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When principles aid performance

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The investment business is full of people claiming a long-term focus. But few are willing to bet the farm on it, particularly when the metrics are structured around quarterly reporting.

Al Gore, the former US vice-president, pointed this out at a recent presentation to the UK's National Association of Pension Funds.

Mr Gore is putting his money where his mouth is. In 2004 he teamed up with David Blood, former chief executive of Goldman Sachs Asset Management, to create Generation Investment Management, a long-only investment firm. It aims to deliver long-term superior returns, but the research-intensive process is guided by principles of sustainability.

"We're all about picking great companies at the right price," says Colin le Duc, head of research and a partner. He means finding stocks of public companies that Generation believes will outperform because they are viable, long-term franchises with sustainable practices.

Unlike most socially responsible investing (SRI) approaches, Generation is unwilling to sacrifice returns to save the world. Rather, it uses sustainability research to form views on a group's quality, its management and its valuation.

Launched with \$60m of partners' capital, Generation is now managing just under \$1bn and Mr le Duc believes the fund's capacity is about \$5bn.

Stephen George, chief investment officer of Capricorn Management, a \$5bn private investment firm that is invested with Generation, says what attracted him was its refusal to sacrifice performance.

"Consistently superior returns do not preclude being principled, but perhaps not across every asset class and investment," Mr George says.

He suggests an element of investors that boast superior long-term track records may be that they build in the concept of principled investing – aligned interests, quality, sustainable business models, management ethics.

"To us, these are sensible things that can help build investment returns. These are some of the elements, among others, that Generation builds into its process. We find that attractive."

In other words, the consistent outperformance of a David Swensen (Yale) or a Warren Buffett might have something to do with the principles of their process.

Mr le Duc notes that there is no magic in Generation's process. It is common sense investing.

Nevertheless, research is rigorous and complex. Generation's team of sector-focused analysts are expected not only to be able to run the numbers – typically using detailed 40-year normalised cash flow models – but to be able to articulate how a group is positioned against its peers, against

the backdrop of a region, and in a macro theme.

Themes such as climate change, pandemics, poverty or the scarcity of fresh water might prompt an advisory board meeting in which partners and analysts debate how to capture such a view in specific investments.

Generation seeks to account for both qualitative and quantitative factors.

For example, Mr le Duc notes the importance of corporate strategy in formulating an investment decision, an area he believes to be largely neglected by traditional SRI approaches.

But with only about 30-50 names typically in the portfolio (roughly 40 at present), conviction is vital.

Urbi, a Mexican homebuilder, illustrates Generation's research process. As a theme, Generation sees global challenges to accessing and delivering fresh water in the near future. After examining Mexico from a macro perspective, homebuilders were identified as an area of interest. But the dry climate and infrastructure concerns meant even good companies might encounter challenges. Urbi, however, boasts proximity to desalination plants, mitigating such concerns.

Although most would agree that long-term sustainable investing is desirable, achieving it can be hard going. The investment business has its share of bright people, but only a handful of Swensens and Buffetts.

Even though Generation says its returns have been on course – publishing specifics before three years in operation would be, according to the firm, short term – and its assets have grown according to plan, looking to the broader industry, not everyone is ready for sustainable investing.

Mr le Duc says that even once a pension fund has decided to allocate to equities, structural hurdles remain.

“We’re long term, global, sustainable and run a concentrated portfolio. Those are four factors that can present obstacles to trustees and consultants trying to understand the model,” Mr le Duc says. “Innovation needs to happen at all stages of the investment value chain. Sustainability is becoming more mainstream, but certain structural changes need to take place on the investors’ side.”

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