Sustainable Development Investing

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Socially responsible investing is evolving, as investor interest in environmental, social and governmental issues grows, to sustainable development investing. Sustainable development refers to companies that are committed to minimizing environmental disruption while contributing to the economic and social advancement of the communities in which they operate. As sustainable development moves further into mainstream investing and continues to be linked with value creation internationally, governments should draw a parallel between sustainable development and good governance.

Socially Responsible Investing

Applying nonfinancial selection criteria to investment decisions, where such criteria relate to social, political, environmental or ethical objectives, has existed for over 100 years. This style of investing has traditionally been labeled *socially responsible investing (SRI)* and includes the processes of screening portfolios, engaging management through shareholder advocacy programs, community investing and social venture capital.

Screened portfolios, the most common form of SRI, typically involve exclusion of certain industry sectors that are deemed by the investment manager to be "objectionable." For example, 83% of Canadian SRI funds exclude companies that produce tobacco products, and 63% exclude alcohol-related industries. Some funds also employ "screening-in" techniques, which seek to identify companies that employ positive environmental policies or human rights programs.

In Canada, the market for SRI is over $50 billion in institutional and mutual fund assets,[1] representing approximately 4% of total assets professionally managed and 50 funds. The SRI asset base is growing at 40% per year, compared to the non-SRI growth rate of less than 15% per year. Though growing rapidly, the Canadian SRI asset base is substantially below SRI activity in the United States, which represents over US$2.2 trillion in SRI assets (13% of total assets),[2] and the 300 funds in Europe utilizing SRI strategies.

Numerous studies and surveys have clearly shown that investor interest in environmental, social and governance issues has increased dramatically in the past five years. In addition, it has become clear that investor sophistication has evolved beyond the relatively simple process of excluding companies that are engaged in certain "nonethical" businesses. Furthermore, the investment performance of typical negative-screened SRI funds has been inconsistent over the past ten years, causing many investors to seek more rigorous and quantitative investment strategies, such as sustainable development investing, that provide both top performance and social responsibility.

Corporate Sustainable Development

The term *sustainable development* was originally proposed by the United Nations in the 1987 publication *Our Common Future.*[3] From a corporate perspective, sustainable development refers to companies that are committed to minimizing the environmental footprint of their operations, while simultaneously contributing to the economic and social advancement of communities in which they operate.

To act upon this commitment, companies engage hundreds of sustainable development initiatives. From an environmental perspective these may include energy conservation measures, waste reduction programs and pollution prevention initiatives. From a social perspective companies may schedule community outreach meetings, create the position of "ethics officer," reduce noise and odor pollution, and provide support for school lunch and recreation programs. Economic commitment often includes local procurement and hiring mandates, providing scholarships for higher education and transferable skills training, and community infrastructure improvement.

Worldwide, companies representing all industry sectors practice sustainable development. Examples of notable Canadian sustainable development companies include Abitibi-Consolidated Inc., Dofasco Inc., Falconbridge Ltd., Noranda Inc., Nortel Networks Corporation, Royal Bank of Canada, Suncor Energy Inc., Telus Corporation, TransAlta Corporation and Westcoast Energy Inc. These companies embrace sustainable development for essentially one reason—to have a positive impact on share price.

Good Business

But how specifically does sustainable development benefit a company? A summary of categories of key causal factors as to why sustainable development is "good business" follows.

Access to Markets/Ease of Operational Start-Ups: A company that carries brand as a sustainable development practitioner will generally be welcomed into communities in which it wishes to do business, and therefore it will realize the revenue and share price benefits associated with expanded business interest(s). Conversely, if a company is seen as an environmental, economic or social pariah, it will not be welcomed, and the associated share price impact resulting from such poor public relations, project cancellations or delays can be substantial. For example, if a mining company builds brand as a "good corporate citizen," it will generally receive accelerated licensing for new operations, whereas if the company is viewed as an environmental outcast its start-up will generally be opposed, which can be costly. In such cases not only would the company relinquish the $20-$40 million typical of a large mining operation's up-front feasibility and exploration costs, but the revenue the mine would have generated during its lifetime would also disappear.

Address Value Chain: Customers are increasingly concerned about the harm that corporate practices might cause from environmental, economic or social perspectives. To retain or gain the business of customers, which will ultimately affect share price, companies are increasingly adopting recognized business practices that demonstrate corporate citizenry. For example, the International Chamber of Commerce and the International Organization for Standardization have developed objective criteria to assess environmental product claims utilizing www.14000registry.com, which is an online market registry for companies to post their adoption of ISO 14001 and to provide a link to their Web site.

