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# Integrated Social Responsibility Portfoliomanagement

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## An Ethical Value Added Model



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# Agenda

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## Integrated SR Portfolio Management

Requirements for universe, return and risk forecasts and index to be used in optimisation and proposals how to integrate modern SRI standards: rating/ranking, in return and risk forecasts for a structured investment process

# Investment Process

<b>Strategic Level</b>	<b>Planning</b>	<b>Investor Analysis</b>	<b>Utility Function &amp; Measurement Variables</b>
		<b>Financial Analysis</b>	<b>Analysis/Forecast of Utility Variables (Targets)</b>
		<b>Portfolio Planning/ -construction</b>	<b>Integrating Targets &amp; Conditions to Portfolio Weights</b>
		<b>Portfolio Revision</b>	
<b>Operating Level</b>	<b>Realisation</b>	<b>Timing</b>	<b>Short term Market Aspects</b>
		<b>Trading</b>	
	<b>Controlling</b>	<b>Results</b>	<b>Measuring level of achieved utility</b>
		<b>Reporting</b>	

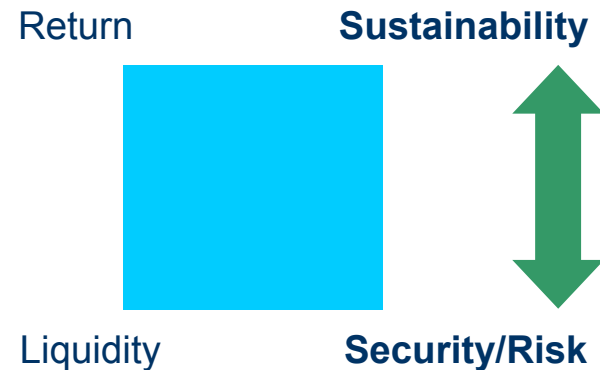
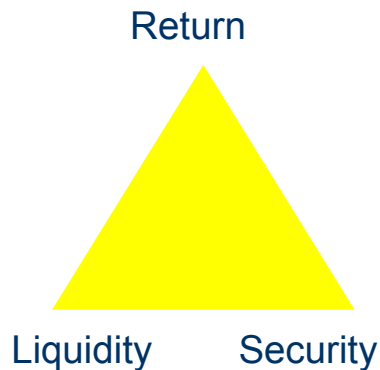
# Strategic Level in Theory and Practise

	Traditional Theory	Current Practise	CSR Integrated	Sustainability Relevance
<b>Target</b>	Individual Utility Maximisation (personal Wealth)	Rarely determining explicitly	Increase & participate in social welfare over long term horizons	Long term and socially oriented goals  Justice (social, across generations) - Transparency (against abuse of power) - Documentation (against arbitrariness)  Capacity to learn can be measured (quantified forecasts) can be repeated (mode consistency)  Documentation Reflection - adaptable - flexible (change)
<b>Measurement</b>	Market value of portfolio	Market value of portfolio	risk adjusted profit aggregated over all companies in the portfolio	
<b>Research/Forecasts of Target Variables</b>	Price potential & Volatility & correlations of market prices	Intransparency & Incomparability	risk adjusted profit potential based on corporate strategy & Volatility & correlation of profits	
<b>Portfolio planning/-construction</b>	Quadratic optimisation	ad hoc & intuitive	Optimisation (Algorithm of choice)	
<b>Revision</b>	Adjusting when divergent market development (disruptive factor)	spontaneous or interference	focus on long term fundamental influences on value drivers	

