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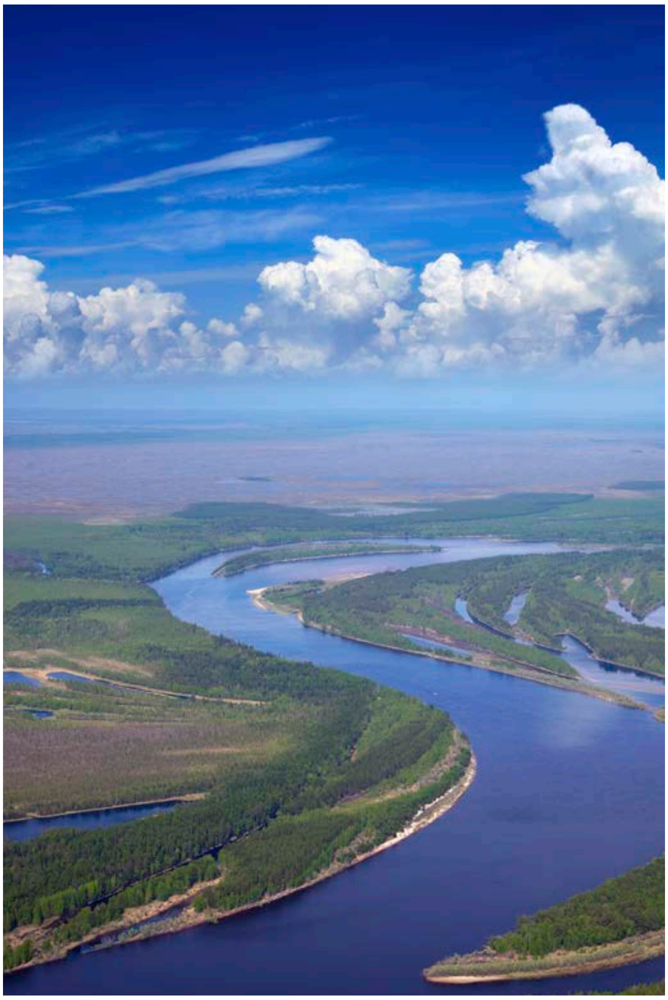
September 2016

Responsible Capitalism Survey

Many rivers to cross – Slow progress towards responsible capitalism

Responsible Capitalism:

The routes we travel today are the most powerful forces shaping the society of tomorrow.



Saker Nusseibeh
Chief Executive
Hermes Investment Management

The decisions we make as asset owners and asset managers are the single most powerful force in shaping the society of tomorrow. Very little can happen without the allocation of capital, from investment in new technologies to holding companies to account for their behaviour. Yet, despite growing recognition of this fact, global capital is still not managed in a way that takes responsibility for shaping society seriously. The hunt for yield and relentless focus on financial returns, rather than total outcomes, stand in the way of making progress, which does a disservice to those whose money is being invested.

Hermes Investment Management provides active investment strategies and stewardship. Our goal is to help people invest better, retire better and create a better society for all.

The Responsible Capitalism Survey 2016

Hermes Investment Management's annual Responsible Capitalism Survey[1] was launched in 2014 to gauge the perception of responsible investment among the investment community. The 2016 survey was carried out on a group of 102 institutional investors during April to May 2016. Responses were anonymous.

The survey covers a range of topics inclusive of ESG assessment in investment decision making, corporate governance and diversity. Some of these topics are updated annually to reflect the latest developments in the responsible investing debate.

Within the past three years, we have seen responsible investment considerations grow in prominence in the mainstream investment agenda. Our survey seeks to assess how far the growing recognition of the importance of these issues is reflected in investment practice.

[1] The Survey was conducted by Citigate Dewe Rogerson.

The table has been set for dramatic change in how we, as a global investment community, see our role as capital allocators and providers of wealth for current and future generations. The Paris climate change agreement is one example of the force gathering behind the need to take our role as responsible capitalists more seriously.

Capital is the biggest weapon in the fight to shape the future. No idea, strategy or corporate policy – whether that relates to technological innovations to agriculture or to the long-term success of existing corporates – can turn into reality without investment. For that to happen, investors have to assess the value of those ideas, strategies and policies.

However, today's investment community fails to accurately account for the effect of those factors on the value of economic activity and, by extension, future returns. The result is a yawning gap between what savers want and what the investment community can deliver. There is clearly some way to go in convincing investors to think about retirement outcomes in broader terms than maximising retirement incomes. When asked if pension funds should give greater consideration to whether their current investments will improve or detract from the overall quality of life experienced by beneficiaries when they retire, rather than focus exclusively on maximising retirement incomes, 58.7% said 'no' or 'don't know'. Only 41.3% said yes.

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41.3% said 'yes'

Things are moving in the right direction – 4.3% more respondents said yes this year than in 2015 – but the rate of change needs to accelerate for the sake of the beneficiaries whose money those asset owners and fund managers are investing.

The survey also reveals a more worrying trend. Although 10% more investors (56.4%) believe companies that focus on ESG issues produce better long-term returns than did a year ago, fewer investors believe significant ESG risks with financial implications justify rejecting an otherwise attractive investment than a year ago. Over the course of the annual Responsible Capitalism Survey, we have seen a steady decline in the number of investors who agree with this statement, suggesting that investors are failing to fully recognise that the impact of investment decisions is both long-term and profound.

