The Investor Revolution

Shareholders Are Getting Serious About Sustainability

Robert G. Eccles

Towards Business 2030 by Integrating Purpose and Materiality

with Innovation and Performance

LUISS Business School

October 8, 2019

Shareholders Are Getting Serious About Sustainability

Most corporate leaders understand that businesses have a key role to play in tackling urgent challenges such as climate change. But:

- Many believe that pursuing a sustainability agenda runs counter to shareholder wishes
- Many have the impression that ESG hasn't gone mainstream in the investment community
- Many underestimate how much SRI strategies affect their shares (US estimation: 5%, reality: 25%)

Interviews with **70 senior executives at 43 global institutional** investing firms say otherwise:

BLACKROCK

STATE STREET

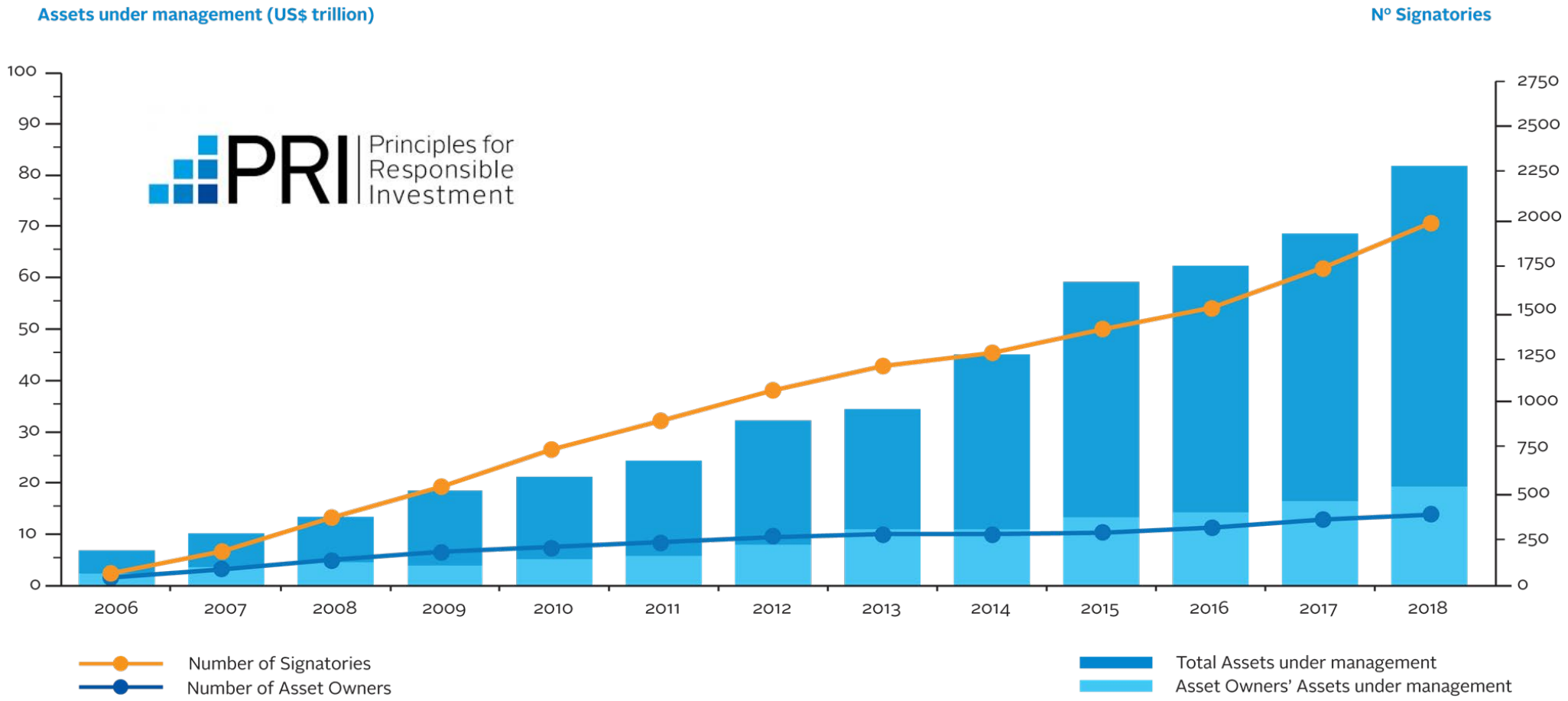
CALSTRS
California State Teachers' Retirement System

Vanguard

CalPERS

GPIF

Shareholders Are Getting Serious About Sustainability



Source: https://www.unpri.org/pri/about-the-pri

What's driving the Change?

