Implementing Responsible Investment

A United Nations Investor Roundtable

Paris, June 16, 2004

Meeting Report

Hosted by

Groupama Asset Management, Paris, France

Organised by

Implementing Responsible Investment

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Meeting Report

Editor: James Gifford

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Executive Summary

On June 16, the Asset Management Working Group of UNEP Finance Initiative held an Investor Roundtable 'Implementing Responsible Investment' in Paris, hosted by Groupama Asset Management. The 40 participants included pension funds from across Europe, consultants, analysts and representatives from the member firms of the Working Group. The key points that were realised from the meeting included:

- Environmental, social and corporate governance issues are clearly material – especially over the long term – and companies and their investors who do not take these issues into account do so at their own peril.
- These issues must be brought into the mainstream and firmly integrated into the work of all players, whether they be investors, fund managers, brokers, investment consultants or companies themselves.
- Collaboration by investors in their shareholder engagement activities is essential to achieve improvements in corporate behaviour in order to address the risks and opportunities posed by environmental, social and corporate governance issues. There is a clear need for a global alliance of investors to collaborate across borders to bring about this change.
- Research, education and the upgrading of skills to address these issues is required on a global basis. There is significant experience with engagement processes in a small number of countries, and this experience can form the basis of a global collaboration.
- There are significant opportunities involved in responsible investment in emerging markets, but more research, better information and regulatory frameworks are required to minimise the risks.

Please note: this report should be read in conjunction with the slide shows that were used during the presentations.

They can be downloaded from http://www.unepfi.net/pensions

For more information on any issue contained within this report, please email pensions@unepfi.net

Introduction

CARLOS JOLY, Co-Chair, Asset Management Working Group; Storebrand

At the ExxonMobil AGM on May 26th, a revealing exchange took place between Lee Raymond, ExxonMobil chairman and CEO, and Dale McCormick, the Treasurer of Maine. When Mr. McCormick asked a question about how the company accounts for liabilities related to climate change regulations on its balance sheet, Mr. Raymond replied: 'The potential liabilities of climate change are neither likely nor can they be estimated'.

Those of us in asset management who are members of the UNEP FI believe that Raymond is wrong to be dismissive and McCormick is right to ask the question. Climate change risks, other environmental risks, social risks, workplace risks and relations with society do count and are increasingly becoming reflected in equity pricing. The decisions of institutional investment managers like us make that so.

The question is not if environmental, social and corporate governance considerations (ESG) are material but rather when, under what conditions, by how much, the timing and what the appropriate corporate response should be.

In the UNEP FI Asset Management Working Group, we are 12 asset management companies with diverse ways of incorporating ESG into portfolio composition, into engagement with companies and into fundamental company analysis.

There are a number of serious issues relating to ESG:

- Excessive claims as to effectiveness of the approach from SRI activists.
- Risks and opportunities are exaggerated.

If the ESG company ranking was sufficiently predictive of equity performance, we would not require fundamental company analysis. In fact, ESG is a way of enriching, adding insight and perspective to traditional equity analysis and a way of increasing the confidence or forcing questions about its conclusions. It is no substitute.

One thing we have all felt lacking is sufficiently robust analytic insight into ESG matters from our broker analysts. Hence, a year ago we established a project to invite our brokers to conduct specific research to be shared with the public.

- We suggested issues that we thought were relevant but left it up to the brokers to decide on the particular criteria of relevance in their sector.
- We reviewed, summarised and interpreted the findings.
- We committed ourselves and our brokers to distribute and disseminate the findings.

- We are organised collegially, and work through monthly conference calls, yearly gatherings, emails and phone calls.
- We have the support of a capable, professional secretariat.

Carlos Joly is an institutional investment manager and has been the initiator of Storebrand Investments' practice to integrate ESG into portfolio management; He is co-chair of the AMWG, co-founder of the UNEP Insurance Industry Initiative, and is on the UNEP FI Steering Committee.

Extra-financial analysis and investment processes

Eric Borremans, Head of SD Research, BNP Paribas Asset Management

The slides for this presentation can be found at http://unepfi.net/pensions

Extra-financial analysis is the systematic and transparent assessment of environmental social and corporate governance issues. It is called extra because it is typically still today not within the remit of financial analysts. They are financial because there is an increasing body of evidence suggesting these issues are material and financially relevant for companies.

'Extra-financial analysis is not meant to substitute for financial analysis – it is meant to provide a more complete view investment risks and opportunities'.

It is not meant to be a substitute for traditional financial analysis. Using the automotive industry as an example, we can see what a financial analyst would typically look and what an extra-financial analyst would look at. We can also see that clearly complement each other. [See slide 2]

Extra-financial criteria for the automotive industry

- **Corporate governance**

  The role of family/state shareholders.

- **Fuel economy**

  Smog, CO_2 and particulate emission standards are becoming more stringent. Some manufacturers are well ahead and some well behind – this will have a financial impact.

- **New technologies (hybrids, fuel cells)**

  There are big differences between manufacturers in terms of research and development, prototypes and commercialisation.

- **End-of-life vehicles**

  Manufacturers are currently required to set up recycling infrastructure in all EU member states. This requires investment – some are making provisions, others are not.

- **Work time flexibility**

  To what extent does the car manufacturer have the ability to accommodate peaks and troughs in production rather than laying off people, causing disruption and losing corporate knowledge?

- **Pension liabilities**

  For example, for the US car manufacturers.

