Introduction: Delivering Benefits through Sustainable and Responsible Investment Strategies

Astute, long-term investors understand that markets include more than financial statements when valuing an investment. Intangibles such as management quality, patents, brand recognition, market size, and market penetration are important factors that many investors consider when making investment decisions. By quantifying and evaluating these intangibles, investors have a better understanding of the risks and opportunities associated with potential investments.

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Sustainable and responsible investing begins with corporate governance and integrates environmental, social, and economic factors in the investment process. This approach provides investors with additional tools in comprehensive evaluation and management of intangibles. Good corporate governance practices are based on disclosure, board independence, and management accountability to shareowners. With this foundation, sustainable and responsible investment strategies consider three more intangibles: the environmental, social, and economic performance of companies.

Sustainable and responsible investing is a market driven methodology that offers competitive financial returns while simultaneously delivering social and environmental benefits. Institutional investors, large and small, recognize this fact and have committed hundreds of billions of investment dollars to these strategies over the past 20 years. Many pension funds, universities, religious organizations, foundations, and other institutions employ sustainable and responsible investment strategies in order to:

- *Provide competitive returns.* Investments made using sustainable and responsible investing strategies have been shown to provide competitive financial returns when compared to traditional investment strategies.
- *Fulfill fiduciary responsibility.* All interpretations and opinions from the Securities and Exchange Commission (SEC) and the Department of Labor allow the use of sustainable and responsible investment strategies by fiduciaries as long as the financial returns are competitive.

- *Assess investment risk.* A careful investment selection process combined with active and engaged share ownership can help identify risk and protect investment value.

Achieving Competitive Performance

Both drives for better corporate governance and for sustainable development will not go away. Increasingly, the two agendas will converge. Markets and society will insist on best practice.

—Peter Zollinger, SustainAbility, Inc.

In recent years, a growing number of trustees have embraced sustainable and responsible investment strategies because they have demonstrated competitive financial returns. As discussed in Chapter 3, more than 20 years of data from mutual funds, indexes, pooled investments, and individual institutions indicates that competitive financial performance can be achieved when considering social, environmental, and economic factors. Evidence suggests the following aspects are important to success:

- Well-defined investment goals and processes that lead to the selection of outstanding money managers and a review of methodologies, and
- Use of risk management strategies to reduce volatility of financial performance.

Successful sustainable and responsible investment strategies generally require the same portfolio management skills as other investment approaches. Clear investment objectives, outstanding money managers, and periodic evaluations are the most important determinants of financial returns. Investment consultants can help initiate and establish processes for determining goals and selecting money managers.

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Chapter 3 illustrates that placing restrictions on investments does not handicap the performance of money managers. The hundreds of billions of dollars invested using sustainable and responsible investment strategies shatters the canard that the best money managers will refuse to work with restrictions. Money managers are unlikely to turn down business and in the past have worked with clients to ensure that particular needs, such as those related to sustainable and responsible investing, are met.

Other than U.S. Treasury notes, all investments carry some level of risk. Institutions understand the need to have a policy for managing risk to appropriate levels. The same is true for sustainable and responsible investment strategies. The multi-factor models used to manage traditional portfolios can be used to manage risk in sustainable and responsible investing portfolios.

One of the most overlooked aspects of sustainable and responsible investing is placing money in underserved markets, which promotes the growth of sustainable communities. Money invested in these communities is used for such purposes as providing capital to small businesses and building affordable housing. Community development institutions effectively serve this market and provide a number of investment options, including FDIC-insured bank accounts and CDs.

The choice of a common stock is a single act, its ownership is a continuing process. Certainly there is just as much reason to exercise care and judgement in being a shareholder as in becoming one.

—Benjamin Graham and David Dodd, *Security Analysis*, 1934.[1]

Meeting Fiduciary Responsibility

Despite indications that the long-term interests of corporations, shareowners, and society are aligned, trustees may not understand that they are able to consider social, environmental, and economic factors in investment decisions. This hesitancy may be due in part to two factors that are thoroughly examined in this guide:

- There are effective sustainable and responsible investment strategies that do not affect the selection of investments and therefore do not affect fiduciary responsibility issues, and
- All institutions may consider a broad interpretation of benefits as long as the financial returns of an investment are competitive.

Strategies such as proxy voting, filing shareowner resolutions, and dialogue with management are meant to align corporate policies with the interests of the owners of the company. The use of the term "shareowner" rather than "shareholder" reflects a growing movement of institutional investors interested in their ownership rights. Proxy voting, shareowner resolution filing, and dialogue with management are deeply related to corporate governance and can be effective in changing the behavior of a company. It is important to remember that because these strategies do not restrict investment choices, they do not impact fiduciary responsibility.

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Every type of institution can use sustainable and responsible investment strategies as long as competitive financial returns are anticipated. Even pension funds, regulated by the strictest rules established by the Department of Labor, may consider nonfinancial benefits when selecting investments. For example, trustees of union pension funds can specifically choose investments that may help the continued employment of fund participants as long as competitive financial returns are anticipated. This is clearly a benefit in the interest of participants.

