



UK  
Social  
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Forum

*Working with others to promote  
socially responsible investment*

# **Discovering New SRI Institutional Investment Opportunities**

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## Foreword

In the last few years there has been a significant growth in both alternative investment and Socially Responsible Investment (SRI), as well as in the acceptance of SRI within mainstream investment practice. However, there has been relatively little consideration of the potential for alternative investments within an SRI investor's portfolio.

UKSIF as the membership network for SRI has been keen for some time to help stimulate debate about the development of SRI products across a wider range of asset classes. We therefore invited Anne-Marie Smith to produce this report. We are fortunate to have been able to draw on Anne-Marie's knowledge and experience of financial markets and non-equity asset classes.

This report will help SRI investors consider how they can move beyond equities and explore the increased investment opportunities that alternative asset classes may provide. As such it is an important and timely contribution to the debate on the future development of SRI.

The conclusions of this report are Anne-Marie's. They do not necessarily reflect the views of UKSIF or of its membership. However in publishing Anne-Marie's work, we are confident that this useful study will assist those exploring this important area.

We welcome comments on the paper and suggestions for follow-up work on SRI investment opportunities beyond traditional equities. These should be sent to [info@uksif.org](mailto:info@uksif.org).

We are very grateful to Anne-Marie for this valuable overview of an increasingly important range of SRI investment opportunities. We are grateful also to the UKSIF members and others who advised and assisted her. I commend her report to you.



**Penny Shepherd MBE**  
Chief Executive  
UK Social Investment Forum (UKSIF)

# 1. Introduction

Despite the significant and concurrent growth in both alternative investments and the Socially Responsible Investment (SRI) market to date, the SRI footprint has remained mainly in the equities camp. The potential for market development is huge. This report serves to give an overview of a range of non-equity investments with a view to their general suitability for SRI investors. It should not be taken as financial advice or seen as an endorsement of any particular company, organisation or individual.

Underperforming stock markets and a low-interest rate environment have fuelled the demand for increasingly-elusive financial return. This has resulted in greater consideration being given to diversification out of the traditional asset classes of cash, stocks and bonds and a significant interest and growth in alternative investments. A key finding in the 2005-2006 Russell Investment Group Survey on Alternative Investing is that alternative investments are expected to reach record levels by 2007<sup>1</sup>.

Since 2000, SRI has moved closer to the financial and corporate mainstream. In the UK this has in part been driven by the introduction of the SRI Pension Disclosure Regulations in 2000<sup>2</sup>. The period has also seen a growth in SRI assets under management and new markets have opened. This has been matched by the development and increase in benchmark indices. There are five FTSE4Good indices covering the UK, US, Europe, Japan and the global developed markets. Recent additions to the Dow Jones Sustainability Index family of SRI indices include an Islamic Sustainability Index and a European Blue Chip Sustainability Index. The E. Capital Partners index covers 24 developed markets and other country specific indices include the South African JSE SRI index, the Australian SAM Sustainable index, the Tel Aviv Maala SRI index and the Bovespa Sao Paulo-based Corporate Sustainability Index.

Varying definitions of SRI criteria dictate that figures on the size and breakdown of the total SRI market differ from one source to another. Taking an enlarged view, in 2003 both Eurosif and E.Capital Partners cited €336 billion for the institutional market while Eurosif estimated €12.1 billion versus E.Capital's €23.9 billion for the retail market<sup>3</sup>. There is no shortage of research to support the compatibility of SRI and profitability. In addition, findings from Mercer IC's 2005 global *Fearless Forecast* survey show that on average investment managers world-wide are becoming more convinced that the adoption of SRI practices and strategies will become commonplace: 89% predict that active ownership will be a mainstream practice within 10 years; 73% predict that the incorporation of social or environmental corporate performance indicators will become mainstream within 10 years; and 65% predict that positive or negative screening will be mainstream within 10 years<sup>4</sup>.

The investment categories covered in this report include bonds, both vanilla and non-conventional, exchange traded funds and alternative investments such as hedge funds and carbon trading. Microfinance and renewable energy are also discussed. In some cases, the investments themselves conform to Socially Responsible Investment (SRI) criteria, where investments are assessed not only on financial

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<sup>1</sup> For further information see [www.russell.com](http://www.russell.com).

<sup>2</sup> An amendment to UK pension fund laws which requires all pension funds to declare the extent to which SRI principles influence their investment strategy.

<sup>3</sup> Socially Responsible Investment among European Institutional Investors, Eurosif, 2003. ([www.eurosif.org](http://www.eurosif.org)).

<sup>4</sup> See [www.mercerIC.com](http://www.mercerIC.com).

grounds, but with regard to their social and environmental aspects. In others there is empirical evidence to suggest there is potential within the capital markets to finance a SRI investment. Where there is evidence that SRI criteria have been adopted, at least one example has been included. However this report does not attempt to provide an authoritative survey of SRI investment opportunities within each category. The examples drawn upon serve to illustrate only. The research on which this report is based was carried out between September and November 2005. The inclusion of a particular investment or investment fund does not constitute a recommendation.

## 2. Fixed Income

### 2.1 Overview

Bonds, also known as fixed-income securities, are debt instruments created for the purpose of raising capital. Bonds are loans to organisations – including governments, local authorities, supranational bodies (e.g. The World Bank) or companies. They usually have a fixed rate of interest paid regularly and aim to pay back the capital at the end of the period covered by the bond.

