Sustainable Investing for Institutional Investors

Risks, Regulations and Strategies

Mirjam Staub-Bisang

Sustainable Investing for Institutional Investors

Sustainable Investing for Institutional Investors

Risks, Regulations and Strategies

MIRJAM STAUB-BISANG

Contributing Authors

Sven Bienert • Peter Brabeck-Letmathe • Reinhold Glauner
Rolf D. Hässler • Ivo Knoepfel • Annette Krauss • Peter Meier
Erika Meins • Andrew Musters • Florian K. Probala • Tobias Reichmuth
Bernd Schanzenbächer • Ingeborg Schumacher-Hummel • Roman Staub
Otto von Troschke • Victor Weisberg

John Wiley & Sons Singapore Pte. Ltd.

Published in 2012 by John Wiley & Sons Singapore Pte. Ltd., 1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

Other Wiley Editorial Offices

John Wiley & Sons, 111 River Street, Hoboken, NJ 07030, USA
John Wiley & Sons, The Atrium, Southern Gate, Chichester, West Sussex, P019 8SQ, United Kingdom
John Wiley & Sons Canada Ltd., 5353 Dundas Street West, Suite 400, Toronto, Ontario, M9B 6HB, Canada
John Wiley & Sons Australia Ltd., 42 McDougall Street, Milton, Queensland 4064, Australia
Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

ISBN 978-1-118-20317-0 (cloth)
ISBN 978-1-118-20318-7 (ePDF)
ISBN 978-1-118-20320-0 (Mobi)
ISBN 978-1-118-20319-4 (ePub)

Typeset in 10/12pt, Garamond-Light by MPS Limited, Chennai, India
Printed in Singapore by Markono Print Media

10 9 8 7 6 5 4 3 2 1

To Philippa, Henry, and Georgina, and all
future generations that will benefit from thoughtful
investments by today's decision makers.

Contents

Foreword

Prof. Dr. Klaus Schwab

This book is necessary for our time. As an asset manager and advisor to institutional investors, Dr. Mirjam Staub-Bisang covers a topic that has just started to establish itself in the financial markets and with investors, although it long should have been an obvious component of investment and risk management: sustainability in asset management.

The task of investing pension fund assets, foundation capital, and family wealth to ensure long-term returns far into the future is cause in itself for sustainable investment. Asset management therefore implies sustainability. The long-term existence of every company, country, and organization is determined by the way it manages its resources, by the effectiveness of its organizational structures, and how it is embedded in society. At the World Economic Forum, for many years we have been engaging business, government, and other stakeholders in partnerships to encourage sustainable business practices and most recently launched a cross-industry initiative to accelerate the transition towards sustainable investing. As all of these institutions generate funds from the financial markets, directly or indirectly, the impetus for greater sustainability will be most effective if it is also stipulated by investors.

This is where Dr. Mirjam Staub-Bisang steps in. She draws upon her experience from day-to-day practice, and she has chosen contributing authors from her wide circle of colleagues. This collaboration has given rise to a work that addresses its potential readers—asset managers and investors—directly and shows them how they can fulfill their fiduciary duty of achieving long-term returns in a more sustainable manner.

It is the right book at the right time.

Prof. Dr. Klaus Schwab
Founder and Executive Chairman of the
World Economic Forum
June 2011

Foreword

Dr. Joseph Ackermann

Dr. Mirjam Staub-Bisang's book is an excellent practitioner's guide to sustainable investing. Sustainability is a fast-growing area, but it is not always well understood. The book's comprehensive survey of sustainable investment strategies across asset classes closes that knowledge gap. Insightful case studies steer the unfamiliar reader. At the same time, the book drives home the message for the investment professional that sustainable investments can offer superior returns.

As much as 10 percent of assets under management in Europe are already invested according to environmental, social, and governance criteria, the keystones of sustainability. Equally encouraging is the influence sustainability is beginning to exert on investment activities more generally. We recognize and support this trend in our own asset management business at Deutsche Bank.

Over the next 20 years, 3 billion new middle class consumers will emerge, adding to pressure on the environment, and energy, water, and food demands around the globe. Resource efficiency will become an ever more important indicator for success. Sustainable investment strategies will be one of the critical cornerstones for addressing these challenges.

