

Tobacco & Dutch Institutional Investors

TOBACCO **BUSINESS AS USUAL?**



An overview and guidelines on how to cope
with investments in the tobacco sector



Tobacco & Dutch Institutional Investors

TOBACCO

BUSINESS AS USUAL?

An overview and guidelines on how to cope with investments in the tobacco sector

Authors:

Hester Holtland, Frank Wagemans (VBDO)

For information:

Please contact Sigi Simons, PR and Communications, sigi.simons@vbdo.nl, + 31 (0) 6 20 33 09 97

Dutch Association of Investors for Sustainable Development (VBDO)
Utrecht, the Netherlands

February 2017

VBDO In co-operation with 'de Hartstichting'



Disclaimer

The contents, conclusions and recommendations of the report are the sole responsibility of the VBDO.



Table of contents

Foreword VBDO	6
Executive Summary	8
1) Introduction	17
2) Methodology	19
3) Background	21
3.1 Introduction	
3.2 Tobacco, a short history	
3.3 The tobacco industry	
4) Perspectives on investing in tobacco	26
4.1 Legal perspective	
4.2 Financial perspective	
4.3 Impact and ethical perspective	
5) Results: The relation of Dutch institutional investors with tobacco	36
5.1 Overview of tobacco investments and policies	
5.2 Use of responsible investment instruments concerning tobacco	
6) Conclusions & Recommendations	45
6.1 Conclusions	
6.2 Recommendations	

Foreword VBDO



Angélique Laskewitz

Executive Director VBDO

In this report the VBDO reviewed the relation between Dutch institutional investors and the tobacco sector. The aim of the rapport is to assist institutional investors in developing and implementing a policy on tobacco.

When looking at the tobacco industry, it is of the outmost importance that institutional investors make informed and sustainable decisions. The aim of this study is to show institutional investors different perspectives and to create more insight into the financial, ethical and health aspects related to tobacco.

It is remarkable that quite some institutional investors still see investing in tobacco as business as usual, while society and politics are closing in on the sale and use of this product. On the other hand, many institutional investors already have a clear policy with regard to tobacco. We see a frontrunner in the insurance

sector, of which a large majority of the respondents have a clear policy. This can be partly explained by the fact that most insurers also provide health insurances.

Of the responding institutional investors, 53% do not have a policy on tobacco. But tobacco is more and more becoming a subject of debate, not just because of growing ethical concerns, but also because of concerns about the financial profitability of this sector. This study offers recommendations on how to translate your view on tobacco into developing and implementing a policy.

I would like to thank the institutional investors, who were willing to share their experiences with us on this topic. I would also like to thank 'de Hartstichting' for without their support, this study would not have been possible.

Finally I wish all readers much pleasure reading this report.



Summary

The use of tobacco is unhealthy and this has been known for a long time. Half of its users will die of the consequences. For the Netherlands this means that every year 20,000 people die due to smoking. The World Health Organization estimates that tobacco kills 6 million people worldwide per year.¹

Still investments in the tobacco sector are common in the investment portfolios of institutional investors. In this report we provide an overview of how Dutch institutional investors cope with tobacco investments and provide institutional investors with recommendations on how to formulate their own policy concerning tobacco. The findings are based on a questionnaire and in-depth interviews with institutional investors and experts.

Key findings include that of the responding institutional investors, 53% do not have a policy on tobacco. However, there are large differences between the types of institutional investors. For example, in the insurance sector, only 9% of the respondents have not created a policy. This is in sharp contrast to the responding pension funds of which 73% do not have a policy on tobacco.

When performing the literature study, four important 'myths' were discovered about investing in tobacco. Throughout this study we aim to disprove these ideas.

¹ Ter Weijde, W., Croes, E., '*Roken. Een aantal feiten op een rij*', Trimbos Instituut (juli 2015).

Four myths about investments in tobacco debunked

Myth 1: Tobacco remains a solid investment and will still offer high returns in the future

Apart from ethical questions surrounding investments in tobacco, these investments have in the past created high returns. However, there are growing financial risks associated with investing in the tobacco industry. In the West, the number of smokers has been rapidly declining. Regulation is also closing-in on tobacco sales in developing countries. The Framework Convention on Tobacco Control, signed by over 180 countries including the Netherlands, requires governments to take a specific set of steps to reduce the number of smokers. These steps are now being implemented worldwide. Even in China the number one producer and consumer of tobacco, for the first time in 20 years the number of smokers has declined. Countries like Australia are leading the way with effective regulatory measures and the rest of the world is following their lead.

Besides regulatory risks, the tobacco industry is confronted with growing risks of litigation. Increasingly, lawsuits are successfully filed against the industry on the charges of concealing the risks of smoking. All these developments will have an impact on the profitability of tobacco investments in the near future.

Myth 2: Smoking is a free choice and therefore it is not unethical to invest in tobacco

Tobacco is often compared to products like alcohol. It is a person's free choice to drink or to smoke, but that is not entirely the case with tobacco. What separates tobacco from any other legal product is that it is highly addictive and immediately harmful. There is no safe level of exposure. The addictiveness of tobacco makes quitting very difficult. 80% of smokers in the Netherlands want to quit and half of the smokers try to stop every year. 90% of the smokers that have tried to quit start smoking again within a year. Two-thirds of smokers start when they are teenagers and are addicted by the time they are adults and are expected to make responsible decisions.²

Smoking is so addictive that even though the health risks are known (half of the smokers die of the consequences of smoking), many people are not able to stop. A Canadian tobacco will executive once stated that "smoking is not like drinking, it's rather like being an alcoholic."³

The fact that smoking is very addictive and people usually start smoking when they are in their teens means that smoking should not be seen as a simple matter of free choice.

Myth 3: The only sustainability concerns connected to the tobacco sector are health-related

The most common reason given for institutional investors to divest from tobacco is the issue of the health effects of smoking. However, there are many more Environmental, Social and Governance (ESG) issues related to the tobacco sector. Human rights violations like child labour, are common in the supply chain. Besides human rights issues, tobacco agriculture also creates environmental damage. Next to pollution from the heavy use of pesticides, tobacco growth leads to deforestation. Because growing tobacco depletes the soil much more than other crops, new areas of farmland need to be created.⁴

² Trimbos Instituut, 'Factsheet continu onderzoek rookgewoonten 2014'

³ Proctor, R. N., *Why ban the sale of cigarettes?* The case for abolition, Tobacco Control (January 2013).

⁴ <http://www.tobaccoatlas.org/topic/environmental-harm/>

Myth 4: Institutional investors cannot divest from tobacco due to their fiduciary duty

Many investors point to their fiduciary duties and the need to deliver financial returns as a reason why they cannot divest from tobacco. Fiduciary duty means that institutional investors should invest in the best interests of their members. These best interests should be seen more broadly than in purely financial returns. According to the PRI (Principles of Responsible Investment) report 'Fiduciary duty in the 21st century', fiduciary duty is not an obstacle in acting on ESG factors. Nor is it an obstacle to divest from tobacco. Also the upcoming European directive "IORP2" states in article 20 that within the 'prudent person' rule pension funds are allowed to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.⁵

RECOMMENDATIONS

To define a policy on tobacco institutional investors move through several phases of policy development as shown in the figure below on page 13. On the basis of these phases we discuss in this section how to translate this to developing and implementing a policy on tobacco.

⁵ <http://www.pensioenfederatie.nl/Document/Nieuws/IORP%20II/bijlage-b.pdf>





Define your policy

In the interviews several investors state that they do not have a policy on tobacco because the topic was not ‘on the radar’ until now. In defining your own stance on tobacco, several inputs can help:

- Screen the international regulations and responsible investment principles you signed-on to.
- Define what the mission and vision of your organisation means for your stance on tobacco.
- Map the opinions and stance of your main stakeholders on tobacco.

- Make a scan of the materiality of tobacco and its ESG-risks.
- Map your portfolio, including:
 - o In which tobacco companies you are invested by direct investments, funds or ETFs and your total amount of investments in the sector.
 - o In which companies you are invested who supply, sell or service the tobacco sector.
- Define which responsible investment instruments would most likely fit your policy and investment management strategy.

