



STIFTELSEN FÖR
MILJÖSTRATEGISK FORSKNING
FOUNDATION FOR STRATEGIC
ENVIRONMENTAL RESEARCH

Sustainable Investment - Towards a New Role for Institutional Investors

A Mistra research initiative focusing on the contribution of asset management to Sustainable Development

Call for pre-proposals for a large-scale research programme

Mistra is issuing a call for pre-proposals for a large-scale academic research programme aimed at integrating the concept of Sustainable Development in asset management and supporting institutional investors in implementing such concept using this approach in their investments.

Mistra is inviting proposals for a large scale, interdisciplinary and internationally competitive academic research programme, implemented by a coordinated group of academic institutions (lead institution must be Swedish) and covering one or more research areas. The focus should be on economic, legal and social science research with, if necessary, integrated elements of the natural sciences. Selected pre-proposals will be funded with so-called planning grants, allowing researchers to further elaborate their proposal in the period between October 2004 and March 2005 in order to submit a complete programme proposal by April 1, 2005. The actual research programme is planned to start in January 2006. The level of funding for a first three-year phase could be in the order of SEK 25-30 million. Further phases could follow, if the evaluation for both scientific and practical value of the research outcomes is successful.

Mistra's *vision* is that institutional investors will eventually take a leading role in Sustainable Development and use their influence to change the behaviour of companies in which they invest. The present call for pre-proposals reflects the needs and requirements of such investors consulted by Mistra in the course of the past months, not necessarily the state of academic research in this area. The proposed research topics are therefore of an indicative nature – researchers are free to propose additional topics within the defined research areas.

Applications for planning grants, with pre-proposals attached, must be received by Mistra by September 15, 2004.

1. The aims of the initiative

The world's development is not on a sustainable path. This was clearly stated at the world summit in Johannesburg 2002. The progress since Johannesburg is not encouraging. The Millennium Development Goals are far from being reached. In economic terms, poverty levels are still high, even though the last decades have seen substantial improvements in the standard of living also in areas plagued by persistent poverty such as in large parts of Asia. In social terms, a large share of humanity still lacks access to basic needs and rights such as education, health, gender equality, democracy, equality before the law, freedom of expression and from oppression. Environmental burdens have been reduced in many areas of the world but are increasing in other areas leading to a growing imbalance and deterioration of ecosystems with consequent risks for different societies.

A Sustainable Development¹ will require that environmental and social concerns be integrated into economic policies on both national and international levels. Sustainable Development also has to be integrated in business strategies of individual companies. This is beginning to be recognized by business leaders convening under the auspices of organisations such as the World Business Council for Sustainable Development, the Global Compact, the UNEP Finance Initiative and the World Economic Forum. Many individual companies are adapting their long terms strategies to this end, as the impact of sustainability issues on business opportunities and risks is being felt and discussed. The level of commitment of individual companies differs from sector to sector, but leaders are beginning to emerge in sectors as diverse as oil and gas, automobiles, reinsurance and also the financial service sector. The mainstream of business, though, remains far from committed to Sustainable Development. Most companies are satisfied with complying with existing regulation, regardless of whether this legislation is adequate or not from the perspective of Sustainable Development.

The markets for financial services make up a linchpin, perhaps *the* linchpin, of the global economy. A critical mass of private actors for sustainable development will require the active participation from the financial service sector. So far, this sector lags behind most other sectors with regard to its implementation of Sustainable Development concepts. Sustainable Development issues are all too frequently seen as costs that may reduce short-term returns.

The impact of the financial services sector on Sustainable Development is by and large indirect, through its impact on company behaviours and strategies. This impact is defined by ways in which issues related to Sustainable Development are taken into account in different areas, e.g.:

- Asset management and corporate finance: in the type of products and services offered to clients
- Financial analysis: when evaluating prospective returns and risks of different asset classes;
- Credit rating: when rating credit risks for debt financing instruments like long term loans and bonds;

¹ Throughout this call we use the World Commission on Environment and Development's (WCED) definition of Sustainable Development (1987): "Sustainable Development seeks to meet the needs and aspirations of the present without compromising the ability to meet those of the future". In its 1997 "Our Common Future" report the WCED added that "Yet in the end, sustainable development is not a fixed state of harmony, but rather a process of change in which the exploitation of technological development, and institutional change are made consistent with future as well as present needs".

