ENVIRONNMENTAL POLICY RESEARCH UNIT

Environmentally Responsible Investment in South Africa: The state of play

A survey of responsible investor opinions and practices

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About the Author

Stéphanie Giamporcaro is a Post-doctorate Research Fellow at the Environmental Policy Research Unit which is housed in the School of Economics of the University of Cape Town, South Africa. Her current research program focuses on the analysis of the implementation of responsible investment approaches in South Africa and how these approaches can facilitate environmentally responsible economic growth in the country. In 2005 she edited an academic research book on Sustainable Consumption titled *Pour une autre consommation*. In July 2006, she obtained a PhD in Social Sciences on the Responsible Investment (RI) movement in France, co-funded by the French government and the research centre Novethic. Her research interests are social studies of finance, economic sociology and the social construction of CSR metrics, responsible investment and carbon finance. She is published in *Sciences de la Société*, *Cahiers Français* and *Revue d'Economie Financière*. During six years (2002-2007), she was the head of Responsible Investment Research for Novethic, a professional research centre on Sustainable/ Responsible Investment, Corporate Social Responsibility and Sustainability that is located in Paris, France. Novethic is a subsidiary of Caisse des Dépôts et Consignations, one of the biggest public investment groups in France.

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Introduction: What scope for environmentally responsible Investment in South Africa?

As the economic recession led the worldwide media headlines in 2009, it was closely followed by the rising concern for climate change. Slowly but surely **Climate change** and other environmental concerns such as water scarcity and biodiversity are climbing in the civic, economic and political agendas of the leaders of the developed and developing countries.

This growing awareness around environmental risks is also to be seen in **the market world** with a growing number of international corporations starting to implement and communicating their environmental sustainability strategies. In the investment arena, in the United States, following numerous environmental disasters that took place at the end of the eighties (the Exxon Valdez wreckage, Bhopal chemical catastrophe) environmental questions and particularly climate change questions rose to the top of **responsible investors' agendas**. CalPERS, the largest public pension fund in the United States and a signatory in 2007 of **the Principles for Responsible Investing** (PRI), implemented from 2003 an environmental strategy to improve data transparency and timely disclosure of environmental impacts such as those associated with climate change, through shareholder resolutions and shareholder coalitions. Around year 2000 both in the United States and in Europe, coalitions of responsible investors such as the **Carbon Disclosure Project** (CDP) and the **Institutional Investors Group on Climate Change** (IICCG) were established. In Europe, 192 theme funds marketed as **environmental funds** were offered at the end of 2008, investing primarily in green technologies.

South Africa is today a country that is wrestling with its economic development challenges in a context of growing climate change anxiety. The South African financial sector is itself having to define its role as an instrument for environmentally responsible economic growth. The investment sector in particular has for the past decade been engaging with its own response to the new world of responsible investing as demonstrated by growing participation by industry players in initiatives such as the PRI.

The motivating questions driving this research are:

Is the SA investment industry an agent for environmentally responsible economic growth in SA? How can the sector successfully play this role and can environmentally responsible investment principles become part of mainstream investment philosophy and practices in future?

I. Research Methodology

This paper seeks to map out the state of play of ERI in South Africa today. The research was conducted between **June and December 2009** through desktop research and interviews. The desktop research aimed primarily to measure the size and trends of the South African SRI fund market and to obtain an initial view of the integration of environmental issues. The primary goal of the field research through interviews was to further explore the **ERI practices** adopted by **responsible investors** and to collect **their opinions** on the integration of environmental risks in the SA investment industry.

A. Desktop Research

The desktop research was done through searches on the websites of the asset manager/SRI fund providers - their quarterly reports, fund fact sheets and investment policy statements. A database of asset managers was then created which included PRI signatories and asset managers that are not PRI signatories but that offer SRI products. The database quantified each asset manager's involvement in SRI if any, and outlined the strategies adopted and the scope and focus of these funds. On the Pension Fund (asset owner) side, further research was conducted through the websites of the relevant bodies, as well as through collection of legal documents and National Treasury Discussion Papers regarding pension fund legislation. The desktop research was supplemented by drawing on a range of relevant international and local literature.

B. Interviews: targeting responsible investors

Face to face interviews were done mainly with **PRI signatories**. The list of the South African PRI signatories was obtained from the PRI website. This group of responsible investors was targeted because it was assumed based on previous research experience led in France that they would demonstrate a more sophisticated understanding and analysis of the question of the integration of environmental concerns into investment decision making processes and shareholder practices. Nevertheless on the category of asset managers which represents the major bulk of PRI signatories and represented our principal focus, it was also decided to include:

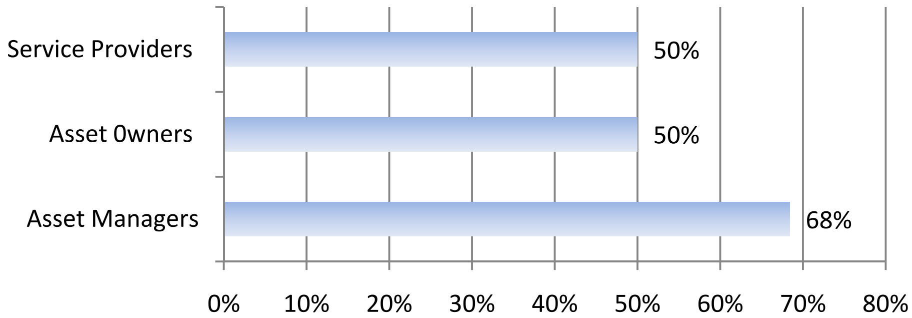
- Asset management houses not signatories of the PRI but suppliers of SRI investment products and,

- The 20 biggest asset management houses in South Africa according to an Alexander Forbes Institutional Investment Survey (End of December 2008).

The idea behind this last inclusion was to establish whether any of the largest South African asset management was in the process of signing the PRI or developing an SRI product. The strategy paid since we were able to identify 1 AM preparing to sign the PRI. Finally from the departure sample of **34 organizations**, **22 interviews,** amounting to a **65% success rate,** were realized between August and December 2009 in Johannesburg and Cape Town, face to face or by telephone.

12 of the **19 asset managers, 1 of the 2 asset owners and 3 of the 6 service providers** listed as PRI signatories at beginning of March 2009 were reached. 2 of the asset managers interviewed were no longer listed as PRI signatories in July 2009 but two other asset managers were listed as new signatories.

PRI signatories reach rate



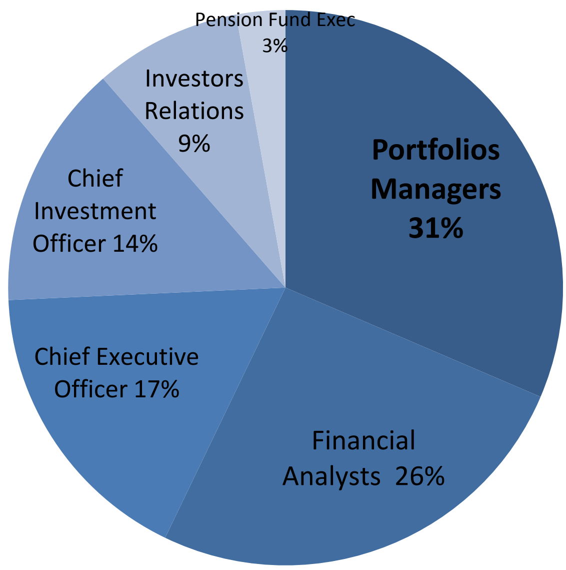
Even though the research sample is strongly biased towards signatories of the PRI, it needs to be emphasized that it does not mean that the survey targeted a marginal community of investors. Indeed in terms of overall reach of the SA investment industry, the field survey reached **60%** of the **20 biggest SA management houses** of whom **12** are PRI signatories.

C. Characteristics of the respondents

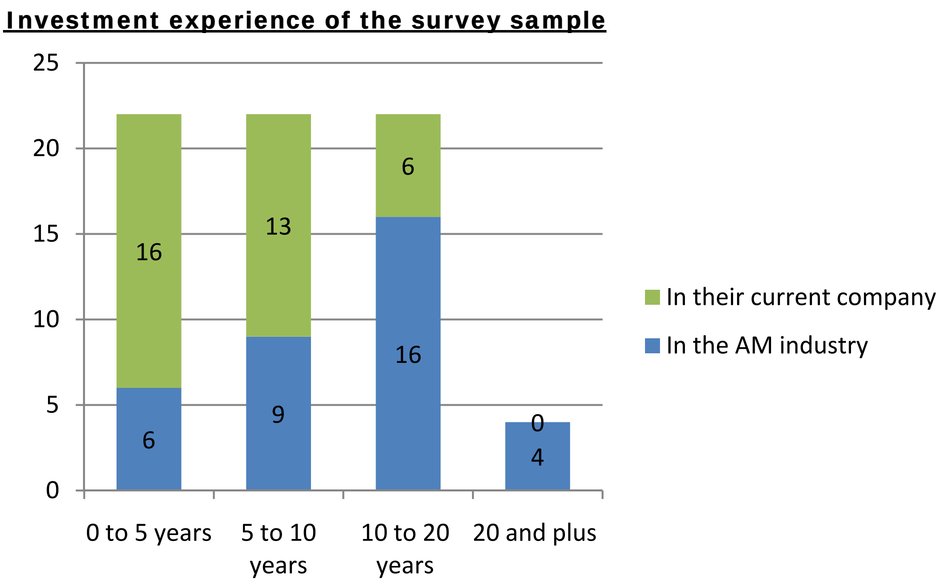
Interviews were fully transcribed and on average lasted **1 hour and a half**. **Anonymity** was granted to the respondents meaning that verbatim quotes would not be linked to their names or the names of their organisations. When a quote is mentioned, we use a coding system: **R1** corresponds to **Respondent 1** for example. Nevertheless, in order to contextualize the research, a list of the organizations targeted and interviewed is given in Appendix A.

