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ESG GUIDELINES AND ALPHA CAN YOU HAVE BOTH?

Investment guidelines that extend beyond return and risk targets to include some restrictions on holdings based on Environmental, Social and Governance (ESG) values or policies have been around for a while. But the United Nations Principles for Responsible Investment initiative outlined in April 2006 now claims to have over 200 global institutions as signatories representing over \$9 trillion in assets under management. The interest to apply assets to help further responsible investing was clearly boosted by the UN initiative and now investment boards and trustees are gearing up their plans to address these new guidelines

Institutional investors have to take a different approach than individuals when considering ESG issues to meet responsible investment guidelines. Individuals can access many mutual funds that adhere to a particular value but may not have the performance of other funds. Institutions, however, have a duty to their plan's beneficiaries that requires meeting certain performance targets. The challenge ahead for institutional investors and asset managers is to develop funds that incorporate ESG principles and provide the needed target returns.

What Data is Available?

Companies are not required to report all components of their ESG exposure, so much of what is available depends of voluntary disclosure policies. The trend so far has been for larger companies to provide fuller reports than mid or small cap companies, so coverage for large cap indices is better than for small cap indices. The reason for this difference may be that large cap companies are under greater consumer/shareholder/activist pressure than smaller companies to respond to ESG concerns and also they have the resources to staff a group to address and mitigate ESG exposure risk.

There are several firms now providing ESG data to the investment community which is collected from company annual reports, 10Ks, web sites, government publications, non-government organizations, media, news, litigation reports, and management interviews among other sources. These data, collectively know as non-financial data, are organized into many categories and each is typically given a rank or score. For example, one data provider breaks ESG data into four categories: 1) Economic, 2) Environmental, 3) Social and 4) Corporate Governance while another provider also has four categories but they are quite different: A) Stakeholder Capital, B) Strategic Governance, C) Human Capital and D) Environment. Each of these providers starts with a host of basic measures, called Key Performance Indicators that are then aggregated into several factors which in turn are combined to form the four categories.

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ESG exposure reporting is voluntary

Large cap benchmarks have better ESG coverage than small cap benchmarks

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ESG ranks are composites of many underlying key performance indicators

Economic Performance	Environmental Performance	Social Performance	Corp. Governance Performance
<ul style="list-style-type: none"> ▪ Client loyalty ▪ Performance ▪ Shareholder loyalty 	<ul style="list-style-type: none"> ▪ Resource reduction ▪ Emission reduction ▪ Product innovation 	<ul style="list-style-type: none"> ▪ Employment quality ▪ Health & safety ▪ Training & development ▪ Diversity ▪ Human rights ▪ Community ▪ Product responsibility 	<ul style="list-style-type: none"> ▪ Board structure ▪ Compensation policy ▪ Board functions ▪ Shareholder rights ▪ Vision and strategy

Source: Asset4 AG

Stakeholder Capital	Strategic Governance	Human Capital	Environment
<ul style="list-style-type: none"> ▪ Regulations and policies ▪ NGO's ▪ Customer relationships ▪ Alliance partners ▪ Emerging markets 	<ul style="list-style-type: none"> ▪ Strategic scanning capability ▪ Agility / adaptation ▪ Performance indicators ▪ Traditional governance ▪ International "best practice" 	<ul style="list-style-type: none"> ▪ Labor relations ▪ Health and safety ▪ Recruitment strategies ▪ Employee motivation ▪ Innovation capacity ▪ Knowledge creation ▪ Workplace practices 	<ul style="list-style-type: none"> ▪ Board and executive oversight ▪ Risk management systems ▪ Disclosure & verification ▪ Process eco-efficiency ▪ New product development ▪ Environmental & climate risk assessment

Source: Innvest Value Advisors

ESG data provides an integrated, normalized and comparable measure

The data offers many useful features but also a few draw backs. On the positive side, the data gives an integrated, normalized and comparable measure across ESG areas that would be very difficult and time-consuming for each investor to collect. Also, the data gives an in-depth look at risk areas for a company that are not contained in GAAP statements and allows investors to track progress over time. Finally, the data provides a basis for comparison across an industry so that companies can be ranked against their peers based on ESG performance.