Putting policy into practice

Although exclusion is the first instrument that springs to mind when putting a policy on tobacco into practice, there are more options available.

Exclusion

The option most often used is to exclude tobacco companies from the portfolio. When doing so it is important to consider if this exclusion will cover public equity as well as corporate bonds and if it will cover the different types of investments such as direct investments, funds, mandates or ETFs.

There is a more far-reaching option. One could also exclude companies of which its turnover is for a certain percentage dependent on supplying, selling or servicing the tobacco sector.

Engagement

Engagement is an instrument within responsible investment that is not often linked to a policy on the tobacco industry. As many interviewees brought forward, it is unlikely that a tobacco company will stop its core activities in tobacco due to engagement.

However, there are other inroads for engagement that are often overlooked by investors. For investors that choose to stay invested in the tobacco sector engagement can focus on:

- Addressing human rights concerns in the tobacco supply chain.
- Addressing the way tobacco is marketed.

Engagement can also take place with companies supplying, servicing or selling tobacco. For institutional investors already excluding tobacco, this can be a next step. Engagement can focus on:

- Reducing their relation dependence on the tobacco industry;
- Making tobacco products less visible in shops or supermarkets;
- Refrain from marketing tobacco products;
- Providing information or nudging smokers to stop smoking.

ESG-integration

For all investors it is wise to include the trends and information on the tobacco sector including legislation, litigation, health impacts and human rights in the supply chain.

Impact investing

Impact investing can potentially be an instrument in a policy on tobacco. For example impact investments can be made in methods that help smokers to stop smoking. However, during the interviews and literature review no examples came up of present opportunities to do so.

Transparency

When developing a policy on tobacco and putting this into practice, it is also of importance to be transparent on the policies, the arguments for making these policies and the dilemma's faced. Investors as well as stakeholders are not always aware of the impact of tobacco and a clear explanation on the policies and steps taken lead to a stronger buy-in.



1. Introduction

Over the past few years there have been major developments in the field of responsible investment. Responsibly managed funds have increased to a total \$21,4 trillion in the beginning of 2014 (GSIA, 2015). Besides a growth in the amount of assets under management, more sustainable themes and topics are increasingly present on the agenda of institutional investors. One of these topics is tobacco.

A large number of institutional investors are investing in the tobacco sector. Even so, over the last few years institutional investors are discussing how they should cope with the sector due to the health risks associated with the use of tobacco, increasing societal concern, but also due to concerns regarding the financial profitability of the sector. This is illustrated by several recent divestments from the sector. Examples are AXA-IM, PFZW and Pensioenfondsen Medisch Specialisten.

The main goal of this report is to provide an overview of how Dutch institutional investors are coping with tobacco investments and to provide them with recommendations on how to formulate their own policy concerning tobacco. The following topics are discussed in order to achieve these goals:

1. An overview of the tobacco sector and its supply chain (chapter 3)
2. A legal, financial, impact and ethical perspective on the tobacco sector in relation to institutional investors (chapter 4).
3. An overview of the relation between financial institutions and the tobacco sector (chapter 5).
4. Practical recommendations and best practices on how to approach this topic as an institutional investor (chapter 6).

We hope the recommendations will serve institutional investors as a first-step to becoming more acquainted with the different aspects of investing in the tobacco industry and to provide the tools to translate these insights into investment policies and practices.

2. Methodology

This research focuses on Dutch institutional investors (pension funds, insurance companies, banks, asset managers) and their investments related to the tobacco industry.

Data gathering

Three different methods of gathering data were used:

- **Literature review:** A review was performed of existing research on the social and financial implications of investments in the tobacco industry.
- **A questionnaire:** On the basis of the desk research, a questionnaire was sent out to 50 Dutch pension funds, 30 Dutch insurance companies, 9 Dutch banks and 17 Dutch asset managers. The questionnaire focuses on the policies these institutional investors apply with regard to tobacco.
- **Qualitative interviews with experts and institutional investors:** 8 Interviews have been held with the sector to collect in-depth information about the motivations for the choice to invest or not invest in tobacco. Interviews were also held with experts to gain more insight into the effects of smoking on Dutch society and the financial aspects of tobacco investments. The interviews were held on the basis of anonymity.

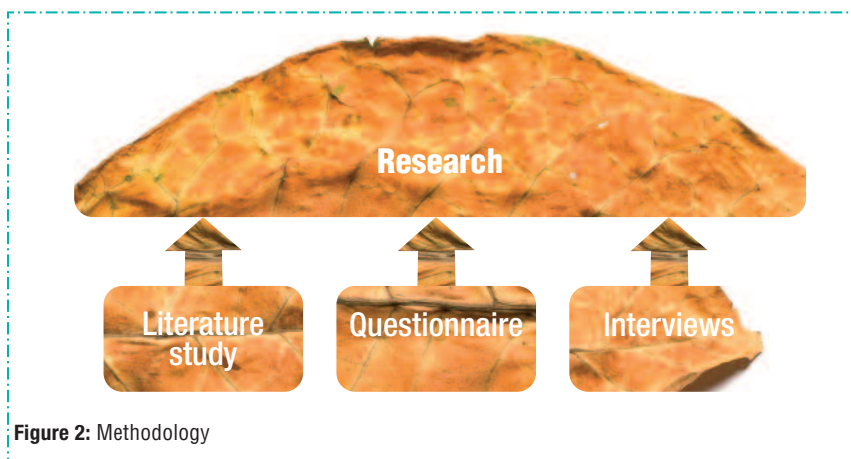


Figure 2: Methodology

Response rate

A total of 55 Dutch institutional investors have filled in the questionnaire. Since those investors that have a clear policy on tobacco may have been more willing to cooperate with this study, the outcomes may have a slight positive bias. Still, the response rate ensures that a significant part of the market is covered.

- **30 of the 50 largest pension funds have responded.
The response covers over 800 billion euro in assets under management.**
- **11 of the 30 largest insurance companies in the Netherlands have responded. The response covers over 270 billion euro in assets under management.**
- **8 of the 17 larger asset managers have responded, covering over 1,600 billion euro in assets under management.**
- **6 of the 9 largest banks have responded, covering a balance sheet of over 111 billion euro.**



3. Background

3.1 Introduction

In this chapter we take a closer look at the tobacco sector. We start with a short history of tobacco in section 3.2. In section 3.3 we give an overview of the tobacco sector, its size and zoom in on its supply chain.

3.2 Tobacco, a short history

Tobacco is a product made out of the leaves of the tobacco plant. Tobacco contains the stimulant alkaloid nicotine. The dried leaves can be used for smoking (cigarettes, cigars, pipe tobacco), snuffing and chewing. The World Health Organization estimates that worldwide 1.1 billion people smoke tobacco.⁶ It was not until the 20th century that the negative consequences of smoking became widely known. But centuries before that, the negative impacts of smoking were suspected by many. King James I of England made quite a visionary statement about the smoking of tobacco in the early 17th century: “a custom loathsome to the eye, hateful to the nose, harmful to the brain, dangerous to the lungs”.⁷

During the First World War, smoking of cigarettes became vastly popular. Unfortunately, smoking cigarettes is more acidic than other forms of smoking, mainly because cigarette smoke can be inhaled into the lungs. After the war the number of smokers increased rapidly across the globe. It was only in the second half of the 20th century research started showing the health risks of smoking and the dangers of smoking became widely known.

