The SRI performance paradox

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How to gauge and measure the extra-financial performance of Socially Responsible Investment

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## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>4</td>
</tr>
<tr>
<td>Summary</td>
<td>5</td>
</tr>
<tr>
<td>1. Introduction</td>
<td>6</td>
</tr>
<tr>
<td>2. Financial performance: The tunnel vision of SRI…</td>
<td>8</td>
</tr>
<tr>
<td>3. Delivering in more than one dimension</td>
<td>10</td>
</tr>
<tr>
<td>4. Extra-financial performance</td>
<td>13</td>
</tr>
<tr>
<td>A. Environmental Return</td>
<td>16</td>
</tr>
<tr>
<td>B. Social Return</td>
<td>20</td>
</tr>
<tr>
<td>5. Discussion &amp; Conclusion</td>
<td>23</td>
</tr>
</tbody>
</table>
Just two years ago now, Pictet asked me to write a short preface to their seminal paper "Less can be More". It was an intriguing paper that criticised the ever-increasing number of 'soft' SRI criteria and advocated the use of just a few, albeit particularly relevant, key impact factors for the sustainability assessment of companies.

At the request of our client, and in close collaboration with specialised consultancies and academic partners, we have been working very hard over the last two years to develop a fully fledged assessment tool (envIMPACT) that allows our clients to determine the carbon intensity of companies along their entire production chain. And it makes me proud that the results of our research effort are already being put into practice for approximately EUR 2bn worth of sustainably managed assets.

The present paper "The SRI performance paradox" is proof of Pictet's ongoing innovation in this area, as it raises an extremely important topic that has been neglected for far too long, namely the reporting of extra-financial performance.

The authors show that by tilting portfolios towards our new envIMPACT rating, investors can substantially reduce the carbon footprint of their portfolios. Pictet complements this environmental performance reporting with its proprietary measure of net job creation, showing again that carefully constructed SRI portfolios are able to create more jobs than conventional portfolios.

This is indeed good news. As a long-standing provider of SRI data, I never felt absolutely happy to be benchmarked exclusively against the financial performance of the rated companies. I am glad therefore that the present paper paves the way for a credible extra-financial performance reporting, and I sincerely hope that more and more investors will be asking for this kind of information in the future in order to ascertain the full value of their SRI investment.

In this sense, this paper makes a very valuable contribution indeed.
Summary

This paper argues that the fixation on the financial return of Socially Responsible Investment (SRI) is a paradox. Financial performance is not a sufficient condition for the success of an SRI investment strategy. Social investors’ objectives are not one-dimensional but multi-dimensional. Their utility function also explicitly includes a social and an environmental performance dimension. Hence the need for a credible and transparent extra-financial reporting. Current SRI ratings are too qualitative and subjective and do not allow for tracking the extra-financial performance of portfolios. By using straightforward proxies for sustainability - CO₂ emissions for the environmental and job creation for the social responsibility of companies – this paper presents for the first time how such an extra-financial reporting might look. We show that the companies in the sustainable portfolio emit less CO₂ and create more jobs than their peers and thus provide the sustainable investor with a measurable social and environmental added value. The decision on how to reconcile and blend the different financial and extra-financial objectives will, and must, ultimately lie with the client. But extra-financial performance measurement may prove helpful to institutional investors such as pension fund trustees who have to demonstrate that they actually act in society’s - and their beneficiaries’ - best interest by investing sustainably.
1. Introduction

One of the first questions that usually arises in addressing Socially Responsible Investment (SRI) is financial performance. Whether or not SRI can add financial value or reduce risks or both is seen as the litmus test for a successful SRI investment strategy. The ‘materialists’ in the sustainable investment community go to great lengths to explain why savvy investors should focus on financially material ESG\(^1\) indicators and neglect all the rest, thereby trivialising the concept of SRI and cutting it off from its origin, which was about sustainable development and what financial markets could do to promote it.

This paper takes a somewhat different stance. It postulates that financial performance is certainly a necessary, but not a sufficient condition for a credible SRI investment strategy. Necessary in this context means that the financial performance is on average and over a reasonably long investment period in line with the broad market. It is a fact that few investors are willing to tolerate a substantial and systematic financial underperformance for ethical reasons. For the cause of SRI to be successful beyond its present niche and to make its way into the mainstream, it is thus mandatory that sustainable investment products deliver solid, market compatible risk-adjusted returns.

