Sustainability and ethical funds management

Increasingly both institutional and retail investors look for companies and funds that offer more than just a return on investment. What they want to be reassured of is that their investment is going to companies that also take their environmental responsibilities seriously. As SUE GOSLING points out however, the difficulty is in quantifying what is meant by environmentally friendly.

Scientific advance has delivered increases in longevity, health, comfort, and material wealth for much of the world. However, these benefits have not been without cost. We have also seen species extinction, land degradation, atmospheric degradation, and global pollution. We now know much more about the effects that these deleterious actions have on the environment.

And there is an increasing awareness that it costs more to rehabilitate the environment than to prevent degradation in the first place. As a result environmental and resource issue are now receiving increasing government, media, consumer and investor attention.

We are witnessing a progressive rise in international environmental standards, coupled with more stringent levels of disclosure for companies. Regulatory changes and other government action, both in Australia and internationally, which target environmental problems are generating both risks and opportunities for companies. These actions and the reactions of stakeholders are compelling companies to change. They are starting to re-impose the costs of environmental impact back onto the companies that generate them.

Not surprisingly, environmental issues have become an important component of ethical funds management. For some they are the key component. There is however no general consensus as to how environmental factors should be incorporated into the investment decision-making process.

A core concept for environmentalists is ‘sustainability’. Sustainable development is concerned with the enhancement of the quality of life of current and future generations. It is focused on progressively eliminating the negative environmental effects of human activities.

In contrast, funds managers have traditionally been concerned with (mainly quantitative) measures of the financial performance of companies and economies. There is a significant conceptual divergence between these two paradigms. Moving away from the traditional towards the sustainable approach involves combining an assessment of economic factors with both environmental and social considerations.

Incorporation of sustainability principles into investment decision-making requires that this tripartite complex of factors be embedded into the investment process and philosophy.

WHAT IS SUSTAINABILITY?
In part because of the large number of...
alternative definitions sustainability is not a well understood concept (see for example Harding, 1998). However, five core inter-related principles of sustainable development have been progressively established (Harding, 1996; and NSW Environmental Protection Authority, 2001):

- Intergenerational Equity;
- Social Equity;
- Conservation of Biodiversity;
- Internalisation of externalities; and
- The precautionary principle.

These principles have been endorsed by governments in Australia and have been used in a number of national and international agreements. They have also provided the basic thinking underlying much of modern environmental law.

Inter and intra generational equity

Intragenerational equity, also known as social equity, is concerned with issues of distribution of income and wealth across the current population. One of the factors exacerbating inequality is environmental degradation. Strategies that result in environmental enhancement may therefore have positive social equity implications.

Intergenerational equity is concerned with the impact of the current generation in meeting its own needs on the ability of future generations to meet their needs.

Central considerations were outlined by Harding, Young and Fisher (1996), they include:

- Depletion of non-renewable resources;
- Maintenance of eco-systems and biological diversity; and
- Maintenance of infrastructure, such as sewage and utility distribution systems.

This is perhaps the most difficult principle to apply, in part because the future implications of current activities can be difficult to assess.

Specific investment screening criteria that are relevant to the issue of intergenerational equity include:

- Levels of material intensity;
- Energy intensity and efficiency;
- Toxic dispersion;
- Material recyclability; and
- Product durability.

Conserving biological diversity

Due to its complex interconnectedness, ultimately conservation of biodiversity is critical to the very survival of humanity. It is closely related to the issues of protection of ecosystems, habitat destruction and the range of impacts of the modern industrial society on the environment. This issue is of particular importance in the Australian context given the unique and diverse biota (see Harding, 1998).

The industrial sectors that have the greatest importance for this objective are the primary industries of agriculture, fishing and forestry. However, all industries have either direct or indirect effects on land, air or waterways. Again specific screening criteria can be related to the impact of firms on biodiversity risk.

Internalisation of externalities

The notion of an externality was first developed by Marshall (1890) to refer to a cost or benefit that was external to the agent who created it, and which accrued instead to others. In the current context the concern is with the negative externalities of commercial activities that cause environmental degradation, and represent a cost to society as a whole.

Externalities arise as the result of market failure allowing private and social costs to diverge. For example, firms are able to use resources and generate and dispose of waste at a cost that is lower than their cost to society in general.

It is via the internalisation of these externalities that the most effective incentive to changed behaviour can be achieved. However, internalisation of external costs can be difficult. The principal route for internalisation is likely to be legislation that adjusts costs towards their true levels and/or prohibits certain activities and has penalties for infringement.

In addition both consumers and investors can participate in the internalisation process. The use of environmental impact information (where this is available) in consumption and investment decision-making can result in market share, profit and share price effects.

These forces not only drive the internalisation process, but also arguably generate an eco-efficiency premium. That is, they generate a positive correlation between environmental efficiency (and sustainability) and financial returns.

The ethical investment decision making process can itself be used to assist in speeding up the internalisation process. The allocation of investment dollars can have two relevant effects. Firstly, it can assist in the provision of capital to develop business with relatively sustainable products and processes.

Secondly it can increase the probability that more sustainable companies will generate higher returns for shareholders than less sustainable companies. The allocation of capital toward eco-efficient and away from eco-inefficient firms can itself encourage behavioural change.

Precautionary principle

The precautionary principle is a core component of sustainable development because of the considerable complexity and uncertainty that surrounds the environmental implications of commercial activities.

The precautionary approach is about changing behaviour as a result of potentially serious environmental consequences without waiting for scientific certainty. Where there exists a serious potential for irreversible environmental damage this potential needs to be recognised because once the evidence is available the damage will already have been done.

