Mainstreaming Responsible Investment

World Economic Forum

Global Corporate Citizenship Initiative

in cooperation with

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Preface

The World Economic Forum's Global Institute for Partnership and Governance is pleased to issue this new report of our Global Corporate Citizenship Initiative (GCCI), which concentrates on the key drivers of CEO and board leadership in corporate citizenship at the international level.

In its report two years ago, GCCI member companies identified an often sceptical investment community as having an important influence on how CEOs and boards view corporate citizenship. To understand better why the mainstream investment community places relatively modest emphasis on social, environmental, and ethical issues in investment valuation and asset allocation decisions, the GCCI launched a public-private workshop series on "Mainstreaming Responsible Investment" in partnership with AccountAbility. There have been many discussions on this question, involving corporate responsibility experts and representatives of funds devoted to socially responsible investment. We believe this is the first set of deep discussions on the topic involving primarily the mainstream actors themselves, including pension fund trustees and executives, portfolio managers of asset management firms, and buy-side and sell-side analysts.

The *Mainstreaming Responsible Investment* project has evolved over the past two years through a series of three roundtables and numerous discussions involving many leading practitioners across the investment community, public sector, civil society and labour community. We are appreciative of the many insights offered by these experts and are particularly grateful to the hosts of the roundtables: Deutsche Bank, Swiss Re and the UK Department of Trade and Industry.

We would like to thank our partner in this project, AccountAbility, and in particular, Mira Merme and Simon Zadek for applying their time, dedication and deep understanding of the subject matter to this endeavour. Very special thanks are due to the three investment community experts who contributed specific chapters on issues and recommendations relating to their particular parts of the investment value chain: Mehdi Mahmud, Executive Vice-President of Jennison Associates; Francis Condon, Head of European Steel Research, ABN AMRO Equities[1]; and Stephen Davis, President of Davis Global Advisers. They have provided exceptional thought leadership that amounts to an exemplary act of private sector leadership on a complex governance challenge.

Our appreciation also goes to Caroline Bergrem, the GCCI's former Project Manager as well as Stefanie Held and Valerie Weinzierl, the current Senior Project Manager and Project Manager, respectively. Finally, we extend our gratitude to the CEOs of Global Corporate Citizenship Initiative member companies and their teams. Their leadership is critically important to advancing the spirit and practice of global corporate citizenship.

Richard Samans, Managing Director
Global Institute for Partnership and Governance
World Economic Forum

Geneva, January 2005

Foreword

Foreword by the Rt Hon Patricia Hewitt MP,
Secretary of State for Trade and Industry, UK

Economically, environmentally and socially, our world is being transformed. No business can now work — if it ever could — in isolation from the wider society in which it operates. And so the challenges our world faces are part of the business climate not just of tomorrow, but today.

A strong society and a strong economy are two sides of the same coin. Responsible businesses are successful businesses — as those companies who are already making corporate responsibility (CR) key to their strategy will testify. That's why CR is not an add-on but a core part of the DTI's business strategy, contributing to our aim of prosperity for all.

When a business loses trust and legitimacy it is likely to lose also the loyalty of its customers, its employees and its investors. For this reason investors too are coming to see CR not just in terms of cost or even avoidance of risk, but as value added, and responsible investment as sound investment.

Calls for fundamental changes to the legal duties of company directors or pension fund trustees therefore miss the point. Successful companies are needed to produce the innovation, jobs and growth essential to achieving sustainable development in both developed and developing markets. At the same time they will deliver the financial returns on which their shareholders — and the beneficial owners of these holdings such as future pensioners — and their current employees depend.

Clearly there is a need for investors and those who manage their funds to have a better understanding of the factors affecting a company's performance, including social, environmental and ethical issues. This is the thinking behind the Operating and Financial Review which all UK quoted companies are to be required to publish.

We want to see investors taking an active interest not just in how well a company performs, but why — and raising concerns where they see problems. Some will vote with their feet and sell where they see a company failing to tackle market risks or suffering reputational damage. But this is not an option for the many investors who are in it for the long run, or who track the market, and pension funds in particular.

For this reason, any initiative to promote dialogue and a common understanding of the issues on the part of the various players involved can only be beneficial. So I very much welcome the work which AccountAbility and the World Economic Forum have done to bring together these different players — trustees, fund managers, analysts, company investor relations departments — to explore the issues and understand better how the others see them. My department was very pleased to play a part in this by hosting the third and final roundtable.

This report is a useful summary of the state of the debate. Though the conclusions and recommendations are of course the authors' own, they highlight some important areas for further work. The UK is already taking action in many of these areas. For example, in the field of occupational pensions:

- the government established a voluntary code of investment principles in 2001, and brought into effect legislation requiring funds to disclose their social, environmental and ethical policies;
- new pensions legislation strengthened the legislative requirements on member-nominated trustees, requiring all trustees to have appropriate knowledge and understanding of the principles governing pension scheme investment and funding — requirements backed by codes of practice.

The investment community itself is responding to the same trends. The Association of British Insurers' disclosure guidelines on socially responsible investment set out basic disclosure principles to guide institutional shareholders in engaging with companies in which they invest. The stock exchange has launched an initiative to consolidate the many different questionnaires used by analysts, rating agencies and indices to assess the corporate responsibility of a company. The "questionnaire fatigue" which this is designed to tackle is itself evidence of the growing interest in these issues by investors.

We may not yet have all the answers to creating long term, sustainable— in all senses of the word — business and investment. I believe, though, that the answers lie not in rethinking business and investment from scratch, but in the kind of improvements in knowledge and practice which are discussed in this report. I welcome the report and the process that has led up to it as a contribution to the debate.

Authors

Simon Zadek, Mira Merme, and Richard Samans are the report's lead authors.

Simon Zadek is Chief Executive of AccountAbility, a Senior Fellow at Harvard University, and has worked with numerous major corporations in the strategic development of their approaches to corporate responsibility. Simon has authored numerous books, reports and articles on corporate responsibility, including "The Civil Corporation and Tomorrow's History". (simon@accountability.org.uk)

Mira Merme is Senior Associate at AccountAbility with many years experience in development finance and until recently ran a group of publicly listed companies. Mira has authored various reports and articles on corporate responsibility, including her co-authorship of an AccountAbility report, "Redefining Materiality". (mira@accountability.org.uk)

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Three specialist chapters have been written on financial analysts, pension funds and fund management, respectively by Francis Condon, Stephen Davis and Mehdi Mahmud.

Francis Condon is the Head of European Steel Research, ABN AMRO Equities[2]. Francis has 16 years of experience as an equity analyst following six years with Prudential Assurance Corporation and ten years on the sell-side with ABN AMRO. In August 2004, Francis moved over to ABN AMRO's sustainable development team in Amsterdam. (francis.condon@nl.abnamro.com)

Stephen Davis, PhD, is president of Davis Global Advisors (DGA), the leading consultancy specializing in international corporate governance and publisher of the weekly "Global Proxy Watch" bulletin. His forthcoming book, *The Civil Economy* — co-authored with Jon Lukomnik and David Pitt-Watson — forecasts market architecture. He is a co-founder and former governor of the International Corporate Governance Network and founding partner of GovernanceMetrics International and g3, a corporate governance advisory firm working with the World Bank Group. (www.davisglobal.com)

Mehdi Mahmud is Executive Vice-President at Jennison Associates, a US investment firm. He is responsible for the investment oversight of the firm's "Value, Blend, and Small-Cap" equity capabilities. Mehdi is also responsible for setting the strategic direction of the firm. Previously, Mehdi was a portfolio manager at J.P. Morgan Investment Management, and served as deputy to the Global Chief Investment Officer at Credit Suisse Asset Management. (mehdi_mahmud@yahoo.com)

AccountAbility

AccountAbility is an international, non-profit membership organization developing and advocating approaches to accountability that promote sustainable development. Based in London since its formation in 1995, it has led in the development of corporate responsibility standards. AccountAbility undertakes leading edge research in such diverse fields as partnership and NGO governance and accountability, responsible lobbying, and national competitiveness and corporate responsibility. (www.AccountAbility.org.uk)

Executive Summary

Mainstreaming Responsible Investment

The Global Corporate Citizenship Initiative of the World Economic Forum, in association with AccountAbility, organized a series of discussions during 2003-04, with corporate and investment community executives, as well as other experts:

"To improve understanding of concrete impediments to and opportunities for broader integration of social and environmental aspects of corporate performance in mainstream investment policies and practices."

The initiative's core aim has been to identify specific obstacles to wider incorporation of non-financial considerations in the valuation and investment strategies of major institutional investors. These discussions also sought to explore possible changes in policies and practices that could 'tip' systemic change in the investment community in this direction.

Responsible investing is most commonly understood to mean investing in a manner that takes into account the impact of investments on wider society and the natural environment, both today and in the future. The most visible manifestation of this aspect of responsibility has been so-called 'socially responsible investment' (SRI). Initially confined to the negative screening of investment funds managed on behalf of specific religious communities, or targeted at a narrow range of specific issues such as apartheid South Africa, the last decade has seen an extraordinary growth in the scale and breadth of application of SRI. There is over US$ 2 trillion under professional management in the United States linked to some kind of socially responsible investment strategies, a fourfold growth over the last decade[3].

However, the logic of responsible investment — i.e., the deliberate incorporation of material social and environmental considerations in investment decision-making — has yet to be embraced by the wider investment community. Responsible investing remains a boutique segment of the industry despite widespread, if largely anecdotal, evidence that social and environmental factors affect market valuations both positively and negatively.

Most obvious are instances with direct legal consequences. ABB, for example, is one of many companies facing massive liabilities associated with asbestos. The financial markets discounted Wal-Mart's normally buoyant share price on news of the class action related alleged discriminatory labour practices. Market shifts associated with changing societal concerns are ignored at a company's risk. McDonald's, responding late but forcefully to obesity and broader health concerns, was duly rewarded with a rise in profits and share price. Broader political risk can be rooted in the dynamics of progressive social change. Sasol's SEC 2003 filing highlights the slow pace of black economic empowerment as a significant risk that may adversely affect the business, operating results, cash flows and financial condition. Similarly, recent poor performance in Europe of leading US retail brands has been attributed by some business commentators to broader international disenchantment with the US. More positively, shares in Brazil's top cosmetics group, Natura, offering mid-range products grounded in strong social and environmental credentials, soared upwards on their debut on the Brazilian stock market in June 2004.

Despite these and other examples, attention to non-financial factors within the wider investment community remains largely reactive and episodic. What could propel responsible investing from the boutique to the mainstream? Based on three roundtable discussions involving mainstream investment fund managers, analysts, trustees and advisors convened in 2003-04 by the World Economic Forum's Global Corporate Citizenship Initiative and AccountAbility, the answer is likely to be found in the major demographic changes sweeping most advanced industrialized countries and transforming the nature of corporate share ownership.

The New Landscape of Corporate Share Ownership

Today, beneficial owners — those who will ultimately benefit from share ownership of large corporations — are no longer the wealthy privileged few. Particularly in Northern Europe, North America and Japan, but increasingly on a global basis, the beneficial owners are now the huge majority of working people who have their pensions and other life savings invested in shares of the world's largest companies. The biggest two shareholding bodies in Britain, for instance, are the British Telecom and the mineworkers pension schemes. In Denmark it's the workers' pension fund, the civil service fund in Holland, the public employees of California in the United States, and in Canada, the teachers and civil servants of Ontario. Each of these funds holds a small share of literally thousands of companies. Further, it isn't just that domestic funds own the companies in their own nation. Increasingly, funds have an ever-larger proportion of their equity invested internationally. Quite literally then, these and other such funds constitute the majority ownership of our corporate world. Each pensioner owns a tiny interest in vast numbers of companies. From the telecoms of Panama to the chemical companies of Germany,

from the electronics companies of Silicon Valley to the oil wells of Nigeria, millions of citizens are the beneficial owners.

Most individual participants in pension plans, mutual funds, and insurance companies are investing to provide for their retirement or other long-term financial needs. In this sense, the widespread benchmarking within the fund management industry against short-term performance benchmarks that fail to take account of social, ethical, and environmental aspects of corporate performance is increasingly out of step with underlying client interests. Social and environmental factors can be quite significant drivers of longer term financial performance, particularly through their influence on the enabling environment for business operations and investment. In the long run, the vitality of markets is influenced greatly by prevailing legal, regulatory and macroeconomic conditions, which ultimately reflect policy — i.e., political — choices made by democratic societies. While a serious problem or major opportunity associated with the environmental or social performance of a particular business model may not manifest itself in the short term, it may well show up in financial results and market valuation over time as consumers, regulators, voters or plaintiffs lose confidence and respond accordingly.

Investment is first and foremost about meeting the needs of the owners of capital. If the real owners of most of the capital in today's markets are mainly the intended beneficiaries of the pension funds, mutual funds and insurance companies, then the *responsibility of these investors will increasingly be to meet the intrinsic interests of pension plan participants and insurance policyholders* in not only competitive near-term returns, but also the long-term vitality of their countries' economies, societies and environments. This will require the *deliberate incorporation of material social and environmental aspects of corporate performance in investment analysis and decision making*, grounded in:

1) full appreciation of the rights and long-term interests of the ultimate beneficiaries of funds that typically have very long-term liabilities; and
2) broad understanding of the factors, such as social and environmental considerations, that could influence returns over the long term.

In this important sense, it is the transformation of share ownership by rapidly aging populations in most industrialized countries that is fundamentally altering our conception of responsible investment and potentially driving it into the mainstream financial community, in ways that the founders of the original SRI funds might not have imagined possible.

The Systemic Nature of the Challenge

That the investment value chain (e.g., pension/mutual funds, advisors, asset management firms, analysts, etc.) as a whole does not factor in social and environmental issues is not most usefully understood in terms of the personal values of its participants. It arises because of today's blend of available information, participant competencies and, most of all, institutionalized incentives that drive behaviour. These factors combine in creating the perception that significant competitive disadvantage will befall any one player that strays from customary practice. That is, the development of responsible investment is impeded by a classic "prisoner's dilemma" in which it is in no one's interest to take the first step alone in making changes, notwithstanding that all players could benefit.

Fund managers point to the role of their clients in driving their focus on short-term performance. As one fund manager argued, "As long as client [e.g., pension fund trustees] mandates require us to deliver performance benchmarked against short-term market tracker indexes, we will of course remain short-term in our outlook." Analysts, similarly, argued that they could rarely advance social and environmental performance issues so long as their clients, fund managers, were only concerned with drivers of short-term performance and market valuations. One analyst summarized his experience thus, "Strategic research on future social and environmental risks and opportunities got me my five minutes of fame. But there were no buyers for the work, and this is what counts at the end of the day. Given the choice again, if I want to stay in business, I would not do such research."

Such behaviour in financial markets has a tangible impact on the real economy. One extensive study found that, "Because of the severe market reaction to missing an earnings target, firms are willing to sacrifice economic value in order to meet a short run earnings target…. The preference for smooth earnings is so strong that 78% of the surveyed executives would give up economic value in exchange for smooth earnings.… We find that 55% of managers would avoid initiating a very positive [Net Present Value] project if it meant falling short of the current quarter's consensus earnings."

Specific Impediments

Following are some of the most salient impediments to broader consideration of non-financial factors by the mainstream investment community, identified by the project's three roundtable discussions and further developed in

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chapters of this report, contributed by three distinguished participants (Mehdi Mahmud, Executive Vice-President of Jennison Associates; Francis Condon, Head of European Steel Research, ABN AMRO Equities[4]; and Stephen Davis, President of Davis Global Advisers).

Asset management. Fund managers must act in *demonstrable compliance* with the performance objective of optimizing clients' financial returns, which is typically defined in their contracts relative to certain benchmark indices, at specific levels of risk, and/or with respect to pre-defined peer groups. The need for demonstrable compliance creates a burden of proof on the part of the fund manager, which at best heightens managers' sensitivity towards risk-taking and at worst encourages inertia around "tried and true" approaches that are easily defensible. This high level of regulatory awareness and scrutiny, combined with the widespread use of benchmark indices and clients' gradually shrinking time horizons for performance evaluation, is a powerful driver of conservatism among fund managers with respect to innovation. Today, these indices are ubiquitous, so much so that what began as a means of more rigorously measuring fund managers' performance has gradually become a constraint on fund managers' discretion. While there are exceptions, the empirical evidence is that the average manager's propensity to assume risk relative to their respective benchmarks (a statistical measure called tracking error) has declined over time, leading to greater clustering of fund managers' returns. As the time horizon for evaluating performance has gradually shortened, investment management companies have evolved their business models accordingly. The time horizon for business planning has shrunk, with many companies aggressively managing their line-up of products to meet evolving demands in the marketplace. As business planning and compensation practices go hand in hand, it is not surprising the compensation practices in the industry have evolved towards shorter-term performance. If left unchecked, this is likely to further encourage clustering of fund managers' performance around narrowly defined benchmarks and discourage adoption of broader, longer-term perspectives in fund managers' investment decisions.

Investment analysis. The broad philosophy of responsible investment has made little headway among most mainstream equity analysts. This reluctance to move the research time horizon beyond the foreseeable and the quantifiable represents a concern that such analysis falls short of being "commercial". Three major impediments are: (1) the current data set of performance indicators does not yet add up to a consistent whole (i.e., company data on social and environmental performance is patchy, often unaudited and lacking in historical benchmarks); (2) there is limited ability among the current population of investment analysts, and new analysts are receiving too little training in the use of non-financial criteria in financial valuation; and (3) the way that sell-side equity analysts are paid represents a significant disincentive to challenging this situation. On the buy-side, research analysts who have spent years honing their analytical skills and industry knowledge — and are therefore at peak levels of preparedness to perform truly differentiating investment research on companies' long-term business models — are typically removed from specialist roles and placed into more generalist fund management positions where there is less scope to apply such skills and knowledge.

Pension funds. The greatest impediment to the ability of pension plans to reflect the inherently long-term investment horizon of their participants is perhaps the one most deeply embedded in their own architecture. Most funds fail to meet the bedrock governance standards they increasingly demand of companies. This can most clearly be seen in the principal ways in which accountability and transparency fall short. For example, savers can only rarely discover how their funds are managed. They normally have no voice in how the funds operate or who makes key fund decisions. Corporate funds and employee stock plans in many jurisdictions are entirely or largely controlled by company management. Boards of trustees of pension schemes generally do not operate as professional oversight bodies. Recent probes in the US, UK and the Netherlands have exposed many of the flaws. Most trustees are not getting trained, spend too little time on the job, communicate too little with scheme members and ignore shareowner activism and socially responsible investment, according to a Consensus Research report for the UK Department of Work and Pensions[5]. They are typically not paid or given authority comparable to directors at public companies, and few spend efforts assessing their own performance or communicating with beneficiaries. In other cases, particularly those of civil service funds, trustee boards may be swayed excessively by political factors. Moreover, intermediaries such as investment advisors, gatekeepers, consultants and fund managers that link trustees to the investment process typically dominate trustee decision-making. Finally, too many funds rigidly split the functions of ownership and portfolio trading. The responsibilities to vote shares and monitor social, ethical and environmental (SEE) and governance may often fall into a compliance or legal division, while professionals doing the buying and selling of shares are rarely encouraged to gain knowledge and experience in the ways in which SEE and governance affect risk and performance of particular companies.

