What is Sustainable Investing?

Can it really have a positive impact on the world? Will it affect my investment returns?

By: Barrett Wadsworth – June 2018

Phrases like "socially responsible" and "sustainable" investing

tend to evoke a strong reaction, either positive or negative. Like most first impressions, these reactions are often unfounded, based more on existing biases and poor assumptions than on knowledge or experience.

According to the dictionary, the word *sustainable* means "able to be maintained at a certain rate or level" and *investing* is defined as "committing money to earn a financial return". So, if we're using the term properly, sustainable investing ought to mean "committing money to earn a financial return that is able to be maintained at a certain rate or level". This seemingly generic description sounds like it should be inherent to any sane investment strategy; which is precisely why it turns out to be a perfect definition. Contrary to expectations, this definition does not reference the environment or social responsibility, it merely adds the element of *time* into financial returns.

At its core, sustainable investing is an investment discipline that seeks to achieve higher long-term risk-adjusted returns by focusing on longer term metrics and data points than current "traditional" investment strategies. In doing so, it challenges the common belief that profits and ethics are opposing forces, each existing only at the expense of the other. Sustainable investing believes that *profits vs. ethics* is a false dichotomy and posits that proper long-term investment analysis brings our financial self-interest into alignment with our ethics.

If this is true it begs the question: why would people invest in a way that is at odds with their ethics if doing so doesn't boost their investment performance? Why is it so widely believed that "Greed is Good" when it comes to corporate profits, and how did that idea become so ingrained in our collective consciousness? Like most things, the answer for why we are where we are is both simple and complex: history.

First, let's clear up a misnomer;

"Wall Street" does not make money by investing; at least not the way we normally think of the term. Warren Buffet, Vanguard, and most well-known mutual funds are not part of Wall Street. Wall Street makes revenue through the movement of money: trading, short term lending, derivatives, IPOs, arbitrage, etc. Those are all important functions in our capital markets and they are the oil that makes our capital engine run

smoothly, but they are not the actual investments themselves. More on Wall Street's significance later.

Now for the history. Over several decades the shift from defined-benefit pensions to defined-contribution 401(k)s created an army of inexperienced investors. Simultaneously, technology and the internet provided unprecedented access to financial information while virtually eliminating barriers and costs to trading. Give an army of inexperienced investors lots of raw data and easy access to do their own investing and what do you get? An enormous over-emphasis on the data that is most readily available and most easily understood.

Now back to Wall Street. Wall Street's role is not (and never has been) that of a long-term investor, but it is where long-term investors do their trading. As our new army of investors grew, so did their demand for data, and data is something that Wall Street has in droves. In fact, providing massive amounts of investment data became the carrot that Wall Street firms used to entice investors to do their trading with that particular firm (a practice that has been harshly criticized and now banned in most of Europe).

What was missed by our army of inexperienced investors, and ignored by the often-zealous "sell-side" of Wall Street, is that most of these metrics were derived from the very short term data that Wall Street traders care about. *Over time, the short-term metrics of Wall Street came to be accepted as the predominant data points for long-term investors as well.* Today, quarterly earnings calls (the ultimate celebration of short-term data points) almost completely dominate investor sentiment (and therefore stock prices).

As in any free-market economy, companies care about what shareholders (investors) care about. In 2004 the National Bureau of Economic Research found that 78% of CFO's of publicly-traded companies would give up economic value (read: long-term growth) in exchange for smooth earnings (read: quarterly profits).[i] Even more extreme, a full 55% would avoid initiating a "very positive" long-term project if it meant falling short of the current quarter's consensus earnings.

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Executive compensation packages began to mimic investor's short-term demands by pegging bonuses to shorter and shorter-term goals. These types of compensation structures are widely accepted as having been major contributors to the build-up in risk that led to the 2008 financial crisis, several of which were made famous in Michael Lewis' best-selling book and subsequent movie "The Big Short". Perhaps the most famous and egregious examples are those of Lehman Brothers and Bear Sterns, who's top executives generated enormous earnings growth and were therefore paid $1B and $1.4B respectively in performance-based compensation in the period from the year 2000 right up until each firm collapsed in 2008.[ii]

These structures not only limit long-term strategic thinking, but highly incentivize risky and sometimes unethical behavior. The recent Wells

Fargo scandal is a perfect example of the negative effects from short-term incentives. On September 8th, 2016, the Consumer Financial Protection Bureau (CFPB) fined Wells Fargo "$100 million for the widespread illegal practice of secretly opening unauthorized deposit and credit card accounts. Spurred by sales targets and compensation incentives … employees opened more than two million deposit and credit card accounts that may not have been authorized by consumers".[iii] As of this writing, Wells Fargo stock has underperformed the S&P 500 since the scandal was reported by approximately 9.0% annually as a result.

