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Investing for a world of change

Investing in a net-zero world

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The fast view

- There is growing demand from investors for responsible and impact investing.
- To date the sustainability focus has largely been driven by the institutional investor market and large asset allocators. However retail investors – particularly the younger generation or 'conscious consumers' – are increasingly starting to ask the same questions.
- In the long term, companies that are adapting their business strategies to meet ESG demands should outperform, but in the short term expected returnoutcomes are less clear.
- The race towards net zero is creating supply imbalances, particularly in commodities, which could lead to unintended consequences.
- The debate goes much further than portfolio construction decisions as impacts will be wide ranging, affecting not just sectors or industries but countries and entire geographies.
- Companies are adopting different strategies to improve their ESG metrics. Strategies range from management of ESG risk, integration of ESG priorities in key performance indicators to exclusion or divestment away from ESG problems.
- Our focus is for concerted action to be part of informing the strategies and targets set by investee companies and the industry as a whole.

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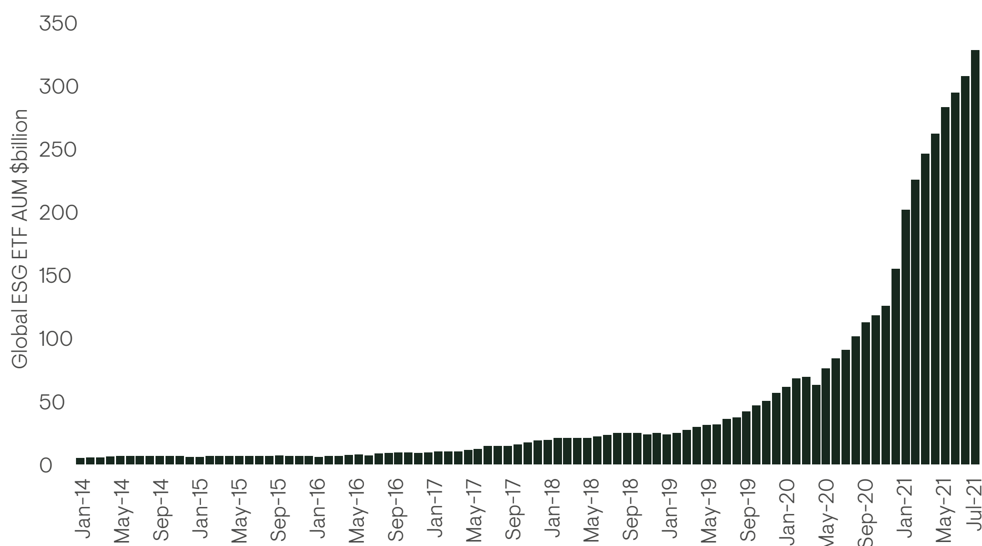
Over the last 2 years, the flow of funds into ESG (environmental, social & governance) funds has risen exponentially and now measures at $325bn in assets under management[1] in exchange traded funds (ETFs) alone. According to Bloomberg Intelligence, global ESG assets under management (AUM) are likely to reach $53 trillion by 2025, approximately a third of forecasted global AUM[2]. It is no wonder therefore that every asset management firm has launched an ESG fund in some form or another. While Europe may be leading the charge in terms of AUM flows into ESG funds[1], the rest of the world is increasingly becoming aware of the merits of this trend and even here in South Africa, integrating ESG factors into investment decision making has become a focus area for many asset owners.

What is clear though is that we are entering a new era for investing. An era where performance (outperformance) is and remains important, but one in which more than just performance matters. Clients, trustees and institutions want to see a 'better world' and are demanding a focus on sound, responsible and impact investing from their asset managers. They also require their asset managers to represent them as a stakeholder and to be held accountable on their efforts in this regard.

Figure 1: The growth in AUM of ESG exchange-traded funds



Source: Trackinsight (1st Jan 2021- 31 July 2021).

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1. https://www.trackinsight.com/en/article/esg-etfs-capture-european-flows-2021.
2. https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.

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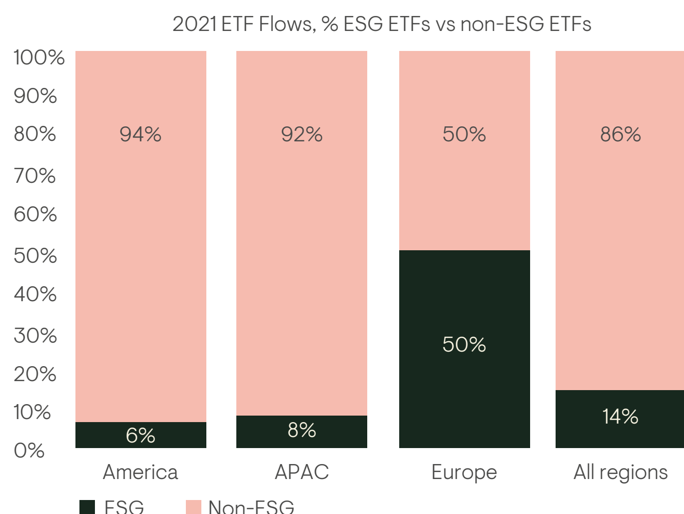
Figure 2: Allocation to ESG ETFs in global ETF flows



Source: Trackinsight (1st Jan 2021- 31 July 2021).