From the **22 organisations** that participated in the research, we interviewed **35 individuals**. **Portfolio managers** (**31%**) and financial analysts (**26%**) represent the big part of the interviewee population. **Chief Investment Officers** (**14%**) and **Chief Executive Officers** (**17%**) usually accompanied by their staff responded directly to our question, showing apparently that the interest for responsible investment questions was embraced at the higher levels of the organisations.

Job functions occupied by the survey sample



Another interesting fact to note is that of the 35 individuals interviewed, **40%** declared to occupy the role of **Head of SRI** in their organisations indicating advanced awareness of SRI/RI concerns. It also appears that the majority of the professionals we met were quite senior in the asset management industry but that most of them were not in their current organisation for more than 5 years.



Further details were asked during the interview on asset management style, stock picking techniques and investment constraints adopted. **Fourteen** of **15** Asset Management houses (excluding multi-managers) interviewed declared to implement **active asset management techniques** rather than **passive techniques**. Among the **14** active asset management houses, **6** organizations were described as **using a mix of qualitative and quantitative techniques** whereas **7** were described as only using **qualitative techniques** such as fundamental analysis of companies. **2** houses declared to also implement **hedging techniques**. Only **1** asset management house described itself as a **purely quantitative house**. Even though it cannot be strictly statistically proven on this type of small qualitative sample, in South Africa as also observed in France during previous research, it appeared that generally qualitative stock picking techniques relying **on fundamental analysis of companies** share common ground with SRI/RI principles that also require the necessity of in depth analysis of companies.

D. Interview process

The interview guideline was semi-structured. This meant that some questions were closed questions whereas other questions were designed to let the interviewees to develop their own thinking on a specific point. The challenges of the guideline remain the fact that interviewees presented **a diversified** range of **practices and opinions** concerning environmentally responsible investment **(ERI)**. The major difficulty was to focus the discussion precisely on environmentally responsible investment practices and opinions instead of more general practices and views on responsible investment and SRI products. Thus the guideline was strictly structured but was adapted for each interviewee in case it was experienced that questions were not relevant for the interviewees. Nevertheless, the interviews followed the steps described here:

Details of the interview guideline

Part I: Detailed information on the respondent	Age, Training, Job Function, Experience in the investment industry and the organisation
Part II: Detailed Information on the organization of the respondent	Asset management style of the house , asset allocation, geographical zone of investment, clients and investment philosophy
Part III: Definition of Responsible Investment and environmental themes.	Spontaneous definition of SRI / RI, reaction to a specific definition of SRI, spontaneous definition of environmental themes
Part IV: ERI practices	Current SRI products supply and RI philosophy, integration of environmental concerns in the currents SRI products and RI philosophy
Part V: General Views on the future development of environmentally responsible approaches	*"Do you wish to see a growth of environmentally responsible approaches in the SA investment industry?"* *"Do you think there will be a growth of environmentally responsible approaches in the SA investment industry?"*
Part VI: Identification of Obstacles and Enablers to a further integration of environmental concerns	"*According to you what are the main obstacles and enablers to further environmental concerns integrations in the investment industry?"* -At the international investment level -At the South African international investment level -At the firm level
Part VII: Reaction to a set of obstacles and enablers to ERI identified in the academic literature through a series of illustrative quotes	-Short termism of the financial market -Herding/ Peer and clients pressure -Incentive Structures

The research followed an inventive process in Part VII of the interview. Respondents were asked to read quotes from portfolio managers or institutional investors taken from international academic literature. It was decided to use this research protocol amounting to borrowing the statements of finance industry peers using real quotes instead of research questions such as: "Do you think that short termism of the financial market represents an obstacle to environmentally responsible approaches" to break the routine of the interviews and to inject some playfulness by engaging more directly the respondent in the thinking process. Each quote illustrated a specific obstacle or enabler judged as important to test. After reading the quotes, interviewees were asked to say if they agreed or not with the quote, if they were experiencing similar obstacles or enablers in their professional activity and if they thought that being a South African portfolio manager had influence in their points of view. The research protocol designed was quite demanding for the interviewees since they had to read and to react quickly to quite complex assertions in a short period of time. It was assumed that this part of the research protocol had a large chance to be rejected by a large part the population sample. Eventually, even though the level of commitment and playfulness varied from a respondent to another, it was well received and led to interesting reactions and research results.

II. SRI funds: A limited scope for an environmental focus

A. Size of the South African SRI funds market

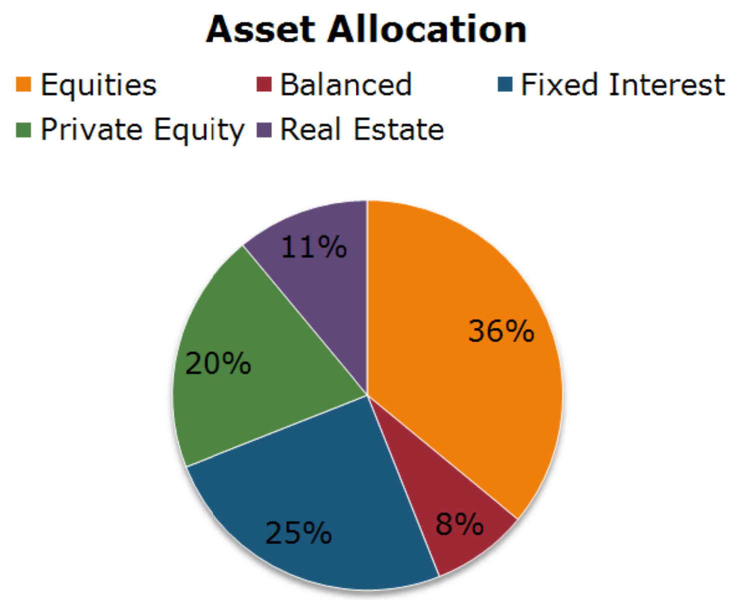
In 2009, there were **38 SRI labeled products** in South Africa, standing approximately at a market value of **R23.28bn** (July 2009). This figure represents approximately 1.04% of total investments in the country. The figures calculated are an estimation of the size of the local SRI sector. The market values of the funds in the following table give the total assets managed by each fund as in June/July 2009.

South Africa SRI labelled funds

Fund Type	Fund Name	Assets Managed Million
Equity	Element Earth Equity Fund	R476
	Element Islamic Equity Fund	R103l
	Futuregrowth Albaraka Equity Fund	R801.5
	Futuregrowth Infrastructure & Development Equity Fund	R490,2
	Futuregrowth SRI Equity Fund	R42
	Investec Jadwa Africa Equity Freestyle Fund	USD 11
	Investec RI Equity Fund	R390
	Oasis Crescent Equity Fund	R3127
	Oasis Crescent International Fund of Funds	R374
	Old Mutual Community Growth Equity Fund	R2.4 billion
	Prescient SRI Equity Active Quant	Unavailable
	Sanlam SRI Equity Fund	R50
	Sasfin TwentyTen Fund	R97.04
	STANLIB Shari'ah Equity Fund	R123.4
Balanced	Advantage Shari'ah Fund	R4.6
	Advantage/Momentum Super Nation Fund	R72
	Cadiz Money Market Fund	R112
	Futuregrowth SRI Balanced Fund	R6
	Investec TDI Balanced Fund	R96
	Metropolitan African Wealth Creator	R1.1 billion
	Old Mutual Community Growth Equity Fund of Funds	Unavailable
	Sanlam Infrastructure Fund	R250 mill
	STANLIB Corporate Wealth Development Fund	R250 mill
	27 Four Shari'ah Fund	R30 mill
Fixed Interest	Cadiz Infrastructure Bond Fund	R53.9 mill
	Cadiz SRI Bond Fund	R105.7 mill
	Coronation Siyakha Bond Fund	R27 mill
	Futuregrowth Infrastructure and Development Bond Fund	R 4.6 bn
	Old Mutual Community Growth Gilt Fund	R 900 mill
	Old Mutual Community Growth Money Market Fund	R 17.7 mill
	Sanlam SRI Bond Fund	R 150 mill
Alternative / Private Equity	EMF Kagiso Infrastructure Empowerment Fund	R 649 mill
	Investment Solutions Sakhiswe Fund	R80 mill
	Investment Solutions Shari'ah Fund	R1 bn
	Macquarie and Old Mutual AIIF African Infrastructure Investment Fund	R 721 mill
	Macquarie and Old Mutual SAIF South African Infrastructure Fund	R1.32 bn
	OMIGSA Ideas Fund	R2.25 bn
Property	Futuregrowth Community Property Fund	R2.6 bn

Source: Researchers' own construct Asset allocation (assets under management), equities and fixed-interest:

% of SRI assets by asset type in South Africa



B. Responsible Investing (RI) Strategies

Worldwide there are two main strategies available to responsible investors: screening and active owner strategies that can be described as:

SCREENING STRATEGIES

Negative screening: This strategy consists of avoiding investment in some sectors (tobacco, alcohol, armaments) or in specific companies violating Human Rights

Positive screening: This strategy consists of investing in « positive » sectors such as renewable energies, clean transport, infrastructure in developing countries or in specific companies acting proactively on a specific concern such as BEE (in SA). **Cause-based or targeted investments** in South Africa are a form of positive screening focused on primary investment/unlisted space. These investments often focus on BEE companies, infrastructure, or start-ups that are likely to create employment.