Unlike shares or equity capital, bonds carry no ownership privileges. The bond remains an interest-bearing obligation of the issuer until it is repaid, which is usually on its maturity date. The different types of bonds in the European market reflect the different types of issuers and their respective requirements. Some bonds are safer investments than others. Bonds issued by developed country governments are deemed to be guaranteed investments in that the final repayment is virtually certain. Agencies and supranationals are a competing asset class to government bonds. They carry explicit guarantees or implicit support from sovereigns. For a corporate bond, in the event of default of the issuing entity, bondholders rank above shareholders for compensation payments. There is lower investment risk associated with bonds.

The capacity of bond issuers to repay their debt is rated by ratings agencies such as Moody's and Standard & Poor's. Bonds rated Baa to Aaa by Moody's and BBB to AAA by Standard & Poor's are considered investment grade. Those with lower ratings are termed substandard grade. Substandard grade bonds or bond funds can often be recognised by the words "junk" or "high yield" in their title. Bond ratings are periodically revised based on recent data.

There are more esoteric debt instruments also available to investors. These include convertible bonds, covered bonds and CDOs. Many of these instruments are also rated by the agencies.

### Accessibility

The bond market is by far the largest securities market in the world providing investors with virtually limitless investment options<sup>5</sup>. Despite the size, these markets operate without a central exchange, instead operating as an over the counter market with hundreds of market makers and thousands of participants. Many institutions will only invest in bonds listed on a Recognised Investment Exchange (RIE), e.g. London.

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<sup>5</sup> The precise size of the global bond market is difficult to assess owing to rapid growth and increasing diversity. Merrill Lynch's, *Size and Structure of the World Bond Market: 2004*, estimates that there were about \$45 trillion in global bonds outstanding at the end of 2003 while a recent study by the McKinsey Global Institute, *\$118 Trillion and Counting: Taking Stock of the World's Capital Markets*, estimated the size of the global bond market at about \$43 trillion in 2003. For comparison, the same McKinsey study estimated the size of the global equity market was \$27 trillion, not quite two-thirds of the size of the global bond market.

### Advantages/Disadvantages

The advantage of bonds to an investor is that they represent a fixed source of current income, with an assurance of repayment of the loan on maturity. Furthermore corporate bondholders as creditors to a firm have a higher claim on the company's assets than the shareholders. In the event of bankruptcy, what bondholders give up in rewards may be partially redeemed by gaining the primary claim on bankrupt assets.

Whilst bondholders do not have voting rights, a bond prospectus can include covenants to include protective measures.

### Examples of SRI investment opportunities

*UK:*

- AEGON Ethical Income Fund ([www.abetterway.co.uk](http://www.abetterway.co.uk)).
- Morley Sustainable Future Corporate Bond Fund ([www.Morleyfm.com](http://www.Morleyfm.com)).
- Rathbone Ethical Bond Fund ([www.rathboneunittrusts.com](http://www.rathboneunittrusts.com)).

*Europe*

- The Dexia Sustainable Euro Bonds. The fund's eligibility criteria for government issues are in relation to the democratic nature of the state and their respect for international agreements on human rights ([www.dexia-am.com](http://www.dexia-am.com)).
- The Sarasin Sustainable Bond Euro invests in issuers who make a positive contribution to sustainable development ([www.sarasin.co.uk](http://www.sarasin.co.uk)).
- E.Capital Partners offers benchmark SRI bond indices ([www.e-cpartners.com](http://www.e-cpartners.com)).

### *The International Finance Facility for Immunization (IFFIm)*

The IFFIm has won approval to raise funds by issuing bonds in the international capital markets. The bonds will be secured against donor governments' pledges. IFFIm aims to raise \$4billion over 10 years. The proceeds of the bonds will be used for vaccine development with the aim of preventing 5 million childhood deaths before 2015. Participating governments include Brazil, Britain, France, Italy, Spain and Sweden. Pledges are not classified as government debt. The funding will be channeled by GAVI (Global Alliance for Vaccines and Immunizations). The bonds are likely to be AAA-rated and will pay interest commensurate with this. The Trustee will be the World Bank<sup>6</sup> [www.vaccinealliance.org](http://www.vaccinealliance.org).

### Research and information

Oekom's Country Rating uses 130 indicators to paint an overall picture of countries' social and environmental records ([www.oekom-research.de](http://www.oekom-research.de)). EIRIS and Innovest have also recently launched research products in this area ([www.eiris.org](http://www.eiris.org) and [www.innovest.com](http://www.innovest.com)).

## **2.2 Convertible Bonds**

A convertible bond is an issue giving the bondholder the right to exchange the bond for a specified amount of shares (equity) in the issuing company at some future date and under prescribed conditions. Convertible bonds are globally traded instruments. The market capitalization of the convertible bond market is estimated at \$675 billion<sup>7</sup>.

### Advantages/Disadvantages

Convertible bonds provide the upside potential of stocks (the opportunity to participate in company earnings) with the downside protection of bonds (a fixed return and repayment of principal at maturity). As the price of the company stock increases, the convertible bond price also increases because the option to convert

<sup>6</sup> Hall, J. Financial Times. 8<sup>th</sup> February, 2005.

<sup>7</sup> Source: Jefferies International Ltd.

becomes more valuable. Almost all convertible bonds are callable. Even though they are a "hybrid" investment, convertibles (like all bonds) are sensitive to interest rate fluctuations.

