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Sustainable Investment Research Platform

SIRP
Sustainable Investment Research Platform

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THE SWEDISH FOUNDATION FOR STRATEGIC ENVIRONMENTAL RESEARCH

Sustainable Investment Research Platform

The Challenge

AN INCREASING NUMBER of actors in the financial market are working on integrating the environment, social aspects, and corporate governance issues into their investment processes and decisions.

At SIRP, we research such issues as how institutional investors and, in particular, pension funds can create economic added value through sustainable asset management and also the obstacles that impede the adoption of this kind of management. As owners, institutional investors possess the necessary power to drive companies towards a more sustainable development.

There may be a multitude of obstacles, one of which relates to uncertainty about the financial consequences of a sustainable and responsible investment strategy. This poses the question whether sustainable investments can be expected to yield an economic return and, if so, within what kind of timeframe. There may also be organizational obstacles if there is a lack of consensus among different levels of organisations as to crucial values and the responsibility that should guide their operations.

Moreover, the strictly financial character of managerial responsibility and the short-term perspective of evaluation and reward mechanisms are obvious obstacles, while there is also an inadequate supply of sustainability data from companies, which could be incorporated into the analysts' recommendations and the managers' decisions. As a result, sustainable investments run the risk of being excluded from important objectives or issues on the agenda, which will have consequences for future development.

Our Contribution

The objective of the programme is to draw up guidelines on and recommendations for sustainable investments so that these can form a part of the fiduciary responsibility of the pension funds. We evaluate sustainable portfolios and their restrictions on managers and also include bonds, venture capital, and properties as sustainable investment objects.

The programme examines how investors use such information about sustainability and analyses companies based on their economic, social, and environmental performance.

Particular attention is devoted to the manner in which the managerial responsibility of the pension funds could be reviewed and changed from the short-term financial perspective so that it also includes longer-term issues of responsibility. Such a change can also help reduce the systemic risks that exist in the financial market with regard to the short-termism of evaluation and reward mechanisms.

A parallel study is made of how corporate profitability and the outcome for institutional investors would be affected were they, in their investments, to take into account the companies' adaptation to sustainable development.

All the knowledge from these studies will provide a basis for a more developed and coherent theoretical construct for sustainable and responsible asset management. The programme also seeks to develop draft guidelines for greater transparency in accounting and management, for individual companies, assets managers, and, in particular, pension funds, among institutional investors.

Benefits of what we do

The knowledge generated within the programme benefits both institutional investors and analysts and those who monitor operations as well as a higher degree of corporate preparedness for a more sustainable development.

Among investors, the primary target group is asset owners and managers who want to adopt sustainable investment strategies in the future. Finally, the programme is expected to contribute to research within such academic disciplines as finance, accounting, law, economics, business management, and psychology. In the longer term, it is hoped that it will benefit the natural world and future generations.

Contents

The field of sustainability and finance is exciting, diverse and ever-changing

IT SPANS A MULTITUDE of issues and academic disciplines, from the quantitative analysis of the relationship between the sustainability performance of companies, their financial performance and the financial performance of investment portfolios that include those companies; via the interactions between companies' business strategies and public policy on issues such as climate change; to the social, cultural and legal factors that determine the way that investment institutions and those who govern them frame their strategic approach to the issues.

This is what makes it so interesting being a member of the Program Board of SIRP. The research teams within the programme are investigating all these dimensions. The challenge for the management team and the Program Board is to join the dots – to see the connections and ensure the bigger picture stays in focus.

A particular area of interest for me is the way pension trustees make their decisions about sustainability. Although pension funds' legal duties are broadly the same throughout the world, pension funds in some countries are far more active on sustainability than others.

Funds in Sweden and the Netherlands, for example, take a particularly strong interest. It is large asset owners like pension funds that will drive the market for sustainability-focused investments. The faster and farther they move, the closer financial markets as a whole will move towards sustainability.

I hope that SIRP will be able to continue the good work it is already doing in this area and help to accelerate the process.

Rob Lake
BOARD MEMBER SIRP
HEAD OF SUSTAINABILITY AND GOVERNANCE
APG ASSET MANAGEMENT

Keen Interest in a study on Fraudulent Behaviour

Henrik Nilsson's study on "Personal Character and Firm Performance. The Economic Implications of Having Unethical Board Members" received much interest during 2010. His research was very well received in both financial institutions and the media.

HENRIK NILSSON'S STUDY showcases unique proprietary data on criminal records of Swedish listed company board members. The study reveals that a significant proportion, 22 per cent, of board members in Swedish listed firms have been convicted of crimes. Henrik Nilsson and his co-authors Eli Amir, London Business School, and Juha-Pekka Kallunki, University of Oulu, propose and support with evidence the claim that criminal convictions and other proven, dishonest behaviour impair the boards' ability to monitor and advise the firm's management.

They find that the greater the proportion of unethical board members, the lower the profitability and the higher the volatility of earnings and cash flow. They also find that firms with a greater proportion of unethical board members have lower earnings.

Finally, they find that board members exhibiting unethical behavior are more likely to be male than female. Their results suggest that committees, which nominate board members, should consider the individuals' ethical background and behaviour.

In September, SIRP arranged a very well attended seminar at Nasdaq OMX. After Henrik Nilsson's presentation there was a lively discussion between the audience and the panel, which included Magnus Billing, Chief Counsel Europe, Nasdaq OMX, Helena Levander, Managing Director Nordic Investor Services, and SIRP board members with Lars Hassel, program director of SIRP.

Henrik Nilsson, who is affiliated with the Stockholm School of Economics, is now conducting a study on the correlation between unethical behavior and CSR, which will be presented during 2011.

For more information about "*Personal Character and Firm Performance. The Economic Implications of Having Unethical Board Members*" see www.sirp.se/publication cast horizons. The returns on SRI portfolios can be driven by superior stock-return surprises of leading ESG firms regarding their earnings announcements.

Research also documents how annual abnormal returns react negatively to current and past negative ESG rating revisions in a KLD panel data set by spanning a long time series. Similar results are found in the credit market, where research suggests that the credit worthiness of borrowing firms is affected by the potentially costly legal, reputational, and regulatory risks associated with environmental incidents.

Research on the property market and energy efficiency suggests that energy efficiency and sustainability have a distinct influence upon the risks and returns associated with institutional property investments. Besides the fundamental value drivers, investors need to identify and integrate elements of environmental sustainability in property investments. The evidence provided shows that energy efficiency improvements in commercial and residential buildings are capitalized at the time of sale.

Research on private equity investments demonstrates how venture capital financing for early-stage investors and related investment funds can help to catalyze the growth of companies developing new sustainable ventures. To support sustainable investments for economic growth, research includes private equity investments in young entrepreneurial firms that are developing new sustainable technologies.

