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Deres referanse	Vår referanse (bes oppgitt ved svar)	Dato
08/694 TM	*Niklas Kreander*	*19. august 2008*

Høring - evaluering av de etiske retningslinjene for Statens Pensjonsfond

Det vises til høringsnotat av 18.06.2008 vedrørende Evaluering av de etiske retningslinjene for Statens Pensjonsfond. Kommentarer til høringsnotatet er lagt ved i notatet "Some thoughts about the Ethical investment policy of Statens Pensjonsfond Utland". Notatet er utarbeidet av Niklas Kreander, førsteamanuensis ved Høgskolen i Telemark.

Notatet omhandler i første rekke bruken av positive kriterier som virkemiddel i fondsforvaltningen. Notatet kan oppsummeres i følgende tre hovedpunkter:

- Vi støtter i utgangspunktet den eksisterende etiske investeringspolitikken, men argumenterer for at det er behov for ytterligere studier i bruken av positive kriterier.
- Flere organisasjoner og fond som over lengre tid har operert med positive kriterier, hevder å ha oppnådd god avkastning.
- De faglige argumentene som reises mot bruk av positive kriterier har metodiske svakheter og gir dermed et utilstrekkelig beslutningsgrunnlag.

Med hilsen

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Some thoughts about the Ethical investment policy of Statens Pensjonsfond - Utland

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Background

The importance of ethical conduct in business has a long history and some texts covering business ethics issues are 3000 years old (Gorringe, 1994; Hancock, 1999). Methodists and Quakers have invested ethically many years before ethical retail funds were available (Hancock, 1999; Shepherd, 2000). Ethical funds available for individual investors were launched in Sweden (1965), USA (1971)[1], France (1983), UK (1984) and Norway (1989) (Sparkes, 1995; Kreander, 2002).

Institutional investors have a longer history of ethical investment than the funds available for individuals. Investors such as the Church of England has invested ethically at least since 1948 (Sparkes, 1995) and the Church of Scotland since 1932 (Church of Scotland, 1988). According to Sparkes (1999), charities and churches in the UK had £23.5 billion invested ethically in 1999 compared to £3.2 billion in ethical retail funds. At that time there were 160 ethical retail funds in Europe and by summer 2001 the number had grown to 252 (Bartolomeo and Daga, 2002). In December 2005 socially responsible investment in Europe amounted to €105 billion (Eurosif, 2006).[2]

A recent phenomenon in Europe is the development of ethical indexes such as the Dow Jones sustainability indexes (launched in 1999) and the FTSE4Good indexes (launched in 2001)[3]. Ethibel in Belgium launched ethical indexes in 2002. Although these indexes are increasingly important they have not shaped the ethical investment movement in Europe and some studies suggest they may not be very useful as benchmarks for ethical funds (Bauer *et al.,* 2005).[4]

In Norway a large part of the revenues from petroleum activity are channelled into the state pension fund (Staten pensjonsfond – Utland)[5]. This fund invests in securities in non-Norwegian companies. Since 2004, the operations of this fund have included ethical criteria which have led to the exclusion of a small number of companies (mainly producers of weapons such as cluster bombs and nuclear weapons). In March 2007 the fund invested in more than 7000 companies and excluded 17 weapons producers and four other companies (St.meld.nr. 24, 2007). The number of excluded companies increased to 27 in January 2008 (St.meld.nr. 16, 2008). The existing ethical criteria and the analysis of ethical issues pertaining to the companies seem to work well.