This being said, we think it neither necessary nor reasonable to postulate that SRI consistently outperforms the broad market in order to be admitted to the pantheon of acceptable investment strategies. Such a view is not reasonable because it is irrational to ask SRI to do what all other (more traditional) investment strategies fail to: active managers are known on average to underperform the benchmark, and this outcome has more to do with logic than incompetence. After all, by definition, half of the managers will attain above-average returns whilst the other half will deliver below-average returns. Add fees to that, and the majority of active asset managers will not be able to beat the benchmark they set out to beat\(^2\).

But, then, consistent financial outperformance is probably not only asking too much, it is also not even necessary. All other things being equal, a rational investor will always switch to a sustainable investment strategy when returns are in line with the market because such an investment strategy is likely to generate positive externalities for society; and as a member of society the investor would thus benefit twice. This is what this paper

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\(1\) Some people are trying hard to get rid of the supposedly old-fashioned expression “SRI” by invoking the ‘different nature’ of “ESG” investing. We do not think this is really necessary, given that Socially Responsible Investment fully espoused the importance of environmental and governance aspects along social ones already a long time ago. For most practical purposes, the existing acronyms (CSR, RI, SRI, ESG) can safely be taken for synonyms. In this text we will mostly be sticking to “SRI”.

is all about. It explores how extra-financial performance can be measured and reported, and to what extent sustainable portfolios can actually be said to deliver upon their promises.
There is a growing dedicated SRI research industry catering to the SRI-related information needs of investors. Up until recently, this information had to be purchased from specialised research agencies or by investing in one of the many specialised SRI products on the market. Investors looking for a comprehensive and homogenous analysis of a large investment universe still have to pay for SRI research, although a lot of traditional brokerage houses have recently built up small, dedicated SRI units and have thus made investment-related sustainability information almost a commodity. Historically, SRI products had been priced largely above comparable active products due to the lower volume of assets under management and smaller economies of scale. Today, as a result both of progress in research and portfolio management efficiency, a mark-up against traditional active management no longer seems justified, although lots of SRI retail products still seem to fetch a premium from investors. Be that as it may, the right question to ask is less that of fees but rather whether investors are actually getting what they are paying for.

One of the oddest characteristics of SRI is that sustainability-oriented investors expend considerable efforts to identify their investment candidates according to their vision of sustainability but at the end of the day content themselves with measuring the financial performance of their holdings. One cannot but notice the blatant contradiction of expending both money and effort to identify the ‘good’ companies when all that counts in the end is how these companies have fared financially. Such a reductionist ‘tunnel vision’ only makes sense for a purely opportunistic SRI investor or for so-called ‘SRI materialists’³. If the sole purpose of SRI research is to identify the factors that are material to a company’s financial performance, then indeed it makes sense to measure just that and nothing else. Full stop.

The more interesting case, however, is to look at what we would call ‘social investors’, for in our experience the overwhelming majority of SRI-oriented investors are indeed ‘social investors’ and not short-term opportunists⁴. ‘Social’ in this context has no political connotation but conceptually refers to the term ‘social planner’ in resource economics. The social planner stands above the profit-maximising individual and strives to allocate resources in a Pareto-efficient way. Social investors embark on an SRI investment strategy because they explicitly seek more than just financial performance in their investments. Institutional investors in particular acting as trustees for their beneficiaries are almost by definition social investors, optimising the returns for a group of people

³ For a critique of the current materiality hype, see our recent article “Back to Sustainable Development – Or why the ESG materiality debate missing the point”.

⁴ Investing in good companies for the wrong reasons is not necessarily a bad thing, since good companies will profit from higher valuations and easier access to capital, but the problem arises, whenever sustainability and profitability collide. One simply cannot deny that kind of conflict in a world of externalities.
whose individual preferences are unknown, but can be reasonably supposed to converge with society as a whole, because, ultimately, society can be interpreted as the aggregate of all such individual beneficiaries.