Other types of institutions can also specifically consider a broad definition of benefits when considering investments. For universities, nonprofits, and religious organizations, the definition of benefits includes considering ethics and the mission of the organization. Nearly

30 years ago a book entitled *The Ethical Investor* stimulated some university trustees to recognize that ethical considerations related to endowment investments were indeed part of their fiduciary responsibility.[2]

Identifying Risk and Protecting Value

Our Triple Bottom Line model appears to be appropriate and timely in a fast-changing business world where, according to a growing school of thought, "intangible assets" are becoming increasingly important in achieving true valuation of a company.

—*This is Dow* Public Report Update 1999-2000.

Institutional investors have immense responsibilities in maintaining a careful and defined process when selecting investments. The trustees and financial managers of institutions are stewards obligated by law to manage their portfolio investments in the sole interest of their participants and beneficiaries. Sustainable and responsible investing strategies help identify risk and protect share value. They do that through the following methods:

- Comprehensively evaluating intangibles in the investment process by including the analysis of social, environmental, and economic factors, and
- Protecting long-term value components, such as brand value, through engagement in fundamental corporate decisions

The consideration of economic, social, and environmental factors in the investment process allows investment managers to evaluate and influence the value of intangible assets. By specifically assessing a company's record on such issues as diversity, environmental performance, and overseas labor, investors can identify potential problems. Resultant risks might include lawsuits, government fines, community ill will, and customer boycotts. The unexpected or repeated appearance of such problems at a company can decrease brand value, goodwill, and ultimately the price of the stock.

At the same time, analyzing social, environmental, and economic factors helps identify leading companies that are likely to have higher levels of employee retention and that are likely to foresee the changing demands of society and the market. As explained in Chapter 3, social, environmental, and economic performance has been shown to be a predictor of good management because of the inherent complex and interdisciplinary talents required to tackle the issues. Thus, by assessing social, environmental, and economic factors in the investing process, institutions can choose industry leaders that are most likely to be successful in handling unforeseen problems.

Sustainable and responsible investment strategies can also aid investors in protecting the value of equities already in their portfolio. As long-term relationships are forged with companies through passive investing techniques, such as index purchasing, it becomes increasingly important for investors to become vigilant in overseeing share value. This is especially true of very large investors, as they may not be able to sell a position in a company's stock without causing an extreme disruption in the share price. Proxy voting, shareowner resolution filing, and dialogue with management are valuable tools for helping investors maintain and even increase the value of a company's stock.

Terminology

A large number of institutions consider social, environmental, and economic factors in their investment process, and have incorporated sustainable and responsible investment strategies into their investment policy statements. A sample of such institutions in Appendix 6 gives a sense of their diversity. Pension funds, foundations, religious organizations, universities, unions, and nonprofit organizations are all well represented.

However, these organizations may not fully agree on a name for investing strategies. Sustainable and responsible investing is but one phrase that describes the process of considering intangible performance factors in investment decisions.

Over the past thirty years, as the development of sustainable and responsible investing has advanced, there have been numerous terms used to describe the process of including intangible performance criteria in the investing process. Probably the best known and widely utilized is "socially responsible investing." Another related term popular in the U.S. is "corporate social responsibility" which specifically looks at business practices of companies.

In Canada and Australia the term "ethical investing" is typically used when describing the inclusion of social and environmental factors in the investing process. The terms "double-bottom line" and "triple-bottom line" are gaining prominence in Europe – implying that businesses and investors need to measure social and environmental results in addition to financial results. More recently, the best-in-class strategies of "sustainability investing" and "eco-efficiency investing" have been added to the glossary of terms used in Europe and by some investors in the United States.

"Sustainable and responsible investment strategies" is the primary term used in this guide because it connotes the inclusion of environmental, social, and economic criteria in the investing process. It also specifically includes community investing strategies that might not be present in other terms. Sustainable and responsible investing does not specifically require institutions to evaluate investments from a moral or ethical perspective, although many may choose to do so. This guide also uses the term "social and environmental screening" as one strategy for defining an investment universe.

Financial vs. Economic:

In this guide, the terms "finance" and "financial" generally refer to the earnings of specific investments or companies. The term "economic," in the simplest sense, is an investment's or company's potential for creating profits by exploiting trends and opportunities or by mitigating risk associated with those trends. For example, a large insurance company may view global warming as a significant risk and therefore begin efforts aimed at reducing its exposure to that risk. The company is thus taking advantage of economic trends to increase its financial well being.

Sustainable and responsible investing helps investors support and profit from business practices that leading companies are using to sustain themselves into the future. This process benefits investors and society.

Introduction Endnotes

1 Graham, Benjamin and David Dodd. *Security Analysis*. New York: McGraw-Hill. 1934, p. 508. (Referenced from CalPERS Investment Policy Guidelines.)

2 Simon, John G., Charles W. Powers, and Jon P. Gunnermann. *The Ethical Investor*. Yale University Press. 1972.