

# CLARITY



**REDFIN WEALTH**  
INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

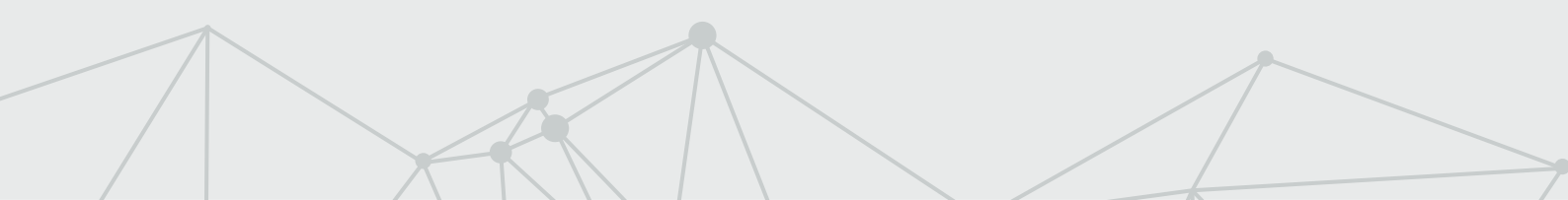
**FUNDHOUSE**  
investment clarity





# CONTENTS

CLARITY • VOLUME 2

- 01 — Introduction
  - 02 — The Benefits of Allocating to Multiple Investment Managers
  - 06 — The Impact of Interest Rates on Equity Returns
  - 10 — ESG Investing - Challenging the Status Quo?
  - 14 — Don't Look Back in Anger
  - 17 — Are Chinese Equities Worth Investing in Separately?
- 

# INTRODUCTION

MATTHEW MARRIAN

---



Welcome to the second edition of our Fundhouse Clarity Newsletter. The year 2020 will always be remembered for the 'global lockdown' and since March our worlds have changed significantly as we have been forced to adapt and navigate through this new COVID-19 world. During this time, all industries have been affected in some way or form, however not all have been affected equally with some industries such as tourism and hospitality coming to a complete standstill, while others, like asset management, have been able to continue working and for the most part it has been business as usual.

From a Fundhouse perspective, we have also been very fortunate as technology has enabled us to continue engaging with the fund managers, servicing our clients, and managing their portfolios from our respective home offices.

Although the asset management industry has been able to operate largely unaffected during these times, it has not been an easy time for many managers as they have had to navigate through extreme volatility and uncertainty and deal with nervous clients. All the uncertainty has led to a relatively unique situation where we see managers with completely opposite (almost binary) views – different individuals experiencing extreme optimism or extreme despair at the same time. This has led to an increase in engagement with managers as we continually test their views and their actions to ensure we remain comfortable with the funds we allocate clients' assets to.

The investment universe is complex, and the number of fund options and other investment alternatives available in the market increases the potential risk of incorrect implementation. In our first article, Peter Foster steps through the various levels of risk management we consider when building a portfolio and shows how allocating to multiple investment managers can benefit a portfolio.

Global interest rates are crucial to any investment decision and are a key input into the valuation of all asset classes.

Generally, a low interest rate environment is said to be supportive for equities, however, over the past decade as interest rates have declined, only certain types of equities have benefitted. In our second article, Lehan Kruger evaluates the link between interest rates and equities, and explores why certain investment styles have benefited more than others.

The importance of ESG within the asset management industry has seen a sharp increase over the past few years, with many asset managers now having dedicated teams focusing solely on the ESG aspect of a portfolio's current or proposed holdings. In our third article, Stuart Copley discusses the rise in ESG and challenges that come with ESG investing.

In our fourth article, Ian Jones addresses the age-old saying, "Past performance is not necessarily a guide to future performance". Ian highlights the importance of selecting a fund based on the future outlook, not the past, and uses some examples to illustrate times where our rating of a fund and the view in the market have been at opposite ends of the spectrum.

One cannot build a global portfolio without carefully considering not only the size of your allocation to China but also how you choose to invest in the Chinese market. In our final article, Benjamin Jones and Stephane Issa El-Khoury, from our UK office, discuss whether you should still include China as part of your general emerging market exposure or whether you should consider China separately given its prominence in the global economy?

The investment and fund management industry are fast-moving and continuously changing and as a business we are continually trying to help our clients navigate these changes. Our ambition remains to protect and grow the independent wealth management industry and ensure the best possible investment outcome for end investors.

# THE BENEFITS OF ALLOCATING TO MULTIPLE INVESTMENT MANAGERS



PETER FOSTER

*As the saying goes, 'hindsight is 20/20'. But how do you solve the problem of building forward looking portfolios? Our portfolio construction approach has a number of layers to it to ensure that we provide clients with the greatest range of investment opportunities – after all, it is returns we are all seeking. However, this comes with an interwoven set of risks which we need to be able to identify, assess and mitigate. Some of them are also more obscure than others and have the potential to derail a financial plan. In this article we touch on the various aspects we consider when looking at how best to construct a client portfolio.*

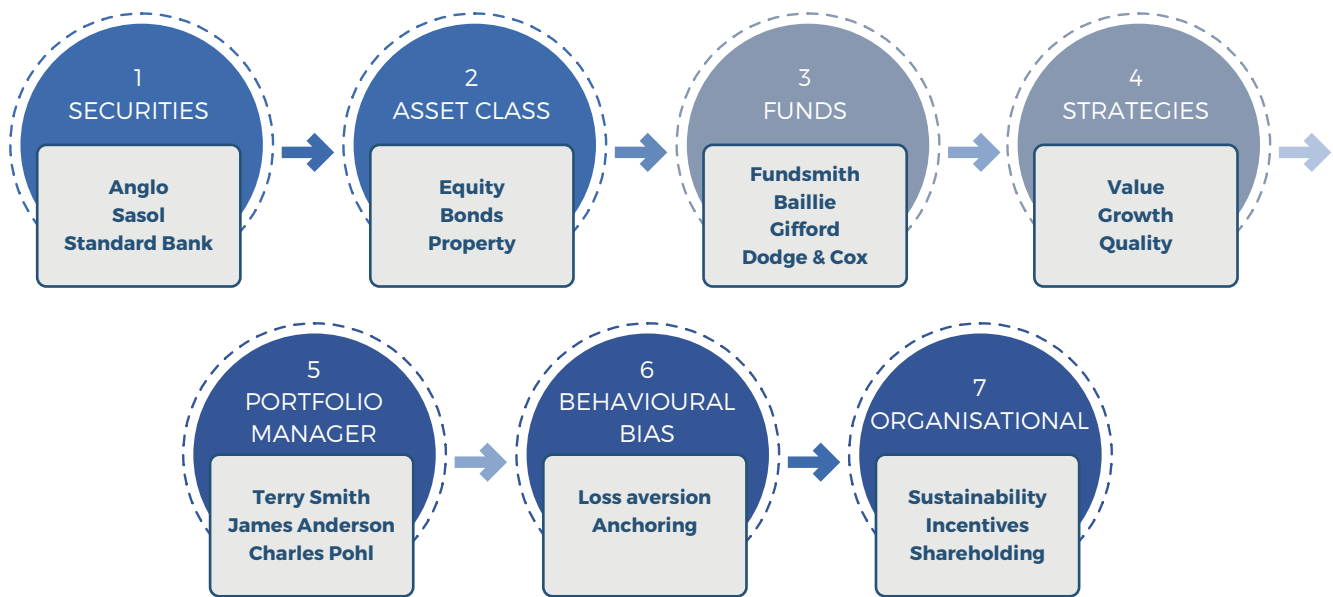
---

## MULTIPLE INVESTMENT MANAGERS

The setting of a financial plan has a key determinant to its success: the appointment of suitable investment managers to deliver on the plan's return expectations. There are many investment alternatives, offered through an increasingly diverse and complex range of fund options in the market. As investors we can elect to go active or passive, fundamental or quantitative, we can use value managers or growth managers or some variation thereof, we can use large managers or small managers, or one of the many 'boutiques'. This range of choice is complex and

fraught with pitfalls, and can adversely affect an investor's wealth if not implemented well. So how do we go about making sure that our clients' portfolios are the best they can be?

We believe that a diversified portfolio of individual funds is the most optimal way to deliver on return requirements. To provide some context, below we show the various levels of risk management we consider when constructing portfolios:



The first two risks ('selection') relate to the selection of various securities across the range of asset classes (equity, bond, cash, property). These are controlled by the fund manager, where a relatively high number of individual positions diversifies investors against specific problems with any individual instrument. A recent example here would be Sasol, with its cost overruns on the Lake Charles Project causing share price decline, ahead of a complete collapse in oil prices in Q1 2020. This would be offset by the 30 or 40 other securities held in a portfolio not exposed to this event. In this context equities are more diversified than securities like bonds, as they are spread across industries and regions, whereas government bonds are highly reliant on only a few factors to underpin their returns.