Social investors also try to forestall the potentially negative consequences of an excessively short-term and ruthless investment strategy. An investment strategy aimed at maximising short-term profit, forcing companies to cut jobs or outsourcing them to low-wage countries or urging them to curb on environmental spending, is likely to backfire on the very people that are supposed to benefit from enhanced investment returns.

However, whereas a host of performance measurement and attribution tools cater to the needs of performance-driven investors, there is an almost complete lack of equivalent tools for the measurement of an investment’s extra-financial performance. The SRI-oriented investor is left with bleak and standard performance measurements that are unable to tell him whether he is also on track regarding his extra-financial objectives. In the following section we explore why this is so and what can be done to ease this startling paradox.
3. Delivering in more than one dimension

One of the most astonishing things about the ‘SRI performance paradox’ is that there are virtually no, or very few, serious attempts to change the situation for the better, although SRI has now been around for quite some time.\(^5\) We believe the reason for the persistence of this anomaly is mainly twofold: shortcomings of today’s SRI research on the one hand and on the other a certain reserve among asset managers to report performance along the extra-financial dimensions as well. Let us first look at current SRI research.

The overwhelming majority of SRI indicators used today are of a purely qualitative nature. Even when apparently quantitative data is taken into account (e.g., emissions data), this data is often just used to corroborate or check the qualitative conviction of the SRI analyst. Consequently, coherent quantitative time series of SRI data are still scarce, and it is therefore very difficult to establish an accurate and verifiable measure of a company’s progress over time.

Closely related to the first point is the inherent subjectivity of the analysis process. If we observe that a company’s score has improved between two points in time, we have a priori no clue as to whether this reflects an actual improvement in the SRI performance or whether it is an artefact introduced by the analyst (i.e., caused by increased availability of data or by re-interpreting the available information differently). What cannot be measured must be taken on trust.

A third problem we already identified some time ago\(^6\) is the increasing number of criteria and indicators in so-called standard SRI assessments. If hundreds of SRI-related criteria and indicators are collected and combined, then we run the risk of burying the most relevant ones under a burden of insignificant and potentially contradictory indicators. It is then very difficult to draw a clear and unambiguous conclusion on the actual progress of the company.

Lastly, there are lots of different and often competing ways of evaluating ‘sustainability’. Although a closer look reveals that there is a considerable overlap in the environmental, social and governance indicators between different providers, there is not as yet a clear consensus as to how to aggregate all these indicators into a meaningful global sustainability rating. Often, there is no will for consensus, since SRI research houses

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\(^5\) *To be fair, here Trucost’s Carbon Footprint screening goes in this direction as well as other, more academic initiatives such as, for instance, the MIET life cycle software developed at Leiden University in the Netherlands. However, in our view, these approaches fail to account for the social dimension and/or they are less appropriate for gauging the SRI performance of broadly diversified best-in-class portfolios because the outcome is largely determined by the sector allocation.*

\(^6\) *“Less can be More... A new approach to SRI research. Pictet Study. 2005”.*
and providers explicitly try to differentiate themselves in the marketplace, thereby obstructing the development of common performance-reporting frameworks.

The combined effect of these problems already explains to a large extent why there is not yet a standardised set of tools for presenting the extra-financial performance of SRI investment to clients. But there might be more to it. Another reason for the virtual absence of extra-financial performance reporting is probably that financial service providers are inherently reluctant to embrace it. After all, once you decide to report along the environmental, social and financial dimension, you must also be able to live with the possibility of an extra-financial underperformance. But, of course, this should not and cannot serve as an excuse for remaining inactive. No one would seriously consider dropping financial reporting just because there is a chance of underperforming. Any such financial service provider would very soon be out of business.

Extra-financial performance reporting should therefore not be seen as a threat, but rather as an opportunity. A multidimensional SRI performance measurement can prove a useful complement to the standard financial reporting and also a welcome justification for the chosen sustainable investment strategy, particularly in times when financial markets are not properly rewarding companies’ sustainable behaviour. Furthermore, provided the underlying SRI stock selection method is effective, a negative SRI outcome should theoretically be much less likely than the chances of underperforming financially. Stock market returns are driven by a lot of factors over which the firm has only limited control; sustainable behaviour is, by definition, something that the company decides to do.

