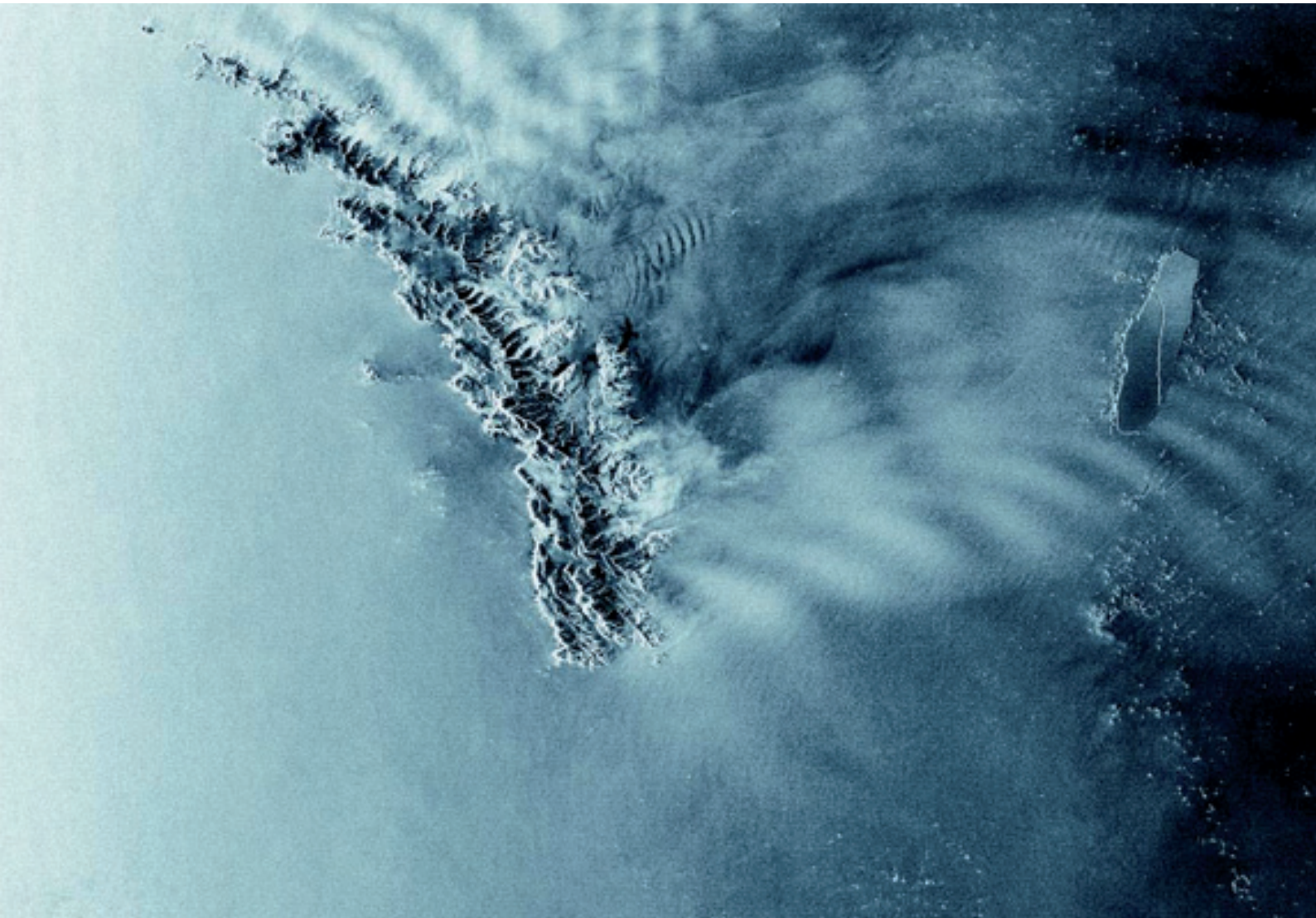


# Sustainable Capitalism

---

February 15, 2012



## Sustainable Capitalism

For additional copies of this report, please contact:

Generation Investment Management LLP  
One Vine Street  
London  
W1J 0AH  
U.K.

Main: +44 (0) 207 534 4700

Fax: +44 (0) 207 534 4701

[suscap@generationim.com](mailto:suscap@generationim.com)

v. 1.0 (January 2012)

Copyright © 2012 Generation Investment Management.

All rights reserved.

Design by Manoverboard.

## IMPORTANT INFORMATION

This report is for information purposes only. It is for the sole use of its intended recipient. It is intended solely as a discussion piece around the topic of furthering the goal of Sustainable Capitalism. In consequence, under no circumstances is it to be considered as a financial promotion. It is not an offer to sell or a solicitation to buy any investment referred to in this document nor is it an offer to provide any form of investment service. This report is not meant as a general guide to investing nor as a source of any specific investment recommendation.

While the information contained in this report is from sources believed reliable, we do not represent that it is accurate or complete and it should not be relied upon as such. Unless attributed to others, any opinions expressed are our current opinions only.

Certain information presented may be provided by third-parties. Generation believes that such third-party information is reliable, but does not guarantee its accuracy, timeliness or completeness, and it is subject to change without notice.

**For Non-US Recipients:** Generation Investment Management LLP (“**Generation UK**”) is authorised and regulated by the Financial Services Authority (“**FSA**”). This Document does not constitute investment research with the meaning of the FSA Rules due to its generic nature and should not be relied upon as such.

**For United States Clients:** Please note, Generation UK is an affiliate of Generation Investment Management U.S. LLP (“**Generation US**”) and is a limited liability partnership based in the United Kingdom. Generation UK is not registered and does not plan to obtain registration with the SEC under the Investment Advisers Act of 1940 (“Advisers Act”). It does not seek to conduct business in the United States. Generation US is a Registered Investment Adviser under the Advisers Act.

**Copyright © 2012 Generation Investment Management LLP. All rights reserved.**

For further information or any inquiries, please contact us at [suscap@generationim.com](mailto:suscap@generationim.com).



# CONTENTS

1. Executive Summary	1
2. Introduction	2
3. Understanding Sustainable Capitalism Today	6
4. Achieving Sustainable Capitalism by 2020	14
5. Conclusion	24
Appendix	25

This paper is the product of the collaborative efforts of the Generation team and has drawn on the expertise and advice of numerous specialists and practitioners. We thank everyone who contributed to this process, and in particular, acknowledge those who shared extensive time and insight with us (see Appendix). We accept any errors in this document as our own.

# 1 | Executive Summary

The challenges facing the planet today are unprecedented and extraordinary; climate change, water scarcity, poverty, disease, growing inequality of income and wealth, demographic shifts, trans-border and internal migration, urbanisation and a global economy in a state of constant dramatic volatility and flux, to name but a few. While governments and civil society will need to be part of the solution to these massive challenges, ultimately it will be companies and investors that will mobilise the capital needed to overcome them.

To address these sustainability challenges, we advocate for a paradigm shift to Sustainable Capitalism; a framework that seeks to maximise long-term economic value creation by reforming markets to address real needs while considering *all* costs and stakeholders.

The objective of this paper is twofold. First, we make the economic case for mainstreaming Sustainable Capitalism by highlighting the fact that it *does not represent* a trade-off with profit maximisation but instead actually fosters superior long-term value creation. Second, we recommend five key actions for immediate adoption that will accelerate the mainstreaming of Sustainable Capitalism by 2020:

1. **Identify and incorporate risks from stranded assets;**
2. **Mandate integrated reporting;**
3. **End the default practice of issuing quarterly earnings guidance;**
4. **Align compensation structures with long-term sustainable performance; and**
5. **Encourage long-term investing with loyalty-driven securities.**

In addition, we also believe that there are five broader ideas that merit ongoing support and attention. Specifically, we think there is a need to:

- i. **Reinforce sustainability as a fiduciary issue;**
- ii. **Create advisory services for sustainable asset management;**
- iii. **Expand the range and depth of sustainable investment products;**
- iv. **Reconsider the appropriate definition for growth beyond GDP; and**
- v. **Integrate sustainability into business education at all levels.**

Ben Franklin famously said, “You may delay, but time will not, and lost time is never found again.” We have the opportunity to rebuild for the long term and an obligation to seize it. Sustainable Capitalism will create opportunities and rewards but it will also mean challenging the pernicious orthodoxy of short-termism. Now is the time to accelerate the transition.

## 2 | Introduction

We have often said the market is long on short and short on long. Yet, remarkably, even after enduring the global financial crisis – caused in significant part by short-term, unsustainable strategies and actions by both companies and investors – many of us are still content to embrace short-termism in nearly all aspects of our lives. From investing, to living beyond our means, to relying on instant opinion polls and tolerating a political discourse based upon sound bites, tweets, and 30-second TV commercials, we focus far too frequently on instant gratification and immediate results. As a result of this short-term perspective, we are – in economist Herman Daly’s prescient phrase – driving our economies and our planet into liquidation.

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 maximise long-term economic value creation. It explicitly integrates environmental, social, and governance (ESG) factors into strategy, the measurement of outputs and the assessment of both risks and opportunities. Sustainable Capitalism encourages us to generate financial returns in a long-term and responsible manner, and calls for internalising negative externalities through appropriate pricing.