Meanwhile, many companies are struggling to rebuild trust lost as a result of the financial crisis. Doubts about the compatibility of markets and ethics, if not addressed, can undermine the foundation on which open societies have been built. Corporations, including banks, need to respond with responsible and sustainable business strategies and greater focus on long-term value. But business can only succeed in these efforts if the investor community focuses on sustainability. Institutional investors, especially pension funds with trillions of dollars under management, could be at the vanguard.

This publication comes at the right moment because it addresses the pertinent challenge of our time: how to create value with values for a sustainable future.

Dr. Joseph Ackermann
Chairman of the Management Board
and the Group Executive Committee of
Deutsche Bank AG
December 2011

Preface

We don't inherit the Earth from our ancestors; we borrow it from our children.

—David Brower

The efficient use of natural resources, regard for human rights, good corporate governance: Thoughtful investors should take these aspects into account when making investment decisions, and not only for ethical reasons. Sustainable investing is the market-oriented answer to the pressing issues of our times: climate change, poverty, pollution, and water shortages, to name just a few. Not a form of intervention or regulation, it rather concerns long-term investors making intelligent decisions about protecting their assets and seizing opportunities. Sustainable investing is likely to become a megatrend in asset management.

The first part of this book offers an introduction to sustainable investments, including definitions and a historical perspective. This section also covers the advantages and disadvantages of different investment approaches, overviews the global and regional markets for sustainable investments, and presents academic and practical analyses of the risk and return of various strategies and products across asset classes.

Part II outlines the legal framework for sustainable investments with a specific focus on fiduciary duty and the legal provisions governing sustainable investments for pension funds in different legislations. The implementation of sustainable investment strategies within the institutional investment process is discussed extensively.

Part III contains in-depth contributions from academics and industry specialists across all asset classes: bonds, equities, real estate, private equity, real assets (including infrastructure, agricultural land, and timberland), commodities, and hedge funds.

The final part of the book is comprised of 24 case studies of institutional investment groups. Pension funds, insurance companies, charitable trusts, and family offices across the world have taken the time to introduce

us to their sustainable investment approaches and their experiences, motivations, and strategies going forward.

We designed this book for institutional investors in particular, and have addressed the specific issues related to investing third party assets. Nevertheless, the book should prove useful to all thoughtful and intelligent investors and financial professionals, whatever their areas of expertise.

Acknowledgments

Special thanks to the many people who made significant contributions to this book through their technical expertise, valuable contributions, and kind support:

Paul Achleitner, Philipp Aeby, Rodrigo Amandi, Chris Andersen, Lori Anderson, Annika Andersson, Albert Baehny, Julia Balandina-Jacquier, Jeanett Bergan, Martin Bisang, Otti Bisang, Iris Bohnet, Marianna Bom, Simonetta Bono, Caroline Botto, David Bresch, Annie Chen, Marcelo Cajias, Rafael S. R. Castro, Antonio Celeste, Davide Dal Maso, Ulrike Danielson, Sabine Döbeli, Marina Donati, Ossian Ekdahl, Ezio Fantuzzi, Stanley Fink, Yves Fischli, Christopher Flensborg, Guido Fürer, Klaus Gabriel, Michael Gray, Helen Hagberg, Jan Heil, Axel Hesse, Christina Hillesöy, Johannes Hoffmann, David Imbert, Marcel Jeucken, David Jones, Célia Juere, Thomas Kabisch, Walter Kielholz, Barbara Kux, Alexander Krater, Reinhard Lahusen, Bonny Landers, Manuel Lewin, Michael von Liechtenstein, Lars-Erik Liljelund, Magdalena Lönnroth, Peter Lunt, Jürgen Maier, Ines Markmiller, Vinzenz Mathys, Amanda McCluskey, Reto Michel, Sabine Miltner, Wilhelm Mohn, Raphael Moses, Carolina Müller-Möhl, René Nicolodi, Dirk von Padberg, Falko Paetzold, Iivo Paukkeri, Herwig Peeters, Hamilton von Portatius, Gilbert Probst, Christian Ragnartz, Sophie Rahm, Cecilia Reyes, Ricardo Rodriguez, Urs Rohner, Lucia Rückner, Martin Salm, Rene Sanda, Cornelia Sander, Günther Schiendl, Melanie Schmude, Norbert Schnorbach, Markus Schwingruber, Martin Senn, Philippe Setbon, Peter Signer, Paul Simon, Hans-Peter Thür, Claudia Tober, François Vetri, Fritz Vischer, Joseph Wild, Katy Yung.

I would also like to thank Nick Wallwork, Jules Yap, Judy Howarth, and Stefan Skeen at John Wiley & Sons for their interest, support, and flexibility.