The basis of a proper extra-financial performance-reporting framework is ‘measurability’. A listed company’s stock price can be monitored real-time. It is there for anybody to see and there can be no possible disagreement about its actual numeric value at a given point in time. Of course, one might disagree about the appropriate valuation of the stock, but that is a different story. Unfortunately, the same cannot be said for sustainability.

So we first have to tackle the above-mentioned problem of the ‘measurability’ of SRI performance. Here, we believe that we have already put forward a viable proposal in the past. In a working paper from 2005, we built the case for introducing fewer, simpler but above all more verifiable environmental and social key impact factors in order to gauge companies’ sustainability performance. We came up with a limited set of particularly relevant environmental criteria (mostly energy-related, or, equivalently, related to...
CO\textsubscript{2} emissions) as well as a pragmatic after ‘down-to-earth’ metric measuring net job creation by companies\textsuperscript{8}.

The environmental key impact concept has in the meantime been further refined in close collaboration with our long time SRI provider Centre Info into a new and fully fledged SRI assessment tool (envIMPACT®) that allows for rating and identifying investment candidates according to their greenhouse gas emissions.

\textsuperscript{8} Cf. “Do Stock Markets Reward the Creation of Jobs?” (Pictet 2006), where we introduce and discuss in detail the underlying concept of job creation as a measure for the social responsibility of companies.
4. Extra-financial performance

Our first task is to show that the portfolio construction process is indeed capable of yielding a portfolio that is distinctly more sustainable than the broad market. This sounds trivial, but we have to remind ourselves that this is only possible when all companies of the investment universe have been rated according to the same rating scale. Investment approaches that concentrate on a few ‘leaders’ from the start and do not properly analyse the remaining companies in the benchmark cannot convincingly establish a ‘sustainable difference’ against the broad market. That is why we believe a broad SRI research coverage to be paramount: without knowing all companies equally well, it is virtually impossible to say to what extent the companies ultimately selected really differ from the rest of the pack.

A straightforward way to show the sustainability level of a portfolio is to express the sustainability ratings of each company as a Z-score, i.e., a statistical variable with a mean of zero and a standard deviation of one. The Z-score is very practical in this context, because it ideally conveys the notion of a ‘best-in-class’ rating, expressing each company’s position against the average of its own sector in terms of standard deviations. Hence 2/3rds of all companies have a score between -1 and plus 1 and 95% of companies have a score of -2 to +2. The sustainability level of the portfolio can then simply be computed by multiplying the sustainability score of each company by the company’s weight in the portfolio.

Based on our own products, the range of the ‘sustainability difference’ is usually between 0.6 and 1.5 standard deviations, depending on the investment universe, the rating methodology applied and for an ex-ante tracking error of 2%. We use a quantitative process to construct a ‘sustainably efficient’ portfolio in the sense that no other portfolio comprises more sustainability for the same level of risk. The following graph illustrates (schematically) how the distribution of the scores in the sustainable portfolio is shifted to the right, i.e., towards more sustainability.

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9 The concept of the SUSTAINABLE EFFICIENT FRONTIER leading to sustainably efficient portfolios was introduced by Pictet Asset Management back in 1999 within the scope of a broadly diversified Swiss equities portfolio.
Does the portfolio indeed overweight the best companies?

To plot the distribution of the sustainability scores of the client’s portfolio against its benchmark is an important first step towards reporting along the extra-financial dimensions, since it enables the client to see at first sight whether the portfolio construction process is actually favouring those companies that have been deemed more sustainable. We believe this systematic approach to be more appropriate than substantiating one’s claim (regarding the portfolio’s superior sustainability) with anecdotal evidence alone. Nevertheless, Z-scores and standard deviations remain statistical and relatively abstract concepts, and this is why we would in the following section like to develop, if tentatively, a new concept of presenting the extra-financial performance in an intuitive way.

“Impact” score allows performance measurement

And this is exactly where our newly developed "Impact" method (CO₂ emissions and net creation of jobs) kicks in. The quantitative nature of the impact scores makes it easier for us to report the extra-financial performance of a portfolio in very much the same way as we do for the financial performance. For this purpose we will estimate the concrete emission reductions and the number of jobs created by the client’s sustainable investment strategy. Such an extra-financial performance measurement can then be interpreted as ‘equivalent’ to the classical financial performance measurement, enabling the reporting of the achieved ‘environmental’ and ‘social’ return of an investment as opposed to its conventional financial return.