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Opportunities for Progress

Responsible investment requires an orientation towards strategies that optimize long-term returns, both because this delivers better financial returns over the time profile that interests intended beneficiaries, and because over these periods social and environmental issues become more material and so can be better considered. Realigning fund management towards the longer-term performance of their investees requires a host of measures, embracing changes in incentives, competencies and available information. Following is a summary of recommendations emanating from the roundtable discussions and chapters contributed by expert participants:

Modify Incentives

- Establish an international set of good governance principles for pension funds — a voluntary Fund Governance Code? that ensures accountability (disclosure of votes, policies, and management relationships) and professionalism (training, representation) on the part of boards of trustees. The aim of these principles would be to ensure the representation of long-term beneficiary interests in intent, capability and practice.
- Modify pension fiduciary rules which discourage or prohibit explicit trustee consideration of social and environmental aspects of corporate performance.
- Increase the average duration of asset manager mandates to lend momentum to current experimentation with fund manager compensation arrangements linked to superior long-term performance.
- Increase disclosure of fund manager compensation structures to encourage better linkage between pay and long-term performance.
- Develop new business models for research on non-financial issues by analysts and incorporate this into the current regulatory review of the sell-side analyst function in diversified investment houses.
- Require analysis of material non-financial factors to be included in pension fund mandates to asset managers.
- Re-evaluate the relationship and relative organizational standing of buy-side analysts and portfolio managers in order to cultivate a more attractive long-term career path for analysts, allowing for the accumulation of necessary expertise.
- Develop new performance assessment models that enable trustees to support long-term investment strategies while complying with fiduciary obligations.

Build Competencies

- Pay, train, and empower pension fund trustees more like corporate directors in order to increase the capacity of boards of trustees to exercise independent judgement in the long-term interests of beneficiaries.
- Create a specific professional competency for non-financial analysis either through increased training of existing investment analysts or the establishment of a new category of specialists.
- Increase the emphasis on non-financial aspects of corporate performance in graduate business schools and mid-career analyst educational programmes.

Improve Information

- Improve the consistency of the content, collection and assurance of material non-financial information.
- Refine the concept of materiality and the basis for measuring and communicating its application to the links between financial performance and social and environmental performance.
- Expand the dialogue between analysts and corporate investor relations officers on the need for greater consistency in the content, collection and assurance of non-financial information.

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Extending the Dialogue

It became apparent through the course of the project that considerable value could be realized by deepening the dialogue among companies, pension trustees, advisors, fund managers, analysts, policymakers and independent experts on many of the impediments and opportunities for progress cited above. Many promising areas for continued discussion and research are posed by the following questions:

- What might an international set of voluntary principles for good governance of pension funds contain?
- Which jurisdictions would benefit by a change in fiduciary guidelines to provide greater scope for consideration by trustees of social, ethical, and environmental considerations, and how should such changes be structured for maximum benefit and minimum effect on existing legal structures?
- What new business models for non-financial research by the buy- or sell-side are possible, perhaps driven by changes in the mandates provided by pension funds to asset managers?
- How could compensation arrangements for portfolio managers be modified to encourage increased focus on long-term performance, and what conditions would be need to be present for such practices to become more commonplace within the industry?
- How might a professional competency in non-financial issues be developed more fully within the investment analyst community?
- How could the content, assurance, and collection of corporate non-financial information be improved so that it would be of greater utility to investment analysts?
- What new performance assessment models and strategic management tools (integrating social and environmental factors) show particular promise?
- What does the responsible investment debate imply for investment in debt and derivative instruments?

Integrating social and environmental considerations into the investment decision process is slowly moving from an incidental activity to one that is integral to the fundamental changes sweeping the investment world. It is increasingly central to an appreciation of the interests of the tens of millions of individual participants in pension funds, mutual funds and life insurance policies who now comprise the bulk of share ownership and, by extension, the future role of financial markets in supporting global economic growth and social progress. The World Economic Forum's Global Corporate Citizenship Initiative and AccountAbility look forward to the opportunity to continuing this vitally important discussion.

Progress and Impediments

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14 The State of Responsible Investment

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23 Barriers to the Mainstream Practice of Responsible Investment

A Dialogue On Responsible Investment and the Mainstream Investment Community

During 2003 – 2004, the Global Corporate Citizenship Initiative of the World Economic Forum, in association with AccountAbility, organized a series of discussions with corporate and investment community executives as well as other experts:

To improve understanding of concrete impediments to and opportunities for broader integration of social and environmental aspects of corporate performance in mainstream investment policies and practices.

The initiative's *core aim* has been to identify specific obstacles to wider incorporation of non-financial considerations in the valuation and investment strategies of major institutional investors. These discussions also sought to explore possible changes in policies and practices that could "tip" systemic change in the investment community toward this direction.

The *learning from the initiative* has come from a dialogue grounded in three roundtables, convening senior representatives from a cross-section of the investment community[6] together with members of the Global Corporate Citizenship Initiative and other experts, including key governmental, labour and academic leaders. This dialogue was supported by other key initiatives in this field as well as a range of available research documented in endnotes to this report.

"Mainstreaming Responsible Investment" summarizes perspectives and issues raised throughout the dialogue, including specific chapters authored by participants reflecting perspectives from key elements of the mainstream investment community: pension funds, fund managers and investment analysts. The views expressed in this report do not necessarily reflect the views of individual members of the World Economic Forum's Global Corporate Citizenship Initiative or AccountAbility.

The Roundtables

Mainstreaming Responsible Investment, London, July 2003
The first roundtable, hosted by Deutsche Bank, broadly explored investment community perceptions of the relevance and treatment of social and environmental aspects of corporate performance. The discussion focused upon three key factors that could either *inhibit or drive* effective change: (a) information; (b) knowledge and competencies; and (c) incentives. In attendance were 40 senior representatives from the international investment community and related institutions, including representatives from major pension funds (e.g., CalPERS, USS), asset management companies (e.g., Goldman Sachs, HBOS), representative and regulatory institutions (e.g., US Public Accounting Committee Oversight Board, Association of British Insurers), and business networks (e.g., International Business Leaders Forum, World Business Council for Sustainable Development).

Trustees and Fund Managers, New York, October 2003
The second roundtable, hosted by Swiss Re, explored key relationships in the "investment value-chain", notably between institutions representing the intended beneficiaries and ultimate owners of capital, and those mandated to invest funds on their behalf. A particular focus was on *embedded incentives* that determine to a great degree the outcome of these relationships. It was attended by sector representatives of fund management (e.g., Citibank, Jennison Associates, Strategic investment Group, Zurich Financial Services, Barclay Global Investors) and pension fund trustees and managers (e.g., New York City Employees Retirement System, New Zealand Superannuations Scheme, NYC Comptrollers Office, BT Pension Fund), and labour representatives.

Financial Analysts, London, June 2004
The third roundtable, hosted by the Department of Trade and Industry of the UK government, brought together analysts, fund managers and corporate investor relations officers to explore how *analysts' information, competencies, and incentives impact on valuations and decision-making*. The focus was on how analysts, ratings organisations and investor relations made decisions as to whether to factor in specific non-financial aspects of performance. It was attended by executives of fund management/buy-side (e.g., Merrill Lynch Asset Management, ISIS, Hermes Focus Asset, Morgan Stanley and Co, Nomura Asset Management), corporate investor relations officers (e.g., Novo Nordisk), insurance companies (e.g., SwissRe, Standard Life) and investment bank/sell-side analysts (e.g., Merrill Lynch Asset Management, ABN AMRO, Goldman Sachs).

Note: A full list of participants is included in the annex to this report.

The State of Responsible Investment

Context

A. Increasing attention on the importance of *business in economic development,* incorporating respect for its social and environmental impact.

B. Concern about the *quality of risk assessment* in investment decisions.

C. Growing recognition that social and environmental performance *materially affects* investment returns.

D. Appeals for *"socially responsible investment"* to evolve beyond its current niche in financial markets.

E. Emerging *public policy discussions* about the changing nature of corporate and fiduciary responsibility in today's global economy.

Broad Context

Business behaviour has always shaped societies as well as markets. This impact has become more powerful with the growing role of private business in the delivery of education, health and other public goods. Pressure on business to adopt credible, responsible practices has been amplified as part of the contentious global debate about the role of business in society and its associated responsibilities. The call for business to adopt "corporate citizenship" practices embraces an ever-broadening range of issues, from human rights and carbon emissions, through to privacy, religious tolerance and financial responsibilities to pension holders.

The willingness of investors and consumers to both punish and reward companies for their handling of such issues have increased the importance of non-financial aspects of performance in underpinning business success; in short, the "business case" for responsible practices. From a societal perspective, the extension of business responsibilities to account for more than narrow definitions of financial performance is increasingly seen as crucial in addressing social and environmental challenges[7].

These business and societal gains are, and rightly must be, intimately connected. This aim and fact is increasingly recognized by business and other communities of interest. At the World Economic Forum Annual Meeting in New York in 2002, for example, CEOs of the Forum's Global Corporate Citizenship Initiative issued a joint statement expressing the view that:

"Leaders from all countries, sectors and levels of society need to work together to address these [social and environmental] challenges by supporting sustainable human development and ensuring that the benefits of globalization are shared more widely. It is in the interests of business that these benefits continue both for companies and for others in society." [8]

Just as other parts of the business community are embracing corporate citizenship, parts of the mainstream investment community are beginning to do the same. A survey exploring the perceived importance of corporate citizenship to key players in the European investment community was undertaken during 2003 by Deloitte, and reported in the Global Corporate Citizenship Initiative's recent report "Values and Value: Communicating the Strategic Importance of Corporate Citizenship to Investors", completed in association with the International Business Leaders Forum[9]. The survey concluded that a growing proportion of investors, analysts and investor relations officers viewed social and environmental issues as of growing importance to business performance and market value.

There are varied reasons why the investment community is waking up to the significance of social and environmental drivers of investment performance. Core to this is the consolidation of the industry. Almost –50% of all ordinary shares listed on the UK's London Stock Exchange, (worth over US$ 1 trillion), are owned by insurance companies, pension funds and other institutional shareholders. This consolidation of financial services has greatly accelerated interest in the more effective management of social and environmental externalities. Insurers are a particular case in point, faced with risks both as investors and insurer. A recent West LB report pointed out that claims on insurance companies relating to losses following 9/11 were in the order of US$ 20 billion, but that in addition stock market losses of insurance companies, following 9/11, were in the order of US$ 60 billion[10]. Richard Murray, Chief Claims Strategist at Swiss Re, puts the point firmly in reference to climate change, "We do not wish to do business with policy holders who are not willing to deal with issues like this and we are going to be more selective about who we'll do business with, bearing that in mind."

Do social and environmental factors affect returns?

The underlying link between financial returns and how businesses manage their social and environmental performance has long been a topic of debate and extensive research[11]. Crucially, however, is whether these interests intersect by impacting directly on share price, or at least are

Values and Value

- Investor relations officers (IROs) believe that good social and environmental performance in the long-term strongly influences a company's brand and reputation (69%), economic performance (46%) and market value (36%).
- For 79% of fund managers and analysts, the management of social and environmental risks has a positive impact on a company's long-term market value.
- Both fund managers/analysts (52%) and IROs (47%) believe that social and environmental considerations will become a significant aspect of mainstream investment decisions over the next two years.
- The majority (85%) of IROs are convinced that the next three years will see more legal requirements imposed on companies for social and environmental reporting.

Source: "Values and Value: Communicating the Strategic Importance of Corporate Citizenship to Investors", World Economic Forum and International Business Leaders Forum, 2003

reported by businesses as price relevant. While there are many constraints to such an impact, there are a growing numbers of cases exhibiting such a connection.

The evidence is increasingly clear that these factors count. Over US$ 2 trillion under professional management in the United States are linked to some kind of socially responsible investment strategies, a fourfold growth over the last decade[12]. And social and environmental factors are beginning to affect market valuations. Most obvious are instances with direct legal consequences. ABB, for example, is one of many companies facing massive liabilities associated with asbestos. The financial markets discounted Wal-Mart's normally buoyant share price on news of class action related alleged discriminatory labour practices. Market shifts associated with changing societal concerns are ignored at a company's risk. McDonalds, responding late but forcefully to obesity and broader health concerns, was duly rewarded with a rise in profits and share price. Broader political risk can be rooted in the dynamics of progressive social change.

Responsibility Counts

- *McDonald's.* McDonald's introduced a range of premium salads to sit alongside the fattier fare, pledged to phase out the super-size portions by the end of 2004 and changed its chicken nuggets "formula" to make them white meat only. Jim Cantalupo, Chairman and CEO of McDonald's commented, "We are responding to lifestyle issues with an initiative that focuses on three important areas: menu choice, physical activity and education." Alongside other changes it was marked by a 56% rise in first quarter net profit reported in April 2003. The changes doubled the fast food giant's share price.[13]
- *ABB.* In 2001, ABB financial statement notes attributed US$ 470 million of its reported total US$ 510 million losses (on a net income loss of US$ 610 million) to asbestos-related liabilities. However by 30 June 2002, a new 20F filing (Item 5. Operating and Financial Review and Prospects Contingencies and Retained Liabilities Asbestos Claims) stated there was an accrued liability of US$ 1,118 million as of 31 December 2002, for resolution of the asbestos-related personal injury claims against Combustion Engineering, Lummus and Basic.[14]
- *Sasol's* SEC 2003 filing states on future risks that South Africa still faces a series of social, political and economic challenges which may adversely affect the business, operating results, cash flows and financial condition. Sasol declares that it cannot assure investors that these transactions will take place at fair market terms.[15]
- *Wal-Mart's* disclosure to the SEC on material changes to the business states that: "The California Department of Labor Standards Enforcement has initiated an investigation of Wal-Mart for alleged failures to comply with California wage-and-hour laws…. If the Court certifies a class in this action and there is an adverse verdict on the merits, or in the event of a negotiated settlement of the action, the resulting liability could be material to the Company, as could employment-related injunctive measures, which would result in increased costs of operations on an ongoing basis." [16]
- *Natura Cosmeticos.* The shares of Natura Cosmeticos SA ordinary shares, Brazil's top cosmetics group, soared almost 12% on their debut on the Brazilian stock market in June 2004. Unibanco analyst, Ramanho, stated, "From what we can see about the company's history, you really have to search hard to find anything negative. Natura was founded in 1969 and sells beauty and health products it says use natural ingredients grown in an ethical and sustainable way." [17]

Sasol's SEC 2003 filing highlights the slow pace of black economic empowerment as a significant risk that may adversely affect the business, operating results, cash flows and financial condition. Similarly, recent poor performance in Europe of leading US retail brands has been attributed by some business commentators to broader international disenchantment with the US. More positively, shares in Brazil's top cosmetics group, Natura, offering mid-range products grounded in strong social and environmental credentials, soared almost 12% on their debut on the Brazilian stock market in June 2004.

These developments, however, have to be balanced against a background of continued marginalization by the investment community of most social and environmental issues. As one analyst commented in one of the roundtables, "We do look at long-term factors, but they are strictly background to the dominant variables like free cash flow and, to be frank, rumours on the street about the company." A major survey of UK investors' attitudes to environmental and social issues found that less than 5% of financial analysts and fund managers, when asked (unprompted) what they take into account when making or recommending investments, mentioned social and environmental aspects of corporate performance.[18] Similarly, the same survey cited in "Values and Value" found that the majority of fund managers and analysts did not believe that social and environmental factors affected short-term market valuation. That is, even where there is a growing belief that social and environmental issues do, should or could count, the fact is that most analysts and fund managers do not take such factors adequately into account. This fact is rooted in short-term horizons dominating today's financial markets, and associated approaches to valuation and profit-taking, and reflects a continued resistance to mainstreaming responsible investment.

Nevertheless, there is little doubt that investors are taking non-financial issues more seriously, as a growing number of leading practitioners, public bodies and thought leaders profile both the potential and necessity of such a development.
A growing number of financial institutions have declared their commitment to sustainable development or some variant of corporate responsibility. For example, twenty major investment companies ? including Banco do Brasil, Credit Suisse Group, Deutsche Bank, Goldman Sachs, HSBC and Morgan Stanley ? have endorsed a recent United Nation Global Compact initiative report[19] providing guidance in this respect. Similarly, the Global Reporting Initiative is working with ten financial institutions from Australia, Germany, the Netherlands, South Africa, Switzerland and the UK in developing a sector-specific reporting supplement.

An Emerging Responsible Investment Movement?

The *"Responsible Investment Initiative"* was launched in mid-2004 by the *United Nations Environment Programme Finance Initiative (UNEP FI),* with investors proposing a global alliance to guide responsible investment best practice. Twelve firms from the asset management sector have committed to developing the ability of mainstream fund managers to identify and respond to social and environmental issues relevant to their profession. (http://unepfi.net)

The World Business Council for Sustainable Development (WBCSD)'s *"Capital for Change"* guide for investors aims to support sustainable livelihood business activities that serve the needs of the poor and contribute to companies. "Finding capital for sustainable livelihoods businesses" advises companies to shift their financing strategy from a "centralized" capital strategy, which primarily involves commercial banks, to a "distributed" capital strategy. (www.wbcsd.com)

Twenty major investment companies have endorsed a recent United Nation Global Compact publication "Who Cares Wins — Connecting Financial Markets to a Changing World" on connecting financial markets to environmental, social and governance criteria, and agreed on how these factors would become standard components in the analysis of corporate performance and investment decision-making. (www.unglobalcompact.org)

The *Equator Principles* represents an industry approach for financial institutions in determining, assessing and managing environmental and social risk in project financing, and has been signed by 27 major banking institutions. (www.equator-principles.com)

Fannie Mae Initiative - More than US$ 80 million has been committed for local anti-predatory initiatives in cities across the country, as part of a responsible lending strategy. (www.fanniemae.com)

The *Investors' Right-to-Know* campaign asks US mutual funds to voluntarily publicly disclose their proxy voting polices and voting records, in order to make mutual funds more accountable and lead to a stronger corporate governance process that balances the interests of all stakeholders – stockholders. (www.responsiblewealth.org)

The Corporate Library evaluates "board effectiveness" based on indicators of special interest to shareholders and investors, to determine which boards are most likely to enhance and preserve shareholder value and which boards might actually increase investor risk. (www.thecorporatelibrary.com)

The State of Responsible Investment

The Coalition for Environmentally Responsible Economies (CERES) represents a network of over 80 organizations including environmental groups, investors, advisors and analysts representing over US$ 400 billion in invested capital, public interest and community groups endorsing the CERES Principles. (www.ceres.org)

Tomorrow's Company's "Restoring Trust: Investment in the 21st Century" makes recommendations for voluntary initiatives for change, based on consultation and research led by a team of 20 top UK business and financial leaders, including interviews and workshops with over 500 investment professionals. (www.tomorrowscompany.com)

The *Carbon Disclosure Project* (CDP), a group of institutional investors representing assets in excess of US$ 10 trillion, launched its report on climate change and shareholder value. The report, by Innovest Strategic Value Advisors, is based on responses to CDP's second information request to the FT500 Global Index of companies. (www.cdproject.net)

What Is Responsible Investment?

Investment is first and foremost about meeting the needs of the owners of capital. The single largest portion of invested funds today is associated with pension liabilities; therefore, responsible investing must begin by ensuring that these liabilities to current and future retirees, most of whom will not retire for another 20 years or so, will be met. However, the public is losing confidence in those who have historically been responsible for delivering acceptable income levels to older people. An opinion poll by Market & Opinion Research International (MORI) in the UK found that two-thirds of respondents did not trust companies to deliver on their pension commitments. Similarly, an international study released by the Principal Financial Group found that only 5% of respondents thought that their governments were adequately guaranteeing financial security for retirees[20].