PART I

Fundamentals

CHAPTER 1

An Introduction to Sustainable Investments

1.1 Environmental and Social Challenges

As economic markets have become increasingly interconnected, the effects of globalization on investors are unavoidable. Moreover, the immense social and environmental challenges of the twenty-first century will have a long-term impact on investors' success. We next describe some of the most significant challenges we must meet to ensure sustainable development of life on planet Earth.

Climate Change

Depending on the level of greenhouse gas emissions, it is highly likely that the temperature of the Earth's atmosphere will rise by between 1.1 and 6.4 degrees Celsius during the course of this century, having already risen twice as much in the past 50 years as compared to the previous 100 years. Greenhouse gas emissions would have to fall by 50 percent by the year 2050 to limit global warming to two degrees Celsius (Intergovernmental Panel on Climate Change, 2007).

The number of meteorological and hydrological catastrophes has tripled in the past 30 years, and geophysical events such as earthquakes, volcanic eruptions, and tsunamis—which pose an immediate mortal danger as well as an environmental threat—have nearly doubled, as shown in Figure 1.1. We can expect such dramatic climate phenomena to increase.

Since 1993, as a result of global warming, sea levels have risen by an average of around three millimeters annually, as compared to 1.7 millimeters annually during the course of the entire twentieth century. Slightly more than half of this rise is due to thermal expansion of warming oceans; around

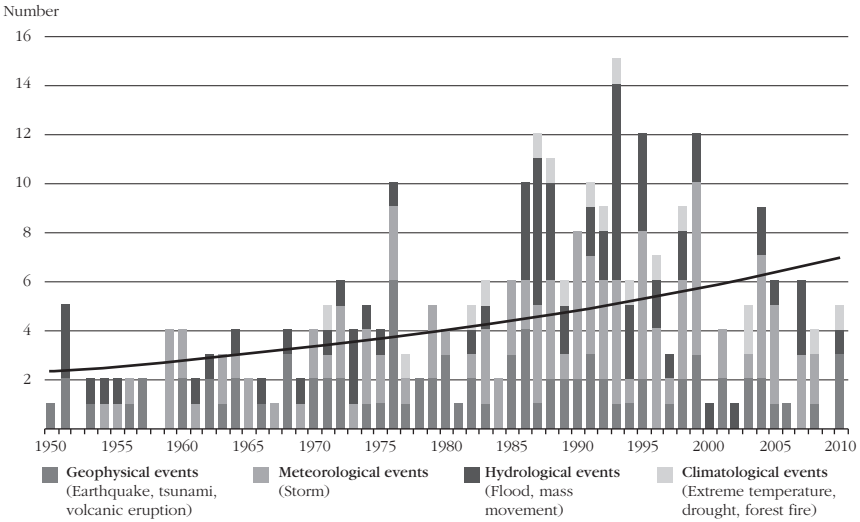

FIGURE 1.1 Natural catastrophes in the past 30 years.
Source: Munich Re (2011)

25 percent is due to the melting of Alpine glaciers; and about 15 percent to the melting of ice sheets. From the start of industrialization to 2005, the carbon dioxide (CO_2) content of the earth's atmosphere rose by 35 percent, of which 78 percent is attributable to the use of fossil fuels (IPCC, 2007).

The International Energy Agency (IEA) predicts that the world primary demand for energy increases from approximately 12,300 in 2008 by one-third, in 2035 and energy-related CO_2 emissions increase by 20 percent (see Figure 1.2). The dynamics of energy markets are determined more and more by the emerging economies. Over the next 25 years, 90 percent of the projected growth in global energy demand comes from non-OECD economies; China alone accounts for more than 30 percent.

Scarcity and Pollution of Freshwater Reserves

Both the global extraction of water and water consumption rose sixfold in the twentieth century, relative to a threefold increase in the global population. According to current estimates, by 2025, 1.8 billion people will be living in countries or regions with absolute water scarcity and two-thirds of the world population could be subject to water stress (UNEP, 2007).

