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INVESTING IN VALUES

SOCIALLY RESPONSIBLE INVESTMENT
(SRI) is one of the main pillars which relies on the rise and professionalization of social responsibility.

ANNEX IN FOCUS

SRI: An Investment

Philosophy

Socially Responsible Investing (SRI) is one of the main pillars on which the growth and professionalization of Social Responsibility is founded. A growing number of investors, in absolute terms and by volume of managed resources, have begun to pressure corporate agendas to analyse and differentiate between investments not just according to traditional financial parameters but through ethical, social, environmental and good corporate governance (ESG) screens.

An enormous variety of investment strategies have flourished since the days of the first SRI investors who were committed to ethical ideologies based on religious doctrines. Today investment strategies involve exploiting risks and opportunities that stem from secular trends in our socioeconomic environment such as climate change, water shortage and changing demographics. There are two reasons for this. On the one hand, SRI is a formula that makes it possible to bring investment portfolios into line with individual and stakeholder´s concerns and idiosyncrasies. On the other, ESG criteria improve financial analyses by including risks imperceptible to traditional assessment models.

Do productivity disputes with workers subtract value from a company? What organisations could survive in an environment that is economically restrictive to carbon? How does an increasingly virulent season of hurricanes affect a hotel chain in the Caribbean? The answers to these questions are some of the improvements that SRI brings to traditional financial analysis.

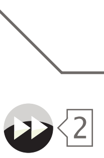
One source of innovation in the field of investing which has stood out the most in the past ten years has been SRI. Its importance and sophistication has grown in quantitative and qualitative terms alike. Some industry professionals have compared the challenge of incorporating socially responsible criteria into investments with the revolution of the widespread use of derivatives or alternative investment products in the 1980s and 1990s.

Responsible investment means taking ethical, social, environmental and good corporate governance criteria into consideration in investment management processes. The acronym ESG (Environmental, Social and Governance) is frequently used to refer to socially responsible investing criteria

SRI in the Investment Process.

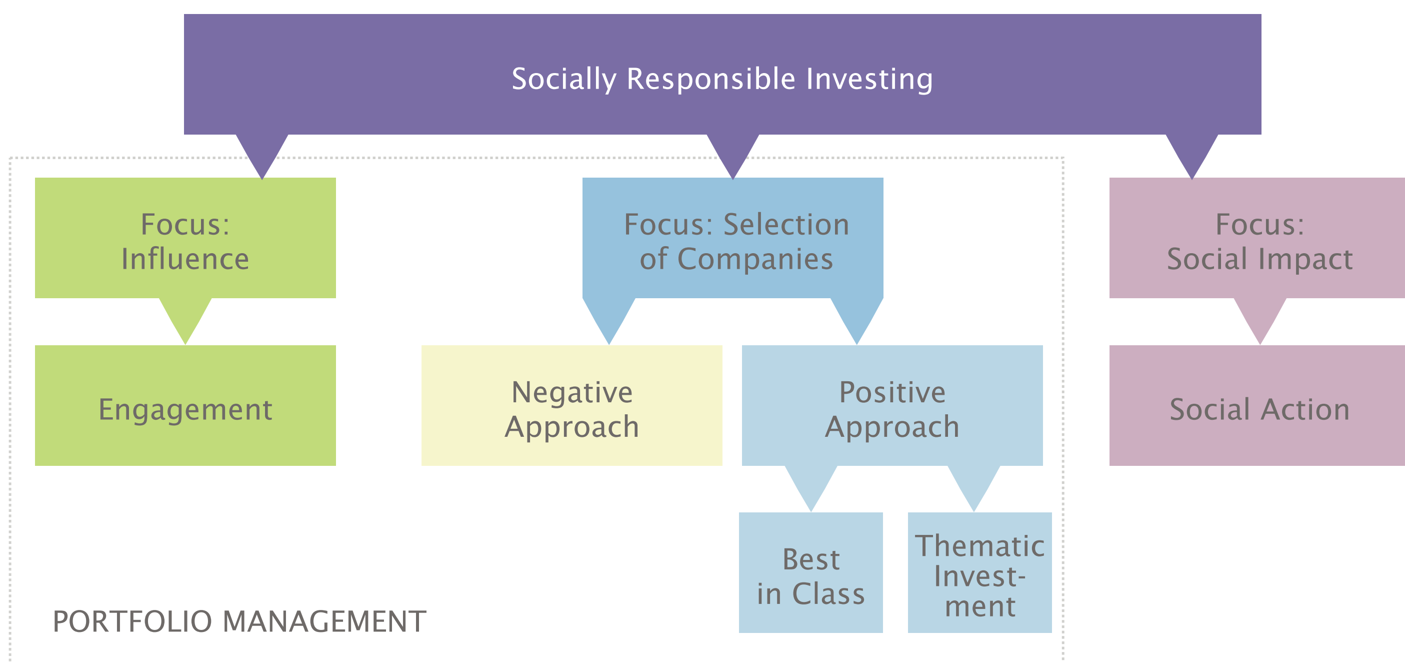
The first thing we would emphasize is that SRI is an investment philosophy, not a product family. It is the result of incorporating ESG criteria into some or all phases of the investment process.

