REDEFINING
VALUE IN THE 21ST CENTURY

SHAPING THE WAY

It is no secret that asset owners seek to generate returns above their targeted benchmark whilst hedging against any potential downside risk. This is more especially important for defined benefit funds such as the GEPF whose benefits are guaranteed by National Treasury and do fluctuate by portfolio returns.

At the GEPF we appreciate the intersection of evaluating traditional financial measures alongside sustainability measures to deepen our understanding in markets, sectors and investee companies to distinguish between those that are susceptible to disruption and those that can adapt and to further measure and quantify emerging and existing risk. We believe sustainability factors provide for a more multi-dimensional perspective and deepen our understanding of potential downside risk tied in macro risks.

Moving away from the moral and ethical dilemma of what is wrong and right, investors and those across the investment value chain still question whether doing the right thing generates alpha and if doing the right thing truly creates intangible value. In order to answer this question, a variety of concepts will be explored.

NOT A NEW CONCEPT

The notion of using environmental, social and governance (ESG) factors to invest for the greater good for society has evolved and become more structured over the last 70 years. Channelling investor and consumer capital away from economic systems that were no longer seen to be socially acceptable such as the American Civil Rights movement in the 1950s, and business and civil boycotts against South Africa's apartheid system indicate that broader society is concerned about how business profits are generated.

Earlier economic works by the father of economics, Adam Smith's Theory of Moral Sentiments (1759) and The Wealth of Nations (1776) formalises and institutionalises the sentiment that economic systems are inherently driven by the human need for self-preservation and the benefit of collective society. Smith (1776) further develops this by stating that the progress of a developed system largely is reliant on material growth of society.

With the advent of mature financial systems, ESG investing has become more mainstream however integrated into existing traditional investment theories pioneered by Markowitz's Modern Portfolio Theory (1952) and a decade later worked on by Sharpe et al (1962) to produce Capital Asset Pricing Model (CAPM).

EMERGING ACADEMIC THEORY

The exploration for a positive correlation between ESG criteria and financial performance can be traced as far back to the early 1970s.

Over the years, as new information has emerged and evolved, investors have leveraged off data analytics to harness new insights to help inform investment decisions. This has paved the way to a more nuanced approach and there remains variability of interpretation and implementation in the incorporation of a broad range of techniques from screening and/or the use of environmental, social and governance factors to mitigate risk or contribute to potential alpha.

The impact of high environmental and social risk increases corporate financial instability, increases their probability of default, increases their cost of capital and causes portfolios to not outperform indexes Pástor et al. (2021), Luo & Balvers (2017), Nagy et al, 2016 Heinkel et al. (2001),

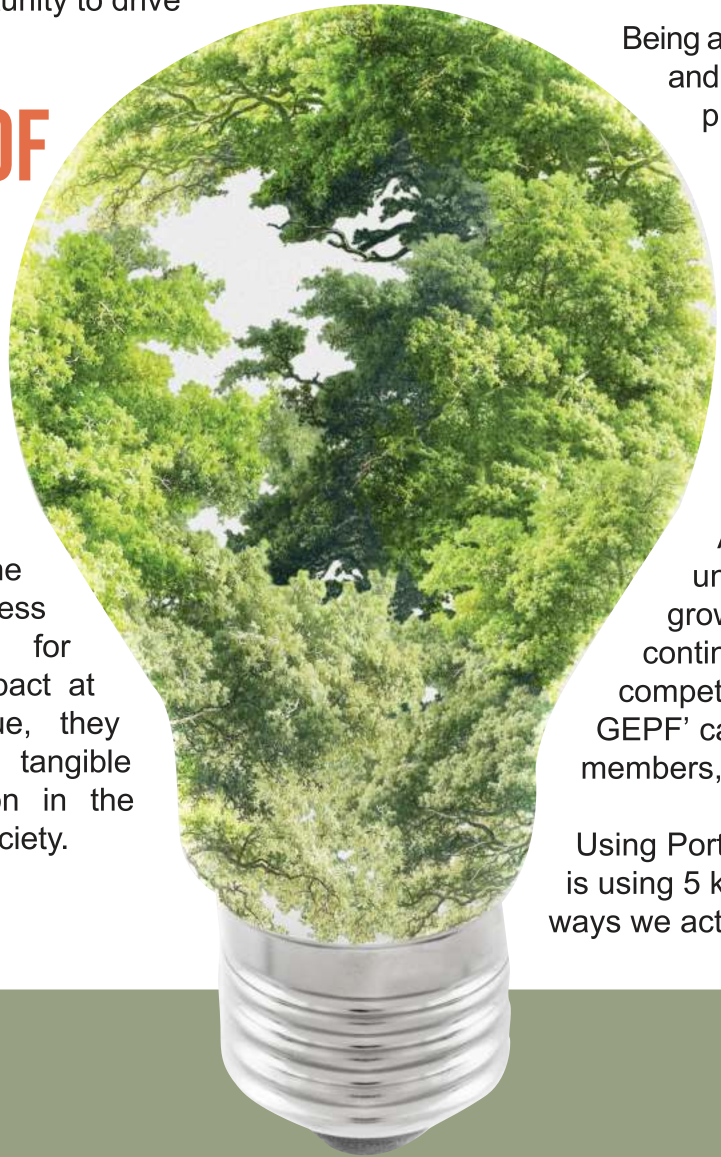
Empirical evidence indicate that negative governance events decrease investor confidence, negatively affect the integrity of certain institutions, devalue stocks and bonds which in turn devalue pension fund returns through the poor performance of investment portfolios (Price and Norris, 2009). Stewart and Yermo (2008) support this argument by stating that robust governance in a pension fund leads to enhanced operational and investment risks mitigation and control and improve the returns generated by the pension fund (Whitehouse et al.,2009).