- SRI returns are different in values-driven and profit-seeking segments.
- SRI returns are related to errors in analysts' forecasts.
- Leading ESG firms have more positive earnings surprises.
- Tracking errors of optimized sustainability funds are lower than benchmarks.
- Portfolios can be constrained by ESG criteria without economic losses.
- Risks associated with environmental incidents are priced in equity and credit markets.
- ESG quality can shield stocks from macro-incidents.
- Improved energy efficiency in commercial property leads to higher rents and sales prices.

Programme Objective

The objective of the Sustainable Investment Research Platform is to find out how sustainable investment practices can create added value for institutional investors and identify barriers to mainstreaming such practices.

Research Areas

To support the objective, research is conducted in four areas: Sustainable Investments and Markets, Sustainable Companies and Ratings, Incentive Systems, and Fiduciary Duty.

Sustainable Investments and Markets

Sustainable investment portfolio analysis in equity markets evaluates financial outcomes with a focus on long-term sustainability issues. The research approaches the task of constructing optimal sustainable investment portfolios from relevant perspectives for investors and portfolio managers. An examination of other asset classes of venture capital, real estate, and credit markets and the implications sustainability has for these markets is also on the agenda.

The research represents a comprehensive review of SRI performance in equity markets with a specific focus on the individual criteria of ESG and ethical screens underlying SRI in order to better understand the return and risk features of different SRI strategies. The results demonstrate that a better understanding is needed of investor preferences.

Ongoing research documents that differences in SRI returns are generated by market segments of '*values-driven*' investors or '*profit-seeking*' investment choices with different investor preferences. For alpha-seeking investors, the objective of the research is to show how the returns on SRI relate to the earnings forecast accuracy of leading versus lagging ESG firms over different fore-

Sustainable Companies and Ratings

Companies and investors require both long-term and forward-looking ESG performance metrics. The quality of existing ESG company ratings can be improved to be useful for not only ESG/SRI rating agencies, but also financial analysts and investors, with recommendations to address future-oriented environmental evaluation criteria. When the concept of sustainability is made operational in analyses of companies' sustainability principles, impact categories, future-versus present-oriented criteria, data availability, the number of criteria, the basis for comparison, the weighting of criteria, and sector-specific criteria need to be included. The dominating pattern among ESG rating agencies is that criteria are labeled in terms of risk, and it is less common to define criteria in terms of opportunities. The link between technology and sustainability criteria is sector specific.

The sustainable value-driver network provides a new framework for practitioners to identify how and where sustainable value is created at a company level relative to their peers. Building on this network, companies can develop sustainable value-creating strategies. In addition, the value-driver network allows practitioners to analyse and identify different effects in eco-efficiency performance over time. The return-to-cost ratio and the effect analysis allow managers to identify and quantify the drivers behind changes in corporate eco-efficiency. It also translates eco-efficiency into managerial terms by applying the well-established notion of opportunity costs to eco-efficiency analysis.

At a sectoral level, the research seeks to enhance the understanding of the fundamentals of the sustainable development of Swedish industrial firms when it comes to economic growth, technological change, and the development of the ecological footprint. Sustainability is specifically addressed by linking the economics of a Swedish industrial firm to its long-term impact on the environment in terms of CO_2 emissions. Longitudinal studies on Swedish industry show that the static effects of the CO_2 tax on technological progress are negative, but considering dynamics suggests that there may be limited long-term efficiency gains in some sectors, especially for relatively inefficient firms.

- Sector-specific, future-oriented, and long-term ESG criteria are developed.
- Alternative measures of corporate eco-efficiency are being carried out.
- Efficient online data collection for GHG emissions.
- Gaps and inconsistencies in GHG emission reporting have been identified.
- Financial analysts include risk-oriented ESG information in reports.
- CO_2 tax reduces technological progress and increases costs in most sectors.

Incentive Systems

The tendency of pension plans to prefer short-term investments runs counter to the effects of long-term ESG factors. Capital allocation decisions by asset management are guided by a short-term perspective that potentially leads to systemic risks in the market. Sustainability factors are long-term value drivers. When an investment culture is focused on short-term outcomes, it may produce investment analysis that fails to uncover relationships between the financial success of environmental sustainability and social equality.

In the programme, studies on incentive systems are conducted regarding how asset managers' investment decisions are affected by how they are monitored and act upon the incentives provided. Counteracting short-termism in the finance sector is expected to help organisations to manage their operations in ways that are more closely aligned with sustainable development.

Sweden provides a good example of a widespread practice to provide incentives for portfolio managers based on short-term financial performance. Bonuses are predominately based on one-year intervals. If longer-term bonus components are offered, they are generally of an insignificant size.

A series of experiments demonstrate how long-term bonuses become equally as attractive as short-term

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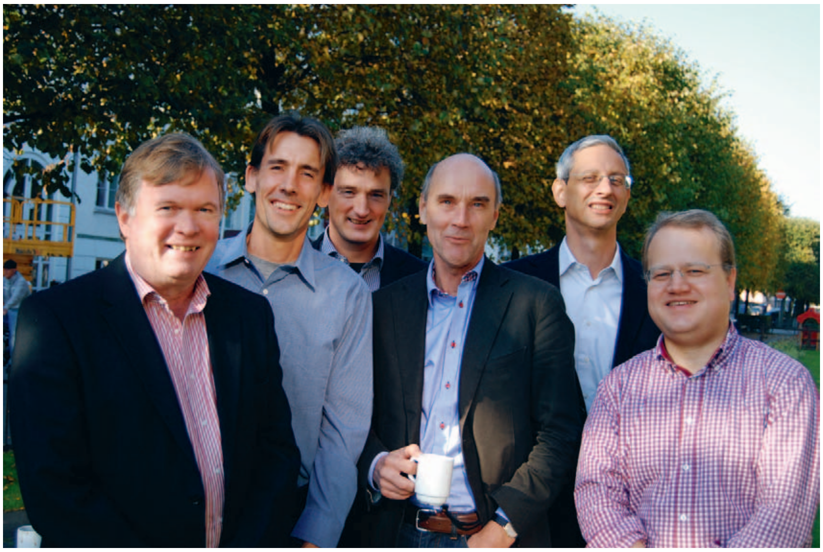

SIRP Management Group
Lars G. Hassel Programme Director
Pontus Cerin Umeå School of Business
Rob Bauer University of Maastricht
Anders Biel University of Gothenburg
Stefano Herzel University of Rome
Frank Figge Queen's University

bonuses and what negative effects on performance short evaluation intervals have compared with longer evaluation intervals. The main conclusion from previous experimental research is that people generally prefer to reap immediate benefits, in that short-term bonuses paid out every year are preferred to a nominally equally large long-term bonus.

