WORLD ECONOMIC FORUM

COMMITTED TO IMPROVING THE STATE OF THE WORLD

Accelerating the Transition towards Sustainable Investing

Strategic Options for Investors, Corporations and other Key Stakeholders

FINANCIAL RETURNS
SUSTAINABLE VALUE CREATION
ENGAGEMENT
FINANCIAL MATERIALITY
INTEGRATED REPORTING
ESG COMPETENCIES
RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

A World Economic Forum White Paper

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The views expressed in this publication have been based on workshops, interviews, and research. Although great care has been applied to synthesize the different perspectives, the integrated views expressed in this publication do not always reflect the personal views of the individual Working Group members and/or the organizations that they represent or those of the World Economic Forum.

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Table of Contents

Introduction

For many years, the World Economic Forum has been engaging business, government and other stakeholders in partnerships to encourage sustainable business practices. From conversations with both investors and corporate executives, it became clear that financial markets in particular have great potential to accelerate the transition towards sustainable business practices and sustainable models of economic development. For this reason, the Forum over the past year has embarked on a cross-industry initiative to further stimulate the integration of environmental, social and governance factors into mainstream investment analysis.

The initiative builds on the World Economic Forum's earlier work, released in January 2005, which highlighted a series of suggestions on how environmental and social factors could be integrated into investment valuation and asset allocation decisions. Since then, there has been an ever-increasing interest by investors to understand and evaluate sustainability risks and opportunities in their investment decisions. For example, more than 850 investors have signed up to the UN-backed Principles for Responsible Investment since its inception in April 2006, while the launch in August 2010 of the International Integrated Reporting Committee is an important step towards integrating sustainability reporting and financial reporting.

Despite the progress made, there are still considerable barriers to overcome before sustainable investing can be considered a mainstream approach. With this white paper, we aim to contribute to the international debate on how to overcome some of these barriers. The paper in particular focuses on the following central question: What are key pathways for investors, corporations and other key stakeholders in the investment value chain to accelerate the transition towards sustainable investing?

This white paper is the result of engaging over 100 investors and corporate executives through interviews, workshops and conference calls. It is meant to broaden the work published in January 2005 in the following three dimensions:

- First, we focus on the role of asset owners and asset managers as well as of corporations, governments, accounting bodies, investment advisors and other key stakeholders
- Second, we more explicitly explore the role of active corporate governance as a key factor in driving the transition
- Third, we look beyond functional changes (such as adapting incentive structures across the investment value chain) to encompass also the necessary mindset changes (such as approaching sustainability issues not only from a risk and compliance perspective, but also from an opportunity and value creation perspective)

We hope that this white paper will provide relevant insights and, most importantly, will catalyse further dialogue and initiatives to accelerate the transition towards sustainable investing.

On behalf of the World Economic Forum, we would like to thank the members of the World Economic Forum's Sustainable Investing Working Group and the many individuals and organizations that have contributed so generously to this initiative.

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Executive Summary

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RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

Executive Summary

Financial markets have great transformational power to accelerate the transition towards more sustainable business practices and value creation. Recognizing this pivotal role of financial markets, the World Economic Forum has embarked upon a cross-industry initiative to stimulate the integration of environmental, social, and governance (ESG) factors into mainstream investment analysis.

This white paper explores the following central question: *What are key pathways for investors, corporations and other key stakeholders in the investment value chain to accelerate the transition towards sustainable investing?*

Sustainable Investing – a Definition
Sustainable investing is an investment approach that integrates long-term environmental, social, and governance (ESG) criteria into investment and ownership decision-making with the objective of generating superior[1] risk-adjusted financial returns. These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios.

The focus on superior risk-adjusted financial returns distinguishes sustainable investing from similar-sounding approaches such as "impact investing" or "socially responsible investing", in which lower financial returns can be accepted as a trade-off for meeting social or environmental goals. As defined in this paper, sustainable investing is therefore consistent with the fiduciary duty of many institutional investors to maximize risk-adjusted financial returns.

The Potential of Sustainable Investing
Empirical evidence indicates that a sustainable investing approach can lead to better risk-adjusted financial returns. Still, only a small percentage of investors include ESG factors in their investment and ownership decision-making processes. This paper argues that sustainable investing has the potential to become a mainstream approach among a broad range investors, especially those who are in a position to take a longer-term perspective.

Key drivers include:
- Growing awareness within the investment community that global mega trends such as climate change and natural resource scarcity (and their related externalities) are becoming increasingly financially material
- Increasing demand from large asset owners (as universal owners)
- Increasing demand from retail investors (including high net worth individuals)

Key Barriers to Sustainable Investing
Some key barriers are currently inhibiting the transition towards sustainable investing as a mainstream investment approach. This paper analyses them in four categories:
- Key barriers for investors include: restrictions in conventional valuation models, lack of ESG expertise, lack of awareness and/or scepticism regarding the investment case
- Key barriers for corporations include: insufficient integration of sustainability factors into core business strategies, lack of formal approach in setting ESG targets and holding senior staff accountable

1 Compared to traditional benchmarks and traditional investment approaches for the same asset class.

- Key barriers for investor-corporation interaction include: lack of clarity on which ESG factors are financially material and over which time frame, insufficient communication of link between ESG and corporate financial performance
- Key barriers at system-wide level include: disproportionate focus on short-term performance and issues with a near-term impact, and the fact that many negative externalities are underpriced.

How to Accelerate the Transition towards Sustainable Investing

To accelerate the transition towards sustainable investing, both functional and mindset changes need to take place. Functional changes identified by the World Economic Forum's Sustainable Investing Working Group included:

- Where appropriate, linking incentives in the investment value chain more towards superior risk-adjusted financial performance over the long-term – for example, increasing performance assessment periods for fund managers (both in-house and external), and including ESG factors as indirect financial performance criteria for corporate executives.
- Buy- and sell-side analysts working with corporate executives to determine key performance indicators for financially material environmental, social and governance factors at sector level, and asset owners using their mandates to asset managers to encourage the analysis of these factors.

The Working Group also identified new mindsets that need to be adopted by both investors and corporate executives, for example:

- ESG indicators are direct and indirect drivers of business value
- Sustainability considerations – if effectively integrated into core business strategies – have the potential to strengthen the financial performance of companies

The Role of Key Stakeholders in Accelerating the Transition towards Sustainable Investing

The process of transition towards a more mainstream acceptance of sustainable investing is a "chicken-and-egg" situation: more investors will consider ESG information only when more corporations provide it; more corporations will provide ESG information only when more investors demand it.

To accelerate this process of transition, leadership from all stakeholders across and around the investment value chain is required. This paper highlights concrete actions that asset owners, asset managers, corporations, governments, accounting bodies, investment advisers and other key stakeholders can consider undertaking.

1. The Potential of Sustainable Investing

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SUSTAINABLE VALUE CREATION
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FINANCIAL MATERIALITY
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ESG COMPETENCIES
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SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

1. The Potential of Sustainable Investing

1.1. Why this White Paper?

According to a recent UN Global Compact – Accenture survey[2] of 788 senior executives, most CEOs recognize that "the power of financial markets, if harnessed, could perhaps be the strongest driver towards companies around the world integrating sustainability into core business". Still, the survey also indicates that many business executives believe that the investor community is not interested or prepared to factor the sustainability metrics into their valuation models.

Nonetheless, there does seem to be a growing interest in sustainable investment approaches within the investor community. For example, more than 850 investors – representing approximately US$ 25 trillion assets under management – have signed the UN-backed Principles for Responsible Investment since their launch in April 2006.[3] In doing so, these investors committed to incorporate environmental, social, and governance issues into their investment analysis, decision-making processes, and ownership policies and practices.