For companies, this means internalising the business case for sustainability and adapting business models accordingly, with C-level and board support. It means talking openly and candidly about the need to build businesses for the long term and rewarding investors who endorse this approach. In addition, this more responsible approach can be and should be supported by the adoption of integrated reporting (defined on p 4).

For asset owners, this means embracing the long term and sustainability as value-creating tools. In particular, it means recognising the risks that stranded assets carry (defined on p 3) and embracing ways to reshape incentives across the investment value chain. Consultants and advisers will be critical in facilitating this change and are urged to adopt similar long-term sustainability-orientated principles.

For asset managers, this means investing for the long term and adopting incentive structures that reward such behaviour. It means carefully considering the effect of sustainability factors on the valuation of companies and then changing their mindsets and financial models in response.

For governments, this means understanding that there are serious and on-going fundamental market failures that threaten not only the future of our companies and investments, but also the sustainability of our planet. It means not just focusing on global treaties, government policy and legal solutions at summits but also understanding and adopting the more immediate changes that can be made to alter incentives and behaviours, and partnering with business to find solutions.

For Non-Governmental Organisations (NGOs), this means clearly defining their role in the economic system. It means developing a better understanding of the motivations of companies and investors and identifying ways to encourage them to change through appropriate methods of impactful engagement. It means drawing attention to unsustainable practices in financial markets and lobbying not just on single issues but for structural changes in the way that the global economy deals with the challenge of sustainability.

For the media, this means challenging companies – and commentators – to do more than just talk about sustainability and holding companies to a high standard when evaluating their actions. It means encouraging the adoption of integrated reporting and celebrating those companies that prove the business case for sustainability. It also means providing a forum for debate in order to win over the mainstream.

## 2 | Introduction

The discussion around the business case for sustainability has not been short on words but the follow-through has been short on actions. Asset owners and fund managers with US\$30 trillion in assets under management, which is approximately 20% of the world's capital,<sup>1</sup> are signatories to the UN Principles for Responsible Investment (UN PRI), a network of international investors who commit to “incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large.”<sup>2</sup> If the majority of those assets were actually shifted into truly sustainable investment models, the effect would be dramatic and would signal that Sustainable Capitalism is entering the mainstream.

Since its inception, Generation Investment Management (Generation) has been an advocate of the mainstreaming of sustainability in financial markets. Unfortunately however, we believe that global progress towards this effort has reached a plateau. This is because of a number of factors, including a widely shared failure to rigorously make and reinforce the economic case for Sustainable Capitalism.

That is the reason this paper seeks to re-energise the discourse around Sustainable Capitalism. We believe it is necessary to refine our arguments and thus make a stronger and even more persuasive economic case. We seek to do our best to reach and win over the ‘convince me’ group, which consists of those open to persuasion on the business rationale for sustainability. Most importantly, we present, discuss, and prioritise ideas and actions designed to accelerate the current slow and incremental pace of change to one that matches the urgent need for faster and more innovative change, with more widespread and appropriate action in the near term.

The journey we have taken in sustainable investing and our advocacy work in this field over the past eight years have helped us develop the five ideas set out below, which we believe have the potential to accelerate the transition to Sustainable Capitalism. We also note five other broader ideas that merit ongoing support and attention. We recognise these ideas are not exhaustive (see Topics for Further Research p 23) and that they are necessary but not sufficient to achieving our goal. In particular, we have chosen not to include in this paper a full exploration of the appropriate role of regulation and policy intervention, and emphasise that our exclusion of this topic does not in any way neutralise its importance in accelerating the transition towards Sustainable Capitalism.

### 1. IDENTIFY AND INCORPORATE RISKS FROM STRANDED ASSETS

Stranded assets are those with a value that would change dramatically, either positively or negatively, under certain scenarios such as a reasonable price on carbon or water, or improved regulation of labour standards in emerging economies. Stranded assets have the potential to result in significant reductions in the long-term value of entire sectors ranging from oil and gas to pharmaceuticals, and not just the value of particular companies. As a result, there is the potential for ‘stranded businesses’ – a prospect which seems to be giving many people an interest in maintaining and defending the status quo and slowing the transition to more sustainable models. Efforts to prevent progress on this front are as overt as lobbying for favourable policy and as covert as financing inaccurate, pseudo scientific ‘studies’ on the climate crisis, with the aim of creating false doubts about the reality the world is facing. Until there are policies that establish a fair price for

---

1 2011 UN PRI Annual Report, [http://www.unpri.org/publications/annual\\_report2011.pdf](http://www.unpri.org/publications/annual_report2011.pdf).

2 UN PRI, ‘About us’, <http://www.unpri.org/about>.

## 2 | Introduction

widely understood externalities, academics and financial professionals should strive to quantify the impact of stranded assets and analyse the subsequent implications for assessing investment opportunities.

### 2. MANDATE INTEGRATED REPORTING

Despite an increase in the volume of information made available by companies and the frequency with which it is produced, access to more data for public equity investors has not necessarily translated into more comprehensive insight into companies. Integrated reporting addresses this trend by encouraging companies to integrate both their financial and ESG performance into one report that includes only the most salient or material metrics. This will enable both companies and investors to make better resource allocation decisions about how ESG performance can contribute to sustainable, long-term value creation. While voluntary integrated reporting is gaining momentum, it must be mandated in order to ensure swift and broad adoption.

### 3. END THE DEFAULT PRACTICE OF ISSUING QUARTERLY EARNINGS GUIDANCE

Quarterly earnings guidance can create incentives for executives to manage for the short term and encourage some investors to overemphasise the significance of these measures at the expense of the longer-term, more meaningful measure of sustainable value creation. Ending this default practice in favour of only issuing guidance as deemed appropriate by the company (if at all) would encourage a long-term view of the business rather than the current focus on quarterly results. More thoughtful issuance of earnings guidance is compatible with enhanced standards of disclosure.

### 4. ALIGN COMPENSATION STRUCTURES WITH LONG-TERM SUSTAINABLE PERFORMANCE

Presently, most compensation schemes emphasise short-term actions disproportionately and fail to hold asset managers and corporate executives accountable for the ramifications of their decisions over the long term. Instead, financial rewards should be paid out over the period during which these results are realised, and compensation should be linked to fundamental drivers of long-term value, employing rolling multiyear milestones for performance evaluation.

### 5. ENCOURAGE LONG-TERM INVESTING WITH LOYALTY-DRIVEN SECURITIES

The dominance of short-termism in the market, often facilitated and exacerbated by algorithmic trading, is correlated with stock price volatility<sup>3</sup>, fosters general market instability as opposed to useful liquidity and undermines the efforts of executives seeking long-term value creation. Companies can take a proactive stance against this growing trend of short-termism by attracting long-term investors with patient capital through the issuance of loyalty-driven securities. Loyalty-driven securities offer investors financial rewards for holding a company's shares for a certain number of years. This practice encourages long-term investment horizons among investors and facilitates stability in financial markets, therefore playing an important role in mainstreaming Sustainable Capitalism.

---

<sup>3</sup> Frank X Zhang, *The Effect of High-Frequency Trading on Stock Volatility and Price Discovery* (Yale University School of Management, 2010).

## 2 | Introduction

We also believe that there are five broader ideas that merit ongoing support and attention. Specifically, there is a need to:

- i. Reinforce sustainability as a fiduciary issue;
- ii. Create advisory services for sustainable asset management;
- iii. Expand the range and depth of sustainable investment products;
- iv. Reconsider the appropriate definition for growth beyond GDP; and
- v. Integrate sustainability into business education at all levels.

## 3 | Understanding Sustainable Capitalism Today

Capitalism has great strengths and is fundamentally superior to any other system for organising economic activity. It is more efficient in allocating resources and in matching supply and demand. It is demonstrably effective in wealth creation. It is more congruent with higher levels of freedom and self-governance than any other system. It unlocks a higher fraction of the human potential with ubiquitous, organic incentives that reward hard work, ingenuity, and innovation. These strengths are why it is at the foundation of every successful economy.

Critically, capitalism has proven itself to be adaptable and flexible enough to fit the specific needs of particular countries. Capitalism comes in many forms, from that practised in the US to the very different model that has been adopted within communist China. The causes and consequences of these variations are, of course, significant – but the more important fact remains: the mainstream debate is about how to practise capitalism not whether we should choose between capitalism and some other system.

Yet while the present form of capitalism has proven its superiority, it is nevertheless abundantly clear that some of the ways in which it is now practised do not incorporate sufficient regard for its impact on people and the planet – and are now posing a number of fundamental challenges that require attention, particularly in a resource-constrained world of seven billion (soon to be 8-10 billion) people. These include short-termism, over-reliance on GDP growth as a primary metric of prosperity, diverting wealth into shadow banking and financial engineering and away from addressing real needs. These challenges also include rising inequality, increasing volatility in the global financial market, and growing contributions to the climate crisis perpetuated by a resistance to internalise externalities.

We and others have argued for long-term responsible capitalism for some time. We have called this Sustainable Capitalism.<sup>4</sup> Sustainable Capitalism is more than corporate social responsibility or impact investing, which are worthwhile endeavours compatible with the precepts of sustainable investing, but narrower in focus.

### DEFINITION

Sustainable Capitalism is a framework that seeks to maximise long-term economic value creation by reforming markets to address real needs while considering all costs and integrating ESG metrics into the decision-making process.