It is also shown that shorter evaluation intervals lead to worse performance than longer evaluation intervals since the investors fail to detect long-term price trends. Counteracting short-termism in the financial sector is expected to benefit organisations that manage their operations more closely aligned with sustainable development. Showing that short-term bonuses cause myopic investment decisions with inferior outcomes should be a strong impetus for institutional investors to make their bonus systems long term.

- Bonuses are predominantly short term and in line with managers' preferences.
- Short-term evaluation intervals lead to lower performance when long-term price trends are neglected.
- Uncertainty about the future weakens preferences for short-term bonuses.
- A strong impetus exists to extend monitoring and incentive intervals.

Fiduciary Duty

Legal frameworks and their interpretations are crucial in determining if fiduciary responsibility to beneficiaries allows policies that may sacrifice financial returns for environmental or social causes. This is compounded by the belief that they cannot secure the best returns of their fiduciary obligations with current socially responsible companies.

SRI faces the challenge to integrate environmental and social issues and values alongside the financial requirements of the beneficiaries. As the market matures and progresses, SRI has to move towards more sophisticated means of addressing the perceptions and values of its beneficiaries. Such a development can demand a revision of the current legislation on fiduciary responsibility. Norms-based screening, followed by exclusion or engagement, is an example of how sustainability-related issues and values have been incorporated in the Nordic countries.

One important precondition for the effectiveness of SRI practice is that the dominating sustainability-related issues and values of the beneficiaries are known and respected. Differences in the values of beneficiaries and financial professionals constitute in this context an important obstacle to the inclusion of the beneficiaries' values. Where the values of beneficiaries and finance professionals differ, the latter consequently have to take decisions that differ from their own set of values.

The programme sheds light on this important, but as of yet under-researched, area. It looks at both core values of beneficiaries and financial professionals as well as prioritizations of key sustainability-related issues. In the first phase, large-scale surveys have been conducted in the private SRI market to proxy for beneficiary values that have influenced, or can influence, the decision making of different segments among SRI clientele.

- Legal frameworks hinder efficient sustainable investing within present fiduciary duty.
- Different segments in the private SRI market have been identified.
- Female investors with no financial advisor are more likely to buy SRI funds.
- Swedish pension funds have different SRI strategies.
- Shareholders can actively use litigation to discipline management in corporate control.

Corporate Sustainability – more than environmental awareness

Swedbank is one of the major banks in Sweden and has a reputation for its interest in sustainability. Swedbank Robur is Swedbank's fund management company. They manage assets close to 80 billion euros which include a large number of sustainable mutual funds.

IN 1997 ANNA NILSSON started to work for Föreningssparbanken's mutual fund company (later transformed into Swedbank Robur) conducting analysis for their sustainable investments. At that time sustainable investment was only related to environmental issues. Today the scope is much broader, including human rights, labour rights and business ethics.

UN PRI's principles for responsible investment focus on the incorporation of ESG issues into ownership activities and the decision-making processes of analysts and investors, as well as fostering integrated ESG-reporting (environmental, social, governance) at company level. For Swedbank Robur, pro-active collaboration with the companies in which they are investing is one of the main activities.

"As an institutional investor we have a duty to act in the best long-term interests of our beneficiaries. We are a part of Swedbank, the people's bank, and we strongly believe that people not only want good return on their assets but are also interested in how we invest and if their money is doing good", says Anna Nilsson.

Anna Nilsson and her three colleagues continuously study more than 150 Swedish companies and 1 500 foreign companies, for which they sub-contract the basic external analysts. Ten years ago the most common way to work with sustainable investments was to exclude companies that didn't reach the minimum level of environmental standards.

Nowadays, however, the focus for Anna Nilsson and her colleagues is to include not exclude. They look for the companies working most proactively with their sustainability risks and opportunities; what commitment and targets does the company have and what results have been reached regarding product development, transportation, production processes and the supply chain? The analysis is done on environmental issues, human rights, labour rights and business ethics. "I'm not a big fan of only using norm-based screening, that is to say, to focus on what kind of mistakes the company already has made. Instead we prefer to work proactively and engage with the company so that incidents are avoided. We want them to identify the risks before they materialise and we want to be seen as a catalyst for the company in their work for sustainable growth," says Anna Nilsson.

Starting out as a separate part of Swedbank Robur, Anna Nilsson's group is now more involved in the everyday decision-making of the investment process.

Anna Nilsson. Photo: Jann Lipka

"We have seen an increased interest in environmental and social issues among our financial analysts and portfolio managers. It's not only about identifying future risks and problems that can affect our investments, but also about discovering future investment opportunities," says Anna Nilsson.

To screen potential investments that can add value to the portfolio, companies with an environmentally and socially proactive strategy for process and product development have the potential to be included in the portfolio. Integration can make sustainable investments profitable.

The reports done by Anna Nilsson's group are not made public. They are only shared with the financial analysts and portfolio managers within Swedbank Robur and used for the benefit of Swedbank Robur´s clients. According to Anna Nilsson, it is all about credibility.

"But we want to improve the communication to our clients about our work within to sustainable investments field, how we decide and why and what efforts we have made in improving companies' sustainability work," says Anna Nilsson.

"When it comes to sustainable investments I have never been as hopeful as I am now. But we still have great challenges to meet in the world, for example the fight against poverty. To encourage and develop environmentally and socially sound production is especially important as more production is moving to emerging markets," concludes Anna Nilsson.

Awards

Daniel Hann and Rob Bauer. Photo: Sacha Ruland

During 2010, several awards have been given to researchers in SIRP for their outstanding research.

DANIEL HANN and **ROB BAUER** at Maastricht University were awarded the Moskowitz Prize for their study on *"Corporate environmental management and credit risk"*.

Companies that maintain high environmental management standards pay significantly less interest on their bonds than companies that do not pay much attention to environmental issues. For corporations, this can amount to a reduction in the annual cost of debt by several million euros per bond issue.

The study investigates the relation between the environmental profile of firms and key measures of their credit risk (i.e., bond spreads, credit ratings). The results indicate that in particular the association between environmental concerns and the credit risk measures is statistically significant, but also provide first evidence that a proactive environmental engagement is linked to a lower cost of debt financing.

Although this study focuses on US corporations (between 1995 and 2006) the findings are also expected to apply to corporations that are based in countries with comparable environmental regulations and media influence.

JOAKIM SANDBERG, a research fellow in philosophy at the University of Gothenburg, won a Highly Commended Paper Award at the International Conference on Corporate Governance in June. The theme of the conference was Corporate Governance and Sustainability. Joakim Sandberg's paper was entitled *"Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective"*.

