

ESPA Responsible Investments

ESPA-VINIS Sustainability Funds in CEE



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I. Responsible Investment, Rating and Emerging Markets

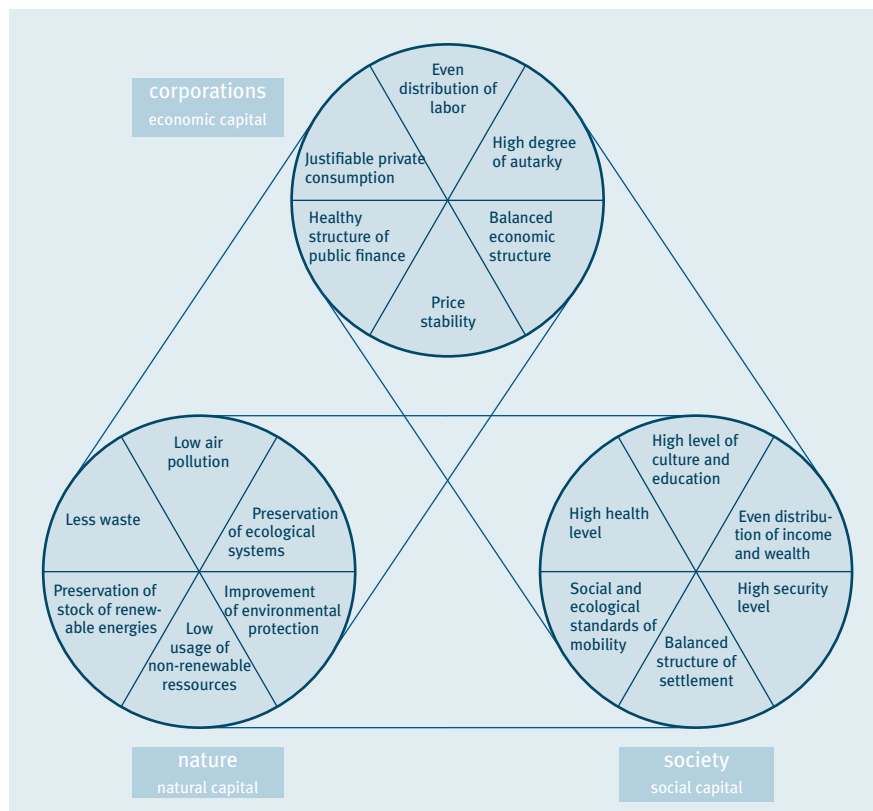
I. a. Responsible Investment, SRI & ESG

According to both current academic discussion and performance history there is no contradiction to be expected between (social) responsibility and profitable investment. It is possible to reconcile both targets, to behave in a responsible way on the one hand and to achieve attractive performance on the other hand – by the implementation of sustainability issues in the investment process.

The most widely used definition of sustainable development dates back to 1987, and was set up by the so-called Brundtland Commission, formally the World Commission on Environment and Development. The definition focuses on the conservation of resources for future generations and distributive justice:

»Sustainable development is a development that meets the needs of the present generation without compromising the ability of future generations to meet their own needs.«

GRAPH 1: Dimensions of Sustainability



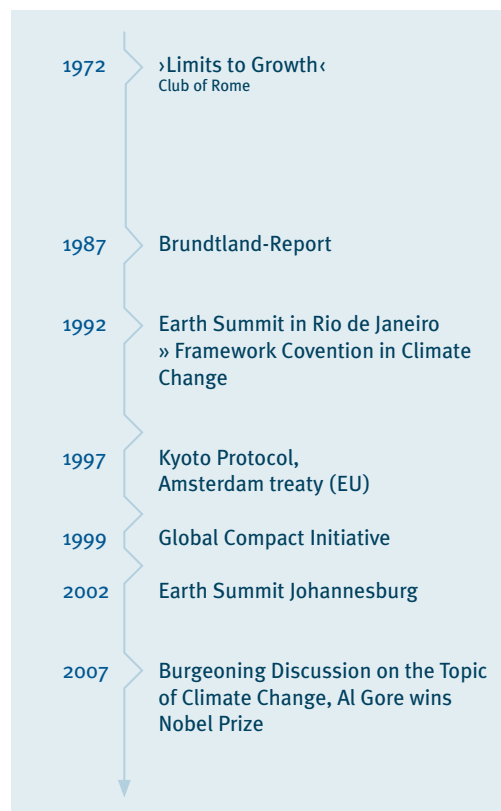
Source: Diefenbacher (2001)

On the basis of the three dimensions of sustainability there has to be a reconciliation of economic, ecological and social issues. The idea behind is to achieve a more balanced and therefore more positive development in the long term. The »capitalist economy« which dominates primarily in the US gives high priority to economic issues and profitability, whereas the »social economy« that can be found across Europe does include a social dimension – focusing on the interests of stakeholders like environment, employees and society – at least to some extent. Accordingly, current issues and points of discussion with regards to sustainable development and sustainability focus on the ecological dimension, with the aspects of climate change being an important part of it.

The following graph (GRAPH 1) illustrates the three dimensions mentioned above and shows various interrelations and interdependencies. Good results for all three dimensions – economy, environment and social issues – are, due to various trade-offs, difficult to achieve. The graph does also point out the various sub-targets for the three dimensions that can be put forward on the basis of a sustainable foundation.

Sustainability and sustainable development have their roots in the past. From the ecological point of view, sustainable concepts first appeared in the area of forest management in German-speaking countries in the 18th century. Another concept that shows similarities to the modern idea of sustainability is the three-field crop rotation system that became popular in Central Europe during the Middle Ages.

GRAPH 2: Milestones of the Discussion about Sustainable Development



Source: Pinner (2008)



GRAPH 2 illustrates the highlights in the discussion on sustainable development over the last decades. In 1972, it was a well-known »Think-Tank«, the Club of Rome, that challenged the prevailing philosophy of economic growth and pointed out its limits. Fifteen years later the above mentioned Brundtland Report was published. In 1992 the so-called Agenda 21 was conceptualised during the Earth Summit in Rio de Janeiro. According to the Agenda 21 there has to be a differentiation between goals in sustainable investments in the industrialised world versus emerging countries. With regards to emerging markets the Agenda 21 refers to poverty reduction, demographic policy, education, health issues, supply of drinking water, sanitary conditions, waste-water respectively waste disposal and rural development.

The history of sustainable investments with regards to investment funds started at the beginning of the 20th century. In then 1920ies the first ethical portfolios emerged which did not invest into companies that produced weapons, alcohol or tobacco. In the Seventies ethical funds were influenced and dominated by the peace movement. Later, there was a larger focus on »green and ecological« positive criteria. Only at the end of the Nineties was the term of »SRI/ Socially Responsible Investments« coined, based on an investment style that included both social and environmental issues. The term ESG – for »Environmental, Social and Governance« factors – has recently gained in importance as it does explicitly include the »Governance«-factor. Over the last years, sustainability concepts have been developed for almost all asset classes. With regards to the sub-asset class of emerging markets equities, this new development has only just started. Therefore sustainability funds that invest in emerging markets on a global basis started only recently. Products with clear regional focus in that group are a completely new approach. The ESPA VINIS STOCK EUROPE EMERGING is the first fund with a focus on the CEE region.