It applies to the entire investment value chain from entrepreneurial ventures to publicly traded large-cap companies, from investors providing seed capital to those focused on late-stage growth-orientated opportunities, from company employees to CEOs, from activists to policy makers and standard setters. Sustainable Capitalism transcends borders, industries, forms of ownership, asset classes, and stakeholders.

---

4 Al Gore and David Blood, 'We Need Sustainable Capitalism', *The Wall Street Journal* (5 November 2008).

# 3 | Understanding Sustainable Capitalism Today

## THE ECONOMIC CASE

The economic rationale for Sustainable Capitalism is emerging through the quantitative and qualitative results of empirical research as well as real-world examples. Mainstreaming Sustainable Capitalism by 2020 will require independent, collaborative and voluntary action by companies, investors, government and civil society, which we hope to accelerate by advancing the discourse on the economic benefits of sustainability.

## COMPANIES

There has been significant work done to identify the many ways in which embracing sustainability enables a company to create value. Through our own investment research we have seen first-hand the positive effect that sustainability can have on the continued profitability of a company. As others have noted, “Leading companies are using sustainability to create operational and strategic long-term advantages.”<sup>5</sup> Typically, the adoption of sustainability within a corporation has three distinct phases as executives discover the multi-layered benefits.

- › Strategic advantage: Developing sustainable products and services can increase a company’s profits, enhance its brand, strengthen public trust<sup>6</sup> and improve its competitive positioning as the market increasingly rewards this behaviour.<sup>7</sup>
- › Operational effectiveness: Sustainable Capitalism can also help companies save money by reducing waste and increasing energy efficiency in the supply chain and by improving human-capital practices so that retention rates rise and the costs of training new employees decline (subsequently improving corporate culture which has been shown to generate superior long-term returns<sup>8</sup>).
- › Compliance and risk management: Focusing on ESG metrics allows companies to achieve higher compliance standards and better manage risk since they have a more holistic understanding of the material issues affecting their business.

As companies undergo the transformation to becoming more sustainable through these stages, it usually becomes evident within the company that sustainability does not involve a trade-off between profitability and improving the environment and society. Rather, it can in fact improve operations and inspire innovation. The benefits outlined above can clearly yield top-line growth, cost reductions and enhanced profitability through strategic competitive advantage. By integrating sustainability into the company’s strategy and operations, executives are simply running the business better and are positioning the company for greater long-term success.

There is also empirical evidence to show that sustainable business practices are associated with financial benefits. For example, work by Bauer & Hann has demonstrated that pro-active environmental practices

---

5 PwC’s Deals Webcast Series, *Private equity & environmental sustainability – creating long-term value*, 30 June 2011. <http://www.pwc.com/us/en/transaction-services/webcasts>.

6 Edelman. *2011 Edleman Trust Barometer*. <http://www.edelman.com/trust/2011>.

7 Eccles, Robert G., Ioannou, Ioannou, and Serafeim, George, *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance*. Harvard Business School Working Paper, 2011.

8 Edmans, Alex, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 20 January 2010. *Journal of Financial Economics (JFE)*, Forthcoming. <http://ssrn.com/abstract=985735>

### 3 | Understanding Sustainable Capitalism Today

are associated with a lower cost of debt.<sup>9</sup> They also find that the effect is not limited to companies that are operating in sectors that are traditionally considered environmentally sensitive (eg, oil and gas).

Work by Cheng, Ioannou, and Serafeim finds that companies with strong ESG performance also face lower capital constraints.<sup>10</sup> As they also confirm, companies that suffer from capital constraints are associated with poorer stock returns. These authors find that one of the reasons for the improved access to capital is precisely the companies' greater transparency and stakeholder engagement. Greater transparency around ESG performance reduces information asymmetries in the capital market, where improved stakeholder engagement reduces agency costs that can cause significant contracting costs. Both effects lower capital constraints and allow companies to invest more efficiently.

Those who advocate Sustainable Capitalism often find themselves having to argue why integrating sustainability adds value. Yet the question that should be asked of those who are sceptical is why an absence of sustainability does not damage both the company and wider society. Whether there is a formal licensing requirement or not, society ultimately does require, in one way or another, that a company earns the right to operate. When managers do not consider the impact of their decisions on all stakeholders, not just shareholders, we believe that they are putting this licence to operate at risk.

The consequence of not maintaining this societal licence to operate can be, and often is, damaging to companies in a variety of ways.

- › Popular disapproval of a company's actions may lead to boycotts or reduced sales and brand degradation.
- › Government and regulatory pressure may restrict the company's freedom to operate.
- › Investor flight may increase the company's cost of capital.
- › Staff may be unwilling to remain at the company and top talent deterred from joining.
- › Potential business partners and suppliers may be less willing to trade with the company.
- › Lack of confidence in management may lead to a decline in the valuation of the company and the risk of a takeover.

Most companies will not get to the point of actually losing their licence to operate because shareholders and boards will eventually intervene. However, companies have a duty to monitor these issues in order to avoid value destruction.

Building a sustainable company is not straightforward, even with a committed board of directors, CEO, and executive team. Just as an executive team cannot embed a culture of innovation in an established company without a major multiyear change programme, the same is true for sustainability.

---

<sup>9</sup> Bauer, Rob and Daniel Hann, *Corporate Environmental Management and Credit Risk* (Maastricht University, European Centre for Corporate Engagement, 2010).

<sup>10</sup> Cheng Beiting, Ioannis Ioannou, and George Serafeim, *Corporate Social Responsibility and Access to Finance* (Harvard Business School Working Paper Number 11-130, 2010).

# 3 | Understanding Sustainable Capitalism Today

## INVESTORS

The role of business in society has been evolving for years and now, more than ever, a growing number of companies are embracing the principles of Sustainable Capitalism and are acknowledging that the singular, unadulterated goal of short-term profit maximisation – without regard for ESG factors – is not a viable way to maximise long-term shareholder return. This developing trend creates an opportunity for investors pursuing investment strategies that seek to maximise long-term value creation.

It is, of course, entirely appropriate for investors to respond to short-term circumstances and changes in company performance and to enable this there must be sufficient liquidity in the market to allow investors to trade and create value. However, in the last few decades the market has become heavily weighted towards trading on the short term and frequently appears to have forgotten that true value is created in the long term.

For example, at a recent conference hosted by Morgan Stanley<sup>11</sup>, chief investment officers from top asset management firms were asked what their investment time horizon was: one day, one week, one month, one quarter, or one year or more. Only 20% of attendees voted for more than one year, while 55% voted for a quarter or less. The vast majority of them focused on short-term horizons that are disconnected from the organic process that typically creates real value in businesses. This anecdote illustrates what the wider academic evidence has also revealed: the majority of investors are increasingly focused on the short term.<sup>12</sup> However, the investment horizon for the average person contributing to a pension or making investments for their future has not decreased and, if anything, has probably increased because of longer life expectancies. Nor has the time that a company requires to build a business changed significantly.

Still, the pressure for short-term returns that investors are placing on companies is leading to dramatically inefficient capital allocation. Aside from the damage this short-termism is doing to our planet and to society, it is also reducing returns for investors. Haldane and Davies (at the Bank of England) show that across the public markets, long-term investment opportunities are routinely missed because cash flows are inappropriately discounted.<sup>13</sup> In their paper, they show that cash flows five-years out are routinely discounted as if they were eight-years out, and cash flows 30-years out are scarcely valued at all. They also document evidence that this pattern has been accelerating since the mid-1980s. Since it is investors who ultimately set the discount rate for companies through the returns they expect on their capital, it is therefore investors who have the ability to redress this market failure.

In addition, there are several other compelling reasons why this short-term approach does not necessarily maximise economic value and why the alternative of Sustainable Capitalism provides investors with opportunities for greater wealth creation.

---

11 Morgan Stanley Global Investment Seminar 2011, June 9-11 2011, Spain.

12 John Bogle, 'Restoring Faith in Financial Markets', *Wall Street Journal* (19 January 2010).

13 Andrew Haldane and Richard Davies, *The Short Long*, (Speech at the 29th Société universitaire européenne de recherches financières colloquium: New Paradigms in Money and Finance?, Brussels) <http://www.bankofengland.co.uk/publications/speeches/2011/speech495.pdf>.

## 3 | Understanding Sustainable Capitalism Today

### THE FINANCIAL PERFORMANCE OF SUSTAINABLE COMPANIES

A recent study by Eccles, Ioannou, and Serafeim indicates that sustainable companies outperform a matched group of firms in the long term.<sup>14</sup> The authors identified 90 companies that adopted a substantial number of environmental and social policies in the early 1990s. They then created a second sample of 90 companies that adopted almost none of these policies during the same period. The two samples exhibited almost identical size, capital structure, operating performance, and growth opportunities in the early 1990s.

The study found that US\$1 invested in a value-weighted portfolio of sustainable firms at the beginning of 1993 would have grown to US\$22.6 by the end of 2010. In contrast, US\$1 invested in a value-weighted portfolio of unsustainable firms at the beginning of 1993 would have grown to US\$15.4 by the end of 2010. The difference in annual abnormal stock-market performance, after taking into account four risk factors (market, size, book-to-market, and momentum) was 4.8%. Moreover, the study found that the portfolio of sustainable firms exhibited less volatile performance relative to the portfolio of unsustainable firms. This empirical evidence suggests that investors, who spend resources identifying companies that embed sustainability into their strategy, can earn substantial returns while experiencing low volatility.

