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Abstract

The paper in-hand shows an analysis of the socially responsible investing (SRI) from three different players on the SRI market.

The first part covers the main literature findings concerning SRI. The different definitions and the main evolution stages are given as an introduction to the topic.

Later, the concept of SRI is discussed in detail. There are currently four main approaches to track sustainable investments: avoidance, positive screening, engagement and integration.

Furthermore, the current SRI market and the main drivers are given to highlight the significance of the topic.

On the basis of different academic findings, the performance aspect is discussed in detail. The paper demonstrates that socially responsible investments do not have a negative impact on the performance compared to the conventional investments.

The second part of the paper presents a comparative analysis of the SRI process on the Erste Sparinvest with Sarasin and Sustainable Asset Management (SAM). In the first step the different investment processes of SRI are discussed and later the major differentiations among the players are pointed out.

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“The future belongs to those able to provide creative answers to the challenges ahead.”

(Sarasin)

1. Introduction

*"The social responsibility of a business is to increase its profits – the one and only social responsibility of a business is to use resources and engage in activities designed to increase profits."*¹

*"...companies that conduct their operations with an eye on causing the least amount of harm to the environment and sustainability of our habitat...companies that minimize negative externalities and accentuate positive externalities..."*²

The view that an institution should solely centre on the generation of profit is now switched to a view where the companies are expected to be a societal actor of economic, environmental and social relevance. The responsibility of a corporation goes beyond the maximization of wealth and so it should furthermore consider the environmental, social and governmental (ESG) side of business.

Especially the recent financial crisis or corporate scandals, rising concerns regarding sustainability challenges, like global warming or resource and water scarcity, have enforced the attention of the investors and companies.³ Corporate related issues like poor governance and regulations, misaligned compensation or lack of transparency are being more addressed now.⁴

To give a recent example for a corporate scandal which will further emphasize the significance of corporate responsibility toward environment is the British

¹ Friedman (1970, 218).

² Sethi (2005, 101).

³ SAM (2010, 7).

⁴ Eurosif (2009).

energy company BP. The company is responsible for the huge oil spill after an explosion at one of its wells off the US coast.⁵ Since the incidence the company has been trying to clean up the massive environmental catastrophe, but until now with little success. This is a perfect example for corporate irresponsibility, which catastrophically harmed the operational and financial performance of the company.

All these issues make investors reconsider their investment approaches and they are now seeking for more sustainable forms of investing. Therefore the investment approach of socially responsible investing (SRI) is receiving more and more attention.

How socially responsible investments have emerged as an essential investment style can be seen in the survey, which was conducted by EUROSIF (European Sustainable Investment Forum) in 2009. It states that 89% of consultants anticipate an increase of client's interest in ESG matters in the next three years.⁶ Moreover, the increasing commitment of the asset owners and asset managers to the United Nations Principles for Responsible Investment (UN PRI) is another strong evidence for SRI.⁷ The UN PRI is promoting good practice in the integration of environmental, social and governance issues into investment decisions and ownership practices.⁸

This strong demand is mainly driven by corporate and public pension funds, high net individuals and charities, which are becoming more and more aware of the impact of ESG issues on the long – term financial performance.⁹

⁵ <http://news.bbc.co.uk/2/hi/americas/8658081.stm>, downloaded on 04/07/2010.

⁶ Eurosif (2009b,6).

⁷ SAM (2010).

⁸ EIRIS (2009, 6).

⁹ Interview with Pinner, Erste Asset Management, 05/06/2010.

All these issues are emphasizing the necessity of socially responsible investment.

1.1 Context of Thesis

The thesis focuses mainly on the concept of SRI. The first part of the thesis covers the literature review of SRI. In the second part the different SRI approaches of three asset manager companies (Erste Sparinvest, Sarasin, Sustainable Asset Management - SAM) are analysed.

The thesis is structured as follows:

The second chapter covers the theoretical part of the thesis and is divided into six sub - chapters.

2.1 gives a general introduction to the different definitions of SRI, followed by 2.2. with the important evolution stages of SRI.

The next subchapter (2.3) focuses on the concept of SRI. In doing so, I will explain the different investment approaches.

2.4 deals with the current SRI market and in 2.5 the main drivers and trends of SRI are summarized.

The final part of chapter 2 focuses on the performance aspect. Here the main literature and academic findings are reviewed.

The second chapter gives the reader the theoretical background information, before entering the empirical part of the thesis.

The third chapter solely concentrates on the different SRI investment strategies applied by Erste Sparinvest, Sarasin and SAM. The main differences among the strategies will be explained and pointed out.

2. Socially Responsible Investments

2.1 Definition in General Terms

Different definitions are used in the literature for SRI.

Kinder defines SRI in the following way: *"Socially responsible investing is the incorporation of the investor's social or ethical criteria in the investment decision making process"*.¹⁰

The Social Investment Forum describes SRI as: *"SRI involves evaluating companies on CSR (Corporate Social Responsibility) issues, analyzing corporate social and environmental risks, and engaging corporations to improve their CSR policies and practises"*.¹¹

The most commonly used definition, which I personally see as the most appropriate one is: *"SRI is a generic term covering ethical investments, responsible investments, sustainable investments, and any other investment process that combines investor's financial objectives with their concerns about environmental, social and governance issues."*¹²

There are authors who see an apparent difference between responsible investment and ethical investment. Whereas "ethical investment" excludes specific companies, responsible investing is seeking out particular companies to invest in.¹³

There is usually a confusion regarding SRI and CSR. According to Kinder the one side of a coin would be SRI and the other one CSR. We can say that SRI is

¹⁰ Kinder (2007,4).

¹¹ Statman (2007, 2).

¹² Eurosif (2008,6).

¹³ Pinner (2007, 47).

the personal responsibility of investors to align their social views with the investments and CSR is about corporation and the aspiration of its people.¹⁴ Assessments for SRI investments are in general based on the CSR ratings of companies.¹⁵

The different definitions for SRI show us the extended diversity of the investment approach. There is not a general guideline for SRI. Some investors focus more on the social or on the environmental issues and some want to enhance corporate governance issues in their investments. Also the interpretation of ethical or social norms differ from investor to investor because to some extent this is a subjective view. So, SRI is often criticised for its lack of uniformed standards.¹⁶

Here is a short example which illustrates the problem when a company is assessed after its social responsibility: McDonalds is a decently run company with forward looking employment policies and a commitment to reduce environment unfriendly packaging. In that context the company has a good sustainable performance. But at the same time McDonalds encourages junk food with obesity rising in the world, especially in the US.¹⁷ This shows us that the investments are determined by different point of views and therefore it can not lead to a uniform way of investing. Certainly the conventional investors have their different views of the market or companies. However, the differently applied financial measurements for a company's performance, like the price earnings, price to book or return to equity ratios, provide a kind of standardisation or orientation for the conventional investments.

After this general introduction to the topic, I will focus in the next section on the evolution of SRI.

¹⁴ Kinder (2007,16f).

¹⁵ Pinner (2008, 4).

¹⁶ Kinder (2007).

2.2 Evolution of SRI

The first milestones toward sustainable development were established in the forestry business in the 18th century. In order to prevent uncontrolled deforestation people were told that the amount of trees cut should never exceed the amount of new trees planted.¹⁸

This idea was further developed by the UN World Commission on Environment and Development, the so called Brundtland Commission, in 1987. Since then sustainable development has been defined as: *"Sustainable development is a development that meets the needs of the present generation without compromising the ability of future generations to meet their own needs."*¹⁹

The first steps toward sustainable investment funds were made in the 20th century and can be traced back to America. In the 1920s various religious communities excluded "sin stocks" which were involved in areas such as tobacco, gambling, weapons or alcohol, from their investments.²⁰

With time the focus expanded on green, ecological and also on shareholder issues. Shareholder activism appeared at first with Saul Alinsky at Eastman Kodak in 1966, followed by the first screened portfolio investing in 1971 with the Pax World Fund.²¹

Only in the 90s the concept of "socially responsible investing" was introduced. Until that time responsible investments did only exist in connection with one or other exclusionary criteria or with regards to ecological criteria, but not on the

¹⁷ Kinder (2007).

¹⁸ Sarasin "The future in your portfolio." (6).

¹⁹ Sarasin "The future in your portfolio." (6).

²⁰ Sarasin "The future in your portfolio."(6).

²¹ Kinder (2007,8).

basis of a holistic concept.²² In 1994 the “tipple bottom line” idea that sustainable investments should include economic, environmental and social factors into the investment process, was brought up.²³ With the new millennium, responsible investments began to attract the interest of more and more investors. The evolution of SRI was especially supported by the strong corporate governance and engagement movement that started in the U.S.²⁴

Since then SRI began to spread from traditional asset classes like equities and bonds into alternative segments. The concept of SRI as an evolving topic is still in change.²⁵

In the next section of the thesis I will focus more on the concept of SRI.

²² Pinner (2007, 63).

²³ Sarasin “The future in your portfolio.”

²⁴ Pinner (2007).

²⁵ Pinner (2007, 63).

2.3 The Concept of Socially Responsible Investing

Investors are using different kinds of sustainable investment approaches to differentiate sustainable companies from the conventional ones. The following section will give an overview of the approaches.

2.3.1 SRI Approaches

Hutton defines types of SRI as shareholder activism, community development investing and guideline portfolio investing.²⁶ Similar to Hutton, UKSIF (Sustainable Investment and Finance Association) distinguishes between the following three main approaches:

- negative and positive screening
- shareholder activism and engagement
- integration.²⁷

The following table gives you an overview of the different SRI approaches, which can be used individually or in combination:

Table 1: SRI Investment Approaches

	Screening: Exclusionary criteria	Screening: Positive criteria	Screening: Best-in- class	Shareholder activism & engagement	Integration
Number of stocks in universe	Rather low	Rather low	Rather high	High	High
Deviation/ Tracking error versus total market	High	High	Rather low	Low	Low
Typical name of product	In general "ethical fund"	Thematic fund	In general "Sustainability fund"	Conventional fund name with reference to engagement	Conventional fund name with reference to integration
Characteristics of product	High degree of responsibility	Positive thinking and a clear goal in focus	Alternative to conventional fund product	Low to marginal degree of responsibility	Low to marginal degree of responsibility

Source: Pinner (2008, 3).

²⁶ Hutton (1998).

²⁷ Pinner (2007, 49f).

Screening

The screening strategy can be applied based on exclusionary criteria, positive criteria or on a best in class approach.

Positive Screening

Positive screening, also called qualitative screening, is the selection of companies with a commitment to responsible business practices. This can be for example the assessment of companies' stakeholder relations. The positive screens are the basis for "best in class" asset management products, which invest in the best companies per sector on the basis of qualitative screening.²⁸

Positive screening can include:

- investing in companies that sell positive products – for example educational materials or essential necessities of life (food, clothing, electricity, water, housing),
- thematic investing (i.e. environmental issues) and
- investing in companies with the best performance against a defined set of ESG criteria compared to the sector peers (Best in class).²⁹

The frequently used issues to screen the companies are corporate governance, community, diversity, employee relations, environmental or human rights.³⁰

Negative Screening

The other differentiation of the non financial criteria applied in the investment process are the negative or exclusionary screens. This approach is also called avoidance. Negative screening excludes companies that violate one of the

²⁸ Pinner (2008, 7).

²⁹ Eiris (2009, 7).

³⁰ Statman (2007, 4).

negative criteria or do not meet the ESG criteria.³¹ Companies from tobacco industries are the most excluded investments, followed by companies associated with alcohol, gambling and weapons.³²

Best in class

In the best in class approach the investor selects the best company per sector according to a SRI ranking. Usually SRI agencies set up questionnaires for particular sectors and discuss them with the respective companies. Issues like stakeholder relations, sector, product or service impacts are discussed.³³

An example for a global rating agency, which provides best in class data to investors, is Innovest. Innovest evaluates the company with regard to more than 120 performance factors, including innovation capacity, product liability, governance, human capital, emerging market , and environmental opportunities and risk. The overall performance of the company is communicated via a simple rating signal of AAA to CCC. The Dow Jones Sustainability Index is one of the best known indices based on the best in class methodology. The index tracks the financial performance of the leading sustainability driven companies worldwide, excluding companies involved with tobacco, alcohol, armament, firearms or gaming.³⁴

Engagement

Engagement is a long term process of dialogues with companies to influence company behaviour in relation to their social, ethical and environmental practices.³⁵ Investors are contributing an active part to a better sustainable performance. Mostly it takes the form of dialogues with companies or voting at

³¹ Pinner (2008).

³² Eirsi (2009).

³³ Pinner (2007, 51).

