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Don't bother with SRI! (Who's really responsible?)

Philippe Zaouati and Carlos Joly argue that current approaches to responsible investment are critically flawed.

If the sorry state of financial markets today doesn't concern you, don't bother. If you don't care about a developed world economy that seems to stumble from recession to recession without respite, don't bother with that, either. In fact, don't bother with socially responsible investment (SRI). Either it makes much ado about something irrelevant to returns, such as environmental and social issues or ethical concerns; or it tries to do too little, failing to respond to the underlying causes of boom and bust and of the ongoing malaise, while simultaneously not managing to get away from short-termism in investment portfolios.

Our conviction is, however, that – yes – you should bother with SRI. But with an SRI that has its mandate broadened and that develops real differentiation from what prevails in today's mainstream institutional investment practice. There are two aspects to this:

- First, differentiation in portfolio composition. Not being so heavily dependent on large cap companies, but rather extending the reach to mid and small cap, private equity and, more generally, to companies that provide sustainable solutions and adopt sustainable behaviours.
- Second, engagement with corporate managements to promote the broader social and environmental protections necessary to the flourishing of democratic and prosperous societies.

Rising inequality and diminishing real wages and job opportunities do not lead to sustainable profits. The result is social insecurity, violence and a polarized social landscape – conditions that are bad for business and business owners alike.

The risks and shortcomings of continuing with 'business as usual'

“Most SRI funds are managed in the same way as non-SRI funds”

are already evident in the evolving crisis of asset management. The returns necessary to meet pension fund needs are not forthcoming. Meanwhile, ‘safe’ government bonds are no longer safe and provide returns below inflation, and equities are generally doing no better. Individual and institutional investors alike have lost their lust for shares. Trust in financial intermediaries is at a low.

Faced with this reality, we argue for a radical departure in two directions. First and foremost, because it is at the heart of investment management, we argue for new ways of thinking about portfolio composition, about asset allocation, and stock and bond selection. Second, we argue for an in-depth dialogue between investors and companies. Too many large mutual fund asset managers and large institutional investors remain silent and on the sidelines, despite having signed up to the Principles of Responsible Investment.

Moreover, as stakeholders in the wellbeing of the financial system, it is also time for us to argue for restriction and regulation of players and techniques in financial markets whose activities are systematically counter-productive to the whole: a) the outsize role of the rating agencies; b) the perverse effects of high speed trading; and, last but not least, c) the zombie attitude to real risk induced by relying too much on passive index investment strategies predicated on outmoded indices. If we had to give a name to what we argue for, this could be Strong Responsible Investment: an evolutionary response to SRI as it is generally practiced today.

Portfolio composition

Ironically, most mainstream asset managers who have SRI funds generally apply the same investment philosophy to these funds as to their non-SRI funds, replicating the same shortcomings. They seek to create SRI funds that will perform as closely as possible to their other funds. One wonders why. Is it their lack of conviction in the relevance of environmental, social and governance (ESG) considerations? Or the institutional investors’ inability to ignore short-term gyrations in favor of long term convictions? Thus, the typical SRI fund ends up being a ‘best in class’ large cap fund that is built to replicate the performance of a standard market index within what is generally a narrow tracking error constraint. As a consequence, SRI portfolios are not appreciably different from non-SRI. Serious reviews of SRI versus non-SRI fund performance conclude that SRI, as currently practiced, implies neither over- nor under-performance in and of itself, but performance which depends on the particularities of the investment process, the quality of the analysis and interpretation, and the talent of the portfolio manager. Given the similarity of standard SRI and non-SRI approaches, this is no surprise.

This standard SRI approach creates little if any added value for investors and, in general, has negligible impact on the way economic players behave. Not only is its utility limited, but it is dangerous insofar as it creates a poor impression about the significance of responsible investment. We thus believe SRI should include as its major objective the improvement of investment performance over the long term in the following ways:

- avoidance of sectors prone to crash;
- alignment of overall strategic asset allocation geographically with economic growth prospects;
- alignment with sectors likely to provide profitable solutions to environmental problems (and which thus benefit from doing what is environmentally sustainable) or that are likely to benefit from natural resource constraints or climate change, with reduced exposure to sectors and geographies likely to suffer strong negative impacts from same;
- investment choices based on a 360-degree analysis of country, sector and company, including economic, financial, environmental, social, and ethical considerations; and
- favoring a ‘buy and hold’ strategy based on industrial and ESG logic provided key elements do remain unchanged.

