LONG-TERM MATTERS
SUSTAINABILITY

Elephants in the sustainability room

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Decent folk in the investment world are beginning to ask why our sector is so slow to change. Why can't it function as a fit for purpose enabler of human prosperity? Three events in last few weeks illustrate real change may be in the air.

The CIO of Japan's Government Pension Investment Fund (GPIF), the world's largest pension fund, acknowledged at the PRI 2017 conference that institutional investors continue to focus on the short-term despite demanding a long-term focus from their managers and companies in which they invest.

Fidelity now speaks about "helping companies become better companies" and frames its commitment to ESG as part of being a "responsible allocator of capital" to foster "economic growth and job creation".

The CFA Institute is now talking about the need for "purposeful capitalism" in its Future State of the Investment Profession manifesto, specifically mentioning "preventable surprises" in its analysis of a Purposeful Capitalism Scenario.

So can change agents retire now, secure in the belief that finally we've won? Sadly not. This is only the end of the beginning. All that's needed is to develop the capacity and will for this thinking to become integrated into the cultures and decision frameworks of a critical mass of the investment industry.

What is slowing progress? There are a number of elephants in the room of the global investment industry. Here are some of them:

- **Perverse incentives** – dysfunctional incentives (performance metrics and durations and incentive design) continue to operate throughout the investment chain, from asset owners to agents and from investors to boards and CEOs. Operationally focused, short-term accountability actively mitigates against consideration of the long term and encourages the externalisation of social and environmental costs;
- **Narrow gene pool** – directors and trustees lack the ability and or the desire to focus CEO attention on long-term intrinsic value creation. Decision-makers at asset owners remain captured by the service chain – the tail wags the dog and creates conflicts of interest. No amount of training can compensate for recruiting management or advisers who lack the capacity or will to innovate and create future value;
- **Wrong asset mix** – despite considerable evidence to suggest that long-term investors should be long private investments and short public markets, most largely continue with what they know best. In part, this is due to concerns about how easily clients can be taken for a ride by private market managers.

Thankfully, things are moving forward on each of these fronts. Here are some reasons to be optimistic.

On incentives, a growing number of expert commentators are vocal about the weaknesses of the approach used by the dominant agents (for example, remuneration consultants and proxy advisers). It is perfectly possible to offer competitive corporate pay without the misalignment created by translating target-dollar pay into shares or other short-term valuation metrics. Relative pay for long-term returns on invested capital or changes in future value should serve as the foundation of equitable pay for performance.

Don Raymond (formerly of Canada Pension Plan), developed a contract for external managers based on this approach. Finance professors Alex Edmans and Xavier Gabaix have developed "dynamic CEO compensation" and Stephen O'Byrne has developed a performance share plan. Others, such as Daniel Godfrey at the UK's (sadly unsuccessful) People's Trust, advocate using extended time periods (rolling seven-year periods) to deliver equivalent outcomes.

On the subject of talent, the industry has bought new sources of expertise into key decision-making groups. A few members of PRI (for example, Aviva and LGIM) give executive committee status to their heads of ESG. Following the example of corporates that have had sustainability experts on their boards for many years, investors are doing the same. For example, Liontrust Asset Management (a traditional fund manager) recently appointed a sustainability expert to its board. This is a small minority of organisations for now but it's a start and one that groups like PRI could encourage simply by monitoring this data.

On assets, infrastructure, renewable energy, agriculture, real estate, venture capital and private equity are all on an upward trend. How sustainably this investment is being done, however, is far from clear and some key markets (for example, the US) are clearly lagging.

Asset owners are like the blind men of the Indian parable. Never having come across an elephant, they learn and conceptualise what the elephant is like by touching the different parts. So the first step is to acknowledge that the animal exists and that it's valuable to collaborate with others.

Incrementalism remains the order of the day but various initiatives are under way to accelerate bridging the divide between short-term portfolio level thinking and longer-term systems thinking. Managing risks and rewards at the systems level (environmental, social, financial) while simultaneously achieving competitive returns at the portfolio level – balancing risks and rewards of strategic and investment decisions at both levels – is among the most difficult challenges for corporate and asset owner fiduciaries/managers. It is also critical to long-term wealth creation.

Creating the critical mass and momentum for an industry that is fit for purpose will also require that the 'heads' and 'hearts' of investors and corporate leaders be brought into play too. The heads – systems thinking – are essential but, by themselves, this hasn't been and won't be enough. Taking the time to explore personal authenticity, purpose and leadership is the key to unlocking this potential and aligning our inner and outer worlds more fully.

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