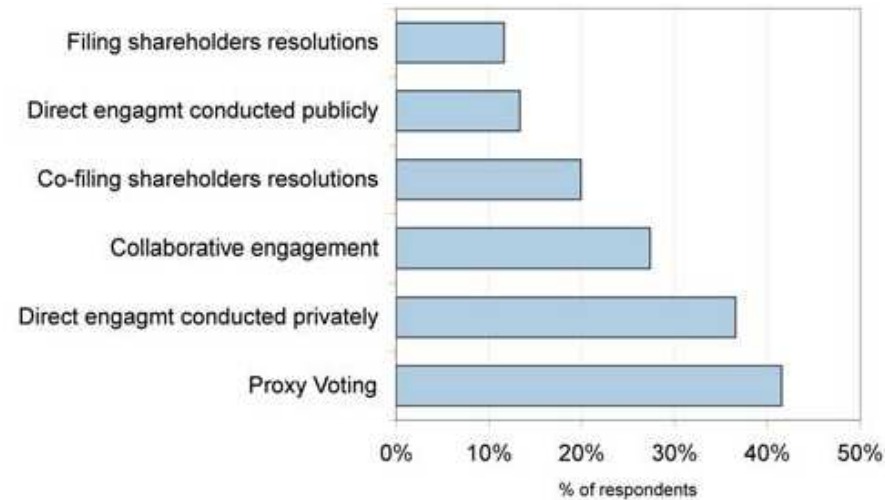
³⁴ Pinner (2007, 51).

³⁵ Eurosif (2008, 54).

Annual General Meetings. Within the engagement approach, fund managers are mainly focusing on corporate governance issues around the management of the company (i.e. director’s remuneration, separation of chair and chief executive functions, non-executive directors and audit committees). For example Black Rock states that they are focusing on raising standards in corporate governance and protecting the economic interests of clients. The company is engaging in a dialogue with executive management, non – executive directors and company advisers.³⁶

The following table shows the different engagement strategies that are mostly used by the European SRI fund managers.

Figure 1: Engagement % of European SRI Fund Managers Practicing



Source: Eurosif (2008, 13)

Integration

The integration approach incorporates potentially material ESG risks and opportunities into normal investment analysis, stock weighting and/or stock selection processes. The launch of the UNPRI in 2006 played a major role for the increasing integration of the ESG.³⁷

³⁶ Eiris (2009).

³⁷ Eiris (2009, 23).

The different SRI approaches are segmented into two sub groups by Eurosif: a core and broad SRI market. The core strategy includes the ethical exclusions, positive screening, including Best in class and SRI theme funds and the combination of both. The broad strategy composes simple screening, including norms based screening (up to two negative criteria), engagement and integration.³⁸

The following part will focus more in detail on the strong divergence of the strategies regarding market volume.

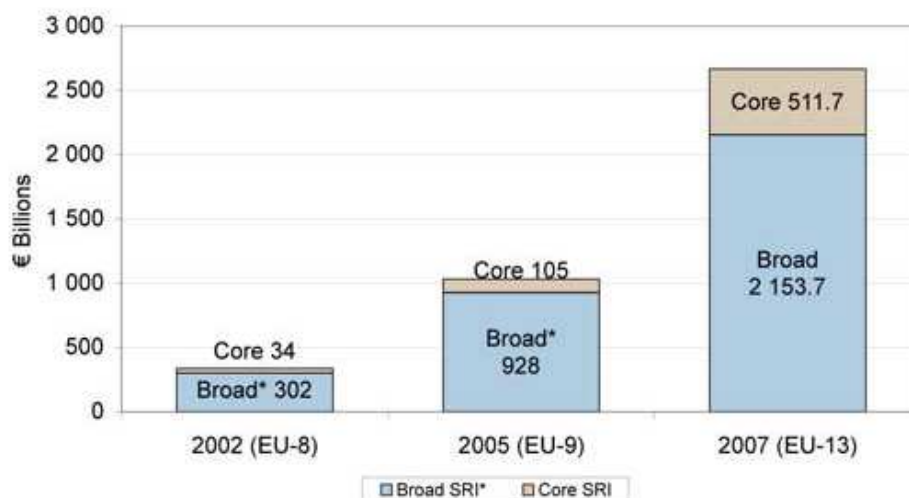
³⁸ Eurosif (2008).

2.4 SRI Market

The total assets under management invested in SRI have reached €6.8 trillion as of December 2008. Especially the European market had a significant growth over the last years. Compared to the U.S. SRI market, the European market had a relative late development. The invested volume in SRI represented 17.5% of the asset management industry in Europe as of 2007 and this reflected a growth of 102% in two years.³⁹

The major part of total SRI amount was made up of €2.2 trillion for broad SRI and only €511 billion was invested into the core SRI. The following figure shows the significant gap and the growth of the SRI strategies over the years.⁴⁰

Figure 2: Core and Broad SRI in Europe, 2002 - 2007



Source: Eurosif, (2008, 10)

Despite the relative small market for socially responsible investments, the segment is still a fast growing one in many countries. The biggest market for SRI is the United States, but also in countries, like Sweden, United Kingdom,

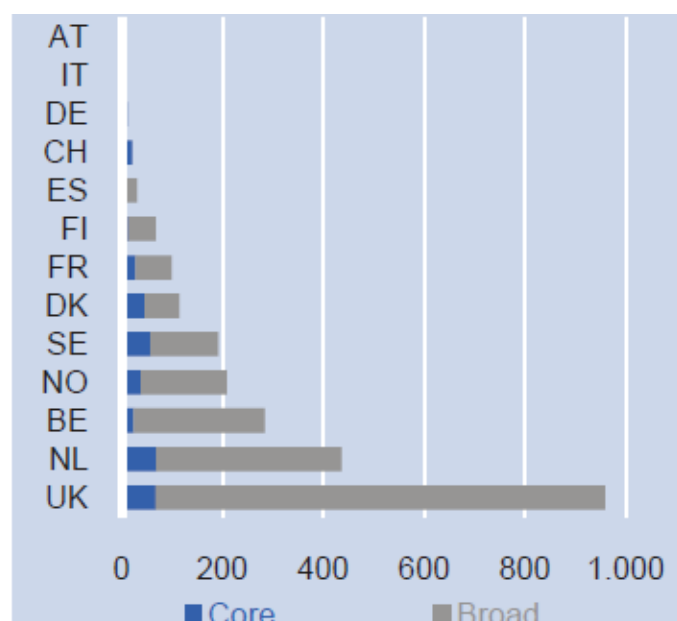
³⁹ Eurosif (2008, 10).

⁴⁰ Eurosif (2008, 10)

the Netherlands and Switzerland SRI has risen significantly over the last decades.⁴¹

Within the European countries sustainable investing differs considerably in size, growth and market share. The following figure compares the SRI investment volume for each European country as of December 2007. The United Kingdom holds the largest market share in the overall SRI market, while the Netherlands has the largest share in the core SRI market. Compared to the Scandinavian market, countries like Germany, Austria and Switzerland have a relatively small share on the SRI market. One of the main reasons for this strong variation in the investment volume within the European countries is the different investment philosophy of the institutional investors. ⁴²

Figure 3: SRI in Europe (EUR - bn, December 2007)



Source: Eurosif (2008a)⁴³

The following sub - chapter will cover the main driving forces of SRI.

⁴¹ Schroeders (2003, 2).

⁴² Deutsche Bank (2010).

⁴³ Figure is only available in German.

2.5 Main Drivers of SRI and Trends

Investors have different motives to invest in ethical funds. Especially social norms seem to have a significant pressure on the investors, particularly for institutional investors.

Harrison Hong (2007) published a paper where he tested whether sin stocks, like tobacco, alcohol and gambling, are less favoured by institutions due to social norm pressure. His number of findings support his hypothesis that sin stocks have less institutional ownership and less analyst coverage than the conventional stocks. In contrast to that the mutual funds and hedge funds are more willing to hold sin stocks compared to other stocks. In conclusion it can be said that the social norms have an important influence on the behaviour of investors and on markets.⁴⁴

As Hong (2007) has demonstrated in his paper, social norms, but also the environmental and governance issues have an enormous impact on the asset management industry in the last years. Schwartz (2003) points out that factors like investor concerns regarding environmental issues or product safety, growth of business ethics and CSR movement have contributed to the growth of SRI.⁴⁵ Beal et al. (2005) sees three motivations for ethical investments. The possibility to achieve superior financial returns, to gain non – wealth returns and finally to contribute to social changes.⁴⁶

Solomon et al (2002) differentiates two main sources of drivers. The first are internal drivers, like fund managers, clients and institutional investors and the other drivers are external, like lobby groups, government or society's interest.⁴⁷ Another study by Worthington et al. (2007) identifies legislative and

⁴⁴ Hong (2007).

⁴⁵ Schwartz (2003).

⁴⁶ Beal et al. (2005).

⁴⁷ Solomon (2002).

policy development, economic imperatives, stakeholder pressures and ethical influences as forces for engaging in socially responsible activities.⁴⁸ According to Williams (2005), SRI may be driven more by investors attitudes to the social aims of firms rather than by financial returns. He has conducted a large survey of investors across five countries to reveal the determinates of social responsible investment decision.⁴⁹

Other important SRI drivers, which were also recognized by several authors, are engagement and activism. Dillenburg et al. (2003) shows that the SRI is turning to a comprehensive paradigm that seeks to affect corporate behaviour.⁵⁰ Graves et al. (2001) strengthens the assertion by highlighting the fact that shareholder resolutions on social and environmental issues have become commonplace in US over the last 30 years.⁵¹ Furthermore a study by the US Social Investment Forum resulted that SRI funds are stronger proponents of corporate governance than conventional funds. SRI funds are more likely to support social or governance issues or to withhold votes from directors. This finding can be underpinned by Rivoli (2003) who reports that since the mid 1990s there have been two hundred and fifty to three hundred shareholder resolutions per year from religious groups, SRI funds and pension funds. Between 1997 and 2000, 27% of the resolutions were withdrawn due to satisfactory agreement with the management.⁵²

Also Sparkes (2001) highlights the connection between SRI and engagement with the following statement *"SRI is generally considered to be an equity-based activity, as one of its core aims is to use the power and influence of shareholders to positively affect corporate behaviour."*⁵³ Sparkes and Cowton

⁴⁸ Worthington et al. (2007).

⁴⁹ Williams (2005).

⁵⁰ Dillenburg (2003).

⁵¹ Graves et al. (2001).

⁵² Rivoli (2003).

⁵³ Sparkes (2001, p.195).

(2004) demonstrates that the shift in SRI from margin to mainstream is a major step in maturing of SRI. It offers the prospect of putting important pressure on the companies to address CSR issues. The corporate executives can no more ignore the SRI issues since those are mainly embraced by institutional investors, which is the most important ownership group.⁵⁴

As mentioned before, one of the main internal drivers are the institutional investors, represented by 94% of the total EU SRI market as of December 2007. Those investors were mainly from Netherlands and the UK, but also Scandinavia, France and Spain were playing an important role for the development of the SRI market.⁵⁵ The strong demand has been mostly intensified by the enforcement of the sustainable investment philosophy in the pension funds. One of the pioneers in this area was Great Britain, where in 2000 a reporting commitment about the sustainable investments of the pension funds was implemented. Due to the increased transparency, more pension funds were being motivated to consider the ESG criteria into the investment process.⁵⁶

The other increasing force for the huge demand is driven by the high net wealth individuals (HNWI) in the European market. This growth can be translated into further institutional interest as the HNWI market normally acts as an early signal of investing appetite for the more mainstream institutions.⁵⁷

Main triggers are also coming from the regulatory requirements and from the external pressure by Non-Governmental Organizations (NGO) and media. More and more countries have specific national SRI regulations that cover their pension systems: the UK, France, Germany, Sweden, Belgium, Norway,

⁵⁴ Sparkes & Cowton (2004).

⁵⁵ Eurosif (2008, 18).

⁵⁶ Deutsche Bank (2008).

⁵⁷ Eurosif (2008, 18).

Austria and Italy.⁵⁸ However, there are no generally mandatory transparency laws at the EU level and so the investors do not have to disclose the ESG issues of their investments. Many institutions, like Eurosif, are trying to introduce a law for more transparency.⁵⁹ Also with the successful introduction of the UNPRI, sustainable investment is getting increasingly significant among the investors. This can be seen in the increasing number of the members who are committing themselves to the principles.⁶⁰ In the meantime, a total volume of \$20.000 trillion are invested under the UNPRI.⁶¹

On the retail market UKSIF defines following major issues which influenced the SRI market:

- change in society's values,
- major economic trends,
- an increased awareness of SRI,
- disclosure & recognitions of the business case for CSR and
- the increased interest of fund managers in SRI.⁶²

The following table summarizes the main key drivers for SRI demand in the next 3 years.

⁵⁸ Eurosif (2008, 18).

