

## SRI STRATEGIES IN ASSET MANAGEMENT: TYPOLOGY AND APPLICATION TRENDS

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### Abstract

*Socially responsible investments, also often referred to as sustainable and responsible investments (SRI) have been gaining importance for the last ten years. Climate change, severe environmental problems, raising ethical concerns across the globe led to the emergence of the question whether companies need to be both profitable and responsible towards society and if yes, whether investing in companies which follow such principles, would be a profitable endeavor. For the last ten years, as a result of intensifying interest in SRI, seven types of strategies related to this activity have emerged, each of which proves to be gaining more and more assets under management.*

*The aim of the current paper is to explain the essence of these strategies and to present their typology and the trends of their application. The author supports the belief that SRI strategies will be gaining more and more importance in the future considering climate change side effects, pollution, the growing importance of ethical issues, and the corresponding shifts in consumer preferences and legislation.*

**Key words:** SRI, exclusion, ESG integration, corporate engagement, asset management

### 1. INTRODUCTION

Socially responsible investing (SRI) has emerged comparatively recently as a result of a number of circumstances and phenomena which go beyond the purely financial world. Climate change, severe environmental problems, raising ethical concerns across the globe led to the emergence of the question whether a company need to be both profitable and responsible towards society and if yes, whether investing in companies which follow such principles, would be a profitable endeavor. For the last years SRI has seen an increased interest on the part of investors and is becoming a widely-followed practice.<sup>1</sup>

One of the difficulties facing analysts and asset managers when trying to evaluate the scope and impact of SRI is the lack of existence of a single, universally accepted definition of this term. To date, there is a lot of heterogeneity in the current academic literature, too, as regards this subject.<sup>2</sup> SRI is used to denote investments that are oriented to a social cause in one way or another. It is often used as synonymous to “ethical investing” or “value-based investing”, and denotes “integration of certain non-financial concerns, such as ethical, social or environmental, into the investment process.”<sup>3</sup> The term SRI is also used in connection to the corporate social responsibility of a company, the latter term embracing environmental and social principles into its meaning.

Despite difficulties in defining SRI, a number of international organizations, among which the PRI, EFAMA, Eurosif, ALFI, GSIA and others, has been doing extensive data collection and analysis and it was found that there are several specific investment strategies used by asset managers in the field of SRI. Each of these strategies has its specificities and regions where it is predominantly used. Analyses show that all of the strategies are gaining momentum for the last years.

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<sup>1</sup> Kent, B. H., Norsinger, J. R. Socially Responsible Finance and Investing: An Overview. CourierWestford, 2012., p. 3

<sup>2</sup> Von Wallis, M., Klein, C. Ethical requirement and financial interest: a literature review on socially responsible investing. Business Research DOI 10.1007/s40685-014-0015-7, Springer, 2014, p. 3

<sup>3</sup> See Sandberg, J., C. Juravle, T.M. Hedesstro'm, and I. Hamilton. 2009. The heterogeneity of socially responsible investment. Journal of Business Ethics 87(4): 519–533.

## 2. DEFINITION OF SRI

There are several well established typologies of SRI. They help investors and analysts in their efforts to identify the desired investment type, as well as to follow the trends for each specific type of SRI.

One of the main sources for information about the types and trends in SRI are the biannual Eurosif's studies on this market with a focus on Europe. The Association of the Luxembourg Fund Industry (ALFI) conducts joint research with KPMG on European responsible investing trends and also provides insightful information. Another leading source is the Social Investment Forum Foundation which is following the data relevant for the USA.

Defining a precise SRI typology which to become globally accepted by investors and regulators is a challenge both for academics and for the financial industry as well. Currently the terms in circulation are multiple and do not allow for one universal understanding of SRI. This could be explained with the extreme complexity and existing interconnections of economic sectors in which SRI could be identified. Oftentimes for example a company could act responsible towards its employees and have a well outlined social program for the local community, and at the same time be involved in polluting activities as its core business. In this case, under which category should this company be classified and is it correct at all to consider investing in its securities an SRI? Another example could be a company dealing with the production of oils for cosmetic purposes, the oils being produced by hand following all requirements for the preservation of the quality of the product and hence the good health of the customers who are going to use it, but using child labor, or other negative labor practices for the purpose. How should such a company be treated – should investment in its securities be treated as an SRI, and if yes, under which category could it fall? There is no concrete answer to such questions to date. In many instances, the answer is left of the discretion of the investment manager who researches as much as possible the companies in which the fund is going to invest and labels it SRI or not for his company's internal purposes.

