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Investment & Actuarial Consulting,
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Investment Consulting

Responsible Investing – General Considerations and Implications for Fixed Income

EPFIF

Some of the graphs/pictures are not available online

PPCmetrics AG

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Bern, September 21, 2016

According to Cambridge Dictionary:

- **Sustainability**

1. **The ability to continue at a particular level for a period of time.**

2. **Environment, natural resources:**

The idea that goods and services should be produced in ways that do not use resources that cannot be replaced and that do not damage the environment.

- **Socially responsible investment**

1. **An investment in a company whose business is not harmful to society or the environment.**

Source: <http://dictionary.cambridge.org/dictionary/english/>

Brief History of Socially Responsible Investing

- At the end of the **17th century**, religious investors refused investing in **alcohol, gambling and tobacco companies**.
 - In 1928, a group of 24 funds (“pioneer group”) conducted a sin screening of the investments, which led to the exclusion of the above mentioned industries.
- In the 60s, **student protests** against the **war in Vietnam** led to a continued exclusion of the **arms industry** (e.g., at the Pax World Fund).
- In 1972, the Dreyfuss Corporation excluded companies that were doing business **in South Africa** due to the Apartheid.
- In the 80s, socially responsible investing became “mainstream” (e.g., Calvert established 9 funds).
- Around 1990, the first **sustainable index** was introduced (Domini 400 Social Index).

Source: Cory (2012)

Arguments for Socially Responsible Investments

- **Avoiding reputation risks** (also from employer's perspective)
- **Anticipating a possible regulation**
- **Act in the beneficiary's best interest**
- **Achieving an outperformance compared to the benchmark**
(Does it pay to be good? Or to be bad?)
- Combine business with pleasure: **earn money** and **make a difference**

Critical Evaluation of Arguments (1)

- **Avoiding reputation risks** (also from employer's side)
 - ✓ **Avoiding negative news paper articles**
 - ? However: in what way is reputation relevant for the achievement of the pension fund's main purpose, i.e., securing rents?
 - ? Possible goal: align the investment policy of the pension fund with the strategy of the company and the values of the employees.

Critical Evaluation of Arguments (2)

- **Anticipating a possible regulation**
 - ✗ **Weak argument** due to **transition periods**.
- **Act in the beneficiary's best interest**
 - ✗ According to open-ended surveys, **monetary and service-oriented aspects are important for employees**.
 - ✓ However, in closed-ended surveys, where **sustainability is explicitly** a possibility, the insured employees think it is **important**.

Critical Evaluation of Arguments (3)

- **Achieving an outperformance compared to the benchmark**
(Does it pay to be good? Or to be bad?)

? There are arguments and studies which argue for an out- or and underperformance ?!

Source: Dimson, Marsh and Staunton (2015)

Critical Evaluation of Arguments (4)

- Expecting an outperformance **compared to the benchmark**
 - ✓ Sustainability **reduces risks**, e.g., litigation or reputation risks.¹
 - ✓ Sustainable companies have a **better governance**.²
 - ✗ These **risks** could be **compensated** by the financial markets.
 - ✗ The price of a “sin” stock is lower and as a consequence, the **expected return increases**.
 - ⇒ **Investors require compensation** to hold such “noxious and nasty” stocks.
 - ✗ “Sin” companies have steady demand for their goods and services and high entry barriers. ⇒ **high-margins business**
 - ✗ **Academic and empirical studies** indicate a **lower return** for sustainable stocks.³

^{1,3} Nofsinger and Varma (2014)

² Renneboog, ter Horst and Zhang (2007)

³ e.g., Fabozzi, Ma, Oliphant (2008)

Critical Evaluation of Arguments (5)

