Investing in the sustainable economy

June 2012

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The Principles

The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The six Principles are:

1. **We will incorporate ESG issues into investment analysis and decision-making processes.**
2. **We will be active owners and incorporate ESG issues into our ownership policies and practices.**
3. **We will seek appropriate disclosure on ESG issues by the entities in which we invest.**
4. **We will promote acceptance and implementation of the Principles within the investment industry.**
5. **We will work together to enhance our effectiveness in implementing the Principles.**
6. **We will each report on our activities and progress towards implementing the Principles.**

Contributions

The PRI Secretariat is grateful to the following people for their contributions to this report:

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Foreword by Wolfgang Engshuber

Chair, PRI Advisory Council

Rio+20 provides a timely opportunity to explore the role of the investor in the transition to a sustainable economy. The goals of the summit; to reduce poverty, advance social equality and ensure environmental protection, are not possible without the allocation of capital towards investments that create long-term, sustainable, economic growth.

Over three days in the run up to Rio+20, business leaders from all over the world will discuss these issues at the Corporate Sustainability Forum organised by the UN Global Compact. Investments that address sustainability challenges can offer sufficiently attractive financial returns, at acceptable levels of risk for long-term investors such as PRI asset owner signatories. This report is intended to highlight such examples of how institutional investors are actively allocating capital in projects that contribute to the Green Economy[1] and other Rio+20 themes. Such examples include investments in renewable energy, microfinance and sustainable forestry. This report is not meant to be read as an exhaustive account of all investment made in this sector – it is a selection of what some asset owners across the world have been doing and what obstacles they face.

Investors act as stewards of the world's wealth. There is growing awareness amongst the investor community of how the returns they will provide to beneficiaries over longer periods may be negatively impacted by sustainability challenges. This creates a need and opportunity for government and policymakers to engage with investors and to support them with a robust policy environment in which to operate. By so doing, we are confident that the types of investments described in this report will grow in number and scale.

1. Defined by United Nations Environment Programme as "a system of economic activities related to the production, distribution and consumption of goods and services that result in improved human well-being over the long term, while not exposing future generations to significant environmental risks and ecological scarcities".

Foreword by Hugh Wheelan

Managing Editor, Responsible-investor.com

The Organisation for Economic Cooperation and Development (OECD) estimates that the world has US$ 65 trillion of long-term savings assets. The PRI represents over US $32 trillion of this total within a specific category, institutional investment management: pension funds, insurers, foundations and the asset managers that run those assets. The mobilisation of that US $32 trillion figure towards sustainable investment within just six years (the PRI was launched in 2006) shows how private capital can contribute effectively to the sustainable development themes outlined by the first Earth Summit and set to be added to by this 2012 gathering.

What such mobilisation needs, however, is clear organisation, a convening structure, and the policy support of governments. None of this is easy and requires significant political will backed up with rationale and empirical evidence of progress.

To that end, this series of case studies is designed to be part of the roadmap for continued mobilisation of private savings towards sustainability goals. It looks at the strategies of some of the world's most advanced asset owners from a broad geographical base in terms of sustainable finance. Importantly, it shows how these organisations, whose foremost role is to protect and grow the retirement money of millions, can marry a dual financial and sustainability driven goal given the right framework and support.

The report examines how some pension funds and other investors are actively allocating capital to projects that contribute to the Green Economy and other Rio+20 themes such as jobs and food security. They are doing this by investing in social and environmental sectors in both developed and developing economies.

Its aim is twofold:

- To demonstrate practical examples of investments made in, for example, renewable energy, energy efficiency, microfinance and sustainable agriculture and forestry.
- To highlight the challenges around risk and return, asset allocation and length of investment that are paramount to long-term pension fund investors.

The report can hopefully make a valuable, practical contribution to the public/private financing discussions that will be a key part of the Rio+20 sustainability agenda.

www.responsible-investor.com is the dedicated news service reporting on responsible investment, ESG (environmental, social and governance) and sustainable finance issues for institutional investors globally.

