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SRI & ESG Inclusion : Does it pay after all ?

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ANBID / UNEP FI Roundtable:

Private Banking and Sustainable Investment in Emerging Economies

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Market background - summary

- **Breakdown of the market**
  - Market for SRI products globally is estimated to be at least $3 575bn
  - 63.5% of this is in the US,
  - In the US SRI AUM account for approximately 9.5% of total FUM
  - 34.2% of the market is in Europe
  - ***An emerging topic in emerging markets*** : Asia and GEM = less than 1% AUM

- **Trends**
  - Historically dominated by negative screening : US, UK …
  - Most of the growth is in positive screening and best in class
  - Although in some markets these are combined with negative screens
  - There are significant regional differences
  - This means a "one size fits all" approach is unlikely to be successful
  - The market is clearly lead by big institutions like Pension Funds : Calpers, Calsters, Swedish AP Funden, PGGM, ABP, USS …

SRI market - main features and regional differences

US	**Wide range of approaches**, from basic negative screening through best in class and positive screening, advocacy to community investing
UK	**Historically negative screening** but new funds concentrated in best in class/positive screening products. Many of these retain some elements of negative screening. Best in class/positive screening greater share in retail market and less in institutional
France	**Bias to social and community issues.** Dominated by best in class
Other Europe	**Many differences between countries** e.g. Germany and The Netherlands environmental bias, Scandinavia well developed, sharing funds in Spain
Asia – Japan	**Asia – Japan also environmental bias**, Hong Kong dominated by global funds. Interest in Singapore

UN Principles for Responsible Investment : Institutional investors lead the way to mainstreaming

PRI Principles for Responsible Investment

PRI launched in April 2006 by UN Secretary General

"The Principles provide a framework for achieving better long-term investment returns, and more sustainable markets. They offer a path for integrating environmental, social and governance criteria into investment analysis and ownership practices. If implemented, they have tremendous potential to more closely align investment practices with the goals of the United Nations, thereby contributing to a more stable and inclusive global economy".

January 2007

Significant and growing support: 151 signatories. **Representing > US$6 trillion.**

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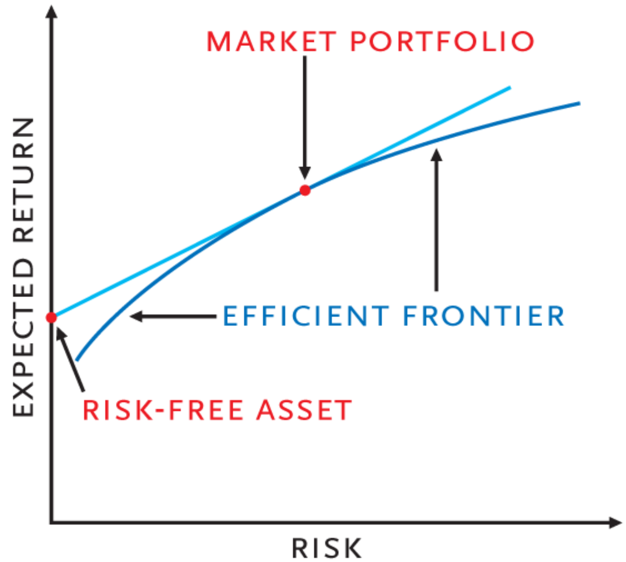
But, according to Markowitz Theory SRI should structurally underperform …

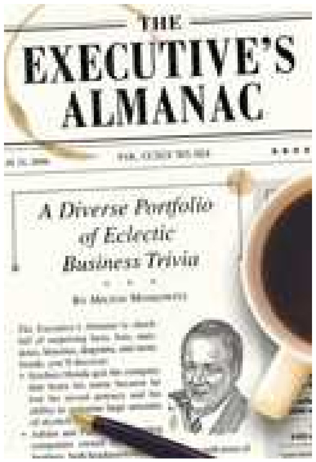
- **1952 : Markowitz theory proposes**
  - How rational investors will use diversification to optimize their portfolios,
  - How an asset should be priced given its risk relative to the market as a whole.
- **The basic concepts of the theory are the**
  - Efficient frontier
  - Capital Asset Pricing Model
  - Beta coefficient
  - Capital Market Line and Securities Market Line.



