



Tipping the balance: Matthew Kiernan wants to make an impact on financial markets by identifying the most agile and nimble companies

Digging beneath the surface

Companies that pursue ethical and environmentally sound policies are better managed and thus more likely to outperform in the long term, says Matthew Kiernan

How can investors make good returns while respecting the needs of society and the planet? We put this question to Matthew Kiernan, president and CEO of Innovest Strategic Value Advisors, one of the world's largest socially responsible investment (SRI) rating firms.

How do sustainability analysts go about their work?

Most sustainability research is based on self-disclosed information, for instance, from questionnaires filled out by companies themselves. While such information may be helpful, you should never confuse what companies say with what



Out of the box

Matthew J Kiernan founded Innovest Strategic Value Advisors in 1995, which today is one of the largest research companies specializing in SRI.

Represented in New York, London, Paris, Tokyo, Toronto, San Francisco and Sydney, Innovest's more than 50 analysts monitor over 2,400 companies worldwide. Based on the best-in-class approach, their ratings have won the acclaim of institutional investors who named Innovest 'the number one global provider of non-traditional investment research' in 2006 and 2007. Clients of Innovest include institutional investors and investment banks such as UBS, Goldman Sachs, JPMorgan Chase, and HSBC.

Kiernan was born in Winnipeg, Canada. He received a Master's in Environmental Studies and his PhD in Strategic Environmental Management at the London School of Economics in 1982. After co-founding a strategy consulting firm which he later sold to KPMG Peat Marwick, he became a senior partner of this major business consultancy. From 1991 to 1992 he was director of the Business Council for Sustainable Development and acted as an advisor to the UN Earth Summit in Rio de Janeiro.

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they are actually doing. Instead of relying on self-disclosed information, you need a more rigorous, thorough approach.

Do you apply any special methods?

We would argue that our research methods are precisely the same as the fundamental financial analysis practised by leading investment houses. Like them, we wouldn't dream of assessing a company without first analysing the whole industry's drivers, risks and opportunities. And like them, we visit the companies and interview their management at several different levels. That's why the majority of our analysts are highly qualified, many with PhDs as well as strong financial backgrounds including MBA or Financial Advisory degrees.

So what makes your approach different?

Think of the balance sheet as an iceberg. Financial data are important, but most of a company's true risk profile and value potential lurk beneath the surface. That's where we focus. While we use tools that are similar to those of traditional research departments, we focus them on different criteria. Every company we analyse is benchmarked against more than 100 factors. And we have been studying these factors for a while. In the case of climate change, we have built up our expertise over seven to eight years. By contrast, mainstream analysts have been looking at the issue for just one or two years.

What factors would you focus on in the auto industry?

In the auto sector, our most heavily weighted issues are fuel efficiency, power train technology, the ability to rapidly commercialize R&D, supply chain management, exposure to commodity price volatility and the potential of human capital. Generally, we think that the end of cheap gasoline and tightening regulations present the industry with a game-changing challenge. Profit opportunities and risk will be realigned over the next decade. The companies most likely to succeed, we believe, are those that are best placed to develop high-mileage, low-carbon power trains, including fuel efficient hybrids and clean diesel engines.

And whom do you rate top in the industry?

Of the 23 auto companies we analysed in our last wave, Toyota was ranked top with a triple A in their environmen-

tal and a double A in their social rating. The key factors are Toyota's leading position in hybrid power trains and their advanced R&D programmes. In 2006, they overtook General Motors to become the world's largest car manufacturer, both in revenue and vehicle sales. Overall – environmentally, socially and strategically – Toyota seems to be the best positioned auto company.

Socially responsible investments, at best, keep up with traditional investments, but they don't outperform them.

There are many studies on the performance issue, but their conclusions are mixed. We find strong evidence to support superior financial returns for companies with a superior ESG performance (i.e. environmental, social and strategic governance). In other words, they are better investments over time. Rather than arguing about the reasons for this, I would like to highlight the 100 Most Sustainable Companies in the World list. Innovest is the research provider for this Global 100 ranking, which has been published annually for three years. Typically about one-quarter of the companies are replaced each year. The Global 100 have surpassed the MSCI World Index every year since we launched the list. Last year, they outperformed by as much as 7%. So, I suggest the numbers speak for themselves.

The Dow Jones Sustainability Index has not outperformed as strongly as that.

There are ever more sustainability indices and some could be more transparent about how they are put together. The DJSI is the longest-standing of all and it is composed more or less along lines we would support. That said, we do have some methodological questions. The crucial question with all indices is how the underlying research was done – and here there is much room for improvement.

So why do your Global 100 outperform other companies?

In our approach, which we call third-generation SRI, we focus on the factors that influence risk and return. Every survey of traditional financial management experts tells us that management quality is the top determinant of financial performance. Well, that's exactly what we are after: we look for the better managed companies, the more agile and nimble ones. And we have found that our ESG or sustainability fac-

tors are increasingly robust leading indicators and proxies for the superior corporate management that delivers superior financial returns.

Are you saying that, despite the costs of meeting environmental and social requirements, sustainable companies are financially more successful?

Maybe not at all times in all sectors, but in the long run that's certainly what you would expect. ESG is not just cost; it generates cost savings and business opportunities. That's not really surprising as sustainable companies are better managed. Of course, one also has to take into account the regulatory framework, politics and public opinion. In some regions such as Asia, first movers still struggle to reap the rewards for their efforts. But we see this changing.

Some see consumers as drivers of sustainable change. What's your view?

Consumers clearly have a big role to play. They will have an economic effect as they opt for energy-efficient housing and carbon offsets in their personal travel. They also have a say in politics. But given the magnitude of the challenge and the volume of resources required to confront it, I think it's the large institutional investors that have the leverage to make a difference. Take climate change – the most effective way to get corporations to manage climate risks well is through the financial markets.

How does that work?

To give you an example, we find that the exposure of large-cap utility companies to climate risks varies by a factor of 30. In other words, while some companies face relatively low risk, others are confronted with quite a considerable amount. This is not yet well understood in the financial markets. But once investors become aware of these differences, the markets will do what they've always done: reward superior performers and punish laggards, thus giving companies an incentive to improve their performance.

Does socially responsible investing actually make a difference to the environment?

That's a tough question. We know that the environment is degrading before our eyes. I would like to think it would degrade faster without all the ESG activity. Of the \$60 trillion of invested assets in the world, our clients have about \$7 trillion under management. We don't think that every dime of this is invested according to our advice. But if it does get to a critical mass, then you begin to influence the broader market. So, if we can move the trajectory of mainstream investment by even a fraction of 1%, multiplying that by \$60 trillion, you have a quite significant outcome. /

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Adrian Roost is an editor for *Wealth Management* magazine