Additionally, governance aspects impact the fiscus; poor governance causes sovereign downgrades which affects the creditworthiness of sovereign bonds (Connolly, 2007). This results in capital outflows due to loss in investor confidence and inherently implies that taxpayers in more corrupt states face a negative fiscal externality. For example, by paying a higher rate for debt hindrances to local and foreign direct investment, damage to reputation of the sovereign causing a reduction in economic growth (Connolly, 2007),thereby increasing levels of poverty for our members, beneficiaries and pensioners.

Much of the investment community, however, still views ESG issues either as irrelevant to maximizing shareholder value or merely as a risk factor to diversify away and not as an opportunity to drive alpha.

ENTERING A NEW ERA OF VALUE

A new era of understanding in the linkage between investment performance and social impact has emerged. This moves away from previous approaches, such as socially responsible investing and ESG screening. This comes from the notion that when companies do not understand or rigorously track the interdependency between social and business results, they miss important opportunities for innovation, growth, and sustainable social impact at scale. When companies create social value, they increase economic performance and create tangible societal benefits. This embodies an evolution in the association between investors, business, and society.



BEING PURPOSE-LED

Being a purpose-led investor requires deep introspection and commitment on a fundamental and first principles level – understanding why you are investing and the sole reason for your existence to ensure your sustainability for the long term. This includes taking into account emerging social norms and expectations, government policies, and other external factors as they remain dynamic and impact business' social license to operate.

Broadly speaking, we remain cognisant of our operating environment – that South Africans experience high levels of structural unemployment, energy insecurity, low GDP growth widening inequality, weak climate change contingency plans and deficiencies in the country's competitiveness and therefore leveraging off the GEPF' capabilities remains paramount for many of our members, pensioners and beneficiaries.

Using Porter et al. (2018) we can identify how the GEPF is using 5 key practices that represent the most important ways we activate value for society.

1. LEADING WITH PURPOSE

Many of the risks South Africans experience relate to economic and social risks and therefore we have long led with the purpose that we invest for the dual reason of investing for risk adjusted returns while supporting positive, long-term economic, social and environmental outcomes for South Africans.

2. CULTURE

We value integrity, transparency, client centricity, accountability, and innovation. We have a deep ambition to transform business and mobilise capital towards purpose-led investees who have ambition to solve business and societal issues together. We are active owners who engage and use a collaborative approach to effect change.

3. STRATEGY

We find sources of differentiation in our investments by addressing unmet societal needs and create a more sustainable business environment. We are guided by our philosophy of investing responsibly for the long term and making specific allocations towards developing our economy.

4. OPERATIONS

Our in house methods and approaches to investment decisions reflect the nexus point of unmet social needs, impediments to business success and alpha generation. We are guided by a mind-set and a culture that embraces the belief that business and society can mutually benefit from ensuring ESG aspects are considered throughout our investment value chain.

5. PEOPLE

Our people are at the heart of our organisation. We believe in purpose-driven, high performance and leadership excellence. We attract new talent, motivate and retain those who are already within the organisation.

MEASURING VALUE IN A FUNDAMENTALLY DIFFERENT WAY

Professor Porter of Harvard Business School, in his 2011 seminal Harvard Business Review article, Creating Shared Value defines shared value as “policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates.”

Shared value creation focuses on identifying and expanding the connections between societal and economic progress. Shared value practices offer companies new ways to innovate, compete, and create a business environment that is sustainable.

Shared Value Investing, Harvard Business School

THE LINK: SOCIAL AND BUSINESS RESULTS

Shared value seeks to enhance the competitiveness of a company while simultaneously improving societal and economic conditions by leveraging a company’s core business. It also provides the allowance to monitor the development and outcomes of determined social and business outcomes; their converging objectives are to solve a social issue and boost business. Porter & Kramer (2011) explain that companies can pursue shared value opportunities on three levels.

1. RECONCEIVING PRODUCTS AND MARKETS

Creating shared value from reconceiving products and markets focuses on revenue growth, market share, and profitability that arise from the environmental, social, or economic development benefits delivered by a company's products and services.

2. REDEFINING PRODUCTIVITY IN THE VALUE CHAIN

Creating shared value from redefining productivity in the value chain focuses on improvements in internal operations that improve cost, input access, quality, and productivity achieved through environmental improvements, better resource utilization, investment in employees and suppliers.

