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Socially Responsible Investment in Asia

Geoffrey Williams

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Recent worries about product safety, transparent corporate governance and the social and environmental impact of corporate activity have been the drivers of "Socially Responsible Investment" (SRI) in Europe and North America. Geoffrey Williams delves into the rise of SRI in Asia, where opportunities for strong investment returns are wide and growing.

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"Sustainable and Responsible Investment (SRI), also known as Socially Responsible Investment, is investment which allows investors to take into account wider concerns, such as social justice, economic development, peace or a healthy environment, as well as conventional financial considerations."

Association for Sustainable and Responsible Investment in Asia (ASrIA)

WHAT IS SRI?

SRI funds try to deliver two forms of returns for investors. Firstly, financial returns based on standard financial analysis that match or exceed returns on conventional investments and secondly, social and environmental benefits that are added value from investment portfolios in addition to the returns to investors.

They are also expected to produce more stable returns by tracking sources of risk within portfolios, such as poor corporate governance or bad environmental management. By identifying non-financial sources of risk, SRI investors try to manage the risk profile of their investments and reduce or remove exposure to companies that face current or future problems on environmental, social and governance (ESG) issues. SRI is closely linked to Corporate Social Responsibility (CSR) and Environmentally Sustainable management. From an economic perspective it addresses externalities, which are the costs or benefits that arise from company activities that are not priced into the shares. SRI allows investors to make positive economic decisions by taking into account not only financial but also non-financial management of risk.

SRI covers all types of investments including direct share-ownership, unit trusts and mutual funds, hedge funds, venture capital, private equity investments, private and national institutional pension funds, corporate and country bonds, endowment funds for universities, charitable organisations and sovereign wealth funds. It also includes community investing and investments in social enterprises on a smaller scale.

Ethical investment which includes faith-based financial products such as Syariah compliant investments are also a key component of SRI, especially in Asia. Some investors also refer to RI or Responsible Investment. The difference here is that RI is more mainstream whereas SRI may have a more values and ethics based approach.

INTEGRATION OF ESG INTO THE INVESTMENT CHOICE

Whilst there are many forms of SRI, general investment styles have emerged over time and have become more sophisticated as our understanding of the link between ESG issues and financial returns has developed.

From an investment perspective SRI makes sense for a very straight-forward reason - good management of ESG issues leads to good financial performance and adds shareholder value. Two approaches sustain this hypothesis. One approach uses comparative valuation. A company like British Airways with ongoing strike action due to complex employee relations management, is seen as having greater investment risk than, for example, Singapore Airlines which has a record of well managed human resources. The second approach uses option values. Clean-technology companies with low-carbon products that consumers increasingly prefer are expected to have better future business opportunities than companies that pollute the environment and face carbon taxes or emissions penalties.

In addition to these two approaches, the discounted cash flow valuation method (DCFV) gauges the current value of future profits adjusted by risk. In simple words, the DCFV method states that good management of ESG leads to increased profits with reduced risk. The Body Shop, for example, sells products that are similar to those in most other cosmetics stores. However, people prefer to pay a higher price for Body Shop products based on its recognised environmentally and socially responsible supplier rules and its policy of prohibiting animal testing. This produces a price premium. On the cost-side, companies that manage their energy consumption efficiently are able to reduce greenhouse gas emissions (GHG) and at the same time cut their energy bills. These lower costs translate positively to the bottom-line. Added to this, companies with good corporate governance avoid the risks that hit Satyam and Enron. Companies that manage their

Sustainable and responsible investment is supported by the world's major institutional investors. Estimates of the size of SRI funds vary but it is likely that at least US$5 trillion is managed using SRI criteria globally. A report in 2009 by the International Finance Corporation estimated that around US$300 billion was held in sustainable investment in emerging markets at the end of 2008 including around US$40.8 billion in Asia. In 2007 OWW Consulting estimated Asian SRI funds to be around US$33.2 billion, which represents a 23% increase over two years.

environmental systems properly avoid the risk of fines for pollution and companies that look after their staff, their customers and the communities in which they work avoid strike action and consumer boycotts. They can also build good stakeholder relationships through CSR programmes which enhance their brand and reputation and translate into better business performance.

Put simply, higher prices and lower costs give better profits both now and in the future and well managed companies have lower risks so that profits are sustainable in the long-term. This all adds value for shareholders as well as creating benefits to society and the environment.