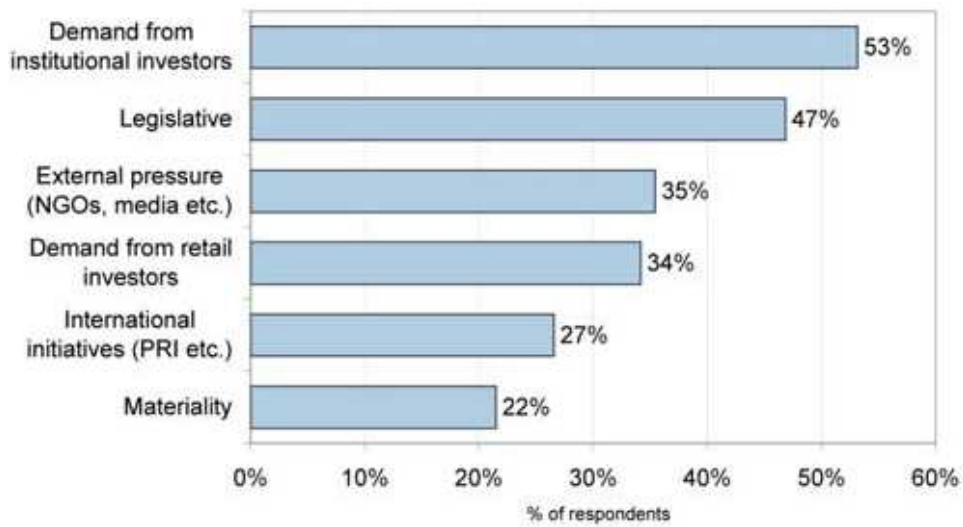
⁵⁹ Eurosif (2008).

⁶⁰ Eurosif (2008, 18).

⁶¹ SAM (2010, 8).

⁶² Pinner (2007, 67f).

Figure 4: Key drivers for SRI Demand in the next 3 years



Source: Eurosif, (2008, 10)

In the next sup - chapter I will give an overview of the main literature and academic findings on the performance aspect of socially responsible investments.

2.6 Performance

2.6.1 Five Arguments on SRI

One of the major discussion point of socially responsible investment is its performance aspect. The question if sustainable funds perform better or worse than traditional benchmarks is being discussed in many papers and studies.

The idea that sustainable investing can actually “kill two birds with one stone”, i.e. to do good while generating an attractive return, is for many investors an illusion. They believe that sustainability in the companies compromise their financial performance.⁶³

In principal there are five technical arguments for and against SRI. Sparkes (1995) defines them as:

- diversification effect,
- small company effect,
- anticipation effect,
- information effect and
- positive selection effect”.⁶⁴

The diversification effect is based on the capital market theory. The theory states that a portfolio constructed from a much widely held investment universe is more efficient than any other portfolio. Since the sustainability filter restricts the investment universe, the diversification opportunity of a portfolio is limited. Consequently, the optimal risk/return relationship of a sustainable portfolio is undermined.⁶⁵ Therefore the markets, which represent all the

⁶³ Sarasin (2008).

⁶⁴ Sparkes (1995).

⁶⁵ Sarasin (2008).

investable companies, will outperform all subsets of portfolios if markets are efficient.⁶⁶ However, Cobb et al (2005) concludes in his paper that investors are unlikely to be worse off by restricting their investment universe, and may well be better off as there is no significant evidence that the (SRI) indices underperform.⁶⁷ Havemann & Webster (1999) see also effects of reduced diversification, but also a higher tracking error. Sectors like service, tobacco, pharmaceuticals, engineering and banks seem to have an overweight in an ethical universe.⁶⁸ A further support against the reduced diversification effect is given by Barnett and Salomon (2005). The study is based on the hypothesis that "the financial loss borne by an SRI fund due to poor diversification is offset as social screening intensifies because better managed and more stable firms are selected into its portfolio." An empirical test on 61 SRI funds from 1972 – 2000 was conducted and it reveals that as the number of social screens used by the funds increases, financial returns decline first, but then rebound as the number of screens reaches a maximum.⁶⁹ The general counter argument by SRI investors against the diversification effect is that a limited investment universe is not relevant in practice, since many sustainable investment universes comprise around 700 international shares and this is big enough to assemble a well diversified fund. Moreover, a conventional manager is also working with a limited universe of investable stocks.⁷⁰

The small – cap effect argues that SRI investments are more skewed toward companies with smaller market capitalization.⁷¹ Consequently the stronger small cap exposure has detrimental effects on liquidity and therefore also

⁶⁶ Pinner (2008,8).

⁶⁷ Cobb et al (2005).

⁶⁸ Havemann & Webster (1999).

⁶⁹ Barnett and Salomon (2005,1).

⁷⁰ Pinner (2007,56).

⁷¹ Gregory (1997).

harms trading opportunities.⁷² However, on the long term small caps will outperform on a risk adjusted basis.⁷³

The anticipation effect describes argument that investors tend to anticipate future legal actions and financial problems by using qualitative screens.⁷⁴ These qualitative screens enable the selection of companies which for example adjust to future environmental trends. The opponents of SRI arguing that companies considering environmental improvement or social benefits above the legal requirements can have a competitive disadvantage due to the additional costs. Consequently, the value of the company is impacted negatively and will underperform compared to the market. However, all the impacts of companies regarding environmental, social or government issues are potential risks over the long run and also opportunities that could at some point become financially relevant as well. The following example will demonstrate this⁷⁵:

One of the key issues in our current society is the climate change and to reduce the energy consumption. Companies with energy intensive products, such as carmakers, are increasingly facing risks in the form of tougher environmental regulations. The decision by the EU to impose limits to reduce the greenhouse gas emissions of vehicles has increased the financial relevance of the sustainability aspect. Technological changes and reposition of the model ranges to cut fuel consumption and CO₂ emissions are now demanded from the carmakers. This leads to additional costs. Companies that have already switched to energy efficient vehicles or new appropriate technologies have a competitive advantage with new business opportunities. Here we can see the transformation of environmental and social risks into financial risks and that new opportunities can be achieved by an early consideration of the

⁷² Pinner (2007).

⁷³ Fama & French (1992).

⁷⁴ Pinner (2007, 8).

⁷⁵ Sarasin (2008, 10).

environmental issues.⁷⁶ Investors who have anticipated the sustainable performance of such companies will be rewarded on the long term. This is also approved by the study of Klassen & McLaughlin (1996) which discovered that companies investing in areas such as new products and processes are rewarded by the market.⁷⁷ A further finding by Gunthorpe (1997) shows that firms which conduct unethical business practices are penalised by the market.⁷⁸

The information effect of the SRI investments is due to integration of the ESG factors. The incorporation of these additional information of the companies, which is not widely known by the market, gives more chance for an outperformance of the SRI funds.⁷⁹

The positive selection effect says that the positive criteria applied leads to investments in well run companies.⁸⁰ Sustainable managers are able to generate new stock ideas since most of them are not working with a pre-defined share universe. In this way new companies that usually do not appear on the radar screen of financial analysts are considered and consequently the universe can be expanded. This investment process leads to companies with good environmental and social performance.⁸¹ One of the studies on the positive selection effect was conducted by McWilliams (2000). He proves high positive correlation between R&D investment and CSR, because both are associated with product and process innovation. R&D investment is an important determinant of firm development and improving long-run economic performance.⁸²

⁷⁶ Sarasin (2008, 10).

⁷⁷ Klassen & McLaughlin (1996).

⁷⁸ Gunthorpe (1997).

⁷⁹ Pinner (2008,8).

⁸⁰ Pinner (2009, 8).

⁸¹ Sarasin (2008,6).

⁸² McWilliams (2000).

2.6.2 Review of the Main Literature Findings

There are numerous studies on the performance aspect of the SRI.

Webley & More (2003) assessed companies with published code of ethics regarding their market value added (MVA), economic value added (EVA), price earnings ratio (PE) and return on capital employed (ROCE). The results suggests that companies with a code of ethics have a better MVA and EVA rating from 1997 to 2000. ROCE figures for companies without code were higher in the same period, but the situation changed in 2001. The P/E ratio was more stable for companies with codes. The findings ensure the indication that companies with an ethical code are associated with higher and more stable returns.⁸³

Morgenson (2003) strengthens Webley's findings and shows that companies with the highest measures of good governance outperformed their peers across a number of performance measures.⁸⁴ Also Picou and Rubach (2006) approved that companies, which announced the enactment of corporate governance guidelines had a positively affected stock performance.⁸⁵

Orlitzky et al (2003) conducted a metastudy, which inquired the relationship between corporate social/environmental performance (CSP) and corporate financial performance (CFP) on the basis of a meta analysis. The findings reveal that corporate and environmental responsibility are profitable for the companies. CSP seems to be positively correlated with CFP.⁸⁶

A further study by Schroeder (2007) analyzed 29 sustainability indices with conventional benchmarks. The findings show that there is no difference in the performance of sustainability indices and the benchmark. The hypothesis that

⁸³ Webley & More (2003).

⁸⁴ Morgenson (2003).

⁸⁵ Picou and Rubach (2006).

⁸⁶ Orlitzky (2003).

SRI funds have a worse performance than those of conventional assets can be rejected.⁸⁷

Alexander Kempf and Peer Osthoff (2006) examined the influence of different sustainable criteria on the performance of synthetically constructed portfolios. Therefore, a high-rated (low rated) portfolio consisting of stocks with high (lower) sustainable ratings was formed. The findings show that the performance of the socially responsible portfolios is never significantly negative. This means that the hypothesis that socially responsible investors do suffer a performance loss can be once again rejected. In contrast, the low rated portfolio with the screens like community, diversity or employee relations had a significant performance loss. This can be explained as a failure of the market in pricing companies with low social responsibility correctly.⁸⁸

The finding of Kempf and Osthoff was also supported by Derwall's (2005) study in 2005. He compared a portfolio of companies with the best CSR rating with a portfolio of companies with the worst CSR ratings. The analysis demonstrates that sustainable shares had a higher return compared to the shares with negative sustainability ratings.⁸⁹

Another study of Tsoutsoura (2004) addressed the effect of corporate social performance on the financial performance. The results reveal a positive significant relationship between the CRS and financial performance.⁹⁰ The positive relationship can also be caused by the fact that companies with a strong financial performance are able to invest more in social issues, like employee relations or other services for the community. A company with financial problems is most likely to stick to projects with a short horizon.⁹¹

⁸⁷ Schroeder (2007).

⁸⁸ Kempf and Osthoff (2006).

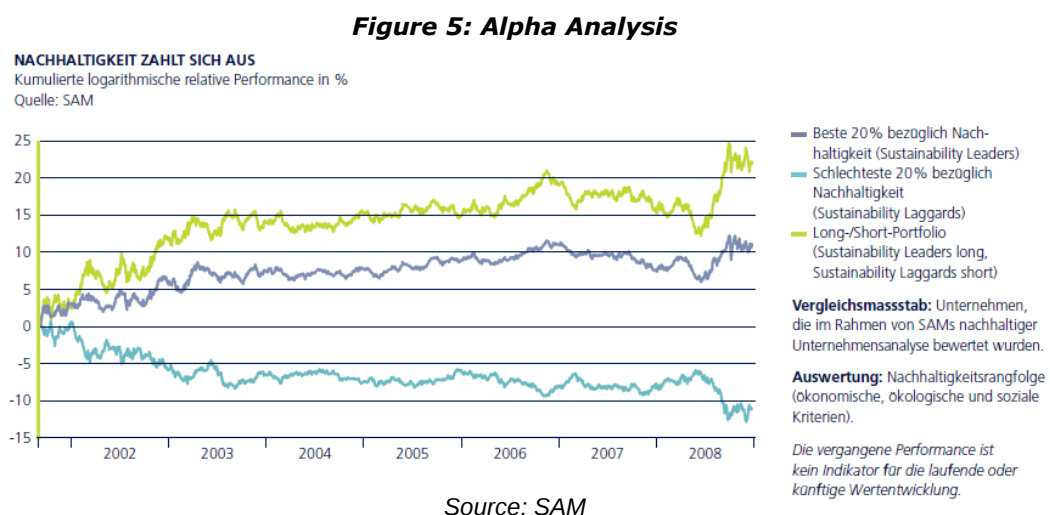
⁸⁹ Derwall (2005).

⁹⁰ Tsoutsoura (2004).

⁹¹ Tsoutsoura (2004).

Another reason according to Waddock and Graves (1997) is that companies with a good social performance have an enhanced brand image and attract therefore employees, customers and business partners.⁹² All these positive factors can be transformed to a better financial performance.

Finally, a survey, which was conducted by SAM, an investment group focusing exclusively on sustainability investing, has analysed the alpha of the stocks due to sustainable investing. SAM compared the performance of five different portfolios, in which the companies are allocated according to their sustainability scores. The portfolio 1 represented the sustainability leaders and portfolio 5 the sustainability laggards. The following figure shows the result of the statistical analysis:



The green line represents a portfolio, which was long on the sustainability leaders and short on the sustainability laggards. The dark blue line is the portfolio consisting of the sustainability leaders and the light blue one covers the sustainability laggards. The results clearly demonstrate the alpha potential of the sustainable companies which can also be observed by a positive information ratio of 0.47 of the sustainability leaders. The following table summarize the main statistical ratios of the analysis:

⁹² Waddock & Graves (1997).

