

# SUSTAINABLE DEVELOPMENT AND YOUR PORTFOLIO

Does it make sense to invest in a company known for bad environmental or labour practices? An increasing number of pension fund managers think not.

**By Anne Pappmehl**

The prime obligation of pension plan sponsors is to make money for their plan members. With globalization broadening the range of investment opportunities, fulfilling this task should be getting easier. But the world is a complicated place. As access to international markets expands, risk management becomes increasingly important.

At the same time, advances in global communications have made corporate behaviour more transparent than ever. News of a company's poor environmental record or human rights violations can destroy its branding, profitability and share price quickly. The recent indictments of Enron, Worldcom and Global Crossing have made investors more aware of the link between corporate ethics and portfolio safety. Increasingly, pension plan sponsors are recognizing

the impacts of non-financial criteria on share price as well as the need for reliable tools to appraise them.

These trends are leading to a growing awareness in the institutional investment world of sustainable development (SD). As an investment style, SD belongs to the broader category known as socially responsible investing (SRI). It is a business approach that incorporates environmental, economic and social best practices. The term 'sustainable development' was first coined in a United Nations publication called *Our Common Future* (World Commission on Environment and Development, 1987). It is defined as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

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SD companies display several common characteristics, all of which can have a positive effect on share price.

- They tend to be more readily accepted in communities where they wish to do business. This affords them easier access to markets and expansion opportunities.
- They generate less waste, require less manufacturing and shipping material and use less energy. This saves money.
- They tend to be seen as less risky. That provides a discount on the cost of borrowed capital and lower insurance premiums.
- They attract and retain top talent. That means higher workplace productivity.

In some areas of the world, SRI and SD criteria are being factored directly into investment policy legislation. Since July 2000, U.K. pension fund managers have had to state whether or not they take the environmental, social and economic impacts of their investment decisions into account.

*The Turnbull Report*, published in December 2000, decreed that all companies trading on the London Stock Exchange itemize and account for their risks—whether financial, environmental, social or ethical—and report them at year-end.

In the U.S., the Employment Retirement Income Security Act (ERISA) determined in 1998 that socially and environmentally screened mutual funds could be included in an ERISA-qualified retirement plan.

## CANADIAN RETICENCE

Curiously, while some Canadian business leaders recognize SD as a value generator, many plan sponsors have held to a more neutral view. Blair Feltmate, vice-president sustainable development research, Jones Heward Investment Counsel Inc. in Toronto attributes that to two things.

First, “the value added of sustainable development best practices remains at an elementary stage of understanding with many plan sponsors, many of whom still view it

as the cost of doing business rather than as a revenue generator,” he says.

Second, “sustainable development investing, which is performance focused, is often confused with ethical investing, which is values focused,” says Feltmate. “The values encompassed by ethical investing typically reflect an investor’s personal objection to investing in companies that are associated with tobacco, alcohol, nuclear, gambling, salacious materials, mining and/or petroleum production. Although not investing in such a range of industry sectors may make certain people feel good, removal of a large range of investment options can negatively impact a fund’s performance. In contrast, the focus of sustainable development investing is to maximize performance. The positive environmental, economic and social aspects associated with this investment process are ancillary benefits that investors, socially oriented or not, generally appreciate.”

Within the broader context of SRI, some investors view the application of screens with caution. Modern portfolio theory asserts that the application of any type of screen restricts the universe of potential investments. That limits a fund’s risk/return profile.

In practice, however, this limitation is not the case uniformly. “When you constrain the possible set of investments, you’re somewhat surprised that the performance doesn’t seem to be worse,” says Paul Halpern, Toronto Stock Exchange chair in capital markets at the Rotman School of Management, University of Toronto.

