Responsible Investments: Proposal of an operational taxonomy

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Responsible Investments: Proposal of an operational taxonomy

Part 1: Definition of Terms

Responsible Investments

"Responsible investments" is the broadest and most generic term. Responsible investments embrace the three dimensions ecology, social and (corporate) governance.

Sustainable Investments

Responsible investments can be separated in different categories. Sustainable investments include ecological and social investments and typically ignore governance aspects.

Socially Responsible Investments (SRI)

"Socially Responsible Investments" (SRI) should – other than often today – be exclusively used for investments focussing on social improvements.

ESG portfolios

ESG portfolios are only accepting securities which adhere to certain minimum standards regarding E, S and G ratings.

Exclusion portfolios

Exclusion portfolios explicit exclude investments in certain market segments such as cluster bombs.

Ethical portfolios

Securities in ethical portfolios are selected according to ethical, often religious, rules and restrictions.

Themed portfolios

Themed portfolios cover specific "responsible" or "sustainable" themes such as "renewable energies".

Impact investments and philanthropic activities

Impact investments try to generate active change. Usually they only use refer to activities within one of the E, S, and G categories. Philanthropic activities typically exclusively pursue non-financial goals and therefore cannot be regarded as typical investments. Impact investments often have lower return goals than traditional and other responsible investments since they partially pursue philanthropic goals.

Combination of terms

Terms can be combined, e.g. "Impact ESG" portfolios try to make a specific impact only using only securities with acceptable E, S and G ratings. ESG exclusion portfolios use exclusions in addition to minimum E, S and G. ratings for each security.

Part 2: Operationalisations

Exclusions

Exclusion portfolios: All exclusion segments should be listed precisely, including the number of exclusion segments. Ideally, it should be stated what percentage of an acceptable benchmark index (e.g. world equities in a global equity portfolio) is excluded at the time of the review. There are no minimum requirements for the number of exclusions.

Exclusions essentially mean that no minimum limits are permissible (0% rule). In other words, it will not be permissible in the future to advertise with an exclusion if, for example, 5% of turnover may be generated in “excluded“ segments. In addition to turnover other references such as “profits” or “assets” are permissible. The reference basis of the exclusions has to be disclosed.

Only the issuer‘s officially reported data and other data from reliable and economically accessible sources has to be taken into account.

Trading companies could be treated differently from producers. Example: Broadly oriented trading companies usually offer alcoholic beverages. They do not necessarily have to be excluded from a broadly diversified portfolio, even if that portfolio explicit excludes producers of alcohol.

As long as market-leading data providers are not (yet) able to supply the required data at reasonable cost, minimum limits are permissible. A maximum of 5% of an issuer‘s turnover or other relevant indicator may be in the excluded segment. These exceptions to the 0%-exclusion rule must be disclosed.

Ethical (Christian, Islamic, etc.) portfolios are typically considered to be exclusion approaches.

It is also permissible to specify the number of segments excluded. Below is the list of typical exclusions[1]:

- Weapons (production and trade)
- Human rights abuses
- Labour law infringements
- Gambling
- Corruption and bribery
- Tobacco
- Pornography
- Alcohol
- Nuclear energy
- Environmental destruction

Other recognised exclusion segments:

- Fossil fuels
- Death penalty
- Pharmaceuticals
- Beef/Dairy production

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[1] Source: Top 10 exclusion criteria in Germany according to Forum Nachhaltige Geldanlagen (2017): Market Report 2017, p. 33 and 2018, p. 26

Impact and themed portfolios

Impact portfolios: It must be stated how many and which UN Global Compact Sustainable Development Goals (SDG) are realistically targeted by the portfolio. All securities in an impact portfolio must serve at least one objective of the SDG.

Themed portfolios, such as “renewable energies“ or “green bonds“, must invest 100% - with the exception of cash - in securities or projects within the respective themes.

ESG portfolios

Portfolios that do not exclude at least the bottom 10% according to E, S and G individually (best-in-universe view in regard to all data of the relevant data provider), may not be referred to as ESG portfolios.