More than nice-to-have

In our view, reporting on the purported environmental and social return of a portfolio is not just a nice-to-have item but should increasingly be regarded as an integral element of the standard reporting framework for an SRI investment mandate. After all, the most important difference between a conventional investment strategy and a sustainable investment strategy is that the latter explicitly aims to create value along the extra-financial performance dimensions as well.
We would now like to present how such an extra-financial performance reporting might look. We would like to draw the reader’s attention to the fact that such an undertaking is necessarily a work in progress. The “impact” methodology used to rate companies and to build sustainable portfolios has been developed fairly recently, and although the method is a promising tool for this type of measurement, it is still subject to further improvement and so is necessarily the reporting that is based on that data.

Furthermore, in order to be fully transparent, we would like to draw the reader’s attention to the following point: listed companies usually state their earnings and key financial figures on a quarterly basis, whereas employee-related data which serves as input to our social rating is on a yearly basis only. The same holds for our environmental rating. This is why our extra-financial reporting depends on the availability of a comprehensive annual reporting and its frequency will be limited to a yearly basis. Final data for 2007, the year on which our extra-financial reporting below is based, will not become available until during the regular annual reporting season in the first half of 2008. Therefore, the definite, ‘realised’ social and environmental performance will not be known until then. What we will show, hereafter, is therefore a pro-forma calculation of the extra-financial performance for the year 2007 based on the two-thirds of companies for which turnover and employee-related information was already available when this paper went into print. Therefore, the actual extra-financial results might eventually deviate from our projections. Despite this partial disclaimer, we believe it is worthwhile and important to present our preliminary results at this point in time in order to make our point, and eventually to encourage others to take up extra-financial reporting as well.

Let us add one last, particularly important comment, before moving on to the results section.

In order to be as close as possible to investment reality, we have chosen to work with our real “impact” scores, i.e., our combined sustainability scores that are based on an industry-specific weighted average of a company’s job creation score and its CO₂ score. It is this global score that is actually used for optimisation in our client portfolios that is also at the basis of the following performance reporting, and not some ‘pure’ partial social or environmental score. Optimising our portfolio separately based on a ‘pure’ partial score would certainly have yielded even better results for each domain.

However, we believe this to be too theoretical an approach, since all our existing clients have a preference for rating companies both for their environmental and their social credentials (as expressed by the combined score). Consequently, using the combined score for sustainable optimisation conveys a more realistic picture of what is actually achievable by pursuing a fully-fledged (environmental and social) sustainable investment strategy.
### A. Environmental Return

**Indicators: Energy and CO₂**

Let us first look at the environmental dimension. There is so much talk about climate change nowadays that we think it might be time to check whether an SRI investment style can actually contribute to curbing greenhouse gas emissions, or whether such a claim is mere wishful thinking. In accordance with what we did above, we have therefore reduced the complex concept of ‘environmental responsibility’ to greenhouse gas emissions (equivalent CO₂).

**Carbon intensity unit (CIU)**

In our optimised portfolio we will then systematically overweight companies that emit less CO₂ per unit of turnover than their sector peers. The key indicator underlying the environmental impact rating is the so-called CIU (Carbon Intensity Unit) that expresses in simplified terms just the CO₂ emissions in tonnes per USD million of turnover. Accordingly, we can estimate a company’s total emissions of greenhouse gases over a certain period by multiplying its CIU figure with its turnover over the same period\(^1\).

**Active return equals avoided emissions**

Again, the difference of the weighting of the titles in the portfolio and their weighting in the benchmark, multiplied by their respective CIU value and turnover, and summed up over all titles, yields the active ‘environmental return’ of the client’s portfolio, i.e., the expected emission reductions in tonnes of CO₂. Note that the ‘environmental return’ will show a negative sign, and rightly so. For the more sustainable the portfolio is, the less greenhouse gas emissions it will generate. The investment-specific reductions in greenhouse gas can then be derived by dividing the achievable reductions by the market capitalisation of the individual companies.