# Operating Level in Theory and Practise

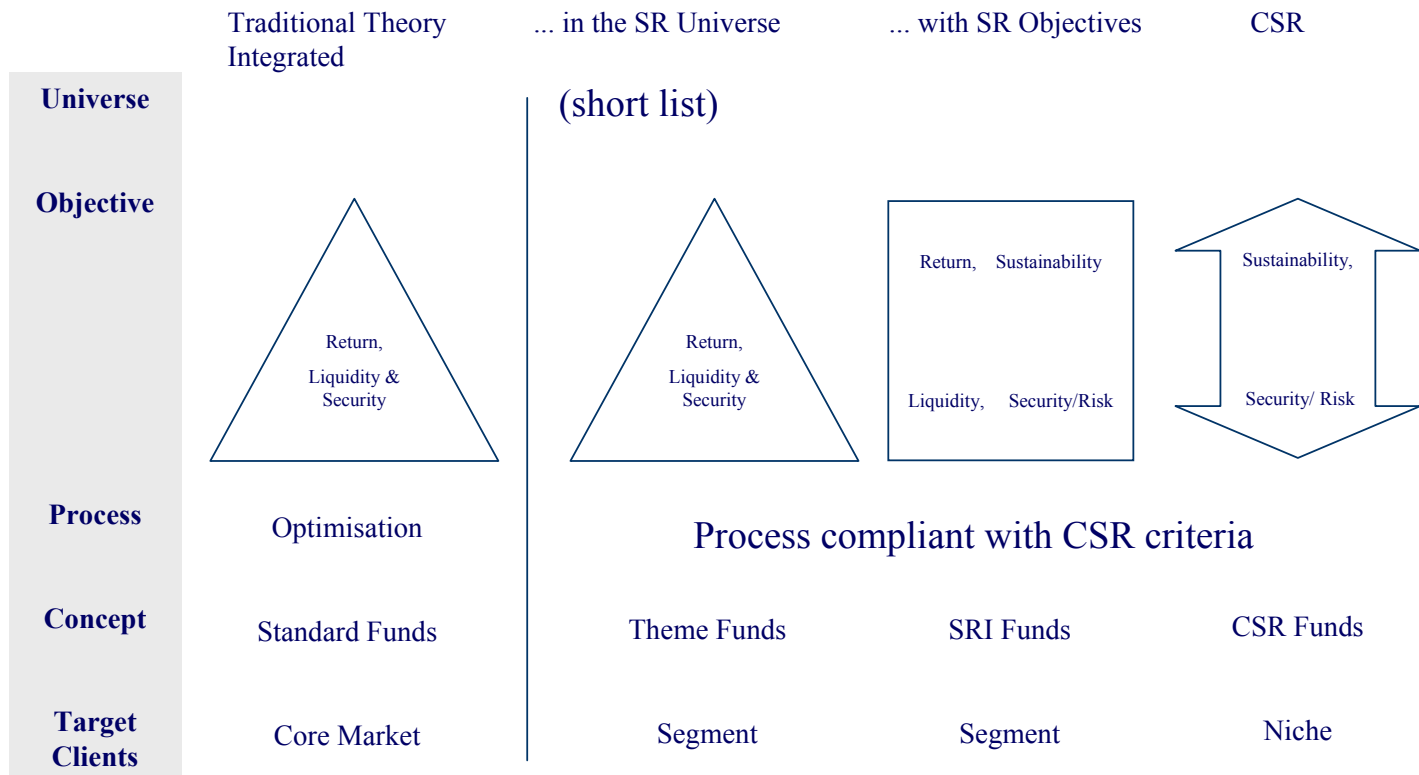
		Traditional Theory	Current Practise	CSR Integrated	<b>Sustainability Relevance</b>	
		<b>Operating Level</b>	<b>Realisation Timing</b>	No Statement		Developing a Market Price Forecast
Determining Best Trading Date	Priority of PM			Determining Best Trading Date	Capacity to learn	
<b>Trading</b>	Best Execution of Each Single Transactions		Priority of PM	Fair & Sincere Trading	can be measured (quantified forecasts) can be repeated (mode consistency)	
<b>Controlling</b>	<b>Measuring Success</b>		Price Development of Portfolio Attribution Analysis	Price Development of Portfolio	Fundamental Value Development Gains from Timing Gains from Trading	Documentation Reflection - adaptable - flexible (change)
	<b>Reporting</b>		No Statement	Annual Report Interims Report	Report according to Transparency Guidelines	

# Amending the Magical Triangle ...



... concerning the Positioning via/with Process

# Positioning and Process





# Client Orientation

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- ◆ Suppliers in segments lose their niche existence, the niche must be defined anew: demand orientation
- ◆ Sustainability requirement will be recognised by some target and client groups more consciously as a quality feature: process orientation
- ◆ Supply requires wide ranging strategy



# Management or Participation

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- ◆ Investor relations: necessity conflicts with model of financial markets
- ◆ Individuals direct their decisions increasingly towards „pleasure“: principle of excitement instead of saturation
- ◆ Funds manager rely on sources of information which spread acute effects of incubation



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# The Ball is Round!