Best of sector screening: This strategy consists of investing in the best companies concerning ESG issues in an economic sector. This requires detailed ESG scoring of companies by criteria.

ACTIVE SHAREOWNERSHIP

Engagement: Spread in UK and growing in South Africa. It consists of private dialogue with company boards and management on ESG issues

Proxy voting: Spread in the USA, UK and growing in SA consists of voting and proposing new resolutions at company annual general meetings

International shareholders coalitions: Spread internationally, consists of being part of a group of investors fighting for a special ESG issue e.g.: Carbon Disclosure Project, Transparency Initiative.

The research identified the following strategies adopted by South African responsible investors:

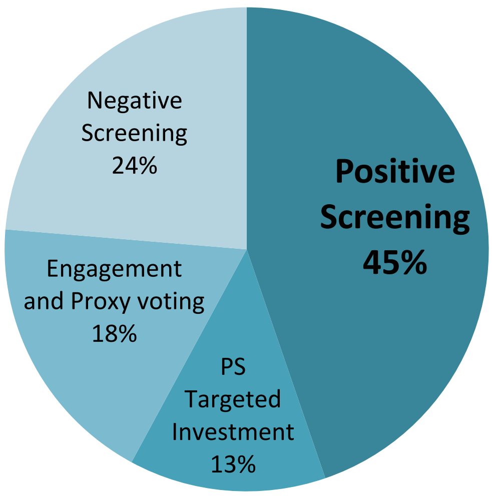
-A majority of 22 SRI labelled funds appear to adopt a **positive screening approach** (including targeted investment approaches)

-7 funds adopt responsible strategies based on **engagement and proxy voting**. **6** of these combine this strategy with positive screening

-9 funds adopt **negative screening** (Shariah compliant). Shariah compliant funds employ a negative screening strategy consisting of the exclusion of alcohol, gambling, pornography, Non hallal foodstuffs, financial institutions and companies with high level of financial leverage (gearing) debtors and interest income.

It is interesting to note that unlike France where the best of sector screening practice based on underweighting or overweighting your portfolio based on companies' ESG scores is widely spread, SRI labelled funds in South Africa do not apparently implement such practice. Similar to the UK, engagement and positive screening are favoured.

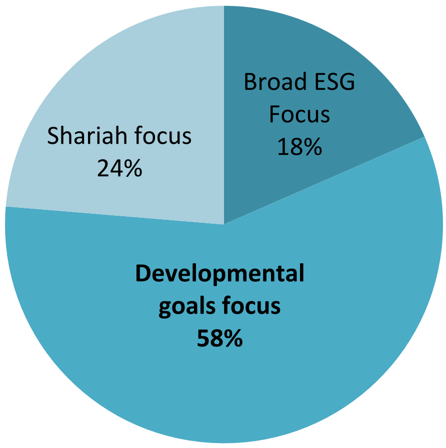
SRI labelled funds and RI strategies adopted



C. Environmental Focus

SRI funds that have a negative screening, mainly Shariah compliant focus are not characterized by an integration of environmental concerns **(24%)**. A majority of funds (**58%**) characterized by a positive screening approach on listed equities and unlisted targeted investments focus primarily on black economic empowerment (BEE) and development goals such as poverty alleviation, job creation or infrastructure development (housing, transports, retailing). **18%** of the funds which in their majority combine positive screening and engagement on the listed space can be described as adopting a broad ESG focus.

RI Focus of SRI labelled funds



In all these funds, environmental issues are seen to be taken into account as part of social and corporate governance matters in the analysis of companies, investment decision making and engagement/proxy voting process. It is interesting to note that unlike Europe, the South African SRI labelled asset management funds industry has not developed for now **thematic green funds** focused on clean or renewable energies for example.

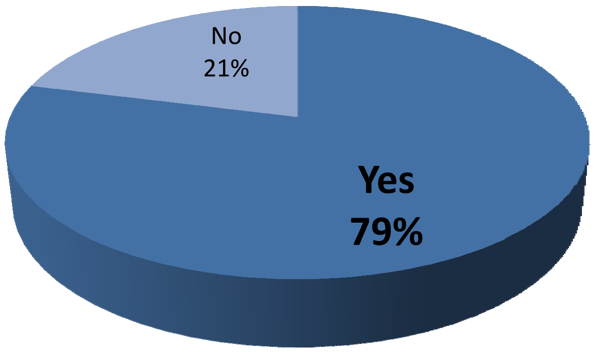
Thus, The SRI funds labelled market appears to be strongly driven by a focus on social transformation and **currently indicates little interest or action for environmental themes**. The next section will explore further the ERI practices of responsible investors.

III. Exploring ERI Practices

A. SRI funds, RI strategies and ERI products and services

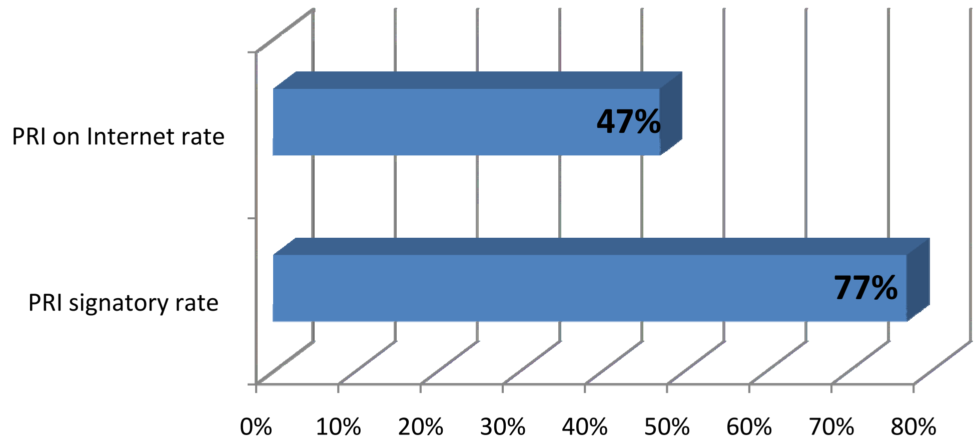
A majority of asset manager and asset owner respondents **(15)** were managing or distributing SRI labelled funds at the time of the interviews. **8** invested in a range of SRI labelled products whereas **6** had focused their investments on a specific SRI labelled fund. **Respondent 4** explained that a range of SRI labelled funds had been created but that they could be considered as dormant products since no investors were currently invested in them. On the minority of asset managers without any SRI labelled products, **Respondents 5** and **13** explained that it was a choice of their companies to not create SRI niche products but to try to implement progressively a transversal responsible investment philosophy.

Percentage of AM / AO respondents managing / investing in SRI labelled funds



Regarding the adoption of the PRI, the final research sample consisted of **17 PRI signatories** at the time of the interviews and **5 non PRI signatories**. Of the 5 non PRI signatories, a majority explained that their upper management was at the time considering signing the principles. Nevertheless funds signing the PRI did not mean that this information was communicated, notably through the funds' own websites:

PRI signature rate and PRI communication



Indeed, only **47%** of the PRI signatory respondents communicate on their corporate website on their adoption of the principles. And if they do, they do it mostly by outlining the **6 principles** without any illustrative examples on how these organisations implement the principles. No reporting on specific environmentally responsible strategies was identified.

PRI PRINCIPLES

PRI an international initiative established by the UNEP Finance Initiative and partner of UN Global Compact was launched in 2006. It totals today more than 350 signatories representing more than US$ 14 trillion.

In becoming a signatory to the following principles, investors take on the duty to act in the best long term interests of their beneficiaries. Firstly, in fulfilling a fiduciary role, signatories believe that ESG issues can affect the performance of investment portfolios; and secondly, there is recognition that applying the principles better aligns investors with the broader objectives of society

Hence, investors commit themselves to:

- Incorporating ESG issues into investment analysis and decision-making processes.
- Being active owners and incorporating ESG issues into our ownership policies and practices.
- Seeking appropriate disclosure on ESG issues by the entities in which we invest.
- Promoting acceptance and implementation of the Principles within the investment industry.
- Working together to enhance our effectiveness in implementing the Principles.
- Reporting on our activities and progress towards implementing the Principles.