- **Employment practices in the supply chain**

  Manufacturers have thousands of suppliers in various regions and there are reputational

issues associated with the way employment practices are managed within the supply chain.

Why would we see those issues become more relevant to investment decisions?

- Well-governed companies tend to outperform poorly governed companies, a trend exacerbated by financial scandals.
- More stringent legislation such as CO2 trading schemes.
- Changing consumer preferences.
- Increasing NGO pressure.

Extra-financial analysis is not meant to be a substitute for financial analysis – it is meant to provide a more complete view of investment risks and opportunities.

Building extra-financial analysis into investment processes

The danger with traditional SRI screening is that it not only restricts the fund manager but it also brings with it an inherent conflict of interest between SRI researchers who want to keep stocks out and the fund manager who wants to bring them back in.

Ultimately, we will achieve the systematic integration of environmental, social and governance issues into fundamental analysis. This could be implemented by incorporating a risk premium into the growth rate or cash flow when the materiality of the issue in question becomes clear – e.g., when stringent regulation or CO_2 emission allowances are introduced. However, the full integration of these issues into financial models may be going too far too fast. Company valuation models are very sensitive. Modifying the growth rate or risk premium by a few basis points may lead to large differences in valuation.

At this stage, we decided it was best to run the environmental, social and governance analyses and the financial analyses in parallel. This allows us to get to know the issues and the companies better and build internal capacity and knowledge.

Challenges include:

- Acceptance of these issues by financial analysts who do not feel confident with these issues because they are not easily quantifiable;
- Access time with companies: one-hour meetings are not sufficient to discuss questions of extra-financial issues. Extra time, however, is very beneficial because it enables financial and extra-financial analysts to see each other's points of view.

Regarding performance attribution, we have built long/short portfolios based on our internal rating for the automobile sector. It compares relative performance weighted by the extra-

financial rating and shows that overall, extra-financial analysis is adding value. However, the time period is very short and the sample size is small – but it is an indication.

Materiality of social and environmental risk in oil and gas

Anthony Ling, Co-Director of European Research, Goldman Sachs

Anthony Ling's presentation is based on the Goldman Sachs report, *Introducing the Goldman Sachs Energy Environmental and Social Index*, which can be found at http://www.unepfi.net/stocks/

The slides for this presentation can be found at http://www.unepfi.net/pensions/

There is really is a tremendous degree of interest in this report not just within the investment community but also within the corporate world. Many companies, however, are still struggling to understand what the investment community wants from them.

Main points:

- BP is the stand out leader, both in terms of their reporting and their management relative to the rest of the industry.
- Exxon also does well. American companies perform very badly on climate change but they are relatively outstanding on management diversity, operational excellence etc.
- There is a proliferation of second-tier European players Statoil, Norsk Hydro, British Gas, Total – all of them performing significantly better than their US peers.
- One-off events or NGO-led campaigns have little impact on share prices other than in the very short term.
- We are currently in the age of oil, dominated by OPEC. We are going from the age of oil to the age of gas. Gas is the bridge to a low carbon renewable world. Within 20 years, if current growth rates continue, gas will overtake oil. Overall, this is an enormous structural shift for the industry.

'We are going from the age of oil to the age of gas. Gas is the bridge to a low carbon renewable world'.

- The production mix itself is changing from OECD to non-OECD countries. Operating in non-OECD and developing countries is an absolute must for these companies if they are going to succeed.
- Projects are getting bigger. The scale of everything has gone up dramatically.
- There is a transfer of value and expertise from the traditional international oil companies to the national oil companies with many more players having the ability to take on these huge projects.

- The industry is facing a resourcing crisis. The number of people employed in the US oil industry fell by 30% between 1980 and 1999. The number of people employed in upstream operations has halved over that period. The average age of an upstream employee is now 45. It is extremely difficult to attract new people into the industry. We are asking for more from a reduced workforce and in a more competitive environment.

- It is a more transparent industry. Many developing countries want to improve their performance. They are signing up to transparency initiatives. NGOs are having an effect, operating either on their own or together with SRI funds to raise issues, be it Nigeria or pipelines through Azerbaijan and Turkey. The industry cannot ignore these issues.

- Environmental awareness is increasing. When you go to do business in a non-OECD country such as Kazakhstan or West Africa, companies cannot get away with poor environmental practice the way that they used to.

- An understanding of climate change and its impact on the growth of the gas and renewables industries is essential for success.

- Companies like BP and Shell are looking forward 15–20 years. They understand that if the gas industry globalises, it will have a fundamental impact on the structure of the energy industry.

- It is the absence of US companies in the index that says something about the success factor of the issues we have outlined today. These leading European companies are managed in a much more sophisticated way. They have the same capital bases as the US companies, and the same technology, maybe less. It is in the way that they are managed that has helped them produce outstanding results, not just now but also in the foreseeable future.

- Relative to Exxon, the leading European companies have significantly outperformed. However, Exxon is changing. They have gone from being nowhere in the gas industry to second behind Shell and on a parallel with BP in terms of exposure to next generation gas assets. If you look at issues other than climate change such as diversity of workforce, number of females employed, safety track record, R&D, investment in the environment, you see a very different Exxon. One glaring area of omission was on climate change and gas, and there is no doubt in our opinion that they have worked that out and that they are a changing if not an already changed entity.

