TOMORROW
As invested as you are

THE ROLE OF INVESTORS IN SHAPING THE FUTURE

June 2015
RESPONSIBLE INVESTMENT

- INTEGRATION
- INFLUENCE
- GOOD SENSE
- STEWARDSHIP
- ACCOUNTABILITY
- FINANCIAL RETURNS
Old Mutual Investment Group is committed to investing responsibly and has been on a steady and focused responsible investment journey. What has fuelled our commitment is an understanding of the sustainability imperative and its role in changing the competitive landscape across all sectors. Research shows that companies that are able to respond to this trend and innovate early should reap the benefits of stronger growth prospects, enhanced operating efficiencies, stronger social licence to operate, enhanced staff retention, lower cost of capital and, ultimately, stronger and longer competitive advantage. As allocators of capital we believe that incorporating consideration of environmental, social and governance (ESG) factors into our investment and ownership decisions not only makes good investment sense, but we firmly believe that, as the custodian of our shareholders’ and beneficiaries’ long-term futures, it is also the right thing to do.

Our pledge to responsible investment is summarised in our Responsible Investment Guidelines, which commit Old Mutual Investment Group to:

- the integration of ESG factors into investment decisions;
- acting as a responsible steward of assets;
- playing an active responsible investment leadership role in South Africa;
- managing conflicts of interests;
- collaborating with co-investors on material ESG issues; and
- annual disclosure regarding our responsible investment progress.

Outside of our responsible investment practices we seek to constantly innovate in both the listed and unlisted environments to provide clients with attractive investments that support the transition to a low-carbon, resource-efficient, socially inclusive economy. In respect of this we can be hugely proud of the R27 billion* we have invested in green economic growth projects, including sustainable agriculture, renewable energy, affordable housing and education.

We have taken a leadership role in the Old Mutual Group with respect to responsible investment, which is now firmly embedded as a key aspect of the Responsible Business Strategy that drives the overall growth strategy. In the context of our emerging market growth, it is critical for us to direct our customers’ savings and investments to areas of the economy that build resilience and social inclusion. By investing in the long-term viability of the economies, societies and environments in which we operate, we believe we will be able to deliver better returns for shareholders, better outcomes for customers, and a brighter future for their beneficiaries.

Connecting the dots between the investments we make today and the future world we will live in is possibly one of the more vexing challenges facing the investment industry as a whole. Marrying the science of sustainability with the art of investing (or perhaps vice versa) may well be one of the means to effectively leverage the power of the investment community to deliver financial, social and environmental outcomes.

This publication presents a series of essays penned by Old Mutual executives and investment professionals, along with input from invited experts in the fields of governance and sustainability.

The range of issues covered goes some way towards reflecting the complexity, scale and challenges facing practitioners of responsible investment. While there is no one single answer or solution, we do believe that honest and open engagement on these topics is important for driving change and for surfacing the kinds of investment innovation that we believe will shift the dial on this conversation.

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* as at December 2014
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Angelique oversees the sustainable and responsible investment strategy at Futuregrowth. This includes all aspects of responsible investment, such as environmental, social and governance (ESG) integration and the analysis of investments.

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Craig heads up the distribution of our Customised Solutions boutique and drives strategic asset gathering initiatives across the business. He is a co-founder of our indexation business that has R2.8bn allocated to ESG trackers.

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Chief Executive Officer
Diane is responsible for the strategic management of Old Mutual Investment Group in South Africa. She is also a member of the Executive Committee of Old Mutual South Africa and was the Group Finance Director of Old Mutual South Africa for three years.

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Group Customer Director and Responsible Business Lead
Gail is a member of the Group Executive Committee and, in addition to her customer, brand and digital responsibilities for the Group, she is accountable for delivering on our strategic aim of becoming a recognised Responsible Business leader in the financial services arena.

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Simon Pearse
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Joint Head of Liability Driven Investments
Tanja has been Head of the Liability Driven Investments boutique since July 2007, and has established it as the leading liability-driven investment provider.

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Trevor is an investment actuary and works closely with customers and peers. His in-depth understanding of liabilities adds support to the boutique’s ability to design customised solutions for clients.

Tracy Brodzik
Head of Research, Old Mutual Equities
Tracy heads up a large and an experienced team of investment analysts, and has oversight of company analysis across all sectors. Prior to this, Tracy was an award-winning portfolio manager of the Old Mutual Financial Services Fund, and a banking and oil & gas analyst.

Zulfa Abdurahman
Head of Governance
Zulfa is a member of Old Mutual Investment Group’s Executive Committee and is also Head of Governance, where she is responsible for Compliance, Legal and Risk.
EXTERNAL CONTRIBUTORS

Professor Mervyn E King S.C.
A luminary of the global governance arena, a distinguished author and former Supreme Court Judge, among other leading roles in society and business, Professor King is Chairman of the International Integrated Reporting Council (IIRC) in London, Chairman of the King Committee on Corporate Governance in South Africa and chaired the United Nations Committee on Governance and Oversight. He is also Professor Extraordinaire at the University of South Africa, and has honorary Doctor of Laws degrees from the Universities of the Witwatersrand and Leeds Beckett.

Professor Bob Scholes
Internationally acclaimed scientist and prolific author, Professor Scholes is Professor of Systems Ecology at the University of the Witwatersrand. Prior to this he worked at the Council for Scientific and Industrial Research (CSIR) where he was made a Fellow in 1994. He was a lead or convening lead author on the 3rd to 5th Assessment Reports of the Intergovernmental Panel on Climate Change, and has led many other global research programmes. A National Research Foundation A-rated scientist, he is active in a number of international academies and has served on the boards of the World Agroforestry Centre, South African National Parks, and the South African National Space Agency.

Elias Masieela
A director of DNA Economics and a part-time commissioner on the National Planning Commission, Elias is also a director of the South African Savings Institute, a founding member of the Financial Sector Charter Council and a former member of the Advisory Board of the Faculty of Economic and Management Sciences at the University of Pretoria. Until recently, Elias was the CEO of the Public Investment Corporation (PIC) and a director of the South African Reserve Bank. He has previously held senior positions with Sanlam and the Central Bank of Swaziland and was the Deputy Director General of the South African National Treasury. He has lectured at a number of academic institutions and has written widely on the subject of economic policy.

Nicky Holtzhausen
Nicky is an actuary who has a keen interest in mining environmental rehabilitation. She has presented at three mining conferences, including the International Mining Indaba in 2010 where her topic was the Optimisation of Asset and Contribution Strategies for Mine Closure and Environmental Rehabilitation. She has also worked with several mining houses in this regard. During her career, Nicky has been a Fellow of prestigious industry bodies such as the Institute of Actuaries (London) and the Actuarial Society of South Africa.

Nick Rockey
Nick is the Managing Director and founding member of Trialogue, and has over 20 years of consulting and research experience, across many market and industry sectors. A well-known figure in the South African (SA) business arena, he was one of the early pioneers in the field of corporate sustainability in SA, working with the African Institute of Corporate Citizenship to set up and apply a citizenship management rating tool. He plays a lead consulting role in the fields of sustainable business and corporate social investment, and has worked with a wide range of corporate clients, providing support for strategy development and implementation, stakeholder engagement and reporting.

The views expressed by these authors are not necessarily those of Old Mutual Investment Group.
# Table of Contents

<table>
<thead>
<tr>
<th>Page</th>
<th>Title</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>01 - 03</td>
<td>Investors and influencers – Diane Radley</td>
<td></td>
</tr>
<tr>
<td>04 - 05</td>
<td>Stewards of capital – Hywel George</td>
<td></td>
</tr>
<tr>
<td>06 - 07</td>
<td>A global perspective on responsible business – Gail Klintworth</td>
<td></td>
</tr>
<tr>
<td>08 - 09</td>
<td>Driving green economic growth in SA – Elias Masilela</td>
<td></td>
</tr>
<tr>
<td>10 - 11</td>
<td>The role of integrated thinking – Professor Mervyn King</td>
<td></td>
</tr>
<tr>
<td>11 - 12</td>
<td>The state of integrated reporting – Nick Rockey</td>
<td></td>
</tr>
<tr>
<td>13 - 15</td>
<td>Infographic: housing, schools and farms</td>
<td></td>
</tr>
<tr>
<td>16 - 17</td>
<td>ESG’s regulatory clout – Zulfa Abdurahman</td>
<td></td>
</tr>
<tr>
<td>18 - 19</td>
<td>ESG practices and dividend streams – Simon Pearse</td>
<td></td>
</tr>
<tr>
<td>20 - 21</td>
<td>Investor impact on corporate governance – Tracy Brodziak</td>
<td></td>
</tr>
<tr>
<td>22 - 23</td>
<td>An LDI approach to ESG – Tanja Tippet, Trevor Abromowitz and Tarryn Mentoor</td>
<td></td>
</tr>
<tr>
<td>24 - 25</td>
<td>Say on Pay – Jon Duncan</td>
<td></td>
</tr>
<tr>
<td>26 - 27</td>
<td>Too good to be true – Robert Lewensen</td>
<td></td>
</tr>
<tr>
<td>28 - 29</td>
<td>Infographic: Portside</td>
<td></td>
</tr>
<tr>
<td>30 - 32</td>
<td>Innovation in ESG index investing – Craig Chambers</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Infrastructure investment – Old Mutual Investment Group’s stance</td>
<td></td>
</tr>
<tr>
<td>34 - 35</td>
<td>Incorporating the Equator Principles into debt financing – Rolf Canto</td>
<td></td>
</tr>
<tr>
<td>36 - 38</td>
<td>Doing great things means going beyond returns – Paul Boynton</td>
<td></td>
</tr>
<tr>
<td>39 - 40</td>
<td>A Futuregrowth ESG case study – Angelique Kalam</td>
<td></td>
</tr>
<tr>
<td>41 - 43</td>
<td>The challenge of mining rehabilitation – John Gilchrist &amp; Nicky Holtzhausen</td>
<td></td>
</tr>
<tr>
<td>44 - 46</td>
<td>Climate change and asset managers – Professor Bob Scholes</td>
<td></td>
</tr>
<tr>
<td>47</td>
<td>Old Mutual Investment Group on carbon tax</td>
<td></td>
</tr>
<tr>
<td>48</td>
<td>Green economic investment snapshot</td>
<td></td>
</tr>
<tr>
<td>49 - 51</td>
<td>Infographic: SA’s renewable energy programme</td>
<td></td>
</tr>
<tr>
<td>52 - 53</td>
<td>SA: the Islamic finance gateway into Africa – Saliegh Salaam</td>
<td></td>
</tr>
</tbody>
</table>
INVESTORS AND INFLUENCERS
Diane Radley, Chief Executive Officer

IN A NUTSHELL

- We have reached a tipping point and need to embrace change to ensure positive environmental, social and governance outcomes.
- Responsible investment affects all aspects of our business – from long-term investment viability, to how our brand is perceived by our stakeholders.
- Asset owners and managers have a duty to think sustainably in their investment decision-making processes.
- Short-termism is an ultimately detrimental mindset and governance needs to be aligned with longer term strategy.

There have been a few times in history when the world has had to make life-changing decisions to ensure the ongoing viability of the planet and its people. Today we stand at another such point in time. Economic development is required to address poverty and growing inequality which, as we have seen in the past, will have environmental impacts for us all, unless we start to do things differently. Investors seek returns for the risk they take and look to grow their wealth, but, unless we seek to earn a decent return decently, with the long term in mind, we will not effect the changes required for us to avoid repeating past mistakes.

Notably, the North-South divide has thrown into strong contrast developed markets and the wealth accumulated there, often disproportionately – and which, at times, has been to the detriment of emerging markets. Going forward, strong economic growth is required in emerging markets to ensure social stability. This growth will be driven by investment and, if it is to be sustainable over the long term, investing responsibly will be a priority for both asset managers and asset owners.

Q. Who is Old Mutual Investment Group as a responsible business?
   Our motto is “As invested as you are” and we mean this. We invest our own money alongside that of our customers, and we have started our journey on the road of responsible investment because we believe it is where value lies, because we believe it is the right thing to do, and because we want to leave a positive legacy for future generations.

Q. So how do we enact this?
   Perception is the gateway to trust, in that a positive perception of our brand may cause investors and stakeholders to choose to enter into a relationship with us, and thereby experience the tangible benefits of partnering with a responsible business. In this role, we act in a fiduciary capacity for our clients, which means that in looking after their interests we invest responsibly to the benefit of all stakeholders, namely our employees, clients, communities and the environment. So, through actualising our core values, we begin to influence first perception, then consumer behaviour and, ultimately, change for the good.

“Growth will be driven by investment and, if it is to be sustainable over the long term, investing responsibly will be a priority...”
So how does investing responsibly shift perception, which is so often driven by emotional responses?

- People care about the future – our employees want to work for an organisation that resonates with them and, in the battle for talent, we want to attract people that fit our culture and values, and who can help us deliver on our client promises.

- Community benefits – our clients live in communities that we touch with our investments, often through our infrastructure, agriculture, education and affordable housing projects. The manner in which we conduct our ownership of these investments is visible and tangible, and evidences our deep commitment to building a more equitable and inclusive future.

- Social responsibility – our commitment to positive futures is reflected in our corporate social responsibility projects, such as the Massisizane Fund (enterprise development), the Imfundo Trust (education) and the Old Mutual Foundation (community upliftment), as well as the recently launched R350 million Educational Flagship project. All of these combine to influence how society experiences Old Mutual as an African corporate citizen and, through this, people can understand the real purpose of business in society.

- Customer trust – how customers perceive us will evoke interest; interest leads to research, which will reveal the substance of our commitment to investing responsibly. Both our retail and institutional clients will ask if we are the type of organisation that they want as a long-term service provider and custodian of not only their assets, but the future of their beneficiaries. If indeed they are long-term investors, with real value creation in mind, I believe that they can answer “yes”.

Q: What has Old Mutual Investment Group done to deliver decent returns to its investors?

We offer investors market-leading capabilities in both the real and listed asset arenas.

Real assets
As Paul Boynton details on page 36, we are market leaders in economic and development infrastructure investments, with around R51 billion (US$5bn)* in assets under management across sub-Saharan Africa. That said, it is not enough to simply make capital available for development impact investments; we need to actively drive change within the projects that we finance. In education we focus on providing education opportunities to low income families, which is crucial in alleviating poverty.

Our agricultural investments increase productivity through sustainable farming methods, and through training farm workers as custodians of these farms, while establishing healthcare and other benefits in the farm communities, contributing to social stability and upliftment. The graphic on page 49 details the renewable energy projects, to which we have provided both equity and debt capital, that help to offset the impact traditional fossil-burning energy sources have on the environment. Energy and other infrastructure projects such as roads, bridges, ports and airports promote socio-economic development across Africa, by giving access to economic opportunity. Importantly, many of these investments target CPI + 7% returns in US dollars, which means that it is attractive to our investors to grow their wealth responsibly.

Our listed assets
When we invest in listed instruments, we are guided by the mandates our customers give us, and by the fact that they expect us to act professionally and as a responsible custodian of their assets. This means that we consider all material risks, be they environmental, social and governance (ESG) related or otherwise, and use our ownership influence to drive positive change. We do this via our proxy votes and through management engagement, both of which are demonstrated in a selection of articles in this edition of Tomorrow, as invested as you are. In short, we believe that long-term value is destroyed by companies that do not respond to ESG issues. Their customers, employees and the communities in which they operate will reject them, and they will tie themselves up in fines and claims. While some may choose to invest in these companies in order to exploit short-term opportunities, we want to remove short-termism from investing because, for us, investing is about the future; investing responsibly ensures that the outcome is to the long-term benefit of all stakeholders.