(Source: www.unpri.com)

In terms of environmentally responsible funds, **respondents were not investing or managing at the time of the survey any green thematic funds** focused on **tackling climate change** through investment in companies attempting to reduce **their carbon footprint** via renewable energies/energy efficiency strategies as in Europe for example. Asked if it was something planned for the future, asset managers in their majority answered that is was not in their future plans even though talks on climate change were taking place in their organisations. One respondent, **Respondent 15** explained that he did not think that the SA asset management industry will follow the European AM industry on the matter because in a SA context, a renewable energy fund for example will not be able to find enough large or mid-sized companies or projects to invest in. Another asset manager commented that the listed space lacked of green opportunities and that in the future his organisation was planning to invest in the **private equity space**.

The survey identified only one AM company, **Respondent 5 (R5)** which invested time and resources in an environmentally responsible investment strategy. **R5** had created a tool for measuring the carbon footprint of SA listed companies and intended to use it to assess the carbon foot print of stocks in which it invested.

B. Environmental Information

R5 and **R8** are the **2 asset management houses** that demonstrated a specific effort to look for and to analyze specific information on environmental risks such as water or climate change. These organisations decried the lack of environmental disclosure by South African companies. On Co2 emissions, they highlighted the great progress made by South African companies in their responses to the **Carbon Disclosure Project** but still identified as an obstacle the lack of standardization of carbon data but also of other environmental data such as water or energy consumption.

CARBON DISCLOSURE PROJECT (CDP)

- Since 2000, CDP on behalf of institutional investors challenged the world largest companies to measure and report their carbon emissions.
- In 2009, CDP backed by **475 institutional investors** representing more than US$55 trillions of funds under management sent questionnaires to more than 3700 world largest companies.
- In South Africa, the initiative targets the 100 largest companies on the JSE. In 2009, the response rate was of 68% compared to 59% in 2008.
- At the end 2009, **7 South African Investors** were signatories of CDP.

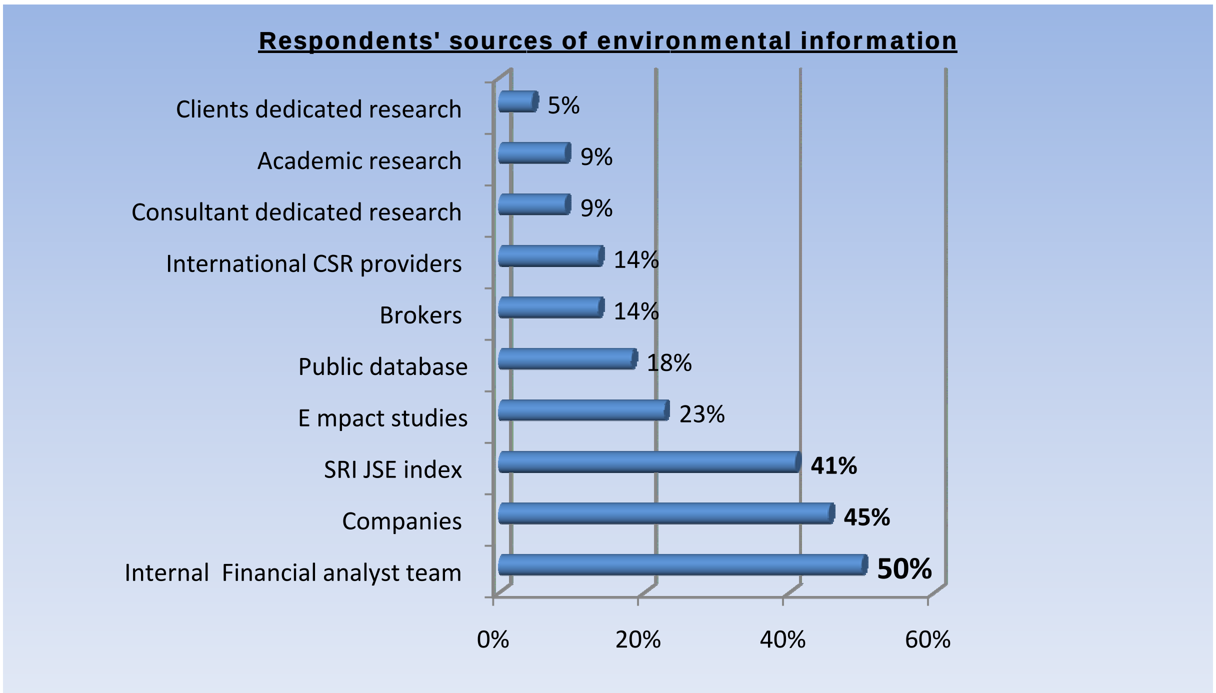
Source: South African Carbon Disclosure project 2009

R5 and R8 also expressed the view that environmental data provided by the **JSE SRI Index** was not detailed enough on environmental criteria.

JSE SRI INDEX

- JSE SRI Index, launched in 2004, assesses a company's performance against four criteria: governance, society, environment, and economy. Inclusion in the index requires a minimum score. Since 2007, JSE SRI Index works in partnership with the UK ESG information provider **EIRIS**.
- Regarding the environmental criteria, South African companies are classified according to a scale of low, medium or high environmental impact. For example, Mining and utilities are considered as having a high impact whereas the banking sector is considered as having a low environmental impact. High environmental impact companies need to score highly to meet the requirements of the Index methodology.
- Currently environmental scores are established through an assessment of the environmental policies, management and reporting/disclosure practices. During the interview the JSE indicated that in 2010 additional indicators would be created to assess in depth the climate change/carbon footprint questions.

Nevertheless **41%** of the respondents declared that their main resource of ESG information was the **JSE SRI Index**. The opinions of respondents on the JSE SRI Index were diversified. Some respondents found that the JSE SRI Index satisfied their needs whereas other respondents that were more focused on fixed income and targeted investment did not view it as an important tool. Surprisingly, individuals interviewed such as **Respondents 10, 12, 13, 14** did not seem to really be aware of the existence of the JSE SRI Index. Some criticism was also heard several times on the fact that the JSE SRI index was biased towards some sectors such as utilities and therefore was to be used carefully. In previous research led in France, this criticism was often encountered about SRI Indexes which are often favouring some investment sectors depending on the SRI rating methodology adopted.



50% of the respondents declared that they will go first to their financial analyst team in order to get environmental information. **Respondent 1** noted a generational paradigm shift in his organisation. Whereas it would have been impossible to speak and to get environmental information from the previous financial analysts, he reported that he could see today that younger generation analysts were eager to work on these new environmental questions.

Secondly **45%** of the research sample declared to get ESG including Environmental information from **company annual reports and their direct interactions with companies**. On the direct interaction with companies, **Respondents 19 and 20** condemned the frequent changes of corporations' heads of sustainability which forced them to start from scratch when they seek ESG information.

Environmental impact studies were quoted by fixed income and targeted investment asset managers because they were identified as obligatory for a range of projects they were inclined to invest in. Interestingly **sell side analysis services from brokerage companies** were only quoted by **14%** of the research sample. **Respondent 10** commented that he doubted that currently in South Africa brokerage companies were into environmental information gathering considering the weak demand for it from investors. Academic research was also only mentioned by **9%** of the respondents as a source of environmental information.

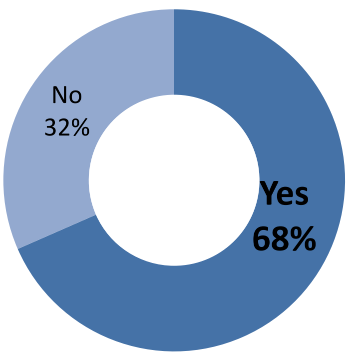
C. Environmental Alpha generation and Environmental screening

Respondents were asked to give actual examples where they identified environmental choices made by companies as a source of **financial Alpha**. Several asset managers gave theoretical reasons why environmental choices could be in the future sources of financial alpha. **Only one respondent, R1** described precisely in which way some of his investment decisions were informed by the environmental strategies taken by some companies. Specific details were also asked on the way **positive screenings** were implemented. No respondent implemented a best in sector approach consisting of under or over-weighting the stocks in their investment portfolios. **5 Asset Managers**, using the JSE SRI Index, declared that their screening strategy consisted in not investing in the corporations not selected in the Index.

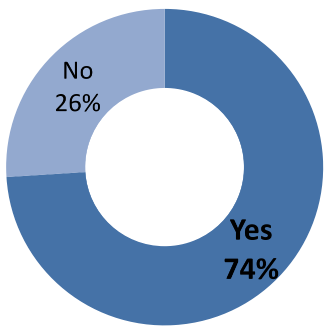
D. Engagement and proxy voting on environmental issues

A majority of respondents declared that they were implementing engaging strategies (**68%**). Among this group, **8 respondents** declared that they were engaging on **governance** but also on **social** and **environmental** issues whereas **5 respondents** were only targeting corporate governance matters. It was however difficult to obtain actual examples on how they had recently engaged a company on environmental questions. Again **R5** was the **only company** we identified able to give such an actual example of engaging interactions with a corporation through written correspondence on carbon emissions disclosure.

Percentage of AM / AO engaging?



Percentage of AM / AO applying Proxy voting strategies?