Ranks from one data provider may not compare with those from another provider

The drawbacks stem from the fact that there are no generally accepted principles for measuring ESG components. For instance, one draw back is that scores from one ESG data supplier may or may not be comparable to the scores from another supplier because the methodologies used to derive the scores are different. Another draw back is that scores from one industry are not comparable to scores from another industry because the components for the scores can be quite different. For example, the environmental score for an Energy company may not be comparable with that from an Internet company.

ESG ranks are most meaningful when comparing companies in the same industry

Approaches to Responsible Investing

The availability of ESG data has given rise to a number of strategies for implementing responsible investing. We review a sample of these strategies below:

Investment strategies include Negative Screening, Positive Screening, Engagement, Selected Benchmarks and Full Integration

Negative Screening This approach involves removing selected stocks from an investible universe. By not investing in the worst offenders, the investor favors neutral or positively ranked ESG stocks.

Positive Screening This process aims to reward stocks that meet certain criteria by only investing in the higher ranked ESG companies. Typically, investors wish to reinforce a particular set of values and put return/risk targets as a lower priority.

Engagement This is perhaps the most direct way for investors to implement their ESG goals. It involves a range of options, from placing members on a company board, to voting proxies or participating in shareholder initiatives. Large institutional investors such as CalPERS have outlined a set of guiding policies for engagement on ESG issues.

Selective Benchmarks In this approach, an investor selects a benchmark that has the desired ESG qualities and then selects stocks from the benchmark constituents in an effort to outperform the benchmark.

Full Integration This is the most challenging approach because it consists of integrating ESG criteria into an investment strategy that seeks to outperform a major benchmark.

Several studies have been done to explore if ESG data alone can be used to outperform the market, but the results thus far are not conclusive. For example, the FTSE group has created the 4Good series of indices to cover companies that meet globally recognized social responsible standards. The longer term performance shows these indices lagging behind the benchmark and exhibiting higher volatility.

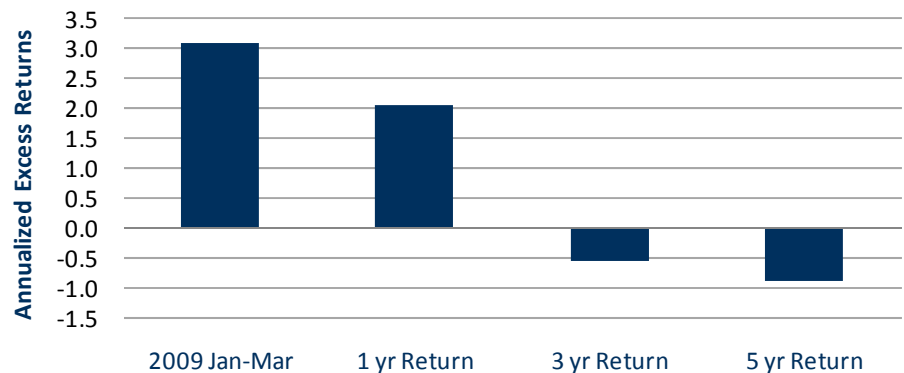
Performance of ESG indices or actively managed ESG funds does not show a persistence of returns

	Total Returns - March 2009						
	1M	3M	12M	3YR	5YR	3yr Vol (pa)	5yr Vol (pa)
FTSE4Good US Index	10.8	-10.7	-37.4	-37.1	-28.4	20.0	16.5
FTSE US Index	8.7	-10.5	-37.5	-33.5	-19.6	18.4	15.3
Excess Returns	2.1	-0.2	0.1	-3.6	-8.8		

Source: FTSE Research

An actively managed universe compiled by the Social Investment Forum showed similar long term results for US large cap funds. In more recent periods, these funds have outperformed perhaps because in the financial crisis of 2008, the

**ESG funds have good performance recently
Less so long term**



Annualized excess returns for Large Cap Equity funds in the Social Investment Forum database compared to the Russell 1000 index. 2009 January to March returns are not annualized

large-cap value, higher yielding companies that typically rank best in ESG were a better defensive investment in the falling market. Over a longer period that incorporates different cycles in the market, the average fund performance lags that of the Russell 1000 index.

