COLLECTIVE insight

Contents

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Responsible investing

A review of the issues

MUITHERI WAHOME
Alexander Forbes

THE FINAL ISSUE of 2007 deals with a delectable smorgasbord of articles on Responsible Investing (RI). The menu goes beyond the consideration of environmental, social and governance (ESG) issues to include wholesome fare for trustees. On the table is an interesting array of articles, including an appetiser that challenges our whole premise as to why bother with RI, complete with the surprising results of a survey on what key players in the investment food chain think about ESG issues; a full menu guide to SRI for the uninitiated; a history of the evolution of SRI funds in South Africa; several particularly savoury side dishes that expand on our core theme by introducing one manager's idea of how to integrate RI into a quantitatively driven investment strategy; an overview as to how Shari'ah investing fits into the whole context of RI, and an insightful paper on where the short-term nature of our industry undoes the best laid plans of responsible investing. Finally, we wrap up with a thought-provoking introduction to the concept of the universal owner.

At the start, our article "Responsible Investment – Why?" by Dr Neil Eccles, who holds the Noah Chair in Responsible Investment at UNISA's Centre for Corporate Citizenship, summarises the results of a survey of key stakeholders in the retirement fund industry regarding RI. While the importance of ESG issues among the investment community isn't in doubt, the adoption of SRI seems beset by inertia. Read this article for an insight into some of the obstacles that have resulted in the slow pace of integration of RI into mainstream investment and what can be done to unleash its ultimate acceptance.

For those still new to the subject of SRI, a "360˚ snapshot of Responsible Investing" by Given Phaladi of RisCura is a good overview. The article looks at the various different approaches that encompass SRI and discusses how in SA responsible investing has focused on socioeconomic transformation but is growing to integrate broader ESG practices, as reflected by the introduction of the FTSE/JSE SRI index in 2004.

While RI may appeal to a number of trustees and consultants, how it becomes integrated into a mainstream strategy is always the more practical problem. "Responsible investing to the core," by Jonathan Kruger of Prescient, introduces one approach that employs a core satellite approach to equity investments. The FTSE/JSE SRI index provides the initial universe, that's in turn screened using price indifferent indexation techniques to select shares weighted by economic value according to predefined fundamental factors.

The quantitative process is further enhanced using behavioural and momentum factors. Satellites that include "high impact" investments could be used to complement the core. It's just one of many current innovative ideas and provides food for thought.

"Where do we come from and where are we heading?" is an extremely abbreviated summary of an exceptional 300-page academic study by Dr S Viviers *et al* that traces the evolution of SRI funds in SA between 1992 and 2006 and perhaps begins to give an insight into some of the resistance to RI here.

For RI to thrive the author suggests that there's a need to address negative

▶▶ 4

On the table is an interesting array of articles, including an appetiser that challenges our whole premise as to why bother with RI.

3 perceptions regarding the risk and return profile of RI funds, as well as the lack of skills and expertise in SA. Viviers believes a rebranding of RI and introduction of innovative products can give RI the required boost into the future.

For a different but no less important take on our theme we publish an article by Thato Minyuku and Andrew Joannou of Renaissance Specialist Fund Managers that takes us back to basics with a look at "The cost of short-termism on retirement investments". It reiterates that our responsibilities as fiduciaries require that we take a long-term approach to pension fund investments.

A number of structural and behavioural reasons why stakeholders adopt a short-term approach to control risk are addressed in the article. Importantly, trustees need to be aware that an indiscriminate focus on the short term comes at a cost of eroding long-term returns. True chicken soup for the investment soul!

Alexander Forbes Asset Consultants' Rezina Suliman weighs in with an introductory piece on how Shari'ah investing fits into the entire ethical investing framework. For anyone unfamiliar with how such funds approach the concept of ethical investing, the article provides a fascinating insight – and not just for Muslim investors. Investment in accordance with Shari'ah law is expected to grow in SA as fund managers seek to tap into an estimated 400 000 Muslim households. Without doubt this is one aspect of ethical investing that we all need to understand more clearly.

And last but not least there's "Grassroot tycoons" by Malcolm Gray of Investec Asset Management. It's a must read. The piece introduces the concept of the universal investor. The new owners of capital – the millions of contributing pension fund members – constitute the grassroot tycoons and they're the essence of universal ownership.

The grassroot tycoons have a direct and vested interest in the management of their assets for sustainable profits to meet their future liabilities. That implies the integration of an ESG framework in the investment approach. Food for thought, indeed.

Happy reading and best wishes for the holiday season. ■

Trustees need to be aware that an indiscriminate focus on the short term comes at a cost of eroding long-term returns. True chicken soup for the investment soul!

CORRECTION

In our previous *Collective Insight* issue on "Alternative views on alternative investments" we incorrectly attributed the authorship of the article "Liquidity and mean reversion of share returns: are there any free lunches?" to Professor Evan Gilbert, of the Graduate School of Business, University of Cape Town. In fact, the article was a collaboration between Greg Bailey and Evan Gilbert, with the primary work coming from Bailey. Our sincere apologies to the authors if we created confusion due to our error.

In the next issue

THE TOPIC FOR our next issue of *Collective Insight* is "Deriving insights into derivatives". Now that derivative instruments have effectively gone "mainstream" – ie, they're cropping up in almost every type of investment portfolio and investment product – investors need to revisit those instruments to formulate a clearer picture of both their potential benefits and their potential threats, particularly in light of the recent market turmoil at their hands.

As such we're looking for a range of articles to cover specific issues relating to derivatives and/or derivative strategies. Authors wishing to contribute should vet their topic choices with us first to minimise overlaps. Please contact our advisory committee convener – Anne Cabot-Alletzhauser at (011) 575 4333 – with your topic ideas. Articles (approximately 1 200 words, plus illustrations) need to be submitted to matsholom@collectiveinsight.co.za by 1 February 2008.

Remember this is a research publication and, as such, please no market commentary or marketing material. ■

Responsible investment – why?

Or more importantly, why not?

DR NEIL ECCLES

Noah Chair in Responsible Investing

WHERE RESPONSIBLE INVESTMENT (RI) is concerned, there are essentially three groups of people:

- Those who haven't heard of it;
- Those who think they know what it is and are sceptical; and
- Those who think they know what it is and advocate it.

Understandably, discussion between sceptics and advocates is often heated. Unfortunately, a lot of that heat stems from the fact that the two camps frequently start out with different definitions. So before I get bogged down in any debate, or align myself to either camp, let me lay out what *I think* RI is:

There's a growing school of thought that argues that the primary motive for adopting an RI approach is securing financial returns.

RI is investment that incorporates an active consideration of environmental, social and governance (ESG) issues into investment decision-making and ownership.

On the surface, that's a fairly simple definition. In fact, the most dramatic thing about it is an omission – that of motive. Motive is important because it's probably the most divisive element in the RI debate. Indeed, it's almost certainly the element that's kept RI on the fringes of mainstream investment practice. More often than not the gatekeepers of the "mainstream" have argued/assumed that the motive in RI isn't financial return but rather social return.

As such they've argued that RI is bad investment.

Responding to that directly would be stepping right into the heated debate trap. So let's step away from RI and consider investment motive in general. Essentially, the motive for any investment is always return. However, the desired return need not always be financial. It could also be purely social; it could be a blend of social and financial; or it could be financial.

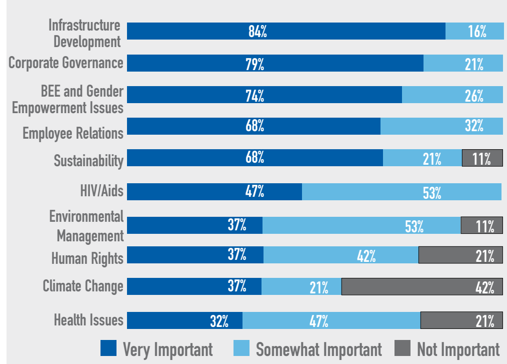
For example, buying a family home yields a blend of financial and social returns to the investor. The key to the motive debate is that, ultimately, the owner of the capital being invested should be free to decide on the mix of return that they want.

In that sense RI (as I see it) is no different to any other investment. There's absolutely no rule that says RI is a "social returns first" investment philosophy. That's something else: social investment, perhaps. RI can just as easily be motivated by purely financial objectives.