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Schulz-Wimmer on the general situation in financial markets:

*As in soccer, excitement became more important than information ... Economics used to be to 50% psychology. But nowadays it seems no longer to be clear, which half this is.*

# The additional Dilemma of SRI Ratings

- ◆ SRI in search of „Best Practice“
- ◆ Looking into the past
- ◆ Punishes the ‚Bad‘
- ◆ Rewards the ‚Good‘
- ◆ Market in search for price „potential“
- ◆ Expected value
- ◆ Punishes the ‚Good‘
- ◆ Rewards the ‚Bad‘

Possible solution in Behavioral Finance?

- ◆ Follow the ‚Good‘
- ◆ Avoid the ‚Bad‘

# Where are the Excess Returns?

- ◆ „Hollywood: The good will win in the end!“, state SRI followers.  
Does this comply with our world?
- ◆ The market is a trade exchange, in the very short term pricing factors depend on liquidity needs or surpluses, surprises, disappointment, change in taste, propensity to speculate ... on the ‚financial behaviour‘ of all participants.

# Behavioral Finance and SRI?

During the last twenty years market participants experienced again and again spectacular examples of huge financial bubbles, price collapses and other inefficient market patterns.

The theory of efficient markets does not seem to hold easily; at least there is need for an amendment with behavioral aspects regarding the ‚formation` of prices.

So called momentum or the tendency of rising prices to trigger more purchases and vice versa, is a phenomenon that results from greed and several forms of fear: another area for SRI and Behavioral Finance?

Perhaps, but only as an ethical impulse:

**Discipline, Avoiding of Errors, Fairness, ...**



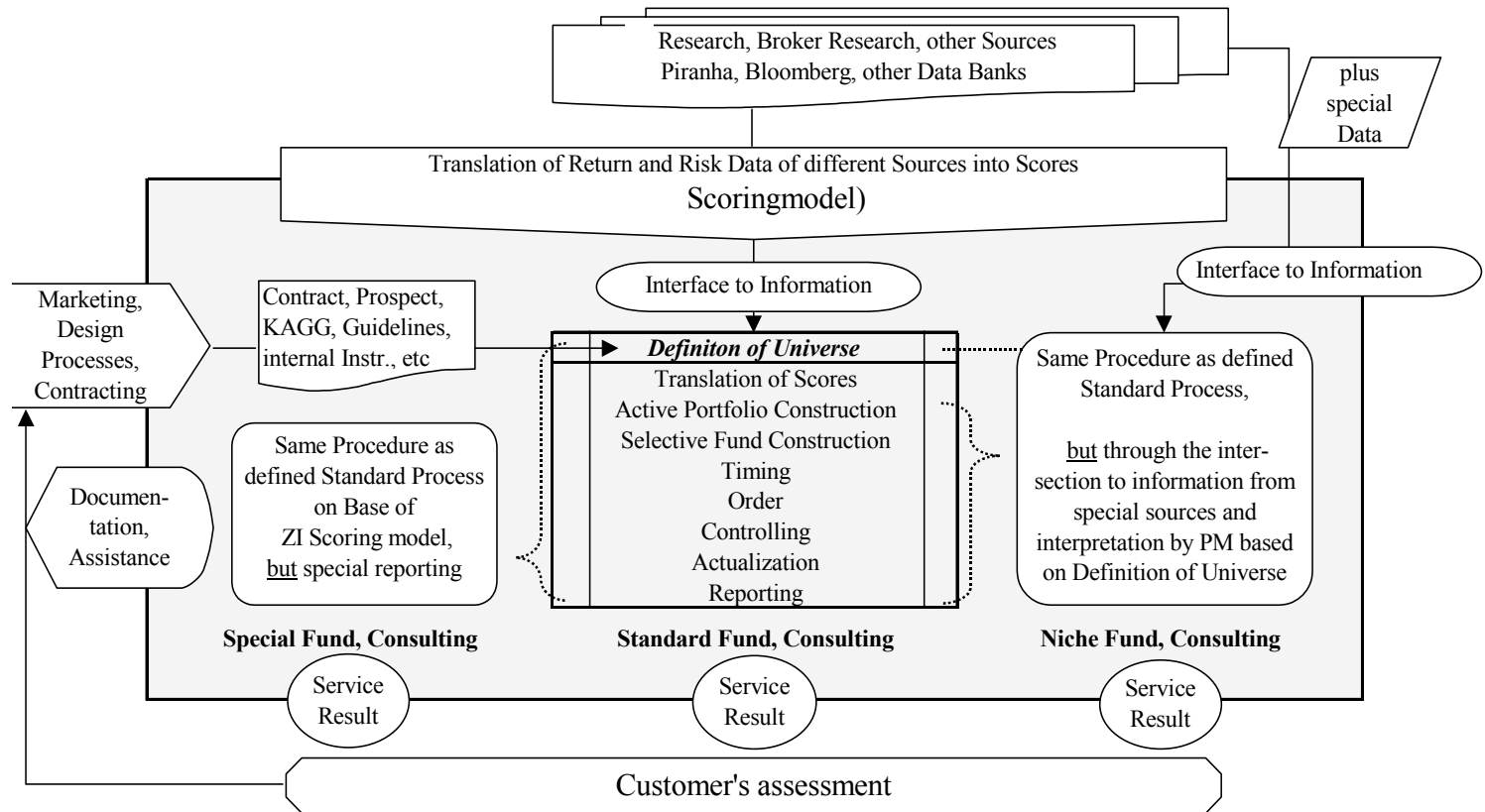
# Behavioral Finance

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- ◆ A young theory, Index already developed
- ◆ Seriously trying to quantify psychological phenomena
- ◆ Speculation on forecast behaviour of market participants (weather forecast)
- ◆ Amplifying instead of keeping still
- ◆ Utility only in avoiding risks

# Portfolio Management Process Overview



# Multi Factor Models

Type of Model	Quality of Factors					
	High Descriptive Power Short Term	High Descriptive Power Long Term	Stable Over Time, Allows to Learn	Risk Attribution along Investment Process	Risk Factors according to Sectors	Allows to Integrate SRI
Statistical Factor Models	X				X	
Structural Macro	X				X	
Structural Fundamental		X	yes/no		X	conditional
Fundamental, Macro	X		X	X	X	conditional
Fundamental, Sustainable		X	X	X	X	X

# And a Matching Risk Model

Idea of Spreading Risk:

“Every additional share reduces the risk!”

Do many shares imply a low portfolio risk?

Stock pickers assume something, that does not apply!

**Example: Marching in step across suspension bridge**

Legal requirement calls for managing risk according to the principle of mixing them. Current standard means optimisation as e.g. offered by Barra et al:

Correlations must be considered for levelling risk!

Above that: Use of ‘options’ for compensating risk!

# Multi Factor Modelling

- ◆ Which factors deem my clients relevant for a sustainable increase in fundamental company value?
- ◆ Which are the factors relevant to me?
- ◆ What real economic factors matter for fundamental risk adjusted profits?
- ◆ How can I reconcile them with market values?  
e.g. through longer redemption periods!

