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## The practice of responsible investment

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*Rory Sullivan and Craig Mackenzie*

Insight Investment, UK

This book is about how investors might play a more positive role with regard to the social and environmental impacts of investee companies. Specifically, it is about two strategies that have emerged to do this: shareholder activism, and enhanced investment analysis and decision-making. While these approaches to responsible investment have yet to be widely adopted, there is now a significant body of experience in their application. The contributions to this book present the experience of the leading practitioners as well as the views of key stakeholders and commentators. As such, they shine a light on the practice of responsible investment—on the way in which institutional investors implement investment strategies to address their responsibilities to clients and to society, the practical issues and barriers faced in implementing such strategies, and the challenges to be faced if such strategies are to become truly mainstream investment approaches.

In Chapter 1, we posed three questions about responsible investment:

- Do responsible investment strategies actually contribute to improvements in the social, ethical and environmental (SEE) performance of companies?
- To what extent is it in investors' interest to encourage higher standards of corporate responsibility (CR)?
- Do responsible investment strategies enhance financial performance for investors?

Each of these questions is discussed further below. The hypotheses presented in Chapter 2—which are briefly summarised in the next section—are used to frame the analysis.

## The scope for investor action on corporate social and environmental impacts

In Chapter 2, it was suggested that harmful corporate impacts on society and the environment have three broad sources: market failure, agency problems and bounded rationality. Chapter 2 also offered some reasons for thinking that shareholder activism and enhanced analysis of SEE issues might be expected to deliver improved corporate SEE performance with regard to agency problems and bounded rationality, but had a more limited role to play with regard to market failure.

Chapter 2 suggested that a key factor in determining whether or not investors would use responsible investment strategies was their interest in doing so and that investor interest would depend on the time horizons over which they were investing and the breadth of their investment exposure. On this basis, it hypothesised that broadly based investors with long-term performance objectives would be significantly more supportive of responsible investment strategies than those with narrow, short-term, relative performance goals.

Finally, Chapter 2 suggested that shareholder activism on agency problems and bounded rationality would be expected to deliver enhanced investment performance over time, while acknowledging that activism on market failure would sometimes be in conflict with investment performance objectives, particularly over the short term. In Chapter 4—where we discussed whether or not enhanced analysis is likely to deliver enhanced investment performance—we suggested that there are reasons for thinking that SEE issues can have a material impact on the financial performance of companies. We then suggested that, in situations where information about the financial implications of these issues for companies is available and well understood, analysts will typically take them into account. However, we also suggested that markets may not be very efficient at doing this in all cases and, as a result, there may be opportunities to deliver improved investment returns through enhanced analysis.

## Does responsible investment contribute to improvements in the SEE performance of companies?

### Activism

There is a growing body of evidence that investor activism can play an important role in encouraging companies to improve their CR performance. The case studies in Chapters 14–18 present a series of specific examples where investors have contributed to improvements in the quality of companies' policies, management systems and disclosures on a wide range of SEE issues, including climate change, supply chain labour standards, human rights, business ethics and access to medicines. In some cases, these have contributed to noteworthy outcomes, such as the increased access to HIV/AIDS medicines in Africa, following investor and non-governmental organisation (NGO) engagement with the pharmaceutical company GlaxoSmithKline (GSK). Investors have contributed to these outcomes through:

- **Facilitating dialogue between companies and stakeholders and/or raising stakeholder concerns with companies.** For example, as noted by Peter Frankental in Chapter 21, investors have helped to raise the profile of human rights issues with companies by supporting specific NGO campaigns and acting as a conduit for the flow of information between pressure groups and companies
- **Legitimising specific debates.** As discussed in the case studies, investors have played an important role in encouraging companies to look on issues, such as equal pay, access to medicines and human rights, as proper matters for corporate attention
- **Supporting companies that wish to take proactive measures to address specific CR issues.** An example is the investor dialogue with GSK on access to medicines, where investors encouraged GSK to increase access to its HIV/AIDS medicines in Africa
- **Encouraging companies that fall below norms of good practice to improve their performance.** For example, in Chapter 17, Will Oulton highlighted the role of investors in encouraging companies to meet the standards required to allow inclusion in the FTSE4Good indices
- **Encouraging companies to ensure that corporate governance arrangements are supportive of CR.** Chapters 15 and 16 illustrate how investors act to ensure attention is given to those aspects of CR that fall within the proper role of the board: for example, tax policy or executive incentives. The case studies also highlight the fact that not all CR issues are of strategic importance to companies nor do all CR issues need to be the subject of board attention

