Deutsche Bank Research

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Responsible Investments

A new investment trend here to stay

Responsible investments (RI) are increasingly attracting the attention of institutional and private investors. Responsible investing refers to financial products and themes which consider environmental, social, governance or ethical issues in addition to financial performance.

The market for responsible investments has grown strongly in recent years. Demand from (public) institutional investors and high-net-worth individuals have been among the main driving forces behind this development. Currently, the market is gradually merging into mainstream as providers of financial services expand their lines of products as well as channels of distribution and more and more institutional and retail investors integrate extra-financial criteria in their investment decisions.

Going forward, corporates and sovereigns will be increasingly judged on sustainability issues. With investors placing greater weight on ESG (environmental, social and governance) criteria, corporates and sovereigns will be pressured to adhere to higher standards. Responsible investing thus supports the emergence of a more sustainable economic system.

We expect the growth trend in responsible investing to continue in the medium term, especially in Europe, with tailwind from various quarters:

— On the investor side the market will benefit from increased awareness for sustainability issues, and with it, rising demand for corresponding investment solutions. At the same time, providers of traditional and specialised financial services are expanding the range of products offered to include ESG criteria.

— In some countries, the mandatory reporting of ESG standards and the consideration given to extra-financial investment criteria by pension funds and insurers are additional drivers for heightened demand for RI.

— Finally, the market will receive additional momentum from public initiatives to promote the efficient use of energy and to raise the share of renewables.

Need for action remains in particular with respect to the development of reliable standards and uniform definitions. So far, the market environment has been shaped very largely by actors' individual perceptions of responsibility and sustainability. Clear standards and definitions will help enhance product transparency and comparability, thus boosting investors' sense of security and readiness to engage in this market segment.

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1. Introduction

Sustainability, its roots

The origin of the idea of sustainability is attributed to Hans Carl von Carlowitz, a senior mining administrator in the State of Saxony. In his treatise "Sylvicultura oeconomica" published in 1713 he coined the term in the face of an extreme shortage of timber caused by mismanagement. For Carlowitz sustainable forestry meant that it should only be permitted to fell timber at the rate at which it can grow again.

Four dimensions of an investment

Source: DB Research 1

The Brundtland Report

The World Commission on Environment and Development (WCED), also known as the Brundtland Commission, chaired by former Norwegian Prime Minister Gro Harlem Brundtland, drafted its report "Our Common Future" in 1987. In its final report the Commission put forward a concept that later became the key statement on sustainable development.

It defined sustainability as "a development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

Extra-financial investment criteria – such as social, environmental and ethical factors – are moving more and more into the focus of institutional and private investors. Meanwhile, a raft of investment products committed to social, environmental and ethical criteria are being offered under the heading of responsible investments (RI). At the same time, when raising capital, corporates and sovereigns are increasingly coming to be judged on these criteria.

There is still no consensus on what the terms "responsibility" and "sustainability" imply.[1] The market for responsible or sustainable investments therefore spans a wide variety of concepts which, though they may be closely related, are largely characterised by individual perceptions of market participants. So how are "responsible" or "sustainable" investments to be differentiated from conventional forms of investment? What products are available? Do sustainable investments necessarily offer lower returns? And how will the market for sustainable investments develop in future?

The present study sets out to provide answers to these questions. It gives a broad overview of the market and identifies the key driving factors for the market's future development.

The fourth investment dimension

In this study the starting point for understanding RI is the classic magic triangle of investing. This consists of the three parameters – return, security and liquidity – used to classify and measure an investment. In addition to these financial objectives, the concept of responsible investing aims at non-monetary or extra-financial objectives, too. Hence, the magic triangle is supplemented by a fourth dimension, turning it into a magic square (chart 1).[2]

As a consequence, ethical, social and environmental criteria might also be taken into account when analysing an investment. Often, these "extra-financial" criteria are perceived in terms of the sustainability concept – on the lines of sustainable development as defined in the Brundtland Report (see box). Against this backdrop, responsible investing in the narrower sense is perceived both as inter-generational as well as intra-generational fairness. However, for the purposes of this study we use the term responsible or sustainable also to refer to investments that relate only to partial aspects of the sustainability concept, e.g. investments which are purely environmentally oriented.

Besides the aforementioned, there are various other terms used to describe this market segment of responsible investments. The most common are sustainable investments (SI) and socially responsible investments (SRI). Nowadays, it is becoming increasingly wide-spread to define sustainable investments based on the so-called ESG criteria. In this context, ESG stands for environmental, social and governance issues (chart 1).

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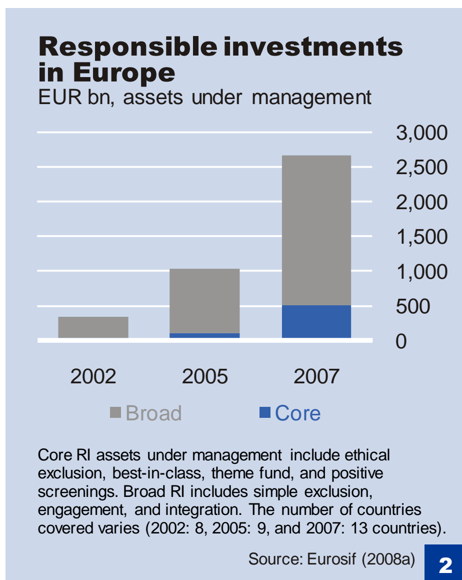
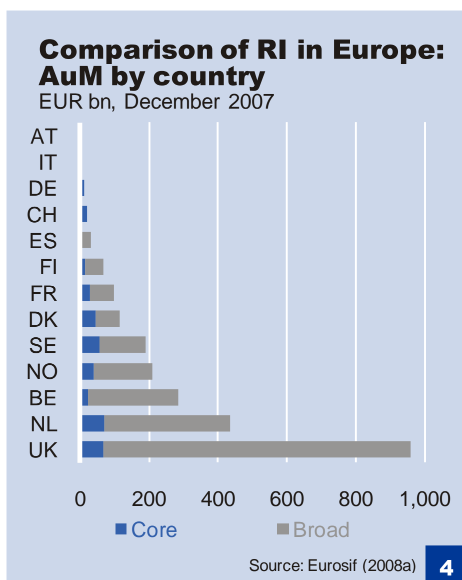
[1] For the purposes of this study the terms responsible investments and sustainable investments are used synonymously.