Such views are fuelled in part by reports of companies seeking to shed substantial portions of their pension obligations[21]. A recent study by UBS, for example, estimates that pension fund shortfalls for the top 500 US companies amounted to a staggering US$ 278 billion at the end of 2003[22]. The New York State and City pension funds lost a combined US$ 16 billion during the period 2001-2002. Over that same period, the average 50-year-old American lost almost US$ 11,000 out of a 401k balance of US$ 92,000, and the 39.6 million Americans with 401k accounts who were aged 30 and over lost an estimated US$ 311 billion[23]. Worse still, the precipitous losses in 401k accounts in the early years of the new millennium were, according to one reputable source quoted in *The New York Times*, attributable as much to poor investment decisions as to the decline in the US stock market[24].

Responsible investing is more commonly understood to mean investing in a manner that takes into account the impact of investments on wider society and the natural environment, both today and in the future. The most visible manifestation of this aspect of responsibility has been referred to as "socially responsible investment" (SRI). Initially confined to the negative screening of investment funds managed on behalf of specific religious communities or targeted at a narrow range of specific issues such as apartheid South Africa, the last decade has seen an extraordinary growth in the scale and breadth of application of SRI. The US-based Social Investment Forum's bi-annual report on "Socially Responsible Investing Trends" (for 2003) states that US$ 2.16 trillion under professional management in the United States is linked to some kind of socially responsible investment strategies. This is nearly four times the US$ 639 billion the Forum identified in 1995[25], or about 12% of the US$ 19.2 trillion in investment assets under management in the US estimated in the 2003 *Nelson's Directory of Investment Managers*[26].

Screened "socially responsible funds" have been a crucially important development, but need to be understood as part of a broader landscape of responsible investment. Responsibility is first to the owners of capital, affording them the right to make decisions as to the application of their property within the law. These choices may remain narrowly based on financial considerations, framed by preferred time periods and selected trade-offs between risk and reward. However, they may and often do include non-financial considerations. Indeed, the connection between financial and non-financial performance may ultimately prove to be of greatest significance, because social and environmental factors can be important drivers of longer-term financial performance through their influence on the enabling environment for business operations and investment. In the long run, the vitality of markets is influenced greatly by prevailing legal, regulatory and macroeconomic conditions, which ultimately reflect political/policy choices made by democratic societies. While a serious problem with the environmental or social sustainability of a particular business model may not manifest itself in the short run, it may well demonstrate itself in financial results and market valuation over time as consumers, regulators, voters or plaintiffs lose confidence and react accordingly.

Traditions of Responsible Investment

Benjamin Graham, in his well-respected book *The Intelligent Investor*, distinguishes the investor from the speculator: *"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."*

Thus, in financial markets increasingly dominated by institutional investors, who intermediate the pension savings of plan participants having inherently long-term investment horizons, responsible investment requires the *deliberate incorporation of material social and environmental aspects of corporate performance in investment analysis and decision making*. It relies on:

- a full appreciation of the rights and long-term interests of the ultimate beneficiaries of funds that typically have very long-term liabilities; and
- broad understanding of the factors, such as social and environmental considerations, that could influence returns over the long-term.

If the real owners of most of the capital in today's markets are mainly the intended beneficiaries of the pension and mutual funds, then responsible investing requires Graham's edict to be viewed in a new light. The investor's responsibility will increasingly be to *meet the intrinsic interests of pension plan participants and insurance policyholders* in not only competitive near-term returns, but also the long-term vitality of their countries' economies, societies and environments. In this important sense, it is the transformation of share ownership by rapidly aging populations in most industrialized countries that is fundamentally altering our conception of responsible investment and driving it into the mainstream financial community in ways that the founders of the original SRI funds might not have imagined possible.

Modes of Responsible Investment

The New York taxi driver ("day trader") and Warren Buffet's Berkshire Hathaway are both investors. But beyond the headline, they share little in common. The day trader adopts essentially an arbitrage strategy, seeking to gain from very short term price movements. Berkshire Hathaway, on the other hand, seeks to invest in undervalued but well-managed companies with strong fundamental growth prospects or in under-managed but otherwise promising companies whose performance could be boosted through an improvement in strategy or competencies.

Debating what "investors" think or want or do is therefore unhelpful without first identifying which classes of investors are under the microscope. Opinion surveys, for example, that set out "what investors think" without carefully distinguishing between very divergent investor interests are essentially meaningless and counter-productive. This is as true when the topic is "likely market movements" as it is concerning the relevance of social and environmental issues in the investment decision.

But not all differences are equal. The day trader, for example, will rarely have any interest in a company's long-term business strategy, whereas a long-term player like Hermes will have little interest in short-term price changes save where they portend deeper and longer-term movements. Similarly, the need to distinguish investor classes is particularly important when it comes to most social and environmental issues. Investors with a short-term focus will tend to be uninterested in such matters, save where there are regulatory, or immediate and catastrophic reputational implications. Investors with a longer-term perspective, on the other hand, might be more concerned with the impact of social and environmental issues on business performance, but respond to such information in diverse ways, depending on their size or investment strategy.

Responsible Investment Modes

- *Transactional*: where social and environmental assessment is applied only within a short-term trading strategy
- *Stewardship*: where the investor engages with corporate management in order to influence and improve corporate governance, social and environmental impacts and financial performance
- *Universal*: where the investor takes account of externalities arising from the activities of both their own and other investees' activities as material to their own performance

For our purposes, we have distinguished three broad investment modes, each of which implies distinct approaches to the matter of "responsibility".

Transactional Responsible Investing

"Transactional Responsible Investing" is a term coined to encompass an approach to investment where social and environmental assessment is applied only within a short-term trading strategy. Transactional investing is common to both the small day trader and the bulk of institutional investors, albeit in different ways. The former is, quite literally, making daily "freestyle" decisions about where to place limited funds. The latter are transactional in the sense that they focus on building and managing indexed portfolios, often covering large parts of the "investible universe", where trading decisions that change the balance of stocks held within portfolios are effectively governed by short-term market movements that impact the index. The average length of time which US mutual funds own individual shares has fallen to a record low of 10 months, compared to an average hold of 7 years in the 1950s[28]. This latter investment approach, somewhat ironically, is termed "perpetual investing".

> "When pension funds say they are long-term investors, what they mean is that they have rolling investments in largely indexed linked funds. To speak accurately, this makes them *perpetual investors* making short-term investments, forever."
> Simon Zadek, Chief Executive, AccountAbility[27]

Transactional responsible investing has until recently been largely underpinned by retail consumer demands to take into account aspects of non-financial performance. This classically leads to the exclusion of "sin stocks" (alcohol, tobacco, weapons, etc.), but can have geographic implications, such as the avoidance of investments in South Africa during the apartheid period by the likes of California Public Employees' Retirement System (CalPERS), or similarly their decision not to invest in Indonesia, Thailand, the Philippines and Malaysia because of their perception of systemic human rights problems.

Screening has been used where trustees have had clarification that this is not contrary to fiduciary duty. The traditional view is that the remit of a trustee must be to maximize financial returns, and so does not allow for a restriction of investment criteria that might impact on performance in these terms[29]. Typically, fiduciary duties are framed in the following manner, although there are variations between different jurisdictions: "The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan

Modes of Responsible Investment

expenses"[30]. Interpretations of what constitutes prudent investment behaviour are constantly evolving, however these have, in general, been taken to mean a focus on financial returns.

Transactional investment strategies linked to social and environmental screens have in recent years grown in interest to the mainstream investment community. This is partly because of the growth in retail consumer demand. But beyond this, it has become more apparent that the research underlying many SRI screens can be an effective element of a risk assessment strategy and practice. The collapse of Railtrack in the UK, for example, came as a shock to many mainstream investors. Interestingly, many "ethical funds" that had historically invested in railways as an appropriate form of transport had already withdrawn their investments from this company, due to interpretations of its poor record in addressing a range of social and economic issues. More generally, there is a growing recognition that SRI-oriented investment research can reveal aspects of risk not adequately captured or analysed by mainstream analysts. Similarly, concerns expressed by the SRI community over traditional mainstream safe-havens such as tobacco, alcohol (and most recently pharmaceuticals and food) have all proved significant in predicting the actualization of societal concerns into material risk.

Stewardship Responsible Investing

"Stewardship Responsible Investing" is where the investor engages with corporate management in order to influence and improve corporate governance, and thereby impact on social and environmental as well as financial performance. Engagement in this sense refers to "active investors" who makes full use of the rights of ownership in order to exert influence on the company's policies, whether through resolutions proposed at annual shareholders' meetings or through a regular constructive dialogue with the company's management. This approach is usually effective only when leverage or a specific critical mass can be achieved. Therefore, this strategy becomes most effective when implemented by institutional rather than individual investors. Best-of-sector type approaches are gaining in popularity, using positive engagement, and screening and investment/divestment as sources of leverage.

Stewardship strategies increase the degree to which social and environmental factors are taken into account in different ways:

- Business risks and opportunities are more closely associated with social and environmental factors over longer periods of time.
- Long-term engagement increases the investor's understanding of these risks and opportunities and how they best might be mitigated or capitalized upon.
- Active engagement with corporate management increases awareness of, and competencies in, dealing with social and environmental factors.

"It's all about shareowning as opposed to shareholding — ownership is both a right and a duty…"
Mark Anson, CIO, CalPERS[31]

Long-term investment is clearly a key ingredient of influencing corporate behaviour and enhancing shareholder value. Long-term investment as a means of enhancing shareholder value is not a new concept. Berkshire Hathaway's long-stated goal is to maximize the average annual rate of gain in intrinsic business value on a per-share basis. Berkshire Hathaway outperformed the Standard and Poor's (S&P) index from 1952 to 1995, in all but three years[32]. The exceptional returns of Berkshire Hathway, whose long-term engaged investment approach has been acknowledged, belies the view that short-term gains must be more beneficial than long-term investment strategies.

This type of approach also underpins, for example, the Australian Eco Share Fund managed by Westpac Investment Management[33], Friends Provident and Schroeder, and others, which similarly use their power as shareholders in proxy voting and discussions with the investees, to encourage companies directly in the promotion of more socially and environmentally responsible practices. From each single sector or industrial group, the best companies, in relative terms according to corporate social responsibility (CSR) criteria, are identified and included in the portfolio. This method uses conventional, benchmark-oriented investment research and portfolio optimization methods. The degree to which the "best-in-class" principle is applied determines the risk diversification potential. Differences can be substantial, for instance between Dow Jones Sustainability Indices and the FTSE4Good criteria, for excluding and including stocks. There are difficulties in the best-in-class approach such as the special need for communication and explanation associated with the selection of certain stocks. For example, it is frequently asked how one can justify the inclusion of oil or tobacco companies in a sustainability index. As the portion of SRI funds under management increases it becomes increasingly problematic for major investors to divest themselves of companies with

poor policies where engagement has not produced the necessary changes.

A stewardship approach to responsible investing also arises because of legal or other restrictions on funds, with regard to how they can factor in social and environmental issues. The UK's University Superannuation Scheme (USS) makes this point, "We do not have a religious or social change mandate or an employer that has a strong reputational reason for excluding particular companies…. Where participating employers could be financially responsible for the consequences of any drop in performance as a result of ethical screening, the legal advice that USS has received is that it cannot screen out companies or sectors for non-financial reasons…. USS is therefore obliged to invest in a wide spectrum of companies and, because of the size of our fund, this inevitably involves having holdings in major international corporations, some of which will be of concern."[34] In other words, USS takes a view that it cannot invest or divest solely because of a company's social and environmental performance. Active engagement, enabled through a stewardship approach, therefore enables USS to take these factors into account within its legal mandate.

Universal Investing

"Universal Responsible Investing" describes strategies where the extended breadth of an investor's portfolio requires it to take into account externalities arising from one investment due to its impacts on others. This third category has conventionally been associated with strategies of very large investors with such extensive portfolios that the externalities of one investment impacts on the performance of others. As Hermes explains in presenting its tenth Hermes Principle, "It makes little sense for pension funds to support commercial activity which creates an equal or greater cost to society by robbing Peter to pay Paul. Where companies are aware that such conditions exist, it is appropriate for them to support measures to align shareholder interests with those of society at large."

Universal investing is most obviously relevant to large investors. As Chief Executive Officer of GovernanceMetrics and former CEO of Thomson Financial Investor Relations, Howard Sherman argues, "Many of today's institutional investors are so large that selling out a position is not always a prudent investment choice — the very act of selling can depress stock prices. Many others invest in indexed funds and have no choice but to stay invested."[35]

Hermes – Principle 10: Externalization of Costs

"Companies should support voluntary and statutory measures which minimize the externalization of costs to the detriment of society at large…most investors are widely diversified; it makes little sense for them to support activity by one company which is damaging to overall economic activity. The ultimate beneficiaries of most investment activity include the greater part of the adult population who depend on private pensions and life insurance."

The relevance of universal investing is not, however, restricted to large investors, but arises because of the inter-connectivity of different investor interests and actions. In 1980 less than 10% of all US households owned mutual funds; by 2000 that number had grown to 49%, with the Investment Company Institute estimating that 87.9 million Americans own shares in mutual funds. Individuals hold about 80% of the money invested in mutual funds. Between 1990 and 2000, total assets of mutual funds rose from US$ 1.065 trillion to US$ 6.965 trillion. Mutual funds are now among the largest owners of American corporations[36]. The 75 largest mutual fund companies control 44% of the voting power at US companies[37].

This third mode of investment arguably has the greatest potential for factoring in social and environmental dimensions of investments, since it grapples with externalities that are less likely to be counted in either of the other investment classes. At the same time, the practicality of universal investing clearly poses enormous challenges. There are significant first-mover disadvantages to any one investor acting in this manner, since others could free-ride on the back of their, often costly, actions. Collective action is therefore likely to be a pre-condition for universal investing. This could be voluntary, but this poses the challenge of establishing a basis for collaboration between investors in a fiercely competitive industry, mainly focused on short-term returns. Equally, initiating public policies that effectively enforce common practice would, and do, meet considerable opposition from those within the investment community with vested interests in the status quo.

Modes of Responsible Investment

> **Conditions for "Universal Investment"**
>
> - *Action by groups of investors*, who together see opportunities for mitigating risks associated with their collective investing activities; for example, initiatives such as the Equator Principles, the Investors Network on Climate Risks, and the Pharma Investor Group.
> - *Action by individual investors* that see a market opportunity in embracing a broader, responsible investing strategy, such as the high profile positions taken by the likes of CalPERS and Insight Investments.
> - *Public policies* designed to enhance the delivery of public goods (e.g., environmental and civil security) through enforcement of investor practices that internalize specific social and environmental costs.

Strategies for Responsible Investing

These three modes of investment are not mutually exclusive and can be, and often are, interdependent. Many institutional investors find themselves investing in most stocks of large companies (publicly traded on major stock exchanges) because of the sheer volume of funds that they have to place. Most portfolios of this kind are indexed, placing them within the "transactional" class. In this situation, disinvestment is clearly an option for isolated cases, but is not a viable model for widespread application. Such pervasive investing makes engagement with investees an attractive option and links together transactional and stewardship investment classes. Finally, for such large investors as CalPERS and USS, the fact is that different investments do impact on each other, bringing the "universal investment" perspective to bear on investment strategies already involving transactional and stewardship elements.

Just as they can be combined, the three classes also offer a "developmental" view on responsible investment. Transactional investing mainly is concerned with establishing what investors will not do (i.e., essentially when to "exit"). Stewardship investing involves the use of the investor's "voice", allowing for closer engagement and, at times, the use of formal governance pathways to apply pressure for change. Clearly the stewardship route allows the "exit" possibility to be present as a background "threat of last resort"; yet the strength of this approach is evident when investors "stay the course", working to enhance the management and overall performance of their investees. Ultimately, universal investing is likely to be most effective in handling the most extensive range of social and environmental externalities (negative and positive) and offers considerable leverage, certainly together with stewardship and transactional elements. However in practice, the data, tools and competencies to undertake universal investing in a systematic manner are often lacking in the mainstream investment community, a point to be further discussed below.

Barriers to the Mainstream Practice of Responsible Investment

The Investment Value Chain

The "investment value chain" comprises the *people, institutions, processes, corporate and regulatory policies that impact the value derived from investments, and its distribution.*

The investment value chain involves a myriad of actors. At one end are the real owners of capital, or the "intended beneficiaries" in the case of pension and mutual funds; at the other are the investees themselves? largely businesses, with their processes of value creation and its distribution. The investment value chain is, therefore, more than what is traditionally understood as "the capital markets", and includes other players that impact the investment process and its outcome, such as public institutions.

We refer to a "chain" however the investment value creation process is far from a linear process that moves funds seamlessly from owners to users. The investment value chain has evolved organically, not through any overall design, and therefore embodies many overlapping and at times confusing roles, including some that embed problematic tensions and conflicts. For example, the capital market is intended to allocate capital to those ventures that are likely to deliver the best prospects for gain, suitably adjusted by time discounts, risk factors, etc. Yet this is often not the experience of companies presenting themselves to the market. As one investor relations manager from a major pharmaceutical company explained, "We want to explain our long-term strategy to fund managers. But since their performance is assessed on the basis of short-term returns, they will only pay for information from sell-side analysts relevant to this time horizon — we find it hard to get through this."

Such tensions can often turn to apparent conflicts of interests. For example, for the market to maintain integrity it is essential for buy- and sell-side analysts to remain entirely independent; however the truth can be contradictory. As one roundtable participant commented, "Buy-side is relying on sell-side to provide tools to quantify equity risk." In other words, those acting on behalf of the owners of capital are taking advice on how to value companies from those seeking to sell them corporate stock.

Such examples are not about "malpractice", although there clearly are real dangers and examples of unethical and, at times, illegal behaviour. Rather, the cases highlight the nature of the investment value chain as a high density, inter-connected network. This inter-connectivity in turn generates diverse and often conflicting signals. Appreciating both progress in, and impediments to, responsible investment requires an understanding of the intertwined and extraordinarily complex characteristics of today's investment value chain, even where analysis is confined (as we have) to publicly traded equities.

> **Intertwined Interests in the Investment Value Chain**
>
> - Rating agencies crucial to establishing benchmarks of likely business performance (and so credit worthiness) are paid by the very companies they rate, as well as increasingly offering advisory services to, amongst others, pension fund trustees.
> - Buy-side and sell-side analysts are often located within the same institution, raising real concerns regarding the fragile nature of the internal "Chinese Walls" that are supposed to maintain the integrity of advice from each.
> - Financial advisors to pension fund trustees often simultaneously represent asset management companies bidding to the same trustees for fund management mandates.
> - The survival of corporate pension funds depend on the fortunes of specific companies that in turn seek investment funds from the pension fund industry.

Performance Drivers and Impediments

If the roundtables highlighted just one thing, it was the inter-connectivity of both the impediments and opportunities in mainstreaming responsible investment. While most roundtable participants could highlight one or a small number of pieces of the investment value chain – such as pension fund trustees, credit agencies, analysts, etc. — there was unanimity that a broadening of the investment community's consideration of social and environmental aspects of corporate performance would require multiple, diverse reforms at different places in the investment value chain. Within such diversity, it was possible to distinguish three sets of impediments that often cut across the different actors in the chain:

- *Information*: Increased and improved information from companies to analysts is needed to underpin investments focused on long term business strategy and value creation, to enable greater accountability of underlying social and environmental risks and opportunities.
- *Incentives*: Changes in incentives along the investment value chain, particularly those driving fund manager

behaviour, are necessary to shift investment towards a longer-term perspective that factors in social and environmental performance.