The case studies provide strong support for the hypothesis in Chapter 2 that investor activism can improve corporate performance with regard to both agency problems (through improving governance systems and processes) and bounded rationality (through ensuring that companies have appropriate systems and processes in place to manage CR issues). Interestingly, the case studies challenge the hypothesis that investor activism will have a more limited role to play with regard to market failure. Some investor activity (e.g. on climate change and access to medicines) has sought explicitly to engage with market failure issues, and has led to some very important outcomes. However, it is our view that investor efforts to address market failures are, overall, likely to be less effective than efforts to address agency or bounded rationality problems, reflecting the relative strengths of the arguments that investors can use. In relation to agency and bounded rationality issues, investors have emphasised business-case arguments for companies to improve performance, including the need to align the interests of shareholders and managers and to minimise the risks to shareholder value of failing to manage specific SEE issues properly. As discussed in Chapters 23 and 24, these arguments are important to allow companies to understand the reasons for investor interest in specific issues. In relation to activism on market failure, it is noticeable that investors have been reluctant to explicitly state that companies may need to act contrary to their self-interests to address the market failure. Instead, investors have tended to rely on arguments around reputation risk or the longer-term benefits of not

exploiting the market failure. While such arguments may have merit, it is clear from the company case studies that these longer-term arguments will require convincing supporting evidence if they are to be persuasive.

### Which strategies?

In Chapter 13, we identified main strategies used by large institutional investors as: the use of voting and other formal shareholder rights; engagement; collaboration; public benchmarking; media communications; and influencing the share price. With the exception of directly attempting to influence the share price, investors have, to a greater or lesser extent, put all of these strategies to use to encourage higher standards of CR performance.

Turning first to the formal rights of shareholders, these strategies (e.g. votes against management) are quite familiar in the context of corporate governance issues, and the use of formal voting rights has been very important in encouraging sustained improvements in corporate adherence to the Combined Code on Corporate Governance. In as much as these improvements have significantly helped reduce the risk of agency problems at the top of British companies, they will have indirectly addressed those corporate issues that arise from these problems. However, in the UK, formal shareholder rights have been rarely used, at least to date, in relation to specific CR issues. This is partly because, unlike conventional corporate governance issues, there are few routine opportunities for shareholders to vote on CR issues. As a result, shareholders are faced with a choice of either seeking to use existing voting opportunities to send a signal on CR or of filing special resolutions. There are some signs that investors are increasingly willing to take the former option. For example, in Chapter 6, Ronnie Lim notes that Morley's voting policy requires companies to disclose 'sufficient' information on SEE risks, and states that Morley may abstain or vote against companies in the FTSE 350 that fail to disclose sufficient information. There is relatively little interest in the latter approach (i.e. filing resolutions). The main reason is that it is difficult to file resolutions in the UK, with the threshold required for filing being 5% of the issued share capital or 100 investors with a nominal collective investment of at least £10,000. This is in marked contrast to the US, where filing a resolution has a much lower threshold and where special resolutions on SEE issues have been far more common.<sup>1</sup>

Another reason why shareholders have been less willing to use their formal rights in the UK is that the largest institutional investors tend to have good relationships with, and access to, company boards and senior management and have been able to achieve significant progress through constructive dialogue (or 'engagement'). The use of shareholder resolutions would be perceived as aggressive and undermining of these relationships, and so may prove counterproductive. As illustrated in the case studies, and also as indicated in comments from company representatives (see, for example, Chapter 23), investors' views are an important influence on the manner in which companies take action on specific CR issues. This is particularly the case in situations where there is a clear business case for companies to take action. As noted above, it is less clear whether companies will respond (or continue to respond) in situations where the busi-

1 See the Interfaith Center on Corporate Responsibility: [www.iccr.org](http://www.iccr.org).

ness case is less well defined. The consequence is that investors' ability to contribute to addressing market failures (i.e. where the business case for companies to take action is weak) is likely to be weak.