Deforestation and Desertification

Twenty percent of all greenhouse gas emissions are caused by the clearance of tropical forests that sequester CO_2 emissions. The Amazon rainforest

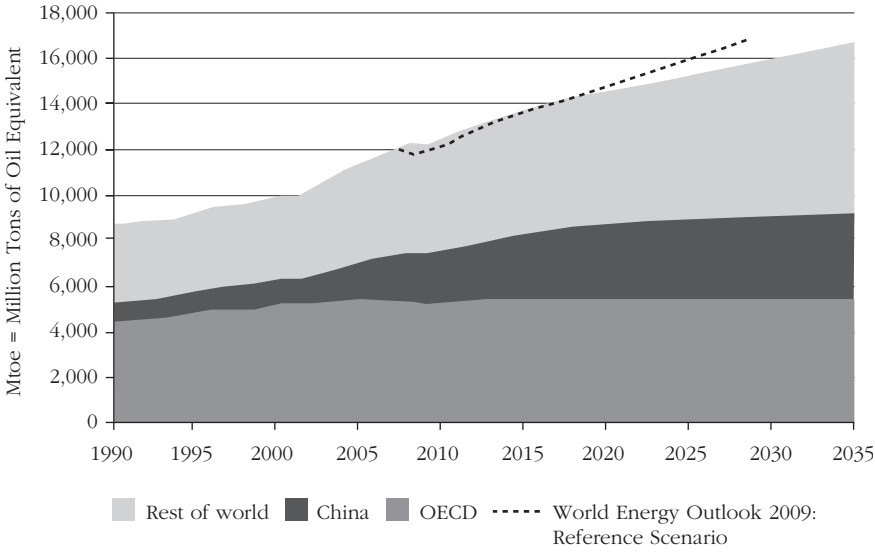

FIGURE 1.2 Growth in primary global energy demand.
Source: IEA (2011)

alone stores 4.6 billion tons of carbon dioxide over four million square kilometers; every year, an area half the size of Germany is lost to deforestation (IPCC, 2007).

Decreasing Biodiversity

Climate change is presumed to accelerate the loss of biodiversity: A 2 to 3 percent increase in global temperature threatens the extinction of 30 percent of the planet's flora and fauna (Sustainable Development Management, 2006).

Poverty

According to the World Bank, around 1.4 billion people currently live on less than $1.25 a day, and the disparity between the rich and poor in the globalized world is steadily increasing. According to the Food and Agriculture Organization (FAO), in 2010 over 900 million people worldwide suffer from hunger. And 10 million children aged five and under die annually, of whom an estimated 5.6 million suffered the effects of malnutrition, UNICEF states.

Population Growth

As of 2011, global population stood at about 7 billion people, a figure that increases by three people every second. According to the United Nations

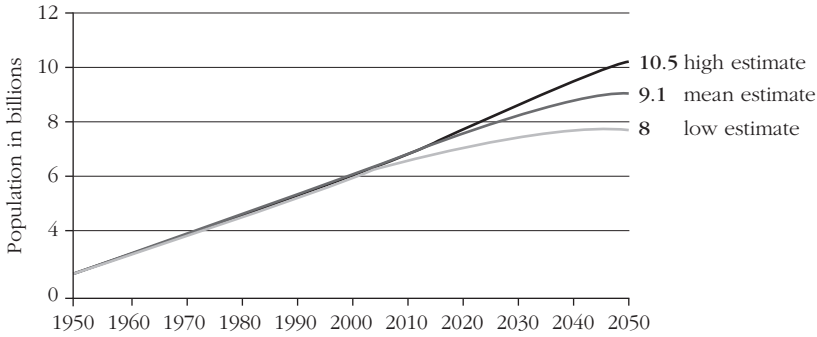

FIGURE 1.3 World population growth.
Source: United Nations (2011)

(UN) forecasts, the earth's population will reach about 9 billion by 2050, corresponding to an annual growth of almost 90 million people. There seems to be no end in sight for the exponential growth of the world's population, as shown in Figure 1.3. At the same time, millions of people will increase their incomes, as well as their consumption. If consumption habits and production methods remain unchanged, a massive drain on the world's resources will result. In particular, demand for energy will skyrocket.

Aging of Western Populations

The populations of industrialized nations (as well as China, due to its one-child policy) are getting older. In Western Europe, 16 percent of the population was over 65 as of 2009, a percentage that will rise to 27 percent by 2050. Globally, the population over 60 is growing at a rate of 2.6 percent per year. Since 1950, the proportion of elderly citizens has been rising steadily, from 8 percent in 1950 to 11 percent in 2009, and is expected to reach 22 percent in 2050. The number of elderly people on the planet is expected to exceed the number of children for the first time in 2045 (United Nations, 2009).

