



# The State of Responsible Investment in South Africa

A survey of approaches and perceptions of the South African investment community to environmental, social and governance issues



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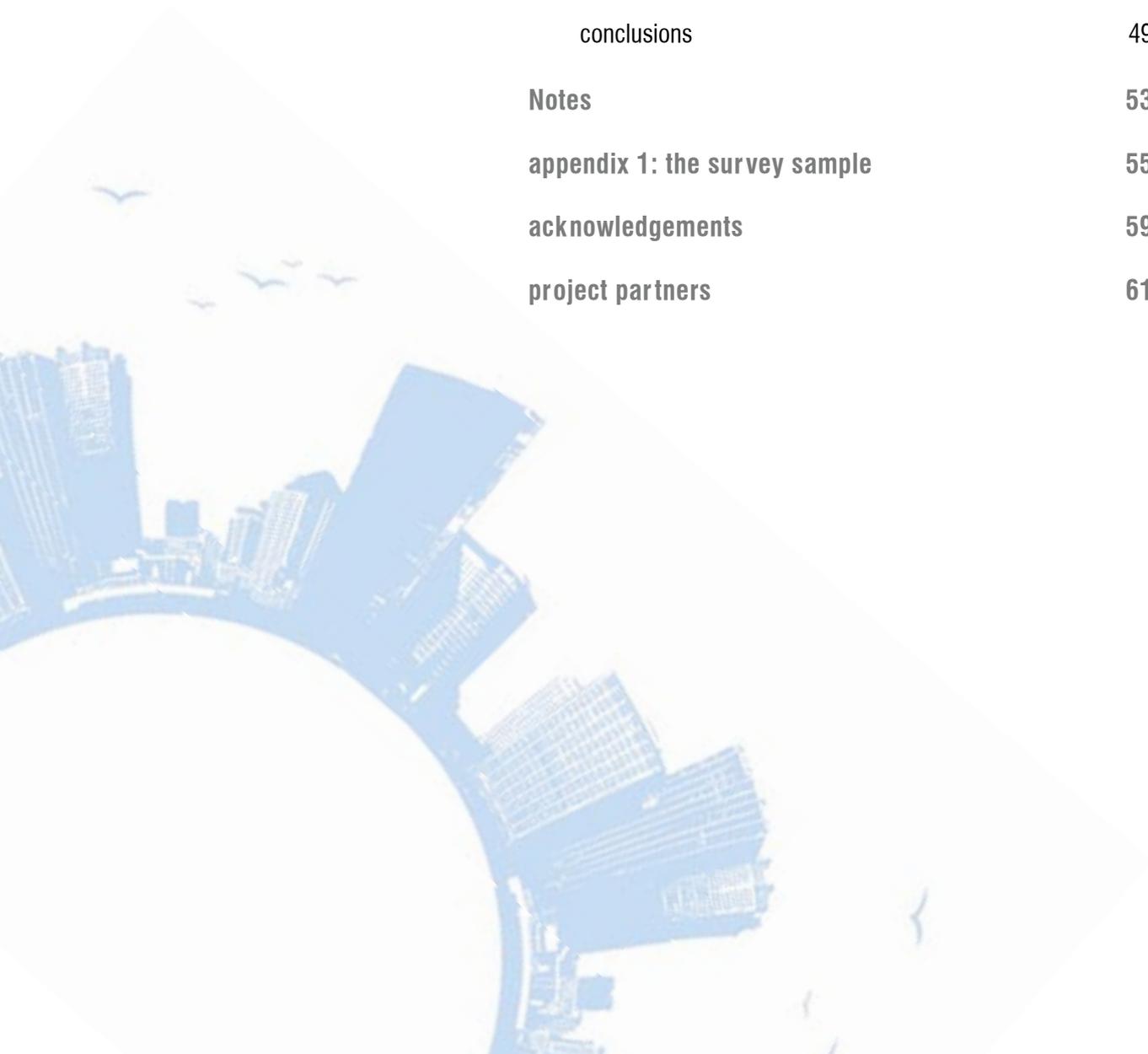
A survey of approaches and perceptions of the South African investment community to environmental, social and governance issues



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# abbreviations

<b>AICC</b>	African Institute of Corporate Citizenship
<b>AMWG</b>	Asset Management Working Group (a working group of UNEP FI)
<b>ATF</b>	African Task Force
<b>BEE</b>	Black Economic Empowerment
<b>CCC</b>	Centre for Corporate Citizenship
<b>CSI</b>	Corporate Social Investment
<b>ESG</b>	Environment, Social, and Governance [issues]
<b>FSB</b>	Financial Services Board
<b>FSC</b>	Financial Sector Charter
<b>IMASA</b>	Investment Management Association of South Africa
<b>JSE</b>	Johannesburg Securities Exchange
<b>JSE SRI</b>	Johannesburg Securities Exchange Socially Responsible Investment [Index]
<b>PRI</b>	Principles for Responsible Investment
<b>RI</b>	Responsible Investment
<b>SA</b>	South Africa
<b>SRI</b>	Socially Responsible Investment
<b>UN</b>	United Nations
<b>UNEP FI</b>	United Nations Environment Programme Finance Initiative
<b>UNGC</b>	United Nations Global Compact
<b>UNISA</b>	University of South Africa
<b>US</b>	United States



# foreword

Investors play an important role in shaping South Africa; they stimulate business activity, employment and economic growth. While driven primarily by profit, many investors realise that future returns are dependant on the manner in which current investment decisions impact on society. This is especially important for large institutional investors such as pension funds, that have long-term investment horizons and clear gains to make from ensuring their present investment decisions are beneficial to long term sustainable economic growth.

It is in this context that the project partners, the United Nations Environment Programme Finance Initiative (UNEP FI), African Task Force (ATF), Noah Financial Innovation, and the University of South Africa (UNISA) Centre for Corporate Citizenship (CCC) came together to conduct this survey. They wanted to understand how the South African investment community integrates sustainable development and particularly environment, social and governance (ESG) issues in investment decision-making. Further more they wanted to understand how investors view and understand the evolving concept of responsible investment.

This survey has a distinct South African flavour. The challenges that South Africa is faced with, particularly of redressing the socio-economic conditions and broad-based black economic empowerment are quite unique. Nonetheless, these findings are important to the larger African context. The South African stock exchange is the largest in Africa and South African investment activities, trends and behaviour are vitally important to the economies throughout the continent. The outcomes of the survey are mixed. We find that while there is an understanding that ESG issues are important for long-term value, there are gaps in knowledge and there is sparse evidence of concrete mainstream investment activities aligned to a long-term view. Further, it seems that perspectives of responsible investment are very broad, some continue to categorise responsible investment as a separate asset class while others view it as an integrated investment approach to apply across portfolios.

Despite these challenges, it is arguably in the African continent, where acute ESG pressures exist, that the benefits of responsible investment could have most impact. We offer this report to trustees of pension funds, asset managers and investment service providers. Whether new to this area or an established expert, we call on the South African investment community to take heed of findings in defining their contributions to continued robust sustainable economic growth in South Africa.

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# executive summary

Responsible investment (RI) or investment that incorporates an active consideration of environmental, social and governance issues into decision-making and ownership is rapidly evolving into a mainstream investment discipline. In order to develop an understanding of the current state of this, in institutional investment circles in South Africa, a survey based on the following research question was undertaken:

What is the current level of:

- awareness of;
- demand for inclusion of (demand side);
- inclusion of (supply side); and
- future prospects for inclusion of environmental, social and governance (ESG) issues into investment frameworks in South Africa?

The survey interviewed principal officers from 32 pension funds controlling approximately ZAR 975 billion (US\$ 138 billion); the Chief Investment Officers from 19 asset management companies managing approximately ZAR 2 320 billion (US\$ 330 billion); and the Chief Operating Officers or Heads of Research from 11 investment advisory service providers.

Across a range of ESG issues, the majority (70% or more) of respondents claimed that most issues were at least somewhat material in “evaluating the likely performance of investments”. But, the majority also said they are either doing nothing about this or had a limited proportion of assets in RI portfolios. At most, 15% of the pension fund assets were managed under a formal RI strategy while at most 11% of asset management company AUM were managed under a formal RI strategy.

The inevitable question that emerges out of this is: “If ESG issues are at least somewhat material, then why is there so little RI?” Paradoxically, principal officers of pension funds generally suggested that the most important barriers were related to the belief that RI necessarily meant lower financial return – the financial business case. Asset managers and advisors generally suggested that their most important barrier was a lack of demand from customers (institutional and retail).

What then, would drive further participation? Well, almost all respondents indicated that more stringent legislation would. But almost no-one really liked the idea. Beyond this, most respondents indicated that demonstrating the business case would be a key driver. Logically, however, as most respondents noted, a broad range of ESG issues are material to evaluating the likely performance of investments, then surely the business case already exists?

Thus, in the final analysis, perhaps the biggest need really is for certain myths to be dispelled and for this very simple business case to be communicated clearly and widely. Responsible investment is not about philanthropy. It is not necessarily about sacrificing financial returns in pursuit of some sort of broader social good. Responsible investment is investment that incorporates an active consideration of environmental, social and governance issues (which are widely considered to be material) into investment decision making and ownership.

# introduction

The aim of this study is to assess the state of RI in South Africa in 2007. In order to set the scene for conducting such a survey, and indeed for presenting the results, it is essential to define exactly what is meant by responsible investment. For the purposes of this study, the following definition shall apply:

*“Responsible investment is investment that incorporates an active consideration of environmental, social and governance (ESG) issues into investment decision-making and ownership.”*

On the surface, this definition is fairly simple to understand. Importantly, there is no explicit positioning of the motives or intent of participants in RI. The definition may be interpreted as a very inclusive framework for investment practices ranging from early Socially Responsible Investment (SRI) practices such as negative and positive screening<sup>1</sup>, which were often motivated by social agendas, through to approaches motivated by purely financial objectives.

Despite this implied “inclusivity”, it is crucially important to recognise that the major conceptual shift heralded by the concept of RI (as opposed to the concept of SRI) is a distinct emphasis on approaches focusing on integrating ESG issues into financial assessment. In other words, there is an increasing emphasis on approaches where ESG issues are considered on the basis of their financial materiality. Indeed, this is the approach advocated by the globally recognised Principles of Responsible Investment (PRI)<sup>2</sup> an institutional investor initiative in partnership with UNEP FI and UN GC. RI therefore includes investors with orientation toward purely financial analysis, as well as those open to sustainability themes, and traditional SRI approaches including moral or ethical investment philosophies. This shift towards a greater focus on financial materiality is likely to be a more powerful driver for sustainability than conventional SRI practices. This is because of its potential to move consideration of ESG issues from the fringe into the heart of mainstream investment practices.

Indeed, there is an emerging school of thought that argues that this purely financial view is in fact “true” RI and that traditional SRI practices (negative and positive screening) are becoming increasingly marginal. Advocates of this argue that this “true” RI emerged out of the recognition by trustees of large pension funds in particular, that in order to take into account all elements that could impact on financial value, ESG issues must be considered. The implication was that in doing so, trustees were acting in a more “responsible” manner towards their beneficiaries, hence ‘Responsible Investment’. This is particularly relevant with the increased recognition by large pension funds in particular that they are “owners” of a large slice of the economy. With such an investment profile, cost saving externalities in one sector can result in costly impacts in another. For example, continued investment

in conventional energy and automotive sectors of the economy may have dramatic impacts on the insurance, property and agriculture sectors through the impacts of climate change.

The move to focus primarily on financial motives for considering ESG issues is compelling on at least three levels:

- It raises the consideration of ESG issues in investment decision-making and ownership out of the quagmire of high risk, low return activity bordering on philanthropy and frequently confused with Corporate Social Investment (CSI)<sup>3</sup>;
- It diffuses all of the tension associated with perceived conflicts between fiduciary responsibility and traditional SRI activities. As such, it is highly likely that the mainstream investment community will have a far greater appetite for this and that it will eventually prevail as the consensus view; and
- The materiality case empowers investors to actively engage with investment entities on ESG issues, acting as interested long term shareowners, and less like share traders.

RI is still evolving as a concept, and in some ways defies precise definitions when applied to the matrix of investment impacting factors considered. The argument that RI is driven only by financial motives is an emerging view rather than the present consensus. In keeping with the goal of this survey to evaluate the current state of RI, it was considered necessary that the survey embrace the more inclusive definition of RI and RI strategies including:

- Negative screening (e.g. tobacco, alcohol or weapons exclusions), positive screening (e.g. targeted infrastructure investments); and hybrids of the two
- An integrated approach involving the explicit inclusion of ESG issues into traditional financial analysis; and
- Active engagement on ESG issues via shareholder activism, proxy voting or exercising some other ownership rights.

As a survey covering perceptions of both traditional SRI activities as well as RI activities, this is not the first study of its kind in South Africa. In 2002, the African Institute of Corporate Citizenship (AICC)<sup>4</sup> published a study entitled “Socially Responsible Investment in South Africa”<sup>5</sup>. This was based on a survey of a range of financial institutions and other stakeholders. The subject matter dealt with in the report was wide-ranging and, despite the title, covered both traditional SRI activities and activities more consistent with the emerging financially motivated notion of RI. It considered both the global and the South African contexts, and included discussion of why uptake of RI might at the time have been limited.