This paper aims to bridge the perspectives between corporate executives and investors on how to the drive the transition towards sustainable investment practices. More specifically, this paper explores the following central question: *What are key pathways for investors, corporations, and other key stakeholders in the investment value chain to accelerate the transition towards sustainable investing?*

Section 1 explores how sustainable investing is understood and currently practised, what are the key drivers and market potential, and why it can make sense not only from environmental and social perspectives but also from an economic perspective. Section 2 explores the key barriers to sustainable investing, looking separately at investors and corporations, interactions between them and barriers at a system-wide level. Section 3 explores how investors, corporations and other key stakeholders such as governments, accounting bodies, and investment advisors can overcome these barriers. Finally, section 4 provides a summary of the conclusions and next steps.

1.2. What is Sustainable Investing?

In this white paper, "sustainable investing" is defined as an investment approach that integrates long-term environmental, social, and governance (ESG) criteria into investment and ownership decision-making with the objective of generating superior[4] risk-adjusted financial returns. These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios.

The focus on superior risk-adjusted financial returns distinguishes sustainable investing from similar-sounding approaches such as "impact investing"[5] or "socially responsible investing",[6] in which lower financial returns may be accepted as a trade-off for meeting social or environmental goals. As defined in this paper, sustainable investing is therefore consistent with the fiduciary duty of many institutional investors to maximize risk-adjusted financial returns.

Sustainable investing is essentially the same concept as "responsible investing", which – per the United Nations backed Principles of Responsible Investment (PRI) – aims to "integrate consideration of environmental, social and governance (ESG) issues into investment decision-making and ownership practices, and thereby improve long-term returns".[7] The project team chose to use

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2 UN Global Compact, Accenture, A New Era of Sustainability – CEO Study 2010, 2010

3 These principles can be found on: http://www.unpri.org/principles/

4 Compared to traditional benchmarks and traditional investment approaches for the same asset class.

5 Impact investing is an investment approach that aims to proactively create positive social and environmental impact against an acceptable risk-adjusted financial return. This requires the management of social and environmental performance (in addition to financial risk and return). So, with impact investing "impact" comes first, whereas with sustainable investing "financial returns" come first. For more information on impact investing: J.P. Morgan, Impact Investments – An emerging asset class, November 2010

6 Socially responsible investing, an area often affiliated with the retail financial sector, incorporates ESG issues as well as criteria linked to a values-based approach. For example, it can involve the application of pre-determined social or environmental values to investment selection. Investors may choose to exclude or select particular companies or sectors because of their impact on the environment or stakeholders. Negative screening (such as weapons exclusions) and positive screening (such as Best-in-Class or thematic approaches) typically fall in the remit of such investments. Source: Eurosif, European SRI Study 2010 Revised Edition, 2010

7 http://www.unpri.org/faqs (accessed 13 October 2010).

"sustainable investing" because during the interview process it seemed to resonate better within the mainstream investment community. Whereas "responsible" connotes duty and ethics, "sustainable" emphasizes more strongly the opportunity for sustainable business practices to deliver better returns to investors over the longer term.

A sustainable investing approach provides opportunities especially for investors that can adopt a longer-term investment horizon

Table 1 summarizes the focus of this paper. It focuses on equity and fixed-income investments in both listed and non-listed companies; other asset classes, such as carbon credits markets, are not taken into consideration. It also mainly focuses on investors that can adopt a longer-term investment horizon (at least three years, but typically more than 10 years) – for example, investors with long-term liabilities such as pension funds – although ESG factors can still be relevant for investors with a shorter investment horizon.

Table 1 **Focus of this white paper**

	Main focus of this white paper
Investment objective	• Generating superior risk-adjusted financial returns by leveraging ESG information
Asset Class	• Equity and fixed-income investments in both listed and non-listed companies
Investment style	• Both value and growth investing
Type of investors	• Asset owners such as public and corporate pension funds, sovereign wealth funds, insurance firms, family offices, endowments, foundations • Asset managers such as mutual funds, private equity firms, hedge funds, asset management divisions of banks

1.3. Integrating ESG Factors into Investment Analysis

Various research initiatives are helping to clarify how investors might integrate ESG factors into traditional investment analysis

Numerous initiatives are underway to help translate the broad goal of integrating ESG factors into traditional financial analysis into a detailed and practical reality. A notable example is the “Value Creation Framework” (see table 2)[8] proposed by the EU CSR Alliance Laboratory, which aims to provide a comprehensive overall illustration of how ESG factors feed into financial performance.

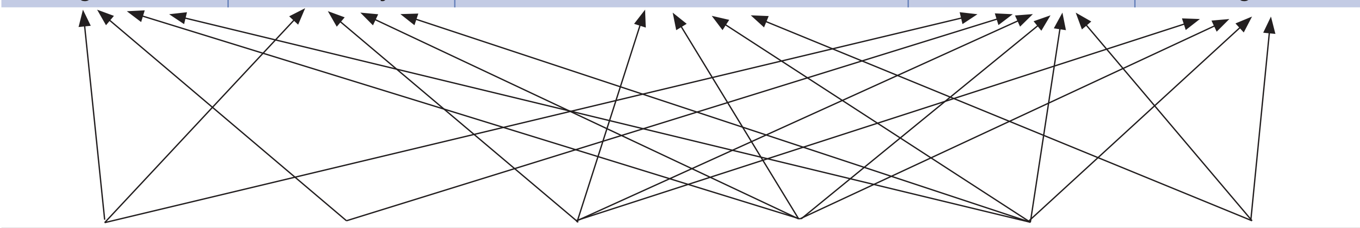
Table 2 **Value Creation Framework**

Primary objective

Market value

Financial drivers

Revenue growth	Operational efficiency	Brand equity	Cost of capital	Risk management



Core non-financial drivers

Human capital	Customer relations	Society	Environment	Innovation	Corporate governance
• Employee engagement	• Customer satisfaction	• Public perception • Supply chain management	• Carbon emissions • Waste management	• New product and process development	• Ethical integrity • Processes and procedures
ESG factors					
• Absence rate • Staff turnover • Health & safety • Fair restructuring • Training • Performance management • Equality & diversity • Reputation • Commitment to customer • Talent recruitment & relation	• Customer loyalty • Retention • Reputation • Trust • Price, product, service quality • Competitive positioning	• Opinion former perception • Media coverage • Community investment • Stakeholder dialogue • Legal/regulatory breaches • License to operate • Inclusion • Social capital	• Energy efficiency • Deployment of renewables • Waste reduction • Recycling • Environmental impacts • Environmental breaches • Lifecycle assessment	• Value of patents • Customer perception • Talent recruitment & retention • Training • R&D expenditure	• Ethical code deployment • Board composition • Equality & diversity • Talent development • Audit processes • Reporting & transparency • Reputation • Shareholder interests • Anticorruption policy/practice • Competitiveness

Source: EABIS, September 2009

8 Appendix 3 of European Academy for Business in Society (EABIS), Sustainable Value – Corporate Responsibility, Market Valuation and Measuring the Financial and Non-Financial Performance of the Firm, September 2009. For more on the EU CSR Alliance Laboratory, see also www.investorvalue.org

More sector-specific work has been undertaken by the European Federation of Financial Analysts Societies (EFFAS) Commission on ESG and the Society of Investment Professionals in Germany (DVFA). In September 2010, they published the results of a major four-year project to develop Key Performance Indicators (KPIs) on ESG for 114 sub-sectors, following the Dow Jones Industry Classification Benchmark lists.[9]

The aim of the DVFA/EFFAS research was to identify how corporates in each sub-sector might report on ESG issues in a more quantitative way, which could be presented in tabular format and integrated by financial analysts and investors into traditional spreadsheet analysis. To briefly illustrate how concrete and specific the KPIs per sub-sector are, see table 3 for a random selection of KPIs for two out of the 114 sub-sectors covered.