1. b. Investment Approaches in Sustainable Investment

»Responsible Investment« or »Socially Responsible Investment« (SRI) is based on a three-dimensional analysis of investments. This investment

style does not only focus on short-term financial performance but also on social and environmental aspects. Some authors prefer the term ESG to SRI. Sethi (2005, p 101) defines SRI as »investing in companies that conduct their operations with an eye on causing the least amount of harm to the environment and sustainability of our habitat. SRI investors look for companies that minimize negative externalities and accentuate positive externalities«. The majority of authors (Sethi 2005, De George 2006) regard SRI as a medium- to long-term concept.

TAB. 1 shows a comparison of different approaches in responsible investment. The criteria analysed are the size of universe and the deviation versus the total market, but also typical names and the characteristics of the products in terms of responsibility. Both the size of the universe and the deviation issue are of relevance with regards to the risk involved in the asset management product. The lower the number of investable stocks and the higher the tracking error as the most important measure for deviation the higher risk involved will be according to traditional portfolio theory. Interestingly, Barnett et al. (2006) show that there is a curvilinear relationship between social responsibility and financial performance. As the number of screens adopted by responsible funds increases, financial returns decline at first but later rebound as the number of screens reaches a maximum.

The first Sustainability fund with a clear focus on Central and Eastern Europe, the ESPA VINIS STOCK EUROPE EMERGING, makes use of an absolute evaluation based both exclusionary criteria and a best-in-class approach. While engagement is part of the underlying process, it is – in contrast to TABLE 1 – not implemented as a style of its own, but as an additional factor in a »holistic« management approach.

The assessment of companies from a »responsible« point of view is usually based on companies' CSR and stakeholder issues as they are important factors for the assessment of companies' »responsible behaviour« and their suitability for responsible investments. According to Mill (2006) SRI and CSR are often portrayed as closely related phenomena. Maybe it is true to say that CSR and SRI are a kind of mirror images of each other (Sparkes 2002). Each concept is based on the conviction that business should generate wealth for society but only within certain social and environmental frameworks. CSR takes the company angle, whereas SRI looks at it from

TABLE 1: Styles of Responsible Investment

	Screening: Exclusionary criteria	Screening: Positive criteria	Screening: Best-in-class	Shareholder activism & engagement*	Integration*
Number of stocks in universe	Rather low	Rather low	Rather high	High	High
Deviation/ tracking error versus total market	High	High	Rather low	Low	Low
Typical name of product	In general »ethical fund«	Thematic fund (Environment, Climate Change etc.)	In general »Sustainability fund«	Conventional fund name with reference to engagement	Conventional fund name with reference to integration
Characteristics of product	High degree of responsibility	Positive thinking and a clear goal in focus	Alternative to conventional fund product	Low to marginal degree of responsibility	Low to marginal degree of responsibility

Source: Pinner (2008)

*see definitions in Eurosif European SRI Study 2006



an investor point of view. Assessments for SRI/ESG-investments are in general based on companies' CSR ratings .

The above mentioned screening process is based on the stakeholder concept. Stakeholders of a corporation are parties which have a stake – an interest or a share – in some effort or undertaking but also people who have an interest in the conduct of the business. Consumers, shareholders, employees, and the community are – apart from the ecological environment – probably the major constituencies of any organisation that is not operating in a vacuum.

On the screening issue Kinder and Domini (1997, p 12) define a social screen as a »non-financial criterion applied in the investment decision-making process«. According to Schäfer (2004) one has to differentiate between financially and normatively oriented processes in screening. The main characteristics of financially oriented concepts are that they focus on the requirements set by investors and are therefore based on risk assessment, efficiency models, innovator concepts or best-practice analysis. In contrast, normative concepts focus on a qualitative analysis of companies

and do not primarily take into account investors' concerns. The majority of SRI research agencies cover both financially and the normatively oriented processes.

The screening-process applied by the ESPA VINIS STOCK EUROPE EMERGING is mainly based on a normatively oriented process which focuses on qualitative data. On the other hand, the detailed stakeholder analysis does also involve financially oriented aspects (see above, definition according to Schäfer), like risk assessment or best-practice analysis.

Impacts and implications of screens (SEE TAB. 2) on the side of the investment product include a reduction of the investment universe and therefore higher deviation from the total market performance. In addition to that the analysis applied tends to become more »holistic«, which is primarily due to the use of extra-financial – in most cases stakeholder-related – issues beside traditional financial analysis. From a procedural point of view they involve the definition of investment criteria, which may lead to some subjectivity involved in the process (see earlier).

One of the major objectives of the development of the screening process for the ESPA VINIS STOCK EUROPE EMERGING is to ensure a sufficient size for the investment universe of the fund. For details on the rating process see part II of the paper.

TABLE 2: Impacts and Implications of Screening

Impact	Implication
Reduction of investment universe	Possibility of diversification risk
Implementation of extra-financial items in portfolio	Data used have to be assessed with regards to performance effects
Focus on corporations' stakeholder relations	Broader view of the company and highlighting of additional risk factors
Standardised approach	Screening is subjective according to criteria used but objective in the implementation

Source: Authors

I. c. Performance

The prejudice of a negative SRI or ESG performance premium or an under-performance of SRI products does not find any proof in recent academic studies. In principle, there seem to be five arguments used for and against ethical investment.

Studies on »diversification« include the argument that SRI/ESG-investment does reduce risk – on a company by company basis. According to the author there is a so-called »company-specific risk« of companies that violate the law, or sell market products of questionable value.

TABLE 3: Five Arguments on SRI

Name of argument	Argument in detail	Assessment of effect on performance	Effects on equities in the Central and Eastern European Region
»diversification effect«	A non-financial restriction reduces diversification and therefore changes the risk/return-profile of a fund	Expected to be negative, counter-argument: every asset manager reduces his universe when composing his portfolio	Strong impact, CSR standards (in implementation and reporting) in some countries (Russia, Ukraine) and sectors (mining) are still on low levels, therefore the number of investable companies out of these countries or sectors tends to be small
»small companies effect«	Investors tend to avoid large conglomerates and concentrate on smaller companies	Long-term positive, short-term neutral, depending on relative performance of small-caps in a certain period	Above average concentration of small to medium sized companies, low market capitalisation for most companies in the region
»anticipation effect«	Investors tend to anticipate later legal action and financial problems by using their screens	Rather positive in the long term, used to explain possible long-term outperformance	Essential effects that should encourage an outperformance are the ongoing convergence in legislation towards Western standards and increasing expectations from society
»information effect«	SRI investment needs a higher level of knowledge about the companies than ordinary investment managers	Positive, makes detailed and intensive process of analysis necessary	A broader basis of information is valuable especially in less efficient markets, the collection of data requires specialised know-how
»positive selection effect«	Positive criteria applied lead to investment in well-run companies	Positive, investments in companies with above average past and future track record	There is a clear preference for companies that adapt their processes earlier, they should outperform their peers also financially – at least in the medium term

Source: Sparkes (1995)



I. d. Emerging Markets

Among studies on *»small companies effect«* authors state that SRI/ESG fund investments were *»skewed towards smaller market capitalisation companies«* (Gregory, Matatko & Luther 1997). It has also been shown that from an SRI screening point of view high-rated *»portfolios tended to be more growth-oriented«* (Kempf & Osthoff 2006).

Studies that cover the *»anticipation effect«* include a paper by diBartolomeo & Kurtz (1999) on SRI/ESG performance that used two separate multi-factor models demonstrating that differences in return probably do not arise from the socially responsible behaviour of the included companies, but rather from economic and sector exposures that are implicit result of social screening of portfolio securities.

Studies on *»information effect«* (Cowton 2004) emphasise that the implementation of ethical investment requires additional information. Compared to conventional products, the investor receives a range of additional and valuable information on possible investment alternatives.

