The DJSI – a story of financial innovation

Richard Sandor and his guest co-author **Alois Flatz** reflect on the birth and development of stock market indexes to aid the growth of sustainable investments

At the beginning of the 1990s two apparently unrelated financial developments occurred. The first was the launching of the International Chamber of Commerce (ICC) Sustainable Development Charter in 1990. It marked the first time that a group of industry CEOs recognised the importance of positive social and environmental behaviour in creating shareholder value. Financial innovation followed, thereby facilitating the flow of billions of dollars into socially responsible investing (SRI) and sustainable investments (SI).

The other was the passage of the US Clean Air Act Amendments of 1990, which provided the legal infrastructure for the successful implementation of the sulphur dioxide (SO_2) 'cap-and-trade' programme. This scheme's financial and environmental success subsequently led to an understanding that these markets would provide profit-making opportunities for companies, thereby increasing shareholder value.

Both of these developments offer valuable insights into financial innovation. This column provides some personal insights into the inventive process associated with sustainable investing.

The eminent economist Josef Schumpeter divided technological change into three phases: invention, innovation, and imitation or diffusion. The conception of a new product or process is termed invention. Innovation is the commercialisation stage, and diffusion is when its use becomes prevalent. It may be useful to trace the development of SI in this context.

Meyer Feldberg, the dean of the Graduate School of Business at Columbia University, took a bold step in the early 1990s and introduced the first course on Environmental Finance taught at a Graduate School of Business, which Richard had the privilege to teach. The students prepared a study in 1992 entitled *Green Investment: Profit or Pain*, which reported that the risk-adjusted performance of SRI funds relative to the S&P 500 index was historically less than stellar. But, in spite of this, they remained optimistic about the future of SRI. They concluded that environmental screening criteria and indexes would become better developed and more widely used and accepted.

Their forecasts proved to be accurate. By 1995 there were 55 socially screened mutual funds in the US with assets totalling $12 billion. Furthermore, 38% of these SRI funds were being screened on environmental performance. This was a change in attitude reflecting a new generation and was not restricted to the US. That same year, 4,000 miles away in Zurich, Switzerland, Reto Ringger, a young Swiss entrepreneur, became the founder and CEO of SAM Sustainable Asset Management. He persuaded two German entrepreneurs, one of them the influential industrialist Alfred Ritter, to provide seed capital of SFr1.5 million ($900,000) to launch SAM.

Just a year later, Reto invited several academics and businessmen to become founding board members of the Sustainable Performance Group (SPG – see Table 1). It was to be the world's first sustainable investment company. He hoped to commercialise SI and, being convinced that negative screens would not attract significant capital, he traveled tirelessly to persuade others that a new era was being born.

Table 1: Founding directors of Sustainable Performance Group

Dr Ernst Brugger, Chairman of the Board
Dr Christian Lutz
Dr Richard Sandor
Dr Klaus Woltron
Dr Alexander Zehnder

Ernst Brugger, a personal friend and a leading Swiss academic and practitioner in the environmental field, led a very successful capital-raising campaign that enabled SPG to initially raise SFr79 million. Lead investments came from Swiss Re and the Volkart Group with Andi Reinhart, chairman of Volkart, subsequently becoming chairman of SAM. The fund was officially launched on 8 August 1997.

It was an inauspicious time to launch an innovative financial product. The asset managers were soon faced with a major financial crisis in Russia that affected the worldwide capital markets. But despite this poor timing, the SPG started to outperform its benchmark, the MSCI World Index. At the first board meeting of the SPG, Richard suggested the development of a sustainability index as a tool for demonstrating that the performance of the SPG was not only superior to the MSCI, but to other competitors that might enter the SI field. As time passed, it became clear that the superior performance of the SPG needed to be explained in terms of SI if clarity was to be achieved in the minds of its investors. The board discussed the idea and concluded that it would be a very valuable tool. Its involvement stopped at that time. SAM would not officially inform the SPG board of the status of its research until a suitable partner had been found.

One year after the launch of the SPG, Alois Flatz from SAM began exploring the possibility of developing an international sustainability index. SAM's management and the research staff started to develop a detailed concept of the index. They sought the assistance of a handful of outside experts, including John Elkington, the founder of UK consultancy SustainAbility.

The concept was simple but convincing. The sustainability index would track the financial performance of the top sustainability companies. The selected companies would be leaders in their industries, reflecting the "best of class" approach. They would be chosen from a ranking of the world's biggest companies based on a relatively simple corporate sustainability assessment system. Initially, it was anticipated that a five-page questionnaire would be sufficient for assessing these companies.

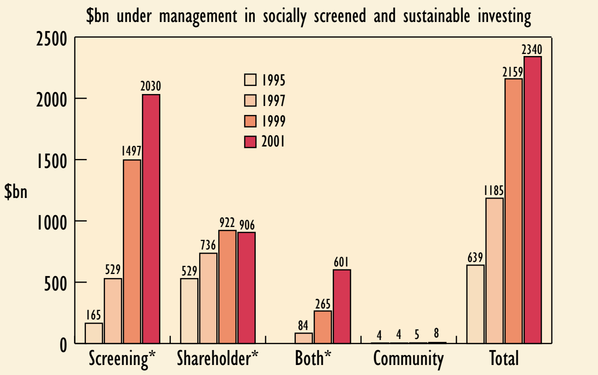
It was also decided that the index could be developed internally but calculated and branded by a third party. SAM's management therefore contacted the major index companies but all rejected the concept. However, a combination of skill, determination and luck resulted in a partner being found.