Since its publication however, both the domestic and international contexts have been rapidly developing. The emergence of the concept of RI as distinct from SRI, with its associated increasing emphasis on financial motives has already been highlighted. A key driver of this on the international

front has been the work of the UNEP FI<sup>6</sup> and the United Nations Global Compact (UNGC)<sup>7</sup>. Their combined efforts have lain to rest a number of myths surrounding RI. Notably the UNEP FI Asset Management Working Group (AMWG)<sup>8</sup> has produced a number of reports that present:

- A robust business case for inclusion of ESG issues into investment decisions<sup>9</sup>;
- A supporting legal opinion on fiduciary responsibility and the inclusion of ESG issues into investment decisions<sup>10</sup>.

Further, working in a partnership spearheaded by former United Nations (UN) Secretary General Kofi Annan, the UNEP FI and the UNGC facilitated the development and launch of an investor framework for the integration of ESG issues in investment decision-making and ownership practices: the Principles for Responsible Investment (PRI). The PRI has stepped up efforts in this regard introducing a dedicated PRI Emerging Markets and Developing Countries Project in which South Africa is one of three key regions. The objective of this project, to be conducted over two years from June 2007, is to promote responsible investment in twenty-four emerging markets and other developing countries via the framework of the Principles for Responsible Investment (PRI). The vision is to encourage responsible business practices by companies operating in the developing or emerging market by sending signals from investors – the owners of business themselves.

In the domestic context, some of the most notable changes since 2002 have included:

- The introduction in 2004 of the Johannesburg Securities Exchange (JSE) SRI index<sup>11</sup>;
- The evolution of the more mature understanding of Black Economic Empowerment (BEE)<sup>12</sup>, and the dimensions of BEE beyond ownership in areas including employment equity, procurement, training and CSI<sup>13</sup>. This conceptual development is now supported by scorecards, charters and independent verification bodies;
- An increasing focus on ESG performance by South African (SA) companies. SA companies have responded well to stakeholder demands for accountability (e.g. in the 2006 Accountability Rating, SA companies outperformed the global average<sup>14</sup>); and
- The commitment of South Africa's largest pension fund, the Government Employee Pension Fund, to the UN facilitated PRI.

This rapid contextual development, together with the desire to once again reinforce awareness of RI amongst the South Africa investment community brought together the project partners UNEP FI, Noah Financial Innovation and the UNISA Centre for Corporate Citizenship to produce this report.



# methodology

In pursuit of developing an understanding around the state of RI in South Africa in 2007, the survey broadly considered:

- **General awareness and perceptions of RI** – this included perceptions regarding the materiality of ESG issues in investment decision-making and management;
- **Demand for RI practices** – this included demand from both institutional and retail investors where applicable;
- **Strategies to fulfill this demand** – this included exploring the allocation of assets under management into RI and SRI strategies, including negative and positive screening, active engagement, and integrated analytic approaches; and
- **Perceived barriers, drivers and enablers for RI.**

Within each of these broad sections, the survey attempted to differentiate between ESG considerations.

The survey focuses on pension funds and asset managers as the two most influential groups in the investment value chain. It also considers consultants, advisors and analysts who provide advisory services to these two groups (referred to in the rest of this document as investment advisory service providers)<sup>15</sup> Pension funds targeted were the largest funds as listed by the Financial Services Board (FSB)<sup>16</sup> within the following sectors: Resources, Financial Services, Retail, and Communications and High Tech, as well as a number of the largest public sector funds and collective industry funds. The survey sample includes all asset managers listed as members of Investment Management Association of South Africa (IMASA)<sup>17</sup>. Finally, a selection of investment advisory service providers were surveyed.

The survey was carried out through telephone interviews based on a formal questionnaire with representatives from selected companies or pension funds. For pension funds, the aim was to interview principal officers; for asset managers, chief investment officers; and for investment advisory service providers, chief operating officers, or heads of research. By conducting the interviews telephonically, an 87% response rate was achieved. Finally, in order to secure frank and honest responses, rather than responses aimed at managing reputation, all interviews were protected by a confidentiality agreement.



# perceptions of responsible investment

The first part of the survey has been designed to provide insights into general perceptions of RI. It started by posing a number of questions without supplying a reference definition of RI. The aim of these questions is to gauge the level of general awareness of RI.

Having done this, the interviewees were presented with the reference definition for RI discussed above in the Introduction:

*“Responsible investment is investment that incorporates an active consideration of environmental, social and governance issues into investment decision-making and ownership.”*

They were then asked about their perceptions of the materiality of a range of ESG issues in an effort to understand the extent to which participants viewed ESG issues as important to investment valuation.

## Key Findings

- General awareness of RI was noticeably lower among principal officers of pension funds (53%) than among asset managers (79%) and investment advisory service providers (82%);
- Principal officers of pension funds commonly held the view that RI is simply investment that ensures the fund is able to meet its financial liabilities;
- A commonly held view amongst all groups interviewed was that RI necessarily meant increased investment risk and more importantly, reduced return;
- Only a third of respondents had heard of the PRI;
- Most respondents indicated that the vast majority of ESG issues discussed were at least somewhat important in valuing investments; and
- Where similar international studies of material ESG issues were available, the rank of importance of common issues was generally very similar to the rank of importance of issues in this survey.

## Pension Funds – General Awareness

Table 1 : Pension Funds – General Awareness

	Assets Under Management		n	% of total
	ZAR billion	US\$ billion <sup>18</sup>		
Total sample	975	138.5	32	100%
Have not heard of RI	19	2.6	6	19%
Have heard of RI	955	135.7	26	81%
Inadequate definition	59	8.3	9	28%
Have heard of the PRI	685	97.3	5	16%

Of the three groups sampled, principal officers of pension funds had the lowest general awareness of RI. While 26 out of the 32 principal officers interviewed claimed that they had heard of the concept of RI, at least nine of these were unable to provide an adequate definition of what RI entailed. The most common definition that emerged from this group was that RI was investment that ensured that the financial liabilities of the fund towards its members were met. While technically not incorrect, this definition made no reference to the fact that in achieving this, ESG issues should be considered. Another common misconception was the view that RI necessarily implied lower financial returns. In other words, that RI was essentially a philanthropic endeavour. This misconception appears to have been fuelled by definitional confusion around CSI. It is important to emphasise that RI is not the same as CSI or corporate philanthropy. Indeed, as discussed at length in the Introduction, there is an emerging view that holds that true RI is motivated by purely financial objectives.

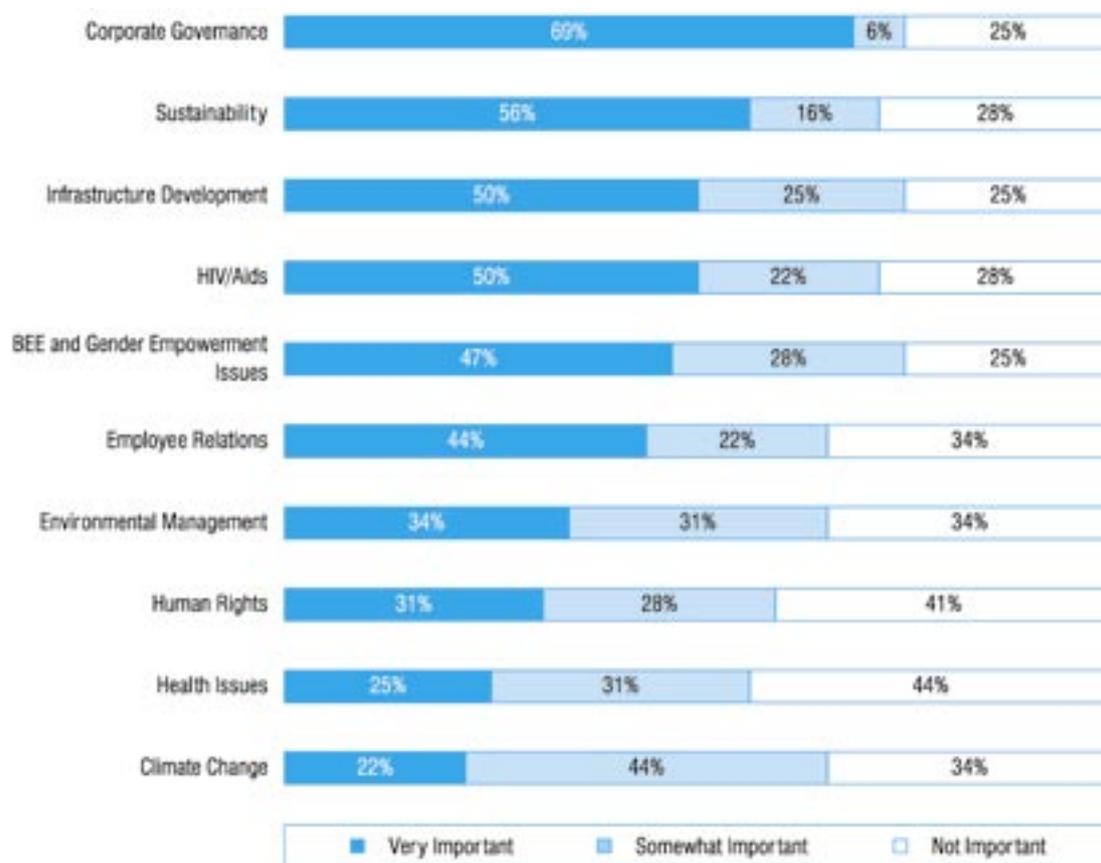
In terms of assets under management, somewhere close to 95% of assets covered by this survey were being managed in funds where the principal officers appear to understand RI in broad conceptual terms. However, it must be noted that this was strongly influenced by a single large fund. By excluding this fund, the amount of money managed by principal officers that understand the concept of RI dropped closer to 77%.

Beyond a broad conceptual understanding of RI, an awareness of PRI was interpreted as an indicator that the respondents were not only conceptually aware, but that they might have taken some time to investigate the concept further. Only five out of the 32 respondents (16%) had heard of the PRI. Once again, in terms of assets under management, these five represented a significant portion of the total.

## Pension Funds – The Materiality of ESG Issues

In order to evaluate perceptions on the materiality of ESG issues, interviewees were asked the following:

*“Please indicate the extent to which you feel the following environmental, social and governance (ESG) issues are important in evaluating the likely performance of investments.”*



**Figure 1: Pension Funds - ESG Issue Materiality.** (n=32, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)

Looking first at the highest ranking issues, corporate governance ranks at number one. This is likely to have been driven by a combination of high profile corporate scandals which have occurred (most recently the Fidentia scandal<sup>19</sup>), together with the impact of the King II Codes<sup>20</sup> on the South African business psyche. While it is tempting to argue that the high rank of sustainability might be due to the proliferation of sustainability reporting as an integral part of a companies annual reporting, it is also possible that this was interpreted by a number of respondents to refer to the financial sustainability rather than to a “triple bottom line” notion of sustainability. The high rank of infrastructure development is most likely an indication of the financial opportunities that exist in the timely and massive infrastructure development projects, which are currently being undertaken in SA and on the continent. This high rank of infrastructure is likely to have been further fuelled by the Financial Sector Charter’s (FSC<sup>21</sup>) call for “targeted investment” which includes targeted infrastructure development projects. HIV and Aids is clearly a pressing social problem in the region, and empowerment issues are obviously driven by government pressure.

Turning to the lower ranking issues, several respondents indicated that environmental management was sector-specific. This reflects the commonly held view that in a financial sense, management of environmental issues varies in importance across sectors.

Surprisingly, health issues, which would include occupational health and safety and community health and safety, were ranked as not very important. This contrasts strongly with the amount of attention paid to occupational health and safety by corporations. Indeed, this is one of the few ESG issues against which executive performance is very commonly measured.

Beyond this general order, it is interesting to compare the results here with the results from a similar, but larger survey of institutional investors in the United States<sup>22</sup>. The constituents of the 2006 Mercer Investment Consulting survey included not-for-profit organisations, defined benefit and defined contribution corporate and public pension funds [n=183]. Although the lists of issues vary to some extent to capture issues of local relevance, quite remarkably, the rank order of common ESG issues that pension funds view as important was almost identical. Corporate governance and sustainability topped both lists. In our survey, these two issues were followed by a number of South Africa specific issues (infrastructure development, HIV and empowerment). Employee Relations followed these, in line with its position on the US survey list. Bottom of the common lists were climate change followed by health issues<sup>23</sup>. Of the common issues, only human rights and environmental management were not in the same general order in both lists. This similar ranking is a clear indicator of the global nature of the investment business and opinions toward environmental, social and governance factors at this time.