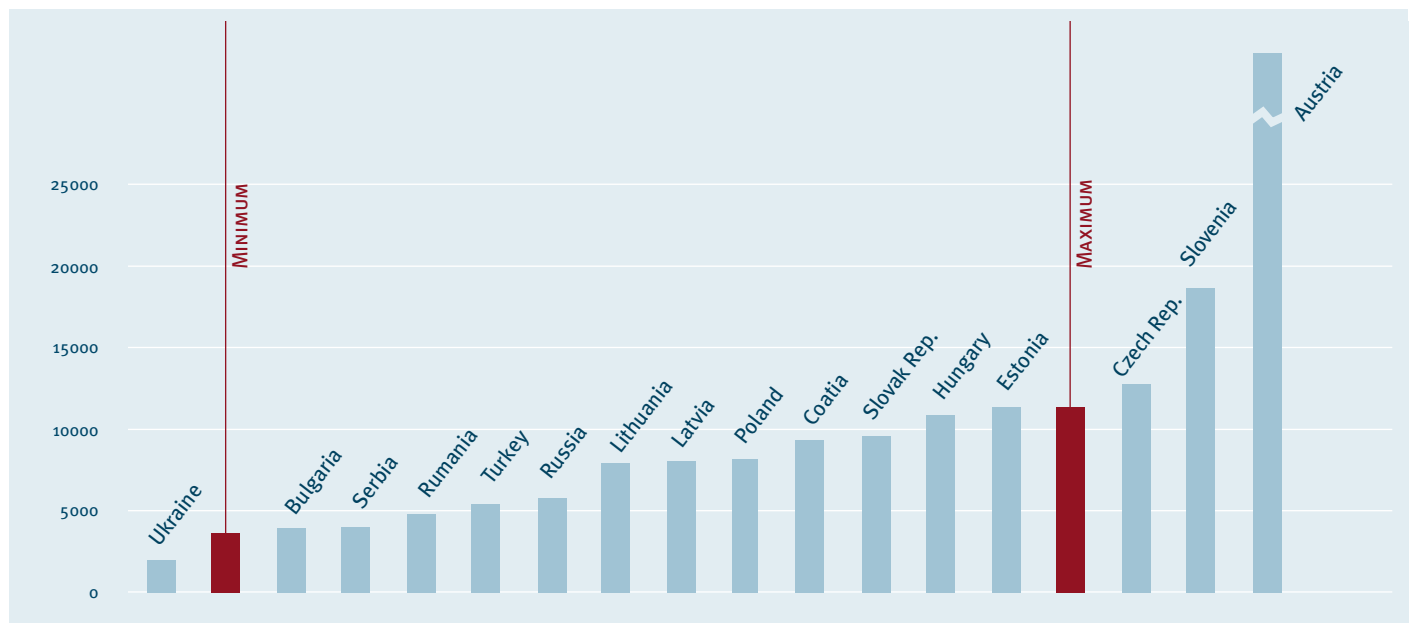
Finally, there are numerous studies on the *»positive selection effect«*. Some authors (McWilliams & Siegel 2000, Derwall et al. 2005, Webley & More 2003) make the point that CSR may lead to higher investment into research and development and therefore improve economic performance in the long-run. In addition to that there seems to be a positive relationship between good financial performance and other indicators of corporate responsibility (environmental management, corporate social responsibility, sustainability etc.).

»Emerging Markets« are countries which show significant growth and catch-up potential. In general, the term is solely defined on the basis of economic criteria. Authors like Wilhelmi (2006) put forward the argument that the development in focus is the economic issue rather than the political or societal aspect. On the other hand it is Mody (2004) who sets up major characteristics for the definition of an emerging market:

- their high volatility and their *»state of transition«*, with transitions in economic, political, societal and demographic respect
- a compromise between an entirely predictable – as demanded by investors – and a flexible political configuration in order to properly react to unforeseen changes in the environment
- a ponderous reformation process – on the basis of complex, complementary and therefore overlapping guidelines – which is supposed to be the background of the independence of the institutions

According to the World Bank classification all countries with a Gross National Income (GNI) per capita of more than USD 10,065 – on the basis of the bank’s financial year (FY) 2006, for the FY 2007 this threshold changed to USD 11,455 – have to be regarded as members of the group of countries with high income (industrial countries), accordingly countries below this threshold can be referred to as emerging markets. According to Güida (2007) the definition of emerging countries should be based on a GNI per capita of between about USD 900 to USD 3,000 – the World Bank’s range for 2007 is between USD 936 and USD 3,705. Based on the definitions mentioned above, it seems appropriate to define a lower limit for an emerging market at USD 3,705 and an upper limit at USD 11,455.

GRAPH 3: Fund Universe - Emerging Markets in Central and Eastern Europe & GNI per Capita (in USD)



Source: ERSTE-SPARINVEST



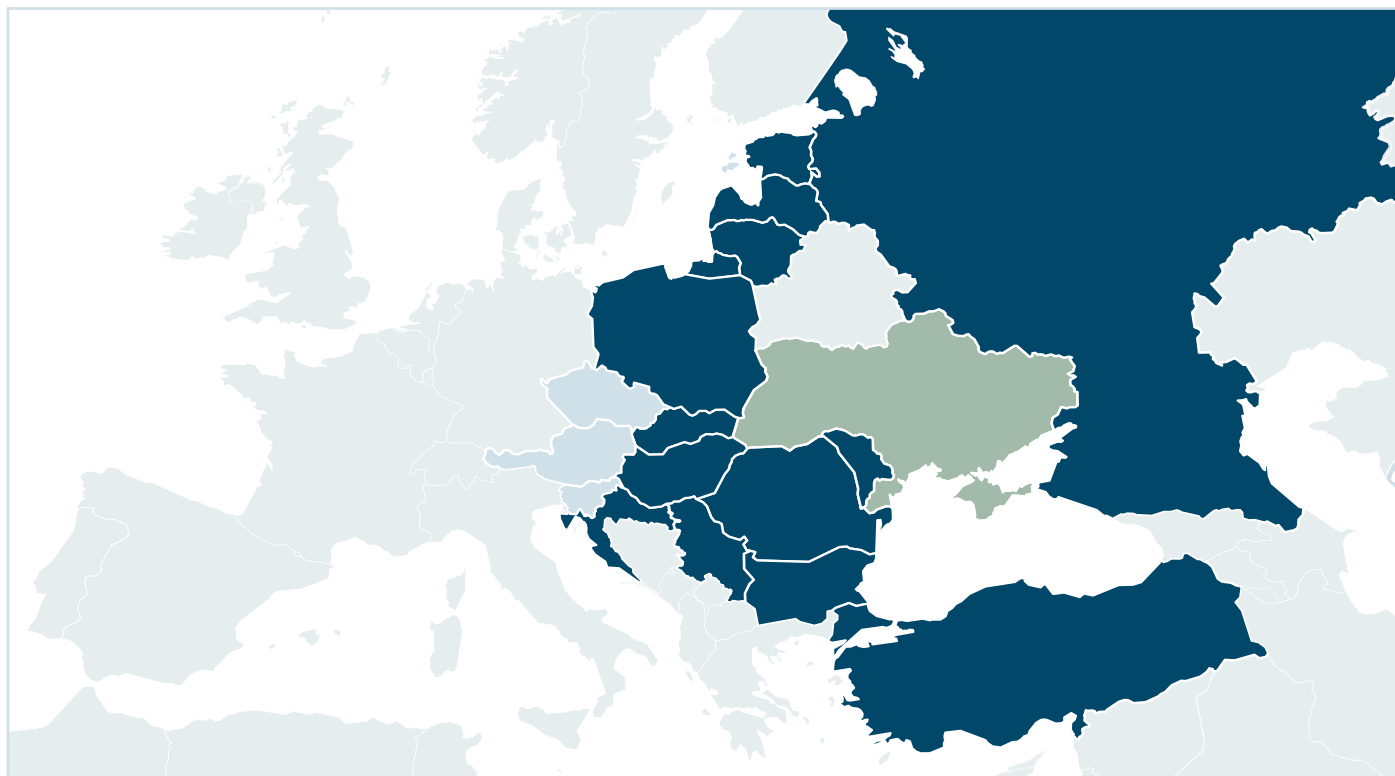
The investment universe of the ESPA VINIS STOCK EUROPE EMERGING consists of – as shown in GRAPH 3 and 4 – sixteen countries (Austria, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Turkey and the Ukraine) in Central and Eastern Europe.

