ANNUAL REPORT 2007

SUSTAINABLE INVESTMENTS

- Sustainable investing does not hurt financial performance on a portfolio level.
- Corporations adopting “green” policies have increased their market value and improved operating performance.
- For institutional investors with sustainable investment policies, internal organisational support drives sustainable investment practices.
- New methodologies have been developed for evaluating the quality of rating data.

Sustainable evaluation criteria

In 2007, researchers in the field of Behavioural Impediments to Sustainable Investments at University of Gothenburg studied how environmental criteria from different analysis organisations correlate with natural science principles for ecological sustainability. The criteria relate to Socially Responsible Investment (SRI). Two sectors were in focus: the forestry and vehicle industries.

Many analysts use SRI criteria to determine if it is financially interesting to invest in companies, based on each company's sustainability work. We have been able to show that there is a relatively good correlation between, for example, what environment researchers consider as relevant criteria and the criteria used by SRI research service providers. The correlation is particularly clear with relation to companies that demonstrate poor environmental performance. Previously, there has been a general belief that sustainability work has a negative effect on financial performance. We find that there is no such relationship.

The results of this research have been presented in several scientific journals and a number of seminars, amongst others in conjunction with the awards ceremony when Al Gore was presented the Gothenburg prize for sustainable development in 2007. We have observed increasing interest in sustainable investment amongst private persons and some institutional investors. Therefore, our results have attracted fairly large interest.

As this work progresses, our researchers will study which environmental criteria are important amongst the various SRI research service providers for assigning high sustainability scores. We will also study how different incentive systems for rewarding asset managers (how they get paid) influence their willingness to make long-term investment decisions.

EVERT CARLSSON
Programme manager for Behavioural Impediments to Sustainable Investments (BISI) in Gothenburg

CSR – from risk to value

Companies that address environmental, social and governance issues – so-called Corporate Social Responsibility (CSR) factors – can add financial value to their business. This is illuminated by research results in a large number of reports published in 2007, by researchers contributing to the initiative Sustainable Investment Research Platform at the Umeå School of Business at Umeå University.

The results have gained the attention of actors in the financial sector. Analysts, investors and portfolio managers – and above all corporations – are beginning to notice that sustainable investing and CSR work bring added value. We in the research group in Umeå have compiled results together with the auditing company Öhrlings PriceWaterhouse Coopers in a book entitled, "CSR – from risk to value," which has achieved wide circulation.

We have shown that sustainable investing and companies' CSR work create business opportunity. The job now is to disseminate information about this to financial analysts, portfolio managers and investors, whom are all beginning to see that sustainable investments are not a waste of money bur rather investments in the future.

In addition, the research group in Umeå and its partner in Holland have succeeded in penetrating the media with their research results. In Sweden we have received a lot of coverage in both the professional and daily press as well as television.

The next step is to look closer at how investors, portfolio managers and analysts integrate CSR factors in investment decisions, and how companies succeed in integrating sustainability analysis and financial analysis in their reporting.

To date companies have perceived the value of sustainability reporting as rather low. The new Global Reporting Initiative can potentially increase the role of sustainability reporting in the financial market. We see growing interest in this type of reporting.

LARS HASSEL
Programme manager for Sustainable Investment Research Platform (SIRP) in Umeå

SRI criteria in practice

Studies from the Sustainable Investments programme indicate that SRI research service providers that rank companies based on a sustainability perspective primarily use relevant criteria in their analyses. But the tools are still missing for identifying the companies with the best environmental performance.

SOCIALLY RESPONSIBLE INVESTMENT (SRI) is one of the most common concepts in evaluations of companies' work with ethical, social and environmental questions. The problem is that there are a range of definitions of SRI, and some of them are fairly vague. "We want to find out how SRI is defined in practice in the investment community. Concretely, this is about which criteria different SRI research service providers use to evaluate companies, primarily from a sustainability perspective," says Martin Hedesström, a researcher in the Psychology department at University of Gothenburg.

