Sustainable Investing 2008 Conference — Keynote Speech

Sustainable Investing as an Emergent Investment Discipline

by Joseph F. Keefe, President & CEO, Pax World Management Corp.

The conference we are gathered at is called "Sustainable Investing 2008." Had this same conference been held a few years ago, it likely would have used the term, "Socially Responsible Investing," or SRI, to denote the subject matter. Or perhaps "Ethical Investing," or "Mission-based investing," or some other variation.

The Social Investment Forum—the trade industry association representing asset managers and investment professionals engaged in this work in the United States—continues to use the term SRI, but has altered the definition: whereas a few short years ago it defined SRI as "integrating personal and societal values with investment decisions," it now defines SRI as "integrating environmental, social and governance factors into investment decisions."

The Social Investment Research Analysts Network—SIRAN—recently became the Sustainable Investment Research Analysts Network, preserving its acronym but changing its name. And a recent survey of over 350 global investment professionals by AXA Asset Managers and AQ Research Ltd. revealed a strong preference for the terms "ESG" and "sustainability" over more familiar terms like "SRI" or "responsible investment," as well as a belief that ESG analysis or integration would yield investment benefits over the long term.

At Pax World, we made this transition a few years ago: although we launched the first socially responsible mutual fund in the United States in 1971, we now call our investment approach Sustainable Investing, which we define it as the "full integration of environmental, social and governance (ESG) factors into investment analysis and decision making."

From "Values" to ESG

There has been a noticeable shift in language and focus these past few years. The language of Sustainability, and of ESG, is fast becoming the preferred terminology. What accounts for this shift and what are its implications? Is it simply a stylistic or semantic change, in order to better market and sell to mainstream investors? Is it a watering down of SRI, a trend

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toward "SRI Lite"? Or is it something more substantive, representing a more significant transformation?

I would argue that it is in fact the latter. The shift in language and emphasis—from SRI to Sustainable Investing, from the language of "values" to the language of ESG integration—is not semantic; it is *definitional*. It marks the emergence of a new investment discipline called Sustainable Investing, premised on the financial *materiality* of ESG factors and therefore the need to fully integrate them into investment analysis and decision making.

By saying that Sustainable Investing is an emergent investment discipline we are saying that it is not a "niche" marketing strategy, or an "alternative" investment category, or an asset class, or a lifestyle choice, all of which were said about SRI at one time or another. It is, instead, like other investment disciplines, or theories, or schools of thought—like value investing, or index investing—in that it has a particular viewpoint on what is the best way to achieve market performance or outperformance over the long term.

When SRI was defined in terms of values integration rather than ESG integration, it did not and could not have such a viewpoint. That's because it wasn't a unified investment theory. It was rather the marrying of various investment styles with various "values," often religious in origin, typically through the use of exclusionary screens—shunning alcohol, gambling, tobacco, firearms, interest or usury for the Muslim investor, contraceptives for the Catholic investor, and so on. Although SRI firms actually led the way when it came to the integration of ESG analysis and financial analysis, the exclusionary approach regarding certain types of companies, or whole industries, based on certain values choices, meant that SRI historically became defined in the popular mind more in terms of what it *didn't* invest in than what it did invest in.

This negative or exclusionary formulation contributed to the skeptical reception that SRI received from Wall Street, and from mainstream investors more generally, as the notion that you could deliver market performance by shrinking the investment universe was considered counterintuitive. So far as I am aware, there is little or no empirical evidence to suggest that SRI firms historically underperformed, but because SRI was not a unified investment approach—different firms made different values choices and deployed different screens—there was no way to prove or disprove claims about performance. The strongest performance case that SRI would make in those days was that you could invest with your values without *sacrificing* performance—again, a negative formulation.

Sustainable Investing, by contrast, is a positive discipline that defines itself in terms of what it *does* invest in rather than what it doesn't invest in: companies with strong ESG or sustainability performance. Sustainable Investing maintains that ESG criteria have financial *materiality*, and that taking them into account—both through fundamental analysis and shareholder advocacy—is a smarter way to construct and manage investment portfolios over the long term. Unlike SRI, where the investment case was perhaps counterintuitive, the case for Sustainable Investing is intuitive. Whereas SRI made the case (and I think the evidence supports) that one needn't *sacrifice* performance in order to invest with their values, Sustainable Investing makes the case (and again, I think the evidence supports this) that integrating ESG analysis can be a strategy for *outperformance*.

