The Investor Revolution
Shareholders Are Getting Serious About Sustainability
Robert G. Eccles

TruValue Labs
ESG Investing Forum 2019
May 20, 2019
Shareholders Are Getting Serious About Sustainability

Most corporate leaders understand that businesses have a key role to play in tackling urgent challenges such as climate change. But:

• Many believe that pursuing a sustainability agenda runs counter to shareholder wishes
• Many have the impression that ESG hasn’t gone mainstream in the investment community
• Many underestimate how much SRI strategies affect their shares (US estimation: 5%, reality: 25%)

Interviews with 70 senior executives at 43 global institutional investing firms say otherwise:
Shareholders Are Getting Serious About Sustainability

Assets under management (US$ trillion)

Source: https://www.unpri.org/pri/about-the-pri
What's driving the Change?

Six factors are acting as tailwinds for this heightened focus

1. The Size of Investment Firms
2. Financial Returns
3. Growing Demand
4. An Evolving View of Fiduciary Duty
5. Trickle-Down Within Investment Firms
6. More ESG Activism By Investors
What’s driving the Change?

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1. **The Size of Investment Firms**
   - Top five have 23% of AUM
   - Top 10 have 34% of AUM

Universal Ownership thesis:
- Large firms have become too big to let the plant fail.
- Large institutional investors are forced to take a long-term view, because they have long-term liability.

Hiro Mizuno, CIO of Japan’s $1.6 trillion Government Pension Investment Fund:

“We are a classic universal owner with intergenerational responsibilities and thus have an inherently long-term view.”
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2. **Financial Returns**

Evolution of $1 invested in the stock market in value-weighted portfolios

- For High and Low Sustainability firms
- Return-on-Equity (ROE)

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What’s driving the Change?

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Materiality Matters

Firms That Perform Well on Material Issues Enjoy Enhanced Accounting and Market Returns Over Firms That Perform Poorly on These Factors

Source, HBS research: http://hbswk.hbs.edu/item/7755.html
What's driving the Change?

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Materiality Matters

Firms That Perform Well on Immaterial Issues Do Not Achieve Better Returns Than Firms That Perform Poorly on These Factors

Source, HBS research: http://hbswk.hbs.edu/item/7755.html
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**Materiality Matters**

<table>
<thead>
<tr>
<th>Effect on Financial Returns, Annualized Alpha</th>
<th>Low Performance on Immaterial Issues</th>
<th>High Performance on Immaterial Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Performance on Material Issues</td>
<td>-2.2%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Low Performance on Material Issues</td>
<td>-0.4%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

What’s driving the Change?

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3. Growing Demand

• Asset owners no longer have to be convinced that sustainable investing is important.
• Asset owners in fact increasingly demand sustainable investing strategies from their asset managers
• Many don’t only care about financial, but also non-financial outcomes

Rina Kupferschmid-Rojas, head of sustainable Finance at UBS Group:

“Our wealthiest clients want to know their investments are making a difference to make the world a better place”
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4. An Evolving View of Fiduciary Duty
   • Mistaken belief that fiduciary duty means focusing only on financial returns.
   • More recent legal opinions and regulatory guidelines make it clear that it is a violation of fiduciary duty not to consider ESG factors

“Failing to integrate ESG issues is a failure of fiduciary duty.”

Will Martindale
Head of policy at PRI

Source: https://www.unpri.org/pri/about-the-pri
What’s driving the Change?

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5. **Trickle-Down Within Investment Firms**
   - Historically, the ESG group at investment firms was separate from portfolio managers and sector analysts
   - Now ESG analysis is being integrated into the fundamental financial activities carried out by analysts and portfolio managers.
   - This shift will change the way investors engage with companies— and the way corporate executives view sustainability
   - Millennials are an important driver of this change

**Example BlackRock:**
CEO, Larry Fink, promotes sustainable investing, but integration is hard. In fact, integrating ESG considerations into traditional financial analysis needs **behavioural change**:

Tariq Fancy, CIO of Sustainable Investing BlackRock

“Some investors are naturally inclined to do it. Others, depending on their asset class, geography, and investment style, take more time to see the investment value [...] But if we can do it at BlackRock, we can do it across capitalism.”
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6. More ESG Activism By Investors
   - Shareholder activism is on the rise in financial markets—and ESG is increasingly becoming a focus of these interventions.
   - One form of active engagement is proxy resolutions and proxy voting (total ISS ES resolution growth by 45% 2011 - 2016)
   - Some Activist Hedge Funds move into ESG (e.g., JANA Partners)
   - Investor Services focus increasingly on ESG (e.g., Hermes Equity Ownership Services)
   - Collaborative Activism rises (e.g., Climate Action 100+)
What’s Holding Back ESG Investing?

• Most sustainability reporting by companies is aimed not at investors but at other stakeholders, such as NGOs, and is thus of little use to investors.

• Data vendors have emerged to assess companies, but ESG data quality is low and methodologies are opaque.

