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Short communication

Indicators of responsible investing

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ABSTRACT

Responsible investment has witnessed significant changes in the past decade. It is estimated that about one fifth of assets under management in the US and about half of all assets under management in the EU are done on the basis of one of the seven responsible investment strategies. This paper discusses the prevailing responsible investment strategies and assesses the metrics used to account for responsible investment. It appears that the definition of responsible investing results in much degrees of freedom about reporting its size.

1. Introduction

Increasingly, firms pay attention to their social responsibility and financial institutions invest in a responsible manner. More and more firms are being rated not only on the basis of their credit status, but also on the basis of their social performance. They engage in social reporting and sign up to international codes of conduct like the UN's Global Compact or the Principles for Responsible Investment. Taking account of environmental, social, and governance factors increasingly is being regarded as business as usual.

Responsible investment, which is also called socially responsible investment or sustainable investment in the academic literature, is done via screening investments, engaging with companies, shareholder activism, community investing, and social venture capital funding. In this article, we use responsible investment when addressing the different names that describe investment that takes into account non-financial criteria. Most responsible investment is undertaken by large investors; retail investors make up only a small fraction of total responsible investment (Eurosif, 2012). In responsible investment, investors try to account for environmental, social, governance (ESG) and ethical issues in the investment process. It encompasses different stakeholder interests, ranging from economic (such as institutional investors, banks, venture capitalists), organizational (such as labor unions), and societal (such as international organizations, governments, non-governmental organizations, academics). The responsible investment market has become more diverse over time, and saw a change in the qualitative nature of these investments. The early responsible investment predominantly was based on negative screens, but current practices are much more based on pro-active positive screening and shareholder engagement. Initially, responsible investment mainly was undertaken by retail investors. Since the 1980s, however, the overwhelming majority of responsible investment is via institutional investors.

Boatright (1999) defines responsible investment as investing that takes account of 'people' and 'planet'. Responsible investment provides investors with a framework to include moral considerations. Responsible investment can relate to both investment and credit practices (Scholtens, 2006). Thus, it may relate to loans, bonds, stocks, commodities, and other financial instruments, including financial derivatives. Usually, it is done by negative screening (leaving out controversial firms and industries, like those involved with tobacco, weapons, gambling), positive screening (concentrating on particular favorable firms and industries), best-in-class (focusing on the top 30%/50% of firms with respect to particular social or environmental performance criteria), activism and engagement (discussing with firm boards and directors), and combinations (Cox and Schneider, 2010; Scholtens, 2006). In addition, integration, i.e. incorporating environmental, social and governance issues into the traditional financial analysis, has become a popular means of responsible investment. By engaging in responsible investment, investors account for environmental, social, governance and ethical issues in the investment process (Renneboog et al., 2008). As such, investors try to affect the social responsibility of firms and the sustainability of countries, while at the same time trying to optimize their financial risk-return tradeoff. A large number of studies have investigated several aspects of responsible investment (for an overview, see Capelle-Blancard and Monjon, 2012).

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The Social Investment Forum (2010) reports that in the US there is about $ 3.1 trillion of assets, or 12% of the universe of professionally managed assets from investors that can be qualified as responsible investments. Eurosif (2012) reports that in the EU this is € 5 trillion ($ 6.5 trillion) and it is growing fast. Several studies focus on the performance of responsible investments as such (Bauer et al., 2005; Galema et al., 2008; Renneboog et al., 2008; Hirschberger et al., 2012). The responsible investment literature generally observes that there do not appear to be statistically significant differences in the financial returns of investments that in some way account for environmental and social dimensions. One of the reasons for the unexpected insignificant impact of responsible investment on stock returns is that asset pricing models may be incomplete. For example, responsibility or sustainability may be an unknown variable that responds in a hitherto unknown way to the conventional risk factors from the arbitrage pricing theory (Cochrane, 2001). Another explanation would be that responsible investment is relatively new to the market and that the expectations of the market participants take time to adapt. Then, the financial market clearly is inefficient and specialists may earn arbitrage profits by exploiting these inefficiencies (Boutin-Dufresne and Savaria, 2004). A third explanation holds that the utility function of investors is much more complex than has traditionally been assumed. Especially various types of risk-aversion, in contrast to the conventional assumption of risk neutrality, might impact on how agents account for environmental and social issues (Sharfman and Fernando, 2008). Bénabou and Tirole (2010) show that non-financial attributes may constitute key elements of the utility function and are able to explain and motivate individual and corporate social responsibility.

