



Why does it need to

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At the risk of some hyperbole, I think that it may be useful to conceptualize the global struggle towards “sustainable investment” in Hegelian terms. (Hegel was that German fellow who postulated around 1812 that the whole of human history could be explained in terms of a grand global dialectic: thesis; antithesis; synthesis. An initial idea or proposition – the thesis – provoked a countervailing reaction or force (the antithesis), and the tension and dynamic interaction of the two produced an outcome – the synthesis – which was a unique combination of the two. This dialectical model was later adopted and refined by Marx (Karl, not Groucho), and has influenced thinkers and philosophers from traditions as diverse as Buddhism and Talmudic scholarship.

And thus it is with sustainable investment. In this case, the thesis – only rarely articulated – is that environmental and social factors and phenomena really have no proper place in a sophisticated, professional investment analysis or strategy. The general historical indifference and even hostility towards sustainable investment from institutional asset owners and their professional advisors – consultants and money managers – can be explained in large part by at least six key elements of their deeply entrenched belief system. Together, they could be viewed as constituting the “thesis” in Hegelian terms, and they go a great distance towards explaining what has until now been the glacial pace of change in the investment community.

The Thesis:

A mythology in six parts

1) *Addressing sustainability factors is irrelevant or even injurious to risk-adjusted financial returns.* Conventional investment “wisdom” has long held that companies’ performance on environmental and social (ES) issues is either immaterial or even harmful to the financial performance of both companies and their investors.

2) *It is, therefore very likely a breach of fiduciary duty to incorporate sustainability factors into investment strategy.* This myth follows directly from the first one. On a good day, analyst time spent assessing companies’ ES performance is alleged to

be simply an unconscionable waste of time; on a bad day, including them in the construction of clients’ portfolios may actually harm both companies’ and investors’ financial performance, by arbitrarily narrowing the available investment opportunity set. Some traditional SRI managers, for example, will simply not invest in *any* mining, oil and gas, or forestry stocks on principle, notwithstanding any financial (or, for that matter, environmental, or social) virtues they might have.

3) *There is no academically credible evidence to support the sustainable investment thesis.* This is at once the most central and the most misguided of the six investment myths. The fact that it is blatantly untrue has done little to prevent some of the most respected and influential investment analysts and consultants in the world from parroting it from the highest mountain tops. The problem is not a lack of evidence; it is the fact that the sceptics are either blithely dismissive of it or, more frequently, unaware of its existence and disinclined to look for it.

4) *Sustainability and other “extra-financial” analyses are inevitably less rigorous and more arbitrary than traditional investment analysis.* Sadly, this particular myth is not simply intellectually inaccurate, it is actively preventing otherwise progressive institutional investors – particularly in the United States – from even considering sustainability strategies that could improve their risk-adjusted returns substantially. In many cases, they have thrown the sustainable investment “baby” out with the “neo-classical SRI bath water”. The claim that sustainability analysis is woolly-minded and subjective becomes particularly ludicrous when one recalls what Wall Street regularly reports as the Number One determinant of companies’ financial performance: management quality. Now there’s an eminently precise, quantifiable metric for you!

5) *All SRI/sustainability research and investment approaches are essentially the same.* While it is true that some SRI analysis and investment products are of inferior quality and generate poor returns, precisely the same can be said for much of mainstream analysis and many of its products (viz: global market meltdown). In neither case should investors abandon the entire genre because of the failings of the worst.

be this difficult?

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6) *Unlike any other single set of investment factors, sustainability factors have to add value all of the time; otherwise they clearly must be intellectually bankrupt, worthless, or even harmful.* The “logical” corollary of this view is that the underperformance of any ES/sustainability fund or, God forbid, several of them, invalidates the entire investment approach. By contrast, every year, according to respected Princeton finance professor Burton Malkiel, roughly 80 per cent of all active, large-cap mainstream asset managers under-perform their benchmarks¹. This, however, is apparently no reason whatsoever to call into question the entire discipline of active management. In the world of sustainable investment, however, this “shortcoming” is, apparently fatal.

The Antithesis:

Stark and countervailing megatrends

This essentially negative thesis, however, runs headlong into the headwinds of some stark and countervailing megatrends, including:

- Accelerating natural resource degradation, scarcity and constraints, driven to a significant extent by the explosive pace of industrial development, population growth, and urbanization, especially in emerging market economies such as those in Brazil, Russia, India, and China (the so-called “BRIC” countries);

Major demographic and economic shifts, concentrating the most rapid population *and* economic growth in emerging markets, where the sustainability risks and impacts are arguably the greatest;

- The ongoing revolution in information and communications technologies (the Internet, YouTube, Facebook, webcasts, bloggers, et al.), which has enabled and accelerated the emergence of a stakeholder-driven competitive environment for companies with unprecedented transparency and, therefore, business and investment risk;
- Growing pressures from international non-governmental organizations (NGOs), armed with unprecedented financial and technical resources, credibility, access to company information, and global communications

capabilities with which to disseminate their analysis and viewpoints;

- A substantial reinterpretation and broadening of the purview of legitimate fiduciary responsibility to include companies’ performance on ES matters;
- A growing body of both academic and empirical evidence illuminating the tightening nexus between companies’ performance on ES issues and their competitiveness, profitability and share price performance.

“...the ultimate triumph of sustainability-driven investment approaches.”

The Synthesis:

An inflection point beckons

While I do confess to occasional bouts of despair about the excruciating pace of progress, I also firmly believe that there can ultimately be but one outcome from this titanic, dialectical struggle for the hearts, minds, and wallets of investors: the ultimate triumph of sustainability-driven investment approaches. The secular global megatrends we reviewed earlier are simply too powerful and compelling to permit any other outcome.

What form will that triumph take? I would propose a zen-like paradox here: sustainable investment will in fact have truly triumphed when it disappears altogether. At some point in the future, sustainable investment will simply cease to exist as a discrete, stand-alone category or investment style. It will be impossible at that point to distinguish between “sustainable” investment and good old-fashioned *smart*, forward-looking investment, period.

And when, you ask, will this nirvana-like state be achieved? Well, I can’t give you the precise week, but I do know this much: progress on this front, much like the impacts of climate change, is likely to be *discontinuous*. It will *not* be gradual and linear; it will involve a step-function change. And I believe that the tipping, or inflection point is nigh. The catalyst may well turn out to be the global market meltdown: by graphically demonstrating the limitations of traditional investment analysis, it could create a once-in-a-generation receptivity to new approaches. Now is our time!

¹ See Malkiel, Burton (2005) “Reflections on the Efficient Markets Hypothesis: 30 Years Later”, *Financial Review*, vol. 40, no.1 (February): pp.1-9