Nevertheless, a word of caution. What is good environmentally is not necessarily a good investment. This is often due to a level of incongruence between the current policy/regulation and what is desirable from an environmental point of view. For example, the current carbon trading system allows for too many emissions permits, resulting in abject performance for carbon funds. Another example is the poor performance of US and European solar and wind energy equipment manufacturers. Governments continue to subsidize carbon fuels as they cut back on solar and wind incentives. At the same time, the Chinese have created overcapacity and overseen price-dumping in order to strategically corner these industries on a global basis. So, on this evidence, structural industrial issues, borrowing sources and pricing, and changes in regulations and subsidies can counter otherwise promising demand signals driven by environmental needs. We are not saying that simply going for what is environmentally good guarantees sustainable profits, rising stock performance or good investment decisions. That is why indexes and funds structured solely on the basis of high ESG ratings seem to us a poor and risky shortcut in place of a thorough 360-degree analysis.

Climate change, one of many global environmental concerns, is a good illustrative case in point concerning portfolio composition.

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Nature and the market

Throughout antiquity and the Middle Ages, geography and natural events played a large part in investment decisions. Winds, storms at sea, droughts and pests in agriculture, floods and forest fires were 'front-of-mind' risks. With progress, we forgot nature. The advent of the industrial revolution brought extraordinary and wonderful advances to mankind: advances in manufacturing, in energy, in agriculture, in medicine. Think of all that has benefited humanity in the past 250 years: the steam engine, the locomotive, electricity, the automobile, the tractor, asphalt roads, sewage systems, water utilities, machine tools, factories, the assembly line, the telephone, antibiotics, antiseptics, modern medicine, organ transplants, plastics: the list goes on. All of this belongs to what we call the industrial revolution, let alone the electronic and informational revolution of the past 20 years.

Throughout history people were critically aware of storms at sea, rainfall patterns for agriculture, droughts, freezes, floods, infectious diseases. Nature, the economy and private wealth were generally acknowledged to be interrelated. With the industrial revolution there emerged a new world outlook, and with it, the legal framework of limited liability and the first corporation. Before these institutional inventions, if an owner could not pay his debts, his home, personal belongings, even his wife and children were at risk and could be seized. The shareholding corporate form and limited liability granted legal protections to individuals, separating the risk of business loss from person and personal belongings. The debts of a business were constrained to loss of the money invested in a business, but no more. This allowed for an explosion of capitalism and risk taking, and with it a growing scorn and neglect of natural risks. Business risk came to focus solely on the risk to capital in the narrow sense. (The great French historian Fernand Braudel describes this very well in his magnificent book Les Derives du Commerce: Civilization et Capitalism du 15 au 18 siècle).

With the advent of modern portfolio theory in the 20th century, it appears that asset managers largely forgot about geography and its interactions with systems of production and distribution, and came to focus entirely on the man-made aspects of economic activity. Within this sphere, managers came increasingly to rely on investment practices predicated on self-referential risk measurements, a system that measures returns relative to what other investors are doing. Their performance has increasingly been influenced by trustees and consultants seeking to replicate what 'the market' suggests, rather than do what is wise and durably valuable regardless of current fashion. (Investor Jeremy Grantham addresses this problem of herd mentality in many of his letters to investors in his GMO Funds).

Today, and in coming decades, the impact of a rapidly-changing climate on the natural resource base on which civilization depends, and the increasing frequency and severity of extreme weather events, put into question prevailing assumptions and techniques. In particular, we need to reexamine and understand the extent to which strategic asset allocation and indexation, as currently practiced, fail to account for the potentially very large impacts of climate change on asset values in the near and more mediate future – impacts both negative and positive for individual companies, for regions, and for countries. These impacts are due to the location of productive facilities, the dependence on vulnerable transportation systems (think of what happens to US grain trade if the Mississippi becomes un-navigable), just-in-time industrial practice (witness supplier interruptions in and from Japan when Fukushima blew up), plant and personnel re-siting costs, epidemic disease outbreaks, and so forth.