### MORE COMPREHENSIVE VALUATION CRITERIA

Studies have shown the materiality of ESG factors for business<sup>15</sup> and have demonstrated that, encouragingly, “investors are increasingly interested in nonfinancial information.”<sup>16</sup> However, most investors are still not considering ESG factors in their valuation processes – operating with incomplete information about the companies in which they invest – routinely ignoring key, highly relevant aspects of performance when assessing companies’ value propositions and relative competitive advantages. According to Aviva Investors, “While there is clearly value in estimating near-term company earnings, the majority of a company’s value is derived from its ability to generate long-term earnings. Therefore, it is important for investors to identify factors that influence long-term earnings and integrate them into their analysis.”<sup>17</sup>

As such, asset managers and financial analysts should move to a more comprehensive valuation methodology. Developing the skills necessary to analyse ESG metrics in addition to traditional financial performance indicators will be critical, as will the discipline necessary for pricing in externalities (see stranded assets under Section 4) in developing a more complete view of a company’s long-term value. While not all ESG issues are easy to quantify and include as line items in a model, it is nonetheless true that acknowledging and considering the impact of material ESG metrics to a company, even qualitatively, is an important first step. Factoring ESG issues into traditional investment analysis may not be a guaranteed way to create wealth; however, it is a helpful dimension in evaluating the long-term viability of a business.

---

<sup>14</sup> Eccles, Robert G., Ioannou Ioannou, and Serafeim, George, *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance*. Harvard Business School Working Paper, 2011.

<sup>15</sup> Eccles, Robert G., Ioannou, Ioannou, and Serafeim, George, *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance*. Harvard Business School Working Paper, 2011.

<sup>16</sup> Robert G Eccles, Michael P Krzus and George Serafeim, *Market Interest in Nonfinancial Information* (Harvard Business School Working Paper 12-018, 2011).

<sup>17</sup> Jason Josefs, Aviva Investors Thought Leadership, *Integrating ESG*, accessed October 2011. [http://www.avivainvestors.co.uk/markets\\_and\\_views/thought\\_leadership/investors-journal-v2/integrating-esg/index.htm](http://www.avivainvestors.co.uk/markets_and_views/thought_leadership/investors-journal-v2/integrating-esg/index.htm).

## 3 | Understanding Sustainable Capitalism Today

### *MATCHING INVESTMENT LIABILITIES TO THE APPROPRIATE INVESTMENT TIME HORIZON*

Pension funds, sovereign wealth funds, foundations, endowments, and other investors with long-term liabilities need to match the performance of their assets to the maturation of those liabilities. As such, the integration of ESG issues that have a material impact on the long-term viability of companies clearly should be an essential step in their valuation and investment process, and thus the ability to manage the integration of ESG issues clearly should be a key consideration for these investors when selecting an asset manager.

### *AVOID LOSING THE LICENCE TO OPERATE*

Dividing the investor group into asset owners and asset managers reveals that in common with companies, asset managers face the threat of losing their licence to operate if they engage in unsustainable practices such as the disregard of key relevant factors in investing including ESG, excessive exposure to unsustainable industries, high portfolio turnover, and short-term trading practices that could be subject to regulation and taxation<sup>18</sup>. Therefore, asset managers should proactively adopt sustainable practices if, for no other reason, to avoid a funding vacuum left by asset owners who seek to avoid these looming risks.

Investors can lead the transition to Sustainable Capitalism through practical action. Already UN PRI signatories – a network of international investors who have committed to “incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large”<sup>19</sup> – account for US\$30 trillion in assets, which is approximately 20% of the world’s capital<sup>20</sup>. However, asset owners now need to ensure that those assets are being invested sustainably, and should proactively ask their fund managers direct and pointed questions about how they are considering ESG factors in the investment decision process. They should also insist on fee structures that reward their managers for long-term, rather than short-term, performance.

Ultimately, what Sustainable Capitalism requires is for investors to be good investors; to fully understand the companies they invest in, to believe in their long-term value and potential, and to engage with management to ensure that they are behaving in the interest of continuous value creation.

## GOVERNMENT

Government is too often left with the task of cleaning up the wreckage left by the short-term and unsustainable practices of both companies and investors. The recent example of the global financial crisis highlights a sad reality: government is the backstop to serious blunders by businesses. As such, the widespread practice of Sustainable Capitalism would have a profound positive impact on government and across all sectors. When investors and companies do act sustainably, we are likely to experience greater long-term social stability as a result of steadier economic growth, greater productivity, and more efficient resource utilisation. Therefore, governments should support sustainability initiatives, since “beyond direct cost savings, many sustainability-focused programs and policies will also provide long-term benefits, such as job creation or retention, increased property values, community revitalization, business attraction and

---

18 Graham Bowley, ‘Clamping Down on Rapid Trades in Stock Market’, *The New York Times*, 8 October 2011.

19 UN PRI, ‘About us’, <http://www.unpri.org/about>.

20 2011 UN PRI Annual Report, [http://www.unpri.org/publications/annual\\_report2011.pdf](http://www.unpri.org/publications/annual_report2011.pdf).

## 3 | Understanding Sustainable Capitalism Today

reduced costs (eg, transportation, housing, and healthcare) for business and residents”<sup>21</sup> thereby generally improving society.

To encourage Sustainable Capitalism, governments can contribute significantly by, among other things, developing key infrastructure and policy frameworks. Programmes related to human rights, public health and education are just some of the essential pillars necessary to help support the private sector’s transition to a more sustainable model. Governments can also foster public-private partnerships, create appropriate regulation to level the playing field among businesses in relation to sustainability (eg, mandate integrated reporting), and serve as an active and collaborative stakeholder in the investment value chain. According to Peck and Gibson, “Governments that lead [in sustainability] will be in a strong position to set the agenda and establish advanced positions for their industries and their citizens. Countries that lag behind will inevitably face increasing competitive disadvantage and lost opportunity.”<sup>22</sup>

Ultimately, government is often the biggest ‘business’ of all and therefore must lead by example. As noted in the Business Magazine for a Sustainable Government: “A sustainable society needs local and central government to lead the way by consuming differently, and by planning effectively and efficiently in order to integrate sustainable practices in the services it provides to citizens, and throughout its estates and workforce.”<sup>23</sup> Governments must also strive for the same tenets of sustainability – the prudent management of financial and ESG resources. In doing so they will create a platform on which stable and prosperous societies can grow.

### CIVIL SOCIETY

Civil society has a central role in accelerating the transition towards Sustainable Capitalism. NGOs must take a 360-degree approach to the process of mainstreaming Sustainable Capitalism, realising their ability to influence stakeholders in every part of the business ecosystem. NGOs must engage with investors, companies, regulators and policy makers to encourage the rapid and effective adoption of Sustainable Capitalism through campaigns, lobbying efforts and partnerships with the private sector. Civil society must call for transparency and can support efforts related to enforcing accountability. However, given the severe fragmentation in civil society, NGOs must also engage multilaterally with one another, forming durable collaborations in order to amplify their impact. Importantly, civil society must also strive to influence how individuals think about sustainable consumption and generational responsibility.

---

21 Tammy Zborel, ‘Sustainable Connections: Strategies to Support Local Economies.’ *National League of Cities – Municipal Action Guide*, 2011. <http://www.nlc.org/File%20Library/Find%20City%20Solutions/Research%20Innovation/Sustainability/sustainable-connections-strategies-to-support-local-economies-mag-jun11.pdf>.

22 Steven Peck and Robert Gibson, ‘Pushing the Revolution’, in *Alternatives Journal*, Vol 26, No 1 (Winter 2000), as found in Bell, David VJ, *The Role of Government in Advancing Corporate Sustainability*. 27 March 2002.

23 Government Sustainability – The Business Magazine for a Sustainable Government, ‘Public Sector Sustainability under the spotlight’ (<http://www.governmentustainability.co.uk>, April 2009).

## 3 | Understanding Sustainable Capitalism Today

### BARRIERS TO OVERCOME

Our thoughts and advocacy work around Sustainable Capitalism date back to the founding of Generation. Building on our earlier efforts and deepening conviction, we realised that to make a more significant and immediate impact on mainstreaming Sustainable Capitalism, we needed to identify and better understand the obstacles we faced. To achieve this, we collaborated with McKinsey in the summer of 2010 to convene a range of experts and practitioners in the Sustainable Capitalism field. Through those sessions we identified five barriers to mainstreaming Sustainable Capitalism.<sup>24</sup>

1. **Short-termism and misaligned incentives:** the often misaligned incentives of company executives and investors, compared to those of their stakeholders, fuel short-termism. For example, reporting and managing to quarterly results clearly restricts the ability to create more favourable long-term results.

2. **Market fundamentalism:** an engrained fear of alternatives to currently prevailing approaches to capitalism plagues investors, and a complacent inertia persists among a majority of people who are waiting to be convinced of the opportunities Sustainable Capitalism presents.