Q: Why is a long-term view so important?

Responsible investing promotes the sustainability of our planet and its inhabitants. Therefore, the quality of the operating environments of our investments is critical to the delivery of value. In fact, environmental and social issues are embedded in the strategies of many forward-thinking companies, which are long-term thinkers by nature. Allocating capital responsibly ensures that opportunities are maximised and that scarce resources are utilised in the most effective way.

Governance is also important and, as Jon Duncan points out on page 24, a current hot topic is executive remuneration and the link into total shareholder returns. In the majority of cases, particularly in public companies, executive incentives are aligned with shareholder outcomes through share incentive schemes. But, too often, these schemes are focused on short- to medium-term timeframes of around three years, and this drives relatively short-term outcomes.

Unlike real asset investors, those in listed instruments have liquidity, which means they can exit an investment if they see a longer term decrease in value, while benefiting from short-term gains. Share buybacks, in particular, have been criticised as a short-term measure. They serve to drive up share prices and maximise short-term gains to the detriment of the long-term success of a business, making many executives significant profits on share incentive schemes. If business is to truly add value, it makes sense for incentive schemes to be aligned with long-term outcomes. Management teams need to be held accountable for the way in which they deploy resources in order to boost their incentives, rather than achieving short-term share price performance through share buybacks – this is an area where engagement can be particularly effective.

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* as at December 2014
Q: What does this all mean for an asset management business?

We all live on the same planet and are part of the same global community. Therefore, it makes sense that it is important to our stakeholders that we are responsible stewards of the assets we manage. It makes sense that a client who chooses to invest with us expects us to be a responsible investor, which includes taking account of material ESG factors to deliver decent returns.

We are custodians of sizable assets and can wield significant influence by deciding when and how to invest. With this accountability in mind, we take responsible investing very seriously and have been doing so for a long time.

The majority of our ESG factors are simply good-sense investment principles that deliver good long-term returns. At Old Mutual Investment Group, we are continually enhancing our ESG analysis and influencing other investors to do the same. We will continue to use our position as custodians of the assets we manage to effect positive change in the listed instruments in which we are invested. In our illiquid, long-term unlisted investments we will help to grow economies across Africa, so that we are contributors to social stability, economic development and environmental sustainability. Our investment approach will make the planet a better place for us all to live, while delivering decent returns to our clients.

Our dedicated responsible investment (RI) team consists of five people, with expertise in sustainability, strategy, ESG data analysis, research, marketing and governance. This team engages with stakeholders across the entire Old Mutual Group.

We are committed to helping drive change in the financial services industry and, as such, are active on many industry committees and also participate in, and commission, thought-leadership research.

We are active members of:
- The Code for Responsible Investment in South Africa (CRISA) Committee
- The Principles for Responsible Investment (PRI) Committee
- The ASISA* RI Committee
- The leadership council of Network for Business Sustainability
- International Corporate Governance Network

Looking beyond the listed markets, we have around R27 billion invested in green economic growth (December 2014).

**OUR RESPONSIBLE INVESTMENT JOURNEY SO FAR**

- **2011**
  - Participated in drafting of CRISA

- **2012**
  - Old Mutual becomes PRI signatory

- **2013**
  - RI Committee established
  - RI Guidelines published
  - ESG analyst appointed
  - Proxy Voting Policy published
  - 1st CRISA report (2012) published
  - RI Standard published
  - Governance and Engagement Manager employed
  - RI disclosure

- **2014**
  - 1st PRI Transparency Report published
  - 1st PRI Transparency Report published
  - Collaboration with USB & INSEAD on African Directors Programme
  - Old Mutual Investment Group
  - Proprietary Governance research of JSE Top 100 completed

- **2015**
  - Client ESG reporting implemented
  - Launch of Tomorrow as invested as you are
  - Sponsorship of PRI in Person in UK

*Association for Savings and Investments South Africa*
The financial services industry has a pivotal role to play in allocating capital to sustainable projects. Sustainability should be integrated into all investment decision making – both in listed and unlisted assets. In the listed arena, capital allocators act as influencers or – if that doesn’t herald results – can sell shares in corporates not making sustainable decisions. In the unlisted arena, capital allocators can have a very direct effect on ensuring that sustainability and responsible investing are embedded in projects. The environment, the workforce, the scarcity of resources and the long-term development of our nation and continent are no longer separate considerations, or “nice-to-haves”; they are integral to delivering successful long-term investment returns.
As custodians of a nation’s savings pools, we in the financial services industry have a pivotal role to play in the allocation of capital across commercial projects. The efficiency of this allocation is central to the success of capitalist economies, where the guiding hand of the market is a powerful and an essential force.

We have now reached the point where such allocation decisions have to be made with more than just commercials in mind; or, to put it another way, the sustainable aspects of an allocation decision have become integral to its commercial viability. The interesting questions are: why has this come about and why now? I believe there are a number of driving factors:

1. The climate change debate has sharpened the focus on the sustainability of commercial practices;
2. Consumer awareness and appreciation of ethical practice has become widespread, through education and general social awareness;
3. The instant spread of consumer information (and subsequent action) via social media has made unethical practice almost impossible to hide;
4. Better measurement of scarce resources (water, minerals) and the impact of climate (pollution) have raised awareness of the human impact;
5. Local information is instantly global; the development of emerging nations is now fully in the global spotlight.

**Listed and unlisted assets**

If we accept that, as responsible stewards of capital, we have a distinct role to play in ensuring we are allocating the funds we manage to commercially sustainable projects, then the key consideration we have to take into account is how we integrate this into our investment decision making. At Old Mutual Investment Group, we are committed to prioritising these factors in everything we do and have actively integrated such processes into our investments in both listed and unlisted assets.

While the same principles of responsible investing apply in each sphere, the approach and the impact we can make are often different.

**Listed assets**

As an owner of a share listed on a stock exchange, our influence on a corporate’s behaviour is one step removed from the actions its management team undertake. Our role is thus to influence the corporate’s executive and management decision making. This is best done in private sessions during which we engage in open dialogue to secure constructive outcomes.

If this is not effective, we can vote on certain resolutions, thereby bringing pressure to bear on the corporate. In the extreme, we can sell the shares and, in so doing, allocate capital away from a corporate that is not making sustainable business decisions, in favour of one that is. Over time and as responsible investing becomes increasingly embedded in more asset owners’ philosophies, capital will be allocated to businesses acting in a responsible manner. The valuation placed on these companies will rise and their ability to raise capital at cheaper levels will improve, with more such capital being allocated to sustainable investment projects as a result.

**Unlisted assets**

As a large insurance business in South Africa and, increasingly, across the African continent, we have been able to invest our clients’ assets in long-term physical investments such as infrastructure (energy, roads, bridges, ports, airports), real estate, private equity and agriculture.

Such investment takes the nation’s savings and invests them directly in this very necessary infrastructure and the new businesses we need to develop our country. It is crucial, therefore, that such investment is carried out in a sustainable way – a way that both secures the assets necessary for future generations and generates sustainable long-term returns for our clients. In this area, as owners of the physical assets, we can have a very direct effect on ensuring that sustainability and responsible investing are embedded in all our projects.

A good example is our agriculture investments where, having bought the farmland, we commit to invest at least 0.5% of the initial capital investment a year in the workforce itself, providing free healthcare, housing, schooling and worker education. This ensures that in a decade’s time, when we may wish to sell the farm on to another owner (perhaps to the workers themselves), we have a sustainable investment that will continue to benefit the workers, secure our investment and provide jobs and food for the locality and broader nation.

“As Director of Investments at Old Mutual Investment Group, I feel very passionate about the role we play as responsible stewards of our clients’ capital; ensuring that we allocate investment into businesses and projects that are responsible to the environment, the workforce, scarce resources and the long-term development of our nation and continent. This approach is no longer a separate investment option, or a ‘nice-to-have’; it is integral to what we do and indeed the route to delivering successful long-term investment returns.”

**STEWARDS OF CAPITAL**
Corporate social investment is no longer enough; businesses need to integrate social outcomes into their day-to-day operations. There are many opportunities for businesses that are willing to tackle issues such as inequality and environmental degradation. Both institutional and individual investors will start favouring responsible businesses.

The responsible business movement is gaining momentum and is the modus operandi of the future. You can deliver great returns and social benefits – it is time for us to live a new story.

**Q:** What does it mean to be a responsible business?

In the financial services industry in particular, being a responsible business means that we conduct our affairs in a way that adds value to all of our stakeholders. As Professor King asserts on page 10, we are not separate to society, we are a critical part of it, and the way we operate can be either regenerative or destructive.

The origins of banks, insurance companies and investment houses lie in the power of the collective that enabled us, the customer, to pool money to better manage risks and improve returns, compared to what was available to individuals. Unfortunately, over time, this ethos has been eclipsed by a focus on returns to shareholders and executive enrichment. As a result, trust in financial services companies is at an all-time low. So, for us at Old Mutual, being a responsible business means living up to our true purpose, which is to help our customers thrive by enabling them to achieve their financial goals, while investing their funds in ways that will create a positive future for them, their families, the community, and the world at large.

**Q:** Describe your role and your passion for it?

My portfolio covers what I believe to be the growth drivers of our business: customer experience, brand, digital, and responsible business. I chose to move to Old Mutual because it is clear to me that financial services is a sector which is uniquely placed to take on the role of creating a regenerative society. Before joining Old Mutual, I spent almost 30 years working in fast-moving consumer goods with Unilever, during which time I was privileged to play a leadership role in various aspects of the business both locally and globally, including CEO of Unilever South Africa. Most recently, I led the Unilever Sustainable Living Plan across the Group, gaining valuable insights through working on the ground with customers and key stakeholders in over 50 countries.
Old Mutual is well aligned with my personal belief in the power of business to be a force for good. I don’t believe that the current level of income disparity, with 4% of the population owning the bulk of wealth globally, is sustainable; nor is the manner in which industry profits at the expense of life-supporting ecosystems. Indeed, the root cause of much of the prevailing socio-political unrest is inequality and competition for increasingly scarce natural resources.

The good news is that there are huge benefits available for businesses that embrace these issues, and seek to address them in partnership with their stakeholders. The innovation opportunities and the trust relationships that can result, will create significant competitive advantage. With its distinguished history, value set and diversity of capabilities, the Old Mutual Group is one of the very few financial services companies that truly understands this, and I believe that my role will help us to act and unleash these opportunities.

Q: What drives the Old Mutual Group strategy?

Among other focus areas, along with our partners at the Cambridge Institute for Sustainability Leadership, we have identified financial wellbeing and responsible investment as areas where we can make a material difference. They are the core operations of our business and the reason we exist. Our customers choose to do business with us because they trust us to help them improve their financial wellbeing, whether it is an individual with life aspirations or an institution that wants to ensure its long-term sustainability. Through focusing on financial wellbeing, we have a unique opportunity to build trust and, through providing them with the products, education, accessibility and transparent information that they deserve, we can become their partner for life. Similarly, with over £300 billion of funds under management, we are obliged to deploy these in ways that not only deliver returns, but do so in the most responsible way, which will create a positive future for the current generation and their beneficiaries. Globally, sustainable investment assets stood at US$21.4 trillion at the start of 2014, and are forecast to continue growing exponentially.

In the past, businesses chose to do their business and then manage reputation by providing philanthropic donations outside of their core operations. While these activities continue to be an essential boost to worthy causes, this is no longer enough. The companies of the future will find ways to deliver strong returns from investments that also solve some of the greatest needs in society, and we choose to be such a company.

Q: How will this change the way Old Mutual does business?

We will increasingly look at everything we do through a responsible business lens and shape our operations accordingly. As signatories to the UN-supported Principles for Responsible Investment (PRI), we need to be compliant in all of our investments. This means consciously applying an environmental, social and governance (ESG) lens to our investment processes. We are making progress and we judge that 60% of our investments mostly comply with our aspirational Responsible Investment Standard, while 40% fully comply, and we are targeting 100%. Globally, we have cast 70% of proxy votes for our listed-equity investments. Looking ahead, we are actively seeking investment opportunities that will build our leadership in responsible investment, with particular inroads made into our African-based operations:

- 2014 – Nedbank screened 22 new Equator Principle-relevant deals, with four worth a combined US$319 million drawn down in the year;
- 2014 – we launched the first African passive fund that tracks the MSCI World ESG Index, which has gained significant traction;
- Old Mutual Investment Group has thus far invested over £670 million in renewable energy alone;
- We intend to up our stake in East Africa-based insurer UAP Insurance to 60.7% or US$253 million, subject to regulatory approval. One of the key drivers of this partnership is a firm commitment to responsible business by both parties.

Then, in the US and Europe, as large institutional investors and pension funds are becoming more demanding of ESG credentials, our affiliates are stepping up their capabilities to add ESG screening to their decisions. We are both supporting them and requiring them to make these changes.

Q: Will this shape the global financial services industry going forward?

Yes, and looking out across the world, the facts speak for themselves.

United States: In what could be argued to be one of the more traditional investment markets, sustainable, responsible and impact investing enjoyed a growth rate of more than 76% between 2012 and 2014.1

United Kingdom: Around 80%2 of pension funds report that they demand their investees to demonstrate active stewardship on ESG factors, many going beyond PRI requirements.

China: The 12th five-year plan is investing heavily in low-carbon initiatives in a bid to lower the carbon intensity of their growth. Sub-Saharan Africa: The Africa Infrastructure Country Diagnostic (AICD) says in excess of US$93 billion in infrastructure development is required annually over the next 10 years. To date, less than half that amount has been provided, leaving a financing gap of more than US$50 billion. Governments, NGOs and global economic institutions have all stated that sustainability must be a key consideration when it comes to developing Africa, in order to avoid some of the societal and environmental issues that are experienced in other parts of the world.

Q: Will investors in collective investment schemes/mutual funds start voting with their wallets in favour of responsible businesses?

This is already happening. In fact, mutual funds are the fastest growing segment of the US responsible investment industry. Who would not want to invest their money in a solution that not only delivers good returns but also does the right thing? I agree with Diane Radley when she says that, quite frankly, it is just common sense. One of the myths we need to break is that you cannot invest responsibly and make good profitable returns. This is just not true. Those investment houses that show ways in which this is possible will reap the benefits. We need to look for these opportunities and we need to create a new narrative in the industry; we need to drive this change.

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1 www.USIF.org 2 National Association of Pension Funds
The investment decisions we make today carry long-term implications for future generations. This also applies to their agents, the money managers. Money managers can be said to have a much bigger impact in that they affect the environment directly through their investments as well as indirectly through how they lend. Therefore, the role of investors is fundamentally one of upholding and preserving sustainability, not only of their investments, but also of the environment within which they operate. This warrants investors taking a long-term view about the decisions they make and implement. It is about planning on sound, going concerns for more than one lifetime, which is about 40 years in South Africa.

It is about internalising, both in the planning and implementation processes, environmental, social and governance (ESG) principles in a wholesome fashion. The bottom line is that it cannot be about profit maximisation at all cost.

Having said this, it is very clear that driving green economic growth is not about hugging trees. It is more fundamental than that. It is also about people – about the entire universe.
Context

However, there is no doubt that we are faced with the challenge of climate change, which is altering the ESG landscape (refer Professor Scholes’s article on page 44) to be inherited by future generations. Green economic growth that is characterised by low-carbon emissions, resource and energy efficiency, and social inclusion is becoming crucial in changing the status quo. Investors can contribute to the efforts of transitioning to a green economy by directly allocating capital to sectors, companies and technologies that have been earmarked as crucial in developing a green economy. Technological advancement is key in speeding up the pace to the end state.

