Strategies & Countermeasures on Portfolio Management based on SRI

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Abstract :
In theory and practice, there is a growing interest in sustainability and social responsibility issues. Given this development, the question arises of how these issues can be integrated into the investment decision-making process. The investment portfolio, which describes the investment opportunities in terms of a set of attributes and part of that group, aims to capture the impacts on society. We associate here with the emerging literature on SRI: a socially responsible investment. Given the multiple attributes of individual investment opportunities, we show how they can be integrated into portfolios with the same portfolio characteristics. We also show how the manager can systematically support the choice between different portfolio features. Within the frame, we use multi-standard decision tools

Mots Clés : *Socially responsible investment, Portfolio management, Environmental, Social and Governance (ESG) criteria*

ملخص:
من الناحية النظرية وكذلك من الناحية العملية هناك اهتمام متزايد بقضايا الاستدامة والمسؤولية الاجتماعية. وبالنظر إلى هذا التطور، يطرح السؤال كيف يمكن إدراج هذه المسائل في عملية اتخاذ القرارات المتعلقة بالاستثمار. تهدف المحفظة الاستثمارية التي توضع فيها فرص الاستثمار اعتمادا على مجموعة من الصفات وجزء من هذه المجموعةيهدف إلى اسقاط آثار تكون ايجابية على المجتمع. هنا نحن نربط مع الدراسات السابقة حول الاستثمار المسؤول اجتماعيا: SRI. ونظرا لأوصاف متعددة السمات لفرص الاستثمار الفردي، فإننا نعرض كيف يمكن دمجها في محافظ ذات نفس الخصائص على مستوى المحفظة. كما نعرض كيف يمكن دعم متخذ القرار بشكل منهجي في الاختيار بين ملامح محفظة مختلفة. وكجزء من الهيكل نستخدم أدوات اتخاذ القرار متعدد المعايير.

الكلمات المفتاحية: الاستثمار المسؤول اجتماعيا، إدارة المحافظ، المعايير البيئية والاجتماعية والحوكمة

1. Introduction:

In 500 BC, the Chinese military strategist Sun Tzu wrote in The Art of War: 'Generally, one that occupies the battleground first and awaits his enemy is peace of mind; who arrives late and joined the battle in haste is exhausted. Therefore, the one who is gifted in the art of war draw the enemy on the battlefield and not the reverse.' As a general campaign, the investor who wants to manage its portfolio of financial assets wisely is to establish long-term plans and be prepared to deal with unforeseen market by taking initiatives.

2. Discussion regarding the contemporary research

There is currently no consensus on the exact terminology of "Socially Responsible Investment ". This semantic disagreement comes primarily (O'Rourke (2002)) the existence of a multitude of funds and rating agencies seeking to differentiate themselves from each other despite a relatively similar offers socially responsible products.

A review of terminologies frequently mentioned in the literature and the main market players nevertheless distinguishes a global trend. Cowton and Sparkes (2004) and distinguish two recurring names in the multitude of terms (social, ethical, green development, responsible, etc.): ethical investment on the one hand and the other responsible investment.

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Ethical investment is the most ancient phraseology. It originates from the first investors to consider ethical parameters in their choice of portfolios: American churches, English and Australian. Cowton and Sparkes (2004) define ethical investment as "the application of ethical and social criteria in the selection and management of investment portfolios generally consist of actions".

According to Sparkes (2001), this terminology called two challenged:

- First, there can be no agreement on the definition of "ethical" in a pluralistic society.
- Then the name "ethics" associated with an investment fund opposes absence of altruism in this area, the search for maximum profit is incompatible with values such as helping others to his own depends for example. It derives in fact the investor himself and not the company in which he is involved.

Therefore, this definition would apply primarily to organizations whose primary purpose is not monetary namely: the Church, NGOs, etc.

Responsible investment is meanwhile following the gradual diversion of the term "ethics", mainly because of its connotation too moralistic and religious makes inappropriate term for a large part of the so-called responsible investors. The term "ethical" in fact leaves assume a traditional investor would occupy a de facto position "unethical" and therefore seems too extreme to be widely adopted. This semantic evolution has led the two main representative bodies for Responsible Investment, the Social Investment Forum (SIF) in the United States and the European Sustainable Investment Forum (Eurosif) in Europe to define the responsible investment more or less accurate:

The Social Investment Forum and announces: "Socially Responsible Investing is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. It is a process of identifying and investing in companies that meet certain baseline standards or criteria of CSR and is increasingly practiced internationally".