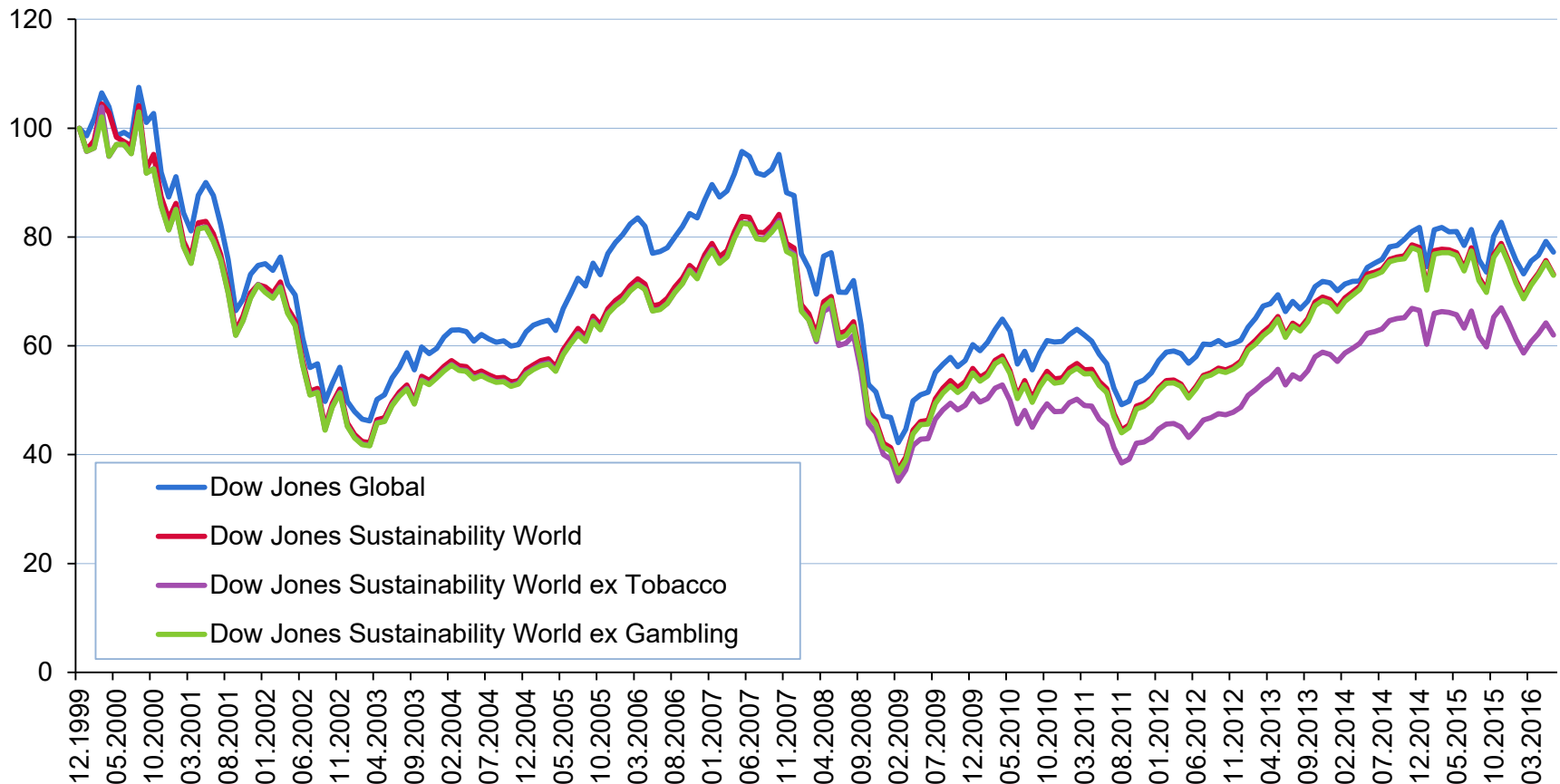
- Empirically, “**sin stocks**”, i.e., alcohol, tobacco, and gambling **outperform**.¹
 - The same with weaponry.
- Tobacco made a transition from neutral to sinful between 1947 - 1965. During that time, those stocks underperformed.
 - After 1965 it was known that smoking is harmful, they outperformed again.

¹ Hong and Kacperczyk (2009)

Investment Case

Critical Evaluation of Arguments (6)