It is not a product family because SRI funds are not necessarily publicised or labelled as such. For example, a responsible pension fund may apply ethical or environmental screens to its investments; however, it can still continue to compete with other general pension funds.



Socially Responsible Investing Strategies

Although the degree of determination of ESG variables when it comes to taking investment and disinvestment decisions on assets can vary enormously, we can design a tree that summarises the main responsible investing strategies:



In this document we will focus exclusively on the sphere of investment portfolio management and exclude any analysis of investments that seek a direct social return, such as corporate philantrhropy, community investment initiatives or 'bottom of the pyramid' projects.

SRI strategies have two main formulas, although they are not mutually exclusive. On the one hand is the idea of influencing business decisions. On the other is the idea of distinguishing between investments in accordance with ESG criteria.

SRI strategies

FOCUS ON INFLUENCE:

Focus on Influence: with a focus on influence, investors incorporate ESG criteria through the active exercise of shares' political rights. This involves embarking on a dialogue with corporate management. The materialization of this shareholder engagement can range from the occasional requirement of accountability at general meetings of shareholders through to the establishment and negotiation of management goals in terms of CSR with management. For further information, see: VII Cuaderno Forética - El activismo accionarial en Europa. Manual europeo 2006

FOCUS ON SELECTION OF COMPANIES:

these types of strategies incorporate ESG criteria into the selection of the companies or assets in which to invest. This is the most frequent practice, especially in Spain, where there is little involvement on the part of fund managers in variables that are not purely financial (dividend policies, capital increases, acquisitions). There are two approaches within the selection of companies:

POSITIVE SCREEN APPROACH:

this attempts to incorporate actions with a particular profile or set of ESG practices.

- BEST IN CLASS: through a Best in Class approach, the investment manager selects only the best companies with respect to one or more objective variables.

  EXAMPLE 1: *Businesses with fewer CO2 emissions per produced unit produced are selected. Example 2: Only companies with a CSR rating above 3, on a scale of 1-5, are selected.*

- THEMATIC INVESTMENT: this type of investment involves capturing a particular thematic opportunity. For some of the more 'purist' sectors, these types of funds are not necessarily SRI if they are simply invested in an activity with social or environmental attributes but do not incorporate ESG criteria in the investment process in an across-the-board fashion. A fund that invests in clean energies but does not take social or good governance aspects into account would not be considered SRI.

  EXAMPLE 1: *Clean energy funds. Example 2: Water funds. Example 3: Funds that invest in innovation. Example 4: Microcredit funds.*

NEGATIVE SCREEN APPROACH:

For its part, a negative approach establishes ethical screens that exclude particular businesses, industries or sectors of the investment universe . The most commonly used ethical screens cover arms, tobacco, alcohol, nuclear energy, gaming and pornography.

Beyond generic SRI strategies, there are a number of socially responsible benchmarks on the market. Major ones in terms of reputation and global scope, respectively, include the FTSE4Good and the Dow Jones Sustainability Indexes. Each index provider establishes a series of socially responsible criteria used in order to be granted permission to join the index.

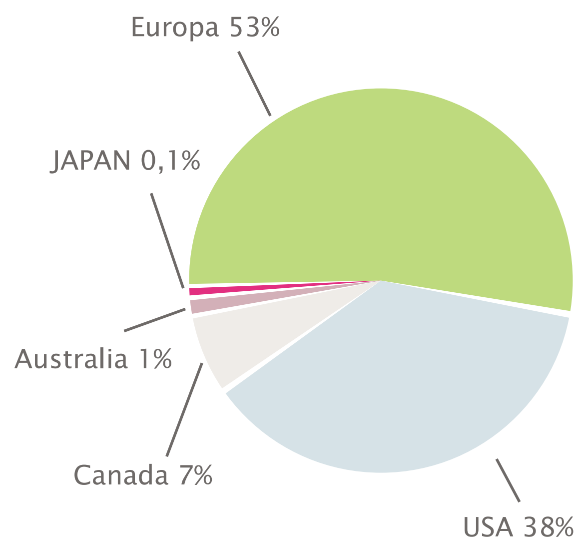
** The evolution of these indexes and their comparison with general indexes can be consulted in the section on RESEARCH indicators.