# Information Processing – „Scoring“

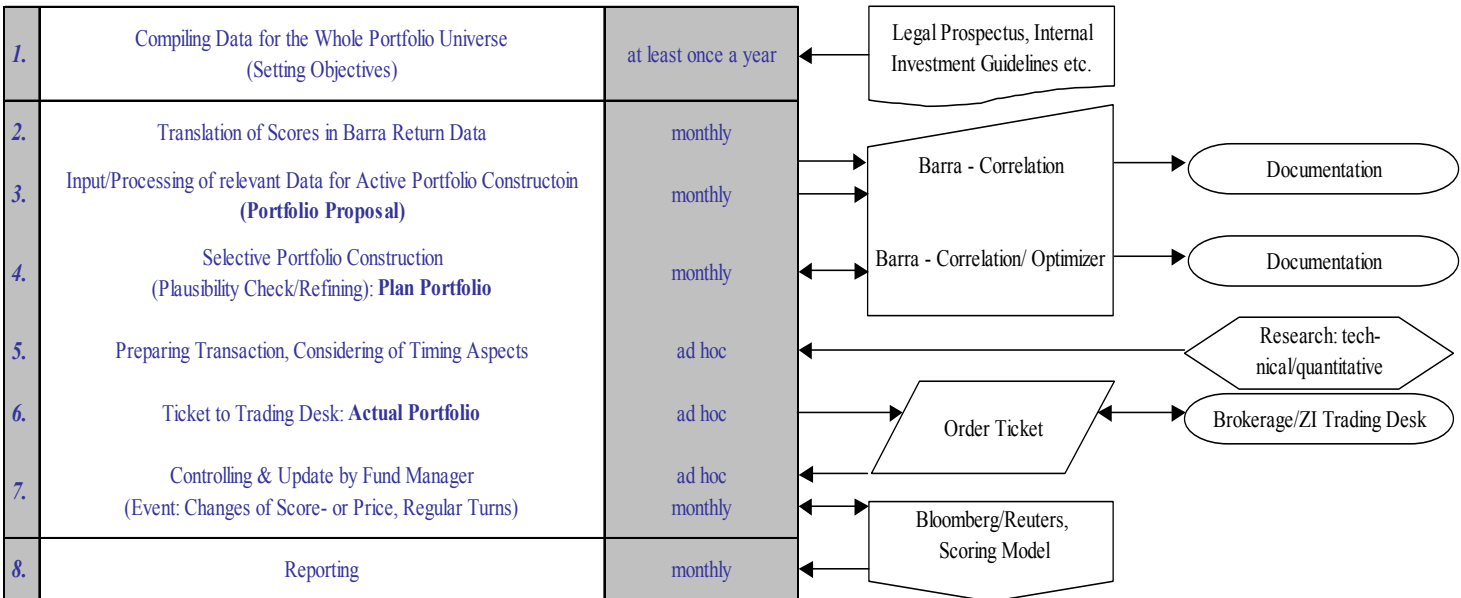
- ◆ Relevant data is analysed in a uniform and systematic way, quality and independence of data rank top
- ◆ Information concerning universe, it will be completely ‚screened‘ according to fundamental variables
- ◆ Available research results, ratings must be included in a consistent manner

# Scoring – Adjusting of Raw Data

- ◆ Scoring (narrow sense), independent raw data will be transformed into scores
- ◆ Raw data are ranked in descending order, ranks are converted into scores, e.g. from -3 to +3
- ◆ Normalisation: Should be transformed into a standard normal distribution (mean 0, standard deviation 1)

# PM in practise

<i>Steps</i>	<i>Frequency</i>	<i>Instruments</i>	<i>Interface</i>
Scoring of Risk and Return Information from different Sources	ad hoc at least once a year	Scoring Model	Research: fundamental/qualitativ





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# Real ,meets` irrational

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- ◆ Company Universe or Index
- ◆ Fundamental Analysis
- ◆ Fundamental Scoring
- ◆ Fundamental Optimisation
- ◆ Trading: Timing Aspects! Now ...  
... Company meets Financial Market



# Why Implement a Fundamentally Oriented Process?

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- ◆ Complexity of all fundamental and financial markets is maintained (no Reduction to stock bets or stock market)
- ◆ Client oriented portfolio decisions will be documented, become transparent
- ◆ Process can be controlled, repeated and improved
- ◆ Portfolio manager works in a systematic and disciplined manner (SRI, CSR)
- ◆ Differentiation in competition: each portfolio management process is unique, client oriented and can be adopted to specific needs by appropriate risk weightings

# What Differentiates an Ethical Investment Process from Others?

- ◆ **Explicit Forecasts of Return and Risk**
  - ◆ Coverage of universe: complete, direct and comparable
  - ◆ Consistent realisation of forecasts in portfolio construction (Optimisation)
  - ◆ Risk management with ex ante consideration of correlation
- ◆ **Implicit and hidden Assumptions**
  - ◆ Incompatible subsets of the universe covered for differing funds
  - ◆ Intuitive and accidental portfolios (traditional approach)
  - ◆ Risk spreading as in lending or insurance

# SRI a Large Opportunity for Active Management!