3.3 The tobacco industry and its relations with other economic sectors

The tobacco business is a multibillion-dollar industry that is global in nature. Though there are many smaller businesses, six companies lead the world's tobacco industry:⁸

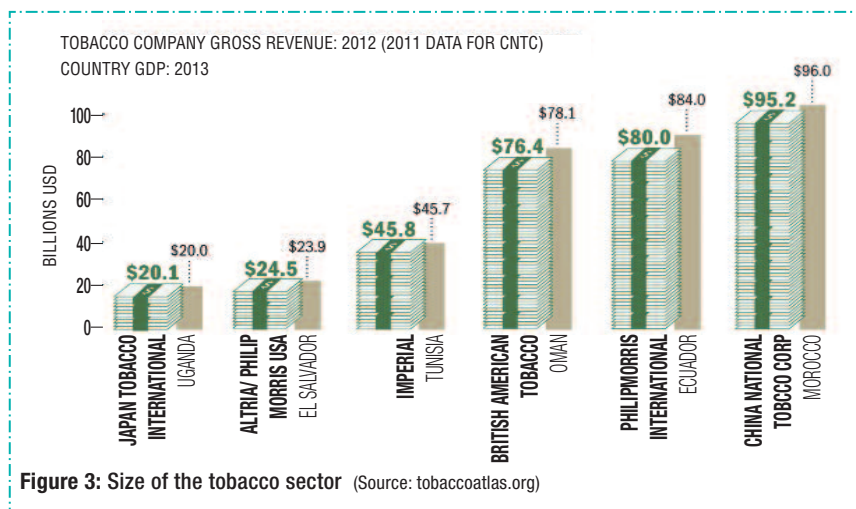
- China National Tobacco Corporation
- Philip Morris International
- British American tobacco
- Imperial Tobacco Group
- Altria/Philip Morris USA
- Japan Tobacco International

⁶ <http://www.who.int/gho/tobacco/use/en/>

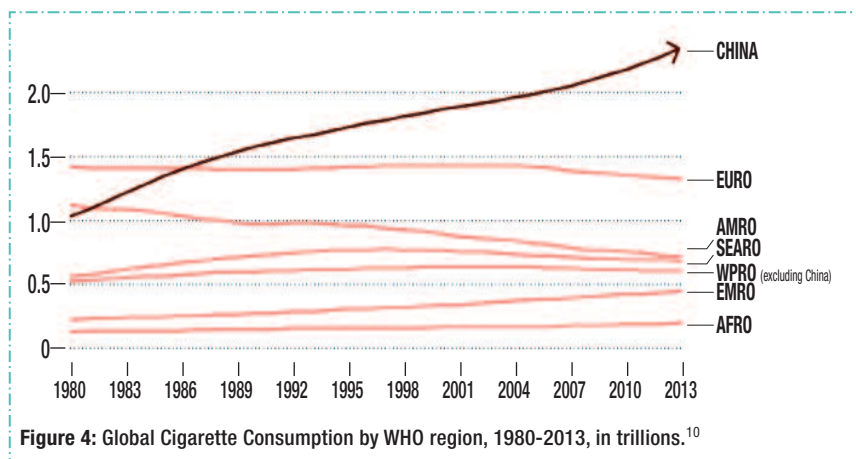
⁷ Gately I., *La Diva Nicotina. The Story of How Tobacco Seduced The world.* London (2001).

⁸ <http://www.tobaccoatlas.org/topic/tobacco-companies/>

The following graph, made by the WHO Tobacco Atlas, shows the profit these largest tobacco companies made in 2011 and compare these profits to the GDP of six countries to demonstrate.



The tobacco industry produces 6 trillion cigarettes every year in more than 500 documented factories worldwide and there are many more un-documented factories. China is the number one producer, manufacturer and consumer of tobacco in the world.⁹



⁹ <http://www.tobaccoatlas.org/topic/cigarette-use-globally/>

¹⁰ Figure 3 distinguishes 7 regions based on the WHO regional offices, EURO stands for Europe, AMRO for the America's, SEARO for South East Asia, WPRO for Western Pacific, EMRO for Eastern Mediterranean and AFRO stands for Africa.

Tobacco supply chain

Tobacco is a very labour intensive agricultural commodity and the process from cultivation to the eventual product takes many steps.

Cultivation

Tobacco cultivation requires specific conditions for soil, climate and irrigation systems. The soil is treated with chemicals and fertilizers. The plant is usually harvested by hand. Although the cultivation of tobacco is very labour intensive, producers tend to get a low share of the value of the final product. China is the worlds leading tobacco grower, followed by Brazil, India and the United States, but tobacco is grown in at least 124 countries. Tobacco farming is mostly done in middle- and low-income countries.¹¹

Curing

The tobacco leaves are cured (dried) and aged or fermented. Curing can be done through heating, by using coal or wood, or the leaves are air- or sun cured, which decreases the environmental impact. After the curing the product is sorted and packaged into bales for export.

Stemming and stripping

Stemming and stripping takes place to prevent deterioration and needs to be done quickly. The processing usually takes place in the producing countries.

Manufacturing

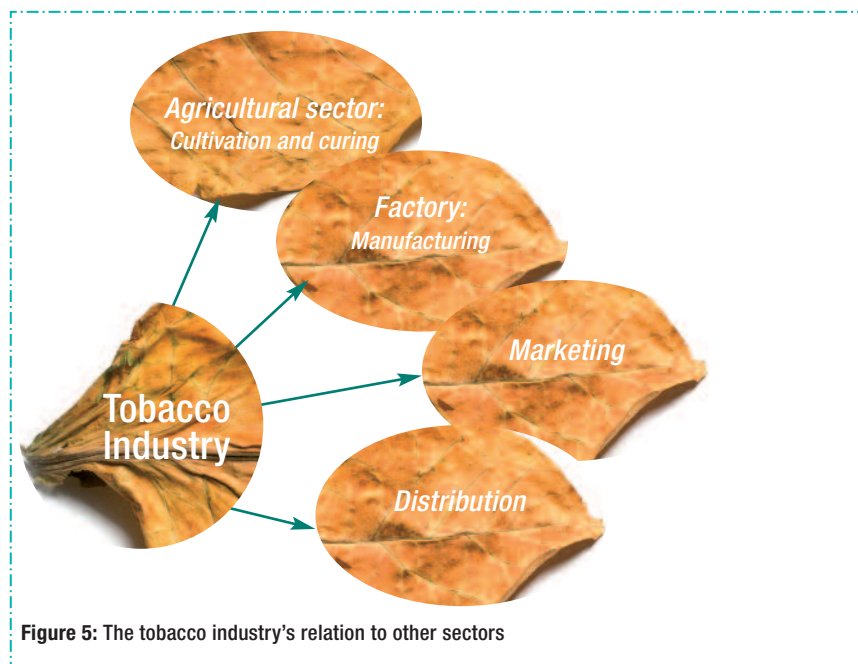
After the stemming and stripping the product is shipped to the manufacturing country, where the tobacco is then transformed into the final product. Tobacco companies usually do the manufacturing internally.

Marketing and distribution

The tobacco companies coordinate the marketing and distribution of their product.¹²

¹¹ <http://www.tobaccoatlas.org/topic/growing-tobacco/>

¹² Goger, a., Bamber, P., Gereffi, G., 'The Tobacco Global Value Chain in Low-Income Countries' (februari 2014).





4. Perspectives on investing in the tobacco sector

Developing a view on tobacco has become increasingly relevant for institutional investors. In this chapter we look at three different perspectives on investments in tobacco.

- **A legal perspective:** What are the different laws and treaties on tobacco?
- **A financial perspective:** Which financial risks and opportunities are linked to the tobacco industry?
- **An impact and ethical perspective:** How does tobacco impact society and therefore also participants of pension funds or clients from banks and insurance companies?

These perspectives will be introduced in the sections below.