#### SRI investment opportunities

In June 2005, German solar energy company Solon AG issued a €45 million 5-year euro convertible bond.

#### Less conventional debt instruments

In addition to investing in regular bonds/bond funds, there is a growing market for less conventional debt instruments such as covered bonds and CDOs.

### **2.3 Covered bonds**

A covered bond is a debt instrument issued by a financial institution and secured on a portfolio of assets which can either be mortgage loans (residential and commercial) or loans granted to/bonds issued by public sector entities. Due to a privileged position in bankruptcy, covered bonds achieve ratings at least equal to the unsecured rating of the issuer and in most cases significantly higher. Essentially a covered bond is a corporate bond with one important enhancement, recourse to a pool of assets that secures or "covers" the bond if the originator (usually a financial institution) becomes insolvent.

#### Accessibility

Although a relatively new concept in the UK, covered bonds are popular in many European countries. The European covered bond market has evolved rapidly over the past decade to become a significant segment of Europe's debt capital market. In 2004 alone, €215 billion of covered bonds were issued across the continent.

#### Advantages/disadvantages

The primary advantages of covered bonds are seen to be:

- Credit quality: most bonds are triple- or double-A rated. Even with an equal rating, covered bonds tend to offer yield pick-up over sovereign bonds.
- Investors get double protection: They can claim against the issuer and have preferential claim over the cover pool in case of issuer insolvency.
- Liquidity: Benchmark issue size and covered bonds have firm market making commitments from a number of banks, and are seen as the second most liquid instruments after government bonds.
- Covered bonds are a cheap source of financing for the issuers.
- Access to new debt markets and investors: Covered bonds, because of their structure, generally tend to be available to investing institutions which have restrictions placed on the types of investment which they may acquire.

The potential disadvantages or short-comings are seen to be:

- For UK investors there is no specific legislation in place for covered bonds. This contrasts with the regulatory position in continental Europe. The Financial Services Authority (FSA) is now evaluating a regulatory framework that will put the UK regime on a more legalistic footing. This should attract more UK issuers to the market, although the FSA is considering limiting covered bond issuance as a proportion of assets.
- The quality of covered bonds is not the same throughout Europe with the structuring dependent on the place of issuance.
- There are many issuers with different structuring dependent on the place of issuance. This requires more in depth credit analysis. Growth in covered bonds may impact the corporate unsecured market.

### Example of SRI investment opportunities

In December 2004, HBOS Treasury Services issued £500m worth of UK social housing covered bonds with 20-year tenure<sup>8</sup>. The bonds are backed by secured loans to Registered Social Housing Landlords and acted as a template for other issuers in the UK, establishing a new asset class. The 20 year issue was followed in January 2005 with another £500m deal with a shorter five-year maturity. The Aaa/AAA rated transaction was the first in HBOS's recently established £3 billion social housing covered bond programme<sup>9</sup>. The superior credit quality and excellent track record of social housing loans in the UK make them very suitable as collateral for a covered bond. There has been 15 years of lending to the social housing sector without a history of default.

## **2.4 Collateralised Debt Obligations (CDOs)**

### Overview

A CDO is a vehicle that raises capital by issuing different classes of debt with different credit ratings (tranches - of which the most subordinated piece is called equity). Proceeds are used to purchase diversified pools of financial assets e.g. bonds/leveraged loans. The income from assets is used to pay the holders of the bonds with any excess paid out to the equity.

The equity tranche can produce high returns but also carries high risk since it is exposed to any losses resulting from underlying asset defaults. A separate 'senior debt' tranche carries less risk, since it gets repaid first, but offers less potential return. Between them are tranches of 'mezzanine' debt.

A synthetic CDO uses credit derivatives as the underlying asset. The fastest growing segment of the market is for 'synthetic' CDOs. Another innovation, the 'CDO squared', is a CDO composed of multiple synthetic CDOs. Some banks even offer a 'CDO cubed' – a CDO of CDOs of CDOs. CDOs are either static or managed. Static CDOs are based on pools of assets which do not change once purchased and are arranged purely through investment banks. A managed CDO pays an asset manager to actively reduce defaults.

### Accessibility

CDOs originated in the US in the mid-1990s. In recent years, low interest rates have meant that investors have struggled to earn reasonable returns in fixed-income securities. That has left investors moving towards instruments such as CDOs, which have consistently offered higher returns. In 2004 the cash value of all CDOs issued and sold to investors in Europe and America reached \$120billion (the value was \$445billion if the notional value of all derivatives in these instruments is included). This cash value figure is nearly equivalent to all European corporate bond issuance for the same period<sup>10</sup>.

Currently CDO's are being used in Europe and Asia and the market is thought to be growing in the UK, Germany, Switzerland and Scandinavia despite a decline in popularity in the US. In the Asia-Pacific region, investors have shown more appetite for speculative investments and regulators have proved more relaxed than in Europe.

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<sup>8</sup> In its latest report, Government bonds from emerging markets – a sustainable investment? Bank Sarasin studied a total of 46 emerging countries to see how well they met environmental and social standards.

<sup>9</sup> The Guide to Mortgage Institutions. Euromoney Research Guide, May 2005.

<sup>10</sup> Clouds sighted off CDO asset pool, Gillian Tett, The Financial Times, April 18 2005.