## Asset Managers – General Awareness

Table 2: Asset Managers – General Awareness

	Assets Under Management		n	% of total
	ZAR billion	US\$ billion		
Total sample	2 320	329.5	19	100%
Have not heard of RI	-	-	0	0%
Have heard of RI	2 320	329.5	19	100%
Inadequate definition	352	50	4	21%
Have heard of the PRI	1 788	254	10	53%

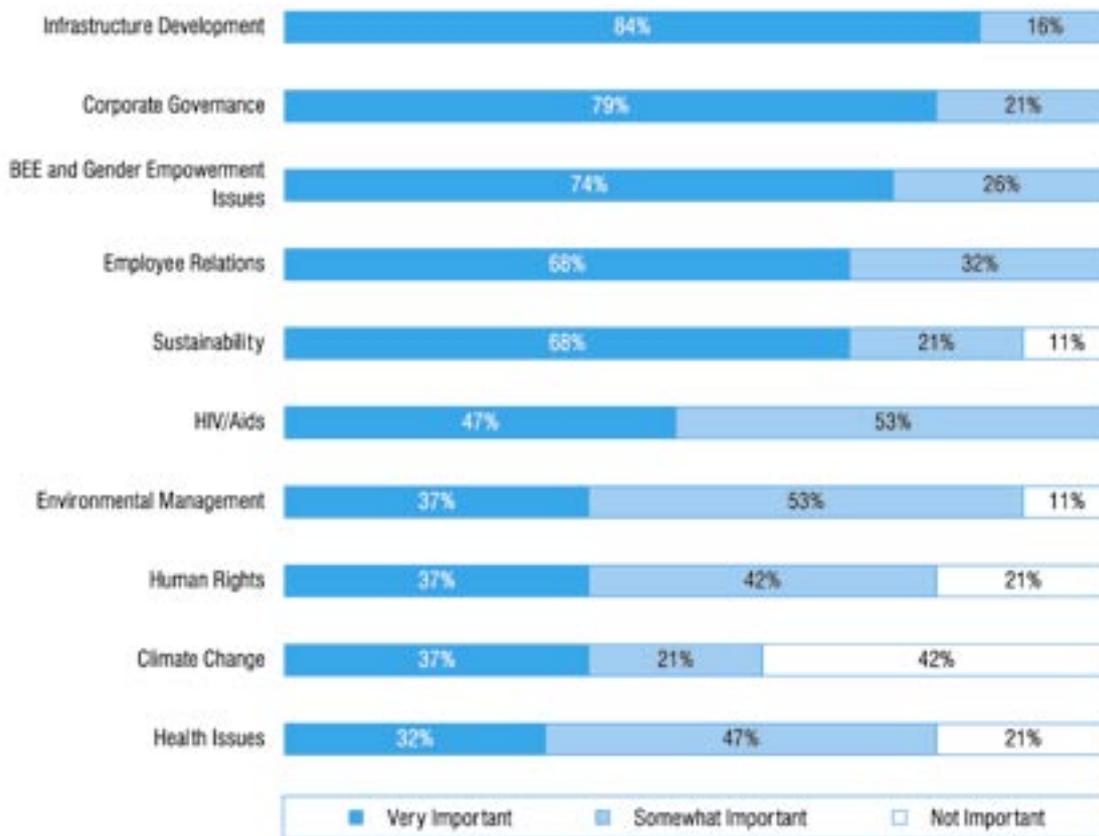
When compared with principal officers of pension funds, the general levels of awareness and the conceptual understanding of RI were far superior among asset managers. Of the 19 asset managers interviewed, all claimed to have heard of the concept of RI and 79% could provide an adequate definition of RI. From the perspective of assets under management, this means that about 85% of the total assets surveyed were managed by asset managers who at least understood the definition of RI. Even the four asset managers who provided an inadequate definition of RI were aware that RI involved integrating ESG issues into investment decision-making. However, all four believed that this would necessarily increase the risk and reduce the return of the investments.

Beyond this generally high level of understanding of RI, over 50% of the asset managers interviewed had at least heard of PRI, compared with the 16% of principal officers of pension funds.

## Asset Managers – The Materiality of ESG Issues

Again, in order to evaluate perceptions on the materiality of ESG issues, the survey posed the following question to asset managers:

*“Please indicate the extent to which you feel the following environmental, social and governance (ESG) issues are important in evaluating the likely performance of investments.”*



**Figure 2: Asset Managers - ESG Issue of Materiality.** (n=19, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)

Overall, asset managers held an even stronger view than principal officers of pension funds that ESG issues were important in evaluating the likely performance of investments. On average, across all issues, only 11% felt that the issues were not important at all. At least five out of the ten issues polled were considered by all respondents to be at least somewhat important. However, this apparent significance attached to ESG issues by asset managers needs to be treated with some caution. Several asset managers added the caveat to their responses that many of these issues are only important in the extreme, a theme that we will return to later in this report.

In terms of the specific order of ESG issues, asset managers appeared to place a slightly greater emphasis on locally relevant issues, with infrastructure development and empowerment issues appearing in the first and third positions respectively. In comparison with a similar international

survey of investment managers<sup>24</sup>, the ranking of common issues was again remarkably similar. In the global survey, corporate governance, sustainability and employee relations were ranked first to third, respectively. These were followed by environmental management and health issues. Finally, human rights and climate change brought up the last two positions.

## Investment Advisory Service Providers – General Awareness

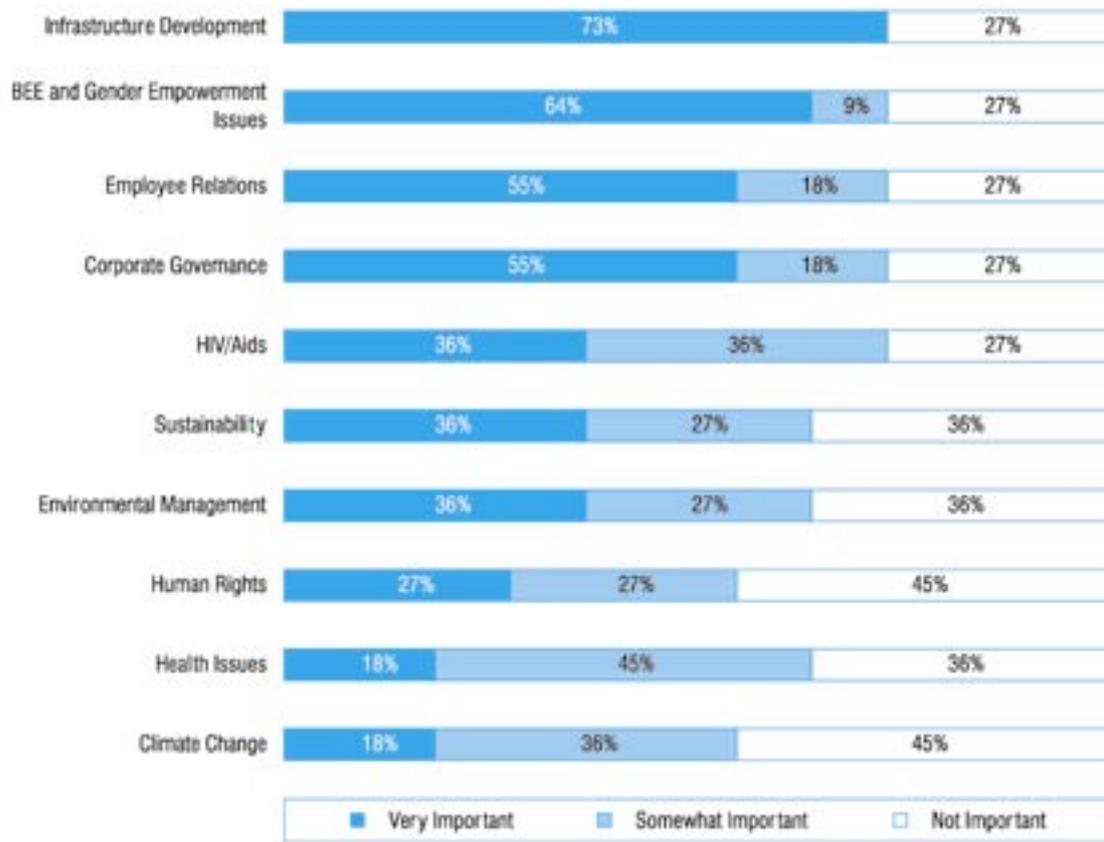
Table 3: Investment Advisory Service Providers – General Awareness

	<b>n</b>	<b>% of total</b>
Total sample	11	100%
Have not heard of RI	0	0%
Have heard of RI	11	100%
Inadequate definition	2	18%
Have heard of the PRI	6	55%

The levels of general awareness amongst this group more or less mirrored those of the asset manager group. The entire sample (n=11) had heard of RI and over 80% were able to provide an adequate definition of RI. Once again, the two that provided an “inadequate” definition both suggested that RI necessarily meant increased risk and reduced return. Over 50% of the sample had at least heard of the Principles for Responsible Investment.

## Investment Advisory Service Providers – The Materiality of ESG Issues

As with the other two groups, investment advisory service providers were asked to indicate the extent to which they felt certain ESG issues were important in valuing investments.



**Figure 3: Investment Advisory Service Providers - ESG Issue of Materiality.** (n=11, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)

Among investment advisory service providers the average percentage of respondents across all issues who felt that the issues were not material was close to 34%. This was more aligned with the views expressed by the pension funds.

In terms of the ranking of the issues however, the advisory service providers group was reasonably similar to the asset managers (Figure 2). Important issues in the South African context, such as infrastructure development and empowerment, were considered more important by this group than by principal officers of pension funds.

# demand for responsible investment

In this section the aim was to assess the current level of demand for RI that the survey groups were experiencing from their “customers”. In addition, the survey sought to gauge whether this demand was expected to increase in the near future (the next three years). In particular, the survey asked:

*“What proportion (if any) of your ‘customers’ are currently expressing a desire to include environmental, social and governance considerations into investment decision-making i.e. to pursue responsible investment?”*

and

*“Do you believe that there is likely to be an increase in demand for environmental, social and governance conscious investment (responsible investment) from this source in the near future (3 years)?”*

In the case of asset managers, these questions were partitioned into their institutional and retail customers. Across all groups, the survey tried to tease out any variation between environmental, social and governance issues. In addition, a specifically South African category of BEE ownership was also considered.

## Key Findings

- The majority of respondents reported very little demand for RI practices from investors at the end of the value chain - pension fund members and retail investors;
- The reported demand for RI practices amongst asset managers from institutional investors was noticeably higher than from retail investors;
- Reported demand for inclusion of ESG issues into investment decision making was generally slightly higher for social issues (excluding BEE ownership) and for governance issues, than for environmental issues;
- Views on whether demand for RI was likely to increase in the short-term (next three years) were evenly split although more asset managers believed that demand was likely to increase from institutional investors specifically.

## Pension Funds

In terms of current demand from pension fund members, principal officers indicated the following:

Table 4: Pension Funds – Current Demand

	0%	1 – 25%	26 – 50%	51 – 75%	76 – 99%	100%
Environmental Issues	78%	22%	-	-	-	-
Social Issues (excl BEE ownership)	50%	11%	17%	17%	6%	-
BEE ownership	44%	28%	11%	11%	6%	-
Corporate governance	50%	22%	-	17%	6%	6%

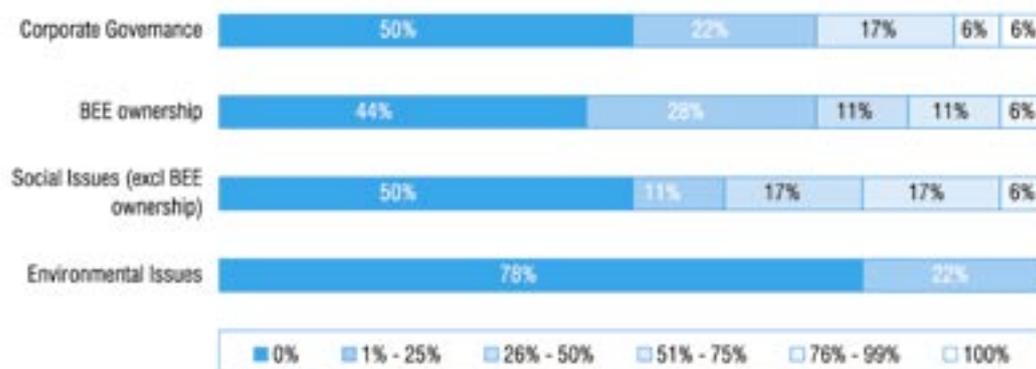


Figure 4: Pension Funds – Current Demand (n=32, respondents asked to indicate what proportion of their members were demanding RI options on a quartile scale of: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

In general, the demand for RI practices from pension fund members appeared to be very low. This was particularly so in the case of environmental issues where reported demand was almost non-existent. This picture of a general lack of demand is further accentuated by the fact that many of the respondents who indicated that there was some demand (in the 1% - 25% bracket) indicated that this was very low – around 1%.

In informal discussions, several respondents (at least 20%) expressed the view that pension fund members were completely disengaged from their assets. Respondents described a “paternalistic” system existed whereby the trustees were solely responsible for looking after the members interests. However, a number of respondents did indicate that labour unions, as representatives of members, were active in driving demand for at least some consideration of ESG issues. This recognition of the involvement of unions in investment activities was emphasised in the second edition of the AICC report on SRI<sup>25</sup> and is not a particularly new finding. Evidence of active engagement by civil society (in this case labour unions) is, however, an encouraging factor in such an otherwise apathetic context.

Beyond apathy, a number of respondents indicated that members’ demands were often purely financial and that there was an aversion rather than a demand for RI. At least one respondent pointed out that this was particularly the case in their fund which, according to the respondent, has an “older age profile”, i.e. a bias towards members nearing or already in retirement. This wariness toward RI was again fueled by the misconception that RI necessarily produces reduced financial returns, and by the fact that most of the funds surveyed are defined contribution funds where the members bear the risk. This is inconsistent with the emerging practice of RI described in the Introduction, which emphasises the creation of investment value through the consideration of material ESG issues.

In terms of expected future demand principal officers indicated:

Table 5: Pension Funds – Future Demand

	Yes	No
Environmental Issues	44%	56%
Social Issues (excl BEE ownership)	44%	56%
BEE ownership	50%	50%
Corporate governance	56%	44%

Principal officers seemed to be divided on whether they believed that there would be increasing demand for RI practices in the near future. However, a number of respondents that answered this question negatively did express the view that the demand might well increase in the longer term – beyond the three years specified in the question.

