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Investing for a
world of change

SA equity and multi asset: A considered approach to sustainable investing

April 2023

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Introduction

At Ninety One, our goal is to create long-term wealth for our clients while making a positive difference to people and the planet. We believe that these objectives are interlinked. Over the past decade, we have found that through the inclusion of a sustainability driver as part of our investment process, we have been able to gain a greater understanding of the companies that we invest in, their future earnings, and consequently reasonable valuation estimates. By having an in-depth understanding of the environmental, social and governance (ESG) issues that companies face, we have also been able to partner with them to help guide them along a path of sustainability. We believe this should not only benefit their operations, but also the environments in which they operate, ultimately leading to more sustainable value creation on behalf of our clients over time.

Integrating sustainability within our investment philosophy

At the centre of our investment philosophy is the belief that a more consistent performance profile is possible by investing in companies with positive earnings revisions trading at reasonable valuations.

In our opinion, there is a tension between earnings revisions and valuations. Successfully navigating this tension ensures a more consistent return profile. Assessing the sustainability of earnings revisions and valuations is an important factor in this endeavour. We, therefore, emphasise ESG issues that could have a material impact on the future earnings prospects of companies and their valuations.



A common understanding of sustainability and ESG

A common approach to thinking about sustainability is to view it through the lens of the three ESG factors: environment, social and governance. When analysing these factors it is helpful to consider ‘double materiality’: firstly, how ESG factors may influence a company, including its earnings and valuation; and secondly, the company’s impact on the world.

Regarding environmental issues, the steps companies take to manage their carbon emissions could imply changes in capital expenditure, and therefore changes in their return profiles. As these companies adopt new technologies, cost-growth dynamics may change. Similarly, opportunities for new and different revenue vectors may arise, changing the investment case.

On the social front, the treatment of workers can greatly impact both income and expenses. Diversity, another ‘social’ metric, helps create more robust businesses. Finally, how a business affects local communities can have a significant bearing on its license to operate.

Arguably, governance – a company’s decision-making system, particularly its leadership structures such as the board of directors and related policies – is the ESG fulcrum. It is only by way of good governance that environmental and social issues can be handled appropriately, and that alignment with shareholders can be promoted. Good governance helps create a culture of improving sustainability, supports sound operational procedures and compliance with the rules and regulations of the jurisdictions in which a company operates, and ultimately contributes to a company remaining operationally efficient and profitable.



Incorporating sustainability in our investment process

We view sustainable investing as the integration of environmental, social and governance factors within the fundamental analysis, both before the allocation of capital and for the duration of our investment. The below highlights the steps we follow when incorporating sustainability into our investment process.

ESG screening: To assess ESG issues, we use a combination of top-down universe screening and bottom-up fundamental analysis. Alongside our own proprietary analysis, we leverage Ninety One's dedicated Sustainability team for top-down universe screening, with particular reference to high-emitting companies. In addition, our Engagement & Voting and Investment Risk teams provide information via various sources, including ISS (voting recommendations), MSCI (sustainability ratings), Carbon Profiler, ESG Profiler and RepRisk.

The stocks within our investable universe are screened using a combination of external and internal screening tools and assigned an ESG rating. These ratings are used to highlight potential avenues for ESG fundamental research. Our universe screening also allows us to assess any near- and long-term ESG trends, enabling us to effectively integrate ESG risks and opportunities into our decision-making process and portfolio construction.

