George Serafeim, Harvard Business School (in collaboration with Calvert)

George Serafeim is the Jakurski Family Associate Professor of Business Administration at Harvard Business School. He has taught courses in the MBA and doctoral programs, chaired Executive Education programs, written more than 100 articles and business cases, and presented his research in more than 100 conferences and seminars in 20 countries. He has published numerous articles in prestigious academic and practitioner journals including the Strategic Management Journal, Journal of International Business Studies, Review of Accounting Studies, Journal of Finance, Journal of Accounting Research, Management Science, The Accounting Review, Financial Analysts Journal, MIT Sloan Management Review, Journal of Applied Corporate Finance, and Harvard Business Review.

INVESTMENT STEWARDSHIP FOR POSITIVE SOCIETAL IMPACT

George Serafeim

Executive summary

- Companies are increasingly addressing environmental, social and governance (ESG) factors as part of strategic and operating decisions. Firms that perform better in some of those factors subsequently have better financial performance.
- However, there are limits to how much individual companies can accomplish in achieving progress toward environmental, social and governance goals.
- Companies that devote resources to certain environmental, social and governance factors may be at a short-term competitive disadvantage to competitors that do not. Collaboration within industries on sustainability issues can alleviate that disadvantage.
- This paper proposes that large investors, including index funds, active managers and pension funds can act as "stewards of the commons" by helping build and sustain industry and more broadly systems-level collaborations for ESG issues.

In recent years, the growth of investor interest in sustainable investing has been remarkable. As that interest has grown, the response of corporations has evolved. Early on, companies usually allocated resources towards projects with positive impact for employees, local communities, and other stakeholders. More recently, corporate strategies have become more sophisticated, integrating environmental, social and governance factors at the core of the organisation to guide both strategic and operating decisions.

Studies have shown that such moves by companies often enhanced financial performance through cost savings, increased brand value, innovation, employee productivity, and lower cost of financing. Other research has documented that sustainability disclosure by companies is helping drive stock performance, as investors use that information to sharpen valuations relative to industry peers.

A brief guide to ESG

Environmental Efforts that reduce environmental impact of business operations and related legal and regulatory risks, and promote sustainable use of natural resources.

The quote

The growth of investor interest in sustainable investing has been remarkable. As that interest has grown, the response of corporations has evolved.

Social Initiatives that seek positive change for employees, communities, customers, suppliers and other stakeholders of the company.
Governance A range of standards that apply to areas such as transparency in accounting, shareholder voting rights and conflict-free board composition, designed to encourage fair and equitable corporate management.

Limits to Self-Interest

However, there are clearly limits to how far corporate self-interest can go in helping foster positive social change. In this paper, we discuss those constraints and offer a new paradigm: investors as stewards of the commons. Investors already routinely engage in constructive advocacy with individual companies for environmental, social and governance goals, and these efforts often influence entire industries. We show that with the great concentration of assets in large firms, investors are uniquely situated to extend these "win-win" initiatives, while improving the risk/return profile of their portfolios. By advocating for collaboration, investors can provide the positive impetus in the many cases where even the best efforts of individual firms are likely to fall short.

Figure 1 offers a taxonomy of the economics of ESG issues, highlighting the roles of individual firm actions, collaborations and asset managers.

There are three primary reasons why corporate self-interest may also be self-limiting, in terms of the need to address the world's significant ESG challenges:

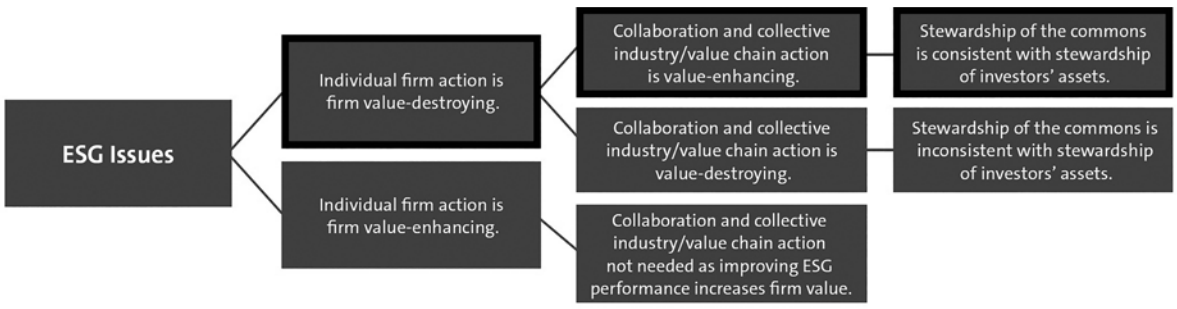
- Good may not be good enough – Even when firms improve financially from increasing their commitment to environmental, social and governance issues, it may not be enough to make a meaningful contribution to the problem. For example, an electric utility company might find that it can improve profitability or lower its risk profile and increase its valuation by increasing production of renewable energy to 10% of generation over five years. However, it may run into diminishing returns, with little or no further financial improvement by boosting renewables to 20%. Unfortunately, generating 10% of production from renewables is clearly not enough to significantly curb carbon emissions and mitigate climate change.
- Consumer indifference – There are cases where improving a firm's social impact does not pay. For example, in some cases consumers are not willing to pay more for "green" products, and usually only subsets of the customer base for specific products are willing to do so. As a result, firms that take costly actions to source products in a sustainable way could find themselves at a competitive disadvantage. Similarly, sourcing from suppliers that respect labor rights might be more expensive in some cases.
- Short-termism – Even though increasing wages or selecting suppliers with better environmental practices might bring a financial benefit in the long-term, short-term pressures on the business might make business leaders averse to such investments. The market for corporate control, the design of executive compensation packages and the board of directors' evaluation horizons could be barriers to such decisions.

The case for collaboration

This paper proposes pre-competitive collaborations as a way to go beyond the limits of individual firms. At the outset, it is important to distinguish between co-operation and collusion. Unlike classic collusion that is undertaken in secret to undermine market competition, cooperation as envisioned here is characterised by transparency and oversight.

Like airlines purchasing jets together to lower costs, collaborations can be mutually beneficial without affecting the fundamental relationship between competitors.

Figure 1. A taxonomy of the economics of environmental, social and governance issues



The bottom branch shows issues where an individual company acting on its own can improve its ESG performance and financial performance. The middle branch shows issues where individual and collaborative firm action is detrimental to financial performance. The top branch is the focus of this paper: Where individual firm-level action is value-destroying but collaboration can provide a solution and catalyze action.

Source: Serafeim, George, Investors as Stewards of the Commons? (August 7, 2017). Harvard Business School Accounting & Management Unit Working Paper. Available at SSRN: https://ssrn.com/abstract=3014952.

Other examples:

- Mobile operators, through their GSMA trade group, are collaborating to improve infrastructure, reduce poverty and provide quality education.
- The International Council on Mining and Metals' has developed transparency principles for mining firms.
- The Responsible Care program of the chemical industry focuses on outcomes ranging from employee safety to environmental impact.
- The Global Agri-business Alliance is developing an agreement for companies operating in different parts of the agriculture value chain on standards of conduct for improving livelihoods of farmers, among other outcomes.

The free-rider problem

The glaring potential problem with collaboration is the free-rider principle – the temptation for one or more industry members to take advantage of the benefits produced by the cooperative arrangement, without sharing in the costs that make it possible. For example, in the coffee and cocoa industry, large-scale production has resulted in environmental degradation and has harmed plant fitness. This has jeopardised both supply chain stability and the availability of quality cocoa and coffee beans.

Reversing this process requires manufacturers to source from sustainable producers, which can only be accomplished through costly investments for education and finance that empower farmers to use sustainable techniques. Non-cooperating companies can also use these sustainable suppliers, without the upfront costs. The attraction of such free-riding creates a disincentive to act collaboratively in the first place.