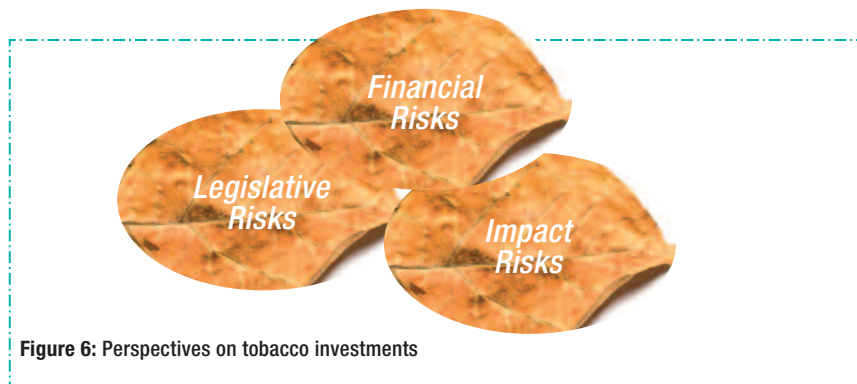


Figure 6: Perspectives on tobacco investments

4.1 Legal perspective

Tobacco is becoming a highly regulated product. Globally, countries are implementing measures to prevent people from starting smoking and stimulating smokers to quit. In this section we provide an overview of the main relevant (inter) national laws and guidelines that may impact tobacco use and tobacco control.

INTERNATIONAL LAW

Framework Convention on Tobacco Control

The WHO Framework Convention on Tobacco Control (FCTC) is the first global public health treaty. It was developed as a response to the globalisation of the so-called tobacco epidemic. The FCTC entered into force on February 27, 2005. The Framework requires parties to implement evidence-based measures to reduce tobacco use and exposure to tobacco smoke. With over 180 parties, including the Netherlands, the FCTC is one of the most widely adopted treaties of the United Nations.¹³

The treaty requires that parties take the following actions:

- Protect their public health policies from commercial and other vested interests of the tobacco industry. This article calls for a limitation in the interaction between lawmakers and the tobacco industry.
- The FCTC recognises that price and tax measures are an effective and important means of reducing tobacco consumption. The treaty requires that parties consider price and tax policies to reduce the tobacco consumption.
- Parties have the obligation to protect all people from exposure to tobacco smoke in indoor workplaces, indoor public places and public transport. Parties are also urged to create 100% smoke-free environments in outdoor public spaces.
- Parties are required to regulate the contents and emissions of tobacco products and disclose the ingredients.
- Within three years after the entry into force of the FCTC, the parties must adopt and implement effective measures to prohibit misleading tobacco packaging and labelling and ensure that tobacco packages carry large health warnings.
- Parties need to provide public awareness of the consequences of smoking through education, communication and training.
- Advertising, promotion and sponsorship of tobacco must be banned within five years of the treaty's entering into force, unless the national constitution forbids it.¹⁴

Parties that signed the FCTC have been creating and adjusting new legislation to fulfil these requirements, including the European Union and the Netherlands.

¹³ *Overview of Key FCTC Articles and their Implementing Guidelines.* See link: http://global.tobaccofreekids.org/files/pdfs/en/Overview_FCTC_Guidelines.pdf

¹⁴ *Overview of Key FCTC Articles and their Implementing Guidelines.* See link: http://global.tobaccofreekids.org/files/pdfs/en/Overview_FCTC_Guidelines.pdf

European Legislation

The European Union was one of the first parties to sign the FCTC treaty. In line with the regulatory obligations, the latest Tobacco Products Directive entered into force on May 19, 2014 and became applicable in the member states of the EU on the May 20, 2016. The Directive aims to bring major changes to the tobacco products sold in the EU. It aims to “improve the functioning of the internal market for tobacco and related products, while ensuring a high level of health protections for European Citizens.”¹⁵

Key measures are:

- Flavoured cigarettes will no longer be allowed.
- Cigarette packages will carry large health warnings.
- Tobacco companies may not use ‘misleading terms as ‘natural’ or ‘light’.
- New provisions for electronic cigarettes make sure that these products are no longer unregulated.¹⁶

As a follow-up, member states have introduced complementary or further measures in their national tobacco Acts such as plain packaging, advertising restrictions or smoke-free environments legislation.

Dutch legislation

In 1990 a Dutch tobacco law (Tabakswet) entered into force with the purpose to control tobacco use. In 2002 the law was revised and expanded. The law states among other things that:

- Employees have the right to a smoke-free workplace
- Public transportation must be smoke-free
- Tobacco advertising and sponsoring is prohibited
- The sale of tobacco to people under the age of 18 is prohibited

In May 2016 a new tobacco law, the ‘Tabaks- en Rookwarenwet’, followed-up the Dutch Tobacco Law with additional measures. Cigarette packs will get health warnings with images. Flavoured cigarettes will be prohibited and E-cigarettes may no longer be sold to people under 18 years old. With these measures the Netherlands has adopted the EU Tobacco Products Directive into its national law.¹⁷

¹⁵ http://ec.europa.eu/health/tobacco/products/revision/index_en.htm

¹⁶ http://ec.europa.eu/health/newsletter/174/focus_newsletter_en.htm

¹⁷ Alliantie Nederland Rookvrij (20 mei 2016) <http://www.alliantienederlandrookvrij.nl/nieuwe-tabaks-en-rookwarenwet-verandert-er/>

4.2 Financial perspective

Myth 1: Tobacco will remain a solid investment and will still offer high returns in the future

Apart from ethical questions surrounding investments in tobacco, these investments have in the past created high returns. There are however growing financial risks associated with investing in the tobacco industry. In the West, the number of smokers has been rapidly declining. But even in developing countries regulation is closing in on tobacco sales. The Framework Convention on Tobacco Control, signed by over 180 countries including the Netherlands, requires governments to take a specific set of steps to reduce the number of smokers. These steps are now being implemented worldwide. Even in China, the number one producer and consumer of tobacco, for the first time in 20 years the number of smokers has declined. Countries like Australia are leading the way with effective regulatory measures and the rest of the world is following their lead.

Besides regulatory risks, the tobacco industry is confronted with growing litigation risks. More and more lawsuits are successfully filed against the industry on the charges of concealing the risks of smoking.

And last but not least there is a reputational risk connected to tobacco investments, not just because of the negative health effects, but also because it is an industry that is intertwined with human rights violations like child labour.

Decreasing sales and customers base

Despite the high interest of tobacco investments, stock analyst Ranger International recently concluded that tobacco shares are “melting ice cubes”. They see a long-term trend of decay.¹⁸ In the US 31% of the cigarette market has disappeared since 2005. Also in Russia, which is a very important market for international tobacco companies, the cigarette volume sold has decreased by 24% since 2011. Cigarette sales are not only decreasing in the developed world, but also in developing countries. In Indonesia and China, with the largest cigarette consumption worldwide, the growth has stopped partly due to worldwide governmental measures such as the FCTC.¹⁹ The Financial Times reported in June 2016 that, for the first time in 20 years’, cigarette sales in China have dropped. This decrease follows a large state-sponsored health

¹⁸ Ranger International, ‘Tobacco stocks as melting ice cubes’, 07-04-2016.

¹⁹ The Post Online, ‘Geen lucratiever beursaandeel dan tabak, vindt ook pensioenfonds ABP. Toch willen de meeste deelnemers van ABP er vanaf’ 27-06-2016.

drive designed to curb the smoking rates. The Chinese government introduced a ban on smoking in all indoor and outdoor public places. The implementation of national health insurance made smoking a burden on the state. The decline of smoking rates in China is also a consequence of the increasing taxes on cigarettes.²⁰

Do Sin-stocks pay off?

Yes, says Credit Suisse. The article “*Responsible Investing: Does it Pay to be Bad?*” shows that so-called ‘sin-stocks’ outperform more responsible investments. The study focuses on tobacco and concludes that in the decades from the 1960s to the 2000s, tobacco companies outperformed comparable firms by over +3 percent per year.

Another study performed by Hampus Adamssona and Andreas G. F. Hoepner named ‘*The ‘Price of Sin’ Aversion: Ivory Tower Illusion or Real Investable Alpha?*’ contradicts these conclusions. In this paper the authors state the following: “When analysing sin stocks in a value-weighted portfolio setting, we witness a significant decrease in financial performance. “Sin stocks perform similar to the market in most cultural settings, with an exception for alcohol.”

Besides past performances of tobacco stocks, the financial risks of investing in tobacco are growing. Past performances make no guarantees for the future and the tobacco sector will only face more challenges in the future.