Six factors are acting as tailwinds for this heightened focus

1. The Size of Investment Firms
2. Financial Returns
3. Growing Demand
4. An Evolving View of Fiduciary Duty
5. Trickle-Down Within Investment Firms
6. More ESG Activism By Investors

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1. **The Size of Investment Firms**
   - **Top five have 23% of AUM**
   - **Top 10 have 34% of AUM**

Universal Ownership thesis:

- Large firms have become too big to let the plant fail.
- Large institutional investors are forced to take a long-term view, because they have long-term liability.

Hiro Mizuno, CIO of Japan's $1.6 trillion Government Pension Investment Fund:

"We are a classic universal owner with intergenerational responsibilities and thus have an inherently long-term view."

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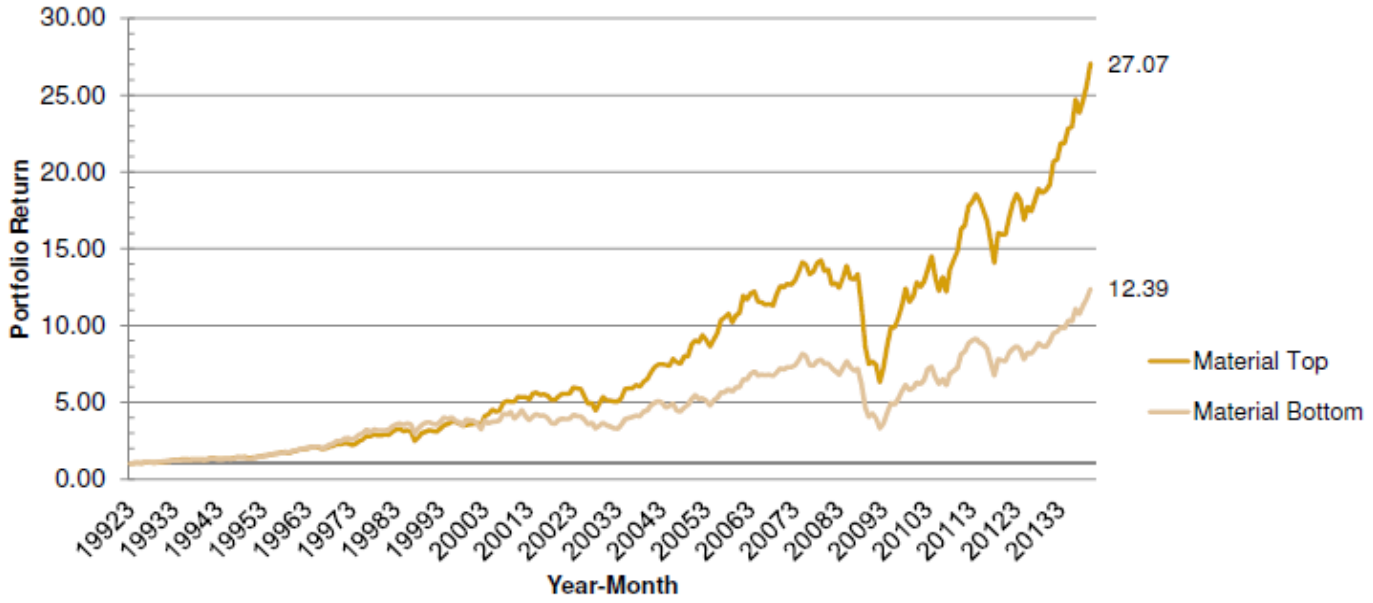
Materiality Matters

Material Index



Firms That Perform Well on Material Issues Enjoy Enhanced Accounting and Market Returns Over Firms That Perform Poorly on These Factors