- Revealing the ultimate truth about company behaviour is almost impossible, especially in countries like Nigeria. How can you penetrate from the outside to really find out what is going on?

- The buy-side community must increase the amount of important it places on these issues in broker polls. Analysts are unlikely to research these issues without being rewarded.

- Companies do not know what the investment community wants. There are too many questionnaires and there is no consistency in the reporting requirements.

Read the full Goldman Sachs report

***Introducing the Goldman Sachs Energy Environmental and Social Index*, can be found at http://www.unepfi.net/stocks/**

Environmental and social issues for the global insurance sector

Volker Kudszus, Associate Director, Insurance Research Analyst, West LB Equity Markets

This presentation was based on the West LB report *Insurance and Sustainability: Playing with Fire*, which can be found at: http://www.unepfi.net/stocks/

The slides for this presentation can be found at http://www.unepfi.net/pensions/

Main points:

After conducting this study, it was clear that there are many links between insurance, climate change, gene tech and geopolitical risk.

- Climate change related claims double every decade. We found the biggest impact is business interruption. The reason most insurers do not care about this if they know that the claims are rising is that most of the business is short-tail business. They can therefore adjust their premiums every year.

- Biotechnology stock prices are highly dependent on possible claims relating to contamination or the discovery of new medicines. Unintentional spread of GM seed into natural seed will be an insurance issue. European insurers are just excluding rather than insuring. At some stage, they will have to price this risk, but without a claims history, that is difficult and expensive.

- The reason for negligible insurance company investment in emerging markets is because of the global principle of congruency. This means that if you are a policyholder in Germany, the insurer must invest in the Euro zone. If the insurer invests in a foreign country, it must make a full hedge. Insurers are allowed to invest no more than five per cent. However, even that is not taken up. Fifty per cent of insurers do not invest in emerging markets at all. The other 50% invest less than one per cent.

- There is investment by European insurance companies in Asia but the capital is either shareholder capital or collected, say, in China from Chinese policyholders. The money of European policyholders is not invested in Asia.

- Since this study, some of our mainstream clients are now becoming more interested in the links between sustainability and financial issues.

- The big reinsurers such as Swiss Re and Munich Re are leading the research in this area. Primary insurers do not have the capability to see all the links. Primary insurers focus on risk exclusion.

- Most insurers have no systematic approach to responsible investment and most do it on a case-by-case basis. Insurers are lagging behind on asset/liability management. Only 12% of European insurers have a working asset/liability model, really measuring this risk and incorporating it.

Responsible investment and fixed income portfolio management

Xavier Desmadryl, SRI Analyst, HSBC

The slides for this presentation can be found at http://www.unepfi.net/pensions/

We are in the pioneering era when it comes to SRI fixed interest and we have much to learn. We have decided to deal with this new asset class because we think it is meeting the needs of our clients. It is true investing in equities is somewhat obvious when it comes to SRI but fixed income can be an interesting alternative, especially in a period of uncertainty for equity markets. This is why we have chosen to take a consistent approach to both bond investment and equity investment.

Main points:

- We wanted to be very rigorous, so our information comes from both traditional sources and by meeting with companies.
- We have chosen to cover a broad fixed income universe including sovereign bonds as well as corporate bonds, embodied by our benchmark, the Lehman Euro Aggregate 500 MM, covering the whole “Investment Grade” spectrum. We thought it was the best way to optimise the risk/return ratio. Consequently we have developed an “ad hoc” analysis methodology for both corporate and sovereign bonds. Governmental emissions are assessed through a proprietary quantitative analysis model using World Bank data.
- If you want to have a quantitative approach, you have to be able to compare countries. We separate the established European countries from the newcomers because they are not on an equal footing. We decided in each sector to have a best-in-class approach and then put an emphasis on those countries with the highest standards in the area of corporate social responsibility. We looked at the attitude of the country towards population, environment and economy.
- We excluded criteria where the issue is controversial or we do not have enough data to integrate it into our model. Ultimately, it is up to the client to decide what is controversial.
- For the less-industrialised countries, we added the eight UN Millennium Development Goals to the criteria.
- At this stage, we do not exclude countries because we are still in the pioneering era and these processes are too new to justify exclusion. Instead, if a country is doing well, we overweight it and vice versa.
- In terms of private companies, we have a restricted universe. Some companies are

screened on these issues by non-financial rating agencies and others are not. After a quantitative filter has been applied based on rating agency information, we then apply an in-house qualitative filter to compare unrated companies with similar companies in their sector.

- We follow a two-stage process. We build an SRI universe and within that, we use a purely financial stock picking process. This is the best way to reconcile the SRI quality and the financial requirement.

- What about where countries hurt bondholders but help their people? To address that issue and combine a high level of financial quality and a high level of "sustainability" commitment, our model uses at least 54 criteria for developed economies (plus 20 additional indicators referring to Millennium Goals for developing countries). This makes our approach very cautious and "non Manichean". When it comes to appraising a country, thirty per cent of the rating is on environment, another 30% on social impacts, 20% on the economy and 20% for the Millennium Goals. We don't exclude countries: we think that underweighting and overweighting is a better approach at this stage.

Michel Ducommun, President, Caisse de Prevoyance du Canton de Geneve

- We have set exclusion criteria for over 10 years on weapons, nuclear, tobacco and gaming, and one year ago, we introduced a GM exclusion.

- We have many different SRI contracts: under and overweighting, best in class. All our contracts now incorporate these criteria.

