Search for the Holy Grail

Summary of the VBA Seminar

Integrating Non-Financial/Sustainability Analysis in Mainstream Investing

"Mainstream finance can have an allergic reaction when dealing with the world of social responsible investing" said one of the panellists at the VBA seminar. This statement exactly highlights why it is important to introduce mainstream finance to the broader world of SRI. On the 21st of September 2005, the VBA commission "Social Responsible Investing(SRI)" organised the seminar "Integrating Non-Financial/Sustainability Analysis in Mainstream Investing" at the Erasmus University in Rotterdam.

The goal of the seminar was to give an overview of the world of SRI, and introduce useful SRI concepts to mainstream finance. To reach this goal, the seminar was split into four blocks, each block with a different approach to SRI. Every block had two speakers: one research agency/broker and one user of the research, an asset manager or a pension fund. Additionally, we invited another research agency/broker and asset manager/pension fund, to participate in the panel and pass additional comments. We asked Fons Lute, of Blue Sky Group, to take a helicopter view and cast a critical eye over the world of SRI.

During the presentations and the discussions, it was made clear that there were many obstacles against the full integration of SRI in the investment process. On the one hand: mainstream finance focuses too much on the short-term performance, this is probably logical if they are only rewarded for short term performance. On the other hand: the SRI world fails to quantify SRI risks in a useful way for mainstream finance. Maybe they should make a clearer split between ethical and sustainable investing.

In general, the end conclusion was that SRI will be integrated more and more into mainstream finance, but that there will always be a niche market for SRI investing. The remainder of this article will further enhance this conclusion by giving a brief overview of the presentations and more importantly, the discussion that followed the presentations.

Panel: van links naar rechts :
Ms. P. Dutronc, Innovest – **Mr. H. de Ruiter,** ABP – **Mr. E. Moolenburgh,** ABN AMRO – **Mr. M. Smith,** Prometheus Advisory services – **Mr. F. Lute,** Blue Sky Group

Block 1 Screening

Speakers: Mr. F. Vergunst of Cordares
Mr. M Jeucken of SIRI

Panellists: Mr. JW Hofland of MeesPierson
Mr. P. Webster of EIRIS

The first block of the seminar is the part of the SRI world that is probably most familiar to mainstream finance, and might lead to the above-mentioned, allergic reaction. This allergic reaction is probably caused by the excessive use of negative screening where an investor can't invest in cars, petrol, gambling, alcohol, etc. Financial theory says, that when you limit your investment horizon, you automatically limit your chances to outperform.

No wonder that mainstream finance is sceptical of SRI. The speakers of Block 1, however, tell a different story. They agree that excessive use of negative screening might not be the answer to create a better world. We should probably accept that cars and planes are an integral part of this world, and that we should concentrate on the companies that build and use the most sustainable cars and planes.

This method of concentrating on the most sustainable companies within in a given sector is called best in class. Research agency's like EIRIS and SIRI help their customers with selecting the best in class by creating extensive databases filled with SRI data.

The collecting of data raised an interesting point regarding the possibility of getting insider knowledge. The use of questionnaires and direct dialog might lead to information that is not publicly available. The members of the panel agreed that there might be a potential for insider knowledge but that because SRI research is more correlated with long term performance the risk of insider knowledge are of a lesser scale.

Another interesting discussion was about the question whether SRI as stand alone concept will still be around in 2015 or will it be completely integrated? To answer this question we have to look if the mandate is alpha of more ethical driven. The opinion of the panellists was that in 10 years time SRI investing will still be a niche market, while mainstream finance will have integrated the SRI issues that have an impact on the alpha.

Block 2 Enhanced Screening

Speakers: Ms. P. Dutronc of Innovest
Mr. H. de Ruiter of ABP

Panellists: Mr. E. Moolenburgh of ABN AMRO
Mr. F. Lute of Blue Sky Group
Mr. M. Smith of Prometheus Advisory Services

In Block 1, the "simple" screening method was discussed. We learned how companies were analyzed, and the way the data was structured, to give the investor an idea of the sustainability of the company. By using both negative and positive screens, an investor creates a portfolio, which best fits with his or her definition of sustainability.

This method of screening might not suit every investor. Mainstream finance is, more often than not, just interested in the risks and opportunities a particular investment brings with it. The fact that a company is sustainable is more or less irrelevant. An unsustainable company can be dirt cheap and thus be a great investment. Those gambling and tobacco stocks did quite well, didn't they? We should have invested in those. Unless of course sustainability has a direct impact of the risks and opportunities of a company that the average investor doesn't see yet. Can your average mainstream analyst/investor answer the following questions?

Will the legal climate for betting companies, and its offshore subsidiaries, change in the UK? Which automobile companies will be hit hardest when climate treaties discourage gasoline slurping SUV's and promote greener cars? Will obesity (and the heart problems associated with it) lead to the same legal battles for fast food companies as the tobacco and asbestos companies faced when the relationship between cancer and tobacco/asbestos was revealed? And which company might be the next Enron, Worldcom or Ahold with overpaid executives and failing corporate governance structures?

Not easy questions to answer, certainly not for the mainstream investor who thinks sustainability is something better suited to your average sandal wearing, beard growing hippie. Some investors, however, think these questions are worth answering, because they give a better insight into the risks and opportunities of their investments. They use research companies to help them quantify these risks and opportunities. We call this quantifying process, for lack of a better word, enhanced screening.

The speakers and panellists of Block 2, spoke about the use of SRI in the investment process, ABP said clearly that if SRI doesn't add value there is no room for it in the investment process. Academic research, however, shows that SRI can add value. Innovest suggested that SRI can be used as a proxy for management quality. According to McKinsky, 80% of the company value is based on revenue streams after 3 years. All of the above, are good reasons to have a serious look at SRI.