### Advantages/Disadvantages

The advantages include:

- CDOs pay a higher return than similarly rated corporate bonds.
- Investors can choose the level of risk and return by investing in the different bonds issued by a CDO. This customised profile is attractive to investors looking to match assets to liabilities e.g. pension funds, insurers.
- Rating agencies play a key role in structured finance markets. Most CDOs are rated and the involvement of the rating agencies at the “deal structuring” stage sets structured finance apart from traditional credit ratings.
- The existence of a CDO library should increase transparency and understanding.

The disadvantages include:

- CDOs are complex instruments and there are concerns regarding the lack of investor understanding most specifically of “correlation” risk - that is, the danger that if one asset turns bad it could affect other assets in a snowball effect.
- Regulations are strict and differ widely from country to country. Fees continue to be high<sup>11</sup>.

### Examples of SRI investment opportunities

*Europe:*

- E.Capital Partners CDO Index and First European Equity Benchmark: the ECPI Ethical Index Euro and a range from Corporate Bonds to Credit Derivatives ([www.e-cpartners.com](http://www.e-cpartners.com)).
- Robeco €30 million CDO Oct 2004. In the Netherlands domestic investors receive special tax treatment for sustainable investment ([www.robeco.com](http://www.robeco.com)).

*Australia*

- Grange Ethical Entity Note (GREEN) is a CDO-squared issue. Grange initially underwrote a transaction size of A\$50 million but having covered that amount the firm is upsizing the transaction. The Note is rated AA by Standard & Poor's. The structure is five underlying CDOs with pooled subordination. The reference names have been selected using SRI screening methodology. The portfolio entities must be rated BB- or above. The portfolio adviser is E. Capital Partners ([www.grangesecurities.com](http://www.grangesecurities.com)).
- ABN Amro socially responsible CDO REEF (Responsibility, Ethics, Environment First) \$20 million. The portfolio for the REEF Series 1 consists of 300 companies from around the world, with US companies making up close to half the portfolio. Companies specialising in alcohol, gambling, tobacco and weapons manufacture are automatically excluded. It is the first financial product with credit rating and CSR rating from RepuTex, 5-year FRN AA\_rated ([www.abnamro.com](http://www.abnamro.com)).

Research and Information:

[www.cdolibrary.com](http://www.cdolibrary.com). The library is open to qualified institutional buyers and dealers. It contains information on specific CDO transactions. Posted in the library for each deal are swap agreements, offering memoranda, indenture documents, and monthly trustee reports. Transaction information is supplied by investment banks on a voluntary basis, and is searchable by deal name, underwriter, collateral manager, and/or deal date.

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<sup>11</sup> The Banker, 2005.

### 3. Hedge Funds (and Funds of Hedge Funds)

#### Overview

Hedge funds are probably the most widely recognised kind of alternative investment, but also one of the least understood. The growth of hedge funds has coincided with the falling markets of the early part of this decade, as investors have looked for solutions that could produce positive returns in any market climate. They are, in effect, a way to “hedge your bets.”

Hedge funds are notoriously difficult to define but can generally be classified according to the following criteria:

- They emphasise absolute returns. In other words, unlike most mutual and pension funds, they are not benchmarked.
- To make such a strategy possible, hedge funds use a wide variety of tools and strategies including leverage, derivatives and short-selling<sup>12</sup>.
- Hedge funds also tend to be beyond the reach of ordinary investors. Despite many funds of hedge funds on offer today, the majority of investors in hedge funds are still High Net Worth individuals.

#### Accessibility

Although traditionally only available to individual investors with deep pockets, the popularity and demand for hedge fund investment has led to the formation of funds-of-funds whereby entities with sufficient capital provide retail clients with access to hedge funds by pooling their resources. A number of traditional funds are also finding ways of adopting hedge-fund strategies, using such instruments as CFDs (Cash for Deposits).

#### Advantages/Disadvantages

A key advantage of hedge funds is their ability to employ flexible investment strategies. Hedge funds can take both long and short positions; utilize futures, options and other derivatives. Additionally, hedge funds are able to adapt their strategies to take advantage of market opportunities in both rising and declining markets. The primary aim of many hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions. A fund of hedge funds can also provide diversified exposure to a number of different hedging strategies and reduce the risks involved in investing in a single hedge fund.

However, serious hurdles to truly broad-based acceptance remain. A number of recent industry surveys show serious deficiencies in transparency, risk control, and meaningful comparative analysis – principally because different data providers use widely varying terminology. In addition, hedge funds are not subject to the same regulations as other widely held investment products such as mutual funds and exchange-traded funds. Since they do not have the same reporting requirements, it can be difficult to find accurate information about some hedge funds.

#### Examples of SRI Investment Opportunities:

##### *Europe*

- The market-neutral Coolum Strategus SRI Fund<sup>13</sup> takes long and short positions in European companies depending on their social and environmental

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<sup>12</sup> Jaeger, Robert A., All about Hedge Funds, 2003 p.2.

<sup>13</sup> The Fund Manager is Armajaro Asset Management which is authorised and regulated by the FSA ([www.armajaro.com](http://www.armajaro.com)).

performance and record as well as on their valuation and financial prospects ([www.strategus.be](http://www.strategus.be)).

- The Morley SRI Long Short Fund (SRILS). SRILS objective is to generate net returns in excess of 12% per annum by investing in large cap European Equities ([www.morleyfm.com](http://www.morleyfm.com)).
- New research points to the growing presence of “green hedge funds” that invest in renewable energy and carbon trading<sup>14</sup>.