Table 2: Statistical Ratios

	Portfolio 1 – Sustainability Leaders	Portfolio 5 – Sustainability Laggards
Outperformance (p.a. In %):	1.48	-1.46
Tracking Error (In %):	3.17	3.22
Information Ratio:	0.47	-0.45
T-Stat:	1.28	-1.25

Source: SAM

The majority of the empirical and academic findings confirmed the positive correlation between the social responsibility and the financial performance. With the consideration of the environmental and social impacts, companies are able to avoid long term risks and can even exploit the associated opportunities.⁹³

⁹³ SAM (2009).

3. SRI – A Competitive Analysis of Erste Sparinvest

This chapter presents a comparative analysis of the SRI process on the Erste Sparinvest (ESPA) with Sarasin and SAM. In the first step the different investment processes of SRI are discussed and afterwards the major differentiations among the players are pointed out.

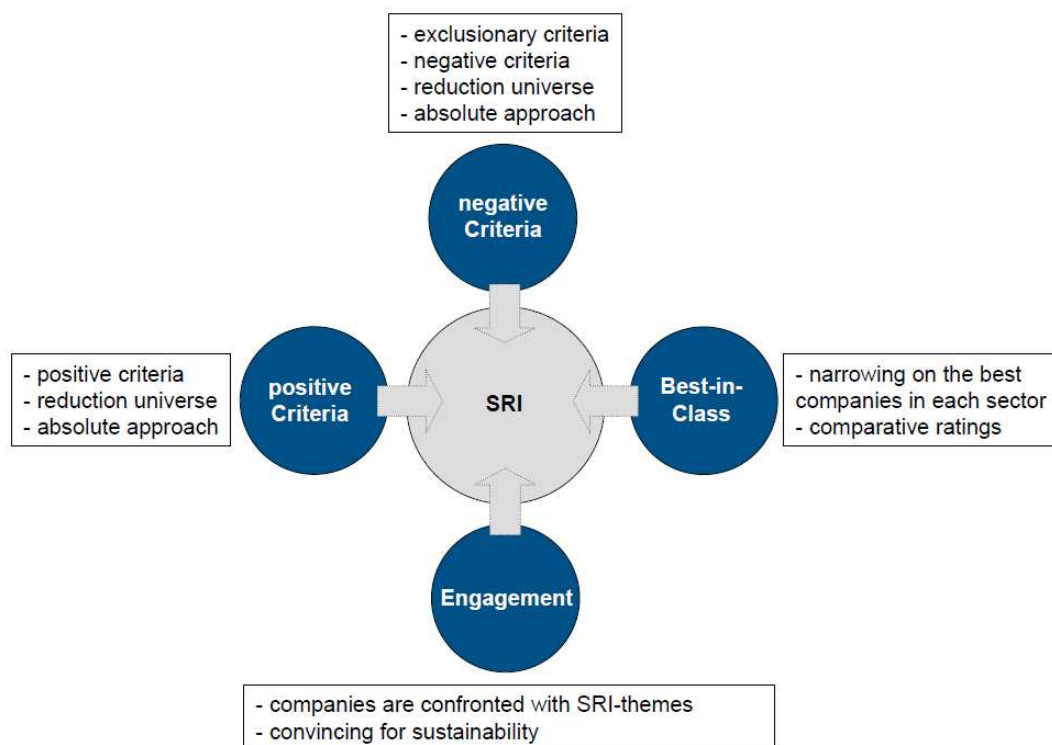
3.1 Erste Sparinvest

3.1.1 ESPA – An Overview and the SRI Approach⁹⁴

Erste Sparinvest is one of the leading asset managers in the Austrian and the CEE market. Since 2001 Erste Sparinvest is represented on the SRI market with the ESPA VINIS funds. The VINIS funds are based on the SRI/ESG methodology and offer an integrative approach, which is comprised of four sustainability styles.

The team applies avoidance, positive screening, best in class and engagement. The following figure demonstrates the integrative SRI approach.

Figure 6: An Integrative SRI Approach



Source: Erste Sparinvest

⁹⁴ Social Responsible Investments (2010, 14ff).

Avoidance includes exclusionary and negative criteria.⁹⁵ Companies that are engaging with nuclear power, green gene technology, child labour, business malpractice, pornography, military devices/weapons, tobacco, (avoidable) animal testing, death penalty and violation of ILO protocol are excluded immediately from the universe. However, when the negative criteria apply, the companies achieve a downgrade in the universe.

The remaining companies are screened on positive criteria based on the three dimensions, which are environment, stakeholders and corporate governance/ethics. The following ones are used for the assessment: work place conditions, corporate governance, energy and water consumption, use of renewable energies, avoidance of environmental pollution, medical care and healthcare, eco-efficiency, leadership in environmental technology and water treatment.

The best in class determines the best companies in each sector. The companies are assessed on the positive criteria and rated relatively to their peers.

The final part of the SRI approach is engagement, which is described during the investment process.

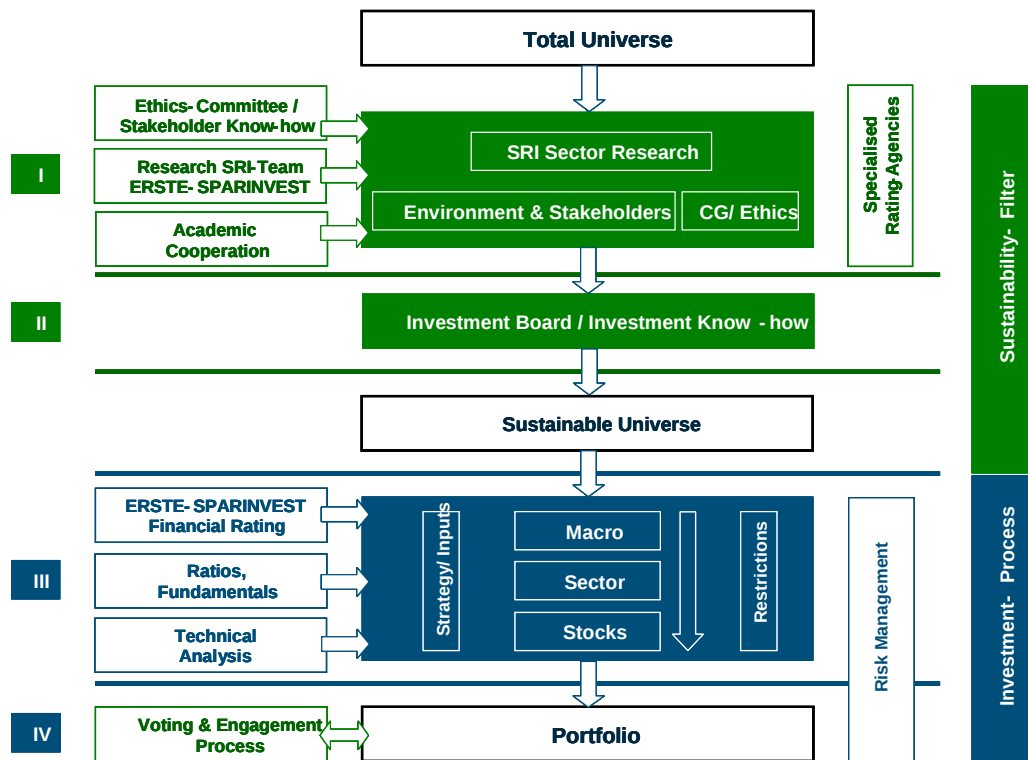
3.1.2 ESPA – SRI Investment Process

The investment process of the VINIS funds can be divided into four layers. The first two layers incorporate the SRI issues and the remaining layers represent the classic portfolio creation process. The focus will be on the first two layers. Figure 7 illustrates the investment process.⁹⁶

⁹⁵ Differentiation between negative and exclusionary criteria only in the case of ESPA.

⁹⁶ Socially Responsible Investments (2010).

Figure 7: ESPA VINIS Investment Process



Source: Erste Sparinvest

3.1.2.1 Layer I – SRI Process

The first layer of the investment process represents the SRI research of the universe. In principal, companies are screened on the inputs of three different SRI rating agencies: Oekom, Innovest and RiskMetics Group. Each of the agencies has their own SRI know-how. ⁹⁷

Oekom applies positive screening for the corporate rating. The rating is based on a comprehensive set of criteria focusing on the social and environmental sustainability, that cover six following areas:

- social rating: staff and supplier, society and product responsibility, corporate governance and business ethics

⁹⁷ Socially Responsible Investments (2010).

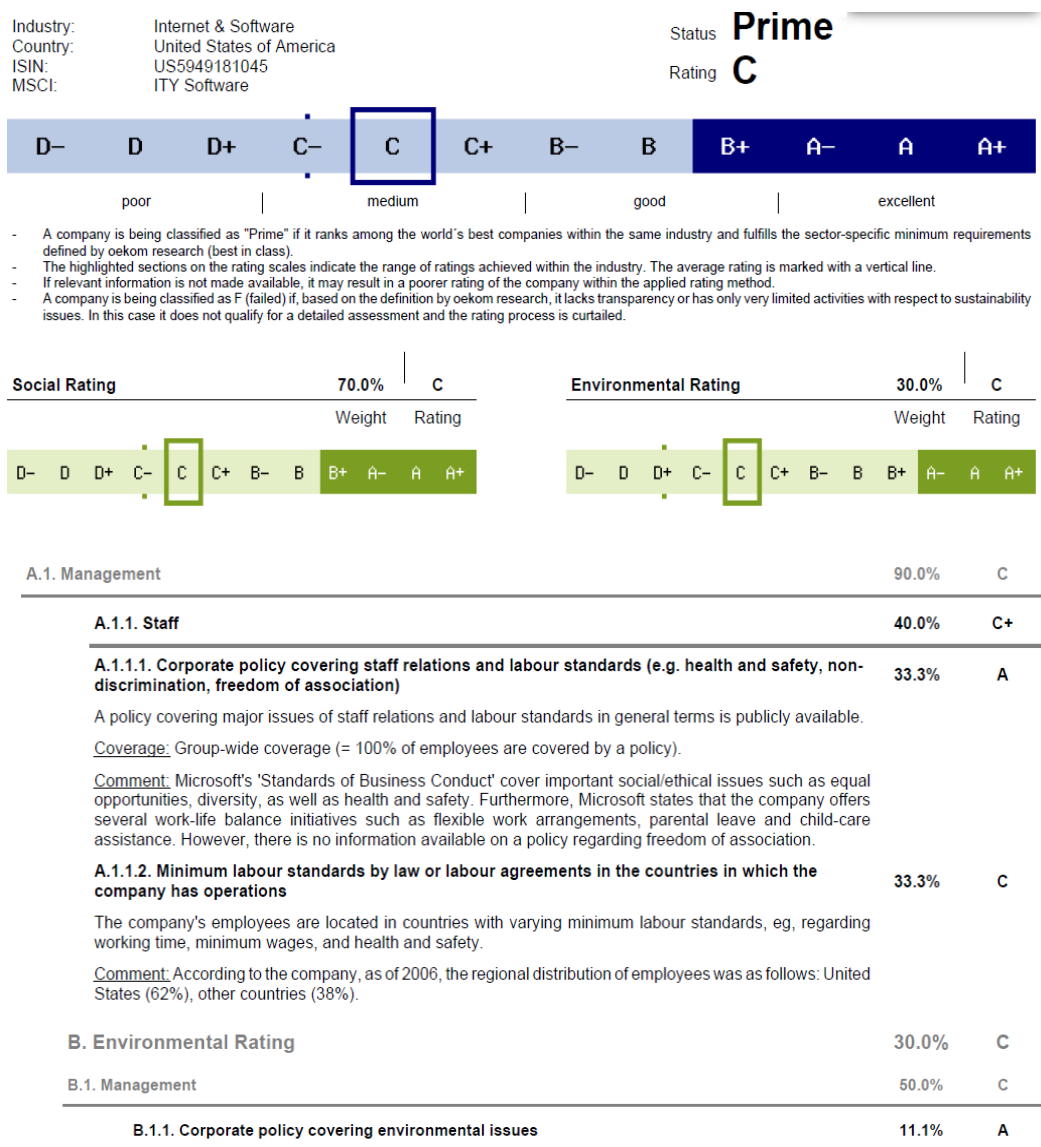
- environmental rating: environmental management, products and services, eco efficiency.⁹⁸

The criteria are defined by a pool of approximately 500 indicators and for each company an average of 100 indicators are selected on an industry – specific basis in order to analyse the company. A practical example of a corporate rating can be seen in figure 8.⁹⁹

⁹⁸ Oekom: http://www.oekom-research.de/index_en.php?content=investment-services , downloaded on 05/07/2010.