We support the existing ethical criteria for the Norwegian state pension fund. However, we do not believe that support of proven existing (negative) ethical criteria rules out the possibility

[1] American Christians had launched funds with ethical criteria as early as 1928 and in the 1950s but these were not widely know to be ethical funds (Melton and Keenan, 1994).
[2] Core Socially Responsible Investment include: Ethical exclusions and positive screens (Eurosif, 2006).
[3] We note that the US based Domini Social Index has a longer history, it was launched in 1990.
[4] FTSE4Good claimed to have around 60 clients using their indexes in July 2008. Personal communication with FTSE 3.7.2008.
[5] There is also a pension fund investing in Norway, Folketrygdfondet.

of using positive criteria. This response to the consultation about the Norwegian state pension fund is structured as follows: First, we provide examples of funds and organisations that have used positive ethical criteria in their investments. Second, we provide comments on the analysis by Johnsen and Gjølberg (2008). Third, we provide some initial thoughts about options for the Norwegian state pension fund in regards to positive ethical criteria. Finally, we offer conclusions.

Examples of funds using positive ethical criteria

The largest and most established ethical retail fund(s) in the UK, the F&C Stewardship fund(s) (launched in 1984) use both positive and negative ethical criteria. Independent studies have documented strong financial performance by these funds (WM Company 1996, 1999, Kreander *et al.,* 2002). Good financial performance has also been documented for the Henderson Global Care funds, which also use both positive and negative criteria (Gregory *et al.,* 1997).

One of the largest and most respected grant giving charities in the UK: The Joseph Rowntree Charitable Trust has for many years successfully combined positive and negative ethical criteria in their investment policy (Joseph Rowntree Charitable Trust, 2003-5).

Qualitative screens with a positive aspect have long been used by many ethical funds in the US (Kinder *et al.,* 1993).

An interesting Norwegian example of combining positive and negative ethical investment criteria is Opplysningsvesenets Fond (OVF). OVF invested two billion NOK in securities in 2006 (OVF, 2007). OVF also invest a small part of their assets in ethical funds (OVF, 2003; OVF, 2006; 2007).

While other examples of the use of positive criteria could be mentioned, we think that this area warrants further study. An investigation of how various organisations and funds have implemented positive (and negative) investment criteria in several countries would provide important background information for decisions about the ethical investment policy of the Norwegian "Statens Pensjonsfond - Utland".

Some comments on the Analysis by Johnsen and Gjølberg (2008)

The report by Johnsen and Gjølberg (2008) provides important insights into ethical investment in general and particularly in relation to the performance of certain ethical indexes. At the same time we suggest that it does not provide a definitive basis for a decision regarding use of positive screening for the Norwegian "Statens Pensjonsfond - Utland". Our view is based on the following four reasons.

1. <u>It is possible to pursue more than one strategy</u>

Johnsen and Gjølberg (2008) seem to imply that Statens Pensjonsfond Utland should either continue implementing existing negative criteria or adopt (new) positive criteria for the entire fund. However, many large investors use a variety of strategies for managing their assets. There are many examples of this among pension funds including Calpers, the largest US pension fund and the Swedish AP2 fund. We also note that combining negative and positive criteria is practiced by many ethical funds, for example funds managed by financial institutions such as: CFS, F&C, Henderson, Jupiter and Standard Life. Some charities also use a combination of positive and negative criteria (Eg. Joseph Rowntree Charitable Trust in England and OVF in Norway). Many ethical indexes also use both approaches (Johnsen and Gjølberg, 2008).

We propose that positive criteria for selecting companies could be used for a subset of the assets of the Statens pensjonsfond - Utland. If positive criteria were applied to a small part of the fund, such as 1 -10% of the total assets, some of Johnsen and Gjølberg's (2008) arguments against positive selection would not be relevant.

2. One cannot answer the question about use of positive ethical criteria merely by analysing financial performance of some ethical indexes (Bauer *et al.*, 2005)

The empirical analysis in Johnsen and Gjølberg (2008) focuses on analysing the financial performance of the Domini Social Index, the Dow Jones Sustainability Indexes and FTSE4Good indexes. However, ethical indexes are a much more recent phenomena than ethical investment. We are therefore not persuaded that it is possible to evaluate the use of positive ethical criteria merely by examining some ethical indexes. For example Bauer *et al.,* (2005) concluded that the Dow Jones Sustainability Indexes and the Domini Social index were **less useful** than standard indexes in evaluating the performance of ethical funds.