3. **Obsession with numbers:** investors value most highly that which can be measured most easily and frequently. Given that ESG-related issues can be difficult to quantify, they are often ignored. Abraham Maslow famously quipped, “If the only tool you have is a hammer, every problem begins to look like a nail.” In the same way, if the only tool you use for measuring value is a price tag, business factors with no price tag conveniently attached may seem to have no value.

4. **Complexity of the challenge:** the adoption of Sustainable Capitalism is a highly complex problem requiring sophisticated and comprehensive cross-sector solutions. Although many businesses have already solved this problem, there is as yet a lack of widespread awareness of the success stories of businesses and leaders driving this change.

5. **Lack of competencies:** there is a dearth of education on Sustainable Capitalism. The skill sets of business leaders, investors and asset owners need to be informed by Sustainable Capitalism.

Overcoming these barriers will be essential to mainstreaming Sustainable Capitalism and we are under no illusions about the effort necessary to achieve this goal. Therefore, we have identified five high-priority solutions, and five broader areas for continued attention, all of which have the potential to accelerate significantly the mainstreaming of Sustainable Capitalism if they are implemented in the immediate term.

---

<sup>24</sup> Generation Investment Management & McKinsey, *Mainstreaming Sustainable Capitalism by 2020: Seize the Opportunity* (unpublished, 2010).

## ACTIONS FOR CHANGE

### 1. IDENTIFY AND INCORPORATE RISKS FROM STRANDED ASSETS

Many investors remain sceptical about the financial impact of sustainability issues on the performance of their portfolios. In many cases, this scepticism has blinded them to the risks they presently face by investing in stranded assets and the unsustainable companies that maintain them.

Stranded assets are those that would be unprofitable under certain scenarios, which include the enforcement of a fair price on carbon and water, or improved regulation of labour standards in emerging economies. Only limited work has been done to date to quantify the potential impact these sorts of changes would have on the value of companies, but one such piece by the Carbon Tracker Initiative (CTI) provides new insights into the likely impact of stranded assets.

The CTI report highlights that just using the fossil fuel reserves of the top 100 listed coal, oil, and gas companies over the next 40 years would emit enough carbon to raise global warming by more than two degrees Celsius<sup>25</sup>. An increase of two degrees in global temperature would, in the view of many scientists, bring catastrophic risks to civilisation. These include: the risk of multi-metre sea-level increases in this century (with large numbers of 'climate refugees' forced to leave their ancestral homes); deepening droughts in heavily populated areas and crucial agricultural breadbaskets; the increased frequency and severity of costly and dangerous extreme weather events such as the 2010 floods in Pakistan, Australia, Colombia and elsewhere; accelerating loss of plant and animal species; and widespread health risks. Indeed, some scientific leaders, such as NASA's James Hansen, point out that the 'two degree' threshold is essentially a political construct and does not represent a scientific conclusion about what would be a 'safe' level of global average temperature increase. These environmental disasters directly link back to the ability of businesses to sustain long-term profitability as the implications of a temperature increase exceeding two degrees would create mass global upheaval, uprooting people through forced migration, inevitably causing disruption in companies and instability in financial markets, showcasing the looming negative implications if the risks related to stranded assets are not identified and mitigated.

Some sell-side analysts criticised the CTI analysis on the grounds that it is hard to build the implications of their report into a valuation model and that there is significant policy uncertainty over how climate change regulation will develop.<sup>26</sup> These are valid practical concerns but in many ways simply serve to confirm the underlying problem: current valuations are inaccurate and beg a solution similar to the 'value at risk' (VAR) concept used by mainstream traders, in order to show an adjusted value for assets after accounting for climate change.

As Bob Litterman observed, "When risks are not priced appropriately, investment behaviour creates the potential for the catastrophic – and unnecessary – future loss of society's well-being."<sup>27</sup> Scenario analysis done by Mercer's responsible investment team has shown that climate risk poses fundamental challenges to strategic asset allocation by investment funds and that by 2030 climate change related risk that is

---

25 Carbon Tracker Initiative, *Unburnable Carbon – Are the world's financial markets carrying a carbon bubble?* (2011): <http://www.carbontracker.org/carbonbubble>.

26 Steven Johnson, 'Unusable reserves: it's hot air, say analysts,' *The Financial Times* (31 July 2011).

27 Bob Litterman, 'Pricing Climate Change Risk Appropriately', *Financial Analysts Journal*, September/October 2011, Vol 67, No 5.

## 4 | Achieving Sustainable Capitalism by 2020

currently not diversified away could cost investment funds US\$8 trillion.<sup>28</sup> Not pricing in material risks to an investment – government regulated or not – is simply unwise.

Stranded assets also have the potential to result in significant reductions to the long-term value of entire sectors as business models could be made obsolete if wholesale transitions to sustainability were implemented. As a result, there are many people currently in those businesses who feel that they have an interest in maintaining the status quo or, at a minimum, advocating that any transition to more sustainable models be pursued as gradually as possible through slow, incremental changes. According to Christiana Figueres, Executive Secretary of the United Nations Framework Convention on Climate Change, “There is a serious group of companies that have a voice that is much louder, better funded, that operates much more in unison and that is still stuck in the technologies and the fuels of yesterday.”<sup>29</sup> The efforts by executives within these companies, and others, to prevent progress on this front are as overt as lobbying for favourable policy and as covert as financing inaccurate, pseudo scientific ‘studies’ on the climate crisis, aimed at creating false doubts about the reality the world is facing.

Further exacerbating the problem is the ever-shortening length of CEO tenures (average CEO tenure has dropped from eight to four years in the past 20 years).<sup>30</sup> Given this new brevity of average tenure, many CEOs are vulnerable to adopting a ‘not on my watch attitude’ as there is no incentive to bear the financial pain that can accompany the support of innovation and long-term solutions. As some financial traders who were blamed for contributing to the credit crisis of 2008 put it in emails among themselves that were later uncovered by forensic investigators: ‘IBG/YBG’. This means, “I’ll be gone; you’ll be gone.”<sup>31</sup>

Inversely, it is also important to note the opportunity that identifying and incorporating stranded-asset risks creates for investors and companies positioned to benefit from pricing externalities. Considering stranded assets in the valuation of a portfolio highlights the strategic advantage sustainable companies gain, as they are prepared to succeed in the context of reaching limits in a resource-constrained world and in the context of any government regulation that may come into effect.

Incremental change will only result in our society becoming less unsustainable, rather than actually sustainable. As such, an attitudinal framework like the one now in place – which all too frequently stalls change and innovation related to identifying and incorporating risks from stranded assets – must be dismantled.

**We propose working with academics and financial professionals to quantify the impact of stranded assets and the subsequent implications for assessing investment opportunities until a fair price on externalities forces a change in valuation methodologies. Our goal is to establish the financial materiality of sustainability through empirical evidence. And through this analysis we hope to provoke a wider discussion about the need for investors, in particular those with long-term liabilities, to fundamentally reassess their investment thesis relating to externalities rather than simply hedging against them.**

---

28 Mercer Responsible Investment, *Climate Change Scenarios – Implications for Strategic Asset Allocation* (15 February 2011).

29 Mike Scott, ‘Greenhouse gas cutters gain higher returns’, *The Financial Times* (18 September 2011).

30 Isabelle Le Breton-Miller and Danny Miller, ‘Why do some family businesses out-compete? Governance, long-term orientations, and sustainable capability’, *Entrepreneurship Theory and Practice*, 30: 731-746. November 2006.

31 Jonathan Knee, *The Accidental Investment Banker*, 2007, p23.

# 4 | Achieving Sustainable Capitalism by 2020

## 2. MANDATE INTEGRATED REPORTING

The current pattern of communication between companies and investors perpetuates and reinforces short-termism in the market. In particular, there is at present inadequate sustainability disclosure in terms of both the quality of the content and the volume of reporting, compared to what is necessary to make information usable to investors.

While there has been significant progress in improving the reporting of sustainability metrics (eg, the Carbon Disclosure Project and the Global Reporting Initiative), most disclosure is still not conducive to mainstream use by investors, since it typically lacks clear links with the company's financial performance and long-term prospects for success. Moreover, some companies with the capacity to measure nonfinancial data, (many already do so for internal purposes), are hesitant to publish any information that goes beyond regulatory requirements, out of fear of disclosing additional information to competitors or increased exposure to lawsuits. This is one of many reasons that new regulation must be enacted to level the playing field.

Few fund managers have analysts possessing the skills required to do bottom-up analyses of nonfinancial metrics. So, understandably, most fund managers look to third-party rating agencies to analyse company sustainability disclosures and provide ratings for them to interpret. With more than a hundred rating agencies providing such advice, there is significant variation in the quality and value of rating systems.<sup>32</sup> We applaud the commitment that some mainstream data companies, such as Bloomberg and Thomson Reuters, have made toward sustainability and support their efforts to increase standardisation and improve quality.

However, we believe that the best-run companies are those that are not only already making the links between sustainability and financial performance internally but are also sharing those links in their investor communications. Integrated reporting provides the framework to ensure that a company has a sustainable strategy and improves internal decision making by exposing itself to the discipline of the market. A handful of companies have already begun to make the switch to the integration of sustainability and financial metrics in their annual reports, explicitly showing the link between the two and, in the process, reinforcing the business case for Sustainable Capitalism.<sup>33</sup>

Given the greater degree of flexibility in reporting that privately held companies are afforded, they are in a position to provide leadership in developing integrated reports. Many leading global private equity funds have already taken steps to invest in improving the sustainability of their portfolio companies and are reporting on sustainability metrics (eg, KKR<sup>34</sup> and Doughty Hanson<sup>35</sup>). Funds could go further and persuade those companies comfortable with reporting the financial benefits of these activities to do so prior to going public.