Additionally, pension funds and investment managers could strengthen their current socially responsible investment (SRI) practices by including climate change considerations in their investment analysis and decision-making processes. Not only that – for a sustainable transition, we need a change in the body of financial analysts that comment on the economy. Until they endogenise the importance of sustainability in their critiques, the mentality of short-termism will be difficult to do away with. There is no doubt that CEOs and managers of companies are influenced by the views of the financial media – which, historically, have been driven by short-term financial considerations.

On the back of the above good intentions, it is instructive to mention that there is a substantial funding gap arising from transitioning to a green economy. The sectors identified as critical for transitioning to this state by the South African Green Economy Modelling Report are: natural resources management; agriculture; transport and energy. Within the energy sector, priority needs to be given to energy efficiency and clean/renewable energy. It is difficult to get an accurate estimate of this funding gap based on publicly available information. Global estimates of the additional investment required in the energy sector alone range between US$190 billion and US$900 billion a year through to 2050. This significant demand for capital cannot be met by Government alone. Private investors and financial institutions have an opportunity to fund this shift to low-carbon sources by investing in cleaner technologies and priority sectors.

Meeting the challenge

For South Africa (SA) to play its part in addressing this challenge requires the co-ordinated efforts of multiple stakeholders. Pension funds and investment managers can play an important role in this regard by strengthening their SRI practices, as well as by including climate change considerations as an investment criterion. The local Code for Responsible Investing in South Africa (CRISA) principles stem from the United Nations-backed Principles for Responsible Investment (PRI), and both sets of guiding principles are yet to give specific mention to climate change considerations under issues of sustainability in investment analysis. JSE-listed companies, however, are increasingly including change metrics and indicators in their reporting. The investment community can play a vital role in promoting a greener economy by using this information to allocate capital to companies that have the highest likelihood of making a positive contribution to a transition to a lower carbon SA economy.

Secondly, it can also use this information to develop a better understanding of which local entities or sectors will struggle to remain competitive in a lower carbon economy. This should avoid the risk of making investments that may end up underperforming in the long term (and thereby increasing the cost of the transition).

Thirdly and not least, the National Climate Change Response Policy clearly states that SA should embark on a just transition to a lower carbon economy. Investors should thus not neglect the existing socio-economic considerations that underlie SRI investments, and, crucially, more work is needed to identify investments that will maximise socio-economic outcomes, while facilitating the required transition.

Strategic imperative

There is no doubt that SA has been a pioneer in many global and domestic initiatives on this subject. For instance, the King I Report greatly influenced the development of the UN Global Compact (UNGC) and has played a critical role in its evolution. The JSE has given broad impetus to these initiatives through its corporate disclosure and transparency requirements. Underpinning all this is the work of the Global Compact Local Network, South Africa through the National Business Initiative (NBI). The Local Network promotes collective action towards elevating sustainability in the private sector. It is also spearheading this initiative at a continental level, under the auspices of the UNGC Africa Strategy, which places the responsibility of continental sustainability in the hands of African CEOs. This has greatly influenced the drafting and finalisation of the future agenda, to be adopted by the UN in September this year.

For all of these reasons, it can be observed that there is growing recognition that long-term financial success increasingly goes hand in hand with environmental stewardship, social engagement and good governance. Corporate sustainability has shifted from being viewed only as a moral imperative to a material one. It is now broadly accepted that ESG challenges affect the bottom line...sustainability is moving up the agenda – away from the public relations realm to a strategic one, handled at the highest levels of the company.”

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3 Georg Kell, at a South Africa UNGC Local Network CEO Roundtable Dinner, 19 November 2014
INTEGRATED REPORTING

THE ROLE OF INTEGRATED THINKING – changing corporate behaviour
Professor Mervyn King, Chairman of the International Integrated Reporting Council

IN A NUTSHELL

• Shareholder primacy is a legacy that needs to be replaced with a broader view of who comprises a company’s stakeholder base.
• The way companies operate can create value or destroy it.
• Value creation can only be sustained if sustainability issues are embedded in the organisation’s long-term strategy.
• Reporting does influence behaviour.
The roots of sustainable capitalism lie in the inclusive approach to governance, as opposed to the exclusive approach, which was practised for approximately 100 years. The latter led to the doctrine of shareholder primacy and the myth that the shareholder was the owner of the company. The shareholder has a conglomeration of very important incorporeal rights such as the appointment of directors, the removal of directors and dictating the purpose for which the company is formed. But no person can be owned.

Shareholder primacy led to a focus on shareholder value and the definition of value through the financial lens of the present value of discounted future cash flows. This was almost irrespective of how the cash flows were created.

The company has always been a critical part of society. Business is at the junction of the economy, society and the environment. The impact of how the company makes its money and its product or delivers its service on these three aspects creates value if they are positive, and destroys value if they are negative. The creation of total value is when the positive impacts are enhanced and the negative impacts are eradicated or ameliorated. In other words, value creation is the process that results in increases, decreases or transformation of resources which are caused by the company’s business activities, outputs and outcomes.

Inclusive governance involves the Board identifying the company’s key stakeholders and taking account of their legitimate and reasonable needs, interests and expectations of the company, but making a decision always in the best interests of the company for the maximisation of total value.

Value creation can only be sustained if sustainability issues are embedded in the organisation’s long-term strategy, and if the impacts of how the company makes its money and its product on resources are positive. The use of resources and the organisation’s relationships with its stakeholders are interconnected and interdependent, both functionally and operationally. This embraces the concepts of integrated thinking and creating value over the longer term and, if adopted, changes corporate behaviour.

The outcome is the integrated report. Reporting does influence behaviour. To have done an integrated report the Board would have had to adopt integrated thinking.

THE STATE OF INTEGRATED REPORTING
Nick Rockey, Managing Director of Trialogue

IN A NUTSHELL

- Reporting practices in large organisations have been entrenched over decades and there is resistance to change – a shift in mindset is required.
- Integrated Reporting (IR) goes beyond reporting what happened, it is about how to create and sustain future value.
- There is often a disconnect between sustainability themes and what is seen as core business; for true integrated reporting to be possible sustainability needs to find its way into company DNA.
- Executive accountability is essential to the writing of a truly integrated report.

A company’s sustainability journey invariably starts with the compilation of a report. And, while it may seem counter-intuitive to communicate sustainability before formalising management practices, the emergence first of sustainability reporting and then integrated reporting has been a strong driver of corporate sustainability.

Initial forays into reporting on material non-financial issues were in the form of separate sustainability reports that were rich in data but mostly short on bigger picture insights. Efforts to integrate this information typically resulted in a summary of the sustainability report being tacked on as a chapter in the annual report. This approach is limiting in that no connection is drawn between how the company makes money and what it does to be more sustainable.

Formalising the framework
The launch of the King III Report was instrumental in establishing the case for the integration of financial and non-financial information. Progress was further boosted by the release of the International Integrated Reporting Council (IIRC) framework, which offers structural guidance to report writers as to how to explain to providers of capital and other stakeholders how value is created and sustained.
This diagram is one way to depict the capitals. Financial and manufactured capitals are the ones organisations most commonly report on. IR takes a broader view by also considering intellectual, social and relationship, and human capitals (all of which are linked to the activities of humans) and natural capital (which provides the environment in which the other capitals sit).


The reporting principles and elements proposed by the IIRC are fundamentally different to traditional annual reports, which largely comprise statements by the CEO and chairperson, along with financials submitted by the financial director. So entrenched has this one-dimensional approach become, that there is resistance to change and a serious shift in mindset is required by companies that choose to adopt an integrated approach to their reporting.

This method places an emphasis on future prospects, conciseness, connectivity of information and the use of the six capitals reflected in the diagram, and their interdependencies to create value. To truly take effect, the transformation of a company’s reporting practices needs to be driven from the top down, starting with at least the conceptual buy-in of the executive team and Board.

Breaking down the barriers
Another major challenge is that integrated reporting flows from integrated thinking. At present, a great deal of activity that is classified as sustainability happens in company silos, or is managed as a distinct business function.

The process of producing an integrated report often follows an information gathering process designed to uncover all sustainability-related activities across the organisation.

This deluge of information is then screened and fed into the sustainability and integrated annual reports. In some cases the outcome is credible, but often the information appears disjointed and lacks business context.

Inevitably, when the thinking is not integrated, it will be difficult to “reverse engineer” the report to make it truly integrated. Executives should understand how the management of non-financial issues and relations with stakeholders enable business. This requires sustainability to be built into company practices and performance measures. To achieve this takes considerable time and effort.

So as it now stands, integrated reporting remains in its formative phase. Progress is found in the form of good examples of integrated reporting elements, such as a flow chart of how the six capitals apply to the business value creation story, or performance highlights that combine financial and non-financial indicators.

But this is not true integration. The integrated report will come of age only when executives feeding into the reporting process comment on how their oversight of issues and relationships assist in creating value over the longer term.

We are not quite there yet.

“The integrated report will come of age only when executives ... comment on how their oversight ... assists in creating value over the longer term. We are not quite there yet.”
ENABLING FUTURES THROUGH HOMES, EDUCATION, FINANCE AND FOOD

We manage in excess of R15.1 billion across a range of funds that aims to provide investors with commercial returns while delivering positive social and developmental impacts. The graphic overleaf shows the spread of these investments across South Africa.

NATION BUILDING THROUGH EDUCATION
Run in partnership with experts in education and through the provision of accessible facilities, as well as the training and equipping of educators, the Schools and Education Investment Impact Fund South Africa has 13 affordable independent schools operating across South Africa (SA), with approved deals for 14 additional schools across SA. Ultimately, we aim to reach over 40 000 learners.

**Fund size:** R1.2 billion  
**Fund benchmark:** 3-month JIBAR + 3%  
**Manager:** Old Mutual Alternative Investments

BUILDING SAFE, AFFORDABLE HOMES
The Housing Impact Fund South Africa aims to help lower-income people who do not qualify for government-assisted housing. It finances the conversion of existing buildings and the construction of new homes. Through its partners, the Fund also provides loans for purchase and rental.

**Fund size:** R9.15 billion  
**Fund benchmark:** 3-month JIBAR + 4%  
**Manager:** Old Mutual Alternative Investments

GROWING FOOD SECURITY
The global population explosion demands innovative approaches to food production. We buy farmland in South Africa and invest in farm expansion and infrastructure development which results in sustainably run farms and job creation. We currently have five mega-farms in operation, growing crops such as fruit and nuts. Our investments in farmlands also support housing, healthcare and education for the local farming communities.

**Fund size:** R2.9 billion  
**Fund benchmark:** 3-month JIBAR plus a spread adjustment  
**Manager:** Old Mutual Alternative Investments

GROWING THE ECONOMY
We are committed to developing a more inclusive financial sector that serves the needs of lower-income consumers. To do so, we target a range of opportunities and innovations at the low-income level, including housing, microfinance, black SMME finance and mortgage loans.

**Fund size:** R5.6 billion  
**Fund benchmark:** 3-month JIBAR plus a spread adjustment  
**Manager:** Old Mutual Alternative Investments

Figures as at December 2014
We actively invest in assets/areas where we have identified gaps or backlogs in social infrastructure. Our expertise lies in developing **AFFORDABLE HOUSING**, providing access to **QUALITY EDUCATION, FINANCE** and developing **SUSTAINABLE FARMING OPERATIONS**.

The knock-on effects of these initiatives are tangible economic development, job creation and social upliftment.

**GENERATING RETURNS THAT COUNT**

**SCHOOLS FUND:** SCHOOLS & LEARNERS

**HOUSING FUND:** STUDENT ACCOMMODATION

**RENTAL ACCOMMODATION**
510 265 loans to the value of R8.3 billion for mortgage bonds, home improvements, microfinance & micro-enterprise development, such as taxi finance.
• Regulation 28 of the Pension Funds Act makes responsible investment a regulatory requirement.
• Asset owners have complete control over how ESG factors are incorporated in investment decisions.
• An independent compliance function ensures the portfolio is managed in accordance with the mandate on a pre- and post-trade basis.
• For the majority of South Africans, employer pension funds are often the only means of saving.

South African pension funds are governed by Regulation 28 of the Pension Funds Act, which imposes limits on the investments of pension funds. These limits and overarching principles are intended to protect funds from making imprudent investments. This is particularly important as most pension funds are “defined contribution” funds, where the investment risk is carried by members (the investors).

For the majority of South Africans, employer pension funds are often the only means of saving and, consequently, their pensions are their sole source of income post retirement. Hence, it is a regulatory imperative that the prudential regulation put in place for pension funds should foster an environment that finely balances sustainable long-term investment performance needs, while safeguarding against excessive losses.

A fresh approach
The review of Regulation 28 in 2011 brought welcome changes to outdated regulations. With it, it also placed the onus on pension funds to adopt a responsible investment approach and, for the first time, stipulated that pension fund trustees must “give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance (ESG) character. This concept applies across all assets and categories of assets, and should promote the interests of a fund in a stable and transparent environment.”

This clearly lends credence to the principle that integrating ESG factors into investment decisions will offer investors long-term performance advantages.

As invested as you choose to be
As an institutional investor with the Old Mutual Investment Group, you can control your own responsible investment destiny; you set the targets; you set the limits; you mandate us to manage your money responsibly. As investment managers, we act as your agents and our partnership relationship is governed by a carefully constructed Investment Management Agreement (IMA), which sets out guidelines that are strictly monitored by the Compliance Team.
In terms of the Financial Advisory and Intermediary Services Act (FAIS), we are required to obtain a signed mandate from a client before managing their assets – the mandate sets the terms within which we manage that client’s assets. This is the client’s opportunity to dictate quite specific investment restrictions. These can include ethical screening, a desired social outcome or screening for ESG risks and opportunities.

Once these investment guidelines are agreed upon, the investment manager has a fiduciary duty to ensure the assets are managed within the framework of these guidelines.

**How do we do this?**

Our Compliance Team is 100 percent independent and is segregated from portfolio managers and the trading team. Client mandates are monitored daily on both a pre- and post-trade basis, using an automated system that is linked to trading. The process includes identifying and reporting on any mandate breaches, as well as monitoring and tracking the resolution of these breaches.

**Client has total control**

Let’s take a practical example to demonstrate how much control the client has over the assets our portfolio managers invest in and how we track compliance with any guidelines our clients may set:

**Scenario:**

ABC Pension Fund awards Old Mutual Investment Group a portion of its assets to manage in an equity mandate. ABC Pension Fund is regulated by the Pension Funds Act and must comply with Regulation 28. In considering its regulatory obligations, the trustees have decided the fund should not have exposure to specific companies that they consider to have poor environmental practices. The trustees provide a list of these companies and include a specific clause in the mandate prohibiting investment in any of these companies. As part of our internal governance processes, the portfolio manager of this fund must agree to the investment restrictions – the portfolio managers are the “first line of defence” and must ensure they manage the fund in accordance with the agreed mandate.

As the “second line of defence”, before the portfolio manager starts trading for this fund, the investment restrictions, including the agreed clause, are coded onto our automated compliance system, which is linked to our front office trading system.

This means that should the portfolio manager attempt to trade in one of the companies on this restricted list, it will automatically block the trade, i.e. our system is a “pre-trade” compliance system. In addition, the Compliance Team runs post-trade compliance reports daily.

Any breaches are immediately escalated and resolution is stringently tracked. Our compliance systems and processes are able to cater for focused investment guidelines, including concrete restrictions that may be ESG in nature.

What does this mean for our clients? It allows them to be as prescriptive as they like and have the peace of mind that their prescribed investment guidelines are being closely monitored by an independent compliance team.