The scope of the study was limited to SRI criteria related to environmental issues. In addition, the focus of the analysis was on two sectors where environmental issues are of considerable importance: the vehicle manufacture and forestry industries. Seven SRI research service providers were asked to contribute data describing the criteria they use and how they use them for ranking the companies they evaluate.

"We used a framework based on principles of ecological sustainability, and a life-cycle perspective, to compare the different SRI research service providers' criteria. We even used life-cycle analyses where the large contributions to environmental impact have been identified for each respective industrial sector," says Ulrika Lundqvist, a researcher in the Physical Research Theory division of the Energy and Environment department at Chalmers University of Technology. Based on that theoretical framework for the study, it is possible to compare how comprehensive the SRI research service providers' criteria are, from a sustainability perspective. It is also possible to compare service providers to each other and see if they use the same criteria when they define sustainability.

Ulrika Lundqvist (left) at the Physical Resource Theory division of the Energy and Environment department at Chalmers University of Technology and Anders Biel (in the middle) and Martin Hedesström (at the right) at the Psychology department at University of Gothenburg are all taking part in this research project.

The results of the study show that most SRI research service providers primarily use relevant criteria, but that there are deficiencies. For example, life-cycle analyses for the forestry industry identify energy efficiency coupled to production, including both resource use and emission levels, as well as biodiversity, as important sustainability factors. Researchers then compared the extent to which the different SRI research service providers used these criteria. "Almost all had criteria for these key factors, but, for example, one of seven had incomplete criteria for biodiversity. When it comes to energy efficiency there were also deficiencies, which is notable," says Ulrika Lundqvist.

ENVIRONMENTAL IMPACT

There are also cases where service providers use criteria for environmental impact that are not identified in the various life-cycle analyses for the sectors. "Including too many irrelevant issues creates a risk that the companies being analysed will not fully complete the questionnaires. So it is better to have few but relevant questions," says Martin Hedesström.

The comparison of service providers also revealed that they use different types of criteria. Some questions are concrete about emission levels, others are about what policies companies have about sustainability work and are more forward looking. "They are two entirely different types of questions. We are considering looking in greater detail at how questions should be formed, in order to get at aspects that create business opportunities, in addition to risk-related aspects. Forward-looking questions can be more relevant in that context. That is why it is important to differentiate between the various criteria," says Martin Hedesström.

BETTER RANKING IS DESIRED

Another important aspect of the analysis was asking the SRI research service providers to provide their respective rankings of companies in the two sectors studied. It turned out that the rankings differed considerably, except with respect to the companies with the poorest environmental performance. "If we use correlations between rankings as an indicator of the quality of the analytical tools used, it seems that the service providers were good at identifying the worst companies, but not as good at finding the companies that were average or really good from an environmental perspective," says Martin Hedesström. Therefore, the researchers want to keep going, and study why it is so difficult to identify the companies that are best. They also plan to recommend useful criteria for differentiating between companies in a better way. ■

Research on the value of sustainable investments

After two years, the research programme Sustainable Investments is presenting results that show, amongst other things, that sustainable investing is profitable. In addition, regular meetings with intended users ensure that the researchers' results can be quickly put to use.

THE RESEARCH PROGRAMME SUSTAINABLE INVESTMENTS (SI) is comprised of two sub-programmes: the Sustainable Investment Research Platform (SIRP) at Umeå University and Behavioural Impediments to Sustainable Investments (BISI) at University of Gothenburg . The researchers in Umeå collaborate with the European Centre for Corporate Engagement, which is tied to two Dutch universities (RSM Erasmus and Maastricht). The Gothenburg group collaborates with the University of Bath.

The researchers in Gothenburg are exploring barriers to more institutional owners adopting sustainability criteria in their asset management. The Umeå group focuses on financial and capital markets. SI contributes to developing better analytical tools, and is studying the extent to which environmentally-adapted investing benefits investors, companies and the environment.