Total Returns of Sustainable DJ Indices

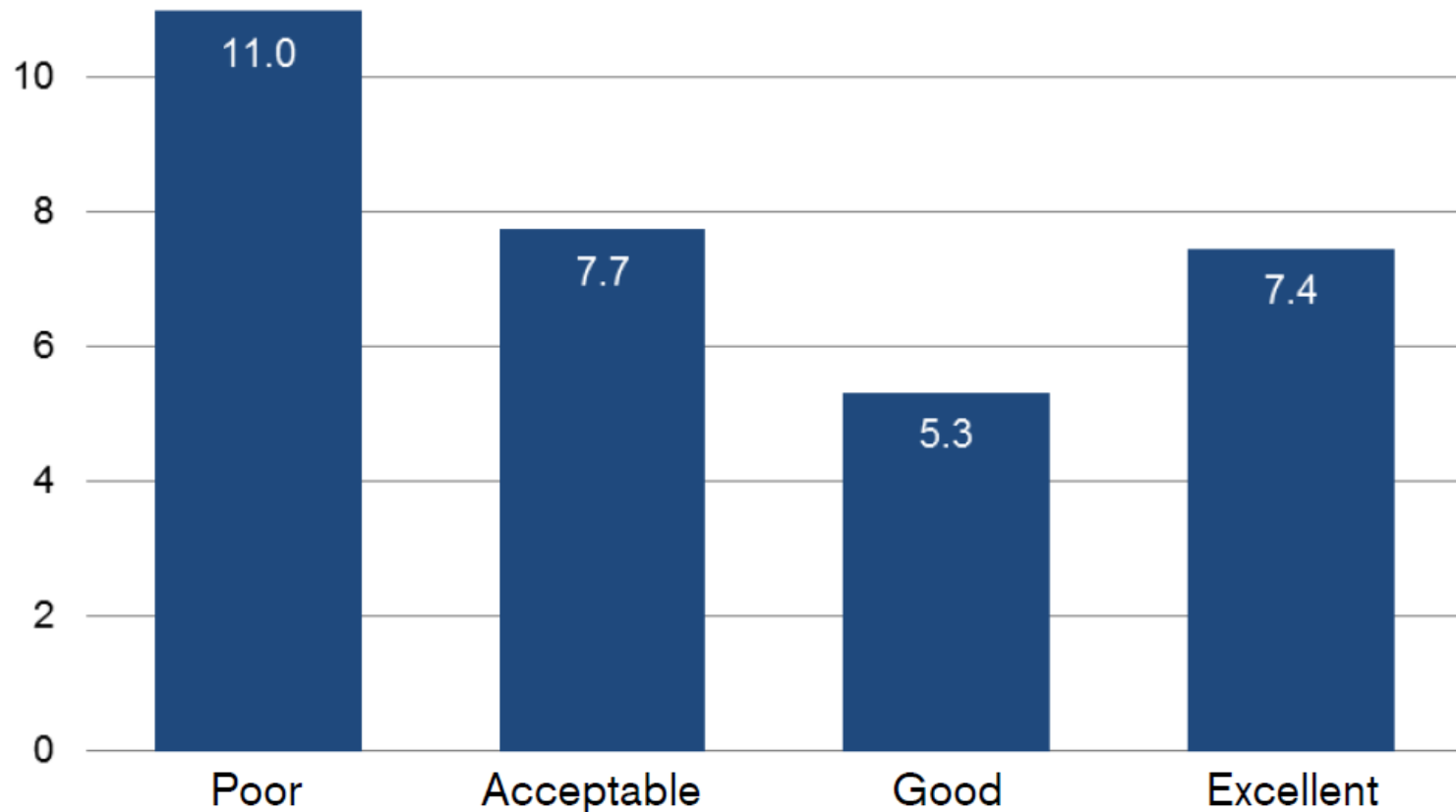


Source: Bloomberg, own calculations

Critical Evaluation of Arguments (7)

- Stock returns are the **highest** in the **most corrupt countries**.

Annualized USD return 2001–2014 (%)



Source: Dimson, Marsh and Staunton (2015)

Critical Evaluation of Arguments (8)

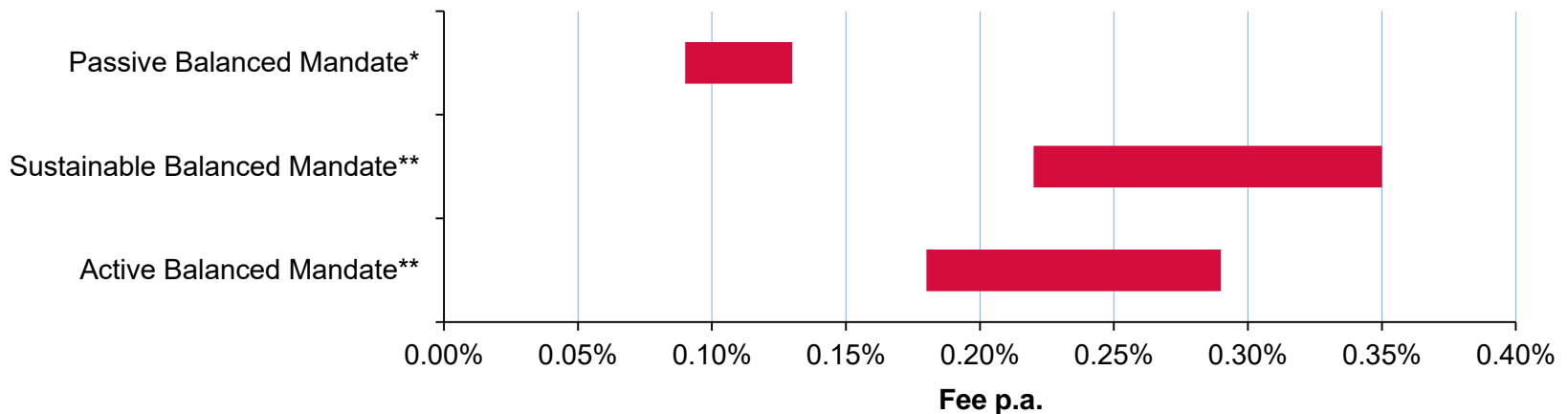
- Combine business with pleasure: **earn money** and **make a difference**.
 - ✓ **In theory**, the **financing costs** should increase. As a consequence, the company could change its policy to lower its financing costs.
 - ✗ There is **no academic evidence** that **avoiding such “sin” investments** has a **positive impact**.
 - ? Interestingly, evidence suggests that **investing in a “noxious and nasty” company** and changing its behaviour through shareholder activism leads to a **higher risk-adjusted return**.¹ However, **shareholder activism funds** are **expensive**.

¹ Dimson, Karakas, and Li (2015)

Further Aspects: Higher Costs

- Ceteris paribus, socially responsible investments come with **additional costs** (e.g., asset management fees, transaction costs, etc.).

