

## THE MANAGERS

# Money from Trees

Asset managers are finding an unlikely new source of alpha—responsible investing.

By Katie Gilbert

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**PIERRE LAGRANGE, CO-FOUNDER OF \$22 BILLION HEDGE** fund firm GLG Partners, cares about sustainability, but not in a way that would make anybody confuse him with a tree-hugging hippie (despite his shoulder-length locks). In his mind, the most important aspect of problems like greenhouse gases, disappearing natural resources and rising global temperatures is not that they could spell the end of life on earth as we know it. It's that they present an incomparable investment opportunity. As Lagrange, who owns a Harley-Davidson, told the United Nations' General Assembly two years ago when he participated in an informal meeting on investments and climate change, "The environment will be as big as the Internet in its impact on companies and consumer behavior."

To try to capture what he called "green alpha" at the U.N., this spring Lagrange rehired Jason Mitchell, a former long-short portfolio manager who had left the London-based firm in mid-2008 to become chief operating officer of a water treatment company in sub-Saharan Africa. Since April, Mitchell's job at GLG has been to develop an investment strategy that looks to profit from the problems surrounding sustainability, and the world's responses to them.

Lagrange isn't the only alpha-hungry hedge fund manager who has recently begun searching for investment returns in environmental, social and demographic issues, long considered either too soft or too irrelevant to turn the heads of cold, hard capitalists.

New York-based Marathon Asset Management, a \$10.5 billion

credit-oriented hedge fund firm, recently introduced a share class that screens investments based on sustainability issues. Auriel Capital Management, a \$340 million London hedge fund firm, has brought on Adam Seitchik, a former chief global strategist at Deutsche Asset Management, to demonstrate how a built-in consideration of extra-financial factors can punch up performance.

"Hedge funds are purely alpha-driven, so obviously the hedge funds that are doing this see real value in this data," says Darragh Gallant, who runs Jantzi-Sustainalytics, the North American arm of Amsterdam-based Sustainalytics, a research firm that provides analysis on the environmental, social and governance performance (commonly referred to as ESG) of thousands of publicly listed companies. Gallant adds that she's seen a recent surge of interest from hedge funds in the firm's research.

Hedge fund managers aren't alone. Private equity giant Kohlberg Kravis Roberts & Co. is rapidly expanding its Green Portfolio Program, which places a premium on improving the environmental performance of the companies it invests in. (Companies in the program now make up 30 percent of KKR's private equity investments.)

"This really plugs right into our existing infrastructure," says Elizabeth Seeger, who came from the New York-based Environmental Defense Fund to manage KKR's green initiative. "It's still all about creating value. In this case, we're creating two types of value: the environmental benefit as well as the financial benefit."

The tentacles of sustainable investing reach further still, touching equity and fixed-income strategies, mutual fund and institutional offerings, and alternative and core investment products. At Scotland's \$260 billion-in-assets Aberdeen Asset Management, the head of socially responsible investing research, Cindy Rose, is pushing for equity analysts and portfolio managers firmwide to use environmental, social and corporate governance criteria to help pick stocks.

F&C Investments, a \$156 billion asset management firm based in London, started the Emerging Markets Equity ESG fund in March for a group of institutional clients who were looking to invest in emerging-markets equities but were concerned about the corporate governance risk and sustainability problems often inherent in such investments.

"I think it's part of the maturing of the sustainable investment industry, and part of the definition of mainstreaming, that this is being seen as valuable across the spectrum of asset classes," says Michael Jantzi, CEO of Sustainalytics.

The growing legion of mainstream money managers embracing sustainable investing distance themselves from their industry forefathers, the pioneers of values-based socially responsible investing, or SRI. This new crop of managers is unabashedly all about smarter investing and improved returns, not ideological debates about how to make the world a healthier and happier place in which to live. (GLG's Mitchell, for one, says he doesn't entertain discussions about the ethics of his investments.) These managers have been pushed to consider sustainable investing from a fresh perspective for multiple reasons: Their institutional investor clients are more likely to assume a concern for sustainability as part of their fiduciary roles (see "No Turning Back," page TK); a growing body of academic research suggests that

Jason Mitchell rejoined GLG Partners to run a sustainability hedge fund





companies scoring higher on ethical, environmental and social issues have better financial results; and a handful of high-profile money managers are establishing track records on sustainable investment strategies that have outperformed their peers. No wonder some of these managers claim to have found, or be well on their way to finding, a better way to invest.

