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“Investment as Usual” Is Broken

Financial analysts must integrate ESG factors into valuation

By Graham Sinclair

The rising prominence, complexity, and urgency of environmental and social sustainability issues facing corporations in the 21st century have challenged the core of business thinking and strategy. Corporations are changing, sustainability has become a key strategic issue, and firms are increasingly creating “Corporate Sustainability Officer” positions. But the “Chief *Sustainability Investment* Officer” is much further off. As corporate managers begin to integrate environmental, social, and governance (ESG) factors into decision-making, “investment as usual”—the current practice of investment management—needs to make a similar adjustment.

“Investment as usual” is broken. Global financial stock now stands at \$140 trillion and growing¹. But most investment decisions are being driven by decision-makers who completed their studies before Google—more influenced by Gordon Gecko of the film *Wall Street* than by climate change activist Al Gore. The sea-change in the way corporations are facing our changing world has yet to catch up to the inertia of investment professionals in New York, London, and other major investment centers.

“Investment as usual” fails to integrate ESG factors properly, and as such, is not pricing the future risks and opportunities linked to ESG issues. Matthew J. Kiernan, founder of Innovest Strategic Value Advisors, estimates that traditional financial analysis captures *only a quarter* of a company’s risk and competitive profile. Risk-adjusted returns must reflect a broad and long-term understanding of materiality, within the bounds of fiduciary duty and applied across portfolios and asset classes.

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1 McKinsey.com, January, 2007.

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In July, 2007, the United Nations Global Compact keynote address was made by Goldman Sachs’ Anthony Ling on behalf of the financial community. Goldman Sachs presents ten reasons for incorporating ESG factors, three of which were: 1) experience with risk and return balance, 2) meeting liabilities (e.g., liabilities related to energy supply and security, climate change, water shortages, rapid industrialization in developing countries), and 3) increasing awareness of ESG issues by analysts and investors. The Goldman Sachs analyst team based in London released a 179-page equity research report titled “GS Sustain,” in which it recommended 44 companies based on a combination of the companies’ ESG performance and fundamentals. Goldman argued that its picks based on this formulation, both in the U.S. and abroad, outperformed the Morgan Stanley Capital International World Index by 25% over the past two years.

Significant risks and opportunities for investment valuation will come from ESG issues and their implications for business. For instance, climate change is likely to have a host of impacts on business—from taxation and regulation to changes in weather patterns, technologi-

“ESG factors will be integrated into investment analysis only when demanded by the market.”

cal innovations, and shifts in consumer attitudes and demands. In the transition to a low-carbon economy, there will be winners and losers. Investors need information to determine how companies will be affected.

Market Demand for ESG Investment Analysis

Key ESG factors, like climate change, will be integrated into investment analysis only when demanded by the market. Involved asset owners (for example, pension funds) are exploring the boundaries already. Pension funds have a business case for reducing negative externalities and increasing positive externalities. CalPERS, the biggest

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pension fund in the U.S., has identified the investment case for incorporating corporate governance into its investment decisions: firstly, shareholders are willing to pay a premium for well-governed companies; secondly, a “corporate governance premium” can be captured to increase shareholder value, and thirdly, well-governed companies have a competitive advantage in attracting capital².

Institutional investors have linked superior investment performance with strong governance according to research by Watson Wyatt and Oxford University³. In September, 2007, a powerful group of investors and advocacy groups filed a petition with the U.S. Securities and Exchange Commission (SEC) asking the SEC to require publicly-traded companies to assess and disclose their financial risks from climate change⁴.

Globally, the Principles for Responsible Investment (PRI) has emerged as an organizing theme for asset owners, investment managers, and their service providers. The PRI is an institutional investor initiative, launched in April 2006 by the United Nations Environment Program Finance Initiative (UNEPFI) and the UN Global Compact. The PRI

2 CalPERS Active Corporate Governance Program, William Sherwood-McGrew, Corporate Governance Officer, November 21, 2003 NYSSA CG Conference NYC.
3 Global Pensions. Governance linked to higher returns, 10-18.
4 FT.com. Green investors: Climate change must feature in trading statements, 10-12.