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\(^1\) As stated above already, turnover figures for the year 2007, and therefore also the exact activity breakdown upon which the CIU calculation is ultimately based, will not be available for all companies until later this year. However, the nature of a company’s business activities tends to be rather stable, so we believe our estimates to be robust, with the bulk of the potential deviation from our estimations coming eventually from the volatility of the 2007 turnover of the outstanding companies.
For our global investment universe (MSCI World), a conventional benchmark investor would have ‘funded’ emissions of 1552 tonnes per one million invested USD, whereas the client invested in the sustainably optimised portfolio would only have been responsible for emissions of 985 tonnes of CO₂. This translates into a considerable reduction in greenhouse gas emissions of close to 35% against a broad market benchmark, and this, note, not by aggressively betting on low carbon-emitting industries, but exclusively by applying a judicious carbon-driven stock-selection process within each economic sector.

The above graph illustrates the results for the fifteen industry groups where the active contribution of the optimised sustainability portfolio has been most significant. The dark bars show how many tonnes of CO₂ have been ‘triggered’ by investment of one million USD into a specific industry group. The light bars show the same information for the sustainably optimised portfolio and the environmental bars show the ‘active green return’ of the portfolio in tonnes of saved CO₂ emissions per million USD invested. As we can infer from the graph, the largest reduction effect could be obtained within the industry groups Energy, Capital Goods and Utilities. In fact this result is hardly surprising given that these sectors are large energy consumers and therefore a sustainable stock selection can indeed make a big difference.

However, because we advocate a strict best-in-class approach, we are not allowed to allocate all our investment to just a few sectors, but we explicitly try to reduce emissions within all the other benchmark sectors as well. The above graph shows how well we succeeded in doing so.

The optimised portfolio emits roughly 35% less CO₂.
Restating our results in per cent yields a somewhat different picture. The relative view in the graph below brings several sectors to the limelight, such as Consumer Durables & Apparel, Transportation and Commercial Services and Supplies, which are not among the largest polluters in absolute terms\(^1\), but nevertheless allow us to obtain large relative efficiency gains between 70 and 80%.

Here, we would like to draw the reader’s attention to an important point: The CIU value of a company is based on a detailed economic Input-Output analysis as well as on a method called Life Cycle Assessment (LCA). The CIU therefore refers to both the direct and indirect emissions occurring along a company’s entire production chain. Indirect emissions include, for instance, emissions originating at a supplier’s premises, but also emissions generated during the final use of a company’s products such as the emission of a car during its use phase. This comprehensive approach makes a lot of sense for the selection of individual stocks. For many companies, indirect emissions are much more important than direct emissions (well over 90% of all emissions for some companies are ‘collateral’), and we would consequently run the risk of misallocating our funds to the wrong companies when basing our judgement solely on their direct emissions.

However, when aggregating \(\text{CO}_2\) emissions across sectors or over an entire investment universe or portfolio we are faced with the problem of double counting. A car company, as stated above, will also be held responsible for all the emissions that their cars emit during their life-time\(^2\). At least some of these cars will not go to private individuals but...

\(^1\) Note that the industry group “Transportation” above encompasses all the logistics companies and should not be mistaken for what is commonly understood by the vernacular term “transportation” (activity).

\(^2\) A logic which is by no means exclusive to our approach; just think, for instance, of stricter emission standards for automobiles, where the manufacturers – and not the end-user – of the car are held accountable.
will be bought and used by other companies – say in logistics firms – that are themselves subject to the CIU analysis. The ‘same’ emissions that have already been blamed on the car manufacturer will again accrue to the logistics firm – this time as an input in the production process. So what makes sense from an individual company’s point of view may lead to multiple double counting when aggregating across sectors. According to our CIU data provider, Centre Info in Fribourg, the effectively obtainable total emissions reductions are considerably overstated, depending on the individual sectors involved and the complexity of their products and services.