Reason: ESG ratings can be structured differently. ESG scoring, however, rarely occurs for an entire universe of securities, but often primarily for companies with a higher capitalisation. Higher capitalised companies have more resources, but also more incentives to position themselves favourably according to ESG criteria. It is also expected that the worst securities according to ESG criteria will differ less among the various rating providers than the “average“ rated securities. Both arguments only serve to favour the requirement that the worst securities be systematically excluded.

In a broadly diversified portfolio (e.g. global equities), stricter minimum rules e.g. the exclusion of the worst 25% can be applied without meaningful losses in diversification. With smaller investment universes, e.g. German mid-cap stocks, the exclusion of the worst 25% equities of the rating provider would potentially lead to very small permissible investment universes.

Minimum requirements for E, S and G are also permissible, which may differ for each category (E, S and G), e.g. “Top 90%“ (minimum) to e.g. “Top 50%“. Top 90% in this context means that the bottom 10% according to E, S and G scores are excluded.

If only E or S or G scores are used, the portfolios can be set up accordingly, e.g. “Top 25% E-score” means that only the best 25% in terms of E-score are included in the portfolio, independent of S and G scores.

The average E, S and G scores of the portfolios should also be specified in addition to the other information.

SRI portfolios

The term SRI (Socially Responsible Investment) should only be used if the portfolio is predominantly geared to the “S“ dimension of ESG ratings and no security in the portfolio is among the bottom 10% S-rated securities.

Controversies

“Controversies“ can be used additionally, but should normally also be reflected in the E, S and G scores. The source of information used to determine controversies should be disclosed.

“Best-in-class/-universe“ portfolios

For best-in-universe approaches, the minimum limit can be specified, e.g. “Top 75% E, S and G”.

Similar requirements also apply to CO_2 scoresetc. for portfolios that refer to such criteria.

Best-in-class portfolios must also exclude the bottom 10% in the overall universe according to E, S and G to be considered responsible. However, different minimum scores (above the bottom 10%) may be set for different asset segments/ classes.

Momentum, progress, voting and engagement portfolios

ESG momentum and ESG progress portfolios must also exclude at least the bottom 10% according to E, S and G, as well as “ESG voting and engagement“ approaches, which focus on active improvements through the exercise of voting rights.

Systematic ESG portfolios and portfolios that take ESG criteria etc. into account

Portfolios that include positions without an ESG rating or that are among the bottom 10% for E, S or G may not be described as sustainable, etc. This definition can mean that many portfolios offered today under the keywords “ESG integration“, “best-in-class“ or “momentum“ may no longer be referred to as ESG portfolios without adaptation to the above rules.

On the other hand, it is still permissible to advertise that ESG criteria are used for the selection and/or weighting of securities, even if not all of the above rules are complied with and the portfolio as a whole may not be described as ESG, SRI, sustainable etc..

Data providers and ratings

“Eligible data providers“ must take into account at least 10 E, 10 S and 10 G criteria and thus at least 30 in total per security and at least the top 25% securities according to market capitalisation of the respective universe (e.g. equities global, equities Germany, etc.).[2]

Internal ratings that satisfy the same criteria are permissible, especially because this is the only way that all market segments, such as small-cap portfolios, can be implemented as ESG portfolios.

All criteria must be systematically reviewed at least once a year.

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[2] As basis we recommend to use the KPIs for ESG 3.0 by DVFA/EFFAS (Key Performance Indicators for Environmental, Social & Governance Issues)

Summary example

A portfolio could be described using the above criteria, e.g. as follows:

1) Underlying: listed shares
2) Investment focus: e.g. German mid and large caps
3) Exclusion categories from the DVFA list: 10 (exclusion categories and exclusion ratio in global stock index can also be specified)
4) ESG minimum: exclusion of the bottom 25% of all stocks according to E, S and G
5) Progress approach: no
6) Data provider
7) E, S, G ratings
8) Review/Update of exclusions and ESG criteria: annual
9) Non-ESG criteria: size and liquidity of positions

Part 3: Goals of the Guidelines

Institutional investors in several countries now have a fiduciary duty to ensure adherence to principles of responsible investment. However, responsible investment opportunities are also being offered to and actively sought after by private investors as well.