Joakim Sandberg received the award from the presenter Sir Adrian Cadbury, a celebrity in corporate governance. As former Chairman of Cadbury Schweppes, Director of IBM and Bank of England, Sir Cadbury has been a pioneer in raising the awareness on corporate governance. He has also produced the Cadbury Code, a code of best practice which has served as a basis for reform of corporate governance around the world.

Joakim Sandberg and Sir Adrian Cadbury. Photo: Chris Mallin

Paul Smeets.
Photo: Wim Smeets

At the PRI Academic Conference in Copenhagen, several researchers from SIRP were awarded for papers of excellence on responsible investment. **PAUL SMEETS**, PhD student from Maastricht University, received the Student Awards for his paper on "Social Values and Mutual Fund Clienteles". Furthermore, the paper Sustainability and the Dynamics of Green Building, by **NILS KOK** and **PIET EICHHOLTZ** from Maastricht University was selected as a winner of the Academic Award.

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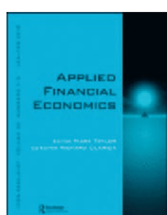

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A profound interest in sustainability

Rob Lake, Head of Sustainability and Governance at APG Asset Management in the Netherlands, is a well-known person in sustainable investments. He began his career in sustainability working with charitable organisations supporting the environment and international development.

AFTER 14 YEARS at NGOs (non governmental organisations) such as Friends of the Earth, Traidcraft and the RSPB, Rob Lake became the Head of SRI strategy at Henderson Global Investors in 2000.

"Actually, the work I did at Henderson and now at APG is surprisingly similar to the work I did at the NGO's; I work with companies and try to persuade them to improve their environmental and social performance. I believe that the extent to which business can offer solutions to some global problems is significant," says Rob Lake.

APG is an investment manager for pension funds, primarily Dutch pension funds, and manages pension assets of nearly 270 billion euros.

According to Rob Lake, environmental, social and governance issues are closely linked to the financial performance of investments. For example, climate change can have far-reaching consequences for investments in terms of opportunities and risks. Clients also require APG to be a socially responsible institution.

"It is my perception that ordinary people expect a high social responsibility of their pension funds. Of course, they have high expectations on returns but also that their money is invested in sustainable investments. This is a driving force that interests APG," says Rob Lake.

APG has a large portfolio with investments in the largest as well as the smallest listed companies in the world. Their portfolio includes real estate, infrastructure hedge funds and agricultural land in South America, Europe and Australia. Therefore their approach differs according to the type of their diverse investments.

Rob Lake and his colleagues often call companies to account for their behaviour and regularly discuss sustainability and good corporate governance. For example, they have ongoing talks with BP where they have asked them to build more check-points and top-down supervision into its operational control procedure to improve safety.

"We are constantly looking for interesting sustainable investment opportunities, like energy-saving technologies. We also monitor how the companies in which we invest score in the field of sustainability and corporate governance and whether they continue to act in accordance with the principles of the UN Global Compact" says Rob Lake.

According to Rob Lake, there is not necessarily a conflict between the concept of fiduciary duty and sustainable investment. Fiduciary duty means that investors have to focus first and foremost on financial return. But the good

Rob Lake. Photo: APG Asset Management

news for sustainability is that in some cases environmental issues are indeed relevant to investment decisions. For example, a company's CO_2 emissions can affect its profits now that CO_2 has a price in the EU, so greener companies might be more successful financially.

The BP oil spill in the Gulf of Mexico in 2010 also powerfully demonstrates that a 'non-financial' issue, in this case safety, can have far-reaching financial implications. Eleven people died and 17 were injured in the explosion on the drilling rig; the social dimension of sustainability is sometimes strongly linked to investors' financial interests.

Sometimes, however, there is no overlap between sustainability and the duties of investors. For example, it is in a company's financial interest to reduce its energy use, and therefore its costs.

Cutting energy use reduces emissions, of course. But if cutting energy use means the company needs to invest more in new equipment than it can save on energy bills, there is no incentive to act. Here fiduciary duty, pursuing investors' financial interests, is not aligned with environmental sustainability.

"Leading investors take challenges stemming from climate change very seriously. These investors expect climate change to impact their investments and they are striving to integrate climate considerations into their investment strategies – especially when it comes to the longer term. They believe that climate change exposes companies, and therefore investors, to new risks including financial, physical and political risks. They also believe that climate change will create new markets and business opportunities, and they are preparing to take advantage of these opportunities," says Rob Lake.

Both APG and its clients have realized the value and importance of sustainability. In 2007, when Rob Lake started at APG, he was the only person looking at this area. Now he leads a team of nine people, including one based in Hong Kong.

"We cannot just focus on allocating money towards renewable energy investments. We have to manage the risks and take advantage of the opportunities that emerge from climate change in all our investments. Considering climate risks should be part of mainstream investment analysis", says Rob Lake.

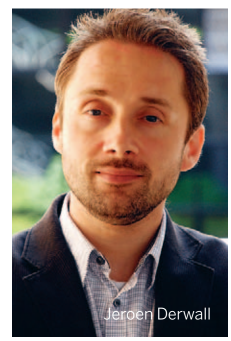
Working for APG requires meetings with companies around the world. Since starting at APG Rob Lake and his wife Fiona have lived in Amsterdam, but they frequently visit London at weekends. Their children, a grown-up son and daughter, are both very talented artists in sculpture and painting. The Lakes enjoy going to exhibitions showing contemporary arts and listening to Bach, especially the motet *Furchte Dich nicht, Ich bin Bei Dir*, which they find very relaxing. If any music could be called 'sustainable', Bach would certainly be a contender.

Projects

Sustainable Investments and Markets

Sustainable Investment Portfolios

Jeroen Derwall and Kees Koedijk


Jeroen Derwall

Aim To analyze the risk/return implications of integrating ESG issues into equity investment portfolio management.

Results We show how the returns on SRI relate to errors in analysts forecast of socially responsible firms' future earnings over short- and long-term forecast horizons, and how returns on SRI portfolios are driven by superior stock returns of socially responsible firms around their earnings announcements.

Benefits for practitioners The research will help investors understand how certain ESG factors influence the performance of their investment portfolios and the potential trade-off between ESG objectives and financial goals. We provide insights into the feasibility of SRI/ESG as being "values-driven" in comparison with the traditional alpha-driven approach. We also demonstrate how "values-driven" SRI/ESG can be implemented in terms of investment decisions and SRI screening methods.

Sustainable Investment Portfolio Performance and Tracking Error

Rickard Olsson

Aim To investigate if portfolio optimization techniques can reduce tracking error (TE) of sustainable equity portfolios while maintaining performance and sustainability, the latter expressed as average sustainability rating of portfolio holdings.