Consider the U.S. Domini 400 Social Index fund. This 400-stock index does not invest in companies that produce tobacco, alcohol, nuclear power, supply services to gambling operations or derive more than 2% of gross revenues from military weapons production. The index applies positive screening to find companies that demonstrate good employee relations practices, environmental responsibility, fair trade in underdeveloped countries and produce safe and useful products. The U.S. Domini

## Growing client interest

According to The Social Investment Organization ([www.socialinvestment.ca](http://www.socialinvestment.ca)), of the \$49.9 billion of assets in SRI investments in Canada as of July 30, 2000, institutional investors held

approximately \$38 billion. "Among money managers surveyed, we found there is growing client interest from pension funds, foundations and public institutions like hospitals and universi-

ties. It is predicted that it won't be too long before SRI receives significant economic clout by major financial institutions," says Eugene Ellmen, the organization's executive director in Toronto.

Social Equity Fund turned in a five-year annualized return of 18.51% between 1997 and 2002. By comparison, the Standard & Poor's 500 index returned 18.99% during the same period.

In Canada, Michael Jantzi Research Associates launched the Jantzi Social Index in January 2000. The index uses negative screens to exclude investment in companies that produce nuclear power, manufacture tobacco products, engage in weapons-related contracting, have poor environmental performance or that manufacture unsafe products. It also uses positive screens to include companies that cultivate good community relations where they do business, encourage workplace diversity and have progressive environmental and corporate governance records. In addition, the index applies a best-of-sector approach. For example, it will invest in a company that has a potentially high environmental impact like mining or forestry, but which operates in a more environmentally sound manner than its peers. Between Jan. 1, 2000 and Aug. 31, 2002, the Jantzi Social Index yielded a return of -23.57%, versus -22.63% for the Standard & Poor's/Toronto Stock Exchange 60 benchmark.

The Dow Jones Sustainability Group Index (DJSI), established in December 1993, holds approximately 330 SD companies. Representing 64 industry sectors, these stocks are selected from the 2,000 that comprise the Dow Jones Global Index. The index employs sustainability-specific positive screens and three with a negative focus (i.e., tobacco, alcohol and gambling). Over an 8½-year period ending this past August, the core DJSI outperformed the Dow Jones Group Index by approximately 40%.

### THE SCREENING PROCESS

The SRI industry faces some criticism by those who see a lack of consistency regarding measures incorporated into screening processes. "You have to remember that among the funds that are screening, the screens are not uniform, and that can affect performance," says Halpern.

Furthermore, a high-performing portfolio may not be as sustainable or ethical as one would like to believe. "One of the [socially responsible] portfolios that performed well happened to own a lot of Microsoft, which at that time

was being charged by the U.S. government as being a monopoly," says Don Walcot, chief investment officer of BIMCOR Inc. in Montreal.

Cognizant of the need to apply rigour to the environmental, economic and social evaluations of companies, Jones Heward launched the Sustainable Development Equity Fund in August 2001. The fund combines financial analytics with its proprietary Sustainable Development Index (SDI) to identify companies for inclusion in the fund. Feltmate and his colleague Brian Schofield, vice-president and portfolio manager at the firm, developed the SDI in Canada over a period of seven years.

The SDI evaluates a company's performance based upon 80 to 160 industry-specific environmental, economic and social measures. The fund consists of 45 to 50 large capitalization Canadian companies. Between August 2001 and September 2002, the fund realized a total return of -0.7% versus -14.9% for the Standard & Poor's/Toronto Stock Exchange 60. "Sustainable development is a good tool to use to identify well run companies that should make excellent long-term investments," says Schofield.

The inclusion of sustainability criteria in portfolio management is now starting to be recognized as a reinforcement of fiduciary responsibility. "Pension plan sponsors are not social activists, but they must be cognizant of the impact of non-financial factors on their investments which extend over a long-term time horizon," says Murray Gold, a lawyer with Koskie Minsky in Toronto. "Ethical and sustainability factors are factors like any others to be considered in selecting an investment. You look at the quality of a company's earnings, its labour relations, its management and its reputation with consumers. These all have to be considered, but none of them, by themselves, are determinative."

Over the long term these non-financial criteria will bear increased weight on a fund's performance and, by association, a sponsor's ability to meet fiduciary obligations. If legislative developments in the U.K. and U.S. are any indication of what Canada can expect, it may be wise for pension plan sponsors to become better acquainted with SD-style investing now.

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