According to this theory

If markets are efficient the CAPM model should demonstrate the **underperformance of any restricted asset management style** such as ethical or SRI investment approach. Indeed, a restricted investment universe should lead to a **lower diversification** potential, thus a **higher risk exposure**

Hopefully Moskowitz is stating SRI could lead to some kind of "virtuous circle"



- **1972 : Moskowitz states**
  - *"social performance of corporations can be influenced by capital markets responding to pressures from investors and customers who perceive new goal for their money."*
  - *"while corporations have long been under a variety of pressures to meet their social responsibilities, they are now faced with the possibility that their publicly traded shares will be bought or dumped on the basis of their actions or inactions on this front."*
  - *"socially investments need not, of course, be unsound financially. To the contrary, the argument has been made that the socially aware corporation possesses the special sensitivity that will enable it to surpass peers."*

- **From intuition to theory**
  - The idea enhanced extra financial integration and stakeholders transparency provide investors with higher level of valuable information not yet identified by the market.

According to this theory

High level of information quality **can improve investors' decision making process** thanks to a better understanding of companies issues and opportunities.

In addition, the traditional “market icons” have different points of views

1. **CSR as a business opportunity driving a competitive advantage**

ESG positively seen as a caution for **reputation** protection

« It takes 20 years to build a reputation and five minutes to ruin it. » **Warren Buffet**.

2. **CSR as an obstacle to capitalism, generating additional and useless costs**

Milton Friedman. (The New York Times Magazine, 1970) shares these views, to say the least …

« The discussions of "social responsibilities of business" are notable of analytical looseness and lack of rigor. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society… »

« There is one and only one social responsibility of business : to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without fraud. »

This controversy generated a **huge** academic research …

Around 150 research pieces published since the early 70s

Nehrt (1996), « Timing and intensity effects of environmental investments »

Dowell, Hart & Yeung (2005), « Do corporate global environmental standards create or destroy value ? »

Wolf & Curcio (1996), « Corporate environmental strategy : impact upon firm value »

Capon, Farley & Hoenig (1990), « Determinants of financial performance : a meta-analysis »

DiBartolomeo & Kurtz (1999), « Managing risk exposures of socially screened portfolios »

Blank, Herbert & Carty (2002), « The eco-efficiency anomaly »

Abramson, Lorne & Dan Chung (2000), « Socially responsible investing: viable for value investors ? »

Derwall & Koedijk (2005), « The performance of socially responsible bond funds »

Angel & Rivoli (1997), « Does ethical investing impose a cost upon the firm ? A theoritical examination »

King & Lenox (2000), « Does it really pay to be green ? An empirical study of firm environmental and financial performance »

Brown & Caylor (2004), « The correlation between corporate governance and company performance »

Dimtcheva, Morrison & Marsland (2002), « Green with envy »

Dimtcheva, Morrison & Marsland (2002), « Boxing against green shadows »

Goyen & Beal (1999), « To invest or to donate – an investigation of the characteristics of some green investors »

Feldman, Soyka & Ameer (1996), « Does improving a firm's environmental management system and environmental performance result in a higher stock price? »

Barth, McNichols & Wilson (1995), « Factors influencing firm's disclosures about environmental liabilities »

Fogler & Nutt (1975), « A note on social responsibility and stock valuation »

Drobetz, Schillhofer & Zimmermann (2003), « Corporate governance and expected stock returns, evidence from Germany »

Derwall, Guenster, Bauer & Koedijk (2005), « The eco-efficiency premium puzzle »

Garz, Volk, Gilles (2002), « More gain than pain – SRI : sustainability pays off »

Gond (2006), « Construire la relation (positive) entre performance sociétale et financière sur le marché de l'ISR : de la performation à l'autoréalisation ? »

And this is just a small sample …

… Producing interesting but diversified results

Key Finding

Neutral trend overall which implies that <u>SRI does not under perform</u> !!!

But question remain unsolved

- Comparing different approaches, SRI styles, in various business zones appears to be extremely difficult
- In addition it's difficult to rely on truly robust data series as SRI, in most cases is pretty recent
- Many surveys focus on pure sector exclusion (alcohol, gaming, weapons, tobacco, pornography and even some times oil & gas) which is indeed dangerous according to Markowitz theory
- In additions, what is working in some markets appears to be less efficient in others depending on "level of market recognition" ?

