THE RAPID RISE OF SUSTAINABLE AND RESPONSIBLE INVESTING:

FROM MARGINAL TO MAINSTREAM?

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One topic in institutional investing where there is a wide difference of opinion is sustainable and responsible investing. Whether referred to as "socially responsible investing," "social investing," or any of its myriad other monikers, SRI and its proponents often have been met with strong resistance from the institutional investment community. Much of this resistance has been grounded in the belief that SRI practices may harm return potential, whether by constraining an investor's opportunity set or precluding an investor from using the best investment managers. Additionally, institutional investors have been skeptical of SRI strategies due to implementation hurdles such as a lack of good information on the social or environmental performance of companies and a lack of investment products or strategies.

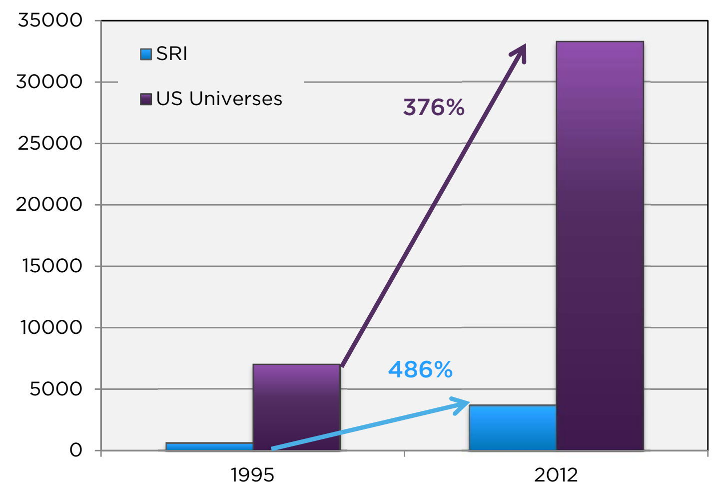
In spite of the controversy, SRI has increased in prominence in recent years and has become adopted by a larger number and variety of institutional investors. By one measure, over 20% of professionally managed assets globally are now managed using some form of sustainable or responsible investment.

Growth in the past two decades

A 2012 report on SRI trends published by the US SIF showed that, in the U.S., growth in the SRI marketplace in the United States has significantly outpaced the growth in overall institutional asset management since 1995. As depicted in chart 1 below, in the 17 years covered by the report, SRI assets under management increased 486% from $639 billion to $3.7 trillion, while the broad U.S. universe increased 376% from $7 trillion to $33.3 trillion. Together, these numbers indicate that one in nine professionally-managed investment dollars within the U.S. involve some explicit form of SRI practice.

Data suggest that SRI practices have been adopted to an even greater extent globally. Surveys conducted by the Global Sustainable Investment Alliance indicate that worldwide, 21.8% ($13.6 trillion) of professionally managed assets in the survey regions involve some form of sustainable or responsible investing practice.

Chart 1 - SRI vs. US Universes growth in the United States



These numbers point to a fairly widespread adoption of SRI strategies. Perhaps the most prominent sign that SRI is becoming more acceptable to the mainstream institutional investment community is the growth in the number of asset managers, asset owners and investment service providers that have become signatories to the United Nations' Principles for Responsible Investment (the PRI). The Principles require signatories not only to integrate the consideration of environmental, social and governance factors into their investment decision making (a practice known as ESG integration), but also to encourage other investors to do the same. Additionally, signatories commit to working in partnership with other investors and stakeholders to increase disclosure from companies on their ESG performance. The very public and potentially resource-intensive

commitments required of PRI signatories have not appeared to hinder the quick adoption of the Principles by a wide variety of investors: the number of signatories has grown from 50 in 2006 to 1071 by May 2012. Today, signatories represent over $32 trillion in investment assets and include many leading asset owners and managers, including PIMCO, Lazard, and MFS.

Key drivers of mainstream interest in SRI

The growth in interest and adoption of SRI has occurred in a seemingly near-perfect environment for that growth. Below, we examine three trends that have come together in a mutually reinforcing fashion to promote SRI: a growing awareness of the potential materiality of ESG factors to company financial and share price performance; heightened headline risk; and the increasing depth and availability of SRI/ESG information and services.

1) Stronger evidence of the potential materiality of ESG factors and sustainability efforts to company financial and share price performance.

