

# Responsible Investing

## Part I: IPM Research

Financial outcomes of investing in responsible companies

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Environmental, Social and Governance matters

## Part III: GES Investment Services

Responsible Investments

### Abbreviations & Explanations:

- RI: Responsible Investments
- ESG: Environmental, Social and Governance
- GES Investment Services: Northern Europe's leading research and service provider for RI
- GES Global Ethical Standard: the name of a service offered by GES Investment Services
- The United Nations Global Compact: A strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption

## Part I: IPM Research

### Financial outcomes of investing in responsible companies

By Boualem Djehiche<sup>1</sup>, Anna Gorka<sup>2</sup> and Tetiana Sowiak<sup>3</sup>

#### Abstract

Preserving the environmental and ensuring high social standards are among the most important tasks of a modern society. This helps explain the large number of studies on the impact of responsible investment strategies on portfolio performance. However, the conclusions drawn from these studies are sometimes contradictory or inconsistent.

The aim of this work is to investigate whether a premium or penalty exists for holding environmentally and socially responsible companies in a portfolio. In contrast to all previous studies that were based on market-capitalization indexes, we perform an analysis based on both market-capitalisation indexes and Research Affiliates<sup>®</sup> Fundamental Indexes<sup>®</sup> (RAFI<sup>®</sup>)<sup>4</sup>. The main conclusion of this study is that the results are dependent on portfolio selection, i.e. the way we define environmentally and socially 'friendly' portfolios. In many cases responsible investing is a superior investment strategy, since it does not lead to lower returns and is preferable in terms of risk. One limitation of our study is its short performance history due to unavailability environmental and social rankings before 2004.

#### Introduction

Responsible investing (RI) has become very popular in recent decades. According to Social Investment Forum<sup>5</sup>, 560 global investment institutions with more than \$18 trillion in assets under management have signed onto the United Nations Principles for Responsible Investment since 2005 and agreed to incorporate environmental, social and governance (ESG) issues into investment analysis and the decision-making processes. In spite of this, there is a debate between practitioners and academics on the relationship between the financial and environmental performance of companies. Many empirical studies have been made in order to determine if adding an ethical dimension to stock selection yields higher investment returns. As stated, the conclusions drawn from different investigations are often contradictory and inconsistent: some of them show that investment in 'responsible' portfolios is beneficial, others draw different conclusions.

Opponents of RI believe that the application of ESG factors to the investment process results in lower investment returns, since potentially profitable investment opportunities may not be available. They also argue that companies cannot improve their social or environmental performance without decreasing shareholder value as the cost of adhering to ethical standards will cause higher product prices, lower profitability and competitiveness. Therefore, responsible investors will suffer from limited diversification and will be forced to report suboptimal returns (Geczy et al. (2005), Girard et al. (2007)).

Proponents of RI argue that improving social or environmental performance will lead to an increase of input-output efficiency and generate new market opportunities because of more cost-efficient use of resources (Porter and Van der Linde (2005), Derwall et al.(2005)).

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<sup>4</sup> Research Affiliates Fundamental Indexes (RAFI) is a family of non-market capitalization weighted equity indexes. Selection and weighting of the companies in RAFI indexes is based on four metrics: sales, cash flow, book value and dividends. Authors of [1] in their studies conclude that Fundamental Index portfolios significantly outperformed the S&P 500 index during the 43-year span tested (1962-2004). The portfolio performance was robust across time, bear and bull stock markets, phases of business cycle and across rising- and falling- interest-rate regimes.

<sup>5</sup> <http://www.socialinvest.org>

There also exists a third view, which suggests that given a long-term perspective responsible and traditional investment strategies produce returns without any meaningful difference (Bauer et al.(2007), Bello (2005), Hamilton et al.(1993)).

This paper is a result of IPM independent ESG research<sup>6</sup> and its purpose is to test if the addition of environmental and human rights factors to the stock selection process improves the portfolio performance. We have conducted an analysis based on a market-capitalisation index as well as on RAFI. We created the hypothetical portfolios of responsible companies using the GES ranking and compared these portfolios with indexes and 'irresponsible' companies. We also carried out a regression analysis for RI portfolios, but as we are considering a relatively short time span (1 Jul 2004 - 31 Dec 2008), the results were statistically insignificant and therefore have not been included in our report.

The main finding of this study is that there is no clear evidence that portfolios consisting of responsible companies systematically outperform or underperform indexes and irresponsible companies, but that these portfolios, as a rule, do have better risk characteristics than their counterparts. While this research has provided some interesting results, we believe that more empirical testing is needed: in particular, an analysis based on additional data sets could be a useful extension to this study.