- *Competencies*: Different and improved competencies along the investment value chain (for analysts, fund managers, trustee advisors and trustees) could increase the account taken of longer-term value creation propositions, as well as the materiality of social and environmental aspects.

> "I have a narrow window of time to absorb a great deal of information. I will look at these issues (social and environmental factors) when I get the time…I don't know when that will be." [38]

Information

The volume of non-financial information disclosed has certainly increased, and some standardization in this information has occurred, for example, through the Global Reporting Initiative and investor-facing indices like the Dow Jones Sustainability Index[39]. The credibility of this information has also increased as a result of improved sophistication within companies and improvements in standards of assurance[40]. As one analyst in a roundtable commented, "There is an extraordinarily rapid growth in the volume and quality of information provided by a new generation of information brokers entering this growing market with new products and services."

Despite this, evidence suggests that information available to mainstream investors is inadequate for the task of linking social and environmental factors to financial performance[41]. Typically, investor surveys suggest that social and environmental information is increasingly available to them. However, the incidence of use of such data, beyond providing one piece of a broad context, remains limited. For example, a recent survey by Arthur D. Little, produced for Business in the Community in the UK, highlighted the perception across the investment community of the inadequacies of non-financial information[42].

> "When Nestle had a problem in Ethiopia, they ended up giving back US$ 1.5 million — this was important, but clearly not seen as a material issue to Nestle or its investors." [43]
>
> "We have been in and out of the federal supreme court on this labour issue. But I cannot think of a single instance of a mainstream investor asking me about it… they are simply not interested and see this stuff as part of the 'cost of doing business'." [44]

The analysis of non-financial information is framed by investors' interpretations of the materiality of the disclosures in corporate reporting. Recent regulatory initiatives, such as the Sarbanes-Oxley Act[45] and the forthcoming changes to UK Company Law[46], reinforce the requirement for companies to disclose aspects of social and environmental performance relevant to their future business performance. This is mainly viewed as a healthy development for those focused on mainstreaming responsible investment, since it will place company boards at centre stage in signing-off on which aspects of non-financial performance are material. It will also require them to be able to provide sound arguments as to how these aspects have been determined.

Whether these developments make a real difference depends, however, on the basis by which materiality is defined. Definitions of materiality are well established in law and in professional practice, for example, of the financial audit community. In broad terms these definitions require that the reporting organization disclose the information about its performance required by its shareholders to enable them to make informed judgements, decisions and actions. But in truth the interpretation of materiality is a largely pragmatic affair. Generally this involves a focus on "generally accepted" financial risks and opportunities as usually defined by quantitative thresholds, thereby largely servicing the needs of transactional investors. For example, the high-profile, two-year case of activist Marc Kasky versus Nike brought the company before the California and federal supreme courts for allegedly misrepresenting the state of labour standards in its supplier factories. Even now, after an out-of-court settlement, the case raises the spectre of further legal action against Nike and others, based on similar claims of commercial misstatements. Yet the case has barely raised an eyebrow from the mainstream investment community which, it seems, sees such cases as simply an acceptable overhead cost of doing business[47]. Yet a comparable case that involved far higher settlement costs would certainly figure on investors' radars who, once sensitized to the potential risk, might well then exaggerate the risk, with resulting effects on share prices. As one corporate risk manager put it, "Materiality appears a scientific matter, but actually has more to do with herding: something becomes material when enough people think it should be."

New ways of defining materiality, interpreting it in practice and subjecting such tests to external assurance are in development. For example, the five-part materiality test proposed by AccountAbility, in their submission to the UK *Company Law Review*, seeks to expose different

interpretations of materiality in how companies report and assurance providers assess the quality of such reports[48]. Rather than allowing the investment market's short-term tendency to, in effect, marginalize issues that would be material in the longer-term, the proposal explains how companies could report on performance and impact issues categorized by different forms of materiality. This would afford investors and other stakeholders greater visibility into companies' understanding of the links between financial and non-financial performance. Approaches that differentiate forms of materiality are being increasingly used by a growing number of businesses producing sustainability or corporate responsibility reports, particularly as such approaches are embedded in emerging standards in the field[49].

Crucial to raising the underlying quality and materiality of corporate information are the costs of acquisition, analysis and delivery to intended users. Even those considered to be among the world's best corporate non-financial reports are often woefully inadequate in addressing the needs of investors. This has been pointed out repeatedly, for example, in SustainAbility's periodic report on the state of sustainability reporting[50]. Factoring in non-financial risks and opportunities is costly, although increased availability of data from analysts such as the Sustainable Asset Management[51] (creator of the Dow Jones Sustainability Index) and a growing number of Web-based platforms (for consolidating non-financial data) has enhanced access to, and reduced cost of investor-friendly non-financial data. Interpretive costs, however, remain high and raise major questions concerning the competencies of today's analysts, a matter to be discussed below.

Incentives

Financial incentives are clearly and unsurprisingly a dominant driver of investor behaviour. Yet there is a serious lack of information on the workings and impact of incentives within the investment community. This is despite the fact that within their investees, the corporate community, "executive pay" has in recent years become a very high profile and often bitterly contested issue. Perhaps ironically, this has increasingly involved active shareholders challenging the rights of their investees' managements to such pay deals.

> "Not surprisingly then, with the longer-term outlook increasingly amorphous, the level and recent growth of short-term earnings have taken on special significance in stock price evaluation, with quarterly earnings reports subject to anticipation, rumour and 'spin'. Such tactics, presumably, attempt to induce investors to extrapolate short-term trends into a favourable long-term view that would raise the current stock price."
> Alan Greenspan, Chairman, Federal Reserve System[52]

Even more pressing than the issue of pay levels are concerns regarding the impact of today's pay *structures* on investment decision-making, and often their apparent absence in many cases of a clear relationship between fund performance and executive pay. One of many cases exemplifying the cause of such concerns is the salary of an Aberdeen Asset Management CEO. His £350,000 salary was topped-up with an additional "deferred benefit", which brought his total remuneration to around £3.2 million, yet the CEO's overall responsibility included Aberdeen's troubled Progressive Growth Fund. As *The Observer* newspaper reported, "Investors in this fund, which invests in zero dividend preference shares and was marketed as low risk, have lost half their money in the last year (2003)." [53]

As Peter Moon, Chief Investment Officer of the Universities Superannuation Scheme (USS) states, "It almost goes without saying that pension funds should invest for the long-term. Unfortunately, the current system of investment decision-making has much stronger management mechanisms for ensuring relative out performance over the short-term."[54] Even more troubling is that the dynamics of the market for fund managers themselves appear to drive distorting incentives and levels of remuneration. One recent report by McKinsey and Co. found that fund management costs rose by 25% between 2002 and 2003, a trend quite at odds with the performance of the funds themselves. As the report commented, "This raises critical questions about how to reward individual performance without creating excessive dependency on the skills of a few star fund managers."[55] Additionally, such remuneration schemes can at times distort investment decisions beyond the law, as a number of recent high-profile cases involving investment houses in different parts of the world have demonstrated.

Unsurprisingly, the roundtables identified current incentives as a core impediment to mainstreaming responsible investment. Fund managers pointed to the role of their clients in driving their focus on short-term performance. As one fund manager argued, "As long as client [e.g., pension fund trustees] mandates require us to deliver performance benchmarked against short-term market tracker indexes, we will of course remain short-term in our outlook." Analysts, similarly, argued that they could rarely advance social and environmental performance issues so long as their clients, fund managers, were only concerned with drivers of short-term performance and market valuations. One analyst summarized his experience thus, "Strategic research on future social and environmental risks and opportunities got me my five minutes of fame. But there were no buyers for the work, and this is what counts at the end of the day. Given the choice again, if I want to stay in business, I would not do such research."

Barriers to the Mainstream Practice of Responsible Investment

Short-term performance measurement is argued by many in the investment community as offering the best way to achieve overall, long-term performance. Yet there are real questions as to whether this is the case. Researchers from Duke University, the National Bureau of Economic Research and the University of Washington have recently published the findings of a survey on the economic implications of the current corporate financial reporting practices of more than 400 financial directors. Their findings support underlying concerns that companies regularly sacrifice opportunities for value creation, in their efforts to meet short-term investor expectations. That is, even the narrow financial interests of the owners of capital are not best served by the investment community's focus on short-term performance.

> **Sacrificing the Long Term**
>
> "Because of the severe market reaction to missing an earnings target, we find that firms are willing to sacrifice economic value in order to meet a short-run earnings target….The preference for smooth earnings is so strong that 78% of the surveyed executives would give up economic value in exchange for smooth earnings…. We find that 55% of managers would avoid initiating a very positive NPV project if it meant falling short of the current quarter's consensus earnings."
>
> Source: John Graham et. al., "The Economic Implications of Corporate Financial Reporting"[57]

Competencies

There is widespread agreement that there exist several major competency gaps that impede the mainstreaming of responsible investment, including:

a) *Material information.* While the need for better non-financial information that is material to mainstream investors is accepted, its production is proving difficult. There are many studies about the "business case for corporate responsibility", yet the data generated through these studies is often weak and not useful to investors undertaking valuations. There are a growing number of initiatives seeking to better identify the bridge between financial and non-financial information. These range from ground-breaking initiatives like the Dow Jones Sustainability Index, to research-based initiatives such as the Global Leadership Network involving a group of leading global companies working with the Boston College of Corporate Citizenship and AccountAbility (developing scorecards and benchmark tools to improve the measurement and management of material aspects of corporate responsibility)[58].

b) *Analysts.* The ability of mainstream analysts to factor in social and environmental issues requires them first and foremost to understand them, including their relationship to the longer-term strategic thrusts of individual companies and entire sectors. However most analysts are focused on creating and selling information to fund managers mainly interested in free cash flow, major short-term risks and opportunities, and the likely behaviour of other fund managers. Such requirements are far more sophisticated and there is little doubt that many members of today's generation of analysts are not currently able to deliver such information. This is partly a matter of incentives, since the analyst community would over time reshape and respond if the market demanded a qualitative shift in information.

c) *Fund Managers.* As cited previously, most fund managers understand far too little about the longer-term thrusts of their focus sectors. Most would correctly argue that this is because the market does not demand it or, in short, that the competency gap is in fact an incentives issue. But the fact remains that most fund managers, if asked to design an investment strategy with a long-term time horizon, would not have the expertise to proceed, lacking knowledge as to what social and environmental issues might count.

d) *Pension Fund Trustees.* This represents a very mixed group with varied competencies. Often those who are most representative of the interests of intended beneficiaries (union members, for example), simply do not understand the complexities of modern-day investment strategies and issues, and so tend to focus on the more tangible but marginal area of "project finances" (e.g., inner city property development). However, as the UK government has made clear,lix it is neither desirable nor feasible to expect pension scheme trustees to become experts in investment, nor is it desirable that pension scheme trustees should be solely investment professionals. Few understand enough to take a leadership role in driving the development of fund manager mandates that are compliant with fiduciary duties, and yet underpinned by a longer-term and broader perspective of beneficiary interests.

Competency gaps in addressing social and environmental dimensions of investment strategies and practices exist all along the investment value chain. But the roundtables highlighted the fact that while these competency gaps are in part about straightforward skill deficits, the underlying problem concerns a lack of institutional competencies in the form of appropriate tools and metrics. Further highlighted was a strong view that the pathway to overcoming both skill and broader competency gaps lay in the area of incentives. While the development of competencies may not be simple or

achieved overnight, it could only occur if the market rewarded different knowledge, skills and their application.

Reshaping the Investment Value Chain

Today's investment value chain comprises many players with diverse interests and approaches. This includes some with a longer-term and at times broader perspective on the manner and purpose of investment. The bulk of the chain, however, retains an essentially short-term, narrow perspective. This perspective is either unresponsive to most social and environmental issues, or actively seeks to invest in companies that are effective in externalizing themselves from their responsibility as a means of enhancing shareholder value. That is, the investment value chain is mainly neutral and, at times, decidedly counter-productive regarding the social and environmental consequences of their investees' actions.

That the investment value chain as a whole does not factor in social and environmental issues is not most usefully understood in terms of the personal values of its participants. This situation arises because of today's blend of available information, participant competencies and, most of all, the institutionalized incentives that drive their behaviour. These factors combine to create the perception that significant competitive disadvantage will befall any one player that strays from customary practice. In other words, the development of responsible investment is impeded by a fear that taking the first step alone toward change also involves the most risk, even though all players together would benefit from such changes. The challenge is clearly to identify appropriate measures that will both overcome specific impediments and trigger the systemic change that reshapes the investment value chain, particularly in ways that reward rather than penalize more progressive investors.

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An Investment Management Perspective

Mehdi Mahmud, Executive Vice-President,
Jennison Associates

Overview

Investment management is one of the most highly regulated industries in the world. Critics argue that this has led to a gradual diminution in creative, long-term oriented (and potentially more rewarding) approaches to investing. On the other hand, proponents point to recurring instances of the industry's failure to police itself as the driver of increased regulatory scrutiny. Regardless of which camp one might sympathize with, the net effect is that the investment management business, in the United States and the United Kingdom in particular, has evolved into a carefully calibrated system of checks and balances designed to value "investment process" and "control" as much as "superior returns" and "risk." Stated differently, the net impact of these checks and balances is that significantly more emphasis is now placed on producing *proof statements* of control and measurement at each stage of the investment process than ever before. This occurred in conjunction with developments in the vernacular of portfolio and performance analysis, which has rapidly become the standard for investment communication among constituents in the fund management industry. Key participants in this equation, on a daily basis, include beneficiaries, trustees and their investment committees, financial advisors and consultants, fund managers, third party research providers (commonly sell–side firms), and of course, the universe of publicly traded companies in which fund managers may invest. Regulators play an omnipresent, though more strategic, role in directing the method and content of interaction among participants. This image — of an industry that has developed around an elaborate system of checks and balances — is critical to keep in perspective during any serious examination of the methods by which the industry's practices might evolve over time.

From the point of view of the investment manager, perhaps the simplest visualization of how the key participants interact with each other is to imagine five rings, arranged in a horizontal line, connected by a string. The leftmost ring represents the client, including beneficiaries, trustees and their investment committees. The centre ring represents the fund manager, and the rightmost ring represents the universe of companies in which the fund manager may invest. The ring that separates the client from the fund manager is the investment consultant to the client, while the ring that separates the universe of publicly traded companies from the fund manager is the sell-side analyst (broadly defined to include investment bankers, market makers and third-party research vendors). Assuming that information is ubiquitous, it is nevertheless a useful (though approximate) construct to imagine the string as the primary pipeline for information exchange and formal interaction among the various participants.

The role of investment consultants in the clients' decision-making processes cannot be overemphasized. Consultants provide a wide range of services to clients, notably: advice on benefits policies, asset allocation analysis, selection of benchmarks, due diligence on fund managers, and recommendations on manager selection, evaluation, and termination. Although plan sponsors retain responsibility as primary (named) fiduciaries, consultants provide much of the analysis and tools by which investment committees and trustees make decisions. As a result, the lens through which consultants and plan sponsors view the fund management industry — composed of the metrics and language by which they evaluate fund managers — is a critical determinant of behaviour in the long-term. Their perspectives on the relative attractiveness of various asset classes, their selection of benchmark indices used to measure fund managers' performance, their assessment of active managers' ability to outperform passively-managed alternatives, and their investment time horizons have profound impact on fund flows into and within the industry. Consultants are key participants in the value creation chain and, in the context of responsible investing, will likely be important agents for influencing change.

The sell-side fulfils a somewhat analogous role with publicly traded companies, through: advice (in the form of investment banking relationships); trading desks (which make markets in their stock): and research departments (that "report" on company news). Notwithstanding the negative press they have received, sell-side research departments fill an important information gap in the fund management industry, providing an efficient means for companies to disseminate information to the marketplace. In particular, following Regulation Full Disclosure (Reg. FD) in the United States, which requires corporations to treat all investors equitably in the dissemination of material information, the sell-side has taken on an even more substantial role in coordinating access to companies' management teams through conferences and presentations. Given their role as "reporters" of financial information — despite the caveat that there is no implicit or explicit guarantee of objectivity in their content — the sell-side is likely to remain an important participant in the industry as it evolves.

An Investment Management Perspective

Where We Are

Among other things, the roundtables made clear that "responsible investing" remains a niche in the fund management industry today (within strict parameters of the definition of "responsible investing" in this paper, for certainly no asset manager would claim to do the opposite). Admittedly, there are pockets of activity focusing on specific themes (such as the Calvert Group in the US), or approaches (such as Hermes Investment Management in the UK). However, for mainstream asset managers, the most common and explicit form of responsible investing involves pre-investment non-financial screening of the universe of opportunities, in compliance with precise guidelines from clients. In addition, active managers typically will also consider the impact of companies' business models, and their managements' approach and track record, regarding social and environmental issues, so long as the analysis is *material to their financial performance within the foreseeable future*. The extent to which this type of analysis is performed varies tremendously from one asset management company to another, driven by differences in philosophy, investment time horizon, propensity to take risk, degree of benchmark orientation and depth of skilled resources. Stated differently, fund managers' interest in and motivation to consider responsible investment criteria — except to fulfil clients' explicit directions (in which case pre-investment screens are used) — stems from their competitive desire to outperform relevant benchmarks and peers, towards which end they will typically bring to bear all relevant information and analysis, so long as it is material to performance and likely to be recognized in the marketplace within a time period consistent with their clients' investment horizons. Despite the competitive urge to outperform using all possible means to generate an investment "edge", the use of responsible investment criteria in day-to-day research and portfolio decision-making remains an exception rather than the rule, driven to a large degree by the inertia of practices and standards that have come to dominate the industry over time.

Regulatory Environment

The objective of responsible investment is complicated by the reality that we live in a world with little disclosure about the long-term impact of corporations' social and environmental policies on their businesses. This lack of disclosure is further compounded by the lack of industry standards by which such long-term liabilities of uncertain magnitude can be incorporated into traditional approaches to financial analysis. Consequently, the link between companies' long-term social and environmental practices and their short-, intermediate- or even long-term financial performance generally tends to be unclear, with the exception of current activity (such as litigation) that falls within extant definitions of "materiality".

On the other hand, it is no surprise that the fund management industry has grown up with explicit rules governing every aspect of their activity, given the highly regulated nature of the business. As a result, the parameters within which a fund manager can invest clients' assets are strictly defined, and those definitions tend to be interpreted in the narrowest construct of financial returns and risks consistent with clients' investment time horizons. Fund managers need to act in *demonstrable compliance* with the performance objective of optimizing clients' financial returns, which is typically defined in their contracts relative to certain benchmark indices, at specific levels of risk, and/or with respect to pre-defined peer groups. The need for *demonstrable compliance* creates a burden of proof on the part of the fund manager, which at best heightens managers' sensitivity towards risk-taking and at worst encourages inertia around "tried and true" approaches that are easily defensible. This high level of regulatory awareness and scrutiny, combined with the widespread use of benchmark indices and clients' gradually shortening time horizons for performance evaluation, is a powerful driver of conservatism among fund managers with respect to innovation. Therefore, in the absence of some combination of greater disclosure on the part of corporations regarding the long-term business impact of their social and environmental policies and wide acceptance of metrics by which such long-term liabilities are valued, the industry standard of *demonstrable compliance* is likely to remain a significant hurdle to mainstreaming responsible investment.