The Problem with Values

The difficulties that SRI confronted in its classic formulation were attributable to the fact that it defined itself in terms of "investing with values." This definition simply begged the question: what values precisely are we talking about? Some people believe that unregulated corporations and unfettered free markets combined with limited government and low marginal tax rates generate the optimal amount of wealth, freedom and equality. This is a *moral* philosophy (i.e., it's about values), and it is the edifice upon which conservative political economy is based. There are other people who think that homosexuality is morally wrong, and may therefore want to construct investment portfolios screening out companies that offer domestic partnership benefits to gay and lesbian employees. Still others, because they believe in creationism, or oppose contraception, or hold other religious beliefs, may decide to screen out firms involved in the biological sciences. These are all different sets of values, but are these the "values" that SRI was talking about? In most cases, probably not.

The problem with values is that they are subjective, having their origins in religion, culture and personal experience. There are moral and ethical values, religious values, aesthetic values, and countless examples of individual values: compassion, non-violence, equality, humility, courage, loyalty, self-reliance, right livelihood, or the conservative nostrum that unfettered free markets are the best arbiters of the good. To speak of "values" in the abstract doesn't mean very much because values are specific, and often in conflict. The notion that you can invest with values—whatever those values may be—is self-evident. Of course you can. It's a free country. But an investment discipline this does not make.

Now, Sustainable Investing, like any investment approach, is also informed by certain values. The fundamental one is that properly functioning corporations and markets that internalize certain normative standards with respect to how they interact with workers, customers, communities and the environment will be more durable and valuable in the long run. In other words, there are certain values *embedded* in the ESG criteria that Sustainable Investing deploys. The desire to preserve and protect the planet, or promote diversity, or respect the human rights of workers, are all derived from values—just as all human activity is a reflection of underlying values. But "values" per se is not an investment concept and is of little use in defining an investment discipline.

The Materiality of ESG

What characterizes an investment discipline is a point of view—a theory—on what factors contribute in the most important way, i.e., are most *material*, to investment performance over time.

For example, in 1949 Benjamin Graham published *The Intelligent Investor*, which his disciple, Warren Buffet, has called "by far the best book about investing ever written." Graham's advice—what is today referred to as value investing—is that investors should purchase securities at prices that are low as compared to the firms' intrinsic value, with the difference (between price and value) constituting a "margin of safety" that will help investors mitigate risk and enhance returns over time, thereby surviving and profiting from the ups and downs of the market.

Other theorists of active management posit other factors as the best indicators of future return: some focus on earnings growth, others on dividend growth, some apply fundamental analysis, others technical analysis or quant models to unearth these factors—to unearth *materiality*. Index investors claim, on the other hand, that trying to beat the market is a fool's errand, so one may as well buy it. The most important factors are deemed to be risk and cost, and one can harvest the entire return of the nation's publicly held businesses, while avoiding the risks and costs associated with individual stocks or actively managed funds, by simply investing in a broad market index fund.

All of these investment disciplines—active and passive—focus on capturing the returns associated with certain factors deemed to be most material. Value investors focus on capturing the returns inherent in the difference between price and value; growth-oriented investors may focus on capturing the returns associated with earnings growth, or dividend growth, or some other factors; index investors focus on lowering risk and cost and capturing the overall performance of the market.

Sustainable Investing focuses on capturing the returns associated with environmental, social and governance (ESG) factors—avoiding the risks associated with substandard ESG performance and capturing the benefits associated with superior ESG performance. A simple hypothetical will illustrate the theory:

Imagine you just inherited $5,000 and you want to invest it. Your broker recommends two "hot" stocks that she thinks will outperform the market over the next several years but you can only invest in one of them because there is a minimum investment of $5,000. You ask your broker to recommend one of them and she says it's a coin flip: the two stocks are virtually identical. She gives you some material on the two companies—brochures, annual reports, etc.—to take home with you to help you make your decision.

When you look at the material you find that the two companies are indeed mirror images of one another: they're in the same industry; have similar product lines; trade at almost exactly the same price; have almost identical price-to-earnings ratios, gross revenues, cash flow, net margins… You name it. They are essentially identical twins and there is no way to tell them apart based on the information you received from your broker. So, you Google the two companies and start doing some research on your own on the Internet.

