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# CORPORATE Finance REVIEW

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# SRI—PASSING FAD OR AN INVESTMENT APPROACH ON THE RISE? SUSTAINABLE AND RESPONSIBLE INVESTMENT OUTPACES MOST TRADITIONAL INDEXES AND EQUITY RETURNS DURING DOWNTURN

Can an investor do well financially by investing in companies that do well in their financial and extra-financial performance? The latest survey of asset owners and managers adopting ESG/ Sustainable and Responsible Investment answers **yes**.

Call it a style (as "value" and "momentum" are styles of investing), a framework, a prism for viewing potential holdings, or an investing discipline—whatever the unsettled identification may be, *sustainable and responsible investment* (SRI) is gaining favor with a growing base of asset owners and professional money managers. Let's call it an *approach* for now. While some other styles of approaches of investing may have faded in popularity or in the volume of transactions in the Great Recession of 2007–2010, SRI gained appreciably in popularity with institutional and individual investors, and part of the reason may be the outperformance of these types of investments as compared to some traditional and better-known investment benchmarks.

The Social Investment Forum, the trade association for SR investors in the United States, charts the approach among institutional investors and money managers every two years. In the period just before the financial crisis, the year-end 2006 value (Assets Under Management) for all SR investments in the U.S. was $2.7 trillion. Fast forward two years through the Great Recession, and the year-end AUM for SR investments was at $3.1 trillion (the AUM at year-end 2009).

Compare this to the experience of hedge funds which were valued in total at $1.5 trillion AUM in November 2010—a decline of almost 30 percent from the $2.1 trillion AUM of 2009.

During the 2008–2009 period the S&P companies had basically flat growth while SRI assets grew by 13 percent. Today, based on the survey of asset owners and managers, SIF estimates that $1 in every $8 invested in the U.S. follows the SRI approach. (SIF estimates are 12.2 percent of the $25.2 trillion in total AUM as tracked by Thomson Reuters Nelson.)

## SIF survey results

Social Investment Forum (SIF) in its "2010 Report on Socially Responsible Investing Trends in the U.S." (issued November 9, 2010) reported this:

- Total SRI AUM grew by 13 percent, 2007 to 2009 year end(s).
- Investors were using multiple strategies (adopting ESG approach to asset management, $2.5 trillion of the total; shareholder advocacy, $1.5 trillion; community investment, $42 billion).

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- Institutional ESG assets totaled $2.03 trillion, dominating the SRI approach in the U.S.; money managers were next, with $691 billion AUM.
- The majority of assets were held in mutual funds; data on ETFs were not available.

SR investors generally agree that there are three elements of the SRI approach: (1) negative screening, avoiding, or eliminating certain companies because of the nature of their operations (such as tobacco and weapons); this was the earliest forms of SRI; (2) shareholder advocacy, to pressure companies in portfolio to change behaviors and actions (a significant activity for many investors and the means by which corporate managers may first come into close contact with SR investors); and (3) community-based investment.

Issues in focus for advocacy-inclined investors especially included the nation of Sudan and allegations of genocide being conducted there by the national government. Many investors think the actions of the government are being supported by public companies, and especially oil companies operating there. Also, the issue of companies marketing tobacco remains a critical concern for some shareowners. A corporation's record in environmental performance is of concern to many SR investors. Other shareholder concerns include manufacture and sale of weapons; the record on labor rights and human rights; corporate governance policies; product safety and product stewardship; and healthcare and pharmaceutical marketing concerns.

Money managers surveyed reported using a variety of strategies, including negative screening "out" of companies; positive screening "in" of issuers; the integration of the two; selection of ESG best-in-class companies; and using multiple strategies within mutual fund families under management. Eight out of ten managers (80 percent) reported that client (the asset owner) demand was the major factor in incorporating ESG factors in decision-making. One-quarter cited current or pending legislation. About half of respondents considered risk management factors. Other responses included "mission-related" (58 percent); return (50 percent); and social benefit (60 percent).

Looking at institutions, the ESG AUM totaled $1.5 trillion in 2005; $1.8 trillion in 2007; and $2.0 trillion at year-end in 2009.

## Shareholder advocacy and corporate engagement

Shareholder advocacy and corporate engagement for dialogue was reported to be steadily rising among SR investors. While the number of proxy resolutions filed and voted on declined slightly from 2007 (187) to 2010 (January–August, 164), the number receiving 30 percent support or total shareholder support increased from 30 to 50 voting outcomes.

What issues are in focus for proxy resolution filers? The largest issue over the 2007–2010 period was corporate political contributions, followed by climate change and the environment. "Sustainability" came into focus more sharply during this period. Global labor standards as an issue of concern is on the rise as corporate supply chains became more globalized. This brings into focus a company's operations in distant lands and compliance with U.S. laws (such as the Foreign Corrupt Practices Act—FCPA), and local laws and regulations.

## Growing popularity of SRI

Engagement with corporate issuers is an important consideration for a growing number of money managers:

- Asset Managers representing $1.5 trillion (total) AUM say they engage in dialogue with corporate executives and boards and when dialogue fails, file and co-file proxy measures (200 institutions including: public pension funds, labor funds, religious and faith-based investors, and foundations).
- Institutional managers representing $740 billion AUM say they engage.
- Included in the SRI universe are 725 investment vehicles with almost $700 billion AUM. There are 250+

mutual funds with individual and institutional shares in 65 families holding $300+ billion—a 45 percent growth in holdings since the 2007 report.