No uniform definitions or classifications

One of the biggest criticisms of the concept of responsible investment is the confusing variety of investment options. This can be attributed to the broad diversity of interpretations when it comes to what constitutes “responsible“ investments, as well as the numerous available product structuring options.

Now, the European Union has also taken up the issue (see https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en), but it may take some time before the topic is officially “clarified“. We have therefore developed the following concept for our members.

Objectives of the DVFA concept

To the best of our knowledge, this concept is the first attempt to classify and compare all sustainability investment and responsible investment concepts based on a uniform framework.

Additionally, we have defined minimum standards so that adhering to just one or a few sustainability criteria is not sufficient in itself to define an investment as “sustainable” or “responsible”. This is intended to prevent so-called “greenwashing“.

The focus is on the transparency of investments. No assessment of investment quality is made, as the quality of sustainability in individual investments can hardly be meaningfully standardised given the broad variety of often very different investor needs[3].

However, the assessment scheme developed for responsible investment should enable interested parties to find suitable investments as easily and quickly as possible and to compare them in terms of the relevant sustainability approaches. Interested parties will also be able to compare similar sustainability portfolios in terms of risk and return.

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[3] See statement 4 of the DVFA Kodex für Nachhaltigkeit im Anlageprozess, http://www.dvfa.de/verband/themengremien/nachhaltigkeit-im-anlageprozess.html

Investor perspective crucial for quality assessment

Even with uniform definitions for responsible investment terms and classifications, investors will continue to differ in what they consider important. Accordingly, our intention is not to categorise investments into “good” or “bad” (no quality assessment) - investors should do this themselves. Rather, it is our intention to help investors and product providers identify the investments and offers that are particularly suitable for them.

Above all, we intend to help increase transparency, without specifying in detail how individual responsible investments are to be assessed or how their effects should be measured. Our primary concern is to make the consequences of trading in responsible investment products more transparent for investors and thus contribute to a trend among investors toward more sustainable investments. Finally, we intend to contribute to an improvement of training and education in the area of responsible investment.

Investor commitment

As responsible investment has matured, a range of voluntary commitments on the part of investors has developed, which often contain exclusions or specific goals. Among the best-known are the UN-supported Principles for Responsible Investment (PRI) and the UN Global Compact, which focus on human rights, labour rights, environmental protection and the measures to combat corruption and bribery. Churches and other associations or groups have also sought to document investment rules (standards) for responsible investment.

The products or portfolios that we look at here do not necessarily satisfy all of these voluntary commitments, or even contribute to their improvement. It therefore makes little sense to measure the products or portfolios themselves against these commitments. In addition, the requirements under these voluntary commitments are sometimes rather undemanding and/or lacking in specificity and, therefore, difficult to operationalise.

More concrete than other standards

The DVFA Guidelines are most closely linked to the Transparency Code of EUROSIF[4]. The Code addresses questions in the following areas:

1. List of funds covered by the Code
2. General information about the fund management company
3. General information about the SRI fund(s) that come under the scope of the Code
4. Investment process
5. ESG controls
6. Impact measures and ESG reporting

Funds are considered transparent when these questions are answered in full.

While such an approach is very helpful, it can only distinguish between transparent and non-transparent funds. The DVFA Guidelines go much further by providing definitions and allowing funds/portfolios to be classified according to several clear, responsible criteria, but without making any statements with respect to quality or suitability for investors. In DVFA‘s understanding, only investors themselves can assess the quality of a fund or portfolio in relation to their individual needs.

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4 http://www.eurosif.org/wp-content/uploads/2018/04/Transparency-Code-4.0.pdf

Part 4: Fundamentals of responsible investment

Responsible investment does not have to entail disadvantages

The so-called “magic triangle“ of financial investment means that investors should seek an “optimum“ of return, security and liquidity when making an investment. Meanwhile, there is also talk of the “magic square”, which has the additional dimension of responsible investment.

