



Alternative assets and responsible investment: **a new combination**

Like salt and pepper or fish and chips, some things naturally go together. But every great partnership has to start somewhere and responsible investing and alternative assets could be coming together in the investment world as a new double act.

Matthew Craig reports

At first sight they may seem an unlikely combination, but there is a growing convergence between alternative assets and the application of the principles of responsible investing. Responsible investing uses ethical, social and governance (ESG) criteria in investment decision-

making in the belief that long-term investors, such as pension funds, need to take account of issues such as climate change and sustainability that can have financial consequences (see further in *FSR, April 2007, 46-9*).



Erik Breen,
Head of Corporate Governance
and Sustainability, Robeco

Traditionally, ethical or socially responsible approaches to investment have been associated with long-only equity investing, but they are becoming more prevalent in alternative asset classes such as private equity, property and infrastructure, where investors typically have a long-term perspective and the underlying assets can be illiquid. In addition, the large and relatively sophisticated pension funds which are most likely to embrace responsible investing are among those more likely to diversify into alternative assets

Dutch fund manager Robeco runs a sustainable private equity mandate for the Environmental Agency pension fund and Robeco's Head of Corporate Governance and Sustainability, Erik Breen, commented on the trend: "We believe responsible investing is here to stay. It started in the listed equity area, but will definitely affect other investment decisions. The nature of private equity,

and financially. The changing environment will be more destructive to buildings, potentially shortening life spans and making maintenance more costly, while choosier tenants are less likely to occupy unsustainable buildings, lowering returns as a result."

Mercer Head of Responsible Investing, Europe, Emma Hunt, said that many property managers are now increasingly looking at environmental factors as part of their due diligence work. "It is not just the niche fund managers, some of the big firms are doing this. PRUPIM has been very vocal about this," she commented.

Supporting infrastructure

If taking a responsible investor approach is now part of mainstream property investing, then it is also likely to be applied in the area of infrastruc-

Major institutional investors such as the Environment Agency Pension Fund are seeking to apply responsible investing across their entire portfolio. Once scheme trustees become comfortable with thinking about the ESG issues in an area such as property, they will find it easier to apply the same principles in other asset classes.



Emma Hunt,
Head of Responsible Investing
Europe, Mercer

where it takes on long-term holdings in specific companies, fits very well with the long-term nature of looking at sustainability decisions."

A new climate for property investment

Interest in how ESG factors should be integrated in investment decision-making has been promoted by initiatives such as the United Nations Principles for Responsible Investment (UN PRI) and groups like the Institutional Investors Group on Climate Change (IIGCC). The IIGCC recently produced a report, *A Changing Climate for Property Investment: A Trustee's Guide*, which looked at the contribution of property to climate change and risks created to property investment and performance by the negative impacts of climate change. At the launch of the report, Paul McNamara, Head of the IIGCC Property Working Group and Head of Property Research at property manager PRUPIM, commented: "Property investments face a climate change double whammy in the years ahead as global warming affects assets both physically

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ture investment, where similar issues exist. Here, for underlying assets such as power stations, questions are likely to be asked over sustainability and carbon emissions and long-term investors are likely to take these issues into account. Major infrastructure assets, such as airports, toll motorways, tunnels or bridges, may be partly under political control and thus especially sensitive to environmental concerns. FairPensions Director of Campaigns Duncan Exley commented: "If you are investing in airports and emissions targets are coming in and you have not looked at that, you might find you have a problem."

While using responsible investment principles for property and infrastructure is an increasingly obvious move, it is also seen as appropriate in private equity investing. Robeco's Breen said that it can take two forms; one is to limit the investments to private equity assets which score well on ESG criteria. In this case, the private equity fund may be run on thematic lines, such as clean tech private equity fund.

The second approach is to look at more mainstream private equity projects, but to take ESG criteria into account in investment decisions and to engage in a dialogue with companies and push for more responsible behaviour.

Breen commented: "These two different approaches in private equity can be compared to similar approaches in equity investing. There are thematic equity funds, for water or smart energy for example, or more mainstream funds where investors apply a policy of voting, engagement and dialogue with companies." Breen added that the UN PRI are not intended to be limited to equities. He added: "I think responsible investment principles will be integrated more and more into investment decisions made within the alternatives space."

Clean tech private equity

Hunt also sees this as a growing trend and said Mercer has done some searches for clients looking at clean tech private equity fund. "When you are thinking about opportunities in private equity, there are a large range of funds out

return from turn-around deals, hedge funds have been associated with taking a short-term perspective. As such, it might seem improbable that they could espouse responsible investing, but apparently this is not so far-fetched. Hunt said: "I don't necessarily go along with the argument that hedge funds always take a short-term perspective – they can take responsible investment issues into account within their investment approach."

Breen added that for hedge funds taking short positions in stocks, ESG criteria could be part of their risk assessment, with companies that have a less responsible approach being more likely to fall in value as a result of being marked down by investors. Breen also sees ESG criteria becoming part of quantitative analysis of companies, as responsible investing becomes more integrated into mainstream investment decision-making. "It can be difficult to get your hands on really good historical data. We are lucky to have Sustainable Asset Management at Robeco, which has a strong track record and its investment process takes a much more fundamental approach, also supported by an extensive proprietary database."



Duncan Exley,
Director of Campaigns,
FairPensions.

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there with some very sophisticated managers running them. There are some good quality, well-researched clean tech private equity funds," she commented.

Private equity funds of this type will stick to the 'back to basics' essentials of finding and nurturing start-ups and small companies with innovative technology in an economic growth sector, rather than indulging in the type of financial engineering and mega-deals which have arguably blighted private equity in recent years. This is likely to be attractive to investors who are seeking the uncorrelated returns and illiquidity premium that characterise private equity.

Like some private equity funds looking for a quick

Overall, it seems that responsible investing will be applied to alternative assets on a much greater scale in the future than has been the case hitherto. Major institutional investors such as the Environment Agency Pension Fund are seeking to apply responsible investing across their entire portfolio and Hunt points out that once scheme trustees become comfortable with thinking about the ESG issues in an area such as property, they will find it easier to apply the same principles in other asset classes.

So with more and more investors accepting the argument that benefits of responsible investment outweigh any costs it imposes, we are likely to see more alternative asset managers applying responsible investment principles. ■