Indeed, there's a growing school of thought that argues that the primary motive for adopting an RI approach is securing financial returns. In other words, there's an increasing emphasis on approaches where ESG issues are considered on the basis of their financial materiality only. That school of thought is of course particularly relevant in the collective investment context, where fiduciary responsibilities dictate that financial return remains the primary concern.

ASSET MANAGERS - ESG ISSUE MATERIALITY

Graph 2

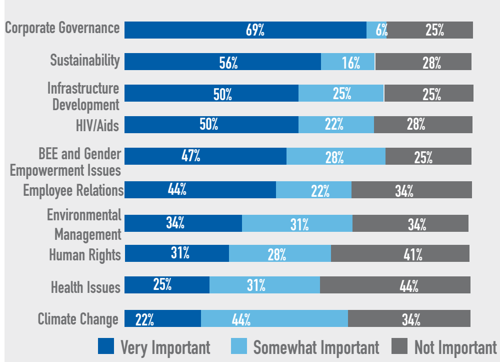


Graph 1: n=19, respondents asked to indicate importance on a three scale ranking of: "Not Important", "Somewhat Important" and "Very Important"

Source: UNISA

PENSION FUNDS - ESG ISSUE MATERIALITY

Graph 1



Graph 1: n=32, respondents asked to indicate importance on a three scale ranking of: "Not Important", "Somewhat Important" and "Very Important"

Source: UNISA

The materiality of ESG issues

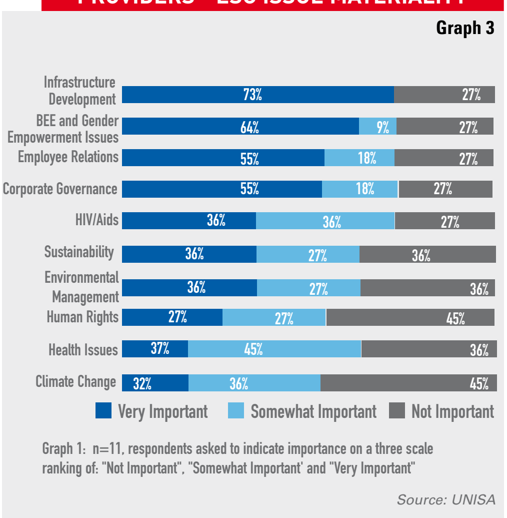
The key question in this context then becomes: Are ESG issues actually financially material? In other words, are ESG issues important determinants of the financial performance of investments? My view on that? Absolutely! You don't need to look beyond Enron to see how governance is crucially material. You don't need to look beyond Zimbabwe to see how crucial social conditions are to investment security. And from an environmental ▶▶ 6

5 perspective, I suspect that in the very near future insurance companies in particular are going to start seeing just how material climate change is to their business. Clearly, I'm an advocate.

But what does the wider investment community think about the financial materiality of ESG issues? In a recent survey, principal officers from 32 of the largest pension funds in South Africa (controlling assets of R975bn) were asked that very question. The results were astounding (Graph 1).

Some ESG issues were obviously considered more important than others, but the really astounding thing here is that somewhere close to 70% of the principal officers interviewed felt that all the issues discussed were at least somewhat important in determin-

INVESTMENT ADVISORY SERVICE PROVIDERS - ESG ISSUE MATERIALITY



Graph 1: n=11, respondents asked to indicate importance on a three scale ranking of: "Not Important", "Somewhat Important" and "Very Important"

Source: UNISA

ing the performance of investments.

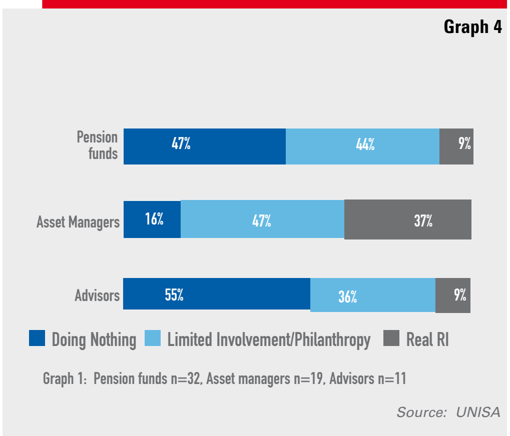
We asked the same question of the chief investment officers of SA asset management companies (this time controlling about R2,3 trillion) – and again the result was the same (if not more dramatic).

The vast majority felt that all the ESG issues discussed were at least somewhat material (Graph 2).

Finally, we asked a number of investment consultants/advisors/analysts and again the result was the same.

In short, the majority of people interviewed (and they were some of the most important people in SA's investment circles) believe that these issues are at

WHAT IS BEING DONE ABOUT RI?



Graph 1: Pension funds n=32, Asset managers n=19, Advisors n=11

Source: UNISA

least somewhat financially material.

The consequence of these results is profound. Earlier on I alluded to the fact that the gatekeepers of the investment "mainstream" have, to date, kept RI out by suggesting that RI was necessarily bad investment from a financial perspective. They thus argued that institutional investors, in particular, with their fiduciary duties shouldn't participate in RI.

These results suggest that institutional investors are actually neglecting their fiduciary duties if they don't take ESG issues into consideration.

However, these results suggest that institutional investors are actually neglecting their fiduciary duties if they don't take ESG issues into consideration. If that's the case then RI – as an investment that incorporates an active consideration of ESG issues into investment decision-making and ownership – should be advocated.

So what's being done about this?

This is where things start getting a bit confusing, because the simple answer is: not a lot.

Only three of the pension funds, seven asset managers and a single advisory service provider that we interviewed seem to have made any real progress towards adopting an integrated approach to considering ESG issues (ie, a real RI approach).

The picture becomes even more confusing when the reasons for that inaction are considered. A full 63% of the principal officers interviewed indicated explicitly that fiduciary responsibility was a significant barrier to participating in RI.

That paradoxical belief translates into a significant lack of demand for advisory services on RI and ESG issues. Nearly 90% of advisors interviewed said that a lack of demand was a significant barrier to them offering ESG related advice.

Finally, because RI is excluded from advisory services, it seldom filters through to asset managers in the form of concrete demand for ESG issues to be considered in pension fund mandates and policies.

Again, 63% of asset managers indicated that a lack of demand was a key barrier to the further pursuit of RI.

Confusion aside, I'd like to reiterate that the evidence on the materiality of ESG issues suggests that formally considering ESG issues must become an essential part of mainstream investment analytics and ownership practices. In the face of that, now is probably as good a time as any to set aside the essentially pointless and confusing ideological debate between sceptics and advocates and focus our attention on figuring out how to unlock the investment value that we almost all seem to agree lies in understanding ESG issues. ■

DR NEIL ECCLES

ECCLES is currently the Noah Chair in Responsible Investment in the Unisa Centre for Corporate Citizenship. He has a PhD from the University of Cape Town. He also has extensive experience in the management consulting industry in both South Africa and the United Kingdom. ■

360º snapshot of responsible investing

A basic primer

GIVEN PHALADI
RisCura Solutions

THE GOVERNMENT Employees' Pension Fund (GEPF) – South Africa and Africa's largest pension fund – recently signed the United Nations Principles of Responsible Investment (UN PRI), thereby setting an example for SA's retirement industry that SRI should no longer be a secondary investment consideration way down on a long list of priorities.[1]

Signatories to the PRI agree to ensure that all their investment activities incorporate environmental, social and governance factors (ESG) into the decision-making process and, in doing so, strive to put an end to business-as-usual investing, which in many cases ignores those factors by claiming that they're not financially material.

A recent progress report indicates that Africa represents just 2% of the total signatories of the PRI, compared with Europe (41%), North America (25%), Latin America (10%), Asia (6%) and Oceania (15%). However, SA's standing is better than the Middle East countries, which represent only 1% of the total.[2]

To benchmark themselves against international standards, SA investors should focus on adopting the Principles. Signing up to the PRI would commit a fund (and, by implication, its service providers) to incorporate ESG issues into all its investment decision-making processes.

Socially responsible investing (SRI) is an alternative way of addressing responsible investment and one that's been around for a while in various guises. It's a trend that SA pension funds have picked up from their international counterparts.

The definition of SRI remains vague, meaning different things to different people. Definitions also differ between countries. Environmental investing, ethical investing, sustainable investing, socially responsible investing, etc, are all different labels that can be attached to the broad SRI banner.[3] But in essence SRI refers to a group of investment mandates and products that in one way or another take into account ESG factors.

