JOINING FORCES: A FRAMEWORK **FOR VALUE CREATION**

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Rob is responsible for proxy voting and engagement, championing responsible investment and representing the Old Mutual Investment Group on various industry bodies.

If the practice of responsible investment includes acting as a responsible steward of our clients' assets, a question that is often posed to us is "What value can be created by responsible ownership?"

In our view, the answer lies in our approach towards responsible ownership, as well as to quantitative and qualitative research on the value added by an actively engaged shareholder on a company's long-term performance and good governance practices.

We demonstrate our approach and highlight some research findings here to illustrate this further.

RESPONSIBLE OWNERSHIP

To act as responsible stewards of assets, we ensure that the management teams of investee companies are accountable for company performance and conduct. We implement our stewardship activities both in terms of proxy voting and engagement with listed investee companies, locally and internationally, and with investee companies in unlisted markets. We see this as an effective way to meet our commitment to protect investor interests with regard to the way companies manage their environmental, social and governance (ESG) risks and opportunities. We publicly disclose the outcomes of our responsible ownership activities on a regular basis and our latest report (2016) can be accessed on our website.

There are two important questions to consider with regard to responsible ownership:

1. Is there a correlation between poorly governed companies and low returns?
2. Is there a correlation between active engagement and positive performance?

As there is no extensive record of ESG engagements by investors in the South African market over a long period, we look to overseas markets for critical analysis. In most jurisdictions, it seems that research into the correlation between investment performance and engagement is still being formulated, bar a recent academic report by various UK and US institutions[1] into an extensive proprietary database of corporate ESG engagements with US public companies from 1999 to 2009 by a large institutional investor.

The analysis produced a number of interesting results, such as that successful (unsuccessful) engagements are followed by positive (zero) abnormal returns. It also found that companies with inferior governance practices and with institutional investors that take their responsible ownership responsibilities seriously are more likely to be engaged.

Furthermore, successful engagements were more likely if the firm has reputational concerns and better capacity to implement changes requested by the institutional investor. These findings appear to hold true in the South African market where companies with strong management of ESG risks and opportunities are more likely to establish correct governance policies and practices, empowering management to think strategically about the long term.

Another important finding of the report is that collaboration between responsible owners on a number of occasions increases the likelihood of successful environmental and social engagements. This is unsurprising given the latter's scale and long-term nature, which often require in-depth expert analysis and research into the specific issues that are material to the company. Unlike governance concerns, it is difficult to quantify the impact on a company's long-term sustainability and its financial performance on the environment and on social issues.

What does the financial performance of a company following engagement look like? According to the report, ESG engagements generate a cumulative size-adjusted abnormal return of +2.3% over the year following initial engagement, with cumulative abnormal returns much higher for successful, successive engagements (+7.1%). After a year these gradually flatten out when the objective is accomplished (for the median firm in the sample). The report did not identify any abnormal returns for unsuccessful engagements.

Among other insights, the important take-away points from the research are twofold:

1. Successful ESG engagements generate abnormal, positive returns.
2. Collaboration with other responsible owners contributes positively to successful engagements, particularly with regard to environmental and social issues.

In our summary of our engagement activities in our 2016 Responsible Ownership Report[2], we emphasise the importance of the outcomes achieved from successfully concluded engagements and show where we have collaborated with other institutional investors to achieve these. It is also important to note that where we have not achieved a successful outcome on a specific ESG issue with the company, follow-up engagements are initiated to press management on the matter until we can conclude that the ESG concern has been satisfactorily addressed and the engagement concluded.

As we deepen our responsible ownership practices and investee companies improve their reporting practices and stakeholder engagement (as encouraged by King IV), our aim is to quantify the impact of long-term engagement on their risk-adjusted returns. We are eager to ascertain whether the empirical evidence in the South African market supports the conclusions derived from the international research data set. Practising responsible ownership, the outcome of our application of Principle 17 of King IV, creates different types of value on a daily basis and we see our internal business environment, our clients and the market itself capturing the full value benefit of our responsible ownership practices.

[1] Dimson, E., Karakas, O., & Li, X. (2015). Active Ownership. Review of Financial Studies
[2] www.oldmutual.co.za/docs/default-source/old-mutual-south-africa/omig/omig-about-us/responsible-investments/responsible-ownership-report-2016.pdf
[3] Engagement: Unlocking the black box of value creation – Niamh O'Sullivan & Jean-Pascal Gond (June 2016). Sustainalytics and Cass Business School (City University London)

BENEFITS BEYOND FINANCIAL PERFORMANCE

Sustainalytics' recent report entitled *Engagement: Unlocking the black box of value creation*[3] provides a good summary of the different types of value created by responsible ownership beyond the financial value.

Value creation in this context includes:

- Fulfilling fiduciary duties
- Obtaining more in-depth insight into investee companies
- Increased collaboration between the portfolio manager, analyst teams and ESG analysts
- Raising companies' awareness of investors' ESG concerns
- Improved relationships with investee companies
- The transformation of investee companies' corporate behaviour.