Fund Manager Evaluation

The science of performance measurement has undergone revolutionary change. The introduction of Harry Markowitz's Capital Asset Pricing Model[60] (CAPM) helped establish the concept of a "market portfolio". Over time, the combination of insights from CAPM, further refinements thereof and, in particular, the often misused work on asset allocation by Brinson et al.,[61] catalysed the propagation and in some cases creation of a myriad of benchmark indices covering almost every asset class, geography, market capitalization and style. The language of asset allocation quickly became the standard for discourse in the industry, leading to rapid, widespread and systematic implementation of index-oriented performance measurement for fund managers. Today, these indices are ubiquitous, so much so that what began as a means of more

rigorously measuring fund managers' performance has gradually become a constraint on fund managers' discretion. While there are exceptions, the empirical evidence is that the average manager's propensity to assume risk relative to their respective benchmarks (a statistical measure called tracking error) has declined over time, leading to greater clustering of fund managers' returns. This tendency towards herding is another hurdle to mainstreaming responsible investment, as it reduces managers' willingness to try new approaches. The good news is that many investment consultants and fund managers have recognized this problem and are at the leading edge of reform in the industry with respect to the specification and usage of benchmarks for performance evaluation. It is still unclear as to whether this counter-trend is sustainable, but initial evidence in the US is encouraging, driven by clients' renewed demand for differentiated, less correlated (with each other) investment performance from their fund managers. To the extent the counter-trend persists, the "benchmarking" hurdle to incorporating responsible investment into mainstream fund management will diminish over time.

Correlated to the problem of benchmarking, two other elements of performance evaluation have negatively impacted fund managers' inclination to evolve their investment approaches to incorporate new and/or different perspectives, including that of responsible investing. These are: (1) the industry's overwhelming focus on the "investment process," often superseding results, and (2) the rapidly shrinking time horizon over which investment performance is measured. Perceived *theoretical rigour* and *stability* of fund managers' investment processes are often key components of fund managers' scorecards among third-party performance evaluators, and are therefore drivers of business success. It is no surprise then that fund managers are reluctant to employ research or portfolio management approaches that could, under scrutiny, appear revolutionary or less than "air-tight." Similarly, short time horizons for performance evaluation provide incentive for managers to try "what will produce results today" rather than take risks that are intended to pay off over a longer time horizon. These hurdles are the result of shortcomings in existing standards for fund manager evaluation, which nevertheless have become pervasive and are unlikely to be reversed overnight.

Compensation

As the time horizon for evaluating performance has gradually shortened, investment management companies have evolved their business models accordingly. The time horizon for business planning has shrunk, with many companies aggressively managing their line-up of products to meet evolving demands in the marketplace. As business planning and compensation practices go hand-in-hand, it is not surprising that compensation practices in the industry have evolved towards shorter-term performance. If left unchecked, this is likely to further encourage clustering of fund managers' performance around narrowly defined benchmarks, and to discourage adoption of broader, longer-term perspectives in fund managers' investment decisions. The good news, however, is that there are many notable firms in the industry that are exceptions to this trend, and to the extent they are able to continue building investment cultures focused around and compensated according to superior long-term performance, they could form the nucleus of a counter-trend in compensation practices. In the US, increasing demands from regulators for greater disclosure regarding fund managers' compensation structures could well be a tailwind to this counter-trend — if not taken to the extreme. To the extent this idea catches on globally, it would provide clients and consultants better visibility into the environment and culture of investment management organizations and could be a powerful catalyst for re-focusing the industry on longer-term investment performance.

As the primary conduit by which publicly traded corporations access capital markets, the increasing focus of financial market participants on short-term performance is reflected in and abetted by sell-side behaviour. A wonderfully revealing (though limited) example of extreme myopia can be found in analysts' earnings forecasts. For examplel[62], as of 31 August 1989, there were 14 publicly available earnings forecasts for each of the first and second fiscal years of the Intel Corporation (Intel); however, there were only four publicly available forecasts of earnings three years forward. As of 31 August 2004, there were 37 publicly available earnings forecasts for each of the first and second fiscal years of Intel, a clear indication that the industry (and the company) has grown significantly over the last 15 years. Most notable, however, is that there were only two publicly available earnings forecasts of earnings three years forward (yet this is one of the most widely analysed companies on the planet). While this example is intended to be illustrative and not prescriptive, it very lucidly encapsulates the short-term orientation of the sell-side analyst as an aggregator and disseminator of information. As a consequence, it is no surprise that the sell-side analyst's short-term orientation not only spills over into the financial press and general media, but also reflexively influences the perspectives of clients, investment consultants, and ultimately investment professionals at fund management companies, as well. With that as backdrop, it is clear that any serious attempt to promote responsible investment will entail fundamental

alterations to behaviour in "reporting" upon the nature of long-term social and environmental policies of the companies they analyse, and their potential impact to future financial returns. There is no doubt this will require greater disclosure on the part of corporations, most likely catalysed by regulatory scrutiny if not intervention; in addition, it will require closer inspection and possible re-organization of business models and incentive structures of research providers.

Investment Experience

Another practical impediment to mainstreaming responsible investment has to do with the level of experience and depth of talent within fund management organizations. With the exception of firms organized around intensive proprietary research efforts and performance oriented cultures, the vast majority of fund management companies tend to recruit relatively inexperienced professionals as research analysts. Analysts in such positions typically rely heavily on sell-side information and analysis during their first few years of employment, which of course further bolsters the extent to which short-term information drives investment recommendations and decision-making at the average fund management complex. Furthermore, the typical career path in such organizations is that successful research analysts are promoted to become fund managers, and successful fund managers are promoted to become business leaders. The result is that research analysts who have spent years honing their analytical skills and industry knowledge — and are therefore at peak levels of preparedness to perform truly differentiating investment research on companies' long-term business models — are removed from specialist roles and placed into more generalist fund management positions, where there is less scope to apply those skills and knowledge. Similarly, successful fund managers are typically laden with increasing responsibility for business and administrative functions over time, which impairs their ability to manage portfolios in meaningfully differentiated ways. Stated differently, this situation compels them to rely on less seasoned investment professionals for buy and sell recommendations on securities in their portfolios. On the other hand, given the uncertain nature and magnitude of the impact from companies' long-term social and environmental policies (on their business models and eventual financial performance), it is clear that only investment professionals with sufficient length of experience and depth of industry knowledge would be capable of effectively assimilating this information into concrete investment conclusions that could be expected to outperform consensus points of view. This divergence between career paths at typical fund management companies and the investment skill-set that is a pre-requisite for successful long-term investing is an impediment to mainstreaming responsible investment.

The Path Ahead

It was clear from the roundtables that the intellectual underpinnings of responsible investment appeal to both fund managers and their clients. The theory goes that fund managers would benefit from clearer understanding of companies' long-term policies and prospects by making better investment decisions, while clients would reap the rewards through higher returns on their capital over the long-term. Given the fundamental alignment of interests, therefore, the path ahead must begin with basic fiduciary principles: what is in the clients' best interests should drive evolution in the fund management industry, with public policy support when needed.

A few of these evolutionary processes are already underway. The combination of slowing economic activity and reduced expectations of financial asset performance has forced market participants to re-think their investment policies. Widely held pre-conceptions about asset allocation policy and use of benchmarks are being questioned, with much creative thought directed toward alternative methods of meeting clients' needs through portfolio engineering. The current heady pace of change in this area, if sustained, is likely to lead the fund management industry in a new direction over the next few years (just as asset allocation research ushered in a new wave in the mid-80s), one that appears at this juncture to encourage managers away from "herding" around their benchmarks. It is too early to tell how this type of shift in the industry's attitudes towards investing will impact investors' time horizons, though it is logical and indeed probable that their time horizons will at least stop shrinking. Frankly, many fund managers will resist this type of change. However, the good news is that the industry at its core is a performance-driven culture, which is likely to embrace the shift away from "benchmarking."

An area where some progress is being made, albeit episodically, is in the extent of due diligence that is performed on fund managers outside of investment performance analysis. This includes the thorough review and assessment of whether or not a fund management company's depth of resources, level of investment experience and organizational structure is conducive to creating and sustaining a culture that can reasonably be expected to generate superior investment performance for clients over the long term. While regulatory pressure for greater disclosure on compensation practices is likely to help — assuming those pressures are not extended to

burdensome extremes — it will require a seismic shift in clients' preferences towards lengthier relationships with their fund managers, in order to steer the industry in the direction of more thorough due diligence of investment cultures. While much information along these lines is collected in the typical Request For Proposal (RFP) process during fund manager searches, most decisions in the industry continue to be made primarily on the basis of historical performance analysis. In the absence of identifiable catalysts, it is unclear how and when such an evolution of buyer preferences might unfold.

Finally, the area where least progress is being made (and likely to remain that way without some level of public policy intervention or guidance) relates to corporations' willingness to disclose information about their social and environmental practices, and to estimate the impact of those practices on their long-term business performance. This is perhaps the most significant hurdle to mainstreaming responsible investment, and will likely require an extensive, multi-disciplinary investigation in order to fully understand the underlying issues. In the public policy arena, decisions will need to be made about the feasibility of legislative solutions to compel corporations to identify and disclose issues that are inherently complex. Indeed, whether or not such legislation could even be enforced is an open question, given the long time horizons over which companies' social and environmental policies may produce measurable impact. Assuming those hurdles are surmountable, accounting and valuation standards will also need to be established for such disclosures to be effectively incorporated into mainstream fund managers' day-to-day investment decisions.

Responsible Investment and Sell-side Analysis

Francis Condon, Head of European Steel Research, ABN AMRO Equities[63]

Overview

Acceptance by sell-side equity analysts of the need for responsible investment is low. In the words of one company investor relations director, "… they just don't get it." This paper intends to shed some light on this lack of engagement and offers some ideas on the steps that might be required if this is to change. Its broad conclusions are:

- Mainstream sell-side equity research is comprised of a fragmented community of analysts whose priorities are formed through their interaction with companies and particularly with clients.
- Sell-side equity analysts currently focus most on social and environmental issues when identifying and quantifying risks expected to emerge in the very near term.
- Three major impediments to a more mainstream adoption of responsible investing are that: (1) the current data set of performance indicators does not yet add up to a consistent whole; (2) there is limited ability among the current population of investment analysts with respect to analysing social and environmental investment criteria; and (3) the way sell-side equity analysts are paid represents a significant disincentive to challenging this situation.
- Key drivers promoting change include steadily improving information, the current review of the research business models and the inherent flexibility of the sell-side equity analysts community to change. However, the initiating factor will only come from a greater demand to use responsible investment criteria from the buy-side client base. Regulators may contribute with measures that promote the publication of good quality data, enhance the competency of analysts and lead to a review of how incentives are paid.

Responsible Investment and Sell-side Analysis

What position does sell-side equity analysis occupy in the Investment Value Chain?

Sell-side equity analysis occupies a very specific position in the investment value chain. Its goal is to uncover investment opportunities from among the various equity instruments quoted on a recognized exchange. The critical factor that defines the sell-side is that these ideas, and the rest of the research service, are provided to investment professionals in a broad range of client firms.

Investment banks and stockbroking firms employ the vast majority of the population of sell-side equity analysts either as individuals or as part of sector teams.

The purpose of investment banks/stockbrokers employing these analysts is to capture a greater share of trading commission in secondary equity market. There is therefore a close connection between the revenues of an equities business, the perceived value of the research service provided and the remuneration of the individual analyst or team. Side benefits of employing analysts, such as in providing information to trading desks and supporting corporate finance activities, have been subject to greater regulation in the last four years, which has further focused the priorities of analysts on generating secondary commission revenue.

"Mainstream" (or occasionally "large-cap") analysis distinguishes those analysts that focus on the large and mid-sized listed companies in North America, Europe and, within limits, Asia. Among these regions the size cut-off is far from clearly marked, but currently appears to be near an equity market capitalization of approximately €2.5 billion. Mainstream sell-side equity analysis therefore represents a distinct and, in market capitalization terms, most significant segment of research provision compared to small-cap, emerging market or socially-responsible investment (SRI) research.

In Europe there are over 1,000 sell-side equity analysts, however use of the term "sell-side analytical community" when making points about this group is simply a matter of convenience. In practice, the population of sell-side equity analysts is fragmented by sector, different competitive advantage of some research franchises and different strengths of individual client networks and company/industry knowledge. Short careers (spanning from about the ages of 25 to 45) and high staff turnover (especially when revenue falls) mean that the individuals that make up the population of analysts has changed markedly over the years. With so little social cohesion it is understandable that there have been few examples of co-ordination within this "community".

For sell-side equity analysts, the two main drivers are their relationships with the companies they follow and the clients they service. Success on both fronts underpins the standing of any individuals and teams, in internal/external surveys and among the investment banks.

Companies. Most sell-side equity analysts value their independence. Even so, quoted companies have a number of reasons for seeking their help in maximizing their share price. Such reasons include increasing the value of shares used for making acquisitions, minimizing the diluting impact of raising capital, as a defence against hostile takeovers, and optimizing the value of management incentives such as stock options. In doing so, companies seek to provide sell-side equity analysts with information and, on occasion, to court their influence.

Regular statutory results announcements provide the basic financial information that analysts need to operate. At such times company investor relations teams may seek to manage the control of any commentary in order to accentuate the positives. In maintaining their independence, sell-side equity analysts need to weigh the extent to which they can challenge the signals being given out by any company, while maintaining the best possible working relationship with them.

Knowledge of companies and access to both additional information and to management teams is a key differentiating factor between sell-side research teams. In maintaining the dialogue with companies, sell-side equity analysts can enhance their position with market feedback and by the facilitation of contact between company management and their (current or future) shareholders. Most companies welcome this, as it helps them in their quest to increase their share price. An important element in the way that companies view a sell-side equity analyst therefore involves the recognition and respect that that analyst gets from their clients.

Clients. As the paying customer for the research service, clients are the key driver of the behaviour of sell-side equity analysts. Underlying this is the investment approach adopted by most institutions: that a sequence of short-term investment decisions is the best way to generate the required long-term returns of investors.

What is it that clients require of the sell-side? In practice, it is a combination of good quality investment ideas and dependability of contact that contributes to the rating of sell-side analysts. The *Institutional Investor's Survey Report* (March 2004 pointed out that the buy-side rated analysts most highly on industry knowledge, trustworthiness, accessibility/responsiveness,

access to company management, and useful/timely calls and visits. Similarly, Thomson *Extel's 2004* survey points out that "direct analyst contact, well constructed investment ideas and crisp, pointed thematic research are at the heart of a successful sell-side relationship".

Sell-side analysts are, however, finding that they are required to cover more clients. Two years ago the call-list of a mainstream sell-side equity analyst in Europe was dominated by up to 70 long-only funds with different investment styles and approaches and their own analyst teams. This has changed dramatically as hedge funds have emerged as key players in the equity market. Some observers estimate that there are now 500 hedge funds in London alone running US$ 120 billion in assets, and their importance is even greater since their dealing activity means that they account 25-50% of secondary equity commission.

At the same time, there is greater competition for the attention of clients because most large companies on both sides of the Atlantic are now being covered by an average of about 20 analysts. This rivalry is intensifying as firms cut their lists of approved brokers.

A last trend worth noting is the declining emphasis placed on written research. In the *Institutional Investor's Survey Report*, written research was rated only 8th in a list of the most important variables shaping the sell-side's perceptions of research, trailing behind more service-oriented factors.

How do sell-side analysts currently approach social and environmental issues?

Mainstream sell-side equity analysts employ a number of financial modelling, corporate strategy and industry analysis techniques, in order to place the current competitive position of companies and to project their likely future. These help in determining the likelihood of events that will have a significant impact on share price, such as acquisitions and disposals, competition issues, the possibility of bid activity and the need for raising capital. Within this framework, all serious sell-side analysts gain an understanding that non-financial issues affect the value of an equity, even though these might be lumped together under "political risk".

Sell-side equity analysis mostly tends to engage with these issues when they first emerge as risk factors and then become key share price drivers. Litigation in the asbestos and tobacco industries would represent two examples of this shift.

One example of this focus on risk emergence, but not on an underlying analysis of environmental and social risk, comes in the mining sector. Mining companies have long confronted situations which expose them to potential social and environmental issues. While discussion still continues on the legacy of earlier mining activity it is fair to say that most mining companies do now recognize a requirement to balance the generation of returns for shareholders with the needs of other stakeholders. The largest companies have led the way with the launch of the Global Mining Initiative in 2000 and the subsequent publication of the Mining and Minerals Sustainable Development report in 2002, "Breaking New Ground". This has helped to embed a greater level of responsibility in a large part of the industry. In the period since, all of the major London-listed mining companies and the North American aluminium companies have begun to more strongly communicate their record, through the annual publication of environmental and social reports.

The mining industry continues to be confronted by a number of issues. HIV/AIDS prevalence has risen among workforces, especially in southern Africa. Legislative change in South Africa has required the explicit recognition of historically disadvantaged citizens. Monitoring of both environmental and social performance has increased. At the same time, the adoption of the Equator Principles by commercial banks has put non-financial performance centre stage in project financing, and the Extractive Industries Review has further developed the debate on the priorities of the World Bank.

Through all of this, mining equity analysts have continued to focus largely on the sensitivity of mining company earnings and valuation to prevailing commodity prices and exchange rates. Despite the (often extreme) volatility of these short-term factors, changes are at least easily identified on screens. Analysts also seem more comfortable forecasting their future direction than they are in identifying and quantifying changes in non-financial risk.

Responsible Investment and Sell-side Analysis

ABN AMRO's Climate Change

ABN AMRO published "Climate Change and Analysis" in November 2003, a 32-page outline of an analytical framework. The report was initiated by a head of research who identified a cross-sectoral theme and saw an opportunity to involve a number of sectors across his research team. The aims of the note were twofold: "As well as hopefully providing useful information to our investor clients, the purpose of this note is partly to encourage our company analysts to include these issues in their thinking." In order to enhance the external profile of the note, its publication was timed to coincide with the Institutional Investor Group on Climate Change (IIGCC) a couple of weeks later.

The lead author was helped by a number of factors that few individual sell-side equity analysts are able to draw upon. Having previously been an equity strategist he already had experience in writing across a broad canvas. As Head of Global Research he was able to call for collaboration by research teams across a range of sectors. His managerial position also provided the authority to justify an exercise that, in time alone, represented an investment.

The report received various reactions. Among the external audience, it was welcomed by fund management companies with a longer-term viewpoint and achieved its goal of wide circulation around the IIGCC conference. However there is little evidence that it attracted much attention from investment managers outside of this group. Internally, it succeeded in focusing analysts on the issue with follow-up in a small number of sectors, but failed to gain significant traction as a "marketable" product among the equity sales force.

The range of critical comment could be categorised as follows:

Positives
It dealt with a topical and material issue and supported ABN AMRO's involvement in the IIGCC conference in November 2003.

It was a good effort in a cross-sectoral approach to a major global issue.

It was comprehensive, in that it included most of the industries likely to be affected by climate change issues (such as metals and mining, utilities, automotive, aviation, insurance).

It helped to create a contextual background against which ABN AMRO's clients could judge the need to adjust to climate change pressures for individual sectors and companies.

Negatives
Sales teams could not identify the key selling points of the research. It lacked specific equity recommendations and was therefore of itself not "actionable" and not "commercial".

It failed to adequately quantify any of the issues.

It was perceived to have been a burden in terms of drawing senior analysts away from their immediate profit and loss responsibilities.

The note demonstrated to ABN AMRO's analysts that it is possible to write a broad, cross-sectoral piece of research, outlining a global environmental issue and creating a context in which to make decisions regarding investment at both a sector and company level.