Those who have been running climate-friendly strategies or impact funds will argue that this focus on responsible investing is nothing new. In fact, of the 20 largest global ESG funds by AUM, the oldest fund was launched 34 years ago[3]. The concept of being a responsible corporate citizen is well known, as is linking share price collapses to failures in environmental responsibility (consider the BP oil spill in 2010), social damage (Johnson & Johnson Tylenol recall scandal in 1982) or governance (the Enron collapse in 2007). This supports the view that the ESG movement has steadily been gaining momentum over the last decades to a point today where it has grabbed the attention of mainstream investors. Scientific research has convincingly shown that we are on a path to unsustainable levels of global warming and need to act now to prevent catastrophic consequences for future generations. Growing disparity in income levels and poverty among nations have also risen at an alarming level, prompting urgent action. The unequal access to Covid-19 vaccines globally is a current example of this very point.

To date the sustainability focus has largely been driven by the institutional investor market and large asset allocators. ESG credentials significantly influence how pension funds select asset managers, but retail investors – particularly the younger generation or 'conscious consumers' – are increasingly starting to ask the same questions. The 'conscious consumer' is an umbrella term referring to a consumer who engages in the economy with an awareness of how his or her consumption impacts society at large. These conscious consumers are not only making economic decisions in the checkout line, but are willing to pay higher prices in exchange for more ethical business practices.

In the long term, companies that are adapting their business strategies to meet the needs of a carbon neutral future should outperform simply as the goods and services they provide will be in greater demand. Similarly, well governed and socially conscious companies should benefit from reputational advantages of being able to attract the most talented workers, respectable and skilled board members and loyal customers.

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3. https://www.msci.com/documents/1296102/24720517/Top-20-Largest-ESG-Funds.pdf.

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In the short term however, expected return outcomes are less clear. The race towards net zero is creating supply imbalances, particularly in commodities, which could lead to unintended consequences. Take thermal coal as a case in point. The rapid divestment in coal mines is likely to lead to higher coal prices as supply declines at a far more rapid pace than demand from thermal coal fired powered stations erodes. Not investing in fossil fuel companies therefore could be negative for portfolio returns in the short term.

The debate goes much further than portfolio construction decisions as impacts will be wide ranging, affecting not just sectors or industries but countries and entire geographies. Our own country, South Africa, is vulnerable to climate change. With our limited availability of capital and dependence on 'dirty energy' sources, South Africa – along with other developing markets – needs to argue for a fair transition that would provide us and other carbon-intensive economies with the time, a strategy, finance and other resources needed to transition to a lower-carbon environment.

The reality is that a focus on reducing portfolio carbon, or reported carbon intensity, and a rush by role players to see such reductions could reduce or starve capital out of South Africa and other emerging markets. There is a growing move by some developed countries to implement carbon pricing mechanisms such as carbon taxes, emissions trading systems, carbon credits and carbon tariffs on imports from high carbon emission zones. This would negatively impact the cost competitiveness of South Africa to export goods into the relevant jurisdictions. The European Union and the United Kingdom seems to be the furthest advanced on this issue – and they are South Africa's largest trading partners. There could be divestments from assets of every kind, including stocks and bonds. Foreign capital could become scarce and borrowing costs could increase. This would clearly have dire consequences for the savings of South Africans.

It is therefore critical that the COP26 climate conference taking place next month generates agreement on a practical and fair transition for all of the world's 7.9 billion people, most of whom live in emerging markets and will rely on dirty energy sources for a long time to come.

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A number of listed companies, and investment managers, seem to only focus on a simplistic reduction of their reported carbon emissions rather than an overall global decarbonisation plan. Some resource companies are divesting from carbon-intensive legacy businesses in order to get rid of the negative narrative and perception. A recent example is Anglo American, which unbundled its South African thermal coal assets as it pushes towards carbon neutrality by 2040. Conversely Glencore is following a strategy of responsible ownership, recently buying out Anglo American and BHP in their thermal coal mining venture Cerrejon.

Differently, Exxaro is pursuing a strategy of reinvesting cash generated from their thermal coal business into building a renewable energy and green metals business alongside. Lastly, companies like Sasol have no choice but to manage transition risks. At their recent much anticipated capital markets day, they unveiled ambitious targets for significant carbon reduction by 2030 and carbon neutrality by 2050, which will entail the building of gas infrastructure and growth in nascent technologies like the hydrogen economy whilst maintaining its much needed coal-to-petrol supply for South Africa and the vital employment of thousands. We are arguing that it is sensible to remain invested in high-carbon emitters – places and enterprises – on condition that investment is used as leverage to ensure they transition to net zero over time.

Companies are adopting different strategies to answer this call to improve their ESG metrics. Strategies chosen range from management of ESG risk, integration of ESG priorities in key performance indicators to exclusion or divestment away from ESG problems. In particular, the expectation on companies to show leadership on climate change will necessarily transform the way they source materials, operate factories, design products and deliver them to consumers. Many companies that have made net-zero commitments are at the early stages of transitioning their operations and supply chains. As consumer and shareholder pressure mounts, an important consideration for management teams is to understand the total emissions impact across the value chain and identify the largest emissions sources. These include downstream (scope 3) emissions, generally the largest sources of emissions for most companies.

There is no doubt that the investment landscape is changing. As a team our focus is for concerted action to be part of informing the strategies and targets set by investee companies and the industry as a whole. This involves having in place investment evaluation and engagement mechanisms to follow through on our commitment towards responsible investing, with robust accountability structures internally.

As South African investors, the challenge for us going forward is to evolve the overall investing discussion towards an increased appreciation of the social and environmental risks as deserving of higher prioritisation. This is a challenge we eagerly take up.

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