Litigation Risks

Litigation is an increasingly used strategy to strengthen tobacco control. The tobacco industry is now being held accountable through civil and criminal liability. The most commonly used ground for lawsuits is that tobacco manufacturers concealed the risks of smoking.

Dutch litigation risks

In May 2016, lung cancer patient Anne Marie van Veen filed a suit against the tobacco industry. Her mission is to make tobacco illegal. Though the chances she will win this case are unclear at the moment, her case has drawn a great deal of public attention. Van Veen’s claim is that the tobacco industry is deliberately harming the health of the users of their products. She points to article 300 of Dutch criminal law, which states that intentionally harming a person’s health, falls under assault.

²⁰ McClean, P., Hornby, L., ‘China tobacco sales fall for first time in two decades’, Financial Times.

The industry is being threatened by legal action. Civil lawsuits are being filed individually as well as class actions. The goals of these lawsuits are to obtain compensation for illness and early deaths. Another form of litigation risk is criminal liability. Many industry documents demonstrate that executives knew the health risks and misled the public.²¹

The major tobacco companies are facing litigation cases. British American Tobacco, for example, estimates in its annual report of 2014 that there are more than 6.000 pending litigation cases against the company worldwide.²²

Reputational Risks

The tobacco industry is consistently ranked as the world's least reputable industry. Marketing aimed at young people and the widespread use of child labour (see section 4.3), are just two reasons why individuals and organizations are increasingly avoiding affiliation of any sort.²³

4.3 Impact perspective

Health Impact

The societal impact of smoking is significant. In 2015, 23% of the Dutch population smoked. An average smoker dies ten years earlier than a non-smoker. Next to the 20,000 people who die each year in the Netherlands because of the consequences of smoking, of every person that dies, 20 get chronically ill due to smoking. Smoking causes 13% of the total health costs in the Netherlands.²⁴

A cost-benefit analysis done by KWF Kanker Bestrijding, a Dutch foundation dedicated to fighting cancer, examined the effects different scenarios of policies would have on tobacco control. The analysis showed that various measures like campaigns and tax increase, the number of smokers would decrease substantially. In addition to the health benefits, these measures would provide the Dutch society 1.7 billion euros per year in 2050 and only 7.7% of the population would still be smoking. The conclusion of this study is that discouragement of smoking would have a positive financial outcome for Dutch society.²⁵

A study of SEO Economical Research about the total costs of smoking for the Dutch society, estimates that smoking costs the Netherlands €33 billion euro per year (this is the average

²¹ Gostin, L., O., 'the "Tobacco Wars" – Global Litigation Strategies', Georgetown University Law Centre (2007)

²² BAT annual report 2014 [http://www.bat.com/group/sites/uk__9d9kcy.nsf/vwPagesWebLive/DO9DCL3B/\\$FILE/medMD9UWNKU.pdf?](http://www.bat.com/group/sites/uk__9d9kcy.nsf/vwPagesWebLive/DO9DCL3B/$FILE/medMD9UWNKU.pdf?)

²³ Public Health Centre <http://www.publichealthlawcenter.org/topics/tobacco-control>

²⁴ Kok, L., Berden, C., Koopmans, C., 'Kosten van Roken', SEO Economisch onderzoek (Februari 2016).

²⁵ <https://www.kwf.nl/preventie/roken-en-kanker/pages/maatschappelijke-kosten-baten-analyse.aspx>

cost scenario, for the lowest cost scenario it is 21.2 billion a year and for the highest cost scenario it is €43.2 billion per year). In this study, the SEO also values the lost years, decreasing quality of life and at production loss due to smoking.²⁶

Myth 2: Smoking is a free choice and therefore it is not unethical to invest in tobacco

Tobacco is often compared to products like alcohol. It is a person's free choice to drink or to smoke. But that is not entirely the case. What separates tobacco from any other product is that it is highly addictive and immediately harmful, there is no safe level of exposure. The addictiveness of tobacco makes quitting very difficult. 80% of smokers want to quit and half of the smokers try to stop every year. Two-thirds of smokers start when they are teenagers and are addicted by the time they are adults and are expected to make responsible decisions. Smoking is so addictive that even though the health risks are known, e.g. half of the smokers die of the consequences of smoking, many people are not able to stop. A Canadian tobacco executive once stated that "Smoking is not like drinking, it's rather like being an alcoholic." Passive smoking is also never a free choice and very harmful.

Cigarettes are addictive by design. That is what distinguishes them from products like alcohol. Additives make cigarettes more attractive and more addictive. The added substances cause the body to absorb more nicotine and the inhaled smoke is less irritating to the lungs. Manufacturers also add substances such as menthol to improve the taste.²⁷

The tobacco industry directs its campaign at the youth. Since a large majority of smokers starts smoking before they are eighteen, it is the youth the tobacco industry aims to reach. Young people are generally less able to calculate risks; they are more impressionable and more susceptible to peer pressure. Clear evidence exists that tobacco companies use branding to appeal to children. The industry needs so called 'replacement smokers' for people that quit or die. In 2006 British American Tobacco stated that new packs were designed to attract the 'iPod Generation'.²⁸

²⁶ Kok, L., Berden, C., Koopmans, C., '*Kosten van Roken*', SEO Economisch onderzoek (Februari 2016).

²⁷ World Health Organisation, <http://www.who.int/tobacco/media/en/TobaccoExplained.pdf>

²⁸ Pete MacLeod, '*Investing in tobacco – the risks are plain*', EIRIS Blog (31 January 2013).

See link: <http://www.eiris.org/blog/plain-reasons-to-turf-tobacco/>

Myth 3: The only sustainability concerns connected to the tobacco sector are health-related

The most common reason given for institutional investors for divesting from tobacco is the issue of the health effects of smoking. However, there are many more ESG issues related to the tobacco sector. Human rights violations are unfortunately common in the supply chain. Besides human rights, tobacco agriculture also creates environmental damage. Next to pollution from the heavy use of pesticides, tobacco growth leads to deforestation. Because growing tobacco depletes the soil much more than other crops, new areas of woodland need to be cleared.

Supply chain risk

Besides the fact that tobacco kills a large amount of its users, another argument why tobacco is not a responsible investment is that there are many errors in its supply chain. Even in a country like the United States child labour in the tobacco industry exists on a large scale. It is illegal in the US to buy cigarettes under the age of 18, but it is not illegal for minors to work in tobacco farming, even do working in this sector comes with major health risks. Green Tobacco Sickness is a form of nicotine poisoning that is common in the tobacco cultivation.²⁹

Human Rights Watch states that it believes “that no child under age 18 should be permitted to perform work in which they come into direct contact with tobacco in any form, including plants of any size or dried tobacco leaves, due to the inherent health risks posed by nicotine and the pesticides applied to the crop.”³⁰

²⁹ Human rights Watch, Tobacco's Hidden Children. Hazardous Child Labor in United States Tobacco Farming, 13 mei 2014.

³⁰ Human rights Watch, Tobacco's Hidden Children. Hazardous Child Labor in United States Tobacco Farming, 13 mei 2014.

Myth 4: Institutional investors can't divest from tobacco due to their fiduciary duty

Many investors point to their fiduciary duties and the need to deliver financial returns as a reason why they cannot divest from tobacco. Fiduciary duty means that institutional investors should invest in the best interests of their members. These best interests should be seen more broadly than in purely financial returns. According to the PRI (Principles of Responsible Investment) report 'Fiduciary duty in the 21st century', fiduciary duty is not an obstacle in acting on ESG factors. Nor is it an obstacle to divest from tobacco. Also the upcoming European directive "IORP2" states in article 20 that within the 'prudent person' rule pension funds are allowed to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.