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“Investment as Usual” Is Broken (continued from page 2)

appreciates that, at least on paper, the informed end-investor drives all activities in the investment value chain. UNISA’s Centre for Corporate Citizenship, the UNEPFI and Noah Financial Innovation, together with the PRI, have found in their study⁵ that while most market participants think integrating ESG factors in investment practice is important and has a material impact on how companies are valued, few financial institutions or advisers are doing much about promoting this kind of investment. The 32 pension funds, 19 asset managers and 11 investment advisers involved (between them controlling more than \$700 million) believed that ESG issues were material to a company’s value. But most were either doing nothing about responsible investment or had limited involvement.

A New Approach to Investment Analysis

Environmental, social, and governance issues (ESG) are embedded in any firm’s corporate strategy. Anything that affects a firm’s business model can also affect the firm’s financial performance—and therefore its valuation. ESG issues are no exception. The next generation of investment analysts must be ready to:

- understand the industry/sector dynamics of key ESG issues
- identify the material impacts of ESG factors on a firm’s corporate strategy
- drive toward clarity on ESG data points delivered with consistency and clarity into the valuation process
- make investment decisions presented over both short-term and long-term horizons

The next generation of investment analysts may also benefit their investor clients by acting as active investigators, engaging firms directly

5 http://www.unepfi.org/fileadmin/documents/The_State_of_Responsible_Investment_01.pdf

Recommended ESG Resources

UN Principles for Responsible Investment

www.unpri.org

Goldman Sachs GS SUSTAIN Report

www.unglobalcompact.org/docs/news_events/8.1/Goldman_sustain.pdf

Investing in sustainability: An interview with Al Gore and David Blood

McKinsey Quarterly, www.mckinseyquarterly.com

The Eco-Efficiency Premium Puzzle

Financial Analysts Journal

Climatic Consequences: Investment Implications of a Changing Climate

Citigroup Report, available at www.pewclimate.org

to improve ESG performance, and appreciating that the articulation and influence on the investment case may be bi-directional.

“Investment as usual” will change as companies adapt their strategies to the realities of a connected, globalized world with creative talent sensitive to ESG issues. So, too, the next generation of investment analysts must change. ☺

Excerpted and modified from “Investment as Usual,” comments prepared for the launch of the Survey of Responsible Investment in South Africa, October 2, 2007 at Johannesburg Securities Exchange, Sandown, South Africa.

Alumni Spotlight:

Lisa Shpritz, MBA 2005



Lisa Shpritz is currently Sr. Vice President of Corporate Workplace for Bank of America in Charlotte, North Carolina. As a LEED Accredited Professional and Environmental Manager of the Environmental Risk and Sustainability Group, she is responsible for environmental programs and compliance for the approximately 95 million square feet of space occupied by Bank of America associates. She works to integrate sustainability into the workplace as part of Bank of America’s commitment to maintaining the workplace as a competitive advantage.

Lisa hasn’t always seen herself as a typical or traditional environmentalist. Her time at UNC’s Kenan-Flagler Business School helped her pull together all the ingredients—a background in science, a passion for business, and an interest in the environment, both outside and indoors—to create the perfect background for her current work.

... [link to more about Lisa](#) ...



Notes from the Field *Faculty & Student Projects*

UNC Kenan-Flagler has teamed with its Kenan Institute Asia and the School of Public Health in the [Carolina Global Water Partnership](#), to develop and distribute household water treatments in Southeast Asia. The announcement of the Partnership was featured on [Economist.com](#), and the *Herald-Sun* featured the Kenan Institute Asia and quoted **Tom Outlaw** (MBA '08) in "Tying business to safe drinking water." (Nov. 26)

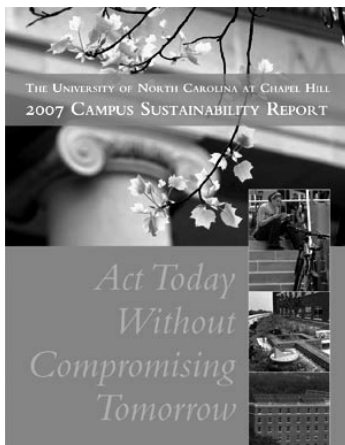
In the Net Impact national "Project Pyramid" case competition, *two* of the 12 finalist teams selected were from UNC Kenan-Flagler. One finalist team from UNC comprised **John Eder, Kevin Martin, Diana Selezanu, Paula Wertheim, and Matt Coury** (all MBA '09). The second included **Bryan Gobin, Jose Manuel Estay, Chen Gao, Alex Klaitis** (all MBA'09), **Theogene Manzi** (MBA '08), and **Anna Sangare** (MBA Exchange '07). The competition challenge focused on addressing solutions to conditions of poverty. The finalists, selected from a first round of 35 entrants, presented at the Net Impact National Conference in Nashville, TN in Nov.