FACTS: Programme Management

The sub-programmes in SI are administered by two Programme Managers and a Programme Board. The composition of the Board is intended to ensure that end-user perspectives receive active attention. The Board is comprised of four members. The Chairman is Lars Gavelin, Senior Advisor at the Swedish Ministry of Finance. The other Board members are: Inga-Lill Carlberg, Head of Private Banking Sweden, Nordea; Hans Petter Graver, the Faculty of Law, University of Oslo (until Dec 2007), John Howchin, Norges Bank Investment Management (from Jan 2008); and Helena Levander, CEO, Nordic Investor Services.

RESULTS FOR USE

SI is financed by the Swedish Foundation for Strategic Environmental Research (Mistra), which in this case is both the financer and an end user for the programme's results. Mistra has worked actively for many years to adapt the management of its assets in accordance with sustainability criteria. When this work started, Mistra quickly discovered that there was a lack of literature and research on the subject. This contributed strongly to the decision to create the SI research programme.

"Because we so actively evaluate our own asset management, we saw many problems and difficulties that we couldn't find answers to. How does one evaluate an asset manager? What are the benefits of sustainable investing? These are some of the questions that the research programme is now studying," says Eva Thörnelöf, Administrative Director at Mistra.

Mistra has invited researchers, financial analysts and asset managers to seminars on a number of occasions, in order to strengthen the connection between researchers and practitioners. Now researchers and practitioners gather regularly under the auspices of the Sustainable Investment Platform.

"For us, the Sustainable Investments Platform is a way of connecting Mistra research and asset management," says Eva Thörnelöf, Administrative Director at Mistra.

"The research programme is special, because it involves two Swedish academic centres, each of which has international collaborative partners. That stimulates the research and facilitates dissemination of the results," says Lars Gavelin, Chairman of the Sustainable Investments Board.

"Due to the continuous dialogue between researchers and intended users, SI research results are put to use relatively quickly compared to other research programmes," adds Eva Thörnelöf.

PRACTICAL BENEFITS OF RESULTS

Lars Gavelin, a senior advisor in the Swedish Ministry of Finance, is the Chairman of the SI Programme Board. He has previously worked as an analyst, broker, and portfolio manager in the fixed income and foreign exchange market. Gavelin feels that the research programme has already succeeded in shedding light on the financial aspects of sustainable investing. "It is important that the financial consequences of taking sustainable development into account become clear in the financial market. The SI programme has clarified that in most cases doing so is not associated with additional costs. Quite the contrary," he says. According to Gavelin, the big challenge in the future is to illuminate existing barriers and how they can be addressed, so that more companies and investors will work actively with sustainable investing.

During 2007 the SI programme grew, and the results have been richer and more exciting than what Gavelin expected. As examples of this he mentions the research areas from both sub-programmes. "One is about the financial aspects of sustainable investments, which the Umeå group has illuminated in collaboration with the Dutch researchers. The other area, which has been analyzed by the Gothenburg researchers, is an in-depth analysis of advisory companies working in this field; which rating criteria they use and the connection between the criteria and sustainable development," he says.

Gavelin thinks that the cooperative efforts of the Board and the researchers in the programme are working well. Programme management and the Board meet at Board meetings three times a year. He tries to meet the researchers a few times a year in addition to that. "The Board is responsible for monitoring the practical value of the research results in particular. During the year to come, when the programme approaches the end of its first phase, we will have plenty of opportunity to provide our opinions," says Lars Gavelin. ■

Creating added value in companies

Companies that integrate sustainability factors into their business can create added financial value. Sustainable investments do not have a negative influence on financial returns.

OVER THE PAST YEAR, the Sustainable Investment Research Platform at Umeå University presented several studies that show that companies that address environmental, social and corporate governance issues – commonly referred to as "Corporate Social Responsibility (CSR) factors" – can create added financial value. The researchers have collaborated with the European Centre for Corporate Engagement (a joint initiative of Erasmus University and Maastricht University) to study how so-called "extra-financial information" (for example, a company's environmental work) effects companies. Results from the studies indicate that addressing CSR factors can both create added value and, in the long-term, improve financial returns compared to companies that do not work actively with such issues.

