

The Sustainable Investment Opportunity in Israel

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WHAT IS SUSTAINABLE AND RESPONSIBLE INVESTING, OR “SRI”?

SRI is an investment process that considers the positive and negative social and environmental consequences of investments within the context of rigorous financial analysis in order to encourage corporate social responsibility.

Investment managers of social investments superimpose a qualitative analysis of corporate policies, practices, and management systems upon the traditional quantitative analysis of profit potential. SRI has proven to be competitive with conventional investments, and investors are attracted by the opportunity to make a difference while making financially sound investments. The growing popularity of social investing has led to **one out of every nine** dollars under professional management in the US being invested in SRI, totaling \$2.14 trillion.¹

DOES SUSTAINABLE AND RESPONSIBLE INVESTING HURT INVESTMENT RETURNS?

A key question for investors considering SRI is whether they will have to forfeit financial returns for the sake of their concern for the environment or society. This question has been the subject of tens of studies over the last decade. A comprehensive summary of these studies and their conclusions was conducted by Phillips, Hager & North Investment Management Ltd².

Ten studies comparing SRI mutual funds with traditional mutual funds are summarized in the PH&N paper. The conclusions indicate that SRI funds perform competitively, as the following two leading investment banks concluded:

¹ Social Investment Forum 2003, “Report on Socially Responsible Investing Trends in the United States.”

² Does Socially Responsible Investing Hurt Investment Returns?

“Contrary to theory, most academic studies show that incorporating social screening into a portfolio does not necessarily have detrimental effects on performance. Studies suggested that SRI portfolios have about the same risk-adjusted returns as their normal counterparts.” (UBS Warburg, 2001 p. 14)

“...the balance of the empirical evidence supports the view that an SRI approach will in general not lead to long run risk-adjusted under performance compared with a conventional approach.” (ABN-AMRO, 2001 p.93)

The conclusion of the PH&N review of SRI investment performance is twofold: first, that “socially responsible investing does not result in lower investment returns;” and second, that “individual investors and trustees of institutional funds...can pursue a program of socially responsible investing with the expectation that investment returns will be similar to traditional investment options.”³

SRI IN ISRAEL: CURRENT STATUS AND OPPORTUNITY

SRI in Israel is poised for growth from both a local and foreign investor perspective. A number of trends and factors pointing to this potential are gaining prominence, including:

- High level of awareness of social, environmental and ethical issues in the non-government non-profit sectors representing the investing public, currently the second largest investor group;
- Recent introduction of a number of socially-related funds and services to meet the growing demand for SRI;
- Expected changes in regulations are encouraging institutional investors to implement SRI within their investment strategy;

³ Does Socially Responsible Investing Hurt Investment Returns? Phillips, Hager & North Investment Management Ltd (2005) p. 5.

- Growing number of international investors with SRI mandates to fulfill;
- A lack of confidence among the general public in the ability of the public sector to promote such issues, coupled with ongoing issues of corruption and scandals in both the public and corporate domain.

SRI and the Israeli Investor

For the first time in the history of the Tel Aviv Stock Exchange, more than 50% of traded stock is owned by the public, making them the main shareholders and holding more influence than a few large individual investors.⁴ This is a watershed moment for the investing public since their interests now can hold greater weight than in the past in shaping the way companies operate.

This same investor majority has recently expressed interest in investments that take more than just the bottom line into account. A recent survey conducted in June 2005 by the Tel-Aviv Stock Exchange's economics division indicates that there is an overwhelming demand by the Israeli investor public for socially and environmentally sound investment products:

- 63% would prefer to invest in companies that are less profitable but contribute more to the community and environment;
- 78% believe that publicly traded companies should serve investor interests as well as contribute to the community;
- 73% stated that they would consider whether a company harms the environment in their investment decision making process.⁵

⁴ <http://www.tase.co.il/portal/pdf/pdf-m/90204.pdf> , Tel Aviv Stock Exchange 31.12.04
http://www.tase.co.il/portal/pdf/pdf-m/TASE_Annual_Review_2004.pdf

⁵ “Omnibus Survey Results on the Topic of Social Responsibility,” Ronit Harel Ben Zeev, VP Economic Division of the Tel Aviv Stock Exchange.

Growing Number of SRI Services in Israel

An additional indicator of the growing interest in socially responsible investing is the introduction of various SRI products and services in Israel by influential organizations. Following is a summary of some of the more prominent offerings:

- **Maala**, which has raised the SRI flag, is a non-profit organization that has pioneered the concept of Corporate Social Responsibility in Israel. In February 2005 Maala set up the Maala Social Index of publicly traded companies together with the Tel Aviv Stock Exchange. The purpose of the index is to raise awareness amongst corporations of the link between corporate social responsibility (CSR) and financial performance.

