PRI Principles for Responsible Investment

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What is responsible investment?

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems.

Responsible investment can be differentiated from conventional approaches to investment in two ways. The first is that timeframes are important; the goal is the creation of sustainable, long-term investment returns not just short-term returns. The second is that responsible investment requires that investors pay attention to the wider contextual factors, including the stability and health of economic and environmental systems and the evolving values and expectations of the societies of which they are part. Looking to the future, these issues will be increasingly key drivers of industrial and economic change, and the most successful companies are likely to be those that respond most effectively to these challenges. Indeed there is a growing base of evidence to highlight that companies which bring sustainability into the heart of their business strategy, outperform their counterparts over the long-term, both in terms of stock market and accounting performance.[1]

Responsible Investment in Practice

In practice, investors have adopted a variety of responsible investment strategies which use ESG information in different ways (see Box 1).

Box 1: Major Responsible Investment Strategies
• Integrated analysis involves the proactive consideration of ESG factors in investment research and decision-making. This may involve considering these factors as part of top-down or bottom-up stock selection or in asset allocation. Integrated analysis can

[1] One example includes research from Robert G. Eccles, Ioannis Ioannou, and George Serafeim, Harvard Business School: The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance, Working paper, 4 November, 2011

result, for example, in investments being over-weighted, under-weighted or avoided in the portfolio.

- Active ownership involves investors using their formal rights (e.g. the ability to vote shareholdings) and informal influence (e.g. their ability to engage) to encourage companies to improve their management systems, their ESG performance or their reporting. Engagement with public policy makers is increasingly seen as an integral part of active ownership.
- Negative screening involves excluding companies from the investment universe on the basis of criteria relating to their products, activities, policies or performance. This includes sector-based screening (where entire sectors are excluded) and norm-based screening (where companies are excluded if they are considered to have violated internationally accepted norms in areas such as human rights and labour standards). These approaches may be derived from legal obligations on an investor (e.g. in the case of some European pension funds) or from the need for the investor to align its activities with the needs and interests of its beneficiaries or clients.
- Positive screening involves preferentially investing in companies or sectors on the basis of criteria relating to their products, activities, policies or performance.
- Best-in-class involves preferentially investing in companies with better governance and management processes and ESG performance.
- Thematic investment involves selecting assets on the basis of investment themes such as climate change or demographic change.

Even within these broad strategies, there is a huge variation in implementation. For example, investors differ on:

- The importance that they assign to ESG issues relative to conventional financial aspects in their investment processes. This, in turn, is informed by a whole series of factors including legal obligations on asset owners, organisational policies and commitments, and the investment objectives for the particular portfolio or assets in question. Like all investment decisions, other factors that need to be considered include investment time horizons (in particular, the weight that is given to long-term versus short-term factors), and the views and judgements of the investment managers and analysts in question.
- The specific ESG issues that they consider in their responsible investment activities.
- The scope of their responsible investment commitments, in particular whether these apply to individual portfolios, to specific asset classes or across all asset classes.
- The resources allocated to responsible investment, the extent of CEO or senior management involvement, and the level of transparency around the actions taken and the outcomes achieved.

Key Debate: The Alignment of Societal Values and Investment Value

One of the central arguments for responsible investment is that it provides a means of delivering market or better-than-market returns in a way that is aligned with the interests of society and the environment. If the whole investment chain is much more focused on long-term value creation, this should help ensure that investors preferentially invest in companies that have better ESG performance and thereby make a real contribution to addressing the sustainability challenges that we face.

Kay, 2012, p. 74

" … institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long-term."

However, current investment practice falls far short of this ideal. First, investors have tended to assign a much greater importance to short-term investment returns (including practices such as share buy backs) rather than the creation of long-term returns; for example, companies have little incentive to invest in significant greenhouse gas emission reductions (beyond the lowest of the low-hanging fruit) if their shareholders would prefer them instead to boost short-term earnings. The challenges posed to companies by the need for adaptation to the physical impacts of climate change are also usually considered to be outside investors' normal time horizon. Second, investors tend to discount relatively low probability events from their calculations of investment returns. Yet, as we have seen in the case of BP's Deepwater Horizon Gulf of Mexico disaster, one of the most high-profile examples of recent times, relatively low probability events do occur and are highly relevant to investors. Third, investors find it hard to identify the financial value of intangible assets on which companies depend for long-term return such as human capital in the form of a talented and motivated workforce. Fourth, investors have tended not to look at the systemic risks presented by or created by companies. Perhaps the most striking example is the role played by the banking and investment sectors in causing the global financial crisis.

Adopting longer-term investment horizons would significantly increase the overlap between investors' financial interests and environmental or social objectives as seen from a societal perspective. Exploring the extent of this overlap, and how to reflect it in investment decision-making and the exercise of active ownership, is a key priority for the coming years. Nonetheless, this broadening and lengthening of investors' focus will not necessarily address all the sustainability or ethical issues related to business and investment; it is likely that further policy and regulation will be needed to close the gap between what is in investors' financial interest and what is in the broader public interest. However, responsible investment enables us to make a huge step towards the better alignment of societal values and investment value.

References/Further Reading

Kay, J. (2012), The Kay Review of UK Equity Markets and Long-term Decision Making. Final Report – July 2012 (Department for Business, Innovation and Skills, London).

http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf

SRI Market: Size and Responsible Investment Strategies

For information on responsible investment in Europe, the United States and Australia/New Zealand, see www.eurosif.org, http://ussif.org/resources/research/ and http://www.responsibleinvestment.org/riaa-research/ respectively.

The annual PRI Reports on Progress provide information on the implementation of responsible investment by PRI signatories. See http://www.unpri.org/publications/

Responsible Investment Strategies

A number of organisations provide useful introductory guides to responsible investment. See, in particular http://www.socialinvestment.ca/individual-investors.htm and http://ussif.org/resources/sriguide/srifacts.cfm

For a useful typology of responsible investment strategies, see Sandberg, J., C. Juravle, T. Hedesstrom and I. Hamilton (2009), 'The Heterogeneity of Socially Responsible Investment', Journal of Business Ethics 87.4: 519-533.

For information on how responsible investment may be applied in different asset classes, see the PRI's publications at http://www.unpri.org/publications/