Sustainability and responsibility in asset management

THE KNOWLEDGE FOUNDATION'S EVALUATION OF ITS EXTERNAL ASSET MANAGERS: FOCUS: HEDGE FUNDS

– DECEMBER 2013

Knowledge Foundation

“We’re currently experiencing a change in trends, where the majority of investors are starting to realise that an integrated sustainability perspective in asset management is the most professional approach. Most of the Knowledge Foundation’s contracted asset managers are also asking for clarity as regards customer demand for this type of approach. Our response is: That is the service we are asking for – active, long-term sustainable asset management.”

Anders Ahl, Head of asset management at the Knowledge Foundation in cooperation with Ulrika Hasselgren, CEO of Ethix SRI Advisors

Help us make a difference

The Knowledge Foundation was founded in 1994 by the Swedish Government and given the task of strengthening the country's competitiveness by funding research and skills development on an advanced level at the country's new higher education institutions (HEIs). The Foundation supports research and skills development that are conducted by academia in cooperation with the business sector. The Foundation's start-up capital from the Government amounted to SEK 3.6 billion. Up to and including December 2013, around SEK 8.4 billion has been disbursed and about SEK 8 billion still remains. No further capital has been provided by the Government.

Since the start, the Knowledge Foundation has managed its own capital using its own asset managers. This approach has quite clearly been very successful. By tradition, the Foundation holds most of its capital in Swedish shares.

As a research funding body, one of the Knowledge Foundation's many distinguishing features is its desire to be at the cutting-edge, something which should also characterise modern asset management. For us, this means incorporating sustainability and responsibility into the investment process and contributing to expanding knowledge about and expertise in sustainability on the finance market.

As an example of "being at the cutting-edge", the Knowledge Foundation is the first Swedish foundation to perform an evaluation of its external asset managers, the majority of them hedge funds, with the aim of gaining an understanding of how these entities approach the issues of sustainability and responsibility themselves – in their own organisation and in the investment process.

The aim of the evaluation is also to give the Knowledge Foundation a platform from which to pursue further dialogue with its external managers. The Foundation strives for constructive discussion focusing on the work going forward and on the dynamics in the process. The Foundation also distinguishes itself as an active and sometimes very demanding player. This is true regarding both its research funding and its asset management activities. Simply by asking seven straightforward questions on sustainability to our 19 asset managers, we clearly illustrate our expectation that they have a well-considered strategy on sustainability and responsibility.

The evaluation, developed in partnership with Ethix SRI Advisors, one of Sweden's leading advisors in sustainability issues for asset management, has been performed based on an established questionnaire sent to each manager respectively. The responses have been followed up via a dialogue with each asset manager to gain a deeper understanding of how they look upon sustainability and responsibility in their asset management and organisation.

The evaluation of our counterparts has been both instructive and inspirational and I look forward to a continuation of the dialogue. I also believe that we are contributing to market development by asking questions, discussing and encouraging active efforts to achieve integrated sustainability.

If we – the entire chain from the Government, agencies, asset owners, asset managers, companies and the general public – feel that sustainability should be incorporated more quickly into asset management than currently is the case, we must urge general debate, stimulate dialogue, discussion and education/training, and support development.

I hope you enjoy reading about the overall findings of our evaluation.

Madelene Sandström,
CEO of the Knowledge Foundation

Why on earth are we doing this?

“Why on earth are you doing this?”, a suspicious more senior asset manager exclaimed when we presented our evaluation. “Hedge funds and sustainability, all very nice, but a manager’s primary task is to generate good return on investment in the same way as a company’s task is to generate shareholder value!”

If this opinion still exists in 2013, one can wonder what has happened since the Nobel Laureate in Economics, Milton Friedman, condensed the sustainability perspective down into the following: “a company’s social responsibility is to increase its profits”[1]. Some investors go further and have previously seen a direct conflict of interest between sustainability and a company’s undertakings vis-à-vis its shareholders: “I believe it is of the greatest importance for us to put a stop to this tittle-tattle about ethics before it upsets the apple cart for entrepreneurship in our country. If we take the cries for more ethics seriously, we will have to recast the role of

Anders Ahl, Head of asset management at the Knowledge Foundation and Ulrika Hasselgren, CEO of Ethix SRI Advisors. ▶

1. Friedman 1970

enterprise in society, ... we will be throwing a spanner into the workings of market economy welfare" was the opinion of finance mogul Mats Qviberg[2].

When considering the thoughts of researchers as regards what drives asset managers, one is struck by the focus on self-interest as the primary driving-force for investment decisions and the conclusion that asset managers don't want to deviate from what are considered to be asset management's most professional values.

In 2012, the UN-backed PRI initiative released a discussion paper on how to apply the concept of responsible investment in hedge funds. The idea is to increase the debate and get both investors and hedge fund managers to discuss these issues. So far, however, sustainability issues have had only a modest impact in the hedge fund sector and it is uncertain when this is likely to happen.

Even if sustainability, ethics and human rights are strong mass-media issues that can be found in policy documents, assessment of the choices to be made is left with interpreters at different levels in the organisations. Direct investment in companies places tough demands on evaluation and control. But how are these issues treated by external managers? Their significance doesn't disappear just because the buying and selling are not being done by the asset owners personally.

In 2013 we evaluated all of the Knowledge Foundation's external asset managers – 19 in total, of which 17 are hedge funds. For us, therefore, sustainability and responsibility in asset management clearly focuses on hedge funds. The evaluation has consisted of two parts: a written questionnaire comprising seven questions, and a dialogue with each asset manager in order to gain a better understanding of their reasoning about and approach to sustainability and responsibility in their asset management and in their organisation.

There are two sides to sustainability in asset management, and each side is multifaceted and rich in content. However, it is important to remember that a questionnaire never provides an answer to the entire question. "The constructive dialogue" always challenges our ability to under-

2. Svenska Dagbladet, March 2006

stand and interpret what is said and not said – with, as in this assignment, the focus on a forward-looking approach and the dynamics in the process.

We are pleased that all the external asset managers replied to the questionnaire and participated in the dialogue. We see the evaluation as the start of a process and an ongoing dialogue and hope that it can contribute to greater knowledge about, and competence of sustainability within, the financial market.

Many asset managers ask for clearer instructions from asset owners at the same time as asset owners in turn expect asset managers to be proactive and show how they incorporate sustainability.

We are currently experiencing a change in trends and soon a turning-point will be reached when a majority of asset owners and managers will consider that an integrated sustainability perspective in asset management is the most professional approach towards handling capital. That is the service we are asking for – active, long-term sustainable asset management. If this is the case, it will no doubt soon be considered unprofessional to see oneself as a "conventional" asset manager when one doesn't accentuate one's sustainability profile.

That is why on earth we have done this.

Anders Ahl, Head of asset management at the Knowledge Foundation
Ulrika Hasselgren, CEO of Ethix SRI Advisors


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Summary

This is the first time the Knowledge Foundation has performed an evaluation of its external asset managers focusing on sustainability and responsibility in asset management. The evaluation has consisted of two parts: a written questionnaire, with seven questions, and a follow-up dialogue with every asset manager. Admittedly, the method is simple and the assessment and analysis are subjective. However, this is intended as a first step in kick-starting a running dialogue with asset managers to focus on the forward-looking work and the dynamics in the process.

The following 19 external asset managers were included in the evaluation (in alphabetical order): Alcur, Agenta, Blackrock, Brummer Multi Strategy, Carve, Catella, DNB, Excalibur, Franklin Templeton, Futuris, Gladiator, Goldman Sachs, Kammarkollegiet, LGT, Nektar, OPM, RAM, SEB and Sentat. Of these 19 asset managers, 17 are hedge funds, both "single-managers" and "multi-strategy managers", or "funds-of-funds".