“You can control your own responsible investment destiny: you set the targets, you set the limits, you mandate us to manage your money responsibly.”
At Marriott, we have found that a key component of a successful income-focused investment philosophy is to only invest in companies that produce reliable and consistent – and ideally growing – income streams. With this building block in place, we are able to provide accurate investment projections from an income and capital perspective, allowing investors to plan effectively for the future. Studies have also shown that companies that pay and grow their dividends tend to outperform the market over the long term. This is evident in the performance of our local equity fund – the Marriott Dividend Growth Fund – which has won a number of awards for its risk-adjusted returns.

How to look forward

Although historical dividend track records are useful for identifying investments with the ability to produce reliable income, even the most reliable track record is no guarantee of future performance. This is because dividend track records are backward, as opposed to forward, looking. To ensure reliable income growth in the future from investments made today, a number of other questions need to be answered. Some of these questions include:

- What are the company’s income growth drivers?
- Are these drivers under threat from current economic conditions, low barriers to entry or regulatory changes?
- Does the company have a solid balance sheet?
- What is the company’s dividend policy?

The analysis process does not stop here. In the wake of the Global Financial Crisis and numerous “big business” scandals, corporate behaviour that is unethical, irresponsible, harmful to the environment or exploitative in nature, is no longer being tolerated by regulators and consumers alike. Changes to industry regulations, or a damaged reputation, can prove extremely costly and pose a significant risk to a company’s dividend payments down the line. Consequently, these issues must be evaluated when trying to identify whether income streams are likely to be reliable and consistent in the future. It is for this reason that the pursuit of reliable dividends aligns so closely with environment, social and governance (ESG) related sustainability objectives.

To this end, it is essential that an investment team should monitor and report on ESG issues on a regular basis.

Transparency is key

An area of particular importance for us relates to company reporting and disclosures. Companies with a reputation for withholding important shareholder information will not be considered for inclusion in a portfolio, as the future prospects of these businesses cannot be determined with a high degree of certainty. Companies that take advantage of ill-informed consumers are also immediately excluded – not only from an ethical standpoint, but also due to the fact that exploitative business models are unlikely to be sustainable. In summary, it is critical that we successfully identify risks to dividends because then we will be able to produce reliable income and predictable capital growth for our investors. Without doubt, questionable ESG practices could pose significant risks to company dividends in the future. Consequently, the evaluation of these issues should be built into any reliable investment process.

These charts illustrate the dividend-paying track records of certain companies Marriott currently invests in and you’ll see they have broadly delivered steadily growing dividends.
IN A NUTSHELL

- Companies that pay and grow dividends tend to outperform over the long term.
- Regulation and reputation can change the fortunes of a company — this is why it is so important to analyse environmental, social and governance factors when researching a potential investment.
- Even the most reliable track record is no guarantee of future performance.
**INVESTOR IMPACT ON CORPORATE GOVERNANCE**

Tracy Brodziak, Head of Research, Old Mutual Equities

**IN A NUTSHELL**

- The Global Financial Crisis highlighted the profound impact governance issues can have on the value of a share.

- Corporate governance is the framework within which a company must operate and touches every aspect of business.

- Remuneration is the true test of whether a company is simply box-ticking or is taking corporate governance to heart.

- Transparency on remuneration in South Africa has some way to go and policy reform in line with international best practice is required.

- Corporate governance has a definite impact on the long-term sustainability of a company’s value.

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**OLD MUTUAL INVESTMENT GROUP’S 2014 PROXY VOTING ACTIVITY**

- Voted at 409 company meetings across 363 unique companies
- Voted on 142 354 resolutions per ballot across all the boutiques
- 72.4% of the issues fell into four categories – the election of directors; remuneration policy; appointment of audit and other committee members; and capital management

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**NUMBER OF RESOLUTIONS**

- **Election of Directors**
- **Remuneration**
- **Appointment of Audit & Other Committee Groups**
- **Capital Management**
- **Appointment of Auditors**
- **Shares Under the Control of Directors**
- **General Resolutions**
- **Financial Assistance**
- **Authority Granted to Directors to Implement a Specific Resolution**
- **Memorandum of Incorporation**

**For**

- 131 932

**Against**

- 9 982

**Abstain**

- 440

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*Abstentions are considered active but % too small to reflect.*
Good corporate governance is crucial to a well-functioning equity market. You just have to call to mind Enron, WorldCom, the Global Financial Crisis and, locally, the epic collapse of African Bank, to realise that poor corporate governance can have a profound impact on the valuation of a company. Corporate governance is the system of rules, practices and processes by which a company is controlled and directed, and interacts with its stakeholders. It is the framework within which the company must meet its objectives and, as such, it touches on every sphere of management and operations.

**Investor influence**

At Old Mutual Equities (OME), we are acutely aware that our clients have entrusted us with their savings. This stewardship bestows some serious responsibilities on us as investors and we need to assess every investment we make, with corporate governance being a key determinant in our decision-making process.

**Evaluating corporate governance**

We are wary of companies that see corporate governance as merely a box-ticking exercise. This is because we have a long-term investment horizon and we want to ensure that the framework within which a company operates supports a similar long-term outlook and encourages sustainable economic success. Once we have undertaken our own thorough analysis of a company’s corporate governance, we cross-check it with external evaluations. We have access to a dedicated responsible investment team that provides an overlay to the work we do. They also assist us in sustainability research and engaging with companies to encourage improved environmental, social and governance (ESG) performance. In addition, we subscribe to the MSCI ESG ratings system. The system rates each company based on its detailed ESG score and provides flags on pertinent news issues on a company-specific basis. Our final assessment impacts the “margin of safety” we require in order to invest in a stock. For example, companies with poor labour relations or environmentally unfriendly mining practices will need to attract a higher margin of safety before we would consider investing in them, as we believe these negatives will impact shareholder returns.

**Proxy voting**

Voting rights are a valuable asset and are the primary tool that we can use to effect change in a company and to signal our views to the company and other stakeholders. Essentially, our clients, as shareholders in investee companies, delegate to us the right to vote on their behalf with regard to Board proposals and decisions.

In 2014, at OME alone, we voted at 201 company meetings across 155 unique companies on 13 770 resolutions (topic of vote). We have voted against 901 resolutions. These votes are largely against remuneration policies, capital allocation and Board composition. Taking into account all its boutiques, Old Mutual Investment Group has voted at 409 company meetings across 363 unique companies on 142 354 resolutions. (See adjacent graph.)

“Corporate governance can have a profound impact on a company’s long-term sustainable value.”

**Engagement**

Management engagement is another way that asset managers can influence for change, because large shareholders can bring pressure to bear on companies. When it comes to such engagements, we concentrate on issues that could have a material impact on the company, such as strategy, management competence, capital allocation and executive pay – to name some of the more pertinent issues. We are encouraged that more and more companies are seeing the merits of active engagement and believe that this can be a constructive process.

**Effective remuneration**

We firmly believe that company performance is directly affected by executive compensation practices, in that how you design your reward structure will drive the behaviour of employees. Importantly, compensation practices provide a window into the quality and priorities of a Board of Directors. When we review remuneration, our starting point is that compensation should meet three criteria: it must be performance based, integrated into the strategy of the company, and long term in nature.

To gain insight into this we look at:

- the composition and functioning of the remuneration committee;
- whether there are performance metrics in place and, if they are, we look to see if they are valid and fit in with the long-term goals of the organisation;
- the transparency and accuracy of the remuneration report; and
- whether there are clawback provisions in place.

Remuneration practices are a true test of whether corporate governance is seen by the Board as a means to drive behaviour and the desired outcomes. This is an area where improvement is still needed in South Africa (SA) and we believe that greater transparency is needed on performance metrics. A current issue on the table is that, in SA, shareholder votes on executive pay are non-binding. We are supportive of a binding vote on remuneration, which will bring SA in line with international best practice. We have noticed a significant increase in constructive engagement with dual-listed companies on remuneration issues since the implementation of the international rules. We believe that a similar policy in SA would be very beneficial and would allow us to drive meaningful change in corporate behaviour (see Say on Pay on page 24, for more details).

**It’s about the future**

That corporate governance can – and does – have a profound impact on how a company operates and its long-term sustainable value, is reflected in significant investment losses around the world due to severe lapses in corporate governance. Ensuring good governance practice is therefore not a nice-to-have quality in an investee company but, rather, a requirement. What it comes down to is that our clients have entrusted us with their savings and it is our responsibility to ensure that we safeguard their investments into the future!
A LIABILITY-DRIVEN INVESTMENT APPROACH TO ESG
Tanja Tippet, Trevor Abromowitz & Tarryn Mentoor, Liability Driven Investments

IN A NUTSHELL

- The integration of environmental, social and governance (ESG) factors into an investment process ensures sustainability over the long term.
- This is no longer a theoretical concept and can be applied to investment analysis.
- Embedding an ESG framework into the investment process gives investors the best chance of meeting their future liabilities.

A liability-driven investment (LDI) approach is when an investor’s liabilities drive their investment strategy, an approach we believe that all investors should adopt. How this approach is applied depends on the specific investor’s financial position and behavioural factors.

For example, a risk-seeking individual with wealth way in excess of their living requirements will have a very different LDI strategy to a retirement fund that is straining to meet its inflation-adjusted obligations to its pensioners.

It is important to note that in some cases, such as defined benefit funds, liabilities can be very long term in nature, and it is not uncommon to see liability obligations that extend in excess of 100 years. These investors need to take a very long-term view when developing an LDI investment strategy.
Long-termism
If an investment manager truly takes a long-term view, it implies that they have applied an environmental, social and governance (ESG) lens to their investment analysis, because these factors have a material impact on the sustainability of the investment and therefore on the investor’s liabilities. If, for example, our generation chooses to ignore ESG considerations, then future growth rates can be expected to be lower. The same would apply to future discount rates (i.e. the rates that we use to determine the value of future liabilities in today’s monetary terms). This would result in liability values increasing in the future. If future growth rates are lower, this, in turn, would decrease the likelihood of being able to find suitable investments that will grow over time to meet the projected liabilities. Incorporating ESG considerations into the investment process is therefore critical.

Applying the theory
While ESG reporting and analysis is in its relative infancy and much work is required to encourage greater transparency and consistency of reporting, a significant amount of progress has been made. It is also no longer a theoretical concept and can, and should, be applied to investment analysis.

Here is an example of how an ESG framework has been applied to the South African (SA) telecommunications sector. The table reflects a sample of ESG risk factors and their influence on creditworthiness and the subsequent impact on the pricing of bonds that may be held in an LDI portfolio, together with our respective views. Embedding an ESG framework into the investment process becomes a “must” in terms of ensuring a sustainable investment strategy. This will serve to give investors the best chance of meeting their future liabilities.

Telecommunications ESG analysis using MSCI risk and opportunity factors

<table>
<thead>
<tr>
<th>ENVIRONMENTAL</th>
<th>ESG factor</th>
<th>Influence on creditworthiness</th>
<th>Credit risk indicators</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy efficiency</td>
<td>Risks associated with rising energy prices are considered low but a steep increase could impact profitability.</td>
<td>Profitability pressures associated with rising energy costs could impact credit ratings.</td>
<td>ESG screening looks at how a company factors in rising energy costs in its business planning as well as the markets in which the company operates, and the cost of energy in those markets. For example, SA’s current energy challenge impacts all local mobile providers, while operators, such as MTN, that have a large presence in emerging markets are faced with associated high energy costs.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SOCIAL</th>
<th>ESG factor</th>
<th>Influence on creditworthiness</th>
<th>Credit risk indicators</th>
<th>Comment</th>
</tr>
</thead>
</table>
| Privacy and data security | - Penalties imposed due to lack of compliance with regulations may impact profitability and cost of capital.  
- Strong controls around customer privacy may act as a competitive advantage. | - Impact on bond yields could result in negative credit mark-to-markets.  
- Sustained competitive advantage could result in lower average spread volatility over the long term. | Best performing companies have strong security frameworks to manage, retain and secure private customer information that comply with emerging regulatory requirements.  
- The SA telecoms sector is exposed to regulatory and reputational risk due to counterparties handling large quantities of sensitive data in a market with strict and evolving legislation and only average data protection practices relative to global peers. |

<table>
<thead>
<tr>
<th>GOVERNANCE</th>
<th>ESG factor</th>
<th>Influence on creditworthiness</th>
<th>Credit risk indicators</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate governance</td>
<td>Weaknesses or breaches in corporate governance have far-reaching implications for profitability, levels of competitive advantage and cost of capital, among other indicators.</td>
<td>Negative news flow could drive spread volatility in fixed-income instruments.</td>
<td>The corporate governance score focuses on four key governance areas: Board Structure, Compensation, Shareholder Rights, and Auditing Practices. When we analyse a telecoms business from this perspective, we have a particular focus on Board independence and the involvement of key stakeholders in the decision-making process.</td>
<td></td>
</tr>
</tbody>
</table>
SAY ON PAY – what is the role of the market in addressing income inequality?
Jon Duncan, Head of Sustainability Research and Engagement

IN A NUTSHELL

- International trends will drive South African policy on income inequality.
- As a shareholder, Old Mutual is active in holding management teams accountable for executive remuneration.
- Regulation is needed to facilitate greater shareholder “say on pay”.

The debate about income inequality is often limited to executive remuneration, but this is just one factor that requires reform if South Africa (SA) is to become a country where all people can enjoy a good quality of life.

While we support the enhancement of shareholder “say on pay” by providing a binding vote on remuneration policy – a move that will bring SA markets in line with international practice – we also accept that debate needs to be expanded to include other issues. Equal attention should be given to policy around job creation and the state of education, as there are clear correlations between quality of education and income disparity.

However, it is the disparity in remuneration that is at the forefront of the income inequality conundrum in SA. Salaries across the pay band, from CEO through to worker level, are increasingly coming under the spotlight. Most recently, the extended 2014 strike in the platinum sector brought the issue of SA’s income gap into stark focus, while also displaying the undeniable might of the trade unions. The remuneration debate and its contribution to income inequality across sectors are not going away anytime soon.

Aside from much media attention, Executive Salaries in South Africa (Massie, Collier and Crotty) details the pay practices and income inequality trends of 50 SA-listed companies during 2012.

The book highlights poor governance practices associated with remuneration and makes a number of pragmatic suggestions to address these.
Social inequality – a global challenge
With all the noise around the impact of strikes on local gross domestic product (GDP), you would be forgiven for thinking that inequality is a uniquely SA phenomenon – but current global media content and history show otherwise. This complex topic has exercised the minds of philosophers, economists and politicians for centuries. And views on its causes and the remedies have, in part, underpinned a divergent array of socio-political/economic systems, along with their respective approaches to resource allocation and wealth distribution.

The much-lauded Amazon best-seller Capital in the 21st Century (Piketty) is one of the latest efforts to present a synthesis of this broad topic. Piketty proposes that wealth inequality can be measured by comparing investment returns (r) and economic growth (g). He says that when r increases and g stays the same or decreases, the portion of capital accumulated by the providers of capital increases relative to that of labour. In such a scenario, inequality increases. Piketty says that extreme social inequality is dangerous for a society since it leads to social disruption, which, ultimately, has negative consequences for stable, long-term economic growth. He says that the current form of free market capitalism is unlikely to resolve society’s issues related to inequality and that radical solutions are needed. He suggests that “when pay setters set their own pay, there’s no limit”, and consequently the best course of action is to impose a “confiscatory tax”.