The second set of risks relate to the way in which securities are selected ('style'). A Value manager for instance would like to buy at low prices, whereas a growth manager would like to buy companies where future earnings growth is high. There are similar examples in the other asset classes too. Some bond managers like to buy high yield bonds, others like to be flexible around how much interest rate risk they take on.

A property fund may anchor on yield, whereas a balanced fund may favour safety first in its process in how it derisks quicker than when it adds risk. The investment philosophy that one will often see as the shop front of the fund manager is essentially how they see the world of investment opportunity - their investment 'style'. It is this style which helps determine how they add value to investors.

The last set of risks relate to the overarching issues which we find across a fund management business ('structural'). These types of risks are less commonly addressed by investors, but we see them as critical in assessing future investment outcomes. If an organization does not offer a pleasant working environment, it's unlikely the fund management team stays long term. At the staff level, if the decision making culture doesn't allow debate and challenge, will the best ideas shine through? Unlikely. More often than not, we see substantial weaknesses in the organizational structure of an investment manager, and this throws up big questions around whether or not we will get the returns we expect, when the business itself is not built on sound foundations.

## MULTIPLE INVESTMENT MANAGERS

When allocating to a single fund manager, we may easily achieve the desired risk management outcome at the selection level, as most portfolios will include a basket of diversified instrument holdings. However, we will be fully exposed to both their style as well as their structural risks, and we will have no protection against problems there. It is appealing to be able to select a single fund manager to implement portfolios for clients, however the disappointment rate is likely to be high. The commonly observed issues come in various forms: styles can be out of favour (e.g. Value, for the past decade), changes to portfolio managers or teams, business profitability and sustainability, or material investment errors causing permanent capital loss.

To offset these potential problems, we could then simply diversify across a range of funds. However, there are pitfalls here too: di-“worse”-ification (blending too many funds and removing the potential for value add), our own behavioural errors or responding to client pressures (buy high/sell low), and the ability to understand what it is you are investing in given we are one step removed from the management of the portfolio.

So, what is the optimal solution? We believe that by addressing the gaps and being aware of our own

limitations, we can minimize the potential risks across the spectrum for clients. What are the benefits, and how do we aim to achieve these?

- 1. Know what you are buying.** This relates to Risks 1 and 2 (selection). Our research process focusses on this area to identify fund managers who are likely to make consistent investment decisions which add value. Our fund ratings indicate the respective level of comfort we have, and we align portfolios towards the highest rated funds. We focus on understanding their decision making traits, behavioural biases, and their style.
- 2. Diversify your style risk exposure (Risks 4 and 5).** We are not value disciples, nor are we growth or quality bulls. All funds are assessed on investment merit, and we focus our efforts on identifying how the various market environments support or detract from a particular investment style. For investors, the journey is important, and for ourselves, increasing the odds of success is a significant goal.

By way of illustration, if we consider three well rated funds across the various styles, and observe how a combination of the three far outweighs the selection of an individual:

FUND	STYLE	VALUE ADD % P.A NET	TRACKING ERROR	VOLATILITY	INFORMATION RATIO	SHARPE RATIO	MAXIMUM DRAWDOWN
Baillie Gifford Long Term Global Growth	Growth	8.7	12.0	20.8	0.7	1.3	-69.0
Fundsmith Equity	Quality	6.5	5.5	12.3	1.2	2.5	-45.9
Dodge and Cox Global Stock	Value	0.1	4.5	15.7	0.0	1.6	-55.0
<b>Average</b>		<b>5.1</b>	<b>7.3</b>	<b>16.3</b>	<b>0.7</b>	<b>1.7</b>	<b>-56.6</b>
<b>Equal Weighted Blend</b>		<b>5.2</b>	<b>4.5</b>	<b>15.3</b>	<b>1.2</b>	<b>2.7</b>	<b>-56.4</b>

### Annualised returns and risk 2009 - 2019

The table shows how the blended combination provides investors with a more reliable outcome. For instance, 10 years ago would we have known it would be a poor decade for Value, as illustrated by the Dodge and Cox numbers. Or that if we needed to give our money to a single manager it should have been Baillie Gifford (recalling that at the time investors were reeling from the GFC and were highly risk averse, and may have been too conservative to make this higher risk selection). The blend results in a high aggregate return, while at the same time smoothing out the journey through lower volatility and less cyclicity relative to the market. We get the best of both worlds. This provides better risk adjusted returns as well. We can achieve this firstly by knowing what we are buying (so that we can select the funds for the blend), but also

because managers think and implement differently, and this diversification passes through in the form of lower risk measures.

- 3. Protect against problems within specific investment businesses or teams (Risk 5,6,7).** Much of this risk is identified and managed in our research process, however there is always the potential for unforeseen issues which arise from time to time. Senior staff departures or a business merger are examples of disruptive events which can hamper the performance of a fund. We will typically avoid funds where organisational risks are high (despite the fact there may be a good fund within the business), and we will always diversify away from single business risk.

## MULTIPLE INVESTMENT MANAGERS

Once we have identified and mitigated these three sets of risks, we can set about looking for good fund options.

We follow a specialist approach to fund selection where we focus on understanding the nature of how investment decisions are made, including how the particular manager perceives risk. This helps guide us on a forward looking basis rather than falling into the mental traps of using past performance as a guide. Fund management is an intellectual capital pursuit, so for us it is essential that we see these fund management teams in person on a regular basis to test their process and our understanding. Desktop research doesn't provide the insights we need to make fund selections.

These specialists allow us to build portfolios which include the broadest spectrum of investment opportunities, not just the ones that an individual manager will deem appropriate or have the capacity to manage. Examples here would be to add a specialist small cap fund, or a fund which only covers emerging markets or property. Or it might be a balanced fund with an absolute dislike for capital drawdowns. Whatever the specialization, this adds further opportunity and diversification to clients.

The easiest way to detract from this process is to second guess your managers, or to lose faith when performance is weak. In this respect we have some advantages over a typical fund allocator where they don't spend substantial time evaluating funds. For example, we are encouraged when fund managers underperform for the right reasons. Saying that, we will also become concerned when a

manager's decision making process seems to have changed, something which can happen during times of stress or underperformance.

This ability to identify, and hold, individual funds over the long term gives us an edge where we can let their individual styles run freely to add value, with the offsetting risk management embedded in the construction of portfolios ensuring that no individual fund, style, or business issue will permanently derail the ability for the investor to reach their financial goals.

This approach does result in more funds within a client portfolio than you would typically expect. Provided that the fund is adding marginal benefit in the form of return potential, or risk reduction, then there should be no issue from a theoretical standpoint. From a practical perspective, investors believe less is more. We are not so sure – the investment industry changes more often than one might hope for, and when we see the opportunity to diversify business, people or behavioural risks, we will take it. We need to start with the client's needs in mind, rather than with what the respective investment managers have put forward. The relatively minor inconvenience of longer fund lists is offset through time by better diversification and more reliable returns.

In summary, we aim to build portfolios which give our clients every opportunity to succeed, and to remove or reduce the risks which are an unwanted hurdle in the pursuit of a good financial outcome.

# THE IMPACT OF INTEREST RATES ON EQUITY RETURNS

LEHAN KRUGER



*The low interest rate environment since the global financial crisis (GFC) has coincided with strong global equity markets. This raises the question as to whether there is a link between interest rates and share prices and whether this impact is uniform across the equity universe. In this article, we consider these questions and look at what can be expected in the future if interest rates were to normalise.*

It is widely accepted that the low interest rate environment has served as a significant tailwind for global equity markets since the global financial crisis (GFC). However, this environment hasn't necessarily translated into strong performance consistently across the equity universe with certain subsets of shares significantly outperforming others. This article evaluates the link between interest rates and share prices, why interest rates impact certain shares differently and what we could expect from a market that normalises off historically low interest rates.

## Interest rates and the Drivers of Equity Returns

Equity returns over time can be broken down into three main sources or drivers of return: 1. earnings growth, 2. dividend yield and 3. the multiple or rating of a share. Let us first consider the relationship between interest rates and these three primary return sources:

### 1. Earnings Growth

Interest rates affect the demand side of the economy (i.e. how much demand is there for goods and services). Lower interest rates reduce funding costs, which results in people and businesses having more money to spend. This increases the aggregate demand for consumption and investment in an economy, which in turn boosts sales and earnings growth at a company level. All else being equal, low interest rates therefore enable higher earnings growth, which is supportive of share prices.