At the institutional level, there are several interest-groups that advance and promote responsible investment. For example, in the US, this is the Social Investment Forum, whereas in Europe it is Eurosif. The latter is an association of several European investment forums and private industry. There are sustainable investment organizations in Australia, Asia and Canada as well. They strategically collaborate in the Global Sustainable Investment Alliance (GSIA). Of these lobby groups, especially Eurosif provides background and details about the development of the responsible investment industry. It asserts that the main drivers of the industry currently are the increased demand from institutional investors, legislation, international initiatives like the UN's Principles for Responsible Investment, external pressure from non-governmental organizations and media, and demand from retail investors (Eurosif, 2012).

As we are interested in the development of responsible investment, we want to find out if the way in which the industry reports is fairly accurate. Here, we intend to find out whether the investments reported as being responsible are so indeed and whether the indicators used can accurately reflect responsible investing. To this extent, we will discuss the main responsible investment strategies and rely on data that is provided by investment forums. Unfortunately, there is no methodology to assess responsible investing. We try to contribute to the literature by providing the first critical account of the data on responsible investing.

2. Responsible investment strategies

This section gives an overview of responsible investment strategies and discusses how they are being measured by the financial industry. Table 1 identifies seven responsible investment strategies (Eurosif, 2012). Sustainability themed investment is investment in assets that are linked to the development of sustainability. Thematic investment funds focus on specific or multiple responsibility issues. Examples are clean-tech funds, renewable energy funds, and healthy aging and lifestyle funds. An example of Best-in-class investment is an investment firm that manages an ESG fund and limits its investment universe to those firms that are among the top 30% within their industry if it comes to their responsibility rating. With norms-based screening, religious or moral standards guide the investment process. The exclusion of holdings from investment universe is related to the norms-based category of investing. Examples of exclusions are firms involved in weapons, pornography, and animal testing. Exclusion can also be based on international or domestic conflicts, like the Sudan war or that in Syria. The exclusion criteria are typically based on the choices made by asset managers or asset owners. With the integration of ESG factors in financial analysis, asset managers account for ESG risks and opportunities into traditional financial analysis and investment decisions. The engagement and voting approach relates engagement activities and active ownership of stock holders through voting of shares and engagement with companies on ESG matters. It particularly seeks to influence the behavior of firm management or to increase corporate disclosure. Impact investments can be made in emerging and developed markets, especially microfinance can be viewed as an example of impact investment.

Table 1
Responsible investment strategies (Eurosif, 2012).

Sustainability themed investment. This is investment in themes or assets that are linked to the development of sustainability.
Best-in-Class investment selection. This is an investment approach where leading or best-performing investments with a universe, category, industry, or class are selected or weighted based on ESG criteria.
Norms-based screening. This approach involves screening of investments according to their compliance with international standards and norms such as those developed by the OECD, UN, UN Agencies or industry initiatives and codes.
Exclusion of holdings from investment universe. This investment approach relates to excluding specific investments of classes of investment from the investment universe such as companies, sectors, or countries.
Integration of ESG factors in financial analysis. The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decision such as asset allocation and individual asset selection based on a systematic process and appropriate research sources.
Engagement and voting on sustainability matters. This investment approach relates engagement activities and active ownership of stock holders through voting of shares and engagement with companies on ESG matters.
Impact investment. These are investments made into companies, organizations and funds with the intention to generate social and environmental impact alongside a financial return.

Fig. 1 gives an impression of the size of the different responsible investment strategies in Europe (Eurosif, 2012). It clearly shows that exclusion is the strategy that is used most; in 2011 it related to assets under management of € 3829 billion. Integration comes second with € 3204 billion. Norms-based screening is used with € 2346 billion of investments, and engagement is reported to relate to the sum of € 1950 billion. The other three categories are much smaller. Best-in-class investments are reported to be € 243 billion in 2011, themed investments € 48 billion and impact investing is at € 9 billion.

The GSIA puts together information from the regional social investment forums. GSIA argues that Europe takes the lead in the world when it comes to responsible investments. Table 2 gives the distribution of the responsible investments originating from investors in the different regions (GSIA, 2013). Table 2 suggests that almost two thirds of the responsible investments are held by European investors. About one fourth is with US based investors, the remaining 10% is with investors elsewhere. Furthermore, GSIA (2013) estimates that in Europe almost half of all assets under managements are invested along a responsible investment