Investing in the sustainable economy – an overview

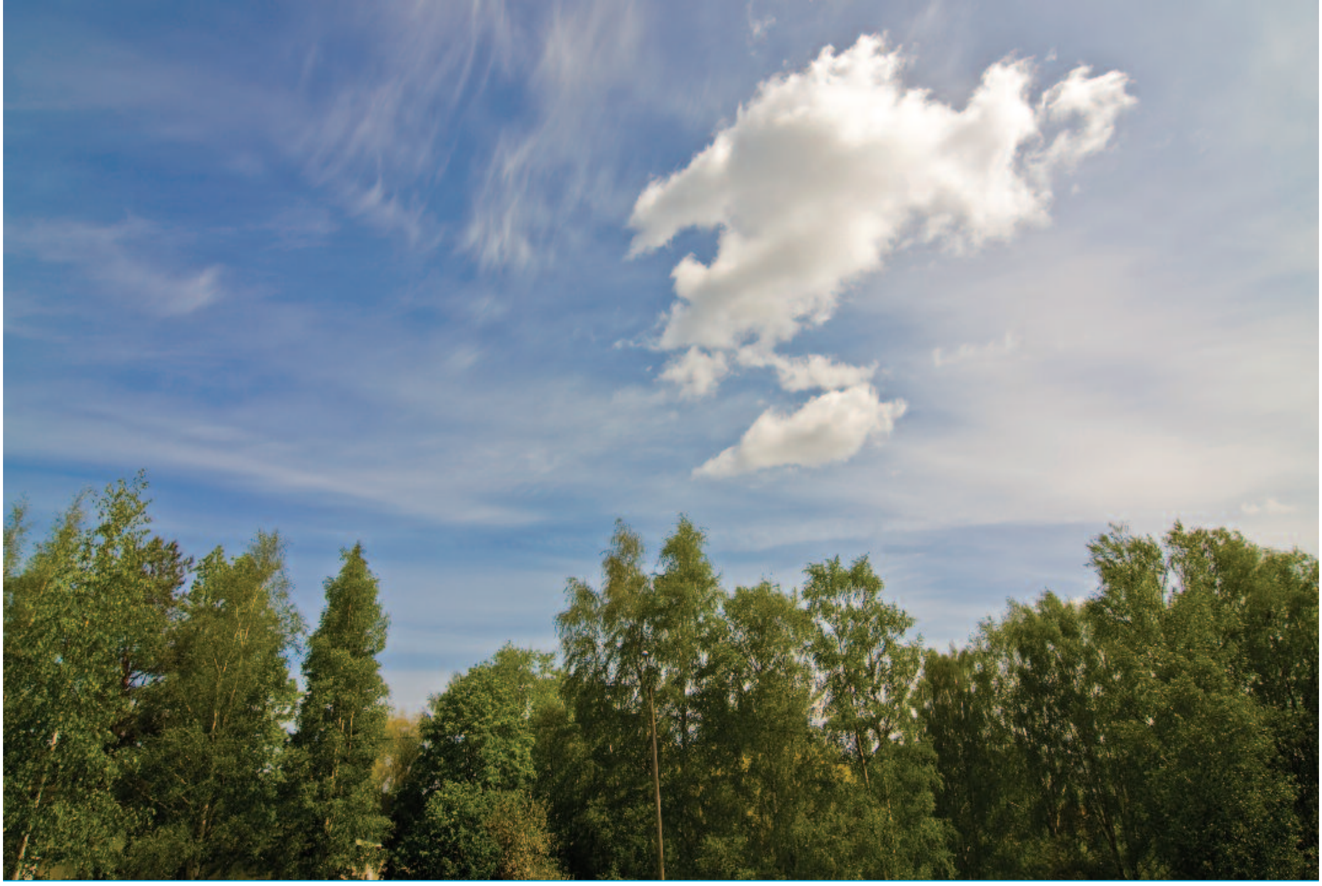
The investments highlighted in this report cover different social and environmental themes for example clean tech, microfinance and sustainable agriculture and forestry. Such investments are sometimes referred to under the umbrella term of 'impact investments'. They may also be referred to as 'sustainability-themed investments' or 'ESG (environmental, social and governance) -targeted investments'. Though there is no universal term, what these investments have in common is the expectation that they will generate positive social and environmental outcomes as well as attractive financial returns.