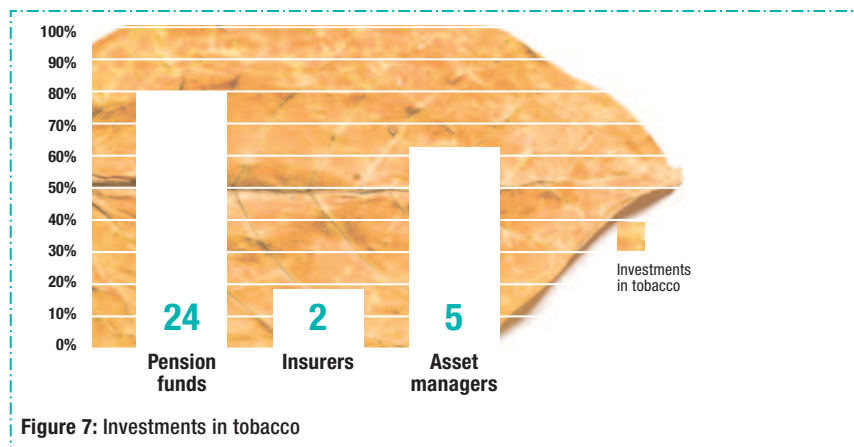


5. Results: The relation of Dutch institutional investors with tobacco

In this chapter we provide an overview of the involvement of institutional investors in tobacco. The information is based on the questionnaire that was filled in by 11 insurance companies, 30 pension funds, 8 asset managers and 6 banks.

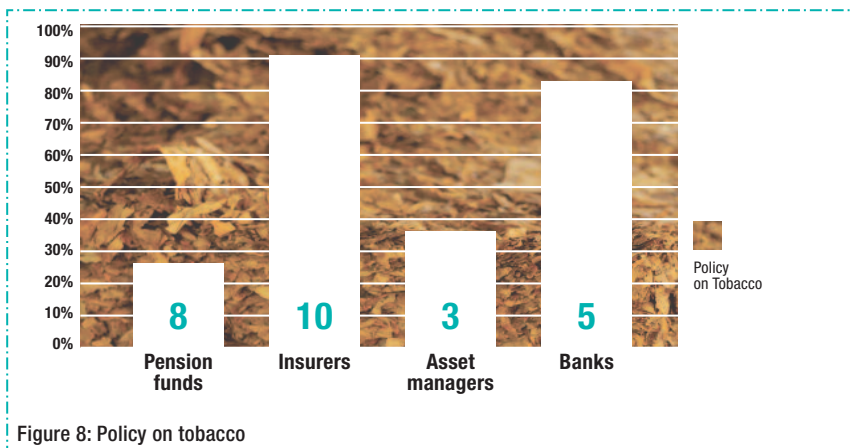
5.1 Overview of tobacco investments and policies

The following graph shows tobacco investments per different type of institutional investor.



Most remarkable is the difference between insurers and pension funds. Insurance companies have a limited exposure to tobacco (9% of the responding insurance companies do not have a policy on tobacco), while more than two thirds of the participating pension funds invest in tobacco (73% of the responding pension funds do not have a policy on tobacco). Especially those insurance companies that provide health insurances, have incorporated an explicit policy on tobacco. This also applies to those pension funds whose participants work in the health sector.

It is important to realise that most standardised indices and benchmarks followed by institutional investors include the tobacco sector. Therefore, without a specific policy institutional investors will be, sometimes implicitly, investing in the tobacco sector.



The institutional investors that have cooperated with this research give many different motivations for the choice to invest or not invest in tobacco. We conclude that the prime motivation for divestment is ethical. In the interviews held with the sector, the growing financial risks of investing in the tobacco sector were also named, but not as a main motivation.

For asset managers it is an issue of choosing a policy themselves, or leaving this decision to their clients. Some asset managers state that it is not for them to decide on a tobacco policy for their clients. Clients can make an exclusion list, which the asset manager will act on. These asset managers will consider divesting from tobacco altogether when a large majority of the clients wishes to exclude tobacco.

Asset Manager: *“Tobacco is not really an issue with our clients, although in recent years we have received a growing number of questions about these investments. We will divest when a majority of our clients indicate they don’t approve of tobacco investments.”*

This particular policy on tobacco contradicts with other asset managers who state that it is the responsibility of the asset manager to create a policy on tobacco. These asset managers stated that they have made the choice to divest while offering the same quality and returns.

Asset Manager: *“You can compare an asset manager to a supermarket, they should also make ethical choices instead of leaving the choice to the customer.”*

5.2 Use of responsible investment instruments concerning tobacco

In this part of the study we provide an overview of the use of responsible investment instruments by Dutch institutional investors concerning tobacco. Responsible investments are investments in which also social and environmental factors are also considered. For example, a consideration can be if companies reduce their CO₂ emissions or if they respect fundamental labour rights. Re-sponsible investments can be implemented in different ways as investors have a set of different responsible instruments at their disposal:

- **Exclusion:** *“An approach that excludes specific investments or classes of investment from the investible universe such as companies, sectors, or countries”*.³¹
- **ESG-integration:** *“ESG integration is defined as the explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources”*.³²
- **Engagement:** *“A long-term process of dialogue with companies which seeks to influence company behaviour in relation to their social, ethical and environmental practices”*.³³
- **Voting:** *“Shareholders use their voting rights or file proposals in (annual) shareholder meetings to pressure companies to report on and improve their environmental and social performance. Filing proposals is a common instrument used by a wide range of shareholders”*.³⁴
- **Impact investing:** *“Impact investing is an investment strategy that aims to generate both financial, social and environmental return”*.³⁵

³¹ Federal Reserve Bank of Atlanta. Economic Review; Wagemans, F.A.J.; van Koppen, C.S.A. & Mol, A.P.J. (2013). *The effectiveness of socially responsible investment: a review. Journal of Integrative Environmental Sciences.*

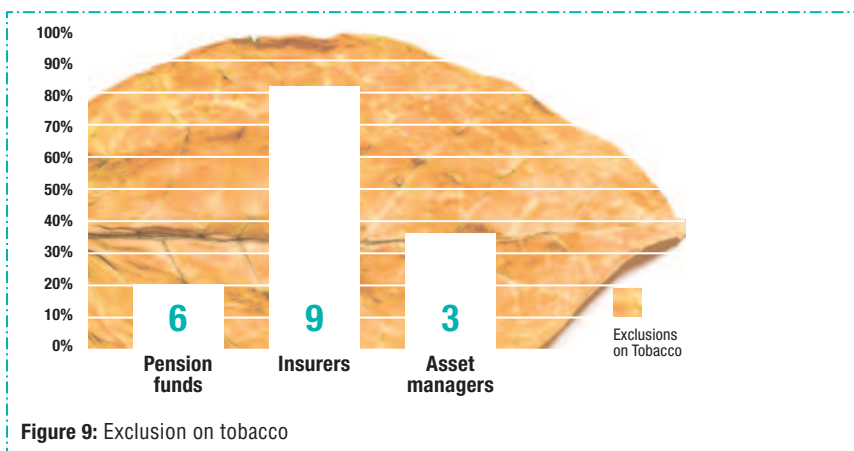
³² Eurosif (2014). *European SRI Study*. See <https://www.eurosif.org/publication/view/european-sri-study-2014/>

³³ Eurosif (2008). *European SRI study 2008*. See <http://www.eurosif.org/publication/european-sri-study-2008/>

³⁴ TKAC, P. (2006). *One Proxy at a Time: Pursuing Social Change through Shareholder Proposals*. Economic Review. Third Quarter 2006. Federal Reserve Bank of Atlanta. Economic Review; Wagemans, F.A.J.; van Koppen, C.S.A. & Mol, A.P.J. (2013). *The effectiveness of socially responsible investment: a review. Journal of Integrative Environmental Sciences.*

³⁵ VBDO (2016) *Impact Investing: From Niche to Mainstream*. See: http://www.vbdo.nl/files/news/ImpactInvestment_Final.pdf

Exclusion



Asset Manager: *"We have made the ethical decision to divest from tobacco ourselves. If customers do not agree with our tobacco policy, they are free to leave, but in practice this has never happened."*

Especially for insurers exclusion of tobacco producers is a common practice, due to the link of many insurers to health. 64% of the responding insurance companies are of the opinion that the best way to act on tobacco is exclusion. Only 20% of the participating pension funds indicated that this was the best way to act.

