Business ownership for future generations

Topic of the month November 2016

Since the creation of the UN Principles for Responsible Investment in 2006, responsible investment has evolved from a niche activity into a mainstream approach: the development of ESG ratings by Morningstar and investment consultants are indicative of institutional investors' desire to better understand how their money is invested and to share their convictions publicly. More recently, individual investors, family offices and foundations have embraced similar principles showing a growing desire to invest in a more sustainable form of capitalism. We believe that this phenomenon results from a number of unrelated trends.

- Corporate scandals are not new, but the problems that engulfed Enron, Worldcom, Parmalat and Petrobras continue to resonate with investors, many of whom are still counting the costs of these governance failures.
- Environmental problems such as poor air quality in large cities, water contamination and climate change pose a challenge from a social, economical and political point of view. This opens up new business opportunities for companies that provide concrete solutions to such problems.
- Shifting consumer preferences for cleaner and healthier products such as electric cars or organic food are reshaping the business models of firms traditionally perceived as safe havens.
- Public policy in areas such as climate change, corporate tax or soft drinks is slowly but surely denting the profitability of companies that tend to generate profits at the expense of society.
- Changing economics in sectors such as energy, where a growing proportion of renewables no longer need public support to be cost-competitive with fossil fuels, which still benefit from subsidies in many countries.

We see three basic options for investors to mitigate the risks and seize the investment opportunities arising from these trends. As a minimum, we believe that every investor should be better equipped for detecting 'torpedoes' in core portfolios. When investing in listed companies, we suggest investors undertake a systematic analysis of corporate governance structures in order to uncover structural deficiencies, such as the use of short-term and accounting-based metrics for setting executive remuneration. Potential concerns should be raised by investors and voiced through proxy voting. Failure by management to address them could be a reason for investors to divest their stakes.

A second option is to focus on 'long-term winners'. Because such companies tend to be more resilient to the fluctuations of the economic cycle and prone to integrate disruptive trends in their development strategy, we believe that they are better positioned to generate steady returns over the long-term. Identifying sustainable businesses requires a good understanding of their fundamentals, business franchise, management quality and track record.

A third option is to target a concentrated universe of companies that specialize in providing specific solutions to environmental problems, such as water treatment technology, energy efficiency, renewables or low car- bon energy sources. This is effectively a growth story, since these activities are set to develop faster than global GDP.

In all cases, time is of the essence. Investors constantly need to resist the pressure of short-termism or the temptation to treat companies like commodities. We also see a need for specific metrics to measure portfolios' ESG characteristics such as their carbon footprint.

There is no one size fits all, but the longer the time horizon, the greater the likelihood that responsible capitalism represents the best way for investors to achieve long-term success.

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