



INTRODUCING
ETHICAL
INVESTMENT IN
A DYNAMIC
SOCIETY

OCCASIONAL PAPERS: 11

INTRODUCING ETHICAL
INVESTMENT IN A
DYNAMIC SOCIETY

EDITED BY
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FOREWORD

This publication presents the edited versions of the interventions made by the writers at a seminar organised by APS Bank in June 2012. The theme was *Introducing Ethical Investment in a Dynamic Society*, a subject that spans several issues that are the object of debate and analysis in many countries. While all peoples yearn for personal development, social cohesion and sustainable economic growth there are gaps between identifying worthy objectives and creating the means to attain them within fairly reasonable time frames. The seminar sought to introduce the series of considerations that relate to the subjects of ethical investment and resilient societies.

APS Bank sponsors seminars as part of its educational initiatives. It publishes the proceedings to diffuse the knowledge to a wider audience. But the views expressed are the authors' personal opinions.

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November 2012

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ETHICAL INVESTMENT
IN A DYNAMIC SOCIETY:
From basic beliefs to economic growth
and personal happiness

No matter how hard societies try to develop an economic system over a defined geographical space that can continuously self-sustain itself and grow in a particular manner, the task turns out to be repetitively elusive. Time and time again, one generation after another is forced by reality to admit that its understanding of the complex set of relationships that bind one person to another in the home, at work and at leisure, is weak. Since this knowledge is imperfect or incomplete, its application for decision-making is bound to be influenced by the gaps in information. As a result, the future is always conditioned by the unknown as much as by what is registered to have occurred. However, people tend to focus more on what they usually know or do rather than on what they leave out. Consequently, they render an appreciation of past experience incomplete and, hence, they turn it into an inadequate tool with which to face an ever-changing future.

This observation applies more forcefully when one talks in terms of global scenarios. The loss of control over one's life that follows the opening of trade, and capital and labour movements worldwide - at times occurring

simultaneously with shifts of economic and financial power tied to changing geopolitical configurations – generates a sense of insecurity when charting one’s destiny. But, this position notwithstanding, people have to take control of their present and future, draw a way forward and proceed to implement whatever plans they make.

In doing so, they are influenced, at times unknowingly, by a set of basic ‘beliefs’ in the way they ought to relate to other people, defined by relations, gender, race, nationality and creed, as well as the manner they interact with nature in its manifold manifestations. Such underlying codes of conduct may be inspired by any of the world’s main religions or by general basic principles regarding interpersonal and intergenerational relationships. One such guideline could be that ‘one wants to leave the world a better place than one has found it’. The challenge lies in spelling out what is meant by such an objective and, more important, implementing measures to approach and, ideally, attain it.

It is as part of this ‘search for a role’ and ‘the means to fulfil it’ that one can consider ethical investments. These financial instruments are one such ‘purposeful interventionist’ tool that people may apply to attain specific objectives. Like all other instruments – means to an end – they cannot be static in nature. They evolve over time, and as the objectives get sharper, they become more focused, or/and enlarged. Being financial instruments, they cover a range of activities that may be undertaken for different reasons by would-be investors, with the result that they have to be considered more in the nature of an ‘umbrella’, a catchment of ideals and means, made up of distinct products that are inspired in their creation by similar, though not necessarily identical, sentiments

ruling Man, Nature and an efficient use of finite resources. The present discussion centres on the allocation of savings among different financial instruments, but the observations regarding entrepreneurial and managerial behaviour apply also, *a fortiori*, to all units involved directly in the production of goods and the provision of services.

Nor are governments, and indeed entire countries, excluded. Governments and countries have to gain their credit-worthiness; they have to be seen generating a self-sustainable quality of life for the present generation as well as laying sound foundations for supporting future economic growth and the welfare of the upcoming generations. Countries with a poor quality of governance are more susceptible to financial and economic crises which can threaten their willingness and ability to service their debt. Indeed, environmental, social and governance (ESG) standards applicable in a community could be more reliable as a gauge of the credit worthiness of a country than the present credit-rating system in use. (Kelleher, 2012)

‘Ethical Investments’ was the subject of a seminar organised by APS Bank in June 2012, to explore several issues that fall under this heading. These refer to the characteristics that make such financial instruments distinct from others; the personal traits that distinguish one decision maker from another and the vision of a world where ‘doing good’ is not only morally correct but also financially rewarding. Such basic ideas relate to the role of markets, legislators, regulators, auditors and general administrations in domestic and international exchanges of goods and services. They also refer to the basic vision of what economic behaviour *should* a community regard as ‘fair’, ‘decent’ and ‘worthwhile

pursuing', which vision need not necessarily reflect what *is actually* happening. The former is value-loaded and therefore subject to fundamental differences between one person and another; the latter is factual, although even data on 'present activities' may be subjected to different interpretations.

This introduction relates several economic concepts to their usage in social cost-benefit analysis, which represents attempts to integrate other criteria, besides satisfaction or profitability, into personal (or households') consumption and investment decisions. This exercise is ongoing; witness the debate on the utility for policy-making of such terms as, 'welfare', 'happiness' and a region's gross domestic product, or the usefulness of selecting key economic policy targets – like annual inflation rates, output growth or employment; or the reliability, as decision instruments, of the tools in use by analysts and fund managers when committing themselves to transfer funds from one position (say, liquidity) to another. Indeed, the debate is actually much wider: there is a lot of uncertainty regarding the effectiveness of fiscal, monetary and exchange rate policies and interventions vis-s-vis the creation of present output and, more important, their impact on future economic growth and a society's well-being. And while not everyone agrees on the wisdom of pursuing down the Socially Responsible Investing (SRI) path (Sheehan, 2002), a set of 'Principles for Responsible Investment' has been adopted even by the United Nations (UNEP, UN Global Compact, 2012).

So, Section one introduces several economic considerations based on 'standard' economic theory. Section two points out the main features of investment decision models that seek to integrate social criteria with the financial and economic parameters. Section three

illustrates the role of underlying religious beliefs for resource allocation from Catholic social teaching and Islam. Section four summarises the main arguments made by the respective speakers at the June seminar on ethical investments. Section five presents concluding remarks.

1. Evolution and clarification of basic economic concepts

In brief, one may define a decision regarding the channelling of resources (funds) to undertake a particular economic activity as being 'ethically driven' when one takes into account not only the financial flows from such an activity, but also other social and environmental considerations. These include the projected impact such activity will have, now and in the future, on the sustainability of the resources; on the natural environment in which it takes place during extraction, production and distribution; the use in everyday transactions of the commodities in question; the governance of the unit – codes of conduct - and its behavioural relationships with all concerned, including fiscal authorities. The list tends to get extended over time, rendering the exercise even harder the more parameters are included in the decision-making equation. The financial returns tend to change, rise or decline, as new factors are introduced. Besides, opinions are bound to differ on several issues, particularly in instances where the underlying personal values of decision-makers do not tally precisely one with another and, equally critical, when the parametric tools used in the calculation are found to be comparatively weak for the task at hand. One has to cut corners in such cases (e.g. fill in or ignore data gaps; apply statistical techniques notwithstanding their known limitations as reliable tools of measurement; combine quantitative with qualitative analyses to reach judgement).

The complexity of an 'ethical investment decision' may be deciphered from the series of diagrams given below. They refer to selected economic, financial, social and political parameters that can be said to encapsulate several inter-societal relationships. The diagrams are introduced in economic literature to synthesise in a snap-shot fashion various inter-relationships between human beings seen as consumers, savers, investors, employers, employees, traders, public policy makers and the rest of society within a nation state and internationally. One has to interpret these diagrams in the context of action by would-be investors, but for the purpose of this article they should only be considered as simple tools that highlight a range of considerations useful for projecting the ramifications of an 'ethically bounded investment decision' and the utility such an approach has for personal and community 'well-being'.

Several socio-economic considerations pertaining to decision-making in a modern market economy may be represented in the four quadrants that make up Diagram 1. All concepts introduced below are subject to discussion, a fact which is conveniently ignored for the time being. And the outcome expected from following particular policy packages is far from being identified in advance with certainty (Vide: Phelps, 2010; Haldane 2012 a, b; Bernanke, 2012; Gordon, 2012). But, for the purpose of this paper, the object is to spell out the interconnection that is thought to exist among the several themes taken up in the ethical investment literature.

Quadrant I refers to the relationship between the commodity markets (**IS** schedule) – a community's aggregate expenditure on consumer and capital goods and services in the private sector economy - and the money market (**LM** schedule). Both graphs denote the aggregate

demand for commodities and funds at different rates of interest (r) and aggregate output (Y). These interactions take place in the context of a given capital stock (K), money supply (M_s) and price level (P). Labour is a variable input; its demand depends on its productivity. The volume of domestic commodities may be changed by imports (M), which augment local supply, and exports (X), which deduct the supply of locally produced goods and services for domestic consumption. International trade also introduces another parameter for consideration, namely, the rate of exchange of a currency (ER). And, the amount of resources will also change in volume once the public sector is introduced. (In which case, the **IS** schedule will have to be re-defined to show such an extension; it becomes $(I+G+X = S+T+M)$, where **I** (Investment) and **S** (Saving) represent the private economy; **G** (Government expenditure) and **T** (Tax revenues) represent the public sector; and **X** (Exports) and **M** (Imports) represent the external sector).

The value of r in Quadrant I equates four important factors, namely, the monetary rate of interest; the 'real' rate of interest (equal to the money rate of interest less the rate of price change which is assumed zero in the model); the rate of return on investment; and the marginal rate of time preference, which reflects society's time preference between present and future consumption. In real life, these rates need not be equal one to another. For example, the monetary rate of interest is influenced also by tax considerations and perceived risk apart from the parameters referred to above.

Quadrant IV relates output to employment (N); the number of active workers (or man-hours worked) is determined by the combination of capital and labour inputs and the resultant productivity of the 'last worker

taken on'. The slope of the output schedule in quadrant IV yields the demand for labour graph in quadrant III (D_L). The amount of workers seeking employment at different real wage levels is represented by the aggregate labour supply schedule (S_L). The average wage settled under such conditions tends to W/P . In turn quadrant II represents the relationship between the return to factor Capital arising after the 'latest project' is carried out, and the return to factor Labour, once the marginal worker is engaged. The ratio (rK/Y) gives the total relative return to Capital, and the ratio $(W/P)N/Y$ represents the relative return to Labour; together they yield the Factor Share Distribution of a country's aggregate Income (Gross Domestic Product). This is an important economic parameter in itself and has significant policy connotations for a community's social cohesion.

Diagram 1 combines several key economic and social factors, namely: the resources available for consumption and capital accretion and their relative cost; the possibility of fiscal intervention, manner of financing and its related monetary cost and potential private sector displacement (crowding-out) effects; productivity of both the 'entire' capital stock and the marginal investment undertaken; the labour supply and marginal labour output; the composition of the labour supply influenced not only by the wages offered and demanded but also by demographics and legislation ruling age and gender activity in the labour market; and the resultant distribution of the national output among the 'capitalists' (income from self-employment, rental income and profits) and 'workers'. In short, any decision regarding the allocation of new funds (S) in an economic activity that expands the capital capacity (I) will have to be guided by the above considerations, among others, if such a decision were to

be efficient both from a profitability angle as well as from a social perspective.

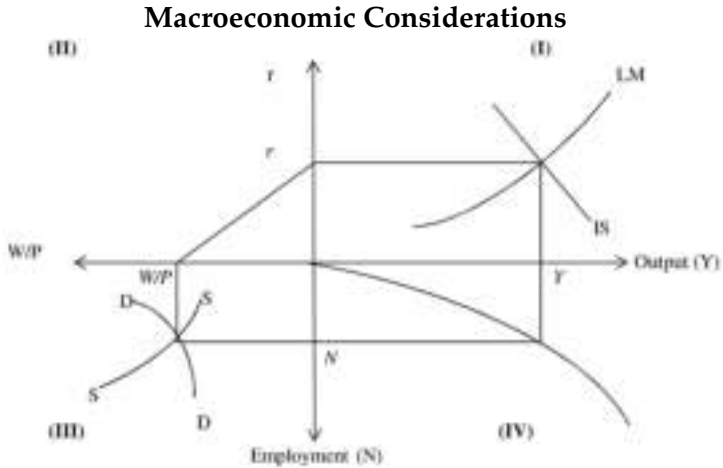


Diagram 1

Diagram 1 introduced parameters representing aggregates or averages. However, individual investment decisions are carried out in particular markets or sub-markets. Therefore, they have to reflect the properties of these trading environments and of the particular regions in which they are executed. The way in which markets are governed, in terms of legislation and day-to-day running, is also scrutinised by ethical investors. Suppliers and consumers may be 'exploited', surplus funds arising from regular economic activity may be used to foster one's own interests at the expense of other producers or consumers, and legislators and/or law enforcers may be corrupted to promote sectoral interests. But, market control may also lead to innovation and surplus profits may be distributed to enhance private well-being by transferring funds to

particular causes but outside the fiscal (tax-government expenditure) system. The distribution of profits and rents depend ultimately on personal decisions regarding the use of own wealth. Such considerations may be illustrated graphically as in Diagram 2.

Market Conditions, Rent-Seeking and Use of Surplus Funds

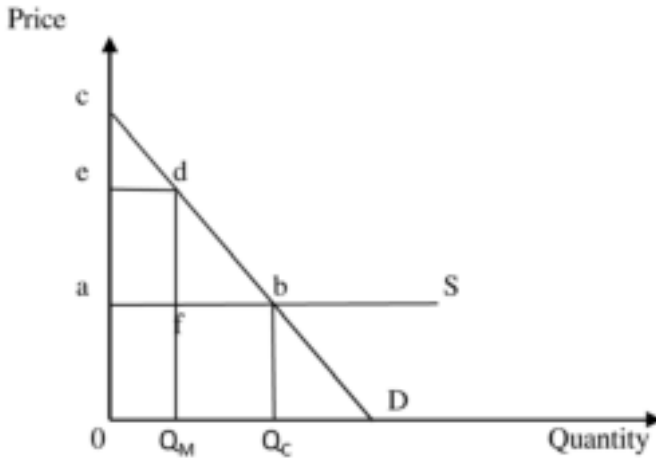


Diagram 2

In a 'perfectly competitive market situation', where the number of producers and buyers is very large, output is at Q_c and exchange takes place at price Oa per unit, a combination arising from the intersection of the Demand (D) and Supply (S) schedules. Total expenditure/revenue is $Oa.OQ_c$. But the total worth to consumers is larger than this amount; additionally it includes triangle abc that approximates the value of a 'hidden surplus'. Its value is equal to $0.5(ac.OQ_c)$. If the market in question is supplied by one producer – a monopolist – the value of sales equals

Oe.OQm. Of which *afde* represents 'monopoly rent', that is profits that arise because of the market control exercised by the producer. Consumers still enjoy a surplus under these conditions, equal to *ecd*, which is less than that recorded under the perfect competitive market structure.

Two points relevant for ethical considerations arise from such market conditions. One is the 'deadweight loss', represented by triangle *fdb* which is lost as a result of the changes in the market conditions. Although consumers also lose the value of the surplus represented by rectangle *aedf*, this is transferred to the producer; it is not lost but appropriated by someone else. A second consideration refers to the use of the resources valued at *aedf*; these may be allocated by the monopolist to lobby for action at local and international levels (e.g. influence trade policies, market regulation, government procurement processes, or tax concessions) to preserve the market-control position and the concomitant economic rents. Such activities are sometimes referred to as '*directly unproductive profit seeking*' (*DUP*); they are difficult to identify because they often end up being hidden under a load of bureaucratic procedures. But, these surplus funds may be allocated, instead, for research or philanthropy even in the case of those markets that of their intrinsic nature tend to monopoly or to an oligopolistic structure. Such entrepreneurial behaviour, which may be considered laudable from an ethical and social perspective, falls under the heading of 'creative capitalism' or 'humanistic capitalism' (Delia, 2010:90-91).

These ideas give rise to considerations regarding corporate governance in private and public sector entities; the creation of market structures; law making, enforcing and monitoring of trade and employment practices; international agencies; and bribery and corruption. Since governments have

monopoly control over various activities, including the domestic currency, fiscal and national debt behaviour find themselves in the list of factors that are scrutinised by ethical investors. The credit rating of governments and public utilities are therefore also indicative of the worthiness of sovereign debts and the prices that private investors demand for buying such securities. This is especially so when specific reference is made to a government's environmental and governance record.