Many people believe SRI to be an asset class when it's really a theme that cuts across many different types of investment mandates, asset classes and investment products. Internationally, the responsible investing concept began with environmental concerns and now includes social issues, such as human rights, employee relations and business ethics.

Different countries have different focuses and priorities: for some, environmental changes are important, others are concerned about corporate governance and others have social issues at heart.

SA has unique issues relative to many of our international counterparts and the SRI approach should focus on addressing those specific issues. In SA, SRI funds were set up in the Nineties in response to Government's call for transformation and policies that support it. Examples are Masakhane, the Reconstruction and Development Programme (RDP), Growth Employment and Redistribution (GEAR) and black economic empowerment. More recently, we're starting to integrate environmental concerns into our investment processes to address global warming issues.

There are three criteria that SRI investors use globally (including SA). First, the practice of screening or filtering companies based on ethical criteria. Screening can be positive (potential companies are included in an investment universe because they fulfil certain positive criteria), or negative (excluding companies for products or practices considered negative). Screening can go as far as screening out emerging market countries with power regimes that investors oppose.

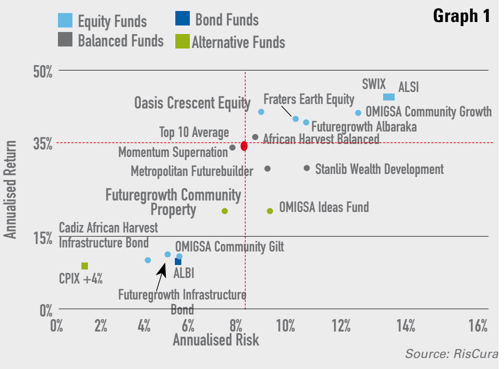
In May 2004 for example, SA launched the JSE SRI index to promote the sustainability concept. The index provides a positive screen of companies that integrate social, economic and environmental business practices with good corporate governance[4] and complements international benchmark indices, such as the Dow Jones sustainable world index, FTSE4Good, etc.

The process of categorising companies as SRI-acceptable still requires a more holistic approach, as the recent furore over Mittal Steel suggests. Specific attention needs to be paid to how share-weighting in the index can reflect the success of a company's SRI initiative. This is an additional focus of the JSE's working committee.

The second criterion is, "you can't influence if you don't invest" concept, which is shareholder activism or engagement. Shareholders own a piece of companies they invest in and with that ownership comes both rights and responsibilities. Shareholders can positively influence company behaviour and achieve socially responsible outcomes through their ownership stakes and voting rights. Many pension funds unknowingly hold an enormous amount of clout in that area.

Third is targeted investment or community investment available to SRI investors. This focuses on real economy projects via, for example, equity or debt financing, which have a direct impact on areas such as infrastructure development (energy, telecommunications, education, water and waste management, health facilities,

SRI SCATTER 36 MONTHS ENDED 30 JUNE 2007



Source: RisCura

roads, etc), low-income housing, agricultural development and SMEs.

A number of investment managers offer SRI products. The accompanying chart shows the performance of those products, as reflected by RisCura's SRI survey over a 36-month period. The chart illustrates that performance of those products is acceptable, given the relevant benchmarks for each asset class.

That's a snapshot at a particular time, but what matters for retirement funds that have long-term liabilities is how companies perform over an extended timeframe. Incorporating SRI processes or funds into a pension portfolio provides a good opportunity to generate strong returns while also contributing to social, environmental and grassroots economic development in SA, resulting in improved economic growth.

Though it might not seem that SA is doing enough relative to other countries, in essence it's doing well by addressing its own challenges that fall under the responsible investment umbrella.

Once those grassroots challenges are overcome it will then step up to international challenges. For now though, proper corporate governance is increasingly becoming a concern, particularly after a Fidentia type event.

The FSB is looking to strengthen corporate governance and make sure that the laws and principles stipulated in the King II report are implemented.

In his speech at the launch of the UN PRI in SA in October, GEFP chairman Martin Kuscus challenged fiduciaries, investment managers, consultants and other service providers in the retirement industry to follow in the footsteps of the GEPF and sign the PRI.

In doing so, those signatories will be forced to revisit the criteria that constitute "good investments".

That will have a knock-on effect of forcing companies to change their way of doing business to accord with "good investment standards" – resulting in improved governance, better social and environmental conditions and stronger economic growth for SA.

And in doing so, retirement investing becomes not only about the amount of money that individuals have to retire on but also the state of the world/environment that they'll retire into and ultimately leave behind.

Notes:

1 *"State's R700bn pension fund to sidestep PIC"; Business Day, 4 October 2007.*
2 *"PRI: Report on progress 2007"; Principle Responsible Investment 2007.*
3 *"Rewards of virtue"; Global Pensions, November 2003.*
4 *"Doing well while doing good? The Investment performance of South African socially responsible equity unit trusts"; G Meharchand.* ■

GIVEN PHALADI

PHALADI is a quantitative analyst at RisCura Solutions, within the Quantitative Research Team. He holds an MSc in astrophysics and space science from the University of Cape Town. ■

Responsible investing to the core

JONATHAN KRUGER
Prescient Investment Management

SO YOU'VE CROSSED THE great ideological divide and decided to make a responsible equity investment. Is there a viable solution?

Clearly, the most straightforward approach is to simply invest in those companies that have been positively screened for their successful efforts in environmental, social, governance, and essentially "triple bottom line" best practice. Unfortunately, many of the investments that would rank highest on the list would share some of the characteristics of private equity i.e. they may be unlisted, difficult to value timeously, and potentially have investment lock-in periods.

The challenge then is to identify a strategy that is simple to apply, employs listed shares and yet can counterbalance potential risks embedded in SRI investing.

One approach to portfolio construction that's gained significant support is the core satellite approach.

One approach to portfolio construction that's gained significant support is the core/satellite approach, where the core exhibits the stable investment characteristics in terms of tracking error and performance while the satellite provides additional alpha by taking on more specific risk. Is it now possible that this core satellite approach can be applied to responsible investment (RI) equity?

The positively screened investments could certainly make up the satellite, providing a high social impact investment with higher potential alpha. But what about the core? Ideally, that core portfolio should be benchmarked on an index that's objectively and independently constructed, with a rigorous process for screening companies across multiple environmental, social and governance (ESG) issues.

One possibility is the FTSE/JSE SRI index launched in May 2004. It's seen modest success in becoming a trusted, independent benchmark for SRI equity. However, in its early stages the index received some criticism. Companies that met the ESG criteria were included in the SRI index at their market cap weighting (as in the FTSE/JSE all share index). This did not necessarily reflect their company-specific success at ESG best practice. In a renewed effort to establish the credibility of the benchmark, the index underwent a strategic review this year and a refined model was introduced to evaluate companies regarding ESG issues. The new SRI index and its constituents are due for release at end-November 2007.

The fact that shares in the SRI index are market-cap weighted means that the index should not perform too dissimilarly from the FTSE/JSE ALSI 40. Since its inception, the SRI index has actually outperformed that benchmark simply because it has a higher weighting in resource shares. But it does suggest that with this approach, investors shouldn't be sacrificing performance over the long term by taking an SRI tilt in their portfolios.

The question still remains: Once an RI index has been established, is there an investment process or methodology that produces a portfolio with those desirable core characteristics?

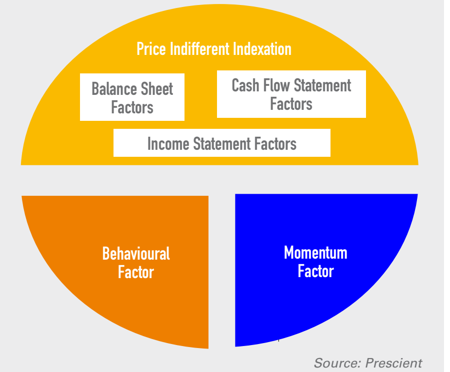
Price indifferent indexation (PII) yields promising results. It's a quantitative method, where shares are selected and weighted by economic value according to predefined income statement, cash flow statement and balance sheet metrics. In our exercise, however, only constituents of the FTSE/JSE SRI index are considered.

Two enhancements – momentum and a behavioural factor – are added to the PII model to yield a well-rounded quantitative equity portfolio with enhanced returns and reduced relative risks.

Investors seeking to invest in an RI portfolio certainly won't want to sacrifice investment performance or take on additional risk. By using a quantitative investment approach a core portfolio can be constructed using an SRI index that considers ESG issues while producing consistent, stable alpha, low risk in terms of tracking error at a quantitative management cost.