While the word “sustainability” is often used to connote environmental preservation and all things green, sustainable investing has much broader implications. It is meant to take into account a wider picture of a company’s operations than a traditional investing process might and thereby gain greater insight into the real health, and potential future health, of a business. Sustainable investing emphasizes a company’s environmental impact, social responsibility and response to human rights issues, and corporate governance structure, all of which arguably play important roles in the sustainability of that company — and its share price. For example, a large company’s supply chain might connect it to labor rights violations in a developing country, or its board of directors might be too cozy with its executives — situations that are potential causes of scandals, litigation or reputational damage for a corporation. “Why wouldn’t a professional money manager want to know this stuff?” asks Amy Domini, founder and CEO of New York-based Domini Social Investments, and one of the pioneers of SRI.

The vast majority of money managers, however, have long resisted incorporating environmental, social and governance data into their investment processes. Responsible investing was for decades considered the domain of fringe money managers, whose rhetoric boasted that they could help investors do their part to improve the world. But when it came to performance, SRI managers could only tepidly assert that, at best, their responsible investing tactics wouldn’t affect returns. Most in the larger investment community balked, insisting that imposing nonfinancial constraints on an investment portfolio could only hurt.

That widely held wisdom is rapidly dissolving.

“More and more, we’re seeing evidence that these factors are actually impacting security valuations,” says Kevin Parker, global head of \$725 billion Deutsche Asset Management, which has integrated ESG data into the research platform that portfolio managers access throughout the firm. “So from a fiduciary standpoint, we would be remiss in our duties if we did not take this into account.”

Still, not everyone is convinced that the benefits of ESG outweigh the costs. This is especially true among U.S. money managers, for whom the discussion surrounding sustainable investing is less developed than it is in Europe and Australia, where more investment vehicles integrate ESG data in a fundamental way.

Capturing the benefits of ESG isn’t as easy as turning on a sustainable-investment switch within a fund. Managers who have successfully found ways to implement it tend to echo the same point:

“**What this rebranding does that is beneficial, both from a financial and societal point of view, is it puts the ESG issue front and center for money managers.**

—C.D. Baer Pettit, MSCI

The value lies in each manager’s respective approach to ESG. In other words, the devil is in the investment process details.

“It’s not a silver bullet where you can say, ‘I’ve got this ESG rating that’s going to give me a positive return,’” says Bruce Kahn, a senior investment analyst at Deutsche. “If that were the case, it would be commoditized like P/E ratios. Then there’d be no value to it. It’s in the subjectivity that the portfolio managers bring when they make an investment and in using this information to influence that subjectivity. That’s where the value is.”

ESG implementation is often a process of trial and error. GLG, for example, launched a long-only environment fund in 2007, using data from Trucost, a London-based company that offers research that shows analysts and portfolio managers the carbon footprints of the companies they follow. Lagrange and other members of the investment team believed that by investing in companies that were 30 to 50 percent cleaner than the rest of the market, they could unearth some green alpha. But, as Mitchell recalls, it wasn’t that easy.

“A filter based purely on quantitative environmental data just doesn’t capture factors like regulatory change,” he says. “We’ve learned that you can’t let something like this blindly guide investments. You can use it as an initial screen and then apply layers of intelligence on top of it, but you can’t allow this filter to just steer the fund.”

In other words, successful integration doesn’t mean treating ESG information as a factor that money managers base all decisions on, or ignoring it completely, but simply using it as another tool among a wide array.

More than a few signs indicate that’s exactly where the industry’s headed as ESG becomes more mainstream. In June, MSCI acquired RiskMetrics Group, a provider of risk management analytics that had months before acquired KLD Research & Analytics and Innovest Portfolio Solutions, both longtime SRI research houses. C.D. Baer Pettit, global head of sales and marketing at MSCI, says that clients had been pushing the firm to offer ESG analytics. He believes that folding the ESG indexes into MSCI’s suite of products — and putting MSCI’s name on them — will not only satisfy that demand but drive new demand among the firm’s wide base of clients.

“What this rebranding does that I think is beneficial, both from a financial and societal point of view, is it puts the ESG issue front and center for money managers,” says Pettit.