### 2. Dividend Yield

There is persistent global demand from investors for income generating assets like bonds to meet near term liabilities.

In the low interest rate environment since the GFC, global equities have offered a higher yield than global bonds (2.97%<sup>1</sup> vs 1.05% at end March 2020).

This has led many income seeking investors to look outside of the bond markets for yield and invest in equities. In particular, these investors have looked to the seemingly safer, stable and reliable dividend paying companies to invest in as an alternative to investing in bonds. Low interest rates have therefore supported the demand for stable dividend payers (over bonds) which has been supportive of share prices.

### 3. Multiples or Rating

Interest rates also affect share prices by the very methodology used to calculate the present value of a share. The present value of a share is calculated by discounting all the expected future cash flows (dividends for example) by the cost of capital, where the cost of capital is the investor's compensation for taking the risk to hold the asset. An investor's compensation for holding cash in the money markets, for example, is the prevailing interest rate. Equities are riskier than the money markets, so an investor demands a premium over the prevailing interest rate for investing in shares.

When interest rates are lower, investors demand less compensation for investing in assets, including equities. This enables future cash flows to be discounted by a lower cost of capital, which increases the present value of shares.

The relationship shows that persistent interest rate cuts can inflate share prices without any fundamental changes to the profitability of the underlying companies.

A simple example helps to explain: the present value of a R100 cash flow expected 10 years from today will be around R60 discounted at 5% per annum, compared to around R25 if discounted at a higher interest rate of 15%. Lower interest rates result in higher present values, all else being equal.

<sup>1</sup> Dividend yield of the MSCI World Index

# THE IMPACT OF INTEREST RATES ON EQUITY RETURNS

There is an additional aspect to consider and that it is the time period over which future cashflows are received from an investment.

Cashflows that are further into the future are discounted more – simply put, R100 due in one year’s time is worth more to an investor than R100 due in 10 years’ time.

In summary, lower interest rates generally result in higher earnings growth, support for shares paying higher dividend yields and provide support to equities through higher multiples given lower discount rates.

## One market, different shares

The stock market is generally divided into three “buckets” of shares: Growth, Quality and Value. Shares are classified into a “bucket” based on their relative sensitivity or exposure to the three drivers of equity returns (earnings growth, the dividend yield and rerating). While shares typically demonstrate a combination of these qualities, we can distil the market into the following broad buckets:

❖ **Growth shares:** expected to generate total returns primarily through strong earnings growth. Growth companies tend to reinvest earnings to maintain a high growth rate, which means dividends are low.

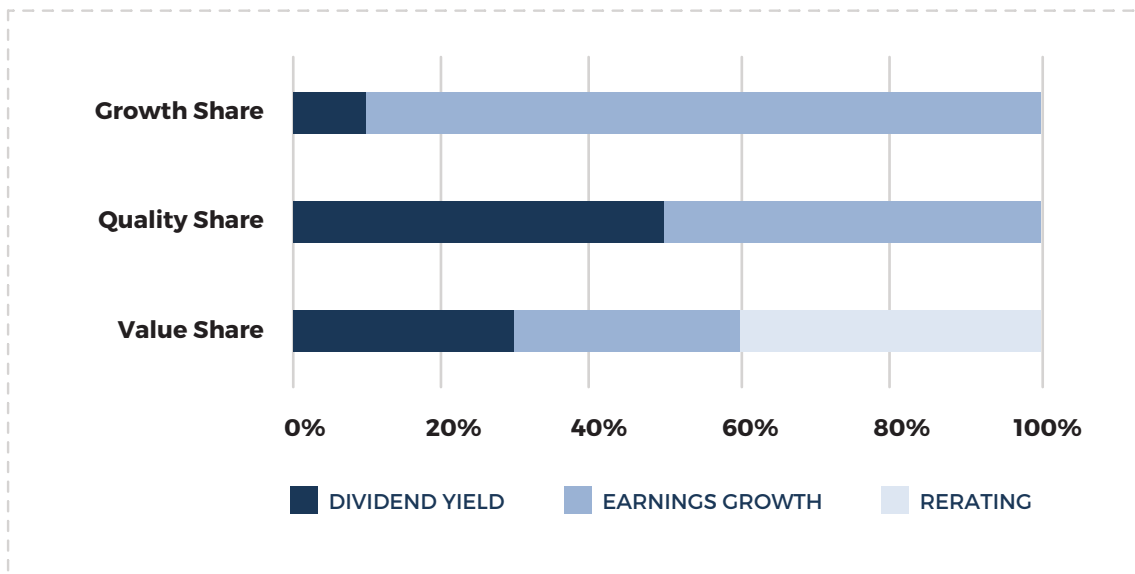
Investors are typically willing to pay high multiples for the strong growth and valuations generally remain elevated, so returns do not often come via a rerating.

❖ **Quality shares:** enjoy higher barriers to entry, strong brand power and high cash conversion. The primary return drivers are high and growing dividends and reasonable earnings growth (due to brand power and defensive industries). Investors are typically willing to pay higher multiples for the comfort of stable dividends, and hence rerating is expected to play a negligible role in the total return.

❖ **Value shares:** typically recovering from a period of abnormally weak earnings (which could be cycle or event driven). As a result, it offers investors a reasonable dividend yield (because valuations are low) and reasonable earnings growth as operations normalise. However, the primary return driver of value shares comes from rerating as the company recovers, sentiment improves, and the market prices for this improvement.

We demonstrate the hypothetical return drivers for these different categories of share in the chart below.

**Figure 1: Breakdown of total return drivers (note that these are hypothetical values)**



# THE IMPACT OF INTEREST RATES ON EQUITY RETURNS

**Figure 2: Interest rate impact on quality, growth and value shares**

SENSITIVITY TO INTEREST RATE CHANGE			
	QUALITY	GROWTH	VALUE
Earnings Growth	Moderate	High	Moderate
Dividend Yield	High	Low	Low
Rerating	Moderate	High	Low
Overall Sensitivity	High	High	Low

## Linking interest rates to the share buckets

Given that lower interest rates enable companies to achieve higher earnings growth, we would expect Growth shares to benefit disproportionately from the lower interest rates. Secondly, lower interest rates make stable dividend payers compelling investment alternatives to bonds, which are supportive of Quality shares in particular. Thirdly, lower interest rates reduce the cost of capital which tends to inflate share prices across the market. However, cash flows expected far into the future are more sensitive to interest rate changes which would support Growth shares more than the other styles as the higher earnings growth factored in mean that more of the return will be paid further into the future. The table above links the impact of interest rates on equity return drivers and the different share buckets that we described earlier.

Given their sensitivity to the various return drivers, we would expect quality and growth shares to be the most

sensitive to interest rate changes and benefit the most from a low interest rate environment.

## Has this played out in Actual Performance?

The last decade has seen record low interest rates prevalent across most of the developed economies. Over the last decade to 31 March 2020, the broader global developed market (i.e. the MSCI World) has returned 5.4% per year in excess of US inflation. Quality shares have outperformed the market by 3.4% per year, growth shares outperformed the market by 2.2% per year, while value shares have underperformed the market by 2.3% per year. These differences are even more pronounced over the last 1- and 3-year periods, as the table in Figure 3 below shows.

This contrasts with longer term numbers, where value shares have outperformed the market and growth shares for almost 50 years.

**Figure 3: Annualised returns of global style indices relative to global equities (to 31 March 2020)**

	QUALITY	GROWTH	VALUE	WORLD	US INFLATION
1 yr	0.07%	-0.92%	-18.62%	-9.87%	2.00%
3 yr	8.85%	7.98%	-3.01%	2.49%	2.10%
5 yr	8.40%	6.95%	0.61%	3.83%	1.90%
10 yr	10.61%	9.33%	4.92%	7.17%	1.80%
SI*	N/A**	9.58%	10.86%	10.29%	3.72%

\*Since inception on December 31, 1974 | \*\*The quality index was only launched in 1994.  
Source: MSCI World Quality, MSCI World Growth, MSCI World Value, MSCI World factsheets as at 31/03/2020

## THE IMPACT OF INTEREST RATES ON EQUITY RETURNS

While other factors have influenced the relative returns of the various styles over the last decade, Growth and Quality have clearly outperformed Value through this period of very low interest rates.