Still, mainstream finance seems to focus more on the short-term than on the long-term prospects of a company. Does mainstream finance for instance, seriously think about the question "will Fast Food and Alcohol producing companies face the same lawsuits as the Tobacco companies?"

Why is mainstream finance focussing so much on the short term? Possible explanations given by the speakers/panellists are:

1. Mainstream finance (but also the SRI research agencies) finds it difficult to quantify SRI. For example CO_2 emissions were an issue within the SRI world for a long time, but mainstream finance only picked it up when the emissions trading scheme was introduced.
2. Most investment firms are structured to look at the short term (think about bonus/rewards structures).

Block 3 Integrated Approach

Speakers: Ms. C. Volk of WestLB
Mr. Niels de Graaff of SNS

Panellists: Mr. M. Packman of DrKW
Mr. A. Sorange of I.D.E.A.M.

In Block 2, we saw that mainstream finance might be more interested in the risk and opportunities associated with SRI than simply screening companies for SRI issues. However, problems arose when these risks and opportunities were identified. Were they material enough, and how would you quantify these risks and opportunities?

These questions might be the Holy Grail for integrating SRI in mainstream finance. The speakers and panellists gave different possibilities for the integration of SRI in mainstream finance.

Broker WestLB recognised that a company's value is determined by both tangibles and intangibles. SRI issues are a big part of the intangibles, and should therefore be included in the risk coefficient, together with the forecast, liquidity and financial risk. According to WestLB, including sustainability risk, leads to a significant change in the companies value.

Asset manager SNS, has a different approach where companies are judged on long term prospects. Within the full scope evaluation, the SNS analysts look at the Economic, Social, and Environmental Dimensions of a company. To measure the effect of SRI, an internal benchmark was created. Lack of history however prevents bold statements regarding the effects of SRI.

Broker DrKW, has a different approach, where all their mainstream analysts integrate SRI into their normal analysis. One analyst may be quicker to pick it up than another, but because SRI is integrated in their bonus structure, all the analysts have an incentive to look at both short and long term issues. According to DrKW, rewarding analysts, only for short-term performance, will mean that analysts/investors will have less interest in SRI which deals more with long term risk and opportunities.

I.DE.A.M. uses SRI to improve its alpha where it doesn't make any sector, country or style bets. The alpha of I.DE.A.M is almost fully concentrated with SRI bets. To be able to concentrate the SRI bets, I.DE.A.M uses a best in class approach to rank companies, but they don't exclude any companies from their universe. It could mean that in all companies in a certain sector could be invested from their point of view.

One problem remains; the quality of SRI Data. Most SRI research agencies provide a broad, but shallow, set of data that's not always useful, for example, in a Discounted Cash Flow Model. This perhaps highlights the fact that a research agency might have to choose between doing research for ethical investors, or doing research for sustainable investors. The first group will be more interested in screening, while the latter group will be more interested in the material risks and opportunities of SRI.

Block 4 Engagement

Speakers: Mr. M. Appleby of Morley Fund Management
Mr. B. Ruter of Triodos

Panellists: Mr. E. Breen of Robeco
Mr. R. Sullivan of Insight Investments

Engagement is an altogether different approach to SRI. Via an active dialog with a company, and the full use of voting rights, the investor tries to influence the company in becoming a better company for all the stakeholders.

Shareholder activism can be combined with the methods discussed in Blocks 1-3, but can also be used by investors that have no other interest in SRI issues. An interesting part of engagement, is that it might be financially rewarding to invest in a non-sustainable company, and then try to make it more sustainable. In this way, the investors help management assess the risks and opportunities associated with SRI. This can lead to an improvement in the value of a company.

Another interesting part of engagement is the cultural difference between countries. For example, in the United Kingdom, the press is used more often to put pressure on companies than it would be in the Netherlands. In the US and UK in general, shareholder activism is used more often than in Continental Europe and Asia.

Size is obviously important when using an engagement strategy. The bigger part an investor owns of a certain company, the more reason this company has to listen to the investor. However, size is not the only consideration according to the relatively small Triodos. When you approach a company with a constructive and professional attitude, companies tend to listen to you. It is important that you are very well prepared, don't base your arguments on a sole source, and double check everything in order to have a successful engagement strategy.

What should be done next?

The idea to set up a SRI learning program for mainstream finance might not be the straightforward answer to the question: "how to integrate sustainable / non-financial, or perhaps better called extra-financial information, in the investment process?". One of the things we learned during the seminar is that before extra-financial information will be integrated, the two worlds should become more familiar with each other.

The SRI world needs to understand how "traditional" financial analysts/portfolio managers are working and what kind of information they are using while the financial analyst should examine, with an open mind, the research that is provided by the SRI community. This is not a one way education program, but should be seen more as a process where both sides learn from each other in specially set up workshops. With the results, suggestions and conclusions coming out of these workshops we can set up a learning program for both the traditional financial analyst and the people working in the SRI world. The VBA commission on sustainable investing will look into this matter and if you are interested in participating, you can contact us (Marcel de Berg, marcel@21c.nl).

VBA commission Social Responsible Investing
Author: Michiel Smith

Members of the commission: Marcel de Berg (chairman) – 21C, Marcel Jeucken – DSR, Robert Klijn – ING Financial Markets Lysanne van der Made SNS, Herialt Mens – Cordares, Marietta Smid – SNS, Michiel Smit – Prometheur Advisory Services, Masja Zandbergen (secretary) – Robeco