Another set of deliberations arise from ideas illustrated in Diagram 3. These refer to the quantification of the economic surpluses introduced in Diagram 2. These amounts are influenced in part by cultural values that rule traditionally and often unconsciously the way people in a community relate to one another in their everyday transactions. Such cultural traits may be reinforced, in an evolutionary manner, but at times even in a revolutionary way, by enactments. Laws condition the distribution of property rights and, so, they also determine the valuation of the 'hidden' economic rents for consumers and producers. All private actions convey some form of third-party effect; markets cannot allocate resources efficiently at all times. So there has to be a way on how to compensate for unintended harms arising out of one's actions, or of recuperating rewards for benefits that may arise from one's behaviour. The estimation of such gains or losses will depend in part on personal perceptions of things arising generally from a society's cultural heritage and, also, partly on the status at law of the condition in question. The absence of laws or directives ruling interpersonal behaviour on selected occasions bear directly on both personal welfare, on the identification of liabilities, and, in turn, on the appraisal of any compensation that one may have to pay.

These monetary amounts, apart from the simple approximation of the consumer surplus for a fixed output value represented in Diagram 2, are depicted in Diagram 3. It introduces the concepts of Willingness-to-Pay and Willingness-to-Accept, also referred to in economic literature as the Compensating Variation (CV) and the Equivalent Variation (EV) of the implicit economic surplus.

**Valuing the Economic Surpluses:
Personal Perspectives and Legislation**

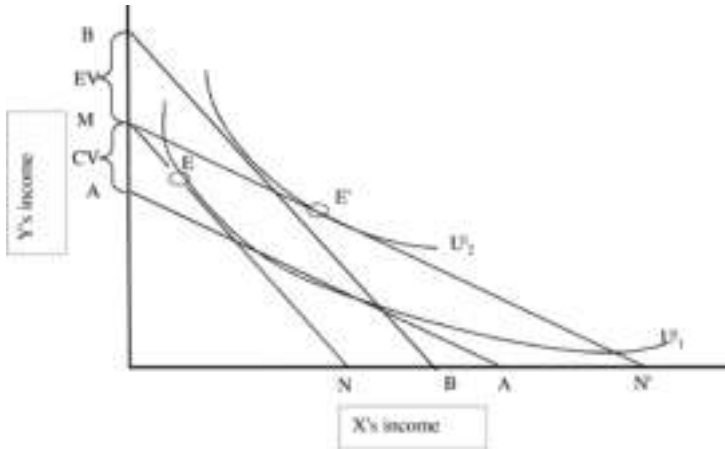


Diagram 3

CV reflects the amount an individual will be willing to pay in order to improve his well-being, by, say, buying a good or service for a given price. Such a condition will be represented in Diagram 3 by a move from a level of welfare labelled U_1^i to a higher level labelled U_2^i to position oneself at E^1 . Since the total expenditure will now have to include that on the service, there must be a maximum

amount which the consumer will be willing to pay in order to benefit from the offer, adjust total expenditure, and still be better off. This maximum amount is measured by **CV**.

Conversely, if one were to give up a favourable position and accept to, somehow, be treated differently – graphically moving down from level of welfare U_2 to level of welfare U_1 – then a compensation will be expected to make up for – or be equivalent to – the welfare surrendered. This amount will be such that, after the compensation is received, one ‘returns’, at least, to the initial welfare position. This value is represented by **EV**. The respective values of CV and EV are therefore heavily conditioned by the initial point of departure, which is, in turn, specified by the existence or otherwise of relevant legislation ruling rights and obligations. EV is expected to be greater than CV because one would be surrendering rights to which one is entitled.

In sum, one can relate several economic concepts, derived from microeconomic and macroeconomic literature, and relate them to ideas prevalent in the literature on ethical investment. These concepts, taken together, highlight the complexity that characterises a modern market economy in which private and public sector decisions tend to reinforce each other. They also suggest that a modern community has to decide on matters that involve both intra-generational distributions of resources as well as inter-generational allocation of assets via demographic changes, capital accretion, and factor productivity. All together they impact on the rate of aggregate economic growth. Since these concepts have to be translated into their statistical counterparts to be useful operationally, it is pertinent to examine briefly on the ways in which they were introduced in the investment

appraisal literature, particularly that section allotted for the economics of development and the economics of the environment. This is carried out in Section Two below.

2. Economic and Social Criteria in Investment Decision-Making Models

Diagram 1 introduces two concepts, and therefore two statistical parameters, for income distribution. Quadrant II depicts the relative price ratio of the two factors included in the model, namely Capital and Labour. The determinants of r and w/p recorded in the markets are various, and these exert different degrees of pressure over time. The factors introduced in Quadrants III and IV and in the LM function do not exhaust the list. Besides, this basic information can be extended to compute the distribution of a country's income between the two factors involved in its production. Such allocation gives the returns accruing to Factor Capital (rents, profits, part of income of self-employed) and to Factor Labour (wages and salaries and part of income of self-employed). However, Quadrant I depicts an Aggregate Households' Consumption (and Saving) schedule that is dependent on Personal Disposable Income. Disposable income represents total household's (personal) income, irrespective of source; it includes income from work, capital, entrepreneurial activity, and transfers from government programmes. From these amounts one deducts taxes on income and other mandatory contributions made to government regarding social security schemes.

These two types of income distribution are not really integrated in basic economic analysis. The two categories arise in distinct parts of economic analysis, with the

disposable income statistic taken as given. The political and social connotations arising from considerations regarding the distribution of income and wealth in a community are not given relevant weight in most economic analyses. They are seen emerging from the many events and turmoil that happen in a society. These may reinforce historically-given distributions of wealth and income or change them to various degrees. Political upheavals, selected fiscal interventions, and complementary measures ruling governance of enterprise and trade can induce profound changes in ownership of assets and related income flows over time. They are also influenced by the prevailing thought referring to state-ownership of assets and popular participation in the affairs of a democratic State.

But economic thought over the past half century attempted to address these policy lacunae by integrating some of these ideas directly in the appraisal of investment projects. The conclusions reached regarding the desirability and viability of particular projects, and as a consequence the allocation of scarce resources to their attainment, was made dependent on the array of objectives one wanted to reach and the way in which 'standard' investment selection criteria were operated.

Thinking departed from the simple rule that companies should only seek to use resources in such a way as to generate profits, possibly maximise profits or record what is considered an acceptable rate of return on the capital invested. Resources would be allotted according to the risk-appetite of the decision-maker (the 'investor'), which 'appetite' also reflected a prevalent time-frame within which the initial capital outlay would be recouped. Monetary instruments, like derivatives, were introduced to insure against specific risks. And legal forms of associations, like the Co-operative or the Limited Liability

Company, were also created to spread risk and limit personal liabilities.

As thinking evolved on the role of government in an economy, especially after the 1940's, other policy objectives began to be discussed with the intent of including them in a list of 'policy desirables'. Economic growth, fair income distributions among households, the sustainability of natural resources and environment – in particular unpolluted air, water, the seas and their resources, natural gas, petroleum and, lately, space – : these became the subject of special analysis in investment appraisal. Simultaneously, a greater sensitivity was shown to race and gender considerations in the process of economic development of a community, hence on social mobility and personal fulfilment.

Some thinkers sought to reconcile all these objectives over time, through the introduction of several statistical measures. Others tried to incorporate them all together, in the data sources themselves or in the decision making process ruling resource allocation for particular projects. The latter category includes the efforts to keep 'enhancing' statistical data such as the value of a country's aggregate output or Gross Domestic Product (Stiglitz, Sen and Fitoussi, 2009), and the suggestions for re-vamping the methodology that evaluates investment projects, particularly in so-called 'developing countries'. Two of these are briefly described below; they belong to the class of models that advanced social cost-benefit analysis on lines recommended by, among others, P. Dasgupta, A. Sen and and S. Marglin (1972), I.M. D. Little and J. A. Mirrlees (1974) and Squire and Van der Tak (1975). They may be considered as precursors of the present approaches to appraisal of Socially Responsible Investments (SRIs).

Colin Bruce (1976) summarises a series of guidelines on which appraisal of an investment project may be carried out. These guidelines incorporate factors such as the prime agent to whom income generated from the project accrues (is it private households or government?); the source of resources used in the production of the commodity, whether it is locally sourced or imported; the impact the project will have on the household income distribution in a region (i.e. whether it enhances the resources going to low-income earners or not); the rate of discount used in valuing income accruing over the life-time of the project. These criteria are incorporated together in the evaluation of the project, using specific parameters ('shadow rates' which adjust existing data by introducing premiums and discounts) to reflect the objectives to be maximised. As a result, the final outcome differs, sometimes widely, from the ordinary discounted cash flow evaluation. This latter is already an intricate exercise subject to the assumptions made. The former becomes even more demanding and may become susceptible to the deliberate adjustments by the evaluator. Even a change in the objective to be reached – e.g. maximise 'uncommitted income in the hands of government' or the 'base consumption level' – can change the ranking of different projects. One can thereby condition an investment decision by modifying the values of the parameters introduced with the implicit intent of producing the desired results.

If one were to add other criteria to the scope of investment, such as the emancipation of women by generating jobs outside a particular sector, then the ranking of projects and the use of scarce capital resources, foreign exchange and skilled labour will turn out to be even more demanding. For this reason, it was thought to be a more pragmatic way to handle this matter by taking it in steps.

Rather than integrating several analyses into one final coefficient, as the then current methodology indicated, it was considered more transparent and realistic to present a series of evaluations that would trace the movements in the ranking of different projects as these emerged from the introduction of additional considerations. The final statistical results may already be influenced by the investment selection criterion applied; hence there is no need to compound this process by introducing other elements that pertained to social and political desiderata. Such considerations are not strictly-speaking directly related to the viability of the project in question.

To this end UNIDO (1978) proposed to build the information matrix for decision-making in terms of a series of appraisals. Stage one refers to the financial analysis and regarded the profitability of the project. Stage two adds the direct economic benefits; this is where the 'external' impact of the project, both positive (benefits) and negative (costs), are introduced and, if possible, calculated. Stage three introduces measurement of the benefits accruing over time – the savings impact (inter-generational impact). Stage four measures the income distribution impact (intra-generational distribution). Stage five brings in considerations derived from social politics – the assessment of merit and demerit goods. The former would be subject to government subsidies in order to augment the amounts produced by the private market; the latter would be subjected to specific tax treatment in order to curb consumption and, hence, production. These steps, taken together, would lead to a transparent presentation of the data regarding the performance of different projects and, in principle, lead to a better way of allocating resources and attaining set objectives. But the financial viability of a project – subject to the usual caveats

related to all investment appraisals – will be determined at the outset. If other matters are taken into account, then one can identify the resource utilisation costs and the projected benefits that may accrue from them.

The approach proposed by UNIDO highlighted the complexity of decision-making that purported to integrate political, social, financial and economic objectives into a single coefficient. It simply cannot be done without the risk of losing the ability to interpret meaningfully the results obtained from the exercise carried out. It was more fruitful to draw a series of criteria and compile the related data. In this way, it would be possible to obtain an overall assessment of the project and then, take a decision. This outcome cannot be considered entirely 'objective' in the sense that it is solely based on numbers. It is always bound to remain 'subjective'. This is so because personal choices condition the selection of the model used, the inclusion of data bases (what is listed and what is left out), and their interpretation. This chain of exercises will always reflect the underlying values and 'character' (risk averse or otherwise) of the analyst. In part, they also influence the on-going debate on the various topics that make up choice of investment projects, both at the primary level of capital injection and in the selection of particular bonds and equities, or funds already on the market.

Suffice to point out that in a text of readings on, say, the economics of the environment, one finds that the themes taken up span issues related to ethics, markets, scientific knowledge, finance, corporate governance and regulation, the treatment of third-party effects and possibilities for their internalisation. This is quite a long list, which immediately suggests that any debate on such matter has to be intrinsically on-going. (Vide, Stavins, 2000) It is expected to be so because policy priorities

keep adapting themselves to scientific knowledge in various sectors and to public opinion. The latter reflects, in part, the age-profile of a community as well as regional economic differentials, which are expressed in output, incomes and labour activity rates by age and gender. These differences often give rise to 'innovative' ways to generate employment via government support to existing and new institutions.

For example, at present, a drive is on in many countries, including the European Union and the United Kingdom, to promote 'social enterprises'. These are entities that are motivated by economic efficiency and sound management; they may be profit-oriented or non-profit but whatever their legal format they are not meant to be dependent on government subsidies for their survival. Therefore, they are expected to be creative in supporting employment-generation for sub-groups of the labour market that are not being catered for satisfactorily financially and organisationally by existing institutions. They can address some of society's 'most trenchant problems too' (Munshi, 2012). The legal form of the unit tends to reflect the historical development of communal types of organisation. On the continent, EU states tend to veer towards the co-operative structure. In the UK, the model tends towards the other legal formats like charities or limited liabilities. But, irrespective of the legal form used, the objective remains the same. At a time when government's fiscal role and the resultant size of public sector deficits and national debts are under scrutiny by the international financial markets and rating agencies, societies have to identify ways forward with the aim of creating productive systems, in general, and welfare and cultural services, in particular. These latter activities may lose funding following the curtailment of resources by

the State. By promoting successfully social enterprises, societies hope to attain the dual objective of encouraging personal initiatives in various sectors and keeping society together.

These policy decisions often tend to reflect certain basic principles that emerge from a community's beliefs, including religious tenets. Such beliefs may contribute to the way in which a community organises itself in the production of tradable commodities and in voluntary work. Therefore, they will have an effect on the well-being of the group. It may be useful to examine the role of religious beliefs in policies and decisions ruling investment behaviour in the context of Catholic Social Teaching and Islamic economics and finance.

3. Religious Beliefs and Sustainable Investment and Finance

Catholic Social Teaching

Catholic social teaching is summarised in the *Compendium of the Social Doctrine of the Church* (2004). It brings together the insights into Man's existence and relation with fellow men and nature deriving inspiration from Revelation. It lays down principles; it is up to all those involved in economic activities to translate such basic tenets into every day operational criteria. In this context, economic activity and material progress are placed at the service of man and society. Social development can be properly understood in the context of integral and solidarity humanism. "The economy has as its object the development of wealth and its progressive increase, not only in quantity but also in quality; this is morally correct if it is directed to man's overall development in solidarity and to that of

society in which people live and work'(par.334). Several key principles (*ibid.* paragraphs 323 – 376) that guide behaviour are the following.

- i) The freedom of the person in economic matters is a fundamental value and an inalienable right to be promoted and defended.
- ii) Businesses should be characterised by their capacity to serve the common good of society through the production of useful goods and services. They also perform a social function, creating opportunities for meeting, co-operating and the enhancement of the abilities of the people involved.
- iii) Profits act as a first indicator that a business is functioning well. But these should arise in the context of 'properly serving society'.
- iv) The legitimate pursuit of profits should be in harmony with the irrenounceable protection of the dignity of the people who work at different levels in the same company. Recourse to usury is to be morally condemned.
- v) The market is an irreplaceable instrument for regulating the inner workings of the economic system. It has to be firmly rooted in its ethical objectives, which ensure and at the same time suitably circumscribe the space within which it can operate autonomously. Because of this important social function of the market, one must identify its most positive potentials and create the conditions that allow them to be put concretely into effect.
- vi) The fundamental task for the State in economic matters is that of determining an appropriate juridical framework for regulating economic activity. With a view to the common good, it is necessary to

- pursue the goal of a proper equilibrium between private freedom and public action, understood both as direct interventions in economic matters and as activity supportive of economic development.
- vii) Private non-profit organisations have their specific role to play in the economic sphere. These organisations are marked by the fearless attempt to unite efficiency in production with solidarity.
 - viii) Globalisation gives rise to new hopes but at the same time it poses troubling questions. It is able to produce potentially beneficial effects for the whole of humanity. But one has to note the risks connected with the new dimensions of commercial and financial relations, which may increase income and wealth inequalities.
 - ix) The experience of history teaches that without financial systems, economic growth would not have taken place. So there is an urgency to find institutional solutions capable of effectively fostering the stability of the system without reducing its potential and efficiency. There is the need not just for States but also the international community to take on this delicate chore with adequate and effective political and juridical instruments.