### What does the future hold?

There is a significant level of uncertainty permeating economies and markets at the moment which makes forecasting exceptionally difficult. Given the expansionary central bank policy over the past year (and the last decade), as well as the massive monetary stimulus announcements in response to the COVID-19 crisis, it is difficult to imagine a world with inflation and higher interest rates in the short term. What we can be clear on is that interest rates are currently very low relative to historical averages and, on a balance of probabilities, it is difficult to argue that interest rates will remain at these levels in the medium to long term. Central banks are, for the most part, mandated with maintaining price stability, so unexpected shocks to global supply chains (whether caused by trade wars or global pandemics) or a meaningful economic recovery could cause this environment to unwind if inflation expectations rise. This was demonstrated in Q4'2018 as US inflation peaked at 3% and the Federal Reserve was hiking rates. Global markets fell around 20% in that quarter, with value shares outperforming both quality and growth shares. While other factors contributed, rising interest rate expectations played a significant role in the drawdown.

What should we expect from an environment where rates normalise off historic lows? Clearly a shift in the interest rate environment is unlikely to happen overnight or in a straight line, and interest rate normalisation will not happen in isolation, rather there is a complex interplay of variables that impact the direction and magnitude of share price returns when interest rates rise.

However, within the context of a longer-term investment horizon, the concerns around interest rates rising in the developed world is the loss of the decade long tailwind that has been supporting equities in general and a certain part of the market in particular. We expect this to impact the buckets as follows:

1. Growth companies should come under pressure as the high earnings growth expected far out in the future is discounted at higher interest rates, reducing their present value. In addition, depending on the prevailing economic environment, higher interest rates also reduce aggregate demand in the economy, which impacts earnings growth.
2. The concern for quality companies is that the value investors place on stable dividends is eroded as bonds offer more attractive yields.
3. Value shares are certainly exposed to these factors, but we would expect the overall impact to be lower given the points we've discussed. In addition, there is less accumulated benefits to unwind in value shares should interest rates rise.

Quality and growth funds have enjoyed a strong period of performance for over a decade to the extent that the existence of value as an investment philosophy has come into question. However, we have been exposed to an unusually low interest rate environment since the Global Financial Crisis which has created a unique set of circumstances that benefitted a certain part of the market.

We cannot predict when this environment will end, but the prudent portfolio construction decision would be to retain a diversified approach to different parts of the market and not be caught overly exposed to past winners when the environment eventually unwinds.

# ESG INVESTING – CHALLENGING THE STATUS QUO?



STUART COPLEY

*ESG Investing has been around in some shape or form since the 18th century, but it is only over the last year or so that we have seen broader interest from investors in ESG funds and a reaction from the majority of asset managers to incorporate ESG factors into their investment process.*

---



The origins of Environmental, Social and Governance (ESG) investing can be traced back to the 18th century when various religious movements prohibited their followers from investing in “products that may cause harm to your neighbour”, including any investment in guns, liquor, tobacco or the slave trade. It wasn't until the late 1980s that investors started to consider that focusing on ESG factors as part of their investment process may actually enhance returns. ESG eventually entered the mainstream investment environment in 2006 when, with the support of the United Nations, the Principles for Responsible Investment (PRI) were launched by a group of global institutional investors. This led to a number of asset management firms and asset owners becoming signatories to the PRI – today, there are over 3000 signatories from across the globe.

## THE PRINCIPLES FOR RESPONSIBLE INVESTING (PRI)

[www.unpri.org](http://www.unpri.org)

### PRINCIPLE 1:

We will incorporate ESG issues into investment analysis and decision making processes.

### PRINCIPLE 2:

We will be active owners and incorporate ESG issues into our ownership policies and practices.

### PRINCIPLE 3:

We will seek appropriate disclosure on ESG issues by the entities in which we invest.

### PRINCIPLE 4:

We will promote acceptance and implementation of the Principles within the investment industry.

### PRINCIPLE 5:

We will work together to enhance our effectiveness in implementing the Principles.

### PRINCIPLE 6:

We will each report on our activities and progress towards implementing the Principles.

## What is ESG Investing?

ESG Investing, often referred to as “Sustainable Investing” or “Socially Responsible Investing” (SRI), is where ESG factors are integrated into the fundamental investment process. ESG factors are the non-financial performance indicators of a business.

**E :** Environmental factors cover the risks created by any business activity that has a negative impact on the environment (e.g. water or air pollution, deforestation, impact on community health). Investors consider how the company manages their resources and reduces pollution or carbon emissions, as well as how they reduce any reputational, regulatory or litigation risk.

**S :** Social risks refer to the impact that companies have on society at large, including consideration of ensuring the basic living conditions of employees, whether their human rights are protected and whether health and safety is prioritised in the workplace.

**G :** Governance risks are concerned with the way companies are managed, with a focus on governance activities like the diversity and accountability of the board, the protection of shareholder rights, and the disclosure of information in company reports.

## How is ESG Investing implemented?

One of the challenges with ESG Investing is the confusion created by the range of methodologies adopted. The approaches to implementing an ESG philosophy include:

- ❖ excluding shares with any defined ESG issues out of the investment universe (referred to as screening),
- ❖ integrating ESG issues in the fundamental analysis of a share (e.g. through requiring a higher rate of return to accommodate the extra risk associated with the ESG concerns),
- ❖ approaching ESG in a thematic way by investing with a specific social or environmental outcome in mind.

The table below sourced from unpri.org sets out the range of approaches adopted by asset managers and owners to build ESG factors into their decision making processes.

# ESG INVESTING - CHALLENGING THE STATUS QUO?

## CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)

ESG issues can be incorporated into existing investment practices using a combination of three approaches: integration, screening and thematic.

### INTEGRATION

Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.

### SCREENING

Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics.

### THEMATIC

Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.

## IMPROVING INVESTEEES' ESG PERFORMANCE (known as: active ownership or stewardship)

Investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices.

### ENGAGEMENT

Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors.

### PROXY VOTING

Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.

## The Status Quo

Despite the increase in the number of signatories to the UN PRI and indications that ESG was being taken into account in some form by most asset management businesses, there has been widespread scepticism from the industry on ESG:

1. Firstly, the flows into ESG funds was historically not material - the demand from the average investor wasn't there. There was effectively no evidence that a focus on ESG enhanced returns.
2. Secondly, there was a general view that many asset managers treated ESG as a box ticking exercise. Something that marketing or a due diligence process required, rather than an integrated component of the investment process. The managers tended to treat ESG as a secondary input to the investment process, partly because there wasn't widespread belief that it added value to the decision making process but also because obtaining concrete data on the issues at hand was very difficult. For example, how does an asset manager gauge the risks relating to Social issues for an industrial business?

However, over the last 18 months we have seen a definite shift. Flows into ESG funds increased materially across the globe in 2019 and a number of the prominent global investment businesses have publicly announced that ESG factors would be core to their businesses in the future. By way of example, BlackRock announced in January 2020 that they were implementing sweeping changes to their business to incorporate Sustainable Investing. Larry Fink, their CEO, stated that BlackRock will now assess environmental, social and governance "with the same rigor

that it analyzes traditional measures such as credit and liquidity risk".

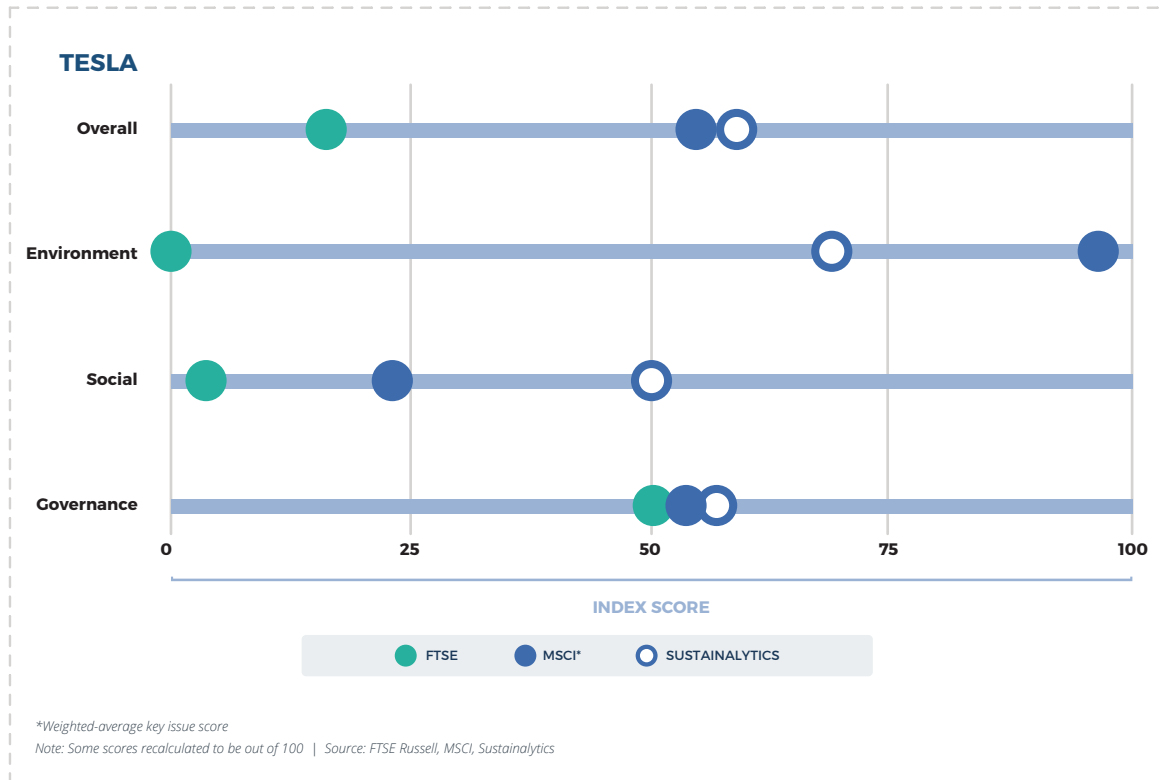
Part of our fund research looks at a fund manager's approach to ESG and whether it adds value to the investment process and end outcome for clients. In South Africa, we have seen an increased focus on ESG factors from fund managers over the last 18 months or so with certain managers building teams that focus on ESG analysis, others including it as part of their analysts' fundamental research process. In our view, this increased focus on ESG is more than just a marketing exercise - many managers have now bought into the concept that a core focus on ESG factors and the associated risks results in better decision making at a stock level.