Table 3 **Examples of Material ESG Performance Indicators**

Sub-sector: Automobile
Example KPIs: • Percentage of total product output in terms of revenue which has undergone a design for disassembly design process • Average fuel consumption of fleet of sold vehicles – in l/100 km • Percentage of total products sold or shipped corporate subject to product recalls for safety or health reasons • Average NCAP rating for product fleet according to US-NCAP, Euro-NCAP or JNCAP or equivalent NCAP methods (selected from a total of 67 KPIs)
Sub-sector: Food retailers and wholesalers
Example KPIs: • Breakdown of materials used for packaging in per cent for paper, glass, metal, non-biodegradable plastic, biodegradable plastic, material from FSC • Percentage of total revenue from products certified and stamped as Fair Trade by an affiliate or partner organization of Fair Trade Labelling Organizations International (FLO) • Percentage of refrigerant refilling in relation to total refrigerants contained in cooling systems (selected from a total of 46 KPIs)

Source: EFFAS/DVFA, KPIs for ESG: A Guideline for the Integration of ESG into Financial Analysis and Corporate Valuation. Version 3.0

As this framework is voluntary, it is up to market mechanisms within the corporate and investment community to drive the uptake of these KPIs.

Current practices of sustainable investing vary widely

Surveys of investors who say they already practise sustainable investing show that the depth of ESG integration into their investment activities varies considerably. In a recent Eurosif[10] survey, of respondents practising ESG integration, 31% apply it to a selection of companies in specific sectors or based on specific risks, 36% on a case-by-case basis, and only 33% to each portfolio company. Only 8% systematically include ESG rating(s) in standard spreadsheet analysis. 29% say they have ESG analysts working directly and on a regular basis with mainstream analysts, but only 11% provide a "large extent" of ESG training for general investment management staff.

This large variation of ESG integration practices reflects the fact that sustainable investing is at an early stage of development, and shows the significant progress that can still be made even among investors who have already adopted this approach.

The case study below illustrates how an investor – in this case a private equity firm – integrates ESG factors in its investment and ownership decisions. This case study should be interpreted as an example and not as a universal approach; many other effective sustainable investing approaches exist.

9 EFFAS/DVFA, KPIs for ESG: A Guideline for the Integration of ESG into Financial Analysis and Corporate Valuation. Version 3.0

10 Eurosif, European SRI Study 2010 Revised Edition, 2010

CASE STUDY

Example of ESG integration in practice

Actis, an emerging markets private equity firm, believes that the integration of sustainability factors into investment analysis and decision-making generates sustainable returns. Actis uses its in-house responsible investment team, and a commitment to international best practice to make sustainability issues an integral part of the investment process. Three elements are critical for sustainable investment to take root: risk minimization, value enhancement and integrity assurance.

Risk minimization: The first task for a responsible investor must be to evaluate and minimize the market, regulatory and reputational risks of an investment posed by potential environmental, climate change, social, ethical and governance factors. Well-defined procedures for screening all investments according to a consistent set of social, health, safety, environmental, and climate change risks are integrated into the investment decision-making procedures, and discussed at the firm's Investment Committee. This sort of due diligence is important for identifying potential problems and developing action plans to reduce risks and enhance performance. This procedure also constitutes an important tool in screening out investments that have high business integrity risks in markets where governance standards are low and political interference in business practices is rampant.

Value enhancement: Once an investment is made, Actis professionals construct action plans for improving the value of investments through the implementation of best in class sustainability practices. New investments are given a risk rating to determine appropriate levels of management and monitoring. Investee companies are required to sign up to an undertaking that they will comply with the Actis ESG code. Internally, Actis investment managers receive training on sustainability management as part of their core induction process; this training enables them to monitor the implementation of the portfolio company action plans. The payoff of this approach is evident in returns generated at exit.

Integrity assurance: The third element of a sustainability strategy is to assure the integrity of investments by transparent and accountable reporting; enabling a timely response to rising client and societal expectations of corporate behaviour. Actis has instituted a quarterly reporting system for its portfolio companies to include reporting on sustainability issues. Actis also reports to the UNPRI on an annual basis, to the Carbon Disclosure Project, and provides additional updates to its investors as required.

1.4. The Investment Case for Sustainable Investing

Empirical evidence indicates that a sustainable investing approach can lead to better risk-adjusted financial returns

Ensuring greater uptake of sustainable investing will require overcoming investor scepticism regarding the business case for sustainable investing. This scepticism is partly due to the confusion with "socially responsible" or "impact" investing, referred to in section 1.2. It is also explained by a sense of confidence that if ESG factors contribute to improved corporate financial performance, the stock market will already have priced this in.

However, a growing body of evidence indicates a positive relationship between ESG factors and financial performance. For example, in 2007 and 2009, Mercer conducted two meta-studies on the investment returns of responsible investment strategies.[11] Combining the results of both studies, of the 36 studies analysed, 20 show evidence of a positive relationship, 2 a neutral-positive relationship, 8 a neutral relationship, 3 a negative-neutral relationship, and only 3 a negative relationship.

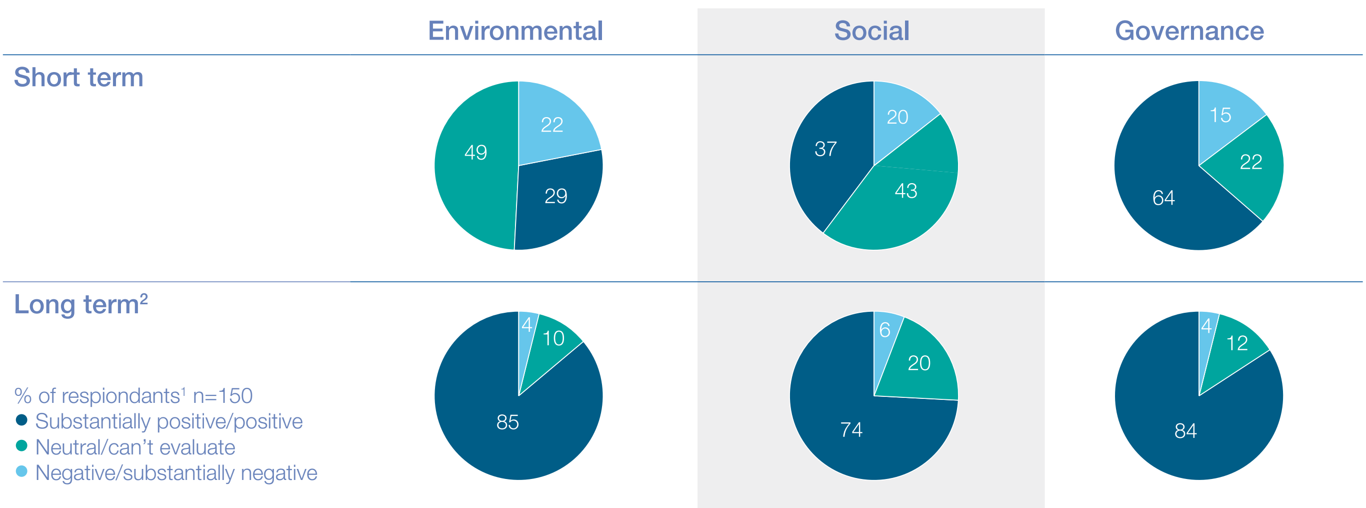
Another meta-study conducted by Innovest Strategic Value Advisors and the United Kingdom Environment Agency indicates that out of the 60 studies analysed, 51 show a positive correlation between environmental governance and corporate financial performance.[12]

Of course, a positive correlation does not necessarily imply causality. Actually, there are compelling arguments that the relationship between ESG and financial performance goes two ways: an effective ESG focus may improve corporate financial performance, and a strong corporate financial performance may strengthen the ESG focus.