These types of investments are increasingly popular with PRI signatories. In the 2011 Reporting and Assessment process, 38 per cent of the participating asset owners reported that they made investments in social and environmental areas. The signatories included both corporate and non-corporate pension funds as well as insurance companies, development finance institutions (DFIs) and foundations, from all over the world.

The most common theme was clean tech, with investors making allocations to, for example, renewable energy, energy efficiency, water and waste technology. Investments in clean tech tend to be made through private equity although there are also examples of listed equities and fixed income investments. On the social side, microfinance remains popular with PRI signatories as well as other sectors such as global health, education and social infrastructure. While sustainable forestry has traditionally been an important asset class for many asset owners, sustainable agriculture is also gaining increasing attention.

Investors may choose to dedicate a certain percentage to investments in social and/or environmental areas as separate from their overall asset allocation. Others will look for investments in these areas across asset classes and investment teams. Asset owners may find these investments attractive because it is a way that they can contribute to sustainability in the long term while meeting their risk/return needs. These investments can also improve their overall risk/return profile and provide diversification benefits, however this is not always the case.

As the case studies in this report show, allocations are often small in comparison to investors' entire AUM. While many are planning to increase the size of their investments, they are constrained by issues such as deal size, lack of historical performance data, lack of knowledge about these investment areas as well as high real or perceived risk levels. However, as investors get to know these investment areas better, many have found that the risks associated with these investments may not be as high as they were initially perceived to be and that investments can generate healthy financial returns (see for example the Obviam and CalPERS case studies).>



> Moreover, investors are finding solutions to overcome some of the other challenges, for example through collaborative investments and public-private partnerships (see for example PKA which has made collaborative investments with other pension funds and DFIs). There are also positive benefits for investors in communicating with their pensioners and other stakeholders on these investments (see PGGM and Christian Super for examples of reporting and marketing).

Most of those interviewed for this publication were clear that government policies which help to mitigate investment risk are key to making the allocations. For example, the Obviam case study shows that when the public sector underwrites a part of the risk of running sustainable businesses, then these investments become more attractive to investors and ensure capital follows into them, particularly in the emerging markets. Policies and subsidies related to renewable energy have been a key factor in making such investments attractive in parts of the world such as Europe, the US and Brazil. See for example the PKA case study where the Danish government guaranteed the price of electricity.

In conclusion, and as the following case studies show, attractive opportunities already exist for asset owners wishing to match long term risk/return needs while contributing to solutions for sustainability challenges. These investments remain relatively small as many barriers and difficulties exist. However, investors and public policy makers are finding ways to overcome them.

PKA – Working with partners for green investment innovation

Denmark's PKA pension fund (Pensionskassernes Administration A/S) is one of the largest administration companies for occupational retirement schemes in Denmark with about US$ 23 billion in assets under management. Its 250,000 members are mainly employees in the public, social and health sectors and approximately 90 per cent are women. The pension fund does not invest in companies that violate the UN's conventions on human rights and labour rights, the environment, corruption and weapons.

PKA is one of Denmark's biggest investors in sustainability themes. About five per cent of its assets –close to US$ 1.2 billion – is invested in the Green Economy. These include allocations to private equity and infrastructure or taking direct stakes in companies such as a US$ 185 million investment in Genan, a Danish company which recycles tyres, or a US$ 25 million stake in KK Electronics, which supplies the electronic systems for wind farms.