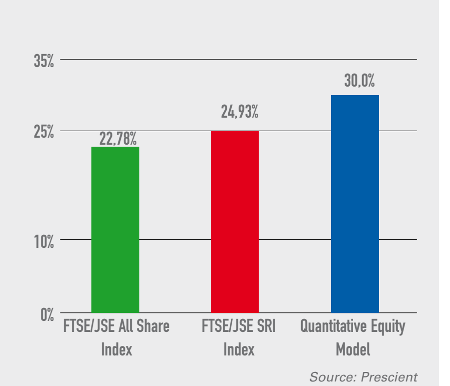
Challenges facing RI equity include refinement of an independent RI benchmark to include a broad universe of shares with appropriate sector weightings. That's certainly achievable and its success won't leave investors stumbling around looking for solutions but rather making responsible investments with confidence. ■

INVESTING TO THE CORE



Source: Prescient

2007 YEAR ENDED SEPTEMBER PERFORMANCE



Source: Prescient

JONATHAN KRUGER

KRUGER is a quantitative portfolio analyst at Precient Investment Management. He holds a BBusSci degree in Actuarial Science and is a level III candidate in the CFA programme. ■

Where do we come from and where are we heading?

Responsible investment funds in SA

DR SUZETTE VIVIERS
Nelson Mandela Metropolitan University

ALTHOUGH ANTI-SOUTH AFRICAN sentiments ignited the growth of responsible investment (RI) internationally in the Seventies, the adoption of RI strategies in South Africa has been slow, to say the least. The main RI strategies include:

- Negative (exclusionary) screening: Avoiding investments in morally undesirable companies and countries. Such investors often base their screens on their religious convictions and hence avoid investments associated with tobacco, alcohol, gambling, armaments and pornography.
- Positive (inclusionary) screening: Investing in companies deemed good corporate citizens – ie, companies that value their stakeholders and place a high premium on corporate governance. In SA a great deal of emphasis is placed on broad-based black economic empowerment issues as well as the development of social infrastructure.
- Best-of-class screening: Combining positive and negative screening strategies.
- Shareholder activism: Actively engaging with a management board on environmental, social and corporate governance (ESG) considerations through dialogue, by filing resolutions, voting at annual general meetings and divesting from companies that fail to transform.
- Cause-based (targeted) investing: Supporting particular causes (such as empowerment or social infrastructural development) by investing in it.

In my doctoral research, which was partly funded by the National Research Foundation, an RI fund was defined as "…any local collective investment scheme that employs a screening, shareholder activism and/or cause-based (targeted) investment strategy".

The salient features of all RI unit trusts established in SA up to 31 March 2006 are indicated in Table 1, whereas Table 2 provides more details on other pooled (non-unit trusts) and segregated RI funds.

Figure 1 indicates that the first RI funds in SA were founded in June 1992. In the

TABLE 1: SALIENT FEATURES OF RI UNIT TRUSTS

RI FUND NAME	STATUS(A)	CLASSIFICATION(B)	DATE OF INCEPTION	DATE OF DISCONTINUANCE	SIZE ON 31 MARCH 2006	BENCHMARK INDEX
Community Growth Equity Fund	A	D-E-G	1-Jun-92	-	R 2 180 002 754	FTSE/JSE All Share Index(d)
Fraters Earth Equity Fund	A	D-E-G	4-Oct-01	-	R 635 682 778	FTSE/JSE All Share Index with a 50% weighting applied to the resources sector
Fraters Islamic Equity Fund	A	D-E-G	1-Feb-06	-	R 36 754 520	The company monitors the fund's performance against the FTSE/JSE All Share Index although this is not seen as its "true" benchmark since the investment universes differ considerably
Futuregrowth Albaraka Equity Fund	A	D-E-G	1-Jun-92	-	R 545 709 044	FTSE/JSE All Share Index
Nedbank Sustainability Investing Index Fund	D	D-E-G	6-Aug-02	31-Oct-03	-	Edward Nathan & Friedland sustainability index(d)
Oasis Crescent Equity Fund	A	D-E-G	31-Jul-98	-	R 1 657 300 000	FTSE/JSE All Share Index
Oasis Crescent International Fund of Funds(j)	A	F-E-G	28-Sep-01	-	R 300 200 000	Dow Jones Islamic market index(e)
Sanlam Empowerment Equity Fund	D	D-E-V	15-Sep-97	30-Apr-03	-	Barings ING empowerment index(d)
Sasfin Socially Responsible Fund	A	D-E-V	14-Oct-05	-	R 6 883 733	FTSE/JSE RI index(f)
Sasfin TwentyTen Fund	A	D-E-G	1-Nov-05	-	R 14 735 531	Composite benchmark: 25% FTSE/JSE All Share Index & 75% FTSE/JSE Financials and Industrials Index
Fraters Flexible Fund	A	D-AA-F	15-Oct-01	-	R 782 188 779	Composite benchmark: SA Equities (45% FTSE/JSE All Share Index & 25% FTSE/JSE Financials and Industrials Index), SA Bonds (15% BEASSA All Bond index(g)), Property (5% Property Unit Trust index) & Cash (10% Stefi index(h))
Fraters Real Income Fund	A	D-AA-TARR	9-Oct-02	-	R 731 781 343	CPIX(i) + 3%
Community Growth Gilt Fund	A	D-F-B	14-Jul-98	-	R 947 884 644	BEASSA All Bond Index

(a) A = Active; D = Discontinued
(b) D = Domestic; F = Foreign; E-G = Equity-General; E-V = Equity Varied Specialist; AA-F = Asset Allocation-Flexible; AA-TARR = Asset Allocation-Target Absolute and Real Return; F-B = Fixed Interest-Bond
(c) The FTSE/JSE All Share Index consists of the top 99 percent of eligible listed companies ranked by full market capitalisation (FTSE/JSE Africa Index Series, 2006). This index replaced the older JSE Actuarial All Share Index on 24 June 2002.
(d) As monthly data was not available for this benchmark index, the FTSE/JSE Socially Responsible Investment Index was used as proxy.
(e) This excludes the producers of alcohol and pork-related products, providers of conventional financial services (such as banking and insurance) and providers of entertainment services (hotels, casinos, cinemas and producers of pornography and music). Tobacco manufacturers as well as defence and weapons companies, although not strictly forbidden for investment under Islamic law, are also excluded. In addition to industry screens, companies are furthermore subjected to a series of financial ratio screens dealing with excessive levels of debt and interest income (Hussein & Omran, 2005:110).
(f)This index screens JSE-listed companies on the three pillars of the triple bottom line as well as corporate governance.
(g)This index consists of the top 20 listed bonds on the Bond Exchange of South Africa ranked according to market capitalisation and liquidity. These are mainly issued by the government (RSA loan stock), public utilities and public companies (Van Zyl, Botha & Skerritt, 2006:280).
(h) Stefi Index = Short-term fixed interest index.
(i) CPIX = Consumer price index excluding interest rates on mortgage bonds.
(j) This fund sometimes called the Oasis Crescent International Feeder Fund.

Source: Viviers (2007)