Results Minimal TE increases with sustainability. Optimization reduces TE relative to equal- and value-weighting of portfolios, especially for higher levels of sustainability. The TEs of optimized sustainable portfolios are lower than those of typical US sustainable equity funds with similar benchmarks/universes.

Benefits for practitioners High TE is perceived to be an impediment to sustainable investing among practitioners, but optimization seems capable of markedly reducing TE without sacrificing sustainability or performance. The results on how minimal TE varies with portfolio sustainability should be useful for setting investment goals and performance evaluation.

Changes in ESG Ratings and Abnormal Returns

Cristiana Manescu and Catalin Starica

Aim To show if ESG information is an "alpha driver" or an "exotic beta driver."

Results We find that only declines in less responsible behaviour, as measured by KLD ratings, led to persistent negative abnormal returns, which were particularly strong for the corporate governance dimension, and weaker for product safety and the environment.

Our results are robust to endogeneity concerns, as a potential reversed feedback mechanism by which KLD ratings are revised as a consequence of stock returns performance, a standard criticism in similar studies, has been carefully controlled and corrected for.

Benefits for Practitioners Information on ESG is relevant to investors only to the extent that the information refers to negative ESG events. Information on positive ESG events does not drive alpha. Consequently, the aggregation of CSR dimensions and event types into single CSR indices might obscure relevant information.

The Latent Link between Financial Returns and ESG Scores


Elena Stanghellini

Stefano Grassi, Marco Nicolosi, Elena Stanghellini and Catalin Starica

Aim To understand the relationship between CSR scores and measures of financial performance by modelling both of them as expressions of latent dimensions measuring the firm's social responsibility.

Results We implement a statistical model (Item Response Model, IRM) that captures the ability of each firm to comply with ESG factors in the KLD dataset. The model measures the CSR ability of a firm by taking into account that the challenge to fulfil the social responsibility standards depends on the ESG dimensions and on the industrial sector where the firm operates. The latent dimension model seems to outperform traditional models on the direct relation between ESG and company financial performances.

Benefits for Practitioners The latent dimension model is able to capture the link between ESG and financial performance where leading ESG firms demonstrate higher financial performance than those companies that are less environmentally focused.

Portfolio Management with CSR Constraints

Stefano Herzel, Marco Nicolosi and Catalin Starica


Stefano Herzel

Aim To study the impact of different types of sustainability constraints on the mean variance efficient frontier.

Results Investors can constrain their investment portfolios by applying CSR criteria without significant losses (in terms of adjusted expected returns).

Benefits for Practitioners This research helps to quantify the impact over time of different kinds of social screening. It is important for an investor who wants to exclude some assets from his or her portfolio because they do not satisfy some responsibility criteria and also gives an estimated cost of such an exclusion.

Macroeconomic Events and Stock Market Reactions

Leonardo Becchetti, Rocco Ciciretti and Stefano Herzel

Aim To study the effects of unexpected macro news on CSR and non-CSR stocks.

Results The stock market reaction to the Lehman Brothers filing for chapter 11 shows a move towards to CSR-quality. The reaction to the Lehman event extends beyond the event date and implies that investors rationally attribute more value to the direct information on strengths and weaknesses in each CSR rating domain than to affiliation/non affiliation to the Domini CSR stock market index. The weaker signal of the Stock Index depends from its total number of constituents which inevitably creates a (shadow) waiting list of stocks with good CSR attributes. Companies cannot enter the Index unless one of the current constituents loses its place. We verify empirically that non-Index affiliated stocks with high CSR standard still register a positive effect.

Benefits for Practitioners Investors seem to discover after the event that CSR ratings perform a crucial role in financial markets by providing original information which is not captured by traditional financial rating indicators.

Sustainability and Commercial Property

Piet Eichholtz and Nils Kok

Aim To assess the extent to which sustainability and energy efficiency have financial implications for institutional investors and to investigate the optimal corporate governance structure of property investments.

Results The project has documented the value of sustainability in commercial property and has developed an environmental scorecard for institutional investors to investigate the environmental performance of their real estate investments. The project has also assessed the effectiveness of corporate governance in listed property companies.

Benefits for practitioners This project demonstrates that energy efficiency improvements in commercial and residential buildings not only lead to higher rents, but they are also capitalized at the time of sale. This facilitates decision-making on investments in energy efficiency. The environmental scorecard allows investors to implement a socially responsible investment policy for real estate investments.

Sustainable Venture Capital Markets

Anders Isaksson


Anders Isaksson

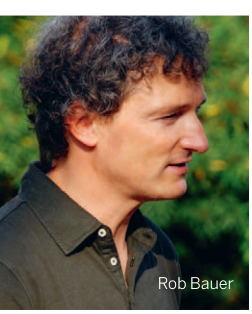
Aim To research how early stage investors (e.g. venture capital, VC) and investment funds can help catalyze the growth of companies developing new sustainable technologies (e.g. cleantech).

Results Investments in clean technologies is one of the largest growing investment sectors for venture capital investors. The VC Industry in general is still lacking systematic approaches for ESG considerations. The research also shows that entrepreneurs (ecopreneurs) might be driven by different values and motives than traditional entrepreneurs and therefore risk for value gap.

Benefits for Practitioners Guidelines for sustainable investments is being developed in cooperation with practitioners. Better understanding of the problems facing early stage sustainable investors for policymakers and entrepreneurs.

The Role of ESG in Credit Markets

Rob Bauer, Jeroen Derwall and Daniel Hann


Rob Bauer

Aim To analyze the credit risk implications of corporate ESG practices.

Results Firms with strong employee relations have a statistically and economically lower cost of debt financing, higher credit ratings, and lower firm-specific risk. Moreover, firms with poor environmental practices are shown to have a higher cost of debt financing and lower credit ratings than firms that engage in proactive environmental activities. We also show that this effect is not restricted to high-risk industries and has become stronger over the last decade.

Benefits for Practitioners Our research produces evidence that specific environmental and social practices are reflected in the pricing of corporate debt. The identification and evaluation of such practices can help enhance bond pricing accuracy, provide better guidance for risk managers, and influence capital decisions.

Sustainable Companies and Ratings

Improving Measurements of Companies' Environmental Performance

Anders Biel, Ulrika Lundqvist, Sofia Poulikidou and Joakim Sandberg


Ulrika Lundqvist

Aim To provide ESG rating agencies with recommendations and to address future-oriented environmental evaluation criteria.

Results Criteria used by ESG rating agencies tend to be labelled in terms of risk rather than opportunities. We have established links between technologies and environmental impacts in the automobile industry. Our analysis shows that unsupported variations in weighting criteria that are presently used to evaluate environmental impacts play a decisive role.