#### USA

- Green Cay Asset Management has four market neutral funds with approximately \$200 million under management.
- Winslow Hedge Fund focuses on environmental factors ([www.winslowgreen.com](http://www.winslowgreen.com)).
- A number of Catholic and Islamic funds have recently been established. These include offerings from Gabelli Asset Management ([www.gabelli.com](http://www.gabelli.com)) and a Catholic FoHF, the Good Stewardship Fund (launched by 5 Catholic healthcare organisations).

## 4. Exchange Traded Funds (ETFs)

### Definition

An exchange traded fund (ETF) is a type of tracker fund. It differs from a standard tracker fund because it is set up as a listed company, which means investors can buy and sell shares in them on the stock market through most UK stockbrokers. In a traditional tracker fund you can only trade (buy and sell) units with the company that manages the fund.

### Accessibility

The market for ETFs is most developed in the US. The European ETF market has been relatively slow to develop; products did not debut there until early 2000. However by the end of the first quarter of 2005, European exchanges had listed 122 ETFs between them, with \$36.9billion in assets<sup>15</sup>. The European ETFs industry is dominated by three issuers: Indexchange, BGI and Lyxor Asset Management.

### Advantages/Disadvantages

ETFs trade electronically and, being priced continuously, can be bought and sold anytime throughout the day. Exchange Traded Funds offer pure asset class exposure. The most obvious advantage of investing in ETFs is that investors gain access to the performance of an index or portfolio without the need to buy the constituent shares/bonds. Bond ETFs share many of the benefits of equity ETFs including low cost, transparency, trading flexibility, and all day tracking and trading. There is not currently a formal market making structure in ETFs.

ETFs can be bought as part of an Isa or existing Pep, and unlike other shares and investment trusts, are exempt from stamp duty in the UK. By their nature ETFs are flexible, allowing individuals to buy and sell at any time to suit their own changing risk profile. The up-front cost is the same as buying ordinary shares and they have annual management fees as low as 0.35%. However broker commission is charged on each trade.

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<sup>14</sup> Please refer to the sections below on renewable energy and carbon trading which include information on hedge fund products.

<sup>15</sup> ETF evolution speeds up, The Banker, 04 July 2005.

### Examples of SRI investment opportunities

#### US:

- The iShares KLD Select Social Index Fund is the first exchange-traded fund designed specifically for socially responsible institutional and individual investors. The Fund tracks the KLD Select Social Index ([www.ishares.net](http://www.ishares.net) and [www.kld.com](http://www.kld.com)).
- There are a series of PowerShares ETFs. The PowerShares WilderHill Clean Energy Portfolio ETF focuses on companies that support renewable and cleaner energy production. The PowerShares Clean Energy ETF tracks the ECO index and the PowerShares Water Resources ETF tracks the Palisades Water Index (ZWI) ([www.powershares.com](http://www.powershares.com)).

## **5. Microfinance**

### Definition

*Microcredit* is the name given to small loans made to very poor people who would normally be regarded as bad financial risks and so be unable to obtain funds through conventional banks. Though still a long way from the financial mainstream, many governments now see microcredit as an effective way to build up local enterprise and reduce unemployment; they include not only countries like Bangladesh, where the Grameen Bank has been a pioneer, but also industrialised areas such as North America and Australia, where microcredit meets special needs. Women are often the prime recipients of loans. The World Bank has issued a number of papers on the subject and has set minimum standards of reporting from microcredit institutions.

The term microcredit has however been gradually replaced by microfinance which is broader and refers to the variety of services low-income people may now access in a growing number of countries. The term *Microfinance Institution* (MFI) is used to refer to all types of formal and semi-formal institutions that offer microfinance services.

### Accessibility

Investors can invest in microfinance funds. Securitisation has also been used as funding alternative for MFIs. During 2005 the UN's International Year of Microcredit made efforts to increase public awareness of microfinance.

### Advantages/Disadvantages

The advantages of MFIs include that many are rated and that they have accessed some domestic and international capital markets.

However financing is the primary constraint to growth. Market demand for microfinance services is estimated at \$300billion, while supply is just \$4billion. Limited access to the international capital markets means that there are currently few mainstream opportunities to invest in microfinance.

There are a number of constraints to growth which include foreign exchange risk, liquidity, lack of standardised regulations and infrastructure. MFI shares do not trade in a liquid market (i.e. do not have a price). They also do not currently fit traditional investment strategies and as they are unlikely to represent more than a small fraction of a portfolio, they have no impact on diversification.

To overcome concerns about the ability of microfinance to offer financial returns and fit traditional investment strategies, MFIs are characterising microfinance as a commercial investment opportunity<sup>16</sup>.