Given this line of thought, some commentators have called the book leftist propaganda. Others question its fundamentals, with Chris Giles, economic editor of Financial Times, saying that its conclusions “do not appear to be backed by the book’s own sources”. However, while Piketty may be accused of academic sloppiness, the general consensus is that the main thrust of his thesis holds, although the jury is still out.

Global lessons for SA
Given the premise and reception of this seminal work, it is not strange that the executive salaries of listed companies have become the lightning rod for the broader inequality debate. In seeking solutions to address income inequality in the listed environment, perhaps SA should use global precedent as a departure point. For example, since 2003 the US has focused on enhancing the disclosure of executive pay and public companies are required to disclose details of the remuneration of the CEO, CFO and the next three highest paid executives over a three-year period.

As of October 2013, UK-listed companies must submit their remuneration policy to a binding shareholder vote (simple majority) once every three years, along with an annual non-binding shareholder vote on application of the remuneration policy. This brings the UK in line with European markets, such as Denmark, Netherlands, Sweden and Norway. Australia enforces a “two-strike rule”, holding directors accountable for executive remuneration.

If a company’s remuneration report is not passed by 75% of shareholders at the company’s AGM for two years in a row, the directors must stand for re-election.

In simple terms, the situation in SA is that disclosure of individual directors’ remuneration and benefits is a listing requirement of the JSE. In addition, King III recommends that a company’s remuneration policy should be subjected to an annual non-binding shareholder vote. While mandatory disclosure is to be applauded, it is not sufficient to hold management accountable for ensuring alignment between executive remuneration practices and the creation of shareholder and broader long-term stakeholder value.

In an ideal world, executives would act on this as a leadership issue and regulation would not be necessary. Yet globally, this has not been the experience and market interventions on such issues are perhaps symptomatic of the emergence of what Roger Urwin from Towers Watson termed “guided capitalism”, an approach that seeks to balance market fundamentalism with the limitation of state-driven alternatives.

Our stand on remuneration practices
The introduction of “say on pay” legislation should come as no surprise to executives of JSE-listed companies, given the international trends and the very real income inequality in SA. Old Mutual Investment Group’s position on executive remuneration for listed companies is clearly set out in its publicly available proxy voting policy. While we are happy to pay for performance, we expect top quality governance around remuneration practices. Consequently, we are keenly interested in, but not limited to, the following:

- the structure and functioning of the remuneration committee;
- the split between base, short-term and long-term incentives;
- the links between the pay structure and the stated company strategy;
- the nature of metrics, targets and award levels used; and
- clawback provisions.

During 2014, Old Mutual Investment Group collectively voted against the remuneration policies of 68 companies and undertook a range of direct engagements with various company management teams on these issues.

While some of these engagements were productive, we are constrained by the non-binding nature of our votes in relation to remuneration policies. We see the provision of regulation to facilitate greater shareholder “say on pay” as an important step in closing the accountability loop between beneficiaries, asset owners, investors and the market. It will also enable us to further deliver on our commitment to ensure responsible investment practices. However, the exact nature of any “say on pay” regulation will need careful consideration and should be coupled with an equally vigorous debate on regulation and policy on job creation.

TOO GOOD TO BE TRUE?
– the effect of good governance on listed equity investment performance
Robert Lewenson, Governance and Engagement Manager

IN A NUTSHELL
- By investing to reduce governance risk, you reduce overall portfolio risk and increase the potential for reward; companies with good governance receive better valuations.
- Company engagement is a powerful and an effective tool.
- Companies with a high governance rating show material positive alpha over the long term.

We are often asked, does governance matter? And, if so, how do we ensure that the companies we invest in on behalf of our clients act according to best practice from a governance perspective? These are both valid questions, which can be answered as follows:

Governance risk and reward
General investment theory states that there is a strong positive relationship between risk and reward (the higher the risk the higher the reward, and vice versa).

The responsible investment approach argues that the inverse is true, in that when you invest to reduce governance risk, the rewards will be greater. A vast majority of studies show that solid governance practices result in better operational performance by companies. For example, they receive better valuations and have in place properly designed executive compensation schemes.

These studies also indicate that the share price performance of companies is positively influenced by good governance practices, so that well-governed firms outperform poorly governed firms1.
The influence of owners
A well-known example is California Public Employees’ Retirement System (Calpers)’s long-term engagement with about 188 companies it selected for engagement, both publicly and privately, from 1987.

On average, these companies outperformed the Russell 1000 Index by 14.4% during the five years following Calpers’s engagement process* – this is commonly referred to as the “Calpers Effect”. In the three years prior to engagement, the companies had on average lagged the Index by nearly 39%.

While a seemingly negative correlation may exist between governance and total shareholder return, with a possible explanation being that investors ignore the risks of investing in companies with a low governance rating, a recent South African study** says differently. What the research found is that when considering long-term financial performance, if risk-adjusted market-based performance is analysed, the companies with a high governance rating showed material positive alpha in the long term.

Targeted engagement
At Old Mutual Investment Group, we are committed to being a responsible steward of our clients’ investments by ensuring that we have a specialised Responsible Investment team that is dedicated to achieving a sound understanding of corporate governance, including best practice policies, using both internal and external research.

We vote at shareholder meetings and, importantly, engage with companies on key governance-related issues and aim to improve investee companies’ governance ratings through targeted engagement.

By engaging with companies, we attempt to reduce governance risk, which in turn should increase opportunities for alpha generation and a better return on investment for our clients.

Furthermore, our clients benefit from the improved behaviour of company management and the board of directors, which will create a more sustainable business. A positive consequence is also the spin-offs this has on the broader South African market by raising the bar on governance.

Best practice benefits
We argue that good governance does indeed matter when it comes to ensuring that governance best practice and sustainability are embedded in our investment decision-making process and, by way of engagement, we bring about change that continues to benefit our clients in the long term.

Better managed companies are, in our view, better investments for clients. By subscribing to these principles, we believe they will enable us to become the leading responsible investment manager in Africa.
Portside
5 Buitengracht Street, Cape Town
A perfectly positioned commercial gateway to the bustling City of Cape Town, this pioneering 5 Star Green Star-rated high-rise capitalises on its prime location and panoramic views, while adding to the urban charm of the inner city – a project by Old Mutual and FirstRand.
With its panoramic views and contemporary interior design, Portside is a benchmark of environmental sustainability, both in terms of the construction process and the building management system.

Importantly, every effort has been made to ensure an attractive and a comfortable work space that provides ambient temperatures, great lighting and stunning views, combined with optimal health and safety features.
**FAST FACTS**

- An Old Mutual and FirstRand joint venture
- SA’s first 5 Star Green Star-rated high-rise
- R1.6 billion
- Architects: DHK and Louis Karol Architects
- Master Builders Association safety grading of 5 stars
- Won the regional Master Builders Association competition in the category of R500m+
- 3,000 jobs + 1,500 indirect jobs were created during construction process
- 44 professional firms involved in project
- 1 million injury-free man hours

A water heating system comprised of six vacuum tube solar panels is located on the roof. On cloudy days, heat pumps are used. A second heat pump-based system is located in the parking area. They service some of the kitchens, hand basins and pause areas, as well the cyclist and staff facilities on the ground floor.

**95% LED lighting:** Portside is the first commercial building in SA with majority LED lighting. It also has passive infrared sensors ensuring that only occupied areas are lit and air conditioned.

High-performance glass adds energy efficiency; cool in summer, warm in winter.

**Smart elevators calculate optimum routes to collect and deliver people efficiently.**

**PORTSIDE’S GREEN RATING**

- 139 metres high
- 34 levels
- +55 605 m² prime AAA office space
- 3,000 employees
- 1,495 m² of retail and banking space
- Separate entrances for each partner – ensuring a unique address
- Six restaurants

**TREES AND LANDSCAPE DESIGN – greening the inner city**

The 50-year-old Ficus trees were protected and monitored by an arborologist during construction, and new indigenous trees and plants were added to the area on completion. Drip irrigation will be removed once plants are fully established. Trees reduce wind turbulence, provide relaxing shade and soften the urban landscape.

**A SINGLE TREE WILL ABSORB ONE TONNE OF CARBON DIOXIDE OVER ITS LIFETIME.**
**ENERGY** – maximising efficiency and reducing the carbon footprint

When it comes to total energy consumption, Portside does very well when compared to a standard building of the same size.

![Energy Usage Chart]

- Choosing an LED light bulb can reduce carbon emissions by 60 kg a year.
- 25% LESS | R4.2m a year saving on energy bills

![Greenhouse Gas Emissions Chart]

- 49% LESS

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**ENERGY** – harnessing nature and technology to achieve optimum results

Heating is supplied via energy-efficient electric terminal re-heaters, while cooling is achieved via a high efficiency water-cooled chilled water plant. When the external temperature is low enough, the economy cycle introduces fresh external air in place of conditioned air – saving energy and providing healthy air to breathe!

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**TRANSPORT & CONNECTIVITY** – linking people, the city and nature

Fuel efficiency and physical wellbeing are promoted through Portside’s central location. It is close to trains, bus stations and the MyCi network. In addition, there are 260 state-of-the-art staff bicycle racks, 21 showers and 170 lockers. Parking includes 72 preferred location bays for hybrid cars and 42 bays are wired with electric charge points.

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Cycling is good for the earth, good for your heart and good for your waistline.
In 2013 Portside was awarded a 5 Star Green Star rating by the Green Building Council of South Africa (GBCSA) in the Office Design category. In 2015, the building achieved a further 5 Star Green Star rating in the Office As Built category.

**WATER – saving this precious resource through innovation**

Portside uses 72% less water than a standard building of the same size and utilities are separately monitored for easy leak detection.

Rain water feeds the low flow/low flush technology in bathrooms and kitchens. Water that exceeds storage capacity is filtered before entering the city’s storm water system.

Fire test water that is drained from the fire sprinkler during maintenance is recaptured in the fire water tank.

Greywater is captured from hand basins, air-conditioning condensate and cooling tower water, and is used for flushing toilets and urinals. Shower water is excluded as the storage tank is above the showers and would have used energy-inefficient pumping to capture it.

**RECYCLING – reducing output and creating awareness**

Efficient waste management through the recycling of most office waste helps to dramatically reduce Portside’s carbon emissions. Colour-coded recycling bins are provided in offices and shops, and 129 m² of floor space and a compactor are dedicated to collection and storage of ± 14 tonnes of compacted recyclable waste. Each floor has a recycling collection area and waste is collected daily.

- Cardboard & paper, e.g. files, envelopes & milk cartons
- Glass
- Plastic bottles
- Aluminium
- Tetra Pak
- E-waste
- Grease/cooking oil
- Organic waste
- Any item marked with a "recyclable" symbol

**INTERIOR DESIGN – focusing on the health and comfort of occupants**

- Workers and shoppers enjoy 150% more fresh air than standard buildings offer and CO2 levels are monitored.
- This is a low-emissions environment and paints, carpets and sealants are required to contain low levels of volatile organic compounds.
- The glass façade allows natural light in, provides sea and mountain views for enjoyment, eye relief and a sense of connectivity with the outside world.
- Noise levels are optimised to promote concentration – not too loud or too quiet.

**PORTSIDE’S GREEN STAR RATING – 10 Green Stars for the city skyline**

In 2013 Portside was awarded a 5 Star Green Star rating by the Green Building Council of South Africa (GBCSA) in the Office Design category. In 2015, the building achieved a further 5 Star Green Star rating in the Office As Built category.

**WHAT IS A GREEN BUILDING?**

It is a building where design, construction and operational practices reduce or eliminate the negative impact of development on the environment and on people. Green buildings are energy efficient, resource efficient and environmentally responsible.

**OUR GREEN BUILDING FOCUS**

- Platinum founding member of the Green Building Council of South Africa (GBCSA)
- Sponsors of the IPD Sustainable Buildings Index – a benchmark for a building’s resource efficiency versus its financial return
- 21% saving in energy spend across our shopping centres since 2008
- Cavendish Square won the 2013 Energy Efficiency Forum Award

ESG index funds empower investors to vote with their feet by investing specifically in companies with high sustainability profiles, without compromising on investment returns.
Historically, index-tracking investment managers have had limited scope to incorporate environmental, social and governance (ESG) factors into the investment process. This is because the investment universe is determined by the indices we track, which have generally been pure market capitalisation weighted indices that capture broad market returns.

Innovation in the investment indexation space in recent years has broadened the capabilities that index-tracking investment managers are able to bring to the market. This article provides more detail on indexation innovation in the sustainability space, which has enabled index-tracking investment managers to provide meaningful exposure to ESG factors.

**Sustainability Indices**

Morgan Stanley Capital International (MSCI), a leading index provider, has collected sustainability-related data through its inhouse research capability, enabling it to launch a suite of sustainability indices. We have chosen their MSCI World ESG Index, to demonstrate the methodology used in constructing these indices and highlight the value they can offer to investors.

The MSCI World ESG Index assigns an ESG rating to all the constituents of its parent index, the MSCI World Index, which is a pure market capitalisation weighted index. The rating is based on its Intangible Value Assessment (IVA) of each constituent. The IVA is an industry-specific and a forward-looking assessment of a company’s material ESG risks and opportunities.

An Impact Monitor Report is also generated for each constituent, which is a backward-looking assessment of the company’s ESG controversies/controversial decisions, especially those that make headlines. The companies are then ranked based on their IVA ratings, and the top 50% of companies (based on market cap) in each industry are selected for inclusion in the MSCI World ESG Index. Companies that have an Impact Monitor controversy assessment below the given threshold are not eligible for inclusion in the Index, regardless of their IVA rating. The stocks selected for inclusion are then weighted by their market capitalisation.

**What, no apple inc.?**

The MSCI World ESG Index primarily provides investors with exposure to companies that have a high sustainability profile.

This is particularly attractive to long-term investors who value sustainable economic themes, given their extended investment time horizon. By removing 50% of the companies in each sector, the Index is able to remain sector and region neutral relative to the parent index, which limits exposure to the risks associated with having sector or regional biases. By picking the best-in-sector companies, the MSCI World ESG Index is not exposed to the firm-specific risk of companies with the least sustainable characteristics.

We can demonstrate the company-specific risk inherent in the Index construction methodology by looking at the information technology (IT) sector. In the MSCI World Index, Apple (1.9%) has the largest market capitalisation in the IT sector. Inclusions in the MSCI World ESG Index have not detracted from the Index performance.

The graph below highlights how the exclusion of Apple from the MSCI World ESG Index as there are significant concerns with regard to:
- the alleged price fixing of e-books;
- certified class action representing 20,000 hourly wage employees alleging violations of California labour laws over rest periods and paycheck timeliness;
- Foxconn employee suicides; and
- environmental performance criticisms by the Institute of Public and Environmental Affairs, an NGO in China.

The graph below highlights how the exclusion of Apple from the MSCI World ESG Index has not detracted from the Index performance.

**Average performance of largest IT holdings relative to Apple**

Sources: Bloomberg and Old Mutual Investment Group
Given that half of the IT sector, including Apple, has been excluded from the MSCI World ESG Index, the IT stocks that are chosen will have a double weighting when compared to the parent index. The best-in-sector IT counters currently in the MSCI World ESG Index include Google, IBM and Intel.

The weighting of the constituents based on their market capitalisation, along with sector and regional neutrality, means that the MSCI World ESG Index has a low realised tracking error (similar risk profile) relative to its parent index. As such, the Index does not aim to generate alpha, i.e. returns exceeding those of the parent index.

This graph shows the cumulative gross returns (US dollar) of the MSCI World ESG Index and the MSCI World Index.

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**Organic, at the same price**

So why bother to incorporate ESG factors into their investment process if it will generate broadly similar returns? The key difference is the increased sustainability quality of the ESG index constituents when compared to the parent index.