Source, HBS research: http://hbswk.hbs.edu/item/7755.html

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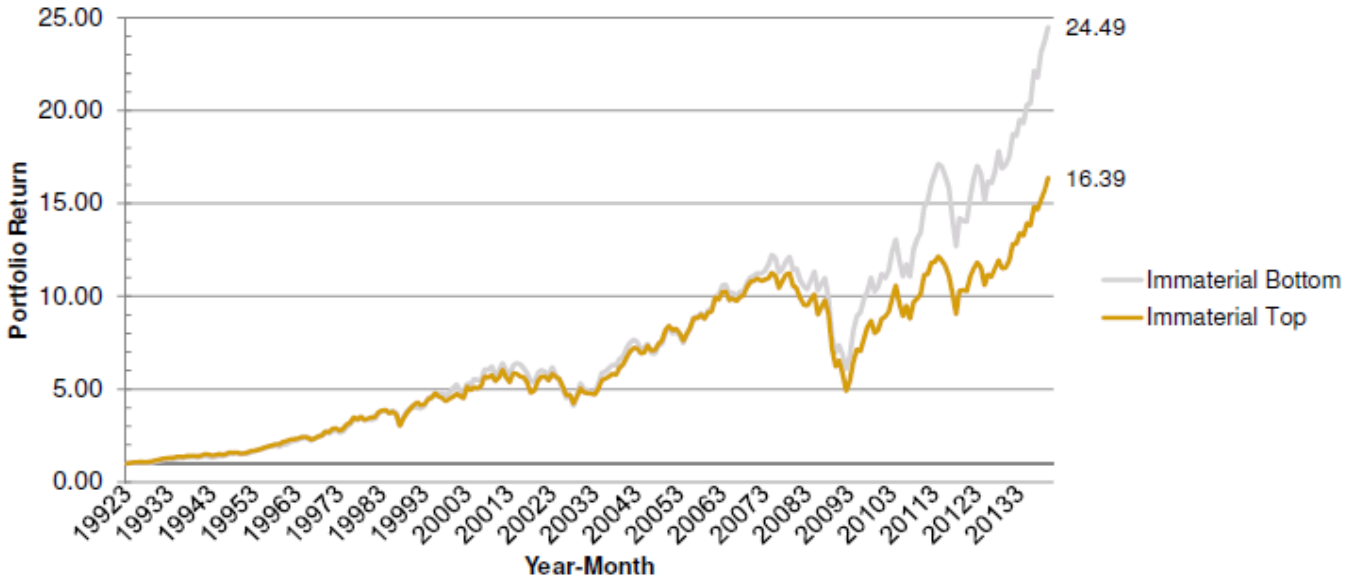
Materiality Matters

Immaterial Index



Firms That Perform Well on Immaterial Issues Do Not Achieve Better Returns Than Firms That Perform Poorly on These Factors