There is evidence that a company's positive reputation on ESG matters can help mitigate the downside risks to share price performance in the event of a negative ESG event. There is also evidence suggesting that companies that manage environmental risks better than their peers, have strong relationships with their employees or engage in best governance practices may have superior financial and investment performance over time.

There is undeniably a growing perception among company management that sustainability efforts merit attention and can add to the bottom line. According to a recent survey by Deloitte, two-thirds of Chief Financial Officers indicated that they were "always" or "frequently" a key driver of the execution of their companies' sustainability efforts, with over 61% indicating that they expect their role to grow in the coming two years. Another survey by BCG and the MIT Sloan Management Review shows that 50% of companies have changed their business models in response to opportunities in sustainability, with 37% indicating that the changes have added to their profits.

While new research continues to shed light on the links between ESG factors and financial and share price performance, generalizations regarding the impact of these factors on performance obscure a number of complexities. For example, different industries can have widely differing risk or opportunity profiles with respect to ESG factors. Additionally, while there is a growing body of research showing links between certain ESG factors and company performance, such support is uneven and is often inconclusive. For instance, there tends to be more empirical support for conclusions regarding the performance impacts of corporate governance practices than the impacts of corporate social practices. The complexity of the impact of ESG factors on company performance requires an in-depth analysis of investment managers and their skill in determining **a)** which ESG factors are germane to a given sector, **b)** which business practices are likely to have beneficial or negative impacts on a given company's ESG performance, and **c)** the ultimate impact of those practices on the risk and return profile of the company.

2) Increase in headline risk.

In general, there has been a growing public awareness and media attention paid to the behavior of corporations and their impact on society. In particular, the prevalent use of social media and the Internet has increased the speed by which a negatively-perceived ESG practice might influence consumer and investor behavior and brand value. The significant negative effects such news can have on both consumer and investor behavior have made companies much more cognizant of the proper management of their ESG profiles.

Such headline risk also has become a significant concern for stewards of investment capital. This is particularly true for foundations, whose increasing prominence in the spheres of social services and public policy has led to greater scrutiny of their investment practices. For example, college and university endowments have been the focus of increasing criticism from their own students and such organizations as the Responsible Endowments Coalition regarding their investments in a wide range of companies including Nike and Apple (for their labor practices in emerging countries), ExxonMobil (for their contribution to global climate change), and Boeing, General Electric and Caterpillar (for arms sales).

With the assistance of SRI asset managers as well as consultants with specialized SRI expertise, stewards of capital have become more sophisticated in their implementation of various strategies that help address stakeholder concerns while still generating strong financial returns. For example, instead of divesting from companies with business practices that are troubling to key stakeholder groups, many responsible investors now take part in various shareholder engagement initiatives in which they attempt to work closely with the companies they own to

improve such practices. Another example of an adaptive implementation is the practice of making dedicated allocations to clean technology or otherwise sustainable investments with the rationale that providing targeted capital to "solutions-oriented" companies has the potential to offset negative impacts from other portfolio investments.

3) Growth in responsible investment information and services.

As investor interest in SRI has grown, so has the availability of responsible investment services and related data. In a virtuous cycle, the general availability of services and data as well as their increasing affordability have helped drive continued adoption of SRI.

Investors have been clear in expressing their demand for more transparency regarding companies' ESG characteristics. One sign of this demand is the broad support enjoyed by advocacy organizations such as the Carbon Disclosure Project, a non-profit organization that works to enhance the disclosures of companies with respect to carbon output, climate change and water usage, and which currently counts as its supporters 722 institutional investors holding $87 trillion in assets. Large corporations also have been clear in responding to this demand, with detailed sustainability reporting becoming the norm rather than the exception. KPMG indicated in its 2011 International Survey of Corporate Responsibility Reporting that 95% of the largest 250 companies in the world publish sustainability reports that are separate from their annual statements. This increased transparency, as well as increased standardization in reporting, is resulting in improved analysis of the ESG characteristics of companies and their potential relationship to company performance.

The increased investor interest and demand also have resulted in the greater availability of SRI investment strategies, with SRI investment strategies now available in some form or another across most traditional and alternative asset classes. Within many asset classes, there are different approaches to implementing SRI that accommodate investors of varied concerns, resources and levels of expertise and sophistication. See Exhibit 1 below.