> The written questionnaire was assessed on a scale of 0–3 points per question. Maximum points: 18
>
> The follow-up dialogue was assessed on a scale of 0–5 points.
>
> Maximum points (questionnaire and dialogue): 23.

In both the questionnaire and the dialogue, respondents were open and gave frank answers. In responding to the questionnaire, most managers said they had good basic knowledge and understanding of sustainability and responsibility in asset management. Several were surprisingly positive. When we included the dialogue, however, we found a considerable difference between the responses to the questionnaire and the content of the dialogue. This gave

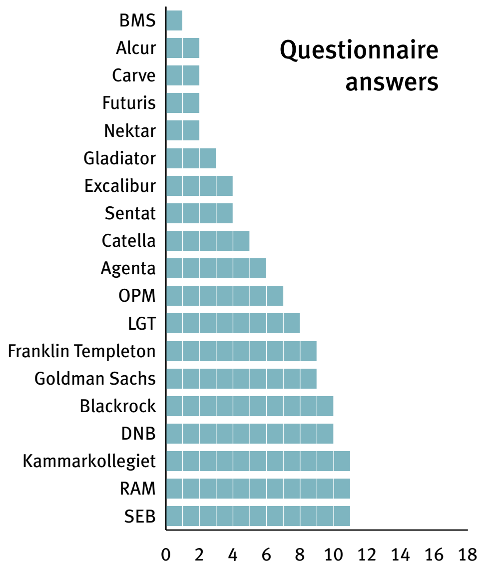
Survey question	Points	Assessment	Maximum points
1 How do you view sustainability and responsibility in relation to your task as an asset manager?	0	No particular understanding	3
	1	Some understanding	
	2	Good understanding	
	3	Comprehensive understanding	
2 How do you integrate sustainability and responsibility into your investment process?	0	No particular integration	3
	1	Outsourced process, not integrated	
	2	Own process, not integrated / Outsourced process, integrated	
	3	Own process, integrated	
3 How do you manage the risks and opportunities regarding sustainability and responsibility?	0	No particular management	3
	1	Some management	
	2	Good management	
	3	Comprehensive management	
4 Which areas do you think are relevant to consider from a sustainability perspective?	0	No particular areas	3
	1	Some understanding	
	2	Good understanding	
	3	Comprehensive understanding	
5 What knowledge and skills do you have when it comes to sustainability and responsibility?	0	No particular knowledge	3
	1	Some knowledge	
	2	Good knowledge	
	3	Comprehensive knowledge	
6 Can you give a concrete investment example where you considered sustainability and responsibility?	0	No particular example	3
	1	Rather weak example	
	2	Average example	
	3	Strong example	
7 Do you have a formalised evaluation process for the funds you are considering or have invested in? (question not relevant for all managers)	0	No particular process	0
	1	Weak process	
	2	Average process	
	3	Strong process	
Total possible points (question 7 not included as it is not relevant to all managers)			18

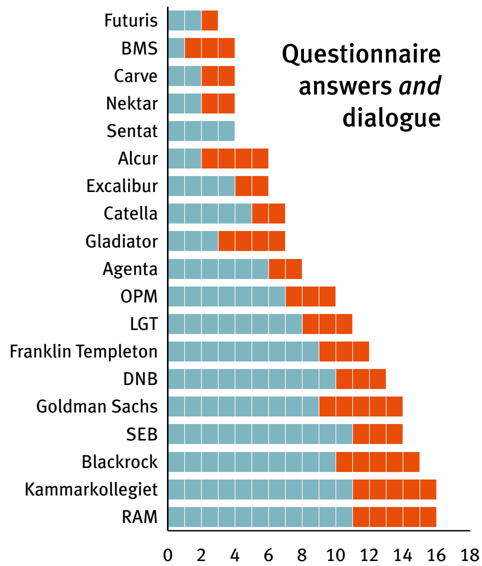
us reason to re-evaluate some of our initial reflections and assessments.

The value of a questionnaire is always limited. The questionnaire also elucidated the challenge of interpreting “brief, concrete responses” to open questions about complex issues. Hence, the dialogue with every external asset manager was a valuable part of the evaluation.

Swedish players are often smaller and have limited resources, but some responded with interesting answers in both the questionnaire and the dialogue, illustrating that much can be done with few resources. The large international players on the other hand are usually very well prepared to answer questions and pursue dialogue, and they have well-formulated presentations and documentation. Here we consider, however, whether they have employed substantial resources to manage their capital with clearly defined management processes that integrate sustainability and responsibility, or whether they are well-prepared for communication and marketing.

The graphs below show the total points from the questionnaire and the total points from the questionnaire and the dialogue.





Sustainability and responsibility in asset management

Sustainability and responsibility are being discussed to a greater extent both in the public debate and in the business sector and finance market. In Sweden, more than 70% of institutional capital is managed using some form of policy for sustainability, ethics and responsible investment. The market has developed dramatically over the last ten years and AP7 *(Sjunde AP-fonden)* set a standard in the market in 2000 when it was the first AP fund to develop a policy for ethics and environmental concern in its asset management based on international norms for the environment and human rights.

> **“We cannot integrate all managers into all parts of the sustainability process. The main focus must nevertheless be on creating greater return on investment while taking carefully calculated risks.”**

In 2006, the then UN Secretary-General, Kofi Annan, launched the PRI initiative with an ancillary organisation, after having convened some of the world’s largest asset owners in 2005 to develop and agree on principles for responsible investment. The result was the establishment of six principles, the first of which is: “We will integrate environmental, social and corporate governance (ESG) issues into investment analysis and decision-making processes”.

PRI believes that ESG can have an impact on returns – to a varying degree for companies, sectors, regions, types of assets and over time – and shall therefore be considered. We agree about this principle, as do more than 1 200 asset owners, managers and advisors around the world who – at the time of writing this report in December 2013 – have become signatories and pledged their support to PRI.

The concept of “integrated sustainability” poses a challenge, however. What does integrating ESG issues into investment analysis and decision-making processes involve? Is ESG the definition of sustainability? If so, how shall this sustainability be incorporated into analysis and investment decisions? And to what value or what benefit? And how shall it be interpreted or applied?

Lars Löwgren, CEO of DNB in Sweden, points out that “we cannot integrate all managers in all parts of the sustainability process. The main focus must nevertheless be on creating greater return on investment while taking carefully calculated risks”.

The issue is surely how such a main focus can exist in symbiosis with a strong sustainability policy?

Integrated sustainability?

Developing an investment philosophy with an integrated sustainability perspective is said to be a continuous process that must be done in dialogue with the customers. This brings us immediately onto the customer perspective, which is something that has emerged in our evaluation as a driving-force for how managers view sustainability and responsibility in asset management. We will discuss the customer perspective in the next chapter.

We agree however about the need for dialogue. We believe in cooperation between the asset owner and asset manager in the same way as we believe in constructive dialogue between asset owners and companies, and between asset managers and companies. For the Knowledge Foundation, sustainability is illustrated in practice when we trade in funds (see illustration next page).

As regards the challenge of "integrated sustainability", it is shared by several in the market, and comprises everything from value and benefit for asset management to definitions, application and the possibility to measure relevant results.

We do not believe that there is a single answer or a single standard. We do believe however that asset owners have an important role to play in development by placing demands on their managers that they need to have a well-considered approach or a strategy for sustainability and responsibility. This has also become clear in

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our evaluation and emerged in particular in the dialogue with the external asset managers.

Changes in the world and the shift from the clear responsibility of countries for people and the environment to the expectation that transnational companies will take their responsibility also means that asset owners have a chance – and are expected – to contribute by demanding, influencing and supporting sustainable development.

