Sustainable Investing: Now with 'Legs' for the Long Term

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In business development, a big idea with significant long-term potential is described as having "legs." Sustainable investing is at an important inflection point in its development and it definitely has "legs."

First, there's a need to agree on a common vocabulary. **The term 'sustainable investing' is newer than SRI (socially responsible investing), and reflects an evolution in thinking about the industry**. It describes an investment approach that uses a financial framework that incorporates environmental, social, and corporate governance issues to evaluate investment opportunities. This differs from values-oriented strategies that include or exclude particular companies based on alignment with social objectives (i.e. benefits for same sex couples) or religious objections (i.e. companies that manufacture birth control products). Values-oriented strategies have generally been described as SRI, faith-based, or ethical investments.

While SRI products hold significant potential, they continue to be challenged by questions about their ability to deliver superior returns. Sustainable investing, on the other hand, is in a different position. Intuitively and empirically, well-run companies are better long-term investments. Today, being well-run means addressing issues of climate change (risks and opportunities), running a sound and honest organization, and managing the corporate governance process effectively. Sustainable investing may be a more accessible idea to more investors, and we anticipate that it will support the growth of both SRI and sustainable investing managers.

That said, classification in major fund databases is a problem. The labels for US funds are not the same for international funds (where SRI/sustainable investing is a bigger business), and no distinction is made between funds that screen proactively versus excluding certain investments, for example. Establishing a global vocabulary and classification system would be very helpful in tracking this sector's growth (and helping individual managers in marketing).

The 'Sustainable' Connection

Besides delivering long-term benefits, sustainable investing and SRI can also meet a variety of more personal investor needs across the investment and social values spectrum. Because so many investors (and advisors) are struggling with trust in the industry – and because people are so much more aware of climate, social and corporate governance issues – **we believe that funds incorporating a robust screening process for good corporate citizenship or a personal, values-based connection may have a sales advantage in the current environment**.

There's a reason that sustainable investing funds in the US have seen total net inflows since 2006 (excluding one anomalous fund from American Funds), and net inflows in three of the last four years.

Socially Conscious Long-Term US Funds Net New Flows in $Million

	2006	2007	2008	YTD-10/2009
Domestic Equity	347	138	-73	1,476
Int'l Equity	434	344	632	200
Taxable Bond	330	475	-613	771
Total	**1,104**	**956**	**-54**	**2,447**

Source: Strategic Insight Simfund MF

Witness, too, the growth of the upstart 401(k) provider Social(k): the firm offers a screened list of nearly 150 sustainable mutual funds, and offers several thousand traditional funds in total. Assets under administration grew 187% from 2007 to 2008; as we might expect growth has slowed in 2009. Currently the firm oversees $45 million in 401(k) assets.

Sustainable investing is global and local. More than 600 firms around the world have signed the UN-backed Principles for Responsible Investing. The investment manager signatories to these principles represent more than $18 trillion in AUM. While the total numbers are significant, it is important to note that the sustainable investing and SRI market is fairly fragmented, with many firms managing $1 billion or less. We would expect to see that dynamic change as the sector matures, sales momentum increases, and funds and firms consolidate. **The sustainable investing sector is actively engaged in product development, having launched 65 funds just since the start of 2005.**

"Sustainable" approaches vary, and funds may use a number of screens, and may either seek or avoid a number of variables including treatment of the environment, impact on climate change, human rights, weapons and more. There are also several funds – and one large portfolio run by American Funds – that simply avoid alcohol, tobacco, and gambling and thus fall into the sustainable/SRI categories, but we don't view those as true "sustainable investing" products.

At the end of October, 60 firms in the US were categorized in SI's Simfund MF database as socially conscious managers. In aggregate, these firms managed about $38.5 billion, excluding American's $49 billion Washington Mutual portfolio mentioned above. The top 10 sustainable investing funds housed $15.8 billion in assets, or 41% of the group's AUM.

Largest Socially Conscious US Long-Term Funds, as of Oct. 2009

	Assets $MM 10/09	Net New Flows $MM YTD-10/09
PIMCO Total Return III	**2.763**	231
Parnassus Equity Income	**2,200**	357
Pax World Balanced	**1,865**	-67
Ariel Fund	**1,630**	113
Amana Growth	**1,377**	450
GuideStone Intl Equity	**1,330**	-55
Ariel Appreciation	**1,200**	-70
GuideStone Growth Equity	**1,181**	-33
GuideStone Value Equity	**1,131**	1
Calvert Social Investment Equity	**1,115**	54

Source: Strategic Insight Simfund MF

Another category of investment strategy has emerged recently: funds that invest in clean energy, alternative energy, or investments based on potential opportunities around climate change. By their nature, though, these are not as values-driven as other SRI funds, and so we see this group as having a slightly different (and more sector-like) orientation – but no less opportunity, as they focus on macro social and economic change.

The bottom line? Sustainable investing is a growing movement that's still emergent, with opportunities for firms to position their unique value proposition.

Prescriptions for Manager Growth

We recommend a number of specific strategies for sustainable investment managers wishing to grow.

1. **Manage product lines aggressively.** Many firms in the sustainable/SRI investing space have flagship funds that capture the bulk of flows. Use this as a starting point for product line rationalization and new product development. Build on core competencies and expand into new investment areas based on client and market feedback. This level of product line management requires putting a schedule together for evaluating your offerings in context, and then another game plan for continual evolution and implementation.
2. **Effectively position products relative to competing offerings.** This is a competitive space with much confusion about labeling and categorization. Each manager must clearly articulate a specific and differentiated approach to sustainability and to investment management, and to how those work together. Be clear about where you fit and why.
3. **Sell the darn things.** "If we build it they will come" is not a distribution strategy. Determine the costs of distribution through the various channels and models, and how that cost structure will affect you. Build, rent, or buy what you need, and stay flexible. We find that advisors today are more alike by business model (i.e., fee-based advisors are more like one another) than by traditional channel labels.
4. **Focus**. Build on core competencies that offer long-term opportunity and low volatility. Active management faces greater skepticism these days, and sustainable managers often have investors' personal attachment to investment strategies to consider. Active managers need to ensure that funds don't hurt trust by stretching the boundaries of prudence.
5. **Carefully evaluate your approach to ETFs.** Today most managers are working to understand how ETFs fit into their product line, either by adding them or working around them. Build an ETF (or non-ETF) strategy.
6. **Highlight strategies that generate income.** If your core strengths involve sustainable investing strategies that support the need for income, you're in the sweet spot, so take advantage of it. Income generation (along with capital preservation) is a hot topic now, especially for Boomers and their advisors.

Sustainable investing managers are no longer waiting for the world to believe that an idea like this makes sense. Rather, they need to take advantage of this unique period and implement strategies for growth.