---

32 SustainAbility, *Rate the Raters: Phase Two* (2010): <http://www.sustainability.com/library/rate-the-raters-phase-two>.

33 Robert G Eccles and Michael Krzus, *One Report: Integrated Reporting for a Sustainable Strategy* (2010), and Robert G Eccles, Beiting Cheng and Daniela Saltzman, eds. *The Landscape of Integrated Reporting* (2010).

34 KKR, 'Creating Sustainable Value 2010 Report' [http://www.kkr.com/ar/downloads/kkr\\_ESGreport.pdf](http://www.kkr.com/ar/downloads/kkr_ESGreport.pdf).

35 Doughty Hanson & Co 'ESG Engagement', <http://www.doughtyhanson.com/private-equity/esg-engagement.aspx>.

## 4 | Achieving Sustainable Capitalism by 2020

We support efforts by Professor Bob Eccles<sup>36</sup> (at the Harvard Business School), the International Integrated Reporting Committee (IIRC)<sup>37</sup>, and Aviva Investors<sup>38</sup> who collectively are leading progress in the field of integrated reporting. Yet even though these aforementioned actors are playing a critical role in shaping this nascent idea and encouraging voluntary action by companies, it is clear to us that significant, widespread change will only come about when integrated reporting is mandated. Although this policy intervention will vary on a country-by-country basis, securities regulators and stock exchanges are well suited to oversee the requirement for integrated reporting.<sup>39</sup> In South Africa, the Johannesburg Stock Exchange set an exemplary precedent in its 2011 decision to require all listed companies to either produce an integrated report or explain why they were not doing so. Even so, the mandating of integrated reporting is just the first step, as reporting standards around ESG information and its link to financial metrics will need to be refined continuously.

What is critical is that the information provided is material to investors and relevant to the specific sector and company. 'Cookie-cutter' forms that do not take into account variations in what is most relevant from one sector to another are not adequate. Additionally, accountants must work to provide assurance on nonfinancial information that is comparable to what they provide on financial metrics and by providing integrated assurance on both.

**We propose integrated reporting be mandated for publicly listed companies by the appropriate regulatory agencies and we encourage voluntary action by these companies in the short term to provide integrated reports until such regulation comes to pass. We also encourage investors to ask for integrated reports from their portfolio companies, including private equity investors, and that they incorporate this information in their investment decisions. Additionally, we support the growing commitment by privately held companies to produce integrated reports.**

### 3. END THE DEFAULT PRACTICE OF ISSUING QUARTERLY EARNINGS GUIDANCE

In the modern world, we often appear to be virtually hypnotised by the short term in our politics, in our culture, in business and well beyond. In business specifically, the vast majority of managers are now clearly choosing short-term profits over sustainable long-term growth. We have long known that an important part of the reason for this distortion is that executives are encouraged – by investor behaviour, by incentives and by business cultures – to focus on short-term earnings.

Investors have become increasingly impatient with CEOs of publicly listed companies who focus on longer-term value creation and are too quick to penalise stocks for short-term underperformance, even if it can be explained in the context of a long-term investment plan. In many cases, whether a company meets quarterly earnings guidance or not trumps the long-term performance incentives for a CEO and makes it much

---

36 Robert G Eccles and Daniela Saltzman, "Achieving Sustainability Through Integrated Reporting," *The Stanford Social Innovation Review* (2011).

37 International Integrated Reporting Committee, *Towards Integrated Reporting Communicating Value in the 21st Century*, 2011, [http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011\\_spreads.pdf](http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf).

38 Aviva Investors, 'Earth Summit 2012- Towards agreement on a declaration for corporate sustainability reporting at Rio+20, 2011, [http://www.aviva.com/data/media-uploads/news/File/pdf/2011/aviva\\_earth\\_summit\\_2012.pdf](http://www.aviva.com/data/media-uploads/news/File/pdf/2011/aviva_earth_summit_2012.pdf).

39 For an example of a customised strategy for the adoption of integrated reporting, conditional on the characteristics of each country, see Robert G Eccles and George Serafeim, 'Accelerating the Adoption of Integrated Reporting,' *CSR INDEX*, Francesco de Leo, Matthias Vollbracht, eds, InnoVatio Publishing Ltd, 2011.

## 4 | Achieving Sustainable Capitalism by 2020

harder for him or her to focus investors on the long-term strategy.

An empirical investigation conducted by Antia, Pantzalis and Park reveals that shorter CEO decision horizons are in fact “associated with more agency costs, lower firm valuation, and higher levels of information risk.”<sup>40</sup> Research by Graham, Harvey and Rajagopal shows that 78% of managers will actually reject an NPV-positive project if it will lower quarterly earnings below consensus expectations. And, an astonishing 80% of managers would focus on this recurring, short-term metric – at the expense of building long-term shareholder value – by cutting discretionary spending, including research and development and advertising expense.<sup>41</sup> This is managing for the short term, not managing sustainably.

Work by Asker, Farre-Mensa and Ljungqvist reveals that this value-destroying habit is clearly manifested in data showing that publicly held companies are investing at half the rate of privately held companies when the gains from such investments will not be realised on a quarterly basis.<sup>42</sup> They also show that this applies when an individual company switches between public and private ownership. And, they make the obvious point that this leaves public companies less able to take advantage of new business opportunities.

For some companies, not providing quarterly earnings guidance would help alleviate the pressure on managers to meet financial performance expectations on a quarterly basis, and allow them to focus instead on building the business for long-term profitability. However, because the majority of public companies provide quarterly earnings guidance, there is a ‘collective action’ problem for CEOs and boards that want to stop the practice. Therefore, we applaud the few CEOs who, despite criticism, have decided to stop giving earnings guidance and have talked openly about what investors should expect from the management time-horizon. For other companies – and even whole sectors – quarterly guidance may be appropriate, but the decision to offer it ought to be part of a company’s well-justified strategy and not simply a reflexive and unthinking response to the prevailing habits of the market.

**We propose bringing together a significant group of CEOs who have already stopped providing quarterly earnings guidance with others who pledge to stop doing so as a catalyst for change around this practice.**

### 4. ALIGN COMPENSATION STRUCTURES WITH LONG-TERM SUSTAINABLE PERFORMANCE

Presently, most compensation schemes disproportionately emphasise short-term performance and fail to hold financial professionals and corporate executives accountable for the longer-term ramifications of their decisions. In addition to accepted industry practices, political and regulatory infrastructure does little to foster more appropriate methods of compensation. As others have pointed out, “remuneration is one of the ultimate

---

40 Antia Murad, Christos Pantzalis, and Jung Chul Park, ‘CEO decision horizon and firm performance: an empirical investigation’, *Journal of Corporate Finance* 16 (2010) 288-301.

41 John R Graham, Campbell R Harvey and Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting* (*Journal of Accounting and Economics*, 2005, v 40 (1-3, Dec), 3-73, 2004). <http://www.nber.org/papers/w10550>.

42 Asker, John William, Farre-Mensa, Joan and Ljungqvist, Alexander, *Comparing the Investment Behavior of Public and Private Firms* (July 29 2011). ECGI - Finance Working Paper No. 282/2010.

## 4 | Achieving Sustainable Capitalism by 2020

expressions of your values.”<sup>43</sup> And the current standards that reward short-term performance at the expense of long-term value creation speak volumes about the prevailing priorities in much of business today.

While the absolute amount that executives and fund managers receive in pay should be debated, given the rise in income inequality, our focus is instead on the importance of aligning their financial rewards to the period over which results are realised.<sup>44</sup> This action will create a more sustainable society by closely linking pay with long-term performance that takes both financial and ESG metrics into consideration for a comprehensive evaluation.

For corporate executives, stock-option based compensation schemes have not achieved the desired goal of aligning executives’ decision making with the long-term good of the company; and in fact Antia, Pantzalis, and Park show that “giving too much stock options might decrease [CEO] decision horizon and thus lead to poor firm performance”.<sup>45</sup> Dominic Barton, the global managing director of McKinsey & Company, proposes that given the complexity of this issue, there will never be a one-size-fits-all approach. However, the compensation structures set by boards, and specifically remuneration committees, should be modified to allow the consideration of links between compensation and the fundamental drivers of long-term value – such as innovation and efficiency – and not just links to share price; those setting compensation should also consider extending the time frame for executive evaluations by using rolling multi-year milestones; and they should create real downside risk for executives who do not manage for long-term value creation.

Similar principles apply to asset managers, as there has been insufficient consideration of the role performance fees and compensation plans can play in promoting long-term perspectives. While there has been significant focus on management fees (particularly on reducing them), we do not believe that there has been adequate discussion of performance fees and incentives, how they are structured, and their appropriate weighting relative to management fees. Similar to corporate executives, asset managers should be subject to rolling multiyear performance milestones. We therefore urge asset owners to evaluate and benchmark the compensation and performance fee structure of asset managers to assess whether or not they truly have embedded a long-term horizon in their practices.

