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Considering **ESG** factors in investment decision-making

With environment, social and governance (ESG) issues occupying more time on retirement fund agendas in a post-CRISA and revised Regulation 28 environment, is this business as usual?

Russell Shanglee is director of business development at TriAlpha Investment Management, the specialist fixed income and alternative investment firm, which manages and advises on more than R10 billion of assets. He recently completed a qualitative action research study for his Executive MBA thesis at the University of Cape Town's Graduate School of Business, entitled *The underlying behavioural dynamics, practices and contextual issues associated with the integration of environmental, social & governance (ESG) considerations into an investment management process*. *HedgeNews Africa* discusses the recent research the firm undertook in this area.

Russell Shanglee

Besides fulfilling the academic requirements for your MBA, what motivated you to do this research?

RS: Within the South African investment context – and given the lack of mainstream systematic application of ESG criteria (also referred to as responsible investing by investors) in institutional investment management models – I realised that while there is a lot written about ESG, there are missing aspects. So much literature is currently available on how to integrate ESG criteria into an investment management process, but there is not much available on behavioural dynamics, management practices and contextual issues that investment management firms need to consider before and during the integration process.

On that basis, what was your research approach?

RS: In a nutshell, I observed my colleagues for two months as they engaged, debated and advanced with the integration exercise. My position was unique in that I was both a researcher and a participant in the integration process. The implication here is that I needed to ensure my objectivity at all times, so it helped that the Graduate School of Business' standards for providing objective evidence were quite high.

How did you define where the integration exercise would start and where it would end?

RS: It is important to mention that we tried to be practical, and most of all, realistic with the exercise. Firstly, we are a small team and don't have dedicated personnel to focus on ESG as a single concept. Our approach was then to identify the area that would give us the highest leverage in delivering systemic change in our business. We identified investment philosophy as that area, which may seem like a simple revelation, but it is surprising how easy it is to be lured into a sense that this area, although quite pervasive, can be glossed over. Secondly, we set ourselves a realistic goal in that, at the end of the two months, we wanted to formulate our policy on responsible investing. The departure point and end goal then set our boundaries. The boundary-setting helped us to stay focused. There is of course still quite a bit of more detailed work that lies ahead.

Looking back at the entire process, what were the major stumbling blocks that you and your colleagues experienced?

RS: Again, without going into too much detail, the essence of what we were grappling with was in effect an organisational change process that was geared towards sustainability. As with many organisational change processes, there are political, economic, social, technological, environmental and legal factors that can contribute to the process grinding to a halt or hitting the proverbial brick wall. This is what happened to us for whatever reason.

Can you elaborate with further insight into your integration experience?

RS: A generic way of explaining 'hitting a brick wall' during a change process is through a system archetype, which is an analytical scheme that represents common patterns of behaviour in an organisation (*Braun, 2002*). It is essentially a diagnostic tool that provides insight into the underlying structures from which behaviour emerges over time. The limits-to-growth system archetype (which played itself out in our change process) is based on the premise that growth cannot continue unabated in an unrestricted reinforcing dynamic (*Braun, 2002*) and that we never grow without limits (*Senge, Kleiner, Roberts, Ross, & Smith, 1994*). This dynamic is best explained using a causal loop diagram (see figure 1).

Causal loop diagrams are used to better understand system structures that cause patterns of behaviour. They are notations for representing system structures that are difficult to verbalise, as normal language presents interrelations in linear cause-and-effect chains whereas actual systems comprise circular chains of cause-and-effect in the form of feedback loops i.e. where a system element indirectly influences itself. So a causal link from A to B is positive (+) if A adds to B or a change in A produces a change in B in the same direction. A causal link from A to B is negative (-) if A subtracts from B or a change in A produces a change in B in the opposite direction (*Kirkwood, 1998*).

Growth from change efforts, for example, are significant (usually depicted as a virtuous reinforcing loop R1) but result in diminishing returns as the limits of change are approached. During the first round of organisational change, relatively easy changes to the system are made and then improvement levels reach a plateau (usually signified by a vicious balancing loop B1). But there is a delay in identifying that a plateau has been reached, hampering our ability to manoeuvre.

The next round of improvements may be more complex and may require organisational-wide support (slowing action). A lack of this support and the mental models of senior managers become the limiting condition that slows or levels off the action (*Senge, Kleiner, Roberts, Ross, & Smith, 1994*).

Before we look at transposing the core variables that emerged from my research data over the limits-to-growth system archetype it is important to define the term 'negative capability'. It refers to the psychoanalytical capacity to experience emotion that allows one to engage, in a non-defensive manner, with change participants that may be displaying dissonance in an organisational change situation (*French, 2001*). Similarly, I need to define 'appreciative inquiry', which is the means of understanding organisation and regulating collective organisational decision-making and action. This non-teleological concept has at its core the notion of maintaining relationships rather than the consciously constructed arrangements of the traditional goal-seeking approach that organisations favour (*West, 2005*).

