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Uncharted risks: portfolio safety isn't always in the numbers

Simon Mumme

Some big investment managers are using extra-financial research to illuminate threats to performance that exist beyond the reach of traditional stock analysis. And they've found that risk takes many forms. SIMON MUMME reports.

The financial data of any business is just one piece of the risk puzzle. Behind these numbers, methods of managing staff, resources and strategy in a shifting regulatory landscape can affect a company's sharemarket performance.

Frustratingly, traditional risk models can't translate these influences into numbers.

In this extra-financial risk spectrum, environmental, social and governance (ESG) factors play significant roles. Among the big funds managers in Australia that have tackled this dimension of risk in their analysis processes are Colonial First State Global Asset Management (CFS GAM), ING Investment Management and Perpetual.

Some of these institutions want to know if a particular company's intellectual property is secure, if it manages staff poorly or how it plans to operate under an impending emissions-trading system.

Others seek broad, thematic information such as sector analyses on the clean-tech or bank lending industries.

"It's all about looking for risk and risk management policies. It's about broadening the research perspective as different risks and opportunities have emerged," Mark Bytheway, chief executive of the Sustainable Research Institute (SIRIS), an extra-financial research provider, says.

Bill Hartnett, managing director of the Sydney office of Innovest, another extra-financial research firm, says that managers are continually looking at new types of risk models or indicators. Some have found value in extra-financial research.

"The key for us is to put it in language that funds managers understand," Hartnett says.

Initially, socially responsible investment (SRI) product managers were the first managers sourcing research from SIRIS, but enquiries now come from mainstream funds managers. Major brokerages Citi and GoldmanSachs JBWere now provide this research, too.

"Investors are asking: is this a rising risk and, if so, how can I respond to it?" Bytheway says.

According to Innovest, there are only 15 companies in the ASX200 that have "world-class" extra-financial ratings, Hartnett says. The remaining companies in the top 200 are poor.

"Australia is a risky market. In terms of the strategic response to climate change, we're generally behind the eight-ball…Australian companies are some of the most emissions-intensive companies going around."

Innovest regards companies' responses to an impending domestic emissions-trading system, to be implemented in 2010, as a matter of stakeholder capital, which encompasses the ways that companies interact with governments and regulators.

"How they deal with regulation is a determinant of management quality," Hartnett says.

Compared with European companies, Australian businesses are more vulnerable to the commercial risks of operating in such an environment, because the Europeans have been operating under an emissions-trading system for the past three years.

Hartnett says that Australian funds managers should observe the way Australian chief executives navigate their businesses through a marketplace in which carbon is more expensive, since this is an indication of management quality. "Today's CEOs didn't read about these situations in text books at university."

Other cases of poor extra-financial performance include instances where some Australian manufacturers have exploited cheap labour in Asian countries, resulting in a "below par" standard of supply chain management. Also, 'product liability' problems, such as the cancer-inducing asbestos products from James Hardie, can arise and affect

companies' sharemarket performance. A notable example of this is the subprime mortgage mess, which Innovest identified in 2006 as a 'social risk' problem when it became evident how unlikely it would be that subprime mortgage borrowers would repay loans issued to them.

"We might applaud a bank for installing energy-efficient lighting, but a bank's real risk is who they lend to and how they do it," Hartnett says.

Certain shades of green

While sustainability is a key factor in analysing a company's extra-financial risk, there is "no hard-and-fast law of what constitutes sustainability", SIRIS' Bytheway says. "It depends on your terms of reference. And criteria change.

"Could you put BHP Billiton in a sustainability portfolio? If you look at how they manage risks and opportunities, it's plausible."

SIRIS included the miner in a sustainability-focused structured product that it recently built for nabCapital – the Sustainability Note – for release into the sub-institutional market, whose investors include universities and high net-worth individuals. The static portfolio of 20 companies also holds major banks such as ANZ, Westpac and National Australia Bank, property group Lend Lease and diversified business group Wesfarmers.

Presenting its view of a sustainable investment, the manager asked SIRIS to build the portfolio from companies among the top 50 in the ASX200 that did not derive more than 5 per cent of their revenue from industries such as tobacco, firearms and alcohol.

International equities boutique Five Oceans Asset Management (Five Oceans AM) takes a different stance. The manager looks for emerging themes from within the business, social, political and environmental spheres, and integrates this with a value-based investment strategy that allows for contrarian cross-checks. Analysis of ESG data is one input into the manager's investment process. For some of this information, it draws on ratings of companies supplied by Innovest.

"We're looking for directional change in the area of ESG," Ross Youngman, Five Oceans AM chief executive officer, says.

"Huge environmental blow-ups have cost companies."

If a company it assesses is exposed to an extra-financial risk and is not combating it, or has not formulated a strategy to counteract it, it will probably be excluded. "If a company is not going to improve, that is risk. We might pass on that company," Youngman says.

Such strategies must be convincing, Bytheway reaffirms. "This is about whether companies are doing what they say they do in their policies, and how they do it."

These policies are seen as a guard against future extra-financial risks to business performance. The impact of an emissions-trading system, scheduled to be implemented by 2010, is being assessed by CFS GAM.

Neil Cochrane, CFS GAM global head of business development and deputy chief executive, says the manager is concerned about some carbon-intensive businesses' capacities to absorb the additional costs that will surface under the system. "If you don't take that into consideration, then you haven't done your job. It's a part of investment analysis," Cochrane says.

"Companies will make more money out of being more efficient."

Cochrane says the manager, which is a signatory to the United Nations Principles of Responsible Investment (UN PRI), and has recently engaged Innovest to assist with the implementation of the principles, applies no default measure of sustainability to companies.

He says the researcher has been hired to broaden the views reached by CFS GAM's internal analytical teams.

"These are complex issues, and one has to be careful to not make them a personal interpretation."

Integrating extra-financial analysis into stock selection is a continual process, Cochrane says, and involves engagement, rather than screening out companies that disregard ESG values. As a result of this mediation process, which is encouraged by the UN PRI, the manager's portfolios should not be transformed radically.

"PRI can add value. Screening out companies doesn't add value," Cochrane says.

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