Reflecting the long history of collaboration on corporate governance issues, UK investors have also sought to collaborate on a range of CR issues. Examples include formal coalitions such as the Pharmaceutical Shareowners Group and the Institutional Investors' Group on Climate Change (IIGCC), as well as more informal arrangements (see, for example, Chapter 15 where Rob Lake describes how Henderson and Insight worked together to engage with Shell in relation to its operations in Nigeria). Collaboration allows investors to present a consistent and unified voice on CR issues (thereby ensuring that companies are not facing competing and contradictory priorities from different investors) while also, depending on the issue, broadening the group of investors that work on a specific issue. Many of the collaborative initiatives have led to important changes in corporate practice, but it is too early to say whether collaboration is more or less effective than the outcomes that would be achieved by investors operating individually (or with minimal co-ordination and information sharing). In addition, issues such as free-riding, the risk of lowest-common-denominator approaches and the possibility of significant transaction costs potentially limit the utility of collaboration as an activism strategy. There are two types of free-riding that affect collaborative initiatives—where some of the participants use participation to demonstrate their 'commitment to activism' (even when their contribution has been minor) and where shareholders not party to the collaborative effort are able to claim most of the benefits resulting from the resultant improvements in corporate governance or CR performance. Collaborative investor activity has also been hampered by the lack of a clear, shared view of what standards shareholders should expect of companies in relation to CR issues. While there is a general consensus on the systems and processes (e.g. corporate policies, clearly defined responsibilities, performance monitoring, reporting) that companies should have in place, there has been a marked reluctance to say what the specific performance measures (or outcomes) should be. The challenge of achieving consensus has meant that the lowest-common-denominator approach (i.e. a focus on management systems and processes) has tended to prevail. While this is an important contribution to addressing bounded rationality issues, it is not clear how far these go towards addressing market failure issues. Finally, our experience with large-scale collaborative initiatives has been that they involve significant time and effort, tend to have long lead times and, frequently, are highly bureaucratic.

Investors have also started to use benchmarking methodologies in order to support engagement. This approach involves developing a benchmarking framework for corporate SEE performance, evaluating corporate performance against the benchmark and then producing a league table of companies based on the analysis. For example, Insight has conducted benchmarking exercises on biodiversity, environmental risk management in the house-building sector and on supply chain management. These exercises have proven very effective in stimulating companies to improve their performance. Another, larger-scale use of benchmarking is presented in Chapter 17, which is a case study on FTSE4Good. This index can be considered as a very large multi-issue benchmarking framework. FTSE has accumulated impressive evidence that the existence of this framework, and the company engagement activity surrounding it, has contributed to improvements in several hundred companies around the world. It appears that com-

panies put a premium on remaining participants in the FTSE4Good index and are willing to improve their practice in order to meet its entry requirements.

In relation to both individual engagement and collaborative engagement, there is an ongoing debate over the appropriate management level with which investors should engage on CR issues. For mainstream analysts and corporate governance activists, most engagement is with senior executive management (generally the chief executive and finance director) and the chair of the board. In contrast, it appears that most discussions on SEE issues tend to occur with lower-level managers tasked with managing CR issues. In many cases, engaging at this lower level seems to have been effective. By supporting the proposals of the CR manager, investors may have served to empower this function within the organisation. However, many CR issues raise questions of corporate strategy, appetite for risk, internal control and executive incentives. These issues can be dealt with only by the board. The failure of investors to engage at this level on SEE issues may weaken the effectiveness of investor engagement. Although in the past it has been relatively rare for investors to engage with board members on CR issues, there are signs that this is starting to change. For example, Henderson (see further Chapter 15) has engaged with boards on tax policy and non-financial aspects of executive incentives, while the Boards and Corporate Responsibility Project developed by Insight with FTSE and Business in the Community (see Chapter 16) seeks to develop consensus about the board's role in this area.

A number of fund managers now offer a stand-alone (or overlay) activism service, where they implement activism on behalf of clients, but without managing the underlying assets. In general, this involves the investment manager voting the client's holdings and engaging with companies on behalf of clients. To date, only a limited number of large institutional investors, such as the Wellcome Trust, British Coal Board and PGGM, have decided to adopt such an approach. The advantages are that it allows pension funds to hold investment managers to account for the delivery of effective activism, and it allows for consistency in voting and engagement thereby helping ensure that investee companies receive a single unambiguous message from shareholders. The overlay or unbundled approach is not, however, without its problems. Perhaps the most obvious is that it becomes an additional cost that pension funds need to meet (as noted in Chapter 28, it could be seen as inappropriate for fund managers to be paid extra for work that, arguably, they should be doing as a standard part of their investment management activities anyway). There is also a view (see, for example, the comments by Rob Lake in Chapter 15) that activism is most effective when it is accompanied by active fund management. Our view is that this problem is avoided where an active equity manager provides the activism overlay, rather than a third party who does not manage the assets. In addition, the reality is that many pension funds currently have no effective approach to activism at all; our view is that, despite the potential disadvantages, an overlay approach to activism is significantly better than nothing at all.