The difficulty of defining SRI becomes especially evident when exclusion logic is based in order to demarcate them, i.e. when one tries to identify what is not to be considered an SRI in order to explain what is SRI. This problem has been well acknowledged in financial literature with some sources stressing the inevitable subjectivity of the process.<sup>4</sup> The way SRI are defined however is not a purely theoretical matter. It affects the returns of the portfolio on which socially responsible strategy is applied to. In this respect, there are basically two types of exclusions employed to define SRI: exclusions to a broad, and to a strict and narrow definitions of the so called sin stocks. The strict and narrow definition implies the application of the widely employed definitions of "sin" raters and SRI funds.<sup>5</sup> The sin stocks are stocks from companies involved in harmful activities. Definitions of sin stocks vary as well, but well-known ones are the so-called Triumvirate of Sins (alcohol, tobacco, and gambling), and the proposed by Ahrens so-called 4Bs portfolio of 'booze, bets, bombs, and butts' (alcohol, gambling, controversial weapons, and adult entertainment).<sup>6</sup> Another broader definition of sin stocks is proposed by Lobe and Walkshäusl, according to which alcohol, tobacco, gambling, controversial weapons, adult entertainment, and nuclear power form the so-called Sextet of Sins.<sup>7</sup> Medical Sin on the other hand comprises potentially controversial medical stocks, encompassing firms

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<sup>4</sup> Jan Trinks, Pieter, and Scholtens, Bert. The Opportunity Cost of Negative Screening in Socially Responsible Investing. *Journal of Business Ethics*, 2015. Available at: <http://link.springer.com/article/10.1007/s10551-015-2684-3/fulltext.html>, retrieved 31.05.2015

<sup>5</sup> Please refer to Renneboog, L., ter Horst, J., & Zhang, C. (2008). Socially responsible investments: Institutional aspects, performance, and investor behavior. *Journal of Banking & Finance*, 32(9), 1723–1742, Fabozzi, F. J., Ma, K. C., & Oliphant, B. J. (2008). Sin stock returns. *The Journal of Portfolio Management*, 35(1), 82–94, and MSCI (2013). Business involvement screening research. definitions and scope. [http://help.riskmetrics.com/Screening/Content/Methodology/Business\\_Involv\\_Meth.pdf](http://help.riskmetrics.com/Screening/Content/Methodology/Business_Involv_Meth.pdf), retrieved on 6 June 2015.

<sup>6</sup> Ahrens, D. (2004). Investing in vice: The recession-proof portfolio of booze, bets, bombs, and butts. New York: St. Martin's Press.

<sup>7</sup> Lobe, S., & Walkshäusl, C. (2011). *Vice versus virtue investing around the world*. Unpublished working paper, University of Regensburg. <http://dx.doi.org/10.2139/ssrn.1089827>. Retrieved 6 June 2015.

engaging with abortion, animal testing, contraceptives, genetic engineering, and embryonic stem cells.<sup>8</sup>

One of the widely accepted definitions of SRI is the one proposed by Eurosif: “Sustainable and Responsible Investment (SRI) incorporates any strategy an investor may deploy which incorporates Environmental, Social and Governance (ESG) consideration or analysis”. Sustainable and responsible investment is considered synonymous to socially responsible investing, or investment.<sup>9</sup>

### **3. SRI STRATEGIES TYPOLOGY AND APPLICATION TRENDS**

The Global Sustainable Investment Association (GSIA) is an organization which follows market trends as regards SRI and systematized data on them in order to facilitate analysis and help investors. In 2013 GSIA published its Global Sustainable Investment Review presenting 2012 data. In this document for the first time data for Europe, the United States, Canada, Asia, Japan, Australasia and Africa were consolidated so that a global picture of the SRI market became evident. The most recent GSIA review is dedicated to 2014 trends and in it, major strategies used by investors are outlined.