Address Media/Activist Pressures: Organizations such as Natural Step, Greenpeace, American Rivers, Sierra Club and Friends of the Earth can affect public perceptions of business, thus affecting customers' buying practices, product switching, operational start-ups and ultimately share price. To gain or retain the support of these organizations, and minimally to avoid their assaults, a company serves itself well to demonstrate its commitment to environmental, economic and social stewardship, and to engage in a dialogue with these organizations to proactively identify potential omissions in practices.

Lower Bank Loan Rates: Most major banks employ senior environmental managers to assess the cumulative environmental risk associated with lending capital for mortgage holdings, land acquisitions, etc. Interest rates are adjusted to reflect risk, and companies that are positioned as sustainable development practitioners are perceived as presenting less risk, and accordingly the cost of borrowed capital is reduced, thus retaining cash for the company that will generally have a positive impact on share price. Also, as banks are increasingly concerned with issues of lender liability, the success of a company to gain a loan, at any cost, is affected by the environmental, economic and social practices of the company.

Increase Ecoefficiency of Operations: Ecoefficiency is born of a contraction of *eco*logical and economic *efficiency,* and it advocates *doing more with less.* For example, an ecoefficient company will reduce energy input, material requirements and waste production per unit of productivity. In turn, the company will retain more cash for alternative applications that, if applied effectively, can have a positive impact on share price.

Employee Satisfaction/Retention: Companies that are practitioners of sustainable development report that most employees welcome challenges associated with environmental, economic and social stewardship. Accordingly, employee job satisfaction scores generally increase within one to three years following the initiation of sustainable development programs, employee productivity increases, and the service time of employees with a company increases (thus lowering start-up training costs). All of these factors generally have a positive impact on share price appreciation.

Facilitate Inclusion in Portfolios: A large and growing number of mutual and institutional funds apply sustainable development or social screens to portfolio construction. Corporate sustainable development programs can facilitate a company's inclusion in these portfolios, thus resulting in a positive impact on share price.

In addition to the direct drivers outlined above, sustainable development can function as a proxy for identifying companies with superior quality of management. By definition, sustainable development companies are interdisciplinary in their approach to business, which reflects a senior management team that thinks ahead of the curve. Accordingly, firms pursuing sustainable production strategies would probably make superior decisions in reference to many business issues and as such these companies present preferred investment options.[4]

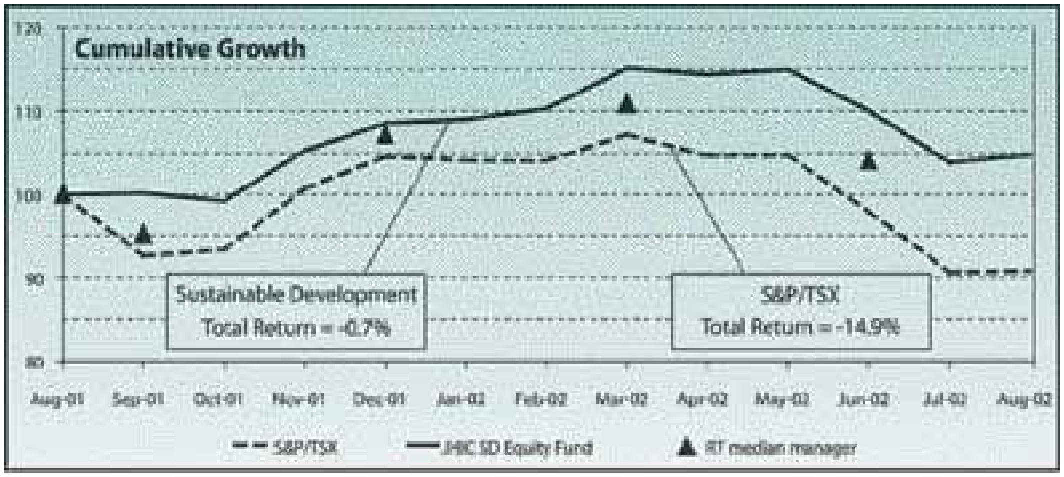
Investment Strategies

Sustainable development has been applied to institutional portfolio management in both Europe and North America. Although the growing body of examples utilizing this investment style are too numerous to mention here, two prominent cases merit review.