The concept of the magic square emphasizes the importance of responsible investing but implies that investors must weigh their objectives. However, we now know that equities with high volatility, for example, do not always yield higher returns (“low-volatility anomaly”). We also know that “responsible“ investment does not have to mean lower returns[5].

The professional capital market is profit-oriented

There is probably no investment that is always and for every investor 100% responsible.

Typically, a responsible investment leads to an inflow of capital in the context of a new issue/capital increase to an issuer who must make a profit or to a typically profit-oriented seller. The latter variant may lead to a higher valuation of the security, which should facilitate future credit or equity increases for the issuer.

Alternatively, responsible projects can be financed directly and it can be assumed that the project initiators also have an interest in making a profit.

If one wants the use of his money to be 100% “good“, there is always the option of donating it to good charitable organisations.

The importance of the temporal dimension

Some investments bring short-term improvements but long-term disadvantages or risks. For example, electricity production from nuclear energy can improve the CO_2 balance in the short term but can entail incalculable accident risks or disposal costs over the long term. An absolute determination of good vs. bad must therefore take into account the entire life cycle of investments, as well as their impact on future generations.

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[5] See meta-study by Friede, Gunnar and Busch, Timo and Bassen, Alexander, “ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies” (October 22, 2015). Journal of Sustainable Finance & Investment, Volume 5, Issue 4, p. 210-233, 2015, DOI: 10.1080/20430795.2015.1118917. Available at SSRN: https://ssrn.com/abstract=2699610, which mostly shows no negative correlation, and quite often even positive correlations

Impact, momentum, progress, voting and exposure portfolios

Some investors want to make positive changes yet still earn money. Such investments are often subsumed under the heading "impact investment". Many of these investments are illiquid. Other investors seek to force changes on the part of the issuers and prefer to invest their money in relatively irresponsible companies. The aim is to make these companies more responsible by exercising voting rights or other forms of active influence (engagement). Such approaches are also known as "ESG momentum" or "ESG progress" strategies.

The disadvantage of these is that investors or issuers who are poorly positioned in terms of responsible investment criteria can most easily show the greatest improvements.

Such approaches are also more suitable for larger investors who can exert appropriate pressure on companies.

DVFA therefore recommends investment in already responsible securities. This encourages issuers of other securities to become more responsible in order to obtain financing on better terms in the future. Even good issuers can be made better through voting and engagement. Thus, an improvement in the responsibility profile of an investor portfolio is not adequate in itself as a general assessment measure.

However, investors who, due to their high volume of investment or other immutable or difficult to change restrictions, must still invest in less-responsible companies can use this as standard.

KPIs and measurability

Despite the difficulties involved, it is of course helpful to measure responsible investments and make comparisons. KPIs (Key Performance Indicators) therefore play an important role. Such improvements should be reflected as objectively as possible in aggregated assessments, such as ESG ratings.

Responsible portfolios and illiquidity

Responsible investment remains subject to the general rules for financial investing: Investing in a closed-end fund involves illiquidity risks and is typically more expensive than investing in an open-end fund.

Overview of “sustainable“ investment opportunities:

Asset class	Examples
Savings products	Microfinance savings account, eco savings certificate rating
Stocks	Shares of companies with a good sustainability rating
Corporate bonds	Bonds from companies with a good sustainability
Green / Social bonds	Bonds with an environmental/climate, social or economic development focus
Government securities	Bonds from countries with a positive sustainability rating
Funds	Large selection of sustainability funds
Real estate	Individual properties and real estate funds with sustainability certificate(s)
Direct investment	Renewable energy systems, infrastructure
Forestry	FSC-certified forestry
Raw materials	Purchase of gold / silver with Transfair seal

Source: Translated from Institute for Responsible Investments (2017) from FNG 2017, p. 16

Most of the investment options listed in the table have also been the subject of criticism, e.g.

