By Colin Habberton

INVESTMENT PRACTICE

Connecting the dots for responsible investment decision-making

A conceptual model to help reduce the complexity in investment decision-making processes.

A recent analysis of global investment practice published by the United Nations titled *Fiduciary Duty in the 21st Century* provides the following prescription:

Fiduciary duties exist to ensure that those who manage other people's money act in the interests of beneficiaries, rather than serving their own interests. The most important of these duties are:

- ***Loyalty:** Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.*
- ***Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an 'ordinary prudent person' would do.*

The problem is though that an ordinary, prudent person does not necessarily have the skill to navigate the complexities of financial markets and instruments they invest in, despite their best care and due diligence.

Quite understandably, trustees serving on pension fund boards look to delegate responsibility to professional investors such as asset managers and consultants who have the required skill. But when it comes to the fiduciary duty of trustees, is delegation enough to ensure that investment decisions are made responsibly?

Reducing complexity

This year marks the 10th anniversary since the launch of the UN Principles for Responsible Investment (PRI). In acknowledgment of the limitations of financial markets to adequately address socioeconomic inequalities, negative environmental impact, corporate governance failures and systemic risk, the PRI seeks to promote the importance of environmental, social and governance (ESG) factors in investment practice.

Aside from the ethical perspective of such a paradigm, the rational argument for "responsible investing" is that it enhances the analysis of investments, risk assessment and potential for medium to long-term investment return (UNPRI, 2015). In effect, the PRI calls for institutional investors to include ESG considerations in their investment decision-making and their market participation.

As detailed in the table, ESG considerations are wide-ranging and, in themselves, complex. However, the recent memory of MTN's Nigerian challenges, the collapse of African Bank and the after-effects of the Marikana tragedy highlight the importance of these issues and their impact on financial markets, returns and what should be considered when making decisions about other people's money.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) DEFINITIONS

CONCEPTS	DEFINITION
Environment	**Examples of environmental issues include:** Biodiversity loss, greenhouse gas emissions, climate change impacts, renewable energy, energy efficiency, resource depletion, chemical pollution, waste management, depletion of fresh water, ocean acidification, stratospheric ozone depletion, changes in land use as well as nitrogen and phosphorus cycles.
Social	**Examples of social issues include:** Activities in conflict zones, distribution of fair-trade products, health and access to medicine, workplace health safety and quality, HIV/Aids, labour standards in the supply chain, child labour, slavery, relations with local communities, human capital management, employee relations, diversity, controversial weapons and freedom of association.
Governance	**Examples of governance issues include:** Executive benefits and compensation, bribery and corruption, shareholder rights, business ethics, board diversity, board structure, independent directors, risk management, whistle-blowing schemes, stakeholder dialogue, lobbying and disclosure. This category may also include business strategy issues, both the impact business strategies on the environment and society, and their implementation.

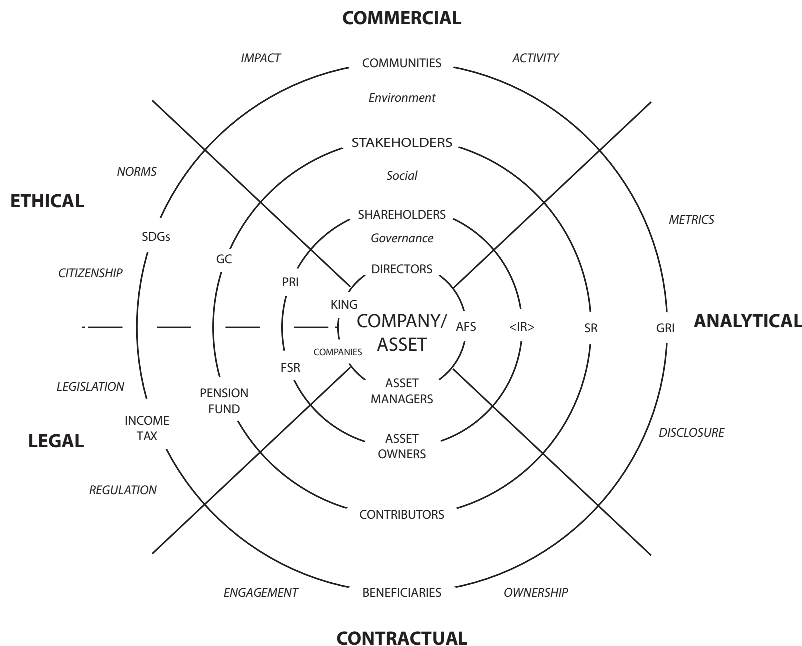
SOURCE: UN Principles for Responsible Investment (2015)

Connecting the dots

The conceptual model on page 28 attempts to address the complexity institutional investors face in their investment decision-making processes.