The table illustrates that the MSCI World ESG Index has a significantly greater exposure to companies with higher ESG ratings relative to its parent index, on a market cap weighted basis.

**Rating Categories**

<table>
<thead>
<tr>
<th>Rating Categories</th>
<th>MSCI World</th>
<th>MSCI World ESG</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above A (includes AAA, AA and A)</td>
<td>44.8%</td>
<td>61.7%</td>
<td>17.0%</td>
</tr>
<tr>
<td>Below A (includes BBB, BB and B and CCC)</td>
<td>55.2%</td>
<td>38.3%</td>
<td>-17.0%</td>
</tr>
</tbody>
</table>

On the outside, a machine-fed chicken may resemble a farm-raised one – but the organic product’s underlying nutrients (read constituents) are more nutritious, given they have less toxins. In this analogy, our support of organic agriculture – by voting with our money – encourages more farmers to improve their sustainability practices.

The same principle applies when deciding to invest in an ESG index. By choosing such an index, you don’t compromise the market capitalisation exposure, but you vote in favour of sustainability with your investment money.

So, essentially, you are getting the organic alternative at the same price, as long as the manager does not increase its current plain-vanilla market capitalisation fee to track an MSCI ESG index.

**Market reception**

Over 1,200 asset owners, investment managers and professional service partners have become signatories of the UN-backed Principles for Responsible Investment (PRI). Broad acceptance of these practices has translated into strong demand for sustainability-themed investment products.

MSCI has reported that about US$25 billion is currently tracking their suite of sustainability indices. There has been a recent surge in inflows of about US$8 billion over the last 24 months (from May 2015).

Work done by Campden Research shows that the global market in ESG investments is expected to grow at a rate of approximately 25% a year. We expect the growth of ESG indices to be buoyed by growth in the broader ESG investment market.

**Investors’ say**

Innovations in investment indexation have allowed index-tracking managers to incorporate ESG factors into their investment process. 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 essence, it empowers investors to vote with their feet, by investing only in companies with high sustainability profiles, without compromising on investment returns.

**Old Mutual Investment Group’s Green awards**

- 2011 – Imbasa Yegolide Award: Socially Responsible Investor of the Year, Futuregrowth Asset Management
- 2012 – Imbasa Yegolide Award: Socially Responsible Investor of the Year, Old Mutual Alternative Investments
- 2012 – African Renewables Deal of the Year*, Old Mutual Alternative Investments’ IDEAS Fund
- 2013 – Imbasa Yegolide Award: Responsible Investment Manager of the Year, Futuregrowth Asset Management
- 2014 – SAHF Housing Project of the Year Award, Old Mutual Alternative Investments’ Housing Fund of South Africa’s Karino Lifestyle Estate

*Middle East and Africa Region, by Project Finance International

References

MSCI Global Sustainability Indices Methodology (June 2013)
MSCI Factsheets
Trends in ESG Integration in Investments (BSR)
As one of Africa’s largest investors in economic and social infrastructure, Old Mutual Investment Group is aligned with the vision of the National Development Plan, and contributes to transport, telecoms, housing and education infrastructure, as well as sustainable agriculture.

Notably, we are a major debt and equity participant in the ground-breaking renewable energy programme (see page 49), which leverages private sector capital to meet the country’s growing energy demands using low-carbon alternatives.

As a responsible business and investor, for our real asset investments we conduct environmental, social and governance analysis, and support the application of the Equator Principles with regard to our debt financing arrangements. In this way, we can make a valuable contribution to our economy and deliver market-related returns to investors, while being mindful of how our activities impact the long-term sustainability of the environment and society.
INCORPORATING THE EQUATOR PRINCIPLES INTO INFRASTRUCTURE DEBT FINANCING

Rolf Canto, Head of Project Finance, Old Mutual Specialised Finance

THE EQUATOR PRINCIPLES
A 2003 International Finance Corporation (IFC)-led initiative has been adopted voluntarily by the majority of banks that arrange project finance debt globally, including all major South African commercial banks. A project will not reach financial close unless it can show it is (or will be able to be) compliant with the Equator Principles.

IN A NUTSHELL

- Unlisted debt plays a crucial role in financing infrastructure development, including much-needed power stations such as solar and wind farms.
- Due to the massive size and scope of infrastructure projects it is vital to assess all possible environmental and social impacts and plan accordingly.
- Environmental impact assessments are generally completed before funding is sought.
- The application of global standards such as the Equator Principles assures investors and financiers that best practice is applied.
- Infrastructure projects have a large environmental, social and governance footprint.

The unlisted debt market has seen a marked increase in lending activity towards private sector infrastructure development, such as long-term concessions covering new power stations (see page 49). These assets are long-lived and highly capital intensive in nature and thus require private investors to raise long-term project finance debt.

ESG is crucial in infrastructure projects
Project finance typically involves long-term lending provided against the future cash flows of a project. The total gearing in such transactions can be as high as 70% of a project’s total cost! This means that debt investors need to conduct a significant amount of due diligence on all aspects of a project, including environmental, social and governance (ESG) matters.

By their very nature, infrastructure projects generally have a substantial ESG footprint as they impact a large stakeholder base.

This includes local communities, who may need to be relocated or will be affected by a large influx of construction workers and users of the infrastructure asset once it has been completed, as well as the natural environment as a whole. And, as Diane Radley states in her article on page 1, it is crucial to consider such impacts before any investment decisions are made.

Global standards
The Equator Principles were developed as a framework to identify and manage the environmental and social risks of privately financed projects. The Principles generally exceed the minimum legal requirements of most countries where the proposed investment is located, and address all stages of a project.

The risks of each stage of a project are identified before any construction work commences, and ongoing monitoring and management systems are put in place to address any impacts over the life of a project.

Environmental and social aspects are considered from inception, and throughout the life of the project. A breach of the applicable loan covenants could lead to a default – a severe consequence of non-compliance.
### THE EQUATOR PRINCIPLES

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description and actions</th>
<th>Typical examples</th>
</tr>
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</table>
| **1. Review and categorisation** | Project categories:  
A: significant impacts  
B: limited impacts that can be mitigated  
C: minimal/no impacts | Most projects (e.g. renewable energy) are classified as B. Large-scale mining operations are typically A. |
| **2. Environmental and social assessment** | Category A and B projects require a full environmental impact assessment (EIA). | EIAs are done before finance is sought and include specialist input, e.g. bat and bird studies for wind farms. |
| **3. Applicable environmental and social standards** | Country-specific and mostly:  
– IFC Performance Standards*  
| **4. Management system and action plan** | Projects must have environmental and social management systems and action plans in place for identified issues. | The management system gives effect to the Principles; the action plan is an agreed roadmap to address non-compliance gaps. |
| **5. Stakeholder engagement** | Projects need to show effective and ongoing stakeholder engagement. This is usually done during the initial EIA process, but can continue throughout a project’s life. | Reports need to be communicated in the local language and encourage feedback. |
| **6. Grievance mechanism** | Projects may require a grievance mechanism to manage and resolve potential grievances. | These must be tailored to the unique environmental and social risks involved. |
| **7. Independent review** | An independent consultant acting for the bank (i.e. not for the project) needs to assess all steps for compliance with the Principles. | Project lenders appoint their own adviser to assist in the due diligence of a proposed project. |
| **8. Covenants** | Lenders need to include certain minimum provisions and covenants in loan documentation, relating to compliance with the Principles. | These include compliance with local environmental laws, applicable standards, action and reporting. |
| **9. Independent monitoring and reporting** | Projects must be monitored by an independent consultant working for the lenders. | Advisers report annually on compliance, including reviewing data and site visits. |
| **10. Reporting and transparency** | Information and annual reports must be publicly available. | Equator banks must report annually. |

Source: Adapted from the Equator Principles (Source: www.equator-principles.com)  
*IFC = International Finance Corporation, in respect of environmental and social sustainability

Old Mutual Specialised Finance (OMSFIN) is an active investor in the South African project finance sector, and engages with the relevant Equator banks to understand the ESG aspects of potential project investments. As a minimum, all projects need to show Equator compliance, as this provides comfort that a rigorous framework has been applied in analysing the social and environmental aspects of a particular project. Our credit review process considers ESG matters and these feed into the final decision to invest. While OMSFIN is a non-bank financial institution and, as such, not a signatory to the Equator Principles, the Principles are well aligned with the Principles for Responsible Investing, to which Old Mutual plc subscribes.
DOING GREAT THINGS MEANS GOING **BEYOND** RETURNS

Paul Boynton, Chief Executive Officer, Old Mutual Alternative Investments

**IN A NUTSHELL**

- Good investment returns and creating a more sustainable future are not mutually exclusive.
- For African development to be sustainable, it must benefit investors and communities over the long run.
- Disciplined investment processes and experienced, passionate teams are essential to deliver both financial and social returns in Africa.
- An understanding of environmental, social and governance issues is integral to assessing the long-term risks and opportunities associated with alternative assets.
The Africa investment story is often characterised by the promise of untapped opportunity in a vast continent that is set to play a central role in future global growth. But, what does this mean, and what is needed in order to unlock this potential to the mutual benefit of the investor, the African community and the environment?

The story
Our investment thesis for Africa is based on the synergy of attractive natural resources, a growing and an increasingly urbanised population, and an improving trend of governance practices at a sovereign level.

Mineral resources
Commodities are an abiding aspect of the global economy and it is estimated that around 30% of the global mineral resource endowment sits in Africa. To access this nascent value requires the development of economic and social infrastructure, as well as positive sentiment in the global investor community.

Food security
This is a pressing issue in an increasingly pressurised environment, and it is estimated that Africa has close to 60% of the world’s uncultivated arable land. This is significant on many levels, not least of which is cultivating this opportunity in a manner that ensures long-term, sustainable yields, not only in terms of produce, but also with respect to social and financial benefits.

Demographics
A much-cited indicator of Africa’s attraction as the global epicentre for economic potential is its attractive demographics. The global population will increase from seven to nine billion by 2050. Of this growth of two billion people, one billion will be born in Africa. The working age population in Africa will exceed that of both India and China by 2035.

Improving governance
The increase in adherence to the democratic process and transparent governance practices over the last three decades cannot be ignored. Prior to 1990, Africa had only experienced one democratic change of government. Since then, we have seen this happen on over 40 occasions, with the most recent feather in the cap of African political transformation being demonstrated by peaceful handover of power by Goodluck Jonathan after his defeat at the polls in Nigeria’s 2015 elections. This is not lost on the international investor.

So what will it take?
Collectively, infrastructure, food security and the secondary economy present a compelling investment case. For example, it is estimated that elevating infrastructure investment to match the middle income needs in Kenya and Nigeria has the potential to add between 3% and 4% to their gross domestic product (GDP) growth rates1, respectively. And, as stated, we acknowledge that to access these opportunities requires a collaborative and mutually beneficial approach to ensure the socio-economic sustainability of the region. In order for Africa’s potential to be realised, the massive infrastructure deficit needs a remedy – and rapidly, particularly given the current high rate of urbanisation. The World Bank estimates that there is an infrastructure development requirement of US$95 billion per year for 10 years – with a deficit of around US$50 billion that cannot be accommodated fiscally and, therefore, needs to be plugged through private sector innovation.

For this to happen, strong partnerships between private investors, government departments, financial institutions, industry-related experts and community leaders are central to developing innovative real asset solutions that deliver returns to investors and socio-economic benefits to communities. Alongside this, a disciplined investment approach that considers environmental, social and governance (ESG) related risks and opportunities is critical due to the long-term nature of investing in alternative assets.

The investment case
Not only do real asset and private equity investments have a low correlation to traditional markets and therefore serve as important sources of alpha, but they are also an excellent diversifier and a hedge against listed market volatility. In addition, real assets have strong inflation protection characteristics with stable, projected cash flows, and these potentially higher returns compensate for lower liquidity. Each of our investment streams has dual outcomes – investment returns for our clients and developmental impact for the countries in which we operate.

Infrastructure
Investing in economic infrastructure has the social benefits of job creation and economic enablement – for example, currently, the costs of getting goods to port in Africa are triple the costs of those in the developed world. Better transport infrastructure would bring these costs down, to the benefit of everyone in the direct supply chain and, indirectly, beyond. Another example is Africa’s power-generating capacity, which is equivalent to that of Spain, a country with around 50 million people. Our investments in these assets should form strong inflation protection characteristics, with a projected real return of 7% a year, plus stable, projected cash flows, which are well aligned with the mandates of pension funds.

Impact investments
Investors in these funds are far-sighted in that they appreciate the impact that housing and education development have on the health of the broader economy and, thus, the value of their overall investment portfolio. After all, every new house is likely, at some point, to generate the sale of a refrigerator, TV, furniture etc. So while these investments admittedly do carry a burden of low liquidity, it is important to note that this is not a return risk, and that a new house implies retail growth and that an educated, salaried person has more demand stimulus to generate.

Private equity
Not for the faint-hearted, or the short-term investor, private equity is an investment arena of exciting potential, with a 3% – 4% return premium over listed markets over time. In emerging markets, private equity has a special role to play in growing more robust business, with all the accompanying social advantages and, ultimately, the expansion of the African listed universe.

Crucially, we have the backing of Old Mutual Investment Group’s professional services, such as compliance, legal and responsible investment teams. This places us at the forefront when it comes to identifying investment opportunities overlooked by others for a variety of reasons, such as high barriers to entry, out-of-favour industries and mispricing, amongst others.

**Strategic alignment**

Our investment activities are aligned with the South African (SA) Government’s National Development Plan (NDP), which is a comprehensive blueprint of our country’s infrastructure requirements, with an estimated spend of an impressive R847 billion over the next three years.

However, even this staggering amount does not address the long-term infrastructure funding gap, which can’t be completely financed by government in the long term. And this is where the power of public-private partnerships comes in. SA has established a solid framework for these as evidenced by our large-scale participation in the renewable energy project that has been provided by SA banks and financial institutions, including life insurers, infrastructure funds and pension funds. Old Mutual has been a significant player in terms of both debt and equity investments in this programme (refer to the graphic on pages 49-51). At Old Mutual Alternative Investments, we are seasoned real asset investors with a team of over 50 investment professionals. We have deep experience in originating investments and insight into how to add value to these investments over the long periods we tend to remain invested in them.

Through our investments in infrastructure assets and development impact funds, we contribute to the development of vital socio-economic infrastructure in a sustainable manner, while delivering long-term market-related returns for our investors.

And through our private equity investments, we help to grow the secondary economy through the robust development of private businesses. This ethos has helped us to position Old Mutual as the largest private alternative investment manager in Africa, with around US$5 billion (R51bn)* invested in socio-economic projects.

Our real asset experience to date in SA and the rest of sub-Saharan Africa is extensive and we believe that we are positioned to actualise the African opportunity in line with a country’s national development framework for the benefit of our customers and communities.

*as at December 2014
A FUTUREGROWTH ESG CASE STUDY
Angelique Kalam, Manager, Sustainable Investment Practices, Futuregrowth Asset Management

Futuregrowth’s Credit Risk Strategy includes financial and non-financial factors

Futuregrowth’s responsible investment strategy focuses on integrating ESG factors into the investment process. This includes investment screening, financial analysis and management engagement. We recognise that in the complex financial environment in which we operate, there is no one-size-fits-all solution to analysing companies for sustainability issues, and note that there will be variances in our approach.
Understanding risk

In order to fully understand the risks associated with an investment opportunity, we consider a range of investment criteria during the due diligence process.