The Swiss stock exchange provided the impetus to finding the partner. It was interested in branding the index but the global nature of the index didn't fit the exchange's strategy. It then introduced SAM management to STOXX, a joint venture of the Swiss, French and German stock exchanges and the Dow Jones Index Co. A newly hired managing director, Michael Schanz, introduced the SAM team to the Dow Jones management.

The critical decision-maker in these first meetings was the chief editor of Dow Jones Indexes, John Prestbo. John was both a distinguished writer as well as a seasoned veteran of Wall Street. If he were intellectually convinced about the validity of SI, then SAM would have its most credible advocate at Dow Jones. John was initially sceptical, but later became convinced that a sustainability index could be differentiated from SRI and would be consistent with the mission of Dow Jones Indexes.

During this time, Andi Reinhart became a significant investor in SAM and chairman of the board. The original investors had supported the development of the index since 1997. Andi also strongly believed that a strategic relationship with Dow Jones would be helpful in legitimising the concept of sustainability and raising the visibility of SAM. Fortuitously, Richard had worked with David Moran, president of Dow Jones Indexes, in the licensing of the Dow Jones Industrial Average to the Chicago Board of Trade, where he served as its vice-chairman for strategy. David, with the advice of his colleagues, would ultimately make the final decisions about the new venture. His vision and leadership would ultimately determine the viability and success of any partnership.

1. Socially responsible investing in the US



* 'Screening' and 'shareholder' both include $84 billion of assets in 1997, $265 billion in 1999 and $601 billion in 2001 in portfolios that both screen and conduct shareholder advocacy. The calculation for total is: Total = Screening + Shareholder + Community – Both. This category is not applicable in 1995

Source: 2001 Report on Responsible Investing Trends in the United States. Social Investment Forum, SIF Industry Research Program, 28 November 2001 http://www.socialinvest.org/areas/research/trends/2001-Trends.htm

Final negotiations took place in New York in October 1998. David and John were joined by Mike Petronella, a very promising and bright member of the Dow Jones team. It was at that lengthy meeting that all of the issues were discussed. The green light was finally given.

But it was only the start. As Goethe said: "The genius is in the detail". Through scenario planning and the assessment of trends and driving forces, various criteria were applied to all 64 industries. From those general and industry-specific criteria, questions were devised. The sustainability questionnaire amounted to 14 pages, compared to the initial estimate of five. Armed with a questionnaire and a defined corporate sustainability methodology, SAM invited the largest 2000 companies in the Dow Jones Global Index – drawn from 64 industry groups and 36 countries – to participate in the first annual assessment.

Companies' reactions varied greatly. Some welcomed the index and provided SAM with completed questionnaires accompanied by boxes of supporting documentation. Others refused to even return the questionnaire because of their scepticism about sustainability. The questionnaires prompted self-assessments among corporates and concomitantly provided an educational tool for sustainability efforts. Companies that did not respond to the questionnaire were ranked using publicly available information.

Over a period of six months, SAM management and a team of 15 analysts completed the assessment of 600 companies. To facilitate the analysis, SAM developed an extensive database. It has been upgraded over the past three years and has become the world's first and largest database tracking global corporate sustainability.

By the spring of 1999, the stage was set for the final determination of the index. Reto and Richard met with the Dow Jones' team. For the better part of a day the final details of the index were completed. There was significant debate about the weapons industry. European investors wanted negative screening to exclude this. However, sustainability measures required the inclusion of companies that produced military equipment if it was only a part of their sales. The solution to the dilemma was to reduce the weight of these companies by the percentage of weapons-related turnover. The salient features of the index were fully debated and only finalised when there was unanimity. It was a familiar scene that occurs in investment banks, stock and futures exchanges on a regular basis. The inventive process in the capital markets is collaborative. This was the process at its finest.

Next came the acid test – the historical performance of the index was determined by backcasting. There was great uncertainty about how it would perform. After hours of calculation the results were unambiguous. The sustainability index outperformed the general Dow Jones Group Index overall, in all three regions, and in eight out of the nine sectors. The calculations were run through the night to double-check the results. Nothing changed. In the Schumpeterian sense the inventive process was completed.

Next came innovation – the commercialisation of this new financial product. The index was launched on 8 September 1999. At the outset, there were five licensees for the index but that number has now grown to 31 with more than €2.2 billion ($2 billion) under management. We are not only in the midst of a Schumpeterian innovation with diffusion, but have also witnessed imitators. That is the final stage of the inventive process.

There has been a dramatic increase in SRI. Figure 1 shows the growth in assets under management from 1995 through 2001 for three categories of SRI: investments selected through screening criteria; shareholder advocacy investing; and investing to support local community development by entities such as credit unions.

Although SRI and SI differ greatly in methodology, approach and investors, they have been driven by similar trends. In both cases, the driving forces behind their growth fall into three categories:

- the need to manage environmental and social risk exposure;
- shareholder pressure; and
- sustainability and maximisation of shareholder value.

Nothing illustrates the last point more clearly than the fact that the DJSI significantly outperforms all other indexes with virtually no increase in risk.

We began with the premise that financial innovation could be viewed as a Schumpeterian process. The development of the DJSI in this context seems to follow this pattern. The mixture of entrepreneurship by capital providers and management helped this process. Inventive activity is ultimately a response to latent or overt demand. The reasons for growth in sustainable investing, and the success of this index, are simple: higher risk-adjusted rates of return. Capital markets have eyes.

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