For the Knowledge Foundation, this means continuing the dialogue, following up and continuously evaluating the work of its counterparts with sustainability and responsibility in the same way as it follows up their return on investment, risk level, management resources or degree of regulatory compliance.

Emma Sjöström holds a PhD in economics and teaches at the Stockholm School of Economics. In her research she describes how shareholders provide legitimacy to corporate sustainability managers, for example when major owners such as the AP funds express concrete expectations in this area[3]. In this way, investors confirm or strengthen opinions that others have also expressed, rather than acting alone in trying to exert influence. Hence, the influence of a single company can seldom or never arise from a dialogue with a single player, but involve several investors, customers or employees.

Sjöström describes this in terms of “norms”, and identifies a “norm” as a “standard for suitable behaviour for entities with a determined identity”. This concept therefore touches on the established term, “best practice”.

3. Sjöström 2008b

Can best practice or a "well-established norm" arise for hedge fund managers?

In an oft-cited research article[4] from 1998, two American political scientists, Martha Finnemore and Kathryn Sikkink, describe the lifecycle of a norm in three stages:

1. *"Norm entrepreneurs"* introduce a new norm: A new norm starts to see the light of day when a new way of looking at what is right and reasonable begins to be advocated. The norm entrepreneurs now try to persuade others to adopt the new way of relating to something.
2. Once the new norm gains a foothold and reaches a broader audience, but is still not established or self-explanatory, those who are convinced about the suitability of the new norm, known as *"norm ambassadors"* try to convince more people.
3. Gradually, the norm becomes fully accepted by most people, is not questioned, and thereby becomes internalised. *"Norm bearers"* maintain the norm and this constitutes its normal state; a best-practice example that is followed (until it is challenged and perhaps even abandoned).

In the context of our evaluation, the new norm would not be the actual investment decision or method of each manager respectively, but a process towards an established best-practice or norm ("normalisation") of e.g. the customer's or the general public's transfer of their expectations onto their contracted managers.

The institutional investor – the asset owner – can never actually be convinced as to whether the asset manager has adopted the norm or not, or whether he or she makes the purely cynical assumption that "norm changing" is commercially justified in order to sell fund units to socially conscientious institutions. Financial reasons behind a norm entrepreneurship or ambassadorship rather than a more genuine conviction about the merits of the norm thereby become the real driving-force. However, one may ask oneself, whether this actually matters or not. Is this not a result of sustainability having been incorporated into the business model or individual investment process?

4. Finnemore and Sikkink, 1998

Is the strategy of waiting for the customer's explicit demands or requirements the best one?

Here are some reflections, given our conclusions derived from this evaluation and from our assertion that an increasing number of asset owners are considering and perhaps are worried about sustainability issues based on the consequences for human beings and the environment, or their own brand and reputation: As asset owners (the Knowledge Foundation) and their advisors (Ethix SRI Advisors), we can see that when asset managers, e.g. hedge funds, refer to sustainability as "customer-driven", they are in fact suggesting that the asset owners have not specified anything other than a general requirement for sustainability and this is then taken as a pretext for a lack of any particular interest in the issue.

> **"... our own common and observed experiences tell us that the various actors can lose their way in each other's cautiousness in not driving forward the issue towards real responsibility and investment decisions."**

But our own common and observed experiences tell us that the various actors can lose their way in each other's cautiousness in not driving forward the issue towards real responsibility and investment decisions. If inadequate sustainability is revealed in an investment decision, it is the managers who will be forced to take "unnecessary" responsibility, something they wish to avoid. But if they instead choose a proactive approach as an asset manager and actively pursue definitions that they can use on concrete investment decision levels, asset owners will often choose the most sustainable alternative. Why? Well, a greater worry that neither the asset manager nor the owner knows what she or he is doing is difficult to identify. It is this type of uncertainty that is becoming less and less desirable for asset owners and asset managers.

Business opportunities

For the opportunistic asset manager, however, the new, constantly more incorporated and globalised capital market offers a great many business opportunities: For example going outright long – making net investments – in companies that define at an early stage, e.g. long-term sustainable trends in certain innovation-oriented, cutting-edge industries. And going short – to net sell – shares in the holdings of companies that are hanging on to yesterday's technologies and not daring to think long-term and be innovative.

Is a new approach to sustainability emerging?

The discussions with several of the hedge fund managers revealed an impressive understanding of sustainability coupled with a good insight into what is relevant to consider, what the risks are in relation to a company's development and profitability, and what can contribute to social development and solutions to global challenges. "Wind power that in the long term needs subsidies is hardly a sustainable business, at the same time as one can ask oneself whether it is financially defensible and sustainable for the Finnish forest company UPM Kymmene to manufacture graphic paper products and plywood or other traditional forest products primarily from the 1.2 million hectares of forest it owns; if anything, this is more like value destruction", reflects Johan Klevby at the Alcur hedge fund.

The traditional fund market for both private individuals and institutions has in many ways developed towards including various sustainabil-

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Johan Klevby at the Alcur hedge fund

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Josefine Ekros, Sustainability Analyst at DNB

Viktor Andersson, SEB

ity trends in its range of products. The hedge fund business has however not yet latched on to these trends. “There should certainly be a niche in the market for an asset management product that uses the transition to the low-fossil fuel society as a springboard. This could even be marketed in Norway, our home market, where most of the economy is built around oil products”, says Josefine Ekros, Sustainability Analyst at DNB.

“It would be easier if we had a clear mandate from our customers on this,” argues Klaus Jäntti at Brummer. “Our interest in this is not primarily customer-driven, if anything it is business-driven by a small number of individuals in leading positions at the bank,” Viktor Andersson and Hans Hellenborg, SEB points out.

Fredrik Tauson, Catella

“It is a source of great frustration that sustainability issues are not more widespread among the customers we approach,” adds Simon Reinius, CEO at OPM. “The institutional capital has been rather ambivalent towards these issues for several years,” comments Fredrik Tauson at Catella.

In our discussions with the big banks in particular, a clear ambition emerges to meet this customer demand, even if it differs considerably among different actors and the different types of assets. “As a fixed-income manager, it is definitely becoming more difficult to place demands on companies, you are not part of the stakeholder collective, are not welcome at the annual shareholders’ meeting when you “only” lend money. The chances of being able to influence the company are therefore virtually non-existent. If you then don’t need the more dubious companies either from a diversification perspective or to generate earnings, it’s best to divest the holding instead of committing oneself”, concludes Fredrik Tauson at Catella.

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Not an altogether becoming picture – the hedge fund industry

"It is not important whether the company pours lead into a lake as long as it doesn't affect earnings and I can buy the shares cheaply", said one of the managers to us in the follow-up dialogue.

The image of hedge funds is normally cynical; fast money, no consideration, and short-termism. At the same time, the regulatory framework gives managers a considerable degree of freedom. A few make philanthropic efforts, but the general impression of hedge funds is not an altogether becoming image as regards ethics, responsibility and other values. As the focus of our evaluation is hedge funds, we would like to give a brief introduction to the business.

