PPCmetrics AG
Investment & Actuarial Consulting, Controlling and Research. www.ppcmetrics.ch
Investment Consulting

Responsible Investing – General Considerations and Implications for Fixed Income

EPFIF

PPCmetrics AG
Dr. Diego Liechti, Senior Investment Consultant

Bern, September 21, 2016
Introduction

Definition

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/
Introduction

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)
Investment Case
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*
Investment Case
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.
• **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.
Investment Case
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)
• 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.\(^3\)

---

\(^1\) Nofsinger and Varma (2014)
\(^2\) Renneboog, ter Horst and Zhang (2007)
\(^3\) e.g., Fabozzi, Ma, Oliphant (2008)
• 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)
Total Returns of Sustainable DJ Indices

Source: Bloomberg, own calculations
Stock returns are the **highest** in the **most corrupt countries**.

Source: Dimson, Marsh and Staunton (2015)
**Investment Case**

**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.
  - **X** 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)
Investment Case

Further Aspects: Higher Costs

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

  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.

---

*Source: PPCmetrics Peer Group  ** Source: Tender documents of selection with a broad universe
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., microchips are used both for mobile phones and missiles.
    - Pilatus: Indian Air Force vs. Royal Flying Doctor Service of Australia
Investment Case
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

What criteria is important to us, i.e., what do the beneficiaries think is important?

What is the sustainability target?

Shall those criteria be applied to all bond segments (including treasuries)?

Implementation strategy (Exclude industries? Exclude firms? Best in class? Thematic Funds)

Active or passive?

Mandate structure? Asset manager (selection)?

Reporting (from the asset manager and to beneficiaries)
Implementation in Case of Bonds
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.
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.
Appendix

References


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

<table>
<thead>
<tr>
<th>Sektion</th>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
<th>MW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Umstrittene Sektoren oder Branchen</td>
<td>64</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.6</td>
</tr>
<tr>
<td>Firmen, die sich nicht an die internationalen Richtlinien halten</td>
<td>67</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.6</td>
</tr>
<tr>
<td>Firmen, die sich nicht an die internationalen Richtlinien halten</td>
<td>63</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.6</td>
</tr>
<tr>
<td>Firmen, die sich nicht an die internationalen Richtlinien halten</td>
<td>54</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.8</td>
</tr>
<tr>
<td>Staaten, die Menschenrechte verletzen</td>
<td>71</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: gfs-zürich RobecoSAM «Pensionskasse & ESGIntegration» 2014
Abgesehen von der Sicherung Ihres Pensionskassenvermögens und der Sicherung der künftigen Rentenzahlungen, welche Erwartungen haben Sie an eine bzw. ihre Pensionskasse?

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
We publish more than 40 articles on various topics per year.

Our experts share their knowledge and opinions with the public.

Experience our conferences, which we organize several times per year.

PPCmetrics AG
Investment & Actuarial Consulting, Controlling, and Research. Read more