## Asset Managers

As mentioned above, in the case of asset managers the survey differentiated between institutional and retail clients in evaluating current and likely future demand for RI.

## Institutional Investors

Table 6: Asset Managers – Current Demand from Institutional Investors

	0%	1 – 25%	26 – 50%	51 – 75%	76 – 99%	100%
Environmental Issues	41%	47%	-	6%	6%	-
Social Issues (excl BEE ownership)	24%	47%	6%	6%	18%	-
BEE ownership	12%	18%	24%	12%	29%	6%
Corporate governance	12%	18%	18%	24%	29%	-

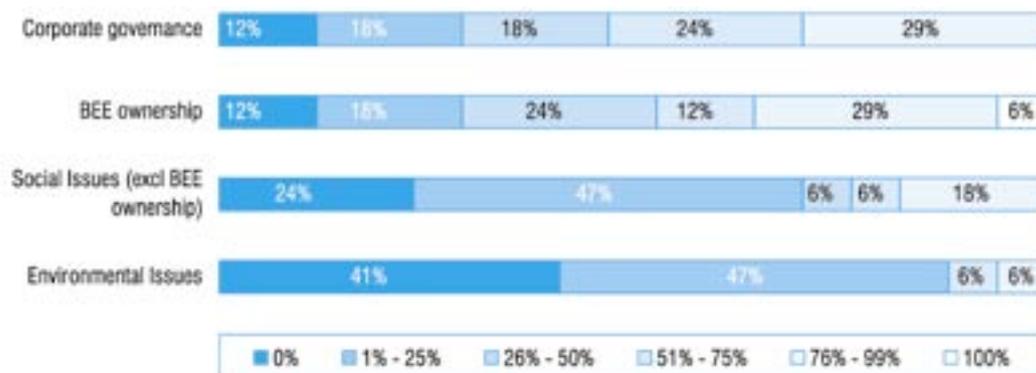


Figure 5: Asset Managers – Current Demand from Institutional Investors. (n=19, respondents asked to indicate what proportion of their institutional investors were demanding RI options on a quartile scale of: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

Reported demand from institutional investors for investments that take into consideration environmental issues was noticeably less than any of the other issues. Consideration of BEE ownership and corporate governance appeared to be most in demand. As already mentioned in Section 3 above, the particular focus on corporate governance was likely to have been influenced by a high profile corporate governance scandals; the most recent being the Fidentia scandal.

In terms of anticipated future demand from institutional investors, the asset managers interviewed indicated the following:

Table 7: Asset Managers – Future Demand from Institutional Investors

	Yes	No
Environmental Issues	82%	18%
Social Issues (excl BEE ownership)	76%	24%
BEE ownership	71%	29%
Corporate governance	76%	24%

A significant proportion of asset managers interviewed (between 70% and 80%) anticipate a growing demand for RI from institutional customers. In particular, many anticipate a growing demand for consideration of environmental issues in investment decision-making. This is promising given the general level of apathy towards environmental issues evident at the time of the survey (Table 6).

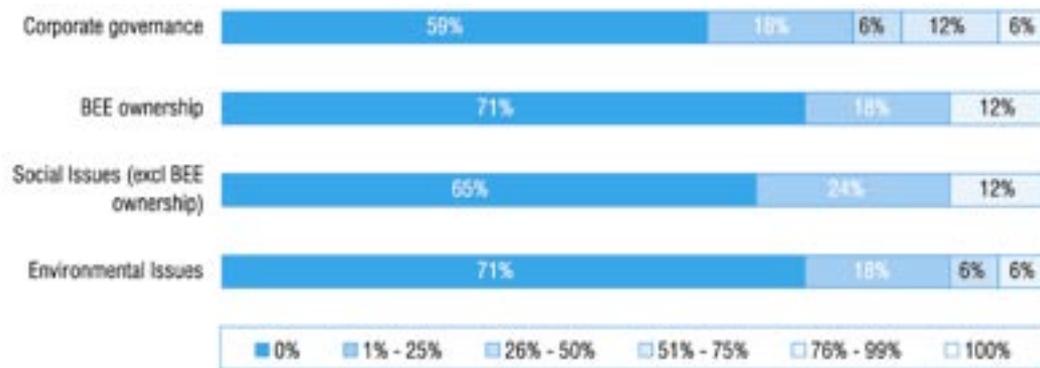
On the other hand, a generally lower proportion of asset managers anticipated the growing demand for considering BEE ownership from institutional investor clients in the near future. This could suggest a sense of optimism that in the very near future, there would no longer be a need for BEE ownership deals. Alternatively it could indicate that asset managers anticipate a growing cynicism amongst investors surrounding BEE deals, particularly concerning BEE funding models and the likely impact of these on investment value.

## Retail Investors

When asked about current demand for RI from retail customers, asset managers indicated the following:

Table 8: Asset Managers - Current Demand from Retail Investors

	0%	1 – 25%	26 – 50%	51 – 75%	76 – 99%	100%
Environmental Issues	71%	18%	6%	-	6%	-
Social Issues (excl BEE ownership)	65%	24%	-	-	12%	-
BEE ownership	71%	18%	-	-	12%	-
Corporate governance	59%	18%	6%	12%	6%	-



**Figure 6: Asset Managers - Current Demand from Retail Investors.** (n=19, respondents asked to indicate what proportion of their retail investors were demanding RI options on a quartile scale of: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

Reported demand from this corner of the market for RI was noticeably lower than that reported for institutional clients. This suggests that retail clients are less aware that firstly, ESG issues can have an impact on investment value and secondly, that by including ESG issues in investment decision-making, they can possibly mitigate any negative impacts of investment on society. It is possible that pension funds have a higher propensity for this type of investment due to union activism and the more social remit this type of activism reflects in investment policies and decision making. Finally, due to their size and nature, pension funds are likely to have a generally broader investment base (“owners” of a large slice of the economy) than retail investors and as such should be more sensitive to general impacts associated with externalising ESG issues in some sectors.

In terms of expected future (next three years) demand from retail customers only about a third of asset managers anticipate an increasing demand for RI products.

**Table 9: Asset Managers - Future Demand from Retail Investors**

	Yes	No
Environmental Issues	35%	65%
Social Issues (excl BEE ownership)	35%	65%
BEE ownership	35%	65%
Corporate governance	35%	65%

## Investment Advisory Service Providers

Finally, in terms of current demand for RI reported by investment advisory service providers:

Table 10: Investment Advisory Service Providers - Current Demand

	0%	1 – 25%	26 – 50%	51 – 75%	76 – 99%	100%
Environmental Issues	44%	56%	-	-	-	-
Social Issues (excl BEE ownership)	33%	44%	22%	-	-	-
BEE ownership	33%	22%	-	22%	22%	-
Corporate governance	33%	33%	11%	11%	11%	-

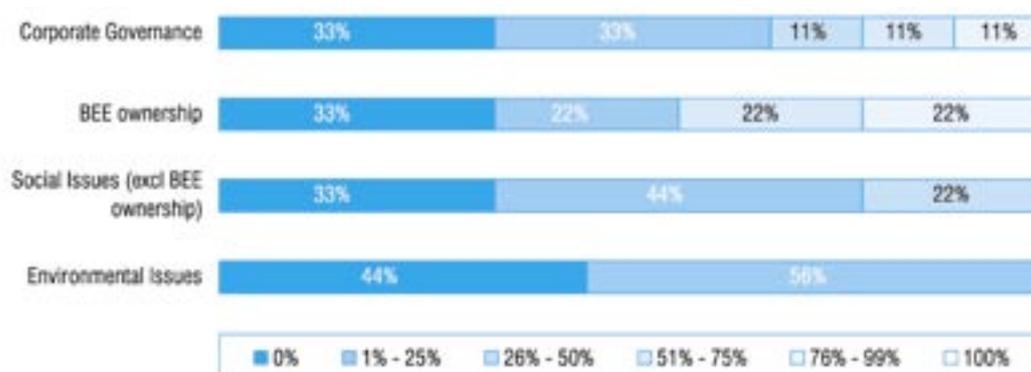


Figure 7: Investment Advisory Service Providers - Current Demand. (n=11, respondents asked to indicate what proportion of their clients were demanding RI options on a quartile scale of: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

Reported demand for investment advisory services that consider ESG issues was generally low across all ESG issue categories presented. In particular, consultants providing investment advisory services to pension funds frequently noted that pension funds usually implicitly delegate any consideration of RI to asset managers without including this into policies or mandates. Finally, a number of interviewees reinforced the general sentiment expressed in all the groups that there was a growing BEE cynicism amongst the investment community.

In terms of expected future demand, investment advisory service providers indicated the following:

Table 11: Investment Advisory Service Providers - Future Demand

	<b>Yes</b>	<b>No</b>
Environmental Issues	45%	55%
Social Issues (excl BEE ownership)	36%	64%
BEE ownership	36%	64%
Corporate governance	45%	55%

Among investment advisory service providers there was a split verdict on whether there would be increasing demand for RI in the near future. At least one respondent indicated that this was more likely to happen in the next ten years than in the relatively short three-year time frame specified in the question.

# responsible investment strategies

This section of the survey focused on learning more about the strategies being employed by pension funds, asset managers and investment advisory service providers to meet current demand for RI. The survey first asked interviewees about their general approach to RI. Specifically, pension funds and asset managers were asked:

## **How would you characterise your current approach to responsible investment?**

- Not important strategy;
- Wait and see;
- Provide a limited range of products to satisfy niche demand / Have a limited proportion of investment portfolio in responsible investments;
- Have a fully integrated responsible investment strategy that is applied to the majority of investments;
- Actively engage with entities in which you have invested on environmental, social and governance issues via shareholder activism or proxy voting.

Investment advisory service providers were asked the same question, but were given the following list of options:

- Do not think it is important – advocate no approach;
- Advocate a wait and see approach;
- Have built limited advisory capacity to satisfy niche demand; and
- Fully integrated responsible investment considerations in majority investment advisory services.

In the case of pension funds and asset managers, the survey asked respondents to disclose the assets managed under a formal RI strategy:

- Please indicate the proportion of your total assets under management that are managed under some sort of formal responsible investment strategy.

Investment advisory service providers were asked the following question in order to gain a better understanding of their approach to RI advice:

- Do you incorporate environmental, social and governance issues into the investment advisory services that you provide?

Finally, respondents were asked to describe their strategies in more detail, specifically focusing on negative and positive screens (as SRI strategies), integrated investment analysis<sup>26</sup> and active engagement<sup>27</sup> as true RI strategies.

## Key Findings

- Despite indicating that the majority of ESG issues discussed were likely to be at least somewhat important in determining investment value, the majority of the respondents stated that they were either doing nothing about RI (39%), or at best had a limited proportion of assets in RI (42%);
- An absolute maximum of between 11% and 15% of assets under management were managed under some sort of formal RI strategy;
- With one or two notable exceptions, the majority of principal officers of pension funds who claimed to invest some assets according to a formal RI strategy, viewed the selection of asset managers as a RI strategy;
- A third of asset managers interviewed indicated that their supply of RI options was limited by the fact that these were not formally demanded by institutional investors in their investment mandates.

## Pension Funds

Principal officers interviewed indicated the following spread of current strategies with respect to RI:

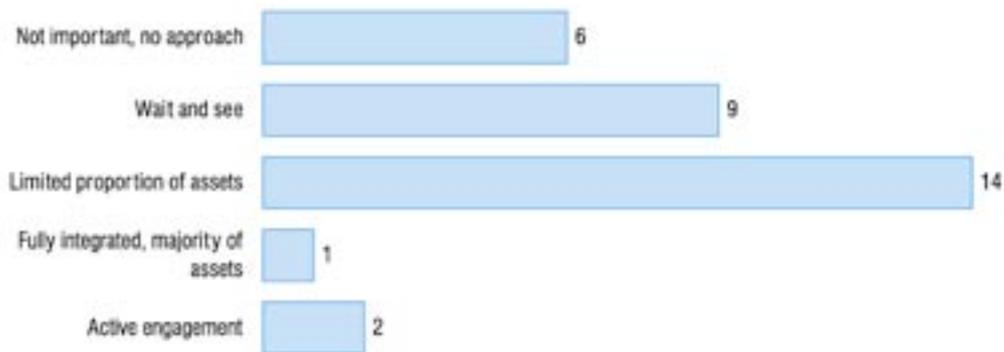


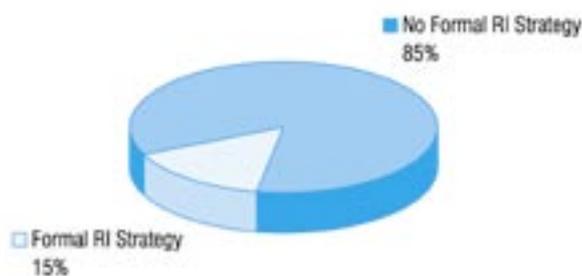
Figure 8: Pension Funds – General Strategy

The majority of pension funds either have no RI strategy (47%) or have a limited proportion of their assets – allocated to RI strategies (44%). Two appear to have an active engagement approach. Only a single pension fund claimed to have a fully integrated approach, which covered the majority of assets although on further interrogation, the validity of this fully integrated approach was highly questionable.