Developed-world aging coupled with a shrinking workforce is leading to substantial increases in the dependency ratio (Urwin 2010a). Pension and healthcare institutions face the difficult question of how to generate returns in order to sustainably fund their obligations.

1.2 Sustainable Investments as Part of the Solution

Philosophical Underpinnings

As a rule of thumb, it takes one generation to implement new ways of thinking. Some 200 years ago, the German philosopher Arthur Schopenhauer described the path of a new idea: First it is ridiculed, then it is violently

opposed, and finally it is accepted as self-evident. Schopenhauer's observation applies to the professional sphere of institutional asset management. Already in the 1950s, Harry M. Markowitz developed the "modern portfolio theory," which postulates the concept of diversification to maximize expected portfolio return for a given amount of portfolio risk. Only 30 years later, in 1990, Markowitz was awarded the Nobel Prize for Economics for this groundbreaking idea. Today, his theory of diversification is widely accepted and shapes regulations on the investment of pension and insurance assets and virtually every investment policy.

More recently, sustainability issues have begun to influence asset management. Though we have passed through the stage of laughter and ridicule, the idea of taking environmental and social criteria into consideration along with financial concerns when making investments continues to be controversial. Currently, the discourse on sustainability has also passed the stage of violent opposition, as evidenced, in part, by the awarding of the 2006 Nobel Peace Prize to Bangladeshi professor Muhammad Yunus and his Grameen Bank, a bank for the poor that brought the concept of microcredit to the world's attention. The following year, former U.S. Vice President Al Gore and the Intergovernmental Panel on Climate Change (IPCC) jointly received the Nobel Peace Prize. Given that the Nobel Peace Prize promotes new ways of thinking, these awards suggest that the time for recognizing environmental and social concerns has arrived. To ignore these concerns would jeopardize social cohesion in our increasingly global village.

This insight—which requires not sacrifice, but initiative—must be reflected in our economic activity. A ruthless society is not only a burden to its members, but also to the environment, and contributions are required of all of us. The allocation of capital to sustainable companies, governments, and real assets is a significant factor. By incorporating the criteria of sustainability in our investment strategy, we take a necessary step toward serving the greater good.

Practical Considerations

The recognition that pollution, climate change, overexploitation of resources, increasing food shortages, and soaring energy needs threaten human well-being has triggered a massive search for sustainable solutions. Some of the remedies being pursued include technological innovations, a switch from fossil fuels to renewable energies, price mechanisms that compensate for environmental damage, and entrepreneurial solutions to social problems—and all of them offer enormous economic opportunities.

These challenges also pose huge risks to the global economy. In 2008, environmental damage caused by human activities amounted to around $6.6 billion globally, according to Trucost. By 2050, environmental

costs could rise from 11 percent to 18 percent of projected global GDP (UN PRI/UNEP FI, 2010). Rising external costs affect the profitability of companies globally as well as diversified investment portfolios. These cost increases are inevitably reflected in long-term increases in insurance premiums, taxes, and prices, which in turn, have a negative effect on future cash flows and dividends of the securities in an investment portfolio.

Pension funds, insurance companies, asset managers, foundations, and family businesses, all of which have a long-term investment horizon, should take these major challenges and threats into account when making investment decisions. On the one hand, enterprises and corporations that do not reflect global changes and challenges in their strategic outlook may make gains in the short or medium term, but are bound to lose out in the long term. On the other hand, investors can seize new challenges as opportunities. Investing in companies that address these challenges in their business strategy should create profits as a result of changing framework conditions. Sustainability is a global megatrend—a development that, regardless of temporary setbacks and resistance, is unstoppable in the long run.

1.3 Conclusions for Practitioners

Climate change, environmental disasters, and increasing scarcity of resources compounded by the rising economic activity of newly industrializing countries contribute to the challenge of sustainable development. Organizations whose investment horizons must be long-term, including pension funds, insurance companies, asset managers, foundations, and family offices, have to be aware of these future challenges and make thoughtful and intelligent investment decisions. Sustainability will prove to be an unstoppable global force in the long run, which will change the framework conditions for investors.

CHAPTER 2

What Does Sustainability Mean?

2.1 Definition of Sustainability

The word sustainability is derived from the Latin verb *sustinere* (from *tenere*, to hold). Modern dictionaries provide more than ten meanings for sustain, including to maintain, support, and endure. Sustainability can be simply defined as the capacity to endure. In the realm of ecology, the word describes how biological systems remain diverse and productive over time; old and healthy wetlands and forests are examples of sustainable biological systems. For humans, sustainability describes the potential for the long-term maintenance of well-being, which has environmental, economic, and social dimensions.