Fundamentally, it assumes a value chain perspective of the investment process regarding the capital flows from contributors to asset owners, such as pension funds, and onto asset managers. It follows the deployment of that capital to assets such as operating companies and traces the return on capital from the activities of those assets back to the eventual beneficiaries of institutional investors.

INTEGRATED INVESTMENT DECISION-MAKING MATRIX



The model illustrates how the integration of ESG considerations suggests separate horizons of proximity to the decision-making processes of a company and its investors and other stakeholders. These horizons connect the decision-makers in both asset and investor domains to the analytical tools, laws and codes of ethics that guide decision-making processes in each of the four domains of investment practice.

1. Contractual domain

From an institutional investor perspective, asset managers' primary contractual responsibility is to maximise risk-adjusted returns from investment activities. These returns are derived from the deployment of capital flows from individual and institutional contributors in order to meet the expectations and funding requirements of asset owners and their beneficiaries, assisted by professional service providers. Through the purchase of assets, certain ownership responsibilities pass onto asset owners and/or asset managers that may demand certain requirements for engagement with those assets.

2. Commercial domain

From a company or asset perspective, as the destination for investment, the primary aim is to deliver value to shareholders, i.e. sustainable financial returns to those institutional investors. Value is materialised through revenue and returns generated through the activities in the communities in which they operate, in conjunction with various stakeholders impacting their performance. As these activities are carried out, certain social and environmental effects on communities in which companies operate may be realised that could have material impact on risk and return.

ESG provides a conceptual framework to understand the risk, return, responsibilities and objectives of institutional investors on the one hand, and companies on the other.

3. Analytical domain

Institutional investors and companies understand each other's aims and analyse performance through a common language of quantitative reporting such as annual financial statements (AFS) that measure return and risk. Integrated Reporting (IR), Sustainability Reporting (SR) and the Global Reporting Initiative (GRI) have inspired the addition of non-financial information into company reporting, including qualitative metrics relating to ESG criteria. The more information that can be delivered through appropriate metrics, the greater the degree of disclosure that becomes possible, enhancing the transparency of investment practice.

4. Ethical-legal domain

In South Africa, institutional investors and the companies they invest in are subject to similar legal and governance structures. King III recognises the impact that companies can have on wider stakeholder groups and communities and should assume the responsibility of corporate citizenship.

In alignment with King III, the PRI and CRISA provide normative frameworks promoting the importance of ESG criteria into investment decision-making. Corporate Responsibility (CR) underpinned by principles like the UN's Global Compact (GC) and Sustainable Development Goals (SDGs) provide a common set of objectives to guide decision-makers who are looking to incorporate responsible business practices into their operations. Legal structures set the rules of the game regarding the allocation, deployment and return on capital mediated by various regulations and respective regulatory institutions.

ESG as a common language

Although these horizons are presented in concentric circles in the model, their "proximity horizon" may differ depending on the relative importance or urgency regarding how a particular ESG factor may affect the interests of investors (or activities of companies as their investments) and consequently their respective decision-making processes.

Synonymous with the term "sustainability" used in CRISA and King III, ESG provides a conceptual framework to understand the risk, return, responsibilities and objectives of institutional investors on the one hand, and companies on the other. Adopting the filters of ESG criteria reveals the potential for a unifying perspective to resolve some of the complexity involved in the purpose and practice of investing responsibly. This is when matching a company's activity and impact with an investor's risk and return objectives.

The model is intended to provide trustees of pension funds, particularly those who are not financial experts, with a diagnostic tool to assist in decoding, at least in part, the complexity of investment decision-making processes. In application, the model aims to guide decision-makers in applying the principles and perspectives of investing responsibly and thereby fulfilling their fiduciary commitments by empowering them to take a more active role in investment practice. ■

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