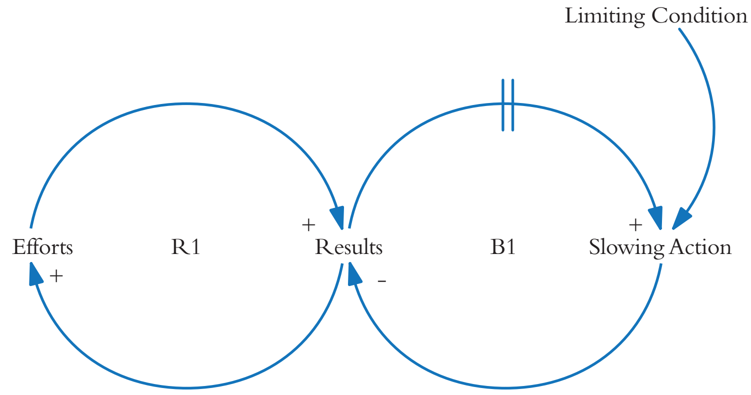

Figure 1: Causal loop diagram of limits to growth system archetype

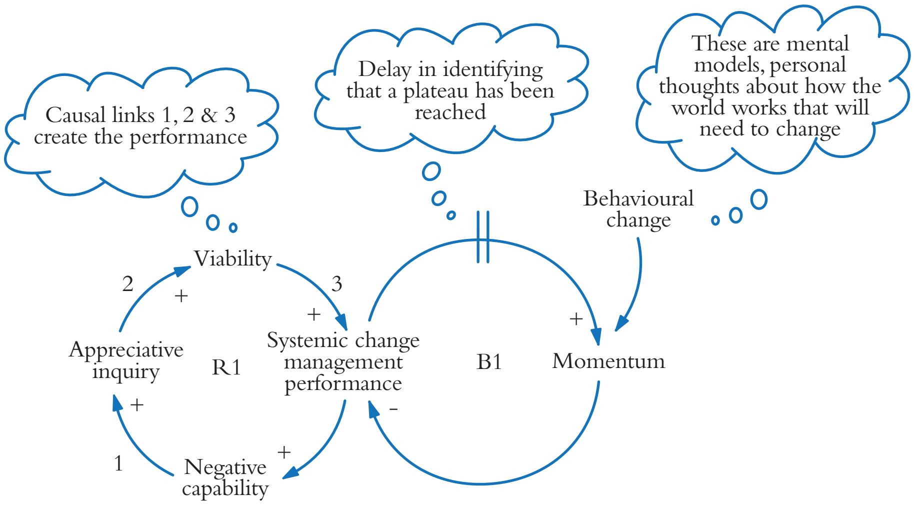

Figure 2: Causal loop diagram of the core variables from the research data that have been transposed over the limits to growth system archetype

In figure 2, negative capability, appreciative inquiry and viability represent efforts. Systematic change-management performance represents results. Momentum represents slowing action and behavioural change represents the limiting condition.

The behavioral dynamics, management practices and contextual issues that I refer to are how negative capability improves appreciative inquiry, which in turn creates the conditions for understanding the viability of

Product focus: Strong investor demand for Nedbank's ESG compatible BGreen ETF

South Africa's investment industry is already reacting to calls for a greater focus on ESG issues by creating investible products.

The Nedbank BGreen ETF has seen strong growth in the six months since launch in December 2011, with assets at more than R100 million as at the end of July, reflecting appetite amongst South African investors for an investment vehicle that offers sustainable returns while allowing them to drive environmental change.

Nedbank Capital's senior transactor, Jacoleen Simpson, said 43 companies now qualify for participation, up from 33 at launch. This was a result of rapidly improving levels of carbon disclosure by South African companies, which has the second highest disclosure score in the world with 83% of the JSE's Top 100 companies meeting disclosure requirements.

Simpson said the fact that constituent companies are among the Top 100 is another contributing factor to the ETF's success.

"While environmentally conscious investors want to know they are making a positive difference to the environment, they also want to know that their investment has the potential to deliver solid returns," she explains, "The BGreen ETF comprises a spread of reputable financial, resource and industrial shares, meaning it offers this performance potential along with a level of diversification that accurately mirrors the South African economy."

Simpson says there has been significant interest in the product from a broad spectrum of institutional and retail investors, and many large investors have been in discussion with NedGroup Beta Solutions to use the BGreen ETF in various investment portfolios.

Significantly, Simpson says that an independent analysis has shown that the outperformance of the Nedbank Green Index, on which the BGreen ETF is based, compared to the general market has been mainly due to stock selection, serving to debunk the myth that environmentally sustainable companies underperform.

