Sustain or Abstain?

by Henry Boucher, Sarasin & Partners

The word 'Sustainable' is now obligatory in any company's annual report. It is easy to be cynical about this; in many ways 'green' has suffered from becoming 'the new black' – Sustainability is the trendy fashion statement of the moment. But encouragingly, in many cases it is no longer being used frivolously or as part of a PR company's greenwashing of the chairman's statement. Many multi-nationals now 'get it.' They hear from shareholders, employees and governments that change is necessary. From Wal-Mart to Nestle and Toyota to British Land, enlightened management teams looking to the long-term realise that, as well as profit, environmental and social challenges really matter.

Of course, there are still enormous gaps between stated ideals and the practicalities of, say, making major reductions to carbon emissions. But the pace of change has picked up – or at least it was picking up until the recession struck. What will become of corporate efforts to improve sustainability in this recession? And will institutional investors build on their early momentum towards a new sustainable investment approach or quietly put the issue to one side?

We can be in no doubt now just how dramatic the change in fortunes has been. Even before the recession, many companies had little pricing power in this internet age of global price comparison web sites, but at least the top line grew as spendthrift customers happily took on debt and ignored the need to save for a rainy day. Now the rain has come and profitability is under attack from all sides, with cost cutting and consolidation the only strategy open to many management teams.

These conditions are not necessarily inconsistent with a more sustainable approach. Indeed it is argued that there are a number of financial reasons why environmentally and socially responsible conduct can pay off for companies, and subsequently for investors as well. For example, companies that consume fewer resources have a cost advantage; avoiding waste leads to lower waste disposal costs; consumer demand for products produced in an environmentally and socially responsible way is growing; fair conduct towards employees and other stakeholders pays off as contented employees are harder working and more motivated, happy suppliers are more reliable, and satisfied customers are more loyal.

But there are some harder reasons why corporate sustainability is likely to see continued momentum. Take as an example the commercial property sector. It is estimated that energy use in buildings accounts for 33% of man-made greenhouse gas emissions. This makes the building stock a key target for energy saving regulation. But it also adds the potential for a two tier property market to develop: on one side efficient and eco-accredited buildings and on the other, older, less energy efficient buildings. The downturn in the property market now puts tenants in the driving seat. Given the choice, they prefer the more efficient buildings and it is no surprise that the large property companies have set in train long-term plans to make their property portfolios more sustainable. In other industries and markets too sustainability is becoming an increasingly important differentiating factor.

Government leadership and regulation are clearly an important driver of real action on environmental awareness and sustainability. Barack Obama's election is another reason to expect momentum to accelerate rather than regress. After a long period of indifference towards climate change issues, the US government is now setting about taking a lead. This is important to many multi-national companies but will be critical to the UN World Climate talks in Copenhagen in December.

The significance of Copenhagen cannot be overstated. The Kyoto Protocol's binding emission reduction targets for developed countries cover the period 2008-2012. The Kyoto national greenhouse-gas-reduction targets for the industrialised nations sum to the equivalent of a worldwide cut of around 5% from 1990 levels. However the Intergovernmental Panel on Climate Change (IPCC) estimate that worldwide emissions need to be cut back by 50% in 2050 compared to 1990 levels. Thus not only does Copenhagen need to achieve a new protocol to take over from Kyoto (no mean feat given the need for a unanimous decision), but also the scale of the emissions reductions within the agreement needs to be of a different magnitude. The commitment from President Obama to engage the U.S. once more (and to lead from the front) greatly enhances the likelihood of a new protocol to cover the period from 2012, which governments globally will enact with powerful new regulations and incentives.

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But with governments and companies keeping up the momentum, are large shareholders being left behind? For many institutional investors, adopting a sustainable investment approach used to be viewed with some suspicion – a 'knit your own sandals' approach that may be good for your conscience but is not necessarily good for your pocket. This is a critical issue – no fund can afford to suffer underperformance from implementing a more sustainable approach. Common sense tells you that companies that carefully manage their use of finite resources are more efficient and indeed, a number of academic studies suggest a positive correlation between sustainability and stock market performance. In other words, the research suggests that sustainable investment strategies outperform rather than under perform.

In response to a more enlightened attitude from sponsoring companies, a number of corporate pension schemes have begun to consider sustainable investment strategies. Local authority pension schemes, who have been leaders in improving governance, have taken steps to become better informed about sustainability, developing their views at the LAPFF and raising environmental and social concerns up the agenda.

The logical next step is to introduce a greater degree of Sustainability into investment portfolios. But how do you define 'Sustainable Investment'? The most common definition is investment in companies that not only promise good financial returns but which also conduct themselves in a socially and environmentally responsible way. In selecting investments, the fund manager needs to take into account a range of factors beyond the conventional financial analysis. What is the environmental impact of the company's production process? What are the environmental and social issues in the supply chain? What happens to the company's products at the end of their life? The problem is that most fund managers employ plenty of well qualified financial analysts, but few, if any, environmental and social specialists. So efforts to cajole your fund managers to take environmental and social factors into account are often thwarted by their lack of resources. In order to introduce a sustainable investment mandate, many funds find that they need to employ a specialist manager.

'Sustainability' originates from the forestry industry and basically means only cutting down the amount of wood you subsequently replenish with new growth. The UN World Commission on Environment and Development defines Sustainability as "meeting the needs of the present without compromising the ability of future generations to meet their own needs." This has a resonance with the obligation on long-term funds to take account of the needs of both present and future beneficiaries. It also rings in the ears of politicians. As we face an explosion in government expenditure to rescue the banking system and stimulate the ailing economy, 'inter-generational accounting' has crept into the lexicon. Can we afford to borrow so much without leaving an unacceptable financial burden on future generations? And are we leaving behind an unacceptable environmental legacy?

The Stern Review was published back in October 2006 and provided one of the most comprehensive global assessments of the economic, social and environmental consequences of climate change. It concluded that the magnitude of the impact depends on the rise in greenhouse gas concentration and the action taken to limit it. If strong action is taken to control emissions, the cost could be limited to 1% of global GDP each year.

However Stern makes clear that the challenge of stabilising emissions is enormous and that, without taking immediate strong action, the impacts could be calamitous: "Using the results from formal economic models, the Review estimates that if we don't act, the overall costs and risks of climate change will be equivalent to losing at least 5% of global GDP each year, now and forever. If a wider range of risks and impacts is taken into account, the estimates of damage could rise to 20% of GDP or more."

Controlling CO_2 emissions is not easy. It requires personal sacrifice that goes against the grain of economic development and improving living standards and it requires significant international cooperation. It is clear that the momentum towards a more sustainable lifestyle must increase and that governments and companies are increasing their efforts to improve sustainability, despite the recession. Institutional investors have been comparatively slow to move to a new sustainable investment approach but they now seem poised to act. 'Change is coming.'

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