As noted above, there are many ways in which an investor can act in a socially responsible way. In particular, GSIA has identified seven strategies that are followed by fund managers across the globe in that respect, and the definitions provided below are close to the ones presented by GSIA Global Sustainable Investment Review 2012:

- Negative/exclusionary screening. Negative/exclusionary screening is by far the most popular and widely applied strategy worldwide with the European market being the leader. It implies the exclusion from a portfolio of some companies on the basis of particular ESG criteria;
- Integration of ESG factors is the second most often applied investment strategy in the area of SRI. In this strategy, investment managers systematically and explicitly include ESG factors in financial analysis when determining the investment choice;
- Corporate engagement and shareholder action is the third most popular SRI strategy in the world. It represents the usage of shareholder power to influence corporate behavior through various ways, including proxy voting on the basis of ESG criteria;
- Positive/best-in-class screening. This strategy includes investing in companies which are selected on the grounds of positive ESG performance when compared to industry peers;
- Norms-based screening. According to this strategy, investing is done after the application of screening of possible investment choices against minimum standards of business practice.
- Integration of ESG factors;
- Sustainability-themed investing. In this strategy, investments are directed towards specific themes or assets which have any relation to sustainability;
- Impact/community investing is a strategy which is directed towards the resolution or alleviation of environmental or social problems, or towards communities which are socially excluded. This is the strategy with the highest growth rate among all strategies observed by GSIA for the period 2012-2014.<sup>10</sup>

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<sup>8</sup> Jan Trinks, Pieter, and Scholtens, Bert. The Opportunity Cost of Negative Screening in Socially Responsible Investing. *Journal of Business Ethics*, 2015. Available at: <http://link.springer.com/article/10.1007/s10551-015-2684-3/fulltext.html>, retrieved 31.05.2015

<sup>9</sup> Eurosif. European SRI Study, 2014. Available at: <http://www.eurosif.org/our-work/research/sri/european-sri-study-2014/>, retrieved 1 May, 2015, p. 10.

<sup>10</sup> Global Sustainable Investment Review 2014. GSIA. Available on [http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf), retrieved 28 June 2015, p. 3

Apart from GSIA, other organizations have put a lot of efforts to identify and classify the types of SRI that exist today. In this respect, Eurosif, the Principles of Responsible Investment (PRI) and the European Fund and Asset Management Association (EFAMA) are noteworthy. A comparison of classifications is presented below in Table 1.

Table 1. Comparison of SRI Classifications

<b>GSIA</b>	<b>Eurosif</b>	<b>PRI</b>	<b>EFAMA</b>
ESG Negative Screening	Exclusions	ESG Negative/Exclusionary screening	Negative screening or Exclusion
ESG Integration	ESG Integration	Integration of ESG Issues	-
Corporate engagement and shareholder action	Engagement and voting	Engagement (three types)	Engagement (voting)
Norms-based screening	Norms-based screening	Norms-based screening	Norms-based screening
ESG positive screening and Best-in-Class	Best-in-Class selection	ESG positive screening and Best-in-Class	Best-in-Class policy
Sustainability-themed	Sustainability-themed	ESG-themed Investments	Thematic investments
Impact/Community investing	Impact Investing	-	-

Source: European SRI Study, 2014. Eurosif.

The above comparison shows that the leading organizations dealing with the SRI market research are using very similar classifications, despite the slight differences in the names of the SRI strategies and in spite of the fact that for impact investing PRI and EFAMA do not define a separate strategy, and that for ESG integration EFAMA does not recognize a specific strategy.