From a purely financial perspective, the first part of the relationship is especially of interest. An effective ESG focus may help identify new opportunities for revenue improvements (e.g. new "green" products and services), cost reductions (e.g. eliminating waste and inefficiencies in production processes), and risk mitigation (e.g. by taking long-term social, environmental and governance risks more explicitly into account). Integrating sustainability principles into core business strategies may therefore improve corporate financial performance and shareholder value.

Two recent McKinsey studies make clear that many business executives also believe that effective ESG programmes can contribute to shareholder value creation.[13] The 2010 study *How companies manage sustainability* indicates that 76% of the surveyed executives say sustainability contributes positively to shareholder value in the long term, and 50% see short-term value creation. The 2009 study *Valuing corporate social responsibility* indicates that most of the surveyed executives believe that environmental and social programmes create value over the long term, and that governance programmes create value in both the short and long terms.

Table 4 **Contribution of a given program to shareholder value (% of respondents)**



1 Figures may not sum to 100%, because of rounding.
2 Respondents who answered "don't know" are not show.

Source: McKinsey, 2009

11 Mercer and UNEP FI, Demystifying Responsible Investment Performance, October 2007; Mercer, Shedding light on responsible investment: Approaches, returns and impacts, November 2009

12 Environment Agency, Corporate Environmental Governance, September 2004

13 McKinsey Quarterly, Valuing Corporate Social Responsibility, 2009; McKinsey & Company, How companies manage sustainability, 2010

CASE STUDY

Innovative Partnerships between Private Equity Firms and the Environmental Defense Fund

Private equity investors are well positioned to capitalize on the long-term benefits of considering ESG factors in their investments, given their diverse portfolios, capacity to influence the ways in which firms are run (as they are often majority control shareowner), and their multi-year holding period.

With this in mind, private equity groups have increasingly been seeking advice on value creation through environmental management and innovation from environmental expert groups such as the Environmental Defense Fund (EDF), a non-profit advocacy group.

Private equity's engagement with EDF began in 2007 through its well-publicized involvement in the buyout of Texas energy company TXU by Kohlberg, Kravis Roberts & Co (KKR). They engaged EDF to broker a deal which resulted in the withdrawal of permit applications for eight coal-fired power plants.

The following year, KKR and EDF partnered to create the Green Portfolio Program through which KKR could help assess the environmental performance of its companies and look for ways to improve business performance by improving environmental impacts.

The two-year results of the programme, reported by both organizations and covered in the September 2010 edition of Environmental Finance, show that across eight companies US$ 160m of costs have been cut by eliminating 1.2 million tonnes of waste and 345,000 tonnes of greenhouse gas emissions.

KKR has rolled out the initiative to further companies, now covering approximately 30% of its global portfolio. The lessons learned and tools created from the partnership between KKR and EDF are shared on EDF's Green Returns website.

Another leading private equity firm, the Carlyle Group – which has over US$ 90bn in assets – is also now working with EDF. In 2010, Carlyle and EDF developed a new due diligence tool called "EcoValuScreen" that will be used to identify opportunities to improve operations and create value through environmental innovation during the assessment of potential acquisitions by Carlyle's US and European buyout funds.

According to Tom Murray, Managing Director, Corporate Partnerships, EDF, "This early-stage approach has the potential to set a new standard for the industry and expands the mindset on environmental due diligence from downside risks to upside opportunities."

As with all of EDF's partnerships, Carlyle, KKR, and EDF have committed to publicly share lessons learned, and expect these initiatives to become a source of best practice across the private equity industry. As private equity investments account for around 10% of the US economy alone, the potential for increasing uptake in sustainable investing is substantial.

Source: "Greener Days Ahead", article in Environmental Finance, September 2010

1.5. Key Drivers and Market Potential of Sustainable Investing

Increasing demand from asset owners will be among the key drivers accelerating the transition towards sustainable investing in the next few years

According to a 2010 Eurosif survey[14], the four main drivers for sustainable investments in the next three years will be:

1. Demand from institutional investors

Many large asset owners and asset managers embrace the concept of sustainable investing. Leading asset owners in this field are pension funds such as APG, CalSTRS, CalPERS, PGGM and the Government Pension Fund of Norway. Although their motivations vary, they typically include: improving risk-adjusted financial returns, demonstrating social responsibility, and helping safeguard the integrity of financial markets.

Many large institutional investors are also interested in sustainable investing from a universal ownership perspective. The universal owner hypothesis states that although a large long-term investor with a diverse investment portfolio can initially benefit from an investee company externalizing costs, the investor might ultimately experience a reduction in market and portfolio returns due to these externalities adversely affecting returns from other assets.[15] Universal owners therefore have an incentive to reduce negative externalities (e.g. pollution and corruption) and increase positive externalities (e.g. sound corporate governance and human capital practices) across their investment portfolios.[16]

2. The uptake of voluntary initiatives such as the PRI

In the past few years, several multistakeholder initiatives have emerged to help drive the transition towards sustainable investing. Examples include: the UN Principles for Responsible Investment (PRI), the Global Reporting Initiative (GRI), the Prince of Wales' Accounting for Sustainability Project, and the Carbon Disclosure Project. The PRI especially has raised awareness among large institutional investors: at the end of 2010 more than 850 investors have signed the Principles, representing approximately US$ 25 trillion in assets under management.

3. External pressures (NGOs, media, unions)

In a media age, investors are increasingly well aware of their potential exposure when companies are implicated in environmental or social controversies.

4. Demand from retail investors

According to the Eurosif 2010 survey, demand from retail investors has increased significantly in a number of European countries – notably Germany, France and Belgium – in the past few years. Eurosif expects this trend to continue and also believes that demand from high net worth individuals (HNWIs) will expand significantly. At the end of 2009, approximately 11% of European HNWIs' portfolios represented sustainable and responsible investments[17]; this is expected to increase to 15% in 2013.

Other key drivers mentioned during the interviews and workshops include:

a. a growing awareness within the investment community that global mega trends such as demographic changes, climate change, and natural resource scarcity are becoming increasingly financially material[18]
b. the growing momentum of legislative initiatives; for example, at least eight countries in Europe presently have specific national SRI regulations in place that cover their pension systems: United Kingdom (2000), Germany (2001), Sweden (2001), Belgium (2004), Norway (2004), Austria (2005), and Italy (2005)[19]
c. the global financial crisis has increased the interest of investors in ESG factors

14 Eurosif, European SRI Study 2010 Revised Edition, 2010

15 James P. Hawley, Andrew T. Williams, The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic, 2000

16 Ibid. For more information, see also: Raj Thamotheram, Helen Wildsmith, Increasing Long-Term Market Returns: realising the potential of collective pension fund action, Corporate Governance, May 2007, Volume 15, Number 3

17 Please note that Eurosif uses a broader definition for "sustainable and responsible investments" than used in this paper. Eurosif defines sustainable and responsible investing as "any type of investment process that combines investors' financial objectives with their concerns about environmental, social, and governance (ESG) issues." This broader definition of Eurosif broadly consists of three categories (1) sustainable investing as defined in this World Economic Forum paper, (2) socially responsible investment (an investment approach which is more values-based), and (3) impact investing (an investment approach that focuses more on environmental and/or social outcomes as opposed to financial returns).