Management Fees of Mandates with a Size of CHF 100 Million



*Source: PPCmetrics Peer Group ** Source: Tender documents of selection with a broad universe

- A sustainable strategy **excludes an indexed implementation** for smaller pension funds.¹

¹ There are usually no passive collective investment schemes. A segregated mandate would be between 0.04% and 0.10% more expensive than standard indexed mandates.

Further Aspects: Definition Problems

- **Disagreement on the definition**

- Should car manufacturers be excluded or included (carbon emissions vs. development of energy-efficient vehicles)?
- What about oil firms investing in “clean energy”?

- **Definition problems**

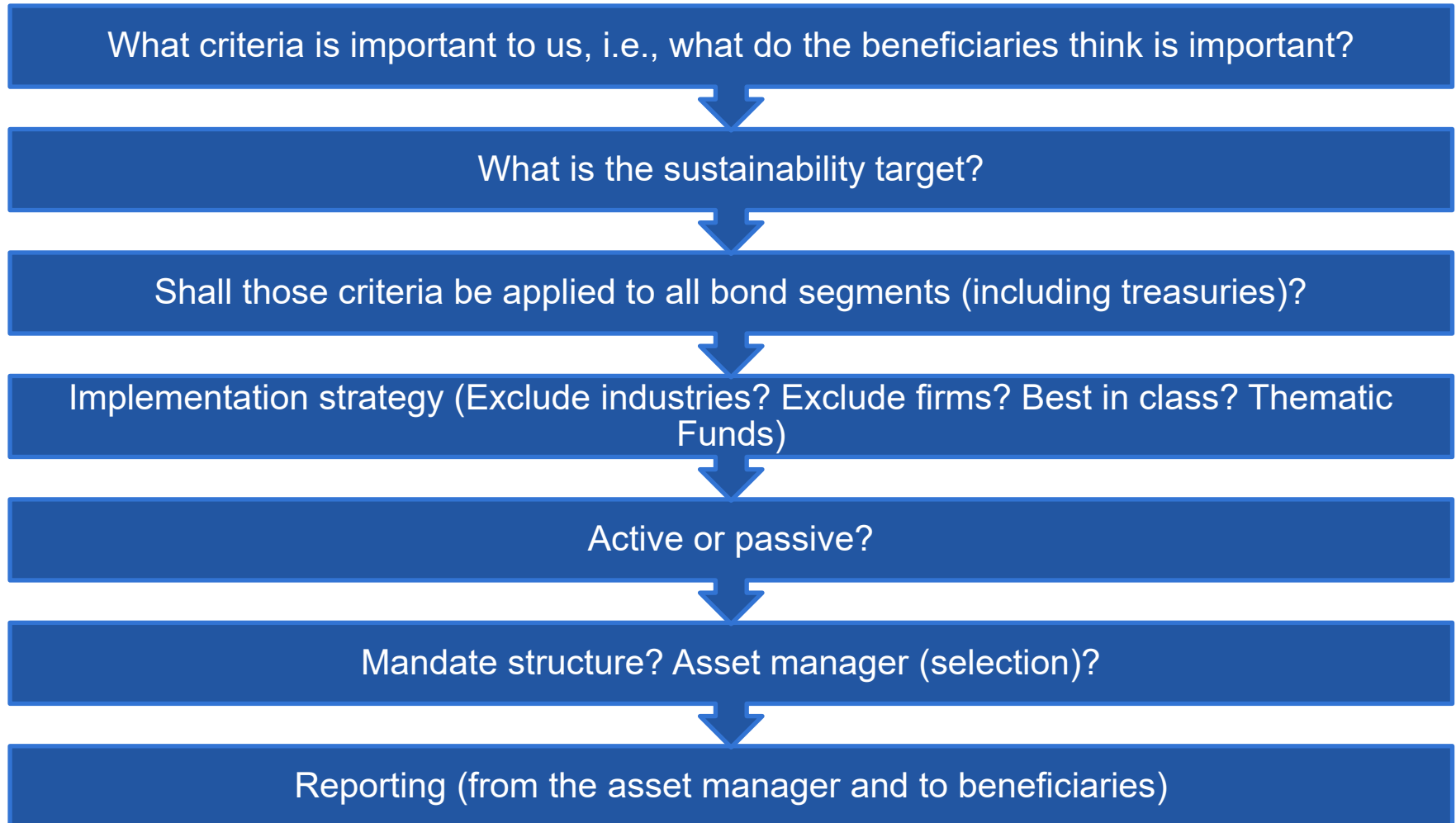
- What about **suppliers** or **firms that buy** products (or services) of “sin” companies?
- What about **banks** financing such companies?
- What about **countries using the death penalty**? What about countries financing nuclear plants?
- A lot of **products can be used for several purposes**: e.g., micro chips are used both for mobile phones and missiles.
 - Pilatus: Indian Air Force vs. Royal Flying Doctor Service of Australia

Further Aspects: Can such Cases be Anticipated?

