# The next generation

David Blood, a former head of Goldman Sachs Asset Management, has pledged that his new venture will put sustainability at the heart of its long-term research process. Here, **Colin le Duc** explains why

At Generation Investment Management, a London-based asset management company formed in April, we believe integrating sustainability research into long-term investment processes is simply common sense.

We define sustainability research as the analysis of shareholder value implications of long-term global economic, environmental and social challenges. Themes are considered relevant when they have the potential to enhance competitive advantage and increase shareholder value, by managing the risks and seizing the opportunities emerging from these challenges.

We believe long-term investors must embrace sustainability research for three reasons. First, long-term investing implies identifying companies with an enduring capability to create value and sustain competitive advantage. Social, environmental and geopolitical issues can materially impact the ability of industries and companies to sustain financial returns. Taking a systemic view of risks and opportunities by explicitly recognising economic, environmental and social challenges makes sound investment sense.

Secondly, a long-term focus also implies a heightened level of uncertainty and ambiguity. Reliance on purely quantitative analysis may be appropriate in the short term, but long-term research means embracing intangible and qualitative aspects of performance as well. The longer the term one focuses on, the more inherently uncertain things become; thus more emphasis on understanding a broader scope of qualitative factors is required.

Finally, in every sector there are long-term challenges which present risks and opportunities for companies' enduring capability to create value. Research into the implications of these business risks and opportunities from a sustainability perspective, and the use of subsequent insights in investment analysis, is currently unsophisticated. Full integration of sustainability in the investment process therefore presents opportunities for investors and researchers to create value.

Integrating sustainability research from the outset enhances the investment process. In the automobile industry, for example, understanding the full implications of a carbon-constrained world is critical. Companies that recognised the need to develop new hybrid technologies are now reaping the financial rewards ahead of the rest of the industry.

So, in practice, how can fundamental equity analysis be enhanced by understanding how a company handles sustainability issues?

Denmark's Novo-Nordisk is the world's leading supplier of insulin for the treatment of diabetes. The disease is developing into a global pandemic. There are now 177 million diabetics globally, compared to 110 million in 1994. By 2025 this figure is expected to increase up to 300 million. Novo-Nordisk is a company which has embedded sustainability into its management and decision-making, and recognises the long-term risk to society and, ultimately, to itself that this alarming rise in diabetes represents.

To tackle this issue, it has led an attempt to help build better diabetes prevention systems in developing countries. For instance, since 2001, in common with some of its peers, Novo has offered its insulin products to the public health systems in the world's 49 least developed countries at below market prices. Furthermore, it works with governments to share information, including developing a diabetes action plan in China, including setting up 31 centres of excellence covering 311 cities.

**Producing insulin in Brazil – Novo-Nordisk's approach to developing countries is central to its long-term performance**

This proactive strategy is in marked contrast to the alternative: it would be possible for Novo-Nordisk to sit back and take no action, and in doing so benefit more from the explosion of diabetes. Instead, the company is showing leadership in potentially giving up short-term gains to prevent a long-term societal risk.

These activities, in fact, create meaningful competitive advantages that can benefit the company and its shareholders over the long term. First, Novo-Nordisk mitigates long-term reputational risk. If a government perceives the company as aiming to profit directly from an issue their society is struggling with, it could easily limit Novo-Nordisk's licence to operate. This is especially true for a highly regulated industry like pharmaceuticals.

Secondly, Novo gains unique insights into the market dynamics and customer base in rapidly growing developing markets. The company builds long-term partnerships with the public institutions and NGOs it must work with to expand its distribution networks and introduce new products.

Thirdly, Novo-Nordisk believes that acting ethically helps it attract and retain the right people. Management believes being a forward-thinking and considerate employer creates a sense of trust and common purpose throughout the organisation, helping to raise employee morale and lower employee turnover. In fact, Novo-Nordisk has one of the lowest turnover rates in the pharmaceutical industry.

In most mainstream asset management firms, sustainability issues – such as those Novo-Nordisk takes into account – are not analysed in any depth until the end of the investment process. We believe that only full integration of sustainability research into equity analysis enables firms to consider such issues within the context of a company's business fundamentals. This integration increases the flow of material information into the investment process and ensures that both financial and sustainability research is incorporated to more accurately analyse the effect of sustainability issues on a company's ability to generate shareholder value.

We are not the only ones who think that sustainability research is a critical component of the long-term investment process. Generation is a supporter of the Enhanced Analytics Initiative, founded by a group of pension funds and long-term investors pledged to commit a percentage of their brokerage commissions to firms whose research product focuses on long-term sustainability issues. In addition, a multitude of issue-based groups, such as the Investor Network on Climate Risk, a forum for US state pension funds and labour unions, is demanding that their investment managers take climate change related risk factors into account in their investment processes.

As the evolution of these initiatives demonstrate, the mainstream money management industry must embrace sustainability research as an integral part of the long-term investment process. It is just common sense. EF

*Colin le Duc is head of research at Generation Investment Management.*
*E-mail: colin.leduc@generationim.com*