The Church's view of the firm tends towards what is termed the stakeholder's view of the corporation, rather than the shareholders' view of the company. According to the **shareholder model**, the company is a private property owned by those who hold its stocks. The company exists to make profit for its shareholders, even though the company is made up of various agents. Corporate executives are employees of the owners of the businesses and, so, they are said to have the responsibility to increase

corporate profits while conforming to the basic rules of society, following the law and acting in a manner that is ethical. In contrast to this view, the **stakeholder model of the firm**, the company is a servant of the larger society. It emerged as recognition of the fact that there is a wide range of groups and individuals who are impacted by the activities of the firm and, so, they also have a stake in the company. Like human beings, companies do not operate in a social vacuum. While this intuition is to the point, it does not resolve the questions concerning who has a stake in the company and the degree of that stake that various competing parties may have.

The *principle of subsidiarity* (decisions should be made at the most appropriate levels of an organisation) may be useful in this context, in particular in the context of corporate governance and the combined pressures emanating from internal management structures, external auditing and credit rating agencies, regulators, and international trade standards. Investors, both individual and fund managers, also act as control/supervisory forces when they account for what 'socially responsible behaviour' is acceptable on the part of managers and stockholders. Corporate governance system thrives when there is a healthy balance within the firm between command governance and self-governance; in corporate decisions between the economic concerns of shareholders, employees and customers on one hand and the social factors of stakeholders on the other; between competition and cooperation; and between external influence and internal governance. It seems that there is more awareness in private and public sector to emphasise the second element. Witness, the debate in the European Union on the way forward within the eurozone and the single market, via a banking and fiscal union; globally, on the revamped

role for the IMF; and, on a micro basis, on Chiara Lubich's proposal of the Economy of Communion model of enterprise where the emphasis on personal behaviour is on *giving* rather than *receiving* (Lubich, 2006; Delia, 2006). It is claimed that such an approach is more compatible with Man's basic empathic tendencies rather than the aggressive, acquisitive approach linked to consumerism and exploitation that many seem to propagate.

In addition, two other 'operational' rules may be derived from Catholic moral theology (Ascension Health, 2012). Following Thomas Aquinas, the fundamental principle of morality is synthesised as 'Good is to be done, evil avoided' (Summa Theologiæ I-II, 94,2). This may be interpreted that every action should promote and respect the dignity of the human person and the basic goods of life, rationality and sociality. Then, to chart one's behaviour, one can follow the basic idea (the spirit) spelled out by the *principle of double effect*, when economic and financial assessors balance their good intentions with any negative side-effects that may emanate from their actions.

But all human actions create third-party effects; and economic literature distinguishes between pecuniary and real externalities. Pecuniary externalities are transmitted through the market system. Real or technical externalities are direct, accidental by products of a person's action on the welfare of another person or the output of the firm. They occur outside the market system and are therefore not accounted for in the emerging price matrices. Consider a case of pecuniary externality. If one buys product X, the producers of X are better off; but by preferring X, the consumer does not purchase Y, so the producers of Y are less well off. In this sense, there is always a negative spill-over effect somewhere in the economy. These types of effects are happening all the time as a result of human

decisions and actions. To meet this quandary, a second operational rule may be applied: distinguish between *formal and material cooperation*. People cooperate with others in order to achieve or preserve important goods, or in order to diminish or avoid worse evils or harm. While formal cooperation (one shares in the object of an agent's intention) is not morally permissible, according to Catholic moral theology, material cooperation (when one cooperates but does not concur with the other's intention) may be permissible in certain circumstances.

These two principles – of double effect and formal and material cooperation - are applied through the Negative and Positive screening processes, explained in the SRI literature, and in the direct intervention by shareholders (read: personal and institutional investors) in corporate general meetings – whether annual or extraordinary – meant to induce a change in the trading or administrative behaviour by the firms' executive. And, indeed, all entrepreneurs may be guided by them, irrespective of the legal model adopted for the productive unit under their control or management.

Islamic Economics and Banking

'Islamic economics' seeks to identify an economic order that conforms to Islamic scripture and traditions. As a discipline, distinct from mainstream economics, it is still evolving (Addas, 2008). It aims to develop an interest-free financial system because the Shari'ah prohibits fixed or floating payment or acceptance of specific interest or fees (equated with *riba*) for money loans; these may represent 'surplus value without counterpart', since the numerical value of a transaction, as such, is considered to be immaterial. Interest payment is acceptable in the case of fiat currency. Investing in businesses that

generate goods or services is also considered contrary to Islamic principles. Islamic banking is restricted to Islam-acceptable transactions, which exclude those involving alcohol, pork or gambling. The aim is to engage in only ethical investing and moral purchasing. The driving force behind this objective is identical to those guiding SRIs in Europe and America. But in the Islamic case, it goes further: it dictates the use, or prohibition, of particular monetary tools and, therefore, effective instruments.

Thus, to avoid charging an interest rate on a loan, operations centred on the idea of sharing profit and loss and risk through profit sharing (*Mudharabah*), safekeeping (*Wadiah*), joint venture (*Musharakah*), cost plus (*Murabahah*) and leasing (*Ijar*). Thus, for example, in an Islamic mortgage transaction, instead of loaning the buyer money to purchase a flat, a bank might buy the flat itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in instalments. The bank's profit is not made explicit; so no additional penalties can be introduced for late payment. However, to protect itself, the bank asks for strict collateral.

Floating rates may be adopted through rental. The bank and borrower form a partnership entity, both providing capital at an agreed percentage to purchase the property. The partnership entity then rents out the property to the borrower and charges rent. The bank and the borrower will then share the proceeds from this rent based on the current equity share of the partnership. At the same time, the borrower in the partnership unit also buys the bank's share of the property at agreed instalments until the full equity is transferred to the borrower and the partnership is ended. If default occurs, both the bank and the borrower receive a proportion of the proceeds from the sale of the property based on each party's current equity.

Similar arrangements are carried out for other kinds of transaction. As a result, theoretically, an Islamic bank should be an example of full-reserve banking, achieving a 100% reserve ratio. In practice, this is not the case. This could be happening because financial institutions may publicise profit-loss sharing (hence interest free) formats, and package standard banking products under Islamic labels. But, in practice, they will be marginalising profit-loss sharing (Farooq, 2008).

In sum, religious thinking can influence human behaviour. The impact of culture on human action cannot be minimised. But one must distinguish between two approaches: laying down general principles and transfer the onus of transposing them in dynamic economic and social contexts on the operators; and defining principles and, at the same time, 'identify/dictate' the economic or financial instruments that operators can adopt. This second approach tends to restrain behaviour. Since, by definition, dynamic societies cannot anticipate their needs and the appropriate tools to satisfy them in advance one must give space for individual and collective inventiveness. In this way the search for suitable instruments can be carried out effectively.

4. The Themes Discussed

The above observations - some based on economic theory, others on investment appraisal criteria and techniques, and, still, others on the guidelines for living and acting derived from religious beliefs and traditions – form the background to the series of presentations made by the speakers at the June seminar. They focus on the decision making process in the allocation of capital and on the

surveillance of the behaviour by a firm's executives. The aim is to ensure sustainable economic growth, the fair treatment of all parties involved in trade and the provision of services, inter-generational solidarity, and the registering of reasonable rates of return on the capital invested.

This assessment is also extended nowadays to financial instruments that do not finance directly the production and distribution of goods and services, but are created with the intent of spreading more widely investors' risks. The financial services sector has expanded very fast over the past two decades. Its share in output and employment generation has expanded fast, some say 'too fast'. The relationship between saving and investing represented in Diagram 1 above represents only one element in the wider demand and supply for funds and financial flows that take place every day. It includes the daily determination of the 'basic' rates of interests (r in Diagram 1) in the form of the Libor or Euribor, and the various issues tied to the global transfer of capital. The latter category comprises considerations related to the movement of funds raised illegally/criminally anywhere around the globe.

The intricacy of such transactions is conditioning the behaviour of all involved: legislators, regulators, financiers and investment advisors, stock-brokers, fund managers and credit rating agencies. But above all, small savers, who want to safeguard both the quantum of their capital and the value of its purchasing power, are finding it more difficult to cope with this emerging scenario. At a time when the world's population is getting older and more people are living longer, 'saving for a future' is becoming for many a requisite to be met with urgency. In particular, the pension funds (read, accumulated savings) would ideally be utilised not only to support the lifestyles

of retirees but also to strengthen the technological bases of different economies, and, simultaneously, to enhance the skills of workers who employ them. People's behaviour in such circumstances becomes the prime parameter on which the development of societies depends. It is within this wide scenario that the role of SRIs is described and assessed.

Alessandra Viscovi, CEO of Etica SGR, traces the historical evolution of the concept. She examines the ongoing search for a clearly defined definition and scope of SRIs as these developed in different communities, giving rise in the process to agencies that provide specialised and timely information on companies' life-histories and mode of behaviour. The resources committed to industry and finance following such examinations are rising relatively fast. And the active intervention by shareholders in a company's way of managing its day-to-day operations is also increasing. In turn, the drive to render public opinion sensitive to these issues is also putting pressure on global and local supervisory authorities to monitor more closely the performance of companies in all sectors, but lately more so in the growing sectors of energy production, finance and gaming. This means that there seems to be a wider consensus at present on what needs to be done to try and avoid committing past mistakes. The challenge remains on devising the tools specific to attain such an objective.

Joseph V. Bannister, Chairman of the Malta Financial Services Authority, draws on his experience as a regulator to highlight the importance of ethics in finance. It is positive to think in terms of ethical finance, and channel resources to desirable sectors and particular initiatives. Yet, it is more effective in the long run to drum home the message that all involved in this sector, both those who

provide services (companies and executives) and those who buy them, have to act responsibly. At times, clients expect service providers to cheat on their behalf, or to go for relatively high risky returns but avoiding at all times to pay for such decisions. Clients also try to dodge tax payments. Hence, while companies have to dedicate more time and resources to educate their directors and employees, the public in general has also to be prepared to abide by an ethically-correct 'code of conduct'.

William T McKibben, broadcaster and writer, explores the lineage of today's drive for a socially responsible organisation of corporations to identify whether 'being morally correct' actually pays also financially. He draws on anecdotal evidence to illustrate the thesis that being fair to all those involved in trade – suppliers, workers, clients – is in the interest of all, financially remunerative, and personally satisfying. It is a win-win situation. And the experience of Robert Owen, Jamie Oliver, Harry Heinz, in the nineteenth/early twentieth centuries, and today's corporations whose performance is addressed in the book *Firms of Endearment*, goes to show that being a fair employer and supplier pays managerially and profit-wise. Such behaviour leads companies to focus on output volume and product-quality improvement, thereby sustaining their economic survival in a global competitive environment and enhancing clients' satisfaction and welfare. Besides, it contributes to improved profits, meaning higher dividends to shareholders and higher reserves to inject into capital and support the firm's expansion. In addition, drawing on recent survey data on consumers' expectations, world-wide, McKibben demonstrates that consumers expect corporations to act responsibly and they are prepared to transfer their custom to those providers who meet their demands. He concludes

that the ethical business model is profitably friendly. And most people, including business leaders, want to do the right thing in every aspect of their life, including the workplace. This is contrary to the common perception that the 'barracuda business model is the norm'.

Penny Shepherd, Chief Executive of UK Sustainable Investment and Finance Association, explores the various ways in which the 'ethical investment philosophy' may be implemented. There is an evolutionary process under way, both in terms of defining the term and in developing financial tools and strategies to reach the defined objective. People may use different terms to express similar (if not the same) set of ideas. The term ESG incorporates environmental, social and governance but, ultimately, economic activities have to be 'sustainable', that is, that the operations can continue indefinitely. The pressures on today's societies, everywhere, emanate from economic decisions that bear on employment and income generation and that have to be taken in the context of environmental constraints. These considerations lead to the emergence of resilient societies, ones that can build and maintain a range of 'capital assets', defined to include Natural, Human, Social and Constructed assets. To do this, societies have to harness three key drivers, namely, connectivity, knowledge about cognition and neuroscience, and the threats of resource scarcity and associated social change. Today's investment must focus on a resilient future, and it is to this end that capital allocation decisions and sound stewardship should be directed.

Mark Robertson, Head of Communications at the EIRIS Foundation (UK), reviews a series of data and events which place green and ethical funds in the unique position to drive companies and investors towards an environmentally friendly and fairer economy. The global

financial crisis and recent governance failings have highlighted the increasing importance of companies having business strategies that are sustainable over both the short and the long-term. Evidence suggests that more people in various countries want to be made aware of 'impact investments' and stock exchanges are tightening rules to take account of ESG issues and launching indices to drive sustainability agenda. EIRIS itself collaborated worldwide with several stock exchanges to develop such indices. Future expansion will be based on two factors: the development of a wider range of financial products which would be tailor-made to investors' ethics and to the emerging novel opportunities and the adoption by mainstream fund managers of longer-term sustainable investment principles across all their investment.

Wolfgang Pinner, Head of Sustainable Investment, Erste Asset Management GmbH, provides direct hands-on experience of the performance of ethical investments. He moves from theory and education to the fine details of results. And his observations support the main thrust made by the other speakers: being ethically correct does not necessarily mean that one becomes financially worse off as a result. SRIs are, at least, as financially attractive as other investments (Kelleher, 2012a).

Mr Pinner explains how a 'holistic approach' to these investment products, based on the performance of the past ten years, with an invested volume of around 2 billion euro, led to a key outcome: sustainability can limit losses even in troubled times. Such funds can produce positive results, contrary to the prejudicial view that SRI/ESG funds underperform. Their results emerge from the approach adopted in reaching decisions, combining positive and negative screening, 'best-in-class', and engagement with the companies. By bringing together a

series of measures in collecting and assessing information and direct discussions with units and companies involved, it is possible to obtain satisfactory results. One can build on these outcomes for further refining the decision-making process in a market that is growing and indicating the possibility of labelling within the SRI industry.

5. Conclusion

The six contributions propose a series of considerations regarding human behaviour in the economy and in finance that had been under scrutiny for centuries. Much is being said at present on the factors that brought about the socially dire situations in many countries worldwide and, also, in the eurozone. Mankind seems to be at a loss for identifying a way forward which can be considered to be in the interest of both the present generation and those that will follow. Identifying systems of production and distribution that are, at the same time, rewarding financially, psychologically and morally is an ongoing exercise for mankind. Culture, religion, nationalism, altruism, ambition, greed: all intersect in the many decisions taken daily at all levels of personal interaction. The writers highlight particular aspects of these multidimensional considerations. They present 'ethical investment and behaviour' as one potential tool that, together with other measures, can lead to an improvement in the quality of life for many, both now and in the future. In the end, one's conduct is influenced strongly by the underlying personal and social beliefs as expressed in daily action. Systems do assist in the formation of thought and they assign a sense of direction. But, in the end, it is the individual uprightness of operators that matter.

The main message that emerges from these readings is quite positive. McKibben counts on the goodwill inherent in all persons to act as a catalyst for human action, although Bannister does point at the usefulness of reminding all those involved in trade – producers and clients - that ethical behaviour pays both financially and psychologically. With regard to the results obtained to date in promoting and investing in SRIs, one can say that decisions to commit resources to these instruments are not detrimental financially. Experience shows that as knowhow and commitment increases, the return from such financial products is equal, if not better, to that of other investment instruments. But, in the end, what is at stake is not solely the financial return, but the quality of life of the present and future generations. SRIs have a contribution to make towards the attainment of this objective. It is up to operators to use them wisely and to legislators and regulators to create the appropriate legal framework and effectively monitor work practices.

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WHAT IS MEANT BY ETHICAL INVESTMENTS?

Good morning to everybody. My name is Alessandra Viscovi, and I am the chief executive officer of Etica Sgr, the only Italian asset management company that develops and promotes exclusively socially responsible mutual funds. I am very glad to be here with you today and to have the opportunity to open this important and interesting event.

Let me start from the definition of ethical investment. What can be defined an ethical investment? Or better, how can we define a Socially Responsible Investment? Currently there is still no single definition. According to Eurosif, a pan-European network whose mission is to develop sustainability and fair corporate governance through the European Financial Markets, SRI (Sustainable and Responsible Investment) is investing that is mindful of the impact those investments have on society. SRI traditionally combines investors' financial objectives with their concerns about environmental, social and governance (ESG) issues. SRI is an evolving movement, whose most recent development is based on a growing awareness by the population, investors, companies and governments of the impact of ESG risks on long-term issues ranging

from sustainable development to long-term corporate performance. The Social Investment Forum (2005), a national non-profit organisation promoting the concept, practice, and growth of socially responsible investing, describes socially responsible investing as “an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis.”