Despite the overall improvement in ESG disclosure, meaningful disclosure is still lacking from smaller-capitalization companies. These companies often lack the resources to effectively monitor or report on many of the issues of concern to responsible investors. Disclosure is also a challenge in emerging markets, where norms regarding the relative importance of the disclosure of ESG factors differ from those in developed markets. While the absence of reliable information can stymie some responsible investment efforts, investment managers that specialize in ESG investing often view the lack of disclosure as a potential opportunity for their fundamental research to uncover hidden risks or advantages that are not recognized by the broad market.

Investors with stringent guidelines will find it difficult to invest in alternative asset classes as the "off-the-shelf"

Exhibit 1 - Strategies by asset classes

LOW — Level of Engagement/Impact → — ← Complexity/Due Diligence — HIGH

						SRI Service Availability and Quality?
Equity	Negative Screening	Active Proxy Voting	Best-in-Class Screening	Thematic Investing	Shareholder Engagement	**Best**
Fixed Income	Negative Screening				Mission-Specific Fixed Income Investing	**Fair**
Real Estate				Responsible Value-Add		**Fair**
Private Equity		Sustainability Integration			Greentech/ Cleantech Venture Cap	**Good**
Hedge Funds	Negative Screening			Long/Short Best-in-Class Screening		**Poor**

availability of SRI options is still quite limited in scope. However, consultants with expertise in the space can identify whether the available strategies meet a majority of a given investor's needs. If not, consultants can help to develop other investment strategies and portfolio structures in which the investor can more fully express their views and beliefs.

Conclusion

The sustainable and responsible investment industry has grown and evolved a great deal in the past several years. The stigma once attached to SRI from the mainstream investment community appears to have diminished over time due to several factors, including increasing evidence of the potential materiality of ESG factors to performance, and headline risk at both the company- and institutional investor-levels. Notably, many of the drivers bringing SRI into the mainstream show few signs of abating. Given these trends, it is likely that investors who have adopted SRI practices will no longer find themselves to be outliers in the institutional investment community. Meanwhile, those institutional investors who have not yet developed a view on the use of various SRI practices may soon find themselves in the unfamiliar position of having to justify their investment practices.

Definition: What is sustainable and responsible investing?

SRI broadly encompasses a variety of investing practices that, while different, share a common feature: a focus on understanding and evaluating the social, environmental or ethical characteristics of their potential investments. The sidebar includes an overview of many of the key practices falling under the header of SRI.

Negative screening, where investors screen their investment universe to remove securities that violate one of the investor's guidelines, is the most common practice and the most familiar to investors. Other examples include active proxy voting designed to improve a company's responsiveness to governance concerns such as executive compensation or board independence, or an investment committee making allocations to managers that specialize in investing in companies well-positioned to weather the effects of climate change. Another well-known SRI practice is impact investing, which is designed to result in specific, measurable societal benefits along with the generation of a financial return.

With respect to the mainstream institutional investing community, the broad category of SRI practices that accounts for a significant portion of its recent growth is known as environmental, social and governance (or ESG) integration. This is where investors analyze and evaluate the potential impact of environmental, social or corporate governance factors on the value of their investments. Importantly, many investors who integrate ESG analysis into their investment decision-making primarily do so as another aspect of their due diligence and risk management. This stands in contrast to the widespread perception that the responsible investor engages in SRI solely or primarily to express or abide by non-investment related values and beliefs.

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Key SRI practices

1. **Screening of investments**
   a. **Negative/exclusionary screening** The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific environmental, social or governance (ESG) criteria;
   b. **Positive/best-in-class screening** Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers;
   c. **Norms-based screening** Screening of investments against minimum standards of business practice based on international norms.
2. **Integration of ESG factors** The systematic and explicit inclusion by investment managers of ESG factors into traditional financial analysis.
3. **Sustainability-themed investing** Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture).
4. **Impact/community investing** Targeted investments, typically made in private markets, aimed at solving social or environmental problems. Impact investing includes community investing, where capital is specifically directed to traditionally underserved individuals or communities, or financing that is provided to businesses with a clear social or environmental purpose.
5. **Corporate engagement and shareholder action** This strategy employs shareholder power to influence corporate behavior including through direct corporate engagement (i.e. communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

Source: Global Sustainable Investment Alliance

March 2013

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