However, the index is heavily weighted in favor of those companies that donate significant money to community projects, and does not provide an objective evaluation of companies' social, environmental and ethical performance. This is for several reasons: 1. Maala is a membership organization funded by the corporations that are evaluated. 2. Maala's research process is not transparent and auditable 3. Aside from amounts donated, the indicators according to which the companies are evaluated reflect only management systems in place as apposed to actual company performance in social, environmental and ethical areas.

- **BDO-Ziv Haft**, a leading accounting firm in Israel, has set up a social accountability division serving corporations seeking to implement social accountability in the way they do business. BDO provides corporations with Social Responsibility Corporate reporting services, and was responsible for producing Discount Bank's social responsibility report earlier this year

Likewise, several SRI funds have been launched in the past 12 months:

- **Altschuler Shacham – Keren Yeruka**: The fund's portfolio is made up mainly of international stocks whose direct business relates to water and waste management, renewable energy, public transport

and efficiency solutions. This fund has been significantly advertised in the mass media, yet its relatively high risk portfolio of unknown stocks and lack of home-grown Israeli stocks reduces its appeal to the mainstream investor. The fund has attracted 40.3 million NIS (\$8.6 million US).

- **Bank Hapoalim - Pakan Maala for Social Responsibility:** Founded in March 2005, Bank Hapoalim's SRI fund has raised only 2.5 million NIS⁶ (\$0.537 million US). Its investment mandate is to invest at least 50% of assets in companies that are included in the Maala index.⁷ It is unclear why this fund has not attracted more investment.
- **Bank Leumi – Psagot Dividend Chevrat:** As the first and largest socially responsible fund in Israel, Psagot has raised 137.1 million NIS⁸ (\$29.5 million US). The fund invests at least 50% of its assets in equities, bonds and options of corporations that donate money and distribute dividends

⁶ www.Globes.co.il

⁷ The Maala index is made up of companies that are in the TASE 100 index or have at least 100 million USD annual revenues and are active in services, trade, industry, and construction or infrastructure sectors. The Corporate Social Responsibility criteria for being included in the Maala index are: the amount of money a company donates to non-profit causes, employee participation in voluntary philanthropic activity, company adherence to the ISO 14001 certification for environmental management, company adherence to Israeli health and safety standards, whether there is someone responsible for the company's CSR program and the existence of a company code of ethics.

⁸ www.psagot.co.il

- **Excellence Nessuah – Kesem Maalah:** This Exchange Traded Fund (ETF) is based on the Maala index. The fund tracks the Maala index. At the launch of the fund a press article stated that there were subscriptions of 24 million NIS (\$5.1 million US)⁹ for the fund. The success of this fund is not clear.

The above SRI products have received a mediocre response from the public. Their implementers seem to have underestimated the need for objective and genuine integration of social and environmental issues. These products focused mainly on rating corporations' social responsibility according to the percentage of donations of corporate profits, providing an SRI flavor. However, this approach does not tackle the real issues concerning investors, and simply involves transferring existing donation money to a different channel.

This type of product does not meet international and Israeli socially responsible investors' needs. Most socially responsible investors are concerned primarily with environmental pollution, human rights abuses, equal opportunity for minority groups, exorbitant executive salaries and a range of corporate governance and business ethics issues. Socially responsible investors want to make a positive impact on society through their investment activity. The above funds do not satisfy this aim.

Easing of Regulations

Institutional public investors valued at over \$100 billion have significantly less regulatory restrictions today than those that historically prevented these funds from investing in the stock market.

In addition, there are initiatives to implement new regulations which will mandate fund managers controlling the public's pension fund money to establish an investment policy which takes into account the social and environmental impact of their investment decisions.

⁹ www.ynet.co.il 05.06.05

International Investors with SRI Mandates

International investors are increasing their holdings of Israeli stocks, and many have SRI mandates to fulfill. The Hermes Investment Management Ltd.,¹⁰ the United Kingdom's leading pension fund manager with funds under management of 51 billion GBP, recently purchased shares in some of Israel's leading companies such as Koor, Nice, El Al, M Systems, Given Imaging, Israel Chemicals and Supersol. Hermes is well known for its emphasis on non-financial issues such as corporate governance and maintains a specific fund which takes on a shareholder engagement investment strategy. With the entry of major institutional investors such as Hermes into the Israeli market who are obligated by law to consider social and environmental issues in their investment strategies, it is believed this class of investor will influence the way local investors behave.