Eurosif for its part, wants more precise by proposing a definition that includes the traditional constants among the various existing variants under which a socially responsible investor would be concerned by the environmental, social and government, these being important criteria determination of long-term performance. A distinction is proposed between

- Responsible investment, taking into account extra-financial factors in the analysis of portfolios
- Socially Responsible Investment, which includes the criteria "ESG (environmental, social and governmental)" as well as criteria based on an approach to values.
- Sustainable Investment aligns the investor to social and environmental realities.

Based on these three aspects, the term "SRI" is ultimately defined as follows: "generic term covering ethical investments, responsible investment, sustainable investments and any other investment that aligns the financial interests of its investors environmental, social or governance-related."

Table 1 Definitions of Socially Responsible Investment

Ethical Investment	**Socially Responsible Investing**	
	SIF	Eurosif
The application of ethical and social criteria in the selection and management of investment portfolios generally consist of shares	An investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. It is a process of identifying and investing in companies that meet certain baseline standards or criteria of CSR and is increasingly practiced internationally.	Generic term covering ethical investments, responsible investment, sustainable investments and any other investment that aligns the financial interests of an investor to its environmental, social and governance-related

If the current definitions of socially responsible investment tend to align, yet it is difficult to establish a precise typology of investment types and methods taken into account without clear distinction between Europe and the United States. The history of these two regions of the world has indeed influenced the methods as well as those involved in managing socially responsible portfolios. Ladle & Lydenberg (2006), however, consider socially responsible investment meets, both in Europe and the US with two common objectives:

- The desire to redefine the relationship between the company and the investor
- The ambition to create a model of self-regulation without government intervention.

3. Managing a Portfolio

To invest their capital wisely, the basic rule is quite simple: it is to diversify its portfolio of financial assets in order to obtain the best relationship return/risk prospective meet its liquidity needs. These will have to be evaluated over time: "Do I need (a part) of my capital invested in a relatively short horizon or can I wait until the liquidation of (part of) my investment with a horizon more distant?" In the first case, we have to avoid concentrating the portfolio risks in too volatile assets. In the second case, it is reasonable to invest a portion of the portfolio in riskier assets in order to offset the erosion of capital inherent in time. This opportunity cost (loss of purchasing power) is often forgotten after a period of strong disinflation.

To manage a portfolio there are several strategies and styles, considering the operational and the informational efficiency of markets, the table below introduces the different approaches of managing a portfolio. The choice of a particular strategy depends on the investor's degree of aversion to risk and the conception of the stock market efficiency.

Table 2 The portfolio management strategies

The portfolio management strategies: Management Style and Portfolio indexing				
Active Management			Passive Management	
Top down approach	Bottom up approach	Fundamental analysis and technical analysis	Buy and hold approach	Indexing approach (Index tracker)
-Assess and predict future economic prospects. -Deciding to invest proportions by country or economic region. -Identify sectors and industries that will benefit from the expected economic prospects. -Decide on the proportion to invest in sectors and industries -Choose the best titles in the selected sectors.	-Select titles and pay less attention to economic cycles -Stock selection with well defined characteristics: > P/E ratio relatively low. > MV/BV ratio low. > Small-cap firms. > Etc.	-Fundamental analysis is concerned with future earnings prospects for individual companies (financial statements, industry outlook, competition, management). -Technical analysis is concerned with historical trends in prices and volumes of individual stocks and the market as a whole.	An investor buys stocks and holds them for a long time based on the view that in the long run financial markets give a good rate of return even while taking into account a degree of volatility	An index portfolio is a portfolio managed to replicate as perfectly as possible a designated benchmark.

4. Portfolio Management Current Challenges

Limited action: So far, the generalization of responsible investment in all asset classes has little concerned indexing that develops massively yet. The majority of investors believe that it is inherently complex and almost impossible to integrate Environmental, Social and Governance (ESG) passive management for technical reasons. However, several European institutional investors argue apply a responsible investment policy for their index fund (index tracker).

