

THE EVOLUTION OF RESPONSIBLE INVESTING IN LIABILITY DRIVEN INVESTMENTS

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Friday 12 June 2020 marked 100 days since South Africa had its first confirmed case of COVID-19. Over this time, what has become abundantly clear is just how interconnected the world is. In last quarter's edition of Fundamentals, we laid out the interconnected nature of our social, biophysical and market ecosystems. The past few months have stressed this lesson: Don't neglect this interconnectivity. To think that a virus that originated in a largely unknown city of Wuhan in China could bring the entire world to its knees is inconceivable. The pandemic has also accelerated change in many ways. Famous historian and author Yuval Noah Harari's words could not be more apt, "*Many short-term emergency measures will become a fixture of life. That is the nature of emergencies. They fast-forward historical processes.*" It has been argued that the COVID-19 pandemic represents

the watershed moment for working from home as well as under-the-skin surveillance. We believe that this pandemic could also be the watershed moment for the active incorporation of responsible investing principles into investment management.

THE CONCEPT OF RESPONSIBLE INVESTING – BEYOND JUST ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS

The United Nations Principles for Responsible Investment (UNPRI) defines responsible investment as "*a strategy and practice to incorporate ESG factors in investment decisions and active ownership*". While ESG investing is a term often used synonymously with sustainable investing,

socially responsible investing or mission-related investing, responsible investing is much broader. The concept of responsible investing is not based on values, ethics or morals (while this may be a consideration) but rather aims to maximise long-term risk-adjusted returns by incorporating ESG risk factors into investment decision-making and active ownership. This practice recognises that there are a host of non-financial risks that impact an investment and, to be responsible custodians of capital, investment managers need to incorporate active ownership.

ESG incorporation and active ownership can be undertaken in various ways and are informed by the type of investment being considered. For example, the different characteristics and challenges of South Africa's bond and equity markets will inform the responsible investing approach. As a boutique, Liability Driven Investments (LDI) adds value to clients' portfolios leveraging its ability to manage their liabilities by hedging interest rate and inflation risk while also providing alpha to client funds. This investment strategy typically involves the use of fixed income securities. Some of the challenges facing fixed income versus equity investors include the lack of voting rights, illiquid markets with pricing not reflecting fundamentals, and the lack of sufficient ESG coverage for issuers of debt. When incorporating responsible investing principles into our fixed income investment strategy, we consider three main focus areas: ESG Integration, Screening and Stewardship.

ESG INTEGRATION

ESG integration is the systematic and explicit inclusion of ESG factors in traditional financial analysis. Here credit analysts undertake ESG risk assessments on each investee company to identify material risks and to establish the financial implications of those risks materialising, with the aim of ascertaining the merits of the investment. This focus area is one that is most familiar across managers who consider ESG in investment decision-making and has been an integral part of LDI's investment process for many years. Where our thinking has evolved is in formalising our approach to screening, as well as being more active owners of assets through stewardship.

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SCREENING RESPONSIBLE INVESTMENTS

The practice of screening typically involves applying filters to a list of potential investments to rule issuers or specific securities in or out of contention for investment based on an investor's preferences. Examples of negative screening include avoiding issuers with complex group structures (think Steinhoff), avoiding issuers with questionable management teams, and not investing in red flag issuers as per Old Mutual's Responsible Investing Policy. Building on from this, we believe that there are opportunities for positive screening whereby investment managers develop a set of criteria to filter investments that one should target rather than avoid. Furthermore, as clients are becoming increasingly more sensitive to the impact of their investments, we believe that client-instructed screening could become more relevant in the future. One way of this manifesting would be clients specifying screening criteria in mandates to ensure that their capital is being deployed in specific ways.

The latest development in our approach to screening utilises a dynamic method whereby portfolio managers run proposed investments through a four-pillar framework before analysts perform their fundamental analysis with ESG incorporation.

This four-pillared framework is designed to consider the nuances with fixed income investing and aims to establish



the favourability of an investment from a responsible investing angle, before conducting a deep dive into the fundamentals.