Our mandate is to be a long-term funding partner and, as such, we view sustainability as key to understanding the risks associated with a particular investment. For this reason, ESG integration – although a critical measure of sustainability – should not be a stand-alone process but should form part of the larger analysis process.

Unlisted investments

ESG analysis involves performing detailed due diligence on a company’s policies, actions and processes. Management engagement is one of the key ways we assess an investment and determine whether the current controls in place support responsible business practices.

It is for this reason that we structure the majority of our unlisted loans internally and thus have dedicated and experienced analysts who take the time to fully understand a business, and are able to successfully negotiate terms that are mutually beneficial to both parties. In our experience, these types of investment opportunities provide us with enhanced protection measures, as opposed to the terms available to investors in the listed market.

Case study

Last year, we were considering an investment opportunity presented by a South African pork producer. We had an opportunity to engage with this privately owned company on their factory farming practices and, in particular, on the topic of the humane treatment of pigs.

Despite the financial standing of the company in question, our point of departure for the industry (and this transaction) was our support of the principles outlined in the World Organisation for Animal Health and GLOBALG.A.P*.

These principles are founded on the ideals of high standards of animal welfare and good agricultural practices.

As part of our investment due diligence process, we took time to understand the company’s view, policy and practices around supplier requirements, factory farming standards and slaughter processes. These were then considered in relation to established standards. In addition to this, we explored sustainable change and alignment with industry best practice standards for farmed animals for the company itself, and also along the supply chain.

We concluded our due diligence and credit approval process towards the end of 2014, with the first draw under the facility taking place in the first quarter of 2015. The following is a high-level summary of the issues considered:

<table>
<thead>
<tr>
<th>Concern</th>
<th>Welfare issues</th>
<th>Good practice</th>
</tr>
</thead>
</table>
| Space and foraging needs for dry sows | - Bar biting due to chronic hunger  
- Sham chewing from boredom and hunger  
- Excessive drinking and tongue rolling due to frustration | - Provide more space and keep sows in natural groups  
- Provide access to rough forage such as straw, earth or pasture to give them something constructive to do  
- Green material improves quality of meat |
| Space and nesting needs of farrowing sows | - Piglet crushing because sows are large  
- Separating piglets from sow prevents bonding and sow may savage them later  
- Limited space to build nest delays birth and increases risk of still-born births | - Breed sows with mothering ability  
- Provide sufficient space for nesting to allow sow to manoeuvre  
- Provide plenty of bedding material for nesting and warmth  
- Safety areas for piglets |
| Avoiding tail-biting in growing pigs | - Overcrowding and boredom cause growing pigs to bite tails  
- Tail docking after birth is painful | - EU regulations: reduce crowding and enrich the environment before docking tails  
- Provide objects such as footballs and chains to limit boredom in the growing pigs  
- Provide ropes, straw, rice holes, ground, and peanut husks to prevent boredom |

Source: Futuregrowth Asset Management

Supporting high standards

It is our philosophy to invest in sustainable businesses on behalf of our clients. Furthermore, we believe that we should be a long-term partner, and as such we believe that given our role, we are able to influence our investment partners to consider all aspects of their business practices, particularly if some processes do not measure up to “best practice”. Futuregrowth is committed to managing its investments in a responsible and sustainable manner. In doing so, we believe that we are able to contribute positively to the long-term success of our business and deliver on our client promise to provide sustainable returns that contribute to pension funds’ long-term return objectives, risk tolerances and mandates.

*G.A.P: Good Agricultural Practice
THE CHALLENGE OF MINING REHABILITATION

John Gilchrist, Joint Head of Customised Solutions and Nicky Holtzhausen, Actuary

IN A NUTSHELL

- Remaining economically competitive while meeting social and environmental obligations is a challenge for mining houses.
- Proposed regulations stipulate more stringent terms around financial provision for closure and rehabilitation, including mandatory capital guarantees for rehabilitation trust investments.
- It is vital that, despite the capital guarantee requirement, mining companies still look to maximise the returns on their rehabilitation trust investments.
- Mining houses should partner with investment managers who have a track record of maximising returns on capital guaranteed investments.

POST-MINING IMPACTS

1. Acid mine water levels:
   1a. maintained by dewatering pumps during mining operations
   1b. after stoppage of pumps (flooding)
2. Flooded land after pump stoppage
3. Collapse of galleries
4. Surface damages
5. Mine galleries
6. Post-closure artisanal miners
The mining industry has been the socio-economic bedrock of South Africa (SA) for over 100 years. However, it is only in recent decades that the issue of rehabilitating the environment around decommissioned and abandoned mines has increasingly come under the spotlight. This is largely due to the pervasiveness of the sustainability megatrend.

Environmental rehabilitation is based on the principle of “polluter pays” and is a costly, complex and lengthy process. However, the reality is that in certain cases funding has not always been set aside for these costs, with some mining houses liquidating and leaving the state to foot the bill for the clean-up costs. But, proposed regulations in the National Environmental Management Act (NEMA) will, if they come into effect, have significant implications for mining in the National Environmental Management Act (NEMA) will, if they come into effect, have significant implications for mining houses and how they approach environmental rehabilitation.

Not so much new, just tighter
While it is not new that the onus is on mining houses to rehabilitate the environment on closure, the draft regulation aims to refine the process. The costs of environmental impact management must be accurately scoped and provided for, annually and throughout the life of the mine in perpetuity, “as and when any latent impacts of mining activity arise, including the pumping and treatment of polluted or extraneous water”, regardless of any in-hand mine closure certificate that has been issued.

In addition, it is proposed that from the date of issuance of prospecting rights, permit holders have 15 months to assess these costs and to put in place accurate financial provision for rehabilitation – failure to comply will carry stiff penalties.

But, before we consider the investment implications, let’s take a look at the challenges faced by SA mining houses and then, more importantly, what support structures they can access in order to help them meet their obligations.

Water, land and people
When it comes to environmental, social and governance (ESG) issues, probably the most pressing point is the impact that mining operations can have on potable water, which is one of our most valuable future commodities and to which access is enshrined as a human right in the South African Constitution.

The media has highlighted the much-documented acid mine drainage issue, where water pumping is used to prevent the water table from rising to a point where it impacts the drinking water of the local communities. But water issues do not only impact the health and sustainability of affected local communities and land; they also affect the broader sustainability of business in South Africa. Thus, the issue of contaminated water extends from being a geo-social issue to becoming an economic imperative. The financial cost of addressing this issue is currently under investigation and the numbers that have been quoted in the press may be understated.

Informal mining and labour issues
Artisanal miners from local communities continue to exploit the resources of abandoned mines. These activities fall outside the ambit of the mining legislation, and are likely to increase the environmental impact, and thus the extent of unfunded liabilities. To compound the situation, labour disputes within the mining industry have been widely reported. These matters, while needing to be resolved at a humanitarian level, add to the many challenges that mining houses need to balance and resolve, while remaining economically viable.

Intended legislation
As evidenced in the aforementioned draft regulation, SA legislators take the environmental and social impacts of mining activities very seriously. However, there remains room for improvement in certain areas. Currently, the issuance of mine closure certificates is rare due to the unquantifiable nature of liabilities and also some uncertainty as to what are deemed to be appropriate standards of rehabilitation.

No certificate means that, if the assets earmarked for rehabilitation are held in trust, they will not be released. This has resulted in mining houses becoming increasingly reluctant to make investments in trusts, preferring to rely instead on closure guarantees combined with ongoing maintenance/rehabilitation.

The proposed regulation not only details what constitutes an accurate environmental risk assessment and what is required of a rehabilitation plan – but also stipulates three options for financial provision.

Assessing the problem
Quantifying the liability associated with rehabilitating abandoned mines is dependent on a number of variables and inputs. Major mining houses have the financial resources to employ consultants and teams of experts to investigate the factors impacting the cost of environmental rehabilitation. In some cases, indicative numbers have been calculated and accepted. However, it is generally acknowledged that the actual costs lie within a range. Some mathematical models have been developed and refined, but variables that relate to mine-specific factors remain a difficult issue. So the fact that regulation may soon call for more accurate and regularly audited rehabilitation and decommissioning costs poses an interesting conundrum.

Making financial provision
Broadly speaking, there are various methods that will be deemed acceptable for financial provision under the proposed regulation. These are one of, or a combination of, a trust, a premature closure guarantee, or a deposit into an account specified by the Minister of Mineral Resources, to whom all interest accrues. This provision must be audited regularly to ensure alignment with the annually assessed liabilities at all times, with a period of 30 days to remedy any deficit.
Premature closure guarantees are essentially insurance against shortfalls in the financial provision, and are issued by banks and insurers, both of which require the back-up of investment collateral. They are generally used to provide for premature rather than final closure and become challenging to arrange when a mine is near its closure date and/or insufficient assets have been set aside for rehabilitation.

An excessive reliance on premature closure guarantees instead of assets held within a trust could have a significant impact on the availability of resources to effect rehabilitation in the event of the liquidation or failure of a mining company.

However, many mining houses prefer premature closure guarantees due to the historical difficulty in obtaining a mine closure certificate, without which assets held in trust for rehabilitation will not be released.

In light of the difficulty of quantifying actual costs, as well as the stipulations regarding financial provision, we believe that a philosophy of regular contributions to a moderate risk rehabilitation fund, with capital guarantees in place, makes financial sense and can help to provide efficiently for any growth in the closure liability.

How asset managers can help
Against this backdrop, asset managers have a dual role to play when it comes to the South African mining sector:

• Duty to investors: When it comes to the valuation of mining shares, applying the ESG lens is essential. This should extend to include analysing their financial provision for rehabilitation. If unplanned for, this significant event may materially impact the mining operator’s bottom line, and thus the performance of an investment portfolio holding shares in the mining operator.

• Duty to mining houses: To provide investments that enable them to comply with the proposed regulations, while helping them to address the dual requirement of capital growth and capital guarantees.

Managing the capital
Due to existing regulations, most mining houses will already have some financial provision in place and can then opt for the combination of a premature closure guarantee of the shortfall (between the liability and the assets held in trust) and a trust that must, according to the provisional regulation, make investments in instruments that offer an explicit capital guarantee.

Despite the requirements for a capital guarantee, ideally the assets within the trust should also offer inflation-beating returns. This would result in the shortfall between the liability and assets held in trust reducing over time. When it comes to selecting a fund in which to invest, due to all the variables involved, an experienced investment manager in combination with a bank or an insurance company can meet the dual objectives of inflation-beating returns and a capital guarantee.

It is important for companies (and regulators) to be aware of the timing and liquidity aspects associated with various capital guaranteed investment options.

For many of these investments, the capital guarantee only applies if the investment is held to maturity, which can range from five years for a capital guaranteed equity-linked note to 20+ years for a bond. This means that before maturity significant losses can be incurred. This has negative implications for the regulation’s intended aim of ensuring sufficient assets are available to cover the rehabilitation costs, especially in the event of premature closure.

The use of bespoke investments which, amongst other things, could have capital guarantees applying over shorter periods of time can help to minimise the potential losses during the capital guarantee term.

How Customised Solutions can help
For 10 years Customised Solutions, in conjunction with Old Mutual Life Assurance Company of South Africa, have offered mining houses bespoke investment solutions – frequently based on a mine-by-mine liability modelling exercise and risk analysis – that:

• are capital guaranteed quarterly or annually, with dramatically lower maximum drawdowns than those shown for other capital guaranteed assets/investments in the table above;
• are liquid; and
• deliver inflation-beating returns over the medium to long term.
SHOULD LONG-TERM ASSET MANAGERS WORRY ABOUT CLIMATE CHANGE?

Professor Bob Scholes, Professor of Systems Ecology, University of Witwatersrand

IN A NUTSHELL

- Climate change is a long-term risk factor.
- Investors should be aware that all major sectors are affected.
- Attuned asset managers will find opportunity within this context.
- A narrow view of company valuations will prove deleterious for shareholders in the long term.

Long-term asset managers are alert to trends that potentially have material effects on their investment strategies and assumptions. Do climate change and the changes in policy likely to be associated with limiting climate change fall into this category?

Following the publication last year by the Intergovernmental Panel on Climate Change of its 5th Assessment Report (www.ipcc.org), there can be no reasonable doubt that the global climate is changing due to human actions – and will continue to do so throughout the 21st century. Furthermore, the changes will have highly material consequences worldwide for virtually all sectors and markets. Thus asset managers will be failing in their duties if they do not pay attention to the issue.

The effects of a changing climate are already apparent in many respects. For instance, there has been a steep increase in life and property losses due to severe weather. For at least the next 40 years, the impacts of climate change will become more severe, typically in a steepening, “non-linear” way.
In other words, simple linear trend extrapolation, such as is typically used in making investment decisions, can seriously underestimate the impacts. The non-linearity of climate change has a number of underlying causes:

- First, the fundamental driver – emissions of greenhouse gases – continues to accelerate, despite the modest efforts made to reduce them. Current emissions lie at the top of the range of scenarios developed for the 21st century.

- Second, the Earth’s climate system (which includes not only the atmosphere, but also the oceans and the land surface) is “complex”. This means that even a steady increase in greenhouse gas emissions translates into a highly unsteady outcome. An example is the slowdown in the rate of the warming of the atmosphere over the past decade. This is a temporary “hiatus”, similar to previous apparent pauses over the past century, and will be compensated for by rapid warming when it ends. It is caused by a reorganisation of circulation in the deep oceans, which are the main heat stores in the global climate system.

An extreme example of this kind of unsteadiness is a climate system “tipping point”, where change is not only sudden, but may be irreversible in the human timeframe. The Earth is close to several such potential tipping points, the exact trigger levels of which are very hard to know. For example, we may already have passed the limit for the complete melting of the Greenland ice cap; or we may still have a degree or two of margin.

- Finally, changes in the average climate are amplified in measures of climate variability and extremes, which are the aspects of interest to engineers, farmers and the insurance sector. Thus, for instance, a fractional increase in the mean annual rainfall translates into a several-fold increase in the risk of floods. Risk is the basis of the insurance business model and known increasing risk is not in itself a problem. However, an unstable and unpredictable risk profile makes it difficult to construct affordable and profitable insurance products, design long-lived infrastructure, and invest in climate-sensitive sectors.

The sensitivity of many other sectors to the climate is indirect. For instance, the manufacturing, mining and service sectors are critically dependent on the availability of good-quality water, either for their own consumption or for generating electrical power. Freshwater supplies are precarious in many parts of the world, including South Africa. As a rule of thumb, climate change makes already-dry countries even more vulnerable to water supply insecurity.

Stranded assets

The arithmetic of the global carbon budget is inexorable. The cumulative rise in the global mean temperature since the beginning of the Industrial Age is proportionate to the cumulative carbon dioxide CO2 emissions since that time.

If the world is to stay below any given threshold of acceptable temperature increase, there is a corresponding maximum permissible cumulative carbon emission. The current negotiations, culminating in Paris in late 2015, are striving to limit the global average temperature change to less than 2°C relative to the early industrial period; this would translate into an approximately 4°C rise in the interior of Southern Africa.

This graphic shows the cumulative “carbon budget”. In order to have a two-in-three chance of staying below 2°C, the maximum cumulative CO2 emission is 2 900 billion tonnes, of which the world has already emitted 1 900 billion tonnes. The total known fossil fuel reserves are several times higher than this limit. It is thus inescapable that the major part of known oil, gas and coal reserves will need to remain unexploited if dangerous levels of climate change are to be avoided.

The 2°C impasse!

