ESG factors seen as increasingly important by Deutsche Asset & Wealth Management's Gebhardt

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Henning Gebhardt, head of EMEA equities at Deutsche Asset & Wealth Management, points to examples involving Xstrata and Novartis that illustrate the growing role of environmental, social and governance factors in investment decisions.

The financial crisis and resulting regulatory changes have brought investor behaviour into closer focus. Dealing with the financial crisis is in full swing and solutions continue to be sought to ensure the financial markets are less susceptible in future. The objective of greater economic sustainability is at the forefront. Investors are no longer seeking short-term profit, but rather are increasingly opting for investment companies which observe the so-called ESG factors in their investment decisions.

Observing environmental, social and governance (ESG) factors poses a particular challenge for investment companies and their portfolio managers. In contrast to conventional financial key figures, these factors reflect qualitative issues, which to a certain extent require much more complex analysis.
Indeed compiling the relevant data on ESG themes demands completely different routes to conventional financial analysis. With standard financial analysis, a portfolio manager or analyst can turn to the analyses compiled by investment banks.

However, such banks rarely consider the ESG theme, often to avoid conflicts of interest. As such, the portfolio manager must rely on other sources of information. In recent years, companies such as Sustainalytics, RepRisk or Oekom have become more important.

Investors today expect their chosen portfolio manager to rise to their responsibilities and devote considerable time to corporate governance. This is a marked change in the interaction between portfolio managers and their portfolio companies.

Companies are now facing increasing critical shareholders who are no longer satisfied with simply "collecting" dividends. At annual shareholders' meetings investors are less prepared to accept poor performance and are demanding changes. This so-called 'engagement' is not just limited to annual shareholders' meetings, but also regularly features in the media. In principle, investors want to see a cooperation based on trust. Conflicts with companies are never pleasant and a portfolio manager never wants to see this. Poor performance by some companies in the past have led to just that which is why our investors expect us to not turn a blind eye and if in doubt to take active corrective measures.

This may also include communications with bodies other than the board of directors, so that the wishes and views of investors are properly heard. Indeed a new dynamic has appeared whereby investors can be actively heard. However at present, expectations should not be too high. Portfolio managers are not personnel agencies or remuneration specialists. Despite this, in future portfolio managers will have to engage with these subjects more intensively with the assistance of proxy voting specialists. Who can call a halt to poor performance if not the shareholders?

The hot subject of ‘say on pay’ is proving fascinating. In the past, there were too many examples of management pay being out of sync with the success of a company.

The most aggressive management methods coupled with a simultaneous lack of transparency saw shareholders’ investments decimated. Such companies were more like hedge funds than solid companies.

It is now likely that shareholders and the public will tackle such unethical behavior much earlier. Examples such as Xstrata and Novartis demonstrate that shareholders have already become much more critical. Blocking the high retention bonus for Michael Davis as part of the Xstrata/Glencore merger is just one example that shareholders will no longer tolerate disproportionate bonuses. The rejection of the consultancy mandate between Novartis and Daniel Vassela is another case in which incomprehensible behaviour by managers and other corporate bodies became a matter of public debate.

These examples illustrate the level of importance of financial intermediaries and, in turn, their portfolio managers. Increasingly they are taking a more active position on this responsibility.
Similarly, in future pension funds and private investors will demand more accountability from their portfolio managers in terms of how they behave towards portfolio companies and the manner of involvement.
In this respect, investment companies will also have to demonstrate a much greater degree of transparency. They could be subjected to enormous pressure to justify any lack of action and as such the trail comes full circle.