

Speech by Vice President Albert Gore

Institutional Investor Summit on Climate Risk

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Generation Investment Management LLP

When you look at the problems that have to be confronted when you deal with climate change in the context of the markets, there are two interconnected problems that I'd like to highlight. There are others, but the two main ones I'd like to talk about have both been discussed, and I'd like to weave them together if I could.

First, is short-termism. And it's not a problem that is only found in markets, by the way. Some environmentalists said 20 years ago that we, humanity, are managing our relationship to planet earth as if it were a business in liquidation. There is a lot of truth to that. My previous life was in politics. I'm a recovering politician now. And, when I first ran for office in 1976, I believe I took one poll. By the time I left politics in 2000, it was common practice to have overnight polling. Everyday. And now it's every few hours and they have tracking polls continuously. And the policy decisions that are made in the political system are influenced by the information flows that come out of that polling and out of that computerized data analysis.

The great physicist Heisenberg -- and I'm not qualified to talk about this, but the one thing that I know that he said is, "the act of observation changes what's being observed." Just because of human nature being what it is, when we observe something, the information affects us. And information carries an imperative. And managers of investment funds who are able to mark to market, who are able to get daily reports, are affected by that. That's one reason why I think it's important to look at the horizon for the incentive structure. But I'll come back to that.

Short-termism is a problem. Look at the average mutual fund today. The average mutual fund turns over its entire portfolio every ten months. I can make a case to you that that is functionally insane. Why? First of all because a long-term investor is supposedly investing in the value of the company. Sixty to 70 percent of the value of the average company builds up over a period of years. If you're trading in less than a

12-month cycle, in such a short time-frame it's not really investing as much as it is trading.

The second reason why I think that it's a big mistake is because a mutual fund or any long-term investors end up competing against hedge funds and others who can go short as well as long. And so they're competing with one hand tied behind their backs. And yet the information flow is such that the time horizon is continuing to get shorter and shorter. And even foundations that have a commitment to a long-term outlook, typically will evaluate their managers according to how they are doing each quarter. Or as Abby Joseph Cohen said, sometimes even sooner than that. And, again, human nature being what it is, if you're evaluated and compensated on the basis of a quarter, then that long-term view is going to suffer by comparison.

We've heard for a long time about the dangers of CEOs responding to quarterly reports. Last week, the McKinsey Quarterly, ironically (laughter), came out with a report that found this: responding to a survey of business managers, more than 80 percent of the executives responding, said that they would cut expenditures on R&D and marketing to ensure that they hit quarterly earnings targets, even if they believed that the cuts were destroying value over the long-term. Eighty percent. Now this is not venal behavior; this is predictable behavior! Because if they're evaluated on whether or not they hit the quarterly earnings, then they're going to behave accordingly. And if they don't, they'll be replaced by someone who will. And this happens on a regular basis. A majority of managers said they would forego an investment that offered a decent return on capital if it meant missing quarterly earnings expectations.

They recommend that companies change the nature of their dialogue with key stakeholders. That means first identifying investors who will support a company's strategy and then attracting them. There is no point, for example, talking about the company's health to arbitragers or hedge fund managers looking for the next trade. I've advised Google over the last four

years. When they went public, they broke the rules and said, we're not going to give this short-term guidance and we're not going to be evaluated that way. There are managers who are trying to break out of this, but -- this brings me back to my point -- even if a CEO breaks out of that way of thinking and behaving, if the biggest investors in that company are looking for their rewards on a short-term time horizon, then those managers are not going to be able to survive with that longer term outlook.

Everybody's crowding into this space. There are now -- as some of you know -- more mutual funds than there are stocks. More mutual funds than stocks. That's been true for several years now. And there is also a herd instinct -- not only to respond to the information -- but also to follow the herd. And, so, there's this huge crowd thundering into moderate risk, getting moderate returns, minus large fees, calculated on the basis of assets under management and velocity of turnover. So what results, again, is not venal behavior, it is predictable behavior.

I believe investors who want to adopt a longer-term horizon, should not approach this issue simply as a challenge to reconcile their conscience and concern for the planet with the mathematics that come out of their investment offices. That's all well and good. But what's really required in my humble opinion is, to challenge the structure of the decision-making process. What are the incentives that the managers have? What is the time horizon? Not just rhetorically, but in the structure of how the investment is made. What kind of information is taken into account?

And I want to use that as the segway to the second big problem in this area. And that is, the challenge of integrating the sustainability information that includes climate change and other environmental issues. Sustainability also includes how a company treats its employees and stakeholders, the kind of relationships it has in the community, corporate ethics, and a company's culture. All of these are sustainability factors. How is that integrated into the analysis of the stock? You know, there's a metaphor I'd like to use; an analogy. If you look at the electromagnetic spectrum from ultraviolet to

infrared -- and many of you have seen these bars -- and the portion of that spectrum that's made up of visible light that we can see with our eyes is a very tiny slice. I remember being impressed the first time I saw that. There's so much more out there, but the part we can see is just a narrow slice. But, again, human nature being what it is, we tend to assume that's what matters. And since most everybody else does as well, we get along pretty well that way.

