

Does it pay to be sustainable?

Over the last decade sustainable investment has grown dramatically and is moving into the mainstream, but what is behind this shift and why should pension funds act?



Sustainable investment market facts

- The European market was €1.033 trillion in December 2005 representing real growth over two years of 36 per cent¹.
- The US market grew 258 per cent in 10 years to 2005 from US\$639 billion to US\$2.29 trillion – 4 per cent faster than the entire universe of managed assets².
- The Australian market grew by 56 per cent during 2006 from A\$7.67 billion to A\$11.98 billion, compared to mainstream portfolios which grew 15.5 per cent over the same period³.

A growing market

Inflows into environmentally related funds have increased dramatically. In the first seven months of 2007 a record 15.2 per cent of net inflows into equity funds across Europe went into such funds, compared with 2.6 per cent in 2006⁴. According to most recent market estimates, there is now around US\$4 trillion globally invested in strategies which incorporate environmental, social and/or governance (ESG) factors⁵. As you might expect, the most developed markets are Europe, the US, Canada and Australia, with smaller pockets of growth in emerging markets such as Brazil, South Africa and various parts of Asia.

What is driving growth?

There are several economic, political and societal factors driving growth in sustainable investment, a number of which are considered below.

Performance evidence

A substantial body of academic work has investigated the relationship between corporate financial performance and sustainability factors. Some studies highlight positive correlations, for example between corporate governance and equity prices⁶, and environmental management and portfolio performance⁷. In the former case, an investment strategy which bought firms with superior corporate governance and sold



those with poor corporate governance, earned additional returns of 8.5 per cent per year between 1990 and 1999, after accounting for style, industry and size biases.

Internalisation of costs

Increasingly, regulatory regimes are relying on financial instruments to enforce the 'polluter pays' principle. European companies, for example, are subject to financial controls on greenhouse gas emissions, waste packaging and electrical equipment. Instruments such as levies, taxes and tradable permits incentivise companies to reassess the way they do business. Companies also recognise the bottom-line impacts of failing to uphold acceptable standards – in supply chains for example – as this can damage brand value and destroy customer trust. Where environmental, social and governance issues can be financially material, investors should seek to understand which companies are best placed to minimise costs, increase efficiency and exploit value opportunities.

Longer-term investment perspective

Sustainability will change the corporate landscape and successful companies will be those that best adapt. For investors with long-term investment horizons, such as pension funds, it will become impossible to take a long-term view without considering the

impact of environmental, social and governance issues on their investments.

Consensus around macro themes

Sustainability is a permanent feature on the political agenda and an ever-present topic in the media. 'Being green' and buying organic is now socially acceptable. Some firms have been quick to appeal to the conscious consumer, both through their product offering and by promoting their green credentials. This is no longer the preserve of affluent brands, but has become part of mass market product ranges. Changing consumer preferences are not confined to the supermarket, and the growth in sustainable investment is just one manifestation of this.

A legal context

Numerous legal jurisdictions including Australia, France, Germany, Italy and the UK, now require disclosure of the extent to which environmental, social and governance issues are considered within investment. A report by an international law firm stated that integrating these considerations into investment analysis, so as to more reliably predict financial performance, is permissible and is arguably required in some jurisdictions.

Leadership of public funds

Some of the world's largest public funds are leading the pack on sustainable investment. Funds such as CalPERS and ABP have

developed sustainable investment strategies based on a long-term financial rationale. While public funds may be more predisposed to the concept of sustainable investment than other funds, we believe their activities will define best practice.

Sustainable investment in practice

There are numerous strategies which can be adopted. To date, most activity has been within equities, but increasingly strategies are crossing over to other asset classes including fixed income, private equity and real estate. Preference for different approaches varies regionally and depends on investment objectives, beliefs and fund governance. Here we consider four options for implementing sustainable investment.

Integration

This approach has become more widely adopted by UK and European institutional investors. Fund managers incorporate environmental, social and governance analysis into conventional stock research, to gain additional insights into how well positioned a company is to adapt and benefit from the shift to a more sustainable future. Insights gained can influence a fund manager's opinion of the company, for example quality of management, security of future revenue streams or appropriate valuation. As a result, the fund manager may adjust



investment decisions or engage with the company.

Engagement

Ownership rights are actively exercised through engagement with company management around environmental, social and governance issues, with a view to stimulate improvements which will unlock shareholder value.

Engagement can be undertaken by the fund manager, by an in-house specialist or by a separate 'overlay' manager who takes over the ownership aspects of the portfolio.