The term *Socially Responsible Investing* can be defined as the integration of environmental, ethical and social analysis into an investment decision, along with the traditional pure financial evaluation of financial instruments (equities and bonds). This means picking stocks which match specific responsible criteria - set in advance - in terms of transparency and fairness to stakeholders (employees, shareholders, clients, environment, citizens, future generations, and so on).

Historically, the origins of what has become known as socially responsible investing date back at least two centuries (XVIII century), when religious investors (Quakers and Methodists in the US and some Protestant communities in Europe), whose traditions embrace peace and non-violence, avoided investing in enterprises that profit from products designed to enslave or kill fellow human beings, or from war or gambling.

In more recent times the modern roots of SRI moved from religious to social principles and can be traced to the impassioned political climate of the 1960s, when a series of movements changed the general consciousness regarding issues of social responsibility and accountability. Concerns about the Vietnam War, civil rights, and equality for women were broadened during the 1970s to include disarmament, fair labour exchanges, and the environment.

In Europe, socially concerned investors grew dramatically throughout the 1980s and money managers arose to help investors channel their capital through mutual funds that also considered questions of social responsibility in their analysis.

The real success of SRI came finally in the 1990s. Nowadays, despite the slowdown in economic growth in recent years, Eurosif’s 2010 European SRI Study reveals the expansion of the European SRI market, now totalling approximately €5 trillion of “assets under management” (AuM).

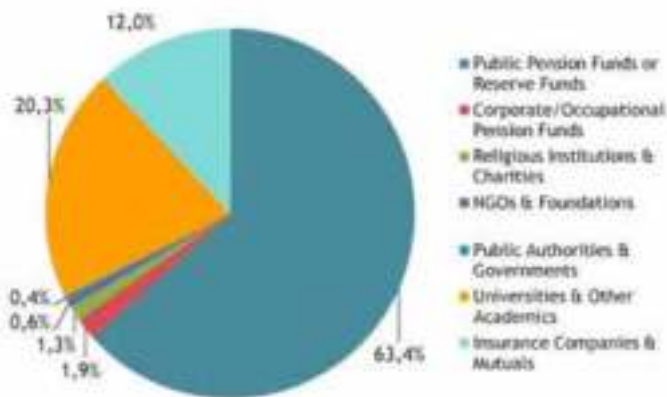
Institutional investors remain the main drivers of the SRI market, with a share of 92% of the total AuM, although the share of retail investors has also slightly increased since 2008, particularly in Austria, Belgium, France and Germany.

SRI Investment Vehicles by Country



Source: Eurosif European SRI Survey, 2010

Type of Institutional Investors (by Volume of SRI Assets)



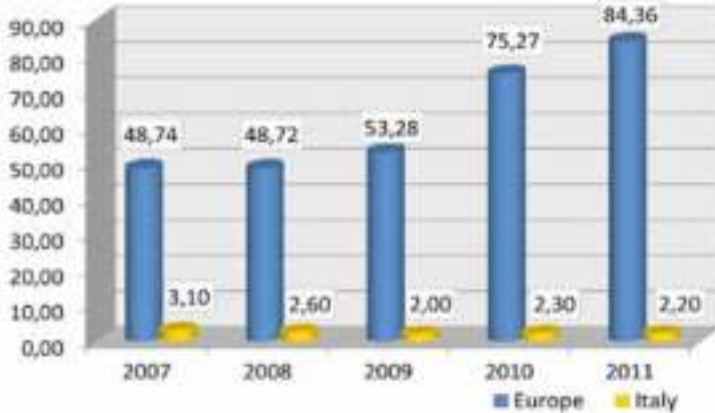
Source: Vigeo, Green, Social and Ethical Funds in Europe, 2011 Review

More recently, Eurosif's 2011 Corporate Pension Funds Study shows asset owners playing a fundamental role in influencing SRI practices. Fifty-six per cent of surveyed corporate pension funds have an SRI policy in place today, and that about a quarter of those without an SRI policy intend to have one in the coming year.

An even greater percentage (60%) feel that environmental, social and governance (ESG) factors affect long-term performance and expect their integration into investment decisions as part of the fiduciary duty of investment managers (66%).

In Italy the situation is different. The development of SRI is quite recent, with the first ethical fund launched in 1997 by San Paolo IMI. Now Italian assets under socially responsible management are around 2,2 billion euro (as of 30.06.2011 – source Vigeo). But according to Assogestioni, the association of Italian asset managers, if one excludes thematic funds (such as green funds and water funds), the

Italian SRI funds manage around 1,2 billion euro. It boils down to definitions. But the volumes are rising annually.



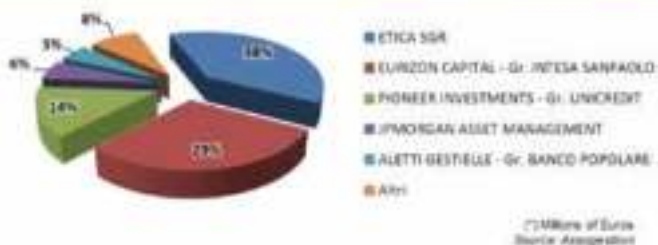
Source: Vigeo, *Green, Social and Ethical Funds in Europe, 2011 Review*.
(Millions of Euros)

These data also indicate how far Italian SRI development is behind the rest of Europe and the USA. The reason for this is clearly linked to a lack of information and to a set of cultural presuppositions regarding investments incorporating a socially responsible approach. Italian financial culture is still constrained by misunderstandings of key concepts, stemming from past history, such as a confusion between the meanings of the words “ethical” and “moral”, or between the idea of SRI and charity. There is, as yet, not enough awareness of the fact that the biggest, leading pension funds in Europe and in the USA have already been successfully managing their assets according to SRI principles for several years.

According to the most recent study by Assogestioni, Etica Sgr is the leading asset management company as regards assets managed according to the principles of

socially responsible investment, followed by Eurizon Capital and Pioneer Investments.

	Assets under management as 3/31/12 (*)	Market share
ETICA SGR	457,89	36,20%
EURIZON CAPITAL - Gf INTESA SANPAOLO	853,32	29,50%
PIONEER INVESTMENTS - Gf UNICREDIT	188,01	14,10%
ALETTI GESTELLE - GRUPPO BANCO POP.	65,83	5,50%
IFMORGAN ASSET MANAGEMENT	97,77	4,80%
Others	89,50	7,90%
Total	1.256,72	100%



In Italy, we still have a hard struggle ahead of us: we need to strengthen awareness of social responsibility, moving towards a new business-oriented concept and starting from the key point that SRI is a way to control financial risk, since socially responsible managers instil within their companies the necessary characteristics to be the best choice for investors who look for low-risk, long term investments, as institutional investors do (or should do).

Socially Responsible Investing can be carried out using different ways of stock analysis and selection. Different strategic views by investors correspond to different approaches; six such views are enumerated and described briefly below. The first three are assessed below:

- Negative Screening
- Positive Screening
- Engagement

- “Best in class”
- Thematic Investment
- Index Tracking

Negative screening is a process which excludes companies as potential investments by taking into account their corporate involvement in unsuitable industries. As time has passed and the ethical investment world has evolved, these criteria have been expanded to include other areas such as the environment.

Some examples of business areas which are generally excluded by negative screening include:

- alcohol;
- arms makers and sellers;
- breaches in the human rights of employees or local residents;
- gambling;
- nuclear power;
- polluters;
- supporters of oppressive regimes;
- pornography and adult entertainment;
- tobacco ;
- users of pesticides in farming.

Positive screening can be applied as well. This enables the ethical investment fund manager to invest in a different selection of companies. Some funds use both positive and negative screening.

Positive screening is essentially the search for companies who try to make a worthwhile contribution to society or the environment. This exercise enables the fund manager to choose from a ‘universe’ of companies that have a history of performing in ways that are considered socially or / and are environmentally beneficial.

However, different funds may view the same company in different ways meaning that firms will be eligible for support by some ethical funds but not by other funds. It follows that the choice of selection criteria, positive or negative screening, yields a wide range of options to where funds could be directed.

The use of a positive screening can also be the way to use a “best in class” approach. The “Best in class” approach is based on the choice of companies which, within one sector, are characterized by the highest ESG ratings.

Detractors of SRI can often be heard saying that by adding an extra-financial analysis (ESG) to the traditional financial analysis, we create problems for ourselves in terms of portfolio management, since the investment universe is more restricted and therefore inefficient. However, the opposite is the case, since investors who adopt SRI principles for their portfolio management have seen how important “non-financial added value” is even in terms of financial-risk-adjusted portfolio performance.

At the same time, on the side of the issuers, those taking into consideration ESG factors in managing their own business activity have a higher probability than others to achieve success, seeing that they are providing value not only for their shareholders, but for the whole network of their stakeholders.

When one buys shares in SRI funds, one joins a community of thousands of investors who make their voice heard to the directors of listed companies, on a range of social, environmental and governance issues. **Shareholder activism**, which is expressed through dialogue with the companies, participation in shareholder’s meeting and voting on motions, helps to steer the companies towards more responsible practices.

SRI is definitely a long term investment strategy, matching for this reason institutional investors' needs and duties. The Asset management working group of Unep Fi (*United Nations Environment Programme Financial Initiative*), in its 2009 report named "*Fiduciary responsibility. Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*", underlined the importance of applying ESG criteria to institutional portfolios, in order to satisfy their fundamental fiduciary duty before those who have entrusted their money to such funds to be managed. This applies above all to pension funds.

There is no unique European regulation that sets the ESG criteria to be applied in all countries; this process is evolving country by country. For example, in the United Kingdom, pension funds have to publish whether, and how, they apply ESG analysis to their portfolios. In Italy, Covip, the pension funds' regulator, stated in March 2012 that, although pension funds are not obliged to apply ESG criteria to their portfolios, if they do decide to do so, they have to publish how ESG criteria are selected, and their impact on the portfolio, in their official prospectus. This represents an important step forward for the Italian SRI market.

The **thematic investing approach** is based on identifying global economic trends, driven by politics, culture, demographics or a combination of all three. The 'core drivers' behind most thematic investment funds are usually population growth, rising wealth in the developing world, natural resource scarcity, energy security and climate change.

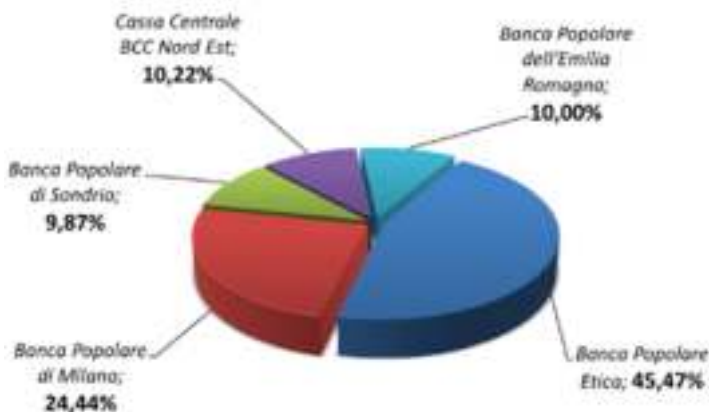
An **index fund or index tracker** is a collective investment scheme (usually a mutual fund or exchange-traded fund) that aims to replicate the movements of an

index of a specific financial market, or a set of rules of ownership that are held constant, such as for example ESG rules.

ESG advisory in Etica Sgr

Etica Sgr is the only Italian asset management company promoting exclusively socially responsible investments through 4 mutual funds, with 7,5 billion Euro under ESG advisory.

Created in 2000, the company is part of the Banca Etica group, and is 100% held by Italian banks.



Our main investors and clients are foundations set up by banks, pension funds, insurance companies and mutual funds.

Etica Sgr belongs to the most important International SRI networks, such as Eurosif (*European Sustainable Investment Forum*), PRI (*Principles for Responsible Investment*), CSR Manager Network, ICCR (*Interfaith Center on Corporate Responsibility*) and the Italian Forum per la Finanza Sostenibile.

Based on the experience of Etica Sgr, our ESG advisory uses 4 different models to complement financial analysis:

- Ex Ante advisory: definition of the investment universe
- Ex post advisory: ESG analysis of portfolio holdings
- Black Lists: list of “not to be picked” instruments
- Engagement: participation in shareholder groups with active propositions to put to management

The research team analyses countries and stocks with the support of International databases, interviews and reports. The following tables give some examples of the criteria used in terms of companies and countries. Companies are evaluated in terms of 65 criteria, countries in terms of 55 criteria.

Companies

ENVIRONMENT	SOCIAL	HUMAN RIGHTS	GOVERNANCE
Environmental certifications	Health and safety	Policy on Human rights, mainly if the company operates abroad (ex: China, Russia, India, etc.)	ESF risks monitoring
Environmental performance	Employees' participation	Reporting on Human Rights	Chairman/CEO separations
Energy efficiency	Employees' training	Social Certifications	Independent non-executives on the Board
Sustainable logging	Quality of contracts		Women on the Board
	Customer satisfaction monitoring		Code of Ethics: implementation and application
	Supply chain monitoring		

Countries

GOVERNANCE	SOCIAL	ENVIRONMENT
Press Freedom	Women in % of workforce	CO ₂ emissions
Civil Liberties	Public spending for instruction	Renewable Energies
Corruption Perception	Public spending for health care	Quality of water
	Access to medical services	Fertilizers' use
	Human Development Index (HDI)	Protected areas
		Waste treatment

Each advisory service is personalised and based on the requirements of clients.

An ESG advisor can play a very important role in different situations, such as:

- in the case of an **institutional investor who is providing an external money manager with a portfolio management mandate**: the ESG advisor could support the investor in defining the best investment universe (ex ante advisory) or check the final portfolio in terms of sustainability (ex post advisory).
- in the case of an **institutional investor who runs his own investing directly**: the easiest way would be to invest in a mutual fund managed with SRI principles, but the investor should agree on the advisory selecting criteria, as they are set in portfolio management. Alternatively, the institutional investor might prefer that the ESG advisor provide him with a black list to be considered when making investment decisions, or to provide ESG ratings.
- In the case of an **institutional investor investing through collective instruments** (mutual funds):

the ESG advisor would give support through the definition of the best investment universe (ex ante advisory). Besides, the provision of ESG rating information might be appreciated by the investor.

Conclusion

The way we invest matters. We live on a small planet and there is not much time to prevent its further degradation. When businesses and market economies function properly and focus on serving the common good, they contribute greatly to the material and even the spiritual well-being of society.

Institutional investors have been given a large amount of resources which could achieve high objectives if used properly. In this new century, many businesses have already brought forth marvellous innovations which have cured disease, brought people closer together through technology, and created prosperity in countless ways. Unfortunately, this century has also brought business scandals and serious economic disturbances, and an erosion of trust in business organisations and in free-market institutions, generally.

Mankind's pristine spaces are disappearing; our natural heritage of species is being decimated. Our rich cultural and ethnic diversity is all but gone, and vast ghettos scar every metropolis. Millions live in slavery, or prisons, or as captives in their own homes. We still have the chance to intervene to change things, but we must do so now. We are living during a dramatic period, but we have an incredible opportunity: **we can change things!**

The "natural" evolution of the financial analysis and the needs for risk-source forecasts lead the market to focus on ethical and socially-responsible securities.

Investment selection is driven by:

- Awareness of environmental and social issues
- Increasing demand for quality goods and services,
- Issues carried by institutional and public authorities
- A review of the asset management offering
- Financial crisis and recession

It is important to remember that there is no trade-off between responsible investment and performance. Socially responsible investments are “patient”, not speculative. They are perfectly consistent with the philosophy of true value creation and a maximization of the invested capital in the medium term.

At the end of June 2011, there were 886 green, social and ethical funds domiciled in Europe, totaling amount 84.4 billion Euros. They represent a growing trend, which demonstrates the strength of this asset management segment. Despite volatile markets, it was driven by real net inflows: a sign of confidence in the robustness of responsible investment, which is becoming more and more a conscious and transparent choice.



AUM ethical funds in Europe (data as 30 June 2011)

When business activity is carried out justly and effectively, customers receive goods and services at fair prices; employees engage in good work and earn a livelihood for themselves and their families; and investors earn a reasonable return on their investment.

Today we have begun to understand that this kind of combination is the key for our future and for that of future generations. This is an issue that concerns not only firms, but also banks, foundations, institutions and small investors.

Surely, the investments we make today shape the world we will live in tomorrow.