18 A recent study from UNEP FI and the PRI concludes that "environmental costs are becoming increasingly financially material. Annual environmental costs from global human activity amounted to US$ 6.6 trillion in 2008, equivalent to 11% of GDP." Source: UNEP FI, PRI, Universal Ownership – Why environmental externalities matter to institutional investors, 2010

19 Eurosif, European SRI Study 2010 Revised Edition, 2010

Sustainable investing has the potential to become a widespread approach in the coming years if some key barriers can be overcome

The global market for "sustainable and responsible investment" is estimated by Eurosif to be around 7 trillion euros, of which Europe accounts for roughly 5 trillion.[20] In Europe, for which the most recent figures are available, the market is estimated to have almost doubled between 2008 and 2010.

These estimates should be taken cautiously, for two reasons. Firstly, the Eurosif figures cover not only sustainable investing, but also impact investing and socially responsible investing, which are not the focus of this paper. Secondly, these figures are based on self-disclosure by asset managers; it is possible that the growing profile of sustainable investing may provide an incentive to overstate the reality of ESG integration. Nonetheless, while the numbers may be disputed, what can be said for certain is that – despite the financial crisis – the uptake of sustainable investing is continuing and looks set to deepen and widen.

Other market estimates were published in a 2008 report by Robeco and Booz & Co. This report argued that responsible investing is undergoing a paradigm shift from niche to mainstream: "We expect the responsible investment market to become mainstream within asset management by 2015, reaching between 15%-20% of total global Assets Under Management (US$ 26.5 trillion) and total revenue of approximately US$ 53 billion."[21] Again, while figures should be taken cautiously given definitional challenges[22], the important consideration is strength and direction of the underlying trend.

Eurosif believes that the market for sustainable investing is "reaching a tipping point", but that accelerating this process will "require activity and commitment from major asset owners, governments and civil society". With this in mind, section two now presents an overview of the key barriers to reaching this tipping point, and subsequently section three describes options for activities to overcome those barriers.

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20 Ibid.

21 Robeco, Booz & Co., Responsible Investing: A Paradigm Shift From Niche to Mainstream, 2008

22 Robeco and Booz & Co define responsible investing as "an investment process that considers the social and environmental consequences and looks at governance aspects, and employs strategies such as positive and negative screening, engagement and integration within the context of rigorous financial analysis." This definition is somewhat broader than the definition in this World Economic Forum paper as the Robeco and Booz & Co definition also includes more ethics driven investment approaches.

2. Key Barriers to Sustainable Investing

FINANCIAL RETURNS
SUSTAINABLE VALUE CREATION
ENGAGEMENT
FINANCIAL MATERIALITY
INTEGRATED REPORTING
ESG COMPETENCIES
RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

2. Key Barriers to Sustainable Investing

Key barriers exist across the investment value chain

Key barriers that inhibit the widespread adoption of a sustainable investing approach can be analysed at four interrelated levels: investors, corporations, interactions between them, and system-wide level. Based on research and interviews, 20 key barriers were identified which were subsequently prioritized by the Working Group (see table 5).

Investors are held back by scepticism, lack of expertise, and restrictions in traditional valuation models

As discussed in section 1, many mainstream investors are not yet aware of the investment case for sustainable investing, and/or confuse the ESG integration approach with the fundamentally different idea of negatively-screened ethical investment. Even when investors are aware of the various empirical studies regarding the investment case for sustainable investing, many still reject the investment case as it doesn't resonate with their conventional paradigm.

However, the Working Group believes that the most important barrier at investor level is that conventional valuation models do not sufficiently integrate ESG factors. This view is also supported by the aforementioned UN Global Compact – Accenture survey[23] of 788 CEOs and senior executives; most executives believe "the investor community is not interested or prepared to factor these [ESG] metrics into their valuation models."

A related key barrier on the investor side is a lack of ESG expertise: most fund managers began their careers as research analysts relying on traditional financial metrics, and have not been trained to analyse how ESG factors contribute to a long-term investment strategy. Even fund managers with the expertise to consider ESG factors may be unwilling to take the risk of doing something different, as benchmarking encourages herding behaviour.[24]

Many corporations do not sufficiently integrate sustainability factors into their core business strategies

According to the Working Group, many corporations do not sufficiently integrate sustainability factors into their core business strategies.[25] In consequence their sustainability efforts are often relatively small scale (e.g. the responsibility of a small CSR department) and narrowly focused on generating environmental and social benefits rather than seeking out opportunities to generate value for all key stakeholders, including customers, shareholders, and society.

Another key barrier on the side of corporations is the lack of accountability for meeting targets set out in sustainability strategies. Whereas accountability for financial targets tends to be clear, accountability for environmental or social objectives is often less clear.

There is often only limited interaction between business executives and mainstream investors on ESG issues

Given the barriers at investor and corporation level, it is no surprise that only limited discussions take place between investors and corporations on ESG issues and strategies. Typically, ESG discussions tend to be between the CSR managers and SRI specialists, rather than between senior business executives and mainstream investors. This trend is slowly changing, as an increasing number of CEOs talk about ESG issues when giving quarterly or annual performance updates; however, this is by no means the norm.

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23 UN Global Compact, Accenture, A New Era of Sustainability – CEO Study 2010, 2010

24 World Economic Forum, Mainstreaming Responsible Investment, January 2005

25 Interesting studies on how to integrate sustainability principles into core business strategies include: Ceres, The 21st Century Corporation: The Ceres Roadmap for Sustainability, 2010; World Economic Forum, Redesigning Business Value – A Roadmap for Sustainable Consumption, 2010; Epstein, Elkington, Leonard, Making Sustainability Work: Best Practices in Managing and Measuring Corporate Social, Environmental and Economic Impacts, 2008

Table 5 **Key barriers to sustainable investing according to the Working Group**

	Investor level	Corporation level	At investor-corporate interaction level	At system-wide level
Highest importance	Restrictions in conventional valuation models	Insufficient integration of sustainability factors into core business strategies, with ESG activities focusing more on creating environmental and social value rather than shareholder value	Lack of clarity on which ESG factors are financially material and over which time frame	Disproportionate focus on short-term performance and issues with a near-term impact
High importance	Lack of ESG expertise Lack of awareness and/or scepticism regarding the investment case	Lack of formal approach in setting ESG targets and holding senior staff accountable	Insufficient communication of link between ESG and corporate financial performance	Market failures, e.g. externalities are not priced
Medium importance	Herding behaviour due to "benchmark" focus	Insufficient integration of ESG criteria in corporations' own capital allocation decisions	Disengagement and lack of active ownership Limited discussions between mainstream investors and corporate executives regarding ESG issues	Overconfidence in Efficient Market Hypothesis and Modern Portfolio Theory
Low to medium importance	Lack of common definitions leading to confusion between sustainable investing and ethical investing Ambiguity about fiduciary responsibilities Weaknesses in fund gover-nance and transparency	Difficulties in collecting the relevant ESG information Disconnect between sustainability managers and investor relations managers	ESG information often not user-friendly	

Source: World Economic Forum, survey among Sustainable Investing Working Group, June 2010

Even when dialogue about ESG does take place between corporations and investors, it often does not bring clarity about which ESG factors are financially material (in terms of increasing revenues, reducing costs, and/or mitigating risks) and over what time frame (short-, medium- and/or long-term).

A disproportionate focus on short-term performance and issues with a near-term impact undermines long-term value creation

At a more system-wide level, many interviewees and working group participants indicated that a disproportionate focus on short-term performance by both investors and corporate executives is one of the top barriers to sustainable investing and long-term value creation.[26] This short-term orientation manifests itself in two ways: the focus on meeting or beating quarterly/annual earning estimates by corporations, and the focus on quarterly/annual fund performance by fund managers.