#### Examples of Microfinance Investments

- The Global Commercial Microfinance Consortium established a \$75 million fund in 2005. The Consortium includes government agencies, banks, pension funds, fund managers and foundations. The fund has a three-tranche debt and equity structure and provides commercially structured financing for MFIs working throughout the developing world in providing credit to self-employed poor. Deutsche Bank acted as leader arranger.
- Blue Orchard – Developing World Markets Microfinance Securitisation. In July 2004, Blue Orchard Securities I issued a \$40 million bond to support MFIs in nine developing countries. This 7-year deal has 4 tranches, one senior and three subordinated. The senior note is secured by a \$30 million guarantee from the Overseas Private Investment Corporation (OPIC) equivalent to a Treasury Note rating. JP Morgan Securities will service the bond. In February 2005 in a similar transaction, Blue Orchard Securities II issued a further \$47 million to support 14 MFIs ([www.blueorchard.ch](http://www.blueorchard.ch)).
- On 15 November 2005, ProCredit a global microfinance group, issued a €45 million bond led by Deutsche Bank AG. The bond is rated BBB- by Fitch and comprises 7-year (€20m) and 10-year (€25m) tranches. This was the first time that a microfinance entity has accessed the European capital markets ([www.deutsche-bank.de](http://www.deutsche-bank.de)).
- Dexia Micro-Credit Fund is the first private worldwide and fully commercial microfinance investment fund. The fund is managed by Blue Orchard ([www.blueorchard.ch](http://www.blueorchard.ch)).
- Axa IM World Funds Development Debt Fund targets investment directly in microfinance institutions that contribute directly to the sustainable development of economies on a local level ([www.axa-im.com](http://www.axa-im.com)).
- Oikocredit is the largest private financier of the microfinance sector world-wide. In October 2004 Oikocredit established a Microcredit programme with ING ([www.oikocredit.org](http://www.oikocredit.org)).
- Minlam Asset Management is launching the Minlam Microfinance Fund, a private equity fund ([www.minlam.com/microfinance\\_fund.php](http://www.minlam.com/microfinance_fund.php)).
- Triodos International Fund Management plays an active role in microfinance. Through funds under management, provides loans and equity trade finance for certified organic/fair trade producers in developing countries ([www.triodos.com](http://www.triodos.com)).

#### Useful organisations/websites:

- Developing World Markets (DWM) structures transactions to enable microfinance institutions and other socially motivated organizations to gain access to debt or equity capital via local and international capital markets ([www.dwmarkets.com](http://www.dwmarkets.com)).
- Microfinance Capital Markets (MCM) is a newsletter dedicated to MCM news. It is produced and edited by CGAP and the Microfinance Information Exchange (MIX), ([www.cgap.org](http://www.cgap.org) or [www.mixmarket.org](http://www.mixmarket.org)).
- MicroCapital provides "honest, no-frills" information on microfinance ([www.microcapital.org](http://www.microcapital.org)).

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<sup>16</sup> Enterprising Solutions Global Consulting is working on benchmarking microfinance against other asset classes. See Tapping The Financial Markets for Microfinance, Jennifer Meehan, Grameen Foundation USA, February 2005.

Microfinance Rating Agencies and other organisations:

- MicroRate ([www.microrate.com](http://www.microrate.com)).
- Micro-Credit Ratings International Limited (M-CRIL) ([www.mcril.com](http://www.mcril.com)).
- The Rating Fund ([www.ratingfund.org](http://www.ratingfund.org)).
- The Consultative Group to Assist the Poor – is a consortium of donor institutions working to build financial systems that serve the poor in developing countries ([www.cpag.org/mcm](http://www.cpag.org/mcm)).

## 6. Renewable Energy

Definition

Renewable energy (sources) or RES capture their energy from existing flows of energy, from on-going natural processes such as sunshine, wind, flowing water, biological processes, and from geothermal heat flows. Neither fossil fuels nor nuclear power are considered to be renewable. Renewable sources of energy could contribute 34% of total electricity production and 20% of energy consumption in the EU by 2020<sup>17</sup>.

Overview

The evidence for global warming is overwhelming and as a consequence, climate change is rising up the political agenda. Alternative energy as an investment is currently very much in vogue. Mcllvaine, the US-based specialist industry analysis company estimates the market was worth \$27 billion in late 2005 and expects this to reach \$46 billion in 2008.

Accessibility

As a sector, renewable energy offers investment opportunities across the whole range of asset classes including ETFs and convertible bonds. A number of investment funds are dedicated to investing in companies and projects that promote sustainable environmental practices and/or support sources for renewable energy. Such funds offer investors a vehicle to participate actively in the dramatic changes taking place in sustainable environment and renewable energy sectors. Moreover, a number of investment operations have recently been set up specialising in this field. These include asset management firms like Generation Investment Management, investment bankers such as Climate Change Capital and firms which do both like the Impax Group<sup>18</sup>.

Examples of Investment opportunities:

- *Indices* – a range of indices have been established covering both specific renewable sectors and the wider field. For example:
  - KLD Global Climate 100 Index was launched July 2005. It is designed to promote investment in public companies who demonstrate the greatest potential for reducing the social and economic influences on climate change ([www.kld.com](http://www.kld.com)).
  - The WilderHill Clean Energy Index comprises publicly traded companies that focus on greener sources of energy and technologies facilitating cleaner energy. WilderHill has also created the New Energy Global Innovation Index ([www.powershares.com](http://www.powershares.com)).
  - The Cleantech Index tracks 75 US companies with majority involvement in cleantech ([www.cleantech.com](http://www.cleantech.com)).

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<sup>17</sup> European Renewable Energy Council (EREC).

<sup>18</sup> For more information, see [www.generationim.com](http://www.generationim.com), [www.climatechangecapital.com](http://www.climatechangecapital.com) and [www.impax.co.uk](http://www.impax.co.uk).