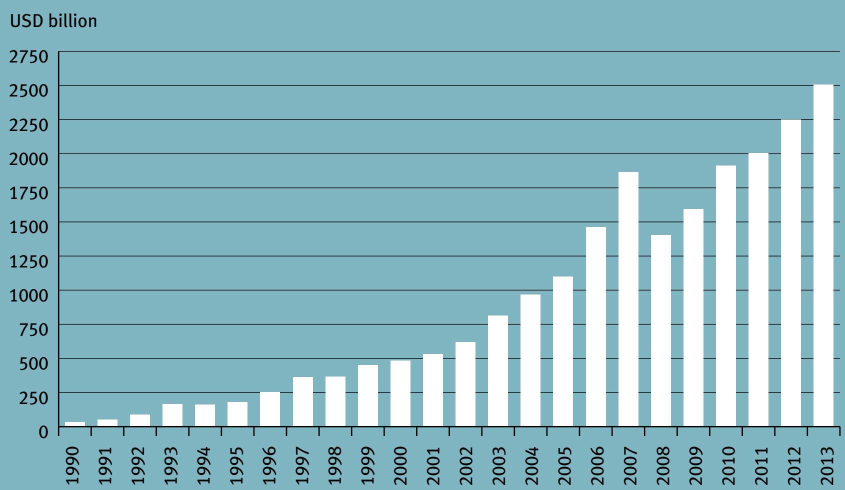
> **"Today, institutional investors constitute the largest investor category in hedge funds, which has led to substantial changes to the structure of the hedge fund market."**

The concept of hedge funds dates back to the end of the 1940s. Albert Wislow Jones launched a shareholding portfolio at that time in the United States which utilised short positions ("hedging") to limit the market risk, combined with loans to increase the earnings potential. Hedge funds got their name from this investment strategy, but at pace with the development of the market, the concept of "hedge funds" has become much broader and now comprises a plethora of different strategies exposed to different types of risk. For this reason, it is difficult to provide one unequivocal definition of what a hedge fund is. In general, however, their common denominator is the fact that they apply flexible investment strategies and normally look for an absolute (positive) return on investment with a limited risk for loss, regardless of the development of financial markets as a whole. This approach is in direct contrast to traditional funds, that have relative return targets, where the results are compared to a specific index. The investment strategies are mainly related to the stockmarket but there are hedge funds today that basically cover investments in the majority of asset classes, e.g. fixed income, raw materials, insurance and energy.

Even if the first hedge fund is thought to have been launched as early as the late 1940s, it was not until the beginning of the 2000s that they achieved a real breakthrough when their absolute returns sparked considerable interest in connection with strong results during the period when the IT bubble burst. The hedge fund market has grown substantially ever since. In 1996, hedge funds managed USD 250 billion, divided among about 2 000 funds; today there are just over 10 000 hedge funds that together manage over USD 2 500 billion dollars. In comparison with other sources of capital, however, the hedge fund market remains rather small; traditional funds managed globally just over USD 26 000 billion in 2012 and Apple's stock market value is today more than USD 470 billion. Hedge funds have also developed strongly in Sweden. In 2002, there were just over 20 hedge funds in Sweden that together managed just under SEK 40 billion, compared to today's SEK 100+ billion managed by about 100 hedge funds, equivalent to almost five percent of the total fund capital in Sweden.

Over the last ten years, it is not just the size of the hedge fund market that has grown, but also its composition has developed as the market has become increasingly institutionalised. For years, it was mainly wealthy private individuals who invested in hedge funds, but this began to change

Global capital invested in hedge funds, 1990–Q3 2013



in the 1990s when American pension funds and foundations started allocating to hedge funds. Today, institutional investors constitute the largest investor category in hedge funds, which has led to substantial changes in the structure of the hedge fund market. The increased demands on asset managers from institutional investors has led to hedge funds with more focus on operational infrastructure, greater transparency, lower fees and better liquidity. In recent years, a demand for ethical and environmentally sound behaviour has also started to surface. There are a number of problems regarding the definition of hedge funds, however, that exacerbate the application of sustainability principles in general terms. Hedge funds are not inherently a single asset type, but instead span a number of different strategies that can typically invest in many different types of assets. However, there are areas where all managers can make improvements, in particular as regards governance and transparency.

What does the research say about sustainable investment?

Academic research into sustainable investment indicates the existence of significant, deeply rooted stumbling blocks among financial market players. The Sustainable Investment Research Platform (SIRP) is a MISTRA (Foundation for Strategic Environmental Research)-funded research programme. SIRP's research aims to increase understanding of how professional investors, such as asset managers or analysts, can integrate sustainability into their investments. SIRP has studied how sustainable investment can create value for institutional investors and has also identified behavioural barriers that prevent the practice from spreading. In his doctoral thesis at the Department of Psychology at Gothenburg University, Magnus Jansson[5] describes the mental processes that prevent investors from applying environmental, ethical and social aspects when making their investment decisions. The research shows that asset managers are influenced by different and sometimes conflicting goals when investing the money of asset owners.

Changed global ownership conditions and new demands for responsibility

Three-quarters of all ownership on the Swedish stockmarket currently consists of institutions such as banks, insurance companies, pension funds and foundations. This shift from private owners to institutions is not unique to Sweden but is a global phenomenon. As ownership becomes increasingly international, say researchers, global governance of the way institutional investors behave responsibly will be required, since national borders are increasingly being erased and are losing their regulatory significance. This is why difficulties arise when asset owners delegate their social responsibility to asset managers, who, historically speaking, have been instructed to act only in accordance with their financial mandate. The solution, according to some people, is to broaden a manager's responsibility, so that his or her financial remit also includes factors such as the environment and ethics. Some managers already work like this but other managers and analysts can view this as vague and actually counterproductive. It is in this context that SIRP's research adds knowledge. How can we expect asset managers to react when the demand for broader management responsibility increases?

Prevailing norms and conventions exacerbate sustainable investment behaviour

As has been said in previous sections, norms constitute rules on how individuals are to behave in different situations. In addition to norms influencing investment behaviour, the research also highlights conventions as

5. Jansson, M. (2011). *Psychological Influences on Adoption of Socially Responsible Investment* (Doctoral thesis, University of Gothenburg, Department of Psychology)

routine behaviour. Conventions emanate from norms that aim to justify and uphold organisational values. Emulating organisational conventions and social norms only mirrors a rational process in which individuals prefer to adopt other people's behaviour when looking for a suitable way to behave themselves.

In addition, normative influence leads to individuals mimicking each other to gain sympathy and recognition. As far as investors are concerned, a great deal points to social influence being responsible for them displaying institutional flocking behaviour – something that can both hinder and help sustainable investment in gaining a stronger foothold. If institutional investors are willing to incorporate sustainable investment, this would probably influence other investors to do likewise.

Conflicting goals prevent managers from investing more in the long term

In the field of asset management, sustainable codes of conduct have become normalised guidelines for how managers are to invest responsibly and act in the presence of their beneficiaries. Other types of governing norms can for example be performance goals that are expressed in terms of risk-adjusted return on investment in comparison with relevant benchmark indices. Usually, norms are stimulated by sanctions or rewards, such as financial incentives and career promotions in order to motivate individuals towards goals that are also considered important for the organisation. But when certain norms represent questionable or uncertain goals, they become counterproductive. As, for example, when monetary incentives encourage managers to deviate from formal investment rules in the form of risk levels or ethical guidelines. This, according to the research, leads to short-term behaviour which is more likely to stimulate risk-taking and quick returns at the expense of more long-term investment. This is why some researchers believe that a short-term approach constitutes a large stumbling block to the spread of sustainable investment but it is also an underlying reason for financial crises[6].

6. Guyatt, D. (2005). *Investment beliefs relating to corporate governance and social responsibility*, (Doctoral Thesis, University of Bath, United Kingdom).

Findings: mental factors influence managers and sustainable investments

Earlier research has shown that the values and mentality of asset managers differ from the rest of society, in such a way that managers are driven by the fundamental principle of generating maximum risk-adjusted return for their commissioners, i.e. the asset owners. The research reveals that the sustainable impact is undermined since managers and analysts are occasionally evaluated and rewarded in terms of how short-term results relate to a comparative index. In other words, the reward models are poorly designed and don't include the positive impact that long-term environmental and social considerations may have on investments.