TABLE 2: SALIENT FEATURES OF OTHER POOLED (NON-UNIT TRUST) AND SEGREGATED RI FUNDS

RI FUND NAME	STATUS(A)	CLASSIFICATION(B)	DATE OF INCEPTION	DATE OF DISCONTINUANCE	SIZE ON 31 MARCH 2006	BENCHMARK INDEX
AMB Empowerment Equity Fund	D	D-E(c)	1-Apr-97	31-Dec-02(d)	-	Could not be established
Futuregrowth Anchor Fund	D	P-D-E	1-Jul-97	31-May-04	-	Composite benchmark: 80% FTSE/JSE Financials and Industrials Index & 20% FTSE/JSE SA Resources Index
Futuregrowth RI Equity Fund	A	P-D-E	1-Jul-04	-	R 33 200 000	FTSE/JSE RI Index + 3%
Rocklands Social Responsible Private Equity Fund	A	D-Alt(c)	Sometime in 2004	-	Confidential	Could not be established
Community Growth Equity Fund of Funds	A	P-D-AA	1-Apr-05	-	R25m	Composite benchmark (no weights indicated): SA equities (FTSE/JSE All Share Index), SA bonds (BEASSA All Bond Index), Alternative investments (CPI(e) + 7%) & cash (Stefi index),
Futuregrowth Diversified Development Fund	D	P-D-AA	Sometime in 1997	31-Jul-01	-	CPI + 4%
Futuregrowth RI Balanced Fund	A	P-D-AA	30-Sep-04	-	R 3 200 000	Composite weighting of the underlying funds' benchmarks
Investec Mafisa Fund	D	D-ALT(c)	1-Oct-97	31-Aug-02(d)	-	Could not be established – CPI will however be used as a proxy as this fund invested heavily in infrastructural development
Investec Sechaba Fund	D	D-ALT(c)	1-Aug-00	31-Aug-02(d)	-	Could not be established – CPI will however be used as a proxy as this fund invested heavily in infrastructural development
Metropolitan Futurebuilder	A	P-D-AA	1-Oct-96	-	R888m	CPIX + 4%
Metropolitan RI Fund	A	P-D-AA	1-Dec-05	-	R112m	Composite benchmark: SA Equities (60% FTSE/JSE RI Index); SA Bonds (30% BEASSA All Bond Index); Property (5% CPI + 6%) & Cash (5% Alexander Forbes Money Market Index)
Momentum Supernation Fund	A	P-D-AA	1-Oct-02	-	R 78 900 000	Composite benchmark: SA Equities (60% FTSE/JSE All Share Index); SA Bonds (25% BEASSA All Bond Index); Property (10% CPI + 4%) & Cash (5% Stefi Index)
Sanlam Community Builder Fund	A	P-D-AA	1-Jan-96	-	n/a	No benchmark
STANLIB Corporate Wealth Development Fund	A	P-D-AA	1-Jan-97	-	R504m	CPI
TopGEAR Fund	D	P-D-AA	1-Feb-98	30-Sep-02(d)	-	7% real growth over rolling 3-year periods
African Harvest Infrastructure Bond Fund	A	S-D-F	1-Jan-01	-	R 517 100 000	Composite benchmark: 25% Govi index(f) & 75% Othi index(g)
Futuregrowth Infrastructure Bond Fund	A	P-D-F	1-Jan-94	-	R 3 664 900 000	BEASSA All Bond Index
AIIF African Infrastructure Investment Fund	A	P-D-ALT	Sometime in 2003	-	R 80 600 000	7% real growth over rolling 3-year periods
AIIF South African Infrastructure Fund	A	P-D-ALT	Sometime in 1996	-	R1 320m	7% real growth over rolling 3-year periods
Futuregrowth Structured Empowerment Fund	A	P-D-ALT	1-Oct-95	-	Not available	CPI + 8%
Investec RI Life Fund	A	S-D-ALT	17-Oct-05	-	R 567 898 129	Could not be established
Investment Solutions Sakhisizwe Fund	A	P-D-ALT	1-Nov-04	-	R 103 927 780	Composite benchmark: SA Equities (20% FTSE/JSE All Share Index), SA Bonds (70% BEASSA All Bond Index) & Cash (10% Stefi Index)
Investment Solutions Shari'ah Fund	A	P-D-ALT	1-Apr-05	-	R 8 184 304	High equity unit trust category average
OMAM IDEAS Fund	A	P-D-ALT	1-Jan-99	-	R 1 208 900 000	CPI + 7% over rolling 3-year periods
Prodigy Transformation Fund	A	D- ALT(c)	Sometime in 1998	-	Not available	Could not be established
Rocklands Growth and Development Fund	A	D- ALT(c)	Sometime in 2004	-	Confidential	CPI + 5%
Rocklands Social Responsible Balanced Fund	A	D-AA(c)	Sometime in 2004	-	Confidential	Could not be established
Sanlam Development Fund	A	P-D-ALT	1-Nov-96	-	Not available	No benchmark
Sanlam Development Fund of Funds	A	P-D-ALT	1-Jul-02	-	Not available	No benchmark
Futuregrowth Community Property Fund	A	P-D-Prop	1-Jul-96	-	R 488 100 000	CPI + 4%

(a) A = Active; D = Discontinued
(b) P = Pooled; S = Segregated; E = Equity; AA = Asset Allocation; F = Fixed interest; ALT = Alternative; Prop = Property
(c) It could not be established whether these funds were pooled or segregated funds
(d) As the exact date of discontinuance could not be established, the date on which the fund was excluded from the Alexander Forbes Asset Consultants' Targeted Development Investment Vehicles Manager Watch Survey serves as proxy
(e) The Consumer Price Index (CPI) is an index of the prices of a representative 'basket' of consumer goods and services bought by a typical South African household and thus reflects the general price level in the economy (Mohr, Fourie & Associates 2004:13)
(f) This index consists of the most liquid government bonds listed on the Bond Exchange of South Africa (Van Zyl et al., 2006:280)
(g)This index consists of all other (non-government) bonds found in the BEASSA All Bond Index (Van Zyl et al., 2006:280)

Source: Viviers (2007)

period leading up to the emerging market crisis (August 1998) a further 17 RI funds were established locally.

Many of those funds were structured as empowerment-orientated special purpose vehicles (SPVs) in line with the new Government's RDP programme and empowerment initiatives (De Cleene & Sonnenberg, 2004:6). However, the SPV structure proved unsustainable in the aftermath of the emerging market crisis and resulted in large-scale losses suffered by several RI funds (Bridge 1999; Hirsh 2005).

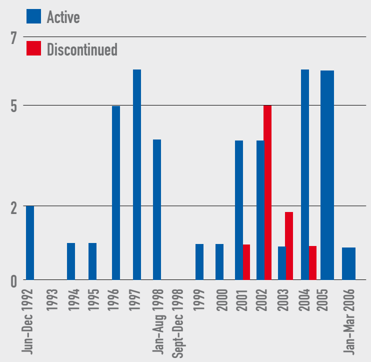
As a result of these losses institutional investors became very reluctant to adopt RI as a viable investment strategy (Visser 2005:30; Bacher 2004:4; Thomas 2004). A total of eight RI funds were discontinued in years to come, some as a result of poor financial performance and others due to a lack of interest.

The most important barrier to growing the RI in SA is the perception that RI involves a financial sacrifice. Rigorous international and local research indicates that perception is unfounded, as RI funds tend to outperform broad market indices and conventional funds over the long run (Statman 2000:30; Bauer, Koedijk & Otten 2005:1755; Bauer, Otten & Rad 2006:33; Viviers 2007). Cause-based (targeted) investments can furthermore offer good diversification benefits, as they typically display low levels of correlation with listed securities.

Other barriers to RI include fiduciary responsibilities and the lack of RI skills and expertise among local asset managers and advisory service providers. Such barriers aren't unique to SA's RI sector, as a report by the World Economic Forum has identified them as important obstacles to the 14

NUMBER OF RI FUNDS

Graph 1



Source: Researcher's own construct based on data sourced from Alexander Forbes Asset Consultants

13 adoption of RI among global institutional investors (Mainstreaming Responsible Investment 2005:5).

The availability and costs of data on companies' ESG performance also poses a potential barrier to RI in SA, as well as uncertainty as to what exactly RI entails.

Greater awareness of and growth in the number of RI funds launched since 2004 can be attributed to a number of local and international factors, such as:

- The introduction of empowerment legislation, sector charters and scorecards, particularly the Financial Sector Charter.
- Sustained stakeholder advocacy, particularly by local trade unions and NGOs.
- The establishment of stock market indices, such as the Dow Jones sustainability and Islamic indices, the FTSE-4GOOD indices and the FTSE/JSE SRI index.
- The far-reaching consequences of corporate scandals.
- More RI research becoming available – eg, the Freshfields Bruckhaus Deringer report on the legal framework for the integration of ESG issues into institutional investment.
- The launch of the United Nations Principles for Responsible Investment.

Despite those drivers and the Government Employees Pension Fund's commitment to becoming a more active shareholder, much remains to be done to stimulate greater demand for RI in SA. In essence, a rebranding process that has the support of all major public and private pension funds, the National Treasury, trade unions and professional investment associations should be undertaken.

That rebranding process should address the negative perceptions regarding the risk/return profile of local RI funds and the lack of skills and expertise in the local sector. In doing so the words of German philosopher Arthur Schopenhauer (1788-1860) should be in mind, namely that "…there are three steps in the revelation of any truth: in the first it is ridiculed; in the second, resisted; in the third it is considered self-evident".