**We propose that the compensation structures for both executives and asset managers be revised (either through voluntary action, board mandate, or pressure from asset owners) so that they are aligned with long-term financial and ESG performance. We urge asset owners to create incentives for asset managers through fee structures that reward long-term performance.**

### 5. ENCOURAGE LONG-TERM INVESTING WITH LOYALTY-DRIVEN SECURITIES

The data on the rapidly declining holding periods for stocks and the rise in high-frequency trading (HFT) reveal that the average holding period for US equities held more or less steady at around seven years from

---

43 Richard Milne and Michael Steen, ‘Executive bonuses tied to green targets’, *The Financial Times* (24 February 2010).

44 Al Gore and David Blood, ‘Toward Sustainable Capitalism,’ *The Wall Street Journal* (24 June 2010).

45 Murad Antia, Christos Pantzalis and Jung Chul Park, *CEO decision horizon and firm performance: an empirical investigation*, (17 March 2008): [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1107422](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107422).

## 4 | Achieving Sustainable Capitalism by 2020

1940 until the mid-1970s<sup>46</sup>, at which point, with the advent of computer technology in finance, it dropped precipitously. By 2011 it was down to seven months.<sup>47</sup> Now, HFT accounts for approximately 70% of consolidated trading volume in the US and 77% in the UK.<sup>48</sup> While we accept that investors may have to sell stock for reasons that are beyond their control (eg, a change in actuarial models that requires a portfolio reallocation) and that carefully balancing time-horizons with appropriate levels of liquidity is essential, the dominance of short-termism in the market – facilitated by algorithmic trading – is correlated with stock price volatility.<sup>49</sup> This in turn fosters general market instability as opposed to useful liquidity (as evident in the ‘Flash Crash’ of 6 May 2010)<sup>50</sup>, and undermines the efforts of executives who are trying to manage for long-term value creation.

Companies can take a proactive stance against this growing trend toward short-termism, and the growing volatility it creates in the markets – which can in turn can have a negative impact on their share price – by attracting long-term investors with patient capital. In many cases, this is done informally through investor relations activities. But companies ought to extend this principle by rewarding investors who invest for the long term. Emerging models such as the loyalty dividend<sup>51</sup> or the loyalty-shares (L-Shares) concept<sup>52</sup> provide suggestions for how this can be achieved. These two ideas both provide incentives for investors to hold shares for a longer period, through the promise of an additional financial gain at the end of a contractually agreed upon period (usually several years).

Realistically, even though long-term investors may hold a particular stock for several years, the extent of their ownership position in a company does fluctuate based on a revised view of the market and updates to portfolio holdings. However, this does not negate the power of loyalty securities in attracting and retaining patient capital, as these instruments promote long-term investment horizons among investors and facilitate stability in financial markets, thereby playing an important role in promoting the mainstreaming of Sustainable Capitalism.

Implementing these models will require overcoming the technical challenges in the way share registers are maintained in order to track share ownership and reward long-term investors. However, the financial incentive if shareholders do register their ownership and the benefit to companies who wish to communicate more directly with shareholders ought to create sufficient reason to overcome these potential problems.

**We propose that companies issue loyalty-driven securities that are only paid to investors who have held stock for more than three years.**

---

46 Andrew G Haldane, ‘Patience and Finance’. *Presented at the Oxford China Business Forum*, Beijing, 2 September 2010.

47 Dominic Barton, ‘Capitalism for the Long Term’, *The Harvard Business Review* (March 2011).

48 Frank Zhang and Stuart Baden Powell, ‘The Impact of High-Frequency Trading on Markets’, *CFA Magazine*, March-April 2011, Vol 22, No 2: pp 10-11.

49 Frank X Zhang, *The Effect of High-Frequency Trading on Stock Volatility and Price Discovery* (Yale University School of Management, 2010).

50 Frank Zhang and Stuart Baden Powell, ‘The Impact of High-Frequency Trading on Markets’, *CFA Magazine*, March-April 2011, Vol 22, No 2: pp 10-11.

51 Hermes Investment Management Limited, ‘Position Paper: Hermes’ approach to loyalty dividends’, 2011.

52 Patrick Bolton and Frederic Samama, *L-Shares: Rewarding Long-term Investors*, 2010. [http://cgt.columbia.edu/files/papers/Bolton\\_Samama\\_L-Shares-Rewarding\\_Long-Term\\_Investors.pdf](http://cgt.columbia.edu/files/papers/Bolton_Samama_L-Shares-Rewarding_Long-Term_Investors.pdf).

## FIVE BROADER IDEAS THAT MERIT ONGOING SUPPORT AND ATTENTION

We also believe that there are five broader ideas that merit ongoing support and attention.

### 1. REINFORCE SUSTAINABILITY AS A FIDUCIARY ISSUE

While the business case for sustainability is clear, some directors of companies and of investment funds continue to be unsure about whether sustainability is a fiduciary issue. Accordingly, the Generation Foundation conducted a review of the legal case for sustainability as a fiduciary issue in 2005.<sup>53</sup> In the years since, the idea of sustainability as a fiduciary duty has gained momentum, even though implementation lags.

However, it is clear that the broad trend is toward the acceptance of sustainability issues as a legitimate consideration by directors and even, increasingly, as an obligatory consideration. In this regard, we wish to draw attention to the precedent-setting action by Intel, when in March 2010, the company made sustainability a fiduciary duty by amending its corporate charter to include mandatory reporting on “corporate responsibility and sustainability performance.”<sup>54</sup>

We support the principles of Flexible Purpose Corporations<sup>55</sup> and Benefit Corporations.<sup>56</sup> These new corporate forms allow companies to articulate their strategy and performance across multiple dimensions, explicitly highlighting sustainability as core to fiduciary duty.

### 2. CREATE ADVISORY SERVICES FOR SUSTAINABLE ASSET MANAGEMENT

The investment consultancy industry provides essential advice to investment funds both on the qualities of particular asset managers and on asset allocation strategies. While many of the leading investment consultancies have invested in developing sustainable investment teams and are conducting significant research in the area, in most cases sustainability has not yet penetrated mainstream investment consulting advice.

Although many mainstream investment funds are not currently demanding information about sustainability issues from their investment consultants, that failure does not change the affirmative duty that investment consultants have to inform clients of the financial materiality of sustainability. The range of ways that sustainability can be incorporated into investing is wide but this makes it even more important that investment consultants are able to distinguish between the approaches taken by fund managers and to understand the implications that this has for their performance and impact on sustainability.

---

53 Jed Emerson and Tim Little for The Generation Foundation, *The Prudent Trustee* (2005). <http://www.genfound.org/i/the-prudent-trustee.pdf>.

54 Intel, Board of Directors Corporate Governance & Nominating Committee Charter. 18 March 2010. [http://files.shareholder.com/downloads/INTC/1437464744x0x296281/88E8EEFB-D387-4A2B-982E-3430CA17C541/2008\\_01\\_BOD\\_Charter\\_Corporate\\_Governance\\_Committee.pdf](http://files.shareholder.com/downloads/INTC/1437464744x0x296281/88E8EEFB-D387-4A2B-982E-3430CA17C541/2008_01_BOD_Charter_Corporate_Governance_Committee.pdf)

55 Susan H Mac Cormac, ‘Baking Social and Environmental Values into Corporate DNA’, CSR Wire, March 2011. <http://csrwiretalkback.tumblr.com/post/4150462923/baking-social-and-environmental-values-into-corporate>.

56 B Corp ‘Passed Benefit Corporation Legislation’, *Public Policy*: <http://www.bcorporation.net/publicpolicy> (Accessed October 2011).

## 4 | Achieving Sustainable Capitalism by 2020

We support the creation of an independent investment consultancy focused on providing high quality advice on the relative attractiveness of sustainable investment products as well as on sustainable asset allocation. The consultancy would create healthy competition within the industry and encourage other players to invest in expanding their sustainability advisory services across asset classes.

### 3. EXPAND THE RANGE AND DEPTH OF SUSTAINABLE INVESTMENT PRODUCTS

There are an increasing number of sustainable investment products from both mainstream and boutique investors. Mainstreaming Sustainable Capitalism will require products from a range of asset classes and will require that the best products reach scale. We particularly support the scaling of products beyond the traditional focus of public equity. But given the lack of track records for many new products, it will be essential for intermediaries and others to consider how to position such products effectively.

### 4. RECONSIDER THE APPROPRIATE DEFINITION OF GROWTH BEYOND GDP

Rampant hyper-consumption fuelled by easy access to credit has not only destroyed value in the global economy but has also done significant harm to the environment – and yet is still counted as a positive contribution to ‘progress’, as measured by GDP growth. As part of the transition to Sustainable Capitalism, the previously assumed metric for success – maximum growth – must be reconsidered in the context of consumption, income distribution, and quality-of-life indicators.<sup>57</sup> The quality, not simply the quantity, of growth should be valued.

By ignoring externalities, GDP is too narrow a definition of growth. As others have cited, more needs to be done to build consensus around what metrics should be measured (and therefore will be managed) in order to track *sustainable* growth – at both the country and company level – and more should be done subsequently to integrate the new definition of progress into political and business decision making.