In a survey of the largest Swedish institutional investors[7], investment managers answered questions on their attitude and propensity to increase the proportion of sustainable investments. The findings showed, rather surprisingly, that there was no positive link between more managers acting alike and a propensity to increase the proportion of sustainable investments, as previous research had shown. Instead, researchers found that among managers focusing on sustainable investment there was a positive link between individually held values about welfare, success and career ambitions and efforts to invest sustainably. This link was absent among investors who did not make sustainable investments. How can this pattern be explained? The authors believe that the majority of Swedish institutional investors are not currently guided by a sustainability perspective. Anxiety over climate change and negative environmental consequences is not something that influences the composition of funds. Instead, they say, it is egotistical driving-forces, belief in the market and long-term financial advantages that lead to an increase in the proportion of sustainable investments.

Another study[8], aimed at both investors with "sustainable profiles" and investors with no sustainable focus, shows that these groups place

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7. Jansson, M och Biel, A. (2011). Investment institutions' Beliefs About and Attitudes toward Socially Responsible Investment (SRI): A comparision Between SRI and Non-SRI Management. *Sustainable Development*.
8. Jansson, M., Biel, A., Andersson, M., Gärling, T. (2011). Investment Style and Perceived Drivers of Adoption of Socially Responsible Investment among Swedish Institutional Investors, Fall 2011, *The Journal of Investing*.

changeable driving-forces behind sustainable investments. Sustainable investors stress the importance of getting other major investors to do the same, whereas "unsustainable" investors attach greater significance to mandatory regulations to stimulate sustainable investments. A possible explanation, according to the authors, is that unsustainable investors who represent that vast majority of conventional investors have no faith in the financial rationality behind sustainable investments. Authors of a previous study have shown that conventional investors are less positively disposed to the likelihood of good returns on sustainable investments, compared to sustainable investors. It is therefore logical, according to them, that investors with a hostile attitude to sustainable investments believe more in reforms or mandatory regulations as a more effective way of influencing the demand for sustainable investments.

SIRP's summary report of the research programme states that *"Significant resistance to sustainable investment seems to be one of the core values of finance market players ... they seem to be more interested in not deviating from professional values than in adhering to values from companies and beneficiaries."*[9]

Based on knowledge from previous literature in the area, the Knowledge Foundation is searching for further answers from its managers. We aim to increase understanding of how these managers work with sustainability factors in the investment process. Based on this understanding, we will aim to influence the future ambitions and efforts of the industry as regards sustainability.

9. SIRP (2012: 3). *Do Sustainable Investments Add Value?* Final Research Report.

Reflections on the questionnaire responses and the dialogue

In the evaluation, we have not had any predetermined model answers or established opinion as regards what sustainability and responsibility in asset management are. We have consciously tried to broaden the perspective. And the focus of the dialogue with the external asset managers has been to discuss and understand their own reasoning, their forward-looking work and the dynamics of the process.

It emerged quite clearly from the dialogue that many hedge fund managers have both knowledge about and insight into issues that concern

sustainability and responsibility and into what we can call "traditional SRI strategies" in relation to corporate valuation and risk and that they measure up well against asset managers who position themselves as sustainability managers or "SRI actors".

"If one has a strong opinion that something is unsustainable, one shouldn't be investing in that particular asset."

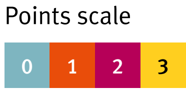
The most common "SRI strategies" in Sweden and Europe today are based on global norms for the environment, human rights, labour standards and corruption, which have been formulated in the UN's Global Compact Principles[10], and a process that identifies companies that are deemed to contravene these norms. In Sweden it is also common to have strategies that identify certain products and industries such as alcohol, tobacco and weapons. Both strategies are often applied as an initial filter or a final screening in the investment process and the results are used to avoid or divest companies, or to engage with companies through what is known as an active owner dialogue.

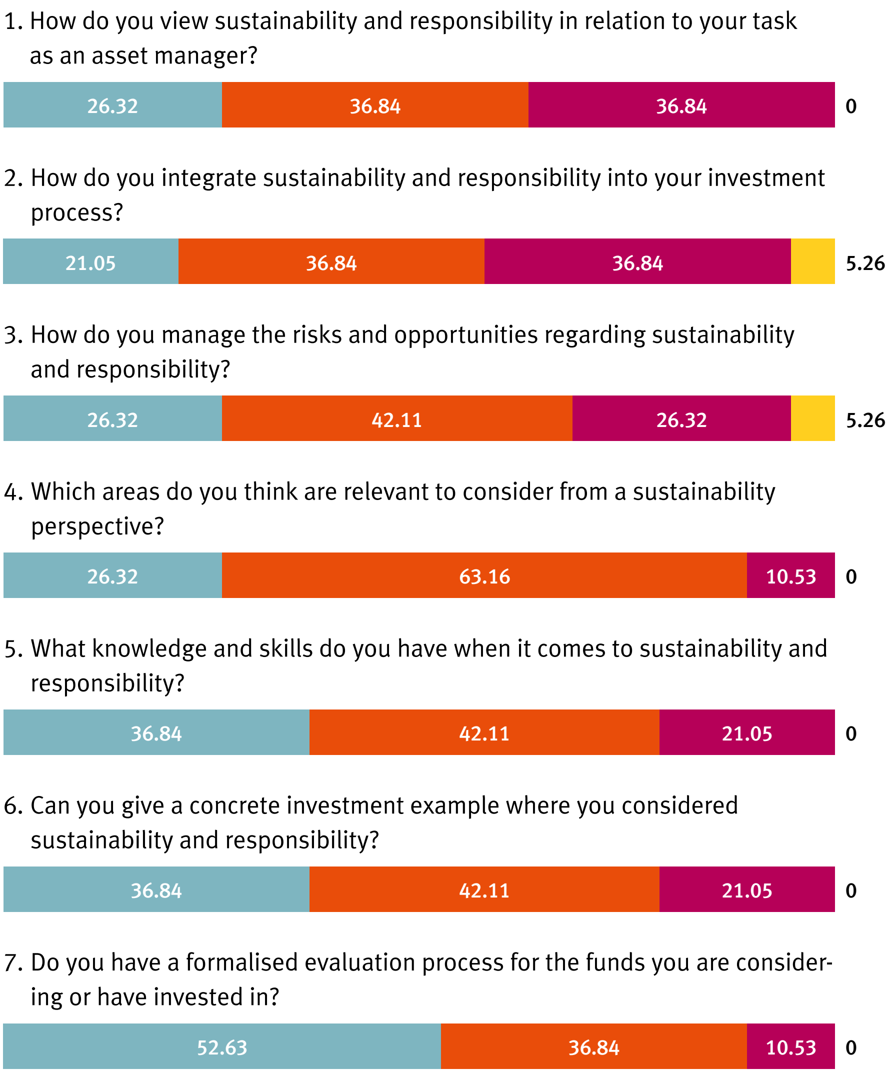
These strategies are seldom applicable to a hedge fund, unless the fund has imposed certain restrictions. But, as one of the asset managers put it: "If one has a strong opinion that something is unsustainable, one shouldn't be investing in that particular asset."

Regardless of which issues one deems to be relevant to consider, it is our opinion that if one really is going to be able to talk of "integrated sustainability", an "integrated approach" is needed to traditional financial analysis and sustainability analysis. "Combining them from the outside", i.e. simply adding one part on top of the other, without a fundamental understanding of or conviction about the value, provides little more than just that, an add-on. Talking about sustainability being an integrated part of the investment process is therefore true only when everyone in a team has an "integrated approach". The challenge of integrating sustainability is therefore just as important for hedge fund managers as for other managers, including those who position themselves as sustainability managers or "SRI".

10. www.unglobalcompact.org

Response rates for each question respectively in the questionnaire





37 % of asset managers felt that sustainability and responsibility in relation to their commission as asset managers are customer-driven.