- Insurance and reinsurance: when identifying long-term risks and liabilities.

Institutional investors such as pension funds, foundations, insurance and reinsurance companies play a key role in the financial services sector. They have a natural long-term perspective, since their liabilities extend into decades. The reinsurance industry will feel the impact of climate change to property damage or fresh water availability to the health insurance directly on its business. Pension beneficiaries have a direct interest in the long-term stream of income from pension funds, but also, since most of them have, or hope to have, children and grandchildren, in the characteristics of the world that generates this stream of income. Long-term issues that may look like intangibles to today's pension funds might be quite tangible to the children and grandchildren of the beneficiaries.

The strategic agenda for the Mistra research initiative

Mistra will, within the framework of this initiative, support academic research that will help institutional investors to better implement Sustainable Investment concepts in their investment activity.

We use the term *Sustainable Investments* in this call for pre-proposals meaning investments which aspire to make an explicit contribution to Sustainable Development, by means of different techniques, methodologies and supporting activities (e.g. engagement with companies).

Mistra's *vision* is that institutional investors will eventually take a leading role in contributing to Sustainable Development through their Sustainable Investment activity and by influencing the behaviour of companies in which they invest.

Mistra's *goal* with this initiative is create an academic platform that will support the development of analytical concepts, tools and skills necessary for Sustainable Development to take hold in the financial services industry.

A Mistra research programme is trans-boundary in three different ways:

- Between academic disciplines: all the relevant disciplines have to be included.
- Between theory and practice: the dialogue between academics and practitioners has to be constantly ongoing.
- Between Swedish and foreign researchers: foreign researchers should be invited to participate as participants in Swedish research groups.

2. The current situation in institutional investment markets

The analytical starting point for this initiative is that Sustainable Development can only be achieved through the direct, firm and long-term commitment of business and that the financial industry probably is the single most important change agent in driving this commitment. Mistra's view is that the involvement of the financial industry will make or break the commitment of business in general to Sustainable Development.

An increasingly lively discussion is already taking place within the institutional investment market about different obstacles and self-reinforcing mechanisms that currently hinder a stronger engagement by institutional investors in the field of Sustainable Investments.

The UK-based think-tank Tomorrow's Company in the context of its "Twenty-First Century Investment" project, for example, has described in detail how the conventions and behaviours of different market actors (often resulting out of a lack of communication and understanding) lead to a decision chain which favours short-termist, conformist behaviours which hinder the implementation of Sustainable Investment concepts. It describes the current situation in the following terms³:

- "fund managers and analysts are pre-occupied with league table and relative performance (chasing the indexes..)
- there is a strong incentive for fund managers to stay with the crowd
- investment consultants value predictability and conformity above diversity and flair
- chief executives are also preoccupied with short-term performance (given their short-term tenure)".

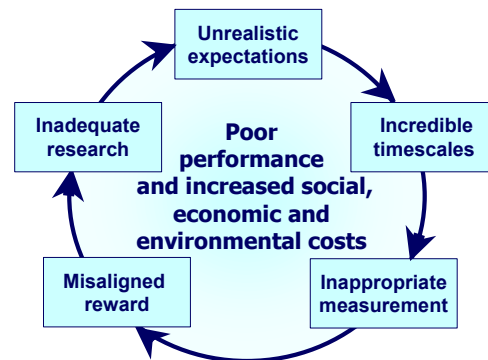


Fig. 1: Self-reinforcing mechanisms leading to poor financial and sustainable development outcomes in the institutional investment market (source: Tomorrow's Company).

The international discussion about this "short-termism" is now rather intense. Unlocking this situation is not easy, however, due to the complex character of the markets and the many interacting relationships between different components. Many actors will have to change their behaviour; new skills will have to be learnt; and training and accreditation principles will need to be revisited.