You learn that Company A was recently named one of the Best 100 Companies to work for in America. You also learn that Company A has four women on its nine-member board of directors and that the positions of Chair and CEO are held by different persons. The company has agreed to submit CEO and other top executive pay packages to its shareholders for approval. You also learn that Company A has recently launched an initiative to reduce its greenhouse gas emissions by 50%, to be completely carbon neutral within five years, and was named one of 50 "green leaders" by *Business Week* magazine for its efforts to integrate environmental stewardship into its business model.

Company B, on the other hand, was fined by the Environmental Protection Agency (EPA) a few years back for illegally discharging toxic waste into a river. The CEO, who is also Chairman of the company's board of directors, was quoted at the time as saying, "these silly laws cost jobs and hurt businesses just to please the tree hugger lobby." The company's seven board members are all white males, and its diversity issues don't end there: several former African American employees recently brought suit against Company B alleging racial discrimination in its hiring, promotion and employment policies.

Which company would you invest in—Company A or Company B? That's a rhetorical question, as the obvious answer is Company A.

The more interesting point, however, is the reasoning behind your answer. In choosing Company A over Company B for your investment, you are actually saying something about investing, and about markets, that is the central insight of the emergent investment discipline we call Sustainable Investing: you are saying that a company's environmental, social and governance (ESG) record is *relevant*—that ESG factors are *material* from a financial, and therefore from an investment, perspective. You are saying that, all things being equal, investing in companies with stronger ESG performance is a smarter way to invest.

Of course, no one can guarantee that Company A will outperform Company B over time. All one can say is that, other things being equal—as they were in our hypothetical example—we would expect companies with stronger ESG policies, programs and performance to outperform companies with weaker ESG policies, programs and performance over time. Since most long-term investors embrace diversification (i.e., owning a lot of stocks in different asset classes through vehicles like mutual funds) as a key strategy for mitigating risk and optimizing long-term performance, what we are really saying is not that Company A will necessarily outperform Company B, but that baskets of stocks, i.e., investment portfolios, made up of Company A's are more likely to outperform than to underperform baskets or portfolios made up of Company B's over time.

The premise underlying Sustainable Investing is therefore as elegant in its simplicity as it is potentially transformative in its implications: Companies that do a better job of integrating environmental, social and governance (ESG) criteria into their business models are better positioned than their less enlightened competitors to provide investment performance over the long term. Therefore, combining rigorous financial analysis with equally rigorous ESG analysis in an effort to identify those companies is simply a better, smarter way to invest.

A Growing Consensus

Unlike traditional SRI, where the notion that you could obtain market or above market returns by shrinking the investment universe through values-based exclusions was considered counterintuitive, the central insight underlying Sustainable Investing—that ESG factors are material and therefore need to be integrated into investment analysis and decision making—is really *intuitive*, isn't it?

Most of us simply assume at an intuitive level that stronger environmental performers carry less risk, achieve greater efficiencies and are better positioned than environmental laggards to take advantage of opportunities in a global marketplace where environmental issues increasingly matter. Likewise, most of us assume at an intuitive level that companies with strong employee relations and workplace practices enjoy higher morale and productivity, and lower turnover and absenteeism, and carry less risk and are better positioned for growth than their less enlightened competitors. And we likewise assume that companies with better corporate governance practices are probably less likely to have blow-ups and are better long-term investments than poorly governed companies.

We assume, in other words, the *materiality* of ESG factors. Why? Because we assume that stronger ESG policies and practices are a proxy for smarter management. We assume that the best managed companies, the most forward-looking companies, the most opportunistic companies, are those that understand the risks and opportunities associated with ESG issues, among all the other issues they face.

It turns out that our intuitions are correct. A growing body of evidence demonstrates positive links between ESG performance and financial performance:

a. A recent report of the United Nations Environmental Programme Finance Initiatives (UNEP FI), *Show Me the Money*, summarizing some of the evidence to date on the correlation between sustainability performance and financial performance, concluded with commentary from financial consulting firm CRA RogersCasey, stating: "[W]e were impressed by the quantity of reports that showed a strong link between ESG issues, profits, business activities and, ultimately, stock prices."[1]

b. The Haas Business School at Berkeley and the Social Investment Forum award an annual prize to an academic paper that is considered outstanding in its quantitative examination of socially responsible investing. The 2005 prize-winning paper, entitled "The Economic Value of Corporate Eco-Efficiency, concluded that the most eco-efficient firms do better than the laggards, earning an "abnormal return"—the term investors use to describe performance above average—of between 2.8% and 5% over the period from 1997 through 2004. [2]

c. A study done by Innovest Strategic Value Advisors, a financial research firm, referenced in a recent Watson Wyatt paper[3], simulated the effect of incorporating Innovest's environmental ratings into portfolios of large U.S. pension funds by adjusting, on a month-by-month basis, portfolio weightings according to those environmental ratings – in other words, overweighting the best environmental performers. Over a three-year period (2002-2004), these environmentally weighted portfolios outperformed the actual portfolios for every scenario (low, medium, and high tilt) in almost every asset class examined. The results were similar over longer timeframes as well.