[2] Ulshöfer and Bonnet (2009).





2. The market for responsible investments

There has been growing demand for responsible investments over the past years. According to estimates published by the European Sustainable Investment Forum (Eurosif), global assets under management in RI amounted to EUR 6.8 trillion in 2008. Assets under management have expanded strongly in recent years, especially in Europe (chart 2), where growth averaged 42% p.a. between 2005 and 2007 (adjusted for those countries that were included in the Eurosif survey for the first time in 2007).[3] Over the same period, RI assets under management in the US grew at an average annual rate of 9% (chart 3). However, this comparatively moderate development in the US followed a phase of strong growth in the second half of the 1990s when RI assets under management quadrupled within five years. The growth in responsible investments in the US between 2005 and 2007 was still as much as 18%, while the growth in total assets under management over the same period was only 3%.

The European market developed relatively late compared to the US market. At the end of 2007 RI on the wider definition (broad RI plus core RI)[4] accounted for an estimated 17% of total assets under professional management in Europe. However, taking only so-called core responsible investments into consideration, the figure is less than 3%. According to figures published by the Social Investment Forum, RI already accounts for over 10% of total assets under professional management in the US. Yet, we have to point to the fact that the European and US RI markets are not directly comparable because the definitions of RI – and thus the data bases – differ.

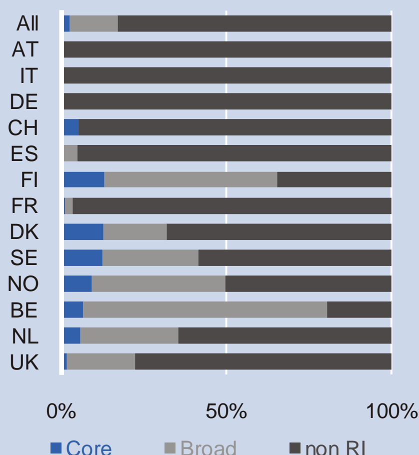
Not only in comparison with the US, but also within Europe, the market share of RI appears to differ widely (chart 4). Owing to its traditional leadership in asset management, the United Kingdom also plays an important role here. In terms of core RI assets under management, responsible investing has been gaining growing importance in recent years especially in the Netherlands, in Belgium and in the Nordic countries – Finland, Denmark, Sweden, and Norway (chart 5 on page 4). By comparison, the importance of RI in Germany remains on a relatively low even though assets under management more than doubled between 2005 and 2007. The investment policy of large institutional investors appears to be among the key factors behind the above-average development in some countries, although there are various reasons for the differences. Again, the national markets are not uniformly defined or covered within Europe, limiting the possibilities for comparison.

The RI market was not left unscathed by the financial crisis, neither at the national level nor at the international level. This becomes apparent, for instance, by the development of RI-oriented mutual funds. While in the previous years assets under management had risen continuously from EUR 5.3 bn in 2004 to EUR 34 bn in 2008, they fell in 2008 by 38% year over year as a result of the financial

[3] Eurosif (2008a). The estimates include investment funds, portfolio management mandates and other investments, e.g. in structured products and hedge funds. A total of thirteen countries were included in the survey for 2007. The annualised growth rate is for AT, BE, FR, DE, IT, ES, CH, NL, and UK.

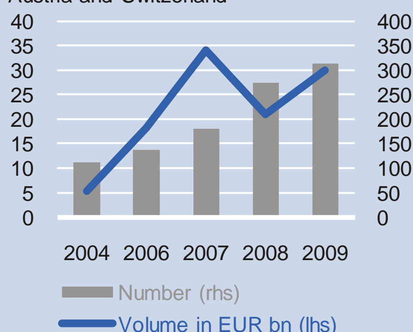
[4] See Eurosif (2008a). Broad RI includes investments based only on a few screening criteria as well as engagement and integration approaches. By contrast, core RI investments are based on a best-in-class approach, sustainable theme funds and more elaborate screenings (for descriptions of the individual investment strategies see Chapter 3).

Importance of RI differs within Europe
RI as % of domestic assets unter management, December 2007



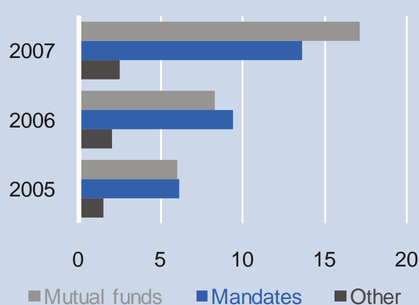
Sources: Eurosif (2008a), ECB, DB Research **5**

Sustainable mutual funds in the German-speaking countries
Funds licensed for distribution in Germany, Austria and Switzerland



Source: Sustainable Business Institute (2009) **6**

Forms of sustainable investment in DE, AT, CH
EUR bn, assets under management*



*With German, Austrian and Swiss financial services providers.

Source: Forum Nachhaltige Geldanlagen (2008) **7**

market crisis (chart 6).[5] This was due partly to net outflows of funds and partly to price falls which eroded the value of the assets under management. In Germany, Austria and Switzerland, sustainable equity funds suffered net outflows of funds of almost 7% in 2008.[6] Still, this compares with net outflows of over 10% for the investment fund segment as a whole in Germany, Austria and Switzerland in the same period. As the markets recovered, the assets under management of sustainable mutual funds rose to EUR 30 bn by the end of 2009. They currently account for about 2 to 3% of the total investment fund market in the German-speaking countries.

Product spectrum becomes broader

As demand has risen, the range of sustainable investment products offered has expanded. At the end of September 2009 there were 313 equity funds, fixed-income funds, mixed funds, funds of funds, microfinance funds and exchange traded funds (ETFs) conforming to RI criteria licensed for distribution just in the German-speaking countries. Five years previously, the investment universe had only numbered 112 sustainable mutual funds (chart 6).

For the investor, the spectrum of available RI investment instruments is likely to be a key criterion in deciding how strongly the RI component is weighted in asset allocation and portfolio planning in future. Today, responsible or sustainable investment strategies can already be pursued through diverse forms of investment (box: Spectrum of Responsible Investment Products, page 6). However, the RI market in the German-speaking countries is still characterised by the dominance of mutual funds and portfolio management mandates investing according to ESG criteria (chart 7).

