Sustainable and Responsible Investing – Taking Steps, Leaping Ahead

Erik Eidolf
Harcourt AG

Amongst a backdrop of turbulent financial markets, the concept of sustainable and responsible investing (SRI) is continuing to develop at a rapid pace. An ever-increasing number of institutional investors around the globe consider and implement SRI[1] in their investment practices. This also presents opportunities for hedge funds to cater to an increasingly SRI-oriented client base. This article describes the most recent developments within the SRI industry, the prevailing current trends, as well as the effects this is expected to have on hedge funds.

"You better start swimming or you'll sink like a stone!" The mid-1960s proclamation of Bob Dylan rings very true today, with the capital markets and financial system having been shaken to their core in 2008. This shakeout has been forceful across all parts of the financial industry, and painful as well as challenging for all market participants.

Hedge funds were not spared either. Despite having fared better than traditional investments, hedge funds on average have not achieved their absolute return targets. However, as hedge funds are exposed to alternative risk premia which are not accessible through long-only vehicles, their risk/return characteristics will remain superior and exhibit low correlation to traditional investments. It is therefore our conviction that hedge funds will continue to have a place in diversified institutional investment portfolios.

SRI investments have equally been challenged by the events of 2008. Performance is of essence, and as SRI vehicles are exposed to global markets, they are not immune to their difficulties. However, a rapidly increasing number of investors adhere to and incorporate such principles in their investment activities. The ever-gaining interest for sustainability has not decreased during the current financial turmoil. Rather, it has increased. We believe that this demand, has amongst others, been driven by the apparent challenges the world is facing, such as mounting globalisation and environmental challenges.

SRI Continues to Witness Substantial Growth

The European Social Investment Forum (EuroSIF) recently published their bi-annual report on SRI in Europe. The growth numbers are staggering. According to the report, total SRI-related assets under management (AuM) in Europe reached €2.7 trillion as of 31 December 2007. This corresponds to a remarkable growth of 102% since 31 December 2005 – a doubling within two years. These assets are significant, the growth is strong, and both serve as a strong indication that SRI is becoming mainstream.

Taking a global perspective, the success of the United Nation's Principles for Responsible Investment initiative (UN PRI)[2] paints a similar picture. This global initiative was launched as recently as April 2006 and has by now been signed by more than 360 signatories globally and represents asset owners with over US$14 trillion committed to adhering to these principles[3].

Is this growth sustainable? Booz & Company, together with Robeco group, recently published a white paper[4] based on more than 50 interviews with market participants. Seeking to project the state of the SRI industry, the report concludes that SRI is likely to represent in excess of US$25 trillion by 2015. This compares to an estimated US$5 trillion as of year-end 2007.

Many factors support this further growth. Key factors among them are increased social awareness; media attention and pressure on companies to behave environmentally responsibly; political pressure stemming from increasing prices for energy and raw materials; and ensuing changes in legislation (such as mandatory

[1] Defined as sustainable and responsible investing (the principle of investors taking responsibility for and through their investments in the quest to improve sustainability in this world, also defined with acronyms such as ESG – Environmental Social Governance, CR – Corporate Responsibility etc.) For more detailed explanation, please refer to swissHEDGE 3Q 2007.
[2] UN PRI provides a framework to assist investors in ESG issues. The principles are not prescriptive, but instead provide a range of possible actions for incorporating ESG issues into mainstream decision making and ownership practices.
[3] UNEP Finance Initiative/UN Global Compact, "PRI Report on Progress 2008", June 2008.
[4] Robeco/Booz & Company, "Responsible Investing: A Paradigm Shift", October 2008.

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CO2 reductions). Based on our experience as a manager of a leading SRI fund of hedge funds vehicle, and being heavily involved with peers, clients and SRI organisations alike, we support this positive outlook. SRI investments will continue to grow substantially and reach a size that will afford it a dominant role in the investment industry.

Definition of Sustainable Investing Revisited – The Common Approaches Used

SRI investing includes all initiatives that integrate extra-financial criteria in the investment decision process and portfolio management. The extra-financial criteria include social and environmental consequences and often also look at governance. There are four major approaches commonly used within the context of sustainable investing:

Positive screening is the process of actively investing in companies with a commitment to responsible and sustainable business practices. The most popular form of positive screening is the so-called best-in-class strategy, where leading companies with regards to social, environmental or other related criteria in each sector/industry are identified and included in the portfolio. Another form of positive screening is the so-called pioneer screening, where investments are focused on certain themes such as renewable energy or improved water supply.