What is the alternative?

It is simple to say, just tricky to do. *Long term investors should focus on long term data*. We should still care about valuations, earnings, margins, and profits, but we should care even more about future earnings growth and long-term risks.

Focusing on long-term data means caring A LOT about a company's corporate governance. It means looking at how a company structures its compensation and how that incentivizes employees. It means looking at the Board of Directors; are they independent and accountable, and do they bring diverse viewpoints to help avoid "groupthink"? And it means limiting risk through good executive oversight, to limit the harm that any one bad decision, person, team, or department can do to the company.

Focusing on long-term data means caring about a company's environmental impact relative to its industry. Particularly in carbon, land, or water-intensive industries, companies with worse environmental track records may save a few bucks this quarter but tend to build up much more legal and regulatory risk in the long-term. Lawsuits over environmental issues almost always cost more on a time-adjusted basis than the savings that were initially achieved. As regulations increase over time, the companies that are furthest behind are typically the most impacted and face the most expensive path to future compliance.

Focusing on long-term data means caring about a company's social impact, both on their workforce and their communities. Countless studies show a direct correlation between specific compensation, benefits, time off, and other policies with worker productivity. This trend is increasing as we move further into a service economy, and even more within the millennial workforce. The reputation that a company builds within the communities in which it operates tends to spill over into consumer perception and behavior, either positive or negative, in the long-term.

When we turn these Environmental, Social, and Corporate Governance (ESG) issues into measurable, quantifiable metrics and data points, we find that companies with better ESG scores provide better risk-adjusted returns in the long-term. In fact, the data on this has become so compelling that recently even the largest and most mainstream investors like Blackrock (largest asset manager in the world) are beginning to incorporate ESG data into all their funds for risk/return purposes.

As for the social and ethical impact, this is where it gets exciting. As previously mentioned, companies care about what shareholders care about. If we as investors change the data points we focus on in making investment decisions, we change the data points that companies are incentivized to focus on. In addition to competing on today's profit margin, we can also incentivize companies to compete on things like their carbon footprint, water quality impact, and executive compensation.

So, what is sustainable investing?

Is it a socially responsible investment strategy that happened to generate strong returns? Is it a quantitative investment strategy based on compelling performance metrics that also happens to align with our ethics? Whether it was the chicken or the egg – it doesn't matter. The reality is that we can have our cake and eat it too. Investing in a way that aligns with our ethics by encouraging responsible behavior from corporations and investing in a way that maximizes our long-term risk-adjusted return potential, are not opposing strategies, they are the same strategy.

Our original definition of sustainable investing was "committing money to earn a financial return that is able to be maintained at a certain rate or level". The reason this definition is important is not because it adds the element of time to that of financial return, but because it points out the absurdity of the fact that the element of time is not already an inherent part of "traditional" investment strategies.

Sustainable investing is righting the ship, fixing a flaw in modern finance that has had enormous repercussions throughout society. Sustainable investing is what should be the norm, and it is the fact that we must add the word "Sustainable" to get our meaning across that is abnormal. Just as nobody still says, "mobile phone", sustainable investing is the term we use today to describe an investment management strategy that someday will simply become known as "Investing".

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1 Graham, J, Campbell, H and Rajgopal, S. (2004) *The Economic Implications of Corporate Financial Reporting*. Available at: http://www.nber.org/papers/w10550.pdf

2 Bebchuk, Lucian A. and Cohen, Alma and Spamann, Holger, The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008 (November 24, 2009). Yale Journal on Regulation, Vol. 27, 2010, pp. 257-282; Harvard Law and Economics Discussion Paper No. 657; ECGI - Finance Working Paper No. 287. Available at SSRN: https://ssrn.com/abstract=1513522

3 "Consumer Financial Protection Bureau Fines Wells Fargo $100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts." *Consumerfinance.gov.* Consumer Financial Protection Bureau, 08 Sep, 2016. Web. 22 May 2018