INTRODUCTION

DOWNTURN BOOSTS INVESTORS' FAITH IN SRI PRODUCTS

The European SRI market remains dominated by institutional investors, writes Elisa Trovato, but interest among private investors is growing as the fallout from the financial crisis leads people to consider investing in a more responsible way

Leaving aside the innumerable debates about the semantics and definitions of the evolving concept of sustainable and responsible investment, often called ethical, responsible, social or socially responsible in a multitude of overlapping and competing expressions, what is constant in this area is the emphasis on environmental, social and governance (ESG) issues. These are considered important criteria in the financial analysis and in the investment decision-making process, as they are thought to determine long-term investment performance. The most readily acknowledged expression, SRI, or socially responsible investment, continues to be used by Eurosif – the European Sustainable Investment Forum – to indicate a broader range of sustainable and responsible investments, encompassing all possible sub-sets.

"One of the consequences of the financial crisis is that investors now really want to know what is inside any investment. SRI has benefited from that, because SRI is about transparency," says Matt Christensen, executive director at Eurosif. In 2003 the non-profit organisation compiled guidelines for the transparency of retail SRI funds, to which asset managers offering SRI investments can adhere on a voluntary basis.

Eurosif is now working on a project with the European Commission to make it compulsory for companies across Europe to publish in their annual reports the ESG risks they face and the ESG issues they are working on, says Mr Christensen. In countries like France and the Netherlands, this is already mandatory. This will contribute to increased transparency and better stock screening.

Investors want to understand whether the investments are more environmentally or more socially oriented, whether the product involves ethical exclusions or positive screening, such as best in class or theme funds, or it is about investing in a company to conduct an engagement campaign to improve its performance, he says. "We want to develop a common language in the SRI space at European level," explains Mr Christensen.

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The financial crisis has triggered demand for SRI products as investors have become painfully aware of the disasters that can be generated from focusing on the short-term and from not considering social, governance and environmental risks, says Mr Christensen. Those SRI products that had identified the social risk of investing in financials as a sector, because of the predatory lending, performed very well during the crisis, he says.

"Across the industry, most SRI funds continued to have net inflows during the downturn," echoes Karina Litvack, head of governance & sustainable investment at F&C.

"The financial crisis brought into very stark relief what happens to markets and individual stock valuations when, as investors, we focus exclusively on micro aspects of the company's performance and neglect macro-economic and systemic factors." That the company has better sales than its competitors is important, she says. "But if you disregard the unintended impact of this activity on the health of the financial system, in the case of the financial crisis, you do this at your peril."

People are increasingly concerned about the future, about leaving such an environmental or social debt to the next generation, she says. Some aspects of the non-sustainable activities are showing their devastating effects today. One example is climate change and its consequences on the environment and economy. Generally, the major problems around sustainable investing throughout the industry, and specifically in private wealth management, are a lack of knowledge and inadequate advice, says Ms Litvack. "While it is getting better in the institutional space because the consultants are starting to look at it more systematically, the fundamental problem with SRI is the lack of awareness and a general misapprehension on the part of advisers."

DIFFERENT WAYS IN

There are various approaches to SRI investing, she says. Private investors can invest in thematic products, which are possibly higher risk, but they can also follow a much more conservative investment style. This can take the shape of a commitment to exercising leverage as an investor, the way institutions such as foundations or high profile families have tended to do, as they can put pressure on companies using their influence and size.

Similarly, individual portfolios managed separately can be pooled for the purpose of engagement or voting. "This is where private banks can have an enormous value added because they can provide individualised portfolios for their clients, but at the same time gather up all those funds into one single voice that influences companies for the better. I have not seen this yet, but that does not mean that it does not exist," says Ms Litvack.

The European SRI market, estimated to be worth around €2,700bn, represents around 18 per cent of total assets under management in Europe but is still largely dominated by institutional investors, who account for 94 per cent of total assets. Retail and high net worth individuals contribute to only 6 per cent of the total SRI assets, but there are many variations across Europe; in Switzerland, the percentage of retail SRI assets is 50 per cent. That is clearly driven by high net worth (HNW) individuals' interest in thematic investments, with clean energy and water as their preferred sustainable themes, according to a Eurosif study.

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The demand for sustainability criteria as an offering within the rich is growing, largely due to a generational shift in thinking about capital growth and preservation, as well as financial outperformance prospects. Around 87 per cent of the HNWs think interest for sustainable investments will grow in the next three years, and 75 per cent of surveyed family offices think sustainable investment will increase in the generational transfer of their family's wealth, according to the study. While sustainable investments represented 8 per cent of HNW's portfolios at the end of 2007, by 2012 the share is projected to grow to 12 per cent, passing €1,000bn.