TABLE 4: Statistical Data on the Countries that are Part of the Investment Universe

Country	Total GDP (in USDmn)	Population (in mn)	GNI per capita (in USD)
Ukraine	106,469.0	46.79	1,940
Bulgaria	31,483.0	7.69	3,990
Serbia	31,988.6	7.44	4,030
Rumania	21,590.4	21.59	4,830
Turkey	402,710.0	72.98	5,400
Russia	986,939.6	142.50	5,770
Lithuania	29,766.0	3.39	7,930
Latvia	20,120.0	2.29	8,100
Poland	338,733.0	38.13	8,210
Croatia	42,925.5	4.44	9,310
Slovak Rep.	55,048.6	5.39	9,610
Hungary	112,920.0	10.07	10,870
Estonia	16,409.8	1.34	11,400
Czech Rep.	143,018.0	10.27	12,790
Slovenia	37,303.4	2.01	18,660
Austria	322,000.0	8.28	39,750

Source: World Bank 2007

GRAPH 4: Investment Universe of ESPA VINIS STOCK EUROPE EMERGING



Source: ERSTE-SPARINVEST



GRAPHS 3 and 4 show the fund's current investment universe. Criteria for the inclusion were the status of economic development and economic integration. Apart from the Ukraine (below minimum in GRAPH 3, marked in light green in GRAPH 4) and the Czech Republic and Slovenia (above maximum in GRAPH 3, marked in light blue in GRAPH 4) all countries meet the definition and characteristics of an emerging market. In addition to that Austria is part of the investment universe.

According to Mody (2004) the lower social standards are among the most substantial differences between industrial countries and emerging markets – they lead to lower life expectancy and lower educational standards. Lower social standards feed into the local regulation and legislation and are to some extent caused by it. Accordingly, one can expect a lower GNI per capita, lower income, lower regulatory and lower legislative standards when comparing emerging countries to industrial countries.

The ESPA VINIS STOCK EUROPE EMERGING is the first sustainability fund product with a focus on the CEE region. Currently there is only a limited coverage of emerging markets with regards to CSR-ratings. When comparing the results, there is a significant gap between emerging markets' CSR-ratings and those of industrial countries – this is true both on a country and a company level.

The absolute level of sustainable development in the emerging markets is significantly below that of the industrial countries. This applies to both Central and Eastern Europe and to emerging markets on a global level. The extent of deviation for countries is quite similar to that on a corporate level. For the comparison shown below the sustainability ratings of the G 7 countries were compared to thirteen emerging markets (Brasil, China, India, Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Poland, Romania, Russia, Slovak Republic and Turkey).

TABLE 5: CSR-Rating on a Country Basis – Industrial Countries and Emerging Markets (per July 2008)

	RATING		DEVIATION	
	Industrial Countries	Emerging Markets	Absolute	in %
Total Score	2.893	2.558	-0.335	-11.59%
A. SOCIAL RATING	3.214	2.712	-0.503	-15.64%
1. Institutional Capacity and Politics	3.250	2.808	-0.442	-13.61%
2. Human and Social Conditions	3.250	2.712	-0.538	-16.57%
3. Infrastruktüre	3.036	2.558	-0.478	-15.75%
B. ENVIRONMENTAL RATING	2.500	2.365	-0.135	-5.38%
1. Institutional Capacity and Politics	2.857	2.923	0.066	2.31%
2. Environmental Systems	1.893	1.827	-0.066	-3.48%
3. Environmental Stresses	2.679	2.385	-0.294	-10.97%

Source: oekom research

The (total) rating – in a scale between 1 (minimum) and 3.75 (maximum) – focuses in particular on both, »Social Rating« and »Environmental Rating«. The following TABLE illustrates the most important sub-criteria for both dimensions. In addition to that it shows the deviation not only in absolute, but also in percentage terms.

Assessments of industrial countries are on average by 0.335 points or 11.59 per cent higher than those of emerging countries. The total deviation results from a gap in social rating (0.503 points or 15.64 per cent) and a smaller gap in environmental rating (0.135 points or 5.38 per cent).

The comparison of CSR-ratings on the corporate level was based on a peer group of different countries as well as different sectors. The (total) rating again consisted of the dimensions of »Social Rating« and »Environmental Rating«. Details on the most significant sub-criteria are given in the following TABLE, which shows the deviation in absolute and in percentage terms.

Ratings of companies from industrial countries are on average by 0.227 points or 11.76 per cent higher than those of companies from emerging countries. The total rating gap breaks down in a difference from social criteria (0.302 points or 13.31 per cent) and environmental criteria (0.133 points or 5.76 per cent).

The extent of a percentage-wise deviation of the CSR-ratings on a country basis (11.59 percent) almost matches that on a company basis (11.76 percent). This is also true for the sub-criteria of social assessment (country level at 15.64 percent, company level at 13.31 percent) and ecological assessment (country level at 5.38 percent, company level at 5.76 percent). The deviation in social rating is two times higher than that in ecological rating, this is the case on both the country and the corporate level.

TABLE 6: CSR-Rating of Companies in Industrial Countries and Emerging Markets (per July 2008)

	RATING		DEVIATION	
	Industrial Countries	Emerging Markets	Absolute	in %
Total Score	2.355	2.078	-0.277	-11.76%
A. SOCIAL RATING	2.270	1.968	-0.302	-13.31%
Staff	2.317	1.926	-0.391	-16.88%
Suppliers	1.660	1.376	-0.284	-17.13%
Product Responsibility	1.786	1.538	-0.248	-13.87%
Business Ethics	2.110	1.919	-0.191	-9.04%
B. ENVIRONMENTAL RATING	2.308	2.175	-0.133	-5.76%
Environmental Management	2.355	2.254	-0.101	-4.29%
Products and Services	2.280	2.114	-0.166	-7.30%

Source: Rating agencies (oekom research, RFU)



TABLE 7 gives an overview of some key issues with regards to sustainable development in emerging markets. As far as the political system is concerned, totalitarian regimes in emerging markets do have the power to »decrease« sustainability if they regard it as appropriate. A low level of democracy does not have to be detrimental to sustainable development in the first place. Demographics and educational policy affect the potential for sustainable development in two ways: on the one hand young people are in general less open-minded for the subject of sustainability, on the other hand it is true that there is a positive correlation between the interest for sustainability and the educational level of people. The issue of corruption has to be regarded as objectionable from both an ethical and sustainable point of view. Corrupt political or economic systems tend to be short-term and solely financially oriented, as a rule they do not comply with sustainability standards.

