

OUTCOMES  
BEYOND  
PERFORMANCE }

# RESPONSIBLE INVESTING

THE PERSISTENT MYTH OF INVESTOR SACRIFICE

October 2017

For professional investors only

[www.hermes-investment.com](http://www.hermes-investment.com)

  
**HERMES**  
INVESTMENT MANAGEMENT





**We have to choose  
between a global  
market driven only  
by considerations of  
short-term profit and  
one with a human face.**  
– Kofi Annan

### **The Responsible Capitalism Survey 2017**

Hermes Investment Management's annual Responsible Capitalism Survey<sup>1</sup> was launched in 2014 to gauge the perception of responsible investment among the investment community. The 2017 survey was carried out on a group of 104 UK, European and Asia Pacific institutional investors during June to July 2017. Responses were anonymous. The survey covers a range of topics inclusive of ESG assessment in investment decision making, corporate governance and diversity. Within the past four years, we have seen responsible investment considerations grow in prominence in the mainstream investment agenda. Our survey seeks to assess how far the growing recognition of the importance of these issues is reflected in investment practice.

<sup>1</sup> The Survey was conducted by Citigate Dewe Rogerson



## Saker Nusseibeh

Chief Executive  
Hermes Investment Management

In June of this year, President Trump walked away from the Paris Climate Change Agreement, saying it would 'hurt the American economy and society alike'. Trump believed that forcing American companies to meet emissions targets would damage their competitiveness. To our mind, this highlighted a persistent myth around environmental, social and governance considerations – that they are somehow 'bad for business'. Good environmental and social practice by companies is good capitalism, but in spite of increasing awareness of its importance, this message is failing to resonate.

A decade ago, environment, social and governance considerations were the preserve of charities or religious groups, a niche part of the investment market. Today, they are widely discussed, but the debate remains narrowly drawn. Investors pay attention to ESG issues, but more often it is for risk management purposes, checking companies are meeting regulatory risks or avoiding costly environmental problems and litigation. In other words, it is all stick and no carrot. The 'carrot' of ESG is often neglected.

The link between ESG considerations and financial value creation needs to be more clearly recognised. Companies that can adapt to social and environmental change are likely to deliver better long term results for shareholders. An airline company that can use less fuel will have lower costs, for example, a company that harnesses big data to make industrial processes more efficient is in a better position than one relying on old and wasteful practices. Companies that treat their staff properly have a more productive workforce.

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Another 'carrot' is also a better alignment with the people we serve. As investment managers, we need to understand the ultimate beneficiary of the service we provide. There is a tendency to look at pension funds as the client, rather than the individuals who must benefit from them. When we look at those individuals, we find that they do not tend to have large amounts of money in retirement: the average annual income for those receiving a defined benefit payout is just £13,000 combined with a state pension. Even current members of wealthy schemes, such as CalPERS are dealing with an average income of £15,000. Even if a pension fund outperforms its benchmark by 10%, they might only add £50 a month for those in a defined contribution scheme.



### Pension funds

£13,000

Average annual income for those receiving a defined benefit payout with a state pension