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21 % of asset managers had no process of their own to integrate sustainability and responsibility into their investment process.

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26 % of asset managers described good management of risks and opportunities as regards sustainability and responsibility.

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10 % of asset managers described clearly and concretely which areas were deemed relevant to consider from a sustainability perspective.

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42 % of asset managers said that they had knowledge and skills related to sustainability and responsibility.

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21 % of asset managers gave concrete examples where sustainability and responsibility had been considered in the investment programme.

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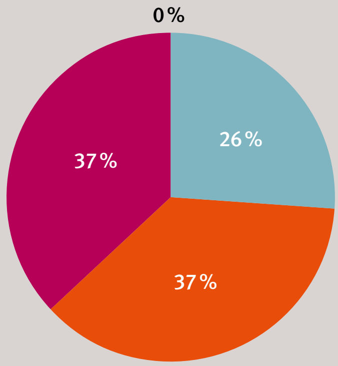
53 % said that they had a formalised evaluation process for the funds in which they were considering to invest or had already invested.

1. How do you view sustainability and responsibility in relation to your task as an asset manager?

- No particular understanding
- Some understanding
- Good understanding
- Comprehensive understanding



Several of the responses to this question can be put into the category "Customer-driven". Since the asset manager's task is to provide the best return for the fund's investors given the fund's commission, everything else can be seen as being outside the commission, and therefore not possible or relevant to take into consideration.

Many of the external asset managers also say that few, if indeed any, investors ask about sustainability, responsibility, ethics, etc. In our discussions with them, most of the asset managers confirmed that the Knowledge Foundation's evaluation was unique.

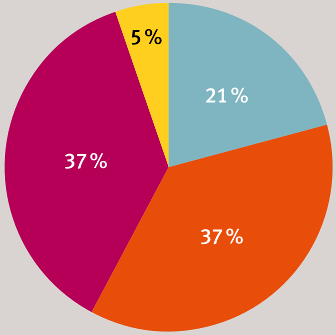
The asset managers who have a clear opinion about sustainability and responsibility are often those with a broader customer base and hence greater exposure to customers' varying demands and requirements. In different ways, they have chosen to adopt a sustainability profile because they feel it is within their remit, because there is a demand for it and because it strengthens their business.

Some asset managers say that the environmental, social and corporate governance and business ethics are gaining in importance for both investors and companies the world over. These areas can therefore constitute a key component of the fundamental research process even if the ultimate investment decision is determined by the assessment of the investment's upside potential versus downside risk.

In response to the question of how they view sustainability and responsibility in relation to their task as asset managers, several refer to their concurrence with the UN-backed PRI initiative and to the fact that these principles guide their work on responsible ownership and investment. There is a widespread opinion that sustainability and good ethics are beneficial to companies/shares. And as one asset manager put it: "Everyone's increasing short-termism is a social problem."

2. How do you integrate sustainability and responsibility into your investment process?

- No particular integration
- Outsourced process, not integrated
- Own process, not integrated / Outsourced process, integrated
- Own process, integrated



We received many interesting and well-formulated answers to this question together with some that can be put in the category of "non-answers", for example: "We integrate sustainability in the research process and incorporate it into the valuation." And that was that! Some also referred to Question 1 where they had made it clear that they had not made any particular commitment to sustainability in their assignment for the fund.

One asset manager answered that there was currently no formalised process for integrating sustainability factors, although he did give examples of various risks that are considered prior to an investment and that can be linked to sustainability.

Another external asset manager said that their basic investment approach was to analyse the ESG risks that influence the valuation of a company.

Some asset managers described their extensive efforts on established processes and platforms with internal and external analysis capacity.

One asset manager described how he was actively trying to integrate ESG issues into the investment process. This is based on a belief that these factors often provide an indication of a company's leadership qualities, particularly over a longer period of time. Asset managers also described the close internal cooperation between the portfolio manager and "the sustainability team" with the aim of increasing awareness of potential risks, such as exposure to companies that are facing

> **"Unsustainable actions can have a negative impact on companies/shares. An increased focus on sustainability, responsibility and ethics is putting pressure on companies that do not live up to the market's demands."**

> **“Sustainability? It’s in the sub-conscious. It is often a bit woolly, but from a business point of view it is a poor decision not to incorporate it.”**

a legal battle, or who risk damaging their brand as a result of poor management of the company’s negative environmental impact.

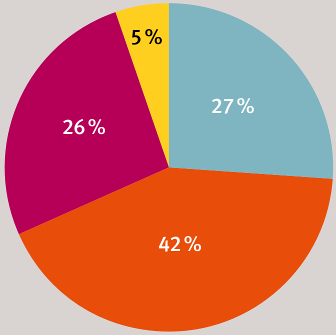
One external asset manager described an established process for incorporating sustainability and responsibility that was applied to all investments (shares, fixed income and fund units) and where they made a well-considered assessment of both ethical and economic/financial factors.

One asset manager said that “Unsustainable actions can have a negative impact on companies. An increased focus on sustainability, responsibility and ethics is putting pressure on companies that do not live up to the market’s demands. We consider this indirectly when valuing shares, without having any formal barrier to investing in such companies”.

And one final quote: “Sustainability? It’s in the sub-conscious. It is often a bit woolly, but from a business point of view it is a poor decision not to incorporate it.”

3. How do you manage the risks and opportunities regarding sustainability and responsibility?

- No particular management
- Some management
- Good management
- Comprehensive management



"We do as I have described in my answer to Question 1." And the answer to Question 1 was "...We have no specific commitment to sustainability in our assignment for the fund." Others mentioned the importance of analysing the company's unique risks, including risks and opportunities relating to sustainability and responsibility, before taking a stake and of continuing to track these once they had taken a stake in a company.

One asset manager highlighted their proactive approach in which they noted both the risks and the opportunities in a company regarding sustainability and responsibility if they thought that these will affect valuation. This is constantly evaluated and also discussed actively in a dialogue with the company.

Another asset manager believed that sustainability risks are often real financial risks for the company, and it is therefore important to be in control of them. They even try to reduce these risks in the portfolios through dialogues with the companies. "We try to actively reduce the sustainability risks by discussing with the companies what measures can be taken to alleviate them." One asset manager said that " the entire banking sector has a huge sustainability problem. The problem lies with the regulators...".

"I take major stakes in a small number of companies that I believe in, that generate good return on investment, over time, on their own merits regardless of the state of the economy in general."

Another asset manager focused on the opportunities in the company: "I take major stakes in a small number of companies that I believe in. These are companies that generate good return on investment, over time, on their own merits regardless of the state of the economy in general."

4. Which areas do you think are relevant to consider from a sustainability perspective?

It is natural that the answers to questions sometimes overlap each other. At the same time, we have consciously formulated the questions to enable us to gain a deeper understanding of how managers look upon and work with sustainability and responsibility in their asset management and in their organisation. With short answers such as "Environmental, social and political aspects." to the question on what areas are considered relevant, we have been able to use the subsequent dialogue to gain a better understanding of what these areas actually are, why they are considered relevant and how the manager takes them into account. In certain cases we can ascertain that some areas are not deemed relevant at all, and hence they are given no consideration. "It is not important whether the company pours lead into a lake as long as it doesn't affect earnings and I can buy the shares cheaply."

> **"It is not important whether the company pours lead into a lake as long as it doesn't affect earnings and I can buy the shares cheaply."**

In the same way, general answers such as "We think that UNPRI has a good framework, and we're also members there" or "We are actively committed to philanthropy", have formed the basis for a discussion on what they mean and do in concrete terms.