The Size of the SRI Market

Socially Responsible Investing has been one of the biggest growth areas in the world of asset management for a number of years. According to Eurosif (the European Sustainable Investment Forum), SRI grew by 46 % per year over the last expansion cycle (between 2002 and 2007) in Europe alone. Here, SRI already represents over 17.6 % of assets managed, which suggests that socially responsible investing may be moving out of a niche market to become a general practice.

The world market for responsible investing reached 5 billion euros at its peak, prior to the economic downturn of 2008. This figure is big enough for listed companies to sit up and take notice of this growing niche of investors. So, if we compare the present volume of SRI with the capitalisation of leading Spanish businesses we can see that these resources are the equivalent to buying the IBEX 35 twelve times over, or 55 companies like Telefónica. (See graph)

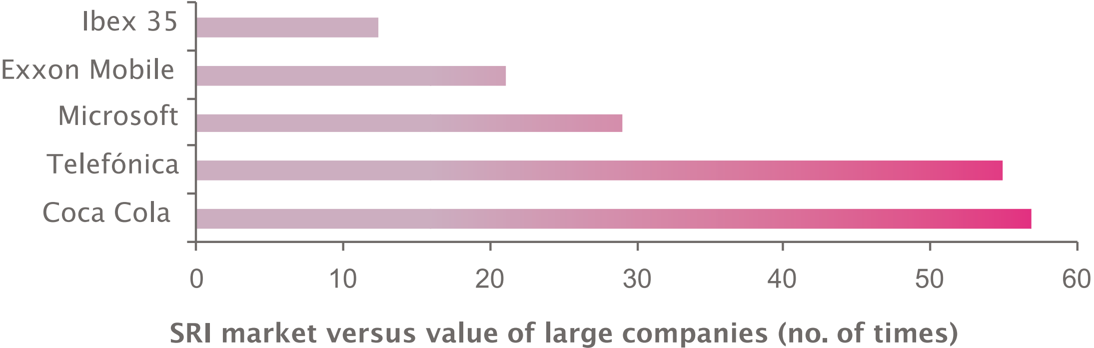
Roll-out in Spain has deviated significantly from the European trend, however. Spain has an under-developed market that accounts for less than 1 % of total investment, according to the Eurosif Report which uses figures from the close of 2007.