- We conducted a study and found that we have neither a better nor a worse result from implementing these approaches. We made the choice for other reasons.

- Regarding fixed income, we had not considered it in as much detail as we had equities. If we gave such importance to the social and environmental issues in equity investment, there was no reason not to do so for fixed income.

- We only started in January 2004, so it is too early to make any judgements.

Shareholder engagement: does it make a difference? What are the financial impacts?

Barbara Krumsiek, President and CEO, Calvert

This presentation was a summary of Calvert's paper on the impacts of shareholder engagement. It can be found at http://www.unepfi.net/pensions

Calvert has a long history of shareholder engagement and we were the first mutual fund to file a shareholder resolution in 1986. We were also among the first to disclose our proxy voting guidelines and how we vote. This disclosure is now legally required by the SEC, and we are supporters of that policy.

How do we engage?

1. Dialogue with companies – before an issue gets to a company meeting, we need to talk to these companies first in an effort to encourage consideration of our point of view in advance of any proxy vote.

2. Voting proxies is an important expression of our view on corporate governance and social responsibility at the annual shareholder meetings. We vote all proxies in a way that is consistent with the financial and social objectives of our fund.

3. If there is not a sufficient response on behalf of the company, we will develop shareholder resolutions and go into coalitions with other investors. We use resolutions as a tool that we turn to when dialogue is unsuccessful. Most efforts in compiling shareholder resolutions and bringing them forward have led to negotiated settlements with mutually beneficial results.

We do not own companies that we do not believe in as a socially responsible investor. Therefore, we do not participate with companies on that end of the spectrum. We will not own company solely for the purpose of shareholder activism, though there are many social investment funds that do, and use shareholder advocacy as their primary tool. We own companies because we believe they will deliver both social and financial results. You may not see as much shareholder activity because we own good companies to begin with. This proxy season 2003/2004, we filed 34 resolutions.

Two of the main areas of focus for shareholder activity are:

1. Encouraging sustainability reporting

We have long been advocates of greater transparency and reporting, and encourage

companies to report on social and environmental performance. While we encourage all sustainability reporting, we prefer reporting that uses the GRI guidelines. The greatest barrier to evaluating investments is the availability of data. Sustainability reports greatly facilitate the assessment of environmental and social risk. The GRI has been very useful in this respect. We have been able to withdraw seven resolutions from a number of companies that have supported our requests. The resolutions that were not withdrawn were widely supported by other investors.

2. Promoting board diversity

We drafted a model nominating committee charter, scripting language to consider a broad, diverse slate of candidates for all open board seats. The State of Connecticut adopted this initiative immediately. It was then adopted by the National Association of State Treasurers. In most cases, when we filed resolutions calling for the adoption of the charter, companies accepted the suggestion.

How well does it work? Does it change corporate behaviour? We believe it does.

Some examples:

1. Along with other investors and NGOs, we have worked with GAP over a number of years and they have just released their first social responsibility report, disclosing the way their overseas facilities treat employees. Most factories failed their initial inspection but the fact that they did this detailed analysis is a real plus. Disclosure alone has significant value. Despite the outcome, we applaud that action. We often look for direct outcomes but we have to remember that we are in a process, and this process is aided by this kind of disclosure.

2. Calvert and the As You Sow Foundation achieved a milestone in working with Dell, which became the first US computer company to publicly release a global recycling goal for computer equipment. Years of dialogue led to this result.

What are the financial implications of shareholder engagement?

- One study cited frequently as an example of a positive price performance is the so-called 'CalPERS effect'. CalPERS (the Californian Public Employees Retirement System) has targeted companies with poor financial and corporate governance performance for focused shareholder advocacy. Wilshire Associates studied the 95 companies that were the focus of CalPERS' advocacy efforts between 1987 and 1999 and found they outperformed the S&P 500 index by more than 14% over the five years after appearing on the list, indicating that CalPERS' efforts paid off financially for investors, and for the companies involved. Short of that, there is not a lot of direct evidence that shareholder activism improves price performance.

- However, we are seeing more evidence of links between corporate social responsibility and financial performance. In the US, the Social Investment Forum study indicated that social investment mutual funds had a higher percentage of four or five star ratings from Morningstar versus the mutual fund universe overall.

- Calvert has worked hard to demonstrate that there is no trade-off between financial performance and social performance. The culmination of this was when two of our funds received top recognition from Standard & Poors and Lipper. These funds were being rated against all mutual funds, not just social funds.

- We look at corporate governance as a social criterion. Governance Metrics International did an evaluation of the correlation between corporate governance practices and stock performance and found that those with well above average corporate governance ratings performed significantly above the average.

- Disclosure initiatives have the highest probability of acceptance by the corporate community in moving towards corporate social responsibility. Standard & Poors has produced a study that links transparency and performance showing that investors, all over the globe, are willing to pay a premium for greater disclosure, indicating that greater disclosure is rewarded with a higher stock price.

- However, a true picture of the impact of shareholder engagement on corporate conduct and the financial implications awaits definitive study.

- Generally, coalitions form around particular issues. For 25 years in the US, shareholder groups like the Interfaith Centre for Corporate Responsibility have coordinated shareholder advocacy campaigns on a variety of social and environmental issues. These early coalitions primarily engaged in shareholder activism and set the stage for subsequent activities and organisations. We now have a coalition around climate change and we are working on one around diversity. Where we do not see a coalition, we look to create one. It is an expensive process to do alone – coalitions make that more affordable.