IN WITH THE GOOD, OUT WITH THE BAD

The most common forms of SRI use portfolio screening which is the inclusion or exclusion of shares in investment portfolios for ethical, social or environmental reasons. Investors can use screens to exclude unacceptable shares from their portfolio, such as tobacco, animal testing or involvement with human rights abuses. They can also be proactive and select companies with good social and environmental performance, such as low-carbon technologies which contribute to more sustainable economies. Many investors use ESG ratings from specialist research organisations to compare company performance across a range of issues such as corporate governance, environment and supply-chain issues. Shares are then selected on a "best in class" basis so that the overall portfolio contains the best performers relative to the available market.

ACTIVE MANAGEMENT AND DIVESTMENT

SRI fund managers have also become more active, especially for large institutional investors such as pension funds. Through shareholder engagement investors use their shareholdings to improve the ESG performance of companies. They can positively influence performance by raising issues of concern with CEOs and investor relations managers and supporting responsible management practices or they can put pressure on companies through voting at Annual General Meetings [AGMs]. In extreme cases investors may even divest under-performing companies and encourage other investors to do the same.

In January 2010 for example, the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF) divested major petrochemical companies in Asia in response to their activities in the Sudan. TIAA-CREF is one of the largest financial services companies in the United States, with just under $400 billion in assets under management.

TIAA-CREF targeted five Asian companies, PetroChina, CNPC Hong Kong, Oil and Natural Gas Corporation, Sinopec, and PETRONAS, all claimed to have links with the government of Sudan. TIAA-CREF stated that it would divest those that refused to acknowledge the genocide in the Darfur region and engage in a productive dialogue to confront it. TIAA-CREF's final decision to divest rested on a number of factors including the seriousness of concerns about Sudan among TIAA-CREF's stakeholders, the success of the engagement with target companies and the calculation that divestment would not have a significant impact on the financial performance of TIAA-CREF's portfolios.

After meeting with each of the companies through its shareholder engagement process TIAA-CREF concluded that there had been insufficient progress. On 31st December 2009 TIAA-CREF sold its holdings in PetroChina, CNPC Hong Kong, Oil and Natural Gas Corporation and Sinopec across all its funds and accounts.

In explaining the action, Roger W. Ferguson, Jr., TIAA-CREF's Chief Executive Officer said, "Our decision to sell shares in these companies culminated a three-year effort to encourage them to end their ties to Sudan or attempt to end suffering there." The benefits of positive engagement were also highlighted when he explained, "We have not divested from PETRONAS, which has acknowledged our concerns and engaged in dialogue about how it might address them."[1]

OTHER FORMS OF SRI

A common form of SRI in Asia is Community Investing which is a way of supporting a particular cause or activity through financing, investment or loans. Community investing like micro-credit, revolving loan schemes and the new on-line forums such as Kiva.com, allow easier access to this market for even the smallest retail investor. Some of the best known examples of community investing, such as Grameen Bank of Bangladesh, originated in Asia and are now replicated around the world.

Community investors often have a target financial return lower than the market rate. This allows them to achieve a specific "social return" from their investment. Unlike making a donation, cause-based investors or the social finance organisations investing on their behalf require, at a minimum, that the original value of the investment is returned by either repayment (for loans) or trading (for shares). Grameen Bank is a good example that illustrates the potential of community investment. The bank provides small loans, 90% of which are to women and 100% to people classified as very poor. The repayment rate is regularly around 98%.

An extension of this form of SRI allows direct investment in social enterprises. The Singapore based Impact Investment Exchange (IIX), for example, aims to provide a regulated trading platform for securities issued by sustainable for-profit and not-for-profit social enterprises in Asia. Investment in social enterprises is expected to provide a liquid and transparent market where social enterprises can raise capital for expansion and enhance their social and environmental impact while investors can also achieve good financial, social and environmental returns.

Another form of SRI common in Asia is Islamic finance and Syariah-compliant financial schemes. These apply ethical screens excluding various forms of business and requiring various types of business practices such as avoiding interest in financial transactions. Asia is a leading centre for Syariah-compliant finance, with Malaysia taking a large share of the global market estimated at above US$500 billion. The recent collaboration between the Bahrain Stock Exchange and Bursa Malaysia has the potential of strengthening this market by building new forms of financial products which are attractive to non-Muslims as well as Muslims.

HOW BIG IS SRI?

