



Removing the barriers to responsible investment

On 1 March 2006, Stephen Timms, the UK Minister for Pensions Reform, launched Responsible Investment, edited by Insight Investment's Rory Sullivan and Craig Mackenzie. The book brings together some of the leading practitioners and commentators in the field of responsible investment to present their views on the practicalities of implementing responsible investment strategies and the practical challenges faced in implementing such strategies. This article provides an overview two of the key themes of the book, namely the effectiveness of engagement and enhanced investment analysis, and the barriers to more widespread adoption of these approaches.

Introduction

By allocating capital efficiently to companies through the capital markets, investors provide the lifeblood of our economic system. Capital allocation has a vital role to play in delivering the products, services, innovation, jobs, and wealth creation that are essential to sustainable development. However, our economic system is by no means perfect. The structure of markets and companies themselves may also harmfully impact society and the environment. The idea that companies bear responsibilities to mitigate these impacts is now widely accepted. In recent years, a belief has emerged that investors, in particular large institutional investors, also have a responsibility to proactively support and encourage companies to mitigate their impacts.

This view was supported by a change made in 2000 to the UK Pensions Act, requiring pension funds to state the extent to which they take account of social, ethical and environmental (SEE) issues in investment. This regulatory change has driven significant new thinking about investor responsibility in the pensions and investment industries.

Predominant approaches to investor responsibility

Prior to the change to the UK Pensions Act, most investors who explicitly took SEE issues into account did so by investing in ethically screened investment funds. However, questions about the legality of this type of investment for pension funds limited their uptake and stimulated the creation of new investment solutions fully compatible with fiduciary duty.

Two approaches have come to predominate. Some pension funds adopt policies of engaging with companies to encourage good practice on SEE issues. Others require investment managers acting on their behalf to incorporate an enhanced investment analysis of SEE issues in their investment processes. Some do both. From an investment perspective, the primary benefit of the former approach is to strengthen the management and performance of companies, while the latter offers the potential to generate financial out-performance and, potentially, improvements in the companies' management and performance – which will be discussed later in this article.

Does engagement work?

A critical question is whether these approaches are effective at improving companies' SEE performance? It is increasingly clear that investor engagement is proving to be a useful catalyst for change in companies. For example, Insight has, in partnership with WWF, pursued a programme of engagement to encourage more sustainable house-building. This has contributed to a number of substantial improvements, as documented in our recent report, Investing in Sustainability: Progress and Performance Among the UK's Listed House-Builders. UK investors have also, with varying degrees of success,

encouraged companies to improve the quality of their policies, management systems and disclosures on issues such as climate change, bribery and corruption, supply chain labour standards, human rights and access to medicines.

Does enhanced analysis improve investment returns?

The scope for enhanced analysis to contribute to ameliorating companies' social and environmental impacts is less well established. In theory, by more accurately weighing environmental and social factors in investment decision-making, enhanced investment analysis should contribute to more efficient capital markets and send signals to companies about the importance of these issues. In extreme cases, financial analysts can send very clear signals on SEE issues – for example, where the adverse health impact of a company's product leads to mass tort litigation in the US, analysts have responded with downward valuations; subsequent falls in the share price send powerful signals for the company's board to take action. The challenge is to demonstrate that this signalling mechanism can work in less catastrophic situations for SEE issues that are less obviously and immediately material.

Barriers to more extensive engagement by institutional investors

One benefit of the recent debate about the roles and responsibilities of investors has been to cast into sharper relief the barriers to addressing companies' SEE impacts through investor activism. In particular, the costs of engagement are incurred in the short-term whereas the benefits tend to be realised in the long-term (or at least beyond the one to three year time horizon on which the performance of many asset managers is assessed). Further, the benefits are shared by the market as a whole (eliminating or at least weakening any investment performance benefit against standard investment benchmarks). Continued investment by commercial asset managers in this area is contingent on tangible support from the owners of the assets they manage. Unless pension funds are prepared to recognise the quality and value of investment manager's engagement on SEE issues in the way they

award mandates, and in their assessment of manager performance, investment in SEE engagement is not likely to accelerate. This is despite the fact that some of the big investment consultants seem now to have appreciated the value that engagement can deliver to their clients' funds, and have developed formal systems for analysing the quality of SEE engagement.

Barriers to enhanced investment analysis

At first glance, the barriers to the development of processes to integrate consideration of SEE issues into investment analysis seem lower than the barriers to engagement. If SEE analysis gives a more accurate picture of a company's value, then asset managers should enjoy better relative performance as a result and have an incentive to invest in it. But often it isn't this simple. The corporate assets most vulnerable to SEE problems are intangible assets, such as brand and reputation. Yet, by definition, these are precisely the assets that analysts find the most difficult to value.

Moreover, because of the time lag between harmful corporate impacts becoming apparent and governmental and society's reactions, the financial risks of SEE impacts for companies are generally not immediate, but tend to accrue over the long term. Given the short-term time horizons of many investors, they see little benefit in undertaking SEE research. Finally, many SEE impacts arise from failures in markets that create incentives for companies to, for example, externalise their costs and damage the environment.

An example could be emissions of greenhouse gases from facilities not covered by the EU Emissions Trading Scheme: there is no cost associated with these emissions and so there is no financial incentive to reduce emissions. In these situations, it is hard to see why investment analysts would attempt to incorporate companies' environmental externalities in their valuations because, in the absence of regulation to internalise these externalities, they are, by definition, external to the company's value. In these situations, it appears that investors are compelled to reward companies that successfully externalise their costs. Enhanced investment analysis fails to offer a solution to this problem.

Conclusion

In the long run, however, it is not in the interests of long-term investors – such as pension funds for these barriers to more responsible and sustainable investment to persist. Investment strategies that boost short-term performance at the expense of long-term sustainable economic growth are hard to square with the fiduciary duty of pension funds to serve the interests of their beneficiaries, some of whom are 40 years from retirement. The challenge is to develop practical strategies that avoid this trade-off. In the last five years, very significant progress has been made in developing and demonstrating the effectiveness of responsible investment strategies that are consistent with fiduciary obligations. Furthermore, a number of pioneering pension schemes and charitable foundations have helped to create an institutional market for responsible investment strategies in the UK. The next challenge is for asset owners, asset managers, government and other stakeholders to address the substantial remaining barriers to responsible investment.

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