When considered together with the views expressed on the materiality of ESG issues (Figure 1) this result is striking. On the one hand, a significant proportion of principal officers of pension funds think that ESG issues are at least somewhat important in evaluating the likely performance of an investment. In fact, averaged across all issues, only about a third of respondents thought that the issues were not important. Yet only 53% indicated that they have an RI strategy in place, and of these, a further 44% acknowledged that this investment strategy was only applied to a limited proportion of the investment portfolio. In short, there is a noticeable gap between ESG issues principal officers view as important determinants of investment value and the extent to which these are implemented in investment strategy and asset management.

At least part of the explanation for this gap lies in the belief commonly expressed by principal officers that managers automatically take ESG issues into consideration. Although not directly asked, no less than ten of the principal officers interviewed specifically mentioned this assumption in informal discussions during interviews. This assumption implies that these pension funds believe that asset managers apply a formal RI strategy to the majority of assets that they manage. The key question remains: is this assumption valid?

Aggregating the responses from principal officers regarding the proportion of their assets managed under some sort of formal RI strategy, the survey indicated the following overall percentages:



**Figure 9 : Pension Funds – Proportion of Assets Managed Under a Formal RI Strategy.** (n=32, respondents asked to indicate what proportion of their assets were managed under some formal RI strategy on a quartile scale: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

Of the pension funds surveyed, 17 out of the total 32 claimed to have a formal socially responsible or RI strategy, which they applied to at least part of their portfolio (Figure 8). When questioned further on the specific nature of these strategies, 13 principal officers claimed to apply ESG screens (technically an SRI approach), four claimed to have adopted and integrated approach whereby ESG issues were formally included in investment analysis processes, and five claimed to participate in active ownership practices including shareholder activism and proxy voting on ESG issues. In addition, some principal officers claimed that they would engage with companies on ESG issues if there is significant mismanagement. However, without any systematic approach to monitoring ESG issues, this can best be described as an ad-hoc approach to ESG issues, and not necessarily RI strategy.

## Screens

When considering screening techniques used, eight pension funds claimed to apply both positive and negative screens, one claimed to apply negative screens specifically, and one stated that although they claimed to have a strategy that included screens, the nature of these screens was entirely at the discretion of their asset managers. It is arguable whether deferring screening strategy and execution to third party asset managers constitutes a true screening strategy. Beyond this, the only screening criterion that principal officers were able to explicitly describe was positive screening for infrastructure development projects. In addition, when pressed, very few principal officers indicated that these screens were actually embedded into mandates.

## Integrated Approach

Only four pension funds out of 32 interviewed claimed to have an integrated approach to ESG issues covering at least some portion of their assets. When asked to describe the integrated approach at least two out of the four indicated that this approach was limited to selecting asset managers that they believed had an integrated approach. These selections were based on the evaluation of asset managers (conducted by their consultants) and the asset managers specifically mentioned were more often than not the niche RI asset managers.

## Active Ownership

Of the five principal officers who indicated that they pursued an active ownership RI strategy, only a single fund was able to provide a satisfactory description of ESG related engagement activities.

## Member Choice

Although the survey did not explicitly ask any questions regarding member choice approaches in defined contribution schemes, the subject did come up in informal discussions with a number of the principal officers and is worth commenting on. Four principal officers indicated that their pensions

were run on a member choice basis, and that within the portfolio of options were RI options. Shariah funds<sup>28</sup> in particular, was mentioned. However, most of these four respondents indicated that uptake by members of the RI options was either slow, or no different to other options. Given the level of member demand described above, this is hardly surprising.

## Asset Managers

In terms of their general strategies with respect to RI, asset managers interviewed indicated following:



**Figure 10: Asset Managers – General Strategy**

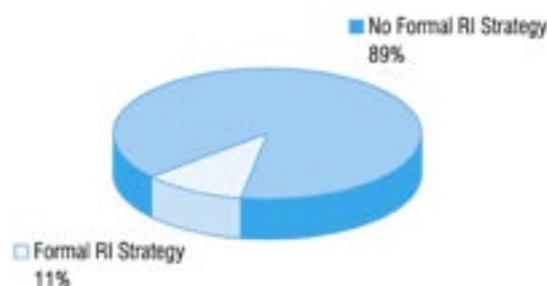
The most interesting aspect of these results is that they essentially provide an answer to the question asked on the validity of assuming that ESG issues are automatically taken into consideration by asset managers. Clearly this is not fully supported by these findings. Only five asset managers stated they had a fully integrated approach to ESG. In other words, only five asset managers would clearly fulfil this assumption. On the surface therefore, this might be interpreted as implying a significant neglect of fiduciary responsibility on the part of pension funds since apparently material ESG issues are not being taken into consideration when making investment decisions, and when managing investments.

There are several possible explanations for this. One of the most likely is that any appetite of principal officers of pension funds for more formal RI strategies is not appropriately translated into investment mandates and hence, the investment processes of selected asset managers. There may simply be a disconnection between the appetite of pension funds and the reality of implementation in investment.

Further, a number of asset managers expressed the view that ESG issues have significant implications on investment value only when gross corporate mismanagement of ESG issues occurs. For example, human rights would only have an impact on investment value in the event of gross human rights violations. While they may not have a formal, fully integrated RI approach, these asset managers do consider and adjust their investments when gross corporate mismanagement of ESG issues occurs.

While this reactionary approach to ESG issues has its merits, it is not consistent with strategic and deliberate RI. Responsible investment is an anticipatory approach to ESG issues, and includes formally assessing investment opportunities for possible ESG mismanagement risks, thereby anticipating any potential value destroying risks and identifying potential value-creating opportunities. Further, RI includes actively working with the managers of underlying investments such as corporations to ensure that the best possible management of ESG issues occurs and assets do not become financially catastrophic extreme incidents.

In terms of the aggregated assets managed by asset managers, the survey indicated that at most 11% of the total assets managed by the interviewed asset managers appear to be managed under some sort of formal RI strategy.



**Figure 11: Asset Managers - Proportion of Assets Managed Under a Formal RI Strategy.** (n=19, respondents asked to indicate what proportion of their assets were managed under some formal RI strategy on a quartile scale: 0%, 1% - 25%, 26% - 50%, 51% - 75%, 76% - 99%, 100%.)

Although not asked specifically, at least one third of respondents indicated that their supply of RI options was significantly limited by the fact that these were not formally demanded by institutional investors in their investment mandates.

## Screens

Ten asset managers claimed to apply negative screens specifically, and ten claimed to apply positive screens to a portion of their portfolios at least. Contrary to the responses of principal officers for

pension funds, respondent asset managers listed a far more comprehensive range of screening criteria including:

- Environmental impact assessments;
- External environmental and social audits;
- Infrastructure development projects; and
- Johannesburg Securities Exchange SRI Index;
- Occupational health and safety standards;
- Shariah criteria;
- Skills development; and
- Tobacco / gambling / alcohol / weapons.

## Active Ownership

Ten of the asset managers interviewed indicated that their RI strategies included an active ownership component. This active ownership described by respondents included both public displays of shareholder activism, as well as more discrete engagement with investment targets. Proxy voting activities depend largely on the nature of the funds and involved either direct voting where applicable, or providing voting advice to clients.

## Integrated Approach

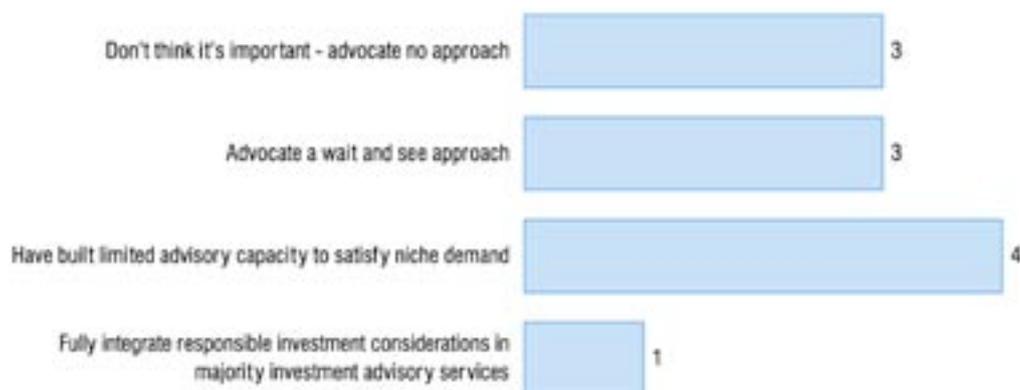
Five of the asset managers interviewed indicated that they applied an integrated approach to at least part of their portfolio. Interpretations of what constituted an integrated approach varied significantly between asset managers. Some described a very formal process whereby ESG issues were embedded into company valuations or the calculation of the cost of credit. Others described a somewhat more qualitative approach which might in fact be closer to a screening approach than a truly integrated approach.

Of the five asset managers with an integrated RI strategy there were two distinct categories. The first were niche players who market themselves to be RI asset managers. While aiming to achieve maximum yield, this group also makes investment decisions based on social and blended returns often selecting investments and sectors for ethical or moral reasons. The second group is comprised of financially focussed asset managers who actively consider ESG issues in as much as these may impact on the underlying financial value of the investment. This category of asset managers will not necessarily exclude making investments based on ethics or moral values if the financial value proposition is strong. In fact in many instances these asset managers will look at poor performance in ESG matters as an indicator of undervalued investments and actively purchase these. They might then engage with these investment targets to resolve the poor performance, if this would unlock value.

It is also interesting to note that a number of these asset managers indicated that if asked whether they were practicing formal RI without the protection of a confidentiality agreement that they would probably say “no”. This is despite actively considering ESG issues in evaluating investments. Their rationale for this was two-fold: firstly, they did not wish to be associated with the common misconception that RI necessarily yields low return and high risk. Secondly, this group generally held the position discussed above that while they would certainly consider ESG issues in as much as they might influence the financial value of an investment, they would not necessarily exclude an investment from their portfolio if there was poor ESG performance.

## Investment Advisory Service Providers

As noted above, investment advisory service providers were given a slightly different set of options when asked to characterise their current approach to RI. In response to this question, the interviewed advisory service providers indicated the following:



**Figure 12 : Investment Advisory Service Providers – General Strategy**

In general, this group appeared to be the most cynical of RI out of the three groups surveyed. Almost a third claimed they did not consider RI to be important and as such advocated no approach in their advisory services. Another 30% claimed to advocate a wait-and-see approach. In total, close to 60% indicated that they currently advocate doing nothing about RI.

**Table 12: Investment Advisory Service Providers – Supply of RI Advisory Services.** (n=11, respondents asked to indicate whether they incorporate the consideration environmental, social and governance issues into the investment advisory services that you provide on a three scale ranking of: “Never”, “On Request” and “By Default”.)

	% of Respondents:		
	Never	On Request	By default
Environmental Issues	73%	18%	9%
Social Issues (excl BEE ownership)	64%	9%	27%
BEE ownership	64%	18%	18%
Corporate governance	55%	18%	27%

The reported supply of RI advisory services was very limited. Where provided, it appeared to be largely limited to the evaluation of niche RI asset managers. This is perfectly in line with the observation discussed above, that many principal officers view an RI strategy as one which begins and ends with the selection of asset managers.



# barriers, drivers and enablers

The last section of the survey focuses on perceived barriers, drivers and likely enablers of RI. The aim here was to gain insights into why RI strategies were not more generally applied, and to try and identify means whereby RI might be encouraged or facilitated.

In order to evaluate this, the survey presented interviewees with the following lists of commonly reported barriers, drivers and enablers and polled respondents on the perceived importance with respect to RI:

## Barriers:

- No evidence for improved financial returns associated with RI
- No evidence for reduced financial returns from responsible investments
- No short-term financial reporting whereas any returns from RI will tend to be long term
- Fiduciary responsibility
- Lack of demand for RI options
- Too costly to implement / Interpretive costs too high
- Do not have necessary expertise
- Lack of adequate information to evaluate investment target ESG related performance
- Do not want to get involved with ethical / moral debates
- Lack of appropriately skilled advisors
- Discouraged by advisors