Pilot experiments rather discrete: Some pioneer investors have already put in place procedures to which they communicate little. They can be grouped into three categories: the use of indices excluding issuers listed on blacklists, construction of specific indices to their responsible investment policy, and the contribution of assets in index management to emphasize actions shareholder engagement.

Innovations to follow: The integration of ESG criteria in index management involves very modest volumes, but has already generated some interesting innovations. In particular has led institutional investors to build their own index, reflecting the ability of responsible investment to fundamentally alter financial models. Finally, the creation of SRI indexes by specialists of extra-financial rating and index providers is launching tools that, for now, do not face any real success with investors.

Traditional benchmarks powerful as ever: Funds using SRI index as a benchmark to measure financial performance. Supported by grants or major global stock indices developers, these indices do not appeal to investors who do not use them for management. They continue to measure the performance of their investment processes responsible to conventional benchmarks.

5. Reconciling Responsible Investment and Index Management

Institutional investors gradually switch their assets to active management to passive management that aims to replicate the performance of a benchmark market index. According to the Boston Consulting Group (Global Asset Management 2013), index management saw its stock rise by 25% within four years. Management companies had 7.9 trillion dollars in assets under management index in 2012, 13% of assets under management in the world. For some large US pension funds, passive management as high as 80% of their asset allocation. The crisis has called into question the model of active management designed to deliver superior performance to the market, and made attractive indexing whose costs are lower.

This market is it compatible with another trend: the adoption of comprehensive responsible investment policies, including all asset classes, especially for the 1000 signatories to the Principles for Responsible Investment?

So far, the analysis and selection of companies on Environmental, Social and Governance (ESG) is more likened to active management. At first glance, the replication of an index implies not deviate and prevents taking a position on ESG performance of underlying securities via their exclusion or selection. This is why many investors consider indexing naturally falls outside the scope of their responsible investment policies.

a. Alleged incompatibility of Index Management and Responsible Investment

The index and passive managements are based on the same mechanism: closely replicate an index whose composition is fixed. This type of management is a priori considered incompatible with the consideration of ESG criteria in the analysis and selection of issuers, for several reasons.

Objective of diversifying

In addition to the advantages of low cost of indexing, replicate an index provides a portfolio invested in all the securities representing a market, ie a highly diversified portfolio. This answers the portfolio theory developed by Harry Markowitz in 1952 that there are two financial risks, market risk and the risks specific to each title, a diversification of securities can eliminate.

However, exclusion or selection of securities ESG practiced by responsible investors would reduce the benefit of diversification or create sectoral bias. The SRI index management would no longer be representative of a market and would lead to specific risks.

Constraint to limit the tracking error

Exclude or otherwise favor securities based on ESG criteria implies to deviate from the benchmark, which can induce a higher tracking error. Now, for an index manager, maintaining a low tracking error is a fiduciary duty. This agrees with investors to meet the fund's objective, namely replicate an index to get the same performance.

ESG stands for active management

Finally, the SRI is generally equated with active management or "belief", based on value choices based on ESG criteria, varying sensitivities of investors. This vision is the opposite of indexing based on an automatic calculation of the corporate weight in the index, which leaves no room for the manager's opinion of a company. In its 2012 annual report, the Australian pension fund VicSuper explains that "when a portfolio replicates an index, there are few opportunities to integrate ESG criteria strictly, unless you use an ESG index. However, this means that this investment is no longer passive.

b. A Myth Challenged by Practice

Management companies as for institutional investors little communicate on the implementation of their responsible investment policies in their index management. These policies rarely address the specifics of the passive or index tracking, and overall contain few details of their scope of application. However, the results of the survey conducted in 2013 by Novethic with 160 large European institutional investors shows that some of them have already initiated steps, challenging the idea that indexing and taking into account ESG criteria are incompatible. Indeed, 45% of investors surveyed using indexing argue apply a responsible investment strategy for this type of management.

The most common practice is to use indices excluding controversial weapons or indices excluding companies found guilty of violations of international standards. These generally focus on human rights, working conditions, corruption or environmental protection - this is called normative exclusions.