² Tomorrow's Company: "Twenty-first century investment – an agenda for change", London 2003

³ Tomorrow's Company: "Twenty-first century investment – an agenda for change", London 2003

Mistra’s point of departure is what here is called the investment “value-chain” in the institutional investment market (Fig. 2) with its different actors and components. Key actors are in particular the trustees and fund managers, but also brokers, company CEOs, investment consultants, rating agencies and regulators that together have a great impact on the way institutional assets are managed. The proposed research initiative should contribute to a new consensus by providing a scientific platform supporting the actors in the value chain.

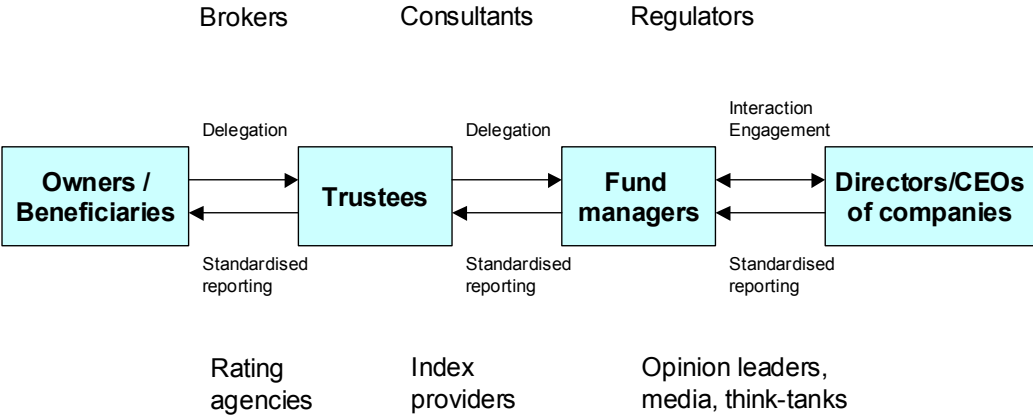


Fig. 2: Value chain in the institutional investment market.

Mistra expects scientific research outcomes under this initiative to support market actors in overcoming current barriers and implementing Sustainable Investment concepts in different ways:

1. By supporting in particular trustees, fund managers, regulators and consultants in reinterpreting and redefining the fiduciary duty concept in order that Sustainable Development concepts can be better included in asset management (see Research Area 1 in the next section)
2. By supporting in particular trustees, fund managers, company boards and CEOs, consultants and brokers in understanding and evaluating the investment case for Sustainable Investment concepts (see Research Area 2 in the next section)
3. By supporting all market actors committed to Sustainable Development by explaining the mechanisms through which Sustainable Investment concepts can influence company behaviours and lead to positive outcomes with regard to Sustainable Development (see Research Area 3 in the next section)

3. Research areas

Mistra has decided to focus this initiative on a limited number of strategic areas in which academic research is likely to make a contribution to the already thriving debate within the international financial industry⁴. They represent the focus of the initiative during its first three-year phase. Additional areas could be added in future phases.

Area 1: Framework conditions for a new role by fiduciaries

This area focuses on overcoming potential barriers to Sustainable Investment that are related to the legal definition of fiduciaries' responsibility, to its interpretation by the investment professions and to prevailing conventions and behaviours of market actors.

Examples of research topics to be addressed in this area are:

- Are current legal definitions of fiduciary responsibility consistent with sustainable development? If not, how would the fiduciary duty concept have to be adapted to avoid that?
- How do prevailing interpretations of the fiduciary duty concept come about? How do different investment professions, their conventions, behaviours, role models, training, accreditation requirements and so on influence the interpretation of the concept? What changes would facilitate a reinterpretation that would incorporate Sustainable Investments?
- Given the dynamic nature of interactions between different market actors, can leadership behaviours and triggering events be identified which could lead to a stronger contribution of institutional investors to Sustainable Development by means of their investment activity? Which actors would be key to this and what would they need to do? Which behaviours of fund managers (e.g. increase of product offer) or of their institutional clients (e.g. public tenders for Sustainable Investment mandates) could unleash the demand for and the implementation of Sustainable Investments?
- What are possible scenarios for the future development of the institutional investment market, based on political, legal, social trends? Do they differ across regions and countries?