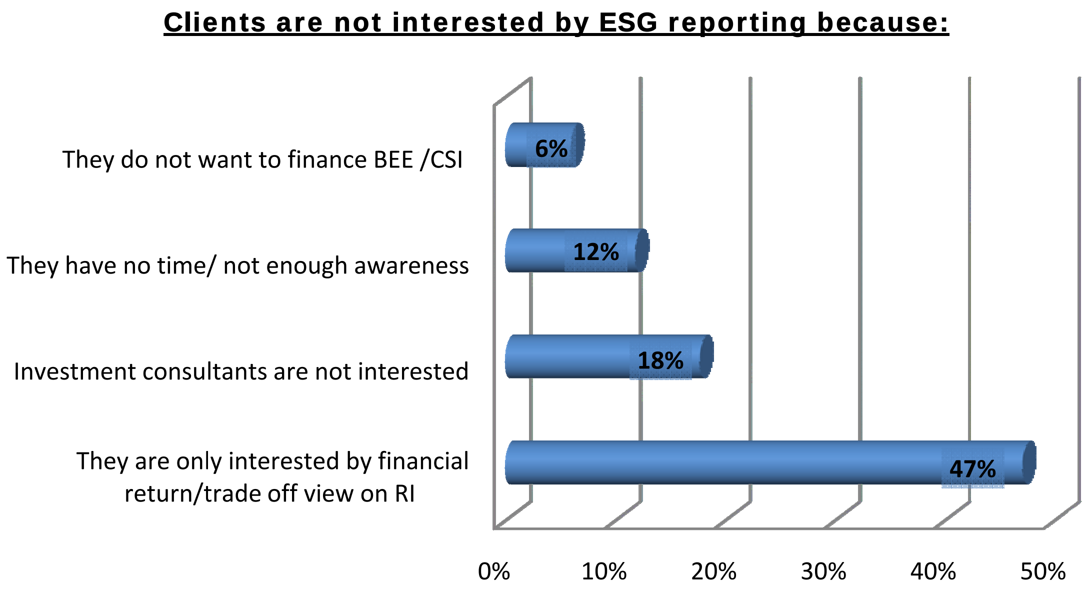


A larger majority (**74%**) declared to be involved in proxy voting but for a majority of them only on **corporate governance**. Interestingly in terms of transparency and disclosure only **2** respondents **R8** and **R11** provided on their website their proxy voting policies and their proxy voting records. The proxy voting policy documents highlighted **the importance of environmental disclosure**. **R5** did not communicate his proxy voting policy but provided detailed records on the results of its proxy voting activities. Again **R5** was the only asset manager presenting a pragmatic example of a proxy voting decision based on the lack of environmental disclosure of specific corporations.

E. Clients, Reporting and Communication

Previous research led in France on RI revealed that one of the most difficult exercises for asset managers was to integrate into their monthly, quarterly or annual financial reports to clients the actual integration of ESG criteria in their investment decision making and active share-ownership activities. Even the most advanced asset management houses such as *BNP Paribas AM* or *Credit Agricole* struggled for a long time to reflect in their monthly report spreadsheets how ESG issues were integrated into their investment decision making and how it impacted their financial performance. Things are not different in South Africa. The totality of the asset manager sample make it clear in their monthly financial reporting that the funds are SRI investment products, only **R1** and **R7** displayed monthly reporting sheets with articulated investment comments on ESG integration. Regarding marketing and presentation material, only **R16** and **R2** handed to us detailed marketing brochures on their SRI funds which were also freely available on their websites.

Interestingly this question of communication and reporting to clients triggered a lot of comments from the AM houses with many arguing that it was **hardly worthwhile** to develop ESG reporting and even less so for environment reporting as such reports would not be sensitive for the following reasons:



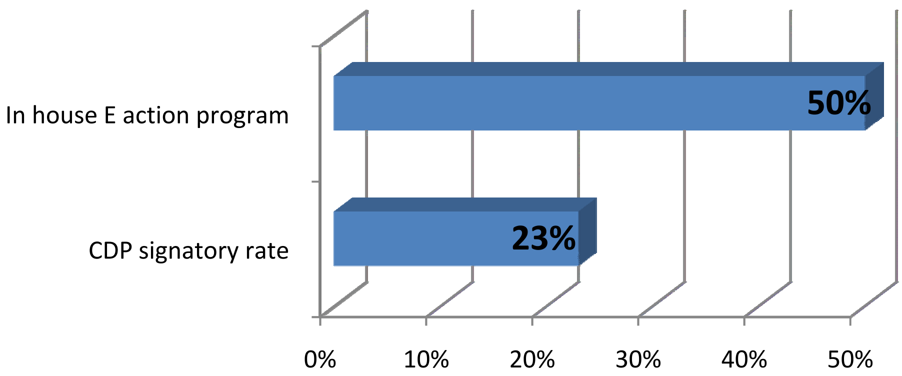
Scepticism was quite spread among many of the respondents because of the view that **institutional clients** are only focused **on financial returns** and are still convinced that integration of ESG implied a **trade-off** between financial and extra-financial goals. Some respondent highlighted the leverage role played by the **South African investment consulting industry** which is in its large majority ignoring RI trends. It was also stressed that asset managers and service providers lacked of time during their interactions with clients to introduce ESG matters. Another view expressed by **R21** was that some institutional investors interpreted RI to financing of Corporate Social Investment and Black Economic Empowerment policies and were not keen on the idea. **R2** illustrated this reluctance by quoting one of its sceptical institutional clients who argued that: "*It is not our role to fix the country with the retirement money of our people. It is the job of the government*".

A **minority of respondents** (**less than 12%)** acknowledged that some of their responsible investors were interested in getting reporting particularly on the social impact of their investments. **R1** explained that his organisation had no difficulty to interest clients to its RI strategies because it could tell detailed stories on how ESG issues mattered in its investment decision process. **R14** noted that the key to efficient reporting for asset managers was being able to tell contextualized stories linking the environmental strategic choices made by companies and their financial performance.

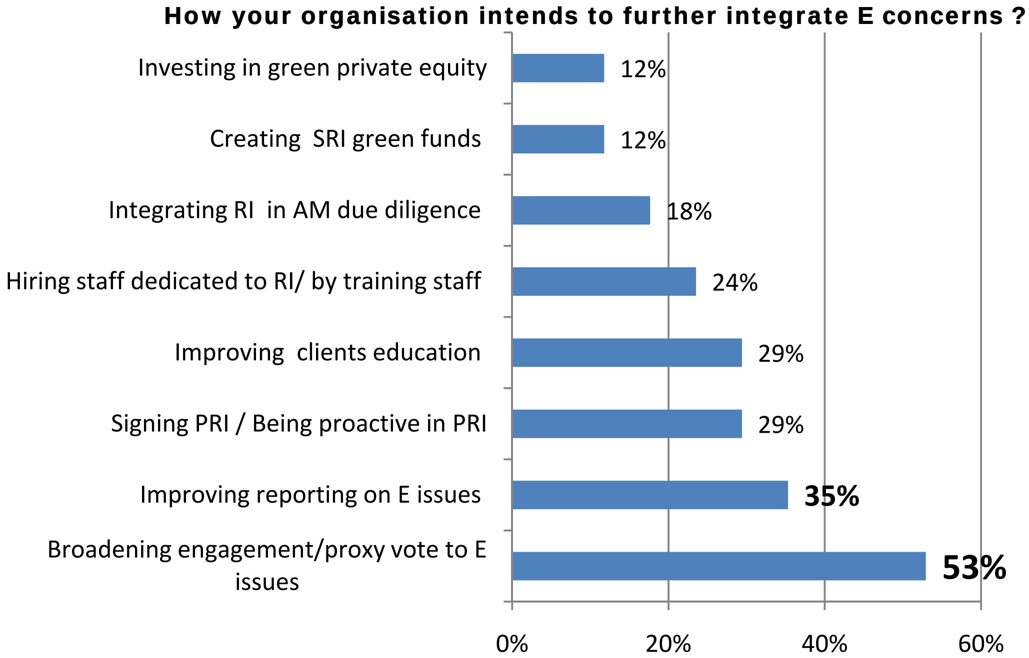
F. Environmental action: Practice what you preach

If the **direct environmental impact** of the banking and investment sector can be considered as less important in comparison to the mining sector for example, it still has a direct environmental impact to be dealt with. Moreover the investment sector has **a tremendous indirect impact** via the projects and corporations it decides to financially support. It was thus important to get a sense of the **internal environmental direct action** taken by the respondents. **Half** of the research sample could illustrate some internal environmental action taken by their companies. The range of action was quite diversified: from 3 environmental actions such as printing less, switching off the light or drinking filtered tap water to detailed environmental strategies decided at the leadership level by the companies and displayed on Internet websites. Regarding indirect environmental impact, it appeared that being a signatory of the **Carbon Disclosure Project** was a satisfactory reflection of climate change awareness to the respondents. Interestingly, **less than one quarter of respondents** were signatories of the **CDP** as on November 2009.