- The first pillar considers the debt type: Is it a bond or a loan? Loans typically have stronger protections and legal terms are more negotiable than bonds. Having stronger protections and being able to add ESG-related wording to legal agreements increases the favourability of an investment from a responsible investing perspective.
- The second pillar considers the listing status of the issuer, as both private and public companies can issue debt. Johannesburg Stock Exchange (JSE) listed issuers tend to have significantly better disclosure than their non-listed counterparts. These companies are also more likely to adhere to voluntary guidelines like the King IV Code, which makes assessing ESG risks easier.
- The third pillar considers the industry or sector that an issuer belongs to. Certain sectors may be more favourable from an ESG perspective (such as renewable energy). There are also external risks that could impact entire industries; for example, the introduction of a carbon tax can be significant for issuers in the fossil fuels industry.
- The final pillar in this framework utilises the OMIG Responsible Investing team's proprietary model to determine a quantitative ESG profile score of a

potential investee company. Using the outcomes of all four pillars, portfolio managers can decide whether the proposed investment is favourable or not from a responsible investing perspective, and could also assist analysts by directing them to specific focus areas when conducting their fundamental analysis.

STEWARDSHIP: BE AN ACTIVE OWNER

An important component of responsible investing is active ownership or stewardship. Notwithstanding the fact that fixed income investors are not owners in the companies they invest in, they still have an important role to play in encouraging issuers to improve its ESG risk management and to develop more sustainable business practices. Actively engaging with companies on ESG risk factors is necessary to ensure that companies operate sustainably, thereby enhancing risk-adjusted returns for clients. This engagement can be undertaken on an individual basis when engaging management teams on roadshows, or in collaboration with other stakeholders in more open forums.

The Association for Savings and Investment South Africa (ASISA) has played an important role in encouraging more collaborative engagement. One of its initiatives we are supporting is improving the JSE Debt Listing Requirements, which govern listed debt instruments.

Currently, the standards of investor protection in these agreements are poor and we believe fund managers have a responsibility to improve these standards on behalf of our clients.

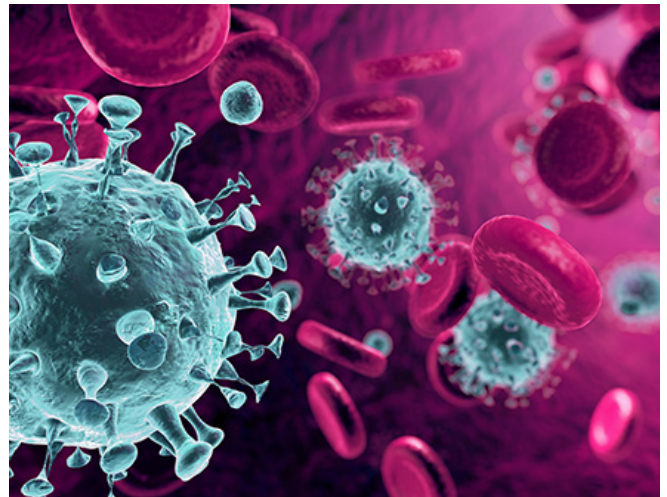
We believe that rating agencies also have a key role to play in actively incorporating ESG risks into their credit assessments and we have been in discussions with agencies to include ESG risk factors as a material part of a counterparty's rating. There is also opportunity for these agencies to publish independent ESG risk reports, since they have a unique level of access to the companies they rate. While many of these practices are present in developed markets, the rating reports on South African companies have scope for significant improvement.

We believe another important element of stewardship is actively engaging with clients on ESG factors in their portfolios. There is significant scope to improve the standard of reporting for investment mandates to include feedback to clients on the ESG risks in their portfolios and how they are being managed, as well as how their capital is contributing to building sustainable outcomes.

COVID-19 AND BEYOND

The pandemic has illustrated that responsible investing practices are no longer nice to have, but are a fundamental requirement in risk assessment. For early adopters of ESG incorporation like ourselves, the pandemic has resulted in us viewing these risk factors more holistically. The concept of an essential service will now garner more attention and aptly demonstrates the trade-offs one needs to consider when performing these assessments. For example, a company being declared as offering an essential service is positive from a revenue-generating perspective but could be negative from a social risk perspective, considering that employees may be unduly exposed to contracting the virus by continuing to work. Companies' responsiveness to external shocks has also been brought to light by the pandemic. We have seen companies repurpose themselves to be part of the solution. Examples include perfume producers making

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hand sanitiser, industrial companies making hygienic masks, luxury hotels becoming quarantine centres, and automotive factories producing medical devices such as ventilators.

In a world characterised by rapidly changing dynamics, we believe that companies that exhibit strong ESG profiles and are stakeholder focused, and have the appropriate structures to ensure they are agile, will likely remain resilient. As an investor, if you ignore these factors it will be at your own peril.