Area 2: Understanding the investment case

The main focus of this research area is in understanding how various Sustainable Investment concepts, motivated by different investment philosophies and customer preferences, contribute to overall portfolio performance in terms of risk and financial return levels. The concepts include, among others, the following elements or a mix of them:

- Negative screening
- Positive screening

⁴ An extensive consultation process involving international and Swedish practitioners in this field has led to the definition of the three areas

- Integration of Sustainable Development criteria in financial analysis and asset management
- Engagement with companies
- Exercise of voting rights.

The business case for better managing Sustainable Development issues at the level of single companies can also be a topic for research proposals under this initiative, but only if it is linked to outcomes at the level of investment portfolios.

Another scope of this research area is to explore the limits of currently used analytical and performance measurement frameworks with regard to so-called tangible versus intangible factors as well as with regard to short-term versus long-term returns and risks. Sustainable Investments will necessarily require an assessment of difficult-to-quantify long-term intangibles, which, however, may well acquire a very tangible nature over time. Related to this is the relation between the time horizons of performance measures, incentive schemes and actual investment behaviour of fund managers.

There is thus a need both for new valuation tools for analysts and performance measures for fund managers and the subsequent need for revisiting training and accreditation schemes.

Examples of research topics to be addressed in this area are:

- How do different Sustainable Investment (SI) concepts and their use in institutional fund management contribute to portfolio risk and return levels? Can this be shown empirically?
- What level of uncertainty is there with regard to traditional issues, e.g. the advantages of passive vs. active management? How does this uncertainty compare with SI related uncertainty and how is it managed in practice? What lessons can be learned for SI? Is SI a valuable approach both for active and passive investment styles?
- How do different “architectures” of an investment process including SI concepts (e.g. negative screening at the beginning or at a later stage of the process) influence portfolio risk and return levels?
- Can SI concepts also be used in defining a strategic asset allocation weighting different asset classes, markets and sectors? What would be the rationale for that? Can risk measures and value drivers at the level of different sectors and industries be defined for that purpose?
- What specific issues should be considered in applying SI concepts to different asset classes, e.g. large/mid/small cap equity, private equity, fixed-income investments, alternative investments etc.?
- Can current analytical and performance measurement frameworks be adapted in order to better include SD criteria? Or is there a need to develop new frameworks? What would they look like?

Area 3: Explaining the contribution toward sustainable development

This area focuses on understanding how and to what extent SI concepts achieve real changes in the behaviour of companies or other market actors leading to tangible results on the path toward a more sustainable economy. Mistra is aware that it will be difficult to quantify the Sustainable Development (SD) impact - it nevertheless believes that it should be possible to describe the basic mechanisms leading to SD impacts.

Examples of research topics to be addressed in this area are:

- Can a framework be defined to measure, or at least explain mechanisms leading to positive social and environmental outcomes of SI concepts for different industrial sectors⁵?
- Can it be shown that different types of companies (e.g. listed/non-listed) which are exposed to different types of investors (e.g. private/institutional ones) behave in a different way with regard to time-horizons and SD performance? Does that differ between countries (e.g. due to corporate governance legislation and practice)?
- Can significant differences be observed between the SD impact of SI concepts applied to a passive vs. an active management of funds?
- Is there a trade-off between financial outcomes and SD outcomes – or how do concepts with a strong focus on SD performance affect portfolio risk and financial performance for different investment styles and asset classes?
- Is it possible to measure the impact of investors' engagement programs on companies' behaviour and their SD performance?
- Through which mechanisms can venture capital investments and emerging-market investments contribute to positive SD outcomes?
- What is the role, if any, of rating agencies?
- Which SI concepts are most likely to stimulate companies to commit themselves to Sustainable Development?