Furthermore, and much under-appreciated, is the potential impact on pricing of long term government bonds from costs of adaptation, remediation and emergency response to one-off extreme weather events, repetitive extreme events, and trend changes in rainfall patterns, storms, drought, fires and extreme cold.

The straight-jacket

Integrating these climate change-related issues, and other environmental or social considerations, into portfolio construction implies moving beyond traditional indexation and benchmarking.

Passive investment is predicated on the belief that markets are efficient (at its core, this is the belief that markets are right all or most of the time, since supposedly 'prices reflect all available information.') Bubbles and crashes can not, therefore, be predicted. Taken to the extreme, the efficient markets hypothesis (EMH) implies that bubbles and crashes cannot even occur. Taken to its extreme, passive investment would result in the self-destruction of the market, as all buyers and sellers would become trackers circling each other. Either buying and selling would cease, or buyers would continuously bid each other up or down into boom and bust – which would seem to explain the boom-and-bust behavior of markets these past years. Many pension funds operate under the strictures of a benchmark that fixes the mix between stocks

'What is good environmentally is not necessarily a good investment'

‘At its extreme, the efficient markets hypothesis implies that bubbles and crashes cannot occur’

and bonds (typically 60/40) and, most importantly, the benchmark fixes geographic allocation. Country allocation is, in general, based on the current size of capital markets rather than on strategic consideration of the dramatic shift of economic growth and power from mature to emerging markets that has been going on for several decades.

Choosing to stay invested in banks systemically exposed to the oncoming storm was an example of a zombie choice. A choice perhaps dictated by a prevalent index strategy, but a zombie choice nevertheless. Another case is the Fukushima disaster. Any asset manager who had done a serious study of the Japanese nuclear industry, its management practices and lack of independent risk controls, could have justifiably avoided investing in the owner of the plant on safety and environmental grounds.

Capital market size and company capitalization size are misleading and dangerous bases for asset allocation and indexation. For institutional investors who are committed to indexation strategies, we asset managers need to develop more intelligent and future-oriented forms of indexation (making much more use of minimum variance, equal weighting, and so forth).

Engagement

One more word on engagement. Asset allocation and portfolio composition are not the whole story. There is a crisis of trust in financial institutions, and it is a crisis that has been brewing since the hi-tech bubble burst. The only way to redress this crisis of trust is by becoming trustworthy. This requires us, as asset managers and institutional investors, to align our fiduciary duty to our ultimate investors, the public, with what is in the public good.

We believe this is the only way to save the integrity of stock and bond markets, and rescue their long-term function: to provide income above inflation for savers. The only way to regain the public’s trust in what the investment community does on their behalf is to align not only our portfolios, but also our engagement focus, with what is ethically right in a society that seeks prosperity through the fair interplay of democratic institutions.

This conclusion implies several courses of action:

- Asset managers and asset owners need to work together more closely, with institutional investors becoming more involved in general assemblies and disclosing their responsible investment or ESG philosophy and practices.
- We need to question companies on their lobbying practices: what they spend on which issues and for what purpose.
- We need to engage with companies on their environmental and social records, going beyond the formalistic review of board composition and a focus on minority shareholder rights.
- We need to engage in lobbying activity in favor of the regulations and enforcement that will bring trust back to the market.

If we as large institutional asset managers are to fulfill our responsibilities to society, writ large, as intermediaries of the savings of the public, we are bound to evolve our practices with respect to portfolio choice and engagement focus to be responsive to the future and attempt to make it a better place.

In our view, the agenda of Strong Responsible Investment will need to pursue the following in order to accomplish this:

- Global equity funds based on a thematic approach, seeking to give robust attention to environmental, social, and ethical considerations, and relying on well-researched themes as the spotlight for identifying companies in which to invest. Moving away from over-reliance on large cap companies to greater exposure to mid and small caps.
- Directed moves into private equity, commodities, real estate, and real assets, searching for assets that can satisfy certain basic requirements of environmental and social sustainability.
- Impact investing in companies and projects where the social and economic benefits to specific communities are readily identifiable and match the kinds of returns reasonably expected by institutional investors.
- Robust engagement with companies, with an active voting policy, so as to really act as a long term active owner.

ABOUT THE AUTHOR

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