Source, HBS research: http://hbswk.hbs.edu/item/7755.html

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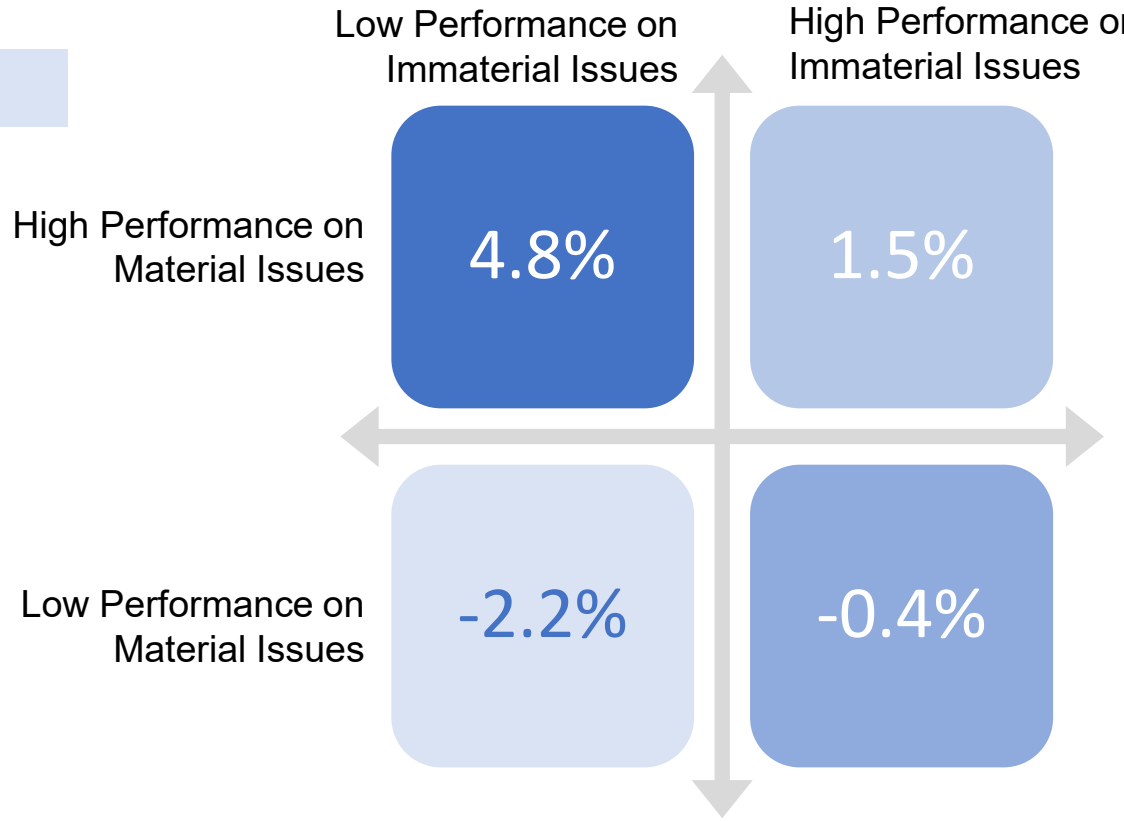
Materiality Matters

EFFECT ON FINANCIAL RETURNS, ANNUALIZED ALPHA



Source: Mozaffar Kahn, George Serafeim, Aaron Yoon, Corporate Sustainability: First evidence on materiality, The Accounting Review, 2016.

What's driving the Change?

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3. Growing Demand

- Asset owners no longer have to be convinced that sustainable investing is important.
- Asset owners in fact increasingly demand sustainable investing strategies from their asset managers
- Many don't only care about financial, but also non-financial outcomes

Rina Kupferschmid-Rojas, head of sustainable Finance at UBS Group:

"Our wealthiest clients want to know their investments are making a difference to make the world a better place"

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4. An Evolving View of Fiduciary Duty

- Mistaken belief that fiduciary duty means focussing only on financial returns.
- More recent legal opinions and regulatory guidelines make it clear that it is a violation of fiduciary duty <u>not to consider</u> ESG factors

Will Martindale
Head of policy at PRI

"Failing to integrate ESG issues is a failure of fiduciary duty."

Source: https://www.unpri.org/pri/about-the-pri

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5. Trickle-Down Within Investment Firms

- Historically, the ESG group at investment firms was separate from portfolio managers and sector analysts
- Now ESG analysis is being integrated into the fundamental financial activities carried out by analysts and portfolio managers.
- This shift will change the way investors engage with companies— and the way corporate executives view sustainability
- Millennials are an important driver of this change

Example BlackRock:

CEO, Larry Fink, promotes sustainable investing, but integration is hard.
In fact, integrating ESG considerations into traditional financial analysis needs **behavioural change:**

Tariq Fancy,
CIO of Sustainable Investing BlackRock

"Some investors are naturally inclined to do it. Others, depending on their asset class, geography, and investment style, take more time to see the investment value […] But if we can do it at BlackRock, we can do it across capitalism."