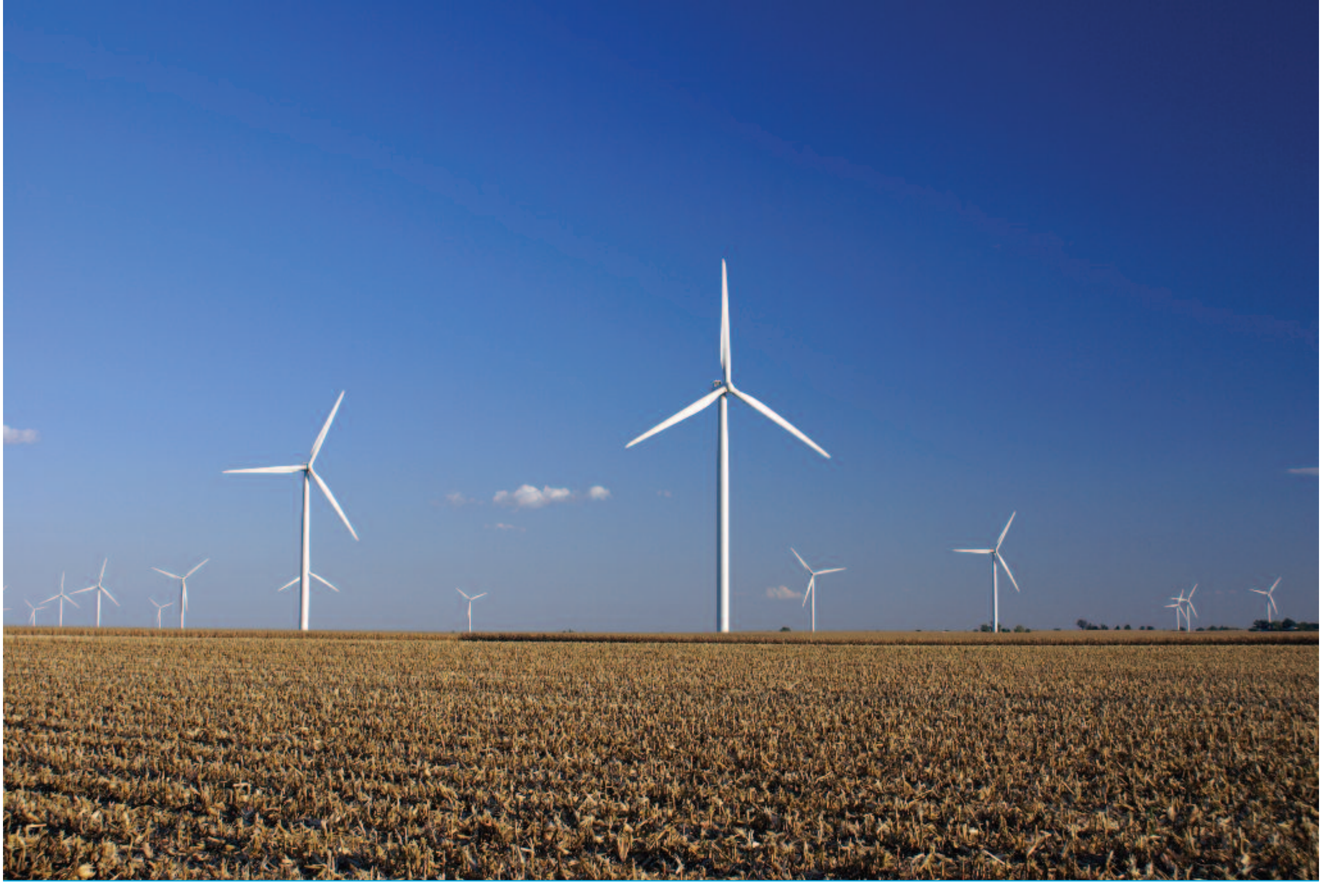
The fund's private equity renewables investments include solar energy, alternative fuels and clean technology. Under infrastructure, the fund makes investments in wind power, bio ethanol, water, solar plants, and hydroelectric power stations in India and China.

The fund has been innovative in carving out new green investment opportunities via public-private partnerships. In 2011 it partnered with Danish pension fund peer, PensionDanmark, to buy a 50 per cent stake in an offshore wind farm from state-controlled energy firm DONG Energy A/S for around US$ 1 billion. The funds signed a 15-year contract with DONG for operation and planned maintenance of the farm, which should be able to meet around four per cent of Denmark's annual power consumption needs.

Importantly, the project is underpinned by long-term government support. The Danish government guarantees the price of the electricity, which helped to underpin the deal. This type of energy deal is likely to be popular in Denmark because government policies have made sure it is a viable model. PKA views this as a long-term contract with a reasonable financial promise of about six to seven per cent returns per annum over 20 years.

Forestry, which it also considered an environmentally themed investment, is a particularly large portion of the fund's total assets, representing US$ 600 million, mainly into plantations in North and South America but also countries such as New Zealand and Mozambique.