The quest for this financial Holy Grail continues

AMWG has embarked with Mercer Investment Consulting into an academic ESG research overlook to be released before the end of this year.

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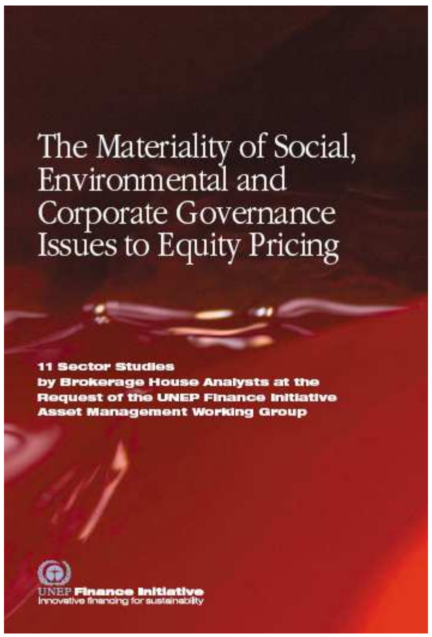
In addition the brokers community is publishing compelling ESG-related research



***The Materiality of Environmental, Social and Governance issues to Equity Pricing,* Launched in 2004**

- ✓ Objective: Identify and quantify the potential impact of Environmental, Social and Governance (ESG) issues on stock pricing
- ✓ Based upon research from major brokerage houses :ABN AMRO Equities, Deutsche Bank, Dresdner Kleinwort Wasserstein Europe, Goldman Sachs HSBC, Nikko, Citiroup, Nomura, UBS, West LB
- ✓ Conclusion: Overwhelming evidence that ESG issues are material to portfolio investment value
- ✓ Downloaded over 100,000 times

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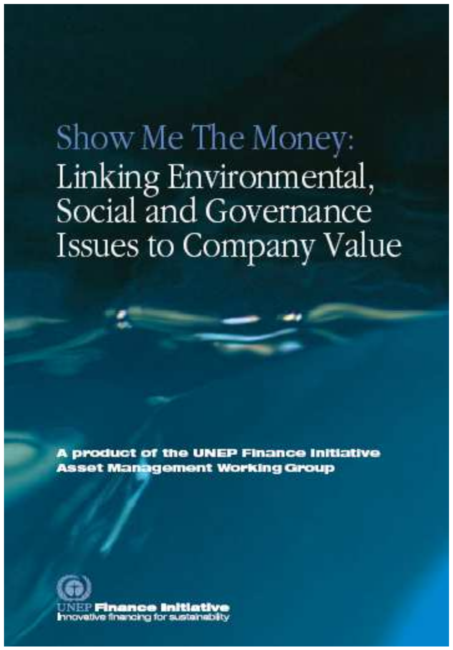
And UNEP FI AMWG keeps on searching for ESG materiality



***Show Me The Money: Linking Environmental, Social and Governance Factors to Company Value*, Second Materiality Report, July 2006**

- ✓ Involvement: 22 financial services firms, including sell side research houses, asset management firms and an investment consultancy. The most salient factors have been extracted from more then 1000 pages of financial analysis across 8 sectors
- ✓ Objective: To unequivocally link Environmental, Social and Governance issues to financial value, using financial analysis tools and metrics
- ✓ ESG issues are material – there is robust evidence that ESG issues affect shareholder value in both the short and long term
  - ➢ Over the course of our research, analysts have presented significant evidence of the positive and negative impacts ESG issues can have on share price across multiple sectors
- ✓ The impact of ESG issues on share price can be valued and qualified
  - ➢ Of the analysts' research provided for the project, 9 reports had evidence of a link to materiality, of which 6 were explicitly quantified
- ✓ Key material ESG issues are becoming apparent, and their importance can vary between sectors
  - ➢ The reports submitted begin to describe an emerging taxonomy of ESG risk categories. Additionally, there are issues that are uniquely important to certain sectors