3. ENABLING CLUSTER DEVELOPMENT

Creating shared value from enabling local cluster development derives from improving the external environment for the company through community investments and strengthening local suppliers, local institutions, and local infrastructure in ways that also enhance business productivity.

CASE STUDY: ROGGEVELD WIND FARM

Whilst we already know that the Fund has made significant allocations in private equity to better the lives of everyday South Africans, we decided to explore whether large investors can apply academic theory such as Porter's Shared Value theory into practice.

The GEPF, through the Public Investment Corporation, invested R281 million on behalf of GEPF members and pensioners in the construction of Roggeveld Wind Farm in Matjesfontein, on the border of the Northern Cape and the Western Cape. The total deployed by investors was R4 billion. Roggeveld started feeding much-needed electricity into the Eskom grid on 26 February 2022, having closed financially in April 2018.

Roggeveld wind farm

Roggeveld Wind Farm

47 wind turbines

Roggeveld will displace 24 tons of carbon dioxide annually

Generating 613GWh of electricity

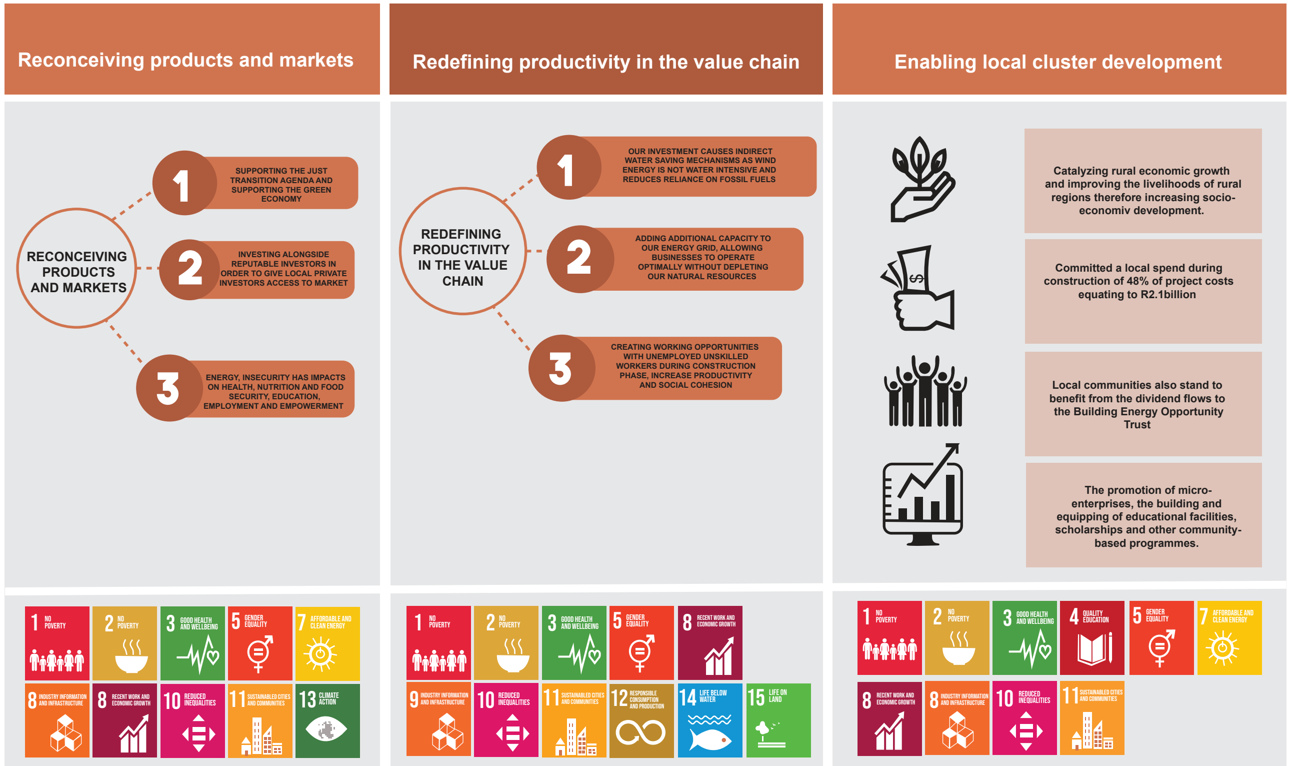
At construction peak, the project provided 851 jobs

Power sufficient for 49 000 households

WALKING THE WALK

Using Porter's Shared Value model, it is apparent that our investment in Roggeveld has triggered shared value on all 3 levels and certainly made strides in developing society. The GEPF has for over a decade long believed in extracting returns through making South Africa more competitive, reducing social backlogs and making the economy more sustainable.This continues to be done through large-scale long-term investment opportunities such as Roggeveld. Our investment philosophy continues to stand the test of time whilst emerging investment theories seem to garner recent traction on why doing the right thing equates to business and community synergy and general community wellbeing. The GEPF, as the largest institutional investor in South Africa, and as a corporate citizen and thought leader, continues to set an example to other investors to support developmental investments.

Belaina Negash is the ESG Manager at the GEPF



GEPF Creating Shared Value through Roggeveld Wind Farm