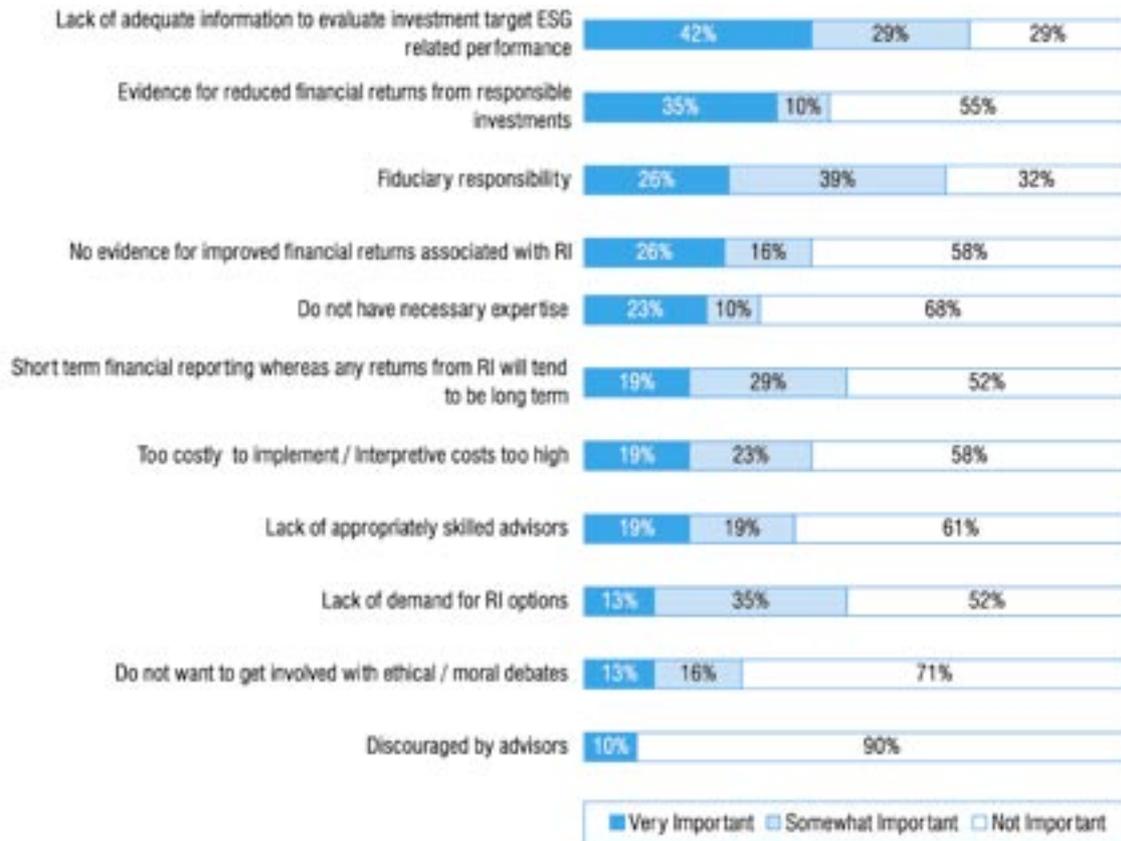
## Drivers:

- Alignment with corporate mission or beliefs
- Pressure from employees (use trustees for pension funds)
- Belief that it will reduce risks
- Belief that it will increase financial returns
- More stringent legislation/regulation
- Pressure from civil society groups
- Pressure from investors

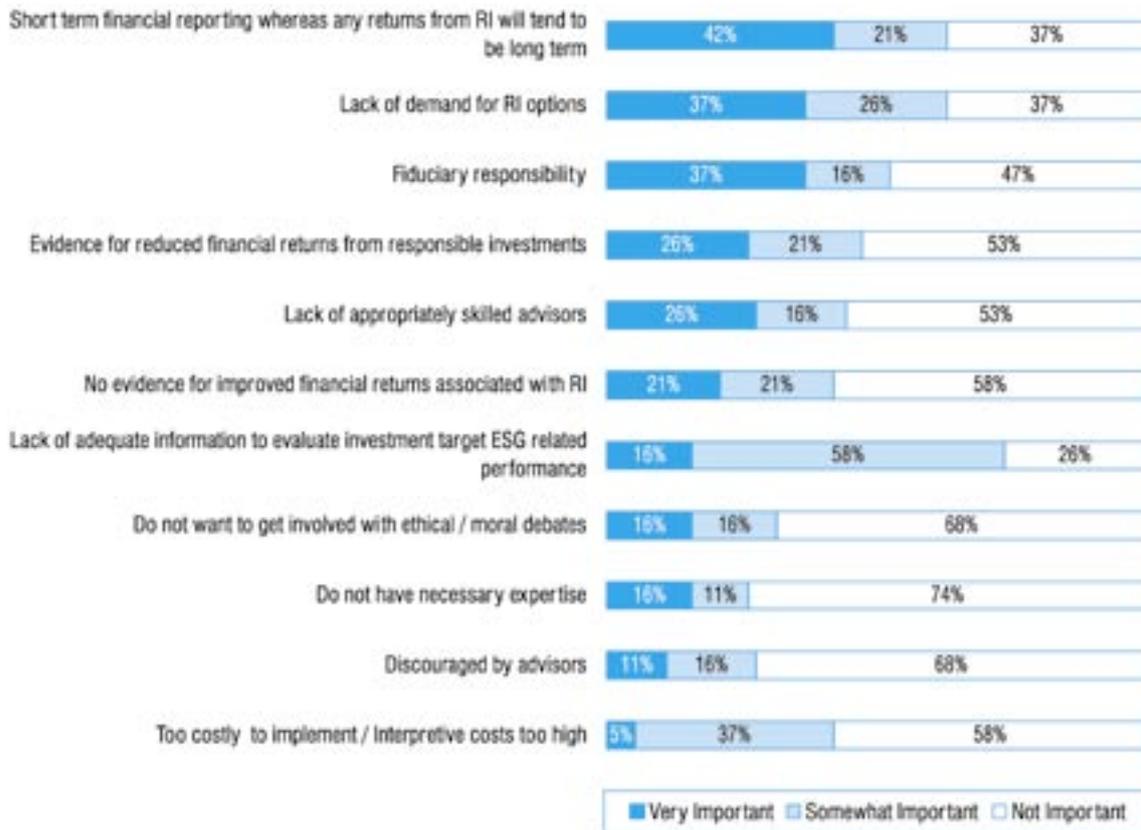
Enablers:

- Co-operative initiatives such as the Enhanced Analytics Initiative<sup>29</sup>
- Mainstream responsible investment benchmarks (e.g. JSE SRI, FTSE 4 GOOD, DJSI)
- Collaboration with civil society organisations
- Responsible investment short courses
- Facilitated industry "conversations"

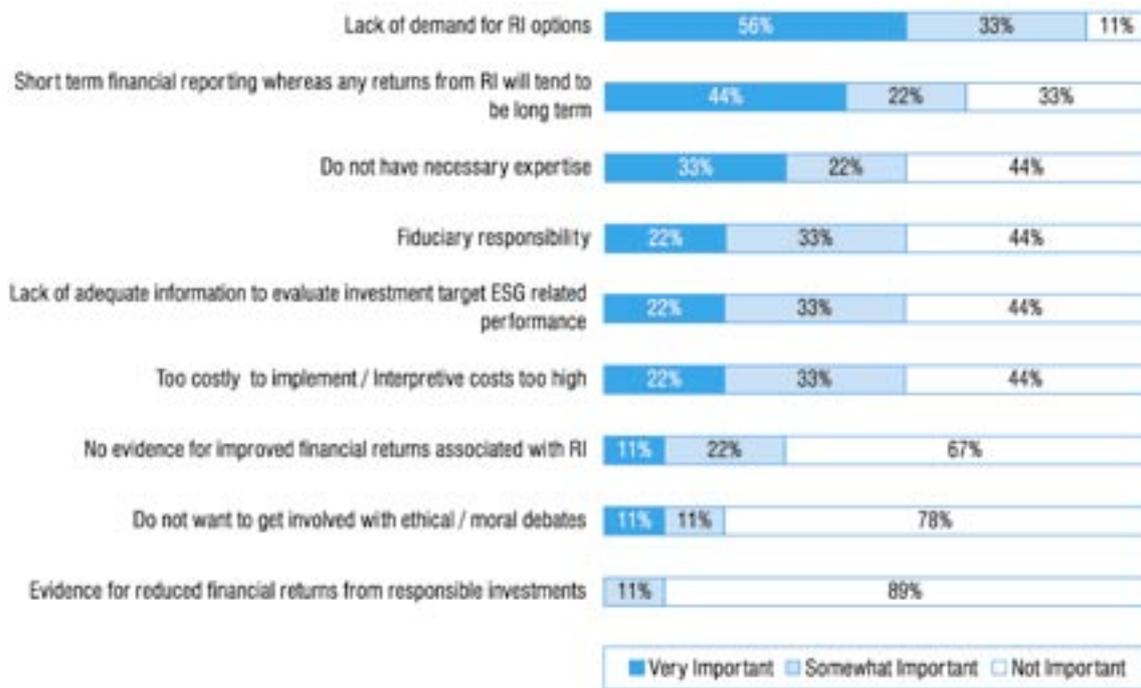
## Responsible Investment Barriers



**Figure 13: Pension Funds - Barriers to RI.** (n=32, respondents asked to indicate importance on a three scale ranking of: "Not Important", "Somewhat Important" and "Very Important")



**Figure 14: Asset Managers - Barriers to RI.** (n=19, respondents asked to indicate importance on a three scale ranking of: "Not Important", "Somewhat Important" and "Very Important")



**Figure 15: Investment Advisory Service Providers - Barriers to RI.** (n=11, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)

In trying to make sense out of these results, the discussion focuses on the three or four most important barriers in each group, and on some of the least important barriers. This enables the comparison of results across the three survey groups.

### Important Barriers Common to All

Looking first at commonalities, all three groups put fiduciary responsibility as an important barrier. This again points to the general misconception that RI necessarily implies increased risk and reduced returns. It also adds fuel to the apparent contradiction discussed above, namely; if ESG issues are important in evaluating the likely performance of investments (as the majority of respondents indicated), then one would actually expect fiduciary responsibility to be a driver rather than a barrier? Considering fiduciary responsibility to be an important barrier simply does not make sense and this is certainly an issue worth exploring further.

## Pension Fund / Investment Professional Group Dichotomy

Apart from fiduciary responsibility, there was on the subject of important barriers, a clear dichotomy between the pension funds and the two investment professional groups (asset managers and the investment advisory service providers). The investment professional groups saw as key barriers, a lack of demand for RI and short-termism in the industry. Pension funds on the other hand, saw evidence for reduced financial returns and inadequate information for evaluation of ESG performance as key barriers.

In terms of lack of demand, the basis for the difference between the groups is not difficult to understand. The relatively weak demand for RI options has already been discussed at great length above. In addition, the somewhat paternalistic attitude expressed by a significant number of pension funds principal officers, and the relative lack of member choice funds have also already been discussed above. The professional investment community run their businesses as businesses and are therefore, demand-driven. Pension funds are run as technical monopolies (members generally have no choice), and are therefore, somewhat less demand-driven.

Superficially, the short-termism dichotomy is also easily explained. It was a commonly expressed view amongst a significant number of the principal officers interviewed that pension funds are inherently long-term in their investment horizon. However, if it is assumed that pension funds represent a significant component of the customer base of the investment professional groups, and it is noted that as a group, investment professionals appear to be strongly demand-driven, then one ought to ask where the pressure for short-termism within the investment community is coming from?

Part of the answer is surely from within the investment professional sector itself. The entire investment paradigm is based on serial trading and profit-taking, and incentive systems are set up to reward short-term performance<sup>30</sup>. However, incentive systems do not evolve in a vacuum, and it stands to reason that pressure from pension funds should play a significant role in perpetuating short-termism. This view is supported by the obvious strong emphasis placed on maximising financial returns by pension funds.

Arguably, the most inexplicable of the important barriers identified was principal officers of pension funds collectively rating the lack of adequate information to evaluate investment target ESG performance as the number one barrier. By all accounts, this group generally does not directly evaluate investment targets themselves. This is usually delegated to asset managers. However, based on comments by principal officers of pension funds, it is possible that this barrier may have been systematically misinterpreted as follows:

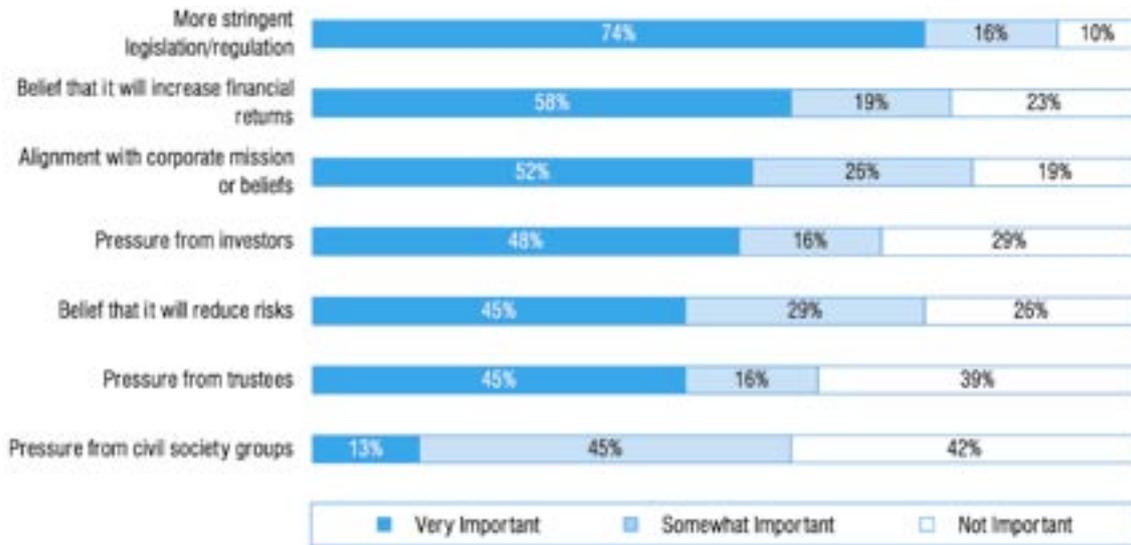
*“Lack of adequate information to evaluate the relative financial performance of responsible investment portfolios”*

Once again, given the emphasis on maximising financial returns for members, this would certainly be a key barrier to the uptake of RI options by pension funds.