Shareholder Engagement: Morley's Engagement Processes

Luigi Minerva, Company Analyst, Morley

The slides for this presentation can be found at http://www.unepfi.net/pensions/

There are three main steps in our investment process:

1. Define the investment universe

We look at companies according to our sustainability matrix, so we look at the products and we assign a rating from A to E and we look at the management approach and we assign a rating from one to five. Every company that is positioned from C3 upwards is investable for us.

2. Positive analysis

We take a theme and look at those aspects of it that are financially relevant and we estimate the financial impact. This acts as a guide to our stock picking and portfolio construction. An example of such a theme is climate change. We focus on, for example, the impact of the emissions trading directive on key sectors such as utilities and then we come up with some insight on which companies are likely to benefit or be penalised because of this scheme.

3. Engagement

Our engagement process

- For us, there is a strong interdependence between engagement and research. Research on the financial impact of key issues establishes the priorities for engagement. Engagement is a way for us to get inside those environmental, social and corporate governance issues, thereby further improving our research.
- Because we focus on key aspects that have financial impact, we have greater legitimacy as investors to talk to companies.
- Although in the SRI team, we manage less than one per cent of Morley's funds, we have a mandate to engage companies for the whole 110 billion pounds. This gives us a lot of power in terms of voting and in terms of the impact of the engagement on the investment grade of companies, both from the SRI and mainstream ratings.

- Both research and engagement are driven by themes.

Key examples:

- **Burma:** We found there was an operational and political risk attached to companies having a strong presence in the region. We wanted to highlight these risks and advise the companies on how better to deal with the risks. We did not ask companies to pull out. We discussed with them how they might take more consideration of social and environmental issues and better manage risk associated with them. We also pulled together many investors, representing more than 400 billion in assets. This helped significantly in getting more response.

- **Corporate governance:** We put a lot of effort into developing a quantitative approach to corporate governance. After studying corporate governance and financial performance over the last five years using FTSE 350 stocks, we found that there is a positive correlation between good corporate governance and stock return. We prioritised only those factors that we found really matter in driving the stock performance, and we are now able to focus on seven criteria – mostly relating to board independence. We start our dialogues with these 6–7 most important governance themes and then we build from there.

- **Disclosure:** We started a very successful dialogue in 2002 with HSBC. Initially, we were unable to evaluate their lending policies from reading their environmental disclosures. We assigned them a rating that excluded them from our investment universe. After further dialogue with the company, including with its Chairman, they disclosed their lending policy not only relating to social issues but also relating to project finance in emerging markets. In October 2003, we included them in our investment universe.

To summarise, the key three issues of a successful engagement policy are:

1. Interdependence with the research process. There needs to be a flow of information between the two processes.

2. The prioritisation of issues driven by the financial impact, giving the process credibility when engaging with companies.

3. A two-way relationship with companies. We do not just write letters and send questionnaires. Our processes often involve a 2–3 year dialogue.

It is also essential to have the support from people at the top of the engaging organisation.

Shareholder Engagement: Investor Perspective

Raj Thamotheram, Senior Advisor, Responsible Investment, Universities Superannuation Scheme

USS, being a large pension fund, is not convinced about the concept of screening. Our directors (trustees) chose to implement a shareholder engagement approach. The intention was to push responsible investment into the mainstream.

For us, our starting point is not an ethical one – our membership is too diverse to have any common ethical viewpoints. Nor did we not want to make a tokenistic SRI allocation. We wanted to bring it into the mainstream for three reasons:

1. It helps us in managing long-term risks. Institutional investors have not been good at managing absolute risk. Most of the focus is on relative risk. Engagement is one complementary tool to manage absolute risk. It does not reduce short- and medium-term performance, and at a portfolio level, it should increase value.

2. As a universal investor, we own a slice of the whole universe of stocks – so if one company externalises an environmental cost, another company in the portfolio is likely to suffer – it makes no sense when you own both companies.

3. Pension funds are trying to increase the retirement wellbeing of their beneficiaries – it does not help them if we return to them a retirement income at the expense of an environment that is worse to retire into. We can do something about this to a certain extent, which is why our directors have mandated the engagement approach.

Engagement for us means engaging with all the investment interactions to make it mainstream: brokers, companies, and investment consultants.

- **Brokers**

  The broker system is not producing what we need. The system is ripe for change. Brokers suspect that when we talk about these issues, we do not mean it. What we have to do is to get real and put our needs into the contractual process. We also want to avoid niche teams in broker houses but rather for every analyst to cover all material issues in every report. To send an effective signal, investors need to work together and hence USS is keen to work with any investors here today who want to get a more appropriate service from our brokers.

- **Companies**

  A short while ago engagement was a very niche activity. Now it seems everyone is doing

it and has been doing it forever! There is a risk that this will undermine what engagement really is, so we should be open about the challenges and why all fund managers will not be good at engaging.

You need good research about companies to do engagement but research is not engagement. A related issue with traditional SRI funds is that they tend not to engage with the worst offenders because they tend not to own them.

There is also the issue of skills and empowerment. Engagement cannot be done successfully by relatively junior staff and certainly cannot be done without the backing of the heads of organisations.

Traditional corporate governance staff often lack the technical knowledge and worldviews and sometimes the space to operate within their organisational roles to engage on social and environmental issues and vice versa – you need both types of specialists if you are intending to do both kinds of engagement.