Jeroen Derwall is a Professor at Maastricht University in the Netherlands and contributes to the Sustainable Investment Research Platform at Umeå University. He first identified the types of value that sustainability criteria can contribute to, such as increased market value, in his doctoral dissertation, "The Economic Virtues of SRI and CSR." He has extended his study of the relationship between environmental responsibility and economic returns in his collaborative work with the researchers from Umeå. In several studies, they have examined how companies' sustainability strategies correlate with their investments, as well as the extent to which sustainable investing influences their profits. But they have also explored how investors use information about a company's environmental work, and the extent to which that information influences their investment decisions. "There is definitely a positive connection between sustainable development and financial aspects. In the long run that means higher returns – and increased market value – for companies. And from our studies of how investors use information, we conclude that CSR information is a determining factor in investment decisions," says Derwall.

LOWER RISK – HIGHER RETURNS

Environmental information is often used when analysts perform risk evaluations of companies. The more a company works with sustainability criteria, the less it is associated with risk, which can result in more secure investments as well as lower capital costs. "We believe the fact that active work with environmental issues lowers risk should motivate companies to work with sustainability issues. Later on it will also contribute to better returns," says Jeroen Derwall. There are, in other words, economic incentives for companies to work to minimize environmental risks. Even investors benefit from companies that do good environmental work, because, according to several studies, the long-term development of their market value is good. Add to that that a company that works actively with social and environmental responsibility is less likely in the future to be responsible for serious environmental problems that are expensive to resolve.

"Several of our studies indicate that there is a positive relationship between a company's sustainability work and its economic returns," says Jeroen Derwall, researcher at the University of Maastricht.

The results of Derwall's dissertation and subsequent publications have received considerable attention in the media, both in Sweden and in Holland. And Derwall has received several awards for his dissertation, including the European Finance & Sustainability Research Award. "Even if some institutional investors are beginning to show increased interest in including sustainability factors in their investment decisions, the traditional finance market is still a bit cautious and wants more information and more results that indicate how sustainability factors can contribute to creating extra financial value, to be able to absorb the results," says Jeroen Derwall.

As this work proceeds, the Umeå researchers will explore in more detail which specific sustainability criteria can be of long-term value to the finance market. ■

BISI – Behavioural Impediments to Sustainable Investments

CONSISTENCY OF JUDGEMENT AMONG SRI ANALYST ORGANISATIONS

The aim is to investigate how environmental sustainability is defined within the investment community and to assess whether criteria used by SRI research service providers cover relevant aspects of environmental sustainability.

RESULTS

SRI research service providers: tend to cover relevant aspects of environmental sustainability, although some miss key indicators and some evaluate less relevant indicators. They rank companies very differently, although there is agreement with regards to the worst performers.

RESEARCHERS

Martin Hedesström, Anders Biel and Ulrika Lundqvist

INSTITUTIONAL INVESTORS' INVESTMENT DECISION MAKING

This project aim to investigate whether decisions to adhere to or reject a Sustainable Investment (SI) policy can be explained by the organisational structure and the decision-making process within investment organisations.

RESULTS

The research show that there is little evidence that social and environmental values promote SI. Organisational support is a strong driver among institutional investors that have adopted a SI policy. Institutional investors tend to underestimate the importance that individual beneficiaries place on environmental and social issues in their investments, and overemphasize the importance they place on financial returns.

RESEARCHERS

Anders Biel, Magnus Jansson, Alan Lewis and Carmen Juravle

BREAKING MAJORITY INFLUENCES IN FINANCIAL MARKETS

The aim is to better understand the mechanisms of social influence or herding in financial markets because it is believed that herding is an obstacle to the mainstreaming of Sustainable Investment practices.

RESULTS

Studies have shown that participants in experiments are influenced by the majority, irrespective of whether or not it makes accurate predictions.
The influence of the majority can be broken when it is made clear that the majority is not accurate. Conversely, under the same conditions a minority has no influence.