Within the mutual funds segment, equity funds account for the largest share of the assets under management in sustainable mutual funds in the German-speaking countries, with a share of 71%, followed by fixed-income funds (15%) and mixed funds (10%), (chart 8 on page 5). In addition to actively managed portfolios, passive fund strategies are also becoming increasingly important in the RI sector. The volume of passively managed exchange traded funds has grown strongly in recent years – even though their relative weight is still comparatively small at less than 2% of the sustainable mutual funds segment. Microfinance investments are another alternative for sustainability conscious investors. However, they are primarily structured as closed-end microfinance investment vehicles (MIVs).[7] At the end of 2009 there were only two microfinance mutual funds licensed for distribution in the German-speaking countries with combined assets under management of EUR 425 million.

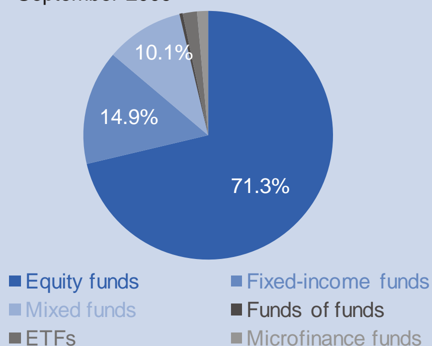
Institutional investors as the driving force

Institutional investors are the driving force in the market for responsible investments. According to data published by the European Sustainable Investment Forum, institutional investors account for over 90% of the investments in this market segment. Institutional investors' share of the RI market is therefore much higher than their share of the European asset management market as a whole, where 65% of the assets are still attributable to institutional investors (chart 9 on page 5).

[5] Sustainable Business Institute (2009).
[6] Finance & Ethics Research (2009).
[7] For an overview of the market for microfinance investments see Dieckmann (2007).

Spectrum of sustainable mutual fund products

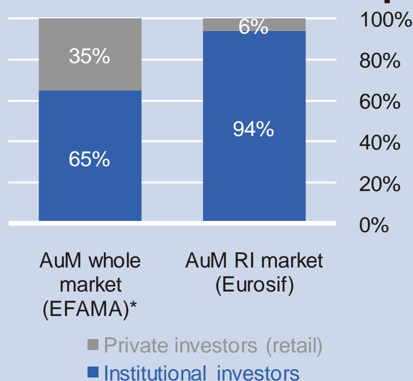
% of assets under management,* September 2009



*Funds licensed for distribution in the German-speaking countries.

Source: Sustainable Business Institute (2009) 8

Investor structure in Europe



* In investment funds and management mandates.

Sources: EFAMA (2009b); Eurosif (2008a) 9

Mandatory sustainability reporting in Germany

For state-supported personal pension plans and company pension schemes there is a mandatory reporting duty regulated by the German Act on the Certification of Retirement and Basic Pension Plans (AltZertG, last amended by Section 7 of the Act of July 5, 2004). Section 7 (4) stipulates: "(…) Within the framework of its annual reporting the provider of the pension plan shall also report in writing whether and how ethical, social and environmental issues are considered in the employment of the pension contributions paid."

In the case of direct insurance policies and pension funds in connection with company pension schemes Section 115 (4) of the Insurance Supervision Act (VAG) stipulates: "(…) The pension fund shall always inform the beneficiaries in writing when the policy or plan is closed and in writing annually whether and how ethical, social and environmental issues are considered in the employment of the pension contributions paid."

Spectrum of responsible investment products

Basically, responsible or sustainable investment strategies can take various forms. In the case of sustainable or socially responsible savings accounts, savings certificates and time deposits the money deposited is channelled for instance into environmentally or socially compatible projects or used for financing purposes based on sustainability criteria. In addition, besides investments in equities, investment fund units, certificates and fixed-income securities (bonds) that are selected on the basis of sustainability or social criteria, it is also possible to take out life insurance policies or personal pension plans that take account of ESG principles.

However, the greater part of the sustainable investments flows into investment funds which give stronger weightings to individual ESG aspects depending to the type of fund. The following broad classification can be made:

Sustainability funds usually refer to investment products that generally also consider social and environmental aspects as well as monetary criteria in their investment decisions.

Eco-friendly funds, also called environmental, ecology or eco-efficiency funds, invest in companies whose core competences lie in the field of environmental protection or which at least stand out for their environment-friendly activity or eco-efficiency.

Ethical funds place a special focus on selecting ethically and morally sound investment instruments. Environmental aspects, on the other hand, can be ignored.

Ethical-ecological funds pursue a combined investment strategy which, besides economic aspects, also considers social and ethical principles as well as environmental standards for companies.

Source: DB Research

The motives for responsible investing are wide-ranging. Churches, but also trusts and universities, might base their investment decisions on ethical, moral or social grounds or motivate them by their specific ideology. Insurance companies or pension funds often pursue a responsible investment strategy that matches their longer-term investment horizon. With regard to long-term investment goals, sustainable investment strategies promise less reputational, environmental and social risks.

Besides the intrinsic motives just mentioned, statutory requirements in particular also play an important role in the decision in favour of responsible investing. In some European countries – for instance in the UK, France, Sweden, Belgium, and Germany – rules have been implemented for sustainable investment policies in pension plans. The UK played a pioneering role in this respect. Legislation was already introduced in 2000 requiring pension funds to report on the application of sustainability criteria in their investments.[8] In Germany a similar reporting obligation was implemented in connection with the pension reform in 2001 (see box). It applies to state-supported personal pension plans as well as corporate pension schemes. Besides increased transparency on how the capital is invested, these requirements were also intended to further promote ESG-conform investing schemes. However, the legislation has not yet produced the hoped-for results. This would appear to be due primarily to the fact that no precise requirements with regard to the format and scope of the reporting are defined.