Internal Environnmental Action



Eventually it can be concluded than in terms of ERI, **more of the effort lies ahead** for the growing South African responsible investment industry. Overall, the development of ERI practices will depend on the development and the professionalization of responsible investment strategies on ESG matters. In the future, **further integration of environmental concerns could happen according to the respondents, around engagement and proxy voting concerns** due notably to the public willingness of GEPF to follow this route:

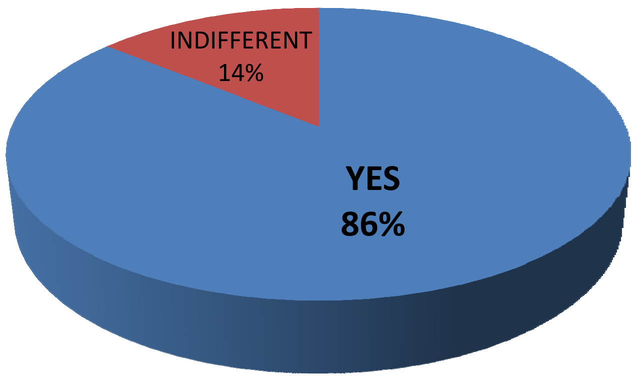


Improving level of reporting notably on **engagement** and **proxy voting activities** was considered by respondent organisations as the next action that could be taken in the future. Signing PRI or being proactive in **the South African PRI network created in 2009 and led by the GEPF** was also seen to be a practical step that could be taken. A stronger effort to improve **awareness of institutional clients** was also one of the important steps identified. After this review of ERI practices which is still in an infancy stage, it is crucial to explore the opinions of the respondents on the modalities of a further integration of environmental approaches in South Africa.

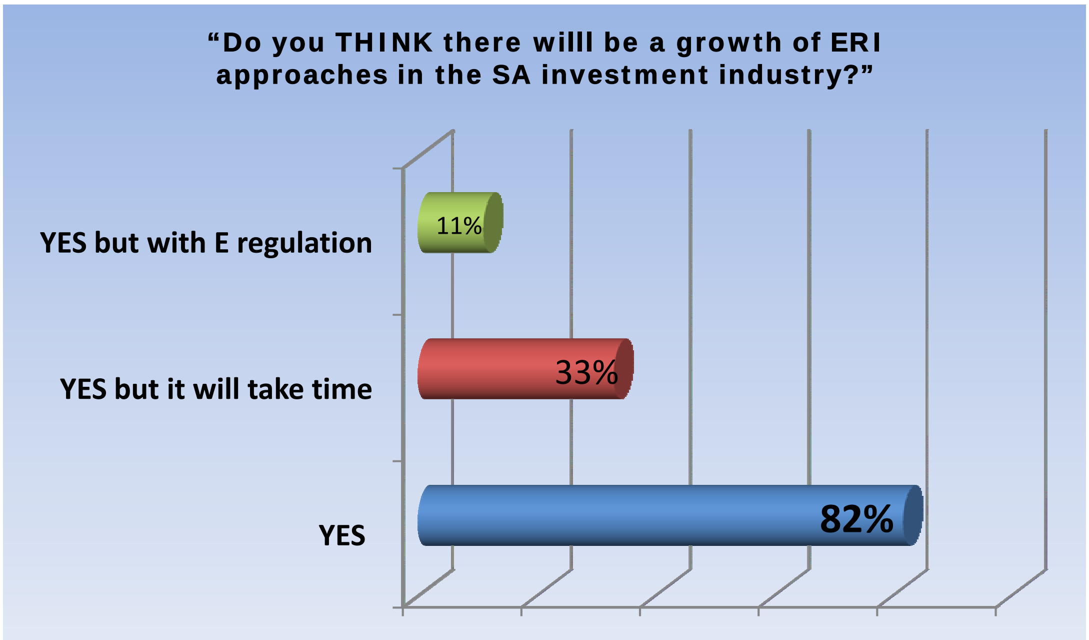
IV.) Assessing opinions on the future of ERI

A. Wishes and convictions: A positive embrace of ERI under some conditions

"Do you WISH to see a growth of ERI approaches in the SA investment industry?"



Unsurprisingly, since respondents can be said to be positively biased towards responsible investment, **19** of the organizations interviewed expressed their willingness to see an increased implementation of responsible investment approaches. **R18** and **R20** emphasized however that they wished above all a mainstreaming of the responsible investment movement including environmentally responsible investment approaches. Only **3 respondents** expressed their indifference to a further increase of ERI practices. Questioned on the likelihood of this happening in the following years, answers gathered were similarly optimist.



18 of **22** organisations expressed their conviction in the **likelihood of a growth of ERI approaches** in the SA industry. Nevertheless this optimism is subject to a range of pre-conditions. One condition highlighted by a majority of the sample was that growth will not be possible in the short term and that it will take from 10 to 15 years to see a real transformation of the investment industry on the matter. **R10, R11** and **R17** articulated more specifically that ERI growth will not happen if **governmental legislation** did not unfold.

B. Political and economic obstacles and enablers to ERI

These two closed questions were followed by open questions on the identification of obstacles and enablers to a further integration of environmental concerns in the investment industry at international and national investment industry levels and inside the respondent organizations. Confronted with the open question, respondents staged a worldwide situation divided between a **Civic World** and **a Market world** with overarching political and economic arguments that are presented as **preventing** or on the contrary **accelerating** further integration of ERI.

The Civic World and the logic for regulation

It appeared that for some respondents, the current growing unity of the **civic world** around environmental issues and the unfolding civil society awareness and political willingness will be largely instrumental at the international level. The role that could be played by the **United-**

States administration led by Barack Obama was viewed by many as a **potential leading force for transformation** that could however be mitigated by the economic recession prevailing at the time of the interviews.

The Civic World in the developing world was not necessarily perceived as a force of change. The point was made that **emerging countries** due to their developmental economic agendas are not at the same pace as the developed counties' civic world on awareness about environmental issues and **could actually oppose further integration in the name of greater developmental goals**. A similar argument was strongly made for the South African context. More urgent political priorities such as **poverty alleviation** and **job creation** were presented as **limiting civil and political awareness around environmental issues** perceived largely as concerns of the "Rich".

> *"The main obstacle in South Africa is that there are too much more urgent concerns such as job creation and poverty alleviation. It is a developmental state where some people are still cooking with coal." R11*

It was pointed out that international awareness around climate change could stimulate the willingness of the South African government to compete at similar standards with the Western world on the environment and climate change:

> *"A thing that could play is the willingness of the SA government to be seen by the external world as an advanced country. The anti-smoking situation in South Africa speaks for it. You can not seriously demonstrate that implementing non smoking policies in SA was a priority for a massive amount of voters. Nevertheless, Government went for it in a kind of drastic way. It could be the same with environmental issue just to prove that we are an advanced country." R14*

In terms of the **logic for regulation**, at the international level, **stronger environmental legislation** aiming at enhancing the level of corporate disclosure was proposed as a way to push the investment industry to internalize environmental costs in their investment decision making. The political role played by the international organisation **United Nation Environmental Programme's Finance Initiative** which mobilised not only investment professionals but also the biggest financial, insurance and banking players in the world around environmental matters was stressed by some respondents.

At the national level, **further environmental disclosure** to be required **from companies** is viewed by some respondents as the best prescription to follow even though it is considered as difficult to obtain considering the general unwillingness of businesses to be forced to comply with compulsory requirements. Compliances business codes such as **King III** are thus presented as the **soft way** to achieve the same results through collaboration.

As much as investment players are generally keen to see **further environmental regulation** applied to corporations they invest in; they appear in their majority **reluctant** to see **hard regulation** introduced on the **South African investment industry**. This is particularly illustrated by the industry's lively opposition to a proposal to amend **Regulation 28 of the Pension Funds Act** which proposes to prescribe asset allocation limits to pension funds. The proposal discussed is that 5% of the assets of pension funds subject to the Regulation 28 should be invested in socially responsible assets. Respondents in their majority **reject this strong political framing in the name of market competition and freedom of investment**. Creating a situation where investment allocation is decided by political interest groups is thus described **as leading to price distortion and an uncompetitive environme**nt that will in turn damage the still fragile reputation of responsible investment and SRI funds in South Africa as it will not achieve the desirable financial performance:

"The idea to say to institutional investors to invest 5% of their money on SRI does not sound like the right approach. Why 5% and not 10% or 20%? Each pension fund should decide what is right for its unique membership. You have to imagine that you force them to do it and it goes wrong, it could be very bad. It has to be self compliance. Maybe some obligation to disclose what you do in terms of SRI and RI could lead them to start to apply their mind on the subject." R17

Thus existing soft regulation tools such as the **Financial Sector Charter** or **PRI adoption** are largely preferred by the respondents.

Another solution offered is the **creation of a comply or explain regulatory framework**, already existing in countries such as United Kingdom or France, inviting pension funds to explain if they are taking into account ESG issues and if yes in what way there are doing it.

Nevertheless a small section of the respondents views the **Regulation 28 proposal** as **desirable** in the sense that the proposal could be a starting point to oblige South African pension funds to apply serious attention to the subject.

"Even if there is a lot of criticism about the 5% SRI assets, maybe it will be actually not such a bad thing. At least, it will get the pension fund industry to start to think about how they are going to tick the box."R6

It could also be in their view the occasion to get **clarification on the definition of the boundaries of what SRI and RI concepts** cover since there is still a high level of confusion on the matter and notably from the pension fund industry.