With regards to household income the result shown above does clearly indicate a positive correlation between GNI per capita and CSR-rating. Higher income and correspondingly a higher level of satisfaction of needs both lead to a higher acceptance of sustainability as an issue. Foreign direct investment results in an increased influence of companies which – in most cases – come from the Western World. This leads to the opportunity of »exporting« the ideas and concepts of sustainability via multinational companies to the respective emerging country. The low transparency in some emerging countries does have a detrimental effect on any kind of information flow. In contrast, the significant potential for improvement can be regarded as an opportunity for the future.

TABLE 7: Major Drivers of Sustainability in Industrial Countries versus Emerging Markets

FACTOR	INDUSTRIAL COUNTRIES	EMERGING MARKETS
1. Political Factors		
Political System	In general democratic, stable	Often lack in democracy, potential instability
Demographics & Educational Politics	Ageing society, high standards of education	Mixed structures, former developing countries with in most cases intact population pyramid; increasing efforts to improve standards of education
Corruption	Rather moderate, North-South divide	Rather high, very much depending on governmental structures
2. Economic Factors		
Household Income	High, dominant middle class	Lower, few very rich people
Foreign Direct Investment	As a rule mutual investments between industrial countries, dependent on accumulation of capital	Unless regulated by government high inflow from industrial countries
Capital Market	Efficient markets with high transparency	Low levels of transparency and corporate governance

Source: Authors

I.e. Enablers and Disablers for SRI in Central and Eastern Europe

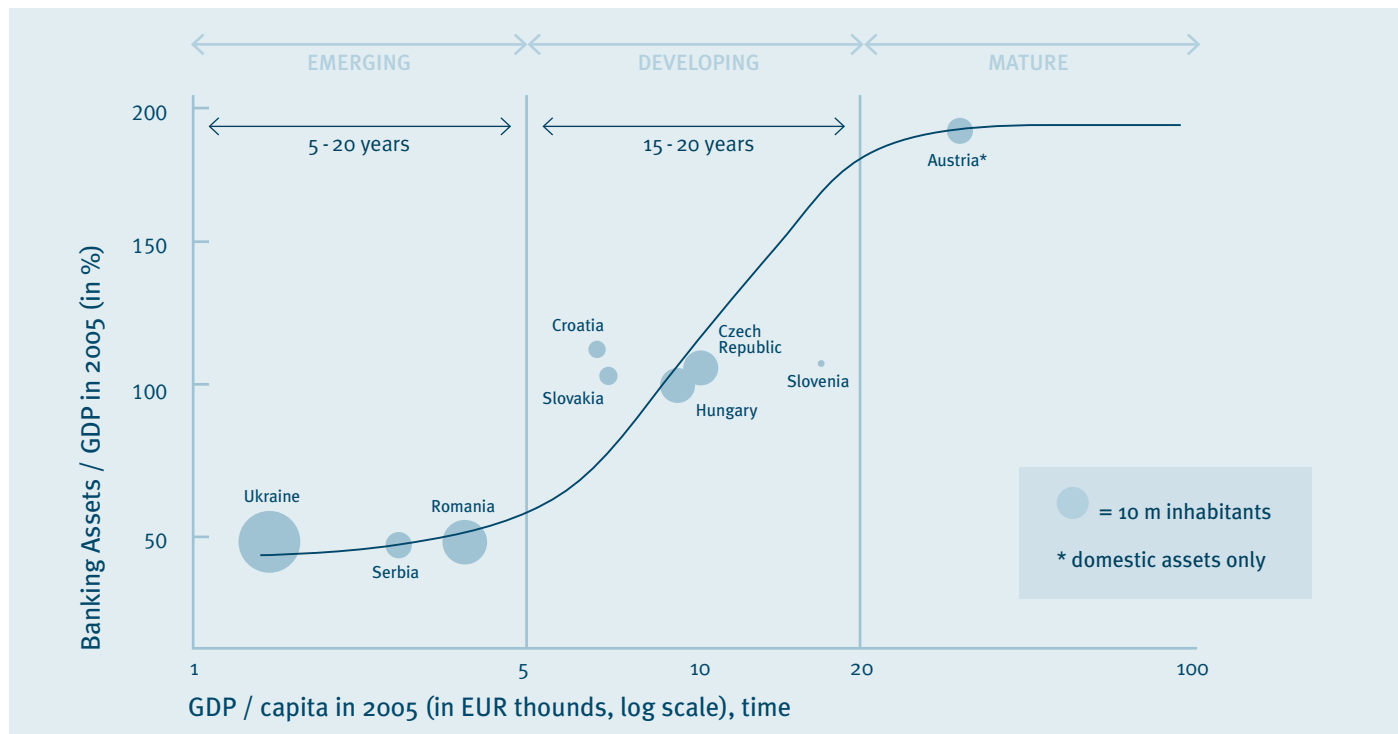
The majority of countries in Central and Eastern Europe have been pursuing a catch-up process in economic terms. Therefore the investor can expect high growth rates and improvements in the productivity of companies in the region. The following GRAPH 5 shows an example for the catch-up potential while focusing on the banking sector. Most markets appear to be still in a »developing« phase, while Austria has entered a »mature« status already. Some countries, like the Ukraine, Serbia or Romania still show the characteristics of »emerging« markets for banking services and do therefore promise the highest growth potential of all groups of countries.

The drivers that make a sustainability equity fund for Central and Eastern Europe an interesting investment alternative are analysed in TABLE 8. From an economic point of view there is the enormous catch-up potential of the countries, which among others focuses on the sector of infrastructure. On the other hand, some countries are on the verge of establishing themselves as important economic partners of Western Europe, like Russia in terms of energy supply or Turkey with regards to manufacturing. The expansion of the EU should be driven farther into the East and thereby support the developing process in a number of countries. Political risk in the region should reduce in a medium to long term. Currently low standards with regards to sustainability and corporate governance should lead to substantial improvements over the next decade. In this regard the »anticipation« factor does play an important role.

As a first mover in Central and Eastern Europe the ESPA VINIS STOCK EUROPE EMERGING is expected to make the best use of the opportunities that are about to arise in the region.



GRAPH 5: Economic Catch-up Potential in Central and Eastern Europe – Sector Study Banking



Source: Erste Bank

TABLE 8: Major Drivers for Sustainability Equity Products in Central and Eastern Europe

FACTOR	POTENTIAL
Economic Catch-up Potential	Above average growth rates over a long period of time, investment in a modernisation of the economic basis (infrastructure)
Industrial Background	Achievement of important roles in the supply of raw materials and industrial capacities as part of the globalisation process – above all for demand from Western Europe
European Union & Eurozone Integration and Membership	More countries that are members of the universe are expected to join the EU and will therefore speed up their process of reformation and growth, in addition to that a membership in the Eurozone should also boost the process of convergence
Political Environment & Risk	Increased political integration of countries into the EU, risk factor Russia
Improvements in CSR und Corporate Governance standards	Takeovers and co-operations by or with partners from the Western World as well as the demand from SRI investors will boost the adaptation of standards
New Legislation and Regulation	Legislation and regulation for the corporations' relations to their stakeholders are bound to be tightened (employee protection, emission limits), the corporate sector can anticipate these changes from an early stage on
First Mover Advantage – Engagement	Investors are expected to benefit from engagement with companies in the Central and Eastern European region because of the currently low standards that give substantial room for an expected and to some extent already ongoing catch-up process

Source: Authors



II. ERSTE-SPARINVEST SRI/ESG Methodology

II. a Overview

The SRI/ESG methodology of ERSTE-SPARINVEST is based on an interlinked »four-layer« system. The responsibility of the whole process lies with the SRI team of ERSTE-SPARINVEST. On the level of portfolio construction there is a close co-operation with the Team »Emerging Europe« of ERSTE-SPARINVEST.