d. Another recent paper showed that returns were higher for companies that ranked highly on Innovest's eco-efficiency measures over a period of more than seven years, outperforming both a market proxy and companies with lower rankings.[4]

e. In 2007, Goldman Sachs introduced GS Sustain, a focus list of companies that Goldman's analysts believe are attractive from an integrated ESG/financial perspective. While Goldman Sachs states that ESG analysis *alone* does not necessarily add value, the integration of ESG with financial metrics does: the sustainability "winners" identified by Goldman outperformed the MSCI World index by 25% over the two years between summer of 2005 and summer of 2007.[5]

f. A brand-new report from the UNEP FI reinforces the findings of groups like Innovest, Watson Wyatt, and Goldman Sachs. This report, written by Mercer Consulting, one of the world's leading financial consultants reviews 20 academic studies that examine the impact of ESG variables on financial performance. The studies chosen all met several criteria, including publication in peer-reviewed journals. Of the 20 studies, 10 found that good ESG performance was positively related to financial performance, 7 found no significant effect (i.e., no difference in the performance of portfolios incorporating ESG factors, compared with more traditionallyconstructed portfolios), and 3 found a negative association. Again, the overwhelming weight of the data demonstrated the financial materiality of ESG or sustainability performance.[6]

g. On May 21, 2008, Mercer announced that it will henceforth include ESG questions in all of its manager searches and rate all managers in its database on the extent to which they "behave as active owners of capital and

[1]United Nations Environment Programme Finance Initiatives, *Show Me the Money: Linking Environmental, Social and Governance Issues to Company Value*, (Geneva: United Nations, 2006).

[2]Nadja Guenstera, Jeroen Derwalla, Rob Bauer, and Kees Koedijka, "The Economic Value of Corporate Eco-Efficiency," August 2006.

[3]Watson Wyatt, "What is? Sustainable Investment," January 2007.

[4]Nadja Guenster, Jeroen Derwall, Rob Bauer, and Kees Koedijk, "The Eco-Efficiency Premium Puzzle," *Financial Analysts Journal* (61:2), 2005.

[5] Goldman Sachs Global Investment Research, "Introducing GS SUSTAIN," September, 2007

[6]United Nations Environment Programme Finance Initiatives, *Demystifying Responsible Investment Performance: A Review of Key Academic and Broker Research on ESG Factors*, Asset Management Working Group and Mercer, October 2007.

> whether they reflect the materiality of ESG in their investment decision making." Tim Gardner, Global Chief Investment Strategist for Mercer, stated that there are a growing number of institutional asset owners "who believe these issues can have an impact on long-term investment performance."[7]

I could go on, as there is more and more evidence—but you get the picture. The weight of the research shows strong correlations between ESG performance and financial performance even though to date the market (and the conventional wisdom on Wall Street) has been skeptical about whether these correlations can be quantified. The studies from mainstream financial institutions I have just cited should begin to upend this conventional wisdom as the correlations become both increasingly obvious and increasingly quantifiable. Moreover, over the next several years we will see increasingly sophisticated attribution analysis that identifies and measures and quantifies the contributions of ESG metrics and other intangible value drivers to long-term investment portfolio performance.

So, like other investment disciplines or theories, Sustainable Investing is premised on a case for outperformance. This was not true of SRI to the extent it became associated with or defined itself in terms of values-based exclusionary screens, which have been viewed by a large section of the investing public as extra-financial and irrelevant, if not compromising, when it comes to performance.

Shareholder Engagement

The evolution from values-based SRI to ESG-based Sustainable Investing can also be seen in the arena of shareholder engagement or active ownership strategies. Shareholder activism is something that religious investors, corporate governance advocates, labor unions, SRI firms and other progressive investors have engaged in for some time, on issues ranging from Apartheid in South Africa, to sweatshop abuses, to non-discrimination against gays and lesbians, to disclosure of emissions and sustainability reporting to executive pay and other corporate governance matters.