The concept of sustainability is subject to varying cultural interpretations. In 1987, the World Commission on Environment and Development (WCED), under the chairmanship of the former Norwegian Prime Minister Gro Harlem Brundtland, defined the term as follows:

> *Sustainable development is the development that meets the needs of the present without compromising the ability of future generations to meet their own needs. It contains two key concepts:*
> - *The concept of "needs," in particular the essential needs of the world's poor, to which overriding priority should be given.*
> - *The idea of limitations imposed by the state of technology and social organization on the environment's ability to meet present and future needs. (WCED, 1987)*

2.2 History of Sustainability

The idea of not using more resources than is necessary, an ethical principle as old as humanity itself, is more difficult for societies to implement than it is for individuals. The development of civilization often goes hand

in hand with wastefulness and destruction. Some milestones in the history of sustainability include:

- In 1592, the Prince Bishop of Eichstätt of Bavaria in Germany, alarmed by the widespread destruction of forests in his region, enshrined sustainability principles for forest management into law.
- In the early 18th century, the mining industry and livelihood of thousands was threatened in Saxony. The mining industry and smelting of ores had consumed whole forests which resulted in an acute scarcity of timber. As a result, the mining administrator Hans Carl von Carlowitz introduced the principle of sustainability that limited the felling of timber to the number of trees that were expected to grow back. Hans Carl von Carlowitz was the first to clearly formulate the concept of sustainability in his work on forestry, *Sylvicultura Oeconomica*.
- In the 1970s, the Club of Rome, a global think tank headed by the U.S. economist Dennis Meadows, issued a report that warned about the limits of economic growth.
- In 1983, the United Nations founded the WCED, chaired by the former Norwegian Prime Minister Gro Harlem Brundtland.
- In 1987, the WCED published a report that for the first time formulated the basic principle of sustainable development: harmonizing the needs of present and future generations.
- In 1992, the United Nations Conference on Environment and Development (UNCED), known informally as the Earth Summit, occurred in Rio de Janeiro. In addition to official delegates from 178 participating governments, 2,400 representatives of non-governmental organizations also took part. One of the motions adopted was Agenda 21, a UN action plan related to sustainable development.
- In adopting the Kyoto Protocol of 1997, industrialized nations committed to targets to reduce carbon dioxide emissions by 5 percent by the year 2012 as compared to 1990 levels.
- In 1999, the UN launched the Initiative Global Compact, which embraced guiding principles in respect of human rights, labor, and environmental protection and established a system of sustainable principles for business enterprises.
- In 2000, 189 member states of the United Nations adopted the Millennium Declaration, its main goal being to ensure the well being of future generations.
- Over the past few years, numerous United Nations Climate Change Conferences took place; 2007 in Bali, 2008 in Posen, 2009 in Copenhagen, 2010 in Cancun, and 2011 in Durban. All of these conferences, however, brought only a minimal consensus.

2.3 Definition of Sustainable Investments

In the financial world, the term sustainability first took shape during the 1970s and 1980s. A fundamental analysis was developed in 1997 by two German universities—the Johann Wolfgang Goethe-University in Frankfurt and the University of Hohenheim in Stuttgart—and published as the "Frankfurt-Hohenheimer Guidelines." It covers 850 individual criteria within three areas: cultural sustainability, environmental sustainability, and social sustainability. In 2004, a group of industry experts developed the "Darmstadt Definition of Sustainable Investments" based on the criteria of the "Frankfurt-Hohenheimer Guidelines." The definition comprises three levels of sustainability for investments: economic, environmental, and social and cultural.

Darmstadt Definition of Sustainable Investments

From an economic perspective, sustainable investments require that:

- Profits are accrued on the basis of long-term production and investment strategies instead of short-term profit maximization.
- Profits from investments are responsibly related to an actual increase of economic value in real terms.
- The fulfillment of basic needs (e.g., water supply) is not threatened.
- Profits are not based on corruption.

From an environmental perspective, sustainable investments require that profit making is consistent with:

- An increase in resource productivity.
- Investments in renewable resources.
- The recycling and reuse of used material and substances.
- The workability of global and local environmental systems (e.g., rain forests, oceans).

From a social and cultural perspective, sustainable investments require that profit making is consistent with:

- The development of human capital (responsibility for employment, education, and upgrading; support of self-governing workers; compatibility with family and job; respect for a person's individuality).