### **What is the role of public policy?**

It was suggested in Chapter 2 that long-term broadly based investors have an interest in correcting market failure, but that enhanced analysis and shareholder activism are of themselves—and absent an appropriate public policy framework—likely to be of limited value in serving this interest. From the evidence presented in this book, investors

have yet to actively support strong policy measures to correct market failures. To date, and as discussed in Chapter 30, most investor activity has been focused on comparatively modest ends, such as improving transparency (e.g. the Operating and Financial Review) and requiring pension funds to explicitly state in their statement of investment principles the extent, if at all, to which they take account of SEE issues in their investment processes. Nevertheless, there are some signs that investors are increasingly willing to encourage public policy-makers to take action to address market failure issues. As just one example, the IIGCC has explicitly supported the UK government's targets to reduce greenhouse gas emissions from 1990 levels by 20% by 2020 and 60% by 2050.

Investors have three key roles in helping to correct market failures. The first, as discussed above, is through encouraging public policy-makers to take action to address market failures. Despite the limited investor activity in this regard, the examples of IIGCC and Pharma Futures (see further Chapter 26) indicate that investors are increasingly willing to contemplate (if not, as yet, actively support) public policy measures to address market failures. The second is through ensuring that existing public policy is effectively implemented. Initiatives to correct certain agency and bounded rationality problems are important contributions. The third, as discussed in Chapter 31, is to strengthen the implementation of public policy by introducing new 'regulators' (in this case, encouraging investors to promote regulatory compliance with investee companies) and introducing new incentives for companies (e.g. peer pressure, publicising investor views of individual companies). However, this third set of activities seems most likely to be effective in complementing and enhancing existing regulatory initiatives (in this case, health and safety) rather than seeking to address completely new policy issues.

## Enhanced analysis

Chapter 2 suggested that enhanced analysis might be effective at encouraging improved corporate performance by improving the ability of the capital markets to give due weight to SEE risks in the pricing of shares. In turn, this would send strong signals to corporate management to manage these risks more effectively. There is considerable support in Chapters 4–12 that SEE risks may be inaccurately priced and that enhanced analysis may allow investors to exploit this inefficiency. However, there is very little discussion of whether or how this will have an effect on the behaviour of corporate management. It is generally assumed by the authors of these chapters that enhanced analysis will be socially useful, although it is not clear that the various authors have a clear view on why this might be the case; the evidence presented in the various chapters for or against this view is correspondingly weak. Further research is needed to cast light on this question.

## Are investors interested in pursuing responsible investment strategies?

In Chapter 2, it was suggested that investor interest in responsible investment strategies depends on the time horizons over which they are investing, the breadth of their investment exposure and the extent to which their performance goals are measured in relative or absolute terms. It was hypothesised that broadly based investors with long-term performance objectives would tend to be significantly more supportive of investor responsibility strategies than those with narrow, short-term, relative performance goals. Does the evidence provided by the subsequent chapters in this book support this hypothesis?

In theory at least, the idea that asset owners such as pension funds have a specific role to play in encouraging moves towards sustainable societies is intuitively attractive. The reasons (as discussed in Chapters 14 and 29) include the fact that pension funds are universal owners with stakes in virtually all the investable stocks in the universe; consequently, in serving their fiduciary duty to maximise the financial return of beneficiaries over the long term, they will have an interest and an obligation to address the SEE impacts of their investments. Therefore, in theory, pension funds should fall into the category of broadly based investors with long-term performance objectives. There is some evidence that pension funds accept that their long-term, broadly based interests should lead them to support efforts to address companies' SEE impacts. However, as discussed in Chapter 2, and as reflected in the comments made by some of the authors in this book (see, for example, Chapters 20 and 29), UK pension funds—with notable exceptions such as the Universities Superannuation Scheme (USS)—have been relatively slow to take a proactive role in promoting the idea of responsible investment. The structure of the institutional investment industry is (largely) that asset owners hire fund managers to manage equities: asset owners have the ultimate rights and interests while investment managers have the practical knowledge and company relationships. Given this structure, if the long-term interests of pension funds are to be reflected in investment practice, asset managers and asset owners need to work together. That is, asset owners need to give asset managers a clear mandate to act on their behalf, and to monitor and reward performance accordingly, while asset managers need to deliver on their mandate and report their results. As yet, few pension funds have created effective mandates and performance management mechanisms (e.g. detailed implementation policies for activism, requirements to comply with the pension fund's commitments to activism in contracts with fund managers, specific objectives and performance measures for activism, performance monitoring). The consequence is that, as noted by Raj Thamotheram in Chapter 29, the signals sent from pension funds to their fund managers tend to be weak. In turn, the signals from fund managers to companies are even weaker or non-existent. Not only have the signals on activism been weak, the investment mandates awarded by pension funds have tended to be relatively short-term and focused on performance relative to specific benchmarks. The consequence is that most asset owners have created incentives for asset managers to place too little emphasis on many of the important longer-term drivers of investment value (see further the discussion of enhanced analysis below).