It's my firm view that RI in SA is set to grow in future, particularly in terms of shareholder activism and cause-based (targeted) investing. The repositioning of the brand and the development of new and innovative products is also bound to attract greater international interest.

With thanks to professor Johan Bosch, NMMU; professor Eon Smit, University of Stellenbosch Graduate Business School; professor Arie Buijs, Utrecht University. ■

DR SUZETTE VIVIERS

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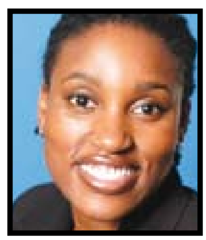
The cost of short-termism on retirement investments



THATO MINYUKU
Renaissance Specialist Fund Manager

ANDREW JOANNOU
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RETIREMENT FUNDS are by nature long-term investors. Whichever investment strategy is ultimately adopted by a fund (balanced, specialist, absolute return, etc), beating inflation over the long term is the common goal to ensure members retire with a pension of real value. Next to combating inflation erosion, maintaining a long-term perspective on retirement savings is the second common denominator of varying retirement investment strategies.

While there are numerous investment strategies proposed to beat inflation over the long term, it's perhaps more crucial for long-term investors to commit to the long term in the first place. That commitment is indeed a critical component of responsible investing, as it specifically facilitates optimal investment decision making to help meet the long-term investment objectives of investors.

While "responsible investing" is typically associated with SRI options, a more holistic definition includes a framework that facilitates optimal decision-making. By understanding the nature and implications of short-termism, investors are better equipped to commit to the long term. What follows will challenge retirement funds to rethink the assumptions regarding their investment horizon and how best to evaluate performance and associated costs in that context.

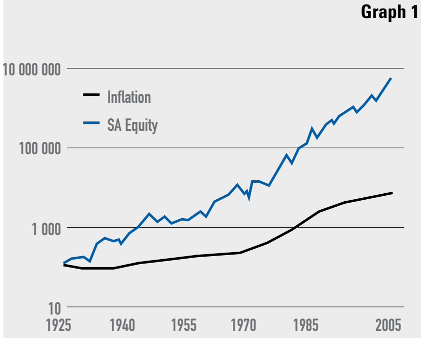
Short-termism is a financial concept not frequently cited in the South African retirement industry. However, its existence and impact are real and quantifiable to long-term investors. For the purposes of this article, short-termism is defined as investing with a short-term investment horizon or having a short-term perspective on long-term investments.

Investors agree in general that equities are the asset class most effective at achieving inflation-beating returns over the long term. That's shown in graph 1. Over the past 81 years equities delivered a 14,8%/year return, versus inflation of 5,8%/year. That amounts to an average real return of 9%/year… and that's only half of the story!

Graph 2 shows the maximum and minimum real return attained in holding periods of various lengths. For example, over the 81-year period, if you held equities for any two-year period you could 16

EQUITIES THE MOST EFFECTIVE OVER THE LONG TERM

Graph 1



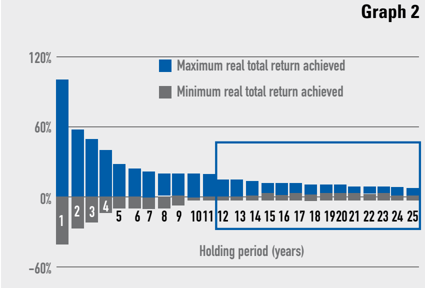
Source: Renaissance, Cadiz

14

have made real returns in excess of 50% or you could have made real losses in excess of -20%. As the holdings periods increase, the inflation beating power of equities becomes more consistent and consistently positive. If you held equities for 12 years or longer, you almost never made a negative real return. More importantly, if you held equities for at least a 20-year holding period then the worst real return you could have made was a positive 4%/year.

THE LONGER, THE BETTER

Graph 2



Source: Renaissance

Over the long term, equities are an effective low risk investment to beat inflation. However, here long term doesn't mean the three to five years that, surprisingly, many investors will define as the long term, but at least 12 years. But 20 years (or even 12 years) may seem excessively long, so let's look at the shorter side of the investment horizon spectrum.

Graph 2 shows that if you held equities for any three-year holding period or less you could have made real returns in excess of 50% or you could have made real losses in excess of -20%. Over the short term equities are characterised by high volatility – a characteristic that diminishes over longer-term holding periods. Short-termism takes away the low risk nature of equities held over the long term and turns it into a high risk asset class.

Another quantifiable cost of short-termism is higher transaction costs. Equity trading costs (brokerage costs, securities tax, VAT, spread costs and market impact costs) can reach up to 1,5%. That amount is lost to the portfolio even before performance is generated and despite any performance generated. While few managers maintain lower portfolio turnover of around 25% – and hence lower transaction costs – the average market orientated manager has a portfolio turnover of 75% to 100%. At the other extreme, a momentum manager can have a portfolio turnover of 200% to 250%, with commensurately higher transaction costs.

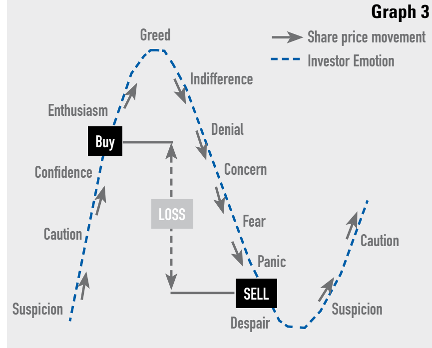
Transaction costs of 1% may not seem high over the short term. If you invested in the equity market over the past 12 months you may not mind a return of 42% instead of 43%. However, over the long term that 1% is significant, because it's consistent over each year of the long-term holding period. Assuming an average portfolio turnover of 100%, over the long term if you made a 4% real return instead of a 5% real return you'd have lost 20% of your long-term real return, to transaction costs.

Short-termism also has the unfortunate cost of inducing behaviour that's detrimental to long-term returns. The impact of private equity activity on the listed equity market is possibly testament to that. To illustrate that point, in 2004 private equity firm Brait bought and delisted Pepcor. At the time of the offer the stock increased 135% – a pleasing outcome for managers who accepted the offer. However, assuming Pepcor would have at least performed in line with the general retail sector, investors would have enjoyed a further 460% over the following three years had Pepcor remained listed.

So why did fund managers sell? Fund managers are subjected to short-termism as they're judged on ever-shorter investment periods: quarterly, monthly and even daily. The temptation to realise a short-term gain is real. So managers take the offer, enjoy the short-term performance and look for the next best opportunity.

THE AGE OLD TRAP OF INVESTMENT DECISIONS

Graph 3



Source: Index Funds: The 12-step Program, M.T. Hebner, 2004

While many decisions to sell to private equity houses are excellent contributors to performance, the Pepcor example shows us that the price of realising a short-term gain may not always compensate investors for loss of the company's long-term potential.

Having identified some of the costs of short-termism let us address some of the reasons why short-termism exists.

First, actual retirement investors are subject to short-term cycles. Trustee tenure varies widely across the industry and is subject to fund rules that stipulate elections as frequent as annually or biannually. It's been observed that the tenure of employee-elected trustees typically varies from one to three years due to limitations such as inflexibility of workloads, re-election to the board and relatively higher staff turnover. Employer elected trustees, who typically consist of management of the sponsoring company, tend to have longer periods of tenure.

Second, the current model of the retirement fund industry could be a structural contributor to short-termism. Interactions between multiple role players from the board of trustees, to its advisors and consultants and ultimately to multi-managers and managers create multiple opportunities to trade stocks. A decision to change an investment adviser or manager is likely to cause transition: hence trading, hence transaction costs.

Finally, the reality of human behaviour itself reinforces short-termism. Graph 3 shows typical investor emotions tracking equity performance movement (or any investment performance from property performance to manager performance) and the resultant buy and sell decisions (including hiring and firing decisions) that ultimately result in lost value to the investor over the long term.

Put simply, it depicts the resultant losses from the age-old trap of investment decisions based on short-term sentiment as opposed to long-term fundamentals.

Custodians of retirement fund assets, including managers, advisers and trustees, have all been seen to react to both positive and negative short-term performance to the detriment of long-term returns. Trustees panic at the sight of short-term volatility.

Managers panic not so much at the sight of short-term volatility but at the sight of trustees' disappointment therein and capitulate, deviating from their long-term strategic positioning in search of short-term relief.

Even more acutely, some retirement funds strategically enforce short-termism with excessively conservative investment strategies that limit and even exclude access to the long-term inflation beating power of equities.