The classification of the strategies, though not still universally accepted and unified, is very useful for the purpose of answering three questions of particular importance to investors:

- 1) what types of strategies exist to date,
- 2) which are the strategies that investors prefer, and
- 3) what is the growth rate of the volume of assets under management (AuM) each of these strategies

GSIA research shows that for the last two years since the launch of the global SRI review project, the dominant strategies for investors are, in descending order – ESG negative screening, followed by ESG integration and corporate engagement and shareholder action. ESG negative screening, or exclusion as named by Eurosif and EFAMA, is by far the most preferred SRI strategy globally. In 2014 GISA reported that it has \$14.4 trillion AuM. This strategy is mainly applied in Europe.<sup>11</sup>

As touched upon above, the success and wide application of it are due to its straightforwardness and the simplicity of the core concept behind it. Asset managers are simply refraining from investing in industries which do not match ESG criteria, this is why the strategy is also often named

<sup>11</sup> Global Sustainable Investment Review 2014. GSIA. Available on [http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf), retrieved 28 June 2015, p. 3

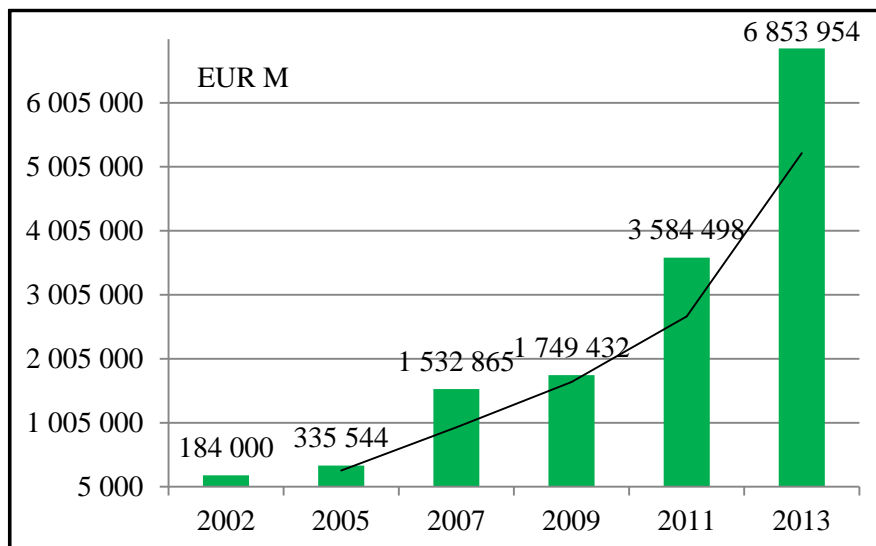
“Negative/exclusionary screening”. To date there is no unified list of which these criteria are, asset managers retain the right to apply individual discretion when making investment choices. PRI offers relatively detailed examples on the types of screening that are most commonly used but remarks that it does not advocate for any of them. Instead, it is in favor of strategies “which ensure investors are completely aware of the implications of their investments and are able to report on those investments to clients and beneficiaries.”<sup>12</sup>

Since Europe has been the most active region in the world in terms of the usage of exclusion practices in SRI, in Fig. 1 below data on the application of this strategy are presented.

As evident from it, growth of the AuM under this strategy has been significant for the 11 years under observation by Eurosif as presented in their 2014 market review. Only for the period 2011-2013 growth was especially steep, it reached 91.2% which is significant considering that these years are marked by the global financial crisis.

At the same time, ESG integration strategy has been applied to \$12.9 trillion AuM in 2014 and is the dominant strategy in the USA, Australia/New Zealand and Asia.<sup>13</sup> Corporate engagement strategy has been applied over \$7.0 trillion in 2014 and is the preferred choice of SRI strategy in Canada.<sup>14</sup>

Fig. 1. Growth of investments as a result of exclusion



Source: Eurosif, 2014

The other four strategy types are of less significance in terms of AuM, however they show rapid growth in the last years. This is especially evident from the data on impact investing, which, although applied over a small share of AuM, comprises a fast growing SRI strategy in the world.