We note that some studies document that ethical funds are tilted towards small companies (Bauer *et al.,* 2005; Luther and Matatko, 1994). These studies stand in contrast to Johnsen and Gjølberg's (2008) suggestion that positive selection would lead to a large company bias.[6] Strong financial performance by ethical small company funds is discussed in Bulleid (2005).

We think it is important to consider funds and organisations which have implemented positive investment criteria in practice rather than focusing solely on ethical indexes when considering the use of positive criteria.

3. It is unclear whether performance effect is due to negative or positive screening

We are concerned about the attribution of performance in Johnsen and Gjølberg (2008). The report provides some interesting discussion as to whether company size, sector or regional bias might explain differences in performance of ethical indexes compared with benchmarks. However, we do not think that the analysis clearly separates the effect on financial performance from positive as opposed to negative screens. It is not clear if the effect on performance for Domini 400 and/or FTSE4Good indexes in their analysis is due to negative or positive screening. If the effect on performance is mainly due to negative screens the study provides only limited evidence about the effects of positive screening. For example FTSE4Good excluded 141 companies due to negative criteria in June 2008.[7] These negative exclusions might be responsible for a substantial part of the difference in performance compared to benchmark (rather than the positive ethical criteria).[8]

4. The report omits relevant literature

[6] We acknowledge that institutional SRI funds are more prone to invest in larger companies (Eurosif, 2006).

[7] Personal correspondence with EIRIS in June 2008.

[8] It is also possible that the selection of firms in some cases was due to financial and not ethical criteria. We are therefore not convinced that the differences in performance can be attributed to positive ethical criteria.

Many papers and studies relevant to the question(s) are not included in Johnsen and Gjølberg (2008).[9] We think some of these omitted studies provide further insights about return and risk in ethical investment (and positive screening) and briefly refer to a few studies below.

Two German finance scholars found that positive ethical selection of US stocks produced significant outperformance in the 1992 – 2004 time period. They conclude that: "The best in class approach typically lead to the highest alphas (up to about 8.7% per year)." They also find that this approach works best in combination with several socially responsible (SRI) invesment screens (Kempf and Osthoff, 2007). They consider more than 500 companies in their main analysis, including those in the DS 400 index. This study finds superior financial performance for a portfolio of US stocks with high SRI ratings.

In an extensive study of the FTSE4Good indexes Cobb *et al.,* (2005) conclude that there is no significant difference between the financial performance of the FTSE4Good indexes and their benchmarks. The same conclusion is maintained in an update by Collison *et al.,* (2008) although they do note that FTSE4Good performance was better pre than post launch.

From a practitioner perspective, Lim (2006) writes about integration of environmental and governance issues into Morley's investment practices. Morley is a UK financial institution, which managed £160 billion in April 2008. Morley is committed to active fund management (Lim, 2006). Lim argues that Morley's view is that considering environmental, governance and social issues will lead to financial outperformance in the long term. Lim claims that the stocks available for Morley's SRI funds 1994 – 2004 outperformed the excluded stocks.[10]

In a study of 30 ethical funds in four European countries, Kreander *et al.,* (2005) found that ethical funds had significantly lower standard deviation and beta values than non-ethical funds. There was no significant difference in risk adjusted financial performance between ethical and non-ethical funds. These results were similar to earlier findings by Mallin *et al.,* (1995) and Gregory *et al.,* (1997) for UK ethical funds and results by Bauer *et al.,* (2005) for German, UK and US ethical funds.[11] We move on to consider different options for Statens pensjonsfond - Utland.

Some thoughts about options for the Norwegian state pension fund

There are several ways in which the Norwegian state pension fund could implement positive ethical criteria. One way is to simply buy shares in existing ethical funds which use positive criteria. Alternatively, given the size of the Norwegian state pension fund it is also possible to create a new portfolio managed by criteria specified by the Norwegian state pension fund.