In recent years, we have seen a convergence of these various strains of the shareholder activism movement as shareholder activist themselves, through necessity (because of SEC rules and management efforts to exclude shareholder proxy resolutions) but also through increasingly sophisticated arguments and strategies, based on a growing body of evidence, have placed more emphasis on the nexus between shareholder concerns and stock price or enterprise value. Once again, SRI firms have played a leadership role in this transition, and though the change in focus may at times be nuanced and subtle, the fact remains that shareholder advocates today are making a much stronger business case that the ESG issues they bring to management, or to a shareholder vote, are not simply a matter of good corporate citizenship or social responsibility, but are intimately linked to long-term shareholder value.

As a recent Australian study put it, "ESG-related investing has a long history, which has progressed from negative screening to positive screening or best in class approaches. And a large part of the response is active ownership and engagement to help protect and enhance the value of investments."[8]

A Transformative Investment Approach

Some SRI practitioners worry that a sustainability or ESG focus reduces every value to financial materiality —if ESG issues are only relevant to the degree they can produce financial results then, it is argued, Sustainable

[7]Mercer, "Mercer manager research developed to consider environmental, social and governance factors," May 21, 2008
[8]Williams, Tim, "Measuring, Managing, and Reporting What Matters—The State of ESG," Regnan.

Investing unwittingly reinforces the conservative paradigm that the corporation's only duty is to make a profit. I don't think this is true.

While it is certainly essential for any investment discipline to make a financial case for market or above-market returns—and Sustainable Investing, unlike SRI in its classical formulation, is able to do this—Sustainable Investing is actually much richer than this. Remember, embedded in the DNA of ESG criteria are certain values. Far from suggesting that ESG criteria are only relevant to the degree they produce financial results, Sustainable Investing posits, to the contrary, that long-term financial health is only possible to the degree that businesses and markets internalize ESG imperatives. It posits an alignment of financial outcomes with environmental, social and governance outcomes—not with values, but with *outcomes*—insisting that corporations and markets behave differently because their long-term success will depend on meeting certain ESG benchmarks. Wealth-creation strategies, in other words, must become *sustainable*. We no longer need to tolerate growing poverty or inequality or environmental degradation as the necessary byproducts of market capitalism.

Sustainable Investing therefore represents an explicit challenge to classic conservative political economy, best exemplified by Milton Friedman's famous dictum that the only duty of a corporation is to make a profit. Sustainable Investing holds, to the contrary, that the best companies (and the best investments) are those that act in the public interest; that serve all their stakeholders, not just shareholders; that do not externalize their costs onto society; and that pursue wealth creation strategies focused on the long term. Moreover, government (i.e., the public) has a positive role to play in regulating corporations and markets to redress social imbalances and optimize social outcomes.[9]

Over the next twenty years, it will be imperative for market capitalism to undergo a Sustainability Revolution equal in significance to the Industrial Revolution that ushered in the modern period. Sustainable Investing will be the investment arm of the Sustainability Revolution just as classical conservative investing was the investment arm of the Industrial Period. Sustainable Investing represents a new investment theory, a new investment discipline, for the new epoch—a potentially transformative investment strategy that can align positive investment outcomes with positive societal and environmental outcomes. Good for investors, good for corporations, good for markets, and right for the times.

Sustainable Investing has great promise, and our work in the coming years is to make sure it lives up to its potential.

Joe Keefe is President and CEO of Pax World Funds, New York, NY, September 23, 2008

[9] Obviously, the degree to which Sustainable Investing can affect corporate behavior and markets, and play a catalytic role in promoting sustainable development, will depend in large measure on improved public policy. Despite what some conservatives may think, markets didn't exist in a state of nature. Governments create markets—from the development of property law and contract law and other aspects of the Common Law in capitalism's early period to the Securities Acts of 1933 and 1934, the Investment Company Act of 1940, and so forth. The prospects for alternative energy and clean technology, for instance, will very much depend on changes in public policy—reduced subsidies to the fossil fuel industry and increased support for sustainable energy sources through tax and spending policies. The role of government and improved public policy isn't addressed in my remarks today but suffice it to say that the prospects for Sustainable Investing, and for sustainable development more generally, will depend in large part on whether government becomes involved as an active partner rather than sitting on the sidelines—or worse, posing as an obstacle—as it has in recent years.

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