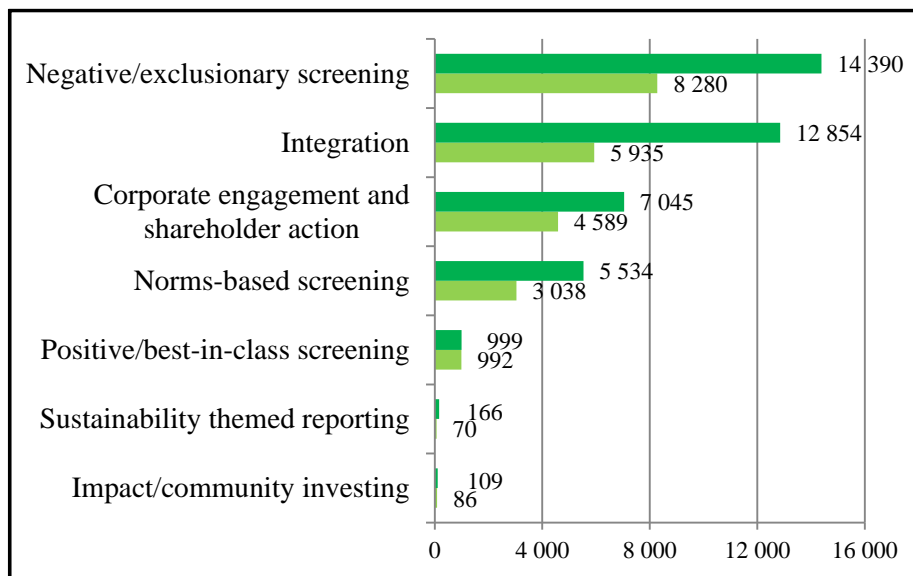
Turning to the third important question for investors, related to the growth of AuM under each strategy, GSIA data reveal that all of them without exception have seen increase. Some strategies have marked higher increase than others, with the three most preferred types preserving their significant growth.

<sup>12</sup> Screening. PRI. Available at: <http://www.unpri.org/areas-of-work/implementation-support/fixed-income/screening/>, retrieved on 18 June 2015

<sup>13</sup> Global Sustainable Investment Review 2014. GSIA. Available on [http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf), retrieved 28 June 2015, p. 3

<sup>14</sup> Global Sustainable Investment Review 2014. GSIA. Available on [http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf), retrieved 28 June 2015, p. 3

Fig. 2. SRI Strategies Growth



Source: GSIA, 2014

The fact that exclusions, integration and corporate engagement strategies continued to be preferred by investors means that their importance will most probably be retained in the near future. The fact can be attributed to the relatively easy application of these strategy types compared to the rest. The growth, however, that the other four types mark, makes investor optimistic that they will be further developing as well.

#### 4. CONCLUSION

Despite that the roots of SRI could be sought back in the past, more particularly in the start of the XX century, it has been gaining momentum and importance for investors for the last ten years.<sup>15</sup> This is the result of the interplay of a number of factors such as the aggravation of phenomena such as climate change and pollution, the growing awareness of society on the importance of these matters and the corresponding interest of investors in businesses which demonstrate that they place efforts towards the alleviation of these problems.

The growing amount of AuM over which SRI strategies are being applied raised the importance of the creation of classification of these strategies, and of data collection and following of particular indicators revealing the trends associated with them. Organizations such as ALFI, KPMG, Eurosif, GSIA, PRI, EFAMA started offering their own classifications and analysis on SRI. Though to date a universal classification does not yet exist, existing classifications are more or less overlapping.

Currently is it generally accepted that SRI strategies could be divided into seven types which could be traced in terms of performance (asset growth) and importance for the different regions/ countries in the world. At present the three dominant strategies are ESG negative screening, ESG integration and corporate engagement and shareholder action (as defined by GSIA). While ESG negative screening is dominant in Europe, ESG integration is the leading choice in the USA, and corporate engagement and shareholder action – in Canada. The rest of the four strategies are used to a lesser extent, but all seven strategies mark significant increase in relative terms for the period 2012-2014.

<sup>15</sup> Please see “EFAMA Report on Responsible Investment, 2014” for more on the history of responsible investment.

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