Market world and economic logic

On the corporation side, **market players** are depicted by many as **reluctant to internalize environmental risks in their operations** particularly in the context of an economic recession. On the investment industry side, **lack of education** leading to the perception that **responsible investment approaches and SRI products equal to a trade-off between financial performance and civic aspirations** is identified as one of **the major obstacle** for a further integration to environmental concerns in the local South African investment world. Nonetheless some positive forces of changes such as the commitment of GEPF and the creation of the South African PRI network are identified in the South African investment context:

> *"GEPF is going to be the main factor in South Africa. GEPF is the biggest investor in South Africa. If they really decide to make a change on environmental issues they can make their point quickly to companies and get them to change. They will have to speak the language that GEPF want them to speak. If GEPF decides that disclosing your carbon footprint could be a matter of importance, it will become one." R14*

Demonstrating scientifically the positive link between environmental risks and share value and share price is presented by some respondents as the best way to disprove the trade off belief. It was pointed out that **several practical obstacles** still lie between investment players and adequate investment analysis models such **as proper access to standardized and comparable environmental data in South Africa**. Concerns were clearly raised about **the willingness of the institutional clients to assume the actual costs** that will necessarily unfold if such calculative efforts were to be deployed in asset management houses.

Some interviewees eventually made a link between **regulation and economic logic** by arguing that at present stage **companies should be subject to further environmental disclosure requirements** because this will facilitate the effort of investors by supplying a base framing of the boundaries of what should be considered as **compulsory disclosure of environmental data**.

Binding environmental regulation going further than disclosure requirements was also presented by **Respondent 10** as the most efficient way to avoid a **"Tragedy of the Commons"** scenario popularized by Hardin (1968) by **giving regulatory costs to environmental risks such as carbon emissions or water pollution for example**. The example of **environmental safety regulation/law** passed in South Africa was notably pointed as a practical example on how corporations and investors are eventually compelled to internalize environmental safety costs the moment the government passed a law on the matter.

"You really need to make the link between environmental risks and stock valuation but you will need regulation to see a pricing of the problem. You have to be realistic if there is no regulation, if you have a situation where one company is really doing something responsible with its water management and the other one is not, as an investor; you are going to go for the one who makes the more money no matter what. But if government make the behaviour of the bad companies unacceptable it changes everything. Now to manage badly your water could be costly and you could be fined for it. Investors will react to such a risk." R10

On the other hand, some respondents also stressed that considering the fact that it could already be proven **that responsible investment approaches do not interfere with financial performance goals** (Vivier, 2006), the real current challenge was to redefine in South Africa the boundaries of what can be considered as **fiduciary duty**.

FIDUCIARY DUTY

- In the institutional investment context ruled by common law, trustees of funds owe fiduciary duty to exercise reasonable care, skill and caution in pursuing an overall investment strategy suitable to the purpose of the trust and to act prudently and for a proper purpose.
- The Freshfield Reports 2005 and 2009 released by the PRI initiative and drafted by legal firms advocates that in order to act in a prudent way and to fulfil their fiduciary duties obligations, investors should not only aim to obtain the best financial performance on the short term but also integrate environmental, social and corporate governance issue that could play on the long term financial performance.

C. Financial market short termism, peer and client pressure and incentive structures: What role?

In her empirical case study among UK institutional investors, Guyatt, head of RI research for *Mercer Investment consulting* was able to determine that **short termism of financial markets** and **herding tendencies** were overarching conventions identified by investors interviewed to justify **their reluctance** to adopt responsible investment behaviour.

Fund managers adopt generally **myopic behaviours** amounting to an over emphasis of the **short term movements on financial markets** notably fuelled by the use of valuation models designed to exploit short-term mispricing in the market. These discounting behaviours are also fuelled by the fact **that performance for active investors is primarily reviewed and measured on the basis of their ability to outperform an index over a one year period**. This incentive system provides fund managers with little incentive to challenge the dominant conventions that prevail in the market.

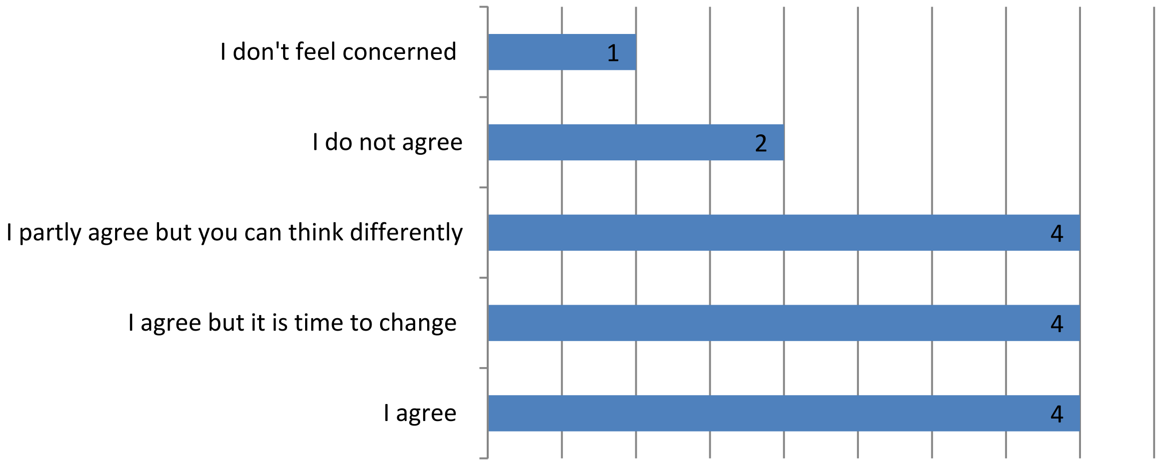
Beside short termism, fund manager have a tendency to gravitate towards defensible decisions that might cause investors **to 'stick with the herd'** based on the assumption that conventional criteria will be easier to defend than those that are unconventional such or go against prevailing consensus opinion for any length of time such as responsible investment principles. As highlighted by Keynes in 1936:*"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."*

This research attempted to check whether a South African responsible investor sample would identify short termism (financial market/incentives structures) and herding (peer and clients pressure) as major obstacle to a further integration of ERI approaches in their organisation, following the reading of quotes by foreigner asset managers articulating their positions on the subject. They were asked if they agreed to the quote, if they experienced similar situations as the international investment professionals and if they believed that being a South African investment professional changed their perceptions. Only **15 respondents,** being directly in responsible for managing funds were asked to react to quotes. Regarding the quotes, some respondents did not give any articulated reaction. In this case they are tagged as "no reaction" in the following figures.

Myopic and discounting behaviours on financial markets are **in majority** recognized by the respondent and identified as serious obstacles to ERI.

Test Quote 1: Financial Market Short termism

"The big difficulty is that a lot of environmental issues play out over a very long period of time and it is only one factor in the process and if the market isn't looking at it you can sit there for a very long time on your high horse saying 'this company is a disaster, it shouldn't be trusted' and you can lose your investors an awful lot of money..." Foreigner AM1



Agreeing partially, **R5** nonetheless deconstructed the flaws that he identified in such short term thinking that do not allow seeing further than immediate financial profit:

"The problem today is that financial players want to maximize their profit today. They do not want to maximize the shareholder value but they want to only maximize their benefit. If you really want to maximize the shareholder value, you have to think on a longer term at least 5 years and take into account discounting risk." R5

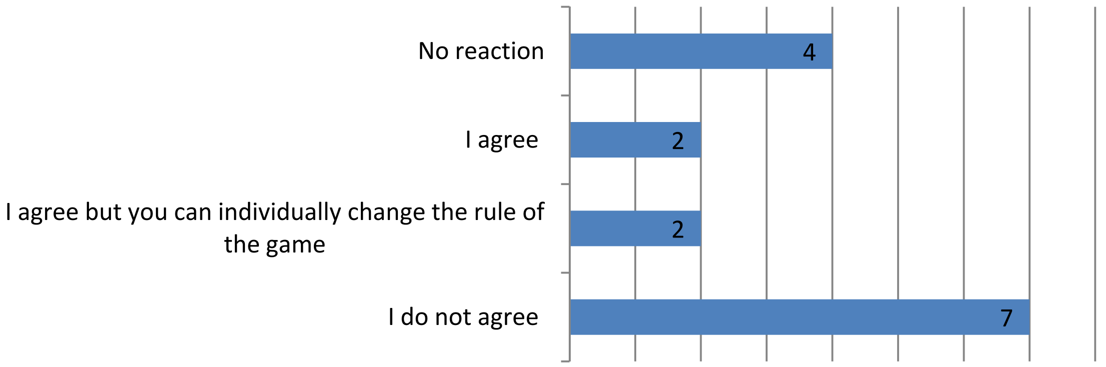
The same point was made by **R14**:

"This is the question of short term versus long term. The question is finally what your time horizon is as an investor. If I take the example of a mining company and how it will be compliant on the question of rehabilitating land, my perspective changes according to my time horizon. Right now and even in five years time, it will have no real or a low impact on the share price but maybe in 15 years time, it is going to be the case. At the end of the day, it is not about the fact that they are doing well with the environment but about the investment returns that you are going to get by taking into account the environmental factor." R14

Herding pressure was recognized but seen by a majority of fund managers interviewed to be **non compatible** with the mission of an active asset management house which is defined as being contrarian to financial markets and being able to believe its choice no matter the peer pressure.