A newer asset class for PKA has been a move into sustainable agriculture investments in Africa. The fund has committed US$ 42 million to a private equity sustainable agriculture specialist. PKA has earmarked US$ 220 million to this area, which should see further investments made into New Zealand and Australia.>



> One of the reasons for investing in agriculture in Africa is a rising middle class that will need better food supplies thus pushing up demand. PKA believes that this will be an increasingly important market and sees this as an investment opportunity that will yield results in the long term.

In addition, it made its first microfinance investment in 2011 by investing alongside fellow Danish pension fund, PBU, into a Danish semi-government body called the Investment Fund for Developing Markets. The three parties committed a joint US$ 67 million, which will be invested via a third-party administrator, to seed micro-finance institutions (MFIs) on the ground. The fund has earmarked investments into Africa and committed to an MFI in India.

PKA's board and members are strongly committed to seeking out opportunities to generate the financial returns the fund needs while at the same time contributing to meeting sustainability challenges. Sustainability-related opportunities now offer attractive risk/return characteristics that are more difficult to find elsewhere in the current low interest-rate environment.

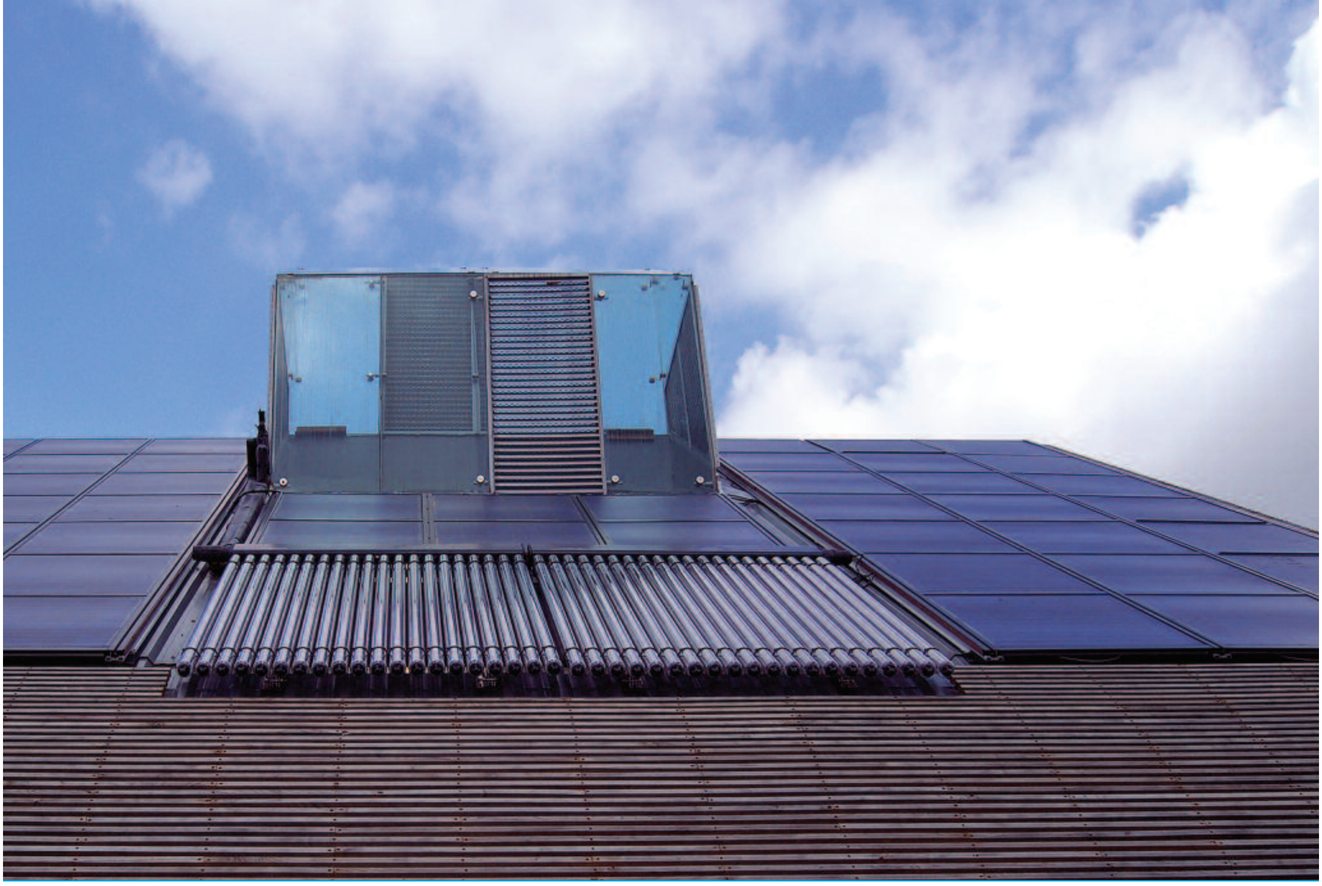
PGGM – Making financial returns and measurable social impact

