Regulations That Value ESG / Long Term

Philippe Desfossés, Director, RAFP: Governments must design regulations that value ESG / long term

A Glut of Debt and Unsustainable Pension Promises Requires an ESGand Long-Term Institutional Sustainability Fix by Philippe Desfossés | January 3rd, 2012

For too long, western economies have been indulging themselves in cheap credit and over-consumption. As Herbert Stein once said "If something cannot go on forever, it will stop". In its 78th report (2007) the International Settlements Bank made a clear statement "The unsustainable has run its course". Here we are. The question is how we reached this point of near collapse when so many clear signals should have warned us. It appears that the West chose to grow through mass consumption. The counterpart, as well as the means to finance this profligacy, has been through credit. One could just read what was written in 1929. On October 4 of 1929, the New York Times quoted the Secretary of the Treasury M. Snowden for whom investors "acted as if the price of securities would infinitely advance." After World War II, the reconstruction, the baby boom and a strong optimism concurred to make it possible to raise standards of living as well as to finance a generous welfare state. It is this model that begun to weaken in the 70's with the first oil shock. The whole building is now falling apart. It is obvious that some social benefits schemes look like gigantic Ponzi schemes and that there should be a strong adjustment to bring them back to a sustainable path. The deleveraging is going to be painful and will last several years. In that respect, socially responsible investment will be a guiding principle for the 21st century.

Let's consider the three themes encompassed by the ESG acronym: social, governance, and environment. During the last 20 years, there has been a massive concentration of revenues and wealth that has made it more and more difficult for the middle class to live without recourse to credit. Businesses under pressure to deliver an ever increasing return to their shareholders had no choice but to limit direct salaries (trying sometimes to defuse anger from their employees by granting them under-priced social benefits [1]). Those same households leveraged their balance sheet through cash credit and by borrowing more and more against their home. Now that a large deleveraging is underway, a more balanced distribution of revenues is necessary to allow cash strapped households to resume consuming. Considering what has happened in the emerging markets, no sustainable development is achievable without allowing the local population to get a just return on their efforts. In that respect, the level of investment in countries like China, beyond the question of the efficiency of all these investments, raises the issue of the sharing of growth and the need to achieve a more balanced growth. For investors, it also means that in a fully connected world it will become harder and harder to ignore how large western businesses can benefit from low salaries, lack of collective bargaining, and poor social benefits that plague many of their suppliers.

Considering governance, we cannot but acknowledge that misalignment of interests and short-termism have gone hand in hand. In large companies, management has behaved as if they own the business. Large compensation incentive packages that reward success without punishing failure created a culture of "unaccountability". Why pay attention to the future when there is no claw back mechanism on stock options? How governments run their states has also suffered from increased "short-termism". Until the moment the sovereign debt crisis blew up investors relied on rating agencies. It is easy to accuse them of all sins when, as they rightly say, they are just providing opinions, meaning that every investor has to exert their own judgement. We should also remember that those same agencies sent many warning shots to governments. Finally, stopping environmental destruction is obviously one of the most pressing challenges humankind has to address. World population reached 1 billion in 1804. This is the amount by which it increased during the last 12 years. We are reaching the point where it is more than urgent to ensure that prices take into account the cost of the damage our activities inflict on non-renewable assets: water, farmland, biodiversity. As long as we maintain prices that ignore negative externalities, all the economic agents will keep on behaving "rationally" to achieve an irrational objective. To summarise, addressing the challenges of tomorrow in the 3 areas that will reshape the economy of the 21st century means being able to overcome "short-termism" and to adopt the quite simple principle of sustainability to enlighten our decisions. It is where big long-term investors have such a large responsibility.

To adopt this new approach means being able to reassess many of the ways we used to work. First, one cannot be a responsible investor if you are not responsible in the way you calculate "the price" of benefits or promises you sell to clients or beneficiaries.