SUMMARY – ISRAEL RIPE FOR SRI

Based on discussions with investor groups in Israel it seems that there is a need for a fund that takes a genuinely critical look at corporations' behavior and their impact on the world, and not only at the amount of charitable donations made by these companies.

Existing products do not present a cohesive plan for investors who want to actively make a difference in the realm of the social and environmental concerns of the Israeli capital markets. In order to achieve this, suitable products and services need to be offered by an independent entity representing the investing public's interests which is able to provide both structure and direction.

Demand for independent SRI research and rating services is also being driven by the corporations themselves who are using corporate social responsibility as a competitive edge. A large cadre of international corporations doing business in Israel has already influenced the local market's drive to achieve international standards of corporate social responsibility. Investors need a straightforward way of grasping all the SRI activity and how it impacts their investments.

¹⁰ www.hermes.co.uk

Based on several meetings with existing financial services companies, it seems that current players in the financial services market will experience difficulty in adapting to the demand for genuine SRI products due to the shift in attitude required. These companies are used to working solely on a financial returns paradigm, and find it difficult to understand that investors are looking for more than financial returns.

SRI RATINGS FOR THE TASE 25 INDEX

Kayema has completed the ratings of Israel's largest publicly traded corporations representing 75% of the market capitalization and trading volume on the Tel Aviv Stock Exchange. For the first time ever, investors have access to information based on international standards of social, environmental and ethical performance as to which Israeli companies are the most socially responsible. The rating process is comprehensive and offers a complete, objective picture of how companies deal with these issues.

The screening process is based on seven themes:

- business ethics
- corporate governance
- environmental impact
- employee relations
- customer relations
- community relations and suppliers.

Each theme is reviewed on four levels:

- transparency
- policies
- management systems
- performance.

The process begins with a review of all publicly available company literature such as annual reports and website. A full review of mass media is conducted to pick up any scandals, such as dumping untreated toxic waste in a public area or an above average occurrence of labor unrest. An interview with senior executives at the company enables us to verify any facts and include any missing details that did not come up in our review. Finally Kayema consults with Non Governmental Organizations to determine which issues are most pertinent to the public. The methodology and process is all documented and is fully transparent and auditable.

ABOUT KAYEMA INVESTMENTS

Kayema Investments is the only independent research firm able to provide objective unbiased evaluations of Israeli corporations' social, environmental and ethical performance. Kayema is the Israeli representative of SiRi Company www.siricompany.com, the leading independent SRI research firm worldwide with over 100 analysts covering over 4,000 companies. Among the group's clients are some of the world's leading institutional investors such as Dexia Asset Management, State Street Global Advisors, ING Asset Management, Rockefeller & Co. and Fortis, representing over €3 billion of assets under management

Kayema provides five core product offerings:

- 1) Independent research of Israeli publicly traded corporations, resulting in ranking or rating of companies based on social, ethical and environmental parameters. In addition, Kayema provides project specific or sector/company specific research and white papers to investor clients both in Israel and abroad seeking a deeper understanding of the Israeli SRI scene.
- 2) Consulting and advisory services to pension funds and other institutional investors wishing to institute an SRI investment strategy, as well as portfolio audits and SRI "health checks," all in accordance with internationally accepted criteria and benchmarks.
- 3) Strategic advisory work with asset managers/portfolio managers looking to establish mutual funds based on SRI criteria.

- 4) Distribution of global SRI funds (fixed income and equities) offered by leading fund managers to Israeli institutional investors.
- 5) Kayema assists Israeli investment firms and fund trustees in addressing issues such as global warming, emissions controls and trading exchanges, the financial risks of global warming and its impact on the finance and insurance sectors, ramifications of international treaties such as the Kyoto Protocols, CERES initiatives, etc.

ABOUT THE AUTHOR

Daniel Schwab – Founder & Senior Partner

As part of the founding team of the Business Ethics Center in Jerusalem, Daniel was responsible for consulting and research projects. These projects included a grading of Israeli companies' performance on social, environmental and ethics issues, and developing an ethics training program for Liberty Life Ltd. Daniel has broad experience in the corporate sector, particularly in the fields of business development and market analysis, and along with his successful track record in executive recruitment for clients such as Citibank, Daniel brings to Kayema the vision and ability to develop a winning business strategy. Daniel is responsible for Kayema's individual clients, marketing and the research department.

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