Apart from the question of investment mandates, are there other barriers to the delivery of effective activism? The chapters in this book point to a number. The proper

monitoring (as opposed to box-ticking, compliance-based approaches) of companies is expensive and may require skills not usually found in fund managers. This issue of monitoring costs is compounded by the problem of free-riders: those that spend nothing on this type of activity reap most or all of the benefits in terms of improved performance and share price than those that incur all the costs. This problem is compounded by the reluctance, to date, of the majority of pension funds to pay for activism or to hold their fund managers properly to account for its delivery.

Another barrier to effective activism is the many conflicts of interest in investment management. For example, a fund manager may be engaging with a company whose pension fund it wishes to manage, or could be undertaking an activity where the corporate finance arm is also involved. Furthermore, pension funds could face difficulties where they are raising an issue that has not been addressed by the fund's own sponsoring company; in Chapter 20, Robert Monks and Allen Sykes note that corporate pension funds, which are controlled by corporate management, have almost never been activist in either the US or the UK. They argue that there is an implicit understanding that each company's pension fund will refrain from an activist stance in return for a reciprocal stance from all the others.

A further barrier is that the results of engagement are not always measurable, either in terms of effectiveness or the financial benefits that result from engagement. If pension funds cannot measure the difference between an effective activist fund manager and an ineffective one, it is difficult for them to choose between them. There are some efforts to address this issue. For example, a number of fund managers, including Insight Investment, F&C and Henderson, now publicly disclose information on their engagement and voting activities, and some ten fund managers have worked with the UK Social Investment Forum to develop transparency guidelines for fund managers in order to encourage fund managers to disclose information on issues such as activism policies, resources, systems and processes, outcomes achieved and reporting (see further Chapter 12). Notwithstanding these initiatives, if the financial benefits of activism cannot be measured it might be difficult for pension funds to justify the modest extra costs of activism. While, in theory, long-term, broadly based investors such as pension funds ought to be better off if agency problems, bounded rationality and certain forms of market failure are addressed, this theoretical benefit is not easy to measure. As a result, pension funds have found it difficult to justify spending money on activism and enhanced analysis on the basis of a theoretical gain. This is a particular problem for pension funds given that they have a fiduciary responsibility to serve the long-term interests of their beneficiaries.

The role of investment consultants may be particularly important in addressing these problems. To date, many investment consultants have been somewhat uninterested in the question of whether responsible investment strategies enhance or detract from investment returns. The lack of consultant interest has had the effect of reinforcing the lack of appreciation of the value of SEE activism and enhanced analysis to long-term, broadly based investors such as pension funds. The good news is that this is changing. For example, the Marathon Club initiative (see Chapter 28) and the decision by the bigger consultants in the institutional market to consider activism and research as an integral part of their research processes (see Chapters 27 and 28, and the recent announcement by Watson Wyatt that it intends to formally assess investment managers on their activism capabilities) are important signals that investment consultants may be start-

ing to take a much more proactive approach to these issues. While assessing investment managers is a start, it remains to be seen whether investment consultants will proactively encourage their clients to explicitly address SEE issues in their investment manager appointment/reappointment processes. It also remains to be seen how much weight is attached to these capabilities in the fund manager selection process.