Sustainable and responsible investment is supported by the world's major institutional investors. Estimates of the size of SRI funds vary but it is likely that at least US$5 trillion is managed using SRI criteria globally.[2] A report in 2009 by the International Finance Corporation estimated that around US$300 billion was held in sustainable investment in emerging markets at the end of 2008 including around US$40.8 billion in Asia. In 2007 OWW Consulting estimated Asian SRI funds to be around US$33.2 billion, which represents a 23% increase over two years.[3]

This is just the tip of the iceberg and outside of equity investment, other forms of SRI are large and growing. In March 2010 the international Climate Investment Fund (CIF), a collaboration of international development banks and the World Bank, endorsed clean-technology projects in Indonesia, Thailand, Philippines and Vietnam worth US$13.6 billion in total.[4] In the private sector, Fortis Investments has raised US$1.2 billion for its China Green Fund between December 2009 and February 2010. For governments too, investment in SRI is high on the agenda. Japan announced a US$5 billion loan fund in March 2009 for developing countries investing in solar power and other green technologies.[5] Looking forward, a report in February 2010 by the Swiss international bank Vontobel, which launched its own successful Asia (excluding Japan) Responsibility Fund in 2008, estimated that SRI assets under management in Asia could rise to between US$1.5 to 4 trillion by 2015.[6]

In terms of SRI funds, Association for Sustainable and Responsible Investment in Asia (ASrIA) estimated that there were around 248 SRI funds in Asia by 2008 and this number has been creeping up since with the launch of new Asia-based SRI funds both here and overseas.

SUSTAINABLE AND RESPONSIBLE INVESTMENT FUNDS IN ASIA

	Public Funds	Private Equity	SRI Pension Mandates	Faith-based[1]	Country Total[2]
China	2	0	0	0	2
Hong Kong	19	0	0	1	20
Japan	59	1	0	0	60
Korea	37	2	6	0	45
Taiwan	3	0	0	0	3
Singapore	3	1	0	10	14
Malaysia	2	0	0	81	83
Indonesia	0	1	0	1	2
India	1	1	0	1	3
Thailand	2	0	0	1	3
Segment Total	**128**	**6**	**6**	**95**	**235**
No. of SRI Funds by Country:					**235**
Asia Hedge Funds:					**8**
Total Number of SRI Funds in Asia (including faith-based funds):					**243**
Total Number of SRI Funds in Asia (excluding faith-based funds):					**148**

1 Mostly Syariah Funds;
2 Includes Private Equity Funds; Source: ASrIA, 2008

PROMOTING RESPONSIBLE INVESTMENT IN ASIA AND AROUND THE WORLD

The United Nations-backed Principles for Responsible Investment (PRI) were developed by a group of leading international institutional investors to reflect the importance of ESG issues in current investment practices. The PRI has around 720 signatories with around US$18 trillion of assets under management.[7]

Signatories commit to six principles and aspire:

1. to incorporate ESG issues into their investment analysis and decision-making processes;
2. to be active owners and incorporate ESG issues into ownership policies and practices;
3. to encourage appropriate disclosure on ESG issues by the entities in which they invest;
4. to promote acceptance and implementation of the Principles within the investment industry;
5. to work together to enhance the effectiveness of implementation of the Principles and;
6. to report on their activities and progress towards implementing the Principles.

Although the PRI is voluntary, becoming a signatory represents a clear public commitment and demonstrates support from top-level leadership to consider ESG issues. The principles are not prescriptive but provide a selection of possible ways for investors to incorporate ESG issues into mainstream investment decision-making and ownership practices. Different investors adopt different approaches but with a similar purpose: To take into account ESG issues and to use investment and ownership practices to address them positively.

The process was convened by the former United Nations Secretary-General, Kofi Annan and coordinated by the UN Environment Programme Finance Initiative and the Global Compact. Since its launch, the PRI Secretariat which administers the six principles and the signatory events has emerged as a powerful organisation in its own right and the PRI Secretariat, headed by Executive Director James Gifford, has become the leading global focal point for the sustainable and responsible investment community.

The PRI has a strong presence in the Asia-Pacific, which has the second largest regional membership after Europe. At the start of 2009, the PRI held a series of important events at the Stock Exchanges of Indonesia, Singapore and Thailand and with the sovereign wealth fund of Malaysia, Khazanah Nasional. Other events were also held to bring together insights from major international SRI funds and local stakeholders and investors. Engagement in Asia continued during the year with events in Indonesia, Malaysia, Singapore and China. In India, where CSR and SRI are gaining momentum, the PRI organised a major event with the National Stock Exchange for companies and investors in 2009. More outreach events are planned in 2010 in Indonesia, India, Malaysia and Korea. In China a joint PRI event is planned in September 2010 with UNCTAD and the UN Global Compact focussing on sustainable stock exchanges. The collective work of the PRI compliments that of local SRI advocacy groups such as ASrIA and KoSIF - the Korean Socially Responsible Investment Forum.

