



'Responsible' Investing Requires Sleuthing

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In Asia, listed companies are just beginning to feel the nudge of a growing breed of “responsible” investors, primarily from North America, the UK and Europe, whose analysts want to peer into their environmental records, ask questions about ethical treatment of employees and scrutinise the activities of the board. To serve them, the investment community has developed new matrices to gauge environmental, social and governance (ESG) issues and responsible investing principles, dominated by the UN Principles for Responsible Investing (UNPRI). UNPRI has more than 550 signatories as of early July, the majority of who are asset owners and investment managers.

Institutional investors' ESG requirements are “like a tsunami about to hit Asia’s largest companies, but they are unprepared for it,” says Lucy Carmody, executive director of Responsible Research, a Singapore-based firm established in 2008 to analyse Asian companies' ESG issues on behalf of global institutional investors.

Indeed, the pressure on Asian businesses is just commencing. The Emerging Markets Investor Survey Report, released in June 2009, indicates that about 70% of institutional investors said they would like to see greater disclosure before increasing weightings to these markets. Fewer than 10% used no ESG or socially responsible investment criteria in their investment processes currently. The report, which polled 67 institutional investors, was sponsored by the International Working Group of the Social Investment Forum and the Emerging Markets Disclosure Project and represents over US\$130 billion of emerging market investment.

Hugh Young, managing director of Aberdeen Asset Management Asia, is sceptical of principles and other frameworks being adopted almost en masse lately. “They are commendable of course, but I wonder how many people put them into practice,” he says.

Aberdeen, which manages US\$47.16 billion in Asia, more than 90% of which is institutional money, became a signatory to UNPRI in February 2008. But the firm has been requiring good governance of every one of the 500 to 600 companies in its investment universe since inception in Asia 20 years ago.

Many “responsible” investors ostensibly have a checklist of items to incorporate into their investment process — such as human rights standards, no trade with Iran, no dealing in alcohol and so on — but this approach tends to miss the subtler, but significant signs of governance quality. Young points to the contextual details that a diligent investor considers: “Would you rather have a company with all the boxes ticked but are run by swindlers? Committees exist but who runs the committees?”

Aberdeen’s investment managers work more like corporate sleuths. They visit every potential investee, chat with senior management to get a feel of the ground that cannot be discerned from reports, watch management’s actions over six to seven years and fine-comb the annual reports before making a decision. “But when we invest, our average holding is eight years in a regional fund,” Young says.

Over the last 20 years, the process has been refined to such an extent where the universe of investments and potential investments has remained constant, while the listed equity market in Asia has grown multiple times. Aberdeen has more than 300 stocks across its Asian portfolios, including Japan. Another 200 stocks are monitored as potential investments.

Much of Aberdeen's investment process looks like common sense. "Read the annual report. Look at the nuts and bolts of the balance sheet and profit-and-loss statements. Most people just read analyst reports, but that's not going to give you the details you need. In our experience, things have gone wrong if subsidiaries have no income or if sales recognition was not on a cash basis, for instance," Young reflects.

Banks have become particularly difficult to understand in recent years because their products and counterparty relationships have become more complex. But the key to fathoming them lies in something fundamental — corporate culture. "It's important to know the culture of the bank. We're comfortable with OCBC's culture; they have a traditional banking culture, unlike an investment bank where the attitude was to do as many deals as possible to get a large bonus," Young says. Aberdeen's holdings include OCBC and Standard Chartered Bank, another traditional institution.

But even veteran investment sleuths can be deceived sometimes. Aberdeen had found no alarming signs in Satyam Computer Services, the Indian firm whose former chairman Ramalinga Raju falsified earnings. He had admitted to placing US\$1 billion of "fictitious" cash on the balance sheet. Saytam was one of the holdings in Aberdeen's India retail fund. "This was an exceptional instance where we couldn't learn from our mistakes because we couldn't figure out what we missed... there was cash in Satyam's bank," Young reflects.

Governance issues in Asia tend to be around company ownership and corporate structure. In Australia, issues come mostly from professional managers who "pump up a story to get the stock price up, cash in and leave," Young says.

"If shareholder value means share price, it is madness. Shareholder value is sensible if it means building the business, looking after staff, suppliers and other stakeholders who help to bring in the profits," he says.

Aberdeen's list of embargoed companies have remained rather constant too. "Lots of things haven't changed. They've just become more subtle... Even before the Asian crisis of 1997, we would not touch many Indonesian conglomerates with a barge pole," Young declares.

But companies with better governance do not necessarily deliver better returns, Young observes. "In what we do, there is a bit of morality too. You wouldn't put money with a crook, whose board is filled with crooks, would you?"

In the shorter term, it is more costly to run an investment firm that digs as deeply as Aberdeen. The firm has more than 50 fund managers in Asia, which is significantly more than firms of a similar size. However, over the longer term, it works out to be cost-effective, as the vigorous due diligence produces fewer mistakes and lowers the need to trade. Aberdeen's annual portfolio turnover is 15%.

"There has been a sea change in the way companies are run throughout Asia and the emerging markets in the 17 years I have been here (based in Singapore). The degree of professionalism and focus on business strengths has changed dramatically," Young says. Consequently, "when the world economy improves, earnings from Asia and emerging markets will come through. My best guess is, that will begin occurring about three years from now."