PGGM is a Dutch pension fund service provider for six pension funds. As of May 2012 PGGM manages over US$ 150 billion of pension assets for 2.5 million Dutch participants. PGGM provides services in the field of pension management, integrated asset management, management support and policy advice to its institutional clients.

At PGGM portfolio managers are encouraged to look for 'targeted ESG' investments where feasible. These are investments that not only perform to the required financial standards but which also are intended to have a social impact. These investments are dispersed across asset classes and teams. Targeted ESG investments reached US$ 6.1 billion in 2011.

Examples of targeted ESG investments on behalf of PGGM clients include:

- A US$ 3.8 billion commitment to the Responsible Equity Portfolio – a concentrated portfolio invested for the long term in listed companies that operate in a responsible manner.
- Through two transactions with Banco Santander, one of PGGM's clients is sharing in the credit risk of its European project finance portfolio. A large proportion of the underlying loans (currently 57 per cent) relate to the financing of alternative energy, such as solar and wind power.
- US$ 324 million committed to 12 specialist clean tech funds in the US, Europe and Asia, through AlpInvest. The aim is to strike a balance between funds aimed at innovative technologies and funds investing in more developed and proven technologies. Both categories improve the efficient use of natural resources and reduce the impact of energy consumption on the environment.
- Joint development ventures such as with the International Finance Corporation (IFC) in its Latin American African Caribbean Fund. The aim of this fund is to contribute to the development of the private sector in order to create opportunities for the poor in developing countries in Africa, Latin America and the Caribbean.
- US$ 40 million in the Climate Change Carbon fund which invests in carbon credits.
- US$ 254 million in two forestry funds.
- Investments in Grassroots Capital's Global Microfinance Equity Fund which invests loan capital mainly in start-up microfinance institutions.
- Three infrastructure funds and a direct investment that invest in sustainable energy projects, mainly in Europe.>



> Currently, there is limited or no information available regarding the social impact of these investments. PGGM is interested in developing some standardised metrics to measure the impact of their targeted ESG investments. Towards this end, working with Rotterdam University's Centre for Strategic Philanthropy, PGGM has developed an approach to identifying impact across eight impact areas.

This year an approach to measure performance on impact indicators for each impact area is being piloted in close collaboration with external fund managers. Going forward, these impact indicators will be included in reporting requirements. PGGM is keen to collaborate with other asset owners to refine these indicators in order to reach a more standardised approach to reporting on impact.

PGGM expects that measuring and monitoring of the social impact of its targeted investments will enable better informed investment decisions. Also, it will allow PGGM to work actively with fund managers to seek ways to achieve greater social impact and reduce possible negative impacts.

While the ESG targeted investments are expected to meet the regular financial requirements as other investments in the respective asset class, it is too early to say what impact they have had on the risk/return profile of their portfolios. However, some teams have argued that this type of investment helps to diversify their investments – which may in turn have an impact on their risk/return profile. This is a question PGGM would like to investigate further in the future.

You can access PGGM's **Responsible Investment Annual Report 2011** here.