2007 World SRI Market
€4.9 billion

Source: Eurosif

SRI Market and Relative Importance

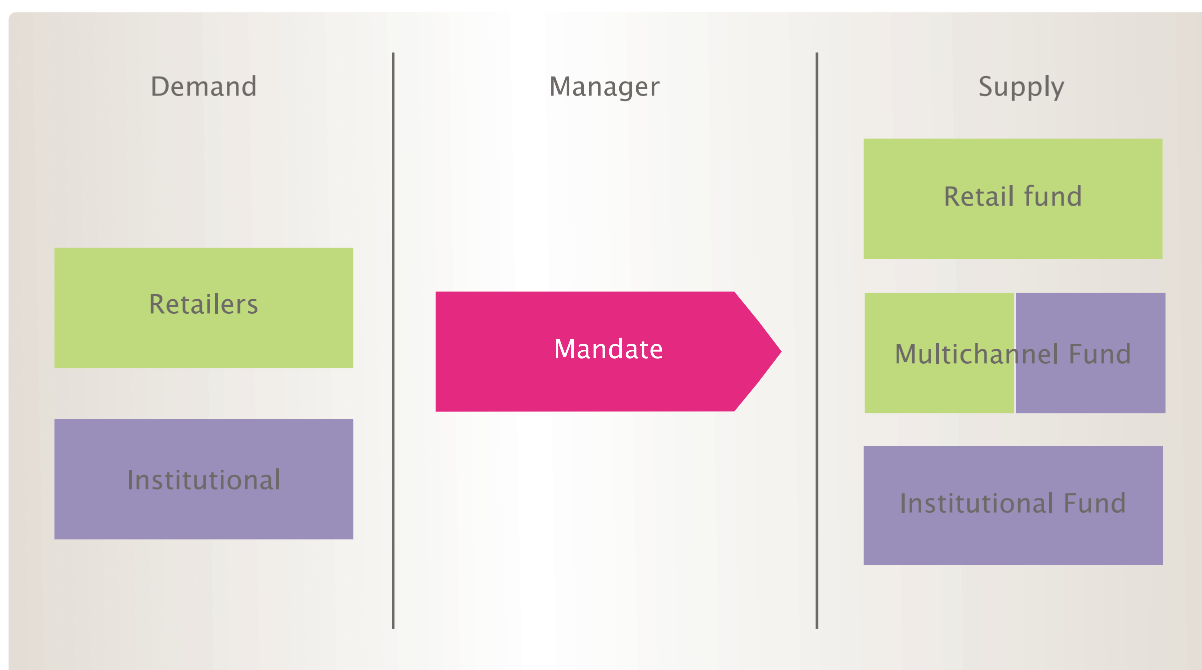


SRI Supply and Demand: Who Manages It? Who Purchases It?

Demand in the investment market comprises two clearly differentiated segments. The institutional market is basically formed of pension plans, insurance companies and private financial entities. The retail section comprises private investors, within which we find everything from large fortunes (High Net Worth Individuals [1]) to small savers.

Supply is structured around asset management companies that receive a management 'mandate' (see graph). A mandate is basically a 'commission' to manage financial resources for a third party, which establishes the type of investments that can be made in relation to a number of profitability goals and desired risks. Managers attempt to satisfy both segements of demand, i.e., institutional and retail. Sometimes they offer specific products for each. Otherwise they can create investment vehicles that feature the participation of both wholesalers and retailers in a single investment portfolio, although with different prices and conditions. An example of the former would be the creation and marketing of an investment fund on the Spanish stock exchange earmarked at private investors. An example of the latter would be the creation of a fund that invests in Chinese equities. The portfolio would be marketed via two types of shares: class A for institutional investors and class B for private investors.

[1] HNWI (High Net Worth Individual) refers to private investors who have over a million dollars in financial assets.



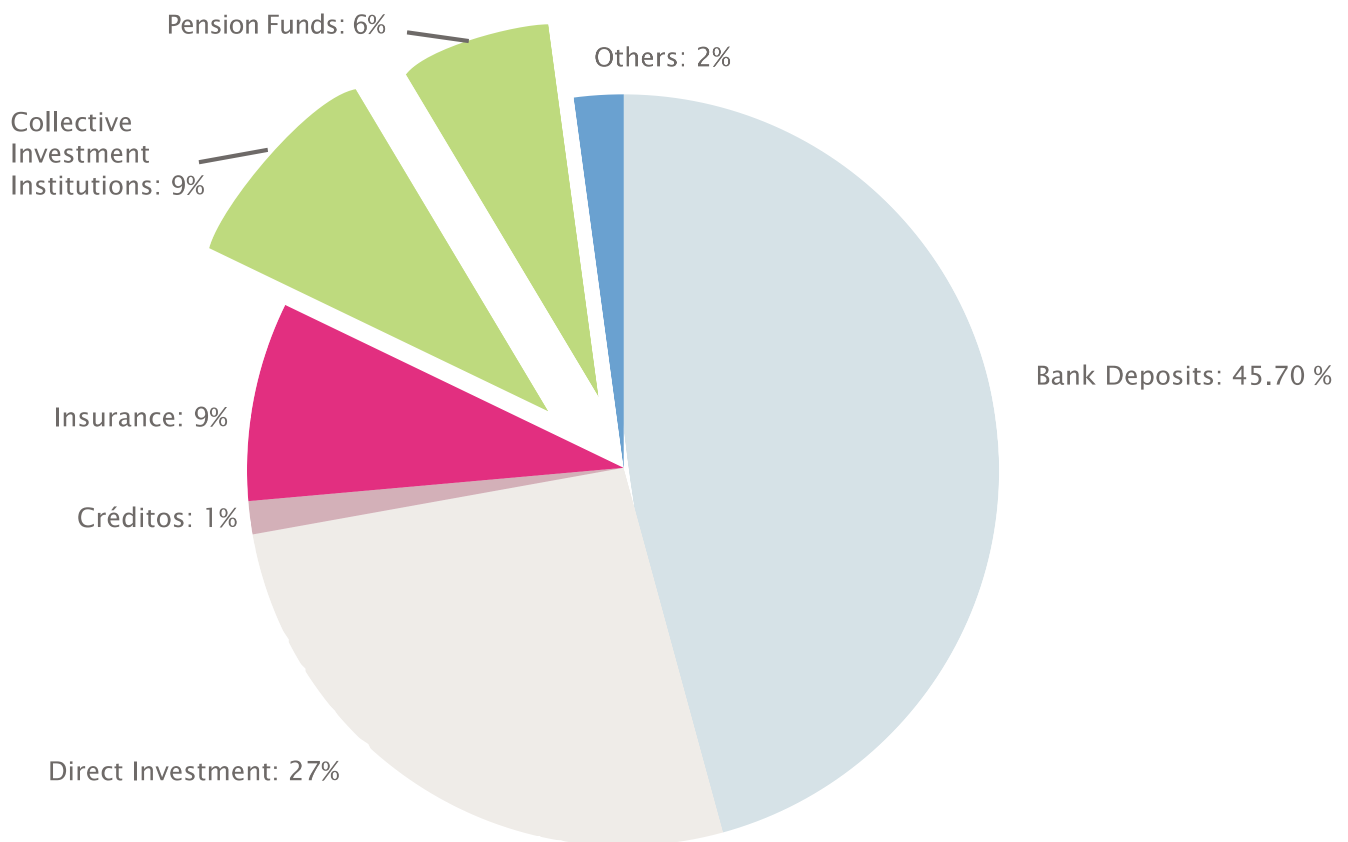
It is a good idea to analyse the two sections, i.e., institutional and retail, separately, as they have significantly different competitive dynamics.