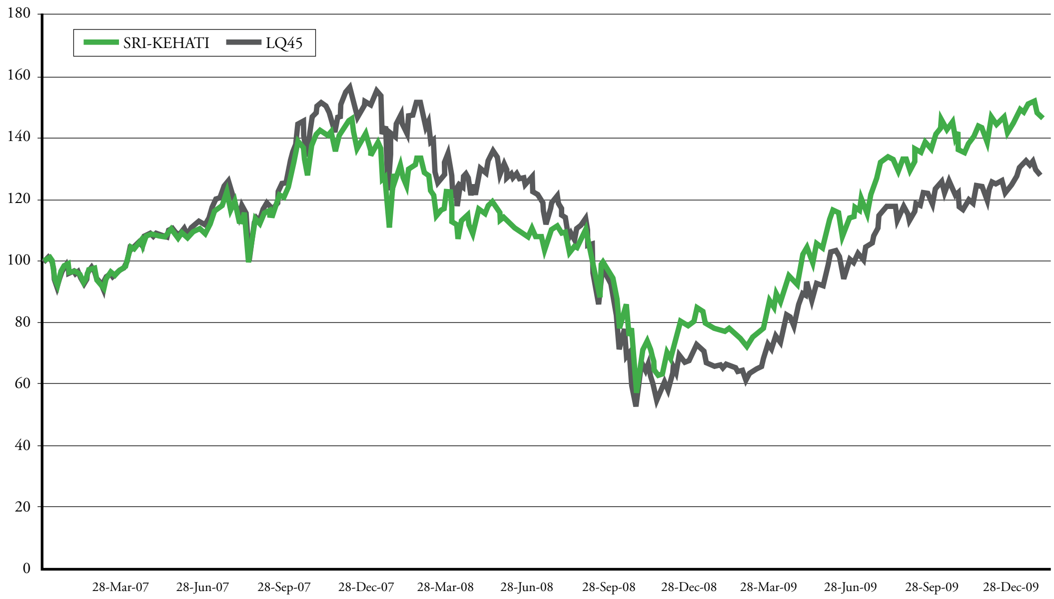
SIGNATORIES TO THE UN PRINCIPLES FOR RESPONSIBLE INVESTMENT

Global	**Asset Owners**	**Investment Managers**	**Service Providers**	**Total**
Europe	109	171	53	333
Asia-Pacific	46	90	30	166
North America	28	78	29	135
South America	18	18	9	45
Africa	2	21	6	29
International	1	1	5	7
Middle East	-	1	4	5
Total	**204**	**380**	**136**	**720**

Asia Pacific	**Asset Owners**	**Investment Managers**	**Service Providers**	**Total**
Australia	31	51	16	98
New Zealand	9	11	-	20
Japan	3	10	1	14
South Korea	1	7	6	14
Hong Kong	-	2	2	4
Thailand	1	3	-	4
Singapore	-	1	2	3
India	-	1	1	2
Malaysia	-	1	1	2
Vietnam	-	1	1	2
Indonesia	1	-	-	1
Oceania	-	1	-	1
Pakistan	-	1	-	1
Asia-Pacific	**46**	**90**	**30**	**166**
Asia	**6**	**28**	**14**	**48**

SRI PERFORMANCE: THE INDONESIA SRI-KEHATI INDEX

Pergerakan LQ45 Indeks dan SRI-KEHATI Index
1 Januari 2007 - 29 Januari 2010



One successful example of SRI can be seen in the SRI-Kehati Index on the Indonesian Stock Exchange (IDX) in Jakarta. The SRI-Kehati Index is a collaborative project between Yayasan Keanekaragaman Hayati Indonesia (The Indonesian Biodiversity Foundation – Kehati) and IDX launched on 8th June 2009 by Professor Dr Emil Salim, former Minister for the Environment in Indonesia.

The Index Universe starts with all listed companies on IDX. Financial screens are applied to remove small companies with a market capitalisation below Rupiah 1 trillion (approximately US$100million) and companies with low share availability, that is with a free-float ratio below 10%. Companies must also have a positive Price/Earnings (PE) Ratio.

A set of ESG criteria agreed to by Kehati, IDX and their stakeholders is then applied. Exclusion screens are used for companies involved in pesticides or chloride-organic-chemistry, Genetically Modified Organisms, nuclear power, severe violations of labour and human rights, armament and weapons, tobacco, alcohol and pornography. A further screen is also applied to exclude companies of concern for other reasons, such as corporate governance issues that arise or remain unresolved during the selection period.