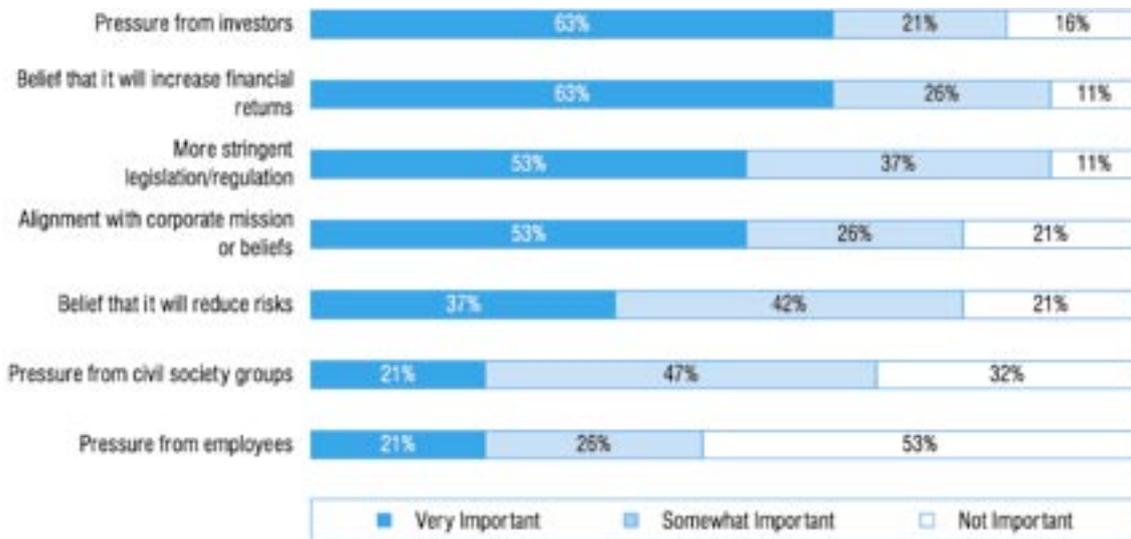
### Least Important Barriers

Looking at the least important barriers, there is one in particular which stands out. The investment advisory service provider group collectively ranked evidence for reduced financial returns from RI as the least important barrier. The obvious implication is that the consensus view within this group is that there is no evidence that financial returns from RI are necessarily lower than investments that do not take into consideration ESG issues. This is almost the complete opposite of the view held by the majority principal officers of pension funds, and indeed by a number of asset managers.

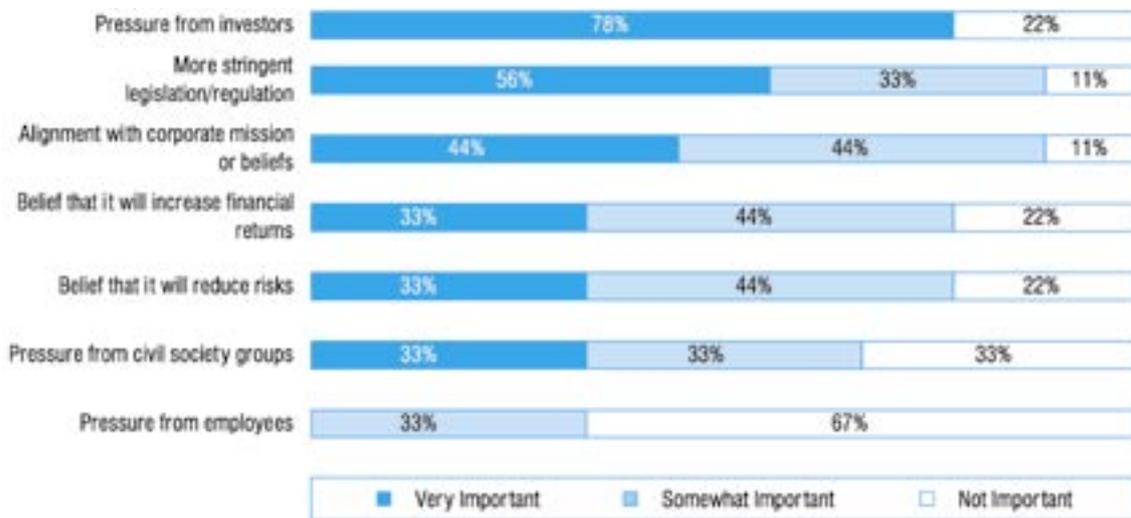
### Responsible Investment Drivers



**Figure 16: Pension Funds - Drivers of RI.** (n=32, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)



**Figure 17: Asset Managers - Drivers of RI.** (n=19, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)



**Figure 18: Investment Advisory Service Providers - Drivers of RI.** (n=11, respondents asked to indicate importance on a three scale ranking of: “Not Important”, “Somewhat Important” and “Very Important”)

Once again, in trying to make sense of these results, the discussion focuses on the three or four most important drivers and on the least important ones. In terms of the most important there is a large degree of consistency between all three groups.

## Regulation

Across all groups, more stringent legislation was ranked as something that would be an important driver (if it existed). To some extent this finding is to be expected: if a certain behavior is a legal requirement, compliance would not be optional.

Besides simply ranking regulation as an important driver, ten respondents made specific comments on this driver. Amongst these, the most commonly expressed view (six out of the ten) was that any form of regulation was a bad idea. Several indicated that they would actively lobby against any attempts at regulation. All but one of these opposing six came from the investment professionals groups rather than the pension funds. Assuming that more RI practices would be a good thing, and that regulation would be a powerful driver of this, one might be tempted to question the motives of this particular lobby group. However, in most cases, legislation or regulation was taken to imply that specific RI targets would be imposed rather than other regulatory options that might exist (e.g. disclosure requirements). And in a certain sense, such targets might well be counter-productive in that they would more than likely further entrench the myth that RI is necessarily a low-return, high risk philanthropic endeavor.

## Financial Returns

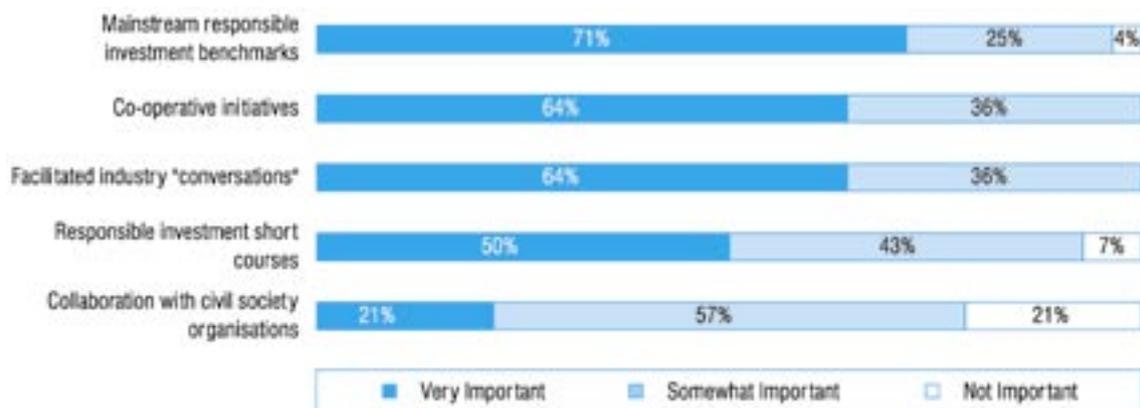
Besides legislation or regulation, all groups expressed the view that evidence for increased financial returns from RI would be an important driver. This view is hardly surprising given the fiduciary responsibility of pension funds, and the very nature of business as a strongly profit driven activity.

Finally, the results here reinforces the view discussed above that the investment professional groups are strongly demand driven. Both investment professional groups ranked pressure from investors as the most important likely driver. Given that there is limited demand this leads to the opposite of a virtuous cycle. Principal officers of pension funds on the other hand collectively ranked this much further down the list of important drivers.

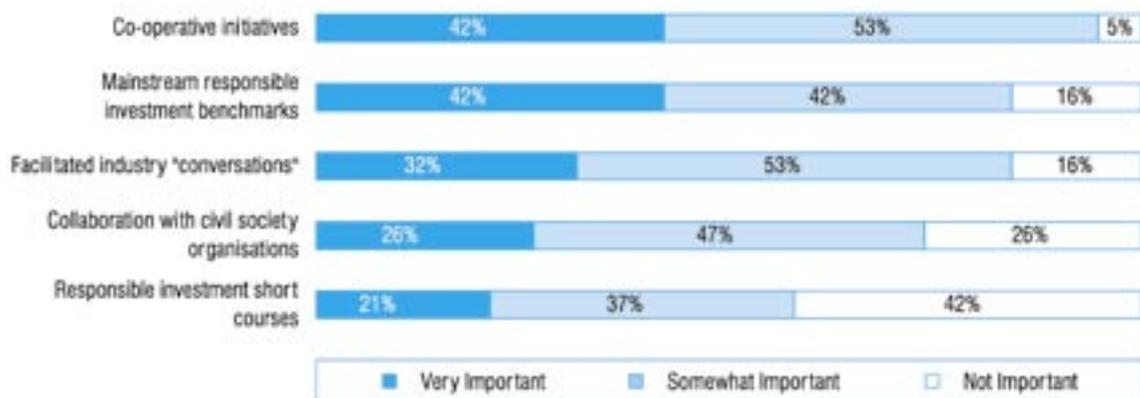
Somewhat paradoxically, principal officers of pension funds ranked pressure from employees as a more important driver than pressure from trustees. The apparently paternalistic approach expressed by a number of funds has already been discussed earlier in this report. This ranking, at first glance appears to contradict this. However, it is possible that this paternalism has evolved out of member apathy and that if pension members were to become more demanding, this would be a significant consideration. Also, in absolute terms, the difference between the two drivers is actually relatively small despite the ranking difference.

Lastly, in terms of least important issues, it is worth noting that across all groups, pressure from civil society groups was consistently ranked at or near the bottom. This low ranking is more than likely due to the fact that most respondents did not consider the labour movement (which would generally find representation through members or employees) to be part of civil society groups.

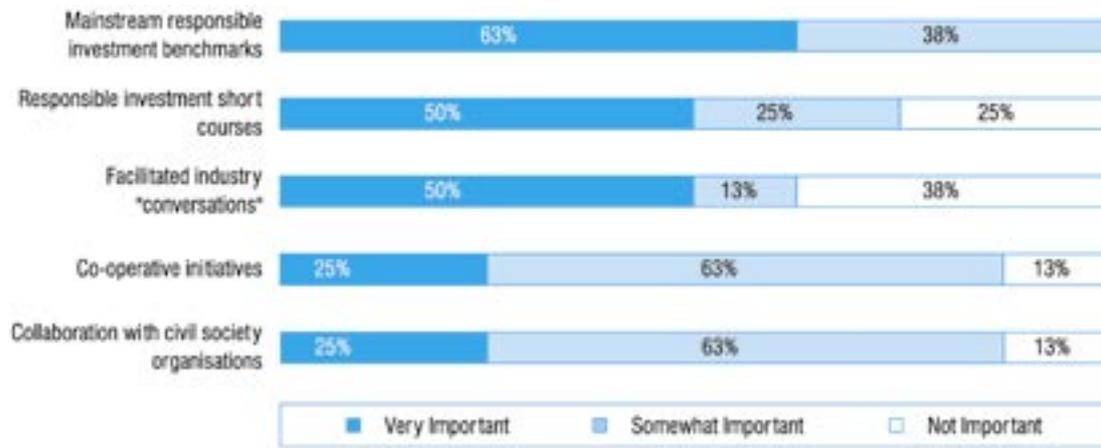
## Responsible Investment Enablers



**Figure 19: Pension Funds - Responsible Investment Enablers.** (n=32, respondents asked to indicate importance on a three scale ranking of: "Of No Value", "Somewhat Valuable" and "Very Valuable")



**Figure 20: Asset Managers - RI Enablers.** (n=19, respondents asked to indicate importance on a three scale ranking of: "Of No Value", "Somewhat Valuable" and "Very Valuable")



**Figure 21: Investment Advisory Service Providers - RI Enablers.** (n=11, respondents asked to indicate importance on a three scale ranking of: "Of No Value", "Somewhat Valuable" and "Very Valuable")

Arguably, the most important feature of these results was that most of the enablers listed were considered to be at least somewhat valuable by most of the respondents.

Looking at the rank order, there was almost a complete agreement across the three groups surveyed (pension funds, asset managers, investment advisors) that mainstream RI benchmarks were likely to be the key enablers. This was clearly driven by a need to better understand the financial performance of RI against more conventional investment approaches. Cooperative initiatives (the example given to interviewees was the Enhanced Analytics Initiative) were also widely viewed as being valuable enablers. The investment advisory service provider group was perhaps the exception here in that this group generally felt that these might be somewhat valuable rather than very valuable.

Although not widely considered to be of no value, at the bottom of the "value pile" were collaboration with civil society organisations and education (RI short courses). Interestingly, the investment service provider group was again a bit of an outlier here in that they collectively ranked short courses much higher. However, this group emphasised that these short courses should be aimed at trustees of pension funds.

# conclusions

The question this survey set out to address was: What is the state of responsible investment in South Africa in 2007? In pursuing an answer to this, the survey focused on pension funds controlling over ZAR 900 billion (US\$ 138.5 billion) in assets and asset managers managing in excess of ZAR 2.3 trillion (US\$ 329.5 billion). It also considered investment advisory service providers. It considered the general understanding of RI, and perceptions on the materiality of ESG issues. It considered the demand for RI, and considered strategies to fulfill this demand. Finally, it looked at the barriers, drivers and enablers of RI.

So, what is the answer to the question?