#### **IN THE EARLY 1980S, AMY DOMINI WAS WORKING IN**

Harvard Square as a retail stockbroker at a small regional brokerage. With a growing level of curiosity, she noted that many of her clients were coming to her with specific companies or sectors that they refused to invest in. For example, a bird-watcher asked Domini what to do about her investment in a large paper company. Another wanted to avoid defense contractors. She set out to research their common plight, which she took to calling “ethical investing.” Coming up empty-handed (save for one article on the Pax World Fund,

**As global head of Deutsche Asset Management, Kevin Parker wants everyone in his firm to understand the importance of ESG factors**

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the first mutual fund that integrated social criteria, founded by two American Methodists in 1971), she prepared an adult-education class on how to invest with ethical concerns in mind. She had no sooner submitted the lesson plans than a publisher contacted her and asked if she'd consider writing a book. In 1984 she published *Ethical Investing*.

In her book, Domini briefly discusses negative screening, which is how most investors up to that point had addressed their social concerns: Anti-Vietnam War activists avoided buying stock in Dow Chemical Co., the producer of napalm; religious investors avoided so-called sin stocks like alcohol and tobacco companies; others divested from companies that did business with apartheid South Africa. But in her book Domini was more eager to talk about positive screening.

"An investor is by definition looking for things to buy, not looking for things not to buy," says Domini. "People didn't want to just divest. They wanted to focus on things that people needed: access to medicine, healthy food, better energy systems."

Though the title of Domini's book didn't stick as a term for investing — the market preferred "SRI," which had been coined about a decade before — the ideas in it proved foundational. In 1990, Domini and partners Peter Kinder and Steven Lydenberg introduced the Domini 400 social index, which tracked 400 mainly large-cap corporations chosen for their positive social and environmental track records. "I wanted to build a record so that if investing this way cost money, I could say, 'This'll cost you an average of 30 basis points a year,'" says Domini. "I didn't see why it would cost money, but I thought, 'Fine, let's see if it does.'"

Indeed, the Domini 400 social index (now the MSCI KLD social index) provided the first hard evidence that this type of investing didn't have to cost money. In its first few years, it performed roughly in line with the market. Since then, it's done better: As of October 31 the index's annualized return for the past decade was 0.07 percent, beating the Standard & Poor's 500 index's -0.95 percent return.

The performance of Domini's index encouraged a slight change of rhetoric around socially responsible investments. Rather than touting ethical investing as worthwhile even at a cost, the handful of SRI evangelists could say that they offered a "free good" — in other words, their style of investing could improve society without impacting returns. But the tactic was still limited to values investors; the larger investment community didn't pay much attention.

Around this time, shareholder activism was starting to gain traction. The concept of banding investors together to change a company's internal practices wasn't a new one: In 1967, Saul Alinsky had led a successful shareholder campaign against Eastman Kodak Co. to get the photo company to improve its minority hiring and training processes. But it wasn't until the late 1980s and early '90s that shareholder activism was seen as a financially viable proposition, says Ralph Whitworth, who during that period was president of the United Shareholders Association, an investor advocacy group started by corporate raider T. Boone



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—Burt Greenwald  
B.J. Greenwald Associates



Pickens. Still, shareholder activism was too rare even to be called a niche strategy: "It was a piccolo that you heard once in a while in the symphony," Whitworth says.

In 1995, Whitworth and David Batchelder, who had worked together as executives at Pickens's Mesa Petroleum Co., founded Relational Investors after winning a \$200 million mandate from the California Public Employees' Retirement System as part of its new corporate governance program. CalPERS remains their largest client, representing about \$1.4 billion of their San Diego-based firm's \$6.1 billion in assets.

By the mid-1990s a small industry had sprouted around SRI. Research shops that specialized in data and analytics for SRI managers had emerged: Kinder, Lydenberg and Domini founded KLD in 1988, and Jantzi Research came along in 1992. (Jantzi and Sustainalytics merged last year.) Other organizations were formed to research and increase awareness of the burgeoning industry. The Coalition for Environmentally Responsible Economies (Ceres) came together in 1989, and KLD helped found the Social Investment Forum in 1995.

In addition to the handful of mutual fund companies that offered SRI products, a few other large firms waded into the industry by offering separately managed accounts to institutional investors with specific requests. State Street Corp. was among the first of the major firms to provide this service, which it began in 1987, screening out companies or sectors to fulfill each institutional client's request.

"The people in SRI vehicles were evangelists for the cause," says Burt Greenwald, president of Philadelphia-based consulting firm B.J. Greenwald Associates. "There was very little widespread support of SRI." The main problem was still performance. "The broad market is driven by performance, and the SRI funds weren't exactly leaping to the top of the charts," Greenwald says.

