SUMMIT
AFRICA

ISSUE 19 May 2019

HIGHLIGHTS Reading time - 3 minutes

- Sustainability - not a one size fits all
- The Focus on Financial Materiality
- Lower risk = higher return
- Future Performance Success

Hi Subscriber

Today, we're looking at what some institutional investors are doing to incorporate sustainability into their investment process. The Financial Services Conduct Authority (FSCA) draft directive for 'sustainability reporting and disclosure requirements' has set a new yardstick for South Africa's institutional investor community. Although the change in regulation is yet to be affected, it will hopefully shift the entire investment chain towards a more sustainable and responsible mindset.

Sustainable investing is not a one size fits all strategy, and your methods could vary widely depending on your investment goal. There are typically three approaches to using sustainability investing (SI).

The oldest is **socially responsible investment** (SRI) which uses a set of ethical values to screen out investment in "sin" stocks. These include businesses such as tobacco, fossil fuels, and munitions.

The second approach is **impact investing**, where an investor looks for investments that have a positive investment return as well as a desired social, economic, or environmental outcome. Unlike the SRI negative screening practice, impact investing uses a positive approach deciding what to include in the portfolio. These portfolios are often theme-based or use initiatives such as the United Nation's Social Development Goals (SDG) to guide investment practice. Impact investors may focus on low-income housing, clean technology projects, health, education, and so on.

The third approach, **ESG integration**, includes environmental, social and governance non-financial data which may have a material effect on calculating investment performance during the investment analysis. More institutional investors are embracing ESG integration. A RBC Global Asset Management survey revealed that 90% of institutional investors in Europe, Asia, US and Canada believe ESG-integrated portfolios are likely to perform as well / better than non-ESG integrated portfolios.

Focus on Financial Materiality

SI is a dynamic process, sensitive to sector, market, and country-specific influences.

The consideration of **material ESG factors** alongside a company's fundamentals make it possible to translate sustainability into financial performance.

The financial materiality of ESG criteria is the critical link between sustainability and driving business performance, which impacts the generation of cash flow and/or the cost of external financing (the weighted average cost of capital). When determining environmental, social, and governance risks, numerous factors can act as red flags. However, only a few of them are likely important enough to have a significant positive or negative impact on a company's business model, risk, required capital, revenue growth, and market share. For example, little is gained by assessing a financial

institution's co2 emissions or water usage. On the other hand, understanding its transparency in governance structures, disclosures, exposure to bribery and corruption or cybersecurity has an impact on the long-term financial sustainability of that financial institution. These ESG issues are material, plausible and of commercial relevance in quantitative investment decisions.

Lower Risk = Higher Return

An interesting study by N.C. Ashwin Kumar et al. (2016), 'ESG factors and risk-adjusted performance: a new quantitative model', studied a group of ESG listed companies across 12 industries. These ESG compliant companies had lower stock return volatility in comparison to the peer companies (those not using ESG practices) – on average by 28.67%. The study also showed that each industry is affected differently by ESG factors. ESG factors mostly impacted industries like materials, banking, energy, and technology. The difference in the stock volatility ranges from 6.10% (for food and beverage) to as much as 50.75% (in the case of the energy industry). This percentage difference is a risk premium that the other (peer or non-ESG) companies face and that investors should take into consideration when making investment decisions. Equity investments in non-ESG companies could bear on average 28% or more risk on an annual basis when compared with investments in ESG companies in the same industry. This contrasts sharply with the popular view that 'lower risk means lower return.'

Future Performance Success

There is an inherent opportunity in generating value through improvements to an investee company's ESG standards. Actively identifying and managing an investment's material sustainability issues creates value for shareholders. These shareholders will benefit from those improvements before they become apparent to the market when financial results are reported retrospectively. This approach is most beneficial to an investor with an active ownership style often used by private equity companies. In this regard, a study by Dimson et al. (2015) concluded that companies with successful ESG engagement strategies experienced higher investment returns. Comparatively, those companies' whose ESG engagements were unsuccessful did not destroy company value. Instead, these companies experienced similar gains as would be expected had no ESG engagement taken place.

There is much work to be done to set up comparable sustainability reporting structures across industries within South Africa. One thing is sure; it is only going to gain in prominence as regulators increase their focus on ESG. Investors and corporates wanting to make effective sustainability investment decisions should concentrate on material sustainability and the financial usefulness of reported data. The 'smart' use of this information informs an investor's understanding of the cost implications of megatrends like changing climate, rising inequality and other non-financial risks on investment decisions.

ESG integration has the potential to drive opportunity. Alternative investment fund managers like Summit Africa are perfectly positioned to help direct the flow of capital into unlisted active ownership private equity investment products. Investment in healthcare, education, infrastructure, and energy generation are critical to South Africa's national development.

Authored by: Summit Value Add Team, May 2019

Tweet Forward Share

Summit Africa is a majority black owned and managed, specialist Alternatives Investment Manager with a focus on investing in Private Equity and unlisted Real Estate that delivers above-benchmark risk-adjusted financial returns and contributes meaningfully and measurably to the Social and Economic transformation and development of the local community and South Africa as a whole.