Also at the Net Impact National Conference in Nov.:

- 50 MBA students from UNC Kenan-Flagler attended (the largest group ever)
- Kenan-Flagler Alumni **Brad Sparks** (MBA 2004), **Pic Walker** (MBA '01) and **Maia Blankenship** (MBA '04) were panelist speakers
- First-year student **Andrew Pearson** (MBA '09) led a workshop on behalf of Resource Generation called: "Making Money Make Change: Investing, Philanthropy and Social Change Giving Tools".

The *New York Times* quoted entrepreneurship professor **Lisa Jones Christensen** in "[Not-so-simple plan to keep African girls in school.](#)" (Nov. 12)

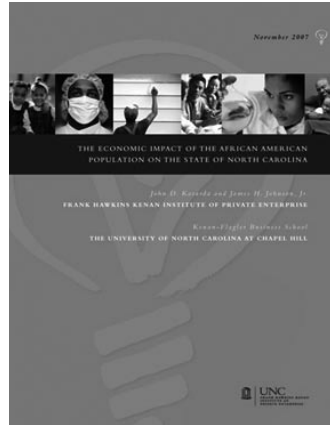
UNC released its [2007 Campus Sustainability Report](#).



Entrepreneurship professor **Jay Swaminathan** was quoted in "[Green supply chains: moving beyond logistics](#)" in the Financial Times. (Dec. 10)

ThinkMTV.com interviewed Center for Sustainable Enterprise consulting program manager **Kelly Boone** (MBA '01) and **Beth Richardson** (MBA '08) in "[Video: Sustainability in N.C.](#)"

The Frank Hawkins Kenan Institute of Private Enterprise released its [N.C. African American Impact Study](#), which shows that African Americans add \$44.7 billion to the North Carolina economy. **Jack Kasarda**, Director of the Kenan Institute, and **Jim Johnson**, Director of the Center for Urban Investment Strategies co-authored the study. The study received extensive media coverage, in outlets including The News & Observer, The Herald-Sun, The Wilmington Journal, The Winston-Salem Journal, News 14 Carolina, and WRAL-TV. (Nov. 13-14)



UNC, Duke and N.C. State have partnered with RTI International to create the [Research Triangle Energy Consortium](#) that will address technical, societal and public policy issues related to energy use.

Student **Sambit Samal** (MBA '08) is working as a spring semester intern with the United Nations Environment Program (UNEP) Finance Initiative's Principles for Responsible Investment (PRI) program. He will be working on research for the Emerging Markets and Developing Countries Investment Project.

Student **Sara Abdoulayi** (MBA '08) will lead a team working on a spring practicum project with the social entrepreneurship organization Carolina for Kibera.

NC Local/Regional Events

Jan. 10-11

[Sustainability Across the Curriculum Leadership Workshop](#)

Emory University, Atlanta, GA

Jan. 31

Focus the Nation: Global Warming Solutions for America Events nationwide

[Link to events in North Carolina](#)

Feb. 2-3

[Sustainable Biodiesel Summit](#)

Kissimmee, FL

Feb. 11-12

[North Carolina's Energy Future: Realizing a State of Opportunity](#)

2008 Emerging Issues Forum
McKimmon Center, NC State,
Raleigh, NC

Feb. 14

[Globalization 2008 Conference](#)

Council for Entrepreneurial Development
RTP, NC

Apr. 22

Earth Day

[UNC Earth Day Speaker:](#)

David Orr, Oberlin College
Environmental Studies Program
Chapel Hill, NC

CSE Events

Jan. 17

CSE Social

West End Wine Bar
Chapel Hill

For sustainable enterprise MBA students, faculty, and alumni. RSVP to cse@unc.edu.