- Microfinance investments are said to demand exorbitant interest rates on microloans or drive borrowers into overindebtedness;
- Issuers of “green bonds” can obtain capital at favourable conditions, even if they are not sustainable overall (“greenwashing“);
- Sustainable real estate is too expensive;
- Renewable energies benefit excessively from subsidies (e.g. feed-in tariffs) and are heavily dependent on changes in subsidies.

The following considerations relate primarily to the issuers of listed stocks and bonds, which make up the largest part of most investors‘ portfolios. In the future, these considerations should be extended to other asset classes.

Responsible portfolios, ESG integration and diversification

Investing in a single project is typically riskier than holding a diversified portfolio. Sometimes criticism is voiced that consistently responsible investments limit the investment universe too much, so that sufficient diversification can no longer be achieved.

In this context, investors should ask themselves a few questions:

What is sufficient diversification? Some scientific studies assume that good diversification can be achieved with relatively few securities and that additional securities in the portfolio only slightly improve diversification effects.

What is the priority of “responsible“ within the hierarchy of selection criteria? If the investment universe is already very small due to many other selection criteria, the addition of responsibility criteria (usually referred to as ESG integration) could in fact lead to a reduction in diversification.

In the interest of evidence-based investing, however, it would have to be demonstrated that responsible investment criteria have fewer positive effects on portfolio performance than other selection criteria and should therefore be applied further down the hierarchy. Otherwise, other (irresponsible) criteria restrict selection more than the responsibility criteria.

Looking at the performance of indices that use (almost) exclusively responsible selection criteria (e.g. ESG or SRI indices), one notices that systematic performance disadvantages are rare compared to traditional indices. Active funds rarely outperform traditional indices and therefore will not systematically outperform responsible indices. Responsible indices usually use only “responsible” selection criteria whereas traditional active funds use mostly traditional selection criteria. That points to the possibility that more traditional criteria may limit investment portfolios more severely than responsible investment criteria.

ESG integration is therefore not a concept promoted by DVFA. A more fitting term would be “ESG-first”, i.e. securities would first have to be qualified according to responsible criteria before other financial indicators are applied.

Responsible portfolios, tracking error guidelines and risk management

Responsible investment portfolios can deviate relatively significantly from traditional benchmarks. Investors who are limited by tracking error specifications are therefore often limited in the extent to which they can implement responsible investment. Accordingly, there are some institutional investors who are already using responsible investment indices for their asset allocation and as benchmarks.

And there are numerous investors using risk management or risk overlays for their portfolios. Many of these risk management mechanisms and risk overlays change allocations quite considerably. It can be assumed, for example, that a - risk-controlled - reduction of the equity ratio has a much more substantial impact on the investor’s portfolio than the use of responsible equity indices or portfolios instead of traditional ones or than increased tracking errors through the use of responsible investment portfolios.

The exclusion problem: transparency, materiality and subjectivity

Exclusions are popular with investors to arouse the perception of “sustainability“.

In Germany, the following exclusion criteria are quite popular: Weapons (production and trade), human rights violations, labour rights violations, gambling, corruption and bribery, tobacco, pornography, alcohol, nuclear energy, environmental destruction[6].

However, there are several problems with exclusions.

First, transparency: Which company is willing to voluntarily state that it is corrupt, uses bribes, violates labour rights (e.g. uses or supports child labour) or destroys the environment. Even for specialised ESG analysts, it is often difficult to determine whether and to what extent companies are directly involved in such activities or, for example, implicated via their supply chains, customers, shareholders or other stakeholders. As a result, it is difficult for portfolio providers to advertise with 100% certainty when it comes to such exclusions.

Second, materiality: Company reports often only deal with core activities. In many cases, therefore, exclusions are relativised; for example, 5% of turnover may be generated in “excluded“ segments. If materiality thresholds are used instead of categorical exclusions, this should be made transparent.

