Playing it smart with socially responsible investments

Financial markets are putting more weight on social, ecological and ethical factors as demand rises for investments which foster sustainable growth. Socially Responsible Investment (SRI) funds provide opportunities

There were around 150 SRI funds on offer in Europe at the turn of the millennium. By mid-2004 that number had risen to over 350. In 2004, the total volume of these funds in German-speaking countries topped the €5 billion mark for the first time. In Europe as a whole, the figure is now around €19 billion.

SRI funds invest in the stocks or bonds of companies that meet specific sustainability criteria. To manage such funds, financial institutions have developed processes that enable them to assess the sustainability performance of companies. Based on their assessments, fund managers select companies with the best SRI profiles from a broad universe, using a best-in-class approach. Some use methods that exclude individual companies or even whole sectors of the spectrum (a process known as negative selection). They may, for example, choose to avoid firms active in controversial industries such as armaments, tobacco or gambling.

Testing for sustainability

Ecological analysis looks at factors such as a company's environmental strategy, examining whether it recycles certain raw materials or tries to minimize its energy usage. Fund managers also take account of the social effects of products, and the working conditions and benefits available to the firm's staff.

SRI analysts evaluate a company's relationships with its customers, suppliers and competitors, public authorities as well as shareholders or creditors. They examine corporate governance, using criteria such as the make-up of the board of directors and the compensation paid to management. Then there are sector-specific issues. In the pharmaceuticals industry, for example, they include the ethical principles underlying genetic engineering or experiments on animals, or policy on drugs pricing for developing countries. In the food sector, fund managers look at the use of organic and genetically modified foods, as well as the working and environmental conditions of suppliers. In the automobile industry, the issue is whether companies are working on energy-saving, low emission vehicles.

The sustainability bonus

Fund managers continuously monitor whether the companies they choose still meet their selection criteria. They also regularly check whether a company has improved to the extent that it can qualify for an SRI fund. They call on the specialist knowledge of third parties such as independent experts, rating agencies specializing in sustainability, and non-governmental organizations (NGOs).

Although only a fraction of total investment is made on the basis of sustainability criteria, more and more financial analysts are taking account of the issue. And an increasing number of analysts are placing a company's social and ecological commitments on a par with its other business-related obligations such as debts, equity capital and pension reserves. There is a realization that sales lost through damage to a company's reputation or class actions brought by aggrieved consumers can impact a company's bottom line and seriously depress its share price.

So financial analysts work to identify the ecological and social risks that companies face. They look at how they deal with them, and at the possible financial consequences of ignoring or dealing inadequately with sustainability risks. These include damage to companies in the consumer goods industry if their suppliers in Asia fail to meet minimum environmental or social standards. For fast food chains and food producers, obesity and its cost to society are major risk factors. For insurance companies, the main danger might be climate change. Financial analysts who overlook these risks are in danger of coming to the wrong conclusions, with potentially disastrous consequences for investors.

A company's quest for sustainability can open up opportunities. In looking for sustainable solutions, it may discover

More and more investors are keen to preserve a healthy environment for future generations

new business fields, for example in the area of energy efficiency. Alternatively, products based on sustainable growth may help to set it apart from competitors in fiercely competitive markets. Not least, a company that treats its staff well increases their motivation and becomes an attractive employer for qualified personnel.

More and more companies are recognizing these risks and opportunities. They are taking steps to ensure that they respond adequately to current environmental and social challenges. Both investors and companies are keen to make a contribution to preserving a healthy society and environment. Ultimately, firms whose sustainability performance earns them a place in the sustainability indexes (the FTSE4Good or Dow Jones Sustainability Indexes) will find favour with an increasingly important segment of the investment community.

The trend towards socially responsible investments will likely grow in the coming years as societies attach increasing importance to economic growth built on sustainable social, ethical and ecological values. /

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SRI concepts

Socially Responsible Investments (SRIs) are investments made not merely for financial reasons, but also on the basis of social, ecological and ethical considerations. In most cases, the investments are in equity or bond funds, but SRIs also include private equity, project finance and micro credits.

Sustainability is defined in the 1987 Brundtland report as: '[making] development sustainable to ensure that it meets the needs of the present without compromising the ability of future generations to meet their own needs.' It therefore includes social, ecological and economic factors which interact with each other in a complex series of ways.

Corporate Governance encompasses the principles and rules governing how a company is managed and controlled at the highest level.

Corporate Responsibility is the way in which a company perceives its role and responsibility within society.