Engagement is not new. Mainstream portfolio managers are engaging all the time. So we need to think of engagement by the fund as a whole, not just by the niche team, and therefore what signals are sent. Portfolio managers are rewarded for beating benchmarks and often over short- to medium-term timeframes, so it is almost inevitable that they will send different signals from RI staff. Do we have systems in place to make sure we don't send contradictory signals to company executives?

Most fund managers have not really appreciated how important collaboration is for their pension fund clients and most pension funds haven't told their suppliers! Without collaboration, it is unlikely that responsible investors will have systemic or durable impact, especially on the really difficult issues or where there is a sector/market weakness. Companies can afford to ignore even large individual institutional investors but really cannot do the same with an alliance of large investors.

- **Investment Consultants**

We need to engage them more since they are critical in shaping the investment worldview of many clients and thus the mandates and monitoring processes. USS implemented a project with Hewitt, Bacon and Woodrow which took the form of a competition entitled 'Managing pension funds as if the long term really mattered'. Currently we tend to give the wrong mandates with the wrong evaluation processes, and then try to add on responsible investment as an "end of pipe" solution. That is not an effective approach. It would be better to give mandates which rewarded long-term responsible investing, consideration of intangibles and absolute risk /reward. The Competition surfaced many innovative ideas for how fund managers could be a bigger part of the solution. USS is now working Hewitt to form a "Marathon Club" for trustees who also want to shift the way their funds operate.

Responsible investment in emerging markets

Pedro Angeli Villani, SRI Portfolio Manager, ABN AMRO Brazil

The slides for this presentation can be found at http://www.unepfi.net/pensions/

SRI investment in emerging markets is supported by two propositions:

1. Emerging markets assets can deliver the growth rate that the pension funds from mature markets are so eagerly looking for. This is driven by demographic trends and from the restructuring currently occurring in these markets.

2. Investment in a socially responsible manner is supported by empirical evidence, academic studies and common sense. Because of the lack of information in these markets, there is more inefficiency that investors can benefit from.

On the other hand, there are significant barriers facing SRI investors in emerging markets including that very lack of relevant information on material environmental, social and corporate governance issues. There are also a limited number of companies in some sectors. It is difficult to apply the best-in-class approach where there are few companies to choose from. This is also a barrier to a broad industry diversification in the portfolio.

This lack of information may decrease over time. There is a contribution to be made by many different participants:

- Large companies in emerging markets must take the lead and improve disclosure practices.

- SRI research firms and sell-side brokers should cover at least the large companies. At this time, there is no SRI research service provider for emerging markets.

- Regulation must be improved.

- Pension funds need to define their SRI investment policies regarding emerging markets.

In order to help with this task, I propose a simplified two-step investment process.

1. The investor would focus only on large listed stocks and apply the top-down approach. The screening process would be primarily applied to the country allocation investment decision. The investor would have exposure to emerging markets by investing only in multinationals with global presence.

2. The investor would then focus not only on large listed stocks but also on non-listed

stocks. It would apply the top-down and bottom-up approaches. The screening process would be primarily applied to the stock picking decision. Exposure to emerging markets would be achieved by investing in local players. The whole process would be guided by the industry best-in-class approach. The risk perception would be assisted by a much more in-depth knowledge of the dynamics governing the political and economic environment relevant to each emerging market country included in the investment universe.

Emerging Markets: Investor Perspective

Luiz Carlos Aguiar, Chief Investment Officer, PREVI, Brazil

PREVI is 100 years old and has 140,000 members. By law, it must invest in Brazil.

Main points:

- The Brazilian market is very concentrated. We invest in more than 100 companies. In more than 22 of these, we are part of the shareholder agreement – that means PREVI controls, with other private and public partners, the most important Brazilian companies.
- Because of our strong emphasis on equities, we send a director to the board of directors. It is therefore easier to conduct shareholder engagement. We produced our own corporate governance code and will be launching it at the International Corporate Governance Network meeting in Rio de Janeiro.
- It is important to note that it is not only macro economic variables that must be analysed when looking at country risk. Some pension funds are doing great research on micro economic issues like labour relations and accounting systems that countries are using. We need to understand how the capital markets work in emerging markets.
- Regarding SRI in Brazil, if we start excluding companies, we are going to face problems. What we have been doing for the last 7 years is collaborating on a social responsibility reporting process. We are collecting information on the companies in which we invest to try to focus on opportunities that involve social and environmental projects.
- Regarding the next step, we are going forward with the underweight/overweight model.

Constructing an Emerging Markets Portfolio

Erda Gercek, Emerging Markets Equity Country Specialist, Citigroup

Citigroup's detailed slide show contains most points that were raised in the presentation, along with diagrams and tables necessary to understand the context. It can be found at http://www.unepfi.net/pensions

Citigroup has three main teams that work closely together to construct a portfolio:

- **Country strategists –** produce the country risk
- **Fundamental equity analysts –** produce bottom up analysis
- **Portfolio managers –** build the portfolio using a mechanical portfolio construction tool

The portfolio managers have the ultimate responsibility for portfolios.

We use the Dividend Discount Model. We prepare several years of explicit forecasts, and for the first two years, we prepare a quarterly assessment of the key variables for each country. Country risk is an important determinant.