The Retail Market in Spain. A Market of Supply

A Market of Supply. Spain has two important peculiarities that make the retail investment market one in which supply prevails over demand. This is due to the fact that financial entities have enormous power when it comes to prescribing saving and investment products. This phenomenon is known in academic circles as a problem of asymmetric information, in which one party (supply) has a lot more information and knowledge than the other party (demand) and therefore a great deal of influence. The fundamental reasons for this include the following:

A. Dependence on prescription: Spanish savers demonstrate a lower level of financial sophistication with respect to neighbouring countries. This generates a natural preference for investment in property, deposits and sovereign fixed income (goverment bonds). 45.7 % of family savings is found in bank deposits, compared to a small 9.1 % in mutual funds. This lack of financial sophistication goes hand in hand with a need for prescription in investing in other, more complex assets such as equities, raw materials, structured products or thematic funds.

Family Financial Savings in 2008



Source: Directorate-General of Insurance and Pensions Funds. Ministry of Economy

B. ■ A great many banks. Spain has more bank branches per inhabitant than anywhere else in the world. Before the financial downturn, Spain had 95.87 branches per 100,000 [2] inhabitants, compared to Germany with 49.41 or the US with 30.86. This figure reveals an important interaction between physical branches and customers. At the same time, this structure of banking networks – oversized, in the opinion of many experts – can only turn a profit by generating commissions on products. Own trademark products usually generate the highest commissions for bank branches. This creates a dynamic favourable to proprietary-product prescription, reducing the visibility of other, possibly more competitive, products.

Taking these two elements into consideration, we see a two-speed banking system. While Spain has had an enormously competitive banking market in terms of mortgage activity and deposit capture in recent years, saving and investment products face a series of conditions that greatly limit their competition and sophistication. This forms an unavoidable barrier to the development of SRI, because it is necessary to previously understand concepts such as equities, the geographic markets where investments are made, whether or not there is a currency risk, and so on, in order to be able to make informed decisions about purchasing these types of products. Here we should point out that the problem is not a lack of transparency or shortage of information on investment products. Abundant and complete information is available. The main barriers are a deficient financial education on the part of the pubic and de-facto reduced competition in retail (the marketing of saving and investment products).

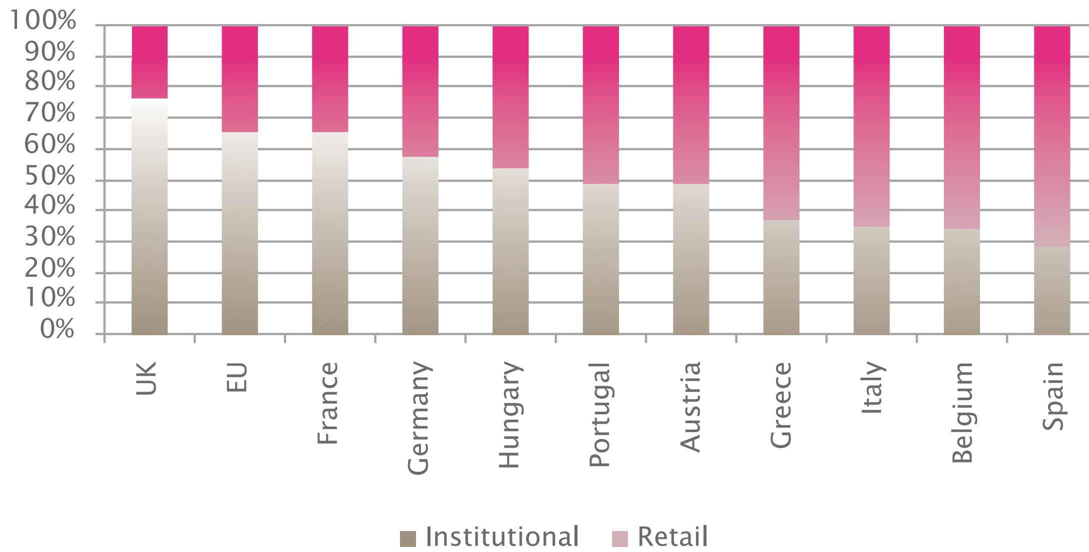
The Institutional Market in Spain: A Market of Demand.