For this, investors can rely on the existing supply of the index providers or use a custom index. Indeed, many asset managers make requests from investors for index warrants based on these indexes called "custom". These approaches are not subject to public disclosure from investors because they are part of a dedicated management. Relatively advanced institutional investors in responsible investment provid their manager an exclusion list, sectoral or normative, or an investment universe defined from ESG, to create their own index. This allows them to have an indexing reflecting their internal ESG methodology.

c. Breaks for The Development of SRI Index Management

No shared vision about ESG Criteria

Throughout asset management, indices such as the MSCI World, the S&P500 or the CAC40 are used as reference because all market players consider them representative. Regarding SRI, each investor has his own definition of what a good ESG performance. The lack of a common definition of SRI and ESG criteria to be used is thus the main reason put forward by respondents management companies to justify the low use of SRI indexes.

The indices which exclude controversial weapons could, however, win the support of enough investors by becoming a reference. Driven by regulatory or regulatory authorities, the exclusion of companies linked to controversial weapons tends to become, at least in Europe, a minimum requirement for financial players. The list of the companies may differ from one investor to another, but today is more consensuses in responsible investment.

- Insufficient liquidity for index tracking

The lack of a shared vision about SRI pose a strong limit to the development of index funds and ETFs that do not reach the necessary critical mass. for the company Lyxor AM, an ETF must weigh between 200 and 300 million Euros of assets in order to be sufficiently liquid to be used in index management strategy. Today, SRI ETFs on the market are small, only four of them have higher outstanding to 100 million. The biggest ETFs are the most liquid. But this liquidity is essential, especially for swap-based ETF for which, a counterparty will be able to offer products on the underlying indices.

- Lack of SRI benchmark

Management companies do not use the SRI index as benchmark for their open SRI funds. Among the 300 SRI funds distributed in France, six are using such an index to evaluate their performance indices that are different from one fund to another.

Only a few institutional investors such as PGGM and KLP use SRI indices as benchmark. Compared to a known benchmark as the MSCI Europe which remains a major concern for investors. Even using an SRI index or non-benchmarked management, investors end up comparing their performance to that of a traditional index.

Search for diversification

If exclude a small number of securities of an index fund does not pose a problem, stricter ESG selection poses more. Even a large universe, this selection means less diversification and so in theory a more risky management. The index providers have changed their offer to meet the demands of customers who wish to apply a responsible investment policy without changing the financial parameters of their indexing.

While the first generation of ESG Indices selects a limited number of companies, new families of more diversified indices are marketed today. The DJSI, launched in 1999, for example, consists of 10% of the most successful companies from an ESG perspective by S&P Dow Jones Indices sector, which represents 333 companies for the DJSI World. In May 2013, a new family of DJSI Diversified was launched. It is based on ESG screening less demanding, making them more diverse; The DJSI Diversified World is composed of 660 companies.

The mainstream indices are also emerging, such as SD-KPI Stoxx Index. Starting from the EURO STOXX 50, all companies are present in the SD-KPI Index Stoxx and maximum 10% of the weight of a company in the index varies according to its ESG performance. This maintains a low tracking error versus the EuroStoxx, use derivatives of it and so overcome obstacles related to lack of liquidity. Maintaining a tracking error close to a traditional index reference mantra of indexing, thus leads to greater diversification indices incorporating ESG criteria. They are thus becoming closer to their underlying indices, reducing their ability to promote a different economy.

6. Conclusion

The integration of ESG criteria in index management is still in its infancy. Examples of such procedures are rare and usually confined to 'test' pockets. Except for PGGM, which only cover one aspect of responsible investment: normative exclusions, or stock selection or commitment.

The challenge now is to translate these experiences more comprehensive responsible investment policies, applied to substantial outstanding. A first step was taken with the indices excluding controversial weapons including the increasing use could make these essential steps.

If the offer of the index providers is crucial in the spread of exclusions, it is not enough to expand the use of SRI indices, judged unrepresentative by investors. But they multiply only the last ten years while the first MSCI indices were launched in the 60s.

The main obstacle to ESG strategies deployed in index management ultimately lies in the purely technical vision, limited replication of an index, this type of management. Indeed, having an opinion on the financial performance of a company is not part of the index manager business. But investing responsibly assumes at minima to recognize the importance of its extra-financial analysis.

Indexing could overcome this obstacle. There is not so long in the active management as institutional management firms saw their business was limited to taking into account the financial evaluation of issuers. Institutional investors are most likely to boost the movement demanding to align all of their management on their responsible investment policies.

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