If short-termism is both a structural and behavioural problem, how do trustees – as the foremost custodians of retirement fund assets – avoid short-termism and limit its costs?

While commitment to a long-term perspective on long-term investments seems quite a simple proposition it's continually tested by the structural and behavioural nature of short-termism. Trustees should reduce the pressure on managers to outperform over the short term and rather increase focus on consistent, inflation beating long-term performance.

	Table 1
How has the manager performed over the long term (at least 3 year performance)?	✓
Have there been any material changes to the investment process?	
Does the manager have good rationale for these changes?	✓
How does the manager make investments? Is this consistent with last quarter?	✓
How has the manager positioned the portfolio?	✓
Does the manager understand their positioning?	✓
Does the manager have good rationale for the portfolio's position?	✓
Does this rationale make sense? Is it logical? Is anything contradictory?	✓
Which positions have changed since the last quarter? Why did they change?	
Are these reasons rational?	✓
Is this thinking consistent with last quarter?	✓
Have there been any chages to the investment team? What are the implications?	✓
Have there been any material changes to the business? What are the implications?	✓

While we aren't suggesting trustees (or managers and advisors, for that matter) ignore short-term performance entirely, we do believe that it's possible to evaluate short-term performance while remaining committed to long-term objectives. The sort of questions that could help investors monitor performance during shorter periods, such as quarterly, while remaining focused on the long term are included in table 1.

While equities are a volatile asset class over the short term, they handsomely beat inflation over the long term – and do so consistently with limited risk. Short-termism detracts from that by focusing on short-term volatility, increasing transaction costs, creating a temptation for managers to chase short-term profits to the detriment of long-term returns and misleading investors into making poor investment decisions (at both a stock and a manager level).

Short-termism is both a structural and behavioural problem that can be limited or eliminated through commitment to the long term to both realise the long-term inflation beating power of equities and minimise the costs of short-termism that ultimately erode long-term real returns. ■

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Shari'ah investing

Using Islamic law to make ethical investments

REZINA SULIMAN
Alexander Forbes

Shari'ah investing

There are an estimated 350 000 to 400 000 Muslim households, creating a potential savings/investment market worth R1,8bn/year.

SOUTH AFRICA IS NO STRANGER to the principal of ethical investing, with socially responsible investments (SRIs) assuming greater importance in the overall strategy of retirement funds. Since Shari'ah compliant funds are based on the ethical screening of shares to exclude specific stocks, those funds can definitely be categorised as SRI.

In the past, due to a lack of feasible Islamic products, Muslim investors were forced to forgo investment returns as conventional investment portfolios didn't conform to Islamic law. Today, due to the continuous advancements

18

17 in financial markets, increasing knowledge and demand for Islamic investments, the development of Shari'ah compliant funds has become the market niche. Investors' appetites for Shari'ah products are increasing, with the current Shari'ah investment market estimated at US$500bn globally, with an expected growth rate of 10% to 15%/year[1].

In SA there are an estimated 350 000 to 400 000 Muslim households, creating a potential savings and investment market worth R1,8bn/year[2].

What is Shari'ah?

Shari'ah is the body of Islamic law within which public and some private aspects of life are guided. Shari'ah encompasses all aspects of a Muslim's life, including politics, economics, business law, family and social issues.

Investing according to the Shari'ah involves a complex set of laws that aim to provide each party of a transaction an equal footing while simultaneously developing a sound work ethic. The fundamental principle of Shari'ah investments is that the return must be commensurate with the risk taken.

Criteria of Shari'ah Compliant Funds

Although the Shari'ah has specific laws regarding investments and finance the interpretation of the laws is subjective and different scholars may have conflicting opinions. That's led to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) developing a number of guidelines and principles to ensure that all Shari'ah compliant funds are managed according to a standard set of principles.

That certainly doesn't eradicate the challenge of personal interpretations and opinions but does assist in ensuring that a guideline exists to ensure accountability. In SA, the Association of Collective Investments (ACI) and the Financial Services Board have adopted AAOIFI's standards as the benchmark to evaluate a fund's Shari'ah compliancy. Those principles are explained below.

Interest: Shari'ah prohibits the trading of short-term debt instruments at other than face value, or from drawing upon the established intrabank market, as those transactions involve interest and excessive uncertainty (Gharar).

That means Islamic financial institutions tend to have highly liquid balance sheets with limited investment opportunities for their current assets. Thus Sukuk have, over the past few years, created opportunities for the short- and medium-term placement of such funds.

The Sukuk (Islamic bond) for the most part fulfils the Islamic financial industry's need for a debt instrument. In its simplest form it's a certificate evidencing ownership of an asset. The development of Sukuk was in response to Shari'ah's prohibition on earning returns from loan contracts where returns are based on interest. Conventional bonds and other derivative instruments that rely on profiting holders by providing returns based on interest are therefore unavailable to Muslims who want to invest in Shari'ah compliant investments.

The AAOIFI – which issues standards on accounting, auditing, governance, ethical and Shari'ah standards – has defined 14 different types of Sukuk. The Sukuk structures rely on the creation of a special purpose vehicle that issues certificates that represent, for example, ownership of the asset, entitlement to a debt or to rental incomes or even accumulation from various Sukuk (a hybrid Sukuk).

The return provided to Sukuk holders therefore comes in the form of profit from a sale, rental or a combination of both.

A distinguishing feature of a Sukuk is that in instances where the certificate represents debt to the holder the certificate won't be tradeable in the secondary market and should be held until maturity.

Business category: Certain business categories don't meet the criteria of the Shari'ah. Therefore, specific stocks are excluded from the stock universe from the outset. The categories that are prohibited include, among others:

- Tobacco.
- Weapons and military equipment.
- Banks.
- Gambling/casinos.
- Conventional financial institutions that are interest-based.
- Entertainment, including cinemas, hotels, pornography publications and music.
- Non-halaal food and beverages, particularly pork and alcohol or other intoxicating products.

That leads to a Shari'ah compliant equity portfolio in SA displaying a bias to resource stocks and potentially sector concentration, leading to a less well-diversified portfolio. Also, different asset managers' portfolio holdings are similar due to the limited universe of stocks.

Financial ratios: Once a listed company has been identified as an appropriate stock by screening the business category, certain financial ratios are calculated. The financial ratios include:

- Debt/Average 12-month trailing market cap or total assets.
- Cash plus interest-bearing securities.
- Accounts receivable/average 12-month trailing market cap or total assets.

The first two financial ratios may not exceed 30%; the third ratio may not exceed 70%.

Non-permissible income: If a listed company complies with all three principles above it's still possible that minor components of its profits are derived from sources that aren't permissible under Shari'ah. Investments will not be made in companies where the interest and other non-permissible sources of income are more than 5% of the company's total income.

Interest income from interest-bearing accounts and investments yielding income that's considered impure by Shari'ah standards must be purified. After being audited and computed, dividends will be cleansed of that non-permissible income before being distributed to the investor. The proceeds from that income are then distributed to charitable organisations.

The distribution of non-permissible income is an important aspect of Shari'ah investing, as it assists in the upliftment of communities and ensures that the investment is socially responsible. 20

Investors' appetites for Shari'ah products are increasing, with the current Shari'ah investment market estimated at US$500bn globally, with an expected growth rate of 10% to 15%/year.

18 Specific areas of focus include disaster relief, education and healthcare.

The Shari'ah Supervisory Board

All funds that claim to be Shari'ah compliant require a Shari'ah Supervisory Board to direct, monitor and supervise the investments and activities of the fund to ensure compliance with Shari'ah principles. The purpose of supervision is to certify for Muslim consumers that the financial product is acceptable to them from an Islamic legal perspective and is therefore lawful to them.

The board is an independent body of specialist jurists in Islamic commercial jurisprudence.

It must consist of at least three members, one of whom can be an expert in general Islamic finance and business principles.

There are currently five Shari'ah boards in SA, namely: Absa, FirstRand, Futuregrowth, Oasis and Stanlib. All five boards are well represented with members not only qualified in Islamic jurisprudence but who also have relevant business and investment experience.

Benchmarks

There are currently no Islamic indices available in the SA market. The majority of the current Shari'ah compliant funds in the SA market benchmark against the FTSE/JSE all share index. The lack of appropriate SA indices may require the construction of a tailor-made benchmark.