Several asset managers said that sustainability areas vary from one company to another depending on the industry and geography and that all companies have unique risks and opportunities as regards sustainability. Someone mentioned the example of the manufacturing industry where energy consumption, emissions and the use and recycling of raw materials are important areas. Concurrently, they point out that it is important for sustainability aspects that companies present relevant information in this context.

One asset manager said that the physical impact of climate change may affect the repayment ability of states (both positive and negative effects) in the long term. Corporate governance, corruption and business ethics are considered by some asset managers to be the most relevant issues on the "down-side". Here, they highlighted new, tighter legislation in the area such as the new Money Laundering and Bribery Act in Sweden and the UK Bribery Act as contributory factors in this regard.

One external asset manager said that they focused on areas that they deemed to be "financially significant for the company's long-term sustainability". These are areas that they believe have an impact on the company's valuation and hence its shareholder value. It might be something within the company or its business or within the industry in which the company operates.

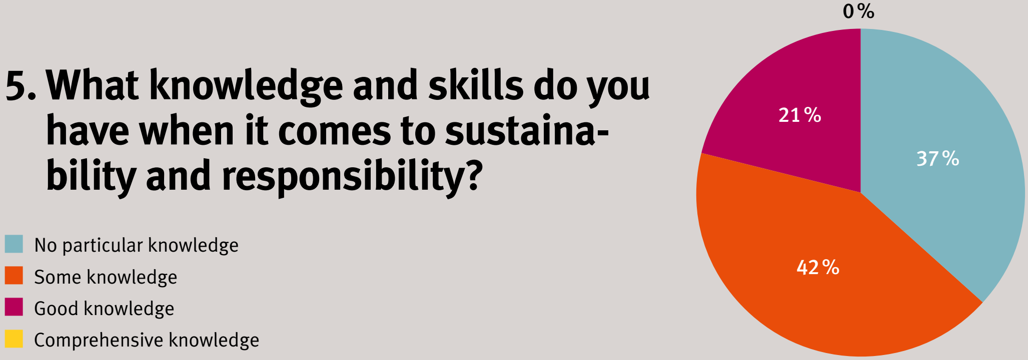
Another asset manager highlighted the fact that companies with the ability to balance economically, ecologically and socially sustainable development have a good chance of generating high return on investment in the long term.

"From a sustainability perspective, we shall add the analysis of a company's impact on stakeholders, the environment and society to our analytical framework. We believe that these environmental, social and governance factors can affect return on investment, reveal potential investment risks, and provide an indication of the company's governance capacity and leadership". We note here that the answer starts with the phrase: "from a sustainability perspective..."

Some asset managers pointed to leadership and governance quality as an important area, and that this is assessed as part of the basic analysis. One asset manager said that they had noticed that "well-qualified management teams that focus on creating shareholder value generally do not enter into dubious business deals that might jeopardise that endeavour". A number of similar answers stated that areas deemed relevant included those that fell within the framework of the UN Global Compact, the OECD guidelines for multinational enterprises, conventions on human rights, environmental conventions and arms-related conventions. Asset managers that gave these answers had normally outsourced the analysis and monitoring of their portfolio companies to an external consultant.

"From a sustainability perspective, we shall add the analysis of a company's impact on stakeholders, the environment and society to our analytical framework. We believe that these environmental, social and governance factors can affect return on investment, reveal potential investment risks, and provide an indication of the company's governance capacity and leadership."

5. What knowledge and skills do you have when it comes to sustainability and responsibility?



The answers to this question together with the dialogue have given us several insights and *aha!* moments. It is worth noting that several asset managers whose questionnaire answer we felt were inadequate or weak provided us with some of the most memorable and valuable contributions on sustainability and responsibility in the subsequent dialogue. Asset managers who, for example, answered: "We have no specific skills in sustainability and responsibility" have, in the dialogue, displayed genuine knowledge and skills in company analysis and valuation activities that can be said to include both sustainability and responsibility.

> **"We have no specific skills in sustainability and responsibility."**

Or, the same asset manager who replied: "We follow the debate, but have no training in these issues", provided several concrete examples in the dialogue of how they valued a company's long-term endurance in relation to the environment and sustainability.

Several asset managers have many years of experience in analysing different companies and countries and in assessing their risks, and where the total assessment may very well demonstrate skills that can be used to highlight aspects that other asset managers don't include in the basic analysis.

We appreciate the sincerity and the frank answers we have received in both the questionnaire and the dialogue, such as: "When we don't understand a key factor in a sector we make sure that we obtain external training for it and collect the relevant information”, or “In the investment team, we have two graduate engineers who, in a credible fashion, are able to evaluate different technologies in fields such as sustainability.

Several asset managers said that they had considerable experience in incorporating sustainability aspects into their financial management and that they had dedicated staff who were sustainability specialists and cooperated with the rest of the investment organisation. Several asset managers had also established processes in cooperation with external advisors and research firms.

Some of the larger asset managers had their own large teams, e.g. 20 people, who focused entirely on corporate governance and responsible investment.

6. Can you give a concrete investment example where you considered sustainability and responsibility?

"We have sold shares in companies where problems have surfaced." or "The issue is by nature too complex for a short written answer". OK, thanks, though perhaps not as exhaustive an answer as they could have given. In addition to these answers, we have also received several concrete examples from various managers, including:

> **"When we have a dialogue with H&M ESG is one subject we regularly discuss and gather further information about."**

- "We invest in H&M. We are aware that H&M's capacity to sell their products is affected by their ability to manufacture them in accordance with ethical principles and with good control over their sub-contractors. When we have a dialogue with H&M ESG is one subject we regularly discuss and gather further information about."
- "Field trips or study visits can improve our understanding of the complex issues facing a company in which we invest. For example, we gained a deeper understanding for how an energy company deals with its environmental and social impact when we visited their oil sands in western Canada. We met the company's management team, site managers, mining engineers, environmental manager, the local mayor and representatives of the local indigenous population."
- "Volvo is serious about sustainability and responsibility. They publish regular sustainability reports and are also included in the Dow Jones Sustainability (DJS) Index. The DJS ranks Volvo among the top 300 of the world's 2 500 largest companies. Volvo is a major issuer on the Swedish capital market and treats its investors with considerable respect."

An international asset manager gave the following example: “Our Global Responsible Equity strategy strives to identify industry-leading companies that use their resources sustainably in order to maintain a long-lasting cutting edge, expand and defend their global footprint, and achieve financial return by means of market cycles. The aim is to highlight sustainable leadership, their position in the industry, financial sustainability and risk-adjusted return.”

Another example from a foreign asset manager: “The strong pressure to exclude controversial arms is a good example of how we include sustainability and responsibility.”

An example from one of the Swedish asset managers: “Our decision to sell TeliaSonera from our SRI portfolios. The decision was based on our opinion that the management team will not have the ability, in neither the short nor medium term, to implement the anti-corruption measures they have established. We are of course continuing the dialogue with the management team to ensure things develop in a positive direction”.

> **“We have a major influence on our selected fund managers and hence a heavy responsibility. They listen.”**

7. Do you have a formalised evaluation process for the funds you are considering or have invested in?

This question was not relevant for all the external asset managers and therefore has not been included in the total assessment. However, the question is valuable for gaining an understanding of the process applied by funds-of-funds managers when choosing their funds.

Two asset managers stressed that the UN-backed PRI Initiative constituted the framework for their evaluation process. One of them also looked at the fund's holdings and compared these with the asset manager's own "exclusion list", which included companies that were involved in the manufacture and/or sale of inhumane weapons.