- The growing popularity in the U.S. of Exchange-Traded Funds (ETFs) includes SRI focus; there are 26 ETFs with a total of $4 billion AUM. This is the fastest growing area of all investment vehicles, and ETFs to date account for only 1 percent of AUM following ESG approaches—meaning there is much room for growth in this category of adoption of SRI ESG approaches.
- Among state and municipal pension funds, holdings are $1.46 billion, and now subject to ESG approaches (these include large funds, such as the New York State Common Fund). Many legislatures are now mandating mission-related investment, enhanced returns, and better management of risk—all considered to be characteristics of successful ESG investment.
- More than 770 companies with 401(k) plans for employees offer ESG investment selections.
- Community investment is on the rise (the third leg of SR investment), moving from $25 billion in 2007 to $42 billion at 2009 year-end. Community Development Financial Institutions (CDFIs), sponsored by the U.S. Treasury Department, are a major factor.
- Trend line: increasing numbers of owners and managers are involved in shareholder networks and coalitions (these include the Investor Network on Climate Risk, managed by the Ceres coalition).

Three basic SR investment strategies are regularly measured and evaluated in the SIF biennial surveys:

- The factoring of ESG in investment decision-making (environmental performance, social issues, and corporate governance factors—the ESG);
- The engagement with corporations and where engagement fails in the view of the shareholder, the filing of ESG-focused shareholder-sponsored proxy resolutions;
- Community-focused investment (which take a variety of forms, depending on the investor; mechanisms exist to facilitate local investing such as the U.S. Treasury Department approved, and supported Community Development Financial Institutions—CDFIs).
- Both quantitative and qualitative behaviors are examined (as "strategic" investor or asset manager behaviors).

The SIF has been measuring investor involvement in SRI strategies since 1995. In the 2009 survey effort the questions were posed to investment companies and money managers (involved in mutual funds, Exchange-Traded Funds, annuities, closed-end funds, pooled accounts, and separately managed accounts) about public pension funds; foundations; university endowments; faith-based institutions; labor unions, venture capital; private equity; and not-for-profits.

Independent third-party data were also considered, including that of Institutional Shareholder Services, part of RiskMetrics Group (owned now by MSCI, the global index providers); Thomson Financial; Lipper; the Money Management Institute; Investment Company Institute (the U.S. trade association of mutual funds); The Corporate Library (board governance researches); and others.

Consider the pace of growth over the period since the first report was prepared:

- First survey results: 1995—$639 billion AUM in "responsible investments" ($1 in $10 AUM base of U.S. capital markets). Survey looked at 1993-1995 results, two years after end of South Africa "Apartheid" movement among SRI professionals.
- 1997 report—$1 trillion mark reached ($1.25 trillion total AUM, 1995 to 1997 investment results).
- 1999 report—$2 trillion mark passed (AUM to $2.16 billion from 1997 level of $1.185 trillion).

- 2001 report—$2.03 trillion mark (AUM increased from $1.49 trillion in 1999 to 2.03 trillion in 2001).
- 2003—AUM reaches $2.18 in core SRI assets.
- 2005—the 10-year review—$2.29 trillion AUM using screening, shareholder advocacy, or community investment—up from 2.18 trillion at the end of 2003.
- 2007—$2.7 trillion mark reached—capital markets downturn begins with seizing of credit auction market early in the year.
- 2009 year end/2010 report—$3.07 trillion total AUM.

Social Investment Forum staff and members assert that Sustainable and Responsible Investment, and adoption of ESG performance evaluations and criteria drive outperformance in varying capital market environments. More than 20 academic studies support this position in terms of SRI mutual fund performance vs. the general market and leading traditional fund returns.

Third-party providers of investable and benchmarking (tools) indexes have recognized the growing popularity of the SRI/ESG approaches to investing and are providing many choices for individual and institutional investors. These include Dow Jones ("Sustainability Indexes," as created by SAM Group of Switzerland); FTSE/KLD (Financial Times Group and KLD/RiskMetrics a unit of MSCI, the global index providers); NASDAQ OMX (the CRD Global 100 Sustainable Index approved for trading); and several other providers.

## Standing the test of time

The growing universe of SR investors eagerly awaited the outcome of the latest survey of asset owners and managers to gauge the impact of professional investors and fiduciaries during the severe market downturn of late—2007 through 2008 and 2009. Would SRI fade in popularity with declining share prices? Would investors "flee" to safer equity investments (whatever those might be)? Is SRI a passing fad? The answers revealed in the 2010 release of the SIF biennial survey were quite reassuring to those embracing SRI approaches. Not only did AUM remain steady, the asset size grew and many more professional money managers adopted SRI/Sustainability/ESG approaches (some adopting multiple styles and methods, the survey pointed out).

For corporate finance managers, the survey results underscore the growing importance of ESG (environmental performance, the "E"; company positions on a range of social or societal issues, the "S"; and the company's corporate governance policies and practices, the "G"). Corporate governance issues have been in sharper focus for a decade or more now, surely since passage of Sarbanes-Oxley in 2002. The widening delta of related issues and corporate performance against the expectations of SR investors has raised the level and intensity of dialogue for many public companies with their investor base.

Corporate finance managers will be hearing from SR investors in the coming months as the 2011 (and 2012) proxy campaigns roll out and issues come into clear focus. ■