### **Measuring Environmental and Human Rights Performance**

The environmental and social measures for our analysis were obtained from the GES Investment Services. GES Investment Services evaluates the companies' preparedness and their performance through a number of criteria and sub-criteria on the basis of international norms on ESG issues in accordance with the United Nations Principles for Responsible Investment (UN PRI). In Table 1 the criteria that GES is using in the process of companies ranking are presented.

GES systematic screening evaluates companies' present environmental status and readiness for the future. Environmental measures are intended to embody both ex post and ex ante dimensions of corporate risk and opportunity.

In environment and human rights areas companies obtain a rating from Aa to Cc. General risk level in the company's industry is evaluated using capital letters (A-C). The lower case letters (a-c) indicate the risk level in the particular company, based on performance and preparedness. The rating shows the company's ability to deal with the general risks that concern the type of activity and to comply with international norms and procedures.

GES ratings are based on information obtained from companies in their official documents. Evaluation also uses public information by non-governmental organisations and media.

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<sup>6</sup> See Part 2 for a description of IPM efforts within ESG area

Table 1: GES Risk Rating Criteria<sup>7</sup>

Environment	Social
<p>1) <i>Preparedness</i></p> <ul style="list-style-type: none"> <li>• Organisation and Routines</li> <li>• Policy and Programs</li> <li>• External Verification</li> <li>• Environmental Reporting</li> <li>• Supplier Evaluation</li> </ul> <p>2) <i>Performance</i></p> <ul style="list-style-type: none"> <li>• Greenhouse Gases</li> <li>• Energy Use</li> <li>• Use of Water Resources</li> <li>• Travel Management</li> <li>• Remediation</li> <li>• Project Development</li> <li>• Hazardous Waste</li> <li>• Air Emissions</li> <li>• + 8 more criteria</li> </ul>	<p>1) <i>Employees</i></p> <ul style="list-style-type: none"> <li>• Discrimination</li> <li>• Freedom of Association</li> <li>• Health and Safety</li> <li>• Working Hours and Wages</li> <li>• + 5 more criteria</li> </ul> <p>2) <i>Community</i></p> <ul style="list-style-type: none"> <li>• Use of Security Forces</li> <li>• Corruption</li> <li>• +2 more criteria</li> </ul> <p>3) <i>Suppliers</i></p> <ul style="list-style-type: none"> <li>• Code of Conduct</li> <li>• Management Systems and Program</li> <li>• Performance Evaluation</li> </ul>

In our study we use the whole universe of US companies ranked by GES Investment Services, which varies between 431-614 companies depending on the periods of time in question.

### An Empirical Study

Data for the analysis were obtained from three different sources: The environmental and human rights scores were obtained from GES Investment Services; Financial data such as company's total returns, S&P 500 index constituents and their weights were retrieved from Bloomberg; Financial data for RAFI US Large from Research Affiliates.

We carried out portfolio analysis for the full available history of GES rankings from 1 July 2004 till 31 December 2008. The algorithm of RI portfolios construction was the following:

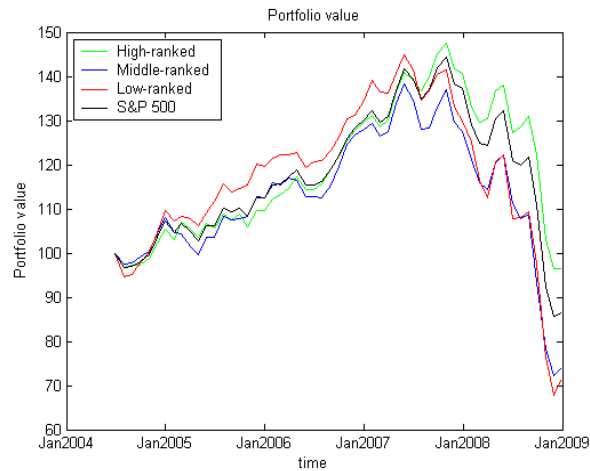
1. Select US companies from the GES list of companies
2. Rank the companies semi-annually on their most recent environmental or human rights scores
3. Create three mutually exclusive stock portfolios:
  - High-ranked portfolio consists of 33% companies that have the highest GES ranks
  - Low-ranked portfolio consists of 33% companies that have the lowest GES ranks
  - Middle-ranked portfolio consists of all other companies that were not included into high- or low- ranked portfolios
4. Match all companies in their respective portfolios obtained in step 3 with their benchmark weights, i.e. assign the corresponding weight to each company either from RAFI US Large or from S&P 500 index
5. Make portfolio weights obtained in step 4 sum up to one

Analysis of portfolio performance in this paper is based on monthly data.