- *Private Equity*
  - The Dexia-FondElec Energy Efficiency and Emissions Reduction Fund (approximately €100 million) funds projects in Central and Eastern Europe that will use clean, renewable energy, and/or energy efficient emission reduction technologies to improve industrial processes, reducing the need for fossil fuel, and mitigating climate change. The fund will make investments that improve the energy efficiency of existing plants and equipment.
  - The Triodos Bank Group's Triodos Renewable Energy for Development Fund (capitalization at approximately €10 million, based in the Netherlands) invests in off-grid renewable energy services in rural areas of Africa and Asia. The Fund will make investments (loans, guarantees and limited seed capital) in the range of €100,000 to €250,000 to private sector enterprises, financial institutions and organizations that facilitate the introduction and widespread access to off-grid renewable energy services to underserved populations in its target regions.
  
- *Equity, Hedge Funds and Other Asset Classes*
  - Impax Group is a financial advisory and asset management company quoted on AIM. The asset management arm provides services in the environmental markets sector including an investment trust Impax Environmental Markets plc, a private equity New Energy Fund and a venture capital fund The Recycling Fund ([www.impax.co.uk](http://www.impax.co.uk)).
  - Triodos Green Fund is a debt fund for renewable energy, organic farming and forestry in the Netherlands. It is a retail investment product sold to individual investors with a capitalisation of over €320 million. Triodos in the UK recently created a Triodos Renewables share issue which allowed UK investors to invest in small-scale renewable energy sector ([www.triodos.co.uk](http://www.triodos.co.uk)).
  - New Energy Fund LP manages a pure alternative energy hedge fund ([www.newenergyfundlp.com](http://www.newenergyfundlp.com)).
  - The Global Environment Fund is an international investment management firm based in Washington, D.C. that makes market-rate investments in environmental projects in the U.S. and throughout the developing world. The firm's private equity portfolios include interest in fast-growing, entrepreneurial companies with aggregate sales exceeding \$2 billion ([www.globalenvironmentfund.com](http://www.globalenvironmentfund.com)).

#### Research and Information

- New Energy Finance is a London-based research company ([www.newenergyfinance.com](http://www.newenergyfinance.com)).
- The Cleantech Venture Network is a membership organisation for investors, service providers and others interested in clean technology ([www.cleantech.com](http://www.cleantech.com)).

## 7. Carbon Trading

### Overview

EU emissions trading commenced in January 2005 to help members meet commitments to the Kyoto Protocol<sup>19</sup>. National allocation plans for the amount of carbon dioxide - the gas most blamed for global warming - that energy-intensive installations may emit are sent by member states for approval by Brussels. Governments then break down the accepted plans among companies, which buy or sell allowances to regulate the release of polluting gases.

Carbon trading operates in a similar vein to the trading of securities or commodities in a marketplace. Carbon has a market value, allowing people, companies or nations to trade it. The value of the carbon is based on the ability of the country owning the carbon to store it or to prevent it from being released into the atmosphere. Penalties are imposed on each metric ton of carbon dioxide emitted above the allowance. Each excess polluter also has to surrender allowances in the second year to make up for overshooting in the first year.

The price of a one-ton carbon dioxide emission allowance started around 8 (about \$9), in January 2005 and peaked at near 30 in June 2005. The standard trading contract on the European exchange is for 1,000 tons, and trades are typically done in lots of 10,000 to 25,000 tons<sup>20</sup>.

### Accessibility

Trading Emissions floated on AIM in April 2005 and is essentially a hedge fund set up to buy pollution credits. The fund plans to scour the world buying credits issued for reducing emissions of carbon dioxide and other hazards. Institutional investors contributed £135m to the fund.

### Green Energy Hedge Funds

By late 2005 it was rumoured that about 10 carbon hedge funds are in formation in both the US and Europe. Their launches are primarily due to the implementation of the Kyoto Protocol (February 16th) and the launch of the EU Emissions Trading Scheme (ETS) on January 1st<sup>21</sup>.

Since June 2005, retail investors have been able to buy a CO2 participation certificate that tracks the market value of EU CO2 emission allowances, with a new securitised product from Dresdner Kleinwort Wasserstein ([www.drkw.com](http://www.drkw.com)).

### Advantages/Disadvantages

The advantages of carbon trading is that they are structured to incentivise the reduction of greenhouse gas emissions. However a concern that has been raised by a number of analysts is that there may be the possibility for exploitation of the trading system.

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<sup>19</sup> Signed in Kyoto, Japan, by some 180 countries in December 1997, the Kyoto Protocol calls for 38 industrialized countries to reduce their greenhouse gas emissions between the years 2008 to 2012 to levels that are 5.2% lower than those of 1990. The Russian government ratified the Kyoto Protocol in November 2004, bringing the agreement on global warming into force in February 2005 (although the United States opted out).

<sup>20</sup> Russell Sparkes, Professional Investor, July/August 2005.

<sup>21</sup> Commodities Now, March 2005.

## 8. Alternative Risk Transfer

### Definition

Alternative Risk Transfer (ART) is the generic term given to unconventional insurance arrangements. The increasingly volatile weather of recent years has led to a growing demand for ART products.

Weather-risk management contracts (or weather derivatives) and natural-catastrophe bonds (cat bonds) are two such devices. Firms use the former to offset the effects of variations in temperature, precipitation and wind speed on their businesses. Institutions from insurers to banks have been willing to supply cover. Cat bonds transfer some of the risk of unusual and devastating events from reinsurers to capital markets<sup>22</sup>.

It is estimated the market for natural-catastrophe bonds has jumped from about \$700m in 1997 to \$5.3 billion today<sup>23</sup>.