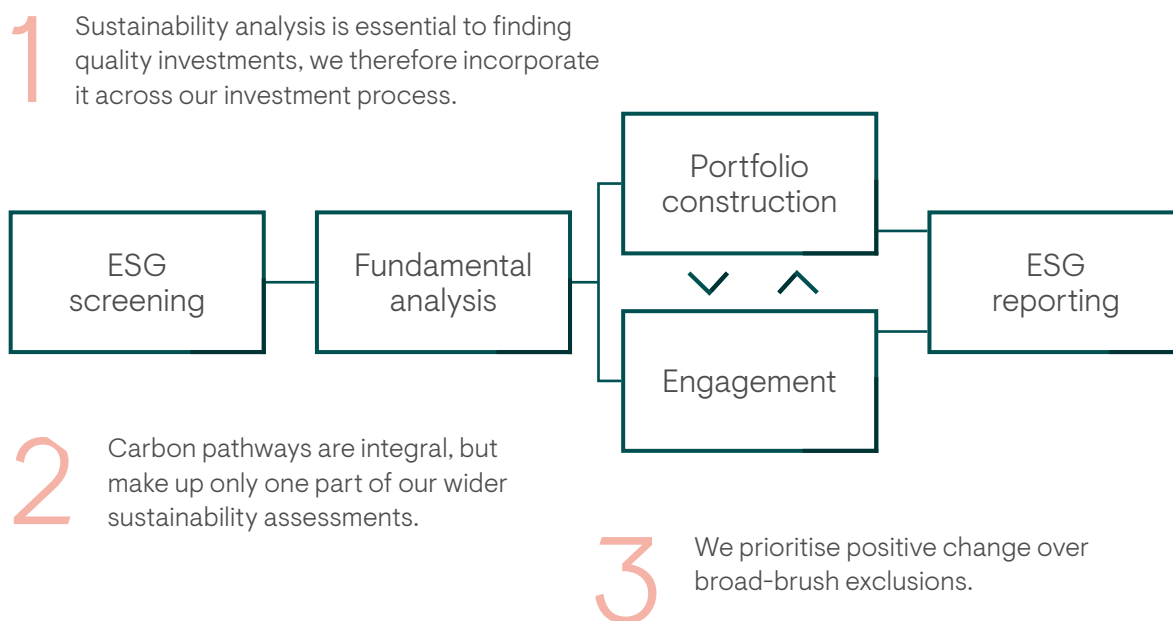
Fundamental analysis: Our investment team is responsible for identifying and analysing ESG issues as part of its fundamental bottom-up analysis. Team members' deep knowledge of the companies and industries that they oversee is an important differentiator. When assessing the sustainability of a company's earnings revisions and valuations, the investment team places emphasis on the ESG issues that could have a material impact.

Portfolio construction: Stock selection and position sizing are adjusted through a structured ESG risk approach. We do not set explicit portfolio construction rules based on ESG issues; instead, we monitor portfolio exposure with respect to ESG ratings alongside carbon emissions exposure. In line with our firm-wide approach to net zero, we focus on promoting real-world change by working with our investee companies to achieve appropriate net-zero targets, rather than on divesting to simply reduce portfolio emissions. An internally developed proprietary portfolio management system (PortfolioViz) provides our portfolio managers with a direct link to the ESG tools for portfolio monitoring purposes. This system has been enhanced recently to include pre-trade ESG checks, aimed at highlighting the latest ESG ratings and any potential issues relating to stock selection prior to the allocation of capital. Through the combination of these ESG tools, our portfolio managers and analysts are able to easily access the ESG profiles of our investee companies.

Engagement: Our investment team is responsible for undertaking focused and constructive engagements as identified during the fundamental analysis and portfolio construction phase. Our Sustainability Committee, with representation from Ninety One’s global Executive Committee, meets with the investment team regularly to review ongoing engagements. Our Sustainability Committee reviews engagements quarterly and has oversight over firmwide sustainability progress and investment integration, while our investment team is responsible for identifying and driving ESG priority areas. In 2021 and through 2022, our investment team undertook a proactive investee company education roadshow to enhance future engagements.

ESG reporting: We are committed to active ownership and proactively engage with investee companies locally and globally, with our engagement findings and outcomes transparently available to all our clients. Upon request, our portfolio managers report back to clients on ESG issues and engagements for companies held within their respective portfolios. In addition, our business reports extensively on ESG activities in our annual Sustainability and Stewardship Report, which is available on our website. We also produce several ESG reports for specific mandates.

Figure 1: Articulating the impact on investment decision making and encouraging firms to improve disclosure





How we incorporate sustainability within our business

Our sustainability evolution

In 2011, we began the first phase of our approach to sustainability and ESG integration within investments, ESG 1.0. Our goal was to establish a common understanding of ESG and stewardship at the firm. This included building awareness around ESG matters, creating a central ESG team, as well as developing a [Stewardship Policy and Proxy Voting Guidelines](#).

The next phase of our evolution, Sustainability 2.0, began in 2019. A key feature of this phase involved investment teams becoming fully responsible for addressing and embedding ESG analysis in their processes, with support from our Sustainability Committee and the Investment Risk function, rather than being driven by a centralised ESG team.

In 2022 we initiated the current phase of our sustainability programme, Sustainability 3.0. This phase involves driving real-world impact and putting our business and our investments on a pathway to net zero by 2050. One of the core components of this approach includes the implementation of a firm-wide net-zero transition plan, which saw us joining the Net Zero Asset Managers Initiative and setting net-zero targets designed to encourage credible emissions pathways, rather than a linear reduction in portfolio emissions.