⁵ Industrial sectors differ with respect to their importance for Sustainable Development. Some have their major impact on climate change, others on ecosystems or on the accumulation of chemicals. The same holds for different social goals.

4. Programme design and application details

Mistra invites proposals for *integrated research programmes*. The proposals should cover several of the strategic issues identified above, although not necessarily grouped in the same way. The programme should preferably be concentrated to one or two academic centres in Sweden. The proposals must meet the following criteria:

- The research should be *solution-oriented*. There should be a clear idea of how the research will make a concrete and significant contribution to a new role for institutional investors with regard to Sustainable Investments. A dialogue should be established with practitioners and the practitioners' perspectives should be given weight in the research efforts.
- The proposed research should be *internationally competitive*. The applicant research groups should have well-established contacts with relevant international research environments. Mistra attaches importance to collaboration and synergies with international research programmes. *Researchers from countries other than Sweden are welcome as members of applicant groups.*
- The proposed research should be interdisciplinary. The emphasis should be on *economics, social and legal science research with, if necessary, integrated elements of the humanities and natural science/technology.*

Programme design

A programme board and a programme manager who is responsible for implementation are always appointed for Mistra's programmes. Activities could be divided up into sub-programmes that have to be incorporated into the programme management structure. Normally, Mistra grants funds for a first programme phase lasting 3-4 years, with the possibility of funding for further phases if the programme is considered successful following international evaluation. This evaluation will relate both to scientific quality and the practical value to institutional investors.

Mistra would like to see a large percentage of PhDs among those participating in the programme. In order to give special support for the participation of junior PhDs in the programme, Mistra would welcome that each research initiative provide for *at least two 3-year research posts for junior PhDs* (PhD's not older than six years) in its programme budget. These posts must offer the possibility of one year's stay at a university abroad. The posts are to be advertised at the commencement of the programme and the programme board in consultation with Mistra will elect the successful candidates. A junior PhD that accepts such a post should also be able to participate in the programme in some other position.

The programme should have a clear problem-solving profile and should engage in an active dialogue with the relevant practitioners. To facilitate this dialogue, Mistra plans to include an *organizational platform for contacts between researchers and practitioners* within the programme framework. The working name of this platform is currently 'the Sustainable Investment Platform'. The Sustainable Investment Platform will be associated with the programme and will have its own budget, its own advisory reference group and, possibly, its own chair. The programme board in consultation with Mistra will appoint the Forum. The purpose of the Forum's activities will be to establish a deep and rewarding dialogue between researchers and practitioners on the possibility of reaching a new consensus with respect to Sustainable Investments.

The programme is expected to commence on January 1 2006. For the first three years the level of funding will be about SEK 25-30 million. The planning schedule for the process up to the launching of the programme is as follows:

September 15 2004	Deadline for applications for planning grants
early October 2004	Decision on planning grants
April 1 2005	Deadline for submission of complete programme proposals
May 2005	Evaluation of scientific value and practitioner's value
June 2005	Mistra's board decides on which proposals to fund
Autumn 2005	finalising arrangements between Mistra, Programme and programme host
January 1 2006	Start of the research programme

Planning grants will thus be provided for the period from October 2004 to March 2005. Each grant will total SEK 200 000 – 250 000.

Applications

The applications for planning grants, with pre-proposals attached, must be received by Mistra by September 15, 2004. The pre-proposals should contain descriptions of:

- The research field(s) relating to Sustainable Investments to be addressed by the research;
- How the research is expected to make a concrete and significant contribution to establishing a new consensus on Sustainable Investments.
- The practitioners with whom the research group is conducting/plans to conduct a dialogue;
- A concise description of the methods to be used;
- The composition of the planned research group and its international contacts.

Applications must be written in English and must not exceed 10 pages. Mistra will award planning grants to the most promising pre-proposals for the preparation of complete programme proposals. The complete programme proposals will be subject to two evaluations during April and May 2005 prior to the decision by the Mistra board in June 2005. One will be carried out by a group of potential users. The other will be carried out by an international peer review group of scientists.

Please send your application to:

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