Benefits for Practitioners Redirecting the focus from present-oriented towards future-oriented evaluation criteria will support institutional investors in identifying investment opportunities. This may also provide a better basis for positive screening practices.

Value-Based Sustainability Analysis of Nordic Companies

Ralf Barkemeyer, Breeda Comyns, Frank Figge, Zoe Foss-Jones, Tobias Hahn and Andrea Liesen

Aim The main aim in 2010 was to start assessing Nordic companies in the Forest sector using the Sustainable Value approach and to further develop and enhance the necessary tools for a wider application.

Results We have developed and applied a Sustainable Value Driver network analogously to Rappaport's Shareholder Value drivers and developed an alternative measure of corporate eco-efficiency. Our online data collection mechanism (www.sustainablevalue.com/carbonsurvey) allows for an efficient collection of GHG data. Our preliminary study on GHG data gaps underlines the importance of such a data collection mechanism.

Benefits for Practitioners Practitioners benefit from having a data collection tool that enables gathering of comparable CO_2 data. The Sustainable Value Driver network gives managerial guidance on how to increase eco-efficiency and the alternative measure developed allows for comprehension of the different reasons for changes in eco-efficiency.

Corporate Sustainability Reporting and ESG Performance

Pontus Cerin and Henrik Nilsson


Pontus Cerin

Aim Study the value and relevance of ESG factors to analysts and investors.

Results Financial analysts who report on environmental aspects often do so from product and company business opportunity perspectives. Ethical analysts focus more on goals, policies and management systems. Absolute emissions, such as CO_2, for an assessed company vary considerably between different analysts of different ethics. Also, the greater the proportion of unethical board members of a firm the lower the firm profitability and the higher the volatility of earnings and cash flows. Preliminary results also show that firms with a high proportion of unethical board members pay less attention to environmental and social aspects.

Benefits for Practitioners Understanding that the scope, quality and value relevance of environmental information that financial and ethical analysts use in their assessments is key for making well informed investment decisions. Illuminating unethical board members' impact on firm performance is not only vital for investment decisions but crucial when appointing board members.

Sustainable Development in Swedish Industry

Runar Brännlund, Tommy Lundgren and Per-Olov Marklund

Aim The project enhances the understanding of the impact of CO_2 emissions policies on Swedish industry, its economic growth and the development of its ecological footprint. Specifically, we investigate the so called Porter hypothesis, that environmental policy induces both lower emissions and increased competitiveness.

Results The short term effects of the CO_2 tax have been found to decrease technological progress and increase the costs in most sectors. The long term impacts of the CO_2 tax are not conclusive; some sectors and firms increase efficiency and profitability due to the tax, while others do not.

Benefits for Practitioners The project sheds light upon how external and internal environmental polices affect Swedish industry in terms of efficiency, profitability and environmental performance.

Incentive Systems

Impact of Incentives and Monitoring of Portfolio Managers

Tommy Gärling, Maria Andersson, Martin Hedesström and Anders Biel

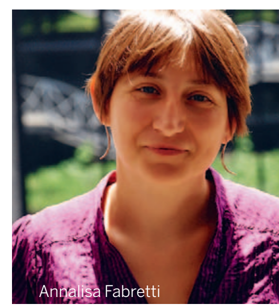
Aim To determine how decisions by portfolio managers are influenced by incentives and monitoring.

Results Bonuses are predominantly based on one-year intervals. Longer-term bonus components that sometimes are offered are generally insignificant. Short-term bonuses are in line with portfolio managers' preferences – bonuses paid out every year or with even shorter time intervals are preferred over a nominally equally large long-term bonus. Uncertainty about the future appears to play an important role; preferences for short term bonuses weaken when uncertainty increases. However, shorter evaluation intervals lead to worse performance compared to longer evaluation intervals since portfolio managers may neglect long-term price trends.

Benefits for Practitioners Counteracting short-termism in the financial sector is expected to benefit companies that manage their businesses more closely aligned with sustainable development. Demonstrating that short-term bonuses cause myopic investment decisions that also lead to worse outcomes should be a strong impetus for institutional investors to make their bonus systems longer-term.

Incentive Schemes for CSR Asset Management – a Quantitative Approach

Evert Carlsson, Annalisa Fabretti, Georgios Foufas, Stefano Herzel and Mattias Sundén


Annalisa Fabretti

Aim To identify how incentives influence an asset manager's strategy and to design a contract between an institutional investor and an asset manager to foster investment in CSR assets.

Results This research has introduced CSR into the theoretically well developed field of Delegated Portfolio Management. We show how to set a bonus for sustainable investment and how to relate it to the knowledge of the portfolio manager of Sustainable and non-Sustainable assets. We determined a relation between the bonus and quantities that measure the statistical distributions of assets returns, the risk aversion of the managers, and their specific knowledge of the assets. The research also examines the remuneration restrictions recently introduced by the Swedish Financial Supervisory Authority and how it affects the trading strategies of the portfolio managers.

Benefits for Practitioners This research may help institutional investors pursuing both Socially Responsible and purely financial objectives to identify and evaluate the most relevant issues when setting the contracts for their portfolio managers.

Fiduciary Duty

Institutional Investors' Fiduciary Duties

Tommy Gärling and Joakim Sandberg

Aim To assess the extent to which the obligations that large financial institutions (e.g. pension funds) owe towards their beneficiaries (e.g. future pensioners) constitute an impediment to their effective engagement in sustainable investing.

Results Our in-depth legal analysis suggests that fiduciary duties as they are formulated in contemporary law indeed hinder effective sustainable investing on the part of financial institutions. Moreover our theoretical-explorative work suggests that it is difficult to mitigate this problem by any simple reformulation of fiduciary duty. Sustainable investing simply cannot always be expected to be in the interests of beneficiaries irrespective of whether one understands these interests as financial, social or ethical. To the extent that there is a political will of strengthening the institutions' mandate to invest sustainably, then, more radical legal reforms seem needed.

Benefits for Practitioners One of the most commonly cited reasons for why so few investment institutions invest sustainably today is the belief that this is incompatible with fiduciary duty. Proponents of sustainable investing try to argue that this belief is misconceived, which has spread a fair deal of legal obscurity around. This project aims to clarify both the current legal reality and the political possibilities for the future, which hopefully should help both legislators and representatives of the financial institutions.

Sustainable Governance among Swedish Pension Funds

Ian Hamilton

Aim To study how five Swedish National Pension Funds (AP-funds) apply the government directive on environmental and ethical considerations in investment decisions.

Results We report on and present how AP funds interpret and implement the government ESG directive and apply influence strategies to shareholder engagement as the ultimate sign of responsible investment strategies.