ETHICAL FINANCE OR ETHICS IN FINANCE?*

It is only well known that the world of finance is a complex one. Every time a crisis or scandal crops up, a small part of this complexity is exposed and new issues of ethics in finance are identified. The recent crisis exposed evidence of weak corporate governance practices and of exorbitant bonuses being paid to executives and traders in financial institutions. The financial crisis of 2008-2009 has indeed occasioned an erosion in trust and confidence in the financial institutions, in their senior officials employees and in the products and services they market to consumers. This has led to investors not trusting banks and banks not trusting each other.

The complexity arises due to various factors. These include the labyrinth of financial institutions which comprise commercial banks, investment banks, savings banks, hedge funds, mutual funds, brokering and insurance companies, and other entities. The complexity is also evident in the clients themselves, who can be private, corporate or private entities. Finally there is complexity in the markets, with money markets, investment exchanges, commodities, debt instruments, derivatives, forex trading, as well as in the instruments

themselves, including equity, bonds and derivatives.

Over the years, these complexities allowed financial institutions to continuously increase in size, become more diversified and keep seeking higher profitability with the focus being regrettably on immediate or short term profits and high levels of personal compensation. These trends encouraged higher risk which became particularly evident in the so-called “high-speed computerised trading”.

All this confusion we are now facing in the fall-out from the crises has led to a large number of recent initiatives under the banner of “ethical finance”. Ethical finance is a very difficult term to define. It may be said to be a philosophy of investing based on a number of considerations which include financial, social, environmental and sustainability criteria. These criteria have led to the concept of Sustainable and Responsible Investment which, as the term implies, carries with it a higher element of social responsibility.

The initiatives under ethical finance marks a shift to the real instrumental function of finance, which is support of the economy with an increasing consideration of environmental, social and governance issues in investment decisions and services being offered. The concept of sustainable investment tends to focus largely on environmental concerns such as clean energy, clean water, waste management and conversion of waste to energy. There is now a growing business trend where investors, particularly high-net worth individuals, align their investments with emerging environmental and social realities. This means that operators in the financial sector who are committed to sustainability investment are converging with those interested in investment opportunities that the on-going shift in regulations and

market practices are creating. However, it is my view that ethical finance should not be considered as something unique to specific projects. Services such as deposits, loans, cheque book accounts credit cards, mortgage lending, microfinance, co-operative banks, social lending, pensions, life and health insurance should also be benefiting from an ethical dimension by institutions efficiently meeting the real needs of clients at a reasonable cost.

A number of voluntary principles incorporating Environmental, Social, and Governance (ESG) issues have recently started being accounted for in the institutional investment decision-making process. Six principles 'guide' decision-making in brief. These are the following:

1. the ESG forms an integral part of the investment analysis;
2. institutions are becoming "active owners" by integrating the ESG issues into their ownership policies and practice;
3. investors are learning to seek appropriate information and objectives disclosure;
4. other investors are being encouraged to adopt the principles;
5. institutions and investors should work together to put the principles into practice;
6. institutions are reporting specifically what they have adopted to implement the ESG principles.

These principles have triggered a great debate in the financial services industry post the series of 2008-2009 financial crises, concentrated on banks more than other financial institutions. These range from small savings banks to huge diversified conglomerates which often find themselves deemed "too big to fail". An argument

has been put forward in favour of narrow banking, which basically means either the breaking-up of financial conglomerates or the creation of fire walls between the various activities undertaken by the institution. Most national authorities support the break-up of very large banks into two legally separate entities: retail banking and investment banking. Retail deposits would no longer be used for high risk proprietary trading. This proposition has recently been advocated in the United Kingdom. These institutions would also be encouraged to divest their asset management activities from their investment funds, particularly hedge funds and private equity. Indeed, hedge funds are considered to be high-risk investment particularly when they take “short” positions (betting that a company’s stock price will fall) or engage in complex trading strategies involving futures, swaps and derivative trading. However, an increasing number of hedge funds are being created as socially responsible investment even though this may not guarantee the return that could arise from high risk investment.

Finally, the introduction of ethical finance principles and practices, which everybody considers to be a good thing, is not a strategic issue simply for the institution. A problem of ensuring ethical behaviour by individual operators and their senior officials in the financial services sector persists. The fundamental purpose of a business is to maximize profit and shareholder value. But many times, the means utilised to achieve these objectives are frequently not questioned sufficiently with the result that the ethical behaviour of a company and its employees repeatedly fails acceptable standards.

Recent events point to a finding that there definitely appears to be a growing problem with ethical behaviour in the financial services industry. The descriptions of the

misdeeds carried out by competent professionals in order to enrich themselves at the expense of those who trusted them to manage their money, has been raising concerns at the highest level of the state of morality within the financial services industry including those who work inside the sector. Continuous reports on huge bonuses, fraud and/or mis-selling have created a worldwide perception that the financial services sector is a highly unethical or even an amoral class of business where a sense of greed rather than high morality prevails among employees, and this despite the fact that the industry is highly regulated.

Sometimes unfortunately the push to act unethically comes from the clients themselves. How many clients expect their insurance agents to falsify their applications or claims? How many clients pressurise their financial advisors to find them products with an unreasonably high return and try to avoid paying tax? The situation therefore has to be tackled in a two pronged manner, the company and its employees and also the consumers.

One notes that progress is being made at the international level on the question of directors' remuneration. It is a company's responsibility to instruct its employees and guide them in adopting ethical behaviour towards clients and to ensure proper mentoring so that employees carry out their activities properly in the best interests of the clients.

Accordingly, and to conclude, companies need to spend more time, attention and money on the ethical training of their employees. Ethical issues in the financial services industry affect everyone – employees and consumers alike – and go beyond issues of competence requirements and ability. Naturally, regulators must do their bit more to promote consumer education and to increase and enhance

customer and operator awareness of the place of ethics in the market place.

**Note: This paper reproduces textually a verbal presentation made by the author. The author acknowledges the assistance of David Fabri, Director for Legal and International Relations at the MFSA, in finalizing this text.*

THE COMPATIBILITY OF PROFITS WITH ETHICAL BEHAVIOUR

It is hard to document when the words so common to us today, 'Profit'-'Ethics'-'Business' came into common usage. Trade, still an important word, goes back much further. However, a 'business' (also known as) 'company' seems to have come into our society with the Industrial Revolution. This vast upheaval in the way almost every



The Heart of the Industrial Revolution: the Watt double-acting steam engine. (Courtesy: *Wikipedia, The Free Encyclopedia*)

aspect of life was changed (mostly for the good) was based on replacing small lot work done in the home with high output, large lot production made possible through technology.

Pioneered in Great Britain in the mid-1700s, steam powered equipment of every nature was soon turning out goods of every kind at unimaginable levels. While we remember the downside issues of the Industrial Revolution, there is no arguing with the upside and with its superiority to what it replaced.

But what about ethics? Were there ethical businesses during this period, or did they get lost in the grasping factory owners' lust for profit? In any time period as chaotic as this there is no doubt that many of the early steam-age adopters were more concerned with recouping the cost of the equipment covering the floor of their factory than with any moral judgment as to the way they ran their company.

It did not take long for the superiority of the ethical business model to show in the person of one Robert Owen. Owen came to London at ten years of age, bound to the leather trade. He soon moved up and by twelve was a top sales person for the company. He had charm and a winning manner and soon moved on to a better sales position with a men's clothing establishment. After a time he offered to give up his salary and take only a commission. Within a year Owen had saved £100, a small fortune at that time. Just eighteen years old, he was ready to go into business for himself. He bought three of the new "spinning mules" and began turning raw cotton from the "New World" into cloth.

Within a year he had tripled his fortune. At nineteen he made the acquaintance of a man with the Dickensque name Peter Drinkwater, who owned a large mill

employing 500 in Manchester. Drinkwater purchased Owen's equipment and goods and hired him at £300 a year to manage his mill. For six weeks Robert changed nothing; he just walked about the mill and got to know the employees. *Makes you wonder if Owen was the model for Tom Peters' "Management By Walking About"*. Each day he was the first to arrive and the last to leave the mill.

Once he felt he knew what was needed, he began to act. He improved the working conditions, visited the workers in their homes, advising and helping as needed. He set up schools for those who worked in the mill and for the younger children at home. The first year he quadrupled Drinkwater's profit. When the owner came up from London to see what this young genius had done, he found a clean, tidy factory with happy, highly productive workers. He gave Owen a £100 bonus and a new contract with a percentage of the profits built in.

Now in his early twenties, Robert Owen kept improving the lot of his workers and Drinkwater's profits kept growing. He added windows and ventilation to the plant. He refused to hire very young children. When a Board of Health was established, he did not join the opposition group of mill operators but proudly invited the Board to come in and see what were, for that day and age, excellent working conditions.

Not only was the mill well run and extraordinarily profitable, the quality of the goods was the finest in the business. Owen's pride in his work led him to attach a label to each package of goods, declaring proudly: "These fine goods were made under the supervision of Robert Owen."

When Drinkwater wanted to buy out his contract so he could put his nephew in charge, Owen offered to cancel it at no charge. Drinkwater had no idea that when Owen

left he took the most valuable asset of the company with him, his name, by now synonymous with quality goods.

Robert Owen had become a "brand." Soon he was acting as a broker for mills that agreed to produce goods to his standards. They were allowed to place his mark of quality on them: "These fine goods were made under the supervision of Robert Owen."

At twenty-seven, while in Scotland, he met the charming daughter of a mill owner and bought her father out for £60,000. The mill was in a beautiful setting outside of Glasgow in a tiny community called New Lanark. Now with a mill of his own and the love of his life at his side, Robert Owen was ready to show what could be done by doing the right thing.

He reduced the workday from twelve to ten hours. He put in showers and provided healthy meals, often eating with his workers. Instead of tenements he built them comfortable cottages and offered prizes for the most beautiful gardens grown from flower seeds he provided. He banned the sale of alcohol in the village. Owen lived simply among his workers. Once when their supply of cotton was cut off for three months, he kept everyone on full pay and had them busy working to improve the community.

He built a combination nursery school, kindergarten, and grade school. It ran day and night caring for the small children of women who worked in the mill and teaching the older children and anyone else who wanted to learn. Those who worked in the school were not permitted to whip or hit the children; Owen explained that it only taught them violence. Makes you wonder if Dr. Spock knew about Robert Owen?

Owen sold stock to buy new equipment and improve the mill. He paid a 5% dividend to his new stockholders,

a very good return for the time, and put every extra penny of profit into improving the lot of his workers. He believed that clean water, a sewage system, healthy employees, trees, and flowers were a benefit to everyone and the bottom line. And he had the bottom line numbers to prove it.

Robert Owen was the first and certainly an outstanding example of the ethical business model that I found. He represents the 1700s, followed in the early 1800s by Peter Cooper (1791-1883) who best describes himself: "I have always recognised that the object of business is to make money in an honourable manner. I have endeavoured to remember that the object of life is to do good."

Scotland born, Jamie Oliver was a farmer. He may have never heard Plato's famed truism, "necessity is the mother of invention," but he understood it and lived it. To Jamie life was simple: see a problem, find a solution.

He ended up in the American Midwest, Northern Indiana where the farming was infinitely better than the rocky hills of Scotland. Like many farmers he took what odd jobs off the farm he could find for extra cash. He worked among the rough and tumble river men, learned to smelt iron and make barrels.

A few years later he ran across a fellow who wanted to sell his interest in a less-than successful foundry. With his experience working iron Jamie figured he would make a go of it, and so he came up with the \$88 the man wanted and went into business. A part of the business was making the one-horse ploughs that farmers relied on to turn the soil. Oliver knew from backbreaking personal experience that the ploughs of the day could stand considerable improvement.

He devoted several years to finding the right design and materials. The result was his "chilled plow," so named for

his proprietary method of hardening the metal. He sold his first Oliver Chilled Plow in 1870. In just a few years his little foundry grew to a 30-acre industrial complex, the Oliver Chilled Plow Works, capable of producing half-million ploughs a year. His innovative design reduced the effort of the horse by half, and of the man guiding the ploughs by at least that amount.

Through it all Jamie Oliver never saw himself as a factory owner; he saw himself as a farmer, solving problems for farmers. He saw his employees as vital to solving those problems and felt a responsibility to make their lives comfortable so they could concentrate on that task. When financial woes struck the nation, Oliver kept his plant producing, storing the ploughs his dealers could not sell until better times came. He never laid off workers and never reduced wages. He saw his employees as an asset. And they saw him as deserving their best effort and loyalty.

He played a vital role in the largest sector of the economy of that day. Jamie considered himself a farmer, a friend of the farmer, a partner of the farmer, and a partner of nature. His success and his wealth came not from seeking it but from seeking solutions that would benefit his fellow men. Jamie Oliver saw a better plough as a necessity, that Plato thing.

The Industrial Revolution was in high gear in the late 1800s and no place on earth illustrates the extremes it created more than Pittsburgh, Pennsylvania. On one side stood Andrew Carnegie's huge steel mills. The gutsy little Scot built a massive steel enterprise largely on benevolent principles. But when his empire was threatened by hard times and falling steel prices, his resolve and moral fibre failed him.

The defining moment in his life came in 1892 at his Homestead Works. With Carnegie's full support, his

plant manager, Henry Frick, imposed draconian wage reductions and declared that he would not negotiate with the workers' union. The union represented only a small fraction of the plant employees, but Frick's demands brought the majority of the workers to its defense. The union and the employees were willing to give Frick everything he wanted. But Frick wanted to kill the union, and that the workers inside and outside the union would not concede.

With Carnegie far away in Scotland, the pig-headed Frick locked the workers out, called in Pinkerton Agency's private army, and turned a solvable dispute into a war. The workers drove off the Pinkertons at the cost of a dozen lives. Then National Guard troops came in and drove the workers off. New workers were hired and the union was crushed. It is hard to imagine this outcome had Carnegie been there to see events unfolding. We know he came to regret his choices in this matter, it forever tarnished his legacy. All the libraries he built, a great university, and his numerous other charities could not erase the stain of his tacit approval of this pointless tragedy.

The lesson Carnegie gained in Homestead was not lost on another local business leader, Harry Heinz. After observing an earlier violent railroad strike, Heinz had been pursuing ways to immunize his business by creating a working atmosphere that would make violence, and labor unions for that matter, unnecessary.

In 1892 Heinz was expanding his food packing enterprise on the north shore of the Allegheny River in a community of the same name across the river from Pittsburgh. His factory was to grow larger and larger in the last decade of the nineteenth century. And as it grew it became a model for enlightened employee working conditions. Like Owen, Oliver, and a few others, Heinz

was out of step with the conventional thinking of the day in every aspect of his business.

He began packing horseradish in his parents' basement. A talented promoter and salesman, he grew the business. But he ran aground and was forced into bankruptcy as a result of his out-of-touch-with-reality (as his competitors saw it) idea that preserving food intended for his fellow human beings should be done under sanitary conditions. He persisted, however, starting over again and even going back and paying off those who lost money when his earlier enterprise went bankrupt. He called those "moral debts."

Heinz outraged his competitors when he supported and even lobbied in favour of federal laws to assure that food packers maintained sanitary conditions and that they refrained from the use of harmful preservatives. He became the most hated individual among his fellow food packers. Conversely, he was equally loved by his employees, suppliers, customers, and his community.

The H.J. Heinz plant that emerged as the century turned was unique in almost every way. It was bright and sparkling clean. A wide range of foods were preserved and packed by natural processes under pristine conditions. Those who worked in the plant (mostly women) wore clean blue and white uniforms and were required to maintain high standards of personal cleanliness. Every employee was given a weekly manicure.

Employees were offered a wide range of educational, recreational, and social opportunities. A roof garden and reading room were provided for use by the workers; a swimming pool, regular outings and picnics made it an ideal place to work. Far ahead of its time and not bad even by today's standards. Sounds almost like life at the Googleplex.

Much of my view of how a business should operate was drawn from my mother's experience as an employee at the H.J. Heinz Company in the early part of the twentieth century. She worked as a secretary, having achieved a then rare four-year high school education plus a business school degree. Her position was unusual since private secretaries in those days, especially those who served high-ranking executives, were almost always men. In fact she was criticised for "taking a job away from a man with a family to support." She would have none of it.

She worked for Nevin Woodside, VP Sales, second only to Mr. Heinz and a member of the Heinz Board of Directors. Woodside and Heinz had offices side by side. Mother frequently did work for Mr. Heinz as well. Over many years with the firm, beginning just as America entered World War One, she observed these corporate leaders on a daily basis and understood their goal and effort to run a company on the highest ethical standards.