The remaining companies are then rated by a leading ESG research company, OWW Consulting, using international ESG criteria, customised for Indonesian laws. These cover corporate governance, environment, human rights, labour practices, community investment and business behaviour related to suppliers and customers. This produces a SRI-Kehati Index candidate list for scrutiny by an independent committee which has sole responsibility of selecting twenty-five constituents which are "best-in-class" when compared to their peers.

The limit of twenty-five was chosen to make membership of the index competitive and it does not necessarily imply that only twenty-five companies are considered responsible. Membership of the SRI-Kehati Index has become a source of pride for companies who are now beginning to improve their sustainability performance in order to enter the index and maintain their position. This was an important motivating factor behind the project which was highlighted by Prof Dr Emil Salim in his launch speech.[8]

The financial performance of the SRI-Kehati Index has been impressive, even through the worst financial crisis since the Great Depression. From the baseline set in January 2007 to January 2010 it had grown 52.8% compared to 33.8% on the benchmark LQ45 Index.[9] During the period of the financial crisis, stocks on the SRI-Kehati Index proved more resilient, falling 62.1% compared to 66.7% on the LQ45. Since the end of the crisis the SRI-Kehati Index grew 168.2% trough-to-peak compared to 146.9% growth seen in the conventional index.

The SRI-Kehati Index has hit a number of important milestones after only twelve months. First, the fact that it was launched successfully shows that SRI has an important role to play in emerging markets in Asia and is not just for rich, developed economies. Second, the out-performance of the SRI-Kehati Index relative to the conventional benchmark demonstrates that SRI can be a successful investment style in its own right. Third, two new SRI funds have been established by Mega Capital and Bahaya Fund Management using the SRI-Kehati Index, which allows institutional and retail investors easy access to sustainable investment products. Fourth, the SRI-Kehati Index being backed by on-line information sources and training programmes has helped companies improve their sustainability management as well as helping fund managers and shareholders understand ESG investment styles and how they work in practice. Finally, it offers a real example for other stock exchanges to follow and will hopefully show them the value of creating SRI-indices across the region.

CHALLENGES AND OPPORTUNITIES

Some challenges exist which should be addressed urgently to take advantage of the growth potential for SRI in Asia. By far the most important is company disclosure on ESG issues. Financial markets need information and companies in Asia have a poor record on writing clear CSR and sustainability reports that meet international standards. Local research companies such as OWW Consulting in Malaysia or Eco-Frontier in Korea offer large databases for this purpose. On environmental performance, the global Carbon Disclosure Project (CDP), which is managed by ASrIA in the region, aims to encourage greater transparency on emissions and environmental management. The Emerging Markets Disclosure Project has similar plans for wider ESG issues. So while efforts are being made to improve transparency, a great deal more needs to be done in order to ensure the potential benefits of applying SRI in Asia. A number of regional stock exchanges in Asia have also introduced SRI / ESG indices. For example, the National Stock Exchange in India and Shanghai Stock Exchange in China are following the example of Indonesia in using SRI Indices to help drive sustainable and responsible investment.

Nonetheless, the momentum generated by SRI funds in Europe and North America is now spilling over into Asian markets where opportunities and returns offer new options for fund growth. Overseas SRI fund managers are already developing new Asian strategies which will put SRI in Asia onto a new trajectory. At current growth rates SRI in Asia is estimated to match that in other markets within five years.

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1 TIAA-CREF, “TIAA-CREF Statement on Former Holdings in Companies with Ties to Sudan”, press release, New York, January 4, 2010, http://www.tiaa-cref.org/public/about/press/about_us/releases/pressrelease313.html.

2 The European Social Investment Forum (EuroSif) estimated €2.7 trillion in European SRI Funds in 2008 (European SRI Study 2008 http://www.eurosif.org/publications/sri_studies) and the US Social Investing Forum (SIF) estimated US$2.7 trillion in the US in 2007. New surveys for both organisations are expected in 2010.

3 International Finance Corporation, “Gaining Ground: Integrating environmental, social and governance (ESG) factors into investment processes in emerging markets,” Washington DC, March 2009; OWW Consulting SRI Newsletter, November 2007.

4 Climate Investment Fund, “Climate Investment Funds set to mobilize US$40 billion for country-led low carbon growth,” press release, 19 March 2010, http://www.climateinvestmentfunds.org/cif/pf_2010_pressrelease_03_19.

5 Japan Bank for International Cooperation (JBIC), “Establishing Leading Investment to Future Environment (LIFE) Initiative,” http://www.jbic.go.jp/en/about/news/2008/0323-01/index.html.

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9 The LQ45 is an index of 45 companies with the highest level of liquidity that are the most tradable in terms of number of shares available in the market, http://www.duniainvestasi.com/bei/prices/stock/LQ45.