The number one reason institutional investors give for excluding tobacco, are the negative health effects on society. A second motivation for exclusion is human rights violations in the tobacco sector. The main violation named is child labour.

From the literature study and interviews it became clear that exclusion normally is directed to the larger tobacco producers. Exclusion of companies who supply or service the tobacco sector, or sell tobacco products is less common. Some institutional investors state that they only exclude those tobacco companies that are involved in human rights violations.

Bank: *“All parties that are directly involved are excluded. For sales and distribution we use a threshold of five percent”*

Examples of motivations for exclusion by AXA-IM and PFZW

AXA-IM

The Deputy Chief of AXA, Thomas Buberl explained very clearly why the insurance company has made the decision to divest from tobacco investments:

“We strongly believe in the positive role insurance can play in society and that insurers are part of the solution when it comes to health prevention to protect our clients. Hence it makes no sense for us to continue our investments within the tobacco industry. With this divestment from tobacco we are doing our share to support the efforts of governments around the world. This decision has a cost for us, but the case for divestment is clear: the human cost of tobacco is tragic; its economic cost is huge. As a major investor and a leading health insurer, the AXA Group wants to be part of the solution, and our hope is that others in our industry will do the same.”³⁶

PFZW

The second largest pension fund of the Netherlands, PFZW, has made the choice to divest from tobacco in 2013. The director of PFZW, Peter Borgdorff, stated that the fund has tried to engage with the tobacco sector for years to discuss working conditions on the plantations, but with no use. Another issue for PFZW were the addictive additives tobacco companies use. The main question Borgdorff asked himself was; how can we make people sick through our investments, while our participants work to cure people? The tobacco industry is still a profitable sector, but for how long?³⁷

³⁶ <https://www.axa.com/en/newsroom/press-releases/axa-divests-tobacco-industry-assets>

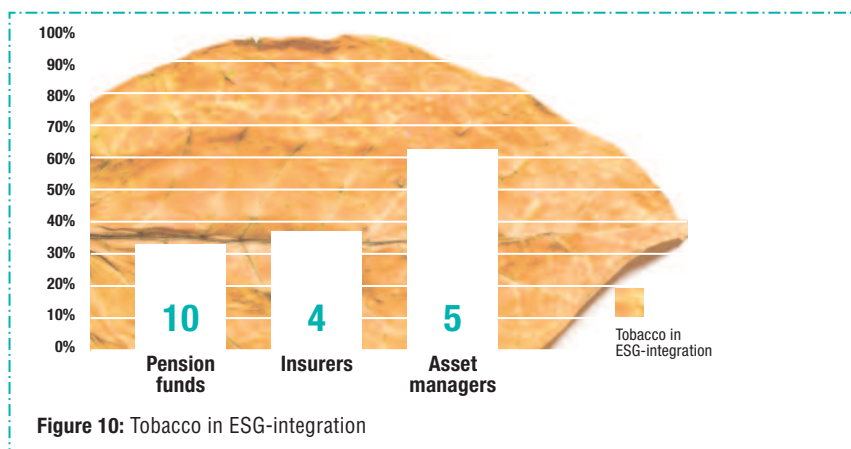
³⁷ <http://pfzw.typepad.com/blog/2013/07/we-hebben-er-tabak-van.html>

ESG-Integration

By practicing ESG integration, asset managers gather and integrate information on the environmental, social and governance performance of companies into traditional financial analysis and investment decisions, based on a systematic process and appropriate research sources. The arguments institutional investors put forward for incorporating tobacco into their ESG-integration, are the issues of health risks and human rights violations.

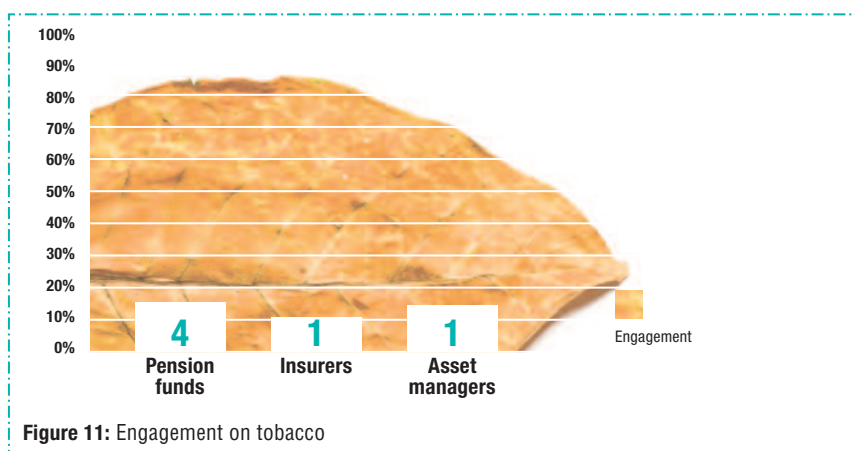
Insurance company: *“There is plenty of ESG data on tobacco. So the lack of data can never be an argument for not implementing tobacco into ESG-integration”*

In the figure below we see that especially asset managers are integrating these considerations in their asset management. With insurance companies we see a significantly lower outcome, which can be logically explained by the fact that insurers are often already excluding investments in the tobacco industry. Overall we can conclude that a large number of investors still have not integrated considerations related to the use and production of tobacco into account in their ESG-integration process.



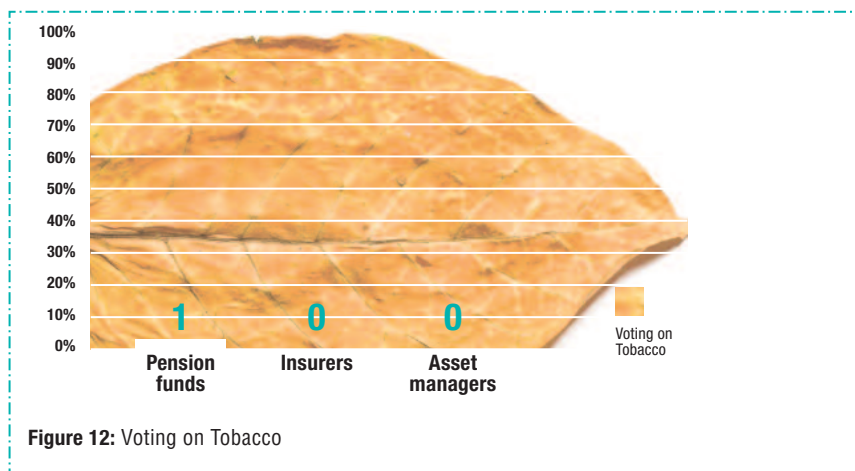
Engagement

Engagement in relation to tobacco is uncommon. A reason that was provided was that tobacco companies are not likely to change their core business because of engagement. The examples of engagement that had taken place were focusing on engagement on the development of e-cigarettes and on the question what their health impact would be compared to regular tobacco products. But institutional investors have more options than solely engaging tobacco companies themselves. Investors can also engage suppliers or sellers of tobacco products. An example is engagement with the goal to reduce the visibility of tobacco products in shops or to reduce the dependency on the tobacco industry. This is however not common practice at the moment.



Voting

Only one of the fifty respondents stated that tobacco is part of the research used for voting decisions. The only respondent doing so provided an example on how voting was implemented regarding proposals on the annual shareholders meeting on the composition of the board of directors of a major tobacco company. This example was however not related to the financial, health or ethical considerations, leaving this a blind spot for institutional investors.



Impact investing

No examples of institutional investors have been found that have impact investments in relation to reducing the use of tobacco products. Yet it is possible for institutional investors to make investments in the field of smoking prevention or in health care specialised in smoking related diseases.



6. Conclusions and Recommendations

6.1 Conclusions

Tobacco is a topic that is becoming increasingly salient among investors. However, still many investors struggle with this sector. The conducted survey showed that of the responding investors 53% do not have a policy on this topic. However, there are several frontrunners. When we look at the insurance sector, only 9% of the respondents do not have a policy on tobacco.