The institutional market is a professional one with an extremely high concurrence between supply and demand. Indeed it is in this segment where most progress has been made in recent years, particularly in terms of pension plans, where companies that promote pension plans for employees are beginning to require ESG criteria from their fund managers.

However, the institutional market in Spain is one of the least-developed in Europe in terms of volume of investments. In Europe, the institutional section represents 66 % of the total market, compared with 28 % in Spain. Within the Spanish market, the most active side of SRI, i.e., employment pension plans, represents just one-third of the total.

[2] Cajas de Ahorros Foundation, FUNCAS

Distribution of the Retail versus Institutional Markets in Europe



Source: EFAMA

We should point out that the success of SRI in Spain, as in other countries, involves the development of these practices in the institutional market. This requires two profound structural adjustments.

Firstly: expanding the institutional market in volume and importance. This market requirement is due to the foreseeable deficit in the public pension system and changing demographics, which make it necessary to shore up and boost the second and third pillars of the pension system. Consequently, increasing the weight of employer-contribution pension plans (second pillar) and individual plans (third pillar) would ensure pensions for the public and bring the weight of Spain's institutional market into line with the European average, which is proportionately 2.35 times bigger.

Secondly, enhanced integration of ESG criteria in pension plans involves greater amplitude in the supply of plans, as well as enhanced transparency in their management. Although regulatory changes were recently introduced in this area, they are being rolled out very slowly.

In this regard, better development of the institutional market would generate economies of scale and greater professionalization among the industry (supply) in Spain. This would be a necessary condition for the development of the retail market, although it does not go far enough. The retail market also requires structural changes with regard to the financial education of savers and more de-facto competition in the marketing of saving and investment products.

Initiatives to Boost SRI

The two most important development initiatives in Socially Responsible Investing also appear to respond to this supply/demand structure. These initiatives are principally SIFs (Social Investment Forums) and PRIs (Principles for Responsible Investment). As a general rule, they can be linked respectively with supply or demand. SIFs are more closely related to SRI supply (managers and analysis suppliers), while PRIs are more often related to demand (mainly institutional investors).

SIFs: Social Investment Forums constitute the first organisation of the SRI market and include the collaboration of managers, NGOs, rating agencies, research providers and academic institutions. The SIF agenda has strong links with providing support to the work of fund managers via the development of market surveys, reports on economic sector sustainability and the creation of transparency guides regarding the analysis process of ESG criteria. Although there is no standardised SIF structure and it responds to local agendas that differ between countries, at the European level there is a meeting point between them. Eurosif is the European SIF association where national initiatives come together to achieve general goals at the European level, such as improving reporting standards and promoting SRI. The first SIFs in Europe appeared in the Netherlands (1995) and the United Kingdom (1998). SpainSif is of recent creation (June 2009), following various years of work on the part of its promoters. Other SIFs around the world include the US, Australia, Canada and Asia.

UNPRI: L: Principles for Responsible Investment were the response to a 2005 United Nations call to institutional investors to develop a number of SRI principles. The six Principles of Responsible Investment arose from the work of institutional investors together with the UN and other stakeholder groups. The PRI agenda is more closely linked to providing promotion and action mechanisms on the part of institutional investors (pension plans, insurance policies and financial institutions) so they develop dialogue platforms between investors and businesses that are objects of investment and other tools. 650 entities around the world presently work with PRIs, a third promoting pension plans.

The Investment Case: Profitability-Risk

One of the controversial principles of SRI revolves around the empirical demonstration of whether ESG criteria add value to or subtract it from investment portfolios.