A good example of the fragility of cooperative arrangements can be seen in the Roundtable on Sustainable Palm Oil (RSPO). The group has successfully brought a large portion of the world's major palm-oil-using companies together under one organisation and has been integral in increasing the amount of sustainable palm oil. Nonetheless, research has found that despite its successes, achieving compliance from all member corporations has proven challenging — the organisation has failed to halt palm oil-related habitat destruction.

The Role of Investors

The central thesis of this paper is that all investors — including individuals, but especially larger asset managers and institutions – may be an invaluable mechanism for building and sustaining pre-competitive collaborations. Institutional investors have been instrumental in promoting sustainable investing. In April 2006, 32 institutional signatories of the U.N. Principles for Responsible Investing (UN PRI) were responsible for $2 trillion under management. By April 2017, 346 institutional signatories were responsible for $16.4 trillion of assets under management.

A key component of the institutional effort has been engaging management to advocate for business practices in keeping with the UN PRI mission. Extending that effort to include industry collaborations would be a logical next step. Indeed, Swedish AP Funds has already set an example. Last year, in collaboration with other investors, the Funds engaged 10 companies regarding the management of fish and shellfish throughout supply chains, and several companies that purchase cobalt mines in the Congo. The 2016 report of the AP Funds states that "the aim is to get these companies involved in cooperation with other companies … to establish a supply chain devoid of child labour and violations of human rights."

In 2017, the world's largest fund, the Norwegian pension fund, partnered with UNICEF to set up a network with some of the top fashion companies to improve children's rights in the supply chain through education, health and nutrition, access to school and working mothers' ability to breast-feed.

The big players

Investors who are able to engage companies at the industry level share two common characteristics. They have significant common ownership of different companies within the same industry or supply chain, and have long-term investment horizons. Key examples are:

- Large index asset managers, such as BlackRock, State Street and Vanguard. By definition, the holdings of these investors will include many competitors within the same industries, and that will remain constant as long as those companies remain in the index. Calvert is another example — not as large as the former group, but dedicated by objective to engagement and advocacy for sustainable business practices.
- Active institutional investors with broadly diversified, low-turnover portfolios, which are large enough to effectively becoming quasi-indexers, and usually seek to limit tracking error. This kind of investor is typified by Fidelity Investments, JP Morgan, BNY Mellon and Northern Trust.
- Large pension funds such as Norges Bank Investment Management, AP, and New York Common Retirement Fund that seek to meet long-term liabilities and have very large assets under management therefore diversifying portfolios broadly.

The advocacy of such investors is already having a significant impact. For example, in June 2017, large investors including Black Rock, State Street Global Investors and Vanguard voted against Exxon Mobil to require that the company report on climate change. In January 2018, two large Apple investors — Jana Partners and the California State Teachers' Retirement System — asked the company to study the impact of excessive phone use on mental health, especially on children. The steps taken by sector leaders such as Exxon Mobil and Apple will undoubtedly have ripple effects across their industries.

Examples such as these also show how investors can help reduce portfolio risk through environmental, social and governance efforts. Products that entail environmental degradation and/or potential harm to customers represent potential long-term liabilities — investors are often better positioned than management to understand the urgency of reducing them.

Figure 2 illustrates examples of industries and the ESG topics relevant for them. As of the first quarter of 2016, the 15 largest asset managers (ranked by assets under management) exhibiting the characteristics identified above held, on average, 34% of the shares of companies of the industries highlighted in the rows of the graphic. This number provides a rough gauge of the significant potential influence large investors can have in promoting collaboration across the spectrum of environmental, social and governance topics.

Figure 2. With major stakes in industries, large investors could influence a range of ESG issues

ESG Topic	Industry	% Owned by Large Investors
Environmental		
Deforestation	Food and kindred products	33.9%
Environmental		
Water pollutants and water consumption	Apparel and other finished products made from fabrics and similar materials	30.3%
Environmental, Social		
Materials sourcing and conflict minerals	Electronic and other electrical equipment and components, except computer equipment	34.3%
Social		
Obesity and customer health	Eating and drinking places	38.3%
Social		
Inclusion, access to affordable products	Educational services	24.3%
Governance		
Bribery and corruption	Construction general contractors and operative builders	40.4%

Source: Adapted by Serafeim and Calvert from: Serafeim, George, Investors as Stewards of the Commons? (August 7, 2017). Harvard Business School Accounting & Management Unit Working Paper. Available at SSRN: https://ssrn.com/abstract=3014952.

