future outperformance, the trend supports the fact that the ESG-led index has paid off relative to the market index. In addition, the table illustrates how the excess return depicted in the chart was achieved at a lower volatility than the SWIX.

OLD MUTUAL RESPONSIBLE INVESTMENT EQUITY INDEX: ANNUALISED RETURN SINCE INCEPTION

(1 APRIL 2016 – 30 MARCH 2018)



Sources: Old Mutual Investment Group, FactSet

ESG RATINGS RAISE RED FLAGS

The Responsible Investment Equity Index is a basket of shares of companies that have a high sustainability profile. We use this index to run our tracker Old Mutual Responsible Investment Equity Index Fund. This fund is particularly attractive to long-term investors that value sustainable economic themes, given their extended investment time horizon. Over the two years since its inception, Steinhoff has never been included in the Responsible Investment Equity Index, based on MSCI's ESG rating.

GROWING GLOBAL DEMAND

Over 1 200 asset owners, investment managers and professional service partners have become signatories of the United Nations-backed Principles for Responsible Investment (PRI). Broad acceptance of these practices in the market has translated into strong demand for sustainability-themed investment products. As at December 2017, MSCI reported that about US\$98 billion of assets were benchmarked against the MSCI ESG indices.

ESG-led index-tracking products can offer investors the opportunity to send signals to capital markets that sustainability considerations are of prime importance, without adversely affecting the risk-return characteristics of an investor's financial returns. In addition, investors also benefit from the substantially lower fees associated with index-tracking funds. In essence, ESG indices empower investors to vote with their feet by investing only in companies with high sustainability profiles, without compromising on investment returns. ■

Indices	Volatility Since Inception*
Old Mutual Responsible Investment Index	9.4%
JSE Shareholder Weighted All Share Index (SWIX)	10.1%

*Inception date: 1 April 2016. Source: Old Mutual Investment Group. Figures as at end of March 2018