Of course, short-term metrics are not, in themselves, problematic; reporting of quarterly results allows investors to hold corporations accountable and corporations to signal when they are doing well. The question is when the focus becomes disproportionate. The belief that a disproportionate short-term orientation undermines long-term economic value creation aligns with the findings of a survey[27] of 421 financial executives which found that "firms are willing to sacrifice economic value in order to meet a short-run earnings target…. 78% of the surveyed executives would give up economic value in exchange for smooth earnings."

It is important to note that this paper does not argue that all investors should be long-term oriented. There is both a market and a need for short-term investing, in terms of investment horizon and/or holding period. For example, for investors with short-term liabilities a short-term investment strategy makes sense, while investors specialized in momentum trading strategies also benefit from short-term horizons and/or holding periods. The issue of

26 The need for a more integrated approach to long-term wealth creation is also highlighted in the report: The Aspen Institute, Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management, September 2009. This report also includes as call to action signed by twenty-seven renowned business, government, and academic leaders for boards, managers and – most particularly – shareholders to embrace a long-term focus.

27 John R. Graham, Campbell R. Harveya, and Shiva Rajgopalc, The Economic Implications of Corporate Financial Reporting, Journal of Accounting and Economics, Volume 40, Issues 1-3, December 2005, Pages 3-73.

disproportionate short-term focus applies to investors who potentially could adopt a longer-term orientation, e.g. due to long-term liabilities.

Two other system-wide barriers were often mentioned by participants. One is overconfidence in the Efficient Market Hypothesis[28] – the belief that no investment strategy can consistently achieve returns in excess of average market returns on a risk-adjusted basis. The other is the fact that negative externalities[29] are often underpriced, or not priced at all – this is a barrier to sustainable investing as it makes investors believe that environmental, social and governance factors are therefore not relevant from a financial returns perspective.

These two beliefs are to a certain extent contradicted by the evidence referred to in section 1.4, suggesting that – even with the underpricing of externalities – a sustainable investing approach can lead to better risk-adjusted financial returns.

The "chicken and egg" nature of the problem is also an opportunity

Many of these barriers are obviously interrelated, leading to a classic "chicken and egg" problem. For example, given that corporations often do not provide clear information about how their ESG activities contribute to shareholder value creation, investors find it difficult to use ESG information to value companies; they therefore do not sufficiently consider ESG information in their investment decisions, which gives corporations little incentive to provide good ESG information.

However, the chicken-and-egg nature of the problem also presents an opportunity. Once a tipping point is reached, the process becomes mutually-reinforcing in the opposite direction: when more investors integrate ESG factors into their analyses, companies will have more incentive to provide better information about ESG factors, making it easier for investors for consider them.

In any situation where a vicious circle can potentially be turned into a virtuous circle, what makes the difference are cumulative instances of leadership. To this end, Section 3 considers options which different stakeholder groups may wish to consider.

28 The Efficient Market Hypothesis (EMH) asserts that financial markets are "informationally efficient". That is, one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information publicly available at the time the investment is made. There are three major versions of the hypothesis: "weak", "semi-strong", and "strong". Weak EMH states that past prices and trading information are instantaneously incorporated into the current price of traded assets (e.g. stocks, bonds). Semi-strong EMH argues that prices reflect all publicly available information and that prices instantly change to reflect new public information. Strong EMH additionally claims that prices instantly reflect all information, whether public or private. There is evidence for and against the weak and semi-strong EMHs, while there is notable evidence against strong EMH. The Efficient Market Hypothesis is relevant for sustainable investing as this investment approach aims to generate superior risk-adjusted financial returns; this is not possible if the strong version of the EMH hypothesis holds. Should the weak or semi-strong EMH hold, generating outperformance based on sustainability data would still be possible as not all relevant sustainability data is broadly available (and when available, due to lack of standardization, difficult to interpret for investors).

29 In economics, an externality (or transaction spillover) is a cost or benefit, not transmitted through prices, incurred by a party who did not agree to the action causing the cost or benefit. A benefit in this case is called a positive externality or external benefit, while a cost is called a negative externality or external cost. Climate change is a classic example of a negative externality in an economic sense, as greenhouse gas emissions do not currently carry a cost that reflects the damage they cause to the environment and society – these damages are external to market transaction.

3. Accelerating the Transition towards Sustainable Investing

FINANCIAL RETURNS
SUSTAINABLE VALUE CREATION
ENGAGEMENT
FINANCIAL MATERIALITY
INTEGRATED REPORTING
ESG COMPETENCIES
RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

3. Accelerating the Transition towards Sustainable Investing

Section 1 established the potential of sustainable investing to realize superior risk-adjusted financial returns, and section 2 pointed out the barriers that inhibit a significant uptake. This section explores some ideas for functional and mindset changes that could accelerate the process of transition towards sustainable investing.

3.1 Functional Changes
In the 2005 World Economic Forum paper on sustainable investing, three action areas were identified which could significantly accelerate the transition towards sustainable or responsible investing: (a) improving information; (b) strengthening competencies, (c) modifying incentives.

In this updated 2011 paper, based on interviews, workshops and additional research, a fourth action area is highlighted: enhancing the governance relationship between shareholders and corporations. This area stresses the mutual interests of investors and corporations in driving the transition towards sustainable value creation through both sustainable investment and business practices.

Table 6 **Action Areas to Accelerate the Transition towards Sustainable Investing**

A. Improve Information	B. Strengthen Competencies	C. Modify Incentives	D. Enhance Governance
Make sure that financially material ESG information is widely shared between corporations and investors, and that ESG and financial information are communicated in an integrated way.	Make sure that both investors and corporate executives have the skill set to assess ESG factors from an economic value creation perspective.	Link incentives in the investment value chain more to long-term risk-adjusted financial performance. NB: This does not imply that all incentives in the financial system need to be long-term oriented. We recognize there is also a need for investing that is short-term in horizons and/or holding periods (see also page 21)	Strengthen the governance relationship between corporations' owners – that is, shareholders – and management teams. This relationship is two-way and based on a mutual interest in optimizing shareholder value creation over the long-run.

An overview of strategic options for consideration by each stakeholder is provided in table 7. These strategic options emerged from both literature review and suggestions by the Working Group. They are not intended to be exhaustive or prescriptive, and are offered with the aim of stimulating further thought and discussion; it is recognized that not all ideas will be suitable in all situations. More information on these strategic options can be found in the appendix.

Table 7 **Ideas to Accelerate the Transition towards Sustainable Investing (by Action Area and Key Stakeholder)**