In the international market, Dow Jones and FTSE have constructed Islamic indices. Currently, the Dow has 31 different equity indices and has also implemented the first Sukuk index. FTSE currently has three different Islamic indices. More recently S&P and MSCI Barra have also introduced Islamic indices.

Shari'ah Compliant Funds in the South African Market

The majority of Shari'ah compliant funds are in the form of unit trusts and invest wholly in equity, which exceeds current prudential guidelines that allow for a 75% equity allocation as stipulated in Regulation 28 of SA's Pension Funds Act. That represents a concern for the retirement fund industry, as members could potentially be invested 100% in equities, exposing them to the volatility of the stock market.

Conclusion

Shari'ah investing is a viable alternative of ethical investment that's expected to grow in future as products are developed to meet the requirements of Regulation 28 and Shari'ah law.

However, legislation also needs to take into account the unique characteristics of those products.

Asset consultants must educate and equip themselves with the relevant knowledge to ensure that boards of trustees of retirement funds are sufficiently informed of the options available. As the demand for Shari'ah compliant products increases and those products are demystified the market will be forced to respond with more product choices, appropriate benchmarks and suitable legislation.

Notes:

1. *www.rics.org*
2. *Stanlib – The Asset Test September 2007*

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Grassroot tycoons

Emergence of universal owner and new paradigm for investment

MALCOLM GRAY

Investec Asset Management

THE WORLD IS CHANGING. Though that may seem a trite comment, over the past 30 years, together with the growing sophistication of capital markets, there's been a subtle yet significant shift in capital ownership that's really changing the world.

Although the ownership of corporations may on the face of it appear to be increasingly concentrated, it's in fact becoming increasingly dispersed. The evolution of modern capitalism and savings is overseeing an unnoticed shift in the character of capital concentration. On the one hand there's a greater concentration of the capital "allocation" decision with institutional investors, the asset managers and life companies. On the other we're seeing a dispersion of capital "ownership" – considering that the capital is in fact provided by the wide array of savers from corporate, union, industry and State pension funds.

Allied with continued long-term growth in the global economy, there's been the accompanied growth in savings of the average worker. Those collective savings currently account for a significant component of global capital. Such pools of savers and shareowners with often-aligned interests are becoming the new – if somewhat distant – shareowners of today's corporations.

Hence an agent-principal problem is emerging with a set of challenges that still needs to be effectively addressed and dealt with. What's clear is that corporate owners now have a distinctly different character, face and ultimately interest to those wealthy families of yesteryear.

Davis, Lukomnik and Pitt-Watson consider these owners in the recently released book as the "grassroot tycoons" or the "new capitalists". As savings have broadened so, in reality, has the savings base. And what links these owners is their interest in the long-term sustainable profitability of their firms. As in the existence of a civil society so a new civil economy is emerging.

This civil economy, Davis and co argue, is the consequence of the constitutionalisation of the marketplace through the evolution of many new rules, standards and behaviours that effectively create voluntary and mandatory frameworks that redefine the role of boards, the requirements for transparency, the nature of share ownership and a number of allied aspects associated with modern capital markets.

The compelling issue is that those owners or new capitalists own shares in order to grow a savings base to match or offset a real liability that they have in the future. That liability is in most cases likely to be their income requirements for their retirement.

The interest of those savers may differ substantially from those of the historical owner/manager families and tycoons. Given that those grassroots tycoons represent the broader community or society in general they may place different priorities on value and have different timeframes with regard to corporate performance.

In their book published in 2000, Hawley and Williams initiated a discourse on the concept of the universal owner. They describe the "universal owner" as "a large institutional investor who holds in its portfolio a cross-section of the economy..." As such, they argued that such a large fund would ultimately hold an index portfolio; importantly, they argued that the universal owner's cumulative long-term return is more a function of the economy as a whole rather than simply the performance of each individual firm they own.

We'd argue that this universal owner and the grassroot tycoons are one and the same. Although those large institutions may on the face of it appear to be a single concentrated owner, in reality they're a collective, with the leadership acting in a fiduciary capacity to the ultimate owners – the fund participants.

What's of importance to those owners or fiduciaries is due consideration of the externalities – both positive and negative – related to the activities of the individual firm(s) and, ultimately, the impact such externalities have on other firms, the economy, the savers' implied liabilities and hence their portfolio.

As the idea of a universal owner is explored, the understanding of an externality is becoming increasingly relevant. Those "externalities" may well be benefits that accrue (such as the impact of improved education or local infrastructure) or a liability (poor quality air or toxic emissions into the environment that impacts on communities with consequent long-term health results).

The externalising of a cost, which may bring short-term benefits in the form of profits and surpluses for the firm (and hence the shareowner) may simply result in the creation of a longer-term liability elsewhere in the shareowner's portfolio, with another firm or within the broader economy.

Consequently, it can be seen that quite possibly the ultimate shareowners may now well place a different priority on the performance of the firm. Why? Because those owners – as citizens and taxpayers – will ultimately pick up the tab for externalised costs from companies seeking short-term profits.

Considering that in the context of SA trustees and institutional investors a recent survey highlights a disconnect between what's considered important (material) by the fiduciaries of those universal owners and their ability to effect the necessary change in their mandates. In the report the participants considered as material to the likely performance of their investments a number of environmental, social and governance factors.

However, when asked what the respondents were doing to incorporate those factors in their mandates – given their importance – most indicated that they were doing nothing or very little.

Trying to understand that disconnect the report explored the possible barriers. Most intriguingly, one of the key reasons for not exploring the incorporation of such material factors into their mandates was the perception that that would be in conflict with their fiduciary responsibility.

That barrier appears to be persisting to some degree due to the inferred relevance of a seriously misinterpreted British court decision in Cowan versus Scargill. This often-referenced case in trustee and fiduciary circles has been misunderstood and distorted by commentators over the years. Incorrectly, it's understood to support the view that it's unlawful for a board of trustees to do anything other than seek to maximise the profit for its beneficiaries.

To test the validity of that interpretation and explore the scope of fiduciary duties in a number of other key investment jurisdictions, the United Nations Environmental Programmes Financial Initiative (UNEP FI) commissioned a report to consider this important issue (the Freshfields Report). The essential scope and brief of the report was to determine if:

"[…]the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) [is] voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?"

The report concluded that, given that conventional investment analysis was focused on value and that there's clear evidence emerging of the materiality of environmental, social and governance (ESG) factors in determining value in a financial sense that the integration of ESG factors into investment analysis was "clearly permissible and […] arguably required in all jurisdictions".

Putting that all together: Responsible investment and the Principles for Responsible Investment (PRI).

The case is beginning to stack up. Universal ownership seems to be aligning broad groups of shareowners with allied interests in relation to corporates, their conduct and performance. Clearly, the generation of economic profits is key for all owners: the only way they can meet their long-term liabilities. However, ▶▶ 22

21 economic profits need to be real and should be achieved in such a way that they don't impose unsustainable externalities on the very owners to whom they're to deliver returns.

The emerging concept of RI provides a context within which that requirement fits. Recognition that "universal owners" have a real interest in the sustainable generation of profit by corporates speaks to the need for owners or their agents to start integrating the consideration of material issues, such as ESG factors, that may affect the true economic performance of their assets. Given the clarity provided by the Freshfields Report, such conduct by fiduciaries would be appropriate, if not required.

The case for adopting a more responsible approach to investments has been clearly made above. It reflects the broader interests of the new universal owners and represents an appropriate application of fiduciary responsibility.

However, the lack of response from SA and the lack of support from many institutional funds remains a mystery to many. There's no doubt that a part of the challenge relates to the diverse perspectives on the subject, the relatively poor educational efforts undertaken by the industry at large and the failure to find a unifying framework within which to place the many related areas of RI.

Fortunately, frameworks such as the UNEP FI Principles for Responsible Investment provide a useful and common approach for integrating material ESG issues into investment mandates and investment analysis. They support the evolution of universal owner networks and provide a context within which the exercise of fiduciary responsibility begins to take on a much more relevant character. The world of capital has changed and continues to change with the rise of the grassroot tycoons. These new capitalists have a very direct and vested interest in the responsible management of their assets. The integration of environmental, social and governance considerations that have a material impact on corporate valuations looks set to become increasingly relevant.

Our grassroot tycoons are turning the tables on the traditional interpretation and management of their assets, which is the logical and right approach. Shouldn't their desire to achieve the highest long-term sustainable returns relative to their future liabilities not be the ultimate fulfilment of a trustee or manager's true fiduciary duty? ■

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