From a scientific viewpoint, profitability in itself is not a good indicator for measuring value creation. An investment is only understood to add value when the profitability obtained by each unit of risk undertaken is maximun in comparison with other investment alternatives. That means that a very profitable investment does not necessarily have to be efficient if higher-than-‘normal’ risks are assumed to obtain it.

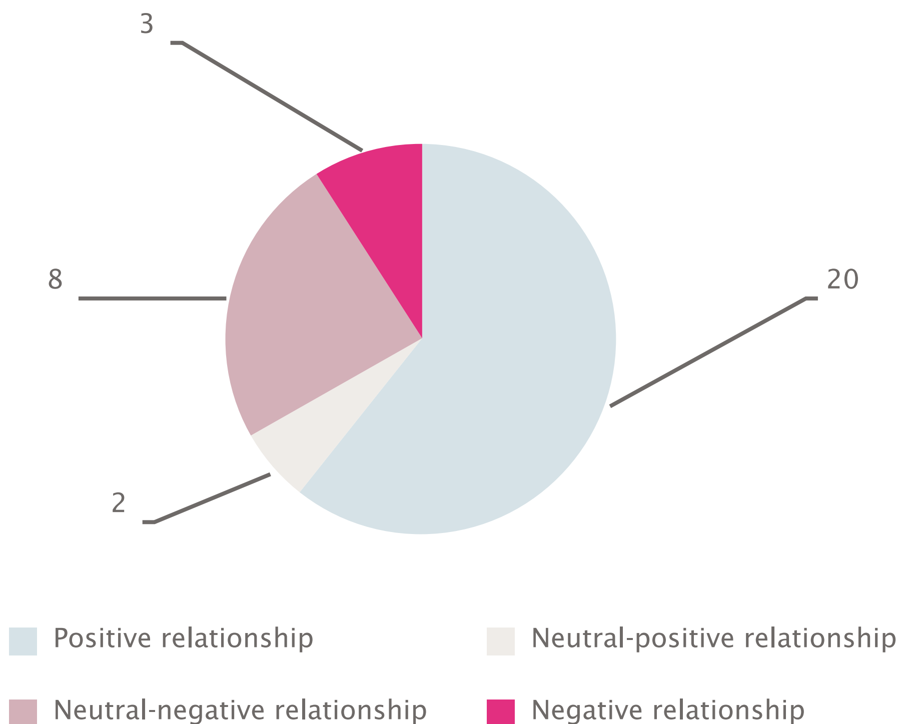
Do Ethics Subtract from Profitability?

Conventional wisdom holds that the integration of ESG criteria in investments is commendable from a humanistic viewpoint but less profitable from the practical side. Investing in polluting sectors or activities that do not offer guarantees with respect to human rights - the argument goes - will provide above-average profit.

A more scientific view in this regard would be that when applying ESG criteria you are first and foremost limiting the investment universe, which therefore could exclude assets within the optimal investment frontier by reducing diversification alternatives.

Or Do They Improve the Analysis of Companies Offering Investment and Disinvestment Opportunities?

This is not borne out by the reality. A recent report from consultancy group Mercer[3] which reviewed 36 academic studies in this regard, some of which covered the period between 1984 and the present day, found that only 10 % would support this popular theory. By comparison, 60 % of the studies established a positive relationship between the application of ESG criteria and financial profitability.