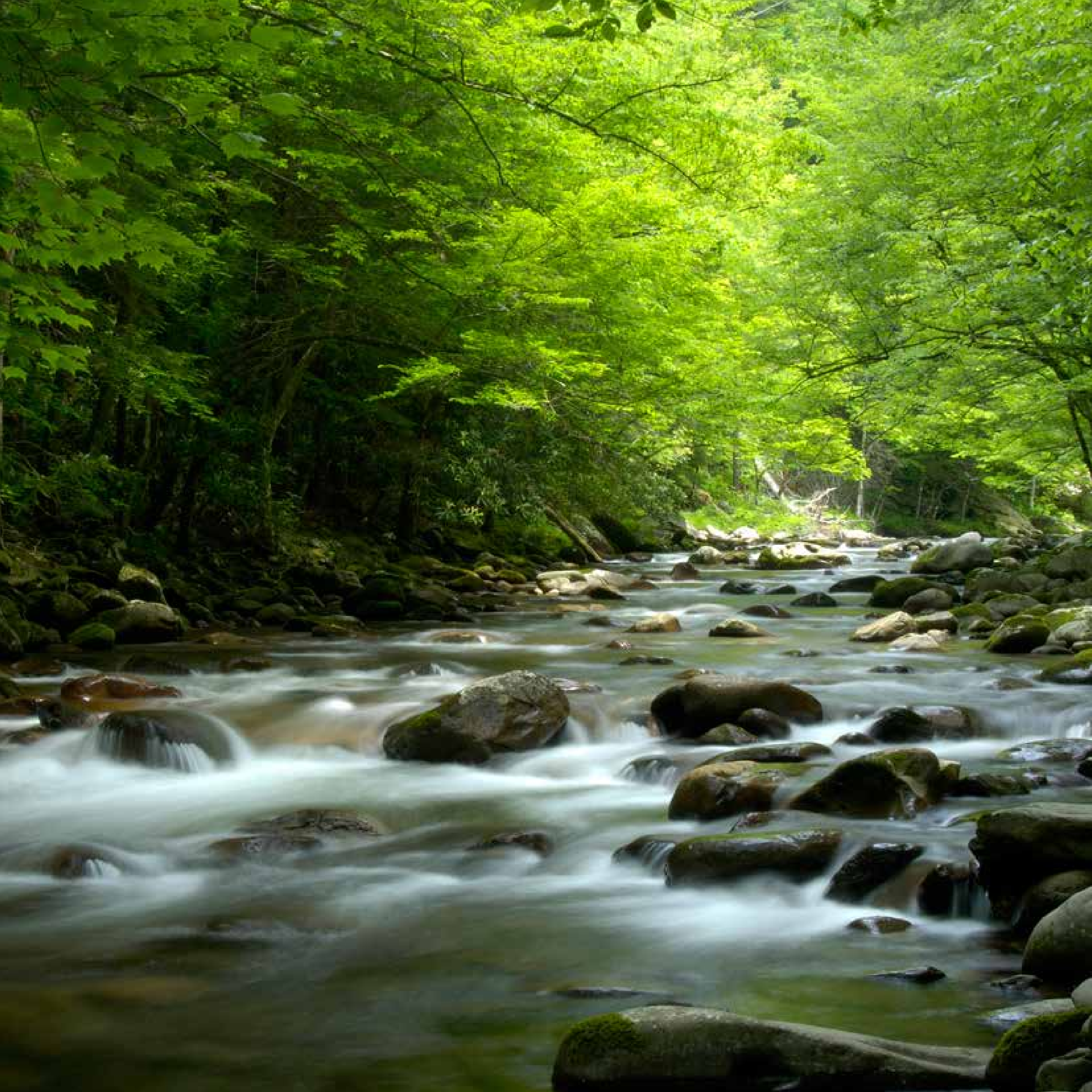
Another asset manager described how they only invested in funds that had been ethically audited and that adhered to the manager's policy.

Another asset manager said they consider ESG issues when evaluating new asset managers. These issues can have far-reaching operative, organisational, legal, economic and strategic consequences. When we invest through our subsidiary managers, we try to incorporate sustainability factors, when they are relevant, in our running dialogue with them.

One asset manager described how they performed a sustainability evaluation prior to selecting a new fund and how they subsequently monitored the funds they had selected. Before choosing a new fund the asset manager's due-diligence team sends a questionnaire to the fund focusing on sustainability, among other issues. The fund must outline its general sustainability values, give examples of the influence sustainability has on the investment process and how it reports on sustainability to its investors. The questionnaire answers result in an ESG rating[11]. The results and rating are entered into the asset manager's monitoring system to enable continuous monitoring.

One asset manager had a discussion with funds which he/she was thinking of investing in regarding how the funds considered and implemented ESG issues in their investment processes. Furthermore, an evaluation process is performed twice a year in cooperation with an external consultant. This helps the asset manager to ensure that the funds he/she is investing in comply with his/her ethical guidelines. In cases where funds do not live up to the ethical standard set by the manager in the portfolio, he/she will firstly pursue a dialogue, either directly or in cooperation with the funds' manager, to exert influence. As a final step, if the dialogue proves fruitless, the holding is divested.

11. ESG stands for Environmental, Social and Corporate Governance.



Some final thoughts

The Knowledge Foundation is a small organisation and totally dependent on committed and competent counterparts. And when opinions are exchanged so is knowledge. Consequently, it has been a valuable experience to meet our counterparts and discuss sustainability and responsibility. Long-term responsible use of resources is important, and the significance of running a sustainable business is only set to increase in the future. We see it as a poor business decision not to incorporate sustainability into one's business. Sustainability risks are often real business and financial risks for companies and are hence important to have control over.

As we have ascertained in this report, talking the talk is not enough. Crucial to all sustainability efforts is that they are concrete, implementable and measurable. This demands skills and resources among asset managers. Simply deselecting, e.g. alcohol, pornography and cluster bombs is to take the easy way out. Sustainability and responsibility must be incorporated into, and become part of, the organisation's culture.

When one buys hedge fund management services, one is choosing an exclusive and relatively expensive active management product. Frankly, it is our belief that a modern asset management organisation that charges good money for active management no longer has the option of ignoring these issues. On the contrary, including them is fundamental.

Sustainability is a process that is never finished. It is an ongoing process, the direction of which is important. And to be concrete and measurable, it requires leadership, opinions and drive. Our hope is that this report will also contribute to this.

Furthermore, sustainability and responsibility in asset management are seldom measured accurately using a questionnaire. Our observations are merely a snapshot. To understand the dynamics in the process and future work, we need to consider the questionnaire responses together with the direction of change expressed through the dialogues.

We recognise that the results we can measure for sustainability differ from, e.g. the world of sport where we simply herald a victor here and now. When it comes to sustainability, we must be able to show results that can yield winners at all stages over time.

Prior to sending this report to print, we invited the external asset managers to comment on the overall results. One of the comments summarised perfectly what we had hoped could be achieved when we began the project: “It’s good that you’re doing this and that we get a kick in the right direction. Even if the questions are difficult to quantify, we can see in several areas of the survey that we can do certain things to improve the overall level. Even though we are not an ethical hedge fund, we notice that investors, and in particular foreign investors, are now starting to place demands in this area. In our company research we will also try to differentiate more between companies that have genuinely introduced a CSR policy of substance and those who just talk the talk”.

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The Knowledge Foundation finances research at universities with the aim to strengthen Sweden's competitiveness and ability to create value. The Foundation supports research that is conducted at Sweden's new universities, provided that industry contributes a matching amount and actively participates to promote business development. The Knowledge Foundation was established in 1994. Since then it has invested over SEK 8.4 billion in more than 2400 projects.

The Knowledge Foundation strives to help Sweden's new universities create internationally competitive research environments, work long-term on strategic profiling and increase cooperation between academia, industry, institutes and society. Universities are responsible for a significant portion of knowledge development and research. Many are leaders in their own special areas, cooperate extensively with industry and contribute towards strengthening Sweden's competitiveness and creating growth.

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