Where it succeeded was in condensing a very broad issue and highlighting the key questions for shareholders. The feedback suggests that where it fell short was in failing to, first, provide answers in a way that was relevant to the majority of clients (and the sales people who talk to them) and, second, to deliver investment recommendations.

What is apparent from the reaction to the note is that innovative research such as this requires both a very strong grasp of the issues (allowing a very structured argument of the likely outcomes) and the ability to focus on the most likely scenario. It needs to be founded on sufficient information or estimation to identify causes, their most likely effects and (critically) the probable impact on sectors and on individual equities.

Mining analysts who have achieved sporadic success in identifying and quantifying emerging risks have been reacting to specific events. An example would be the original leaking of South Africa's draft mining charter, which was a distinct catalyst for movement in share prices. With knowledge of mining company exposure and informed guesswork on the likely impact of black economic empowerment legislation, sell-side equity analysts were able to write research quantifying the likely effects and indicating appropriate share price levels.

Few, however, have been successful in to trying to outline the mining industries' longer-term trends or the appropriateness of company business models. As yet no-one appears to have interpreted recent events as an indicator of future returns.

Yet it would be unfair to pick on mining analysts, when in truth the broad philosophy of responsible investment has made little headway among most mainstream equity analysts. This reluctance to move the research time horizon beyond the foreseeable

and the quantifiable represents a concern that such analysis falls short of being "commercial". The previous box details some examples of reactions that can greet research deemed to be too far out regarding time horizon and breadth of theme. It suggests that closing the gap between identifying the key themes in a global investment idea (like climate change) and generating specific investment ideas needs two, more important, further steps: (1) there must be sufficient information or analysis to differentiate between the implications for individual industries, and (2) the results of the analysis must be sufficiently quantified and focused to underpin specific investment recommendations.

What impediments are there to a deeper involvement of sell-side equity analysts in responsible investment?

The obstructions follow the broad themes of the availability of information, the relevant competencies to analyse it and the incentives/disincentives to pursuing this further engagement.

A. Information

Sell-side equity analysts have a number of tried and tested sources of information on which they can build their financial models and which can serve as pointers to changing trends in company performance. The same is not true for non-financial information; constructing a similar data set represents a major hurdle to the embedding of responsible investment.

There is little doubt that the efforts of multilateral institutions, NGOs, consultancies, industry groups and companies have substantially increased the amount of information available to provide a framework for responsible investment. The World Bank and the UN have published large scale research on the main issues. The principal NGOs have all undertaken their own research and have websites and mailing systems that convey their key messages. The work of various bodies (such as the Carbon Disclosure Project, WRI and Innovest) has created the foundations for many cross-sectoral analyses. Industry groups (such as in the mining industry, and soon, the cement industry) are helping to identify the main issues and working to establish best practice. Almost all of the larger companies covered by sell-side equity analysts publish social and environmental information (see www.CorporateRegister.com). All of this work is steadily creating a background for making judgements on non-financial performance.

Yet the progress that has been made remains fragmented, with little consistency in approach and considerable gaps in the data set:

- Data collection is patchy and difficult to analyse. Gaps still remain in terms of coverage. Only 59% of FT500 firms responded to the second request by the Carbon Disclosure Project, published earlier this year. Sustainable Asset Management sees just 20% of its questionnaires returned. Even the proposed London Stock Exchange survey, helpful though it may be, will only provide information on the UK subset of companies in the pan-European equity universe. At a sector level, there is still too little structure in the individual weightings given to management quality/risk factors. What, for instance, is the appropriate way to weigh safety records relative to employee diversity?

- Equity analysts in Europe largely view NGOs with suspicion. In the US they view them as hostile and patronizing to the financial community, driven by a narrow ideological agenda, unregulated and too often irresponsible with its information. Against this background, the social and environmental lobby groups still have a long way to go in providing rigorous and authoritative information that could be used by sell-side equity analysts.

- Company data on social and environmental performance is rarely audited and lacks any historic benchmarks. There are a number of problems. First, the absence of significant verification or authority of the data gives it a quality that is little better than anecdotal. Companies have proved adept at twisting accounting data, so why not social and environmental figures? Second, the data is published annually and usually too late to significantly update a view on an equity. Third, individual company reports are proving to be of limited use in stock selection, given the absence of agreement on key indicators and a wide variation in social and environmental reporting standards. Finally, for some companies, reporting has only recently begun, therefore is no track record to compare recent trends against.

Considerable progress is being made in establishing indicators of performance for environmental, social and ethical performance. Gaps remain, however, and the data set does not yet add up to a coherent whole. Sell-side equity analysts are, unfortunately, unlikely to fill much of this void. Prevailing pressure on time and resources means that, despite increased computer power on the desk, the processing capacity of sell-side equity research teams remains limited.

B. Competency

Clearly, the ability of mainstream analysts to factor in social and environmental issues requires them to, first and foremost, understand them.

Responsible Investment and Sell-side Analysis

In the last two decades, the development of equity analysis has focused largely on developing financial expertise, anticipating corporate events and establishing valuation benchmarks. Competency revolves around the interpretation of accounts, the analysis of structural position and the development of discounted cash flow valuation models. Analysis of non-financial criteria has mostly focused on "quality of management", particularly following the corporate abuses of recent years. Commitment to this looks thin, however, as it features on the official reading list of the Chartered Financial Analyst (CFA) programme yet has failed to gain sufficient importance to become an issue in the examination process. Focus on other non-financial aspects is even leaner; for example, the London component of the CFA's continuing development programme provides just 1.5 hours of training in social and environmental issues during its entire 12 month duration.

Probably the single biggest step in pushing sell-side equity analysts into their first tentative steps toward responsible investment has been the emergence of Socially Responsible Investment (SRI) funds among the client base. This contact between questioning clients and mainstream equity analysts has helped to raise awareness of the impact of environmental, social and ethical risk. There are a number of sectors (such as mining, tobacco, food producers, oil and gas) where the ability to spot the surfacing of such risks might provide an opportunity for differential performance.

The main reason most advances toward responsible investing by sell-side equity analysts have followed the surfacing of risks is that most analysts (and their contacts) already operate in this manner. And under this model, one of the few ways that sell-side equity analysts can offer added value is by anticipating the emergence of a new risk in the short term.

However, if responsible investment is to take a greater hold among mainstream sell-side equity analysts, it will require a different way of thinking and different approaches to analysis, either by introducing a different set of competencies or a different set of analysts.

- Knowledge on social and environmental factors exists in the sell-side analytical community but it is still thinly spread and tenuous. Given the short lifespan of equity analysts this means that many only become oriented to social and environmental issues towards the end of their investment banking careers.

- Expanding existing practice for analysing equities to include non-financial criteria demands a significant investment in training. Mature sell-side equity analysts learn most "in situ" by research writing. However they only aim to write research that will be immediately consumed and acted upon by their buy-side clients. For the current stock of sell-side equity analysts to gain sufficient knowledge to judge companies on responsible investing criteria, it would require a significant investment in training or in writing research that could be too easily categorized (at least internally) as "non-commercial".

- New analysts are receiving too little training in the use of non-financial criteria in equity valuation. As a result, an impediment still exists on the extent to which the turnover in the population of sell-side equity analysts might promote a change in investment philosophy.

- The prevailing culture in sell-side equity analysis remains focused on financial criteria. Most sell-side analysts remain focused on winning in the current system rather than attempting to change it. Few managers in investment banking firms, who developed in the trading floor environment, buy-in to the notion of responsible investing.

For sell-side equity analysts to deliver a different type of research product focusing on non-financial criteria requires a change in culture and a refocusing of management approach, beyond the "measurables" of call rates and short-term market share. As we will see in the next section, there are considerable short- term disincentives to making these changes.

C. Incentives

The previous two sections have indicated that for sell-side equity analysts to make the shift from financial investment criteria to responsible investment criteria, a significant investment in knowledge and information source is required. Is there anything in current incentive schemes to underpin this kind of investment? Indeed, are there any real incentives for sell-side equity analysts to help to establish responsible investment approaches at all?

Sell-side equity analysts, like most trading floor professionals, share in an incentive structure that provides a basic salary, potentially supplemented (substantially) by a (i.e., year-end) bonus. This structure matches the revenue-oriented nature of sell-side equity research and the transaction that underpins it. For the analyst the rewards are substantially deferred, as most investment banks pay bonuses on an annual basis and only a

handful have developed systems that pay out on a quarterly basis. At a business-level, however, annual bonus payments are an effective way for investment banks to adjust remuneration depending on overall profitability.

Analysing the strength of this incentive is made difficult because while there is little overall transparency in analysts' remuneration. What the results of the Extel and Institutional Investor Surveys demonstrate is that, in Europe at least, the basic salary of sell-side equity analysts is considerably higher than the region's average income level. Moreover, the details of recent tribunal hearings suggest that, at least for some analysts, bonuses can be a multiple of their basic salary in a period of good profitability. The way sell-side equity analysts' bonuses are paid is important to the diffusion of responsible investment because:

- Internal perception matters. The criteria by which bonuses are determined are often situation-specific and include the internal perception of investment banking organizations as to the contribution of individual analysts to overall investment banking revenue.
- Investment in new research methods is very risky. Under these conditions, investment by individual sell-side equity analysts in upgrading knowledge or in path-breaking research is an extremely risky path. A loss of short-term servicing that results in lower client reviews or a drop in business flows represents a significant opportunity cost in terms of reducing the claim to remuneration.
- There is a very high cost to misjudging client demand. The opportunity cost of investing in a switch of investment approach is accentuated by the fact that any misjudgement of client demands that leads to research being met with indifference further undermines a positive perception of an analyst's contribution to the business.

The current structure of incentives for sell-side equity analysts is designed to focus their efforts on maximizing short-term revenues, with the internal perception of their contribution based on concrete "measurables" such as call rates, research production and client visits. These aims do not marry well with the immediate investment and overall change in viewpoint required in a shift toward responsible investment criteria.

What, from the perspective of sell-side analysis, could be done to break through the current impasse?

Mainstream sell-side equity analysts are geared-up to provide commercial research services to their clients. The principal reason they do not engage in responsible investment issues is that there is too little incentive (and possibly a strong disincentive) to do so.

Changes that will occur anyway

This section looks at the current changes in the gathering of information, and the sell-side equity research business model presently underway. Changes are due to occur because:

Information is improving. Constructing a data set and analytical tools for non-financial criteria, that compares to those existing for financial data, represents a major hurdle to the mainstreaming of responsible investment. Individual corporations still need to disclose more information and, importantly, be willing to discuss more openly and specifically the implications of key social and environmental drivers on their business. Cooperation between companies is also going to be necessary in order to establish meaningful benchmarks of performance across sectors. At the same time, it is going to be vital for companies to support (with timely information) the activities of outside parties, to enable them to continue to gather data and to refine their own techniques.

Sell-side equity research is already facing changes, driven by an altogether different debate than that of responsible investment. Regulation of the role has increased on both sides of the Atlantic and includes analysts' relationships with trading desks and corporate finance activities. Over the next year it will become more apparent what regulators are seeking in terms of the "unbundling" of research from other investment banking services.

Changes are also continuing to occur on the investment value chain that impact the business model of sell-side equity research. There is still further to go in terms of long-only funds cutting their broker lists. Growth in hedge fund activity will continue to provide an alternative source of commission revenue. The overall effect is likely to be a continued pressure on sell-side equity research to further shortening its investment time horizon.

Sell-side research business models are flexible over time. It would be wrong to suggest that current pressures on sell-side equity research mean it is necessarily a "dead-hand", or

worse, an obstacle to the mainstreaming of responsible investment. Research business models are flexible, as is the population of sell-side equity analysts itself. Changes in the past, such as the disappearance of some sectors and the emergence of others, have been accommodated in recruitment and restructuring decisions. Yet the position of sell-side equity research as a service provider means that there is little scope for generating changes from within except in response to actions made by other parties in the investment value chain.

Under the right circumstances sell-side equity analysis could change radically. Sell-side equity analysts will have to adopt different perspectives in any shift to more responsible investment criteria. Properly underwritten, the effects would be radical. There would need to be an investment of time and money for education in how to analyse companies on this basis and what the results mean. Analysts would need to upgrade models, to develop ways of using non-financial data that are similar to the ways they use financial data, and then generate meaningful ways of comparing performance between companies. They would also have to be properly prepared to challenge companies on their non-financial performance and discuss how management can improve it.

Changes that will need action by other players in the investment chain

Sell-side equity analysis is a commercial activity that evolved over the last 30 years through the combined pressure of market regulation and of the demands of its clients. It is unlikely to undertake a unilateral adoption of responsible investment criteria without explicit support from the buy-side. The changes that might promote this include:

Finding new ways to pay for sell-side research. In the short term, clients who require research products — those that lie outside the current consensus created by financially focused analysis and short-term share price performance — will (along with their sell-side counterparts) need to develop explicit ways of paying for them. This might take the form of specific directions in terms of allocating future commissions or the commissioning of specific pieces of research covering this area. The importance lies in having a distinct vote of support for this research approach from the client base.

Adoption of responsible investment among the buy-side. Drivers for this might be institutional investors coming under pressure from trustees in the pension funds market, SRI funds gaining greater penetration of the retail funds market or equity investment models becoming more sophisticated among the hedge funds. Whatever the process, there is a point (as yet unclear) at which the buy-side's desire for analysis based on responsible investment criteria is significant enough to drive change in the sell-side.

The willingness of companies to engage in dialogue on information. This stage would itself contribute to further developments. Extending the current dialogue on responsible investing criteria between sell-side equity analysts and company investor relations could lead to improvements in the way companies communicate their performance. Sell-side equity analysts' demands could also enhance the products of other information providers.

Changes that would need public policy interventions

Sell-side equity analysts operate within a market mechanism that has evolved over a considerable period of time. While practitioners might be wary of interventions affecting the workings of efficient equity markets, it is a fact that regulation already shapes the market and there is a role for changes here to promote responsible investing, such as:

Requiring the publication of information and its assurance. In terms of information, the main role of public policy intervention is in requiring its publication and in creating reliable external assurance. One model might be to have social and environmental reporting follow the accounting and legal disclosure frameworks within which companies already operate.

Making responsible investment a part of professional competency. The competency of sell-side equity analysts could be enhanced by introducing questions on responsible investing into the examinations of the main professional bodies, such as the Securities Institute and the CFA programme.

Changing incentives through the financial services industry. The role of equity analysts and how they are paid has been the subject of substantial investigation on both sides of the Atlantic for some time. The motivation behind this has had nothing to do with accelerating a move towards responsible investment. In promoting this, market regulators may have to address the workings of the bonus systems.

Responsible Investment and Pension Funds

Stephen Davis, President, Davis Global Advisors[64]

Policymakers around the world have an historic window of opportunity to shepherd a new political economy of growth. The reason is the widespread ownership of corporate equities.

Through pension, insurance and savings institutions, millions of citizen-savers are gradually inheriting potent stakes in the enterprise — the biggest listed companies — from the state, tycoons or founding families. This emerging economic reality blurs the old frontiers between worker and owner, just as industrialization once overwhelmed social divisions thought immutable in feudal times.

At this critical juncture of transition, there is a simultaneous requirement to offer practical policies designed to match the vigour of private enterprise to the demands of social accountability. The key to unlocking progress is an agenda designed to mobilize ownership to encourage a shift in focus within the institutional investment community toward greater consideration of longer-term and non-financial considerations. This formula represents what I term a "civil economy." A civil economy agenda would have the potential to forge new domestic coalitions behind successful income and employment-creating policies, and provide global leadership in shaping the course of market capitalism toward social responsibility.

This chapter begins with a snapshot of how new financial realities lay groundwork for the new political economy of growth. It then paints a picture of how those politics can energize civil ownership to foster the corporation of the future, equipped to generate profits, jobs and public goodwill.

The New Landscape of Share Ownership

Today, beneficial owners — those who will ultimately benefit from share ownership of large corporations — are no longer the wealthy privileged few. Particularly in northern Europe and North America, but increasingly on a global basis, the beneficial owners are now the huge majority of working people who have their pensions and other life savings invested in the shares of the world's largest companies. The biggest two shareholding bodies in Britain, for instance, are the British Telecom and the mineworkers pension schemes. In Denmark it's the ATP, the worker's pension fund. In Holland it's ABP, the civil service fund. In the United States it's the public employees of California (CalPERS), and in Canada the teachers and civil servants of Ontario. Each of these funds holds a small share in literally thousands of companies. Further, it isn't just that domestic funds own the companies in their own nation. Increasingly, funds have an ever-larger proportion of their equity invested internationally. Quite literally then, these funds constitute the majority ownership of our corporate world. Each pensioner owns a tiny interest in vast numbers of companies; from the telecoms of Panama to the chemical companies of Germany, from the electronics companies of Silicon Valley to the oil wells of Nigeria, millions of citizens are the beneficial owners.

We have a very different starting point from that faced by the framers of traditional economic policy and investment regulation. For instance, the historic rationale for representing the workers' interest against the interest of capital makes little sense. In the new political economy of most advanced industrialized countries with aging populations, the worker and global capitalist are one and the same.

At the same time, the traditional view that employers should be relatively unfettered in going about their business has been discredited by episodes of domestic and international scandals rocking listed companies. In some markets, criticism has focused on excessive director pay unlinked to performance or out of proportion with workplace norms. Elsewhere boards have gone astray with instances of fraudulent financial reporting, wanton abuse of stakeholders (including workers, investors and consumers), and cavalier treatment of communities in which firms operate. Both the global reach of corporations and the new facts of mass ownership are compelling us to rethink the frameworks of enterprise.

Thanks to the new make-up of capital markets, positions once frozen into (bi-polar) place are now thawing into a semblance of fluidity. The path to a robust civil economy now depends on policymakers being able to identify the ways in which the interests of citizen-owners routinely fail to be reflected in money management by institutional investors, and then to define remedies.

Engaged Shareowners

Just as civil society requires engaged citizens for its success, so a civil economy requires owners who perform a similar role. Today, institutional investors managing the savings of tens of millions of people quietly own vast swathes of the market all over the world. But too many funds shirk fiduciary obligations to savers when they neglect to challenge corporate authority, even when an investee company's management is patently flawed.

The roots of this disengagement are clear: a generation ago, the ownership of companies became divorced from management control. Essentially, the shareholder was encouraged to think of his or her ownership interest in the company as a "tradable security," not as a right of ownership. If the company performed badly, the shareholder would sell. Shareholder rights were (at best) seen as equivalent to consumer rights. If you did not like the company's behaviour, you would sell and take your investment elsewhere.

Rules and practices in big capital markets hemmed-in shareowner power in a variety of ways. For one, statutes, regulations and court decisions installed the general principle that investor concern for a corporation's relationship to social, ethical and environmental (SEE) concerns would normally constitute a breach of fiduciary responsibility. The (Lord Justice) Megarry judgment set this standard in the UK, the Securities and Exchange Commission (SEC) regulations did so in the US, and the Canada Business Corporations Act (CBCA) did the same in Canada. The CBCA, for instance, explicitly allowed companies to delete any dissident shareowner resolutions that addressed social matters. As a natural consequence, most institutions steered well clear of applying social, ethical or environmental screens to portfolio selection or ownership engagement. The Clinton administration's Labor Department tried to lower the bar with an interpretation of the Employee Retirement Income Security Act (ERISA). But those efforts did not affect securities regulation, leaving fiduciary responsibilities ambiguous. The UK Labour government has proposed reforms of the Companies Act [1989] that would enshrine investors' rights to consider SEE issues when constructing portfolios. Until that happens, fiduciary obligations there also remain in a grey zone. The result is often a serious mismatch of performance measures. Companies in some jurisdictions are actually obligated to address the interests of all stakeholders, including shareowners. But shareowners of those same companies may be driven by their own fiduciary constraints to press boards to satisfy investors alone.