The ERSTE-SPARINVEST process is based on criteria relating to the SRI styles of »exclusionary criteria«, »stakeholder criteria/ best-in-class« and »engagement« (SEE TABLE 1).

Layer I

The first level comprises the »SRI/ESG knowledge-base« of the process. It includes SRI research provided both externally and in-house, an academic co-operation and the contributions of an ethics-committee including NGOs.

Layer II

The »Investment Board«, being the second step and the link between SRI knowledge plus the SRI universe created (Layer I) and the process of investment and portfolio optimisation (Layer III). Layer II contains the final

discussion of the research inputs and the appraisal of additional investment inputs (like IPOs). The responsibility for the reconciliation lies with this investment committee, wherein investment and research expertise are pooled.

Both Layer I and II must not be regarded as strictly extra-financially oriented. It is the clear objective of the system to ensure a financial quantification of extra-financial items through in-house research and external sector research. The results of this research are later discussed in the »Investment Board« (Layer II)

Layer III

The third level of the process is focused on portfolio construction on the basis of the ERSTE-SPARINVEST methodology and know-how. There is a co-operation with the Team »Europe Emerging« of ERSTE-SPARINVEST.

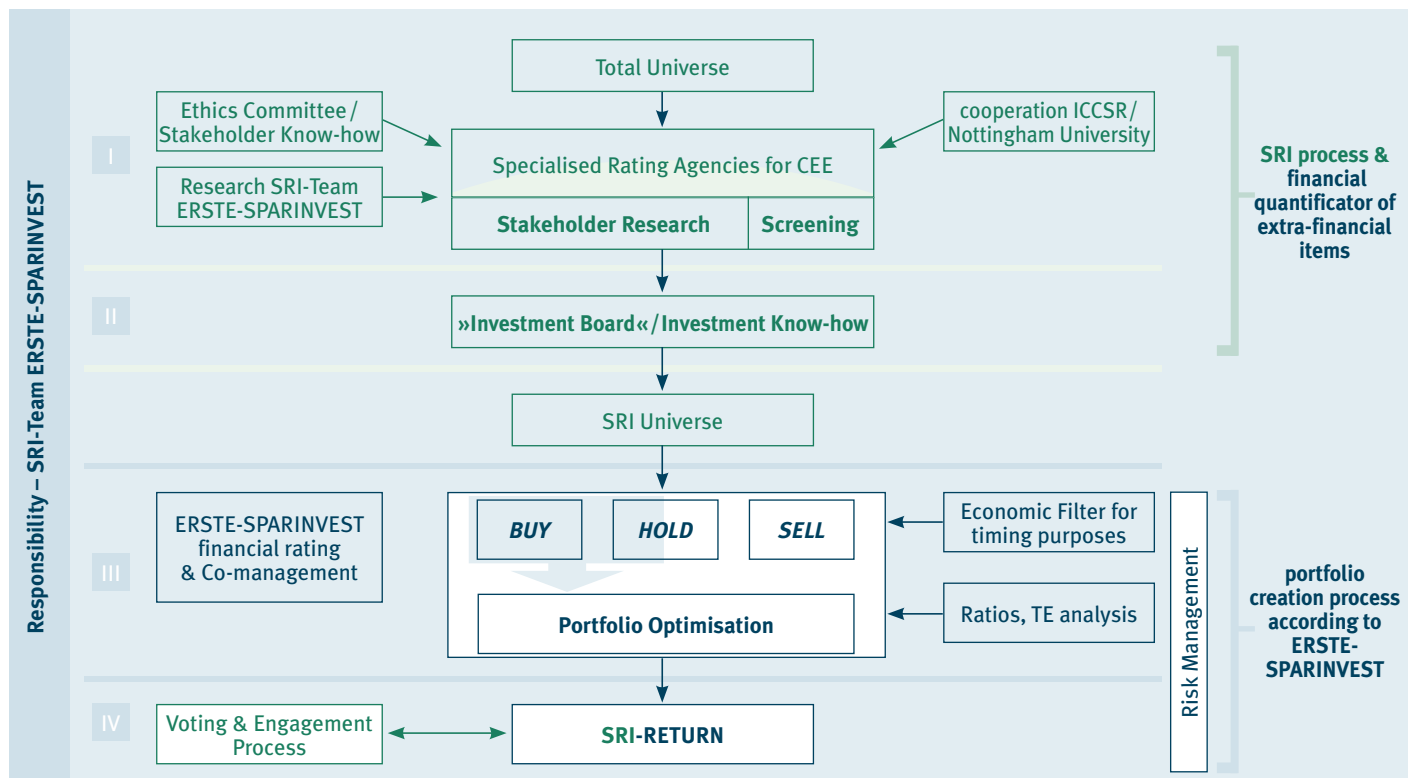
Layer IV

Layer IV is characterised by the measurement of portfolio return and the calculation of performance attribution. The portfolio level is also the basis for the structured engagement and voting process.

Both Layer III and IV are supported by a structured risk management process provided by ERSTE-SPARINVEST.

The following GRAPH 6 shows the SRI concept for the ESPA VINIS STOCK EUROPE EMERGING. Parts of the process that have an SRI/ESG background or are SRI dominated are drawn in green, the strictly financial or financially dominated processes are drawn in blue colour.

GRAPH 6: ERSTE-SPARINVEST Process Overview



Source: ERSTE-SPARINVEST



II. b. Methodology Details

Layer I

a) Academic co-operation with ICCSR/ Nottingham

ERSTE-SPARINVEST has entered a co-operation with the International Centre of Corporate Social Responsibility (ICCSR) – which focuses on academic and practice-oriented research in the fields of CSR, SRI and ESG – to ensure up-to-date processes and in-depth analysis of SRI, ESG and CSR topics both from a theoretical and practical background.

b) Ethics-committee

The ethics-committee is the basis for an ongoing consultation and discussion with stakeholders and NGOs.

c) Research provided by SRI team of ERSTE-SPARINVEST

In-house research is focused on both the extra-financial (based on the inputs from external rating agencies) and financial basis of new trends (topics for in-house primary research) in an SRI/ESG context.

d) SRI valuation process

ERSTE-SPARINVEST entered an exclusive co-operation with an SRI rating agency that focuses on Central and Eastern Europe. The research process includes both exclusionary and stakeholder criteria.

Exclusionary criteria:

Those companies are excluded which have significant activities in relative terms (% of sales) or absolute terms (technological or market leader) in the fields of

Armaments: ABC-weapons & conventional military weapons/ systems incl. core components, specific military materials and services

Nuclear Energy: Electricity from nuclear power plants, nuclear power plants incl. core components & specific services, nuclear fuels

Addictive Drugs: Tobacco, tobacco products & ingredients, alcoholic beverages with more than 20% by volume

Gene Technology: From an ethical or social angle problematic human genome technology and genetic engineering with regards to farming and livestock farming

Gaming: Operation, specific facilities & services

Others: Activities and practices with highly negative ethical, social or ecological effects and risks

The relevance comprises R&D, production, service, sales & financing respectively (regarding non sector-related criteria) practices. For all criteria there is a scope of tolerance for not significant activity (in % of sales).