In conclusion, it is probable that the hypotheses set out in Chapter 2 are too pessimistic. As the case studies in this book indicate, there is significant space within many fund management houses for investors to consider long-term and broadly based issues, thus serving the long-term interests of the economy as a whole rather than short-term relative performance interests. The significant resources devoted by asset managers such as Insight, Henderson, Morley, F&C and others to this area indicates that some asset managers are willing to take their responsibilities as owners seriously. The issues described above remain significant but not insurmountable barriers to ensuring that the long-term, broadly based interests of pension funds are fully reflected in the way their assets are invested in practice. Over the last five years a number of UK pension funds and charitable foundations have found ways beyond these barriers; USS, local authority pension funds in Lothian, Aberdeen, Nottingham and elsewhere, the Environment Agency pension fund and the Wellcome Trust are good examples. A few large European pension funds, such as PGGM and Algemeen Burgerlijk Pensioenfonds in the Netherlands, have also taken action. These pension schemes and foundations have helped to create a small institutional market for responsible investment strategies, providing vital commercial support for the development of many of the activism and enhanced analysis approaches described in this book. However, the maintenance of these teams and resources in the various asset managers depends largely on demand from pension funds. In the longer term, without support from asset owners, activism by managers is unlikely to happen.

## **Can financial performance be enhanced through responsible investment?**

### **Enhanced analysis**

The fact that SEE issues can have a material impact on the financial performance of companies does not, of itself, mean that a focus on these issues can enhance investment performance. As discussed in Section 2 of this book, some investors have sought to generate investment outperformance through two approaches. The first is an evolution of conventional approaches to the fundamental analysis of expected company earnings, with additional research being conducted into, for example, how expected environmental regulations or patterns of social change will affect earnings expectations in the future. The second is more radical, with analysis being driven primarily by data on SEE performance rather than by financial indicators. The case studies in Chapters 5–12 lend some support to the argument that, while markets are reasonably efficient at reflecting the available information about companies in share or bond prices, not all SEE issues are recognised and properly valued by the markets. The various authors offer two broad reasons for this:

- SEE issues have not yet been identified by the market (see, for example, the assessment of the EU's REACH Regulation in Chapter 5 and the discussion in Chapter 7 of the importance of timely analysis when evaluating corporate bond credit risks)
- SEE issues have not been properly valued by the market (see, for example, the discussion in Chapter 6 of the EU's emission trading scheme and the discussion in Chapter 5 of the limitations in the data provided by companies and the inadequacies in the cost–benefit assessments conducted by companies, governments and industry associations)

As discussed in Chapter 2, it appears that there are three areas—long-term impacts, intangibles or extra-financial impacts (e.g. reputation) and uncertain impacts—that are particularly likely to be poorly evaluated or assessed (and, consequently, as offering particular opportunities for investors to add value or achieve outperformance). The case studies demonstrate that it is possible to focus on one or more of these areas and to generate outperformance through doing so. One of the interesting features of the case studies is that most focus primarily on financial analysis of the effects of SEE issues. The investment managers (with the exception of Innovest and SAM who have a more radical investment approach) who have been able to benefit from analysis of SEE issues have done so through incremental improvements to their analysis of SEE impacts on core financial metrics, rather than seeking to analyse issues such as broader impacts on corporate reputation, quality of management or impacts on intangibles. Furthermore, the time horizon used in their analysis has not been significantly longer than 'typical' investment managers.

However, the fact that some investors are able to demonstrate that they have generated outperformance through enhanced fundamental analysis or through SEE-driven analysis does not mean that all investors will seek to do so, or that investment outperformance will be achieved by all investors that seek to focus on these issues. There are three factors that need to be considered: research costs, the quality of investment research and the relevance of longer-term value drivers to short-term investment performance.

With regard to the first of these, financial analysis can be costly, in particular on SEE issues where there is often little easily available information about company performance. The accepted wisdom in financial economics is that investors should invest in research to the extent that the benefits of doing so (in terms of enhanced investment performance) outweigh the costs. In many cases, the costs of enhancing analysis on SEE issues beyond a certain point will exceed the benefits. A common theme in the investment manager case studies (specifically, Chapters 5–7, 10 and 11) is that analysing SEE issues properly (i.e. in the detail necessary to properly factor these issues into investment decisions), is resource-intensive, generally requiring a team of specialists. Given that it is by no means certain that outperformance will be achieved, these research costs are a significant barrier to investment managers investing resources in this specific area. This does not mean that investment managers will not incorporate research (e.g. from the sell side) into their analysis but, rather, that they may decide not to develop their own capacity in this area beyond a certain point.

