



## Mainstream? The opportunity and obstacles for sustainable and responsible investment

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**More and more investment managers use environmental and other sustainability related variables in their investment process. While many like Al Gore think that «Integrating issues such as climate change into investment analysis is simply common sense», there remain skeptics. Yet, even the skeptics notice the impressive growth of United Nation's Principles of Responsible Investing (UN PRI), and of Sustainability and Responsible Investment (SRI) related**

**assets in Europe, US and Asia. Recent evidence also points to a continuation and even acceleration of this trend. Booz & Company, together with Robeco group, recently published a white paper based on more than 50 interviews with market participants. Seeking to project the state of the SRI industry, the report concludes that SRI is likely to represent in excess of USD 25 trillion by 2015 – an approximately five fold increase from 2007.**

Much of this growth is driven by the increasing interest from institutions that manage public money such as

sovereign wealth funds and public pension funds; and want to reflect public preferences. Additionally, many institutions such as private foundations now want all aspects of their business – including investing – to be in harmony with their mission. Similarly there is a growing category of individuals who feel strongly about several core values such as environmental friendliness and human rights and do not want their investments contradict their beliefs. Described in 2000 as «cultural creatives» by sociologist Paul H. Ray and psychologist Sherry R. Anderson, they number around 50 million in the US today; that is one in six people!

This closer alignment of preferences and investment allocations has given birth to several firms that specialize in responsible investing and its variants. The great majority of them are in the traditional asset management business. However, even in the scheme of the entire long-only business, most of these firms capture only a small part of the market share, and the sector remains fragmented.

In «Investing for Change» (Oxford University Press, 2009), we look at this trend from various viewpoints – psychological, social and financial. While a significant part of the growth to date might have been for non-financial reasons, I believe that for the trend to go from niche to mainstream, responsible investing must first make financial sense. And I also believe that it does – both in traditional asset management and in alternatives; both from a perspective of asset gathering and from a perspective of performance. However, the historic focus has been on the former.

For some funds, incorporating sustainability related variables is a way to attract more assets. In the traditional asset management industry, the return differences between funds are not as dramatic as in the alternatives. Additionally, performance-based fees are smaller. Together, this sheds light on why the traditional asset management business is moving aggressively into responsible investing even while they may be unsure about its impact on fund returns. These funds generate their revenue predominantly from fees on assets under management rather than on performance. Thus, the search to attract new clients and retain existing clients has moved on from just performance to all other aspects of the business such as investor preferences, transparency and other value added services. Of course, clients would probably leave if a fund performs poorly but nevertheless, responsible investors are a patient jury. The

relative ambivalence between return and preferences makes it easier for many traditional long-only funds to give these variables the benefit of doubt. Moreover, many of them use sustainability variables in a manner that is less focused on return maximization and more on reflecting client preferences – although sometimes they do coincide.

Little wonder that several leading firms are taking a closer look at responsible investing. BlackRock, for example, has set a target to increase its Responsible Investment holdings from 9 percent of its total AUM to 15 percent by 2010. Several other players, such as Deutsche Bank have launched new funds in the last few years based on sustainability related themes. New distribution channels, such as ETFs, have also allowed these asset management firms to cater to different clients. The popularity of responsible options in 401k plans is also growing. Surveys indicate that 2 in 5 plans will have a responsible investing option in 2 years. These developments all suggest that sustainability related marketing has room to grow.

The bar for responsible investments to infiltrate the domain of hedge funds and alternative investing is set higher. Here the onus is largely on performance – and the fees reflect that. This makes the fund managers more focused on if these variables improve returns. Several studies have looked at this question. Unfortunately, with the diversity of strategies in responsible investments, there have been no conclusive findings. This is not surprising because strategies that incorporate sustainability related variables to cater to preferences, and strategies that use these variables to boost returns, and combinations thereof, are all considered similar when we talk about SRI.

Extra-financial information related to sustainability and responsibility can only be an added plus. If viewed as an option rather than a constraint, integrating these into your decision making process is then indeed common sense. It is the process of integration that may be faulty not philosophy of integration itself. To the extent a firm's actions towards its employees, environment, customers and society affects its value; the idea of integration does indeed seem obvious. And that premise is difficult to argue against with increasing media and policy attention on these issues.

In addition, there are other less obvious but perhaps equally important reasons for a link between sustainability related variables and firm value. Investor loyalty is higher in firms that score higher in sustainability related

variables (many SRI investors are long term holders). This increased loyalty translates into lower stock price volatility, more stability and potentially higher valuations. Some view sustainability related variables as being a good indicator for other more difficult to measure management skills. Yet others think of firm actions towards sustainability as an indicator of readiness to any policy changes that are likely to happen as attention on these topics increases. What these different viewpoints highlight in common is that sustainability related information merits investigation and appropriate incorporation into investment management.