Nerina Visser, Nedbank Capital's head of Beta Solutions, believes the ETF's growth is likely to be sustained as companies and their investors recognise that they can no longer afford to ignore the role they have in slowing or reversing climate change.

ESG integration, thereby improving systemic change-management performance over the longer-term. However, a lack of management capacity, represented by a need for behavioural change to deal with organisational change, detracts from the momentum of change, thereby limiting our effectiveness

In your view, how can organisations transcend these limits to growth as they grapple with behavioural change relating to ESG integration?

RS: The key to transcending limits to growth is in planning for the limits (*Braun, 2002*), which is difficult in a social system such as an investment management firm. The interventions that I proposed in my research paper took this into account and focused on the two broad elements of leadership development and maintaining a resource-based view of the organisation.

Firstly, leadership development prepares an organisation's members for their leadership roles and related processes, and expands their collective capacity. Leadership development is a social process concerned with developing interpersonal competence, building human networks of trust and commitment and social capital, which enhances the collective capacity of organisational members. This allows leaders to adapt to changes in situations, demands and circumstances. But leadership development does not prepare people when political power struggles come into play.

Secondly, when all levels of staff adopt a back-to-basics approach in holding a resource-based view of an organisation, this should lead to sustainable competitive advantage being developed through dynamic capability. A resource-based view of an organisation proposes that the heterogeneous and immobile nature of its tangible and intangible resources can produce a sustained competitive advantage. This is based on the grounds that these resources can be configured in a proprietary way that yields a dynamic capability, which then becomes a source of sustained competitive advantage in a reinforcing manner. This does not mean that firms should not share their knowledge and experiences as many market participants, like ourselves, are still learning.

An organisation's resources increase when they are valuable, rare, inimitable, non-substitutable and exploitable, which convey the potential to achieve a dynamic capability (*Barney, 1991*). This is underpinned by an organisation's ability to adapt to a changing environment and configure its social complexity accordingly to produce sustained competitive advantage. The advantage is, of course, not developed when the resources are not valuable, rare, inimitable, non-substitutable and exploitable.

What are the major changes that you have made as a firm as a result of this exercise?

RS: The changes to our investment philosophy have had an impact on our investment screening process, so there is a heightened awareness and appreciation for the application of responsible investment criteria. We also changed our human resources practices, specifically with regard to job descriptions and performance appraisals.

Has the process changed the way you interact with other parties – such as underlying managers you may invest in?

RS: Yes it has. The research process included an on-line survey of our underlying investment managers to assess their levels of awareness and readiness. Some of them are at an advanced stage, some of them want to transform their thinking as they see value and some of them will require more engagement. We will, in the very near future, be hosting a workshop with our managers on the topic.

Given your experience as a firm, do you feel that the alternative asset management industry in South Africa is able to meet the ESG challenges that CRISA puts forward?

RS: The industry has had to overcome quite a number of normative challenges over the years, especially on the legislative front, so we are confident that progress will be made, but it will, in all probability, not be made at the same pace on all fronts.

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Code on responsible investing (CRISA) to encourage retirement funds to take ESG issues seriously

The Code on Responsible Investing in South Africa (CRISA) was launched in July 2011 to encourage institutional investors, and their service providers such as asset managers and consultants, to adopt the principles of responsible investing with a focus on environmental, social and governance (ESG) issues. The code is voluntary and South Africa is the second country after the United Kingdom to formally encourage institutional investors, predominantly pension funds and insurance companies, to integrate ESG sustainability issues into their investment decisions.

The code was drafted with input from the Association for Savings and Investment (Asisa), the Institute of Directors in Southern Africa and other key stakeholders, such as John Oliphant, head of investments and actuarial for the Government Employees Pension Fund (GEPF) who also serves on the board of the UN PRI South African Network. The GEPF is currently one of the biggest supporters of CRISA having integrated ESG factors into its overall portfolio strategy. "Institutional investors are the people who need to drive the change in investment behaviour. What makes CRISA stand above other codes is its disclosure. How can you be held accountable for your investment decisions [in ESG] if you don't have disclosure? So this is a very important element," says Oliphant.

Various initiatives are under way to encourage retirement funds to adopt CRISA. The Principle Officer's Association (POA) helped set up the Sustainable Returns Project, which provides a "responsible investing toolkit for retirement fund trustees". Trevor Chandler, consultant senior policy adviser at Asisa, said in a statement: "Asisa has assumed a supportive role on the POA-led Sustainable Returns Project, which targets retirement funds. We hope that through this project our members' clients will also embrace CRISA and provide impetus to the roll-out of responsible investing by our members."

The Sustainable Returns Project is run by the POA in partnership with the International Finance Corporation (IFC), a member of the World Bank Group and is supported by Asisa, the GEPF, National Treasury, the Financial Services Board, Institute of Retirement Funds (IRF), trade unions and a number of other stakeholders.