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At the stock level some companies can be obvious sustainability leaders & Winning bets at the same time

ScottishPower

3 year track record

(Source Multex Reuters, January 2007)

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Business Overview

- Scottish Power plc (Scottish Power) is an international energy business registered in Scotland.
- The Company provides electricity transmission and distribution services in the UK; supplies approximately 5.25 million electricity and gas services to homes and businesses across the UK, and operates electricity generation, gas storage facilities and associated energy management activities in the UK, Ireland, the United States and western Canada.
- It operates through its continuing businesses: Energy Networks, Energy Retail, Energy Wholesale and PPM Energy. The Company's PacifiCorp operations were divested to MidAmerican Energy Holdings Company on March 21, 2006. On Nov 28, Spain's Iberdrola launched a friendly bid valuing Scottish Power at EUR 20 Bn.

Sustainability key points

- Scottish Power is a **leading developer and operator of renewable energy in both the UK and the US** : the company aims to increase its renewable energy capacity, mainly through windfarm development, to 1,000 MW in the UK by 2010 and to secure at least 2,000 MW of new renewable capacity in the US. **The company is the UK's leading supplier of green energy products**.
- Regarding climate change, Scottish Power is making progress towards its goal of reducing CO2 emissions. **It has invested in high efficiency gas-fired plant and wind power**. Reducing the carbon intensity of its operations is an on going progress : **the Group CO2 per GWh emissions for electricity generated declined 3.6% against the previous year**.
- **Health and Safety** is another major focus for Scottish Power : one of the five pillars of Scottish Power leadership model. As a result, the Group-wide lost-time accident rate fell from 0.63 to 0.61 per 100 employees.

(These examples are provided for illustrative purposes only and no assurances are provided regarding future performance or results)

Some Small or Midcaps can also benefit from their sustainable development committment

3 year track record

(Source Multex Reuters, January 2007)

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Business Overview

- SolarWorld AG is a Germany-based company that researches, develops, produces and sells solar power technology products.
- The business operations are divided into five units: water and raw materials, solar material, cells, modules, and trading. The water and raw materials division is managed by the subsidiary Deutsche Solar AG. The division's main activities are the production of solar wafers from solar-grade silicon and the safeguarding of supplied of raw materials. The Solar Material division is responsible for processing and recycling raw materials. The Cell division is the subsidiary Deutsche Cell GmbH, it produces solar cells from solar silicon wafers. The Module division interconnects solar cells into larger units. The trading division is operated by Solarworld AG and is responsible fo the sale of solar modules and kits for complete solar power stations.

Sustainability Overview & Environmental +

- **By essence, SolarWorld AG activities are environment-friendly**. Being a major provider of solar energy production equipments : silicon wafers, solar cells and solar modules. Solarworld is one of the only companies with a credible presence at all stages of solar energy value chain including a direct access to raw silicon thanks to its joint venture with Degussa.
- The company has also managed to develop an **environmental friendly process** as it recycles silicon and solar by-products, enabling to minimize the use of raw materials. We consider this policy to be really sound as it results into cost effectiveness.
- The Group has been able to establish itself as the quality leader in the international solar power market. Consequently we can consider **the whole Solarworld, as an environment friendly company**.

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Appendix

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Sustainable Development and SRI: Definitions

What is Sustainable Development?

- *"A development which enables present generations to satisfy their needs without threatening the ability of future generations to satisfy theirs"* *

It is built on 3 pillars

- People: consequences on employees, clients, suppliers, local communities
- Planet: analysis of the impacts of companies and their products
- Profit: financial performance, but also ability to contribute to economic development

What is CSR ?

- CSR stands for Corporate Social Responsibility
- The implementation, on a corporate level, of the three pillars of sustainable development

* Source: From the Brundtland Report to the United Nations World Commission on Environment and Development, 1987

SRI and its Approaches

What is SRI ?

- SRI stand for Sustainable & Responsible Investment
- An investment strategy that takes into account a company's performance in the three pillars of sustainable development, in addition to its financial performance, when selecting and managing investment portfolios
- SRI includes numerous, varied approaches:
  - Ethical
  - Negative screening
  - Positive screening
  - Best in class
  - Engagement
  - Shareholder activism