Stakeholder criteria/ best-in-class:

The universe consists of companies, which actively implement their responsibility versus their stakeholders. Analysis & evaluation are undertaken on 4 different levels

- Principles & Strategies
- Management Systems & Organisation
- Products & Services
- Program, Activities & Results

Stakeholder criteria include the assessment of six stakeholder groups

Employees: e.g. health & safety, training and further education, work-life balance, remuneration, co-decision making process, ...

Society: e.g. corporate citizenship, human rights, ...

Customers: e.g. quality management, CRM, product safety, durability of products, service orientation, ...

Market partners: e.g. supply chain management, partnerships, ...

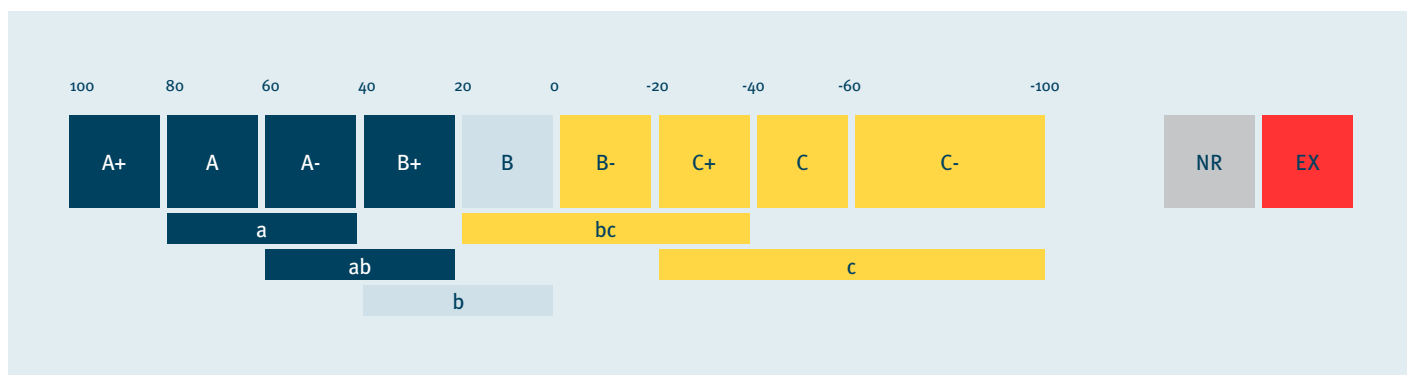
Investors: e.g. corporate governance, shareholder rights, ...

Environment: e.g. environmental management systems, ecology of product resource consumption, emissions, recycling, ...

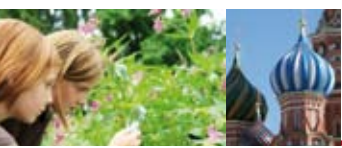
The (SRI) evaluation scale and the CSR rating process behind range from the grade »A+« (innovative) to the grade »C-« (strongly regressive). The ratings are based on a point system, where »A+« is equal to 100 points (upper limit) and »C-« is equal to -100 points (lower limit). The intervals for the grading system are 25 points. GRAPH 7 illustrates the detailed evaluation system employed for the ESPA VINIS STOCK EUROPE EMERGING.

GRAPH 7 shows company ratings in capital letters (»A+« to »C-«) which are based on a sufficient data basis. Low case letters (»a« to »c«) are used for indicative ratings that are based on a reduced data basis and therefore involve higher levels of uncertainty. In case of an inadequate data basis there is a rating of »NR« (»No Rating«). »EX« is used in case exclusionary criteria do apply.

GRAPH 7: Evaluation Scale of CSR-Rating



Source: RFU



The rating agency collects data from a diverse range of sources. Publicly available sources are complemented by data that are collected on the basis of a dialogue with the company (questionnaires, interviews etc.). In addition to that the agency uses secondary sources like data provided by diverse media, NGOs or by the companies' stakeholders. Data processing includes a plausibility check and an interpretation of the information. In order to ensure the »balance« required according to the sustainability research standard CSRR-QS 2.0 there is a consideration not only of the current company status, but also of the sector, of past results and of defined targets for future development. In order to cope with data gaps (indicators and criteria that are not applicable), the rating agency sets up positive and negative cases, which lead to an increased deviation range for the rating.

Layer II

Investment Board

The investment board meets on a regular basis in order to ensure that the »approved list« of investment opportunities comes up to the objectives of research and investment in the process. Tasks of the committee are the verification and monitoring of the process and of the analytic basis. The Board gives inputs regarding new investment topics from an SRI background and discusses the further focus of academic and in-house research.

The Board is responsible for the evaluation of new investment opportunities, IPOs etc.

Board members are:

- a) Investment specialists: ERSTE-SPARINVEST
- b) Research specialists: members of employed rating agencies (oekom research, Innovest, RFU)
- c) The SRI team of ERSTE-SPARINVEST

Layer III

A) Portfolio Creation Process/ Equities

a) Investment philosophy

The »ERSTE-SPARINVEST approach« is based on the pillars of »active management«, »independent investment decisions«, »risk-oriented portfolio construction« and »flexibility in style & size«.

»Active management« – stock market prices of companies do fluctuate more intensely than their underlying fair-values. Active strategies on a stock, country, sector, currency, size and total exposure level give the portfolio an opportunity of generating above average returns. Attractive investments exist in all kinds of market trends, be it up-trends, down-trends or market consolidations.

»Independent investment decisions« – in order to meet the investment goals it is necessary to control the entire investment decision-making process and to make decisions on the basis of independent and consistent analysis. The process in hand relies on a combination of in-house developed tools that focus on fundamental valuation, time-series-analysis and sentiment-studies based on quantitative plus qualitative criteria.

»Risk-oriented portfolio construction« - risk adjustment of the holdings ensure that risks in the portfolio are taken consistent with the objective that single events should not endanger the overall performance of the portfolio.

»Flexibility in style and size« – our process does not constrain our investment on any style or size focus. ERSTE-SPARINVEST regards an – on a style-basis – over-restricted investment universe as a danger for suboptimal portfolio returns. Therefore portfolios may show a value-, growth-, or size-bias over the time of an investment cycle.

b) Investment target

The investment objective is to achieve an active return versus our defined benchmark over a medium term investment cycle, without taking above average risk in the portfolio.

c) Investment process

The investment process from the defined SRI compliant universe to the final portfolio is divided into seven steps.

First there is a filter to check stocks for sufficient liquidity. The second step is a top-down process with rules for maximum deviation on country/FX allocation and sector allocation basis. Thirdly, there is a bottom-up stock selection process (for more details see point d) which is based on in-house stock evaluation. Inputs for the evaluation are fundamental criteria, time-series analysis and sentiment data. Step four, portfolio construction, is based on absolute and active risk criteria (see point e). The next step is portfolio implementation in combination with a strict buy & sell discipline. Finally, the portfolio is the ultimate output of the process.

Risk management is an integral part in all steps of the investment process (see point f).