Emissions from total known fossil fuel reserves = 4-7 times more than the budget

Total carbon budget = 2 900bn tonnes CO2

Current cumulative carbon emissions = 1 900bn tonnes CO2

This finding is particularly problematic for companies whose valuation is implicitly based on the fossil fuel reserves they control. In the long term, these assets are likely to be overvalued.
**Investment opportunity**

Climate change brings investment opportunities as well. Companies in the renewable energy or energy efficiency markets are likely to benefit, including vehicle, aircraft and railway manufacturers with more efficient technologies.

There will need to be infrastructural investment for coastal protection, urban climate proofing, flood control and water security. Some geographical locations will become relatively more favourable for agriculture and forestry than others. A worst-case scenario is that the triple challenges of growing food, water scarcity and energy insecurity during the 21st century, exacerbated by and interacting with climate change, trigger large-scale social conflict. In this case, trade and financial markets will become highly vulnerable.

The investment community worldwide is carefully assessing the short- to medium-term benefits they get from current investment in the sectors driving global change against the long-term risks to their entire portfolio associated with large global temperature increases. The trend is for a rebalancing of the “voice of the business sector” in the climate change negotiations; away from dominance by the energy majors, to a more cautious position, largely led by the investment sector.

“Asset managers would be failing in their duties if they did not pay attention to the issue.”

Cumulative total **anthropogenic CO2 emissions** from 1870 (GtCO2)

This graph shows the relationship between cumulative carbon dioxide emitted through human activities since 1870 and the increase in the global mean temperature since that time. The solid black line with dates up to 2010 represents observed historical data and the coloured lines are various emission scenarios for the 21st century. The orange band is the uncertainty range. The thin grey line and grey band are for hypothetical model runs assuming a 1% per year increase in CO2 emissions (lower than has been recorded since 2000), showing simply that the near-linear relationship between CO2 emissions and temperature rise is robust to a wide range of emission assumptions. [Source: IPCC 5th Assessment Report, Working Group 1 Summary for Policymakers, Figure SPM 10].
We believe that South Africa needs investment-grade climate policies

While understanding that science is not 100% conclusive, Old Mutual Investment Group is supportive of the emerging scientific consensus on human-induced climate change, and we believe that it warrants the “precautionary principle” approach.

This means that, in the absence of certitude as to whether human-released greenhouse gases (GHG) do not negatively impact climate stability, society should limit GHG emissions until such time that we can demonstrate that they absolutely do not.

Further, we think that, as the South African (SA) economy is founded on low-cost, carbon-intensive energy, in order to remain globally competitive, a strategy to decarbonise our economy is needed, and that it should be in line with what science suggests, which is close to zero carbon emissions by 2050.

In this light, SA needs climate-grade investment policies that incentivise private sector participation that is conducted in a manner that meets national objectives as outlined by broader economic policy, such as the National Development Plan and the Strategic Infrastructure Programme, amongst others. Currently, SA’s renewable energy programme provides a good example of a Government run initiative that has effectively leveraged private sector finance towards low-carbon energy production.

Key to setting investment-grade climate policy is defining a National Carbon Budget, or transition pathway, that is aligned with global CO2 reduction efforts, while still recognising that, as a developing country, we need sufficient “carbon headroom” to grow.

Along with this, finding a mechanism for introducing the price of carbon into the economy will be important. One such approach is the use of a carbon tax – however, this should be done in a manner that:

- is sensitive to the structure of our economy and likely impacts
- drives both business and consumer behaviour
- appropriately manages electricity price shocks
- drives growth of alternative energy sector
- is gradual, with clearly defined targets and goals

TOMORROW | AS INVESTED AS YOU ARE
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INVESTING IN TOMORROW

R27bn
TOWARDS POSITIVE FUTURES

R12bn
GREEN ENERGY
WIND | SOLAR | HYDRO

R1.2bn
AFFORDABLE EDUCATION

R9.1bn
AFFORDABLE HOUSING

R2.9bn
START-UP FINANCE

R1.5bn
SUSTAINABLE AGRICULTURE

Figures as at December 2014
Climate change is one of the most hotly debated topics in the world, as policymakers and industry grapple with the grave implications of a planetary fever. Some deny that it is even an issue, while the scientific community and environmentalists assert that global carbon emissions must be reduced by 80% by 2050 if we are to avoid an atmospheric temperature rise of more than 2°C.

Two degrees is the temperature that scientists have identified as the ceiling for a “business-as-usual world”. With this maximum in mind, countries around the world are increasingly turning to renewable sources of energy to supplement and, eventually, replace fossil fuels, namely solar, wind, hydro and biogas. And, while South Africa (SA) is largely reliant on coal, it has ranked in the global top 10 countries for clean energy investment for two consecutive years (2012 & 2013). This is thanks to the SA Government’s Renewable Energy Independent Power Producer Procurement Programme (REIPPPP), which involves both the financing of and investment in renewable energy plants by large financial services institutions, private equity investors, big business and state-owned entities. Bidding for the first round of tenders took place in 2011 and the programme is now in its fourth year, and the results of the fourth phase of tenders were announced on 16 April 2015, with more pending in June 2015.

All projects have socio-economic development requirements, such as job creation, local ownership and enterprise development. These initiatives are intended to benefit communities located within a 50km radius of the project. The graphic overleaf highlights the scope of the renewables programme and Old Mutual’s participation in it.

Old Mutual is a prominent contributor

League table

<table>
<thead>
<tr>
<th>2013 Total Investors</th>
<th>$4,506m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Standard Bank Group Ltd</td>
<td>$490m</td>
</tr>
<tr>
<td>2nd Old Mutual plc</td>
<td>$490m</td>
</tr>
<tr>
<td>3rd Investec</td>
<td>$299m</td>
</tr>
</tbody>
</table>

Source: Bloomberg New Energy Finance

Prominent shareholders in renewables programme Rounds 1-3

![Bar chart showing prominent shareholders in renewables programme Rounds 1-3]

Community benefits: a case study

One of our larger projects is the Cookhouse Wind Farm located in the Eastern Cape.

- **Environmental impact:** It has a generation capacity of up to 138.6 megawatts (MW) of renewable electricity, enough to power 150,943 low-income homes and an implied carbon offset of 379,776 tonnes a year.

- **Social commitment:** Local content expenditure through procurement from local suppliers = R168 million to date. The communities are also shareholders in our projects, with community trusts benefiting from income generated over the lifespan of each project (20 - 30 years).

**What?**

**Watt vs watt hours:**

- Watt (W) = the unit that measures instant power usage.
- Watt hour (Wh) = power usage over time.
  - E.g.: A 200 W light bulb will use 200 W when it is turned on and 400 Wh of energy if it is left on for 2 hours.
- Kilowatt (KW) = 1 000 MW
- Megawatt (MW) = 1 million watts
- Gigawatt (GW) = 1 billion watts (1 000 MW)

**How many homes can the programme power?**

This varies according to the average energy production of an energy plant and average household consumption.

- An energy plant’s output depends on the availability of its source, e.g. wind or solar, and therefore it will not operate at maximum capacity 100% of the time.
- Household consumption varies according to socio-economic (house size; appliances used) and environmental factors (temperatures). Let us say that the “average” household uses around 600 kW (0.6 MW) per month, or 7,200 kWh (7.2 MW) per annum.

The ±4,322 MW* of the first three rounds of the programme will produce ± 5.5 million MWh a year, which could power around 1.3 million average households.

*Calculation: 4,322 MW x 365 days x 24 hours x 25% capacity factor/7.2 MW

Source: PPA/ South Africa’s REIPPPP Success Factors and Lessons 2014

Old Mutual is a prominent contributor
**SOUTH AFRICA’S RENEWABLE ENERGY INITIATIVE**

**PROJECTS ROUNDS 1 – 3**

<table>
<thead>
<tr>
<th>ENERGY TYPE</th>
<th>TOTAL PLANTS</th>
<th>OF WHICH OLD MUTUAL*</th>
</tr>
</thead>
<tbody>
<tr>
<td>WIND FARMS</td>
<td>22</td>
<td>15</td>
</tr>
<tr>
<td>SOLAR POWER</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>SMALL HYDRO</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>LANDFILL GAS</td>
<td>1</td>
<td>N/A</td>
</tr>
<tr>
<td>BIOMASS</td>
<td>1</td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ROUND 4 (NOT STARTED YET)</th>
</tr>
</thead>
<tbody>
<tr>
<td>WIND FARMS</td>
</tr>
<tr>
<td>SOLAR POWER</td>
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<tr>
<td>SMALL HYDRO</td>
</tr>
<tr>
<td>LANDFILL GAS</td>
</tr>
<tr>
<td>BIOMASS</td>
</tr>
</tbody>
</table>

*Old Mutual contracted capacity MW participation with partners

**WHAT HAPPENS AFTER 2°C?**

At a global level, research suggests that the frequency of the following phenomena is likely to increase:

- Extreme weather – wild fires, hurricanes
- Rising sea levels
- Desertification
- Failing crops
- Water shortages
- Human migration
- Ultimately, mass extinctions

This will create significant challenges, given the risks of food and water security, and habitat viability.

**Sources:**
- Total rounds 1-4 MW: Minister of Energy’s 2015/16 Policy and Budget Speech 19 May 2015
- Old Mutual Investment Group participation: in-house and AIIM
- Project locations: Illustrative only and derived from SA Renewable Energy IPP Procurement Programme: Success Factors and Lessons. May 2014. Prepared by University of Cape Town, the World Bank Institute and the Private Infrastructure Development Group
Carbon offsetting is an activity whereby an entity (e.g., a country or company) reduces or offsets its carbon emissions through funding programmes that reduce its overall emissions.

Our Managers: Old Mutual Investment Group participates in the programme via three of its investment boutiques, namely Old Mutual Alternative Investments, Old Mutual Specialised Finance and Futuregrowth Asset Management, as well as via African Infrastructure Investment Managers (AIIM), a joint venture with the Macquarie Group.
South Africa - The Islamic Finance Gateway into Africa

Saliegh Salaam, Portfolio Manager, Customised Solutions

In a Nutshell

- The appetite for South Africa (SA)’s first sukuk was massive and the book was oversubscribed.
- Sukus are a bond substitute for Islamic investment funds.
- The SA government’s sukuk enables capital from the Middle East to invest in SA – providing welcome foreign inflows.

Shari’ah principles

Islamic investment funds may not invest in or be exposed to:

- interest-based money lending transactions, e.g. the activities of banks and lending institutions. This means that no conventional money market or bond investments may be used.
- the shares of companies whose core business constitutes non-permissible activities such as:
  - conventional insurance business in any form in terms of insurance legislation, including intermediaries and brokers connected therewith
  - embryonic or stem cell research and cloning
  - the manufacture, sale and distribution of alcoholic beverages at all levels of trade
  - nightclubs, pornography and gambling, including companies with interests in casinos
  - the sale of non-Halaal food stuffs.
Ethical investing is an investment style that aims to align the investment philosophy of a fund with the investor’s ethical beliefs, while at the same time delivering appropriate risk-adjusted returns. This generally includes a screening process that excludes, or includes, certain types of instruments. Islamic investment funds invest according to Shari’ah principles, which provide a spiritual and an ethical framework. These investments are overseen by a Shari’ah Board that comprises Islamic clerics and ensures that each investment decision complies with Islamic principles. One of the key challenges a Shari’ah fund manager faces is the generation of income in the low-risk space, as interest income is not permitted in a Shari’ah-compliant fund. And this is where sukuk come into play. Essentially, they are a bond substitute because, instead of paying investors a debt-based interest income, they offer partial ownership of a real asset, e.g. infrastructure, and the investor collects distributions as a rental income, which is permitted.

SA’s first sukuk: an economic issue

The South African (SA) Treasury issued a US$500 million Islamic sukuk in 2014, which prompted much debate in the global financial sector, with some asking whether it was a relevant move for SA to make. Questions were focused on SA’s lack of strong Islamic ties, its Islamic finance ambitions and the issue of pricing. Notwithstanding the debate surrounding the issue, SA’s maiden sukuk was well received. It was oversubscribed by four times, clearly indicating there was demand – and potential – for an instrument of this kind in SA and probably on the broader continent too.

When you unpack the criticism levelled at SA’s decision, as a non-Muslim country, to issue a Shari’ah investment vehicle of this size, it is important to note that issuance was not motivated by the country’s Islamic ties but rather its economic rationale. As a cash-flush region, the Middle East and Gulf countries are considered among the wealthiest regions in the world, with some of the largest sovereign wealth funds and some of the highest gross domestic product (GDP) per capita figures in the world. In addition, the economic outlook for these regions is promising given low population growth relative to huge oil and energy reserve surpluses. As a result, global investors believe there are significant opportunities in the region and are keen to tap into the surplus liquidity of the region.

With this in mind, Islamic finance is increasingly becoming a “condition” of doing business in the Middle East, and creating a Shari’ah investment vehicle – in this case a sukuk – as a means of gaining access to the surplus liquidity in the region by offering a product that adheres to the Islamic finance principles of the region’s Muslim investor base.

The issuance of the sukuk took place at a critical time for SA, with the Treasury needing to refinance $14.4 billion of debt over the next three years. By 2017, SA’s debt is expected to be at 48.3% of the country’s GDP. The sukuk issue thus enabled Treasury to tap into a region that has excess capital and thus externally fund a portion of SA’s debt, diversifying the country’s sources of funding.

SA is a gateway to Africa

The previous SA Finance Ministry, as well as current Government, has been very clear about their intention to establish SA as the gateway for Islamic finance into Africa. The reason for this is that SA has the best financial infrastructure across the continent. Global investors can therefore be assured that the Islamic finance infrastructure will be as reliable as traditional finance structures. As such, there is a general push by the SA Government to leverage SA’s sophisticated financial and regulatory infrastructure to access the African opportunity, with a continent whose population is almost 50% Muslim. Therefore, there is a natural demand for Shari’ah-compliant products across the entire continent and the expectation is for this to increase. Given the abovementioned factors, SA is perfectly positioned to play a meaningful role in this regard.

Small, yet powerful

Looking closer to home, SA’s own Muslim population, as the naysayers have pointed out, is rather small. However, despite being a minority, it is an economically powerful group. Shari’ah-compliant banking deposits are valued at around R7 billion alone, while there are R18 billion worth of funds in Shari’ah-compliant unit trusts. The country has thus seen definitive growth in institutions offering these ethical products and SA has established itself as one of the pioneers in Shari’ah-compliant offerings in Muslim minority regions.

Another important point to consider is that Shari’ah products are not confined to Muslims alone. You only need to look at the current offerings extended by mainstream retailers to see that there is a growing trend towards ethical consumption, led by demand from a more socially and environmentally aware consumer. As a result, the ethical framework of Shari’ah investment products is gaining an increasingly broader appeal, as investors start to look beyond pure financial value metrics to include non-quantifiable measures, such as ethics, as an additional layer to performance. For the global investor, the SA-issued government sukuk offers diversified funding sources. In addition, given the asset-backed nature of these products, together with their distinctive structuring, sukuk tend to have relatively low correlations to other asset classes, offering diversification benefits for investors.

Together, this all makes for a powerful case in favour of coming to market with appropriately structured products for the investors in this region – irrespective of a country’s Muslim ties or status as a developed or an emerging market.

What is a sukuk?

In a Shari’ah-compliant investment portfolio, a sukuk serves the same purpose as a bond, but does not entail debt ownership or the payment of interest income. And while sukuk can vary in structure and application, simply put, a sukuk is a special purpose vehicle that, just like a bond, has an issuer, in this case SA Treasury, and investors who buy portions of the sukuk. The pool of investor funds is then used by the issuer to invest in real assets such as infrastructure projects, and investors share in the cash flows and risks associated with the underlying investments.
RESPONSIBLE INVESTMENT

POSITIVE FUTURES

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