Chapter 7: Investing for long-term value creation
Overview of the book

Part I: What is sustainability and why does it matter?
1. Sustainability and the transition challenge

Part II: Sustainability’s challenges to corporates
2. Externalities - internalisation
3. Governance and behaviour
4. Coalitions for sustainable finance
5. Strategy and intangibles – changing business models
6. Integrated reporting - metrics and data

Part III: Financing sustainability
7. Investing for long-term value creation
8. Equity – investing with an ownership stake
9. Bonds – investing without voting power
10. Banks – new forms of lending
11. Insurance – managing long-term risk

Part IV: Epilogue
12. Transition management and integrated thinking
Learning objectives – chapter 7

- explain why the financial system needs to adapt
- discuss what the obstacles to adaptation are and how they can be overcome
- explain the key differences between active and passive investment approaches
- identify the different parties in the investment chain
- list and understand the conditions for long-term value creation by investors
- contrast traditional performance measures with alternative ones
Why invest for long-term value?  
And how?
LTVC

To optimise financial, social and environmental value subject to risk

F + S + E = IV
### Traditional versus long-term investing

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Traditional investing</th>
<th>Long-term value creation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Typology</strong></td>
<td>Sustainable Finance 1.0</td>
<td>Sustainable Finance 2.0</td>
</tr>
<tr>
<td><strong>Market framework used</strong></td>
<td>Efficient Markets Hypothesis</td>
<td>Adaptive Markets Hypothesis</td>
</tr>
<tr>
<td><strong>Pricing of social (S) and environmental (E) dimension</strong></td>
<td>Irrelevant or already priced in</td>
<td>Priced as market participants learn</td>
</tr>
<tr>
<td><strong>Value maximisation</strong></td>
<td>Max F</td>
<td>Max IV = F + S + E</td>
</tr>
<tr>
<td><strong>Value indicator</strong></td>
<td>Earnings per Share (EPS)</td>
<td>Sophisticated DCF with scenarios for internalisation</td>
</tr>
<tr>
<td><strong>Investment chains</strong></td>
<td>Long and complicated</td>
<td>Short and simple</td>
</tr>
<tr>
<td><strong>Portfolios</strong></td>
<td>Extremely diversified</td>
<td>More concentrated</td>
</tr>
<tr>
<td><strong>Dialogues with corporates</strong></td>
<td>Limited</td>
<td>Deep</td>
</tr>
<tr>
<td><strong>Performance horizon</strong></td>
<td>12 months</td>
<td>Years or decade</td>
</tr>
</tbody>
</table>
The current financial system fails to achieve societal goals

Social and environmental capital strongly undervalued

- Overreliance on market metrics (7.1)
- Externalities not priced
- Limitations to current inclusion of ESG factors (7.2)
Overreliance on market metrics

Current investment practices have no role for E and S: unrealistic in a full world

<table>
<thead>
<tr>
<th>Pricing</th>
<th>Allocation</th>
<th>Performance measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>• EMH assumes all relevant info is priced</td>
<td>• Modern portfolio theory / CAPM: risk is driven by volatility past stock returns</td>
<td>• Benchmarking to a market index</td>
</tr>
<tr>
<td>• Implies passive investing</td>
<td>• Implies diversification and passive investing</td>
<td>• Metrics driven by past risk/return characteristics</td>
</tr>
</tbody>
</table>

- Busted by behavioural & sustainability anomalies
- But still dominates communication & thinking
Long & complicated investment chains

Figure 7.1: A stylised investment chain. It looks simple..

- Beneficiaries / clients
- Asset owners (pension funds, insurers, investment funds)
- Asset managers
- Equities - companies
- Bonds - companies
Along the chain, a lot of valuable information is lost
Limitations to approaches for inclusion of ESG factors

ESG tools:
- ESG ratings
- ESG indices

Problem 1: they are add-ons that do not address core issues

Problem 2: Design limitations
- Limited focus on materiality
- Based on reported data & policies only
- Industry neutral
- Focused on operations, not products

More problems:
- Bias to large companies
- Intuitively wrong scores
- Failure to spot material weaknesses
Solving it with an active investing approach

- Pricing: from EMH to AMH
- Allocation 1) from ESG factors to fundamental ESG analysis
- Allocation 2) from extremely diversified to more concentrated portfolios
- Engagement
- Alternative measures of performance
- Simpler investment chains
Pricing: from EMH to AMH

**EMH**
- Instantaneous incorporation of all relevant information
- All ESG information is either irrelevant or already priced

**AMH**
- Degree of market efficiency depends on market ecology
- Pricing of ESG information depends on the number and quality of market participants that take ESG seriously

Unrealistic

Plausible
Allocation 1): from ESG factors to fundamental ESG analysis

ESG factors
- should improve over time
- Need to be complemented by fundamental ESG analysis

Fundamental ESG analysis:
- Materiality assessment
- Hit investment process in all stages – including valuation
- Challenges: mindsets and data – see chapter 8
Allocation 2) from extremely diversified to more concentrated portfolios

Pension funds may hold thousands of different securities

Serious engagement not feasible...

... While not necessary from a diversification perspective....
Engagement

Investors and corporates to exchange funds & ideas:
• Pressure to end unsustainable practices
• Improve reporting
• Share best practices

Engagement is costly:
• Time intense
• Requires deep knowledge, patience & coordination

Ideally:
• Integrated process from analysis and selection to engagement
• Integrated teams for portfolio management and engagement

Engagement in practice:
• Not feasible for large portfolios
• Shallow (disconnected from investment case) and/or narrow: voting, not dialogue
Alternative measures of performance

**Alternative financial performance metrics**
- Versus peers & groups of indices
- Absolute return

**Non-financial performance metrics**
- Performance on specific KPIs
- Externality valuation frameworks
- Contribution to global sustainability goals
Conditions for LTVC

1. Long investment horizons
2. Active management in concentrated portfolio
3. Effective engagement
4. Performance analysis of value-added in the real economy
5. Long-term alignment of mandate asset owner and manager
6. Keep the investment chain short

Long-term value creation
Conclusions

- LTVC requires moving from maximising financial value to integrated value.
- Obstacles are the overreliance on market metrics and complex investment chains.