Benefits for Practitioners The institutional investor community recognizes SRI. However, until SRI moves from recognition to practice it will not be considered mainstream. The outcome of the study will bring empirical evidence and understanding to practitioners and contribute to mainstreaming environmental and ethical considerations in investment decisions both in and outside the AP funds.

Global Long-term Value Outlook – A Global Survey

Rob Bauer, Paul Smeets, Kees Koedijk, Harry Hummels and Nils Kok

Aim To design surveys that determine the impact of ESG factors on different segments of investors' decision making.

Results In spite of the fact that SRI is growing rapidly worldwide, we know very little about the SRI clientele. What different types of socially responsible investors do exist? We identify different segments of socially responsible investors. We find that female investors who are more risk averse and have no financial advisor, are more likely to buy SRI mutual funds. Moreover, we surveyed the global real estate (public and private real estate investors) sector extensively. We find that these funds generally score low on the quality of environmental management (both policy and implementation).

Benefits for Practitioners Mutual funds and banks can profit from the detailed segmentation analysis that we conducted, in order to meet demands of different SRI investors.

Class-Action Lawsuits, Corporate Governance Mechanisms and CSR

Rob Bauer, Robin Braun and Frank Moers

Aim To shed light upon institutional investors' influence on management behavior in terms of risk taking and available actions when it comes to securities violations.

Results Firstly, research indicates that manipulating the allocation of primary securities (in initial public offerings) is a profitable method for underwriting investment banks and corporate insiders. Secondly, socially responsible behavior on the part of managers and corporations is not necessarily a sign of managerial integrity: these firms are more likely to get sued by their shareholders. Thirdly, in the presence of steep incentives from stock options and managerial discretion in pay-setting process, class-action lawsuits are a governance mechanism, which (dispersed) shareholders are avail of. Lastly, shareholder litigation works to discipline individual directors, whereas for firm-wide events litigation is disruptive.

Benefits for Practitioners Evaluations of firms with steep option incentives, awareness of market manipulation in securities offerings, and a more objective definition of CSR with respect to managerial integrity. Institutional investors benefit to a large extent by getting insights on class-action lawsuits as a governance device; how to deal with litigation risk and instances of stock market manipulation. Practitioners learn about the effectiveness of shareholder activism in ESG issues.

An online tool for revealing sustainability

The research group Sustainable Value, financed by SIRP, has constructed an online analysis tool that counts published articles with a sustainability theme, in order to help policy-makers and researchers track and understand the extent of which sustainable development is reflected in people's daily lives.

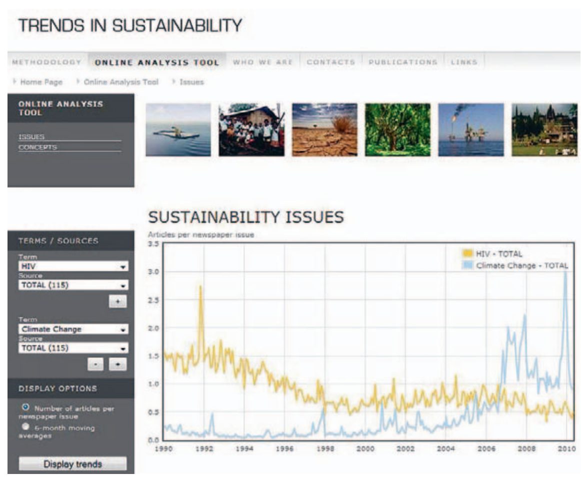
The tool and the website, www.trendsinsustainability.com, were launched at the World Aids Day on December 1 2010, and immediately received a lot of attention by prestigious media around the world. The website now has around 2 500 hits per day.

Media coverage is both a reflection and an influencer of issues that are deemed important to the general public in a given context. Therefore, the level of media coverage on certain developments in the field of sustainable development can serve as an indicator of the extent to which the concept is embedded in public awareness and opinion at any given point in time.

The research group discovered that the media coverage on HIV/AIDS has fallen by more than 70 per cent in developed countries over the last 20 years. While in the early 1990s, an average of 1.5 articles linked to HIV/AIDS could be found in every issue of the main broadsheet newspapers. Levels of coverage have since then dropped to below 0.5 articles per newspaper issue. Coverage in French and US-based newspapers has decreased particularly dramatically during this period.

As the vast majority of research into HIV/AIDS takes place in developed countries, this might potentially have severe consequences. The lack of interest in the developed world might hamper the development of solutions for the spreading pandemic in developing countries. It also causes concerns for future infection rates within the developed world.

The Trends in Sustainability project tracks coverage of issues such as climate change, poverty and human rights



Whilst climate change has recently become a frequently discussed topic in major broadsheet newspapers, media coverage on HIV/AIDS has dropped by two thirds compared to the 1990's

in 115 leading broadsheet newspapers from 41 countries over a 20-year period from 1990 until May 2010. To date the research has looked at approximately 69 million articles in 410 thousand newspaper issues.

The research shows that while attention to sustainability-related issues has increased overall during the last 20 years, the media agenda in this area has changed considerably. On one hand, coverage of environmental problems like acid rain and the ozone hole, which have been successfully addressed, has diminished since the early 1990s. On the other hand, articles on climate change have increased more than ten-fold since in this time, amounting to an average of more than two articles per newspaper issue across the overall sample of 115 newspapers.

Doctoral Dissertations 2010

JONAS NILSSON, Umeå School of Business
"Consumer Decision Making in a Complex Environment: Examining the Decision Making Process of Socially Responsible Mutual Fund Investors"

The market for retail SRI mutual funds is larger than ever but choosing a good SRI fund is different from choosing a good "regular" mutual fund and in many ways more challenging.

Jonas Nilsson has studied how consumers of SRI profiled mutual funds integrate their social, ethical, and environmental concerns with the strictly financial objectives of investment in this complex decision making environment.

While the financial aspect of the mutual fund investment decision is difficult enough for most consumers, consumers that desire to make a good socially responsible decision also have to evaluate how the fund incorporates ESG issues into its investment decisions.

As different mutual funds focus on different ESG issues, and also use differing strategies for including these issues into the mutual fund, this is in many ways a tough task.

Moreover, different segments of SR-investors display different levels of involvement and concern for ESG issues. Thus, the actual importance of ESG issues in decision making differ between groups of SR-investors.

Overall, the thesis contributes to a better understanding of the retail SR-investor that is of importance for both fund providers as well as public policy makers.

ROBIN BRAUN, Maastricht University
"Stock Market Manipulation"

Separation of ownership and management creates an agency conflict between the owners and managers. This dissertation sheds new light on the ability of market participants to recognize that information is unequally distributed in financial markets.