RESEARCHERS

Maria Andersson, Martin Hedesström and Tommy Gärling

PROPOSAL AND TEST OF DIFFERENT RECOMMENDATIONS AND FIDUCIARY MEASURES

The aim is to explore various practical issues related to the integration of sustainability issues into mainstream asset management.

EXAMPLES

This project is composed of various studies related to issues that have been identified in other projects within the programme. One study tries to determine the optimal stopping times and potential deviations from the benchmark index for portfolio managers depending on how they are "incentivised.". Another study explore company behaviour from how company equity is being traded.

RESEARCHERS

Evert Carlsson, Hong Wu and Conny Overland

CSR VS. FINANCIAL PERFORMANCE

This project aim to determine the extent to which sustainability ratings explain and predict the financial performance of corporations. We have developed a methodology (based on advanced statistical learning techniques) that can be applied to any rating data, which determines the extent to which the ratings contain.

RESULTS

Corporate Governance and Codes of Conduct scores contribute to explaining and predicting profitability.
There is strong evidence of non-linearity in the relationship between traditional as well as CSR variables and asset returns. Non-linearity seems to be of lesser importance in predicting stock returns.
The methodology has been used to analyse data on Corporate Social Responsibility (CSR) issues from the Sustainable Asset Management (SAM) Group in relation to profitability (measured as return on assets) and stock returns.

RESEARCHERS

Catalin Starica, Cristiana Manescu and Constantin Belu

For more information:
www.sustainableinvestments.se

SIRP – Sustainable Investment Research Platform

SUSTAINABLE INVESTMENT AT THE PORTFOLIO LEVEL

To estimate and understand how risks related to environmental, social and governance (ESG) factors are assessed and priced in the financial market.

RESULTS

Various studies on mutual funds, fixed-income funds and self-composed portfolios indicate that ethical investment funds and portfolios do not under perform. Investors can allocate their money to ethical funds without a financial penalty.

RESEARCHERS

Rob Bauer, Robin Braun, Jeroen Derwall, Kees Koedijk, Rickard Olsson and Ian Hamilton

For more information:
www.sustainableinvestments.se and www.sirp.se

CSR OR ESG AND FINANCIAL OUTCOMES ON THE FIRM LEVEL

To deepen the understanding of the economic value of CSR and ESG factors. We want to understand whether CSR practices improve a firm's profitability and if financial markets value corporate social responsibility.

RESULTS

Eco-efficiency relates positively to operating performance and market value. The inherent environmental risk of an industry is, in line with the risk-return paradigm, positively related to operating performance, but negatively related to the market value of companies when studying industries with different social norms. Environmental preparedness and performance are both significantly and positively related to the market value and operating performance of US companies.

RESEARCHERS

Robin Braun, Gary Cunningham, Jeroen Derwall, Lars G. Hassel, Tommy Lundgren and Henrik Nilsson