When joining the Net Zero Asset Managers Initiative we made two commitments:

Our approach to cutting emissions will support real-world decarbonisation.

We will work for a fair transition that includes emerging markets.

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The net-zero targets for our investment teams are therefore aimed at driving real-world carbon reduction and allowing emerging markets to transition in a fair and inclusive manner. To this end, we have set the following targets for our investments:

- At least 50% of the corporate emissions that we finance through investments will be generated by companies with Paris-aligned science-based transition pathways by 2030.
- The proportion of our corporate AUM covered by Paris-aligned science-based transition pathways will meet our science-based targets. We calculate this requirement to be 56% of our corporate assets under management with science-based transition pathways by 2030.
- In practice, we will engage actively with our highest emitters and largest holdings to maximise the proportion of our corporate AUM with science-based transition pathways.

Moving into 2023, 28 companies that make up the top 60% of our financed emissions are now included as part of our high-emitter engagement strategy. This currently accounts for approximately 11% of our firm's AUM, however, this amount does fluctuate through time.

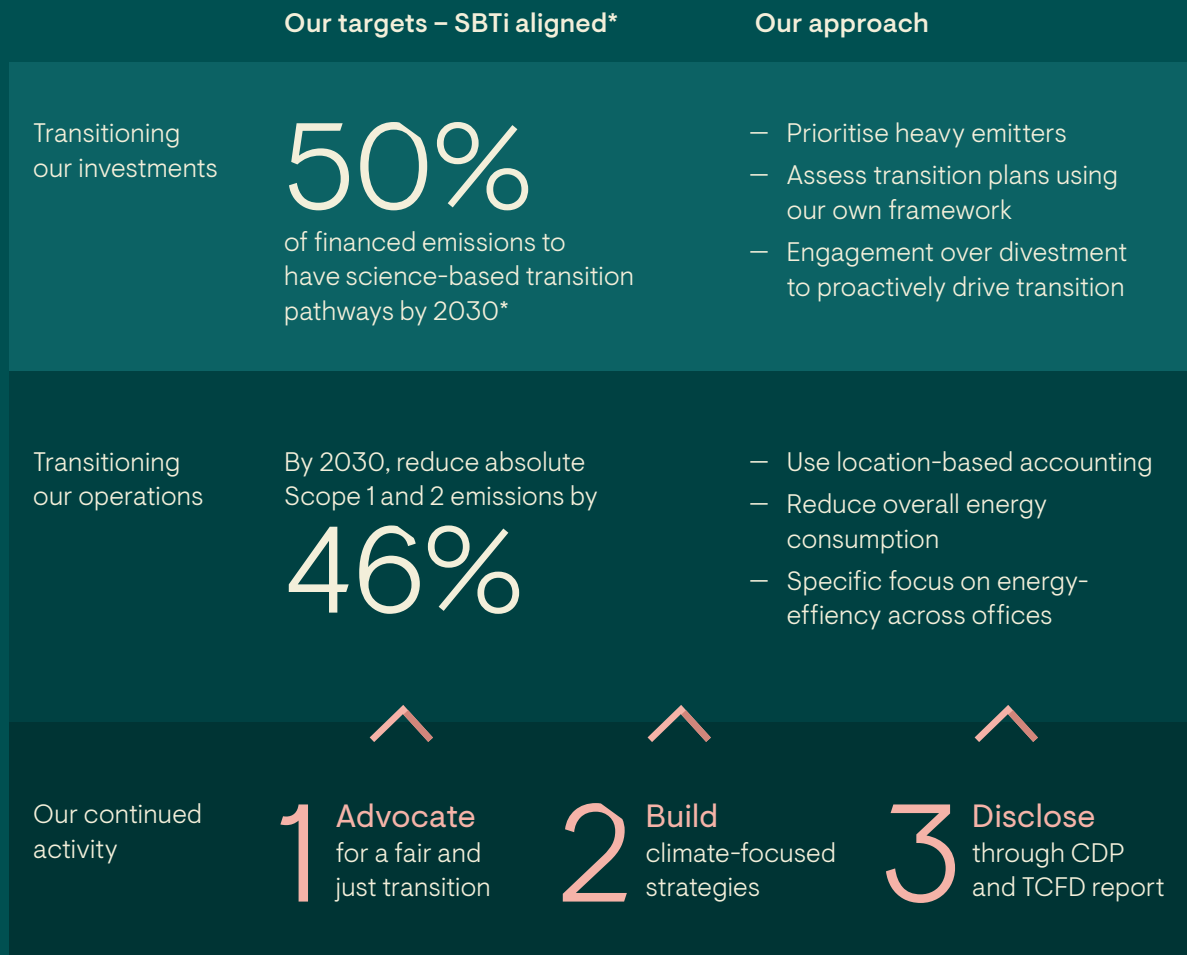
While progress from the big emitters will be essential, we will also require improvements among the rest of the companies we hold in our portfolios. The design of our net-zero targets, therefore, seeks to avoid the following potential negative consequences of targets that focus merely on reducing portfolio-level carbon intensity:

- Portfolio managers tilting portfolios towards asset-light sectors (selling high emitters and buying low emitters) to meet carbon-reduction targets.
- Portfolio managers reducing allocations to high-emitting countries, thus hindering developing-country access to the capital needed to transition.
- Companies divesting high-emitting divisions under pressure from asset owners, which risks moving 'dirty' assets into private hands, outsourcing emissions and potentially decreasing our ability to influence transition.

To increase our impact on real-world emissions, we also aim to increase the assets that we manage which are focused on companies and countries working hardest to reduce their emissions through robust transition plans, particularly in emerging markets, as well as solution providers developing products, services and technologies that contribute to halting climate change.

Figure 2: Ninety One’s net-zero commitments and transition plan

Transition to net zero by 2050 or sooner



* Investment targets equate to 56% of AUM.

Our sustainability framework

Central to our sustainability evolution has been our sustainability framework, which provides an overview of our approach to driving meaningful change within our business, the communities in which we do business, and the companies in which we invest. Our sustainability framework consists of three core pillars:

1 Invest

Through Invest, we integrate the assessment of ESG risks into our portfolios by deepening our understanding of externalities and improving our analysis and assessment of the risks they present. We engage with the companies in which we invest to drive real-world change, and we seek to increase our allocation to sustainable strategies that invest in companies doing the most to increase their positive impact on the world.

2 Advocate

We seek to lead the conversation on investing for a sustainable future. A major focus of our work is to advocate for a transition that includes emerging markets and results in real-world carbon reduction.

3 Inhabit

We believe change starts at home. We run our business responsibly and act sustainably. We work to improve the sustainability of our operations and to support charities and community projects that are important to the team at Ninety One.

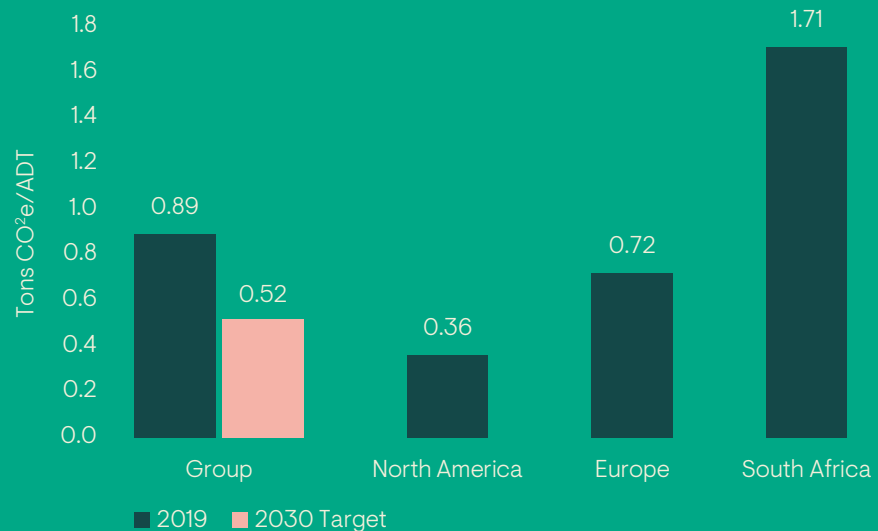


Sappi: A case study

As part of our fundamental analysis of Sappi, a pulp and paper business we have held since 2020, we identified that the company's emissions intensity was significantly higher than the investment universe and its peers. The average global pulp, paper and packaging Scope 1 & 2 emission intensity (two of the four stages of CO₂ emissions) was 0.61 tCO₂e/Air Dry tonnes (ADt), while Sappi measured 0.89 tCO₂e/ADt.