Obviam – A track record of financial returns and impact in emerging and frontier markets

Obviam is an independent investment advisor that offers a broad range of investors access to impact investing in emerging and frontier markets. Obviam's senior partners have invested over US $400 million in more than 70 funds and 300 underlying small and medium sized enterprises (SMEs) on behalf of the Swiss Confederation since 1999. Obviam continues to invest on behalf of the Swiss Government, and is currently the investment manager of the Swiss Investment Fund for Emerging Markets (SIFEM), the Development Finance Institution (DFI) of the Swiss Confederation.

Obviam was established with an objective to mobilise private investments for development. SIFEM's capital remains the largest share of Obviam's mandate, but its goal is to attract other clients that seek to invest responsibly in emerging markets within an established, sustainable structure. Obviam is a fund-of-funds manager: it invests in private equity fund managers operating on the ground in developing countries.

SIFEM, similar to other DFIs, tends to favour investment in SMEs as it believes this is where it can best support developing countries in terms of job creation, private sector development and improving economic revenues. Many SMEs in emerging and frontier markets face barriers to access capital and tend to suffer from a lack of capital for growth because of a dearth of local financing available. Consequently, Obviam tends to invest in local private equity fund managers that invest growth capital where their investment can help, for example, manufacturing to expand production lines or build new warehouses for expansion.

All of Obviam's investments for SIFEM follow four critical development investment tenets:

- **Subsidiarity:** providing long-term financing in markets where it is scarce.
- **Leverage:** mobilising third-party capital by providing a 'signalling' effect to the market through investments.
- **Additionality:** taking an active approach to investing, Obviam aims to assist private equity funds it invests in (especially new investment teams and first-time funds) to develop and improve according to international best practice.
- **Sustainability:** ensuring investments made are both financially viable and follow ESG best practices.>

>Through their investments, Obviam expects to generate impact outcomes including job creation, access to capital, mobilisation of third-party capital, enhanced labour conditions and standards, and improved environmental accountability and corporate governance.

Addressing blockages to SME growth is another way in which Obviam's investments create value. Aside from capital, many of the SMEs require operational and strategic input to attain growth objectives. Obviam invests in private equity funds that specifically cater to these needs. This is done through assisting SMEs to define and implement strategies across a host of activities from financial reporting to product innovation. These strategies include assisting SMEs to manage ESG issues such as formalising board structures, establishing health and safety practices as well as conforming to social and environmental standards in business operations. Obviam's ESG objectives are to ensure that SMEs operate according to local laws at a minimum and to put them on a path towards international best practice.

Obviam has recently been building partnerships for sustainable private equity fund initiatives in areas such as clean tech, education, healthcare and forestry. For example, it recently invested in a sustainable forestry fund in Africa, which faces the most significant deforestation rates in the world. Other examples include an allocation into an education fund in India and the first clean tech fund in sub-Saharan Africa.

With an expected annual internal rate of return (IRR) ranging from five to 15 per cent, Obviam's strategies create value by providing financial returns as well as positive social and environmental impact.

You can read more about Obviam's impact investments here.

CalPERS – Investing for the sustainable economy across asset classes

The California Public Employees' Retirement System, better known as CalPERS, provides retirement and health benefits to more than 1.6 million public employees, retirees, and their families on behalf of 3,000 public employers across the state of California. Its total investment portfolio is valued at US$ 230 billion. CalPERS views sustainability, in its simplest form, as the ability to continue. For a long-term investor like CalPERS, sustainability considerations underpin investment decisions in order to achieve long-term risk adjusted returns consistent with fiduciary duty.

CalPERS has approximately US$ 1.2 billion invested in the alternative energy sector through its Alternative Investment Management (AIM) program. These investments are made in private equity, usually venture capital, and are spread across hundreds of companies. The majority of these companies are in the biofuels and solar sector (22 and 21 per cent respectively). The rest is invested in wind, building and energy efficiency, biomass and waste.

There are several promising companies in the solar and biofuels sectors, which are targeting an initial public offering (IPO) soon, but the portfolio is still maturing and thus far, only has a small number of significant winners. Market adoption has been slower than anticipated, and there is a tendency to underestimate capital intensity in product manufacturing and deployment.

