

A Manifesto for Sustainable Capitalism

How businesses can embrace environmental, social and governance metrics.

By AL GORE AND DAVID BLOOD

In the immediate aftermath of World War II, when the United States was preparing its visionary plan for nurturing democratic capitalism abroad, Gen. Omar Bradley said, "It is time to steer by the stars, and not by the lights of each passing ship." Today, more than 60 years later, that means abandoning short-term economic thinking for "sustainable capitalism."

We are once again facing one of those rare turning points in history when dangerous challenges and limitless opportunities cry out for clear, long-term thinking. The disruptive threats now facing the planet are extraordinary: climate change, water scarcity, poverty, disease, growing income inequality, urbanization, massive economic volatility and more. Businesses cannot be asked to do the job of governments, but companies and investors will ultimately mobilize most of the capital needed to overcome the unprecedented challenges we now face.

Before the crisis and since, we and others have called for a more responsible form of capitalism, what we call sustainable capitalism: a framework that seeks to maximize long-term economic value by reforming markets to address real needs while integrating environmental, social and governance (ESG) metrics throughout the decision-making process.

Such sustainable capitalism applies to the entire investment value chain—from entrepreneurial ventures to large public companies, seed-capital providers to institutional investors, employees to CEOs, activists to policy makers. It transcends borders, industries, asset classes and stakeholders.

Those who advocate sustainable capitalism are often challenged to spell out why sustainability adds value. Yet the question that should be asked instead is: "Why does an absence of sustainability not damage companies, investors and society at large?" From BP to Lehman Brothers, there is a long list of examples proving that it does.

Moreover, companies and investors that integrate sustainability into their business practices are finding that it enhances profitability over the longer term. Experience and research show that embracing sustainable capitalism yields four kinds of important benefits for companies:

- Developing sustainable products and services can increase a company's profits, enhance its brand, and improve its competitive positioning, as the market increasingly rewards this behavior.
- 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.
- Third, 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.
- Researchers (including Rob Bauer and Daniel Hann of Maastricht University, and Beiting Cheng, Ioannis Ioannou and George Serafeim of Harvard) have found that sustainable businesses realize financial benefits such as lower cost of debt and lower capital constraints.

Sustainable capitalism is also important for investors. Mr. Serafeim and his colleague Robert G. Eccles have shown that sustainable companies outperform their unsustainable peers in the long term. Therefore, investors who identify companies that embed sustainability into their strategies can earn substantial returns, while experiencing low volatility.

Because ESG metrics directly affect companies' long-term value, pension funds, sovereign wealth funds, foundations and the like—investors with long-term liabilities—should include these metrics as an essential aspect of valuation and investment strategy. Sustainable capitalism requires investors to be good investors, to fully understand the companies they invest in and to believe in their long-term value and potential.

We recommend five key actions for immediate adoption by companies, investors and others to accelerate the current incremental pace of change to one that matches the urgency of the situation:

- Identify and incorporate risk from stranded assets. "Stranded assets" are those whose value would dramatically change, either positively or negatively, when large externalities are taken into account—for example, by attributing a reasonable price to carbon or water. So long as their true value is ignored, stranded assets have the potential to trigger significant reductions in the long-term value of not just particular companies but entire sectors.

That's exactly what occurred when the true value of subprime mortgages was belatedly recognized and mortgage-backed assets were suddenly repriced. Until there are policies requiring the establishment of a fair price on widely understood externalities, academics and financial professionals should strive to quantify the impact of stranded assets and analyze the subsequent implications for investment opportunities.

- Mandate integrated reporting. Despite an increase in the volume and frequency of information made available by companies, access to more data for public equity investors has not necessarily translated into more comprehensive insight into companies. Integrated reporting addresses this problem by encouraging companies to integrate both their financial and ESG performance into one report that includes only the most salient or material metrics.

This enables companies and investors to make better resource-allocation decisions by seeing how ESG performance contributes to sustainable, long-term value creation. While voluntary integrated reporting is gaining momentum, it must be mandated by appropriate agencies such as stock exchanges and securities regulators in order to ensure swift and broad adoption.

- End the default practice of issuing quarterly earnings guidance. The quarterly calendar frequently incentivizes executives to manage for the short-term. It also encourages some investors to overemphasize the significance of these measures at the expense of longer-term, more meaningful measures of sustainable value creation. Ending this practice in favor of companies' issuing guidance only as they deem appropriate (if at all) would encourage a longer-term view of the business.

- Align compensation structures with long-term sustainable performance. Most existing compensation schemes emphasize short-term actions 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 realized and compensation should be linked to fundamental drivers of long-term value, employing rolling multiyear milestones for performance evaluation.

- Incentivize long-term investing with loyalty-driven securities. The dominance of short-termism in the market fosters general market instability and undermines the efforts of executives seeking long-term value creation. The common argument that more liquidity is always better for markets is based on long-discredited elements of the now-obsolete "standard model" of economics, including the illusion of perfect information and the assumption that markets tend toward equilibrium.

To push against this short-termism, companies could issue securities that offer investors financial rewards for holding onto shares for a certain number of years. This would attract long-term investors with patient capital and would facilitate both long-term value creation in companies and stability in financial markets.

Ben Franklin famously said, "You may delay, but time will not, and lost time is never found again." Today we have an opportunity to steer by the stars and once again rebuild for the long-term. Sustainable capitalism will create opportunities and rewards, but it will also mean challenging the pernicious orthodoxy of short-termism. As we face an inflection point in the global economy and the global environment, the imperative for change has never been greater.

Mr. Gore, chairman of Generation Investment Management, is a former vice president of the United States. Mr. Blood is managing partner of Generation Investment Management.