Establishing for each and every company exactly what proportion of their ‘active’ products is actually going to private end-users (no double counting) or is going to another company that is itself subject to a life-cycle analysis (double counting) is a Herculean task, and a piece of information not currently available to us. Nevertheless, we have asked Centre Info to estimate the amount of double counting on an aggregated portfolio level, and this is what they came up with: eliminating all the double counting – including all the indirect effects of the financial industry which are quite substantial – would reduce the aggregated CO₂ emissions of the benchmark to 892 tCO₂ per million USD invested (instead of 1552 tCO₂ including double counting). The same correction applied to our optimised portfolio leaves us with emissions of 528 tCO₂ per million USD invested (instead of 985 tCO₂ including double counting). Consequently, eliminating all the double counting loses some 200 tonnes of total achievable emissions reductions. Even so, taking all these corrections into account, a globally diversified investor could have saved over 360 tCO₂ of emissions per million USD invested, which is, we think, still quite a respectable achievement. Furthermore, eliminating double counting even increases the relative gain in CO₂ reductions that can be achieved in the portfolio to 40%.
How do things look on the social side? As set out already in our last publication, we firmly believe the creation of jobs to be the most important criterion for the social responsibility of a company. We compute ‘job creation’ by using an weighted average of the past changes in a company’s headcount, whereby we try to correct quantitatively for mergers, divestments and other disruptive developments in the number of employees. The objective of our indicator is to capture both the trend and the dynamics of companies’ job creation. In so doing, we adopt a so-called ‘best-in-class’ approach, i.e., we compare companies only within comparable industry clusters. When constructing our portfolios, we then systematically overweight the good or underweight the bad companies based on this social responsibility rating.

The number of jobs is a publicly disclosed figure and we can therefore compute ex-post how many more jobs have been created by the selected companies in the client’s portfolio as opposed to all the companies of a defined market benchmark. Since we are talking about an active management approach, we believe it makes sense to state the number of surplus jobs that have been created over the benchmark for a million USD that was invested in those companies. For a broadly diversified global equities portfolio with a tracking error of 2% over the broad market benchmark (MSCI World), this additional job creation amounted to 0.05/million USD in 2007. This translates to one additional job for every 20 million USD invested. This might not sound very impressive, but we have to remember that this is an additional social good provided by a broadly diversified portfolio that has a priori exactly the same risk and return characteristics as a conventional portfolio.

An institutional investor with a USD 100 million mandate would thus – ceteris paribus – have supported the creation of five additional jobs per year on top of his common monetary investment objectives. We leave it to the reader to decide whether this is a worthwhile improvement or not. Note, however, that these five jobs are the positive social impact that can be attributed to one individual investor based on his holding only a tiny part of the market. Purely for illustration purposes: the same result scaled up to the entire market capital of the benchmark would amount to over 1.5 million extra jobs for 2007.

The figure below illustrates the results regarding job performance, broken down for the fifteen MSCI industry groups where the active contribution of the sustainably optimised portfolio was biggest. The dark grey bars show the number of jobs created by all the benchmark companies of a particular sector for one million USD invested. The light grey bars show the same information for the companies held in the optimised portfolio, and, finally, the blue bars show the difference between the portfolio and the benchmark, hence the ‘active social return’ or the ‘social outperformance’ over the benchmark.

B. Social Return
In 2007, although the real economy was in rather good shape, net job creation was still weak or negative in some economic sectors. Furthermore, the active contribution of our optimised portfolio was not necessarily tied to the sectors of the benchmark where the absolute creation of jobs was also largest. When we look at the Energy sector for instance, we can see that the companies in the benchmark created only a few jobs during 2007, whereas the Energy companies in the sustainable portfolio were able to create 0.007 new jobs per million USD invested. If we sum up the active social return across all sectors, we are once again at the 0.05 surplus jobs per million USD invested that we already mentioned above.

Stating the results in terms of headcount has the advantage of being rather intuitive. Nevertheless, we could also express the added value in percentage terms. In fact, doing so likens the social return of a portfolio even more to its conventional financial counterpart. Hence, by multiplying the job growth in percentage terms with the active weight of the respective company in our sustainable portfolio (weight of the company in the portfolio minus its weight in the benchmark) and summing up across all titles in the investment universe, we can again determine the ‘active social return’ or social outperformance of the client’s sustainable portfolio.

The optimized portfolio has created more jobs than the benchmark.