Test Quote 2: Herding

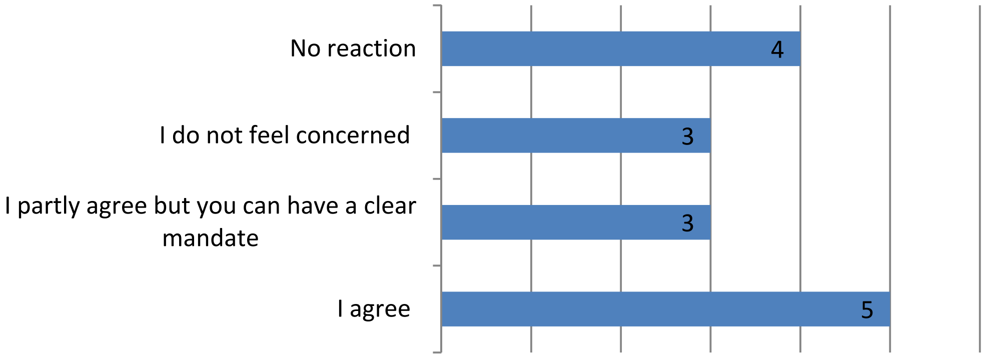
" On this new environmental questions you have got to get it absolutely right, otherwise you can get talked out of it quickly – well, not really talked out if it but questions from the other asset managers, your boss, your clients on why on earth are you in this thing will follow. It would be easier with clear signals from your peers, the direction and above all the clients that you should go for it."Foreigner AM2



Respondents 10 and 16 strongly linked **overarching short termism** and **herding** practiced by financial players to the **incentive structures** of the asset management industry.

Test Quote 3: Incentive Structures

"As a manager of a SRI fund, I have more constraints than other funds managers because there are some stocks that I have to avoid according to environmental risk concerns or I will overweight a position because I believe in the environmental strategy of the firm. Meantime I am judged by my boss and clients on my relative performance compared to the returns of an index that is not tailored specifically for SRI funds. In addition, the official discourse is to say that SRI should be long term investing but we all know perfectly well that we are judged every quarter in comparison to these broad reference benchmark and that our bonus depends on our ability yearly to outperform relatively the benchmark index." Foreigner AM 3



The asset management industry is thus depicted by **R16** as a **value chain** consisting of asset managers, multi-managers, investment advisers that are supposed to satisfy at the top of the chain, the final beneficiaries or final investors who tend to want to see positive financial results on a quarterly basis.

> *"Short termism is the biggest problem faced by the investment industry. We really try to push against it and to let fund managers know that we are not going to judge them on short term. But the problem is that the investment industry is a value chain. You need to keep happy the clients at the top of the chain. This is why the industry as a whole needs to change perspective."R16*

Asset managers interviewed seem to largely feel that what is needed in South Africa is a **broader base of clients** willing to see **responsible investment mandates** implemented by their asset management companies and able **to detach themselves** to quarterly benchmark comparisons with financial indexes that do not have the same investment constraints.

> *"This is a very important and key point for an asset manager. The way its performance is going to be benchmarked in comparison to its peers and indexes. It is a real question to explore if one wants to see an integration of ESG into investment decision process in South Africa. "R10*

Nevertheless, most of the respondents did not feel extremely concerned by the experience of **RI European fund managers** obliged to apply a **systematic selection process based on ESG ratings of companies** since today they are for most of them committed to implement **a punctual positive screening process and engagement on the listed equities**.

R14 pointed out in a detailed way that on the **listed equities** side, the **extremely South African concentrated financial market structure** would not actually allow **thorough screening strategies** such as the one implemented in Europe. Listed equities responsible asset managers would rather **engage with companies on environmental themes** which do not imply a systematic integration in the stock selection process but can in case of disagreement with the companies lead to a withdrawal from the share.

On the **bonds side**, South African responsible asset managers targeting developmental infrastructure clearly expressed that their investment constraints and incentive structures were not comparable with those experienced on the listed equities side and therefore they experienced broader freedom to invest on a longer term base with the consent of clients.

The analysis of the reactions of the interview sample saw emerge **2 different responsible investment profiles**.

A minority group recognizes the reality of behavioural and organizational short termism but argued that individually it was possible to think and to act out of the box, fuelled by the conviction that environmental concerns will matter in the long term.

A majority group also recognizes the point but is clearly waiting for signals from the market (institutional clients at the top of the value chain) and civic world (government regulation) before committing further effort to develop ERI approaches.

How to stimulate an environmental paradigm shift in the South African investment industry?

South African SRI/RI asset managers do not yet provide investment products primarily driven by an environmental focus to their clients. It would however be important to broaden research to include the private equity and public financing sectors to be able to reach a complete picture of the state of play within the broader financial sector.

Among the survey respondents, the integration of environmental concerns in investment decision making and in engagement/ proxy voting is still fairly limited in its scope.

53% of the survey respondents see the inclusion of environmental concerns into their engagement and proxy voting practices as a further step to be taken in the future beyond the current corporate governance focus.

Communication, marketing and reporting around responsible investment commitments including environmental commitments is poor and could be greatly improved.

50% of the sample show some internal awareness, understanding and action around climate change.

More than **80%** of the survey respondents believe that in the future the South African investment industry will see a further integration of ERI approaches.

At the national level, one of the main future enablers is identified as a **stronger environmental disclosure** to be required of companies by regulators and a **more binding environmental regulation** that will compel investors to price environmental risk.

The main market enabler is identified as **a stronger commitment from institutional investors** in following the GEPF in its willingness to implement responsible investment strategies.

The lack of interest and scepticism of institutional clients and of the local investment consulting industry around Responsible Investment is depicted as a major market impediment. Some respondents emphasized that there is still too strong a belief that investors will lose their beneficiaries' money if they make social and environmental concerns a focus of their investment choices.

Finally, one of the major political obstacles identified at the national level is **the tension between social developmental goals and environmental goals.** The belief was spread among some respondents that South Africa needed to deal with the more urgent social priorities such as unemployment, social transformation and infrastructure development at the expense of environmental priorities.

Other respondents however argued that this was a **short sighted view** and that the impoverished sectors of the population would be the first to be impacted by the destruction of their natural environment/surroundings. Similarly, GEPF representatives have argued in public arena (Cape Town UNEP-FI conference, October 2009) that climate change could by boosting food and water insecurity have tremendous negative social impact on the lives of the most disadvantaged people of South Africa. Therefore it is presented as necessary for long term investors to act proactively to adopt investment strategies aligned with the willingness to mitigate the consequences of climate change that could make irrelevant the level of savings provided by GEPF to its beneficiaries in the face of increasing food price inflation.

This question of how political and economic leaders decide the development path of South Africa is one of the core questions to ask. The recent debate around the ESKOM World Bank loan application to finance coal energy infrastructure is largely symbolic of the new era of environmental tensions into which the world now enters. The financing and investment decision taken now in South Africa will shape for a long time the lives and the landscape experienced by both the rich and poor in the country.

Education, awareness, regulation, breaking clichés and injecting human and financial means could help to stimulate this environmental paradigm shift in the South Africa investment industry. The final question may ultimately boil down to the choices of political, industry and civil society leaders, and to the choices that each fund manager makes about which companies to invest in.

Appendices

Appendix A: List of respondents

Asset Managers	Interview Date
Advantage AM	October 2009
Cadiz African Harvest	September 2009
COMANCO/IDEAS Old Mutual Investment Group SA	August 2009
Coronation AM	November 2009
Element IM	September 2009
Future Growth AM Old Mutual Group	December 2009
Investec IM	August 2009
Investment Solutions	October 2009
Kagiso Asset Management	November 2009
Legae Capital	October 2009
Mergence Africa Investment	September 2009
Metropolitan AM	September 2009
Prescient AM	September 2009
Public Investment corporation	September 2009
RMB AM	September 2009
SANLAM Investment Management	August 2009
STANLIB AM	December 2009
Trinity Holding	September 2009
Asset Owners	
GEPF	October 2009
Unity Incorporation	October 2009
Service Providers	
Corporate Governance Accreditation (Pty) Ltd.	Informal itw Sept 2009
JSE	September 2009
RISCURA	September 2009

Appendix B: List of Websites

www.27four.com (July/August 2009)

www.advantageut.co.za (July/August 2009)

www.cadiz.co.za (July/August 2009)

www.coronation.com (July/August 2009)

www.elementim.co.za (July/August 2009)

www.futuregrowth.co.za (July/August 2009)

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www.investmentsolutions.co.za (July/August

www.jse.co.za (July/August 2009)

www.kagiso.com (July/August 2009)

www.legaecapital.co.za (July/August 2009)

www.mergence.co.za (July/August 2009)

www.metropolitan.co.za (July/August 2009)

www.oasis.co.za (July/August 2009)

www.oldmutual.co.za (July/August 2009)

www.prescient.co.za (July/August 2009)

www.prudential.co.za (July/August 2009)

www.sanlam.co.za (July/August 2009)

www.trinityholdingsgroup.com (July/August 2009)

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Contributions: Lise Pretorius

The South African center EfD/ EPRU produce and disseminate policy relevant research of a high academic quality on current environmental economic issues in South Africa. Focus areas of research are conservation and biodiversity; air, water and solid waste pollution; management of the commons: compliance, enforcement and corruption; behavioral responses to climate change and environmental justice, environmental finance as well as the role of social institutions in improving access to basic services.

www.epru.uct.ac.za

EPRU
Environmental Policy Research Unit