In 2000, however, a new law in the U.K. led to something of a sea change, at least on that side of the Atlantic. An amendment to the 1995 Pensions Act required pension schemes to disclose the extent to which they considered social, ethical and environmental issues in their investment processes. Over the next few years, similar legislation spread across Europe. Such legislation meant a spike in investor demand for SRI products, and the offerings in the European SRI realm, particularly for institutions, quickly expanded.

No such laws followed in the U.S., though in 2003 the Securities and Exchange Commission introduced a measure that shone a spotlight on mutual funds' proxy voting, requiring that fund companies disclose all relevant policies and actions. For the first time, U.S. investors had a guaranteed look into how their mutual funds were responding to shareholder resolutions on everything from corporate governance to social and climate-change issues. Corporate governance shortcomings — of the type Whitworth and Batchelder had begun mining for value a decade earlier — had recently leaped to the fore. In the early 2000s investors witnessed some dramatic demonstrations of how governance breakdowns could impact shareholder



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—Adam Seitchik  
Auriel Capital Management



value, via scandals and subsequent meltdowns at Enron Corp., Tyco International and WorldCom.

In June 2004 the term “ESG” burst onto the scene and ushered in much more than a change in vocabulary. “Environmental, social and corporate governance analysis” first appeared in a U.N. Environment Programme Finance Initiative report — actually, a collection of 11 studies of nine brokerage houses that the U.N. had commissioned — overwhelmingly supporting the conclusion that ESG factors did in fact affect long-term shareholder value. The new term, scrubbed of values and ethics connotations, and the paper’s conclusion that ESG was material to performance, helped spark the collective idea that ESG integration could itself be a source of alpha. Paul Hilton, director of advanced equities research at Bethesda, Maryland–based Calvert Asset Management Co., says the new buzzword played a crucial role in the growing institutionalization of ESG that soon followed the U.N. report.

“Investors really picked up on this when they saw the transition from values-based SRI to proactive ESG investing,” explains Hilton, whose firm manages more than \$14.5 billion, \$5.3 billion of which are SRI assets. “A lot of that had to do with having the language right.”

The Social Investment Forum reports that in the U.S. so-called SRI assets rocketed to \$2.29 trillion in 2005 from \$639 million a decade before. Two years later that figure had jumped to \$2.71 trillion, an increase of 18 percent (between 2005 and 2007 the broader universe of professionally managed assets only increased by 3 percent). To arrive at these totals, the SIF sends surveys to institutional investors and money managers, asking them to reveal how much of their assets are subject to “environmental or social criteria, policies or screens.”

Following the U.N. report and the release of a few others like it, mainstream managers were eager to figure out how to tap the alpha that ESG was said to provide. A smattering of funds sprang up on the theory that investing along specific ESG themes (most often specifically environmental ones) would be the best way to capture ESG opportunity. Widely read academic research contributed to the excitement: “The Eco-Efficiency Premium Puzzle,” published in the *Financial Analysts Journal* in the spring of 2005, concluded that a portfolio containing companies with high “eco-efficiency” — high production relative to the amount of waste they created — performed better than a portfolio with more-wasteful companies.

Deutsche Asset Management was one of the forerunners in launching thematic strategies focusing on climate issues. Deutsche established its first climate-change mutual fund in 2006, and by March 2009 the firm had \$4 billion in climate-change strategies. Today some \$8 billion of its \$725 billion under management falls under this umbrella, and products range from mutual funds to institutional and alternative strategies.

But these strict thematic funds have performed with wildly varying results. After all, the “eco-efficiency” idea was generally the theory GLG was so excited by when it implemented its ultimately unsuccessful carbon-tracking strategy in 2007. As GLG has now done,

many firms are stepping back and asking what real integration might look like.

“We rank companies on ESG, but we don’t believe that the ESG ranking is all that matters,” says Auriel Capital Management’s Seitchik. “ESG gets a vote, but it doesn’t get veto power and it’s not the dominant vote.” Before joining Auriel in mid-2009, Seitchik was CIO of Trillium Asset Management Corp. and the chief global strategist at Deutsche. He’s now helping Auriel integrate ESG into its investing process.