I had an interesting experience beginning in late November of 1992, when then-president elect Clinton and I started getting the daily intelligence reports. I noticed everyday there were infrared photos and ultraviolet collection. And communications signals from across the spectrum. And it was used to present a more complete picture of the matter being analyzed. This was in the old days. (laughter) I'm sorry, I couldn't resist that.

But seriously, the practice of looking solely at the financial reports means looking only at a narrow slice of that spectrum of information. Yet the information that lies in a company's environmental practice, employee practices and the other non-financial factors can also be very important.

Abraham Maslow, the great psychologist, once said, "if the only tool you have is a hammer, every problem begins to look like a nail." And in the same way, if the only tool that we use to analyze what's valuable is a price tag, then those things that don't have a price tag can begin to look like they have no value. And those things that are not on a balance sheet can begin to look invisible and not worth taking into account. And for years, good investors have always taken into account everything they can find. But it's episodic for the most part. And anecdotal. Sometimes much more than that, but it should be integrated fully.

Finally, I believe that integrating the issues related to climate change into your analysis of what stocks are worth investing in, how much and for how long, is simply good business and common sense. Eighteen months ago, a report was presented here called "Changing Drivers," that analyzed the carbon intensity of profits in

the automobile industry. And I'm not going to say that reading that report was the only way one could avoid being surprised by what's happened to GM and Ford in the last few months. But I will say this, taking that metric, carbon intensity of profits, into account and integrating it with the rest of the traditional analysis of the auto company's value, makes it far more likely that an investor would have a more accurate picture of the sustainability of that stock's value over time.

You know, there are a lot of companies out there that have been whistling past the graveyard of big environmental risks. And, in fact, 10 of the largest 15 bankruptcies have occurred since 2001. That's partly an accounting artifact of the rising value of conglomerates, but it's also a result of some very large risks that go past the quarterly and the annual time horizon not being adequately analyzed and integrated into the assessment of value.

My two recommendations, for what they're worth, is, that investors make the structural changes to actually invest over the longer term, and that they make the changes necessary to fully, not just rhetorically, integrate sustainability values into equity analysis.

Now, a final point. I began by saying that we're all here filling a kind of a policy vacuum. But I want you to believe -- I want you to know that I believe -- we are here at an extraordinarily hopeful moment. We were buoyed yesterday by the GE announcement. And some here have had something to do with that. And when I heard Jeff Immelt's words, I was thrilled by what he said. And people can knit-pick on this side or the other, but that's a hell of a significant move. And there are other shoes about to drop out there. Some that will surprise people when they drop. And today we were all buoyed by the Cinergy, Duke Energy story. It's fantastic. And to have this kind of leadership within the utility industry, within the business sector, is very, very encouraging.

But, you know, in John Holdren's presentation, he talked about some tipping points in the environment where some things can build up and then all of a sudden, tip. The main reason

I'm optimistic is that I know there are tipping points in the political system also. Globally and nationally. And when GE moved and when Cinergy and Duke moved, that moved us closer to that tipping point. We need to move past the silly, rear-guard squabble over the contrarians trying to convince people that there's some argument about the science of climate change -- God, it makes me mad! You know, they did a study of the science over the last 10 years, 923 peer-review journal articles on climate change. The number of them that disagreed with the global consensus: zero! The number of news stories that treated it as a 50/50 deal: 53 percent. But when we get past that, and we're getting past it, and when the leaders in the business sector begin to make their moves, before the policy vacuum can really be filled, there's one big, final step, and that is, for investors led by those of you who are here who have a requirement to take a long-term view decide to take the businesslike, commonsense, difficult but necessary steps to shift the perspective and integrate the data and start acting in ways that are fully faithful to your fiduciary responsibilities.

And don't let anybody tell you that it cannot be done. We are meeting here in the week of the 60th Anniversary of the end of World War II. The best quote I ever heard about short-termism was from George Marshall, right after that war when said, "It is time that we steered by the stars, and not by the lights of each passing ship." And all of the -- the Marshall Plan, the unification of Europe and all those achievements that we enjoy today came from that. We can look back on this meeting years from now with a similar source of pride -- and I'm serious about this -- if each of you go out from here and say, all right, we're through just simply talking about this. We heard Jeff Immelt say the say/do ratio is the key thing here, and we've said now we're going to do.

Thank you very much. (applause)

Hon. Al Gore is Chairman and a Partner of Generation Investment Management.