Key Stakeholders	A. Improve Information	B. Strengthen Competencies	C. Modify Incentives	D. Enhance Governance
Asset owners, e.g. public and corporate pension funds, sovereign wealth funds, insurance firms, family offices, endowments, foundations	A1. Increase disclosure on ESG factors in investment portfolio A2. Assess materiality of ESG factors at macroeconomic and industry level	B1. Increase the capacity of pension fund trustees to exercise independent judgement in the long-term interest of beneficiaries (including ESG awareness training) *See B2, B3*	C1. Develop performance measurement systems for in-house and external fund managers that balance fostering a long-term perspective with short-term accountability C2. Implement compensation systems that better align stakeholders with the long-term mandate C3. Encourage the analysis of financially material ESG factors via mandates to asset managers	D1. Demonstrate more active ownership through engagement, shareholder resolutions and/or proxy voting D2. Rationalize number of portfolio holdings in order to increase capacities as active owner (and consider potential trade-offs in terms of portfolio diversification)
Asset managers, e.g. mutual funds, private equity firms, hedge funds, asset management divisions of banks	*See A1* A3. Buy- and sell-side analysts determine – together with corporate executives – the financially material KPIs at sector and/or company level A4. Communicate results of materiality assessments by investor to portfolio companies	B2. Increase ESG awareness and analytical skills through – for example – ongoing training and making ESG data available to all staff B3. Strengthen the interaction between financial and ESG analysts and integrate those skills further	C4. Negotiate with asset owners a fund management compensation arrangement linked to superior long-term performance	*See D1, D2*
Corporations (listed and non-listed)	A5. Corporate executives communicate better to investors which ESG factors are financially material and in what timeframe A6. Focus corporate-investor communication around long-term metrics A7. Publish an integrated report as opposed to a separate financial report and a separate CSR report	B4. Further develop the understanding of senior executives and investment relations officers (IROs) on the link between social & environmental performance, financial performance, and stock market valuations	C5. Link the remuneration of corporate executives not only to short-term financial results, but also to longer-term financial and non-financial performance	D3. Create structured, regular dialogue between senior executives and investors on ESG issues D4. Fully integrate ESG factors into the corporate strategy development process D5. Integrate ESG criteria into corporate capital allocation decisions D6. Strengthen the interaction between CSR specialists, operational management, and investor relations officers to inform the dialogue with investors
Accounting bodies	A8. Develop standards for ESG disclosure A9. Stimulate integrated reporting			
Others, e.g. public authorities, investment advisors, ESG research firms, stock exchanges, business schools	A10. Public authorities encourage the disclosure of ESG information A11. Incorporate ESG disclosure requirements in listing rules (IPOs and ongoing) stock exchanges and corporate governance standards A12. Mainstream data providers make ESG data broadly accessible for investors	B5. Business schools increase emphasis on ESG issues B6. Incorporate ESG training into industry and corporate training schemes	C6. Investment advisors raise the awareness of clients (e.g. corporate and public pension funds) to integrate ESG factors into investment analysis	

According to the Working Group, the ideas with the greatest effectiveness potential are (1) restructuring incentives and (2) improving the analysis of which ESG factors are financially material at sector and company level

As the ideas presented for consideration in table 7 vary widely in their potential for effectiveness, the World Economic Forum's Sustainable Investing Working Group set out to prioritize the ones with the greatest effectiveness potential. From this prioritization exercise, two pathways stood out:

1. Where appropriate, linking incentives in the investment value chain more towards superior risk-adjusted financial performance over the long-term; for example by:
   - increasing the performance assessment period for fund managers (both in-house and external)
   - modifying incentives for corporate executives towards superior long-term performance, for example by including ESG factors as indirect financial performance criteria

2. Analysing and determining the financial materiality of environmental, social and governance factors at sector and corporate level; for example by:
   - asset owners encouraging the analysis of financially material ESG factors via mandates to asset managers
   - buy- and sell-side analysts determining, together with corporate executives, the financially material key performance indicators at sector level

Each stakeholder has opportunities to play a leading role, individually as well as collectively

As mentioned above, escaping from any "chicken-and-egg" situation requires cumulative instances of leadership. The Working Group therefore also prioritized what it considers to be the most potentially effective ideas for each different stakeholder to consider. They are:

Asset Owners
- Develop performance measurement systems for in-house and external fund managers that balance fostering a long-term perspective with short-term accountability
- In mandates for fund managers, encourage the analysis of financially material ESG factors and clearly state ESG expectations towards asset managers

Asset Managers
- Determine, together with corporate executives, the financially material KPIs at sector and/or company level
- Communicate results of materiality assessments to portfolio companies
- Strengthen the interaction between financial and ESG analysts and further integrate those functions

Corporations
- Modify incentives for corporate executives towards superior long-term performance, for example by including ESG factors as indirect financial performance criteria
- Create structured, regular dialogue on ESG issues between senior management and investors
- Integrate ESG factors fully into the process of developing corporate strategy

Accounting bodies
- Develop standards for ESG disclosure and stimulate integrated reporting

CASE STUDY

The PRI Clearinghouse Facilitates International Collaboration between Investors on Engagement Issues

The UN-backed Principles for Responsible Investment (PRI) is an investor-led initiative with over 850 signatories and combined assets under management of approximately US$ 25 trillion. PRI members implement six high-level and aspirational principles, including the commitment to join forces with other investors to be "active owners and incorporate [environmental, social and corporate governance] ESG issues into ownership policies and practices".

The PRI Engagement Clearinghouse, established in October 2006, is a private online forum that enables PRI signatories to collaborate to seek changes in company behaviour, public policies or systemic conditions. Since its inception, more than 270 proposals of collaboration have been presented involving almost 250 PRI signatories in total. From June 2009 to June 2010, investors used the platform and contacted 2,235 companies on at least one ESG issue.

Encouraging companies to reduce carbon emissions, separate the positions of chair and CEO, and protect human rights in a supply chain all require shareholders to work together and pool knowledge, resources and influence. Some recent cases include:

- A group of investors in close dialogue with 14 consumer electronics companies to ensure appropriate actions are taken to manage social and business risks on the sourcing of minerals.
- Country teams in Brazil, South Africa, South Korea, India and Indonesia have been formed to promote dialogue with local companies on sustainability disclosure.
- A coalition of investors with US 1.5 trillion of assets wrote to 100 of the world's biggest companies to encourage them to join the CEO Water Mandate, a UN Global Compact project to help companies improve water management.

By working with other like-minded investors, signatories can create a stronger and more representative shareholder voice, which companies respond to. Shareholder engagement with companies can also be time-consuming and expensive, especially for smaller funds that do not have dedicated resources; by combining efforts with peer signatories – only in jurisdictions where that is not legally constrained – active ownership can be more affordable and more effective.

More information can be found at www.unpri.org

3.2 Mindset Changes

The Working Group also emphasized that while functional changes are necessary, to realize the full potential of sustainable investing they need to be accompanied and supported by changes in mindsets. Based on interviews and workshops, the following mindset shifts on the side of investors as well as corporate executives were identified.

Without these mindset changes, functional changes – such as integrated reporting, or enhancing the dialogue between investors and corporations – will remain largely ineffective.

Table 8 **Required Mindset Changes to Accelerate the Transition towards Sustainable Investing**

	Conventional mindsets	New mindsets
Investors (asset owners & managers)	Corporate sustainability strategies undermine the financial performance of companies and dilute investment returns	Sustainability considerations – if effectively integrated into core business strategies – have the potential to strengthen the financial performance of companies
	ESG indicators are non-financial indicators	ESG indicators are direct and indirect drivers of business value
	Financial markets are highly information efficient and therefore if ESG information is material, it will be priced in	Financial markets are efficient at pricing in certain types of information and less efficient at pricing in others; this can be the result of – for example – heuristic biases, bounded rationality, and distortive incentives
	Investors are "shareholders" (in the sense of feeling hardly responsible for the actions and course of the company)	Investors are "shareowners" (in the sense of feeling adequately responsible for the actions and course of the company)
	Investors are the primary stakeholders	Investors are important stakeholders, as are employees, customers, society, and other critical groups
	Thinking of ESG mainly in terms of risks and compliance	Thinking of ESG in terms of opportunities and value creation as well
	Fiduciary duty is transactional and if asset owners don't specify ESG in their mandates, then asset managers can't consider ESG	Fiduciary duty is about professional responsibility and implies that asset managers should consider ESG when in asset owner's best interests
Corporate executives	If investors don't ask about ESG issues, we won't explicitly discuss	We need to create a dialogue with investors on all issues that are financially material today and in the future
	Investments that make long-term sense are not worth making because capital markets mainly care about the short-term costs and not about the long-term benefits	If investments make long-term sense, we should make them
	ESG is bolted onto the core business and is the prime responsibility of the ESG department	ESG is central to the core business and is a widespread responsibility; incentives throughout the business should reflect that

4. Conclusions and Next Steps

FINANCIAL RETURNS
SUSTAINABLE VALUE CREATION
ENGAGEMENT
FINANCIAL MATERIALITY
INTEGRATED REPORTING
ESG COMPETENCIES
RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

4. Conclusions and Next Steps

Financial markets have an important role to play in accelerating the process of transitioning towards more sustainable business practices. This paper has set out to show that a sustainable investing approach is potentially a win-win proposition. It offers not only the benefits of reducing economic, environmental and social risks, but also the potential for investors to achieve superior risk-adjusted financial returns.