For a large pension fund like CalPERS, these investments represent a relatively small share of their total AUM. However, in absolute terms these investments are significant. By trialling the diversification and performance benefits of these investments, CalPERS hopes that they are sending a signal to the market. For example, their capital commitments to the AIM Environmental Technology Program helped catalyse an additional US$ 4 billion of capital commitments into the alternative energy sector. Over time as track records and scalability improves, the size of their allocation is likely to reflect those of more established alternative asset class sub-sectors.>

> In public equities CalPERS identifies investment opportunities in those companies that have been forward-thinking on climate change. In 2010, US$ 500 million was allocated to an internally managed public stocks environmental index fund. This strategy is modelled on the HSBC Global Climate Change Benchmark Index and invests in approximately 380 securities around the world that derive a material portion of their revenues from environmentally friendly sectors such as low-carbon energy production, energy efficiency management and carbon-trading.

CalPERS has a long-standing investment in forestlands. The investment target is one per cent of the total investment fund representing approximately US$ 2.3 billion. Investments are made both in the US market and internationally and are managed by external managers. They are primarily plantations which can reduce CO_2 emissions through carbon sequestration. For a long-term investor like CalPERS, forestry is a robust investment as it has proven attractive risk-adjusted returns, low correlation with other investments and diversification benefits.

You can access CalPERS' **ESG Report** here.

Christian Super – Gaining competitive advantage

Operating since 1984, Christian Super is a not-for-profit Australian industry superannuation pension fund. It applies Christian stewardship principles to the retirement savings of over 18,000 members representing US$ 600 million in assets.

Christian Super's members invest in the fund partly because of its values – they hope to make a positive social contribution to society as well as earning a commercial financial return for their retirement. In order to fulfil this mandate, Christian Super has made a number of investments creating a positive social and environmental impact. Moreover, these investments help Christian Super fulfil its fiduciary duty by providing ways to gain diversification to improve the risk/return profile of the fund.

Its first such investment was in the clean tech field. The investment was structured as a private equity fund of funds, with a value of US$ 25 million. The overall performance of this investment has been better than the average private equity fund in the sector although it has not proved to be the diversifying investment the fund had hoped. This is because in the extreme circumstances of the financial crisis it ended up being more closely correlated with global equity markets and therefore a less effective hedge against equity downside than expected. Currently clean tech accounts for three per cent of the fund's total assets, all of which are located outside Australia.

The Australian clean tech market is difficult. With other cheap sources of energy, renewable energy has struggled to meet performance targets. Many of the efficiency technologies have gone offshore for commercialisation.

However, the Australian government this year put forward its plans for a US$ 10 billion 'green bank', the Clean Energy Finance Corporation (CEFC), which it hopes will catalyse private sector investment and provide a pathway for institutional investors to invest in renewable technology. The fund says government indications that it may accept below market rate for its portion of the investments could bring on board institutional investors willing to take up the potential risk in expectation of receiving any excess returns. However, the access to cheap clean coal in Australia makes the development of the clean tech market difficult.>

> The fund has also invested in the area of microfinance. Its first investigations date back to 2008 when microfinance was moving from being a capital returns only investment to more commercial rates of return on successful projects. The fund has made two allocations so far: an initial US$ 7 million in 2009 and a further US$ 5 million in 2010. Both exposures are hedged back into AUD to protect against volatility. The end beneficiaries of both those investments are clients of microfinance banks around the world. Over half of the ultimate beneficiaries are women, and between 40 to 50 per cent are in rural areas. The clients use the money primarily in microenterprise across a diverse range of industries – from farming and agriculture to clothing, small hardware or tourist shops and small goods manufacturers.

Christian Super has also been a pioneer in quasi public/private investment structures. It became the first Australian superannuation fund to put money into a fund with a Community Development Finance Institution (CDFI) when the government announced the development of a new social initiative where it would match dollar-for-dollar, any externally invested capital, and take the first hit on any investment risk.

The deal is one of three such joint ventures in Australia. The total pool of capital across these three funds is US$ 40 million, of which US$ 20 million is granted from the government and US$ 6 million invested by Christian Super. In the short term it expects returns of around 4.5 per cent, rising to 6.5 per cent as the projects mature and the interest rate cycle comes out of its trough.

You can read more about Christian Super's impact investments in their 2011 Annual Report.

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