Active social return in %
Social return of the optimised portfolio was +4.2%

The figure above illustrates the social return in per cent that a sustainable investor could reap in 2007 in different industry groups. Again the dark bars show the benchmark performance, the light bars the portfolio performance and the blue bars show the active social return (or the social outperformance) over the benchmark. The largest social outperformance (+0.60%) was generated in the Energy sector. Summing across all sectors yields us the result for the entire benchmark and the portfolio, respectively: in 2007 the MSCI World had a positive social return of +2.7% whereas the sustainably optimised portfolio yielded a positive social return of +4.2%. The active, social outperformance of the sustainable portfolio was therefore +1.5%.
5. Discussion & Conclusion

How does all this fit together? The sustainable investor is a utility maximiser just as any other investor. However, contrary to a conventional investor, the sustainable investor pursues a whole bundle of objectives, some of which are financial (return, risk, liquidity), and some extra-financial (social, environmental and corporate governance-related benefits). As we have seen above, it is at least tentatively possible to measure and report on extra-financials, but the question of how to prioritise and weight the different performance dimensions will and must ultimately lie with the investor alone. Social investment utility functions of SRI retail investors and professional institutional SRI investors can be assumed to vary considerably, mirroring the differences between an individual’s personal investment preferences and, say, a pension fund’s trustee’s who must act in the best interest of a large number of beneficiaries.

There has always been a lot of ‘win-win’ talk around in the SRI arena. Most proponents of SRI are fairly confident that investing sustainably can benefit both the world around us and our purse, or, as it is sometimes put, that we can “do well while doing good”. We do not want to dip into this debate for now. Suffice it to say that if the ‘win-win’ hypothesis holds true, there would then be no problem at all. Apart from an outright cynic, even the most hard-nosed investors would then choose an SRI investment style and be glad to take home the sustainable added value as a windfall profit.

The more interesting case and certainly a more cautious position would be to presume the existence of a certain trade-off between the different return dimensions. This idea is illustrated in the following figure below. A conventional investor is likely to pursue maximum financial return and is satisfied when companies merely comply with legal minimum standards in the two extra-financial dimensions. We simply posit here that even a financial investor would not want to invest in illegal business practices. The sustainable investor, however, would explicitly seek a higher performance along the environmental and the social axis and would presumably be willing to forgo the otherwise potentially attainable maximum financial return in order to satisfy his specific sustainable objectives.
Maximizing sustainable utility

If we accept the conceptual implications of the above figure, namely that there might – at least in the short to mid term - be a trade-off between the three performance dimensions, then the SRI investor must define his individual ‘sustainable utility function’ that will specify, for instance, how much financial performance he is willing to forgo in say a bad year in order to attain his extra-financial objectives. This is no easy task for sure, since there are presumably a lot of interdependencies not only between the financial and the extra-financial dimensions, but also between the two extra-financial dimensions themselves. It is, to give an example, well-known that the mechanization of strenuous manual work has improved the working conditions in factories (social dimension) whilst at the same time increasing the energy-intensity of the industrial production processes (environmental dimension).

Therefore, different investors will - dependent on their individual situation and preference structure - have to come up with their own conceptual model of how to balance the extra-financial return against the conventional financial return. But just like a conventional investor, the sustainable investor will then resolutely aim to maximize his specific sustainable utility function.

The most important thing in our view is that SRI investors indeed start looking at the SRI performance dilemma in this way, because it would help to clarify and pin down what the sustainable mandate is actually meant to achieve, and it will provide a tool to benchmark the investment manager against the defined objectives. We are convinced that such a multi-dimensional approach could also help to reassure institutional investors such as public pension funds, who are often willing to assume their broader societal responsibility and to steer a steady course towards sustainable development, but who often lack the necessary evidence to prove to the regulatory bodies and the scheme’s

Arguments for those who assume responsibility...

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beneficiaries that by investing sustainably they are indeed employing the entrusted funds in their very best long-term interest.

In order to provide these long-term oriented investors with the right arguments and enable them to withstand the increasing pressure of financial short termism, it is in our view absolutely necessary to continue to explore and measure the performance also along the extra-financial dimensions. For only what can be measured will eventually be factored into investment decision-making and into comprehensive performance evaluation. In this sense, we hope to have made a useful contribution with this paper.
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