(continued)

(Continued)

- The development of social capital (creation of opportunities for gainful employment; fair balance between generations; treatment of minorities without discrimination; functioning regions; commitment towards responsible corporate citizenship).
- The development of cultural capital (respect and empowerment for cultural diversity, encompassing the protection of personal civil rights and liberties and societal integrity).

The terminology used in the context of sustainable and responsible investments is still evolving. A useful definition is provided by the European Sustainable Investment Forum (Eurosif), which defines sustainable investment as:

> *an investment philosophy that combines investors' financial objectives with their concerns about environmental, social, and governance (ESG) issues. (Eurosif, 2010b)*

For institutional investors, the definition of Urwin may prove useful, which describes sustainable investing for pension funds simply as "long-term investing that is efficient and intergenerationally fair" and aims at optimizing the fund's strategy with respect to present and future circumstances, taking into account long-term as well as short-term considerations in line with the fiduciary duty (Urwin, 2010b).

2.4 Terminology in Current Use

Numerous specialized terms have been created and established in conjunction with sustainable investing. To introduce some order, we offer an alphabetical list of these terms along with a brief definition:

- **Corporate social responsibility (CSR):** A description of a company's overall responsibility toward society.
- **Double bottom line (DBL):** Companies that focus on not only financial targets, but also nonfinancial ones (i.e., social *or* environmental impact is taken into account when measuring performance).

- **Ethical investments:** Describes investments that, in the broadest possible sense, take ethical considerations into account.
- **ESG:** The three pillars of sustainability—that is, environmental, social, and governance (management according to the principle of separation of powers and control). ESG investments embrace all three levels of sustainability.
- **Financial first investors:** Their primary goal is to maximize financial returns, but without completely losing sight of social and environmental returns.
- **Impact first investors:** Their primary goal is to achieve the highest possible social and/or environmental returns. In contrast to financial first investors, they are also prepared to accept below-market returns.
- **Impact investing:** Investments aimed at achieving immediate environmental or social benefits. Examples include venture capital investments in companies operating in the cleantech sector or microfinance investments.
- **Mission-related investments (MRI):** Investment strategies of charitable institutions that are aligned with the institution's mission while also offering market returns.
- **Philanthropic finance:** An investment style whereby investors accept negative or below-market returns in the pursuit of idealistic goals. The primary goal of the investor is to achieve a social and/or environmental impact.
- **Program-related investments (PRI):** Investments that generally provide below-market returns and are directly or closely allied with the charitable mission of an organization.
- **Social venture capital:** Risk capital for a social and/or environmental goal that is also expected to produce a financial return.
- **Socially responsible investment:** Investment products and strategies that, in addition to economic/financial aspects, take into account the long-term influence of extra financial factors such as environmental, social, and governance issues in the investment process and/or social principles as well as ethical or values-based aspects.
- **Sustainable and responsible investment (SRI)/Sustainable investment (SI):** Investment products and strategies that, in addition to economic/financial aspects, take into account the long-term influence of extra financial factors such as environmental, social, and governance issues in the investment process. Market returns are expected.
- **Triple bottom line (TBL or 3BL; also "people, planet, profit" or "the three pillars"):** In contrast to the DBL, the triple bottom line takes into account an expanded spectrum of values and criteria for measuring organizational (and societal) success, including economic, environmental, and social targets.

- **Value(s)-based investing:** Sustainable or responsible investments that address ESG and ethical issues.
- **Venture philanthropy:** A philanthropic approach that is strongly aligned with entrepreneurial principles. Risk capital and loans are used to support social and environmental causes that promote permanent and long-term social change.

Notwithstanding the multitude of terms, sustainable investments invariably pursue the same goal: the integration of social and/or environmental considerations with traditional economic investment decisions.

2.5 Conclusions for Practitioners

The numerous terms that surround the concept of sustainability are often imprecisely formulated and used vaguely. By contrast, the Brundtland definition—which describes development as being sustainable if it meets not only current needs, but also the needs of future generations—is practical and recognized all over the world. It can also be used as a general guideline when developing and implementing a sustainable investment strategy. The "Darmstadt Definition of Sustainable Investments" differentiates between three impact levels—economic, environmental, and social and cultural which are more closely defined by numerous individual criteria.

Institutional investors will have to adapt their guidelines of responsible or sustainable investing to the constraints in which they operate. As they are bound by their fiduciary duty to generate financial returns, they usually have to subordinate nonfinancial, social goals to financial goals.