### Advantages/Disadvantages

Advantages of cat bonds are that they are not closely linked with the stock market or economic conditions and offer significant attractions to investors. For example for the same level of risk, investors can usually obtain a higher yield with cat bonds relative to alternative investments. Another benefit is that the insurance risk securitization of cats shows no correlation with equities or corporate bonds, meaning they'd provide a good diversification of risks. To date few, if any, of the bonds have been triggered. There is a burgeoning catastrophe-modelling industry, which maps and forecasts the expected path of a hurricane or storm. The main players are AIR Worldwide, Equecat, Risk Management Solutions.

The danger of losing all one's money means that most cat bonds are rated below investment grade and appeal only to those with an appetite for risk.

### Examples of SRI opportunities

ART instruments are relatively underdeveloped. However they could prove to be a valuable structure to benefit the victims of natural disasters such as earthquakes and famine.

The World Bank and U.N. World Food Program (WFP) have run a pilot program in Ethiopia using catastrophe bonds to insure the 2006 food crop. Investors receive high interest payments on such bonds, but if the disaster occurs during its term, all or part of the principal is converted to financing the cost of recovery - in this case the purchase of emergency food.

The World Food Program is also examining the potential of weather derivatives, essentially a hedging tool for betting on specified temperatures or precipitation. The WFP could buy derivatives, so that if drought and crop failure drive up prices for its food purchases, the derivative payoff helps cover the higher cost.

In 2006, WFP is planning to go to the international markets and appeal for funding. If successful, the scheme could help in devising effective financial solutions to address natural disasters throughout the world ([www.wfp.org](http://www.wfp.org)).

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<sup>22</sup> Natural Hedge, The Economist, 29 September 2005.

<sup>23</sup> Swiss Re Capital Markets estimates.

## 9. Some Conclusions

Notwithstanding the rapid development of the SRI market, the majority of SRI investment opportunities to date have been focused on listed equities. The unquestionable growth in alternative investments over recent years points to increasing evidence of other asset classes offering suitable investments to an expanding investor base looking for increased financial return through diversification. These opportunities present themselves to different classes of SRI investors from Pension Funds and Insurance Companies to small private investors.

Each alternative asset class provides new opportunities for SRI investors as well as providing diversification and other financial and risk-related benefits. For example bonds, as well as providing greater certainty over expected returns, may allow investors to exercise an “activist” influence by attaching conditions under which the loan is granted. These conditions, or covenants, could stipulate matters central to socially responsible business practice.

Investors have become more familiar with securitisation technology, which is no longer viewed as arcane or the exclusive preserve of the ultra-sophisticated investor. Both transparency and liquidity in the market have improved as more and more mainstream investors such as insurance companies, pension funds and private banks have stepped into the market. Securitisation has become the fastest growing area of the global credit markets. The flexibility of the securitisation concept and inventiveness of investment bankers means that virtually any asset is a candidate for transformation into structured finance securities.

In the UK, the innovative structure of the HBOS social housing covered bonds is viewed as a pioneer of a new asset class<sup>24</sup>. This issue helps demonstrate how attractive pricing creates robust demand and good investor diversification. Both the synthetic CDOs launched in Australia and the HBOS bond demonstrate an ability to conform to SRI criteria.

The growing battle against climate change has propelled renewable energy into the spotlight where it is likely to remain. The introduction of new financial incentives for investment in renewable energies, the pricing of greenhouse gas emissions and concerns about energy supply mark the beginning of a paradigm shift in government policy across Europe. Renewable energy offers opportunities in a range of products covering the majority of asset classes. The sector has caught the interest of hedge funds and private equity investors and mainstream investment opportunities are multiplying.

The outlook for mainstreaming microfinance seems less certain. There has certainly been a multi-pronged drive to increase public awareness, most notably with the UN International Year of Microcredit. The later part of 2005 has seen a number of landmark microfinance deals, which suggests the growing acceptance of microfinance as an asset class in its own right. However, while the constraints to growth of this “asset class” are not insurmountable, it will take time to harvest investor confidence on a more general scale.

Alternative Risk Transfer (ART) instruments, as yet an untested means of capital-raising with SRI objectives, could prove a valuable structure to benefit the victims of

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<sup>24</sup> The HBOS covered bond issue is included in Bank Sarasin's, The Sustainability of Covered Bonds, Klaus Kaempf, July 2005.

natural disasters such as earthquakes and famine should the WFP be successful in its Ethiopia funding appeal.

In conclusion, the investment categories covered in this report have potential appeal for the SRI investor looking to diversify. Moreover, the ever increasing focus on alternative investments will inevitably materialise into new types of allocation strategies which in turn will offer greater access to diversification opportunities.

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## **Short Biography of Anne-Marie Smith**

Anne-Marie has over 12 years' experience working in investment research and analysis. Between 1998 and 2002 she worked for Jefferies International Limited in International Equity-Linked Research as their European Convertible Bonds Analyst, where she had responsibility both for written output and marketing. She held a similar role at SocGen-Crosby Securities Limited as Senior Analyst, Asian Convertible Bonds Research. Prior to that she held analyst and research positions at HSBC and Morgan Stanley. More recently, she has assisted in setting up a high-end independent media house in Asia. In April 2006, Anne-Marie joined Dawnay, Day Lockhart (DDL), a division of Dawnay, Day Brokers. DDL is an agency broker servicing UK institutional clients in the continental European equity markets.