Market architecture suppressed shareowner power in other ways, too. Laws discouraged cooperation among funds on the grounds that they might constitute a joint-party with sufficient blocs to mount a takeover. In the US, many such barriers were only lowered in the early 1990s after CalPERS asked the SEC for reform. Before that, institutions had to undertake cumbersome and expensive procedures if they wished to merely consult with like funds on the state of affairs at a particular company. Some markets retain restrictions. For their part, funds support model statutes that provide a legal safe harbour for such consultations, provided that they are undertaken for purposes of improving governance and not to support a takeover.

Certain markets also limited investor power by handing managements of companies the authority to make decisions without consulting shareowners. The United States is the prime example: under federal and state laws, boards can retain sole power to alter investor rights by introducing takeover defences. They can also restrict minority rights by imposing formidable hurdles, or banning investors' rights to summon special meetings. And in both the US and Canada investors have limited ability to alter boards with which they may be displeased. Ballots permit only a yes or a withhold vote, meaning that even if every share save one voted to withhold for an entire slate, the directors would still all reach office. In other markets, shareowners are rendered less potent by rules giving them little information about companies, or by voting practices that favour voting by loyal and local investors. Such practices may have been appropriate when ownership was closely held — it is unworkable when ownership is dispersed.

In some markets, governments have inhibited investor power by restricting the rise of pension funds or placing severe limits on their ability to invest in equities. France is the most obvious example of the former: the issue of establishing corporate retirement schemes is fraught with politics, as a significant portion of the trade union movement believes that the government would inevitably reduce state pension benefits if they were widely introduced. But their absence has reduced the potential for domestic liquidity, so that today the largest French public companies are majority or near-majority owned by outside investors, far less concerned about the social impact on France of corporate behaviour.

Perhaps the greatest weakness faced by investors is the one most deeply embedded in the institutions' own architecture. The truth is that most funds fail to meet the bedrock governance standards they increasingly demand of companies. This can most clearly be seen in the principal ways in which accountability and transparency fall short.

- Savers can rarely discover how their funds are managed. Only beginning in September 2004, for instance, could investors in US mutual funds discover how their stock is voted. Such information remains hidden elsewhere in the world. Without such disclosure, the risks that conflicts of interest affect decisions rise. A mutual fund is unlikely to vote shares against a company's management if it wants business from the CEO. But it will more likely do so if the

company is troubled and that such votes will become public. (See “Effects of Sunshine” for examples.)

- Savers normally have no voice in how the funds operate, or who makes key fund decisions. Corporate funds and employee stock plans in many jurisdictions are entirely or largely controlled by company management. At Enron, that arrangement gave management the ability to steer disproportionate amounts of employee capital into the firm’s own equity. In fact, such funds very often serve as reliable pro-management voting blocs in the event of contests. More generally, pension plans controlled by corporations typically vote shares mechanically with management. Since the issue lies at the heart of the control of capital, the question of whether pension fund members should elect trustees is a critical one, with fiercely held views on both sides.

- Boards of trustees of pension schemes generally do not operate as professional oversight bodies. Recent probes in the US, UK and the Netherlands have exposed many of the flaws. Most trustees are not getting trained, spend too little time on the job, communicate too little with scheme members and ignore shareowner activism and socially responsible investment, according to a Consensus Research report for the UK Department of Work and Pensions.lxv They are typically not paid or given authority comparable to directors at public companies, and few spend efforts assessing their own performance or communicating with beneficiaries. In other cases, particularly those of civil service funds, trustee boards may be swayed excessively by political factors. Critics, for instance, say that CalPERS remained silent on the issue of whether stock options should be counted in financial statements as an expense, owing to the political clout of Silicon Valley corporates who were dead set against reform.

- Intermediaries such as investment advisors, gatekeepers, consultants and fund managers that link trustees to the investment process typically dominate trustee decision making. This proves damaging because they are driven by factors — especially their own pay schemes — to back short time horizons, excessive trading or stock selection that disregards SEE and governance risks. Bonuses, for instance, may be keyed to turnover rather than growth in portfolio value.

- Too many funds rigidly split the functions of ownership and portfolio trading. The responsibilities to vote shares and monitor SEE and governance may often fall into a compliance or legal division, while professionals doing the

Effects of Sunshine

On 31 August 2004, US mutual funds faced a governance “Big Bang”. They had to disclose, for the first time, how they have voted shares at every company they own, foreign or domestic, over the previous year. Investors are now able to find all the data revealed on new “N-PX” forms filed on the SEC’s online Edgar (Filings and Forms) site, or on the mutual funds’ own sites.

Before 31 August, it was almost impossible for investors to discover how mutual funds behaved as owners; however N-PX now acts as an x-ray. Suddenly the market has the tools in hand to distinguish between funds that vote by rote with management (no matter how troubled the company), from those that use votes to pressure boards of underperforming enterprises to shape-up. Further, investors can identify which funds consider environmental liabilities or workplace practices part of their risk assessments of companies, by checking how they voted on dissident shareowner resolutions addressing such topics.

N-PX has already made a positive impact on fund accountability. Take American Century Investments, based in Kansas City, as an example. After the SEC adopted its ballot disclosure rule, the company sent investors a first-ever statement on proxy voting. The fund’s policy at first clearly signalled that its managers had little interest in playing a critical role at investee companies. “We do not invest in portfolio companies with the intention of… ’fixing’ ineffective management.…” the firm declared. In the new era of transparency that starts in 2004, funds that cling to such old-style guidelines — treating board elections as essentially “routine” rubber stamp exercises — may well pay a price in lost customers. But American Century began releasing actual voting instructions as early as June, using a particularly user-friendly system. And it showed the fund voting critically — against CEO Michael Eisner at Disney, for instance, or regarding many positions taken by the AFL-CIO against controversial managements.

The Vanguard Group, for another, understood that N-PX would make its business hinge in part on its public record as a responsible owner. In November 2003 it revealed that in the pervious year the giant fund had voted “yes” for slates at an astoundingly low 29% of US companies — down from 90% in 2002 — because of its stricter guidelines on board independence.

Investing bodies and market watchers are certain to fashion the new reams of voting data into fresh tools to assess mutual fund performance. Their report cards will affect decisions by individual and institutional investors as they choose which mutuals to trust with their savings. A first example of this process occurred within weeks of the 31 August disclosure requirement. An AFL-CIO report called “Behind the Curtain” ranked Putnam Investments last among major mutual funds in voting to curb excessive executive remuneration. Within days Putnam, already tarred from trading scandals, announced that it would launch a thorough review of its proxy voting policies on pay.

buying and selling of shares are rarely encouraged to gain knowledge and experience in the ways in which SEE and governance affect risk and performance of particular companies. Training and accreditation programmes for portfolio managers reflect this bias, and few address the need for knowledge in these areas. At the same time, professionals charged with monitoring SEE and governance have little training or experience in the challenges of business management. They are often given low status and seen as cost centres and, not surprisingly, they often fail to gain access at high levels at the companies they monitor.

- In many markets, trade bodies representing institutional investors or pension funds have failed to form themselves into political counterweights to the influence of corporate managements. Policy issues they address, in any case, typically do not address SEE concerns. One reason is that they are structured to identify their constituents as the executives of the funds, not the ultimate beneficiaries. But executives may themselves have serious conflicts of interest; for instance, their funds may be controlled by major corporations. Trade groups therefore miss tapping the most promising route to political clout: the millions of grassroots savers whose money they represent. As a result, the wider, long-term social interests of pensioners are usually not at the forefront of trade bodies.

Taken together, these factors render most funds unaccountable to citizen-savers and, as a consequence, relatively passive as owners – and the consequences can be severe. For one, fund aversion to oversight allows some corporations, enabled by somnolent boards, to engage not only in infamous cases of larceny, but in a more corrosive everyday mismanagement of companies' impact on shareowner capital, employees and the environment. The result is that power is abused. At the extreme, scandals surface: Robert Maxwell's pension looting in the UK; TotalFina's catastrophic *Erika* shipwreck in France and the *Exxon Valdez* spill, demonstrating high-level inattention to environmental risks; Enron, Tyco, Worldcom and Adelphia financial frauds in the US; Parmalat, Ahold and Skandia "book-cooking" in Continental Europe; and HIH Insurance and One.Tel mismanagement in Australia.

Enabling Shareholder Engagement

Through voluntary codes, law or regulation, institutional investors must become transparent and accountable, so that they act to reduce risks of corporate faults and are more mindful of the full range of factors that can influence returns over the long-term investment horizon of their investor base. The implementation of these codes must be auditable; they must regularly disclose what guidelines they use in investing, including whether or not they consider social criteria and how they vote their shares. Outreach to members through the Internet and electronic communications should make this routine. Savers should have a role in selecting trustees of such funds, and trustees should have access to robust, independent training programmes, such as those already sponsored by the US Center for Working Capital and the Australian Institute of Superannuation Trustees. At the same time, market regulators should be vigorous in ensuring that funds operate solely in the interests of their clients, rather than for other conflicting business interests.

Some of these reforms are beginning to be introduced by statute in the UK, US, Australia, France and Germany. Where implemented, they are spurring funds to play a more active role as owners, reclaiming, for instance, influence from intermediaries. That, in turn, has compelled more companies to clean up their management and improve both their economic and social responsibility performance.

As well as ensuring the fiduciary responsibility of large institutional owners, an especially effective grassroots engine of shareowner engagement is the fledgling band of investor groups representing small individual savers. They include Aktiespararna in Sweden, VEB in the Netherlands and DSW in Germany. National public policies should be shaped to encourage such civil economy institutions, since they often are less inhibited by conflicts to act as watchdogs.

Most of what is needed from government is surgical adjustment of regulation and law. The beauty of that equation — small public expenditure yielding big results — is that it could be a winning platform for political leaders under pressure to spur both growth and social justice when there is limited money in the public till.

Millions of citizens increasingly own powerful corporations through their pension, insurance and investment savings. They represent the engine of the civil economy — but only if public policy gives them the tools they need to ensure that markets address social interests. Reforms, either enabling or mandatory, must focus on measures aimed at accountability and transparency that mobilize retirement funds and their agents.

Responsible Investment and Pension Funds

- Governments should foster employee pension funds. Big pools of capital help keep ownership of domestic corporations close to home. They ensure that workers have access to stable, insured retirement savings that complement, but do not substitute for, traditional state social security systems. Two policy strategies can unlock benefits. First, trust laws should make each fund fully accountable to the employees and pensioners who are members of the scheme. Second, frameworks should either encourage or require that pension funds make investment choices, and craft engagement approaches, focusing on how well corporations meet social, environmental and ethical tests. Model guidelines of investor responsibility have been developed by individual investment houses (such as Insight Investments), and are being developed by investor groups such as the International Corporate Governance Network[66].

- Pension trustees should be paid, trained and invested with authority similar to that of a corporate board. For instance, trustee boards for funds greater than a certain minimum amount could be encouraged to have separate staff resources. Public policy should encourage or require new forms of trustee training, certification, conflict management, disclosure and ethics, including exposure to the latest research on the financial impact of SEE performance. The objective is to enable trustees to satisfy themselves that member money is invested in public listed companies that meet reasonable "investment-grade governance" standards and "SEE worthiness".

- Trustee boards should be accountable to the fund membership so that their decisions are aligned with beneficiaries. Government can ensure that a certain percentage of pension fund trustees are elected by employees and retirees themselves. They should be elected in periodic annual meetings with full disclosure of their attendance, professional backgrounds and other records. There should also be provisions for beneficiaries to propose challenge candidates to the board of trustees.

- Policy should spur the establishment of a formal profession of governance analysts at investing bodies. These individuals should be skilled not merely in checking compliance, but in promoting governance and SEE performance as growth drivers. This implies all the attributes of professionalism: training, certification, conflict management, disclosure and ethics. Further, trade bodies, educational institutions and certification programmes for portfolio managers should incorporate skill training in SEE and governance.

- Government policy should aim to ensure that trustee boards meet high disclosure ("Sunshine") standards so that members can readily monitor whether their funds are exercising ownership responsibilities. Share voting records, for instance, should be made available, policies on management of conflicts should be clear and public, and members should be able to tell if and how their collective savings are helping press companies to improve records on social, environmental and ethical practices. Some jurisdictions could consider mandating that policies go to a member vote on a regular basis, with provision for members to offer dissident resolutions on the fund's overall approaches to investment.

- Civil society organizations (CSOs) comparable to MoveOn.org[67], the powerful, Web-based mobilizer of US grassroots political activism, are likely to be founded. Such bodies can use emerging information tools such as voting records to advocate alignment of fund management with long-term beneficiary interests. They can also help realize the potential political power of the investor class in contests over law and regulation. Trade unions in certain countries have created groups such as this. For instance, the UK's Trades Union Congress, following tactics pioneered by the US AFL-CIO Office of Investment, is attempting to convert labour-run pension funds into powerful instruments of shareowner activism. Using think-tank research on fund manager behaviour, they get trustees to press agents and, through them, corporations, to improve governance as well as employee relations. Policymakers can create an environment fertile for the rise of CSOs by requiring companies and funds to disclose more. For instance, an obligation on funds to reveal share voting naturally prompts the creation of CSO programmes tracking and lobbying voting. An obligation on companies to unveil more data on carbon emissions would aid groups benchmarking company performance in climate change.

Tipping Points

It is almost always possible to create *some* positive change. It is harder to identify the combination of viable actions that would make a *significant* difference. For example, requiring analysts to demonstrate competencies in their handling of non-financial information would certainly make a difference. But these changes might remain relatively small if not accompanied by other changes, for example, in how fund managers receive incentives. There is a need to focus not just on what counts, but on what could potentially count in a significant way.

There is no one-stop, "silver bullet" to making the mainstream financial community more responsive to some of the softer non-financial factors — including social and environmental aspects of corporate performance — that have an important bearing on the success of business models and companies over the extended period (during which most investors in pension funds, mutual funds and insurance companies commit their retirement savings). This viewpoint was confirmed throughout the roundtables and the background research, and reaffirmed in other responsible investment initiatives. The preceding chapters, including the three authored perspectives, have identified many of the impediments to mainstreaming responsible investment. The dialogue and research indicated a high level of agreement about the nature of these impediments. While these can and have been described individually, taken together what emerges is a view of an institutional culture spanning much of the investment community that needs to be reshaped. Finally, a widely shared view has been that, left purely to the pressures of the market, the investment community would be unlikely to overcome these individual and more pervasive institutional impediments.

Focusing effectively on key tipping points is partly a matter of timing. Unblocking barriers in the wrong sequence is a little like "pushing on a rope". For example, improving the materiality of data that connects non-financial outcomes to long-term business performance might have little effect if pension fund trustees are unwilling to establish mandates for fund manager that focus on long-term performance. Similarly, increasing analysts' competencies in understanding the interface between longer-term business fundamentals and social and environmental performance will have little impact if their clients, fund managers, are locked into the management of indexed funds.

We have brought together and summarized the main elements of this portfolio of proposals, drawing in particular from the proposals offered by each of the specialist authors at the end of their respective chapters. Overall, the proposals focus on three primary routes to change: incentives, competencies and information.

Summary of Recommendations

Modify Incentives

- Establish an international set of good governance principles for pension funds — a voluntary Fund Governance Code? that ensures accountability (disclosure of votes, policies, and management relationships) and professionalism (training, representation) on the part of boards of trustees. The aim of these principles would be to ensure the representation of long-termbeneficiary interests in intent, capability and practice.
- Modify pension fiduciary rules which discourage or prohibit explicit trustee consideration of social and environmental aspects of corporate performance.
- Increase the average duration of asset manager mandates to lend momentum to current experimentation with fund manager compensation arrangements linked to superior long-term performance.
- Increase disclosure of fund manager compensation structures to encourage better linkage between pay and long-term performance.
- Develop new business models for research on non-financial issues by analysts and incorporate this into the current regulatory review of the sell-side analyst function in diversified investment houses.
- Require analysis of material non-financial factors to be included in pension fund mandates to asset managers.
- Re-evaluate the relationship and relative organizational standing of buy-side analysts and portfolio managers in order to cultivate a more attractive long-term career path for analysts, allowing for the accumulation of necessary expertise.
- Develop new performance assessment models that enable trustees to support long-term investment strategies while complying with fiduciary obligations.

Build Competencies

- Pay, train, and empower pension fund trustees more like corporate directors in order to increase the capacity of boards of trustees to exercise independent judgement in the long-term interests of beneficiaries.
- Create a specific professional competency for non-financial analysis either through increased training of existing investment analysts or the establishment of a new category of specialists.
- Increase the emphasis on non-financial aspects of corporate performance in graduate business schools and mid-career analyst educational programmes.

Improve Information

- Improve the consistency of the content, collection and assurance of material non-financial information.
- Refine the concept of materiality and the basis for measuring and communicating its application to the links between financial performance and social and environmental performance.
- Expand the dialogue between analysts and corporate investor relations officers on the need for greater consistency in the content, collection and assurance of non-financial information.

Upgrade the Governance of Pension Funds to Reflect their Central Role in Equity Markets

If pension plan participants, through their pension funds, do not convey an interest in seeing their money managed in a manner that takes full account of factors that shape corporate performance over the long run, then their agents and service providers further down the investment value chain can hardly be expected to act differently. By contrast, if the trustees of major pension funds were, as a matter of course, to require social, ethical, and environmental considerations to be explicitly considered in investment processes, then the highly competitive financial services industry would likely respond rapidly with services tailored specifically to such a mandate. In this sense, the most likely tipping point in the complex framework of impediments to and opportunities for mainstreaming responsible investment is likely to be found in the area of pension fund governance.

We have witnessed a decade of dramatic developments in our appreciation of the importance of corporate governance. This has driven a growing number of major initiatives, often framed by codes setting out the principles of good governance and its implications for practice. These codes have been wide-ranging, covering how board directors of companies are selected, their competencies and responsibilities, and the way in which these responsibilities are manifested. Codes have demonstrated a growing appreciation of the impact of non-financial issues on company performance, which in turn has triggered the development of a new generation of strategic management and accounting tools, as well as broadened disclosure requirements. In this context, understanding stakeholder concerns is no longer seen as a “nice” thing to do, but rather as a competency and practice; boards have to be able to demonstrate a willingness and ability to put this into practice.

Yet throughout and despite these on-going changes, the pension fund industry has remained largely unaffected. While the future livelihoods of the real owners of capital, notably pension policy holders, depend profoundly on the performance of their capital, the trustees of their futures, advisors and implementing agents are largely obscured from view, and in the main do not see themselves as having responsibilities equivalent to company directors. Their collective competencies, the basis on which decisions are made, and even the consequences of these decisions, are mainly opaque to those for whom they act. Intended beneficiaries are, of course, in part protected through the fiduciary requirements of these stewards of capital. But even here the interests of intended beneficiaries are underpinned by broader livelihood strategies than those reflected by traditional interpretations of fiduciary responsibilities, which include both financial and non-financial elements. Pension fund investment strategies clearly impact on both, yet (at best) they understand their own performance purely in terms of direct financial returns.