The Dow Jones Sustainability Group Index (DJSGI) was launched in 1993 and is jointly administered and managed by U.S.-based Dow Jones Indices and Swiss-based Sustainable Asset Management. As of 2002, the DJSGI consisted of slightly more than 300 "sustainable development" companies, selected from 2,000 stocks with the largest market capitalization in the Dow Jones Global Index (DJGI). The DJSGI represents approximately 33 countries and 64 industry sectors. The DJSGI seeks to invest in companies with the following qualities:

- *Sustainability policy and strategy:* excellence in internal responsibility assignments, policies, stakeholder relations, signed sustainability charters and corporate governance
- *Management of opportunities:* excellence in employee incentives, intellectual capital management, extent of information technology integration, use of strategic planning metrics, sustainability planning, environmental health and safety report-

Figure



Performance at September 30, 2002	1 month	3 months	6 months	1 Year
Sustainable Development Fund	**-5.2%**	**-9.7%**	**-13.7%**	**-0.7%**
S&P/TSX Index	-6.3%	-13.1%	-23.6%	-9.1%

Risk Data (annualized)	Volatility	Information Ratio
Sustainable Development Fund	**12.1%**	**169%**
S&P/TSX Index	16.4%	–

ing, and social responsibility reporting

- *Strategic sustainability risks:* excellence in corporate integrated risk management, environmental management systems, worldwide minimum environmental and social standards, and corporate codes of conduct
- *Risk management:* excellence in environmental health and safety audits, social audits, input/output analyses, environmental profit and cost accounting, contingency plans for environmental health and safety incidents, corporate health and wellness programs, and controversies related to the treatment of employees and environmental liabilities.

Based on nine years of total returns, the DJSGI outperformed the DJGI by approximately 44%. Various banks, primarily in Europe and Japan, are adopting the DJSGI for institutional fund management.

The Jones Heward Sustainable Development Equity Fund® was launched in Canada in September 2001 by Jones Heward Investment Counsel/Bank of Montreal. The fund consists of approximately 50 large capitalization equity securities that demonstrate a quantifiable commitment to sustainable development and that meet the firm's core financial analysis review process.

The fund identifies companies that meet its predefined sustainable development standard using its Sustainable Development Index (SDI®). The SDI focuses on 60 to 160 industry-specific environmental, economic and social measures to assess a company's performance. The number of measures in the analysis varies according to industry sector (e.g., chemical sector analysis focuses on 155 measures, whereas financial sector analysis focuses on 60). Companies that receive an SDI score greater than 70% are eligible for inclusion in the Sustainable Development Equity Fund®.

During the first year of performance (September 2001 to August 2002) the fund realized returns of 4.8%, compared with 29.1% for the benchmark S&P/TSX Index. Additionally, the fund's performance placed it in the top quartile of other large capitalization equity funds in Canada (see the figure).

Comparison to Ethical Investing

Although sustainable development and "ethical" investment styles have been

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placed under the common umbrella of SRI, there are notable differences.

Perhaps the key difference between the two investment styles is that sustainable development portfolio management focuses foremost on enhancing performance. The fact that sustainable development companies function as good corporate citizens is an ancillary, socially responsible investment bonus. Conversely, ethical investing focuses foremost on ensuring that the social values of investors are aligned with investment decisions, which may at times compromise returns.

Additional differences between these two aspects of socially responsible investing are evident in their screening processes. Negative screens are used extensively in ethical investing to identify companies not appropriate for inclusion in portfolios. Conversely, sustainable development investing utilizes "positive screening" to identify companies appropriate for inclusion in portfolios, based upon quantitative measures of environmental, economic and social performance. Accordingly, sustainable development investing tends to be highly objective and quantitative in nature, whereas ethical investing tends to be subjective (i.e., one person's ethics may not be another's) and qualitative.

A final point of distinction between the two investment styles is that a company may pass the negative screening process associated with ethical investing, yet still be operating poorly environmentally, economically and/or socially. For example, a technology, mining or hospitality company that would not trigger an ethical red flag might nonetheless be a major polluter or be affecting some form of social or economic disruption that a sustainable development assessment would most probably detect.

Regulatory and Legal Trends

Internationally, changes in institutional investment policy are positioning sustainable development further into mainstream investing.