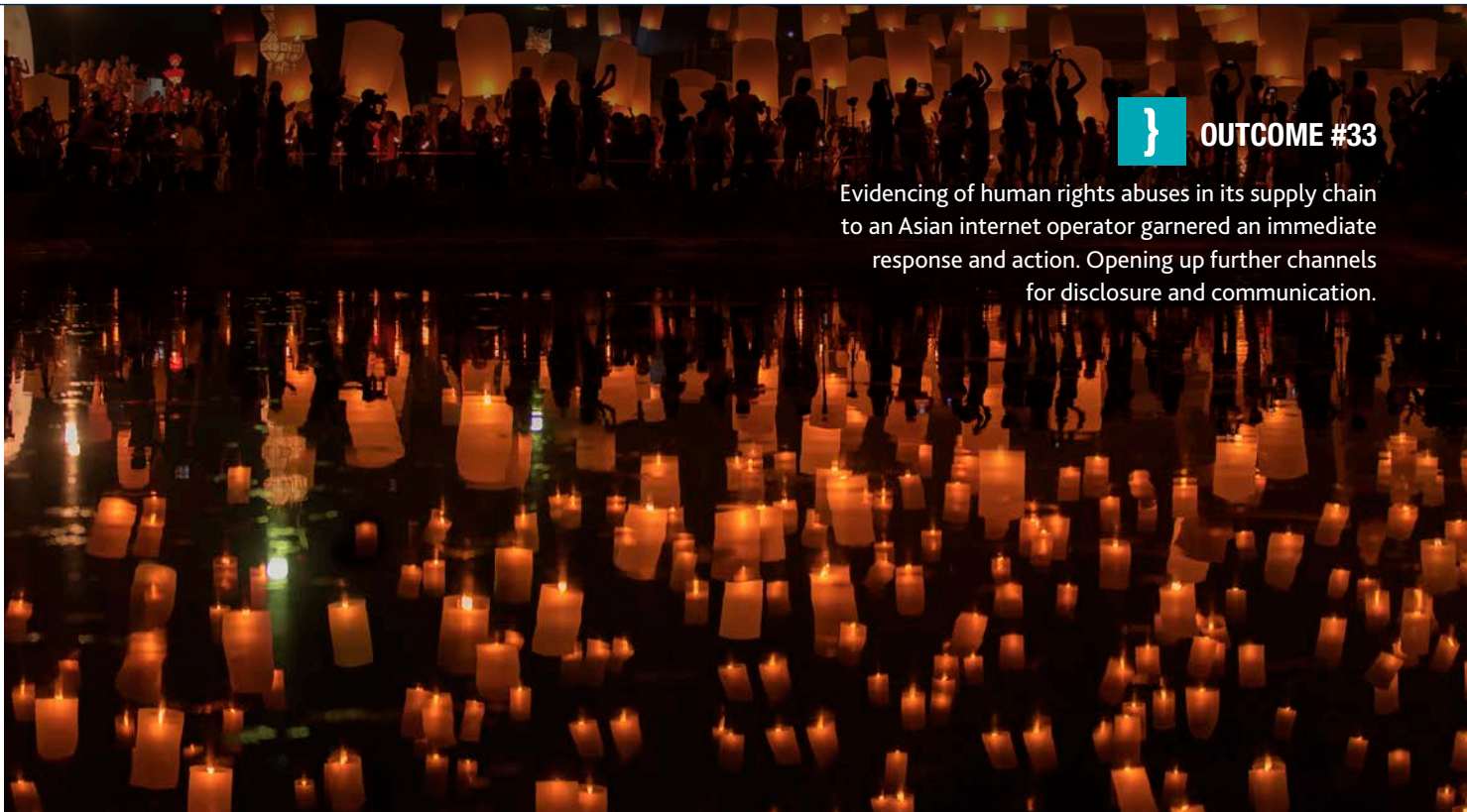
£15,000

Average annual income of members of wealthy schemes such as CalPERS

Far more important for these people is to be able to afford their lifestyle and to live well. For them, it really matters how much they are paying for their water, gas, electricity or food. Investment managers need to think about the society they are building with their savings and understand the laws of small numbers. There is no point striving for a wealthy retirement if society has been destroyed by the ill-considered actions of companies who have been insufficiently held to account by their shareholders.

We see that in the responses of this year's Responsible Capitalism survey: many still view ESG as a tick-box exercise to keep risk managers happy rather than part and parcel of building a better future for retirees. Key to this was when we asked whether pension funds should focus on maximising retirement incomes, or on whether their investments would improve or detract from the overall quality of life experienced by beneficiaries when they retire. Only around half said they should focus on the latter.

This seems to be approaching things backwards. Investment managers are vital stewards of capital and play a key role in holding companies to account. It is in their gift to shape a better future for retirees, and not by beating a benchmark, but by influencing the way companies behave.



**OUTCOME #33**

Evidencing of human rights abuses in its supply chain to an Asian internet operator garnered an immediate response and action. Opening up further channels for disclosure and communication.



**Just 48% of investment managers believe that companies that focus on ESG issues produce better long-term returns for investors.**

It was also clear that investors still believe they must sacrifice something to meet ESG criteria. Although 86% believe that fund managers should price in corporate governance risks as a core part of their investment analysis, alongside traditional financial metrics, just 48% believe that companies that focus on ESG issues – and corporate governance in particular – produce better long-term returns for investors. This represents a drop from the 2016 survey – 56%.