<sup>7</sup> GES Investment Services, <http://www.ges-invest.com>

Let us first consider the analysis of portfolios that are constructed using environmental GES scores and S&P 500 index weights. If we assume that we have invested \$100 in a portfolio consisting of high-ranked companies, \$100 in a portfolio consisting of middle-ranked companies, \$100 in a portfolio consisting of low-ranked companies and \$100 in the S&P 500 index on first of July, 2004. In Figures 1 and 2 corresponding portfolio values and portfolio returns are plotted. From Figure 1 it is clearly seen that high-ranked companies have better performance than S&P 500 index and other companies. Low ranked companies performed well before the financial crisis, but during it the value of the low-ranked portfolio decreased significantly. In addition, the low-ranked portfolio has a higher amplitude of return oscillations in comparison with other portfolios (see Figure 2). As was expected, the amplitude of oscillations increased for all portfolios during the crisis. In order to draw any final conclusions about performance, let us consider other characteristics such as mean and standard deviation of monthly returns, downside standard deviation of monthly returns<sup>8</sup>, maximum and minimum of monthly returns, maximum drawdown (MDD), tracking error (TE) and information ratio (IR) (See Tables 2,3).

**Figure 1**  
Value of 100\$ initial investment into high-ranked, medium-ranked, low-ranked portfolios and S&P 500 index



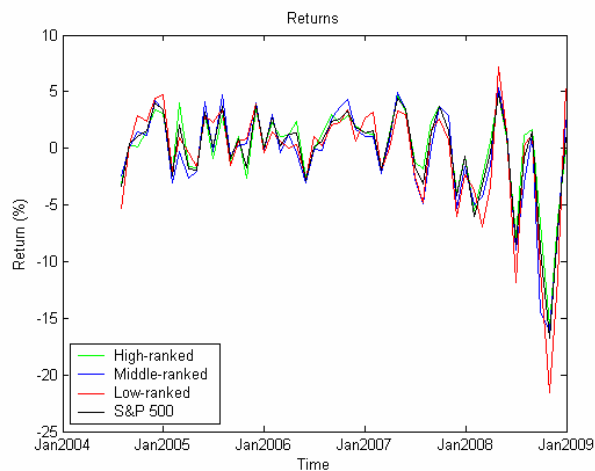
<sup>8</sup> Downside standard deviation of monthly returns is the square root of the downside risk (semi variance), similar to the standard deviation of returns, but only considering negative deviations from the mean. . Downside risk (DR) is an average of the squared deviations of values that are less than the mean, i.e.

$$DR = \frac{1}{N} \sum_{r_i < \bar{m}} (\bar{m} - r_i)^2, \text{ where } N - \text{the total number of observations below the mean, } r_i - \text{the observed value, } \bar{m} - \text{the mean or target value}$$

of the data set.

**Figure 2**

Monthly returns of high-ranked, middle-ranked, low-ranked portfolios and S&P 500 index



**Table 2: Descriptive Statistics (1 Jul 2004 - 31 Dec 2008)**

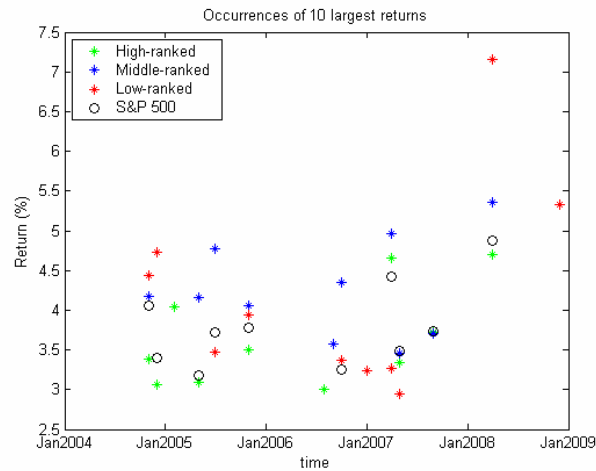
Portfolio	Mean	Std. Dev. of monthly returns	Downside Std. Dev. of monthly returns	Maximum monthly return	Minimum monthly return	MDD
High-ranked companies	0.00%	3.61%	4.83%	4.70%	-15.76%	-34.52%
Middle-ranked companies	-0.46%	4.33%	6.00%	5.36%	-16.12%	-47.78%
Low-ranked companies	-0.49%	4.92%	7.47%	7.16%	-21.61%	53.22%
S&P 500	-0.19%	3.88%	5.35%	4.87%	-16.79%	40.68%