United Kingdom

For example, in the United Kingdom it is the position of the government that financial institutions are, and should be, important instruments to facilitate the application of sustainable development within business.[5] Accordingly, through amendments to U.K. pension fund regulations that took place July 2000, all funds are now required to state whether they take account of the environmental, social and ethical impacts of their investments.[6] The amendments do not require any fund to change its policy, but "its clear purpose is to shine a fiery spotlight on their practices. Socially Responsible Investing fans believe that many funds will now look seriously at ethical investing for the first time, if only to avoid appearing callous."[7]

The ramifications of the amended U.K. pension fund requirements are substantial and potentially far-reaching. For example, a survey of the largest 25 pension funds in the United Kingdom by the research organization Environmental Resources Management,[8] revealed that 21 of these funds intend to implement socially responsible investing principles into their statement of investment policies and guidelines. These funds collectively invest £120-150 billion in U.K. equities, representing 7-10% of U.K. stocks.

The key message of this survey is that pension fund managers and financial analysts will increasingly look for companies whose shareholder value is enhanced, or at least protected, by prudent management of environmental and social risks. Pressure is now on companies to:

- Adopt best practice policies for managing environmental and social risks
- Demonstrate the business case for proactively managing environmental and social risks
- Adequately communicate this information to investors.

Perhaps most meaningful of the U.K. pension fund amendments is the fact that *sustainable development may now be factored into the investment decision-making process without the concern of violating fiduciary responsibility* (i.e., the legal requirement that a pension fund manager's primary mandate is to maximize returns and not engage any investment criteria that might otherwise compromise returns). In fact, recognizing the value creation and lower risk associated with sustainable development practices, it is now arguable that investment decisions made without assessing the environmental, economic and social practices of companies may stand in violation of fiduciary responsibility.

In addition to amendments to the U.K. pension fund requirements, two additional meaningful events have taken place in the U.K. capital markets. Notably, the Turnbull Report is "ringing alarm bells for companies listed on the London Stock Exchange."[9] Produced by the Internal Control Working Group with the support of the government and the Institute of Chartered Accountants, the report requires LSE-listed companies to itemize and account for all their "risks"—financial, environmental, social, ethical—and report on them at their year-end, starting December 2000.

Furthermore, the stock market index Financial Times Stock Exchange (FTSE) announced the launch of the FTSE4Good Index series, which will provide tradable benchmark indices for the rapidly growing area of SRI.[10] The index will take account of social, environmental and ethical issues pertaining to corporate best practices. FTSE CEO Mark Makepeace stated that his decision to launch the index series was in part influenced by his commitment to "encourage companies to adopt socially responsible principles."

Canada

In Canada there is no overriding legal precedence regarding sustainable development investing. However, at the provincial level there has been some guidance. For example, the Financial Services Commission of Ontario has indicated "ethical investing is permitted in pension plans, but the Statement of Investment Policies & Guidelines must state this position and set out the criteria for investments. The members of the plan should be notified of this position."[11] Similarly, the Manitoba Trustee Act (1999) allowed the use of nonfinancial criteria, including environmental and ethical evaluations of companies, to be used within pension fund investment decision making.

United States

In the United States, the Department of Labor's Office of Regulations and Interpretations issued a May 1998 letter that helped settle a lingering question about whether a socially responsible mutual fund could be included in retirement plans that qualify under Section 404(c) of the Employment Retirement Income Security Act (ERISA).[12] The letter clarified that investments such as socially screened mutual funds could be included in an ERISA-qualified retirement plan, as long as the fiduciary determines that the mutual fund is expected to provide an investment return similar to alternative investments having similar risk characteristics. This clarification is helping to spur the use of socially screened funds in retirement plans. It has also helped provide a greater level of comfort for trustees and fiduciaries to utilize sustainable development funds for other types of institutional investments.

Conclusion

As evidenced throughout this article, sustainable development is emerging as a "value driver" that relates positively to share price appreciation, and that has utility within investment decision making. Nonetheless, recognizing that corporate commitment to sustainable development is often viewed by both retail and institutional investors as the "cost of doing business," it is important that "value creators" (e.g., president, CFO, treasurer, CIO, VPs, senior managers, employees) within the financial community more aggressively communicate the value add of corporate stewardship to "value assessors" (e.g., research analysts, brokers, pension and mutual fund managers, institutional consultants).

In addition to the participation of the financial community, greater involvement by government, nongovernmental organizations (NGOs), unions, professional associations and special interest groups in promulgating the message that "sustainable development is a value driver" would further position sustainable development into mainstream business practices and investment decision making. As the evidence linking sustainable development to value creation continues to grow, governments should also be able to draw and position an analogous parallel between sustainable development and good governance.

In sum, good news born of sustainable development is beginning to be realized in the capital markets, both within Canada and internationally. Now the challenge is to effectively meld the interests of those of the sustainable development community and the capital markets into a mutually reinforcing framework of mainstream investing. ◆

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