First, investors learn about effective control of managers. Second, the regulator understands the effects of regulation in financial markets and whether it yields expected benefits. The third group of beneficiaries is the managers themselves. They have to be aware of managerial leeway, the risks that they face and the externalities they impose on financial markets. The last group relates to financial intermediaries and their role in the primary securities market.

Specifically, institutional investors face the question of whether they should hold on to affected stock awaiting improvements over the medium to long-term, or whether to sell the stock immediately.

The study also demonstrates that the type of allegation is important where resulting disciplinary steps are

Robin Braun and Rob Bauer

taken, and proposes a novel distinction between violations of duty of loyalty and duty of care.

Robin Braun finds long-term performance reversals for firms whose individual directors have allegedly committed a violation of duty of loyalty because managers are disciplined by lawsuits. The study helps institutional investors to answer the question as to whether they should initiate or join a class-action lawsuit.

CRISTIANA MANESCU, Gothenburg University
"Economic Implications of Corporate Social Responsibility and Responsible Investments"

Corporate Social Responsibility is a familiar concept but there is still no consensus on how it should be defined, which is problematic when measuring CSR and its effects on financial performance.

In this context, Cristiana Manescu's thesis puts forward the value of a mathematical tool to construct meaningful CSR indices. Its strength consists in producing a firm-specific set of weights for the various CSR dimensions which do not require prior knowledge of the relative importance of the various CSR dimensions.

Manescu has also analyzed the relation between various CSR indicators and financial performance (profitability ratios or stock returns). The results reveal that CSR activities do not generally have a negative effect on profitability and that in the few cases where they have a positive effect, this effect is quite small and somewhat non-linear. Stock returns, on the other hand, are found to react strongly and negatively to negative news about companies.

Finally, the thesis also aims to shed light on the reasons why CSR was found to affect stock returns, distinguishing between mispricing and compensation for risk. Generally, the evidence suggests that both positive and negative effects of CSR are likely due to inefficient pricing of CSR information.

The tools and findings of this thesis are relevant for rating agencies and SRI or mainstream investors alike.

Mr Engagement and UN PRI

The PRI/Mistra 2011 Academic Conference will be held in Stockholm, 26th–28th of September. More than 150 leading thinkers within responsible investments will attend the conference. One of the founders of PRI was James Gifford, today the executive director, also known as Mr Engagement sees the academic conference as an important platform for academics and practitioners to meet.

IN 2003 JAMES GIFFORD had recently finished his Masters in Environmental Management at the University of New South Wales. He won a coveted internship at the United Nations Environment Program in Geneva. Two months later he had a paying part-time job at UNEP.

Today James Gifford is the Executive Director of PRI and has attracted more than 800 investors representing 22 trillion USD in assets.

"PRI is bringing investors together. It is a collaborative platform where engagement is part of the responsible ownership", said James Gifford.

The PRI are a set of best practice principles for institutional investors and asset managers that ask organisations to take into account environmental, social and corporate governance issues into their investment processes. The principles were defined by a group of experts from the investment industry, intergovernmental and governmental organisations and academia in 2006.

"UN PRI was initiated at just the right time. We were beginning to see the effects of climate change and several severe, corporate government issues such as the collapse and bankruptcy of the Enron Corporation," said James Gifford.

In September 2011 the 4th Annual Academic Conference will be held in Stockholm, co-hosted with Mistra, the Swedish foundation for strategic environmental research. According to James Gifford, these conferences are important occasions for researchers to integrate and meet practitioners dealing with everyday issues concerning responsible investments.

"Five years from now the market has matured and realized that focus on ESG gives return of investments. My hope is that our principles have become a norm and the main focus will not be who has signed for PRI, but who has not signed," says James Gifford.

In August 2010 James Gifford participated at the Mistra conference in Stockholm and presented his study "The effectiveness of shareholder engagement in improving corporate environmental, social, and corporate governance performance", the subject of his PhD from the Faculty of Economics and Business, University of Sydney.

ESG Integration for Mainstream Investors

THE INVESTMENT POLICIES of state pension funds were in 2010 lively debated in Sweden. The politically driven argument during the election year was that pension funds are not Responsible Investors if they are owners of shunned stocks. The counter argument by the pension funds was that norms-based screening should lead to exclusion only if the engagement process does not succeed and result in a change to active management of the ESG risks in the target companies.

Norms-based screening and engagement has become the major RI strategies among Swedish investors that have signed PRI. The strategies taken are for reputation risk management only and they will remain a sub-culture in financial markets. Negative screening by values-based investors can only be a small segment of the market and engagement is a resource demanding process for profit-seeking investors to reach out to a broader universe.

Implementing the UN PRI 1 on ESG integration in financial decisions has the potential to mainstream RI. Integration as an investment strategy focuses on the economic implications of long-term ESG risks and opportunities that are associated with strategies of the companies in which investments are made. ESG integration is an investment strategy for both alpha-seeking responsible investors and traditional mainstream investors that consider long-term drivers of financial performance.

Lars G. Hassel
PROGRAMME DIRECTOR SIRP

The map depicts the participating Universities and Institutes in SIRP

Åbo Akademi University
Chalmers University of Technology
EuroMed Management Ecole de Management, Marseille
European Centre for Corporate Engagement ECCE
Institute for Futures Studies and Technology Assessment
Maastricht University
School of Business, Economics and Law, Gothenburg
Sustainable Value
Tilburg University
University of Gothenburg
University of Leeds
University of Perugia
University of Rome, Tor Vergata
Umeå School of Business
Queen's University Belfast

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PRINTED BY Göteborgstryckeriet

‘The research findings published by the Mistra programme “Sustainable Investment Research Platform” have now given the business community the business case for sustainable business development that it had asked for’.

Lars-Olle Larsson, Partner, PwC

Sustainable Investment Research Platform is a unique international and interdisciplinary research programme and involves 45 researchers in seven different European countries.

The objective of SIRP is to find out how sustainable investment practices can create added value for institutional investors and identify barriers to mainstreaming such practices.

The research includes: *Sustainable Investments and Markets*, *Sustainable Companies and Ratings*, *Incentives Systems* and *Fiduciary Duty*.

During 2010 SIRP published 45 academic articles and working papers and SIRP’s researchers presented frequently at prestigious international conferences.

SIRP is funded by Mistra, the Swedish Foundation for Strategic Environmental Research (www.mistra.org), and has a budget of 11 million euro for the period 2006–2012. Umeå School of Business is hosting the programme.

For more information, see www.sirp.se.

Lars G. Hassel
Programme Director
lars.hassel@usbe.umu.se
skype: lars.hassel1

Elisabeth Nore
Communication Officer
elisabeth.nore@imcg.se
skype: elisabethnore