The poster child for ESG investing is Generation Investment Management, founded in 2004 by onetime Goldman Sachs Asset Management CEO David Blood and former U.S. vice president Al Gore. Although Gore is best known for his fight against global warming, environmental factors are just one piece of the investment puzzle at Generation. The firm’s global equity fund, which accounts for \$6.2 billion of the London-based firm’s \$6.9 billion in assets, invests in 30 to 50 large- and midcap companies based on what Generation considers to be sustainable long-term businesses. According to sources, Generation has beaten its benchmark, the MSCI world index, by 800 basis points a year, on average, since 2005. In 2009 the fund was up 49.03 percent, trouncing the index by more than 18 percentage points.

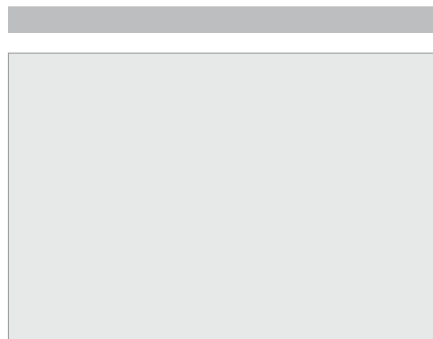
#### DEUTSCHE’S KEVIN PARKER TRACES THE ROOTS OF HIS

interest in climate change to a vineyard that he bought in 1993 in the Languedoc region of France. He decided that he’d convert the vineyard to organic and biodynamic farming, and noted that the Château Maris wine produced there seemed to benefit from the extraction of all chemicals, pesticides and fertilizers from the production process. Ruminations on the sustainability of soil led Parker to study the sustainability of air and water, and before long he was educating himself about the debate surrounding greenhouse gas emissions. He became convinced that the science behind climate change is so indisputable that, as he puts it, “if you’re arguing against the reality of greenhouse gases heating up the planet, you’re a modern-day Don Quixote.”

In 2004, Parker changed jobs, moving from global head of equities at Deutsche to chief of investment management. Not long thereafter, the firm added climate change to its list of megatrends that would shape the asset management industry. Deutsche organized mandatory training events to impress upon its portfolio managers and analysts the importance of climate change and its relevance to what they did.

The theme of Deutsche’s 2007 annual managing directors’ conference was climate change, with Al Gore as the featured speaker. This year’s conference focused on sustainability, and speakers included Jared Diamond, a scientist and author of the book *Guns, Germs, and Steel*; Mindy Lubber, president of Boston-based sustainable investing coalition Ceres; and representatives from individual companies like Cisco Systems, who described the ways in which they are factoring climate change into their business models.

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**continued from page 48** “I don’t think too many people left that conference believing that this was not a business imperative going forward,” says Parker. “I think the skeptics within Deutsche have been silenced.”

Starting in 2007, Deutsche introduced ESG factors into the firmwide investment platform that its portfolio managers use to access fundamental financial data, buy-side reports and sell-side earnings estimates and stock ratings. The ESG data includes companies’ energy and water use, waste management, product toxicity and indications as to how well they understand and manage for changing policies around carbon. Parker acknowledges that the “E” represents the bulk of the ESG data offered on the platform, but Deutsche also incorporates material “S” and “G” data: managers can see red flags spurred by child

of the firm. She says this would be in keeping with Aberdeen’s decision in 2007 to join the U.N.’s Principles for Responsible Investment, which pledge signatories to commit to socially responsible investing. Her efforts are likely to get a boost from the performance of the firm’s SRI funds. In aggregate, they have an average annualized return of 3.86 percent for the five years ended in August, handily beating their benchmark, the FTSE world index, which returned 1.50 percent a year. “It’s a good time, on the back of these strong performance numbers, to more fully understand the ESG risks and attributes of more of the companies in which we invest,” Rose adds.

But ESG integration isn’t always embraced by portfolio managers and analysts. “ESG is something that is still relatively new for fund managers,” Rose says. “But the tide is turning, since the markets — and clients in particular — are demanding that asset managers understand their investments from a 360-degree point of view.”

Another potential problem in integrating ESG at large firms like Aberdeen is that SRI funds may diverge from the rest of the group on certain hot-button issues. An illustration of that chasm is Aberdeen’s stance on its holdings in PetroChina Co., the Chinese oil company that has come under scrutiny from

longer-standing commitment to responsible investing than either Deutsche or Aberdeen. The firm was founded by Quakers in 1868 and launched Europe’s first ethical fund in 1984. But of late, F&C, like these other firms, has been considering how to expand the reach of ESG in its offerings.