CHAPTER 3

Sustainable Investment Strategies

3.1 Overview

Sustainable investment strategies include environmental, social, and governance (ESG) aspects alongside economic considerations. Ethical concerns relating to corporate governance or business practices may also be taken into account.

In line with Eurosif, the European Sustainable Investment Forum, we distinguish between core and broad strategies. Core investment strategies are those that consist of screening strategies that systematically impact portfolio construction. They often imply a values-based approach, such as making exclusions based on norms, values, and ethics and engaging in positive screening, including best-in-class and thematic approaches (see Figure 3.1). Broad investment strategies tend to be adopted by mainstream institutional investors and include the integration of ESG issues in the investment process, as well as engagement and an active shareholder policy. We follow this classification throughout the book.

Another classification approach differentiates between active and passive strategies. Active strategies are aimed at achieving change, whereas passive strategies rely on the implementation of predetermined criteria and rules. Only engagement and active shareholder policy can be classified as active strategies. Naturally, they are limited to equity investments.

3.2 Core Strategies

Negative Screening

Negative screening excludes business sectors or practices that breach environmental, social, or ethical standards from the investment universe. The decision is based on the consideration that capital should not be made available to certain sectors or companies that damage the environment or

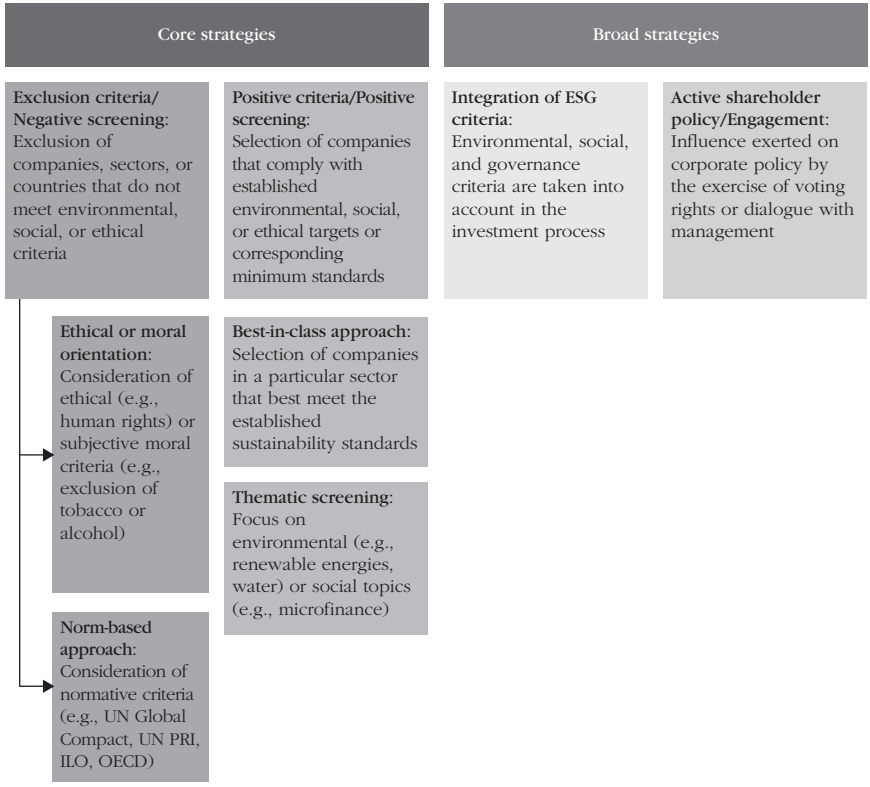

FIGURE 3.1 Overview of sustainable investment strategies.
Source: Independent Capital Management AG

act against social or ethical principles. The basis for such a decision may be normative, ethical, or moral or a combination thereof.

Norm-based screening includes investments in any conceivable sector or company, but only if they comply with certain international standards and norms, such as those set by the Organization for Economic Cooperation and Development (OECD), the International Labor Organization (ILO), or the United Nations. Companies that breach these norms are excluded from the investment universe. Negative screening may also be based on ethical or moral preferences that are primarily subjective (simple screenings).

In the environmental domain, exclusion criteria might include the use of nuclear energy, fossil fuels, or tropical woods; the manufacture and marketing of ozone-depleting or hazardous substances (e.g., pesticides, biocides, etc.); or activities that promote climate change (automotive and oil and gas industries). Established social exclusion criteria include human