⁹⁹ Oekom: http://www.oekom-research.de/index_en.php?content=investment-services , downloaded on 05/07/2010.

Figure 8: Example Microsoft (1)



Source: Oekom Corporate Rating Microsoft

Oekom assessed Microsoft based on a set of positive criteria with an overall sustainability rating of C. For example, one of the assessment criteria for social rating was "Management/ Staff". An indicator for that criterion is an examination of the corporate policy regarding staff relations coverage and labour standards (e.g. health and safety, non – discrimination, etc). The weighting is set by 33% and the company achieved for that indicator a rating

of A. The sum of the scores of the indicators determines the total rating of the criterion management/ staff, which again impacts the overall social rating.¹⁰⁰ Moreover, Oekom has a rating scale from A+ to F. However, the ESPA team considers only the companies rated from A+ to C from the Oekom universe.¹⁰¹

We can also see that the social rating is weighted by 70% in contrast to the environmental one which is by 30%. This indicates that social factors have much more impact on the industry Internet & Software than the environmental factors.

The fundamental differentiation of Oekom's SRI approach compared to the other two agencies is that Oekom applies an in-depth analysis based on a scientifically developed list of criteria. In this way a company is holistically analysed, irrespective to its peers.¹⁰²

The assessed universe of Oekom represents the starting point of the VINIS SRI Investment process. For the following part the universe is referred as "VINIS SRI Universe".¹⁰³

The second step of the investment process is the incorporation of the industry key issues of the "Intangible Value Assessment" (IVA) provided by Innovest. Innovest's research is focused on those factors which contribute most heavily to the financial out – performance.¹⁰⁴ Innovest, which has been acquired by

¹⁰⁰ Oekom Corporate Rating "Microsoft".

¹⁰¹ Interview with Osojnik (2010).

¹⁰² Interview with Osojnik (2010).

¹⁰³ Interview with Osojnik (2010).

¹⁰⁴ Innovest http://i-ratings.innovestgroup.com/index.php?option=com_isva&func=iva&action=home&Itemid=40), downloaded on 09/07/2010.

MSCI Barra, is specialized in SRI sector research and identification of risks from non-responsible activities.¹⁰⁵

The industry key issues are identified in the in – depth industry analysis. The industries are assessed on competitive dynamics with particular emphasis on the special risks and opportunities created by environmental and social factors. Thereby Innovest considers ESG criteria as leading indicators for the analysis.¹⁰⁶

Finally, the ESPA team makes any necessary adjustments on the weightings to the respective criteria as a result of assessment of the industry key issues. The following example will demonstrate this procedure.¹⁰⁷

Example: Microsoft (2) ¹⁰⁸

Innovest identified the key issue “human resources” for the industry “Software & IT Services”. The impact on human resource programs is enormous since the sector has mainly young and specialized employees. Leading companies in this sector that take human capital programs, such as recruitment, retention and motivation seriously should have a higher score in this area since they are more likely to outperform their sector peers.

The ESPA team considers the key issue “human resource” into the Microsoft Company rating which was originally provided by Oekom. The criterion for human resource is adjusted according to the result of Innovest and consequently the overall rating of Microsoft in the VINIS SRI universe will change.

¹⁰⁵ Interview with Osojnik (2010).

¹⁰⁶ Risk Metrics Group (2009, 4).

¹⁰⁷ Interview with Osojnik (2010).

¹⁰⁸ Oekom Corporate Rating “Microsoft”.

In addition to the industry analysis, Innovest provides best in class companies, that fulfil the key issues of the respective industries. These selected companies are achieving additional points in the VINIS SRI universe.¹⁰⁹

The final step is the incorporation of the inputs provided by RiskMetrics (in table 3 referred as ISS Index/Sector). This rating agency is specialised solely on corporate governance issues. The corporate governance rating of the companies is considered in the VINIS SRI universe and this procedure changes the overall rating of the respective companies.¹¹⁰

Now the VINIS SRI universe embodies an intersection of the universe of Oekom, Innovest and RiskMetrics. The last step is now to apply the negative screening on the VINIS SRI universe.

The selective approach by the ESPA team qualitatively and quantitatively reduces the Oekom universe of 1000 equities to a VINIS SRI universe of 500 equities.¹¹¹

The following table shows the Microsoft Corporate Rating with all the adjustments made by the ESPA team. Here we can see that the original corporate rating of Microsoft was a C and with all the adjustments the company receives a rating of B-. However, the company is excluded from the VINIS SRI universe due to the violation of labour rights.

¹⁰⁹ Interview with Osojnik (2010).

¹¹⁰ Interview with Osojnik (2010).

Table 3 : VINIS Universe – Microsoft Corporate Rating

Company	Industry (oekom research)	oekom Corp. Rating	oekom Corp. Rating it. DB	oekom DB	ISS Index	ISS Sector	Innovest Up-/down- Grades	Gesamt Rating neu (inkl. Innovest)	O.k.?/ nach Innovest & Ausschluss & Ds & ESPA VINIS ad hoc decision	VINIS - Rating	Exclusionary Criteria	Exclusionary Criteria it. DB	Negative Criteria
Microsoft	Internet & Software	C	C	2.232	5.000	5.000	150	2.936	Nein	B-	Violations of Labor Rights	Violations of Labor Rights	Business Malpractice (Antitrust)

Source: Erste Sparinvest

Due to this primary external research by the three rating agencies the team is able to integrate positive criteria, best in class approach and negative criteria into their VINIS SRI approach.

In addition to the primary research, the team also includes an ethics committee, which is mainly responsible for the criteriology and for the ongoing consultation and discussion with stakeholders and NGOs.¹¹²

With this multiple sourcing by the rating agencies, ethics committee and in – house team, a holistic and objective SRI approach can be ensured. ¹¹³

3.1.2.2 Layer II – Investment Board¹¹⁴

The second layer of the investment process represents the investment board. The investment board meets on a regular basis and verifies the result of the SRI filter applied in the first layer. It ensures that the “approved list” of investment opportunities is aligned to the objectives of the team. In addition to that the board discusses about the further focus on academic and in-house research. They are also responsible for the verification and monitoring of the process and analytical basis.

¹¹¹ Interview with Osojnik (2010).

¹¹² Pinner W. (2008, 12).

¹¹³ Socially Responsible Investments (2010, 28).

The board includes members from the Erste Sparinvest, the non – SRI team, the employed rating agencies and the SRI team. The mix of the members ensures that the valuation process is not solely based on one point of view. With level 2, the final SRI universe for the VINIS funds are constructed.

3.1.2.3 Layer III & Layer IV – Investment Process¹¹⁵

After the SRI investment universe is defined, the portfolio construction takes place. Layer III is the selection process of equities. Since the focus is on SRI issues, the layer III is not further described.

The last layer incorporates the engagement and voting strategy of the ESPA VINIS team. The team is responsible for the voting and engagement strategies for the domestic market. In terms of the international voting and engagement strategy a renowned partner supports the team in its tasks.

¹¹⁴ Pinner (2008, 12).

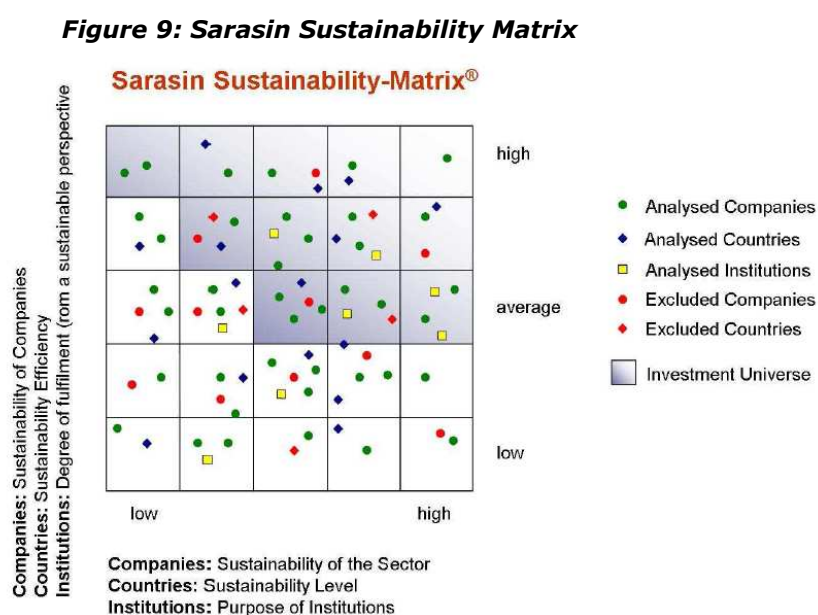
¹¹⁵ Pinner (2008).

3.2 Sarasin

3.2.1 Sarasin – An Overview and the SRI Approach

Since 1989 Sarasin is represented on the SRI market and its first sustainable product was established in 1994.¹¹⁶ The team follows a sustainable philosophy which is based on a risk oriented analysis. Industry- and company specific risks of a firm are considered in the analysis.¹¹⁷

The sustainability rating of a company is based on a two dimensional rating system, consisting of an industry and a company rating. Each rating dimension incorporates an environmental and social analysis. The combined company and industry rating determines the sustainable investment universe of Sarasin. The team uses a Sustainability Matrix where the eligible universe is displayed. The following figure shows the matrix.¹¹⁸



Source: Sarasin Questionnaire (2010).

¹¹⁶ Sarasin Questionnaire (2010).

¹¹⁷ Sarasin "The future in your portfolio" (8).

The X-axis represents the industry rating and the Y-axis is the company rating. The selected investment universe demonstrates that only the top sustainability performers from high - risk industries are considered, while the barrier for entry to the investment universe is lower for industries presenting less of a sustainability risk.¹¹⁹

Sarasin integrates in its SRI approach avoidance, best of classes, best in class and engagement strategies, which are explained during the investment process.

3.2.2 Sarasin - SRI Process

The first step is the industry and a company research. The team employs mainly secondary research, like monitoring of newspapers, research reports, industry specific catalogues and so on. This pool of information is the fundament of the SRI analysis.¹²⁰

Before the social and environmental analysis is conducted on the universe, the avoidance approach rules out the companies, that violate the exclusionary criteria. In contrast to Erste Sparinvest, Sarasin has a milder avoidance approach. The companies are only excluded if they earn more than five percent of their sales from the manufacture of the following products: nuclear power, weapons, chlorine and agrochemicals, tobacco and pornography.¹²¹

In the next step the social and environmental analysis is applied. As mentioned before, Sarasin focuses on a risk oriented approach. The environmental and social risks are closely linked to the products and to the

¹¹⁸ Sarasin "The future in your portfolio"(8f).

¹¹⁹ Sarasin Industry Rating (2006, 5ff)

¹²⁰ Sarasin Questionnaire (2010).

¹²¹ Sarasin Questionnaire (2010).

respective industry of the companies. Therefore the sustainability rating of the industry in terms of its contributions towards environmental and social risks is determined in the beginning of the analysis. Sarasin classifies this as the best of classes approach.¹²²

A set of selected environmental and social criteria are used to determine the industry specific risks. The environmental risk is valued through the criteria: "resource use and emissions". The social risk is determined by the criteria "internal and external conflicts". The internal conflict potential can be caused by the downsizing of the workforce in certain industrialised countries and by inadequate working conditions, like low wages, low working hours and so on. The external conflict potential is caused by health risks due to the products and production methods, corruption and ethical conflicts.¹²³

Based on the criteria the risk potential of an industry is determined. For example the chemical industry is an industry with high risk potential and as a result the industry sustainability rating will be very low, meaning that the smaller the environmental and social risks of an industry, the higher its sustainability rating. The analysis is done throughout the whole product lifecycle, from the upstream production stages, through the production process, to the use of the products. Not only direct effects arising from the production is taking into account, but also the effects caused by the whole product lifecycle are considered.

The following figure shows the four standardized main criteria, that are used for the entire product lifecycle and the indicators to quantify the criteria. ¹²⁴

¹²² Sarasin Industry Rating (2006, 4)

¹²³ Sarasin Industry Rating (2006, 6).