Last year, Boston-based consulting firm Cambridge Associates approached F&C on behalf of a group of institutional clients who were eager to invest in emerging markets, hoping to profit from the outsize economic growth that many analysts are predicting for these countries. But the risks that often accompany emerging-markets businesses in burgeoning industries — lack of government regulation, opaque corporate governance structures, excessive pollution, poor labor relations — had given these investors pause.

Working with Cambridge, F&C developed an emerging-markets equities product that, to mitigate risk, integrates a systematic, stock-by-stock inspection of ESG factors. “The fund is meant to be a mainstream approach with a core commitment to ESG that’s embedded in the process,” says Alexis Krajewski, associate director of governance and sustainable investment at F&C.

The Emerging Markets Equity ESG fund, which F&C launched on March 1, passes each stock through three filters. The fund’s managers begin by choosing stocks that look to be driving sustainable economic growth in emerging markets or profiting from the positive trends there. The companies that pass what Krajewski calls the alpha filter are then screened for environmental, social and governance risks. Last, those that make it through the ESG test are scrutinized financially. Being strong across the board in ESG but shaky on financial metrics is not going to get a company into the portfolio.

“We don’t expect our clients to sacrifice performance because they’ve incorporated ESG,” says Krajewski. “On the contrary, they should expect to get a better return by incorporating ESG.”

At F&C about \$4 billion in assets is in dedicated ESG strategies like the emerging-markets fund. But the reach of the ESG analysis doesn’t stop there. “What the governance and sustainable investment team does is help our fund managers really understand where ESG presents risk and opportunity for them,” Krajewski says. “That can be incorporated into any strategy, even if the underlying strategy

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— Alexis Krajewski, F&C Investments

labor violations or issues surrounding licenses to operate, and can pull executive pay figures.

Aberdeen Asset Management is on the brink of a similar firmwide integration, according to head of SRI research Rose. The firm’s SRI division has been growing at a steady pace since Rose arrived in 2001 following Aberdeen’s acquisition of Glasgow-based Murray Johnstone, where she was an investment writer and web editor. At the end of October, the firm had \$1.7 billion across 12 SRI funds, with an additional \$8.7 billion in another dozen products that are not traditional SRI funds but require screening based on extrafinancial criteria.

Rose is hoping to broaden the ESG research and screening process to the rest

human rights advocates, including Investors Against Genocide, for doing business with the Sudanese government as it continues the war in Darfur. Although Aberdeen’s official policy on its investment with PetroChina is that parent company China National Petroleum Corp. (CNPC) is more of a concern, Rose says her team has failed the stock for the SRI basket because of human rights problems linked to Sudan.

“We tell our shareholders, ‘If you’re in our mainstream fund, this is our technical position on it,’” says Rose. “‘If you’re an SRI investor, then we take into consideration the Sudan issue.’ We realize that’s incongruous.”

London’s F&C Investments, which caters to both retail and institutional clients, has a

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doesn't obligate the fund manager to look at ESG the way we do in the emerging-markets fund." For example, Krajewski has worked with the firm's oil and gas analysts to help them understand which companies have the best ESG performance and which present significant risks.

When a portfolio manager's response is along the lines of "I hear your concerns, but this is a strong investment case," F&C often turns to its in-house engagement service, called REO, which stands for "responsible engagement overlay." Through REO, which was introduced in 2000, F&C works with companies in its portfolio to help them move toward ESG best practices.

Marathon Asset Management — founded in 1998 by Louis Hanover and Bruce Richards to invest opportunistically in global credit markets — introduced an ESG-screened share class within its flagship hedge fund earlier this year after the firm had received several client requests similar to those fielded by F&C. The first such request came in early 2009 from a fund-of-funds firm looking for a fixed-income manager that could run an SRI fund for one of its clients, notes chief operating officer Andrew Rabinowitz. Marathon had to say no. At first, Rabinowitz didn't think much more about the subject, but over the next year Marathon received five or six similar requests, and the firm's senior management decided it was

advantages over equities — still the primary forum for ESG integration — when it comes to leveraging investor positions to persuade companies to change their ways. As Rabinowitz points out, with a credit investment, the investor controls a crucial life source for a company: access to capital. "If there's capital available only to those who don't pollute, for example, it may be a good way to get industries more green," he adds.