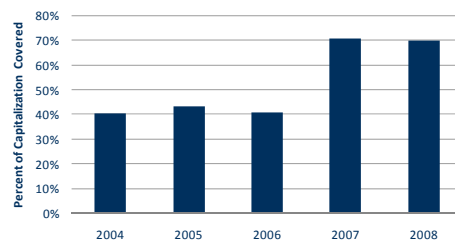
Case Study

The study used historical data in the US Utility sector supplied by Asset4 for the period 2004 to 2008. The data consisted of a numerical rank from 100% for the highest rated stocks to 0% for the lowest. The areas covered were Environmental, Social and Corporate Governance Performance. The scores in each category were combined on an equally-weighted basis.

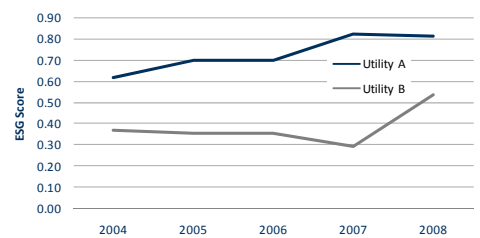
Below are some observations about the data:

More companies are reporting ESG exposures and getting better ranks

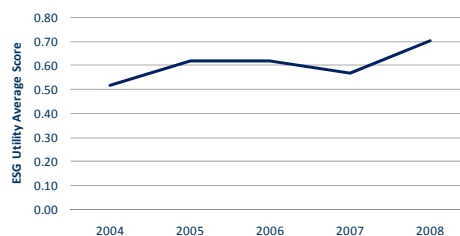
More companies report and are evaluated each year



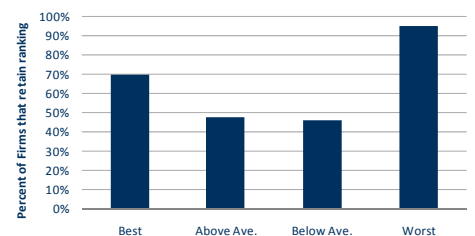
... and company scores tend to improve



... resulting in better industry overall scores



... but best firms one year are still the best the next year



Source: Quotient Investors research, Asset4

Over the 2004-2008 period, increasingly more companies were covered each year, which is a reflection of greater availability of data and greater ability to cover the companies. Coverage remains focused on larger cap companies, so coverage by percent of capitalization in the industry was 70% in 2007-2008 but coverage by percent of firms was less, at 35%.

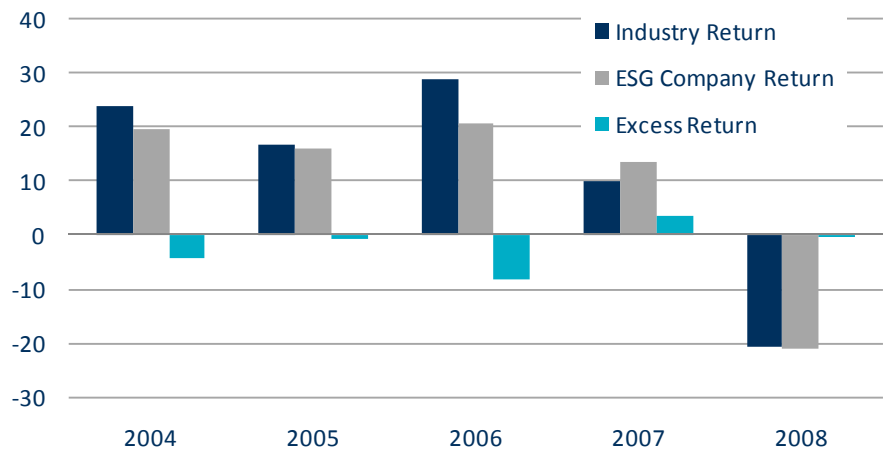
Companies with continuous coverage over the period tended to improve their ESG ranking, perhaps reflecting more compliant ESG policies by company management. At the aggregate industry level, the ESG ranking for all companies covered has steadily improved over the period as well.