In many cases policies are developed due to ethical concerns. Specifically, investors indicate that the negative effects of tobacco has on health is the core motivation. But there are also other valid reasons to develop a policy on tobacco such as financial risks and human rights concerns.

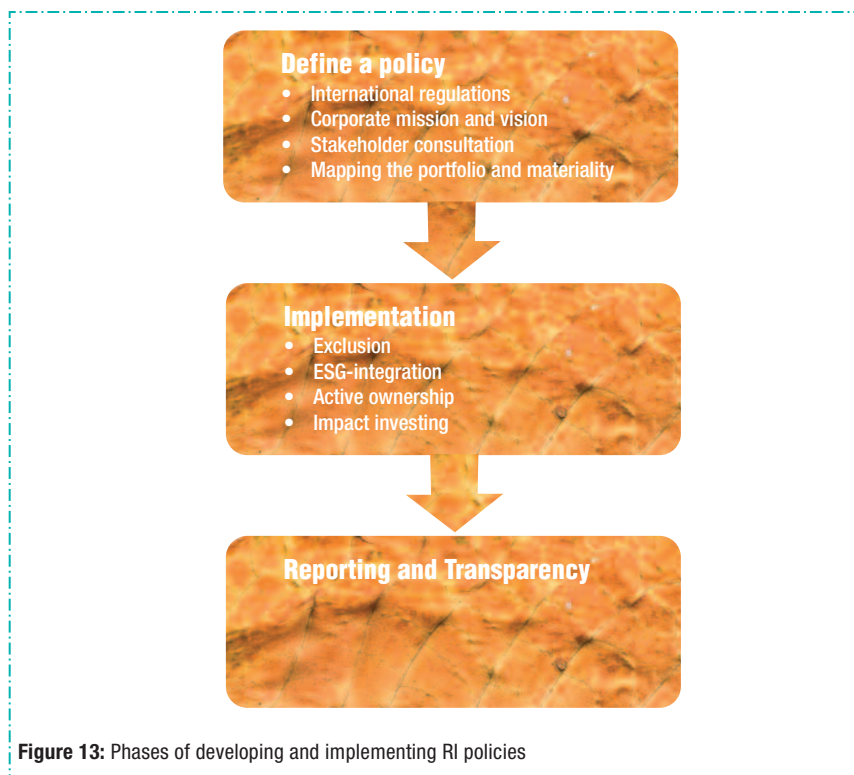
Investors who do not have a policy on tobacco, provide several reasons for not having one:

1. Not on the radar within the organisation
2. The use of tobacco is a free choice, comparable to alcohol.
3. Divestment of tobacco is seen as a risk for the risk-return rate of the investors.

In this study we identify that there are several reasons to consider tobacco in the (responsible) investment policies. Ranging from ethical concern, financial risk management, and human rights issues to questions from participants and clients. In the section below we provide an overview of recommendations on the development of a policy, implementation in asset management and transparency suited to the daily practices of institutional investors.

6.2 Recommendations

To define a policy on tobacco, institutional investors move through several phases of policy development (see figure below). On the basis of these phases we discuss in this section how to translate this into developing and implementing a policy on tobacco.



Define your policy

In the interviews several investors state that they don't have a policy on tobacco because the topic was not 'on the radar' until now. Several inputs can help in defining your own stance:

- Screen the international regulations and responsible investment principles you signed-on to and use these as a basis for your policy (see section 4.1 of this guide).
- Define what the mission and vision of your organisation means for your stance on tobacco. For example, being a provider of health insurance will likely have an impact on the position towards tobacco.
- Map the opinions and stance of your main stakeholders on tobacco. For example

- by surveying your clients and participants on the topic.
- Make a scan of the materiality of tobacco and its ESG-risks (see section 5.2 of this guide).
- Map your portfolio, including:
 - o In which tobacco companies you are invested by direct investments, funds or ETFs and your total amount of investment in the sector.
 - o In which companies you are invested who supply, sell or service the tobacco sector.
- Define which responsible investment instruments would most likely fit your policy and investment management strategy.

Putting policy into practice

Although exclusion is the first instrument that springs to mind when putting a policy on tobacco into practice, there are more options and choices available.

Exclusion

The option most often used is to exclude tobacco companies from the portfolio. When doing so it is important to consider if this exclusion will cover public equity as well as corporate bonds and if it will cover the different types of investments such as direct investments, funds, mandates or ETFs.

There is a more far reaching option. One could also exclude companies of which their turnover is for a certain percentage dependent on supplying, selling or servicing the tobacco sector. When doing so, it is of importance to have high quality data on the links of these companies to the tobacco industry to be able to screen if companies in the portfolio reach this threshold.

Engagement

Engagement is an instrument within responsible investment that is not often linked to a policy on tobacco. As many interviewees brought forward, it is unlikely that a tobacco company will stop its activities in tobacco due to engagement.

However, there are other inroads for engagement that are often overlooked by investors. For investors that chose to stay invested in the tobacco sector engagement can focus on:

- Addressing human rights concerns in the tobacco supply chain
- Addressing the way tobacco is marketed.

Engagement can also take place with companies supplying, servicing or selling tobacco. Engagement can in these instances focus on:

- Reducing the financial dependence on the tobacco industry.
- Making tobacco products less visible in shops
- Refrain from marketing tobacco products.
- Providing information or nudging smokers to stop smoking.

ESG-integration

For all investors it is wise to follow the trends and information on the tobacco sector including legislation, litigation, health impacts and human rights in the supply chain.

Impact investing

Impact investing can potentially be an instrument in a responsible investment policy covering tobacco. For example impact investments can be made in methods that help smokers stop smoking. However, during the interviews and literature review no examples came up of present opportunities to do so.

Still it is possible to have a positive impact through other activities of a financial institution. For example, an insurance company mentioned that in relation to health insurance it is possible to inform or nudge clients to stop smoking.

Transparency

When developing a policy on tobacco and putting this into practice, it is also of importance to be transparent on the policies, the arguments for making these policies and the dilemma's faced. Investors themselves as well as stakeholders are not always aware of the impact of tobacco. A clear explanation of the steps a financial institution can take on this topic leads to a stronger buy-in from clients and other stakeholders. A strong example of a clear explanation of the choices made is the infographic of AXA-IM.

AXA DIVESTS FROM THE TOBACCO INDUSTRY

"Insurers should always be a part of the solution rather than the problem when it comes to health risk prevention. Hence, it makes no sense for us to continue our investments within the tobacco industry."

Thomas Bubert | Deputy CEO and incoming CEO of AXA

TOBACCO: A GLOBAL HEALTH HAZARD



AND A FINANCIAL BURDEN ON SOCIETY



AS A RESPONSIBLE HEALTH INSURER AND INVESTOR, THE AXA GROUP HAS DECIDED TO DIVEST ITS TOBACCO INDUSTRY ASSETS.



This study is supported by:

1. Claudicationet
2. Diabetesfonds
3. Gemeente Amsterdam
4. HANNN
5. Heartbeat Ventures
6. Hersenstichting
7. KNCV Tuberculosefonds
8. KWF Kankerbestrijding
9. Longfonds
10. NVvPO
11. NSPOH
12. NVHVV
13. NVVC
14. Oude Gracht Groep
15. Sinefuma
16. Ik stop ermee
17. Mensch/LPRS
18. Partnership stop met roken
19. Resultaten Scoren
20. Stichting Rookpreventie Jeugd
21. Stivoro
22. Trombose Stichting Nederland
23. V&VN afd PVK/POH
24. Verslavingszorg Noord Nederland
25. VVGN
26. Via syl via
27. ViaTrain
28. PinK-FOX





Dutch Association of Investors for Sustainable Development (VBDO)
Utrecht, the Netherlands

Pieterstraat 11, 3512 JT Utrecht, the Netherlands
T +31 (0) 30 234 00 31, info@vbdo.nl