Table 3: Information Ratios and Tracking Errors vs. S&P 500<sup>9</sup>

Portfolio	IR <sub>1</sub>	TE <sub>1</sub>	IR <sub>2</sub>	TE <sub>2</sub>	IR <sub>3</sub>	TE <sub>3</sub>
High-ranked companies	0.95	2.49%	-0.01	2.01%	1.92	2.87%
Middle-ranked companies	-0.81	4.01%	-0.44	2.81%	-1.01	5.60%
Low-ranked companies	-0.68	5.91%	0.15	3.71%	-1.11	8.46%

From Tables 2 and 3 it follows that a high ranked portfolio has the largest mean of returns and the highest information ratio. At the same time it has the smallest standard deviation, downside risk, tracking error and maximum drawdown. It is interesting to note the relationship between overall risk (standard deviation of returns) and downside risk. The increased “riskiness” of low-ranked companies is more evident in down-markets than in more benign environments. In this limited data set, high-ranked companies have coped better with difficult market environments, than have low-ranked companies. In the Figures 3-5 occurrences of 10 largest returns, 10 smallest returns and 10 largest draw downs are plotted.

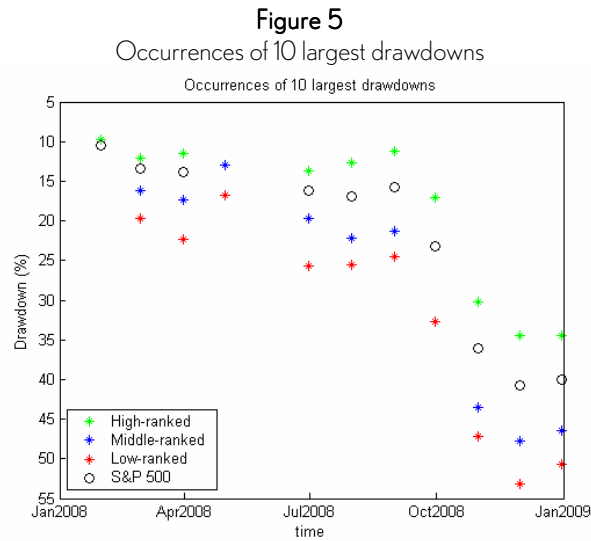
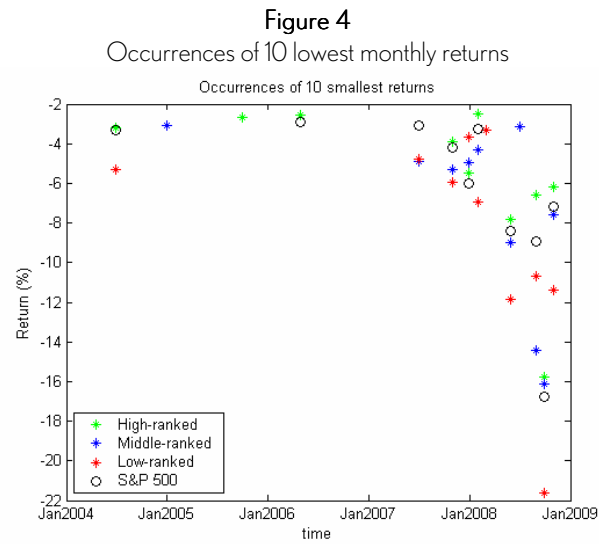
Figure 3  
Occurrences of 10 highest monthly returns



<sup>9</sup> IR<sub>1</sub> - information ratio calculated for the period 1 Jul 2004 - 31 Dec 2008; TE<sub>1</sub> - tracking error calculated for the period 1 Jul 04 - 31 Dec 08

IR<sub>2</sub> - information ratio calculated for the period 1 Jul 2004 - 1 Jul 2007; TE<sub>2</sub> - tracking error calculated for the period 1 Jul 04 - 1 Jul 07

IR<sub>3</sub> - information ratio calculated for the period 1 Jul 2007 - 31 Dec 2008; TE<sub>3</sub> - tracking error calculated for the period 1 Jul 07 - 31 Dec 08