## What are the challenges with ESG investing?

The biggest challenge is that there is no standardised methodology employed across investment managers, regions or asset classes. Each investment manager interprets ESG in their own way with their own level of emphasis on individual factors such as pollution (environmental), employee welfare (social) or board composition (governance). There is no standard definition of poor governance, pollution levels or poor working conditions. The investing landscape is dominated by the marketing of products and the lack of standardisation opens up an opportunity for products to be sold as "ESG focused" without any substance.

Even the companies that publish ESG Ratings can't agree. If you consider the ESG ratings provided by three companies (Sustainalytics, FTSE and MSCI) for Tesla in 2018, there are big differences in their views. MSCI score Tesla close to 100 (out of 100) on Environmental while FTSE give it a score of zero! If the experts have such diverse views, how does one expect the asset buyers to discern between the product offerings?

# ESG INVESTING - CHALLENGING THE STATUS QUO?



Company disclosure is also a major hindrance for investment managers to accurately evaluate ESG factors for individual companies. Investment managers can consider ESG issues in their investment decisions only if they have relevant and timely information to do so. At present, mandatory corporate disclosure provides limited information on ESG-related risks and opportunities. The remainder of ESG disclosure is voluntary in nature. The challenge with voluntary disclosure is that companies may disclose and exaggerate only what reflects well on them and downplay what does not. We expect ESG disclosure to improve over time and in South Africa, the shift towards integrated reporting from many companies is a big step forward.

Finally, ESG Investing faces the challenge of whether it actually results in better investment outcomes.

Academic support for the full scope of ESG factors is still a work in progress. There are numerous examples of a lack of governance or a severe environmental event (e.g. an oil spill) destroying shareholder value but the ability to foresee these major events and ascertain which companies are likely to be impacted in advance remains challenging.

Despite these challenges, we expect interest in ESG Investing to increase exponentially in the coming years due to a combination of regulatory pressure on asset owners to focus on ESG issues, demand from fund buyers for their asset managers to consider social and environmental issues and large institutions trying to establish themselves as the leaders in the ESG space.

# DON'T LOOK BACK IN ANGER

IAN JONES



*Past performance is often seen as the starting point by many when selecting funds. We have always argued the opposite: that past performance is generally the worst way to select a fund. You are selecting an investment for the future (not the past). Fund performance is cyclical by its very nature and in many cases, buying a fund with strong recent performance is "buying high" and selling a fund with poor recent performance is "selling low".*

"Past performance is not necessarily a guide to future performance", the warning on all monthly fact sheets or performance disclosures. A warning that investors should not assume an investment will continue to do well in the future simply because it's done well in the past. Despite this, investors often use past performance as the starting point when selecting funds.

We have always argued the opposite: that past performance is a poor guide when selecting a fund. You are selecting an investment for the future (not the past). Fund performance is often cyclical by its very nature and in many cases, buying a fund with strong recent performance is "buying high" and selling a fund with poor recent performance is "selling low". We believe that the evidence that helps investors discern whether a fund will deliver on its objectives going forward lie in a range of qualitative factors including the business, the team and the process. We believe that having an in depth understanding of each of the qualitative factors increases the odds in your favour when selecting a particular fund.

When carrying out a due diligence on a fund, it is often a difficult task to rate a top performing fund poorly or to rate a fund with significant underperformance well. It tests your conviction and ensures that you have covered all the potential issues in detail. In this article, we have chosen four fund examples where this has happened and highlight the key factors that led to us arriving at the fund rating.

## 1. SIM Global Best Ideas Fund

One of the first funds we ever formally rated in 2013 was the SIM Global Best Ideas Fund, a popular global equity fund managed by a globally respected portfolio manager, Kokkie Kooyman. At the point of rating the fund, the fund was the top performing FSCA registered Global Equity fund.

Despite the great recent performance, we ended up with a Tier 3 rating, our lowest tier.

While there were other concerns relating to the team still being in a building phase, the main challenge for us was the potential bias to financial stocks and the portfolio construction skills across the broader global equity investment universe. The team also ran the SIM Global Financials Fund (for which it has won multiple global awards), the portfolio manager was a financials specialist and the team was "overweight" financial analysts. With this as background, we had to test whether the significant allocation to financials in the portfolio was as a result of the philosophy and process being implemented consistently across all the sectors with financial stocks happening to be the best options at that point in the cycle. Or was it as a result of the team's focus and potential bias towards financials?

In our opinion, the financials overweight was due to the strong skills and experience bias towards financials which meant that the fund was dependant on the relative performance of the financials sector. If financials outperformed, the fund would outperform, but if financials lagged the fund would lag (even if they had better stock picks than the average). This challenge was also exacerbated by our broader portfolio construction concerns. If we were rating the SIM Global Financials Fund, the outcome would likely have been very different.

Subsequent to the rating, global financials underperformed materially, and the fund followed suit as expected. The qualitative concerns regarding the team and skill imbalance provided the clues that past performance was certainly not a good guide to future outcomes.

## 2. Standard Life GARS Fund

We carried out a due diligence on the largest fund in the UK market in 2014, the Standard Life GARS Fund. To provide context, the fund was larger than the entire unit trust market in South Africa. The fund had strong recent performance when we carried out our due diligence. We rated the fund Tier 3 and at the time there was a degree of disbelief in the market given the fund's popularity and performance.