Aside from the regulatory environment, pioneer investors – often in the form of public pension funds – have an important influence on the market's development. Large sovereign investors often act as catalysts through their investment strategies and the development of corresponding investment criteria. The Dutch pension fund ABP, Sweden's Reserve Fund, or Norway's Government Pension Fund

[8] Eurosif/ Sustainable Investment Forum (2004).

for instance play a leading role in their home markets with regard to sustainable investment strategies. Owing to the strong presence of sovereign investors, responsible investing has a relatively high weight in these countries on European comparison (chart 5, page 4). Germany lacks such a pioneer investor to provide impulses for the RI market segment. That may be one of the factors explaining the comparatively small size of Germany's RI market, even though the importance of responsible investments in pension funding has increased in recent years.

Responsible or sustainable investment strategies will become even a stronger focus of institutional investors in future, as more and more inventors commit to adhering to sustainable investment principles. As of today, the number of institutions that have committed to the UN Principles for Responsible Investments (UN PRI) has reached more than 700 signatories worldwide, representing more than USD 20,000 bn in assets under management (chart 10).

Growing interest also among private investors

Private investors also show growing interest in Responsible Investments. Among the private investors, so-called high-net-worth individuals (HNWI) especially are investing increasingly in RI. According to estimates published by the European Sustainable Investment Forum (Eurosif), RI made up about 8% of the portfolios of HNWIs in Europe at the end of 2007, which amounts to an estimated EUR 540 bn. According to the World Wealth Report 2008, there is growing interest among HNWIs and ultra-HNWIs especially in "green investments". At the end of 2007, 12% of HNWIs' and 14% of ultra-HNWIs' assets were invested in green technologies and renewable energies (see chart 11 on page 7).[9]

Responsible Investments have yet to be established on the same scale in the retail markets. So far, extra-financial aspects are usually not part of the advisory of retail clients. Furthermore, generally accepted product standards to guide investors in their investment decisions are still unavailable. Interested investors wishing to inform themselves therefore have to rely mainly on their own initiative or on that of their competent advisers. Despite all obstacles, the positive development of the assets under management of sustainable mutual funds indicates that there is growing interest in sustainable investment products among private investors.

Traditional players discover the market for RI

Among the key factors for the development of the retail market will be the future availability of sustainable investments products. Here, the financial sector has been reconsidering its product line-up in recent years. A number of traditional banks and insurance companies have discovered the potential of the RI segment and accumulated expertise in this area, among them are for instance Allianz, Hypovereinsbank, and Deutsche Bank.

For many financial services providers, corporate social responsibility (CSR) has become an important part of their corporate strategy. Its core elements include accepting corporate responsibility for the environment and to society. The broadening of their product line-up to include sustainable investments fits directly into this policy. Competitive aspects are another driving force for traditional financial institutions to become increasingly involved in the RI segment.

United Nations Principles for Responsible Investments (UN PRI)

A group of 20 institutional investors from twelve countries agreed in 2005 on a framework consisting of six principles for responsible investment:

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

The signatories to the PRI include, among others, pension funds from Sweden, the Netherlands, Canada, and Switzerland. In addition, there are institutions from New Zealand, Australia, the European region, the US, Brazil, Thailand, and other countries.

Deutsche Asset Management (Deutsche Bank's asset management unit) also became a signatory to the UN PRI in February 2008.

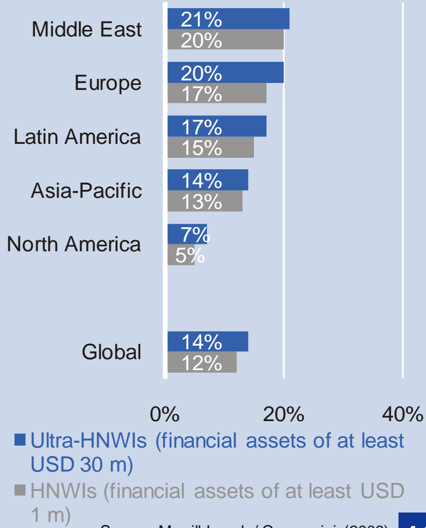
Sources: UNEP Finance Initiative (2007), Deutsche Bank

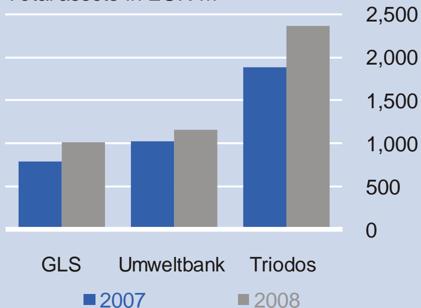
Signatories to the Principles for Responsible Investments

Number worldwide

Source: UNEP Finance Initiative (2008) 10

[9] Merryl Lynch / Capgemini (2008). HNWI are defined as private individuals with financial assets worth at least USD 1 million. Ultra-HNWIs have financial assets worth at least USD 30 million.





Universal banks especially are concerned to provide a broad range of financial services to their clients from one source. Responding to investor demand there will be no way round but to expand further into the RI market.

Although the market for sustainable investment products is no longer the exclusive domain of small specialised firms, the pioneer niche players in this segment such as GLS Bank, Umweltbank, Ethikbank and Triodos still play a pivotal role. Their business model is based exclusively on ethical, socially responsible or environmental principles. These banks have witnessed appreciable growth over the past years although their total assets are still comparatively small (chart 12). The relative success of these niche banks is a further indication that sustainable or socially responsible bank products are in increasing demand. Still, not every financial institution has the potential in terms of product portfolio or market access to serve as an alternative to the traditional universal banks. The majority of bank customers continue to rely on the services offered by traditional providers.

3. Responsible investment strategies

Sustainability objectives can be pursued through a number of different investment strategies. Classic decision tools in the area of responsible investing are negative and positive screenings, engagement in business policies or the best-in-class approach. Sustainable investment strategies can also be implemented by an integrated approach combing various basic strategies, while considering so-called ESG criteria within a portfolio context. This chapter gives an overview of the various investment strategies and their development.

Negative-screening – the origins of responsible investing

The roots of responsible investing go back to the Anglo-Saxon world in the 1920s. At that time, the Quakers refrained, mostly for ethical and social reasons, from investing in so-called “sin stocks”, e.g. in the arms, narcotics and gaming industries, and in pornography. In this respect, they were the forerunners of a now widespread investment strategy that excludes certain investments through negative screening.