THE ROLE OF ESG INFORMATION FOR FINANCIAL ANALYSTS

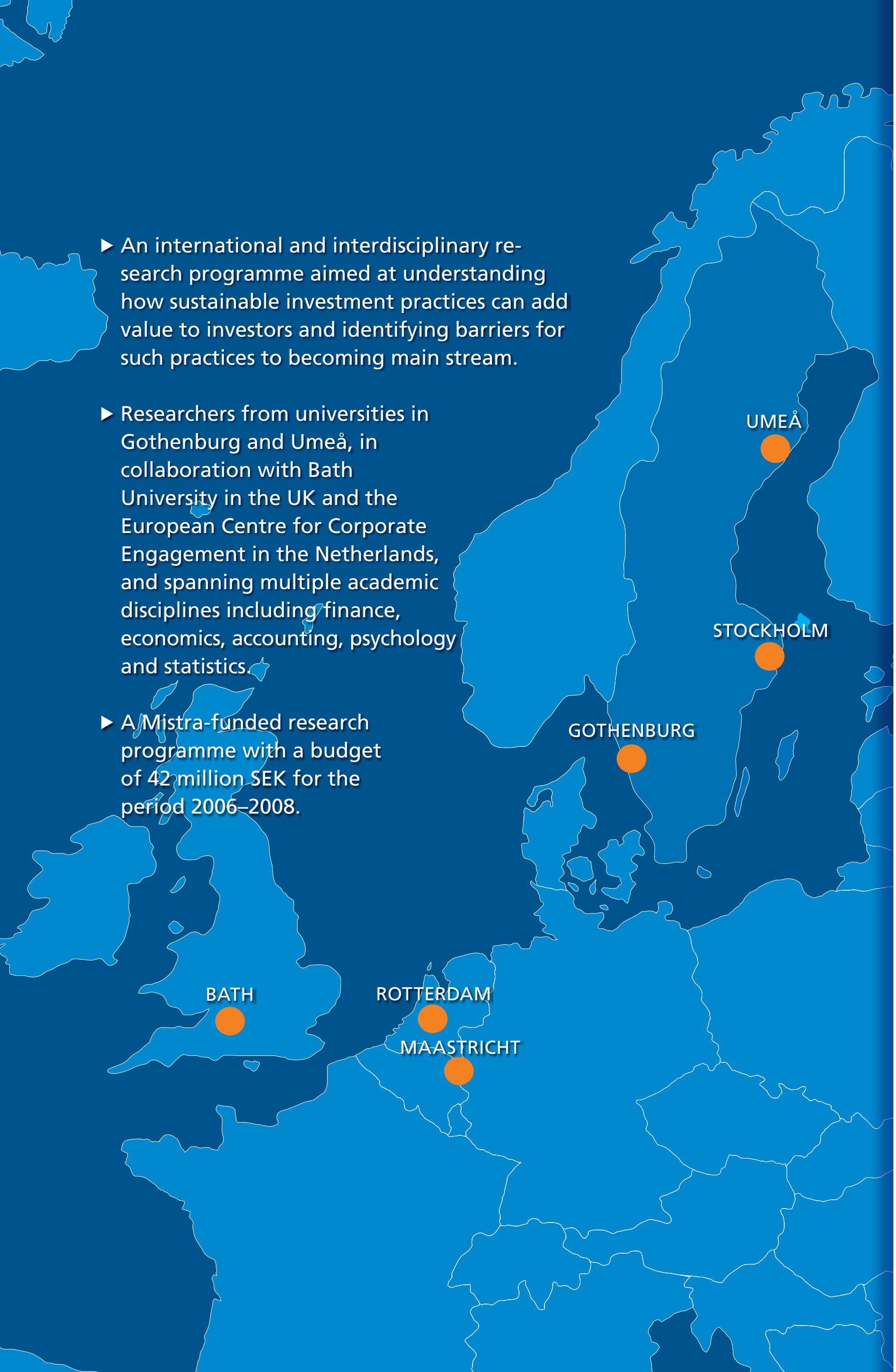
To better understand how financial analysts incorporate environmental social and governance (ESG) issues into their analysis, valuation and investment decisions, and to find out how environmental information is reported together with financial information.

RESULTS

Corporate governance is the most important factor for analysts. Analysts believe that ESG information has a higher impact on brand and reputation than on market value or financial performance. Companies that score high on ESG criteria seem to be rewarded with premium valuations.

RESEARCHERS

Rob Bauer, Gary Cunningham, Jeroen Derwall, Lars G. Hassel, Henrik Nilsson and William Jaworski



- An international and interdisciplinary research programme aimed at understanding how sustainable investment practices can add value to investors and identifying barriers for such practices to becoming main stream.
- Researchers from universities in Gothenburg and Umeå, in collaboration with Bath University in the UK and the European Centre for Corporate Engagement in the Netherlands, and spanning multiple academic disciplines including finance, economics, accounting, psychology and statistics.
- A Mistra-funded research programme with a budget of 42 million SEK for the period 2006–2008.

For more information:
www.sustainableinvestments.se

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