[9] We note that Johnsen and Gjølberg (2008) do recognise that they don't consider all the relevant studies (p15).

[10] Lim (2006) mention that Morley made a profit by investing in a Scottish Energy company identified through climate change factors. Positive selection was integrated into financial analysis and provided a positive return.

[11] Somewhat different results were found by WM Company (1999). They documented marginally higher volatility for UK ethical funds compared to mainstream funds. However many non-ethical funds had higher volatility than the ethical funds. They noted that the marginally higher volatility for ethical funds on average may have arisen from ethical funds having higher exposure to small companies. More recently Gregory and Whittaker (2007) concluded that ethical investors do not lose out compared to ordinary investors.

The implementation of positive criteria can be pragmatic in a similar way in which the negative criteria are. For example, the fund has never excluded more than 30 firms, while investing in 7000. Similarly, the number of companies invested in (or "overweighted" in portfolio) for positive reasons could be limited to 70 companies (or 1–5% of fund assets). Such over or underweighting of shares compared to benchmark (for financial reasons) is standard practice for many fund managers. The Domini Social Index, which according to Johnsen and Gjølberg (2008) had a higher financial return than its benchmark has had for many years, included 50 companies with a good environmental, social and/or governance track record. In other words, they have employed positive selection, whilst maintaining financial performance.

Another possibility for the Norwegian State Pension Fund is to create a new sub fund. In this case, no numerical restrictions on numbers of companies would need to be applied. A sub fund applying positive ethical criteria and the existing negative criteria can still include several hundred companies. More than 800 companies met the positive criteria for FTSE4Good in June 2008.[12]

The use of positive criteria in areas such as child labour and children's rights would give additional credibility to the ethical investment policy of the fund.[13] This approach would enable the fund to invest (and overweight compared to benchmark index) in a few companies with good practice on human rights and furthermore justify the human rights rationale to other investors and the public.

There is considerable discussion in St.meld.nr.26 (2008) about investing in high risk emerging markets such as Colombia, Pakistan and Thailand. The Bank of Norway is advocating such investment. We question whether investments in these high risk countries are less risky than identifying a limited number of companies through positive selection.

Should the Norwegian State Pension fund choose not to pursue positive criteria, an alternative could be extending the negative criteria of the fund.[14] NGOs such as Kreftforeningen have called for tobacco producers to be excluded. Restrictive laws regarding smoking have been approved in many countries (for example, Ireland and the UK). Pension funds such as Calpers in the USA avoid tobacco producers. It is also a common screen for charities and ethical funds.

Conclusions

We have participated in the consultation process of the ethical guidelines for the Norwegian State Pension Fund. We support the existing ethical investment policy but argue for further study of the effects of positive criteria before this option is rejected. Many organisations and funds which have operated positive ethical criteria for years claim to have achieved good financial results.

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[12] Personal communication with EIRIS, 25.6.2008.
[13] by the end of 2006 only one company had been excluded on human rights grounds (St.Meld.nr.24). In 2007 three other companies were excluded for human rights violations and environmental issues. (www.regjeringen.no) accessed in June 2008.
[14] The fund can of course both expand negative criteria and introduce positive criteria.

We have argued that ethical investment has been practiced for more than 70 years by some institutions and more than 20 years by some retail funds. Ethical indexes are more recent and a study of financial performance of a few ethical indexes is not sufficient for a decision about whether or not to employ positive ethical criteria for the state pension fund. We think that funds and organisations which have operated positive ethical criteria also needs to be studied.

Many organisations apply ethical criteria for a subset of their assets and this model could be a possibility for the Norwegian state pension fund regarding positive ethical criteria. We suggest the State pension fund could establish a small sub fund, which would apply positive criteria. Alternatively, the State pension fund could invest a small part of its assets in existing ethical funds which employ positive (and negative) investment criteria.

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