There is no simple answer. On the up-side, as much as 11% of ZAR 2.3 trillion of assets managed by asset managers may be managed under some formal RI (or SRI) strategy. This is clearly a significant amount of money. In addition, the vast majority of respondents from the investment professionals groups (the asset managers and investment advisory service providers) appeared to be reasonably well versed in RI. The overall impression from these groups then was that they were poised to become more active in the RI arena should demand increase.

On the down-side, demand seemed to be in very short supply. Both investment professional groups (asset managers and advisors) indicated that the lack of demand was a major barrier to the expansion of RI offerings. Ultimately, this lack of demand seemed to be rooted in a general lack of demand from the investor at the end of the value chain as indicated by the very low levels of demand reported for pension fund members (Figure 4) and retail investors (Figure 6).

Given the slightly higher levels of demand experienced by asset managers from their institutional investors, it would appear on the surface that some pension funds at least have recognised a fiduciary duty to pursue RI as defined in this study. However, this demand is actually only marginally higher than that experienced from pension members and retail investors. It is therefore quite possible that a significant portion of this additional demand is driven more by a spirit of philanthropy or by the empowerment financing targets in the FSC, than by fiduciary responsibility. The “2.5%” allocated to high-risk, low-return investments to “give something back to society”.

Indeed, one of the most striking themes to emerge out of this survey was the fiduciary responsibility paradox. On the one hand, the majority of principal officers for pension funds interviewed indicated that a wide range of ESG issues were at least somewhat important in “evaluating the likely performance of investments” (Figure 1). On the other hand, most principal officers indicated that their general approach to RI was either to do nothing, or to put a limited proportion of assets in RI (Figure 8). In addition, the majority of principal officers (63%) indicated that fiduciary responsibility was at least somewhat important as a barrier to participating in RI (Figure 13).

Perhaps part of the reason for this apparent paradox was the significant amount of confusion regarding what exactly RI is amongst pension fund managers. Only about half of the principal officers interviewed had heard of RI and were able to give a satisfactory definition (Table 1). Common misconceptions were that:

- RI is simply investment that ensures that the fund is able to meet its financial liabilities; and that
- RI necessarily meant increased investment risk and more importantly, reduced return i.e. that RI was inherently bad financial investment.

This lack of clarity on the part of principal officers for pension funds leads to the opposite of a virtuous cycle: Pension funds do not demand advisory services on RI and ESG issues from their investment advisory service providers. Because there is a lack of demand, investment advisory service providers do not include ESG issues into advisory services. Being excluded from the advisory services, RI does not filter through to the asset managers in the form of concrete demand in mandates and policies. Ultimately, a lack of demand translates into a low supply, which is more often than not aimed at satisfying a philanthropic or niche requirement.

What then is needed to break this cycle? Looking at the drivers section (Section 6.2) three drivers in particular stood out:

- Pressure from investors (in the case of asset managers and investment advisory service providers);
- Belief that RI will increase financial returns (i.e. a business case); and
- More stringent regulation / legislation.

Pressure from investors is essentially demand and unless there is a sudden surge in interest from the investors at the end of the value chain (pension fund members and retail investors), it seems likely that this can be excluded as a real driver. Imagining interventions that could induce such large increases in demand is difficult (although not impossible).

The options remaining are to either find the business case[s], or design regulation to incorporate ESG issues. As already discussed (Section 6.2), regulation is an option that was widely rejected by respondents. Certainly legislation in the form of minimum RI targets brings with it the problem of entrenching the perception that RI is necessarily high-risk, low-return investment – i.e. that there is no business case.

However, the results of this survey provide significant evidence that a strong business case already exists. After all, the vast majority of respondents across all groups interviewed indicated that a broad range of ESG issues were likely to be at least somewhat important in evaluating the performance of investments (Section 3). What more is required to argue that there is a sound business case to consider ESG issues in making investment decisions than this?

In conclusion, perhaps the biggest need in 2007 in the South African investment context is for certain myths to be dispelled and for this very simple business case to be communicated clearly and widely. Responsible investment is not about philanthropy, although society and the environment in general may benefit from the outcomes. RI is not about sacrificing financial returns in pursuit of some sort of broader social good. Very simply RI is investment that incorporates an active consideration of environmental, social and governance issues (which are widely considered to be material) into investment decision making and ownership.



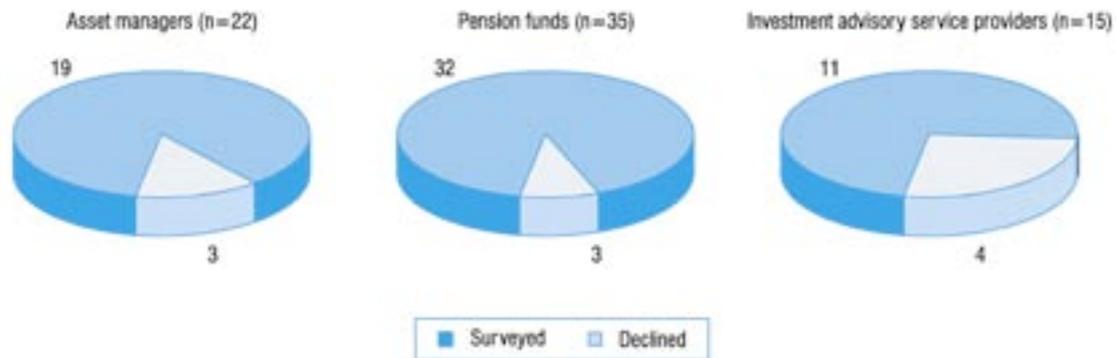
# Notes

- 1 Negative screens involve the exclusion of investments based on a strong moral or ethical position and with little or no regard for the financial consequences (e.g. exclusion of tobacco companies). Positive screens involve the active selection of financially sound sustainability.
- 2 <http://www.unpri.org>
- 3 Corporate philanthropy can be defined as the voluntary giving of wealth by corporations to charitable causes with no explicit expectation of any return.
- 4 [www.aiccafrica.com](http://www.aiccafrica.com)
- 5 De Cleene, S. and Sonnenberg, D. 2002. Socially Responsible Investment in South Africa. African Institute for Corporate Citizenship, Parktown. (A second edition of this was published in 2004)
- 6 The UNEP Finance Initiative is a global partnership between the United Nations Environment Programme and the financial sector. <http://www.unepfi.org>.
- 7 The UNGC is a global network facilitated by the United Nations aimed at bringing companies together with UN agencies, labour and civil society to support universal environmental and social principles. <http://www.unglobalcompact.org>.
- 8 An international group of asset managers that collaborate with the UNEP FI to advance the integration of ESG issues into mainstream investment decision-making.
- 9 The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing. 2004. UNEP FI, [http://www.unepfi.org/fileadmin/documents/amwg\\_materiality\\_equity\\_pricing\\_report\\_2004.pdf](http://www.unepfi.org/fileadmin/documents/amwg_materiality_equity_pricing_report_2004.pdf).
- 10 Freshfields Bruckhaus Deringer. 2005. A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment. UNEP FI.
- 11 The JSE launched the first version of their Socially Responsible Investment (“SRI”) Index in May 2004. The aim of this index is to focus attention on the growing recognition that companies should embrace the triple bottom line as a method of doing business. <http://www.jse.co.za/sri/>.
- 12 Black Economic Empowerment is the South African government sponsored programme aimed at addressing the economic inequalities that resulted from the systematic exclusion of the majority of South Africans from meaningful participation in the economy by apartheid. <http://www.thedti.gov.za/bee/CODESOFGOODPRACTICE.html>.
- 13 CSI can be defined as the laying out of money or capital by a company in the enterprise of broader social development with the expectation of some form of return.
- 14 Financial Mail. 2006. Special Report: Accountability Rating. Financial Mail. October 27, 2006. 128-138.
- 15 A complete list of companies interviewed is provided in APPENDIX 1.
- 16 <http://www.fsb.co.za>

- 17 <http://www.imasa.co.za>
- 18 Based on a ZAR – US\$ exchange rate of ZAR 7.039 to the US\$ as recorded on 1 May 2007.
- 19 Financial Services Board. February 2007. Fidentia placed under curatorship. Available at: <http://www.moneyweb.co.za/mw/view/mw/en/page1655?oid=66354&sn=Detail>. Accessed June 2007.
- 20 The King II Code is currently the *de facto* corporate governance benchmark or in South Africa. A statement of the degree of compliance with the principles of the Code is a listing requirement on the Johannesburg Securities Exchange.
- 21 The FSC commits the Financial Sector in South Africa to 'actively promoting a transformed, vibrant, and globally competitive financial sector that reflects the demographics of South Africa, and contributes to the establishment of an equitable society by effectively providing accessible financial services to black people and by directing investment into targeted sectors of the economy'. [www.fscharter.co.za](http://www.fscharter.co.za).
- 22 Mercer Investment Consulting. 2006. Perspectives on Responsible Investment. A Survey of US Pension Plans, Foundations and Endowments, and Other Long-Term Savings Pools. <http://www.mercer.com>.
- 23 The interpretation of “Health issues” in this survey was broader than that in the US survey which focused on specifically health issues in developing countries arising out of controversy surrounding the pharmaceutical industry.
- 24 Mercer. 2006. 2006 Fearless Forecast. What do investment managers think about responsible investment? <http://www.mercer.com>.
- 25 De Cleene, S. and Sonnenberg, D. 2004. Socially Responsible Investment in South Africa. Second Edition. African Institute for Corporate Citizenship, Parktown.
- 26 An integrated approach involves the explicit inclusion of ESG issues into traditional financial analysis.
- 27 Active engagement is the practice of exercising ownership rights through engagement and voting practices.
- 28 Shariah-compliant investment is ethical investment organised in compliance with Islamic Law.
- 29 <http://www.enhancedanalytics.com>
- 30 Zadek, S., Merme, M & Samans, R. 2005. Mainstreaming Responsible Investment. World Economic Forum & AccountAbility. Geneva.

# appendix 1: the survey sample

In total, the survey attempted to contact 22 asset managers; 35 pension funds; and 15 investment advisory service providers. Of these, 19, 32 and 11 respectively participated. The few non-participants (3 asset managers, 3 pension funds and 4 investment advisory service providers) were a combination of organisations that declined outright or organisations that were abandoned after at least 10 attempts to contact an appropriate person failed.



## Asset manager participants

Metropolitan
Old Mutual
Sanlam
Unity
Abvest
Allan Gray
Barnard Jacobs Mellet
Cadiz
Coronation
Fraters Asset Management

Futuregrowth
Investec
Marriot – The Income Specialists
Public Investment Corporation
Prescient Investment Management
Prudential Portfolio Managers
RE:CM
RMB Asset Management
Stanlib Asset Management

## Pension fund participants

Absa Group Pension Fund
AECI Pension Fund
Altron Group Pension Fund
Amplats Group Provident Fund
De Beers Pension Fund
Dimension Data Group Provident Fund
Durban Pension Fund
Edcon Pension Fund
Engineering Industries Pension Fund
Eskom Pension And Provident Fund
FNB Pension Fund
Foschini Group Retirement Fund
Government Employee Pension Fund
Impala Platinum Workers Provident Fund
Imperial Group Pension Fund
Massmart Pension Fund
Metal Industries Provident Fund
Mine Employees Pension Fund

Mineworkers Provident Fund
Mittal Steel South Africa Pension Fund
Motor Industry Pension Fund
MTN Pension Fund
Murray and Roberts Retirement Fund
Naspers Retirement Fund
Nedcor Pension Fund
Old Mutual Staff Retirement Fund
Pick `n Pay Retirement Fund
Standard Bank Group Retirement Fund
Telkom Retirement Fund
Unilever SA Pension Fund
University of South Africa Retirement Fund
Wooltru Group Retirement Fund

### Investment advisory service provider participants

Alexander Forbes
Fifth Quadrant
NBC
RisCura
Credit Suisse Securities (Andisa)
Deutsche Securities
Investec Securities
JP Morgan
Merrill Lynch
Noah Financial Innovation
UBS Securities



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Noah FI is a niche South African-based stockbroking and financial services firm with an enviable track record of providing innovative, tailored execution and independent research services to institutional investors. Noah's business model is specifically designed to cater for 'unbundled' execution and independent research services in anticipation of global market trends. In addition, Noah believes that the time has come for a new South African company that, in addition to a solid value proposition, has a strong social ethos of contributing to the rebirth and future prosperity of the country and the African continent as a whole.

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The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership between the United Nations Environment Programme and the private financial sector. UNEP FI works closely with the 170 financial institutions that are signatories to the UNEP FI Statements, and a range of partner organisations, to develop and promote linkages between the environment, sustainability and financial performance. Through regional activities, a comprehensive work programme, training activities and research, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations. The PRI Emerging Markets and Developing Countries Project aims to encourage integration of ESG issues in institutional investment impacting emerging markets, and is made possible by UNEP FI and the PRI.

## UNEP FI African Task Force (ATF)

The African Task Force is a platform of financial institutions that collaborate to drive sustainable development, and address the critical environmental and social issues, in Africa. The group's mission is to support and expand sustainable financial practice in Africa. The ATF consists of the following members:

African Institute for Corporate Citizenship  
Banking Association of South Africa  
Citigroup South Africa  
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African Investment Advisory  
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The Centre for Corporate Citizenship is located within the College of Economic and Management Sciences at the University of South Africa. The strategic objectives of the Centre are to provide training and education, conduct research, and create a platform for information sharing and professional

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