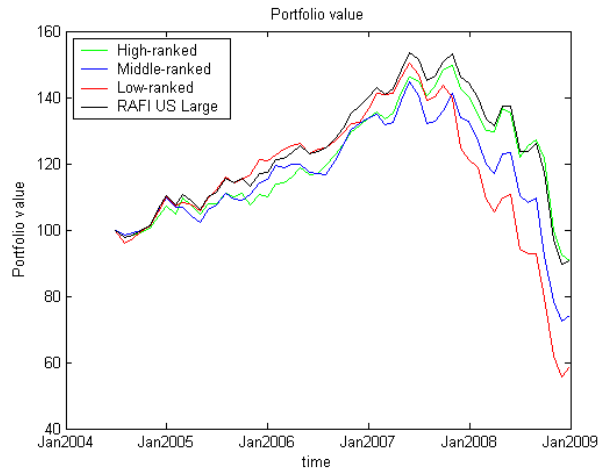
Therefore, from our investigation it follows that if we base the construction of a portfolio on environmental scores and S&P 500 weights then high-scored companies outperform their counterparts. We also applied the same type of analysis to the sample obtained using non-parametric block bootstrap<sup>10</sup> and were able to draw similar conclusions. This result is consistent with the conclusions made in [4] by Derwall et al.

<sup>10</sup> By re-sampling blocks rather than original observations we preserve the original, short-term dependence structure between the observations although not necessarily the long-term one.

The same approach was applied to the analysis of RI portfolios constructed using RAFI US Large weights and environmental GES scores. The results of the research are presented in Figures 6, 7 and Tables 4, 5. From the plot in Figure 6 it follows that RAFI US Large has the largest portfolio value, except for second half of 2008 year (when high-ranked companies showed better performance) and short period at the end of 2005-beginning 2006 (when low-ranked companies performed better). From Figure 7 we can see that returns curve of low-ranked companies has the largest peaks on the negative side, whenever high-ranked companies have the largest peaks on the positive side.

**Figure 6**

Value of \$100 initial investment in high-ranked, medium-ranked, low-ranked portfolios and RAFI US Large



**Figure 7**

Returns of high-ranked, middle-ranked, low-ranked portfolios and RAFI US Large

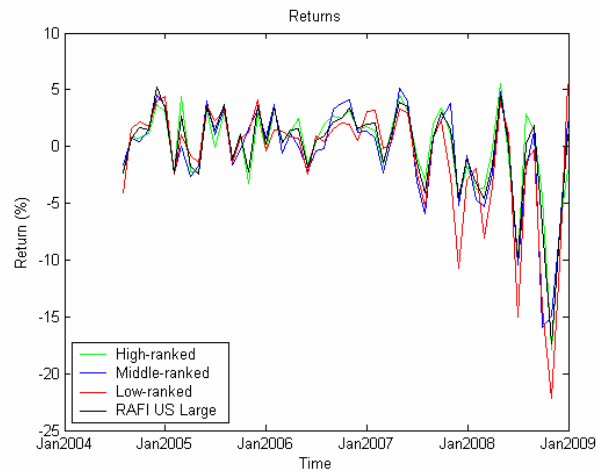


Table 4: Descriptive statistics (1 Jul 2004 - 31 Dec 2008)

Portfolio	Mean	Std. Dev. of monthly returns	Downside Std. Dev. of monthly returns	Maximum monthly return	Minimum monthly return	MDD
High-ranked companies	-0.00%	3.91%	5.13%	5.51%	-17.94%	39.35%
Middle-ranked companies	-0.45%	4.41%	6.02%	5.19%	-15.95%	49.88%
Low-ranked companies	-0.83%	5.27%	7.90%	5.58%	-22.15%	63.01%
RAFI US Large	-0.00%	3.94%	5.61%	5.19%	-17.35%	41.58%

Table 5. Information Ratios and Tracking Errors vs. RAFI US Large

Portfolio	IR <sub>1</sub>	TE <sub>1</sub>	IR <sub>2</sub>	TE <sub>2</sub>	IR <sub>3</sub>	TE <sub>3</sub>
High-ranked companies	0.00	3.28%	-0.76	2.21%	0.45	4.73%
Middle-ranked companies	-0.75	5.71%	-0.74	3.82%	-0.68	8.31%
Low-ranked companies	-1.25	7.16%	-0.30	3.81%	-1.70	9.92%

Let us look at descriptive statistics in Tables 4 and 5. A high-ranked portfolio has the smallest standard deviation, tracking error, downside risk and maximum drawdown. Its mean value of returns is almost identical to the mean value of RAFI US Large. Information ratio of high-ranked portfolio is close to zero for the full period, but positive 0.45 for the “financial crisis” period (1 Jul 2007 - 31 Dec 2008). At the same time we can see that a low-ranked portfolio coped better than a high-ranked portfolio in Information Ratio terms in the benign period leading up to the crisis, but suffered considerably with a negative 1.70 information ratio with a high tracking error during the crisis. Thus, we may conclude that the analysis made on available data shows evidence of beneficial investment in high-ranked companies.

