

wealthy conscience

tobacco, weapons, child labour, shady executives: some investors think these things are bad enough to avoid while others are not as concerned. In the pension world, avoiding the bad stuff used to be called ethical investing, and then socially responsible investing (SRI). These days, the term environmental, social, and corporate governance (ESG) is making waves, even at the United Nations.

Call it what you will, but socially responsible investing is no longer just about the so-called “sin stocks.” It’s now about integrating much broader ESG considerations like climate change and human rights into everyday investment decision-making, and taking an advocacy role in the business management affairs of public corporations. And despite the ethical considerations, ESG can help plan sponsors reduce some portfolio risks and possibly enhance returns.

Most corporate pension plans that are not yet wholly adopting SRI in portfolio construction are already applying the wider principles of ESG by becoming more actively involved in shareholder advocacy via their fund managers.

“On the pension side, we’ve been seeing more and more interest in socially responsible investing, but mostly among large public pension plans,” says

Socially responsible investing is good for society. But the combination of risk and return is enticing some of the larger public pension plans.

By Domenic Monteferrante and Richard Nino

Paula Glick, director of sales and marketing at Jantzi Research in Toronto, a firm that evaluates and monitors the ESG performance of Canadian securities. “But there’s been no big bite on the [private] pension side.”

“Only a handful of corporate plans are looking at SRI,” says Jane Ambachtsheer, global head of Mercer Investment Consulting’s responsible investment group in Toronto. Most interest has been coming from large public pension plans, universities, endowments, and foundations, she says.

Many signs point to a continued growth of SRI assets. In Canada, the Toronto-based Social Investment Organization (SIO) estimates there were \$65 billion in total assets managed using socially responsible guidelines at June 30, 2004, up from \$50 billion in 2000. Out of this \$65 billion, \$21 billion was related to assets managed for institutions and high net worth clients. In the U.S., the Washington, D.C.-based Social Investment Forum reports that assets invested in SRI strategies

rose by more than 250% over 10 years, reaching US\$2.3 trillion in 2005. Of this amount, US\$1.5 trillion was invested by institutional clients.

“It will take years” to get corporate pension plans to follow in the steps of their public plan counterparts, says Ambachtsheer. Greenwich Associates, a financial services consulting and research firm, last measured the demand for SRI among institutional investors in Canada in 2004. They found only one per cent of institutional investors used SRI funds and another one per cent were planning to start doing so. More discussion is needed on why responsible investing makes sense and more case studies are needed showing how ESG issues contribute to risk and return, says Ambachtsheer. Add in greater media attention, and then you have the elements needed to get more corporate pension plans interested in starting to think about ESG, she says. “The key is getting early adopters,” says Ambachtsheer, “and we’re well on our way.”

the principles for responsible investment

More than 20 large institutional investors from 12 countries drafted and signed the Principles for Responsible Investment earlier this year under the auspices of two United Nations agencies. Signatories now include 44 institutional investors representing US\$2 trillion of assets and 47 fund managers managing US\$3 trillion of assets. The principles are:

- ✓ We will incorporate ESG issues into investment analysis and decision-making processes.
- ✓ We will be active owners and incorporate ESG issues into our ownership policies and practices.
- ✓ We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- ✓ We will promote acceptance and implementation of the Principles within the investment industry.
- ✓ We will work together to enhance our effectiveness in implementing the Principles.
- ✓ We will each report on our activities and progress towards implementing the Principles.

Source: UN Environment Programme Finance Initiative and UN Global Compact

THE DRIVERS

Large public pension plans have always been the real drivers on business advocacy issues in Canada because they typically represent members whose wider agenda is to facilitate corporate change. These plans' interest in ESG issues is a natural extension of their advocacy role.

Several public pension plans in Canada, including the Canada Pension Plan Investment Board (CPPIB)

and the Caisse de dépôt et placement du Québec (CDP), have taken the lead in socially-responsible investing and signed the UN's Principles for Responsible Investing created this past spring. The CPPIB and the CDP have also established their own formal ESG policies, says Ambachtsheer.

