Towards Sustainable and Responsible Investment

A Review and Inventory of the Social Investment Industry’s Activities and Potential in Emerging Markets

ISSUE BRIEF

In partnership with the Netherlands, Norway, and Switzerland
Introduction

To support the growth of sustainable capital flows, IFC’s advisory services seek to influence, support, and enable capital market stakeholders to better integrate environmental, social, and governance (ESG) factors into capital allocation and portfolio management processes, using IFC’s own investment practices as a model. IFC is playing its part to support the growth of the market by funding the development of enhanced stock market indices, financial instruments, and through targeted market research.

In 2003, this report provided the first comprehensive overview of socially responsible investing (SRI) in emerging markets. Its findings showed that the social investment industry, having already achieved striking, ongoing growth in developed countries, could ultimately play an expanded role in emerging markets as well.

SRI INDUSTRY GROWTH

SRI has expanded dramatically in developed countries over the past three decades. It now accounts for a significant part of the overall market capitalization and there is evidence suggesting the trend is likely to continue. In emerging markets, on the other hand, growth in SRI has not yet occurred on the same scale, but this could soon change.

Social investors increasingly are turning their attention to global sustainability issues that, by definition, include emerging markets, home to two-thirds of the world’s population and one-third of the world’s resource use. In the medium to long term, the solid prospects for expansion of SRI in emerging markets could make it a major force influencing how corporations contribute to sustainable development.

From its modern beginnings more than 30 years ago to 2003, SRI grew into a US$2.7 trillion worldwide industry consisting of more than 760 retail funds and many institutional investors. In the U.S. alone, assets held in the screened portfolio form of SRI – in portfolios that filter investments according to a range of social or environmental criteria – amounted to more than US$2 trillion. U.S. assets controlled by shareholder advocates, a second form of SRI – in which share ownership is used to advocate socially or environmentally responsible business practice – amounted to almost US$900 billion. Through the first half of 2003, investors filed a record 237 social or environmental shareholder proposals with U.S.-listed companies. SRI growth was also sizable in Australia, Canada, and some countries in Europe. In the U.K., SRI assets grew tenfold from 1997 to 2001, reaching US$354 billion.

Table 1. Developed Country Social Investment

<table>
<thead>
<tr>
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<th>SRI All Investments ($US billions)</th>
<th>SRI as % Total Market Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1999</td>
<td>2002</td>
</tr>
<tr>
<td>U.S.</td>
<td>2,160</td>
<td>2,300</td>
</tr>
<tr>
<td>U.K.</td>
<td>2</td>
<td>354</td>
</tr>
<tr>
<td>Canada</td>
<td>32</td>
<td>30</td>
</tr>
<tr>
<td>Europe</td>
<td>N/A</td>
<td>17.6</td>
</tr>
<tr>
<td>Australia</td>
<td>6.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Asia</td>
<td>NA</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,280</strong></td>
<td><strong>2,710</strong></td>
</tr>
</tbody>
</table>

Source: Enterprising Solutions Global Consulting

However, SRI remains predominantly concentrated in developed countries. SRI held in emerging markets assets in 2003, primarily in large capital stocks, stood at an estimated US$2.7 billion, about only 0.1 percent of all SRI worldwide. Of this, about US$1.5 billion was held by developed-country investors and about US$1.2 billion by emerging-markets investors. The report identifies barriers that have inhibited greater SRI expansion in emerging markets, but also opportunities for overcoming these barriers, and gives evidence of significant untapped demand for growth in emerging-markets SRI.
SRI PERFORMANCE

SRI growth has been driven by its consistently competitive financial performance, overturning the uninformed notion that attention to social and environmental issues detracts from performance: the reality is that the majority of SRI funds outperform their relevant benchmark indices. This superior SRI performance, or “SRI premium,” is believed to be derived from the inclusion of positive and negative social and environmental externalities in SRI decision-making analysis. SRI performance has led some of the world’s largest institutional investors, such as CalPERS and ABP Investments, to employ some social and environmental criteria in their investment guidelines. In the process, they are broadening the range of factors that institutional investors typically consider. Perhaps most significantly, this challenges the practice of interpreting the “prudent man rule” of fiduciary responsibility in a narrow way, wherein all non-financial considerations are deemed irresponsible. Given the evidence that social and environmental factors often have long-term financial impacts, it becomes a matter of financial prudence to consider them.

SRI SUSTAINABILITY IMPACT

SRI has influenced corporate behavior on a range of social and environmental issues bearing on the sustainability of business practices. Although the evidence is abundant, it is largely anecdotal due to the unavailability of broad, rigorous data. This stems in part from the analytical difficulty in separating SRI influence from the effects of concomitant factors like regulatory changes, government actions, and the work of advocacy groups. In any case, different types of SRI have different kinds of impacts. Results, often achieved by multiple forces working together, have included the establishment of low-income housing and community credit unions; the adoption by companies like Wal-Mart, Nike, and Gap of supplier codes of conduct; and the spread of divestment campaigns such as those targeting the U.S. tobacco industry or, earlier, South African apartheid.

Significantly, social investors also have caused companies to produce an incredible volume of corporate disclosure on social and environmental performance. This in turn has helped social investors and others to pressure companies on a range of issues, from improving human resource policies toward minorities and women, to agreeing on the importance of global climate change and its material impact on business, to accepting responsibility for the working conditions of subcontractors.

THE CASE FOR MORE SRI IN EMERGING MARKETS

From an investment perspective, there are a number of sound traditional investment reasons for making emerging markets investments. There are also indications that the “SRI premium” is at work in emerging markets. The view that corporate social and environmental responsibility adds financial value to businesses operating in emerging markets is supported by studies such as Developing Value: The Business Case for Sustainability in Emerging Markets by IFC and the U.K.-based firm SustainAbility Ltd., and Saints and Sinners: Who’s Got Religion, by CLSA, the Hong Kong-based investment bank.

From a sustainable development perspective, the positive impact that SRI can have in emerging markets is clear.

Moreover, greater SRI in emerging markets can also bring the weight and credibility of private sector finance to an area of national development and social investors, as relatively large investors within the context of emerging markets, may also have a favorable impact on sustainable development in those countries that is orders of magnitude larger than it has been in developed countries.

Figure 1: Global Macro Trends Favoring SRI

- Globalization of industry where social and environmental performance becomes a source of differentiation and competitive advantage.
- Tightening global, regional, and domestic regulatory pressures such as the Kyoto Protocol (on global warming), European Union directives, and U.S. clean air regulations.
- Changing consumer/investor demographics, with many younger, “greener” consumers and investors.
- Growing institutional shareholder activism.
- Growing CEO/CFO awareness of the competitive and financial benefits of superior environmental performance.
- Global population/resource consumption pressures.
- Increased transparency and velocity of company information.
- Pressure from nongovernmental organizations armed with better information and growing credibility.

Source: Enterprising Solutions Global Consulting

The full report gives a detailed analysis of the evolution of SRI through 2003, its presence in emerging markets, as well as the barriers to and opportunities for SRI in emerging markets and puts forth recommendations.
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Further reading: “Gaining Ground – Integrating environmental, social and governance (ESG) factors into investment processes in emerging markets” (2009); Mercer

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