- Take a look at **some cases**:
 - BP ⇒ Deepwater horizon
 - Union Carbide ⇒ Bhopal
 - Exxon ⇒ Exxon Valdez
 - Japan ⇒ Fukushima
 - Lockheed ⇒ bribery
 - Grünenthal ⇒ children with malformation of the limbs
 - Siemens ⇒ corruption
 - Enron ⇒ false accounting
 - Walmart ⇒ child labor
 - Mattel ⇒ lead paint

Implementation in Case of Bonds

Basic Questions



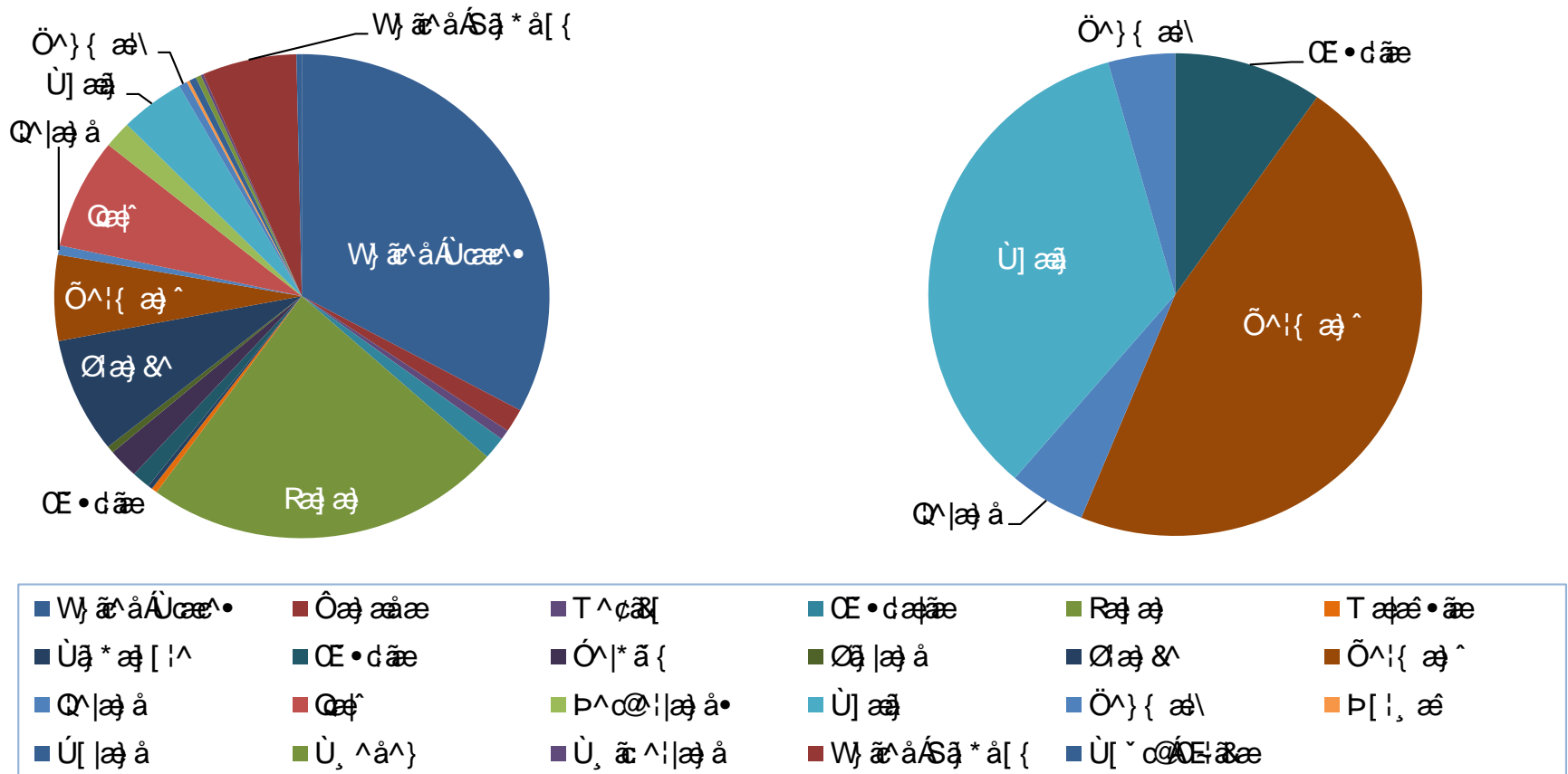
Sustainable Treasuries: Some Food for Thought (1)

- **Implementation with corporates is not a problem, but ... why are there (at least at the moment) no sustainable indices for treasuries?**
- Because you **might end up** with an **undiversified portfolio**.
Example Citigroup WGBI:
 - Exclude:
 - USA (e.g., climate protection, death penalty, nuclear weapons)
 - Japan (e.g., climate protection, death penalty, whaling)
 - France (nuclear power, nuclear weapons)
 - UK (nuclear weapons)
 -
 - Switzerland (euthanasia)
- **So how does the portfolio look like?**

Implementation in Case of Bonds

Sustainable Treasuries: Some Food for Thought (2)

Citigroup WGBI vs. Sustainable WGBI



Source: Citigroup Yieldbook, Indexdata per August 31, own calculations.