The second commonly cited barrier to responsible investment is the quality of investment research. The research produced by sell-side brokers has been criticised for being

overly focused on short-term drivers of share price rather than on long-term value drivers, extra-financial factors and uncertain events. One of the specific criticisms has been that SEE issues tend to be systematically ignored in investment research. Turning first to the question of short-term investment performance, it is important to recognise that the majority of SEE issues that can affect investment performance in the short term (i.e. material issues) tend to be reasonably well understood and reasonably well integrated into investment analysis and decision-making. These issues tend, however, not to be described by financial analysts as ‘social’ or ‘environmental’ issues, but rather in terms such as ‘regulatory risk’, ‘tax’ or ‘litigation risk’. For example, tobacco litigation (which originated as an ethical and public health issue) is a well-understood investment risk and is treated accordingly in investment analysis. That is, SEE issues are treated in a similar manner to other issues that may impact on investment performance (i.e. if an issue has the potential to impact materially on a company or companies, that issue will be identified and analysed). This does not mean that all SEE issues are identified or properly valued. However, these inefficiencies are not unique to CR issues. For example, the weaknesses in the market’s evaluation of the REACH Regulation (see further Chapter 5) are typical of any impending legislation in that the market tends to rely on companies bringing the issue to the attention of analysts, and the analysis of the financial implications tends to be done in a ‘just-in-time’ manner (i.e. once there is clarity regarding the direction of policy and when the information is required by analysts). An important corollary to the question of short-term performance is that many important SEE issues are not financially important or material (at least over the short term). A good example is the cost to mining companies of providing HIV/AIDS antiretroviral therapy, as discussed by Simon Toyne in Chapter 8. While HIV/AIDS represents one of the most important public health issues facing the world today, it does not automatically follow that this creates a short-term financial risk for companies, even those operating in the AIDS-torn countries of Africa. Toyne also notes that, while it is possible to assess the short-term costs of HIV/AIDS, it is extremely difficult to tell what the longer-term financial implications will be for companies (e.g. the availability of workers).

The third question is whether research focused on longer-term performance would actually be of value to investment managers. One of the critical conclusions from the case studies in Chapters 5–12 is that the ability of investment managers to generate out-performance from a focus on SEE issues requires either a detailed fundamental analysis process or an investment philosophy that harnesses the insights generated by an analysis of these issues into investment decision-making. However, as discussed above, given that most investment managers are required to benchmark themselves constantly against an index, and given the relatively short time horizons over which investment performance is judged, it is difficult for large investment managers to propose investment philosophies that diverge from index tracking. Consequently, it is debatable whether (even if the major analytical problems such as assessing impacts on extra-financials were resolved) there would be a significant market demand for research that gives substantially more weight to longer-term rather than shorter-term value drivers. We acknowledge that this may be a ‘chicken and egg’ argument as the emergence of better-quality research may enhance the legitimacy of longer-term approaches to investment and investment decision-making. However, even if these technical barriers could be overcome, the consequences of future events inevitably get discounted in investment analysis. That is, it is by no means certain that effective social controls will

emerge to encourage companies to internalise negative externalities and, even if these controls do emerge, these controls will be implemented or adopted at some indeterminate time in the future (and the effect of discounting future costs means that these costs will have a lower net present value). As a consequence, even if more or better research were to emerge on longer-term value drivers, it is by no means a given that this research would be used by investment managers. Finally, research is not a free ‘good’; for sell-side researchers to focus more on SEE issues they would need to expect a pay-off (e.g. the Enhanced Analytics Initiative proposes that investment managers and pension funds should allocate a minimum of 5% of their brokerage commission budgets to sell-side houses who are effective at analysing material extra-financial issues and intangibles). However, given that many investment managers have less interest in longer-term issues, it is not clear that they would be interested in allocating extra resources to this area.

### The financial value of activism

The examples offered by this book offer some early support for the claim that enhanced analysis may be expected to contribute to improved investment performance. Does shareholder activism do the same? There are two questions here. The first is whether improved corporate SEE performance improves earnings and the second is whether shareholder activism is effective at achieving these changes.

An implication of the arguments presented in Chapter 2 is that, where a SEE impact is caused by agency problems or bounded rationality and companies are effective at reducing these problems, then these companies would expect to see increased earnings over time. However, for market failure issues, improved SEE performance may not pay (unless there are substantial long-term social penalties for exploiting market failure). If this argument is correct, shareholder activism to encourage companies to address agency problems, bounded rationality and market failure (where there are reasonably certain and substantial long-term penalties) should contribute to financial outperformance, but activism on other forms of market failure will not. The contributions to this book, as discussed above, provide strong evidence that shareholder activism can contribute substantially to improving corporate SEE performance, in particular in relation to agency and bounded rationality problems. However, there is limited evidence to date to support the hope that activism will be able to substantially address market failure issues. One of the most striking impressions of the chapters on activism in this book is that, while the authors discuss in detail the impacts of activism on CR performance, they pay little attention to the question of the impacts of activism on investment performance. While there is some discussion of related questions, such as whether or not there is a business case for CR, or whether or not activism on CR is compatible with the fiduciary duties of investors, the specific question of whether or not shareholder activism contributes to measurable improvements in the financial performance of particular stocks or of investment portfolios is not substantially addressed. The lack of attention to the financial performance implications of activism reflects the difficulties in attributing specific changes in share price to the effects of activism and the fact that performance benefits will tend to be shared by the market as a whole (thereby reducing relative gains). While the authors appear to be unwilling to make specific claims about the financial benefits of activism, a number argue (see, for example, Chapter 15