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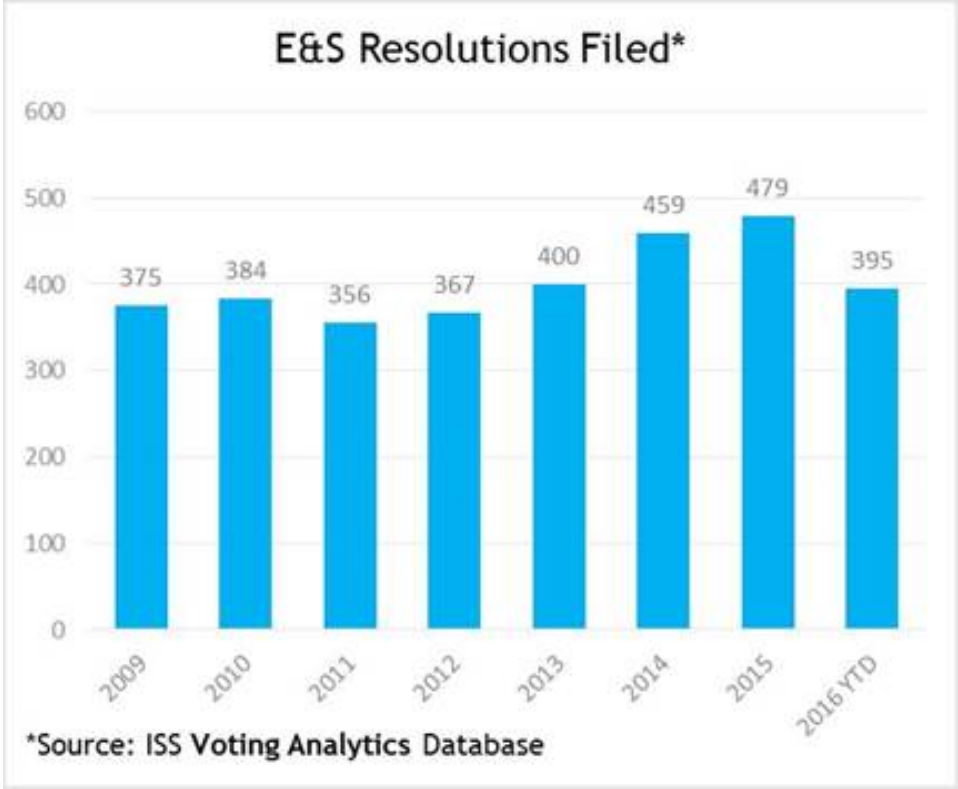
6. More ESG Activism By Investors

- Shareholder activism is on the rise in financial markets—and ESG is increasingly becoming a focus of these interventions.
- One form of active engagement is proxy resolutions and proxy voting (total ISS ES resolution growth by 45% 2011 - 2016
- Some Activist Hedge Funds move into ESG (e.g., JANA Partners)
- Investor Services focus increasingly on ESG (e.g., Hermes Equity Ownership Services)
- Collaborative Activism rises (e.g., Climate Action 100+)



What's Holding Back ESG Investing?

- Most sustainability reporting by companies is aimed not at investors but at other stakeholders, such as NGOs, and is thus of little use to investors.
- Data vendors have emerged to assess companies, but ESG data quality is low and methodologies are opaque.
- Neither corporate nor ESG data is neither comparable nor auditable
- Several NGOs and regulation in certain geographic areas are trying to address this through standard setting – yet there is still a long time to go.

Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

1. Articulate your Purpose
2. Improve Engagement with Shareholders
3. Increase Involvement by Middle Management
4. Invest in Internal Systems for ESG Performance
5. Improve Measurement and Reporting

Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

1. Articulate your Purpose

- "The purpose of a company is not just to produce profits, it is to produce solutions to problems of people and planet and in the process to produce profits" Colin Mayer
- Clarity about corporate purpose is fundamental for board effectiveness
- Boards should publish a **"Statement of Purpose"**

"To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."

Larry Fink, BlackRock

Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

2. Improve Engagement with Shareholders

- Investors are seeking deeper levels of engagement with their portfolio companies
- Shareholders will increasingly engage with the C-Suite on ESG issues
- As well as the board of directors
- Purpose Statements should be integrated into an Integrated Report
- By doing so, companies will signal a change from short to long-term value orientation
- CECP framework for executives to share the long-term strategic plans
- Companies should take charge of quarterly calls and not let them be driven by sho term sell-side analysts

INTEGRATED REPORTING <IR>

CECP

Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

3. Increase Involvement by Middle Management

- Companies need to respond by increasing their own middle management's involvement in identifying and managing the material ESG issues
- Getting middle management more involved is the responsibility of the board and senior leaders
- Middle managers should be involved in Materiality determination
- ESG should be part of reward systems

Jonathan Bailey,
Head of ESG Investing
Neuberger Berman

"Investors and the CEO create the space, but it is middle management that will create the products and services that serve both shareholders and society."