Key barriers have been identified which stand in the way of accelerating the uptake of sustainable investing and a suite of ideas have been put forward for stakeholders to consider as possible ways to overcome these barriers.

We hope that this white paper will not only provide relevant input and catalyse further important dialogue on the issue of sustainable investing, but also contribute towards a shift in mindsets.

The priorities of the Sustainable Investing initiative going forward will be defined at the World Economic Forum Annual Meeting 2011 in Davos, 26-30 January, and we will publish these priority areas on our website (www.weforum.org). Should you have any comments or questions about this paper, please contact us at investors@weforum.org.

Appendix

FINANCIAL RETURNS
SUSTAINABLE VALUE CREATION
ENGAGEMENT
FINANCIAL MATERIALITY
INTEGRATED REPORTING
ESG COMPETENCIES
RESOURCE EFFICIENCY
ENVIRONMENTAL PERFORMANCE
SOCIAL PERFORMANCE
INCENTIVE STRUCTURES
INNOVATION
OPPORTUNITIES AND RISKS

Appendix

Additional Information on How to Accelerate the Transition towards Sustainable Investing

Most strategic options listed in table 7 are to a large extent self-explanatory. Still, some strategic options require additional information and are briefly discussed in this appendix. Please note that this selection should not be interpreted as a selection of the most effective strategic options, rather to provide additional context and insight.

A9. Accounting bodies stimulate integrated reporting

- Integrated reporting[30] refers to the integrated representation of a company's performance in terms of both financial and non-financial results. It provides greater context for performance data, clarifies how sustainability fits into operations of a business, and may help embed sustainability into company decision-making.
- Integrated reporting raises the profile of ESG issues for investor relations and for investors, and it arms IROs and senior management with the information to communicate on ESG issues and their impact on the business.[31]
- In August 2010 two of the leading initiatives to promote integrated reporting – Accounting for Sustainability (A4S) and the Global Reporting Initiative (GRI) – joined forces to launch the International Integrated Reporting Committee (integratedreporting.org). Its remit is to: "create a globally accepted framework for accounting for sustainability: a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format… The intention is to help with the development of more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model".

A10. Public authorities encourage the disclosure of ESG information

- In the past decade, regulatory initiatives such as the Sarbanes-Oxley Act have reinforced the requirement for companies to disclose aspects of social and environmental performance relevant to their future business performance; this places company boards at centre stage in signing-off on which aspects of non-financial performance are material.
- Policies on ESG disclosure have the potential to vastly improve the availability and comparability of ESG data. Regulations on disclosures are increasing rapidly, as is pressure on governments to mandate ESG reporting.
- Nonetheless, regulations have the potential to be counterproductive unless it is ensured that they work with the grain of what corporates are able to provide and investors are able to make use of.

A12. Mainstream data providers make ESG data broadly accessible for investors

For example, Bloomberg has developed an ESG data service that provides all terminal users with access to publicly available ESG data from 2,000 to 3,000 companies.

B5. Business schools increase emphasis on ESG issues

There are a number of industry-wide educational efforts underway. The CFA Institute, for instance, has published a number of resources for investors on ESG integration, and many MBA programmes are beginning to include a curriculum on ESG in finance courses. What's important is for ESG courses not to be presented as elective courses, or a specialization, but as part of the main curriculum.

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30 An interesting and comprehensive book on the topic of integrated reporting is: Robert G. Eccles, Michael P. Krzus, One Report – Integrated Reporting for a Sustainable Strategy, 2010

31 BSR, ESG in the Mainstream – The Role for Companies and Investors in Environmental, Social, and Governance Integration, September 2009

C1. Asset owners develop performance measurement systems for in-house and external fund managers that balance fostering a long-term perspective with short-term accountability

- Today, the typical performance assessment period for fund managers is 12 months. By increasing the performance assessment period somewhat, in principle, better alignment between the long-term objectives of the asset owner (the principal) and the incentives of the asset manager (the agent) will be created.
- How much longer the period should be depends on weighing a trade-off in monitoring effectiveness: if a longer assessment period is applied it become more difficult to assess whether a fund manager is underperforming because his long-term vision hasn't yet (fully) materialized or because he is simply on the wrong track. Due to these trade-offs, some asset owners consider assessment periods of about three years as ideal.
- This risk of underperformance with longer assessment periods can also be mitigated by imposing constraints in terms of tracking error.

D1. Demonstrate more active ownership through engagement, shareholder resolutions and/or proxy voting

- As highlighted in a recent McKinsey publication,[32] a movement is afoot in countries including Canada, France, the Netherlands, and the United Kingdom, to encourage institutional investors to become better "stewards" of the companies they invest in, by adopting a more active and long-term stance.
- The same McKinsey report also makes clear that good stewardship is not about asserting control over boards and management, rather about constructive dialogue between institutional investors and companies to help improve long-term returns to shareholders.

D2. Rationalize portfolio holdings in order to increase capacities as active owner (and consider potential trade-offs in terms of portfolio diversification)

- There is much more potential for influence when the percentage of the company owned is large. Still, collaborative engagement can help small shareholders to become more influential (see also page 33 on the PRI Clearinghouse).
- Active ownership is easier when the investor applies a policy of portfolio concentration; otherwise it is difficult to monitor and engage with investee companies well. The McKinsey report *How institutional investors should step up as owners* (September 2010) indicates that two large Dutch pension funds are contemplating shrinking their equity portfolios by 90%, to 300 to 400 holdings, to improve their capacities as active owners.
- A strategy of more concentrated portfolios doesn't always directly imply higher risks. Various academic studies have shown that the principal benefit of diversification – to reduce portfolio volatility – diminishes rapidly when a portfolio has more than 50 stocks.

32 McKinsey, How institutional investors should step up as owners, September 2010

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Key Terms

Table 9 **Key Terms**

Term	Definition
ESG factors	Environmental, social, governance factors
Impact investing	Investment approach that aims to proactively create positive social and environmental impact against an acceptable risk-adjusted financial return. This requires the management of social and environmental performance (in addition to financial risk and return). With impact investing “impact” comes first, whereas with sustainable investing “financial returns” come first.
Responsible investing	Investment approach that integrates consideration of environmental, social and governance (ESG) issues into investment decision-making and ownership practices, and thereby improve long-term returns to beneficiaries. Source: UN PRI NB: in this paper “sustainable investing” and “responsible investing” are used as synonyms
Socially responsible investing (SRI)	Socially responsible investing, an area often affiliated with the retail financial sector, incorporates ESG issues as well as criteria linked to a values-based approach. For example, it can involve the application of pre-determined social or environmental values to investment selection. Investors may choose to exclude or select particular companies or sectors because of their impact on the environment or stakeholders. Negative screening (such as weapons exclusions) and positive screening (such as Best-in-Class or thematic approaches) typically fall in the remit of such investments. Source: Eurosif, European SRI Study 2010 Revised Edition, 2010
Sustainable investing	Investment approach that integrates long-term environmental, social, and governance (ESG) criteria into investment and ownership decision-making with the objective of generating superior risk-adjusted financial returns. These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios

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