Figure 10: Criteria and Indicators for Industry Rating

Indicators for the industry rating				
	Criteria	Sub-criteria	Indicators	Weight
Environmental risks	Resource use	Energy consumption	Energy consumption per sector and final consumption (households, cars)	18%
		Water consumption	Water consumption per sector ²⁾	7%
	Emissions	Toxic wastes and emissions	Total quantities of waste and toxic emissions (industry) ²⁾	8%
		Mass air pollutants (not energy-related)	Nitrous oxide (NO _x)-Emissions ⁴⁾ Hydrocarbon- (VOC-)Emissions ⁴⁾	16%
Social risks	Internal conflicts (workplace)	Health risks	Frequency of occupational accidents ⁴⁾	10%
		Wealth contribution	Wage level ¹⁾ Employment fluctuations ³⁾	10%
		Workers' rights	Prevalence of child labour and forced labour ⁿ⁾	5%
	External conflicts (society)	Health risks	Incidents (industrial) ⁴⁾ Products harmful to health and accidents during use of product ¹⁾	5%
		Economic and political power	Degree of concentration of the industry ¹⁾ Lobbying expenditure ⁴⁾	5%
		Contribution to international/ intercultural conflicts	Activity in producer countries with low social and political standards ¹⁾ Production of armaments ¹⁾	8%
		Contribution to ethical controversies	Corruption ^{m)} Ethically controversial products and production methods ¹⁾	8%

Source: Bank Sarasin

Source: Sarasin

For example the applied indicator for the criterion "resource use" is the "energy consumption" of the industry. The energy consumption of an industry is in environmental terms very important due to the limited availability of fossil energy resources. Therefore energy consumption is weighted higher among the other indicators of resource use. However, the main criteria are all equally important for the industry rating. ¹²⁵

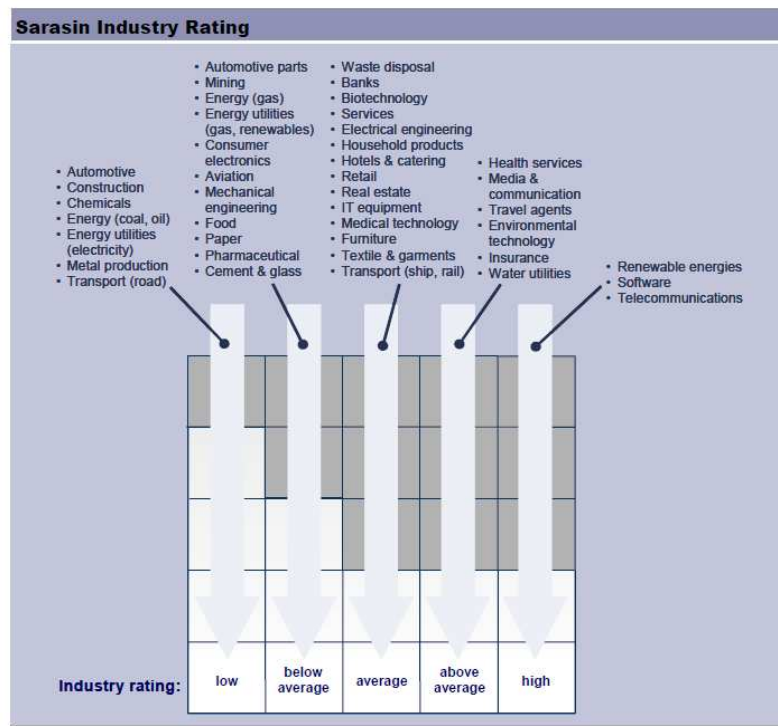
The aggregation of the individual criteria determined the overall risk for each industry. The next figure shows the Sarasin industry rating which placed the industries in five risk categories, ranking from low to high. ¹²⁶

¹²⁴ Sarasin Industry Rating (2006, 7).

¹²⁵ Sarasin Industry Rating (2006, 11).

¹²⁶ Sarasin Industry Rating (2006, 15).

Figure 11: Sarasin Industry Rating



Source: Bank Sarasin

Source: Sarasin

Here we can see that the primary industries that incorporate a higher risk include chemicals, energy, construction, consumer electronics or pharmacy have the lowest sustainability rating. Industries with lower risks like service sector, telecommunications, insurance, renewable energies or healthcare services have the highest sustainability rating.¹²⁷

The industry sustainability rating defines the threshold of eligibility for investment. The lower the rating of the industry, the higher are the demands that companies must meet in order to qualify. The leading thought behind this approach is that companies in less sustainable industries can achieve large economic benefits by engaging in sustainable practices. For example, companies in energy intensive primary industries can cut their costs by increasing their energy efficiency. Those companies with above average

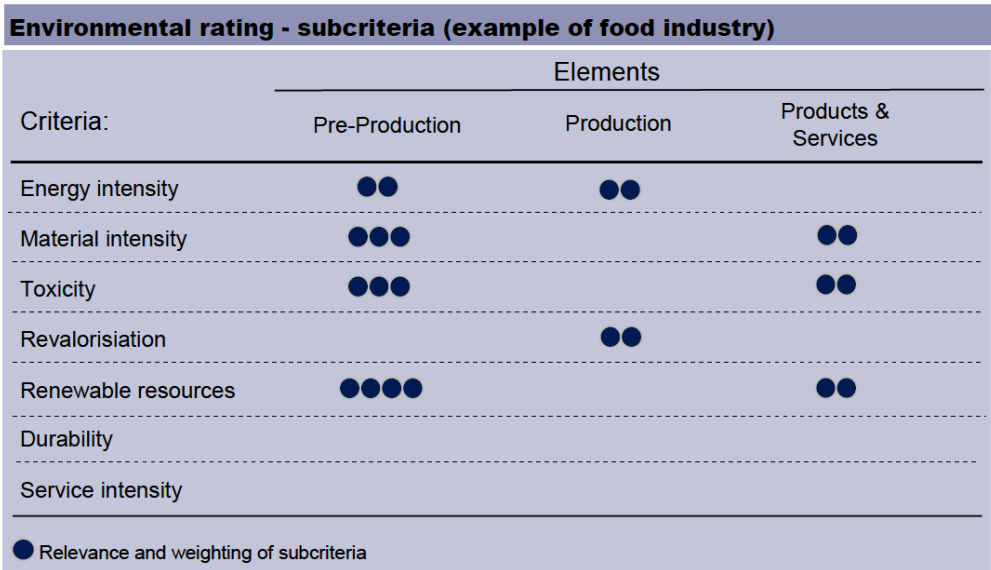
¹²⁷ Sarasin Industry Rating (2006, 15).

sustainability ratings will tend to deliver an above average share performance.¹²⁸

In the next step, the sustainability of the companies toward the industry specific environmental and social risks is assessed. The main question here is how does the company deal with the industry – specific risk compared to its peers? This is assessed by the best in class approach.

The environmental rating measures the contribution of a company to reduce its pollution throughout the product lifecycle. Criteria like energy consumption, water consumption, toxic emissions, waste, material intensity, durability and so on are all considered for the analysis.¹²⁹

Figure 12: Environmental Rating



Source: Sarasin

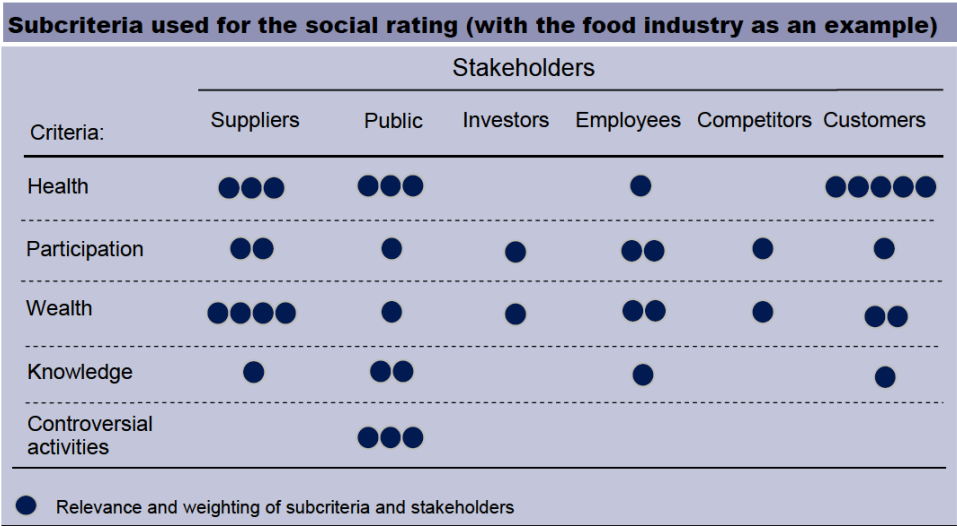
The social rating incorporates the stakeholder approach of a company. It reflects how the company manages the different interests of the stakeholder in terms of the sub criteria “health”, “participation” and “distribution of wealth

¹²⁸ Sarasin Industry Rating (2006, 4).

¹²⁹ Sarasin Company Rating (2007,8f).

and knowledge". Participation takes into consideration whether the company permits stakeholders to participate in decisions that affect them. If a company gives the stakeholders the possibility to improve their education and know-how, it will be positively assessed in terms of knowledge. The sub criterion health measures if companies reduce health risks for their stakeholders and the sub criteria wealth reflects the companies' contribution to reduce material imbalances for stakeholders. The stakeholders, who represent the main criteria of the social analysis, are employees, suppliers, investors, general public, customers and competitors.¹³⁰

Figure 13: Social Rating



Source: Sarasin

After the company and industry rating of the companies are positioned in the Sustainability Matrix, the sustainable investment universe is determined for the further investment process.

Another important part of the SRI approach is the engagement strategy of Sarasin. The team tries to enhance the awareness of the management of the companies toward the interests of the shareholders. Secondly the voting rights

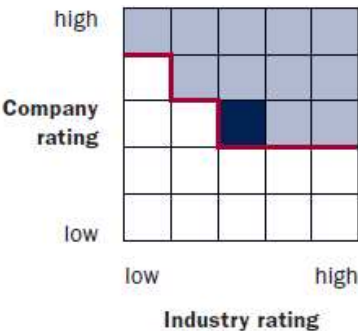
¹³⁰ Sarasin Company Rating (2007, 12f).

of the invested companies are perceived. The voting policy is based on the recommendation of Sarasin’s partners.¹³¹

An example is given to have a better view on the Sarasin sustainability rating process¹³²:

Company X sells its own label fashion clothing and cosmetics and is represented mainly in European countries and the United States. The manufacturing is outsourced to nine production centres, among them Asia, Africa and Central America. In the first step of the SRI investment process, company X is assessed based on the avoidance strategy. The company’s activities are nothing significant according to the exclusion criteria of Sarasin. In the next step the industry rating is conducted. The company belongs to the “retail and wholesale sector” and hence it has an average sustainability rating as far as its environmental and social impacts are concerned. The third step is the company rating. For instance the following question can be examined in order to determine a company rating: How is the environmental rating of the supply chain for company X? How is the environmental effect due to the production in terms of energy consumption, emission or waste management? What are the social conditions in the supply chain? After the industry and company rating is determined the company can be positioned in the Sarasin Sustainability Matrix:

Figure 14: Example for the Sustainability Rating



Source: Sarasin

¹³¹ Sarasin Questionnaire (2010).

¹³² Sarasin “The future in your portfolio” (10f).

3.3 SAM

3.3.1 SAM – An Overview and the SRI Approach

SAM is an investment group that focuses exclusively on sustainability investing since its foundation in 1995. Furthermore, SAM has the right for publication and licensing of the Dow Jones Sustainability Index (DJSI).¹³³

SAM defines corporate sustainability as an approach to business creating long term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments.¹³⁴

In principal SAM mainly distinguishes between socially responsible and sustainable investments. According to SAM, socially responsible investments incorporate the negative screening of companies, which can lead to an exclusion of specific industries. In contrast to that the sustainable investments use solely the best in class approach. SAM counts itself to the sustainable investors since the team applies best in class without a pre - screening of the companies. The blue marked part of figure 16 illustrates the positioning of SAM among the different SRI investing styles.¹³⁵

¹³³ <http://www.sam-group.com/html/about/portrait.cfm>, downloaded on 04.07.2010.

¹³⁴ https://assessments.sam-group.com/documents/DJSI_KeyFacts_2010_Final.pdf, downloaded on 11/07/2010.

¹³⁵ SAM Questionnaire (2010).

Figure 15: Positioning of SAM (the blue area)



Source: SAM - Questionnaire 2010¹³⁶

The SRI approach incorporates best in class, sustainability theme investing, engagement and integration. Since the theme investing is not a major topic in this thesis, this investing style is not described here.¹³⁷

3.3.2 SAM - SRI Process

The corporate sustainability assessment is the core part of SAM's sustainability investments. The first step is to gather information from companies based on an extensive questionnaire. Qualitative and quantitative criteria are examined in the questionnaire to measure the sustainability performance of more than 1,200 companies.¹³⁸

Sam's assessment criteria are divided in two classes: general and sector specific. The general criteria can be applied to companies across all sectors,

¹³⁶ Figure is only available in German.

¹³⁷ SAM Questionnaire (2010).