Woodside was responsible for the Heinz advertising programmes, perhaps the most aggressive of their time. Mother came away from her time at Heinz with a real appreciation of the value of their promotional efforts. They created the first large-scale electric sign in New York City. It was one hundred feet tall, covering the entire wall of a ten-story building at Fifth Avenue and 23rd Street.

Heinz's great success at several World's Fairs around the turn of the century led him to build a huge pier on the famed Atlantic City Beach in 1899. There were two large ornate buildings, one at the shoreline and an even larger one fifty yards out into the surf at the end of the pier. It was topped with a giant sign with the numerals 57 in bright lights. Both buildings were filled with curiosities and works of art. And of course, product samples and promotional materials featuring the company's products.

Always looking for ways to put his people before the public, Heinz displayed large photos of his key employees including the district sales representatives. The Heinz Pier attracted millions over the 45 years it was open up to the end of World War II.

As the one who took her away from it all (in those days the arrival of a child was the end of a woman's working career), I was weaned on the business principles that Mother experienced at Heinz and grew up understanding that an ethical business model was the first step to profitability.

All this in a home that honoured God and Organised Labour in that order and not too far apart. After two years of unemployment during the Depression, Father finally found work as a bus driver. He loved driving. He got up every morning looking forward to seeing all the folks who rode his bus. And they looked forward to seeing him. More than once as a kid while standing at a bus stop I saw people pass an opportunity to board a bus, saying, "I'll wait for Mack's bus." He was known to turn down a side street on a rainy day to drop someone off in front of their house, and he took pride in never opening the bus door at a puddle or a snow bank.

Father was a union officer for all the years that I was growing up. So I heard the issues he was dealing with nightly at the supper table. The suburban bus line he worked for was owned by a corporate lawyer in Pittsburgh. Father believed him to be a good man who just did not realise the problems that his employees were dealing with. I gained an education in "what," as Father put it, "the men really want."

I later found that insight invaluable in creating a workplace atmosphere where the men and women I worked with could do their best. And I found, as did H.

J. Heinz, that kind of atmosphere was the key to make labour conflicts unnecessary. More important, when people work in this kind of atmosphere, they produce more. That translates into both higher wages and more profit. That is what we now call a “win-win.”

While all this history is helpful, who is to say that any of this applies to business as we know it today? A question I often asked myself over the years. My broadcast and marketing firms worked well and profitably under the model, but they were hardly in the running to be counted among the largest firms on the planet. Then came along two academics and a writer who set out to find major businesses that operate under the highest ethical standards. The publication of their book *Firms of Endearment* in February of 2007 gave me assurance that the work of its authors was based on sound research principles. Writer David B. Wolfe and academics Rajendra S. Sisodia and Jagdish N. Sheth have created the seminal research underpinnings to launch a sea change in business practices. They have provided proof positive that the road to profitability begins with an ethical business model.

The work of Wolfe, Sisodia, and Sheth laid a foundation under my long-held belief in an ethical business model. What makes this study even more compelling is their finding that the companies that made their cut based on ethical criteria, returned eight times more on investment than the average (not the worst – the average) companies in the S&P 500 over a ten-year period ending in 2006. The research underlying *Firms of Endearment* proves that an ethical business model is not only a lot more fun, it is a lot more profitable. What leader would prefer the stress and distrust rampant in the barracuda business model, even if it were as profitable?

*The Good Guys That Made the Cut**

Amazon	Harley-Davidson	Progressive Insurance**
Best Buy**	Honda	REI
BMW	IDEO	Southwest Airlines
CarMax	IKEA	Starbucks
Caterpillar	JetBlue	Timberland
Commerce Bank	Johnson & Johnson	Toyota
Container Store	Jordan's Furniture	Trader Joe's
Costco	LL Bean	UPS
eBay	New Balance	Wegmans
Google	Patagonia	Whole Foods

** Shown on the FoE Website 4/07 after the book's publication

I find it remarkable that in 2012, a full five years after the publication of *Firms of Endearment* and nearly a decade after the research project was launched, these companies are still largely in good standing.

Firms of Endearment is a must-read for anyone who wants to make more money. Even those who give not a hoot for ethics, although I think it is a tough position to fake. The book provides details of the policies, techniques, and management tools used by the companies that Wolfe, Sisodia, and Sheth have chosen as models of ethical business practices.

The criteria used to choose the companies that make the cut as *Firms of Endearment* are organised around what the authors call "the five major stakeholders of modern corporations."

They use the acronym "SPICE" to define these stakeholders:

- Society – Local and broader communities as well as governments and other societal institutions, especially nongovernmental organisations.
- Partners – Upstream, horizontal, and downstream partners such as suppliers and retailers.
- Investors – Individual and institutional shareholders, and lenders.
- Customers – Individual and organisational customers; current, future, and past customers.
- Employees – Current, future, and past employees along with their families.

The authors make clear that theirs is a continuing project. On their website they urge visitors to nominate candidate companies to be part of their ongoing search for FoEs. I encourage you to visit www.FirmsOfEndearment.com.

While you are there, sign up for their email alerts. There is no better or easier way to reinforce your ethical business model.

Firms of Endearment should be required reading in every company suite, boardroom, and business school in the world. Those who sit on corporate boards should understand its implications and the benefits of following the business model it defines and advances. It is an excellent tool for directors to use in evaluating the performance of the executives they are charged to oversee and in assuring the stockholders they represent that the company is following an ethical business model that leads to higher returns on their investment.

So much for history and validating the model. What is the latest and most up-to-date on where the players

in the global economy are headed? Several broad brush studies have been released in the last couple of months. Many of the studies do not seem to offer much depth but they do provide some interesting insights at the surface level.

Everyone seems to be focusing on reputation these days. That is a good thing. The Reputation Institute's annual look at the "Reputation Economy" measures the global standings of 150 US based companies. Google led the pack in 2012 with Amazon and General Mills following. The big loser among US players was Bank of America, losing 10 points from an already low 2011 score.

Ken Powell, CEO of General Mills, put the importance of trust and reputation nicely in perspective: "For us, building this trust includes delivering nutrition and value to consumers through innovation, strong community engagement, a commitment to protecting the environment, as well as developing strong leaders to grow our business around the world. We believe consumers reward companies that operate with integrity and stay focused on doing what is right over the long term."

There seems to be a move among consumers to go beyond merely searching out companies that display responsible business practices. Consumers seem ready to punish those that do not behave well.

A new Nielsen study covering 28,000 Internet respondents in 56 countries shows younger consumers willing to spend more to purchase products from responsible companies. They use social media to research companies when planning their shopping. So if you want to reach them, that is where you have to go hunting.

In this study consumers in Asia Pacific (55%), the Middle East and Africa (53%) and Latin America (49%) are more willing to pay extra for products and services

from socially-responsible companies than consumers in North America (35%) and Europe (32%).

I am not at all sure that this data is as important as it looks. The methodology may not engage a broad enough group of consumers, but it does give us a peek into what a large number of internet savvy younger consumers are thinking at this stage of their lives.

The piece of research that really grabbed my attention and made the case for the Ethical Business model was rolled out in Los Angeles at an ad conference called "Transformation 2012 LA". Kate Robertson, UK Group Chairman, Euro RSCG, presented key findings of their **Consumer Conscience Study: "Blueprint for a Sustainable Brand"** showing that the majority of consumers have moved beyond seeking companies that just share their values. They now feel a personal responsibility to censure unethical companies by avoiding their services and products.

"Close scrutiny of everything we do and say as businesses is no longer optional. The tidal wave of the social media revolution is inexorably rolling over us and exposing all—everything will come out, if not today then for sure tomorrow—" said Robertson. "So of course responsibility and sustainability are top of mind for consumers and customers; it's not hard when they're being shown how irresponsible some businesses are. This is the flexion point—and we're best prepared, attending Transformation, to deal with this new relationship between brands and consumers."

The Euro RSCG **Consumer Conscience Study** surveyed 4,000 adults in six markets—Brazil, China, France, India, the UK, and the US—in 2007 and again in the winter of 2011

Key findings of the study include:

1. In our new world of radical transparency, business is under a microscope. Consumers are more focused than ever on corporate values and reputation.
 - 69% of Americans say they are “paying more attention than in the past to the environmental and/or social impact of the products [they] buy,” and 71% believe “the most successful and profitable businesses in the future will be those that practice sustainability.”
 - 67% of Americans say they prefer to buy from companies that share their values.
 - Americans point to transparency as an indicator of a successful business: Nearly three-quarters (74%) say “the more open and collaborative a business is, the more likely it is to succeed.”
2. Consumers expect the companies with which they do business to be *agents of change*. More than three-quarters of Americans (76%) say “business bears as much responsibility as government for driving positive social change.”
3. Consumers are punishing companies that fail to meet their expectations. Globally, 70% of consumers say they have a responsibility to “censure unethical companies by avoiding their products.”
 - China (91%) and India (89%) were the markets most likely to believe consumers have a duty to censure unethical companies by avoiding their products.
4. Consumers are empowered by social media—and they know their own strength.
 - 44% of Americans believe the greatest change agent in the future will be “the people, empowered by social media”—more than twice the number of

respondents who chose politics or corporations as the greatest agent of change.

Moving beyond the general results, these specifics for the individual markets give us valuable insight into the European mindset and how it fits into the global marketplace.

1. I prefer to buy from companies that share my personal values
 - **Total Global** (includes US, UK, France, China, Brazil, India)
 - 64% agree
 - 23% neither agree nor disagree
 - 13% disagree
 - **United States**
 - 67% agree
 - 28% neither agree nor disagree
 - 5% disagree
 - **United Kingdom**
 - 62% agree
 - 29% neither agree nor disagree
 - 9% disagree
 - **France**
 - 72% agree
 - 24% neither agree nor disagree
 - 4% disagree

 2. Compared with a few years ago, it's more important to me to feel good about the companies with which I do business.
 - **Total Global**
 - 63% agree
-

- 23% neither agree nor disagree
 - 14% disagree
 - **United States**
 - 64% agree
 - 26% neither agree nor disagree
 - 10% disagree
 - **United Kingdom**
 - 63% agree
 - 28% neither agree nor disagree
 - 9% disagree
 - **France**
 - 63% agree
 - 30% neither agree nor disagree
 - 7% disagree
3. I have made purchase decisions based on a company's conduct.
- **Total Global**
 - 63% agree
 - 22% neither agree nor disagree
 - 15% disagree
 - **United States**
 - 70% agree
 - 22% neither agree nor disagree
 - 8% disagree
 - **United Kingdom**
 - 64% agree
 - 24% neither agree nor disagree
 - 12% disagree
 - **France**
 - 55% agree
 - 31% neither agree nor disagree
 - 14% disagree

4. Within the last few months, I have actively looked for information on the reputation or ethics of a company.
- **Total Global**
 - 46% agree
 - 28% neither agree nor disagree
 - 26% disagree
 - **United States**
 - 42% agree
 - 30% neither agree nor disagree
 - 28% disagree
 - **United Kingdom**
 - 38% agree
 - 30% neither agree nor disagree
 - 32% disagree
 - **France**
 - 34% agree
 - 38% neither agree nor disagree
 - 28% disagree
5. Over the last year, non-branded blogs or social media made me change my mind about a product or service I had intended to buy.
- **Total Global**
 - 41% agree
 - 26% neither agree nor disagree
 - 33% disagree
 - **United States**
 - 32% agree
 - 28% neither agree nor disagree
 - 40% disagree
 - **United Kingdom**
 - 31% agree
 - 26% neither agree nor disagree
 - 43% disagree

- **France**
 - 27% agree
 - 33% neither agree nor disagree
 - 40% disagree
6. Businesses bear as much responsibility as governments for driving positive social change.
- **Total Global**
 - 74% agree
 - 13% neither agree nor disagree
 - 13% disagree
 - **United States**
 - 76% agree
 - 17% neither agree nor disagree
 - 7% disagree
 - **United Kingdom**
 - 81% agree
 - 14% neither agree nor disagree
 - 5% disagree
 - **France**
 - 84% agree
 - 12% neither agree nor disagree
 - 4% disagree
7. As a consumer, I have a responsibility to censure unethical companies by avoiding their products.
- **Total Global**
 - 70% agree
 - 15% neither agree nor disagree
 - 15% disagree
 - **United States**
 - 77% agree
 - 16% neither agree nor disagree
 - 7% disagree

- **United Kingdom**
 - 71% agree
 - 21% neither agree nor disagree
 - 8% disagree
 - **France**
 - 76% agree
 - 17% neither agree nor disagree
 - 7% disagree
8. I am paying more attention than in the past to the environmental and /or social impact of the products I buy.
- **Total Global**
 - 69% agree
 - 16% neither agree nor disagree
 - 15% disagree
 - **United States**
 - 68% agree
 - 22% neither agree nor disagree
 - 10% disagree
 - **United Kingdom**
 - 72% agree
 - 19% neither agree nor disagree
 - 9% disagree
 - **France**
 - 80% agree
 - 15% neither agree nor disagree
 - 5% disagree
9. The more open and collaborative a business is, the more likely it is to succeed.
- **Total Global**
 - 71% agree
 - 18% neither agree nor disagree

- 11% disagree
 - **United States**
 - 74% agree
 - 23% neither agree nor disagree
 - 3% disagree
 - **United Kingdom**
 - 75% agree
 - 20% neither agree nor disagree
 - 5% disagree
 - **France**
 - 78% agree
 - 17% neither agree nor disagree
 - 5% disagree
10. The most successful and profitable businesses in the future will be those that practise sustainability.
- **Total Global**
 - 70% agree
 - 17% neither agree nor disagree
 - 13% disagree
 - **United States**
 - 74% agree
 - 21% neither agree nor disagree
 - 5% disagree
 - **United Kingdom**
 - 70% agree
 - 23% neither agree nor disagree
 - 7% disagree
 - **France**
 - 76% agree
 - 19% neither agree nor disagree
 - 5% disagree

11. It is important that companies stand for something other than profitability.
- **Total Global**
 - 74% agree
 - 12% neither agree nor disagree
 - 14% disagree
 - **United States**
 - 79% agree
 - 14% neither agree nor disagree
 - 7% disagree
 - **United Kingdom**
 - 79% agree
 - 15% neither agree nor disagree
 - 6% disagree
 - **France**
 - 86% agree
 - 10% neither agree nor disagree
 - 4% disagree
12. Which of the following do you believe will be the greatest agent of change?

A. Global Total

- a. 40% "The people, empowered by social media"
- b. 24% "What we consume"
- c. 19% "Corporations and companies"
- d. 17% "Politics"

B. United States

- a. 44% "The people, empowered by social media"
- b. 31% "What we consume"
- c. 14% "Corporations and companies"
- d. 11% "Politics"

C. United Kingdom

- a. 37% "The people, empowered by social media"
- b. 24% "What we consume"
- c. 19% "Corporations and companies"
- d. 20% "Politics"

D. France

- a. 26% "The people, empowered by social media"
- b. 31% "What we consume"
- c. 26% "Corporations and companies"
- d. 16% "Politics"

I owe an obvious debt to Euro RSCG Worldwide. **Euro RSCG Worldwide** is a leading integrated marketing communications agency and was the first agency to be named Global Agency of the Year by both *Advertising Age* and *Campaign* in the same year. Euro RSCG is made up of 233 offices in 75 countries and provides advertising, marketing, corporate communications, and digital and social media solutions to clients, including Air France, BNP Paribas, Charles Schwab, Citigroup, Danone Group, IBM, Kraft Foods, Lacoste, Merck, Pernod Ricard, PSA Peugeot Citroen, Reckitt Benckiser, Sanofi, and Volvo.

Their generous sharing of data from their 2011 **Consumer Conscience Study** not only gave us support for the ethical business model; it connected it directly to Europe as well.

While I have presented a great deal of data to back up the idea that the Ethical Business model is not only profitably friendly, but it also encourages and produces profit at a higher level than any other, there will always be those who choose a less savoury path. It is increasingly

apparent that in the flat world we now inhabit, that is a foolish choice driven not by factual research but by flawed media perception.

It is my belief that most people - including business leaders - want to do the right thing in every aspect of their lives, including the workplace. It is my experience that in most cases that is the way it plays out in the workplace. Good news does not make headlines. And high-minded businesses do not make great drama for the Hollywood producers. Nor is the spotlight ever thrown on them by the media or grandstanding politicians. These facts of life have fostered a perception that the barracuda business model is the norm. I am convinced that quite to the contrary it is the exception, the path of the misguided, the weak, and the stupid.