A survey of 40 Canadian fund managers by Mercer in late 2005 found that 35% of fund managers expect an increase in client demand by 2008 for the integration of ESG analysis into everyday decisions. And 35% of fund managers also expect more demand for specialty products built on ESG. Over half the fund managers predict that active ownership will become a mainstream practice by the end of 2007, with 85% seeing this phenomenon happening by 2010. Active ownership includes shareholder engagement and activism, as well as proxy voting.

Globalization, corporate governance, climate change, and clean water are the ESG factors most likely to be considered by Canadian fund managers in their investment decision-making in 2010, according to Mercer's survey.

In the U.S., a 2005 Mercer survey of 183 plan sponsors found that 22% invest in SRI, with another 6% planning to do so by the end of 2007. This despite 73% of sponsors saying that ESG factors can impact investment performance.

PERFORMANCE CHECK

How well are managers actually working with ESG factors? Mercer rated 30 global managers last year and found that almost half of them demonstrate above-average capabilities to integrate ESG factors into their mainstream investment decision process. "This result shows that some global managers are starting to dedicate more staff to analyzing ESG, and they're buying more external research on this topic," says Ambachtsheer. "The other managers will eventually have to do

the same if they want the big global pension plans to perceive them as ESG experts."

One of the questions that has been part of the SRI debate for years is whether SRI automatically results in underperformance. "One of the biggest myths is that you'll limit your returns by investing responsibly," says Glick. "You don't have to sacrifice returns to be invested in SRI. In fact, environmental, social and governance issues can be used to highlight risks often missed by mainstream financial analysis and attending to those issues can help enhance returns."

The Jantzi Social Index returned 13.53% annualized in the five-year period ended September 30, 2006, compared with 13.24% for its benchmark, the S&P/TSX 60 Index. In the U.S., the Domini 400 Social Index returned 6.55% annualized over the same period, compared with 6.97% for its benchmark, the S&P 500 Index. However, in the 10-year period, the Domini index outperformed its benchmark by 0.27% annually. Ambachtsheer recommends evaluating ESG performance by individual stocks or sectors, rather than by portfolios, to see more directly how ESG factors impact a stock or sector's return.

While SRI is becoming more mainstream, it's not necessarily because fund managers care about climate change or human rights, but because these factors have risks associated with them that affects their market performance, says Glick. "They're now looking at SRI from a different angle," she says. Ambachtsheer agrees. "It's not that they're taking an ethical approach," she says. Fund managers are adopting SRI because "ESG factors have the potential to impact corporate earnings and therefore investment performance." For example, given a choice between an energy producer with a strong commitment to managing the environmental impact of its activities and one with a weaker

expanding concerns

The Social Investment Organization's latest questionnaire sent to Canadian fund managers lists 17 possible SRI issues from which to choose, including six issues which were not on the SIO's 2004 questionnaire:

- aboriginal relations
- abortion/contraception
- alcohol
- animal welfare
- community relations
- corporate governance
- customer relations
- diversity in the workforce
- employee relations
- environment
- gambling
- human rights
- military/weapons
- nuclear energy
- pornography
- tobacco

Source: Social Investment Organization

commitment, an investor may choose to invest in the former because of the lower risk and higher return potential over the long term.

As word about ESG spreads in the pension industry, and as ESG factors become synonymous with risk mitigation, ESG concerns will eventually trickle down to corporate pension plans. Whether or not officially embracing ESG, plan sponsors will become more active in setting out guidelines for their fund managers.

While pension committees' first priority is to have portfolio returns that beat the market, they are slowly coming to the realization that they can achieve these returns even with ESG mandates. Pension committees will therefore approach their fund managers with more wide ranging investment policy considerations including some intangibles that may not even be on some managers' radar screens. To respond to their clients, or to take the lead, fund managers will have to incorporate a

broader set of investment principles into their thinking and ultimately into their investment strategies.

Plan sponsors concerned about ESG should look for fund managers with a clear understanding of ESG and a commitment to incorporate ESG into their processes. But these managers will also need to have the depth and breadth to be able to properly analyze, and act upon, current and future ESG issues.

With the advent of ESG, plan sponsors have one more method to invest ethically. In addition to "regular" managers using SRI screens, sponsors can choose managers for whom ESG now joins other acronyms like EPS, ROI and EBITDA in the investment analysis process. **BC**

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