

Sustainable investing profits from failures



By Mike Scott

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Recent events in financial markets have been described in many ways, but “sustainable” was never one of them. In fact, the credit crunch and its knock-on effects are “a trillion-dollar advertorial” for “sustainability-enhanced” investment analysis and strategies, says Matthew Kiernan, co-founder and chief executive of Innovest Strategic Value Advisors.

He defines sustainability-enhanced as including an analysis of environmental, social, and governance (ESG) factors in investment analysis of companies. The phrase sustainable investment is much-misunderstood, says Mr Kiernan, whose firm was bought recently by RiskMetrics. Many investors believe their fiduciary duty to maximise returns means they cannot apply sustainability criteria to their portfolios.

Mr Kiernan is at pains to dispel the notion that investors can invest either in sustainable companies or in financially-healthy companies, although the financial crisis of the last 18 months makes the point powerfully for him.

“The subprime debacle and its collateral damage have cruelly exposed the profound limitations and inadequacies of traditional investment analysis and risk management.” But more education is clearly needed.

“There is a confusion in the minds of traditional investors between a sustainability-driven investment strategy, which is all about risk and return, and neo-classical socially responsible investing (SRI), which is based on values-based screening of stocks,” he says. While applying ESG factors to stock-picking implies excluding some stocks – one of the key criticisms of SRI – all fund managers except universal investors pick some shares and exclude others. “It is just that we differ in the criteria we use to do that narrowing,” says Mr Kiernan.

Taking ESG issues into account is not a question of trying to save the world, he says. “We are out to make more money for our clients by identifying more nimble companies.”

Despite the proliferation of investor initiatives such as the Carbon Disclosure Project and the UN’s Principles for Responsible Investment, there is still a lack of understanding of why it is important to incorporate ESG issues into financial analysis, Mr Kiernan claims.

Two companies that the City and Wall Street see as indistinguishable can be “streets apart in terms of their sustainability – and this is financially material”, he adds.

He points out that Innovest’s top-rated companies in the multi-utility sector have costs of compliance with carbon dioxide emissions regulations of 2 per cent of Ebitda (earnings before interest, tax, depreciation and amortisation), while the worst-rated groups face costs of more than 50 per cent of Ebitda. “Investors need to know which is which but even then, how many CDP signatories have invested one dollar differently than if they had never heard of climate change?”

Apart from climate change, he cites access to medicines and “the base of the pyramid” as crucial areas for companies to get to grips with. “There are 4bn people living on \$1 a day. We have to tap that source of talent and income to continue growing – there is a limit to the opportunities available in mature markets.”

Mr Kiernan, has identified trends that will affect sustainable investment in his recent book, *Investing in a Sustainable World**. These include:

- Accelerating natural resource degradation, scarcity and constraints, driven partly by industrial development, population growth, and urbanisation, especially in emerging markets;
- Tightening regulatory requirements for stronger disclosure and company performance on “non-traditional” business and investment risks, including ESG ones;
- Increased investment in emerging markets, where ESG risks tend to be most acute;
- The ongoing internet revolution, which has enabled and accelerated the emergence of a stakeholder-driven competitive environment.

“We believe we can demonstrate convincingly that there has been a historical alpha premium associated with

sustainable investment. Our Global 100 list, a mock portfolio of companies announced each year at Davos, has outperformed the MSCI World Index by 480 basis points a year since its inception in 2005." Ultimately, he says, if capital becomes more expensive or unavailable for companies that fail to incorporate ESG risks into their business plans, behaviour will soon change – to the benefit of investors.

*Investing in a Sustainable World, 2008, American Management Association.

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