We have also conducted a similar research based on human rights GES scores. Ranking of portfolios (highest to lowest) according to different measures is given in Tables 6 and 7 for portfolios based on S&P 500 index and RAFI US Large index correspondingly.

**Table 6: Summary of results for portfolios constructed using human rights GES scores and S&P 500 index weights<sup>11</sup>**

Rank	Mean	Std. Dev. of monthly returns	Downside risk	Maximum monthly return	Minimum monthly return	MDD	IR	TE
1	M	H	H	L	H	H	H	H
2	H	I	I	I	I	I	M	M
3	I	M	M	M	L	L	L	L
4	L	L	L	H	M	M		

Hence, analysis of portfolios constructed using human rights GES scores and S&P 500 index weights showed that investing in the middle-ranked companies can lead to higher returns, but then investors will be exposed to higher risk. Investing into high-ranked companies yields smaller returns, but it is safer. Thus, each investor should make his own portfolio choice according to his preferences.

**Table 7: Summary of results for portfolios constructed using human rights GES scores and RAFI US Large weights<sup>12</sup>**

Rank	Mean	Std. Dev. of monthly returns	Downside risk	Maximum monthly return	Minimum monthly return	MDD	IR	TE
1	I	H	H	L	H	L	L	H
2	L	I	I	M	I	I	M	L
3	M	L	L	H	L	H	H	I
4	H	M	M	I	M	M		

As a result of the analysis of portfolios based on human rights GES scores and RAFI US Large weights, we obtained the following results. High-ranked companies have the smallest standard deviation, but almost the same standard deviation as that of RAFI US Large. Low-ranked companies have the smallest maximum drawdown. Low-ranked companies have a slightly negative, but the highest information ratio, since at the end of 2008, and had a better performance than their high- and middle- ranked counterparts. During the financial crisis period, low-ranked companies had the highest information ratio (0.4836), but the corresponding tracking error was also the highest. Before the financial crisis, middle-ranked companies had an information ratio of 0.5303 and tracking error was slightly larger than tracking error of high- ranked companies. If we look at the characteristics obtained from bootstrapped data, we will come to the conclusion that investing in the benchmark is more beneficial. Thus, we can conclude that different measures show the superiority of investment in different portfolios. Therefore, in this case more observations are needed for more comprehensive and deeper investigation of portfolio performance.

<sup>11</sup> H - High-ranked companies, M - Middle-ranked companies, L - Low-ranked companies, I - Index (S&P 500)

<sup>12</sup> H - High-ranked companies, M - Middle-ranked companies, L - Low-ranked companies, I - Index (RAFI US Large)

In addition to the research described above we have carried out an analysis based on the 'best-in-class' methodology of portfolio construction. The key element of the 'best-in-class' methodology is that information about GICS<sup>13</sup> sectors is used in the process of stock selection. First we defined high-ranked, middle-ranked and low-ranked companies within each sector and then constructed high-ranked portfolio as a union of all high-ranked companies from all 10 sectors, middle-ranked as a union of all middle-ranked companies and low-ranked as a union of all low-ranked companies. The analysis of these portfolios showed that high-ranked portfolios have better risk characteristics than their counterparts, but still we lack a longer data history in order to make a final decision about superior investment strategy.

## Conclusions

In this paper the question of investment expediency in responsible companies was considered. The analysis was conducted for the whole period of availability of GES data. Our study has shown that in many cases investing in portfolios that consist of high-ranked companies do not lead to lower returns, and that such portfolios have a smaller standard deviation and lower risk than their counterparts. In the case of constructing portfolios using human rights GES scores it is hard to conclude unambiguously which investment in which strategies are preferable. A final decision on investment should be made by taking into account the investor's risk profile.

Our work therefore leads us to believe that responsible investing does not necessarily hurt investment returns and may provide a superior investment strategy. Studies based on longer history are needed in order to obtain more accurate results.

This study is backward looking and covers a relatively limited time span. It is possible, and perhaps likely, that the focus on ESG issues will continue to increase in the future. As the awareness of these issues grows, it may lead to change in behaviour amongst investors, corporations, and consumers that may in turn affect future relative returns. The data available is currently too short to study any such effects.