It is a six-step process. Firstly, we define the country risk premium. Because we use long-term valuation models, we have to use a discount factor. We came up with four variables that best explain a country's long-term sustainable outlook. The model uses historical data to calculate the factor sensitivities and then uses these together with the forward-looking data to come up with the discount rate. We need to adjust for risk because different emerging markets have different risk profiles – this allows us to create a level playing field.

Regarding political risk, what we are interested in is policy implementation and policy direction. Whoever gets into power – if they have the right policies and they can implement them, then we favour them in our model. For example, in Brazil, some thought that Lula's administration was going to have a negative effect. But given his status, he is actually putting the right policies in and he can implement them. We use Political Risk Services, which has a long history and conducts a detailed analysis.

Next we conduct the Alpha ranking. We take the analysts forecast which rank stocks from one to five. Then, we break the MSCI benchmark into a matrix by country and sector. For risk management purposes, we identify the 'critical cells' – that is, wherever the benchmark holds more than one per cent of a country/sector. We then try to populate the critical cells based on the Alpha ranking. We overweight the 'best ideas' by 250 bps, followed by the 'good ideas', which we overweight by 200 bps. If we do not have a 'best idea' or a 'good idea' and it is a critical cell that we need to own for risk management purposes, we use a

‘diversifier’. So in the end, all the critical cells are populated.

We have an advanced risk management system. We constantly manage country risk. The analysts conduct an in-depth analysis to avoid company-level problems. We do not overweight or underweight countries by more than five per cent and sectors by more than eight per cent. The maximum holding of any stock is two and a half per cent above benchmark.

In relation to responsible investment, is not impossible in emerging markets. However, there is no SRI benchmark. There is no critical mass of companies. It was impossible to construct a portfolio because the universe collapses dramatically and then you face liquidity problems.

Q&A

Why is SRI in Japan and US at such different stages of development?

Mr Norimichi Mishima, Joint Managing Director and CEO of London Office, Nikko Global Asset Management

- SRI investment by pension funds is very much in its infancy – virtually non-existent. This is somewhat related to culture. Corporations are very much regionally based. They see their responsibilities as trying to generate as much capital as possible for employees and the local community. As long at the company is making profits for local people, it is difficult to think about other issues.
- Unlike Western countries, normally Japanese do not screen funds for alcohol, tobacco etc. This may be because Japanese culture is very accommodating.
- If you ask investors about SRI, more than 75% say that it is very important, and going forward, they may consider it. The first hurdle to clear is performance. We have 40 SRI funds investing in the Japanese market. At this stage, we do not have a benchmark.

Mary Jane Mcquillen, VP, Social Awareness Investment, Citigroup Asset Management

- In the US, we have a long history of retail investment in SRI, since at least the 1970s. Citigroup AM was one of the first mainstream Wall Street firms to offer and integrate SRI into portfolio management.
- The retail market was the heavy driver of SRI. Historically, they used negative screening. However, now, there is also an increasing institutional base. One of the impediments with the institutional investors is the perception of risk and fiduciary issues associated with SRI. The size of the market according to the only report out there is US$2.3 trillion or 12% of the market. This represents a large proportion of negative screening but increasingly a larger proportion of engagement, shareholder activism and community investment.
- What is interesting is the easy access to shareholder engagement by both individuals and institutions. More and more institutions, whether public or private, have been filing shareholder resolutions. From our observations, this has caused corporate change.
- We have seen many corporate governance resolutions, but increasingly we are seeing social and environmental activism, and the voting response is unusually high. Therefore, companies who are challenged for environmental, human rights or diversity reasons are

now starting to speak to these issues.

- Organisations such as CERES and the Investor Network on Climate Risk helped to bring state pension funds and state treasurers together to discuss what their challenges are, sharing best practices and sharing what works.

On questions of performance

Mary Jane Mcquillen, VP, Social Awareness Investment, Citigroup Asset Management

In terms of performance, we do have a long history and we track ourselves against the mainstream benchmark, and we do not feel we should be regarded any differently from other funds. We feel that over time, through dialogue, research and engagement, we will increase our comfort level in companies in which we are investing. Quantifying the impact is one of the most difficult things to pinpoint. As yet, we have not found anyone who has been able to say that there is definitely a quantifiable impact.

Aslak Skancke, Head of SRI, Storebrand

We have managed SRI funds for 10 years and our approach is quite rigorous. Over time, the performance is as good as, and sometimes better than, traditional funds. To prove things beyond that will not be possible. It is our experience that you can go quite far in introducing SRI criteria without sacrificing performance as long as you have a profession team of managers.

Other comments

Raj Thamotheram, Senior Advisor, Responsible Investment, Universities Superannuation Scheme

I worry about defining “success” on the basis that we have X per cent of the market in SRI funds. A lot of these funds are simple screened funds – often just tobacco. Surely, we need to be thinking about capital getting to emerging markets in a way that stabilises globalisation. A screened fund doesn’t do anything about the signals investors send to CEOs that encourage them manage the “number” every quarter and externalise costs onto their workforces and communities.

From the perspective of a universal investor, we need to be careful about making two simplistic assumptions about SRI:

1. The more SRI funds, the more responsible the market. I do not believe this is inevitable – indeed if it means that there is less attention to what the mainstream does, it may have the opposite effect.

2. The only way to validate SRI is by showing that it leads to adding value against benchmarks. But this doesn't address absolute risks or returns or matters which affect the whole portfolio.