Certainly, it is true to say that strong ESG criteria provides a risk management element. The corporate world is littered with examples of poor governance leading to poor results. There can be little doubt that environmental considerations affect outcomes, for example – the Lloyds insurance market survived two world wars, but could not survive asbestos; oil companies have seen profound effects from environmental problems, while German carmakers are rushing to catch up with the challenge posed by electric cars.

However, this neglects the very real commercial advantages of meeting ESG criteria. On gender, for example, any capitalist worth their salt would want to source the strongest skills at a reasonable price. So why halve the potential pool of workers? It could double the price. Gender equality is not simply a nice idea, it makes sound economic sense.

Our survey found that this is still not a significant consideration for investors – just 33% believe that diversity of gender at board level is important or vitally important. It is not just on boards. Just 44% believe that gender diversity is important or very important across the overall workforce, and just 41% for race and ethnicity. This is reflected in the make-up of UK companies – just 6% of FTSE 100 CEOs are women and they earn 77% less than their male counterparts<sup>1</sup>.



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<sup>1</sup> <http://www.independent.co.uk/news/business/news/ftse-100-gender-pay-gap-chief-executives-men-women-income-salary-bonus-ceo-a7873506.html>



A greater proportion (78%) believe that diversity of experience is important and 69% that board independence is important. This seems a curious distinction. Is it possible to have diversity of experience or true independence without diversity of gender? The aim, always, should be for diversity of thought. Companies serve a diversity of customers and need a broad perspective to run efficiently. Siloed thinking is the enemy of progress.

The same is true for labour relations. Companies with strong labour relations have fewer strikes, less staff turnover, lower recruitment costs and employees tend to work harder. Increasingly, there is also a reputational cost to poor practice, as companies employing 'gig economy' workers have found. Yet the survey found only half of pension funds believe companies that actively foster and nurture a diverse workforce through initiatives such as mentoring and return to work programmes deliver better long term returns. We see it as simply sensible business practice. Paying attention to these issues is vital for retaining talent and ensuring loyalty.

Any structure that doesn't reflect the 50/50 gender split of society, or the split between cultures and religious groups, is inefficient. It is a defence mechanism – people rely on their networks – but they need to address it if they are to build better organisations. If they do not, governments may start to do it for them. Good environmental and social governance is not just compatible with good capitalism, it is a vital part of it.



### Diversity

# 50|50

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In spite of the fiduciary duty of pension funds to maximise retirement incomes for beneficiaries, 33% don't believe that significant ESG risks with financial implications justify rejecting an otherwise attractive investment. This is still surprisingly high. There is a diminishing pool of buyers for