Summary

There are reasons to invest socially responsible.
However, you have to keep in mind the consequences.

And.... it is not always easy to distinguish good from bad ... there might be an ugly as well.

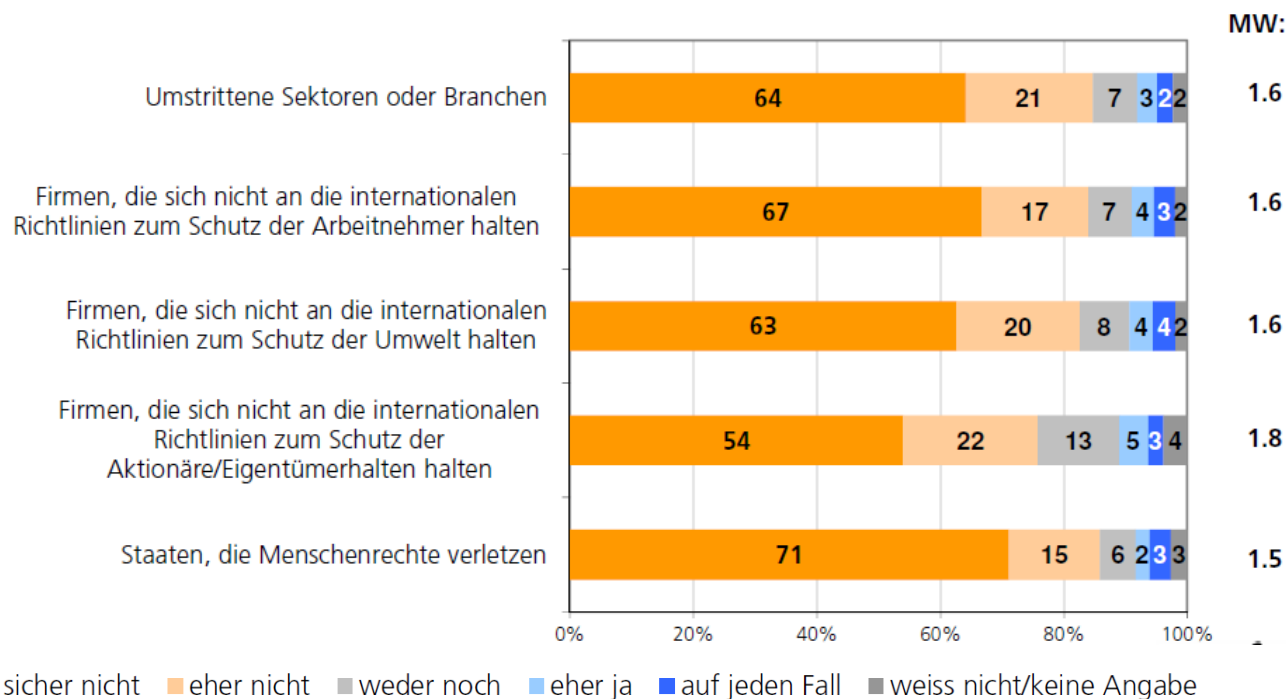
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Appendix

Survey Results (1)

Wie stark stimmen Sie der folgenden Aussage zu?
 Meine Pensionskasse darf, um die maximale Rendite zu erzielen, auch in folgende
 Bereiche investieren:

Skala von 1= sicher nicht bis 5=auf jeden Fall
 N=1'210, Angaben in Prozent



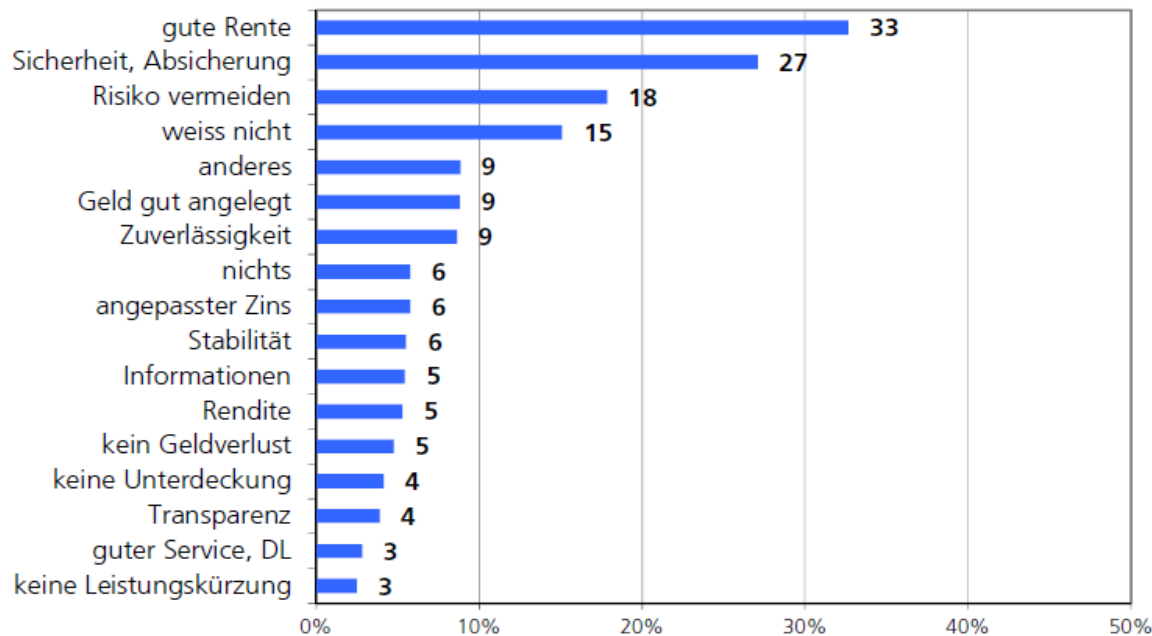
Source: gfs-zürich RobecoSAM «Pensionskasse & ESGIntegration» 2014

Appendix

Survey Results (2)

Abgesehen von der Sicherung Ihres Pensionskassenvermögens und der Sicherung der künftigen Rentenzahlungen, welche Erwartungen haben Sie an eine bzw. ihre Pensionskasse?