on activism and Chapters 6 and 7 on investment decision-making) that one of the outcomes of engagement and activism is a better understanding of companies and their value drivers. Thus, the process of engagement—whether or not directed towards achieving specific improvements in corporate performance—can provide insights that allow investment performance to be improved.

The fact that shareholder activists seem to pay relatively little attention to the implications of their work for investment performance highlights another important issue: the apparent disconnect between the agendas and issues raised by socially responsible investment analysts and mainstream analysts. A number of companies (see, for example, Chapters 23 and 24 on Severn Trent and BT respectively) have noted that their chief executives have not been asked about CR issues by mainstream analysts, that mainstream analysts do not appear particularly interested in these issues and that SEE analysts often do not attend the same meetings as mainstream analysts. Does this mean that SEE analysts are not relevant to the work of mainstream investment processes? Sometimes this can be a reasonable conclusion. Many of the SEE issues that have been pursued by investors through activism may not be all that material to share price. As illustrated by Simon Toyne's analysis of HIV/AIDS in the southern African mining industry (Chapter 8), SEE issues are often too financially insignificant to warrant analysts' attention. The consequence is that shareholder activism to encourage improved performance on such topics, even if successful, will not create significant financial benefits. However, in other circumstances, specifically those where there may be long-term penalties for companies that exploit a market failure, a more accurate conclusion would be that the difference in emphasis reflects the different time horizons of each. As discussed above, mainstream analysts are frequently more interested in short-term influences on earnings, whereas shareholder SEE activists tend to be more interested in longer-term issues (i.e. those issues where the sanctions are longer-term, less certain and impact on issues such as corporate reputation). For example, using the example of GSK presented in Chapter 18, while GSK's old pricing policy for its AIDS medicines may not have been material in the short term, failure to manage the issue may have had substantial long-term implications both for the company's reputation and for ongoing public support, particularly in poorer countries, for the 'trade-related aspects of intellectual property rights' (TRIPS) global regime. One of the risks for responsible investment is that companies may use this apparent disconnect between financial analysts and shareholder activists to reject engagement on CR issues.

## Concluding comments

The material presented in this chapter and, indeed, the book as a whole, allows us to provide some answers to the three questions that we raised in Chapter 1. First, in relation to the question of whether responsible investment strategies actually contribute to improvements in the SEE performance of companies, the case studies in this book offer encouraging evidence that shareholder activism strategies can make important contributions to addressing agency problems, bounded rationality issues and market failure issues. There is rather limited evidence either way on whether enhanced analysis has a

similar role. However, given that a specific challenge in addressing market failures is the weakness of the business-case arguments that can be used to support company action (in particular, given that addressing the market failure is likely to entail costs for companies), improved rigour in the analysis of the long-term, uncertain and extra-financial impacts of SEE issues may strengthen the force of investors' arguments to address market failures.

On the question of whether responsible investment strategies enhance financial performance for investors, there is some limited evidence to support a positive conclusion in this regard. The reality is that demonstrating consistent investment outperformance takes many years. It is too early in the evolution of responsible investment to draw any firm conclusions on this issue.

Finally, this book has allowed us to examine the extent to which it is in investors' interest to encourage higher standards of CR. The material in the book supports the view that long-term, broadly based investors do have an interest in encouraging higher standards of CR, but that the way pension funds invest in practice may not be fully consistent with this interest. This helps explain why responsible investment strategies are not yet all that widely adopted. However, the general conclusions of Chapter 2 were probably a little too pessimistic. The chapters in this book reveal that the CR performance of companies is recognised as an important issue that many different parties to the investment process—pension funds, other asset owners, investment consultants, investment managers, trade unions, NGOs and companies themselves—are trying to address. Many of the barriers to action are starting to be addressed by these parties. If they are successful, we expect and hope to see growing support for responsible investment strategies over time.