ESG as a competitive advantage

As noted earlier, large pension funds have been in the vanguard of advocating for social investing, including collaboration among competitors. But what incentive would asset managers have to devote resources, money and time for engagement?

After all, minimising expenses represents the chief value proposition for index funds, and active managers – especially quasi-indexers – are under pressure to compete on the same terms. At the same time, however, managers are seeking to grow their asset bases. The same pressure from customers that has driven the growth of sustainable investing will likely spark managers to advocate for collaboration, as a competitive edge in the environmental, social and governance space.

For an indication of customer demand, consider a Morgan Stanley survey that found 71% of individual investors were interested in sustainable investing. The survey also showed millennial investors were almost twice as likely as the overall individual investor population to invest in companies or funds targeting specific social or environmental outcomes. These results were echoed in a 2016 quarterly "Atomix" survey by Eaton Vance of financial advisors, who said that millennials were the most likely demographic group to be "very" or "extremely" interested in ESG investing.

The role of customers

Customer pressure on larger asset managers for greater ESG engagement is already being exerted via smaller funds and investors, including socially responsible funds. For example, Walden Asset Management and the Centre for Community Change, along with the City of Seattle Employees' Retirement System and First Affirmative Financial Network, filed a shareholder resolution requesting a review of BlackRock's proxy voting process and record on climate change.

Following extensive engagement and constructive dialogue between BlackRock, Walden and several investors, the shareholder resolution was withdrawn. Soon after, BlackRock updated its website to provide insights into the ways it believes climate change creates risks and opportunities for companies. BlackRock also noted that climate risk will be a priority for their engagement with companies and boards throughout 2017 and 2018.

The demand for showcasing leadership and measurable outcomes from engagement efforts is also likely to increase with the introduction by Morningstar and MSCI of ESG ratings that are reported at the portfolio level rather than for individual companies.

Similarly, a new rating system, Climetrics, enables investors to gauge and compare the climate impact of investments in funds worth a total of €2 trillion. (So far, the service is available only for European funds.) Of course, in evaluating ratings, investors should first understand their relevance and limitations. A rating is only as good as its underlying data and methodology of course.

But in any case, the availability of such information increases pressure on asset managers providing sustainable products as it allows individuals and institutions to scrutinise and compare ESG performance data on mutual funds and ETFs.

Action steps for investors

Ask your asset manager:

1. What is your engagement track record? Specifically, how have your engagement efforts impacted the environment and society?
2. What are your policies and strategies to boost return by improving ESG performance in portfolio companies?
3. In addition to compliance and symbolic actions, how are you moving towards a holistic strategy for value creation and positive social impact?

Investors as catalysts for collaboration

In sum, the role of investors as catalysts for socially beneficial change across industries is already well underway. As long-term stewards of wealth, pension funds and similar institutions have been predisposed to advocacy and engagement. Larger asset managers are acting for competitive advantage, feeling pressure from socially oriented funds and individuals, who are now empowered with significantly more relevant environmental, social and governance information at the portfolio level.

Just as importantly, investors can act as enforcers, helping protect collaborating companies from free-riders, either through engagement with the free-riding company or by shunning its stock. Implemented correctly, investing can be a powerful tool for expressing societal opprobrium.

The global nature of modern commercial activity has given rise to a host of emerging non-governmental regulatory efforts, such as industry association codes, multi-stakeholder association efforts (e.g. Fair Trade), and global institution codes (e.g., OECD Guidelines for Multinationals).

The role for investors outlined in this paper fits squarely in this new governance system. Large investors have the leverage to be stewards of the commons, ensuring that companies make coordinated efforts to address the world's crucial environmental, social and governance goals. All investors have the ability to help make that happen. **FS**