¹³⁸ SAM (2010,7).

whereas industry specific ones differ between sectors. The criteria are allocated to economic, environmental and social dimensions.¹³⁹ The assessment covers issues, such as: operational efficiency & risk reduction, aligning & attracting employees, new markets, innovation and reputation & brands.¹⁴⁰ A detailed set of criteria for each dimension is given in table 4.

The economical, environmental and social performance of a company is measured by a corporate sustainability performance score. The first step of the scoring model is to give all questions related to specific criteria a score. The following figure gives an example for questions related to corporate governance issue.

Figure 16: Corporate Sustainability Assessment

Economic Dimension

Corporate Governance

10. Does your company communicate the remuneration/compensation of your board of directors/supervisory board members and other highest paid senior directors/executives (e.g. CEO) externally? Please attach references.
- ☒ Yes, on individual level of each board member and CEO and additional highest paid senior executives.
 - ☐ Yes, on individual level of each board member and CEO
 - ☐ Yes, on an aggregated level for non-executive directors AND on aggregated level for executives directors
 - ☐ Yes, on aggregated level of board/supervisory board
 - ☐ No
 - ☐ Not applicable. Please provide explanations in the comment box below.
5. How many women are members on your company's board of directors/supervisory board?
- ☒ 2
 - ☐ Not applicable. Please provide explanations in the comment box below.
 - ☐ Not known

Source: <http://www.nestle.com/Resource.axd?Id=9BB65D19-4D19-4404-9E10-7332A18A5C21>

¹³⁹ Stoxx Europe Sustainability Index Guide Book (2010, 9ff).

¹⁴⁰ SAM (2009, 16).

Table 4: Assessment Criteria

Dimension	Criteria	Weighting (%)	Sub-Criteria
Economic	Corporate Governance	6.0	Structure: Board size Board structure Non-Executive Chairman/Lead Director Responsibilities and Committees Transparency Corporate Governance policy Conflict of Interest External Auditor Diversity: Gender Board Effectiveness Entrenchment provisions Transparency of Senior Management Remuneration <i>MSA: Corporate Governance (MSA = Media and Stakeholder Analysis – See Chapter 4)</i>
	Risk & Crisis Management	6.0	Responsibility Risk&Crisis Management Uniform Risk Analysis Definition of Risk Risk Map Sensitivity analysis & stress testing Risk response strategy <i>MSA: Risk & Crisis Management</i>
	Codes of Conduct/Compliance/Corruption & Bribery	6.0	Codes of Conduct: Focus Codes of Conduct: Systems/Procedures Corruption and Bribery Policy: Scope and Business Relationships Breaches Codes of Conduct: Public reporting <i>MSA: Codes of Conduct/ Compliance/ Corruption & Bribery</i>
	Industry Specific Criteria	Depends on Industry	Brand Management, Customer Relationship Management, Supply Chain Management Marketing Practices, Innovation & R&D, Renewable Energy, etc. <i>MSA: Selected Industry Specific Criteria</i>
Environment	Environmental Reporting*	3.0	Content: Qualitative, e.g. on material indirect/direct environmental issues; quantitative, e.g. key performance indicators, targets Assurance Coverage
	Industry Specific Criteria	Depends on Industry	Environmental Management Systems, Climate Strategy, Biodiversity Impacts, Product Stewardship, etc. <i>MSA: Selected Industry Specific Criteria</i>
Social	Human Capital Development	5.5	Human resource skill mapping and developing process Human Capital performance indicators Personal and organizational learning and development
	Corporate Citizenship/Philanthropy	3.0	Measuring the results of contributions Philanthropy/Social Investment Volume
	Social Reporting*	3.0	Content: Qualitative, e.g. on material societal, labor related issues; quantitative, e.g. key performance indicators on workforce, suppliers, community Assurance Coverage
	Industry Specific	Depends on Industry	Product Information, Product Quality and Recall Management, Global Sourcing, Occupational Health & Safety, Healthy Living, Bioethics, etc. <i>MSA: selected Industry Specific Criteria</i>

* Criteria assessed based on publicly available information only

Source: Stoxx Europe Sustainability Index Guide Book

Each question has a predetermined weight for the answer, the question, the theme and class within the question. ¹⁴¹ The following table gives an example:

Table 5: Scoring of Question X ¹⁴²

Does your company ratify the environment charters or does it fully comply with the principles of sustainability council?							
Question 45:							
Answer 1	Yes,						
Answer 2	No						
Scores					Scoring Calculation		
Answers	Answer	Question (Question 45)	Criterion (Environment charters)	Class (Strategical Opportunity)	Maximum of Points:		
More than 3	100	0.4	0.25	0.15			
2 or 3	66				$= 100 * 0.4 * 0.25 * 0.15$		
1	33				$= 1.5$		
No charters	0						
No answer	0						

Source: K. Kicheol (2002, 40).

Question 45 can reach a maximum score of 1.5 for the sub criterion "environment charters".¹⁴³ The sum of the scores of each question determines the total score of the respective criterion, in the example above it is the criterion "environmental reporting".¹⁴⁴ The following table shows an example where the criteria scores of the three dimensions are given:

¹⁴¹ Stoxx Europe Sustainability Index Guide Book (2010, 9ff).

¹⁴² Since the source is from 2002, changes to the methodology are possible.

¹⁴³ Kicheol (2002).

¹⁴⁴ SAM Benchmark Report Company Centrica (2006).

Table 6: Example for a Corporate Sustainability Rating (1)

Explanation	Company Score	Average Score	Weighting of Dimension or Criteria in Total Score (%)
	is the actual score of the company	is the industry group's average score	is the weighting of the dimension respectively criteria to calculate the total score
Criteria Scores			
Economic Dimension			
Criteria	Company Score (%)	Average Score (%)	Weighting in Total Score (%)
Corporate Governance	83	73	6
Risk & Crisis Management	79	53	6
Codes of Conduct	81	67	5.5
Customer Relationship Management (IS)	81	58	4.5
Market Opportunities (IS)	41	42	6
Price Risk Management (IS)	50	47	6
Environmental Dimension			
Criteria	Company Score (%)	Average Score (%)	Weighting in Total Score (%)
Environmental Performance (Eco-Efficiency)	40	42	7
Environmental Reporting	75	63	3
Environmental Policy/Management System (IS)	81	65	4
Advanced Environmental Performance (IS)	100	56	1.5
Storage, Transportation and Distribution Infrastructure (IS)	100	55	4
Manufactured Gas Plants (IS)	100	68	4
Infrastructure Projects (IS)	28	32	3
Climate Strategy (IS)	47	52	6
Biodiversity (IS)	55	53	3
Social Dimension			
Criteria	Company Score (%)	Average Score (%)	Weighting in Total Score (%)
Labor Practice Indicators	93	67	5
Human Capital Development	94	35	5.5
Talent Attraction & Retention	67	51	5.5
Corporate Citizenship/Philanthropy	78	53	3.5
Social Reporting	94	64	3
Stakeholder engagement (IS)	95	73	4.5
Occupational Health & Safety (IS)	65	48	3.5

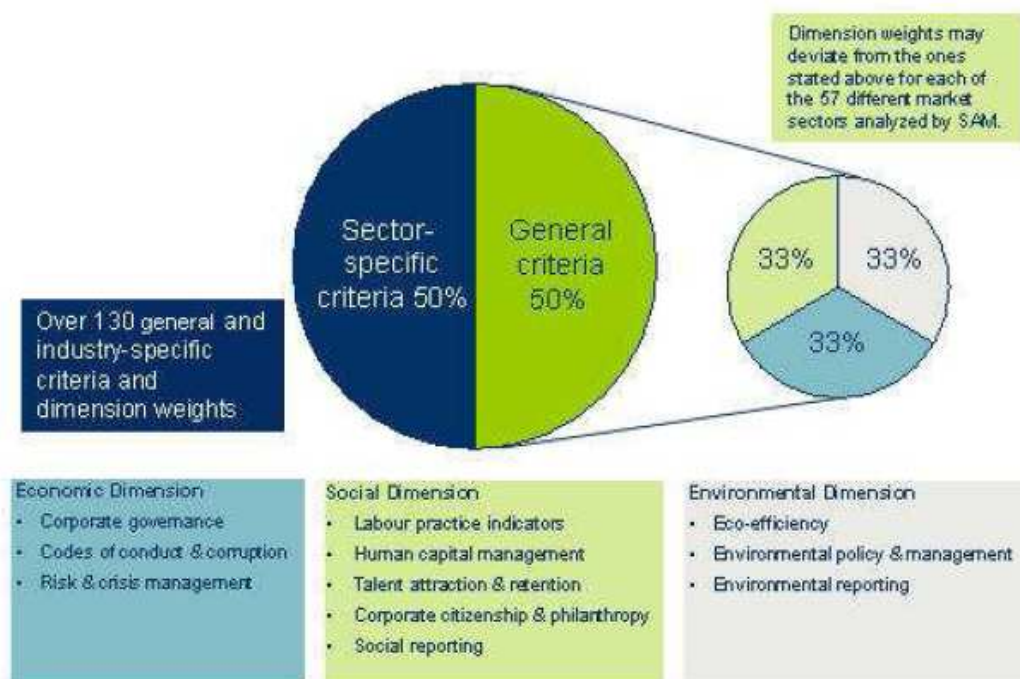
Source: SAM Benchmark Report Company Centrica (2006)

The company score is the actual score for the respective criterion and the average one represents the industry's group average score. The last column of the table gives the different weighting for the general and industry specific criteria. The general criteria have a pre - defined weighting scheme and the sector specific weighting depends on the industry.¹⁴⁵

¹⁴⁵ SAM Benchmark Report Company Centrica (2006)

The three dimensions are in general equally weighted. However, some industries have a non – equal exposure to the three dimensions, which is reflected in the industry’s specific assessment part.¹⁴⁶ The weight of the industry – specific criteria has constantly risen from around 30% to just under 60% of the total score. SAM believes that sector relevant sustainability opportunities and risks play a major role in the long term success of companies. The following figure shows the systematic weighting of the corporate sustainability assessment, which can differ from industry to industry.¹⁴⁷

Figure 17: Weighting Systematic



Source: SAM Questionnaire (2010).

Based on the individual weightings of the criteria, the dimension scores can be determined. Since the scoring methodology is not fully published by the company, the actual calculation of the scores can not be followed. Basically the dimension score should be influenced (among other components) by the

¹⁴⁶ SAM (2009, 20)

¹⁴⁷ SAM (2010, 11).

company score of the criterion, the weighting of the criterion and depending on whether it is a sector specific or general criterion, the respective weighting of the criterion.¹⁴⁸ The following table shows the result of the three dimensions.

Table 7: Example for a Corporate Sustainability Rating (2)

Dimension Scores			
	Company Score (%)	Average Score (%)	Weighting in Total Score (%)
Economic Dimension	68	56	34
Environmental Dimension	65	53	35.5
Social Dimension	84	55	30.5

Source: SAM Benchmark Report Company Centrica (2006)

As figure 17 demonstrates, each dimension of sustainability accounts of one third of the total sustainability performance score. However, the weighting of the dimensions differs according to the average and best score of the respective industry.¹⁴⁹ Table 7 shows the different weightings of the three dimension scores. Now the final corporate sustainability performance score can be calculated.

Table 8: Example for a Corporate Sustainability Rating (3)

Total Scores:		
	Company Score (%)	Average Score (%)
Total Score	72	55

Source: SAM Benchmark Report Company Centrica (2006)

The total sustainability score is the basis for the best in class selection. The aim is to identify the best companies in each sector. This approach enables

¹⁴⁸ Conclusion based on SAM Benchmark Report Company Centrica (2006).

¹⁴⁹ SAM (2010).