In the 1960s civil rights, women’s rights, and consumer and environmental protection movements led to an increased awareness for social and ecological issues among broad sections of the population. Protests against the war in Vietnam rekindled the idea of responsible investing. Principle-based investment received further attention during the struggle against apartheid in South Africa. Several investors expressed their rejections of the apartheid system by withdrawing their capital from companies that had dealings with the South African regime then.[10] Today, negative screening is still an important basic strategy for building a sustainable investment portfolio.

[10] Social Investment Forum (2005).

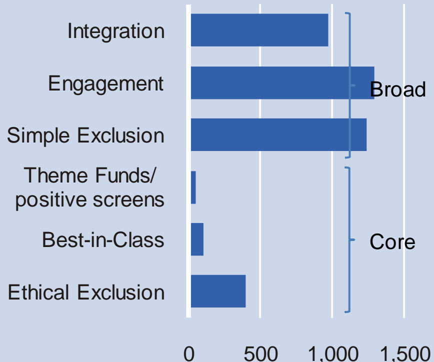
RI investment strategies

Strategy	Characteristic/ definition
Negative screening	Companies and sector conflicting with predefined ESG principles are excluded from the investment universe on the basis of *negative criteria.*
Positive screening	Companies, sectors and investment themes that stand out for responsible / sustainable business practices, products, or processes are identified on the basis of *positive criteria.*
Best-in-class	Those companies are selected that show the *best relative* environmental and social performance compared to their peers.
Engagement	Concept of *shareholder activism* realised for instance through the excercise shareholder rights or through an ongoing dialogue with the company's management.
Integration	*ESG criteria* are explicitly integrated in the investment analysis and decision-making process.

Source: DB Research 13

RI investment strategies in Europe

EUR bn, assets under management, end-2007



Source: Eurosif (2008a) 14

Positive-screening – selection on the basis of environmental and social criteria

Except for excluding certain investment options, also positive criteria can be applied when selecting assets into a portfolio. Positive screening refers to an investment strategy where companies and sectors qualify for the portfolio on the strength of their socially or environmentally oriented business interests. Such strategy integrates stocks of companies in the RI portfolio that, for instance, are engaged in the fields of environmental or climate protection or stand out for their strong stakeholder focus – not only share-holders/owners but also employees, suppliers and society at large.

Positive screening often aims at exerting influence on the nature and manner in which business activities are conducted. It can be traced back to the 1970s, at times when environmental disaster were growing and the Club of Rome discussed "The Limits to Growth", which could result from the growth of the world population, increasing industrialisation, and the depletion of natural resources.[11] To date positive screening continues to be a core strategy in responsible investing.

Engagement – exerting influence on corporate policy

A further strategy is the so-called engagement approach, also referred to as shareholder activism. With this strategy, investors seek to actively shape corporate policy through their rights as debt- or shareholders.

Shareholder activism originated at the time of the Vietnam War. By flooring critical motions at general meetings shareholders sought to voice their criticism of the war.[12] Engagement can be realised either through an ongoing dialogue between the investor and the company, e.g. in the form of (informal) requests to the management, or in the exercise of (formal) shareholder rights. Large institutional investors, such as the Californian pension fund CalPERS, were instrumental in shaping the corporate governance principles in the 1980s and 1990s. In their role as critical shareholders they perform an important function in ensuring good corporate governance.

Best-in-class – only the best get picked

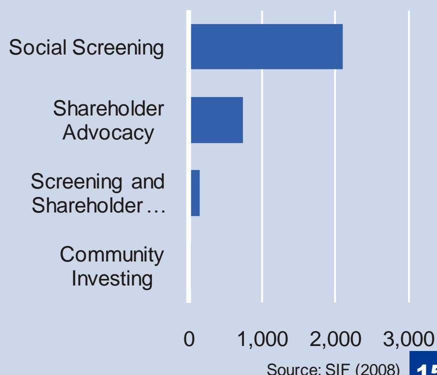
With the best-in-class approach, the focus is on a company's performance relative to its peers. Companies' environmental and social performance is measured against the industry standard and only the best in their respective class qualify for the portfolio.

Since best-in-class only requires that the best companies in a given sector are chosen for investment, it cannot be precluded that a given sector or company might still be questionable from a responsible investing viewpoint. In practice, additional positive and negative criteria are applied to exclude controversial sectors, such as genetic engineering or nuclear power, or to give a stronger weighting to others.

Best-in-class can be an effective strategy in promoting eco-efficiency, which gained importance especially after the Earth Summit in Rio de Janeiro (1992) and has gained additional momentum in the international climate dialogue. With the aim of producing no more environmental impact than is actually compatible with the eco system in future, the goal is to reduce input in both

[11] Klasen and Röder (2009).
[12] Klasen and Röder (2009).

RI investments strategies in the US
USD bn, assets under management, end-2007



Source: SIF (2008) **15**

Weighting of social and financial objectives

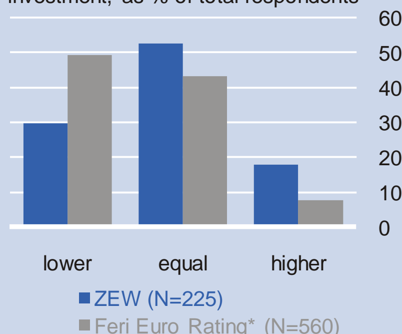
With the intention to invest responsibly, investors need to ask themselves how much weight should be given to social, and how much to financial aspects.

For **philanthropically motivated** investors the minimum financial return expected from a responsible investment can be very low or even be negative as an alternative to donations. In this case the concern is to achieve the greatest possible social benefit with the capital invested.

So-called **impact investing** is also oriented primarily to making a positive contribution towards achieving social or environmental objectives. The profits generated are reinvested in the "social business" in order to achieve the greatest possible impact.

Commercial investors, on the other hand, mostly pursue a balanced strategy (double bottom-line) where they do not have to accept much lower returns than on a conventional investment but also take social objectives into account. The impact potentially extends to broad sections of the economic system and supports efforts by corporates and sovereigns to integrate sustainability issues into their actions, strategies and policies.

Return expected from RI
Compared to conventional forms of investment, as % of total respondents



* Survey based on sustainable investment funds.