The desire to attract the expanding segment of HNWs interested in SRI was one of Bank Sarasin's major drivers in its recent decision to make clients' discretionary portfolios compliant to SRI principles. The investments of discretionary mandates are all screened against sustainability criteria, unless clients opt out. If they do, they have to pay more. "A standard is always cheaper than a tailor-made product," says Erol Bilecen, head of sustainable advisory at the private bank. So far, less than 5 per cent of their discretionary clients have opted out.

"With our 20 years experience in sustainable investments, we have evidence that, on average, SRI portfolios outperform and have less risk," says Mr Bilecen. "Companies that are environmentally and socially sustainable and have better governance streamline production and take decisions accordingly, and have an advantage on those firms which just focus on the short-term profits without looking at the future."

The move to SRI is not made at all costs; non-SRI products too, when they are believed to offer a real added value, are included in clients' portfolios, says Mr Bilecen. SRI funds have been traditionally available in the long only equity space, as it is easier to get relevant information from publicly listed companies. Although now there is clear move to an SRI type of approach in different asset classes, currency funds or alternative asset classes such as commodities or private equities, for example, are currently not at all or hardly available in the SRI space. Most of the bank's discretionary mandates are therefore only "largely" managed in a sustainable way, says Mr Bilecen, although the bank also offers clients 100 per cent sustainable managed mandates.

This radical change in portfolio management proved to be a competitive differentiator for the Swiss bank, which in the first half of the year registered net inflows for SF4.8bn (€3.2bn). This success was due mainly to this major shift to SRI, maintains Mr Bilecen. The number and the volume of the pure sustainable discretionary mandates increased by 44 per cent and 65 per cent respectively during the period. Of Sarasin's total SFr80bn (€53bn) of assets under management, around €6.6bn are sustainable investments.

A SHRINKING UNIVERSE

Performance concern is the first hurdle that wealth managers need to overcome with their clients. That the universe of investable stocks becomes too restricted when screened against sustainability criteria, leading to poorer choice in portfolio construction, is one of the main prejudices against SRI, says Mr Bilecen. On a theoretical basis, the universe may become smaller, he says, but in practice nobody has the information on all the stocks available in the world and those that are sustainable are so numerous that any good manager should be able to build a good portfolio.

"There are more and more academic studies that are finding that sustainable funds deliver a modest outperformance of 2 or 3 per cent over the benchmark over an extended period of time," says Ms Litvack at F&C. "Our experience is that our funds have performed more or less in line with our unscreened funds but they have experienced more volatility over a short period." The higher volatility is due to the fact that these products exclude certain sections of the market, she says.

The analysis that was before reserved to SRI products has now become mainstream, says Sylvain Massot, co-head of private banking investment services at Lombard Odier. "Today, for example, when you analyse a company you normally check that it has the right governance or monitor its impact on the environment," he says. "Our analysts have started to look, for example, at the carbon footprint of their companies, even in non SRI products."

But unlike his colleagues, Mr Massot says that because of the financial crisis people have been focusing more on short-term returns and there has been less demand for SRI products in the last 12 months. "Companies that are respectful of the environment, that treat workers and shareholders well, are bound to make a difference in the future, but it is very difficult to demonstrate over a short period of time that these

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ERIC BREEN, ROBECO

attributes will result in better performance," he says.

Although there is clear demand for thematic funds in the SRI space, a very large group of investors still want to buy the regular mainstream funds, says Erik Breen, head of responsible investing at Robeco. "We believe that the impact of being responsible is biggest in mainstream investing. We want to offer a responsible product proposition to that part of the market," he says.

The translation of ESG factors into financial discount or premium for the expected value of a particular company will directly influence the buy or sell at Robeco, says Mr Breen. "The integration of ESG factors into investment decision making processes offers, in our opinion, a better company risk analysis and an earlier identification of investment opportunities, and that will lead to a better risk return profile."

Active ownership is also an important component. "We exercise our voting rights at annual shareholder meetings of companies in which we invest, and we engage in active dialogues with companies aimed at improving company behaviour in governance, social and environmental areas," says Mr Breen. "We also 'walk our walk' meaning that we follow corporate responsibility criteria in the operational management of our company."

John van der Moezel, head of business development at Robeco Asset Management says: "What I am experiencing is a growing awareness and appetite for information. After the financial crisis people are more aware that investments have to be made in a more responsible way. Responsible investing means transparency, if investments had been made in more transparent ways we wouldn't have had the blow-ups of the last year."