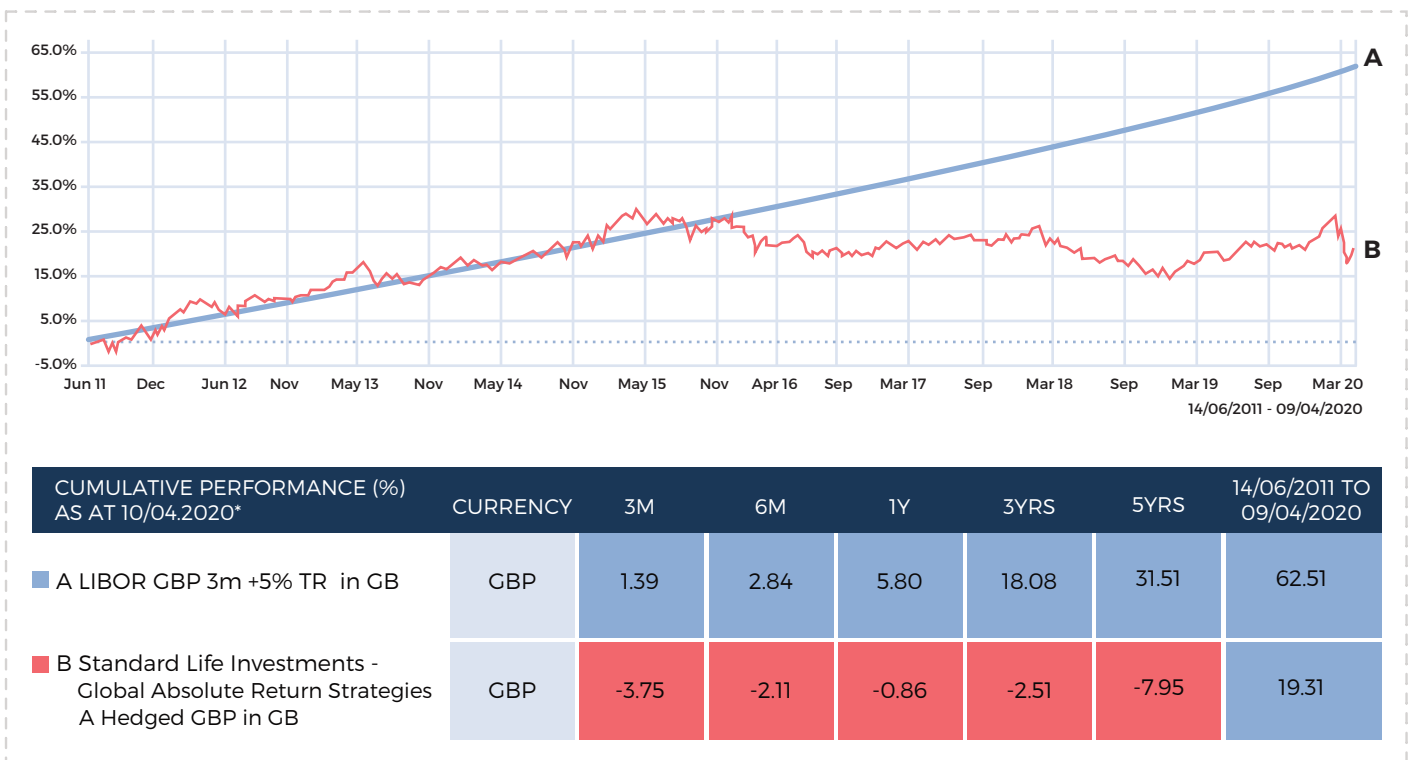
The GARS approach to investing aims to combine multiple sources of return, which collectively offer equity-like returns at half to a third less risk than equities. Many of these return sources will be non-traditional, such as taking positions in volatility, or implementing hedge fund-like pair trades. The premise is that this diversified approach will always have a potential source of return, enabling the fund to meet its objectives through all return environments. But we did not find this to be the case in practice.

Since inception, we found that returns were particularly biased towards certain strategy types and asset classes.

We analysed all their current and historic strategies and found that the bulk added little value, with fixed income related strategies making up the majority of their historic return. Creating diversification without adding return was a concern: besides fixed income type strategies, most other strategies had broadly netted off.

Our testing showed that hit rates and the ability to generate excess returns in security selection and relative value investments were low over long time periods.

All this evidence worked against the central premise of the fund – diversification of returns. It made us question what would happen if the historical primary return driver (fixed income strategies) didn't deliver. That is what ended up happening: when fixed income returns disappointed, the fund performed poorly and did not deliver on the diversified sources of return to clients. This is illustrated in the chart and table below – up until mid- 2015, the fund had delivered on its objective (represented by the blue line) after which it has disappointed. The detailed analysis provided clues that the past performance was unlikely to be repeated going forward.



Source: FE Analytics

### 3. Investec Value Fund

The Investec Value Fund (now Ninety One Value Fund) managed by John Biccard is a deep value fund that aims to provide investors with capital growth over the long term and specifically to deliver alpha relative to the market over longer time horizons. The fund is run in such a way that the performance cycles (both positive and negative) are very deep. When we first rated the fund in early 2015, the fund had underperformed materially – the fund was almost 16% behind the index over 1 year and the severe short-term performance meant long term performance was also poor with the fund 8% per annum behind over 5 years.

We ended up rating the fund a Tier 1 at this point. What was the key qualitative evidence that allowed us to arrive at the conclusion?

- ❖ Timeframe is crucial for alpha - active managers need time for their calls to come through. This is especially true for a deep value manager where they can look very wrong for protracted periods. The business and shareholder need to have a deep understanding of investing to have the patience to allow the time for the alpha. The business and shareholder provided support to the fund manager despite significant outflows.

- ❖ Secondly, the portfolio manager has demonstrated material skill (and conviction) at implementing a deep value philosophy over long periods of time, while also having the temperament to not get too excited when the fund is either underperforming or outperforming materially.

Finally, despite the period of underperformance, the process had remained consistent and the manager remained very clear in explaining each of the positions in his fund through time.

The high levels of conviction in the fund have delivered good returns to clients who have remained in the fund. It has certainly been a bumpy ride but worth it for those that have been patient. For us, it was another good demonstration of how past performance would have led to the incorrect call on a fund.

### 4. Fundsmith Equity Fund

Fundsmith has been one of the best performing global equity funds for a number of years now. They manage the fund following a strict Quality style, which has clearly been a significant tailwind, but they have also added significant value through their stock picks. Fundsmith communicate their investment strategy as follows:

- ❖ Buy good companies
- ❖ Don't overpay
- ❖ Do nothing

Despite the strong performance, we decided to downgrade the fund from Tier 1 to Tier 2 in February of this year which surprised many. Our concerns centred around a set of behaviours which seem to be symptomatic of overconfidence, and a business culture that appears to suppress criticism and constructive feedback. Although we continued to recommend the fund, we no longer had the high level of conviction needed to award it a Tier 1 rating.

We are clear that this fund and team have several strengths. Their process, which they stringently adhere to, involves researching a core universe of 65-70 companies with a history of generating superior free cashflow returns on the capital employed and, in their judgement, an ability to continue growing them. The theory is that if they own these companies for long periods, the gains from these 'high-quality' businesses will create powerful long-term return compounding.

Our rationale for downgrading the fund stemmed from concerns around an apparent increase in the manager's confidence (verging on overconfidence), coupled with commentary on how others who follow a different investment process are misguided or even wrong. For us, this is often an indication of 'closed loop thinking' and suggests to us a limited degree of introspection and self-criticism. Clearly, they have done a lot well, but we were concerned that the feedback loops may not be there when things go wrong.

We wait to see whether our concerns have merit but for us, the qualitative concern clearly outweighs the strong past performance – it is the future that matters.

### In conclusion

Extensive research and analysis exist that show selecting a fund based on past performance is deeply flawed. There are many reasons for this but the main one is the constant change happening within businesses, the investment teams, or the philosophy and process they follow. Even when these are consistent, you are still faced with the potential for changes in the behaviour of key members of the team. All those changes mean that what you end up getting in the future is very different to what you thought you were buying based on the past. This is why we rely on the qualitative assessments.

It is clear that we will not always get it right - forming a view of a particular investment offering based on qualitative factors is a subjective call based on our individual and collective experience of working in and assessing asset management businesses. However, we do believe there is evidence that relying on our qualitative due diligence when looking forward tilts the odds in our favour when compared to looking at the past.

# ARE CHINESE EQUITIES WORTH INVESTING IN SEPARATELY, RATHER THAN PART OF MSCI EM?

BENJAMIN JONES

STEPHANE ISSA EL-KHOURY

*One of the most important questions facing investors in the future is how to invest into China as their economy opens to foreigners and their share market becomes more accessible. Should investors rely on Emerging Market specialists to allocate to the Chinese equity market as new opportunities arise or should they consider China separately from the broader Emerging Markets given its prominence in the global economy?*

---



## A background to China for equity investors

### Transition

China has been through enormous transition in the last 70 years, turning from a fully collectivised society where private ownership and property rights were almost absent, into a flourishing market economy that became the world's largest economy in PPP terms in 2014, and is second only to the US in nominal US\$ GDP (IMF, 2019). The rural population of the Chinese mainland have enjoyed amongst the most rapid levels of income growth in history, with sustained per-capita real income growth of around 11%pa in the 1980s, which accompanied by rapid urbanisation added up to the greatest long-term migration of people in history, as well as the era in which it is estimated more than 800m people were lifted out of extreme poverty.

### Opening-up

For several decades, State Owned Enterprises (SOEs) were the only permitted form of enterprise. In a conscious period of reform and opening-up of the economy that began with the Chinese leader Deng Xiaoping in the late 1970s, private enterprise has returned to China in a big way. Special Economic Zones like Shenzhen were established to encourage Foreign Direct Investment, property rights and proper company law were gradually re-introduced, and the Shanghai and Shenzhen stock exchanges awoke from decades of dormancy to host the newly privatised equity markets in the early 1990s. The speed at which the Party and government have adopted a market system (which sat completely at odds with their ideologies in very recent history) has been quite breath-taking. China journalist and author Richard McGregor characterises the changes as follows: "The change of political attire is akin to a Wall Street banker disappearing Clark Kent-like into a phone box, and emerging swiftly after a few minutes dressed as Karl Marx".