### 5. INTEGRATE SUSTAINABILITY INTO BUSINESS EDUCATION AT ALL LEVELS

Mainstreaming Sustainable Capitalism requires the incorporation of sustainability into the education and training of current and future managers, consultants, executives and investors.

The continuing education of current practitioners should include:

- › raising awareness among asset managers of the importance of sustainable investing and providing information on how to launch ESG products across asset classes;
- › working with investor-relations teams and investment consultants who can encourage adoption by their respective investor base of long-term sustainability orientated thinking; and
- › training corporate boards on how to integrate sustainability into their duties and strategic planning for companies.

To educate future leaders, undergraduate and business school courses should integrate sustainability

---

<sup>57</sup> Professor Joseph E Stiglitz, Professor Amartya Sen, Professor Jean-Paul Fitoussi, “Report by the Commission on the Measurement of Economic Performance and Social Progress”, 2009. [http://www.stiglitz-sen-fitoussi.fr/documents/rapport\\_anglais.pdf](http://www.stiglitz-sen-fitoussi.fr/documents/rapport_anglais.pdf).

## 4 | Achieving Sustainable Capitalism by 2020

across a range of disciplines. The Chartered Financial Analysts (CFA) certification should continue to expand the sustainability related issues included in its tested material and training programmes within financial institutions, and consulting firms should incorporate this material as well.

### OUR COMMITMENT

Sustainability has always been at Generation's core. While we have advocated consistently for the integration of sustainability principles in business, we envision this paper as not only a call to action for other investors and members of the business community but also as an opportunity to renew our own commitment to Sustainable Capitalism.

To honour that commitment, we intend to use two distinct channels – our investment management business and the Generation Foundation – to further develop and implement the actions we have recommended.

Through our investment business, we will continue to formulate investment strategies that fully integrate sustainability factors with fundamental analysis. Sustainability will remain a key driver of long-term value creation. Additionally, we will engage with our portfolio companies on what we regard as the appropriate action to promote these changes and will offer our guidance, when necessary, on how best to implement these new practices.

The Generation Foundation, which is funded by 5% of Generation Investment Management's profits on an annual basis, is critical to our own efforts to mainstream Sustainable Capitalism by 2020. We will use The Foundation to partner with relevant organisations, where appropriate, and to fund research and advocacy work related to the action items and broader issues for ongoing support proposed in this paper. Through our knowledge and opportunity to convene, we will support ongoing efforts to accelerate the transition to Sustainable Capitalism.

### TOPICS FOR FURTHER RESEARCH

In addition to the priority action items and broader ideas we support, there are several other subjects that will play a pivotal role in mainstreaming Sustainable Capitalism. While we did not have the ability to explore all of them with the necessary level of detail they deserve in this paper, we encourage others with greater subject matter expertise on these issues to further investigate them. They are:

- › the role of policy and regulation in supporting Sustainable Capitalism;
- › more effective engagement between business, government, and the NGO community;
- › the implications of diverting wealth to shadow banking activities and financial engineering;
- › rising inequality of income and wealth;
- › the link between Sustainable Capitalism and the billions who do not directly interact with the markets;
- › behavioural economics in the context of making the transition to a sustainable economy;
- › Sustainable Capitalism and entrepreneurship; and
- › enforcement of both a transaction tax and carbon tax to encourage long termism.

## 5 | Conclusion

Contemporary Chinese artist Ai Weiwei observed that “Liberty is about the right to question everything.”<sup>58</sup> This empowering statement reminds us that those who have the ability to question the status quo should cherish the privilege and make their voices heard. Only through collective discourse are we able to advance, by refining or even completely changing key tenets of our society. Similar to the way artists often draw inspiration from challenging times, perhaps companies and investors can use the global financial crisis as a catalyst to reshape how we view the world and to foster positive change.

The barriers to mainstreaming Sustainable Capitalism are formidable but not insurmountable. We believe that the actions for change we are recommending, taken together, will affect the entire business ecosystem and encourage reform by investors, companies, government and civil society alike to adopt long-term horizons and consider ESG factors in addition to financial ones.

These actions will also drive the development of solutions for our sustainability challenges. By this we mean not only investing in assets using an integrated sustainability methodology but actively funding projects and companies that are developing the solutions to sustainability challenges themselves (eg, smart grid infrastructure service firms, low income housing developers and affordable life-saving drugs).

According to Tim Jackson, the Economics Commissioner on the UK Sustainable Development Commission, “Questioning growth is deemed to be the act of lunatics, idealists and revolutionaries. But question it we must.”<sup>59</sup> The exercise of reflecting on the sustainability of current business practices and developing ways to improve going forward requires us to revise our views on the nature of the value we create, the type of expansion we seek and how we measure success.

Incremental change will prove insufficient to mainstream Sustainable Capitalism by 2020. So, like an artist at the easel, our goal is not to make superficial touch-ups that conceal deep structural flaws beneath. We are calling for a fresh canvas on which, together, we can paint a new picture of our future.

**Copyright © 2012 Generation Investment Management LLP. All rights reserved.**

---

<sup>58</sup> Ai Wei Wei Sunflower Seed Exhibition, Tate Modern, London England, 2011, <http://www.tate.org.uk/about/pressoffice/pressreleases/2010/21489.htm>.

<sup>59</sup> Jackson, Tim, *Prosperity Without Growth: Economics for a Finite Planet*. London: Earthscan, 2009.

# Appendix: Experts Consulted

We would like to thank the experts who graciously donated their time and wisdom throughout the development of this paper:

- › Jacques Aigrain, LCH Clearnet Group Ltd
- › Jane Ambachtsheer, Mercer
- › Victoria Arroyo, Georgetown Law
- › Byron Auguste, McKinsey & Company
- › Giulio Boccaletti, McKinsey & Company
- › Elisabeth Bourqui, Mercer
- › Erik Brenninkmeijer, COFRA Holding AG
- › Melissa Brown, Serasi Capital
- › Ben Caldecott, Climate Change Capital
- › Laura Callanan, McKinsey & Company
- › Alice Chapple, Forum for the Future
- › Aron Cramer, BSR
- › Ruth Curran, Forum for the Future
- › Brian Czech, Center for the Advancement of the Steady State Economy
- › Richard Davies, Bank of England
- › Mark Dominik, Deutsche Bank
- › Robert Eccles, Harvard Business School
- › Matt Edge, Partners Capital
- › Mark Florman, British Private Equity and Venture Capital Association
- › Marc Fox, Goldman Sachs
- › Michele Giddens, Bridges Ventures
- › James Gifford, UN PRI
- › John Goldstein, Imprint Capital
- › Gordon Hagart, Australia Future Fund
- › Bracken Hendricks, Center for American Progress
- › Don Henry, Australian Conservation Fund
- › Andreas Hoepner, University of St. Andrews and UN PRI
- › Catherine Howarth, Fairpensions
- › Anwar Ibrahim, Opposition Leader- Parliament of Malaysia
- › Ioannis Ioannou, London Business School
- › Erica Karp, UBS
- › Bruce Kahn, Deutsche Bank
- › Mitchell Kapor, Mitchell Kapor Foundation
- › Andrew Kassoy, B-Corporation
- › Joel Kenrick, UK Department of Energy and Climate Change

# Appendix: Experts Consulted

- › Tom Kiely, McKinsey & Company
- › Phil Kirshman, UBS
- › Mark Kramer, FSG
- › Jonathan Lash, Hampshire College
- › James Leaton, Carbon Tracker Initiative
- › Michael Lent, Veris Wealth Partners
- › Alexander Ljungqvist, NYU Stern
- › Thierry Lombard, Lombard Odier
- › Mindy Lubber, Ceres
- › Robert Kinloch Massie, Initiative for Responsible Investment at Harvard University
- › Peter Malik, Natural Resources Defense Council
- › Tony Manwaring, Tomorrow's Company
- › Mira Merme, Independent Advisor
- › Amanda McCluskey, Colonial First State
- › Susan Mac Cormac, Morrison Foerster, LLP
- › Charlie Moore, Center for Corporate Philanthropy
- › Jeremy Oppenheim, McKinsey & Company
- › Shilpa Patel, IFC
- › Jonathon Porritt, Forum for the Future
- › Diana Propper, Expansion Capital Partners
- › Mary Robinson, Mary Robinson Foundation - Climate Justice
- › Curtis Ravenel, Bloomberg
- › Will Rosenzweig, Physic Ventures
- › Judith Samuelson, Aspen Institute
- › John Sauven, Greenpeace UK
- › Orville Schell, Center on US-China Relations
- › Elliot Schwartz, Committee for Economic Development
- › Jason Scott, EKO Asset Management Partners
- › George Serafeim, Harvard Business School
- › Michael Toffel, Harvard Business School
- › Nigel Topping, Carbon Disclosure Project
- › Roger Urwin, Towers Watson
- › Thomas Van Dyck, RBC Wealth Management
- › Bob Welsh, Sustainability Advisers
- › Lisa Woll, US SIF
- › David Wood, Initiative for Responsible Investment at Harvard University
- › Simon Zadek, Global Green Growth Initiative and Centre for International Governance Innovation

Generation Investment Management LLP  
One Vine Street  
London  
W1J 0AH  
U.K.

Main: +44 (0) 207 534 4700  
Fax: +44 (0) 207 534 4701

[suscap@generationim.com](mailto:suscap@generationim.com)

