generation

Sustainable Capitalism

David Blood, Senior Partner

Generation Investment Management Global Client Conference

March 19, 2010

Defining Sustainable Capitalism

The question over the kind of economic system most likely to deliver the greatest benefit to society is not about capitalism versus communism. There is no question markets lie at the core of every successful economy. The question however, is what type of capitalism will maximize sustainable economic growth. The last decade clearly demonstrates free and unfettered markets – market fundamentalism – do not deliver optimal long-term results.

The global financial crisis had its origins in short-term, unsustainable strategies and actions. Before the crisis and since, we (and others) have called for a more long-term and responsible form of capitalism – what we call "Sustainable Capitalism". Sustainable Capitalism seeks to maximize long-term economic value creation. It explicitly integrates environmental, social and governance ("ESG") factors into strategy, and into measuring outputs and assessing risk and opportunities. Sustainable Capitalism challenges us to generate financial return in a long-term and responsible manner.

Why Does Sustainable Capitalism Matter?

Sustainability and long-term wealth creation are closely linked. Our economic activity in essence, is based on the use of natural and human resources. Business and markets cannot operate in isolation from society or the environment. In addition, the sustainability challenges the planet faces today, namely, the climate crisis, poverty, oppression of women, pandemics, water scarcity, migration and urbanization are extraordinary and completely unprecedented. And, business and the capital markets are often best positioned to address these issues.

We often hear the question "Shouldn't CEOs and business leaders be focused on growth, profitability, competitive position and shareholder returns?" Of course, and a focus on sustainability and long-term value creation does just that. Central to this thesis is the explicit recognition that sustainability factors directly affect long-term business profitability. In a December 2008 McKinsey survey of CFO's, sustainability investment and corporate social responsibility professionals from around the world, solid majorities of all respondents said they expect environmental, social and governance programs to create more value in the next five years. They listed reputation and branding, attracting, motivating and retaining employees, license to operate, operational efficiencies and new revenue opportunities as the five most important value creators. The interests of shareholders, over time, will be best served by companies that maximize their financial performance by strategically managing their social, environmental and ethical performance.

In the McKinsey survey, respondents also identified the biggest constraint to mainstreaming sustainability as the lack of metrics to integrate and quantify ESG performance into a company's finances. We agree better quantitative measures are important. In analyzing business quality, we clearly are looking for new and sustainable revenue streams (like businesses which are leading the transition to a low carbon economy, or consumer and health care companies addressing real needs) and companies which are driving efficiencies through their cost structures (reduced energy usage, lower employee turnover or better logistics).

We also support better disclosure of risks like the new SEC interpretive ruling requiring companies to disclose their exposures to climate change. However, we should not allow a blinkered drive for figures to inhibit common sense. Sure, lack of disclosure was an issue at Lehman Brothers, but so was culture, incentive structures, leadership and governance. All of which are difficult to quantify, yet their failures were the cause of the misleading disclosure, not vice-versa.

In fact, the top three long-term value creation initiatives cited by McKinsey: brand, people and license to operate are all difficult to quantify. But, we can all name numerous businesses which drive and maintain competitive position by getting these things right.

How to Move Towards Sustainable Capitalism

Business – and by extension the capital markets – need to change. We are too focused on the short-term: quarterly earnings, instant opinion polls, rampant consumerism and living beyond our means. We have often said, the market is long on short and short on long. This short-termism results in poor investment and asset allocation decisions with disastrous effects on our economies. As Abraham Lincoln said at the time of America's greatest danger, "We must disenthrall ourselves, and then we will save our country."

So what is now required? How do we change? First, we must consistently focus on the business case and common sense. We must resist ideology and at the same time, an over reliance on quantitative measures. We need to start by reconsidering the basic building blocks of commerce and markets: accounting and disclosure, incentives, regulation and responsibility.

Disclosure and transparency are critical to the optimal allocation of capital. In addition, a broader accounting of economic activity will enhance economic policy and decision-making. We commend the work of Professor Joe Stiglitz and The Commission on the Measurement of Economic Performance and Social Progress for recognizing that while facts and figures are important – indeed critical to thoughtful decision-making – we have placed too great an emphasis on outdated modes of distilling economic value. The longer we defer the proper accounting for externalities such as global warming pollution, the greater the strain we place on our already fragile economies.

In Common Sense (1776) Thomas Paine wrote "A long habit of not thinking a thing is wrong, gives it a superficial appearance of being right" This is certainly true for compensation metrics and levels in both business and finance. Mercer, the global consulting firm, estimates that from 1999 to 2008, inflation adjusted median CEO compensation at large US firms increased 48%. This is over a period in which real household income declined by 2%. Notably, during this period the S&P returned approximately -16%. We also experienced two economic downturns, including of course, the ongoing global financial crisis. Clearly, something is not right.

Executive and Wall Street compensation needs to be better aligned with stakeholders and long-term objectives. It must also reflect fulsome measures of performance including environmental, social and governance factors and be equitable. This should also be true for the compensation of investors and asset managers. If asset owners continue to reflexively review and reward their asset managers on a quarterly or annual basis, they should not be surprised to find their investors optimizing returns within this timeframe – often at the expense of long-term value. After all, people often do what they're paid to do. In truth, however, this approach to investing is actually not investing at all; it is trading. Actually, at its worst, it is a sophisticated form of gambling. And as mutual fund performance statistics demonstrate, this approach has not typically maximized value for investors or economies. This should change. Asset managers (and owners) should be evaluated and incentivized (that is, compensated) using long-term metrics that measure – and reward – long-term performance

In addition to regulation, which is quite rightly receiving scrutiny, investors and asset owners must take the initiative to significantly step-up their efforts to be responsible owners. We must vote our proxies, work with global regulators to improve shareholder rights and responsibilities, and more aggressively hold company boards to the highest standards of governance and ethics. We must also ensure trustees are given the proper resources and training.

The Actions

The Scottish Mountaineer W.H. Murray said: "Concerning all acts of initiative … there is one elementary truth, the ignorance of which kills countless ideas and splendid plans; that the moment one definitely commits oneself, then providence moves too". To solve the profound and still prevalent problems in capital markets, we need to commit to new thinking. We must revisit the basic fundamentals necessary for strong and functioning Capital Markets. Specifically, we in the investment community must reaffirm our commitment to the UN's Principles of Responsible Investment and become more engaged and active owners. We must insist that businesses are managed responsibly and for the long-term. Incentive structures must be aligned to the long-term, reflect broader measures of performance and be equitable. We must also change asset management incentives to emphasize and reward long-term investment performance. Finally, we must develop better research processes to identify the impact of sustainability on business, which in turn will assist in making the business case for a more sustainable model. But, let's use common sense and not become enslaved to figures which do not always tell the full story. For the health of our societies, environment, economies and businesses, let us fully commit to responsible and long-term capitalism.