Preparing for the New Era

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4. Invest in Internal Systems for ESG Performance

- All firms have financial IT systems, but few firms have reliable systems for measuring ESG performance.
- Accurate Integrated Reporting is inhibited by poor ESG data management.
  To help avoid this, firms can:
  a) Put suggested standards (GRI, SASB) into practice
  b) companies should challenge the software vendors that provide financial information to extend into ESG metrics.
  c) businesses should press their audit firms to provide assurance on reported ESG performance.

Preparing for the New Era

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5. Improve Measurement and Reporting

- Some ESG issues don't affect a company's bottom line but still impact society at large
- A growing segment of the investment community is interested in impacts—and willing to allocate capital to firms that actively work to benefit society.
- No agreed upon measure for "externalities"
- Good framework for thinking about impact is the United Nations Sustainable Development Goals (SDGs)
- Impact Management Project

THE IMP HAS LAUNCHED A ‘STRUCTURED NETWORK’ OF STANDARD-SETTING ORGANISATIONS….

IMPACT MANAGEMENT PROJECT

Clara Barby,
CEO IMP

“Through provision of significant technical input, the IMP supports these organizations to coordinate – and even co-create –content.”

The IMP Structured Network comprises organisations that are working together to coordinate standards of impact measurement and management

PRI · SASB · SOCIAL VALUE INTERNATIONAL · UNDP · UNEP FINANCE INITIATIVE · GIIN GLOBAL IMPACT INVESTING NETWORK · GRI · GSG Driving real impact · IFC · OECD · United Nations Global Compact · World Benchmarking Alliance

The IMP Strategic Partners are a group of organisations whose partnership is essential for informing and/or disseminating standards of impact measurement and management

HOW IMPACT MEASUREMENT BUILDS ON ESG MEASUREMENT

Illustrative management motivation	Management question	ESG measurement	Outcome measurement	Impact measurement (Outcomes in context)
'We want to mitigate risk'	Does my business have policies and practices in place to mitigate risks of negative outcomes?	✓		
'We see a positive relationship between stakeholders' wellbeing and long-term value creation'	Is my business generating positive outcomes for its stakeholders?		✓	
'We want to use our capabilities to tackle a pressing social or environmental challenge'	Is my business significantly increasing an important positive outcome for an otherwise underserved population?			✓
'We want to reduce costs associated with the social and environmental damage we are causing'	Is my business significantly reducing an important negative outcome for an otherwise underserved population?			✓

Context-based metrics for investment decision

ASSESSMENT MEASURES	WASTEWATER TREATMENT	RENEWABLE ENERGY	PHARMACEUTICALS
Impact metrics *Data source: Combined business activity/technology/ sociobiogeophysical impact metrics, as proposed here*	**Outputs:** Volumes of waste-water treated (e.g., cubic meters per day) **Outcomes:** Pollutant concentration reductions in receiving waters (e.g., milligrams per liter) **Impacts:** Beneficiary populations drawing drinking water from downstream (1000s), stream length of improved fish habitat (kilometers below threshold)	**Outputs:** Emissions reduced (CO_2, $PM_{2.5}$, SO_2, NO_x) (e.g., metric tons per year) **Outcomes:** Ambient air pollution improvement (e.g., parts per million; number of smog alerts) **Impacts:** Lives extended, hospitalizations and sick days avoided, reduced health-care spending	**Outputs:** Spatially distributed drug sales **Outcomes:** Target populations reached (e.g., millions; % of total) **Impacts:** Lives extended, hospitalizations and sick days avoided, reduced health-care spending
Financial (standards-based) *Data source: Mandated corporate financial statements*	Valuation Corporate strategy and relative competitive position		

"The approach...is to... evaluate corporate products and services within broader environmental or human beneficiary settings."

Source: Vörösmarty, et al. (2018) Scientifically assess impact sof sustainable investments Metrics can inform investors wary of "green washing". In: Science, Vol 359, Issue 6357.

A New Outlook

A SEA CHANGE in the way investors evaluate companies is under way. Its exact timing can't be predicted, but it is inevitable.

CONTACT

robert.eccles@sbs.ox.ac.uk