The top-down process is based on a variety of country & regional criteria respectively sector criteria. GRAPH 9 provides an overview of the quantitative, qualitative and technical criteria.

d) Selection

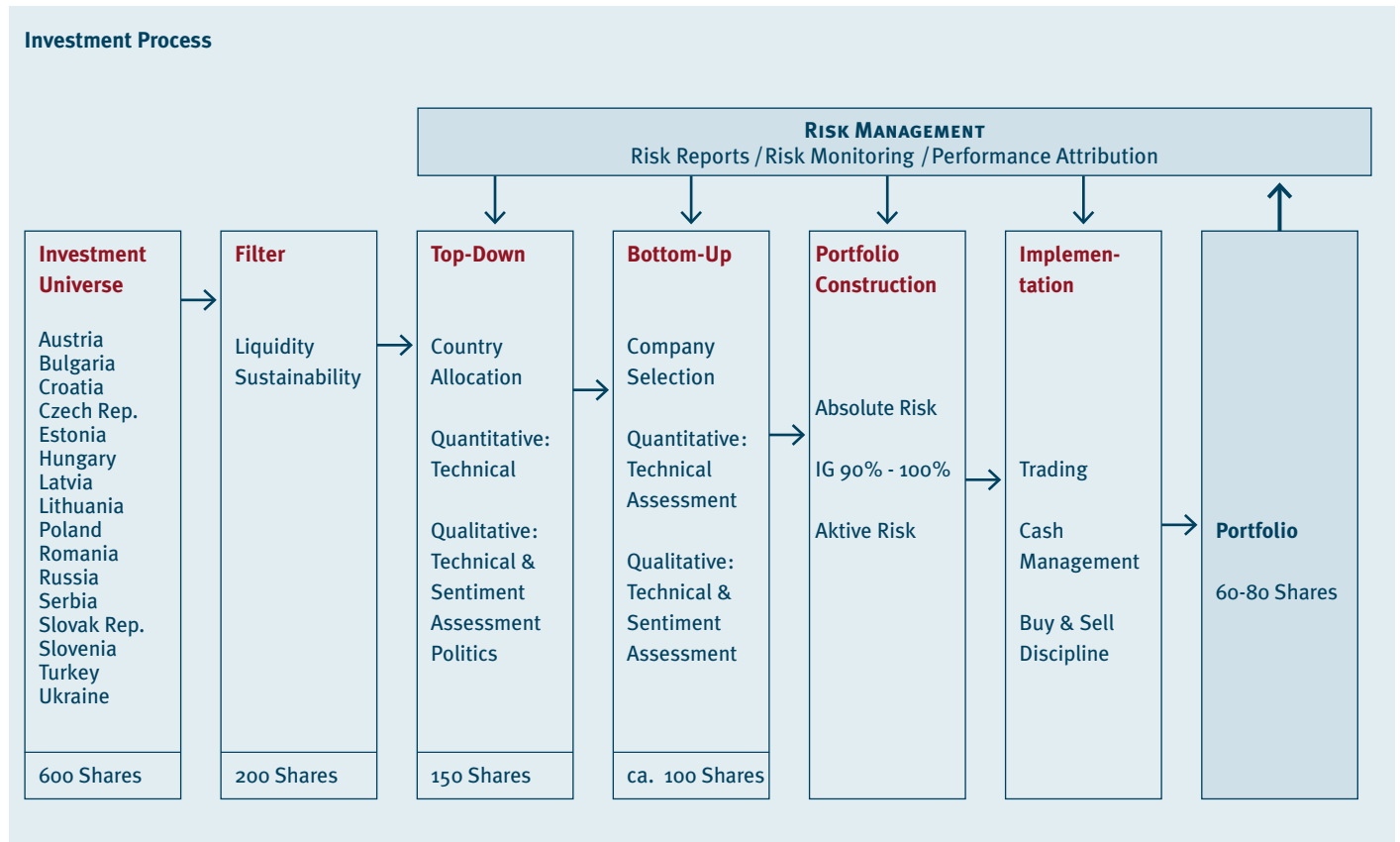
The »ERSTE-SPARINVEST« selection process incorporates the three elements of fundamental valuation, technical & time series analysis and sentiment analysis. All factors we use within this screening process follow an economic rationale and have proved to be significant drivers of market prices in long-term back-test studies.

e) Portfolio construction

The portfolio construction process follows the principle of risk-adjusted returns (a proprietor rule based system used by the »Europe Emerging« Team of ERSTE-SPARINVEST). The size of active positions is determined by the calculation of a risk factor for every holding. This process leads to a portfolio in which active positions with high risk show a below average exposure and vice versa. The result is a portfolio where every investment idea has both an equal opportunity to contribute to outperformance and the same impact on the active return. In addition to that, active risk is reduced.



GRAPH 8: ERSTE-SPARINVEST Investment Process



Source: ERSTE-SPARINVEST

GRAPH 9: ERSTE-SPARINVEST Top-down Analysis

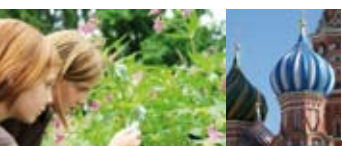


Source: ERSTE-SPARINVEST

GRAPH 10: ERSTE-SPARINVEST Investment Selection Process



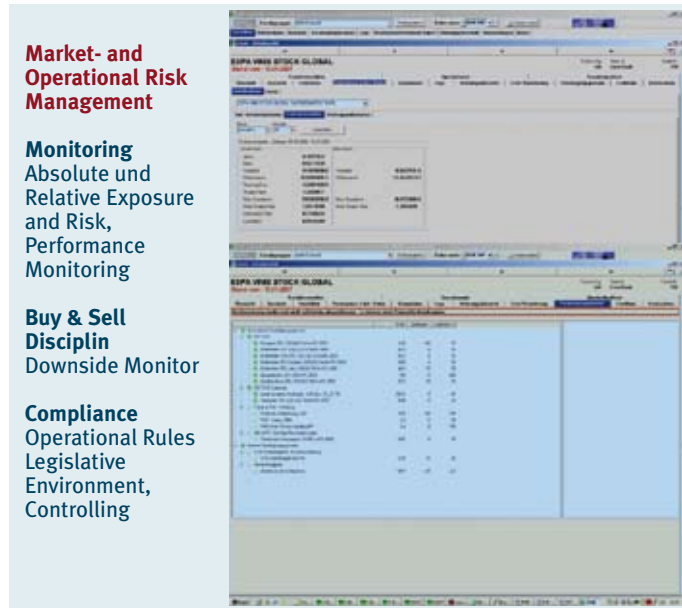
Source: ERSTE-SPARINVEST



f) Risk management

Market and operational risk are controlled and managed by different and independent teams. Ongoing model portfolio reviews, position monitoring, performance and risk attributions enable a disciplined portfolio implementation and a buy & sell discipline.

GRAPH 11: ERSTE-SPARINVEST Risk Management Process



Source: ERSTE-SPARINVEST

g) Investment team

The SRI team of ERSTE-SPARINVEST is integrated into the structure of the asset management team of ERSTE-SPARINVEST as a whole. Regional teams support market know-how for the SRI managers.

Layer IV

The SRI process is expected to lead to an at least neutral performance versus the total market.

ERSTE-SPARINVEST has standardised both its »voting« and »engagement« processes. On an international/ global level there is a co-operation with an international partner regarding voting procedures. Regarding the engagement process there is a different strategy for Austria and the international portfolio components. Engagement with Austrian companies is done in-house. For companies outside Austria there exists a co-operation for engagement with an international partner.



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www.rfu.at

WEB:

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www.erstebank.at (Erste Bank)

www.erstegroup.com (Erste Bank Group)

www.sparinvest.com (ERSTE-SPARINVEST)



Notes

ERSTE SPARINVEST KAG
Habsburgergasse 1a
A-1010 Vienna
T. + 43 (0) 50 100 - 19930
www.sparinvest.com

VINIS
Member of VBV-Group
Petersplatz 4
A-1010 Vienna
T. + 43 (0) 50 100 - 19930
E-Mail: wolfgang.pinner@vinis.at
www.vinis.at

Autor: Wolfgang Pinner
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