SAM not to exclude any sectors from the sustainable universe and to invest in best sustainable companies from a wider pool of industries.¹⁵⁰

The next step of SAM's investment process is the integration of the sustainability performance into the financial valuation in order to achieve a better fair value of the companies.¹⁵¹

The first step of this integration is to translate the absolute sustainability performance of the respective company into a measure of sustainability performance relative to the industry. In order to reflect the impact on the intrinsic value of a company by the sustainability performance, the free cash flow (FCFF) and the discount rate (WACC) are adjusted. The sustainability related risk is reflected in the WACC and the sustainability related opportunities can result in a better level of operational efficiency. This leads to a better return on invested capital (ROIC) and to a lesser extent to sales benefits. These are also drivers for the shareholder value of a company. The good sustainability performance will increase the ROIC and sales growth, while reducing the WACC. This leads to a sustainability premium on the top of the company's fair value as illustrated in figure 18. ¹⁵²

To give an example: A better human capital development policy will lead to a greater employee motivation and employee satisfaction. This will translate into a superior operational efficiency which improves the ROIC and sales growth. Finally, the improved ROIC and sales growth will translate into rising FCFF, which will positively impact the fair value of the company. ¹⁵³

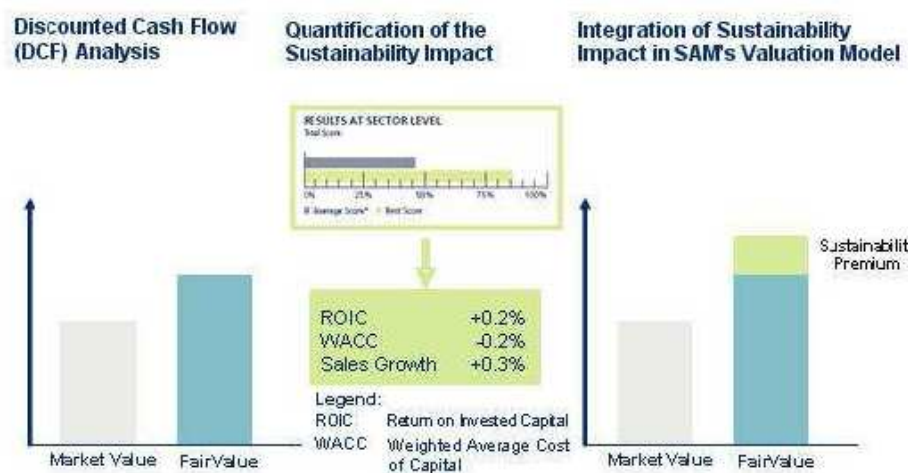
¹⁵⁰ SAM Questionnaire (2010)

¹⁵¹ SAM (2010, 14ff).

¹⁵² SAM (2010, 14f).

¹⁵³ SAM (2010, 15).

Figure 18: Integration of Sustainability



Source: SAM Yearbook 2010

This investment approach enables SAM to integrate sustainability and financial analysis in a systematic way.

The other major part of SAM's sustainable investing is engagement. SAM provides an objective report regarding the sustainability performance of the companies that supports the companies to gradually improve their strategy and to adopt more sustainable business practices. The corporate sustainability assessment process helps SAM to reach a number of companies and it provides the basis for an ongoing structured dialogue with companies on their sustainability performance. 67% of the participating companies improved their sustainability performance year on year.¹⁵⁴

¹⁵⁴ SAM UN Principles for Responsible Investments (2009, 4)

4. Conclusion

In this thesis I have focused on the concept of SRI. My aim was to give an insight into the different approaches of SRI that are employed in practice.

The evolution of SRI can be traced back to the 18th century. The traditional view was that the responsibility of a corporation is only the maximization of wealth. However, investors are now more aware of the corporate responsibility and seeking for more sustainable forms of investing. Issues like financial crisis, corporate scandals or sustainability challenges have enforced more the importance of SRI.

We have also seen that the definition of SRI differs from investor to investor according to time and country. From my point of view, which is supported by the definition of Eurosif, SRI is a combination of ethical, sustainable and social investments. The investor considers non - financial criteria like environmental, social and governance issues into the investment decision in order to have a comprehensive view of the company and the respective industry.

Principally SRI can be divided into three main investment approaches. The first is screening of the companies, which can be based on positive or negative criteria. The negative ones are mostly used for the exclusion of the companies. The positive screening is based on a set of criteria concerning environmental, social and governance issues. The second approach is engagement, which is a long - term process of dialogue with companies to influence them toward socially responsible business practises. Finally, we can conclude with the integration, which is the incorporation of ESG risks and opportunities into the investment process.

The strong demand of socially responsible investments comes from the institutional side, especially from the pension funds. This is mainly due to the

enforcement of responsible investment philosophy in pension funds. Further drivers are regulatory requirements, NGO's and media.

On the performance side, the main criticism is that traditional benchmarks achieve a better performance than the SRI funds. Based on the referred findings it can be concluded that there is no significant evidence for an underperformance of socially responsible investments.

Given the theoretical background information about the topic, the socially responsible investment process in practise is introduced. Erste Sparinvest, Sarasin and SAM are given as examples, with a special focus on Erste Sparinvest.

Basically ESPA and Sarasin have a similar approach compared to SAM. The main differentiation is the application of avoidance, whereas SAM considers every industry based on best in class. This enables SAM to invest from a wider pool of industries, whether it is the tobacco or energy sector.

Sarasin has a milder avoidance approach than ESPA since the companies are only excluded if they earn more than five percent of sales from non - responsible activities. ESPA applies exclusionary criteria, where specific companies are immediately ruled out. However, the Sarasin Sustainability Matrix restricts further the universe depending on the industry specific risk potential. The higher the risk of an industry regarding its environmental and social sustainability, the more is the barrier for companies of the respective industries to enter the universe.

In terms of the ESG methodology all the three players are incorporating environmental, social and governmental issues into the sustainability assessment.

Another crucial differentiation of the ESPA SRI process is the holistic and objective SRI approach based on a multiple sourcing by the rating agencies, ethics committee and in house team. Different expertises and methodologies are incorporated in the investment process. Especially the application of the qualitative screening based on a comprehensive set of criteria, irrespective of the industry, outlines the ESPA SRI approach from the other two competitors. The combination with positive screening, best in class, avoidance and engagement leads to a multi dimensional approach. The measurement of sustainability of SAM and Sarasin is done by best in class, whereas Sarasin additionally combines it with the best of class strategy.

However, SAM's corporate sustainability assessment process is based on primary research, where the companies are directly questioned in order to gather the information. The questionnaire provides the basis for an ongoing structured dialogue with companies on their overall sustainability performance. In that way SAM has as extensive engagement strategy with the companies compared to the other competitors and is able to collect a comprehensive pool of information for the corporate sustainability assessment.

Compared to ESPA and Sarasin, SAM incorporates the approach integration into all of its investment strategies. The in-house sustainability analysis is considered in proprietary valuation models in order to achieve a fair value of sustainable companies.

The main findings are given in the following table below:

Table 9: Summary of the Main Findings

	ESPA	SARASIN	SAM
Definition	"Socially Responsible Investment is based on a three-dimensional analysis of investments. This investment style does not only focus on short-term financial performance but also on social and environmental aspects."	"Sarasin defines sustainability in business as the socially responsible production of goods and services with maximum resource efficiency using production methods with a low potential for conflict."	"Sustainability Investing is the incorporation of risks and opportunities deriving from economical, environmental and social dimensions."
Number of Years in Sustainable Investing	Since 2001	Since 1989	Since 1995
SRI Approaches	Negative Screening (Negative and Exclusionary Criteria)	Negative Screening (Exclusionary Criteria)	No Negative Screening Applied! (No industries are excluded)
	Screening: Positive Criteria	-	-
	-	Screening: Best of Class (Industries)	-
	Screening: Best in Class	Screening: Best in Class	Screening: Best in Class
	No Integration Applied.	No Integration Applied.	Integration
	Engagement	Engagement	Engagement
SRI Investment Process	1. Research (incl. application of SRI approaches)	1. Research	1. Research
	2. Screening	2. Pre screening	2. Application of scoring process and best in class
	3. Investment board	3. Social and environmental analysis	3. Valuation - Financial integration
	4. Sustainable universe	4. Sustainable universe	4. Sustainable universe
	5. Traditional investment process	5. Traditional investment process	5. Traditional investment process
	6. Engagement	6. Engagement	6. Engagement
Research	Independent external primary research by Oekom, Innovest, RiskMetrics, Ethics Committee	Mainly secondary research (news, research, etc.), but also to a lesser extent primary research in form of company meetings	Inhouse primary research - "Annual Corporate Sustainability Assessment" in the form of a questionnaire
Rating Process	Oekom: Corporate Rating based on qualitative screening focusing on social and environmental sustainability. Weighting of social and environmental criteria according to the industry characteristics (Positive Criteria)	Sarasin Sustainability Matrix: two dimensional rating system, consisting of an industry and a company rating. Each rating dimension incorporates an environmental and social analysis.	Corporate Rating based on general and sector specific criteria. Criteria allocated to dimensions of economic, environmental and social.
	Innovest: Incorporation of industry key issues resulting from IVA (sector research). According to the key facts the criteria for the corporate rating are adjusted (Positive Criteria)	X Axis: industry rating and Y-axis: company rating.	Dimension weights are set according to average and best score of the respective industry. Sector specific criteria are weighted higher than the general criteria
	Innovest: Corporate Ratings are additionally adjusted based on the assessment of the best in class companies. Those companies are achieving more "points" in the SRI universe. (Best in Class)	Companies from high risk industries are considered only if they have high company sustainability ratings. Low sustainability rating industries have higher barrier for entry to the investment universe	Financial Integration of Sustainability Performance by adjusting WACC and ROIC
	RiskMetrics: Incorporation of the corporate governance ratings		
	Involvement of the ethics committee in the SRI process		
Positive Criteria	Positive Criteria applied by Oekom: <u>Social</u> : Staff and Supplier, Society and Product Responsibility, Corporate Governance and Business Ethics <u>Environment</u> : Environmental Management	Quantitative and qualitative criteria applied for the whole product lifecycle. <u>Environmental Criteria</u> : energy consumption, water consumption, toxic emissions, waste, material intensity, etc. <u>Social Criteria</u> : based on the shareholderconcept --> Criteria: shareholdergroups, Sub-criteria: internal and external conflict potential	<u>Economic</u> : General Criteria --> Corporate Governance, Risk & Crisis Management, Codes of Conducts/Compliance <u>Industry Specific Criteria</u> like Brand Management, Customer Relationship Management, Supply Chain Management <u>Environmental</u> : General Criteria --> Environmental Reporting, <u>Industry Criteria</u> : Environmental Management Systems, Climate Strategy, etc. <u>Social</u> : General Criteria --> Human Capital Development, Corporate Citizenship, Social Reporting <u>Industry</u> --> Product Information, Product Quality, Safety, Healthy, etc.
Negative Criteria	Exclusionary Criteria: nuclear power, green gene technology, child labour, business malpractice, pornography, military devices/weapons, tobacco, (avoidable) animal testing, death penalty and violation of ILO protocol	The companies are only excluded if they earn more than five percent of their sales from the manufacture of the following products: nuclear power, weapons, chlorine and agrochemicals, tobacco and pornography.	No Negative Screening Applied!!!
Integration	Not applied.	Not applied.	Sustainability Information is systematically integrated in it's valuation model to evaluate the fair value of companies
Engagement	Espea is responsible for the engagement strategy in the domestic market. In terms of engagement on the international market a renowned partner supports the team. (voting rights, boardmeetings,...)	Communicate with the management regarding shareholder interests. They conduct actively voting policy.	The corporate sustainability assessment process helps SAM to reach a number of companies and provides the basis for an ongoing dialogue with companies on their sustainability performance.

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Abbreviations

ESG (Environmental Social Governance)

SRI (Socially Responsible Investing)

Eurosif (European Sustainable Investment Forum)

UN PRI (United Nations Principles for Responsible Investment)

CSR (Corporate Sustainability Rating)

UKSIF (Sustainable Investment and Finance Association)

HNWI (High Net Wealth Individuals)

NGO (Non-Governmental Organizations)

MVA (Market Value Added)

EVA (Economic Value Added)

PE (Price Earnings Ratio)

ROCE (Return on Capital Employed)

CSP (Corporate Social/Environmental Performance)

CFP (Corporate Financial Performance)

ESPA (Este Sparinvest)

IVA (Intangible Value Assessment)

SAM (Sustainable Asset Management)

FCFF (Free Cash Flow)

WACC (Weighted Average Cost of Capital)

ROIC (Return on Invested Capital)

Appendix

Abstract – German:

Die Arbeit befasst sich mit dem Thema nachhaltige Anlagen – „socially responsible investing“ (SRI). Das Konzept wird anhand von den SRI Investmentprozessen von drei Kapitalanlagegesellschaften näher gebracht. Der Hauptfokus liegt auf dem SRI Prozess der Erste Sparinvest, welche anschließend mit den SRI Anbietern Sarasin und SAM verglichen wird.

Im ersten Teil der Arbeit wird das Thema SRI wissenschaftlich näher gebracht. Hierzu werden unter anderem die verschiedensten Definitionen in der Literatur und die wichtigsten Meilensteine in der SRI Entwicklung genannt. Die Relevanz dieses Investments wird auch durch die Darstellung des SRI Marktes und deren Hauptantriebskräfte verdeutlicht. Im letzten Schritt wird der Performance – Aspekt von SRI diskutiert. Da im Allgemeinen die Hypothese vertreten wird, dass Nachhaltigkeit die Performance benachteiligt, wurde dieser Aspekt durch Heranziehung etlicher akademischer Studien genauer beleuchtet. Es kann der Entschluss gefasst werden, dass Nachhaltigkeit in der Veranlagung keine signifikante Benachteiligung hinsichtlich Performance aufweist.

Der zweite Teil beinhaltet die Gegenüberstellung des SRI Prozesses der Erste Sparinvest mit Sarasin und SAM. Die Hauptunterschiede des Investmentprozesses werden anschließend diskutiert.