One useful way to spur progress would be to establish an international set of good governance principles for pension funds akin to a corporate governance code. These voluntary principles, perhaps memorialized in a Fund Governance Code, would aim to ensure that pension trustees, and others governing the use of funds owned elsewhere, demonstrably represent beneficiary interests in intent, capability and practice. Such a Code should include the requirement for trustees to be certified as competent to understand, for example, technical dimensions of investment practices, conflict management, disclosure and ethics. Maintaining an acceptable level of competencies would require regular exposure to the latest research on beneficiary interests and the links between financial and non-financial performance.

Intended beneficiaries should be able to tell if and how their collective savings are helping press companies to improve records on social and environmental practices. As part of this Code, trustees should therefore be required to meet high disclosure standards, enabling members to readily monitor whether their funds are exercising ownership responsibilities. Share voting records, for instance, should be made available, and policies on management of conflicts should be clear and public. Accountability, through clear processes of representation, need to accompany the principle of transparency. Trustee boards should be accountable to the fund membership so that their decisions are aligned with beneficiaries’ interests. Governments can ensure that a certain percentage of pension fund trustees are elected by employees and retirees themselves. They should be elected in periodic meetings with full disclosure of their attendance, professional backgrounds and other records. There should also be provisions for beneficiaries to propose challenge candidates to the board of trustees.

Informing intended beneficiaries is crucial, but not enough to ensure that trustees act on their behalf. Some jurisdictions could consider mandating that policies go to a member vote on a regular basis, with provision for members to offer dissident resolutions on the fund’s overall approaches to investment. In other cases, a “lighter touch” might be preferred, focused more on shifting the culture within which trustees understand and act out their responsibilities. This can be realized by an obligation on the part of trustees to demonstrate a specific understanding of the interests of their

intended beneficiaries, particularly with respect to non-financial interests. These interests may be relevant both as an end in themselves, or through their potential impacts on the financial interests of intended beneficiaries.

This latter element is consistent with an emerging body of corporate governance and related risk reporting requirements that necessitate companies demonstrate an adequate understanding of the interests of their shareholders and other stakeholders. The evidence from other regulatory and voluntary "light touch" initiatives (that involve credible and reported engagement of boards and managers with their stakeholders) is that their impacts go beyond informational change and, over time, reshape competencies and underlying cultures of decision-making.

Engaging intended beneficiaries as citizens would require that they were well-informed, able to interpret relevant information, and possessed the means to act on that information, whether individually or collectively. When it comes to pension funds and other financial instruments, most people feel quite helpless. Few understand even the limited information that is available, and generally act in ignorance, and largely in isolation. The effectiveness of any Code that amplified the voice of intended beneficiaries would need to be underpinned by a broad-based educational model, serving to enhance their ability to understand and act on information concerning the actual and possible uses of their capital. Elements of such a model do already exist, often developed and delivered by civil society organizations and publicly-funded citizen advisory services, such as MoveOn.org[68], the powerful, Web-based mobilizer of US grassroots political activism. Such bodies can use emerging information tools such as voting records to advocate alignment of fund management with long-term beneficiary interests. They can also help realize the potential political power of the investor class in contests over law and regulation. Trade unions in certain countries have created groups such as this. For instance, the UK's Trades Union Congress, using tactics pioneered by the US AFL-CIO Office of Investment, is attempting to convert labour-run pension funds into powerful instruments of shareowner activism.

Such a Code could be developed and adopted voluntarily by the industry, following the pathway taken by many corporate governance initiatives, particularly in Europe. In other instances, such a Code could be backed by legislation to avoid free riders and ensure compliance, more akin to a US approach. In practice, differing enforcement approaches are likely to be taken, but the key starting point is to acknowledge the need and to develop a basic framework that could be relevant to trustees in the major markets (Europe, North America and Japan), but also increasingly elsewhere in Africa, Asia and Latin America.

Strengthen the Capacity of Fund Managers And Research Analysts to Serve Long-term Institutional Owners

The fund management industry pursues predominantly short-term investment strategies, even so-called "perpetual investors", which can be best understood as adopting short-term investment approaches, perpetually. These practices are pursued, although the evidence points unambiguously to the enhanced financial returns associated with successful long-term investment strategies, and in contrast to the interests of the owners of capital mainly being long term. This "short-termism" is underpinned by performance benchmarking to indices that encourage fund managers to focus excessively on beating short-term market movements. This practice is, in turn, reinforced by advice to fund trustees from their advisors, further embedding such benchmarking at the heart of pension fund mandates. Current approaches to risk-adjusted returns, in short, drive trustees to focus on the mitigation of personal risk by focusing on short-term market tracking, even with the knowledge that this does not optimize long-term returns.

Responsible investment clearly requires an orientation towards strategies that optimize long-term returns, because: (1) this delivers better financial returns over the time profile that interests intended beneficiaries, and (2) social and environmental issues become more material over these periods, and so can be better considered. Realigning fund management towards the longer-term performance of their investees requires a host of measures, embracing changes in incentives, competencies and available information.

The foregoing discussion has highlighted a number of areas in which asset managers and investment analysts, whether from the buy- or sell-side, would need to evolve and modify their services and practices, if responsible investment were to become a mainstream practice in the financial community. In particular, research into non-financial information would need to expand and be financed differently. The structure of compensation for fund managers and analysts would need to change, to reflect a higher premium placed by long-term institutional owners (like pension funds) on superior long-term fund performance. The training of analysts and portfolio managers, whether in graduate business schools or mid-career professional courses, would need to substantially incorporate more time on social, ethical, and environmental issues and how they can drive long-term financial returns.

An underlying, further need is to develop and implement acceptable performance assessment models that enable trustees to support long-term investment strategies while complying with their fiduciary responsibilities. These long-term performance models are beginning to emerge, often underpinning funds with a corporate governance focus, and sometimes associated with funds with explicit non-financial (as well as financial) aims. However, to date these have remained largely marginal to the bulk of fund management strategies and practices.

The basis on which such strategies and practices evolve needs to become a key competitive edge for fund managers. One way to encourage this is for trustees and other capital providers to demand performance benchmarks that distinguish between sources of return underlying fund management strategies and practices. While benchmarks will differ widely, a useful underlying starting point may be to establish benchmarks that separate portfolio performance into three fundamental sources of return: (1) dividends; (2) earnings (that portion which is not paid out in the form of dividends); and (3) valuation changes (of the company). Distinguishing among these fundamental elements of return can be very useful from a trustee's perspective, in that it reveals much about fund managers' investment processes. Over long periods of time, "income" oriented managers, for example, should show a pattern of high returns from dividends and lower returns from the remaining two factors. Similarly, "value" oriented managers should show a balance between returns from dividends and those from changes in companies' valuations, as companies' presumably healthier-than-expected business prospects become recognized in the market-place. "Growth" oriented managers should show very little returns from dividends, and much more earnings growth and changes in valuations[69].

"Operationalizing" the next generation of performance benchmarks, focused on the longer term, would have to be done in conjunction with a number of other initiatives; for example:

- transparency, to capital providers, of investment strategies in adopted practice, including the actual proxy voting behaviour by fund managers;
- disclosure of information, as increasingly demanded in the US, about the relationship between rewards to both the investment house and individual fund managers, and the proposed basis for driving and benchmarking full-term fund performance.

Shifts in pension fund mandates with realigned incentives are necessary but not sufficient to mainstream responsible investment. Clearly, the ability of mainstream analysts and fund managers to factor in social and environmental issues requires them to, first and foremost, understand them. In the last two decades, the development of equity analysis has focused largely on developing financial expertise, anticipating corporate events and establishing valuation benchmarks. Competency revolves around the interpretation of accounts, the analysis of structural position and the development of discounted cash flow valuation models. Analysis of non-financial criteria has remained thin where it exists, focused mainly on "quality of management".

There has been some increased understanding of social and environmental issues by the growing number of analysts and fund managers working alongside specialist SRI teams. However, this growing appreciation has been mitigated by the weakness of data, and the focus of analysts and fund managers' clients on shorter-term variables. For this reason, the development of appropriate competencies will in all likelihood be market-driven on the back of changing client needs. Fund managers would be required to demonstrate, in responses to Requests for Proposals, their skills in longer-term investment strategies. And they, in turn, demand very different research from analysts, which drives a competency shift in this part of the investment value network.

There would be a need, however, to develop a more effective means of assessing and attesting to the competencies of key players. This would be particularly important in the early stages for investment houses, since their competencies will (more than previously) underpin their bids for fund management deals. Over time, however, this may become less important as more investment houses build up a track record in successful, longer-term investment management.

Taken together, this package of proposals, further developed and implemented, would encourage pension fund trustees and other capital stewards to request proposals from fund managers that, to be successful, would require:

- investment strategies linked to longer-term performance benchmarks;
- incentives demonstrably aligned to such performance;
- a clearly established basis of relevant and adequate competencies on the part of the fund management team to effectively implement the proposed investment strategy.

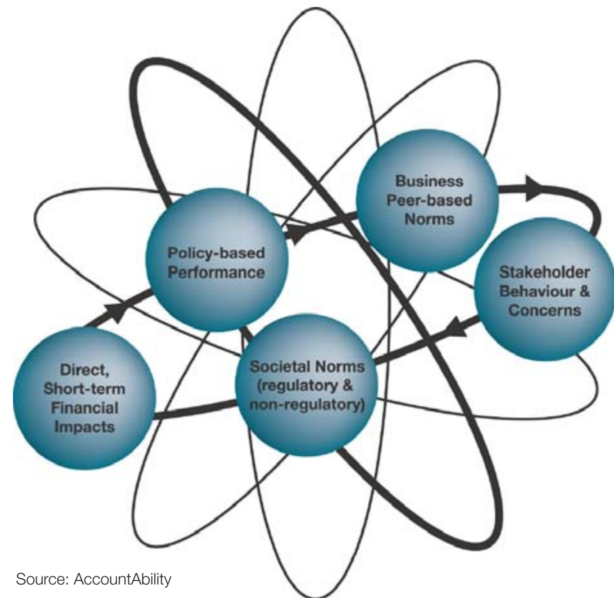
Increasing the Availability and Utility of Non-Financial Information

Even if there were major changes in pension fund governance and asset management analyst capabilities along the lines proposed above, serious issues would remain regarding the quality and utility of non-financial information. The effective operation of the investment value chain depends, ultimately, on information provided by and about the likely future performance of potential investees (the business community). The quantity of corporate non-financial information has increased dramatically in recent years, particularly from those companies publicly listed in Western Europe and North America, and to a lesser extent in emerging markets like Brazil and South Africa. Initiatives promoting more standardized non-financial reporting, such as the Global Reporting Initiative Guidelines[70], have driven an improvement in practices, as have emerging models of sustainability assurance, such as AccountAbility's AA1000 Framework[71]. Furthermore, a new generation of investor-facing indexes is also emerging, seeking to bridge measures of social and environmental performance to future financial performance (led by the SAM Group's innovative Dow Jones Sustainability Index), and includes a growing array of largely risk-focused tools.

Yet the fact remains that the coverage, quality and level of credible assurance remains very patchy[72]. Crucially, the ability of businesses to credibly articulate the materiality of social and environmental issues to future financial performance, let alone share prices and dividends, is extremely poor. This shortfall is becoming even more significant as regulations on corporate governance and risk-related reporting increasingly demand companies to disclose "material non-financial issues that are likely to impact on future business performance". These regulatory moves will increase pressure to accelerate the development of robust methodologies in the face of litigation dangers associated with inappropriate metrics or misjudgements in the nature and degree of substantive materiality.

The danger is that emerging metrics and guidance will be framed by the very narrowness of perspective and "short-termism" in the investment community that is at issue. Most social and environmental aspects of corporate performance will be deemed "immaterial" by the bulk of the investment community, which has little interest in longer-term performance (or the broader dimensions of performance) of inherent interest to intended beneficiaries of retiree saving vehicles like pension funds. Overcoming this double bind requires the evolution of methodologies that frame materiality in terms of:

- both short- and longer-term performance, and;
- both narrow financial goals and broader concerns.



Source: AccountAbility

That is, there is a need for disclosure to be driven by multiple levels of materiality, thus making broader and longer-term dimensions of material non-financial performance more visible, alongside data relevant only to narrower, shorter-term financial performance. Some work has already progressed in this field, both to inform service providers delivering sustainability assurance and those companies responding to new regulatory requirements such as the UK company law Operating and Financial Review. This work has guided companies to disclose social and environmental performance relevant to short-term financial performance, corporate policies, the non-financial disclosure practices of business peers, and specific stakeholder concerns, as well as broader societal norms. This "tiered" approach to materiality is proving effective in encouraging companies to develop metrics models that can distinguish different type of materiality, and in providing more structured information to investors.

Although progress has been made, much remains to be done in redefining materiality and establishing a suitable basis to measure and communicate its application to the links between social and environmental and financial performance. Arguably, the greatest gap lies not so much in reporting, but in the area of strategy development. As one analyst remarked, "There is no point in demanding metrics from a management team that does not even intuitively understand the relevance of the non-

financials." This is clearly less so where social and environmental factors become more visible in the market, either because they are traded or because they carry statutory weight, as we increasingly see in the case of climate change. But even in cases of such importance, it is surprising how few companies have really worked through for themselves the longer-term implications for their business models. More generally, the measurement gap reflects a more fundamental shortfall in most companies' underlying appreciation of the importance of social and environmental factors in informing business strategy and enhancing performance.

A new generation of strategic management tools is needed that offers a more sophisticated treatment of non-financial performance drivers, including social and environmental dimensions. Emerging innovations in risk measurement and management offer part of the solution, but they remain limited in focusing mainly on downside risk, and generally fail to illuminate strategic choices resulting from predicted significant shifts in a company's social and environmental context. Obesity for the food industry, climate change for the automobile industry, preventative health models for the pharmaceutical industry or demographics for the pension industry are but a few cases of momentous, market changing factors that were widely debated in society, yet failed to impact all but the most progressive companies until they had short-term financial significance. Initiatives, such as the Global Leadership Network and work at Harvard's CSR Initiative, are moving this agenda forward in developing understanding and tools to support the integration of social and environmental issues into business strategy development and management[73]. Much, however, remains to be done in establishing effective platforms for senior business managers to focus on the strategic dimensions of social and environmental issues, and for linking these platforms to executive compensation and investor communications.

Extending the Dialogue

The next decade is likely to see significant changes in the investment community. Demographic changes alone will reshape our understanding of what the capital markets can and cannot provide to ageing populations. As Alan Greenspan commented, "As a nation, we owe it to our retirees to promise only the benefits that can be delivered. If we have promised more than our economy has the ability to deliver to retirees without unduly diminishing real income gains of workers, as I fear we may have, we must recalibrate our programmes."[74] Growing demands for choice and control by the ultimate owners of capital are already reshaping how pension fund trustees think and act, while encouraging the emergence of new investment vehicles. The drive toward improved risk management and the longer-term stability of returns, together with the growing importance of intangible assets in the valuation process, is encouraging the creation of new tools and enforcing the need for new competencies.

The social and environmental dimensions of the investment equation are part of this changing landscape. Crucially, it is not an add-on or an appendix to other more fundamental shifts – it is part of, and integral to, these deeper changes. Integrating social and environmental dimensions of investment is about better understanding and responding to the interests of the ultimate owners of capital. It is about moving the relationship between investors and investees towards a focus on long-term performance, and raising the bar of that performance to ensure that social and environmental issues — key foundations of tomorrow's markets — are taken into account, and therefore counted in business and investment decisions. This in turn requires shifts in how the intermediaries operate, including trustees, fund managers and analysts, but also including rating agencies, advisors and many other actors. Their competencies, the tools they use and the basis on which they are rewarded all have to evolve to ensure alignment of changes at the two opposite ends: the interests of the owners of capital and the basis on which value is created by businesses.

This initial stage of the Global Corporate Citizenship Initiative's Mainstreaming Responsible Investment project has highlighted the importance of these changes and pointed to specific opportunities for progress, based on the discussions in our roundtables and developed in greater detail in the preceding chapters. While progress has been made, it is apparent there would be merit in deepening the dialogue on some of the issues raised in this report among companies, pension trustees, advisors, fund managers, analysts, policymakers and independent experts. Among the most promising areas for continued discussion and research are:

- What might an international set of voluntary principles for good governance of pension funds contain?
- Which jurisdictions would benefit by a change in fiduciary guidelines to provide greater scope for consideration by trustees of social, ethical, and environmental considerations, and how should such changes be structured to have maximum benefit and minimal effect on existing legal structures?

- What new business models for non-financial research by the buy- or sell-side are possible, perhaps driven by changes in the mandates provided by pension funds to asset managers?

- How could compensation arrangements for portfolio managers be modified to encourage increased focus on long-term performance, and what conditions would need to be present for such practices to become more commonplace within the industry?

- How might professional competency in non-financial issues be developed more fully within the investment analyst community?

- How could the content, assurance, and collection of corporate non-financial information be improved so that it would be of greater utility to investment analysts?

- What new performance assessment models and strategic management tools (integrating social and environmental factors) show particular promise?

- What does the responsible investment debate imply for investment in debt and derivative instruments?

Integrating social and environmental considerations into the investment decision process is slowly moving from an incidental activity to one that is integral to the fundamental changes sweeping the investment world. It is increasingly central to an appreciation of the interests of the tens of millions of individual participants in pension funds, mutual funds and life insurance policies, who now comprise the bulk of share ownership and, by extension, the future role of financial markets in supporting global economic growth and social progress. The World Economic Forum's Global Corporate Citizenship Initiative and AccountAbility look forward to the opportunity to continue this vitally important discussion.

Roundtable Participants

Participants

Name	Position	Organisation	Country
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Mark Anson	Chief Investment Officer	CalPERS	USA
Kamran Baig	Executive Director	Goldman Sachs Asset Management International	United Kingdom
Hewson Baltzell	President	Innovest Strategic Value Advisors	USA
Robin Batchelor	Investment Manager, MLIIF New Energy Fund	Merrill Lynch Investment Managers Ltd	United Kingdom
Edward Bickham	Executive Vice-President	Anglo American Plc	United Kingdom
Steven Bleiberg	Head of Global Investment Strategy	Citigroup Asset Management	USA
Adam M. Blumenthal	First Deputy Comptroller, Chief Financial Officer	Office of the NYC Comptroller	USA
Deborah Boedicker	Director of Business Development	Strategic Investment Group	USA
Georg Braun	Investor Relations Solutions	London Stock Exchange	United Kingdom
James Keith Brown	Partner	Och-Ziff Capital Management Group	USA
Kit Burdess	Policy and Corporate Affairs	Accenture	United Kingdom
Ian Byrne	Director, Standard & Poor's Governance Services	Standard & Poor's	United Kingdom
Laura Callanan	Associate Director of Investments	The Rockefeller Foundation	USA
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Tom Croft	Director	The Heartland Labor Capital Network	USA
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Gavin Grant	Director, Global Corporate Governance Research	Deutsche Bank Securities Inc.	USA
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Roundtable Participants

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Roundtable Participants

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Mark Tawney	Managing Director, Weather Risk Derivatives	Swiss Re Financial Services Corporation	USA
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Andy White	Director of Research	Innovest Strategic Value Advisors	United Kingdom
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AccountAbility and the World Economic Forum

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Valerie Weinzierl	Project Manager, Global Institute for Partnership and Governance	World Economic Forum	
Simon Zadek	Chief Executive	AccountAbility	United Kingdom

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2. Mr Condon has recently moved to join the Sustainable Business Advisory team of ABN AMRO's Group Risk Management.
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