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<sup>13</sup>The Global Industry Classification Standard (GICS) assigns each company to a sub-industry, and to a corresponding industry, industry group and sector, according to the definition of its principal business activity. According to GICS all companies are divided between 10 sectors: 'Energy', 'Materials', 'Industrials', 'Consumer Discretionary', 'Consumer Staples', 'Health Care', 'Financials', 'Information Technology', 'Telecommunication Services' and 'Utilities'.

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## Part II: IPM Policy

### Environmental, Social and Governance matters

At IPM we support the principle that companies have a responsibility to comply with international norms, even though they are not legally obliged to do so. Furthermore, we do not wish to support the violation of the well-established international norms by which the companies in our investment universe operate.

It is our belief that an ESG overlay will lead to long-term rewards in terms of risk reduction and potentially higher returns (or at least at no opportunity loss in terms of lower returns).

At IPM we screen our equity portfolios for their compliance with international conventions and guidelines on environment, human rights and business ethics such as UN Global Compact, OECD Guidelines for Multinational Enterprises, ILO Core Labour Conventions, Environmental Conventions, and Weapons related Conventions. For this purpose, IPM uses the GES Global Ethical Standard.

#### IPM ESG Committee

The objective of IPM ESG Committee is to provide advice and guidance for IPM activities, strategy and research agenda in the area of ESG matters. The Committee also serves as a discussion, advisory and decision making panel regarding Exclusion and Engagement activities for IPM RAFI Funds. The details on IPM ESG Committee Guidelines for Exclusion and Engagement are included in the Appendix.

- **Exclusion**

The companies which do not comply with well-established international norms on ESG issues are excluded from the investment universe if so recommended by the IPM ESG Committee. At the same time we re-include in our investment universe any companies that are included in the Re-Include List of GES Global Ethical Standard Report if IPM ESG Committee recommends so.

In addition, since October 2008 IPM RAFI Funds have not invested in companies involved in cluster munitions according to the Convention on Cluster Munitions (since November 2008, the Convention on Cluster Munitions became an integral part of the GES Global Ethical Standard process, and therefore since that time companies involved in cluster munitions have become an integral part of the Engage/Exclude List of the GES Global Ethical Standard Report).

- **Engagement**

IPM engages in a dialogue with all the companies from the IPM investment universe included on GES Engage/Exclude List with the goal of improving the conduct and policies of these companies. Our engagement efforts are several.

Firstly, as IPM is a client of GES Global Ethical Standard service, GES regularly engages in dialogue with the companies on behalf of IPM.

In addition, IPM is a part of GES Engagement Forum which acts as a collaborative tool for an active ownership process aiming at improving the less developed parts of a company's management systems. The forum offers a meeting point for investors to interact upon company's compliance with international norms on ESG issues. The process is based on the same principles as the GES Global Ethical Standard but the GES Engagement Forum calls for a higher degree of participation from its clients.

As a member of the GES Engagement Forum, IPM has a full access to the GES's dialogue with companies that have been alleged to violate international norms. In addition IPM is able to participate in company meetings and telephone conferences together with GES and other clients of the GES Engagement Forum. Also, as a client of the GES Engagement Forum, IPM can request GES to coordinate among its clients to find support for actions regarding specific incidents of particular concern in order to create increased leverage in the engagement process, through letters to companies, resolutions, during company meetings etc.

The Engagement Forum also provides IPM with upcoming resolution notifications concerning ESG matters. IPM votes on all ESG related resolutions in a manner ensuring company's compliance with international ESG norms for all its Engagement cases.

Furthermore, since Q3 2009 IPM has independently engaged in a dialogue with relevant companies. This is done by letter and phone conferences with the companies from the IPM investment universe included in GES Engage/Exclude List.

## **Active Ownership**

IPM incorporates proxy voting according to best governance standards into IPM ESG programme. This is done through cooperation with the RiskMetrics Group.

## **APPENDIX - IPM ESG Committee Guidelines for Exclusion and Engagement:**

The basis for the analysis and recommendations made by the Committee are the GES Global Ethical Standard Reports, provided by GES. However, the Committee will also consider other relevant information in their analysis of recommendations.

### **1.1. Cluster munitions involved companies**

All companies involved in cluster munitions according to GES Report will be directly recommended for exclusion.