Negative screening is the process of exclusion. It consists of barring investments in certain companies, sectors or countries based on social and environmental criteria. Investors primarily use negative screening to avoid a specific exposure in the portfolio. The criteria screened range from specific sectors such as weapons, alcohol, tobacco, gambling etc, to a norm-based/ethical screening focused on companies' compliance to international standards and conventions.

Engagement is primarily a post-investment tool. It is the collective term for a number of actions that can be taken to influence companies as an active owner. Traditionally, ownership engagement has been mostly used in corporate governance matters. Nowadays, more responsible investors are engaging in corporate dialogue to influence behaviour across social, environmental and ethical topics. There is a diversity of means available to the engaging investor. The first step usually consists of dialoguing with management on areas of concern, followed by eventually filing, co-filing and voting on shareholder resolutions. The proxy resolutions generally aim to improve company practices and policies on social and corporate governance issues in order to achieve a positive change and creating sustainable long-term performance and shareholder value.

Integration is the approach whereby the investor seeks to fully integrate environmental, social and governance issues into the investment decision process. Often, the investor uses SRI as a key input in developing the investment strategy and thereby actively seeks to generate return by exploiting SRI risks and opportunities in parallel, or integrating them into company valuation.

Key SRI Trends Today

The SRI industry is not new and has been around for decades. In its earliest days, SRI was rooted in norm-based principles of seeking to express ethical or even religious beliefs in investment practices. The industry has since undergone many changes and evolutions. Up until recently, SRI practitioners commonly defined SRI as socially responsible investing; whereas today, the term socially is exchanged for sustainable.

Sustainability is more apt, as it captures more than the norm-based social aspects and goes beyond to include all aspects related to a sustainable society. Today, the following are key trends in the SRI industry:

1) From sole negative screening to incorporation of corporate engagement
There is increased interest in more actively combining SRI approaches from sole (negative) screening to best-in-class selection and engagement. This trend is fuelled by the overall quest to achieve change and improvement through the investment practices. Through engagement, the SRI strategy can get a bigger impact as it entails direct communication with the underlying company to affect change according to SRI principles.

2) SRI investors unite – finding common ground
One of the key challenges for the SRI industry has been the lack of a uniform understanding and definition

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of SRI. Non-financial information is not easily expressed through objective facts and figures, as it is subjective in nature. However, as the awareness and true understanding of SRI increases, we see signs of harmonisation of SRI approaches and policies. With initiatives such as UN PRI, where investors join forces and actively share best practices on SRI, this process is facilitated and a common ground is found. There is still a long way to go before a standardised framework is defined in the SRI industry, but development is pointing towards that direction.

3) Regulatory pressure

Taking Europe as an example, we see more and more regulatory pressure for (public) investors to incorporate elements of SRI into their investment policies. A number of European countries have developed SRI-related requirements for their public pension systems: UK (2000), France (2001), Germany (2001), Sweden (2001), Belgium (2004), Norway (2004) and Austria (2005).

In January 2008, all public pension funds in Italy have disclosure obligations related to SRI; in Spain, such regulation is in the making. Such disclosure obligation is also discussed at the EU level with further transparency requirements also from institutional investors. EuroSIF is actively lobbying the EU for the introduction of an EU-wide "Statement of Investment Principles" for investments funds.

Following the administration change in the US, many SRI practitioners foresee that President Obama's interest in environmental issues will lead to regulatory changes in this regard. All of these regulatory changes are likely to increase further across the globe, and this is something that Harcourt together with other SRI practitioners are following closely and with anticipation.

4) Extra financial information in the context of company valuations

In the wake of the increased focus on SRI issues by investors globally representing meaningful assets, companies are starting to realise that SRI can represent a competitive advantage and a host of opportunities. For most companies, annual audit financial reports go hand–in-hand with issuing sustainability reports as to how they deal with SRI issues. This is a means to enhance their ability to attract long-term investment and to better manage their level of overall enterprise risk. Considering that SRI is often seen as a sign of good management, it therefore has a direct impact on how these companies are valued by the capital markets. This integrated valuation approach is set to accelerate even further.

All these trends paint a very positive picture. But a word of caution seems appropriate. Despite its size and growth, SRI remains a nascent and relatively non-transparent industry, where norms and best-practices are fluid at best. New players enter the market constantly. Some of those are valid and have truly institutional-quality processes and products. Many of them do not. As such, it is difficult to separate the high quality players from less serious ones. SRI investors are therefore encouraged to get thoroughly educated and conduct rigorous due diligence on each offering.