Sources: Feri Euro Rating (2009), ZEW (2007) **16**

economic and ecological aspects across the entire production chain. This puts the focus on the best performers in each industry.[13]

Integration – comprehensive consideration of ESG criteria

To meet the demands of modern portfolio management institutional investors usually try to integrate sustainability issues into their investment decision tools. To this end, corporates and sovereigns are screened on the basis of so-called ESG (environmental, social and governance) criteria. ESG information is then processed within the traditional portfolio management framework.

To be able to quantify the extra-financial performance of an investment target so-called key performance indicators (KPIs) are used, which capture a company's "degree of sustainability". The selection of the individual investments then mostly follows on a best-in-class basis, whereby certain sectors can be excluded or overweighted in the sense of a negative or positive screening.

4. Responsible investments in asset management

Responsible investments are characterised by their twofold objective: As with other investment strategies, the aim is to earn a (financial) return, while at the same time impulses are to be given for an ethically sound, environmentally compatible or socially responsible development.

Pursuing sustainable investing, investors have to weigh up social and commercial goals (see box). For instance, they can set a minimum return and then maximise social performance within those self-imposed limits. Often, they will set minimum requirements in social as well as financial respects but seek to maximise both objectives in a balanced fashion.

No evidence of a systematic disadvantage in terms of return

Responsible investments are generally perceived to yield inferior returns compared to conventional investments (chart 16). This is probably one of the reasons for the comparatively small market share of RI to date compared to conventional investments. Still, in most cases there is no empirical evidence to support this view.

There are a number of studies that investigate the correlation between consideration of non-financial criteria and financial performance.[14] While earlier studies are mainly concerned with sustainable equity investments, more recent studies also examine the bond markets. Some studies find a negative correlation between consideration of extra-financial criteria and financial performance, whereas others show a superior return. Differences in the methodologies used, the period observed, and the underlying sample are one reason for the contradictory results. However, in the overwhelming majority of the studies at least no systematic

[13] Ibid.

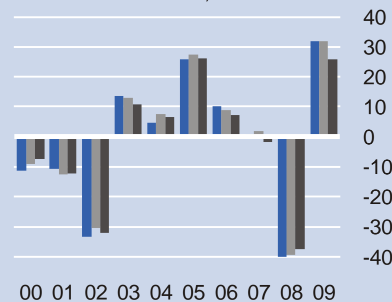
[14] A good overview of the literature on the effects of ESG factors on RI performance and the performance differentials between RI and conventional investments can be found for instance in:

— Renneboog, L; J. ter Horst and C. Zhang (2008). Socially responsible investments: Institutional aspects, performance, and investor behavior. In Journal of Banking and Finance 32, pp. 1723-1742.

— Mercer (2009). Shedding light on responsible investment: Approaches, returns and impacts. London. November 2009.

Globale stock indices: comparison of performance

Annual return in euro, in %



■ DJ Sustainability Index World
■ DJTSM GlblLrgT*
■ MSCI World

*Dow Jones Global Total Stock Market Large Cap Index

Source: SAM Group **17**

Sustainability stock indices

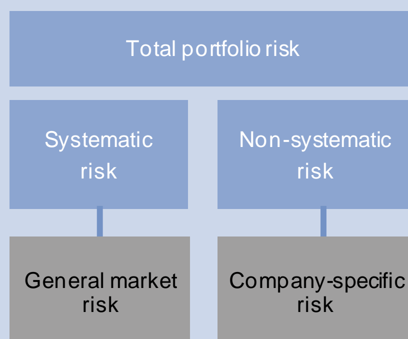
Sustainability stock indices usually represent a sub-segment of a broad market index, with sustainable companies being selected on a best-in-class or screening basis.

Sustainability indices are often used as a benchmark for measuring an investment's relative performance. They also serve as the basis for passive RI investment strategies. Well-known indices include:

- DJSI World
- DJSI STOXX
- Natur-Aktien-Index (NAI)
- DAXglobal Sarasin Sustainability
- UmweltBank-AktienIndex (UBAI)
- ÖkoDax
- FTSE4GOOD
- Emerging Market Umwelt Index
- ASPI
- DB NASDAQ OMX Clean Tech Index

Source: Sustainable Business Institute (2009)

Risk profile of an investment



Source: DB Research **18**

disadvantage in terms of return was established for sustainable investments.

It should be noted that the above findings relate to sustainable investments within the framework of conventional equity or fixed-income investments. Direct investments in social projects, especially in the context of development cooperation, or philanthropically motivated investments are not considered.

Diversification potential not necessarily restricted

According to portfolio theory, the overall portfolio risk can be reduced by spreading the capital invested over different assets. The overall risk of an investment consists of the systematic risk and the non-systematic risk of that investment, whereby only the latter can be diversified (see box).

As mentioned above, sustainable investments focus on specific sectors (positive screening) or exclude others from the investment universe (negative screening). Following portfolio theory, this can lead to inefficient asset allocations, if sensible diversification opportunities are excluded from the outset. Consequently, portfolios managed on the basis of sustainability criteria can harbour an elevated (non-systematic) risk compared to conventional investment styles.

However, this effect can be more or less pronounced depending on the investment strategy and asset class. It is usually more pronounced with positive or negative screening than if a best-in-class or integration approach is used. Also, selection can be easier without a significant loss of diversification within a generally large sector than would be the case in a narrow sector. On the one hand, an investor might conceivably concentrate on a specific sector, e.g. only invest in companies in the solar industry, and is therefore fully exposed to the market fluctuations in that sector. On the other hand, if a best-in-class approach is pursued – assuming that no or only a few sectors are excluded – there is sufficient scope for risk diversification.

Diversification issues are not unique to responsible investments. Conventionally managed funds may also focus on specific themes or sectors (e.g. German small and mid caps or emerging markets), with the result that potential diversification benefits are not realised. A restriction of the investment universe applies essentially to all theme-based investment strategies.

Arguments for RI outperformance

The pursuit of social and environmental objectives does not necessarily have to be at the expense of financial returns. In fact, there are a number of reasons why financial, environmental and social objectives can be consistent with each other and consider-ation for ESG criteria can increase shareholder value.

For instance, a credible corporate social responsibility (CSR) strategy can have a positive influence on employee loyalty or strengthen the company's positive reputation in the marketplace. Moreover, it is likely that the avoidance of environment-related and social risks can reduce the company's reputational risk and its exposure to claims for damages. If these benefits are not completely priced in, extra returns can be earned.