## We live in a transparent, connected world, where poor practice is readily exposed.

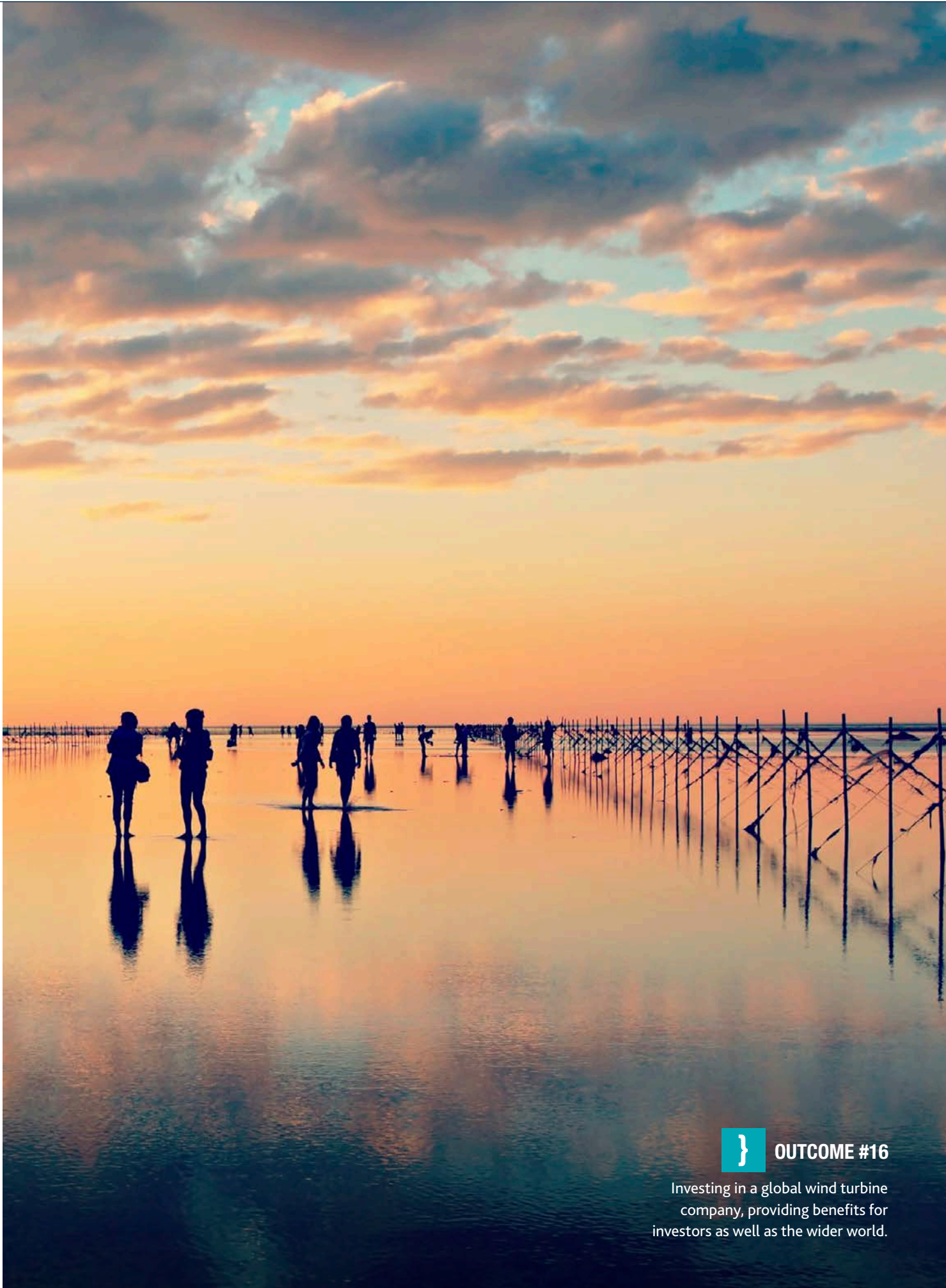
companies with poor ESG records – 57% of pension funds believe that the number of investment opportunities rejected on ESG grounds will increase. This should give those who believe that ESG criteria can stand independent from financial returns pause for thought.

Why do these myths persist? There remains some confusion over the nature of ESG. People believe it naturally excludes certain areas that have done well in recent years – tobacco stocks, for example. However, this is to misunderstand ESG, which is about understanding the long-term sustainability of a company and having proper governance. It is about being aware of the risks. In reality, it is just old-fashioned fund management.

Markets remain very short-term. People tend to get very exercised about short-termism when markets go down and then gradually forget about it as markets go up. Companies want to talk long-term, but say fund managers don't want to. Fund managers want to talk long-term, but say companies don't want to. Perhaps more honest communication is the answer?

There is also a tendency within the financial industry to talk about the next day, the next week. What is the short-term effect of inflation on markets? What is the impact of a Federal Reserve rate rise? But inflation and interest rates don't matter over the short-term; they only matter over longer horizons. Investment managers need to be long-term, responsible stewards of capital, rather than ebbing and flowing with the latest economic announcement.

Patterns of demand are shifting. A new generation of literate consumers is emerging, who want their goods to be made responsibly, by a company who treats its workers properly, with a supply chain that protects worker safety. We live in a transparent, connected world, where poor practice is readily exposed. In such an environment, who would want to invest in an unsustainable company?



**} OUTCOME #16**

Investing in a global wind turbine company, providing benefits for investors as well as the wider world.

## HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

### Our investment solutions include:

#### Private markets

Infrastructure, private debt, private equity, commercial and residential real estate

#### High active share equities

Asia, global emerging markets, Europe, US, global, and small and mid cap

#### Credit

Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

#### Multi asset

Multi asset inflation

#### Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

### Offices

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