### **1.2. New companies (other than cluster munitions addressed in 1.1.) on the GES Engage/Exclude List**

At each meeting special attention is drawn to new entries on the GES Report Engage/Exclude List, and these companies are put on special watch. The Committee will carefully study these companies in order to verify any signs of progress in improving their conduct. Lack of improvements for two consecutive six month periods (neither satisfying 1 out of 4 GES revision criteria per year, nor presenting any documented proof that confirms significant improvements) or remaining on the Engage/Exclude List for more than 3 years will act as sufficient reason for the IPM ESG Committee to recommend exclusion of that company from the investment universe.

### **1.3. Companies on the GES Engage/Exclude List excluded from the investment universe**

All companies excluded from the investment universe will remain excluded until they are included in the Re-Include List of the GES Global Ethical Standard Report, unless the Committee decides there are extraordinary circumstances that warrant a re-inclusion. Only circumstances related to an improvement in company's conduct will be taken into account.

### **1.4. Companies entering the GES Re-Include List**

All companies which are included in the Re-Include List of the GES Global Ethical Standard Report will be reviewed by the Committee for possible recommendation for re-inclusion in the investment universe.

### **1.5. Companies on the GES Observation List**

All companies which are included on the GES Observation List are not recommended for engagement /exclusion unless extraordinary circumstances exist.

These points described above act as operating guidelines, and the IPM ESG Committee may deviate from them if it decides that the behaviour of the companies warrant quicker exclusion or further patience before taking action.



## Part III: Responsible Investments

### GES Investment Services

By Fredric Nyström<sup>14</sup>

Responsible investment (RI) is straightforward and simply means an investment approach that combines investors' financial objectives with their concerns about environmental, social and governance (ESG) issues. This is in contrast to standard investment approaches concentrating solely on financial returns. The history of RI shows that the major drivers behind the growth over the last thirty years have been geopolitical issues - the Vietnam war, apartheid in South Africa, increased environmental concern, human rights and outsourcing issues, and worries over globalisation. Even though it at a first glimpse looks like a modern phenomenon RI has a long history.

In 1760 John Wesley published "The use of Money". Wesley's point was that making money in ways which injure our neighbour cannot be right. Central to his message is the idea of stewardship: that everything we gain or are given is only conditionally ours. We are not the absolute owners of our wealth, rather we are custodians or stewards. This message comes again more than 200 years later in the report of the Brundtland Commission "Our Common future". The report deals with sustainable development and the definition of this term is well known and often cited: "sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs". RI is the financial industry's contribution to a sustainable development.

According to Eurosif ([www.eurosif.org](http://www.eurosif.org)) research, total RI assets under management in Europe have reached €2 665 trillion as of December 31 2007. This means that RI assets represent almost 20% of the total asset management in Europe. This represents a real market growth for the total RI market of 85.5% over two years. The European RI market remains clearly driven by institutional investments which represent 94% of the total EU RI market. Large, long-term institutional investors continue to help drive the development of European RI. According to the Eurosif study 53% of RI investors predict that demand from institutional investors will be the main driver for RI demand in the next three years, followed by legislative changes and external pressure from NGOs or media.

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RI as it has been developed since the 1970-s consists of screening strategies systematically impacting portfolio construction. This means ethical exclusions, often implying a values-based approach as well as different types of positive screening (Best-in-Class, RI theme funds, etc.). The most used exclusion criteria are norm-based, weapons and tobacco but we also see cultural twists - animal testing in the UK and adult entertainment in Sweden for example.

Large financial institutions moving into the RI market today, representing the mainstreaming of RI, use a broader definition of RI. For those actors RI is composed of three strategies which include simple exclusions, engagement, and integration of ESG risks into traditional financial analysis.

Institutional investors are undergoing changes: a renewed look at fiduciary duty is giving them more tools for improving investment returns. This includes a growing practice of active share ownership. Active share ownership involves steps that shareholders take when they own shares in a company, as opposed to when they sell it. The concept relies on three fundamental components; the search for long-term profitability, the long-term influence of extra-financial factors, such as ESG issues and the use of shareholders' rights, such as the right to vote and the right to ask questions.

Following investors increased stakes in international equities collaboration amongst investors can be useful because it creates clout and allows them to find allies in countries where they have smaller holdings or have less familiarity with domestic companies. Established in late 2006, the Principles for Responsible Investment (PRI) have been an important factor in facilitating collaborative engagement. Following the success of the PRI one can also expect that integration and engagement will increase in the coming years and represent larger volumes of assets.

RI has evolved considerably since the earlier part of this decade, both in terms of a greater spread among asset classes and in the different strategies being employed. To conclude, even in a downturn of the financial markets RI is expected to grow above and beyond the general market in line with the increased awareness of a need for action for a Sustainable Development.