On mainstreaming consideration of social and environmental issues and why pension funds need to invest in emerging markets

CARLOS JOLY, Co-Chair, Asset Management Working Group; Storebrand

- The intent of the AMWG has been precisely to try to mainstream the recognition and develop the tools so one can consider and then integrate certain social and environmental issues into the investment process. What we are doing with brokers has nothing to do with niche products. We are about enriching research and performance by taking more cognisance of those factors that lead to long-term value.

- Why should pension funds need to increase their exposure to emerging markets? It is clear that the demographics of mature economies of Europe are such that we are seeing a great increase in older people and not a great increase in populations at large.

- Since there is no great demographic growth, and older people tend to consume less, the growth in mature economies is not sufficient to support the corporate earnings growth that is required to produce the level of earnings. European funds have reached saturation level in terms of risk exposure to the US. So where does that leave us? Emerging markets. Currently, we have less than half a per cent of the five per cent that is legislatively available for say UK pension funds to invest in emerging markets. Therefore, there exists a need and there exists a gap.

- I would like to see much more creative thinking on the part of major financial institutions to develop appropriate instruments for pension funds to invest in bonds and equities in some of the larger emerging markets. This is a greater challenge and answers the question: what is sustainable investing in the 21st century, rather than asking whether 11 or 12 or 20 per cent of assets screen.

Rob Bauer, Head of Research, ABP Investments

We prefer the long-term shareholder value model because we are a long-term investor. We see social and environmental risk as something that influences the long-term returns of fund.

To close our eyes to all these environmental issues would not be wise and we may even breach our duty.

Regarding performance, I did a study on SRI mutual funds two years ago in the US, UK and Germany looking at more than 100 funds. We compared them with the returns of conventional funds. The result was that both SRI and conventional funds did worse relative to their benchmark. That is what we expected. Management costs were the reason they underperformed. The question always comes up, 'does SRI add value?' Well, you do not ask the same question to conventional fund managers. Regarding the results, the people who like SRI quote, 'it does not cost money' and the people who do not like SRI quote, 'it does not add value'.

Ariane van Buren, CERES / Investor Network on Climate Risk

Regarding mainstreaming, what we did at the summit in November 2003 at the UN was to consider climate risk as a purely financial issue, not as a social, environmental or ethical one. We got together over one trillion dollars of investors. Forty-six people signed the convening letter as trustees. They then instructed the CEOs of their fund managers to be in the room. The question is how are these issues going to affect the portfolio. This is now being developed in Calpers and the other major funds asking the fund managers to report to them on their capabilities for this research and then to do it later this year. There will be another summit in the spring of next year with UNEP FI on how to join our work together on the US side.

Volker Kudszus, Associate Director, Insurance Research Analyst, West LB Equity Markets

Just a perspective from the sell side: we do whatever the buy-side wants. Therefore, it is crucial for us to get votes and be on broker lists because we made the effort to provide SRI research. If it is not mainstream on the buy-side, it will not be mainstream on the sell-side.

Raj Thamotheram, Senior Advisor, Responsible Investment, Universities Superannuation Scheme

I would like to ask one thing of UNEP FI. There is a very important issue to be explored regarding globalisation, the future of emerging markets and the benefits to members of pension funds from developed countries. Put simply, does it matter to these members whether emerging markets do or do not succeed? Answering this question is beyond what one pension fund, fund manager or consultancy can do. It's a project that needs to be undertaken by the World Bank, the OECD or another such high-level organisation. Could UNEP FI help make this project happen?

Closing Remarks

Monique Barbut, Director, Division for Technology, Industry and Economics, UNEP

The Materiality report has been a 15-month project and it is clear that we have forged a relationship between UNEP and member companies from the world of asset management. It is clear to us that this partnership is showing evidence of establishing links between environmental, social and corporate governance issues and the world of business.

We believe that integrating sustainability and governance issues into investment decisions not only mitigates investment risk but also opens new windows of investment opportunity. New inventions like fuel cells, new regulations like emission trading schemes and better management and strategic decision-making for a complex world will give responsible companies and edge in the market place. And you have a role to play.

Investors will benefit from rewarding those companies acting early and embracing the discipline of sustainable development and better governance. We believe these new tools combined with better research will ensure less long run risk for investors and the people whose pensions they safeguard.

However, the investment community can do better.

Many trustees and investors do not pay sufficient attention to the evidence that improved management of environmental, social and governance risk makes good investment sense.

At UNEP, we are committed to working with investors, brokers, and governments to break down these barriers. Following the success of today's meeting, UNEP is keen to explore with pension funds and asset managers a process to link like-minded investors and policy makers around the world in an effort build true momentum supporting responsible investment. The world of project finance has the Equator Principles, a set of voluntary standards covering environmental and social management in projects exceeding US$50 million. Twenty-three banks, 18 of them members of UNEP FI and representing more than 80% of global project finance have adopted the principles.

UNEP firmly believes that there should be a process to develop a similar best practice for the investment community to assist them with the challenges and opportunities of responsible investment. Such a public-private exploration, convened by the United Nations, could roll out investor and pension fund roundtables around the world, develop research and training and build a network of institutions and advisors to discuss and raise awareness of issues surrounding responsible investment. Such a network would work with the nationally based associations of pension funds as well as groups like the ICGN and the INCR. There are many different options.

For those participants who wish to continue the dialogue, UNEP would be very happy to bring the convening powers of the United Nations to facilitate such a process.

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