RI financial analysts and rating agencies

There are already a number of providers at the national and international level that analyse and rate corporates and sovereigns on ESG criteria. They make their research available to the financial sector as external information service providers for banks and institutional investors. They include among others:

— Sustainable Asset Management (SAM)
— Oekom research
— Sustainalytics
— Asset4
— RiskMetrics

Voluntary ESG reporting standards and initiatives

The disclosures on extra-financial parameters by companies should be harmonised so that they can be integrated into the investment analysis process and the information is made more readily comparable. Some organisations and institutions have already recognised this need and drafted guidelines for uniform and comparable reporting which can be applied on a voluntary basis. They include:

— The Global Reporting Initiative (GRI);
— The KPIs for ESG (see below);
— The Carbon Disclosure Project (CDP) for the reporting of company-specific data on climate-related issues.

Sources: Global Reporting Initiative, DVFA, Carbon Disclosure Project

Key Performance Indicators (KPIs)

The DVFA "Commission on ESG" is currently working hard to integrate ESG factors into conventional financial analysis by means of so-called key performance indicators (KPIs). For this purpose relevant ESG issues were identified and broken down into individual, quantifiable indicators. The aim is to establish extra-financial corporate performance indicators in order to achieve better comparability.

The KPI system has meanwhile been adopted at the European Federation level (EFFAS).

Sources: DVFA (2008), EFFAS (2009)

Measuring extra-financial performance is key

There are various approaches for integrating ESG criteria into the portfolio management process. One possibility is to use the services of external information providers. Specialised sustainability rating agencies and analysts have developed their own methodologies for analysing and valuing corporates and sovereigns on the basis of the ESG criteria. Such ratings can serve as a useful starting point for assessing the intensity with which sustainability efforts are pursued. They are above all a suitable instrument that makes it easier to compare companies or sovereigns.

Measuring the non-monetary benefits of an investment is still a major challenge, however. To process extra-financial information, such as ESG criteria, in a portfolio context, it needs to be quantifiable. An important source for ESG-relevant data is the companies themselves. Many companies already publish detailed sustainability reports on a voluntary basis. However, as yet there are no uniform standards with regard to the content and scope of such reporting. This limits the use of the data available and puts additional burdens on corporates, which have to respond to various individual requests (see box: Voluntary ESG reporting standards and initiatives).

A promising approach to overcoming information problems is the development of so-called key performance indicators of the kind put forward by the German financial analysts association (DVFA). They are derived from the ESG factors in order to make company performance quantifiable on a systematic and uniform basis (see box). KPIs can therefore help towards greater transparency and objectivity in the analysis process provided there is a sufficient critical mass of companies that make such information available.

5. Future growth drivers

The market for responsible investments has grown strongly in recent years. However, responsible investments still only represent a small fraction of total assets under management worldwide. In light of current developments, a number of growth drivers can be identified that will keep on fuelling this trend in the medium term.

Heightened awareness among private and institutional investors

A change of mindset is currently taking place in many aspects of life: the environmental and social impact that consumption and investment decisions have is now being reflected upon more strongly than in the past. In the medium term this development will also lead to growing demand for sustainable investment solutions.

Today, this is already manifested both in rising volumes in the market for RI and in rising numbers of institutional investors committed to sustainable investment criteria. The growth in the number of signatories to the UN Principles for Responsible Investment in recent years is evidence of the heightened importance attached to extra-financial aspects among institutional investors.' The broad support for the Carbon Disclosure Project in the corporate sector also signals a trend towards a systematic approach to dealing with the problem of climate change and developing alternative solutions (see box on page 12).

In some countries, the growing relevance of private pension plans, coupled with increasing consideration of extra-financial investment

Carbon Disclosure Project (CDP)

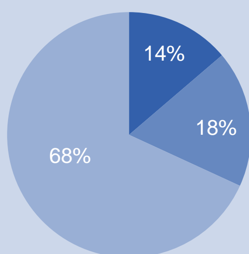
The CDP is an international initiative aimed at greater transparency in the disclosure of greenhouse gas emissions by companies. At the same time, the intention is that more transparent reporting will support companies in managing their own CO_2 emissions. Participation in this project is voluntary.

In 2009, CDP already represented over 475 institutional investors (2007: 300 signatories) with total assets under management of USD 55 trillion. Each year CDP gathers information on CO_2 emissions, climate strategies and the risks and opportunities of climate change from the perspective of the companies participating in the survey (over 1,800 in 2009) on behalf of the signatories.

Sources: Carbon Disclosure Project, Global 500 Report

Climate/environment technology & energy funds

as % of total assets under management of sustainable mutual funds*, June 2009



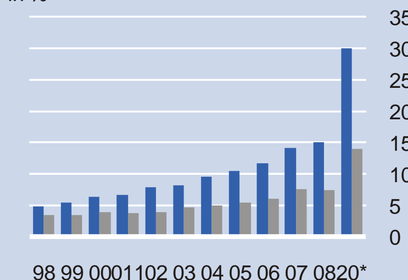
Climate/environmental technology funds
Energy funds
Other sustainable mutual funds

*Mutual funds licensed for distribution in the German-speaking countries claiming to be sustainability oriented.

Source: Sustainable Business Institute (2009) 19

Share of renewable energies in Germany

in %



* targeted

Share of renewables in power generation
Share of renewables in thermal energy supply

Source: Bundesministerium für Umwelt, Naturschutz und Reaktorsicherheit, 2007/ 2009 20

criteria among pension funds and insurers, is also driving demand for RI. Extensive coverage in the media helps draw public attention to environmental and social challenges, thus increasing the demand for responsible investments.

