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Sustainability? Possibly more important than you might think!

Gerold Permoser



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I have recently read an interesting research report by one of our independent research partners, **Gavekal Research**. Gavekal Research is based in Hong Kong, and one of its strengths is its deep knowledge of the Asian market. The piece titled "Good Governance, Poor Performance" discusses good corporate governance. This is a central pillar of traditional as well as sustainable investment.

Does good governance lead to higher return?

In order to answer this question, I would like to briefly (and with the consent of Neil Newman, author of the Gavekal report) paraphrase the content of the report: an important economic programme, called "Abenomics", is named after Japanese Prime Minister Shinzo Abe. The first two arrows are dedicated to the expansive monetary and fiscal policy. The third arrow, which is often forgotten about, is the most interesting one: increasing the long-term growth of the Japanese economy through structural reforms.

One of these reforms aims at increasing the incentive for good corporate governance. **The underlying idea is that well-governed companies should outperform badly governed ones, both in terms of financial figures and, as a result, in terms of share price.** To this end, quantitative and qualitative filters have been defined with the goal of identifying the best 400 companies of the 1,000 companies with the highest market capitalisation. These 400 companies are bundled into an index which serves as benchmark for passive investments, among others from the giant public pension fund. The demand thus created should facilitate the success of the aforementioned idea (good governance = good performance).

So far, so good. But the result has been disappointing at first glance: the graph (performance of the JPX Nikkei index 400 relative to TOPIX) suggests that good governance actually leads to lower returns.

What happened?

Given the mechanical approach employed in rebalancing the index (N.B. annually at the end of the Japanese fiscal year, on 31 March, about 30 to 40 companies are newly admitted into the index and 30 to 40 others are taken out), it is clear prior to the rebalancing act what companies those will be. Since the JPX-Nikkei 400 is used mainly by passive investors, many investors have to emulate these changes.

As a result, a share due to enter the index will experience massive demand on day X. Conversely, if a share leaves the index, the market is flooded with excess supply. These are ideal conditions for active investors to prepare for day X. They buy shares due for inclusion cheaply and short-sell shares that are about to exit the index and then buy them back at lower prices. This is exactly what the performance analyses established by Gavekal Research suggest. This effect is so significant that on aggregate it creates the underperformance of the JPX-Nikkei 400 vis-à-vis the Topix index.

What conclusions can we draw from the reports produced by Gavekal Research?

- With years of experience on the capital market, I am convinced of the law of unwanted side effects: every action, as well planned out and well intentioned as it may be, creates incentives. The capital market is a perfect mechanism when it comes to exploiting these incentives, intentionally or unintentionally. Generally speaking, it is mostly the unwanted side effects that make life difficult for a fund manager a few years down the line (e.g. during the property or euro crisis).
- Reports on the future of asset management seem to suggest that the unstoppable triumph of passive investments (passive funds or ETFs) is an unalterable fact. But from my point of

view this does not take into account that a capital market can only exist if there are different philosophies of investment. Otherwise there are no buyers **and(!)** sellers. Also, passive management also creates unwanted incentives. The relation described above is only one example. And active managers make their living from exactly that.

- Good corporate governance is one, if not THE intersection of sustainable and traditional fund management. The third arrow of Abenomics does not have the goal to turn Japan into a pioneer of sustainability, but to increase potential growth. In my opinion, it is nice to see that support for the fact that sustainability also makes sense in terms of performance comes from a direction that one has not anticipated.
- Gavekal also shows how difficult it is to draw the right conclusions, for example with respect to the question of whether sustainability in a fund has positive or negative repercussions.
 - Superficially, the data produce simple results. Three years of almost constant underperformance “prove” without a doubt: sustainability produces costs.
 - However, a closer look shows that quite the opposite seems to be true: sustainable companies seem to be the outperforming ones. Yet sustainable indices do not illustrate this effect (which is one of the reasons why we do not use them).
 - At an even deeper level, corporate governance does not seem to be the crucial issue, but the supply of and demand for shares that are part of a certain index.

I believe that this is the core piece of information. Sustainability is a rapidly growing topic. The more investors (in the optimal case, passive ones) behave accordingly, the better the environment for the (active) manager to reap solid returns from it.

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Gerold Permoser

Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013.

He is responsible for all asset management activities and investment strategies for all investment funds held by the Erste Asset Management Group in Austria, Germany, Croatia, Romania, Slovakia, the Czech Republic, and Hungary. Before joining the company, he served this function at Macquarie Investment Management Austria KAG. Permoser has gathered experience in investments since 1997.

He began his career as a fixed-income analyst at the Creditanstalt in Vienna. He moved to asset management at Innovest KAG in 2000. He made significant contributions in the investment field there and advanced to CIO (director of asset allocation and research). Gerold Permoser studied at the University of Innsbruck and is a CFA charter holder. He offers training at the University of Vienna and at various post-graduate institutions for analysts and portfolio managers (i.e., at VÖIG, the Association of Austrian Investment Fund Companies).