The introduction of sustainability in alternatives, while more challenging is also more rewarding. Unlike in traditional asset management, there are only a few hedge funds that take into account sustainable and responsible variables in a return-oriented manner. So the space is indeed 'blue-sky' open.

In our fund, we take into account sustainability and responsibility variables by combining what is historically been termed integration and best-in-class. Integration oriented strategies look at sustainable and responsible variables in addition to other financial, operational, strategic and macro variables, to make a bet on future returns. A firm is not selected simply because it is a good corporate citizen – it also need to meet certain criteria among other variables. To evaluate corporate citizenship, we focus on various categories such as environmental actions, employee treatment and customer friendliness. With regards to these three 'stakeholders' we focus on a firm's performance relative to its sector peers thus making it a best in class approach. Within each of these categories, there are good and bad firms – any concern at all makes a firm suspect, avoiding issues of ranking by adding apples and oranges. Not surprisingly, most firms that are good on one dimension are laggards in another. So, we create three sub-products relating to each dimension. Consider for instance, the environmental product. A firm that has a poor environmental record compared to its sector peers will never be selected. But a firm with a good record might also lose out if it does not meet other criteria that are unrelated to sustainable and responsible variables.

Our approach is consistent with the findings of the Booz and Company survey mentioned earlier. They predict a convergence among SRI implementation with standard screening methods losing ground in favor of engagement and integration.

Another approach that I believe is promising, but one that we do not follow, is that of thematic investing. For example, several sectors will benefit from the likely de-carbonization of our economy and will generate investment opportunities. As capital needs here go up, the return on capital will likely be higher. Funds such as Generation Investment Management are among funds that use integration and theme based investing.

Among the few hedge funds in this space, there are fewer still that can convincingly show the benefits of these extra environmental and sustainable variables. In our fund, we run a parallel tracking fund that uses exactly the same decision models as the responsible fund, but without the environmental and sustainable variables. This allows us to track the incremental importance of these variables with real money and real returns.

More innovation is bound to happen in product offerings and I expect several emerging private equity and hedge fund managers to take advantage of investor demand over the next years. Extra-Financial data is making rapid advances in quality and coverage with firms such as Innovest (now part of Risk-metrics), KLD, and Trucost leading the way. As interest in the space grows, better ways to use this information will automatically benefit both traditional and alternative asset management.

One reason for my optimism in the continued growth of SRI is my belief in self-reinforcing cycles. As more institutions adopt SRI, the returns of existing SRI portfolios (including the ones that might have been designed just to cater to investor preferences) will get a boost. This in turn will make even more investors interested in SRI. In parallel, more interest in SRI has already increased the demand for high quality responsibility ratings, which in turn helps making SRI more credible and more useful from a return perspective. The adoption of SRI is mutually reinforcing. This «snowballing» effect has begun and is unlikely to reverse.

Another reason for optimism is the lesson learnt from corporate governance related variables. It is now well documented that good governance firms outperformed poorly governed firms (see Gompers, Ishii and Metrick, Quarterly Journal of Economics, 2003 as well as Cremers and Nair, Journal of Finance, 2005) by an annualized return of over 9% through the 90s. Funds such as the Lens Fund, started by Robert Monks and Nell Minnow in 1991, benefited from this re-pricing trend. The slowly growing importance of governance

variables and the consequent impact on returns makes for an interesting precedent. We could see a similar trend related to sustainability and responsible variables – if implemented correctly!

While the rush into the sustainability area has been led by long-only asset management, and for reasons that might not completely coincide with returns, there still remains enormous scope for growth in both the traditional and the alternative space. Additionally, we will also see the implementation of sustainability related variables converge among the long only and the alternative space, as moving executives help cross-pollinate ideas and joint ventures are formed.

A discussion of any trend without a discussion of the current environment would be incomplete. How has the turbulent financial markets and the global recession affected my outlook? Interestingly, the reduction in

capital from the asset management industry has made asset managers more focused on investor preferences. This has been a good sign for responsible investments since this is yet another way to engender investor loyalty and provide a differentiated product. On the other hand, we expect investors – now poorer than they once were - to investigate any returns more closely before committing to any sustainable or responsible fund. Yet, I expect other factors to be more long lasting – continuing and growing support for these principles from governments and the broader media appears to be a more stable driver than current market conditions.

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