Jan. 18

Sustainable Enterprise Career Fair

Carolina Club
Chapel Hill

Companies and organizations are invited to meet over 100 MBA and other graduate students specifically interested in careers related to environmental sustainability, corporate social responsibility, and social enterprise. Registration fees are waived for registrations received by December 21. Details at: www.cse.unc.edu/recruiting.

Mar. 28-29

Sustainable Venture Capital Investment Competition (SVCIC)

Kenan Center, UNC Kenan-Flagler Business School
Chapel Hill

MBA teams from Harvard, MIT, Wharton, Haas, Kellogg, and other top business schools compete to apply venture capital skills to assess businesses for the "triple bottom line" of financial profitability, environmental integrity and social equity. Details at: www.svcic.org.

CSE Program News

Join McKinsey & Co., URS, Earth Fare, Newland Communities, Fourth Sector Bancorp, and dozens of other organizations for the upcoming **9th Annual Sustainable Enterprise Career Fair** on January 18. Participating organizations will have the chance to connect with over 100 UNC MBA and other graduate students interested in project work, internships, and full-time positions related to sustainability, CSR, environmental management, social enterprise, green building, socially responsible investing, and other environmental and social career paths. For more information or to register, visit www.cse.unc.edu/recruiting.

On Nov. 30, UNC Kenan-Flagler hosted the **6th Annual Careers in Sustainability Forum**. Over 110 graduate students from UNC, Duke, and NC State came to hear panels on topics such as Sustainable Communities, Alternative Energy, and International Development, and interact with speakers in small group lunches. Twenty-one speakers attended from organizations as diverse as Scientific Properties, Divine Chocolate, Novozymes, Africa Rising, Advanced Energy, Burt's Bees, and Education Pioneers.

UNC Kenan-Flagler was ranked 12th in the world and 10th in the United States by the **Beyond Grey Pinstripes** biennial ranking of innova-

tive MBA programs that integrate issues of social and environmental stewardship into curricula and research. UNC Kenan-Flagler also was ranked 3rd in course content and 4th in faculty research. Triangle Business Journal featured the ranking in "[UNC's B-school given bragging rights in listing.](#)" (Oct. 26)



The Center for Sustainable Enterprise co-hosted an invitation-only event on Oct. 11 titled "**Aligning Profit with Purpose: A Forum**

on Socially Responsible Investing." Foundation executives, faculty, SRI experts, and distinguished guests gathered to discuss the strategies and real-world case studies of putting SRI into practice.

On Oct. 11, Kenan-Flagler Business School hosted CSE Distinguished Speaker **Martin Eakes, founder and CEO of Self-Help Credit Union**, speaking on the topic of "Subprime Lending, Social Justice, and Self-Help." Mr. Eakes' inspiring speech can be viewed online at www.kenan-flagler.unc.edu/KI/cse/videosPresentations.cfm.

Student Spotlight:

Tom Outlaw, EMBA 2008

Tom Outlaw has a mission to bring safe and affordable drinking water to the developing world. His passion and energy have led him to the far corners of the world looking for ways to bring his mission to life. A member of the EMBA class of 2008 at UNC Kenan-Flagler and an international health consultant, Tom's work on water and sanitation issues has sent him to Asia, Africa and Latin America.

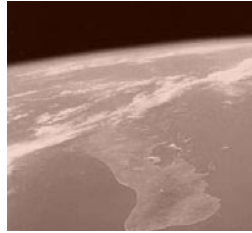
Tom recently returned from a consulting assignment in Uganda, where he put many of the skills he's learning here at UNC Kenan-Flagler to use. There, he helped USAID develop market-based approaches for improving access to sanitation products (i.e., latrines) in poor, rural parts of the country, where supply chains are weak and the diffusion of innovations is slow.



Tom's coursework at Kenan-Flagler and his internship with CSE Consulting have taught him how to incorporate sustainability issues into his work with businesses, governments and the non-profit sector. "One of the most important skills I've gained here at Kenan-Flagler is the ability to translate sustainability concepts into the language of business..."

... [link to more about Tom](#) ...