60% Percentage of investors who agree with the statement that 'ESG risks with financial implications justify rejecting an attractive investment'

28.4% Percentage of investors who disagree with the statement that 'ESG risks with financial implications justify rejecting an attractive investment'

No doubt there are many reasons that feed this trend, not least the increasingly difficult task of finding yield in a low interest rate environment where central banks continue to manipulate markets. The desperate hunt for returns is undoubtedly shortening the horizon over which the global investment community considers its allocation decisions. Although investors are beginning to feel uncomfortable about companies that behave poorly – such as the big polluters or those avoiding paying their share of taxes to support the future development of societies – it is taking a long time for those companies to be excluded from portfolios. It is evident that the mood is changing – 73.1% of respondents expect to see more investment opportunities rejected by pension schemes, while only 1.1% expect the number to decrease. There's a suggestion that investors are thinking about the impact of their investee companies, as 55.4% consider ESG monitoring and reporting of supply chain to be either 'vitally' or 'very' important. Investors are increasingly aware of the importance of seeing companies in the context of their stakeholder relationships. However we are still waiting to see the gradual shift in mindsets reflected in portfolios.

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The trend towards short-termism is worrying because it reveals investors are not only failing to recognise the long-term and profound implications of their decision making, but also that ESG considerations are still very much compartmentalised rather than being included in core economic-based decisions. Short-termism is a psychological response to meeting volatility event by event.

Asked if organisations that adhere to strong ESG principles are less susceptible to market volatility, a total of 80.2% of those surveyed responded 'no' or 'don't know.' Investors are not integrating what they think of as 'nice-to-have' ESG factors or considering holistic outcomes, possibly because of the challenges they see in investing in a volatile, low-growth and low-yield environment. We believe them to be wrong, not least because a truly long-term view, i.e. investing with conviction in good companies and assets, gives a compass with which to navigate choppy market waters.

The artificial separation of investment returns and outcomes happens because investors have learnt over many generations to look at value in two-dimensional terms: risk and time, which sit at the heart of all discounting methods and asset pricing models used in finance today. In this two-dimensional world the environmental and societal impacts of investment are exogenous. When investors are calculating expected future returns on investment, positive or negative externalities are therefore treated as an addendum.

This view cannot prevail in the long-term. Considering externalities in the core of return expectation methodologies is not about choosing to promote ethical values, but about financial outcomes.

The average defined benefit pension pot is around £300,000, which translates into roughly £13-15,000 of income per year at today's rates. Increasing that pot by 10% results in an increase of around £150 per year in retirement income. However, if the typical retiree's total utility bill, for example, has gone up by £300, then the trustees of their scheme and their asset managers have lost them money.

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Consider also that a pensioner on £13,000- £15,000 a year will be heavily reliant on government subsidies such as winter fuel allowances, discounted travel and free health care to survive. If the government is less able to pay for those services, again, savers have lost out. Now consider the real cost to savers of the poor governance practices that prevailed in the banking sector in the years before the financial crisis. Society as a whole has lost £1 trillion over the last eight years which is the combination of the monies pumped into the system to counteract the banking crises and lost revenue. This was necessary because of the failure of investors (asset owners and managers) to exercise proper governance while allocating capital to banks. Since the capital is essentially owned by ordinary citizens through their savings, the result of this failure of governance is that the owners of the capital have taken on the additional debt of £1 trillion collectively because of failed investment policies. While stock markets generally have recovered to their pre-crisis level, the debt has still not gone away, it is just sitting in a different pocket. As a result the government will have far less capacity to provide the additional services pensioners will be reliant on to boost their financial incomes, so that, net, the savers or owners of capital are £1 trillion worse off, although this does not show in the financial returns of their funds.

Furthermore, savers are telling us they want societal and environmental externalities to form a core part of future return calculations. Look, for example, at the success story of the French 'Solidarity Investment Funds'. In France defined contribution schemes are required to offer savers at least one of these holistic outcome products, whose quality is attested by an independent body. Assets under management in these funds reached over $4 billion in 2014, many times the €478 million they held in 2008.[2]

What is sorely needed, therefore, is a fresh approach to calculating total financial outcomes that takes environmental and societal externalities into account. Effectively, adding a third dimension to how we approach income generation.

Professor Armen Papazian proposes one such approach that considers the value of money in 'space' (real world) time. He argues future expected cash flows are not just expected in time, but also in space – the physical context within which time is observed and experienced. The positive and negative externalities of investments therefore have a space impact that needs to be accounted for. Papazian's Space Value of Money measure integrates the impact of investments in valuation models, allowing investors to compare both the returns and space impacts of different investments in monetary terms.

Unless we as a global investment community embrace new holistic approaches to valuing investments, our ability to fulfil our environmental and societal responsibility will be severely constrained. Although investors appear committed to doing so – 79.2% say fund managers should price in corporate governance risks as a core part of their investment analysis alongside traditional financial metrics, for example – without grassroots change in how we value future returns and total outcomes for savers, shaping the future of our society will remain a peripheral objective in how capital is allocated. Ultimately, this means we will be doing savers a massive disservice.

Factors such as climate change, waste management, debt, infrastructure and government services will have a material impact on financial outcomes. The political and financial market uncertainty created by the UK's Brexit vote is a very current example of how negative externalities, such as the growing equality gap, can have a real and lasting impact on financial outcomes. Current uncertainty and volatility clouding markets in the short-term support the long-term investment approach.

As with all problems, it takes a creative adjustment to reach the point of having a solution. This solution should be led by the investment community, the stewards of capital. The adoption of an alternative approach to valuation is one such creative adjustment that would force investors to overcome the hurdles to long-term thinking, become responsible capitalists and allocate assets in a manner that is truly beneficial to those they mean to serve. Without it, the two-dimensional risk/time approach will continue to function as a financial cyclops.

[2] http://www.economie.gouv.fr/facileco/finance-solidaire

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