One of the main reasons for Sappi being such a high carbon emitter was the company's reliance on Eskom's coal-fired energy in South Africa (accounting for two-thirds of Sappi's Scope 1 & 2 emissions and 20% of FY22 sales). Although the company's operations in Europe also had coal exposure, it had already reduced emissions by 10% relative to its 2019 base. A contributing factor to this steady decline is that Europe has some of the most stringent legislative carbon requirements globally; as a result, carbon taxes are significantly higher in comparison to other jurisdictions.

Chart 1: S1 / S2 Sappi carbon intensity



Source: Sappi.

Our engagement strategy

We believed that it was important to engage with the company to establish and promote short-, medium- and long-term objectives to help guide the company along an emissions reduction pathway. Specifically, we aimed to ensure that:

- Viable science-based targets were set.
- The carbon reduction pathway was measurable and high quality.
- Monitoring was done over time to sustain accountability.

Over 18 months, we engaged with various stakeholders at the company, including members of the board, the executive management team, and key individuals responsible for sustainability-specific elements of the business. We found that the combination of in-person and virtual meetings, alongside unilateral and collaborative engagement letters, proved to be instructive in achieving some of the goals that we set out to achieve.

Our key objectives with these interactions were:

- To encourage the company to set and pursue science-based targets with respect to its carbon reduction.
- To understand and evaluate whether Sappi's emission reduction pathway plan was sufficiently ambitious.

Outcomes from our engagements

Through our conversations and by working closely with company representatives, and on occasion alongside other investors and stakeholders, we ascertained that Sappi was able to demonstrate significant traction concerning its pathway to net zero and general carbon initiatives.

In July 2022, Sappi announced that the SBTi (the Science Based Targets initiative) had validated its carbon reduction targets for Scope 1 & 2 greenhouse gas emissions. This will see Sappi targeting a 41.5% emissions reduction by 2030 relative to a 2019 base, and ensure that 44% of suppliers by spend will have science-based targets by 2026.

How has Sappi performed thus far?

Sappi’s emission trends have declined by 8% over five years. The company’s North American operations consume 81% of its energy requirement from renewable sources, while the group uses more than 50% of renewable energy across its geographic footprint. Given where South Africa sits in terms of global carbon emitters, we are comforted by the company’s initial alignment with SBTi and we will continue to monitor the progress of its emissions reductions.

In conclusion, with science-based emission targets set, measurable and verified, we now have the means to track annual trend changes. We are pleased with the outcomes of our engagements with the company and the impact this had to drive real-world change. The high quality of Sappi’s transition pathway and measurable SBTi targets are now aligned with our approach to sustainable investing, and high degrees of accountability and engagement will continue to form part of our investment strategy going forward. We believe that these changes have not only benefitted the broader environment, but also created a tailwind for the company’s earnings revisions and valuations, and consequently greater long-term value for shareholders.

Chart 2: Specific GHG (Scope 1&2) emissions (CO²/t) per year

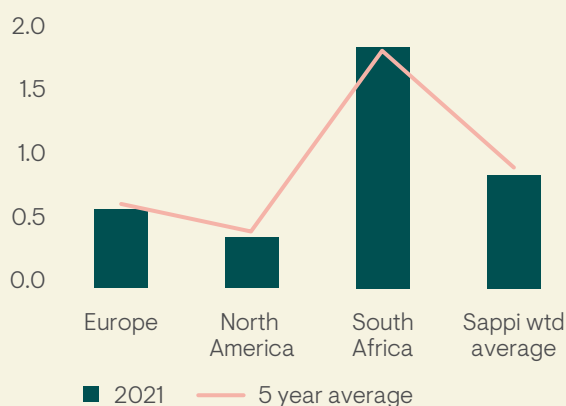
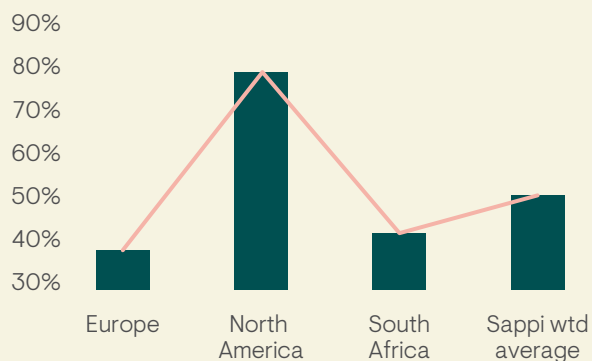


Chart 3: Renewable energy (% of demand)



Source: Ninety One.

Important information

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