Third, subjectivity: For many exclusion criteria, oppositional voices or contradictory arguments can be found in addition to supporters or supporting arguments: Do we need nuclear energy because it is climate-friendly, or are we excluding it? Should arms manufacturers be excluded on principle or do we need weapons for defence or internal security? Are genetically modified organisms fundamentally bad or can they help to reduce hunger, for example? Should animal experiments be banned or are they important for medical progress? Should lotteries and gambling be legal because they generate a lot of tax revenue, and where does one draw the line between hardcore gambling and harmless entertainment? Are alcohol and tobacco (on a small scale?) permissible as a luxury (and attractive source of tax revenue) or should suppliers and merchants (then one would have to exclude a great many companies) be fundamentally condemned? Even excessive consumption of tobacco and alcohol might be justified by a potential reduction in pension costs. Should pharmaceutical companies be excluded on principle because of potential for drug abuse? Should we abandon all investments that support beef or dairy production because cattle are among the largest sources of CO_2? Should plastic production be outlawed, although plastic is indispensable in many areas of life? And do we have to exclude fossil fuels because they impact the climate or do we need fossil energies to keep electricity accessible for low-income groups and industrial production? Should one generally avoid countries that enforce death penalties (then one should no longer buy US government bonds and - depending on interpretation - also no other US securities)? Should we promote government debt or perhaps (even completely) abstain from the purchase of government bonds?

Some investors have exclusions that go even further, e.g. car manufacturers, banks or internet companies. Should these be excluded or do they contribute to the freedom of people and efficient service logistics?

Every investor has to answer these questions individually. However, DVFA wants to help make portfolios more transparent and comparable.

[6] Source: Top 10 exclusion criteria in Germany according to Forum Nachhaltige Geldanlagen (2017): Market Report 2017, p. 33 and 2018, p. 26)

Divestment

Investors can improve the sustainability profile of their portfolios by selling securities (divestment). In principle, incompatible holdings should be divested immediately.

Investors who, due to the volume of their investment or other immutable or difficult to change restrictions, must still invest in less-responsible companies can use improvements over time as a yardstick.

Problems with best-in-class and best-in-universe approaches

With a so-called "best-in-class" approach, investments can be included in a portfolio that are the best in their "class" but have a relatively poor profile in relation to the entire investment universe.

A "best-in-universe" approach does not have this problem. But there are other possible problems. If securities are selected according to an aggregated score, e.g. an ESG (Environmental, Social, Governance) score, securities that have a very poor score in one of the dimensions (E, S or G) can be added to the portfolio if they perform well in the other dimensions. If all three dimensions are important to investors, it is therefore important to ensure that all three dimensions are given a relevant weight and that minimum requirements apply to each of these dimensions.

Climate and other individual criteria

Improvements in climate protection and reductions in CO_2 are very important. But improvements in other air quality attributes, improvements in the supply of clean water or soil quality are also important.

Specialised rating agencies often collect data on hundreds of criteria to assess the environmental quality of a security. Investors who attach special importance to individual criteria should also implement this in their investments. A portfolio that helps to reduce CO_2 should transparently demonstrate this fact. But such a portfolio may perform relatively poorly according to other responsibility criteria. And, this fact should also be made transparent. An extreme example would be a portfolio of investments in nuclear power producers.

The assessment of such a portfolio should also be made by the investor. It is conceivable that an investor from a country with extensive use of nuclear energy, such as France, could have a better opinion of nuclear power than, e.g. someone in Germany.

DVFA Guidelines are independent of data or rating providers

DVFA aims to avoid defining standards with regard to specific data providers or rating providers (for rating providers see e.g. http://nachhaltiges-investment.org/Ratings/Researchkonzepte.aspx). For instance, using internal company ratings should also be possible.

But minimum standards for acceptable ratings should apply: Today, professional rating agencies sometimes use hundreds of subcriteria for the respective dimensions E, S and G. We assume that at least a two-digit number of criteria should be used for a credible ESG rating.

Additionally, data and rating providers should ensure that their data and ratings are adequately observed. In other words, an ESG portfolio should be defined as one that adheres to E and S as well as G criteria. If users are misleading in their use of data or ratings, the providers should call attention to this and, if necessary, stop supplying the information.

Investors should decide for themselves which data or rating providers they wish to use.

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