Techniques such as scenario analysis and optimisation methods that are used to manage uncertainty and develop risk-adjusted strategies can also be used to incorporate this additional precautionary aspect into the ethical investment decision-making process.

This can be achieved (subject to data availability) if these precautionary issues are taken into account when assessing the overall risk of alternative investments.

Overview

In translating sustainability principles into ethical screening criteria it is necessary to make value judgements about what is and what is not acceptable. In doing so ethical investment managers will define the extent to which they embrace the principle of eco-efficiency premium and/or adopt a "deep green" versus a "shallow green" stance.
A common perception has been that adherence to environmental and social objectives will involve a cost to the business (Arnold, 2001). This view is now being challenged (see Ekins, 2000). In particular, there is a growing belief that the objectives of environmental efficiency and financial management are consistent (Kiernan, 2000).

**THE ETHICAL INVESTMENT PROCESS**

Ethical managers use investment screens to eliminate investment in companies that are generating specific negative effects. Generally this requires detailed information on a company’s activities. Assessing a company for its sustainability requires the inclusion of economic, social and environmental criteria.

These criteria may be aggregated into an index that permit a ranking of investments from most to least preferred. Alternatively, investment selection may be made on the basis of individual criteria that permit more flexibility in the weighting of factors, though this adds complexity.

The ideal approach may be some combination of the two where a single index is designed but some over-riding absolute criteria are also used to exclude certain investment opportunities on the basis of unacceptable single factor performance.

One of the difficulties in applying a quantitative approach is the limitations on data availability. Following a series of industrial environmental disasters and related legislative reaction, the early 1990s saw increased attention devoted by companies to environmental reporting (Elkington, 1999); and the emergence of Triple Bottom Line reporting which is closely related to sustainability (Deegan, 2000).

Australian companies lag behind best practice environmental reporting standards of their international counterparts (Newson and Deegan, 1996).

The triple bottom line reporting format can provide information essential to the implementation of sustainability investment screening criteria. Key components of these screening criteria include:

- **Inputs:** Material and energy intensity; use of non-renewable resources; external effects with respect to input materials and their production, including eco-system effects.
- **Process:** Eco-efficiency; employee health and safety; external effects including emissions, toxic dispersion, waste composition.
- **Product:** Durability, life cycle assessment; recycling and re-use potential; external effects resulting from product use.
- **Waste Management:** External effects as a result of waste management strategies.
- **General Management:** Use corporate environmental reporting; ‘cradle to grave’ policies; employment policies; general consistency with sustainability principles.
- **Other:** Consistencies/inconsistencies with sustainability principles.

Once companies have been screened, some will have been automatically excluded from the portfolio on the basis of specific single factor criteria. The portfolio is then constructed from the remaining stocks.

Value judgements have to be made as to how tight to set the absolute single factor criteria. Setting them too loosely may compromise the ethical integrity of the portfolio; while setting them too tightly will restrict investment opportunities unnecessarily.

A common approach is that of “best of industrial sector”, combined with some preferred or absolute prohibitions. For example, some ethical funds permit investment in Rio Tinto despite a negative uranium screen, because the company’s uranium activities are “insignificant” (Manning, 2001).

On the other hand, a number of ethical portfolios exclude BHP on the basis of the damage mining operations have caused in Papua New Guinea (Kavanagh, 2001). Value judgements of this sort seem an inevitable element of the ethical investment screening process.

As environmental criteria are imposed, the deviation of portfolios from the market index can be expected to increase. Initially, assuming the existence of a positive eco-efficiency premium, sustainability screens will add value. However, as environmental criteria are tightened, the potential for underperformance and higher stock-specific (as opposed to market) risk increases.

Given a high level of investor sensitivity to short term comparative performance, business risk considerations must be weighed against sustainability objectives in determining the tightness of criteria underlying the investment screen.

However, the problem of comparative short-term performance is largely non-existent in the private equity sector. This sector has no standard short-term benchmarks and funds are assessed on the basis of long-term performance. Also, sustainability criteria can be more readily applied to the smaller and less complex companies that comprise this sector.

The greatest sustainability benefits are likely to be generated by investing in companies developing processes, products and technologies that are providing the solutions to environmental degradation.

It is difficult to obtain exposures of this sort in the listed equity market because, while innovation is occurring, it is often only a small part of the overall activity of a company. Most of the exposures to these companies arise from the private equity sector, and it is these companies that are likely to benefit most from any rise in the eco-efficiency premium.

It is in the private equity sector that the objectives of sustainability and the achievement of strong returns for investors appear most consistent, offer the best potential of fulfillment, and have the highest return potential for the investor.

**CONCLUSION**

Governments and industry throughout the developed world are responding to the concerns of the general community to increase the environmental sustainability of products and services.

These concerns stem from clear scientific evidence that the current patterns of demand versus supply of the world’s resources, and the environmental impacts of economic activity, are both unsustainable.

The concept of sustainability is of importance to investment decision-makers because regulation and stakeholder behaviour is internalising what were previously external costs. This is creating both risks and opportunities. These growing forces are, it is increasingly believed, generating a rising
ecological return premium. Evidence is mounting that the two are not only consistent, but that financial performance is increasingly under threat from a failure to manage environmental risk. This implies that investors can “do well by doing good”.

As this evidence continues to strengthen, the use of ethical screening will evolve from a niche product, to being a component of mainstream investment processes and products.

“There is a rising tide of environmental awareness. Smart companies will get ahead of the wave. Those that don’t will be wiped out.”


REFERENCES


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