Opportunities Abound

For the SRI investor

One of the major benefits of the positive developments within the SRI industry is that there is an ever-increasing diversity of related SRI investment opportunities in various asset classes and investment strategies.

This also holds true in the alternatives space. The UK Social Investment Forum (UKSIF) recently published a discussion paper on "Sustainable Alternatives"[5] and looked at SRI-related solutions that exist within private equity, property, infrastructure, hedge funds, ETFs, structured products and commodities. The report confirms a broad diversity, and predicts that the number of such investment solutions is set to rapidly increase going forward. This means that pension funds and institutional investors will be able to create truly diversified investment solutions, using all asset classes, which are in compliance with SRI criteria.

For hedge funds

Given all of this, how is the hedge fund industry addressing the opportunities presented by SRI? As institutional investors are increasingly incorporating SRI, these investors will require the ability to express their SRI requirements across all their investments, including hedge funds, which will continue to play an

[5] UKSIF Sustainable Pensions Project, "Sustainable Alternatives", November 2008.

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integral part in institutional portfolios. Many large institutional investors which adhere to SRI requirements struggle with the need to maintain portfolio diversification whilst implementing SRI across the whole portfolio.

In short, there is a pronounced and growing demand for hedge funds that offer SRI-compliant products; but there is limited supply. Until only a short time ago, some investors have deemed the universe of SRI-compliant hedge funds as too limited and opted for the interim to either invest in non-compliant hedge fund solutions, or forego an investment altogether. This is changing, and Harcourt is proud to be playing an active role in this development[6].

The key issue for hedge fund managers when it comes to SRI is of course whether it is viable to incorporate SRI into their existing investment strategy, without putting limitations to the risk and return objectives. In other words, all else being equal, SRI has to perform as well as non-SRI. One common critique to SRI is that limitation to the investible universe will hamper the possibility for return generation.

This issue has been debated for years and subjected to many academic studies. Most often, they come to the conclusion that it is rather manager skills and investment style that ultimately determines the performance effects of incorporating SRI[7]. As this goes hand-in-hand with manager skill being one of the most crucial aspects for a successful hedge fund, we believe that truly skilled hedge fund managers that create vehicles that incorporate SRI will prevail.

A major benefit of the scope of SRI increasingly expanding is that the SRI-screened and SRI-approved universes today often are extensive, which provides a tradable SRI-compliant universe of companies with big diversity within. A large tradable universe provides the necessary prerequisite for hedge funds to express their strategy in an SRI-compliant context without hurting performance.

The Leaps Ahead

Undoubtedly, the SRI industry is currently taking giant leaps in its development.

The distress in financial markets has actually accelerated this trend. Meanwhile, environmental and social issues are not going anywhere. Estimates are that the world's population is set to grow from six to nine billion by 2050. This dramatic redrawing of the demographic landscape will occur in conjunction with increased globalisation, accelerated industrialisation and resource consumption at a rate far surpassing long-term capacity. This exploration of resources (be it human, natural or economic) will not only have far reaching consequences on our environment and society, but also on the capital markets. Consequently, it will shape the products and services provided by the asset management industry.

We expect the movement to embrace SRI in investment practices to continue to accelerate in meaningful ways. This will induce a demand-driven trend to encourage product providers in the financial industry to develop new SRI solutions that fit these growing needs.

The ever-increasing reach of SRI and the existing steps underway for standardisation of SRI frameworks will facilitate the creation of such solutions in all asset classes. The UN PRI is a good example of an initiative that brings investors together to share best practices and ideas with the quest to develop SRI in a more uniform manner. Another example of an initiative that is deepening the understanding of SRI is the annual Moskowitz Price, which encourages and recognises academic research within SRI and was introduced in 1996 by the Social Investment Forum (SIF) in the US.

All such initiatives play an important part in creating awareness, understanding and uniformity of SRI which further fuel the rapid developments in SRI.

Skilled firms which are quick to respond with institutional and robust SRI solutions will prevail. We also

[6] Harcourt, together with the two leading European SRI investors Folksam of Sweden and Storebrand of Norway, established the first institutional SRI compliant FoHF by the successful launch of Belair (Lux) Sustainable Alternatives SRI fund in November 2007.

[7] UNEP Finance Initiative / Mercer, "Demystifying Responsible Investment Performance", October 2007

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expect further diversity in how these SRI solutions are constructed, utilising different combinations of SRI approaches into the investment strategy.

As pertains to hedge funds and sustainable investing: they better start swimming!

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