N=1'210, Angaben in Prozent

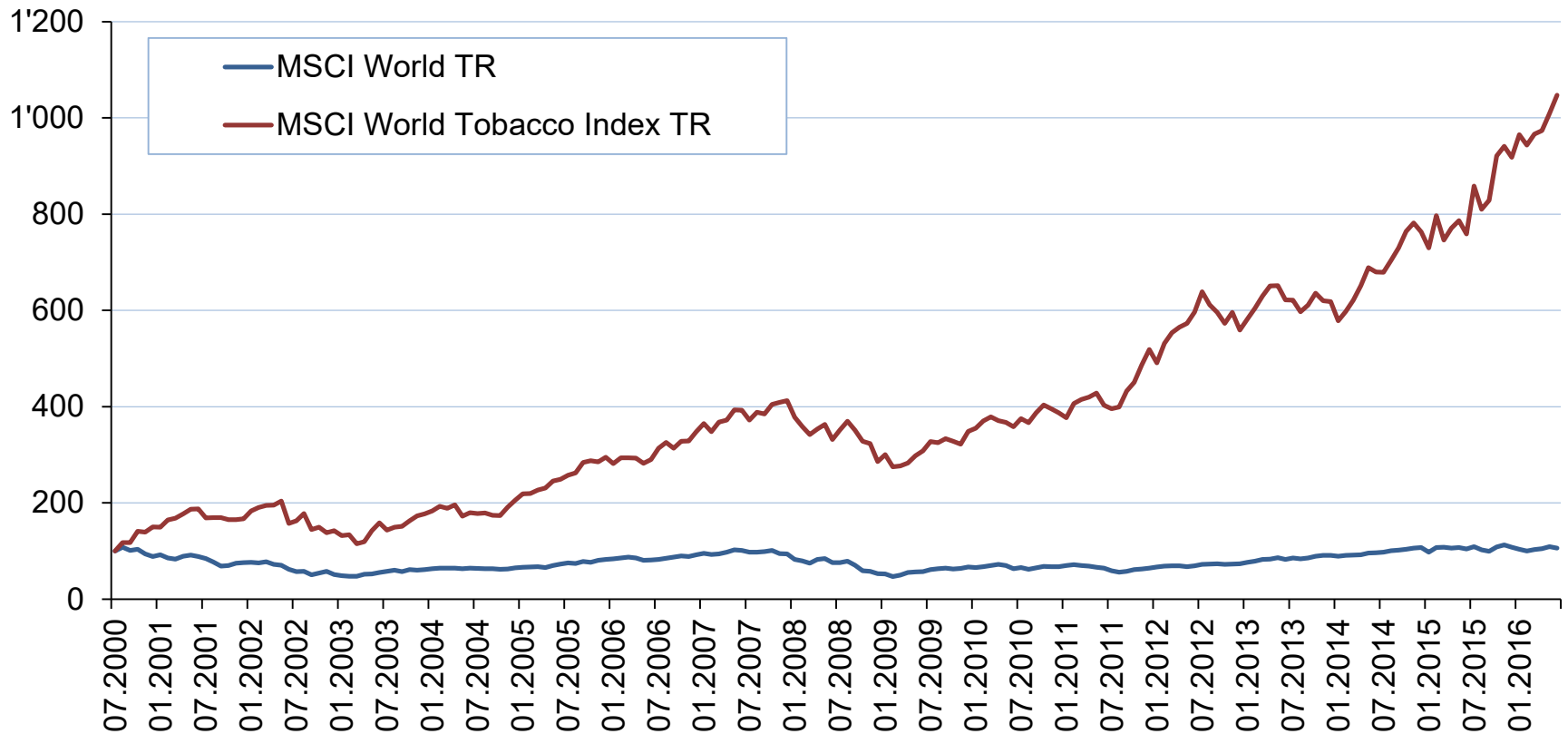


Source: gfs-zürich RobecoSAM «Pensionskasse & ESGIntegration» 2014

Appendix

MSCI World vs. MSCI Tobacco

Absolute Return in CHF

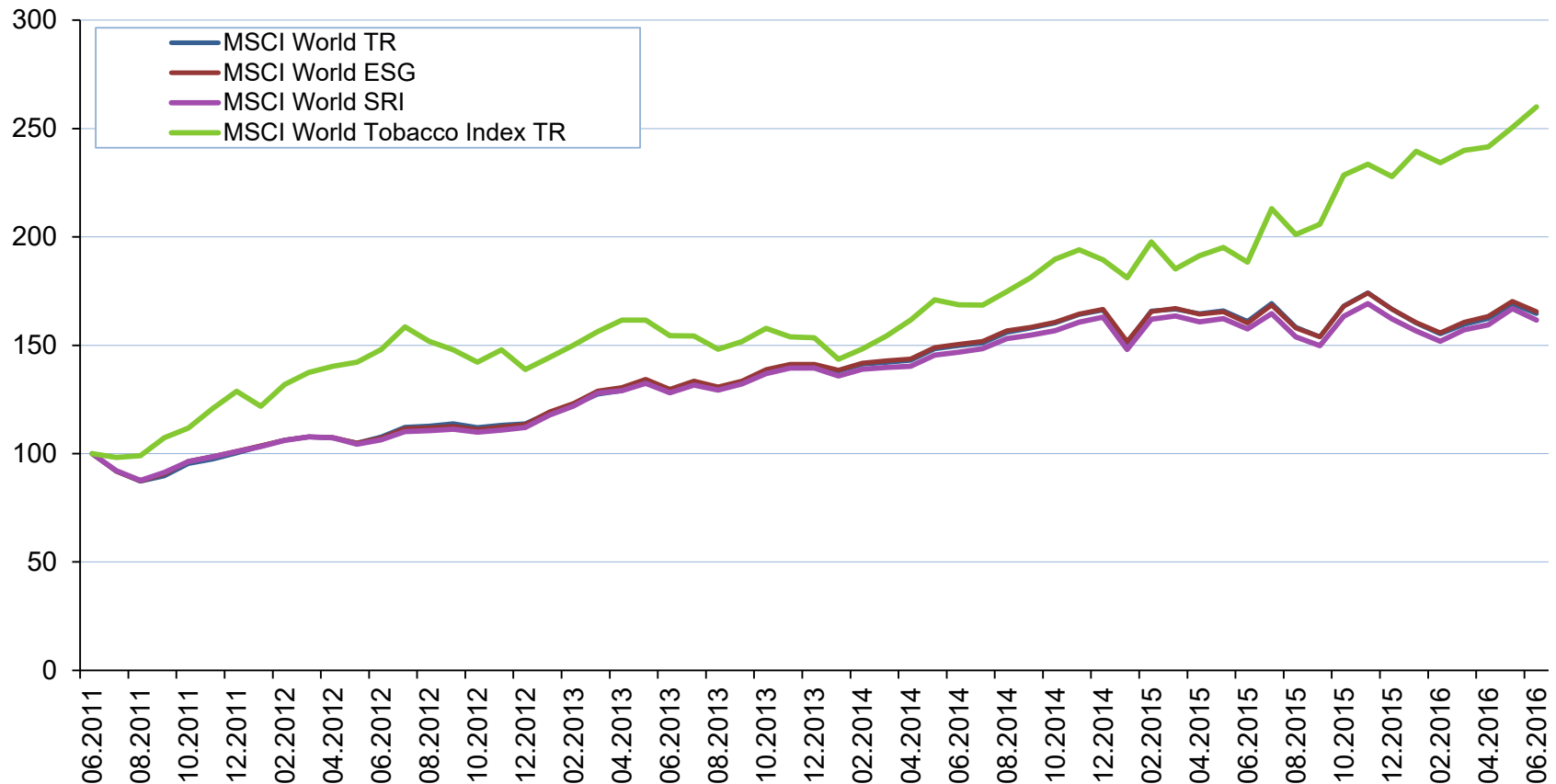


Source: Bloomberg, own calculations, since inception of MSCI industry indices

Appendix

MSCI World vs. MSCI ESG and SRI

Absolute return of sustainable MSCI Indices



Source: Bloomberg, own calculations, since inception MSCI World SRI Index



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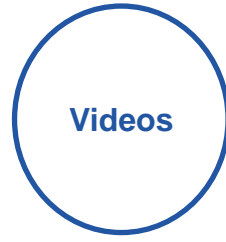
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