### Structural issues that remain today

We do find some teething pains and oddities. SOEs are still highly influential in the market. Numbering over 50,000 and collectively valued at over US\$30tn (OECD, 2017), they dominate financials and industrials ('Old China'). Their loyalties are split; delivering to private shareholders, but also at times acting to advance the long-term strategic goals of the state. However, the government has actively and successfully de-emphasised their influence over time; we find that the share of all corporate revenue in mainland China from state-owned and state-controlled firms declined from around 90% in 1998 to less than 50% in 2013 (Hale and Long, 2007<sup>1</sup>).

Today, the government continues to reform the sector, and is currently following advice from the IMF to de-emphasise

SOEs' role in the economy, such as by lowering barriers to entry for competitors, and reducing the preferential debt availability that they have enjoyed for so long.

There are some other peculiarities that international investors should be aware of. China has very high levels of retail ownership of its shares relative to other markets (c.45%, versus 14% in the UK and 22% in India) who are quite short-term driven in mindset, and we believe that they contribute considerably to volatility and momentum, such as in the 2015 A-share bubble. Additionally, we understand that a group of large financial institutions in mainland China (almost entirely SOEs), known informally and unofficially as the 'National Team' are thought to intervene in markets to further the goals of the central government. They are thought to be "state-backed and state-directed Chinese financial firms who have been ordered to directly buy stocks in an attempt to boost investor confidence. As the name suggests, these firms work in tandem to push share prices higher" (Zeng, Huang, and Hueng, 2016<sup>2</sup>).

### Growth in markets

But the signs are overwhelmingly positive; we find strong evidence that the equity market is wide (in a number of stocks and sectors), deep (in terms of liquidity) and is on a long-term trajectory to encourage material levels of foreign ownership. The onshore equity markets (A-shares traded through Shanghai and Shenzhen, such as Kweichow Moutai) have grown in the last 30 years from nothing to being worth over US\$7tn in total market cap. The market for companies listed offshore, such as in New York ('N-shares' such as Alibaba) or in Hong Kong ('H-shares' such as Ping An Insurance) has also grown tremendously.

### The economy today

GDP growth in China has been stalling, falling to 6.2% in 2019, which is the slowest in almost three decades (OECD 2020), with some modest further slowing expected (IMF, 2019). Clearly there will be a material impact from COVID-19 as well. To combat this, the government has been rolling-out measures over the past two years in an attempt to boost growth; namely tax cuts and permitting local governments to sell large volumes of bonds to fund their infrastructure programmes. The trade war with the US has been especially impactful on China's exports, as the US represents around 20% of export demand. However, in January 2020, the two governments signed a Phase 1 trade deal (Reuters, 2020), which halves the tariffs put in place by the US. This should ease the strain the trade war has put on the Chinese economy.

<sup>1</sup> Hale, Galina, and Cheryl Long. 2007. 'Is There Evidence of FDI Spillover on Chinese Firms' Productivity and Innovation?', January.  
<sup>2</sup> Zeng, Fanhua, Wei-Chiao Huang, and James Hueng. 2016. 'On Chinese Government's Stock Market Rescue Efforts in 2015'. *Modern Economy* 07 (04): 411-18. <https://doi.org/10.4236/me.2016.74045>.

We also note gradually rising debt levels, with debt/GDP thought to be over 50% today; this does not seem terribly high versus other major economies, but we note that there could be hidden debt as high as \$6 trillion (almost half of Chinese GDP in 2018), mostly taken by local government financing vehicles to finance for infrastructure development.

Whilst this is obviously concerning, our remarks earlier on the de-emphasising of Chinese SOEs by the government does give us some comfort about gradual resolution of this problem.

**Summary**

We find that China has experienced, and continues to enjoy, a fast-paced move away from state-centric enterprise towards private enterprise. Economic reforms have been substantial (although some issues like GDP growth and debt levels are of concern, they do not overshadow the positive story) and equity markets have opened up substantially. A 'New China' has emerged from industrially-focused and SOE-heavy 'Old China', best represented by the more tech-heavy domestically focused A-share market, which has rapidly opened up to international investors. China certainly presents a unique and distinct market for investors to consider.

**Considerations for investors**

**Access to markets**

What market access to China can international investors enjoy? Whilst accessing Chinese offshore listed companies (H-, N-shares etc) has been relatively easy for international investors, trying to buy onshore A-shares has been quite difficult. This has been a problem for investors wanting to access an all-China universe, given that they represent a

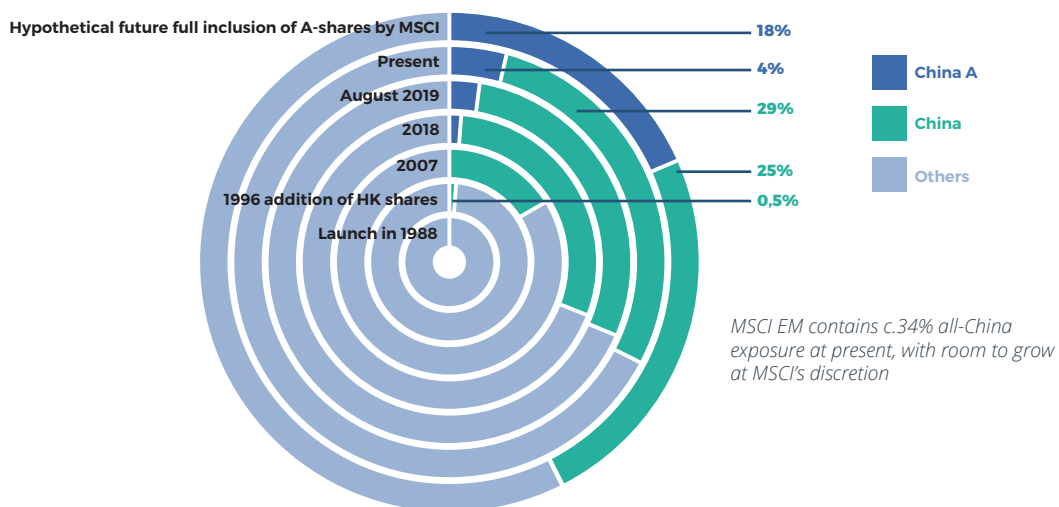
significant majority of market cap, and account for nearly 4,000 companies. Additionally, they represent much of the 'New China' economy which is tech-focused and driven more by domestic demand growth than the industrial focussed 'Old China' companies that have given China the reputation of being 'the factory to the world'. International investors had no means of accessing A-shares until the early 2000s; even then, significant barriers, quotas and capital repatriation limits made it difficult for all but the largest and most committed institutional investors to participate. The introduction of the Stock Connect system has been revolutionary, reducing many of these barriers, and the trend of easing access for foreigners looks set to continue.

**MSCI**

China entered the MSCI Emerging Markets index in 1996 at a tiny weight which has grown substantially since then, and following the improvements to market access listed above, MSCI (who give greater inclusion of markets in their indices as those markets become more accessible) have recently decided to include onshore A-shares for the first time.

China still remains relatively under-represented in the index versus other markets (for reasons of accessibility and maturity), but it is expected that this will improve as the equity market continues to open-up (as was the case with Taiwan and South Korea). In the event that MSCI decided to include China A-shares at their full weighting, it is thought that all-China equity exposure would account for almost half of the MSCI EM index weighting, as shown in the graph<sup>3</sup> below. This emphasises the ongoing importance and dominance of China in the context of emerging markets, and at such a large weight suggests that a carve out would be sensible.

**Components of MSCI EM through time**



<sup>3</sup>This chart was constructed by Fundhouse, with data from MSCI (2018a; 2018b; 2019a; 2019b; 2019c) and CICC Research (2019).

### Portfolio construction considerations

Over the 15 years to 2019, we note that there has been a very low correlation between the MSCI China A Onshore index<sup>4</sup> and MSCI World (0.39) and MSCI EM (0.49) as measured in US\$; this presents an opportunity to diversify portfolios<sup>5</sup>. Additionally, due to the considerable domestic exposures within the all-China stock market (which is perhaps counter-intuitive, given China's reputation as the 'factory of the world'), allocating away from MSCI EM to MSCI China would provide a portfolio with much greater exposure to the domestic Chinese economy at the expense of the US, and in terms of underlying economic exposures, be diversifying. These attributes make an allocation to Chinese A-shares potentially attractive from a portfolio construction point of view.

Are there any portfolio construction pitfalls that investors should be aware of? We have identified a number of biases that can present themselves when splitting-out Emerging Markets into Emerging Markets ex-China/ China: investors should be aware of potential overweights to consumer discretionary and communications sectors and an under weight to IT, amongst others.