• Neither corporate nor ESG data is neither comparable nor auditable

• Several NGOs and regulation in certain geographic areas are trying to address this through standard setting – yet there is still a long time to go.
Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

1. Articulate your Purpose
2. Improve Engagement with Shareholders
3. Increase Involvement by Middle Management
4. Invest in Internal Systems for ESG Performance
5. Improve Measurement and Reporting
Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

1. Articulate your Purpose
   • “The purpose of a company is not just to produce profits, it is to produce solutions to problems of people and planet and in the process to produce profits” Colin Mayer
   • Clarity about corporate purpose is fundamental for board effectiveness
   • Boards should publish a “Statement of Purpose”

“To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”

Larry Fink, BlackRock
Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

2. **Improve Engagement with Shareholders**
   - Investors are seeking deeper levels of engagement with their portfolio companies
   - Shareholders will increasingly engage with the C-Suite on ESG issues
   - As well as the board of directors
   - Purpose Statements should be integrated into an Integrated Report
   - By doing so, companies will signal a change from short to long-term value orientation
   - CECP framework for executives to share the long-term strategic plans
   - Companies should take charge of quarterly calls and not let them be driven by short-term sell-side analysts
Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

3. Increase Involvement by Middle Management

- Companies need to respond by increasing their own middle management’s involvement in identifying and managing the material ESG issues
- Getting middle management more involved is the responsibility of the board and senior leaders
- Middle managers should be involved in Materiality determination
- ESG should be part of reward systems

Jonathan Bailey, Head of ESG Investing, Neuberger Berman

“Investors and the CEO create the space, but it is middle management that will create the products and services that serve both shareholders and society.”
Preparing for the New Era

Five actions that companies can take to prepare for the new era of sustainable investing.

4. **Invest in Internal Systems for ESG Performance**

   - All firms have financial IT systems, but few firms have reliable systems for measuring ESG performance.
   - Accurate Integrated Reporting is inhibited by poor ESG data management. To help avoid this, firms can:
     a) Put suggested standards (GRI, SASB) into practice
     b) companies should challenge the software vendors that provide financial information to extend into ESG metrics.
     c) businesses should press their audit firms to provide assurance on reported ESG performance.
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5. Improve Measurement and Reporting

- Some ESG issues don’t affect a company’s bottom line but still impact society at large.
- A growing segment of the investment community is interested in impacts—and willing to allocate capital to firms that actively work to benefit society.
- No agreed upon measure for “externalities”
- Good framework for thinking about impact is the United Nations Sustainable Development Goals (SDGs)
- Impact Management Project
THE IMP HAS LAUNCHED A ‘STRUCTURED NETWORK’ OF STANDARD-SETTING ORGANISATIONS....

Clara Barby, CEO IMP

“Through provision of significant technical input, the IMP supports these organizations to coordinate – and even co-create – content.”

The IMP Structured Network comprises organisations that are working together to coordinate standards of impact measurement and management.

The IMP Strategic Partners are a group of organisations whose partnership is essential for informing and/or disseminating standards of impact measurement and management.
### HOW IMPACT MEASUREMENT BUILDS ON ESG MEASUREMENT

<table>
<thead>
<tr>
<th>Illustrative management motivation</th>
<th>Management question</th>
<th>ESG measurement</th>
<th>Outcome measurement</th>
<th>Impact measurement (Outcomes in context)</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘We want to mitigate risk’</td>
<td>Does my business have policies and practices in place to mitigate risks of negative outcomes?</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>‘We see a positive relationship between stakeholders’ wellbeing and long-term value creation’</td>
<td>Is my business generating positive outcomes for its stakeholders?</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>‘We want to use our capabilities to tackle a pressing social or environmental challenge’</td>
<td>Is my business significantly increasing an important positive outcome for an otherwise underserved population?</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>‘We want to reduce costs associated with the social and environmental damage we are causing’</td>
<td>Is my business significantly reducing an important negative outcome for an otherwise underserved population?</td>
<td></td>
<td>✓</td>
<td></td>
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</table>
## Context-based metrics for investment decision

<table>
<thead>
<tr>
<th><strong>ASSESSMENT MEASURES</strong></th>
<th><strong>WASTEWATER TREATMENT</strong></th>
<th><strong>RENEWABLE ENERGY</strong></th>
<th><strong>PHARMACEUTICALS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Impact metrics</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Data source:</em> Combined business activity/technology/sociobiogeophysical impact metrics, as proposed here</td>
<td></td>
<td></td>
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<tr>
<td><strong>Outputs:</strong> Volumes of wastewater treated (e.g., cubic meters per day)</td>
<td><strong>Outcomes:</strong> Pollutant concentration reductions in receiving waters (e.g., milligrams per liter)</td>
<td><strong>Outcomes:</strong> Emissions reduced (CO$<em>2$, PM$</em>{2.5}$, SO$_2$, NO$_x$) (e.g., metric tons per year)</td>
<td><strong>Outputs:</strong> Spatially distributed drug sales</td>
</tr>
<tr>
<td><strong>Outcomes:</strong> Beneficiary populations drawing drinking water from downstream (1000s), stream length of improved fish habitat (kilometers below threshold)</td>
<td><strong>Outcomes:</strong> Ambient air pollution improvement (e.g., parts per million; number of smog alerts)</td>
<td><strong>Outcomes:</strong> Target populations reached (e.g., millions; % of total)</td>
<td><strong>Impacts:</strong> Lives extended, hospitalizations and sick days avoided, reduced health-care spending</td>
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### Financial (standards-based)

**Data source:** Mandated corporate financial statements

- Valuation
- Corporate strategy and relative competitive position

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*“The approach...is to...evaluate corporate products and services within broader environmental or human beneficiary settings.”*
A New Outlook

A SEA CHANGE in the way investors evaluate companies is under way. Its exact timing can’t be predicted, but it is inevitable.
CONTACT

robert.eccles@sbs.ox.ac.uk