**THE CATALYST FOR KKR'S DECISION** to embrace ESG came in early 2007, when the New York-based firm teamed up with Texas Pacific Group to acquire Texas power company TXU Corp. At the time, the \$45 billion deal was the largest private equity acquisition in history. It also set an internal precedent within KKR for how private equity ESG investing could work.

Before KKR's investment in TXU, several environmental groups, including the Environmental Defense Fund, had protested TXU's plans to build 11 new coal-fired power plants. Even before the deal was finalized, KKR negotiated on behalf of TXU with EDF and other groups, getting them to agree on a compromise: The new power plants would be reduced to three from 11, and a number of environmental goals and limits, including a cap on carbon emissions, would be imposed on the utility, whose name was later changed to Energy Future Holdings.

## "We aren't just sitting in New York watching these companies perform. We're actually engaging with them."

— Elizabeth Seeger, Kohlberg Kravis Roberts & Co.

time to do something.

The firm decided to engage RiskMetrics, which flags companies in Marathon's Special Opportunity Fund that have some sort of E, S or G issue — those that have been smacked with violations because of pollution or those that are not adhering to labor laws, for example. The companies that fail the ESG screen are put on a restricted list and not included in the SRI share class.

Admittedly new to the concept, Rabinowitz calls Marathon's ESG approach "a starting point." But as he has grown more familiar with ESG issues, he's come to believe that fixed income may offer some inherent

That collaboration between KKR and EDF became the basis of a more formal partnership that the two officially launched in May 2008 with the introduction of KKR's Green Portfolio Program. In the first year, KKR and EDF worked together on three companies for the pilot project and facilitated a collective \$16.4 million in savings for the companies by reducing 25,000 metric tons of carbon dioxide emissions, millions of tons of waste and thousands of tons of paper.

Since the collaboration began, Elizabeth Seeger has played a leading role — first for EDF and then for KKR. Seeger, who has an undergraduate degree in environmental

studies from the University of Chicago and an MBA from the Wharton School of the University of Pennsylvania, joined EDF in the summer of 2007 as a fellow in its corporate partnerships program, which engages companies to help them improve their business practices. After the TXU deal, she was one of the first people at EDF to consider what a more permanent partnership between her group and KKR might look like. Once the Green Portfolio was established, she helped manage the program from the EDF side for the first 18 months before moving to KKR early this year to work with its Capstone group of some 50 consultants who work with portfolio companies to improve their operations.

KKR announced the Green Portfolio's second-year results in June: Companies in the portfolio had saved a collective \$160 million by cutting out 345,000 metric tons of carbon emissions, 1.2 million tons of waste and 8,500 tons of paper.

Dollar General Corp., a leading discount retailer, enrolled in the program in 2009 and, with the help of KKR Capstone specialists, has focused its efforts on improving energy efficiency in its stores and distribution fleet, and on reducing cardboard waste. KKR reports that, to date, Dollar General has eliminated \$106 million in costs, reduced its emissions of greenhouse gases by 160,000 metric tons and improved waste efficiency by 75 percent.

The Green Portfolio now covers about a third of the firm's private equity investments. Seeger says private equity is in many ways a natural fit for this type of ESG integration because of its governance structures, its relationships with its portfolio companies and its focus on creating long-term value in companies. Seeger adds that the longer-term, in-person involvement that the KKR Capstone team brings to its portfolio companies means the firm has more say in suggesting and implementing changes.

"We aren't just sitting in New York watching these companies perform," she says. "We're actually engaging with them on the ground."

The ESG effort at KKR doesn't stop with making portfolio companies greener. Social risk awareness is becoming an increasingly important subject within the firm too. KKR recently partnered with San Francisco-based Business for Social Responsibility, which



works with member companies to promote sustainability. KKR has also launched a responsible-sourcing initiative that seeks to teach the firm's portfolio companies more about supply-chain and human rights issues. Half of KKR's portfolio companies have participated in events focused on the subject of sourcing, including a half-day conference where experts gathered to speak about the issue. Seeger says KKR hopes to hold such conferences in China, where several KKR Capstone professionals are based.

Auriel Capital managing director Seitchik says that when he joined the quantitative hedge fund firm 15 months ago, he was intent on instilling in its portfolio management team

ESG, and then we did a backtest adding ESG and it enhanced the performance by adding about a half percent to an 8 percent return," he explains.