INVESTING SUSTAINABLY: ECONOMIC PRESSURES, ENVIRONMENTAL LIMITS AND SOCIAL CHANGES

The approach to investment often described as “ethical investment” has today evolved into both an investment philosophy and a diverse set of approaches. These seek to tackle the fundamental challenges facing societies, economies and financial institutions – both today’s economic pressures and the shift to living within environmental limits and responding to the associated social change.

Today, we talk also about sustainable, responsible, green and “ESG” investing as well as ethical investing but these terms all mean broadly the same thing. I will mainly use “sustainable” here.

Sustainable Investing in the UK and Europe

Sustainable investing is sometimes described as investing that incorporates environmental, social and governance (ESG) issues but more fundamentally it is investing that is “sustainable” according to the more widely used definition of the word i.e. that “can continue indefinitely”.

As Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF), I am conscious that I look at this particularly from a UK perspective, but I am pleased to say that the UK is a global leader in the field. When UKSIF celebrated its 20th anniversary in 2011, we highlighted that the UK investment sector managed about 14% of global assets known to be managed responsibly¹, the UK had the second largest number of signatories to the UN-backed Principles for Responsible Investment (PRI)² and London was home to a range of innovative global responsible investment initiatives such as the Carbon Disclosure Project (CDP) and PRI itself.

Over the decades, sustainable investment in Europe has developed and matured. In 2010, I made a video presentation for the CFA Institute on “A short history of Responsible Investing in Europe”. This is available at no charge on the CFA Institute’s web site³. In it, I identified four phases of development:

1. The Ethical Era
2. Waking up to Materiality
3. A Mainstream Choice
4. Investment & Society: A New Relationship

Of course, as an area develops, early products may still remain popular. It is notable that, as sustainable investing has evolved, demand for products that avoid investing in some activities remains strong. At the same time, the whole field has evolved to include a wider range of successful offerings including ones without this feature.

“Make Money and Make a Difference”

Since 2008, UKSIF has run an annual marketing campaign called “National Ethical Investment Week” to

promote sustainable investment – or rather to encourage consumers, charities and churches to use their savings and investments to “make money and make a difference” at the same time. In 2011, our short promotional video available on YouTube⁴ highlighted some of the areas of opportunity:

- Combat Climate Change
- Provide Clean, Safe Drinking Water
- Grow Healthy, Sustainable Food
- Increase Access to Basic Healthcare and Medicine
- Provide Social Housing and Urban Regeneration

It emphasised that “people like you can make money and make a difference”, i.e. that this was an option for all investors not just for those with strongly held views.

UKSIF’s research for the Week has found that a large proportion of consumers are interested. In 2011, 42% of GB adults with investments said that they wanted to ‘make money *and* make a difference’, with over one in three (34%) wanting at least 25% of their investments to include sustainable considerations and a further one in ten (10%) wanting to ‘dip their toe in the water’ by including these considerations in a smaller proportion of their investments.

Economic pressures on society and on the investment sector

Over the last few months, the Occupy movement has been a visible presence in the City of London with a camp just outside St Paul’s Cathedral. But it is the economic pressures on society today which cause the resonance between this campaign and the concerns of the general

public. This poses a genuine challenge to the “license to operate” which society gives to the investment industry. Some in the industry are responding. One example is the ‘Next Generation Vision’ produced by a group of young people working in UK financial services. They highlight that financial services must again become “a part of society – not apart from society”.⁵

The investment industry itself also faces major challenges. Institutional clients are demanding lower fees and staffing within fund managers is shrinking. Sustainable investment funds are not immune from these wider pressures. At the same time, demand for long-term and more responsible investment approaches is growing and deepening. As I highlighted in an article in the Financial Times earlier this year, “at a time of change for the asset management industry, sustainable and responsible investment is restructuring, developing and thriving” and “amid the turmoil of wider industry restructuring, an exciting new era for SRI is emerging”.⁶

Environmental limits

This year’s “Rio+20” conference on sustainable development, held twenty years after the 1992 Earth Summit in Rio de Janeiro, has highlighted the urgency of a transition to a resilient economy.

Today, we are all working our way out of one global crisis, the warning signs of which went largely unrecognised. The next crisis is plainly visible and even more challenging. “It is predicted that by 2030 the world will need to produce around 50 per cent more food and energy, together with 30 per cent more fresh water, whilst mitigating and adapting to climate change.” UK

government adviser Sir John Beddington said in 2009. “This threatens to create a ‘perfect storm’ of global events.” he warned.

Indeed, sustainability practitioners at a recent event hosted by the Aldersgate Group, a UK-based alliance of leaders from business, politics and society that seeks to drive action for a sustainable economy, saw food security as the most significant issue that needed to be tackled at Rio.

The challenges of the past have led to socially valuable innovations like insurance, pensions and trade finance. Averting this coming “perfect storm” will similarly require positive financial innovation to reallocate capital at speed, manage unfamiliar risks and enable new lifestyles and income sources. For this reason, sustainable finance is central to the global transition to well-being within a resilient resource-efficient economy.

It is also vital for the future success of the investment industry. Over the next twenty years, sustainability trends and societal responses will cause the drivers of value creation to change. Investment institutions that fail to predict and adapt to these changes will be unlikely to protect and grow their clients’ wealth.

Towards Resilient Societies

A resilient economy requires investment approaches that support societies to build, maintain and enable effective use of a range of “capital assets”:

- Natural capital (ie. nature)
- Human capital (ie. people and their skills and knowledge)
- Social capital (ie. social structures, institutions and connections)

- Manufactured and constructed capital (ie. “things” like buildings, tools and intangible assets, etc.)

Societies need to harness three key drivers in particular to deliver breakthrough innovation in technologies, business models and cultures. These drivers are:

- Increased connectivity
- Developing knowledge about cognition and neuroscience
- Threats of resource scarcity and associated social change

What does that mean in practice?

Let me give four examples of how both established and new investment providers are responding today:

1. *Being Good Stewards*

Savers and investors need their investment managers not only to select good investments but also to be good stewards of the investments they hold. This means protecting and growing the value of company shares and other investments by demanding a long-term responsible approach rather than short-term profits achieved in ways that damage long-term profitability. For example, investment managers need to use responsible ownership practices like company dialogue and shareholder voting on AGM resolutions to encourage companies to behave in ways that treat customers well, make efficient use of natural resources and invest in good relationships with the communities in which they operate.

This year, investors in UK companies have been active particularly in voting against inappropriate

executive pay. Indeed, by analogy with the Arab Spring, this increase in active stewardship has been described as the “Shareholder Spring”.

Leading investors believe that effective stewardship cannot be restricted to influencing companies. Instead, they must also influence financial services law and regulation to create a framework that encourages long-term responsible investment and lobby for public policies that enable companies to profit from responsible and sustainable practices and that incentivise other desirable investments.

The “stewardship agenda” therefore includes all of:

- Financial regulation and the availability of professional services that enable socially useful financial innovation
- Governance, transparency, good ownership practices and effective demand throughout the investment chain
- Investments that generate value by providing long-term solutions to society’s needs within an incentivising and predictable public policy framework

Good stewardship is of interest to public policymakers at both the European and national levels. For example, the UK’s Department for Business, Innovation and Skills has commissioned noted economist John Kay to undertake a review of the impact of UK capital markets on long-term decision making by British companies and make policy recommendations on how this can be improved⁷.

2. *Speeding the Low Carbon Transition*

Investors have a critical role to play in driving the reallocation of capital needed for a low carbon and resource efficient economy in which biodiversity is protected, temperatures are contained to a safe level and climate instability is avoided. This is a major challenge. In 2010, a report from Ernst & Young, the management consultancy, estimated that there was likely to be a shortfall of £370 billion in investment in UK green infrastructure over the period 2010-2025 unless new approaches were taken to attracting institutional funds. Only £70 billion of the total of £450 billion of low carbon investment needed over this period was likely to follow from existing approaches such as bond issues by utility companies, the report said. At the European Union level, the challenge is even greater. At least 1.5 trillion euros of capital investment must be shifted into low carbon sectors to deliver a 30% cut in greenhouse gas emissions by 2020 according to a report published in February 2012 by E3G, a specialist think tank.

“Climate bonds” have emerged as one positive financial innovation that could help to fill this gap. Good practice standards are being developed by the Climate Bonds Initiative, an investor-focused non-profit created to develop a high quality market in these financial instruments. According to its report “Bonds and Climate Change: The State of the Market in 2012” (June 2012), there are already some 174 billion US dollars in outstanding climate-themed bonds in the global market. This total represents over one thousand bonds from 207 issuers. In Europe, the Ile-de-France regional council’s environmental and socially responsible bond issuance in March

2012 attracted particular attention. In spite of an unfavourable financial environment, the issuance was significantly over-subscribed and raised 350 million euros for energy measures, low-energy social housing and dedicated biodiversity activities as well as social and solidarity economy initiatives. This was highlighted in a May 2012 briefing from CDC Climate Research which also analysed the wider green bond market⁸.

3. *Financing Social Enterprise*

The third example comes from the increasingly high profile area of “impact investing” which is also sometimes known as “social investment” or “social impact investing”. According to the Global Impact Investing network, impact investments are investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.

One strand of impact investing is investment in social enterprises. A social enterprise is a business that exists to achieve a social and/or environmental purpose. Indeed, the European Commission sees this area as so significant that it is planning a “Social Entrepreneurship Fund” label to help investors to identify high impact funds.

The rising interest in social enterprise investment has coincided with a shift in thinking about the delivery of public services. For much of the twentieth century, public services were delivered directly

through public bodies. In the 1980s, many services started to be delivered through contracts with private companies instead. Today, policy makers are interested in increasing public service delivery through specialist social enterprise and mutual businesses rather than for-profit businesses. This offers the opportunity to combine the best of private and public approaches. Perhaps more significantly, following the financial crisis, there is a rising global interest in paying for public services using a “payment by results” model that measures the long-term social impact achieved - and the resulting reduction in future public expenditure - rather than the units of service delivered.

These trends have come together in the design of the “social impact bond”. This “bond” is a quasi-equity structure rather than a conventional bond in that the whole of the investors’ capital is at risk. It has been developed by Social Finance, a specialist provider of impact investing products, to increase funding for preventative services that improve social outcomes.

The first Social Impact Bond⁹ is being pioneered in Peterborough, a city in the UK. It is funding a service for short-sentence male prisoners discharged from Peterborough prison. 60% of short-sentence prisoners re-offend within one year of release, resulting in significant cost to society and the public purse and yet few receive support to prevent re-offending. The bond raised £5 million mainly from charitable investors for experienced non-profit organisations to provide intensive support to 3,000 prisoners and their families. The public sector will pay the investors

only if the measured re-conviction rate is below an agreed level compared with a control group of other short-stay prisoners in the UK. The financial return will depend on the degree to which the re-conviction rate improves.

Although this six year initiative was launched only in 2010, it is already attracting strong interest both within the UK and globally. Further social impact bonds are being considered for areas such as pre-school education and intensive work with troubled families.

4. *Harnessing Connectivity*

My final example looks beyond the conventional investment sector to the emerging field of “peer-to-peer” investing. This approach uses the internet to enable individuals to select investments without the involvement of conventional investment institutions. Early pioneers were social investment platforms such as Kiva. This enabled individuals to make small loans to entrepreneurs in developing countries. More recently, The Co-operative Banking Group in the UK has provided support for the “Lend with Care” platform which takes a similar approach.

Today, these initiatives do not offer the financial returns sought for mainstream investments but it is a mistake to dismiss them only as niche offerings. Disruptive innovations often start by targeting markets that mainstream players dismiss as irrelevant. For example, thirty years ago, major computer corporations did not see companies like Apple as potential competitors because their products were suitable then only for

hobbyists and specialist users rather than major corporate clients.

Further peer-to-peer solutions are providing finance for other markets. In the UK, Zopa pioneered peer-to-peer personal lending while Funding Circle is one of a number of providers of loan finance for small businesses.

Most recently, a peer-to-peer platform called Abundance Generation has been launched to enable individuals to invest in renewable energy projects by buying debentures for as little as £5. It has created an animated video¹⁰ to explain its approach.

Investing for a Resilient Future

Today is a very positive time for responsible investors as well as being deeply troubling. To be successful, investment institutions will need to look with fresh eyes at how value is created and how it is protected. We indeed live in a dynamic society. It is a time of opportunity for ethical and sustainable investment.

About the UK Sustainable Investment and Finance Association (UKSIF)

The UK Sustainable Investment and Finance Association (UKSIF) is the UK's membership network for responsible investment and other financial services that advance sustainable development. Launched in 1991, we now have over 260 members of which over 60 are banks or asset managers. We are one of a range of similar organisations across Europe and around the world. Within Europe, we

come together with other sustainable investment and finance associations in Eurosif, the European Sustainable Investment Forum.

UKSIF's role is to support and encourage the UK finance sector to remain a global leader in advancing sustainability through financial services and to work with our sister organisations to deepen the practice of sustainable investment and finance across Europe. We also aim to grow market demand for sustainable and responsible investment and finance within the UK.

Over these years, UKSIF has played a key role in supporting the vibrant UK cluster of sustainable investment and finance providers to develop and grow. By facilitating a strong **network**, we have enabled our members to develop their capacity and compete more effectively. By **convening** them to understand, educate and influence their stakeholders and by providing a **collective voice**, we have supported the development of key sustainable finance initiatives and public policy measures within the UK which have helped to deepen practices and maintain leadership.

Notes

- 1 Percentage of responsibly managed assets tracked by sustainable investment and finance associations around the world that are managed in the UK.
- 2 Calculated using signatories listed at www.unpri.org.
- 3 http://www.cfainstitute.org/learning/products/multimedia/Pages/48752.aspx?WPID=Topic_List_Tabbed&PageName=All
- 4 www.youtube.com/watch?v=7BofjPblGhk&feature=player_embedded
- 5 www.nextgenerationvision.co.uk/our-vision/role-in-society/
- 6 “Industry changes spur SRI development”, 25 March 2012 at www.ft.com/cms/s/0/341f93a6-66ba-11e1-863c-00144feabdc0.html
- 7 His report “The Kay Review of UK Equity Markets and Long-Term Decision Making” was published on 23 June 2012 and is available at www.bis.gov.uk/kayreview.
- 8 “Climate Brief No14 - Financing the transition to a green economy: their word is their (green) bond?” at www.cdcclimat.com/Climate-Brief-no14-Financing-the-transition-to-a-green-economy-their-word-is-their-green-bond.html?lang=en
- 9 www.socialfinance.org.uk/resources/social-finance/SF_Peterborough_SIB.pdf
- 10 www.youtube.com/watch?v=OhazuqKobf0

THE GROWING APPETITE FOR GREEN AND ETHICAL INVESTMENT

Green and ethical funds are uniquely positioned to drive companies and investors towards a greener, fairer economy.

In many respects 2012 has been a big year for green and ethical investment. Calls for a more responsible approach to capitalism are growing, along with the sense that a more sophisticated understanding of investment risk – one which takes longer-term sustainability issues into account – is urgently required.

June 2012 saw the United Nations (UN) Conference on Sustainable Development take place in Rio de Janeiro, Brazil. Though widely criticised for failing to deliver the government commitments and practical actions needed to shift the global economy onto a sustainable path, there were some positive aspects to the conference.

A number of finance CEOs announced their commitment to the Natural Capital Declaration - a statement by and for the financial sector to work towards integrating natural capital considerations into lending, investment and insurance products and services. Natural capital comprises the earth's natural assets (soil, air, water, flora and fauna), and the ecosystem services resulting from

them which make human life possible. Ecosystem goods and services from Natural Capital are worth trillions of Euros per year and constitute food, fiber, water, health, energy, climate security and other essential services for everyone. Presently, neither these services, nor the stock of Natural Capital that provides them, are adequately valued compared to social and financial capital. The Natural Capital Declaration seeks to address this imbalance.

At Rio the Corporate Sustainability Reporting Coalition also called on UN member states to commit to develop a policy framework on corporate sustainability reporting and advocated effective mechanisms for investors to hold companies to account on the quality of their disclosure on environmental, social and governance (ESG) issues.

The global financial crisis and other high profile ESG failings have highlighted the increasing importance of companies having business strategies that are sustainable over both the short and the long-term. Integrating ESG considerations into financial decisions is critical in supporting efforts to tackle the pressing issues of climate change, food, water and energy scarcity, and human rights. Such an ambitious task requires a concerted response.