Additional funding requirements

Additional funding requirements will be created especially by the national and international efforts to increase energy efficiency and boost the share of renewable energies. Climate and environmental technology funds and energy-related funds make up almost one third of the assets under management of sustainable mutual funds in the German-speaking market (chart 19). At the end of June 2009 approximately EUR 8 bn was invested in this segment.[15]

At the international level, additional funding requirements will be created by climate policy and implementation of the Millennium Development Goals, which set social as well as environmental goals. In Germany, the measures of the Federal government's integrated energy and climate programme should also give a boost to the RI segment. A central part is the new Renewable Energies Act, under which the share of renewables in electricity production is to be increased to at least 30% by the year 2020, with further continuous increases in the years thereafter (chart 20). Under the Renewable Energies Heating Act the share of renewables in the production of thermal energy is to be raised to 14% by the year 2020. Another aspect is the promotion of combined heat and power generation with a view to improving energy efficiency through the simultaneous generation of electricity and heat.[16] The target is to increase the share of combined heat and power generating capacity to 25% of electricity production by the year 2020. The Energy Conservation Regulation (EnEV), too, will lead to additional investment in building facilities and associated funding requirements.[17]

In addition to the legislative measures cited, generally rising energy costs (chart 21 on page 13) are likely to be another factor driving the search for alternative energy sources and the efforts to make more efficient use of energy.

Ever broader range of sustainable investment solutions

The range of sustainable investments has been continuously broadened over the past years. Even in 2008, at the height of the financial market crisis, over ninety funds were launched or licensed for public distribution in the German-speaking countries. Almost forty more were added by the end of 2009. This trend will continue in future, albeit in slightly weaker form.

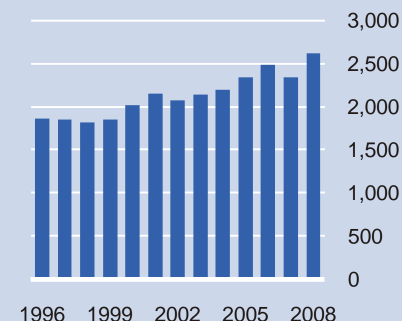
So far the focus of responsible investments has been mostly on equities. However, this could shift towards bonds and other fixed-income securities in future. Given the importance of bonds, especially for institutionally managed portfolios, an expansion of the spectrum of sustainable products in this market is likely.

The range of products available in the area of indirect real estate investment is likely to expand, too. The main driver here is the heightened energy efficiency demands of property owners and tenants.[18] The property sector, too, proceeds with respect to the

15 Sustainable Business Institute (2009).
16 See Auer (2008).
17 See Auer, Heymann and Just (2008).
18 See Nelson and Rakau (2010).

Household energy costs in Germany

EUR, annual spend per household*



*For space heating and hot water, process heat, lighting, fuels and other.

Soure: Bundesministerium für Wirtschaft und Technologie (2009) **21**

Eurosif transparency guidelines

European Sustainable Investment Forum (Eurosif) is a pan-European network focusing on socially responsible investment (SRI) issues. Its members include pension funds and financial services providers as well as research agencies and non-governmental organisations (NGOs).

The aim of the Transparency Guidelines is the disclosure of the sustainable investment principles and practices of the respective funds to third parties.

The voluntary commitment by the providers of sustainable funds to base their reporting on these principles breaks down into the following individual categories:

- Basic information, especially on the respective fund and the fund's management;
- The investment criteria applied by the fund for considering the sustainability component;
- Information on the research process, especially on he methodology, the timing and the publication of the research findings;
- Evaluation and implementation of the research results
- Details of the engagement approach if the fund uses this approach;
- Details of voting behaviour if the fund has policies on how voting rights are exercised;
- Reporting on the fund's activities over a given period of time.

Source: Eurosif (2004)

measurement, disclosure and certification of the energy efficiency and environmental friendliness of buildings.

The providers of exchange traded funds (ETFs) have also developed new product lines in response to a generally growing demand for passively managed investments. Here, the development of new products is made easier by the broadening market coverage of corporate ESG reporting and the increasing availability of sustain-ability indices.

Finally, more and more traditional financial institutions will enter the RI market segment and add sustainable investment solutions to their product portfolios. Sustainable investment alternatives are also being developed and offered increasingly for conventional bank products such as current accounts, savings plans, life insurance, and personal pension plans.

Uniform standards and definitions

One of the key challenges for the development of the market for responsible investments is the establishment of uniform standards and definitions assuring an adequate level of product transparency. So far the market is still very largely shaped by the various players' individual perceptions. Uniform criteria and standards are lacking. This shortcoming relates, on the one hand, to the reporting standards for companies, which, after all, are the basis for judging a sustainable investment, and, on the other, to the definition of investment principles justifying classification of a given investment product as RI at the provider level.

To achieve greater transparency in the sustainability rating of corporates and sovereigns uniform criteria need to be applied throughout the RI sector. A promising approach here is for instance the key performance indicators (KPIs) that were developed by the German financial analysts association (DVFA) and have meanwhile been adopted as standard at the European Federation level (EFFAS).

With the Eurosif Transparency Guidelines (see box) there is also a pan-European approach at the product level to improve the report-ing by sustainable mutual funds to their investors. To assure uniform and transparent reporting, and thus the comparability of different investment products, it would be conceivable, for instance, to develop a more far-reaching code – building on the Transparency Guidelines – and/or to flank this with a legally anchored quality seal. A statutory framework can be supportive in establishing uniform standards and definitions and provide incentives for the implement-ation of ESG-based investment approaches. However, also in the absence of legislative rules, large institutional (also sovereign) investors can forge standards by giving stronger consideration than before to environmental and social criteria in their investment decisions.

6. Conclusion

The market for responsible investments has developed dynamically over the past years. The financial crisis also left its mark on this segment but, as a whole, only led to a relatively small decline in assets under management.

A growing change in awareness among private and public investors will keep demand for sustainable investment products on the rise in

future. At the same time, there is growing pressure on corporates and sovereigns to integrate sustainability issues into their actions, strategies and policies. However, in light of past and expected developments, responsible investing appears to be a trend here to stay.

In the course of this process more and more conventional players are also discovering the market for responsible investments. With their additional offerings they are making sustainable financial products accessible to broader sections of the population. The spectrum of products is expanding and new distribution channels are being opened up. At the same time, RI is benefiting from new opportunities and options. Sustainability-oriented companies and projects face growing funding requirements. New investment opportunities are presented especially in the area of renewables and energy efficiency.

One of the biggest challenges for the development of the market for responsible investments is the establishment of uniform standards and definitions that assure an adequate level of product transparency and strengthen investors' readiness to invest in this segment. Here, there is a need both to standardise the reporting at the company level and to increase the transparency of the investment products.

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