Early next year, Auriel, with support from Trillium, intends to launch an absolute-return (long-short) equity hedge fund. The fund will fully integrate ESG research, using indicators in each of 23 sectors based on their expected impact on mitigating risk or enhancing return.

But Seitchik stresses that while ESG indicators can influence stock selection, it's important that they "at times get outvoted by traditional financial themes." He gives the example of Swiss Re, a Zurich-based

approach GLG's second incarnation of a sustainable investment strategy, the lesson learned from the firm's failure plotting carbon output remains at the forefront of his mind. He says that by focusing solely on companies' carbon footprints, GLG was missing the point of investing sustainably.

"What I'm trying to do as I build this new strategy is look at it from a very Darwinian perspective," Mitchell says. "What industries and companies will benefit the most from changes that relate to sustainability? Those changes could be greater demand for products like energy-efficient lightbulbs, or they could be regulatory changes for tightening emissions standards. They could come from revaluations of older-economy efficiencies, like if a booming recycling business suddenly has more value because of resource scarcity."

Mitchell's self-defined task is to find the companies best positioned to profit from global responses to sustainability problems — and at this point, he's not looking for the cleanest ones. He's been digging deeply into themes such as social housing, health care provisioning and energy efficiency in countries like China, whose government is devoting massive funds to address these and other issues. He's added Wacker Chemie, a Munich-based polysilicon producer for the solar industry, to the fund because it is poised to help answer China's demand for renewable energy; Novo Nordisk, a Danish insulin provider with a 60 percent market share in China that will likely grow on the back of government funds being funneled into health care; and Hong Kong-based Xinyi Glass Holdings, which produces glass products for low-cost housing in China.

"We're making the bet that this is such a big area of necessary investment and regulation, and such a massive trend, that it will stay with us for at least the next 20 or 30 years across a number of sectors — from agriculture to infrastructure to transportation to health care and education services," he says. "When your strategy is taking into account something as broad as sustainability, your reach extends to all of the facets of life and resources that it affects."

If investors like Mitchell, Seitchik and Parker are right, the impact on the money management industry will be equally everlasting. ●●

## **“We’re making the bet that this is such a big area of investment that it will stay with us for at least the next 20 or 30 years.”**

— Jason Mitchell, GLG Partners

the idea that ESG analysis can fit naturally into a firm's existing investment framework. This is particularly true, he notes, for a hedge fund on the lookout for the next great source of alpha.

For many years, Seitchik worked at large mainstream investment institutions, like Wellington Management Co. in Boston, where he was an analyst and portfolio manager, and then Deutsche, where he was the London-based chief global strategist (before Parker's arrival at the firm). In 2004 he decided to focus his career on responsible and sustainable investing and became CIO at Trillium Asset Management, a \$1 billion-in-assets Boston-based firm dedicated to that approach.

Seitchik has introduced Auriel's portfolio managers and analysts to the idea that ESG research allows them to score companies based on environmental, social and corporate governance health the same way they are already scoring them on traditional valuation and profitability. "In a way, it wasn't a huge change for Auriel, because we're always looking for the next thing that might give us a little bit of an edge," Seitchik says. "It fit very seamlessly into the investment process."

Auriel has been researching an ESG strategy to find out whether it really does add value — and if so, exactly how much. The results have been encouraging, Seitchik says. "When we did the test, we looked at the performance of the portfolio without

reinsurance company that promotes sustainability by developing products related to climate change. The company, however, scores poorly on valuation and investor sentiment. As a result, Auriel is underweight its stock (though Seitchik says he's less negative on it than he would be without the strong ESG tie-in).

By contrast, Amsterdam-based Royal Philips Electronics presents a good short-term trading opportunity and a strong valuation, as well as solid ESG factors such as significant resources devoted to research and development and energy efficiency. "The ESG analysis has increased the size of what was already an overweight position," Seitchik says.

GLG's Mitchell, for his part, is working to build a strategy that isn't defined by its inclusion of ESG data but rather uses it as yet another dimension to augment and define a broad-ranging investment process. To illustrate the wider gaze Mitchell's strategy is taking, the fund he's overseeing will be renamed the GLG Global Sustainability Fund (from the GLG Environment Fund) at the beginning of 2011. Since Mitchell changed the focus after rejoining GLG earlier this year, the fund has thrived. As of November 1 it was up 7.61 percent for the year, beating its benchmark, the MSCI Europe index, by nearly 300 basis points, even though it has underperformed the index since its launch in 2007.

As Mitchell has considered how to best

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