### Active or passive?

We have identified a number of potential headwinds and tailwinds to taking an active approach to investing in China (rather than passive). The heavily retail (and unsophisticated) presence in the marketplace creates alpha mispricing opportunities as well as providing substantial liquidity, and we note that there is quite limited sell-side research coverage in place at present. Historically, there have also been surprisingly good levels of alpha generation across China mutual funds, even after fees. On the other hand, the influence of the state through SOEs, and a relatively low number of active managers to choose from, may provide challenges for active management. But the evidence points to actively managed exposure.

### Overall conclusion

We have seen tremendous growth and privatisation occur within the Chinese economy in recent history, and a gradual opening-up of its equity markets that has put China increasingly in focus for international investors. We find evidence of reducing SOE dominance, and although some teething issues exist (like a large retail investor influence), the markets are heading in a positive direction and today they are more accessible than ever. This has been recognised by MSCI, who have included A-shares for the first time recently, and if things continue positively, China may account for almost half of all MSCI EM exposure before too long.

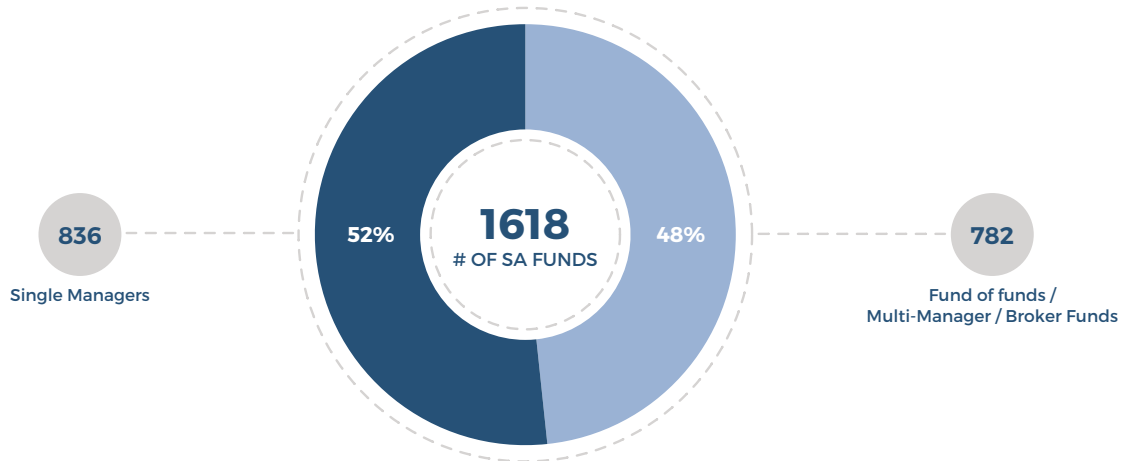
In terms of portfolio construction, we see potential benefits in diversifying the underlying economic exposures of a portfolio, as well as the opportunity to increase exposure to A-shares which have had low correlation to developed and emerging markets over long periods.

Overall, although there are some issues that investors should be aware of, we think it is worthwhile for investors to consider China separately, rather than just as a part of MSCI EM, when making asset allocation decisions. Accessing both onshore (A-shares) and offshore (H-, N-shares etc) exposure will be important to get access to both 'New' and 'Old' China, and our initial research suggests that active investment is preferable over passive.

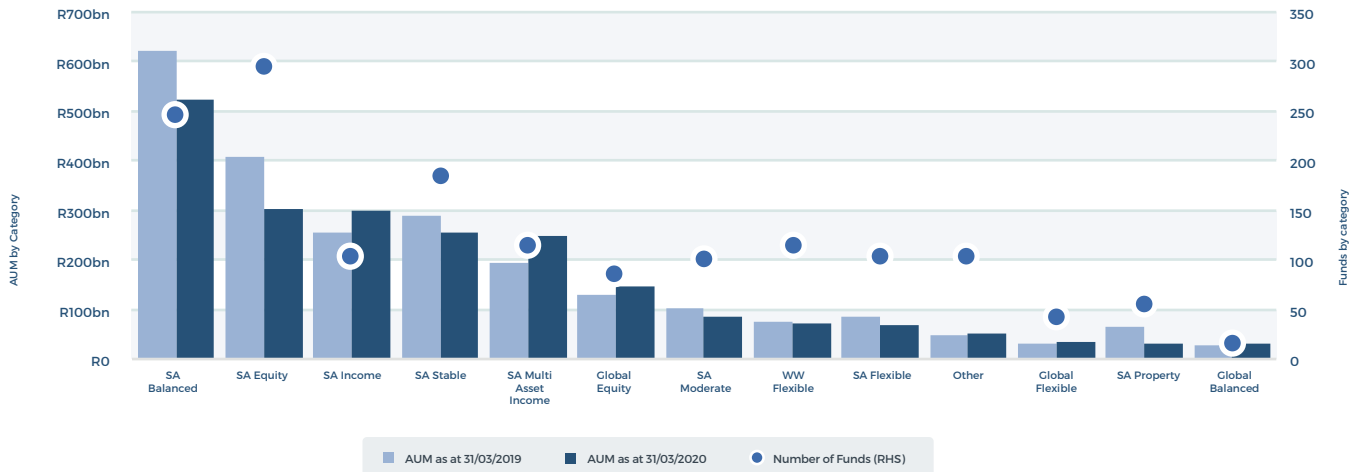
<sup>4</sup>A wide A-share universe, currently un-investable for foreigners, but which will more closely represent the investable A-share universe as reforms continue.

<sup>5</sup>Data summarised by Aberdeen Standard Investments (2019).

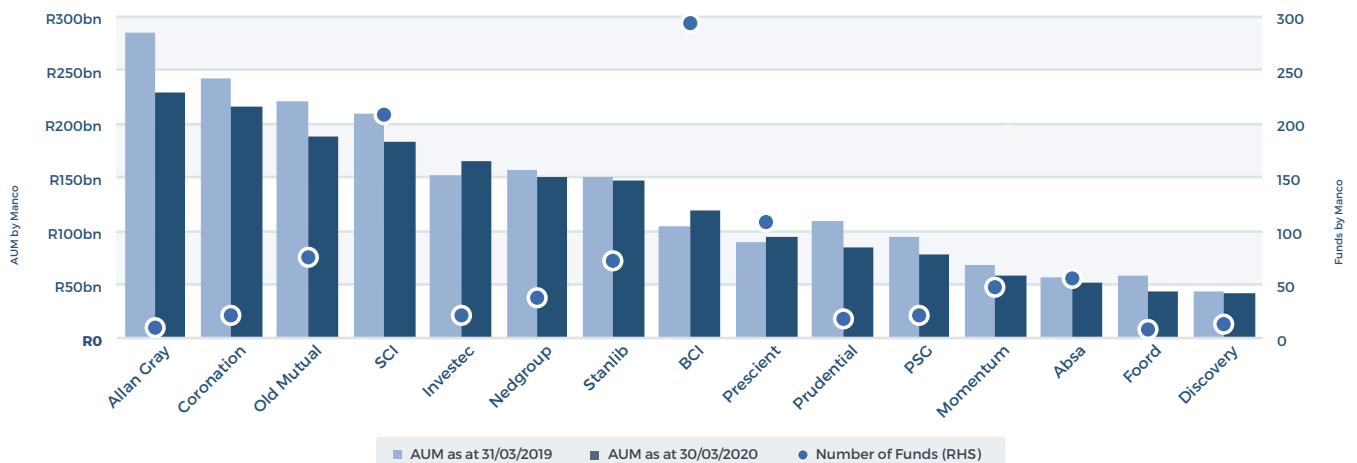
# SOUTH AFRICAN FUND UNIVERSE IN NUMBERS



## SA FUND UNIVERSE BY CATEGORY



## SA MANCO ASSETS UNIVERSE



Note, these figures may include double counting of assets where funds are used in fund of fund structures. The funds used in this analysis are retail, Rand denominated, Asisa registered unit trusts. Money Market funds have been excluded from this analysis. Source: Asisa, Finswitch

# REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

T: +27 33 347 0831 • W: [www.redfinwealth.co.za](http://www.redfinwealth.co.za)  
Unit 8 • The Junction • Garlington Estate  
Seeking Drive • Hilton • 3245

Redfin Wealth Managers CC is an authorised  
financial services provider, FSP 13261

# FUNDHOUSE

investment clarity

T: +27 21 670 3340 • W: [www.fundhouse.co.za](http://www.fundhouse.co.za)  
5th Floor MontClare Place • Cnr Campground and  
Main Road • Claremont 7708 • RSA

T: +44 173 723 3979 • W: [www.fundhouse.co.uk](http://www.fundhouse.co.uk)  
7 Chapter House • 33 London Road • Reigate  
Surrey RH2 9HZ • UK

Fundhouse Investment Advisors (Pty) Ltd is an authorised  
financial services provider, FSP 43960