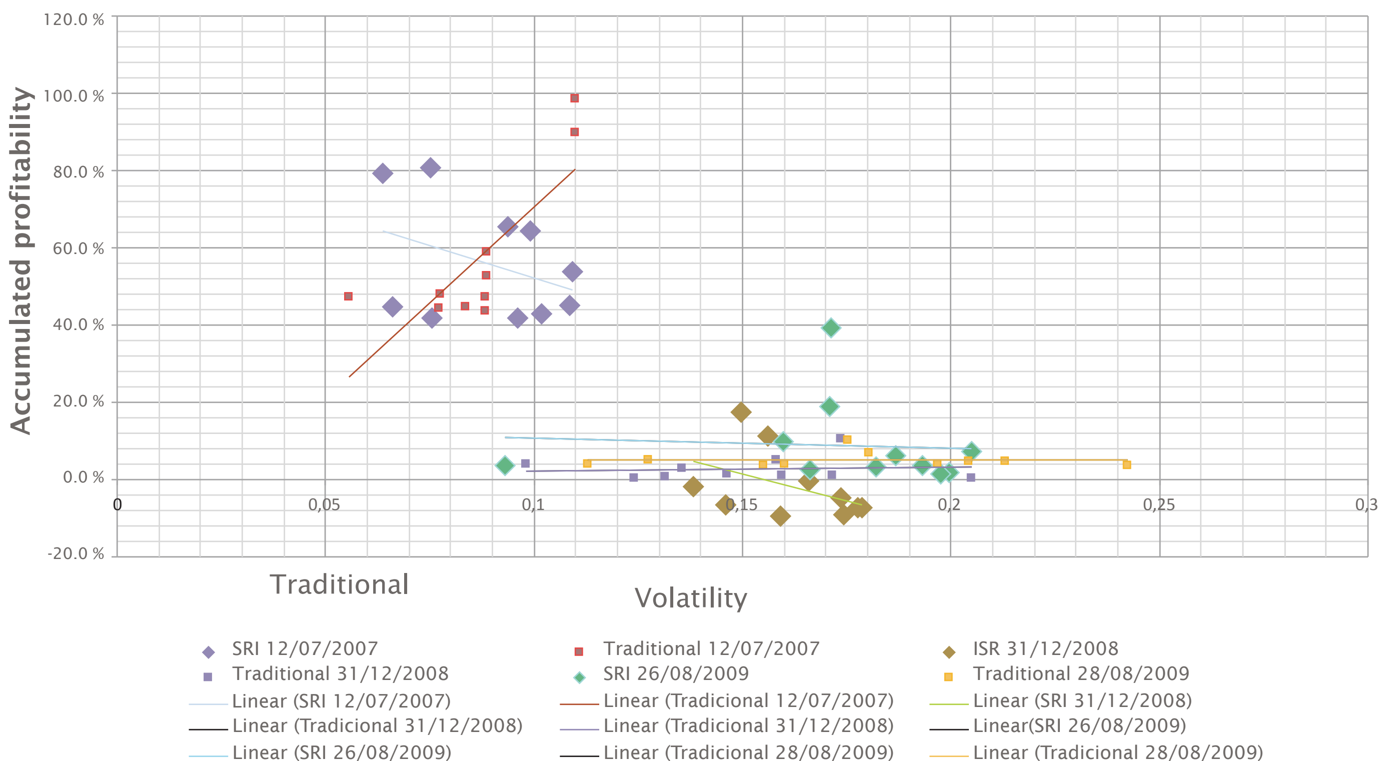
[3] Shedding Light on Responsible Investment: Approaches, Returns and Impacts. Mercer, November 2009.

Perhaps, As Always, It Depends on the Quality of the Manager

In the last analysis, the quality of the manager is the truly differential point in portfolio management. Forética has spent three years following the five-year evolution of the ten best-performing SRI funds versus the ten best-performing traditional funds in the Morningstar Global Large-Cap Blend Equity category.

The three observations that follow were taken at the last stock exchange peak of 2007, right in the middle of the 2008 downturn and during recovery in 2009. The results show that prior to the downturn, the two best-performing funds (of the 20 considered) were SRI ones, taking their profitability/risk ratio into account. This pattern continued during the downturn of late 2008. Subsequently, now in the recovery of 2009, four of the top five funds were SRI ones and once again the top two were as well.

SRI Profitability and Risk Versus Traditional Managementl



Source: Morningstar, Avanzi, Forética

The samples tested at three securities cycle show efficient relationship between profitability and risk of SRI products.

Conclusion

Socially Responsible Investing is a reality on the international assets-management landscape. The immense majority of investment fund managers have been rolling out teams and launching investment products related to aspects of sustainability, while a whole related industry has flourished. ESG rating agencies, investment consultancies, NGOs and research centres have made SRI more than a niche market.

Spain, as we have seen, is lagging seriously behind in the development of SRI because of characteristics typical to Spanish savers (generally removed from financial investment circuits) and the limited development of the institutional market. However, a changing trend has appeared in recent years, brought about the incorporation of a growing number of employment pension plans in SRI activity.

Once SRI has reached its maximum penetration in this segment of the institutional market, future growth will slow down unless end consumers change their savings preferences. We should not forget that from the marketing perspective SRI is a hyper-segmentation of saving and investment products and as such requires a series of previous notions with regard to capital markets, analysis methodologies and asset management.

When this first barrier has been overcome, savers will have to mature and match their variable aversion to risk with an appreciation of the social and environmental attributes of their investments. Here at Forética we are optimistic that growing public awareness of sustainability (see the different Informe Forética (see the different Informe Forética reports) will reach the world of savings. Sociological changes are slow. It is a matter of waiting.

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