News from around the World



Herman Miller, ShoreBank Corporation, and Seventh Generation were among the 10 companies to be recognized with the first for-profit [Social Capitalist Awards](#) by *Fast Company*.

And, in Nov., *Fast Company* published "[50 Ways to Green Your Business](#)."

A [U.S.-EU proposal](#) would liberalize trade in environmental goods and services such as solar panels; the proposal would make 43 goods "with clear environmental benefits," tariff-free.

The United Nations, **Cisco**, and **Google** created [www.mdgmonitor.org](#) to track progress towards the Millennium Development Goals of decreasing global poverty by 2015.

EnviroMedia will release the [EnviroMedia Greenwashing Index](#) in Jan. with consumer opinions of good and bad green marketing campaigns.

Dell is seeking entries for a new [green computer design competition](#).

Sales of Rainforest Alliance-certified bananas, coffee, and chocolate [surpassed \\$1 billion](#) in 2006, and growth is expected to continue.

Office Depot issued its 4th [Green Book](#) catalog of environmentally preferable office supplies.

NBC Universal launched a "Green is Universal" campaign with a week of [150 hours of environmentally-themed television programming](#), a first for a major media company.

The U.S. House of Representatives switched to [100% post-consumer waste recycled paper](#), in partnership with the New American Dream Responsible Purchasing Network.

In clean energy news...

Google plans to spend tens of millions on R&D and related [investments in renewable energy](#) in 2008.

HP announced partnerships with SunPower and Airtricity to [purchase renewable energy](#).

Lemnis Lighting has introduced the [Pharox light bulb](#) in the U.S.—an LED bulb that fits into a normal incandescent light fixture, but lasts 50 times longer and uses 90% less energy.

MIT, with the **U.S. Department of Energy** and utility company **NSTAR**, unveiled a new [\\$200,000 Clean Energy Entrepreneurship Prize](#), aimed at encouraging innovative new clean energy technologies.

The [largest solar power system in the U.S.](#) is set to come online in Dec.; the **Nellis Air Force Base** solar farm will provide 15 megawatts of power and save the base \$1 million annually.

In climate change news...

The **New York Mercantile Exchange (NYMEX)** has launched [The Green Exchange](#) for trading carbon emissions and other environmental products.

Barclays Capital announced the launch of the [Barclays Capital Global Carbon Index](#), the first index to track the performance of carbon credits associated with the world's major greenhouse gas emissions trading schemes.

Royal Hawaiian Honey is the first U.S. food product [certified as "carbon free"](#) by Carbonfund.org.

Xerox says its [greenhouse gas reduction program](#) saved the company \$18 million last year.

Continental Airlines launched a voluntary [carbon offsetting program](#) for travelers.

Energy company **National Grid** pledged to [reduce greenhouse gas emissions](#) 60% by 2050.

ING will purchase wind energy credits to become [carbon-neutral](#) by the end of 2007.

Fiji Water pledged to make its products "[carbon-negative](#)" in 2008.

Bayer launched a \$1.46 billion group-wide [Climate Program](#).

Resources

[Deeper Luxury: Quality and Style When the World Matters](#)

WWF-UK report examines the environmental and social record of some of the world's top luxury brands, including L'Oréal, Hermès, Tods, Tiffany & Co.
(Nov. 2007)

[Handbook on Responsible Investment Across Asset Classes](#)

Handbook from the Boston College Institute for Responsible Investment.
(Nov. 2007)

[McKinsey Quarterly: CEOs on strategy and social issues](#)

Article reports that CEOs are increasingly incorporating environmental, social, and governance (ESG) issues into core strategies.
(Oct. 2007)

...and...

[Assessing the impact of societal issues: A McKinsey Global Survey](#)

Global survey of executives reveals that executives expect the environment, including climate change, to affect shareholder value far more than any other societal issue during the next 5 years.
(Nov. 2007)

[EcoPinion Survey Report](#)

Survey conducted by EcoAlign finds that consumers don't understand terms used to communicate about energy and environmental issues/products.
(Nov. 2007)

[In Search Of Green Technology Consumers: Why Tech Marketers Should Target This Emerging Segment](#)

Forrester Research report summarizes findings from survey of 5,000 customers about attitudes toward "green" products (full report: \$279).
(Nov. 2007)