Obviously an annuity will be much more attractive (i.e. cheaper) if optimistic assumptions on the expected returns of the assets that back it can be used. But the crisis reminds us that discounting future revenues with overoptimistic expected returns generates explicit and implicit debts that will be long and hard to wind down. Is it responsible for a retirement benefit scheme to distribute benefits whose generosity is made possible only by the sacrifice of the young or the future contributors? When a pension fund discounts its liabilities with a rate that is treble the rate of growth of added value has it any choice but to invest in assets delivering high returns but also proportional risk? This widespread “under-pricing” of social benefits has encouraged putting more pressure on the businesses so they reach double digit ROE. The risk a financial intermediary accepts to bear is always borne on the liabilities side of its balance sheet. Regulators should pay more attention to this issue! Second, for big long term investors, assuming that they cannot (should not) anymore rely on expected returns that a sustainable economy cannot deliver, the question they have to answer is: can responsible investment remain a slice or the icing on the cake, a marginal share of their investment, or should it become an integral part of their investment process? This can be discussed, but more and more long-term investors consider that an SRI approach (fine-tuned to their specific situations) should be applied to the full spectrum of their investments. In that respect, a best-in-class approach seems the best suited although it may present less appeal than an approach based on exclusion or a thematic approach. Exclusion is simple to understand and makes it possible “to make a statement”. But if it fits the needs of small communities sharing strong beliefs, it is difficult for large pension funds managing tens of billions of Euros for millions of people to determine what should be excluded (beyond the obvious exclusions resulting from the law or international treaties). For a public pension scheme like the RAFP, could we imagine the members of the board having to decide whether the companies that develop medical research using stem cells should be banned from our investment universe? Anyone may have their own opinion, but as long as it is legal, a public pension fund cannot a priori exclude companies that are doing business in this area. Thematic investment is easy to identify and attractive because it is a way to address issues that public opinion can easily understand and that contribute to “solve problems” (wind farms, waste management, etc). But pension funds and other large investors cannot invest only in thematic investments; they are just too big. Besides, funnelling too much money towards “quick fixes” can lead to new bubbles. The best-in-class approach starts with the acknowledgment that the world of tomorrow will largely be the world of today. We may regret it but there is no magic wand that will make it possible to avoid using steel, cement or oil for quite a long time…

In that respect, accepting that all economic sectors will remain necessary to the sustainable growth we want to promote, our challenge becomes to determine how in each of these sectors we rank the issuers in order to weed out from our investment universe those who are not serious in addressing the challenges in the Social, Governance and Environment areas and conversely to select those that have understood that being proactive will give them a competitive advantage. Third, long-term investors should behave like….. long-term investors. What's the use of managing the liabilities in a responsible (i.e. prudential) way, of implementing a best-in-class approach to investment, if our governance is still unable to detach itself from quarterly returns? For too long, market cap benchmarks have led investors to prefer following the herd rather than exerting their judgement. One has to recognize that regulators unable to understand the peculiarities of long-term investors have set up rules that increase procyclicity…. Long-term investors, especially those that still enjoy net positive cash flows, should take advantage of their ability to exercise the option they have against the market. The price of liquidity having been underestimated we have seen lately that many investors could be forced to sell at prices that were quite penalizing for them. It is precisely during those times of disruption that investors able to stay invested for a long period (buy and hold investors) can profit from good entry points and also contribute positively to stabilize the market. Once again we come back to the concept of sustainability. Being a responsible investor means also acting like a "contrarian". When asset prices become overvalued (i.e. they exit the upper band of the sustainable valuation path), long-term responsible investors, by starting to sell, can send a signal that the risk of a bubble is getting closer.

Conversely, when the markets lose confidence and valuations become so low that only an "end of the world" scenario could justify it, long-term responsible investors can and should step in. Up to now, we have said nothing about individuals. Does it mean they are not interested in responsible investment? Obviously not, but individuals tend to be quite short-term and unfortunately the financial products that they were sold lately have increased their appetite for liquidity (in the case of France, life insurance policies offered yield, security and… liquidity). For households, responsible investment is attractive when it materializes in thematic products and exclusion. Best-in-class is quite difficult to understand and it lacks the appeal of the others as it is a pragmatic answer to a very complex issue. People like the idea that their investment makes an immediate difference. Buying shares in a fund that invests in wind farms is perfect, we can see exactly what we invest in and it is always rewarding to get the feeling that we are doing good. However, we know that is more important to encourage big business to prepare and accelerate the transformation of our economies towards less carbon intensive production processes. Before the unfolding of the crisis, SRI attracted at best a polite interest. The last three years have hopefully opened our eyes. We are on a collision course. Developed countries leveraged to the hilt realise that they can no longer discount growth rates that were made possible by the long period of reconstruction after World War II, cheap energy and more and more credit. Emerging countries have no intention of giving up their hope of reaching the same standard of living. Therefore, promoting sustainable investment – meaning investment that takes into account how it addresses the 3 great issues: Social, Governance and Environment – is not just another option. It will be a guiding principle for the 21st century. The earlier politicians acknowledge that long-term investors will be the main engine to give traction to this move, the better. It is time for them to design rules and regulations that value the long term.

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