Green and ethical funds can play a key role in driving improvements in the companies within which they invest, but it is clear that financial institutions around the world need to do much more to ensure that long-term, sustainable business values which brings benefits to profits, people and the planet become the norm.

Evidence suggests that a large chunk of investors across Europe would agree. In the UK a 2012 YouGov poll for National Ethical Investment Week found that 55% of adults in Great Britain with investments want their bank or financial adviser to tell them more about

‘impact investments’, i.e., investments that produce both a financial and a social or environmental benefit.

Whilst in France a 2012 Ipsos MORI national consumer poll run for EIRIS and the French Social Investment Forum (FIR) found that 52% of retail investors attach importance to environmental, social and ethical criteria in their savings decision. The survey also suggested that socially responsible investment (SRI) may hold the key to helping to rebuild public trust in financial institutions with 53% of respondents saying that confidence in their financial institution would increase if it adopted an SRI approach.

Growth

The good news is that momentum is shifting things in the right direction and the amount of money invested responsibly in key markets around the world is increasing.

Latest statistics from EIRIS show that there is currently around £11 billion invested in around 100 green and ethical funds, up from £4 billion 10 years ago. In the summer of 2012, ethical banks attracted more than 100,000 new customers at a time when many high street banks were hit by a series of scandals including Libor fixing at Barclays, and HSBC and Standard Chartered falling foul of American regulators.

Across Europe, investors are adopting an array of responsible investment strategies, often in combination: sustainability-themed, best-in-class, norms-based screening, Exclusions, ESG Integration, engagement/voting and Impact investments. According to EUROSIFs 5th SRI Study the growth of each responsible investment strategy covered has been stronger than broader asset

management market growth. Four strategies have even grown by more than 90% between 2009 and 2011. Norms-based screening is the fastest growing strategy with an estimated €2.3 trillion Assets under Management (AuM), a growth of 137% since 2009. In addition, exclusions of specific sectors, companies or practices and best-in-Class strategies have experienced growth in AuM of 119% and 113% respectively. With almost 17% growth, engagement and voting is still growing in Europe, starting to spread to new markets like Spain or Italy. Integration grew 14% over the period.

In the USA the picture is also one of growth. According to the US Forum for Responsible and Sustainable Investment broad-based sustainable and SRI approaches encompassed an estimated \$3.07 trillion out of \$25.2 trillion in the U.S. investment marketplace as at December 2010. From 2007 to 2010, SRI assets increased more than 13% compared to all investment assets under management which edged up by less than 1%.

Drivers

So what is behind the growth in green and ethical investment and which factors are likely to increase demand?

Sustainability megatrends will continue to make the case for long-term, sustainable investment. There is a growing need to 'do more with less' in the context of population growth, climate change and resource availability, particularly with regards to pollution, and the consumption of energy and water resources. Those investors that reduce risk and maximise investment opportunities by seeking out companies which have the

best performance on ESG issues, or by engaging with companies to improve performance, will be best placed to manage the global challenges that are coming our way.

At the same time growing consumer interest in green and ethical issues such as climate change, animal welfare, fair trade and human rights and the environment is encouraging more consumers to consider green and ethical financial products.

Corporate scandals and high profile failings at big companies continue to shine a spotlight on sustainable investment. You only have to look at failures at BP, News Corporation, Vedanta and Olympus to see the importance of understanding and improving corporate performance on ESG issues.

There is now greater accountability and more focus on the extent to which investee companies are compliant with global norms and conventions such as the UN Global Compact and the UN Environment Programme Finance Initiative. Investors are becoming more active shareholders by engaging with companies to improve their sustainability performance and integrating ESG issues into voting decisions, especially on key issues such as executive pay.

In recent years, an increasing number of stock exchanges around the world have implemented initiatives aimed at driving improvements in corporate disclosure and performance on ESG issues.

In 2010, the Istanbul Stock Exchange (ISE) and the Brazilian Stock Exchange (BM&FBOVESPA) both signed the UN Principles for Responsible Investment, taking the pledge to actively seek ESG disclosure from their investee companies.

The Indonesia Stock Exchange also introduced the KEHATI-SRI Index and the Shanghai Stock Exchange

established the Social Responsibility Index, the Egyptian Exchange launched the S&P/EGX ESG Index, the first ESG index in the Middle East and North Africa and the Korean Stock Exchange launched its Socially Responsible Investment (SRI) Index.

At the same time, the NYSE Arca (the wholly owned subsidiary of NYSE Euronext) began trading the ESG Shares North America Sustainability Index ETF, which consists of equity securities of issuers in North America that meet specific ESG criteria.

As a global responsible investment research specialists, EIRIS has a long track record of promoting responsible investment and working with listing agencies and exchanges around the world to increase the uptake of responsible investment.

In 2001 we began working with FTSE on the development of its FTSE4Good Indices. Supported by EIRIS research, the FTSE4Good indices are designed to objectively measure the performance of companies and are only open to those companies that meet globally recognised corporate responsibility standards. Over the last 10 years, FTSE and EIRIS have engaged with over 1,000 on new FTSE4Good criteria to raise corporate performance across a broad range of sustainability criteria.

In 2007, EIRIS also began to work with the Johannesburg Stock Exchange (JSE) on the development of its Socially Responsible Investment (SRI) Index. The JSE SRI Index employs a broad range of listing criteria which reflect global SRI standards amongst its listing criteria, while accommodating issues of specific relevance to South Africa such as Black Economic Empowerment and HIV/AIDS. In 2010 the JSE upgraded its ESG reporting requirements to include integrated reporting on a 'comply or explain' basis, making South Africa the first

country to mandate the disclosure of financial and non-financial performance in one integrated report for all listed companies.

More recently we have worked with the Bolsa Mexicana de Valores (BMV), the Mexican stock exchange, to launch a new sustainability index. Launched in December 2011, BMV's new sustainability index is based on the 70 most liquid shares on the Mexican Stock Exchange. Companies eligible for inclusion on the index are assessed according to their performance, impact and responses to emerging ESG issues, including climate change, human rights and policies and systems to counter bribery. Each company is evaluated in comparison to the sustainability practices of its sector globally. Mexican companies have to score in the top 50% of performers to be eligible for inclusion.

Mainstreaming green and ethical investment is about ensuring a good range of green and ethical financial products are available to all consumers across all aspects of ethical finance. But it is also about ensuring that retail fund managers embed sustainable investment principles across all funds under management, not just in the green and ethical funds they offer.

This might mean engaging with investee companies to improve their performance on key issues like climate change, environment, biodiversity and human rights. Or integrating ESG factors into investment decisions to reduce risk and identify investment opportunities. It can also mean making a commitment to join relevant sustainable initiatives such as the Equator Principles or the Principles for Responsible Investment.

Given the credit crunch and financial crisis, plus unethical behaviour at scandal-hit banks, it is not surprising that growing numbers of consumers across Europe and elsewhere are interested in financial products

that offer a more ethical, sustainable and long-term approach to finance.

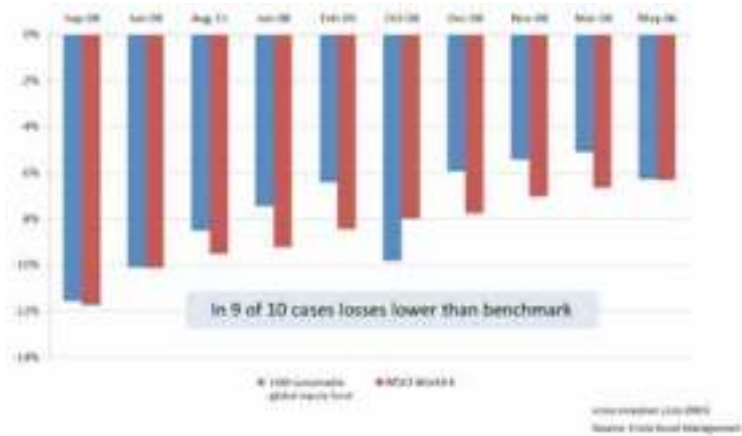
Looking ahead, we need a greater range of financial products that enable investors to invest in line with their ethics and to provide access to the many exciting new types of sustainable investment themes and opportunities which exist. For green and ethical investment to be really effective we also need mainstream fund managers to report back to their customers on how they are adopting longer-term sustainable investment principles across all their investments.

ERSTE ASSET MANAGEMENT: SUSTAINABLE INVESTING

Sustainability is a concept that has a long history at Erste Asset Management. We already recognised early on that investors are placing an increasing emphasis on responsibility for the environment as well as ethical and social aspects when deciding on where to invest. Erste Asset Management has taken these changes as an opportunity to develop a wide range of ethical and sustainable funds for private and institutional clients over the past ten years. With an invested volume of around 2 billion euro, Erste Asset Management is one of the most important provider of sustainable funds.

The objective here is to show the benefits of sustainable investments from a risk point of view.

When working as an SRI specialist one is often confronted with the prejudice of SRI/ESG underperformance. However, results speak differently. Therefore, our key message is that sustainability can limit losses. Our global equity fund ESPA VINIS Stock Global outperformed clearly in 9 of 10 of the weakest months over the last years.



Experience shows that one should never put all one's eggs in one basket; this applies also in the field of ESG. That means one has to diversify. Different people understand ESG differently. We at Erste Asset Management think that a holistic approach makes a lot of sense.

A combination of ESG styles should be an investor's target, in order to achieve the optimum investable universe. Each of the styles shows specific risk aspects.

Our approach combines:

1) **Positive and negative screening**

We exclude for instance child labour and therefore avoid reputation risk – like for Nike some years ago

2) **Best-in-class**

We focus on e.g. the existence of an EMS (environmental management system) in the production process, in the end to reduce the risk and avoid environmental disaster.

3) **Engagement/ Active ownership**

We actively talk to companies about ESG risk factors. An example in Austria is OMV, where we addressed the question if the Company wants to be an oil & gas

company only or rather an integrated group in the energy business, including renewable energy.



When it comes to **negative screening** an investor should – from our point of view – exclude for instance nuclear power.

The issues and risk factors here include:

- risks of environmental damage through mining, processing, transport
- nuclear weapons proliferation
- unsolved problem of nuclear waste
- serious accident
- terrorism

Therefore, we believe that the investment in nuclear power is not a question of belief, but a question of risks involved and their possible externalisation – this means the question if the state (and in the end the taxpayer) pays in case of a disaster.

Also the **best-in-class** approach reduction of risk is relevant. This is, however, much more complex and includes multiple aspects and levels of dissemination.

As an example, take the case of AIG. There were several reasons why one should not invest even before the emerging of the financial crisis!

The minor reasons included:

- responsible marketing issues were missing
- there was no EMS system in place

The more important reasons for exclusions were:

- the use of fraudulent insurance transactions
- the manipulation of AIG's earnings over some years
- help for customer companies to commit accounting fraud

Therefore, we were skeptical about AIG already some time before the slide in the share price began – simply because of ESG-related motives!

However, one should not only focus on negative issues and the discussion as to why one should not invest and therefore avoided losses.

A positive example for sustainability performance is Henkel, the German producer of household goods. The company has been awarded a number of sustainability awards over the last years. We listed some of its strengths.

- environmental and health & safety issues are assessed for products and ingredients
- the Company promotes renewable raw materials
- there are ongoing improvements in staff and supplier relations

Henkel has been an out-performer both in sustainability terms and performance-wise over the last years!

The examples explained above indicate that there is a financial value of sustainability.

A negative effect from ESG exclusion, therefore, has clearly to be denied. There is a positive effect concerning risk reduction, benefits of ESG with regard to risk –

that means in bearish to neutral markets. However, a calculated ESG universe shows a neutral performance even in the recent bull market.

Risk reduction via ESG leads – according to how we at Erste Asset Management understand ESG – to lower volatility. For us reduced risk with regard to price fluctuations is one of the main features of sustainability portfolios. But does that mean that there is a free ESG lunch? There is the well-known story about Mr. Rothschild who told his chauffeur: either to enjoy good food or sleep well. Apparently this dichotomy does not apply here and SRI leads to good returns and lower risk.

If one takes a look at the process behind a successful SRI product, the creation of a portfolio out of a broad universe involves various steps. In our ESG understanding they look as follows:

- 1) The universe is screened – we use 3 different research agencies – each of them supplying data according to its major strength.
- 2) The second level is the Investment Board; our regular communication platform with our independent research agencies.
- 3) The screened universe is then used for a state-of-the-art portfolio construction process.
- 4) On the basis of the portfolio we practise active ownership.



For research we use our three dimensions of ESG approaches combined with internal research – all that on a monthly basis.

Our internal research efforts do include the analysis of ESG factors on a sector level, but they also incorporate inputs from company meetings and from direct engagement.

On a global context we receive data from 3 different research agencies. They were chosen as a result of a tender some 7 years ago.

At Erste Asset Management we developed a number of positive and negative criteria for our funds. This was done on the basis of discussions with our ethics committee, which consists of members that represent the relevant stakeholder groups. Behind all that lies a long-lasting process that has constantly to be monitored. Some criteria appear to be quite controversial (GMOs), others rather clear and beyond discussion (child labour).

Via our committee we tried to objectivise our criteria (they are often regarded as the subjective part of ESG) and capture the majority of potential investors.

Best-in-class wise we use a triple-digit number of data points to evaluate the sustainability level of a company. Important questions when working with a best-in-class approach are:

- Where to draw the line or threshold
- Whether one deals with homogeneous sectors or not – in order to give sense to a comparison

The example of basic materials shows that we are allowed to invest in Norsk Hydro, Lonmin and Aurubius. There are many companies that do not meet the necessary ESG level.

For the calculation of the sustainability universe we use the best-in-class data but do also include the violations of exclusionary criteria.

The investment board is one of the USPs of our process. The main themes of the board are:

- The verification of the assessment process
- Up-to-date information about ESG criteria
- The discussion of our own findings with the agencies
- An on-going discussion with but also among the agencies
- The ESG information on IPOs
- The discussion of the further focus of our in-house research

Finally our Layer 4 contains the engagement and voting process.

We do engage either directly or via our international partner. Besides that, we are constantly broadening our Engagement activities with cooperation with the UNPRI and other platforms like CRIC and EUROSIF

Here are some examples where we ourselves engaged in a dialogue with companies.

Starbucks:

- The Company has the size and power to enable change
- On the other hand the Company might be threatening existing coffeehouse/ café structures
- We addressed labour standards in our discussions

Essilor:

- We had engaged the company years ago via our ethics committee – with regard to the question of specialised products for weaponry
- We focused on the marketing issue in our discussions

The main features of our portfolios are:

Low volatility	the SRI universe shows a low standard deviation
Outperformance I	the sustainable universe is usually equal or ahead of the MSCI World, alpha generation in every market environment but strong bull markets
Outperformance II	strong relative outperformance in significant market downturns
Long-term	holding periods exceed that of traditional portfolios, low portfolio turnover = lower transaction costs
Risk-reducing	alpha generation via using ESG integration as a risk management tool

Trends and future opportunities in SRI include, among others, the growth perspective.

- The ESG volume is growing steadily, but still definitions across Europe vary.
- There is an increased focus on engagement and voting.
- The acceptance of the risk-adverse qualities of core

SRI portfolios – especially interesting in a market environment where uncertainties prevail – is growing.

- There is a trend to labeling in the SRI industry.

In sum, benefits from sustainable investments are real. And, at Erste Asset Management, we want to ensure that these benefits are reaped in the interest of our clients. By combining a series of measures in collecting information, assessing it, undertaking strict discussions with units and companies involved, we managed to obtain satisfactory results. But, there is still more to be done; the prospects for ESG growth are promising. Hence, there is scope for continuing to refine the ways in which we address our approach to this method of selection of investment opportunities.

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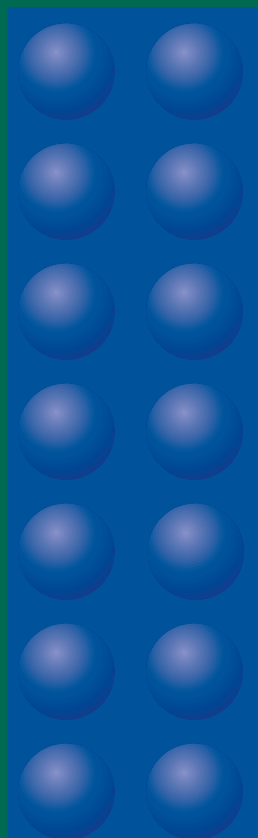
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