Given the nature of ESG data, companies are ranked once a year, so the rank for year-end 2003, for example, evaluates the ESG performance of a company over the entire year. An interesting trend observed in the data is that better ranked companies in one year retained their top ranking in the next. So even if

the overall industry rankings were improving with time, the better ranked companies improved alongside the worst ranked companies and retained their relative position within the Utility sector.

How does the ESG ranking performance stack up? The data was reviewed from two difference perspectives. The first approach was to see if companies that report ESG exposures, whether good or bad, have different stock performance than the industry.

Average annual return comparison

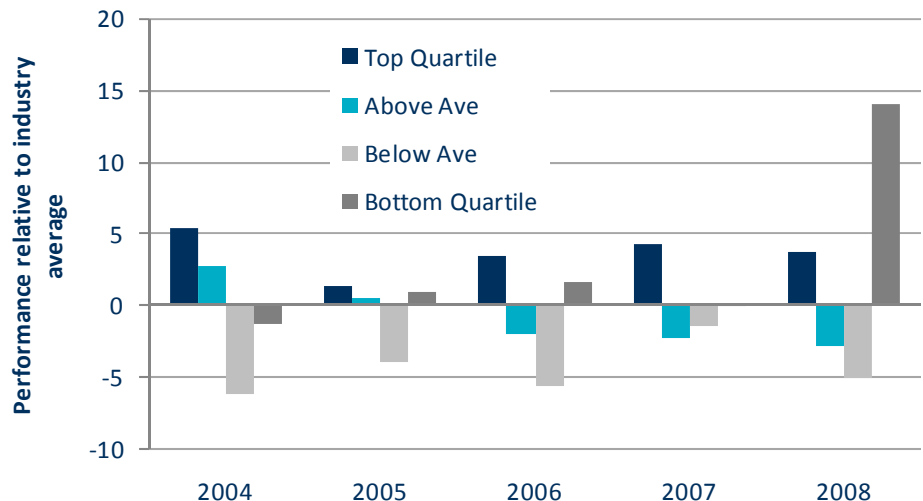


Reporting ESG exposures, good or bad, does not indicate a connection to stock returns

The results for the Utility industry show the same pattern as the FTSE 4Good index performance and the Social Investment Forum fund database. Long term performance does not indicate that there is a stock performance advantage for companies that report versus companies that do not.

What about performance within the narrower set of companies that report? Do

Quartile relative performance



Higher ranked ESG stocks may outperform lower ranks, but the trend is not conclusive

investors reward better ESG performing stocks? The performance of Utility companies was reviewed and divided into 4 quartiles over the period 2004-2008.

There is an indication that stocks with top ESG ranks outperformed their peers with lower ranks. However, the trend was not uniform across quartiles suggesting that the ESG rankings are not consistently associated with stock performance in the Utility sector.

The Challenges Ahead

The implementation of ESG guidelines into actively managed strategies does not currently have a standardized or common procedure. However, it seems clear that for institutional investors to be able to target certain return levels and to meet ESG investment guidelines, asset managers must consider strategies that fully integrate ESG ranks. The challenge here is to pick stocks that have, at the same time, attractive prices and above average ESG ranks.

Another challenge lies in the monitoring and measuring of ESG characteristics within investment plans. How much ESG exposure should a portfolio have to meet guidelines? Can a manager hold a low-ESG ranking stock if the return prospects are good? How should companies with no ranking be treated?

The solutions to these challenges are a work in progress for institutional investors and asset managers alike. Much of the groundwork has already been done, with the United Nations initiative helping to gather interest from institutional investors, public awareness and legislative attention increasing, and coverage of non-financial data becoming more widespread.

For asset managers, however, the challenge ahead is clear. Whether ESG ranks in and of themselves have “alpha” should not be the only measure to implement socially responsible investments. Instead, asset managers need to incorporate ESG ranks into their investment process and provide institutional investors with the desired exposure to ESG characteristics while targeting the required returns.

Full integration of ESG ranks into actively managed strategies will provide funds that target a return level and ESG exposure, and also address the needs of institutional investors.