Investing in sustainability themes

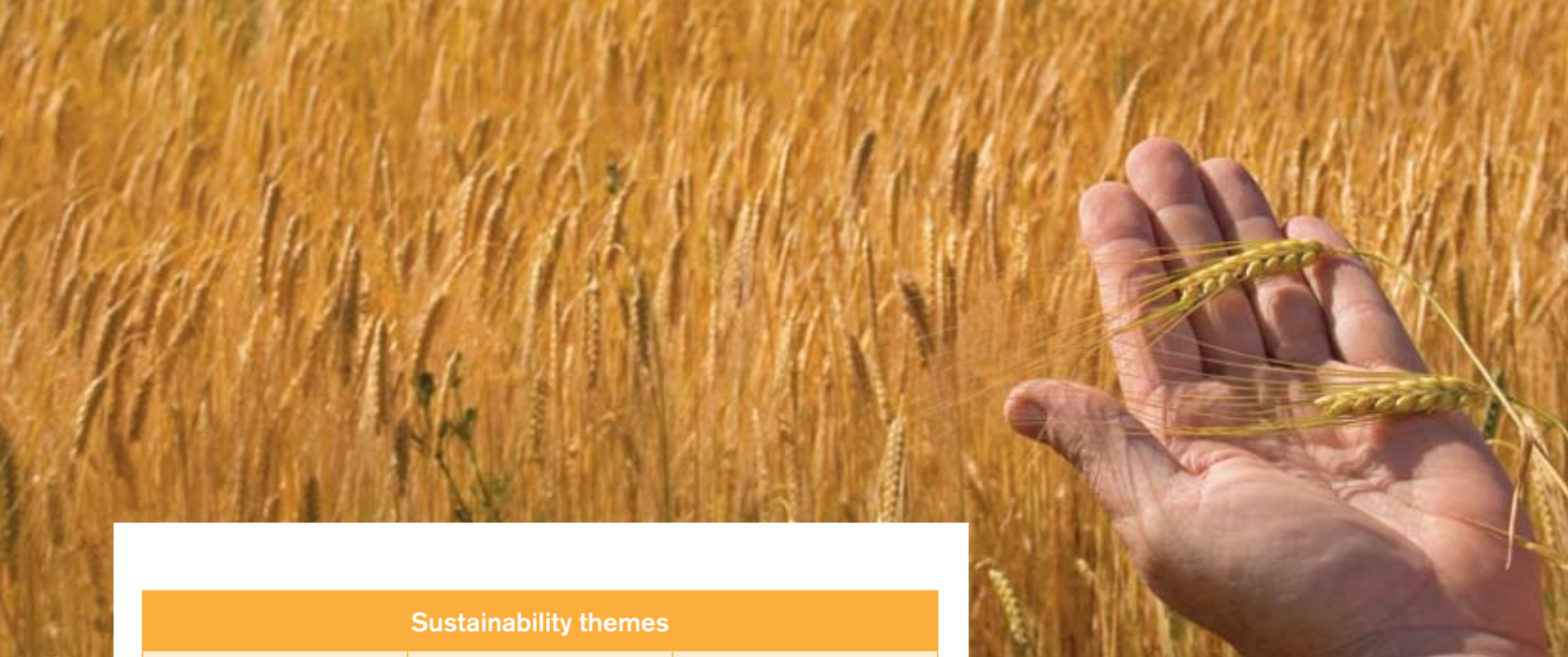
The shift to a more sustainable economy creates new commercial opportunities which investors can exploit as a differentiated source of return. Some funds invest in multiple themes such as climate change, water, health, energy efficiency and sustainable products, whilst others are single theme funds. For example, in the second half of 2007 numerous investment managers launched 'climate change solutions' funds. Thematic funds should be viewed as long-term investments and are differentiated from broad market indices, so will have a high relative tracking error. Therefore, institutional investors might consider investing in these themes as a satellite portfolio.

Screened funds

These funds can impose negative or positive screens (or both) to an investment universe from which the portfolio is constructed, either in an active or passive way. Traditional approaches involve negative screens which exclude certain sectors such as armaments, tobacco and gambling. Positive screened funds involve selecting companies that meet specific environmental, social and governance performance standards. In most countries, the use of negative screened funds within most DB plans is unlikely to be appropriate, though they could be considered as an option within a DC scheme.

Why should pension funds act now?

The economic landscape is changing. To be competitive over the longer term, companies must account for the cost of their environmental and social impact. Empirical evidence has identified positive correlations between good management of sustainability factors and corporate financial performance. More investors recognise that while adopting a sustainable investment approach will not guarantee outperformance, it does not necessarily imply giving up performance. It also makes sense from a risk management perspective. Sustainable investment is growing both in popularity and in real assets under management, driven by a number of significant and enduring economic, political and societal factors. We believe this is a fundamental and permanent shift within the investment industry and anticipate that more funds will strive for best practice and incorporate sustainability into their long-term investment strategies.



Sustainability themes		
Environment	Social	Governance
Climate change	Demographics	Corporate conduct
Natural resource use	Labour standards	Legal compliance
Waste and pollution	Pandemics	Corporate governance

Next steps for funds

Develop knowledge

- Training
- Seek views of scheme beneficiaries



Sustainable investment policy

- Determine investment and sustainability beliefs
- Assess available governance budget
- Identify requirements/objectives of fund



Sustainable investment strategy

- Review existing fund manager activity and communicate sustainable investment policy
- Select appropriate strategies either with existing or new managers:
 - integration
 - engagement (in-house, fund manager, overlay, collaborative)
 - investing in sustainability themes
 - screened funds (including DC fund options).



Monitor and report progress

- Review activities of fund managers
- Monitor effectiveness of strategy
- Report progress to scheme beneficiaries



Review policy and strategy

- Review effectiveness of policy and strategy
- Refine and enhance approach

¹ *European SRI Study*. EUROSIF 2006

² *2005 Report on SRI trends in the US*. Social Investment Forum. 2006

³ *Sustainable Responsible Investment in Australia 2006*. Ethical Investment Association September 2006

⁴ Lipper FERI

⁵ *The State of Responsible Business*, EIRIS September 2007

⁶ *Corporate Governance and Equity Prices*. Gompers, Ishii, Metrick Harvard University and NBER, The Wharton School, University of Pennsylvania 2001

⁷ *The eco-efficiency premium puzzle*. Derwall, Guenster, Bauer, Koedijk, RSM Erasmus University, Maastricht University. 2005