Examining the Links between Sustainable Development and Financial Performance in Canada

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Table of Contents

Opening remarks 1
Patricia McCunn-Miller 1
Peter Chapman 5
Gordon Gibbons 6
Helen Kearns 7
Alan Willis 8
Questions and Comments 9

Opening remarks

Gene Nyberg, Acting Executive Director and CEO, National Round Table on the Environment and the Economy (NRTEE), welcomed participants, noting that the NRTEE was looking for feedback on its major new program, Capital Markets and Sustainability (CMS).

He explained the role of the NRTEE, noting the goal of the CMS program is to produce a "State of the Debate" report with recommendations to Parliament. It is a "tall order" to fulfill, but steps can be taken to promote more integration of environmental, social, and ethical considerations into financial decision-making.

The panel discussion outlined the CMS program, which is addressing three key questions:

- What are the returns to business of pursuing corporate responsibility (CR) policies?
- Are CR policies and performance rewarded through the investment decisions of fund managers in the capital markets?
- If not, what can be done differently to reward CR policies and practices?

Patricia McCunn-Miller

Co-Chair, Capital Markets Program, and Vice-Chair, NRTEE

McCunn-Miller explained that she would share insights from the scoping sessions held so far to help focus the CMS program and to identify key issues and areas for further research. The final report and recommendations will go to the highest level of government, corporations, large institutional fund managers, and labour and environmental groups.

More people are discussing CR at all levels today, she said. It is about doing business in a smart and thoughtful way at a time when expectations of corporate conduct are growing.

The terminology in this area is still in flux. It was decided to use the term "corporate responsibility" or CR, which strikes a chord with stakeholders and best captures the broad sweep of concepts.

Stakeholders expect businesses to do more than just generate a profit. They increasingly evaluate businesses in terms of environmental, social, and ethical performance as well. Employees, investors, regulators, governments, and citizens want to understand the impacts of business and want to encourage responsible behaviour. CR also matters to businesses that want to operate profitably and responsibly. Clear CR commitments, backed by demonstrable CR performance, express a company's overall corporate integrity.

Links among capital markets, financial performance, and CR performance are evolving. But the mechanisms or measures needed to translate CR performance into financial results are not well understood, McCunn-Miller noted, and herein lies the challenge. The idea is to encourage or enhance strong CR performance by harnessing the strength of capital markets, whether through decisions on capital allocation, risk assessment, share performance, or overall corporate valuation.

There is a growing belief that beyond strong financial performance, businesses must also address longer-term risks linked to their environmental, social, and ethical behaviours. However, there remain challenges that currently prevent a better integration of CR into market assessments and action.

The CMS program is also considering the issue of Socially Responsible Investment (SRI). McCunn-Miller believes SRI should not be a niche investment strategy, but part of normal investment analysis of overall good management. It is not clear what information or indicators are being used in the financial community to assess CR factors, so the idea is to explore what type of disclosure would assist in mainstreaming this type of assessment.

Returning to the goals of the CMS program, McCunn-Miller reiterated the three key questions that Nyberg set out. As well, the program will look at how to ensure that the investment community considers the longer-term risks addressed by CR practices, given the difficulty of assessing them with traditional quarterly performance tools.

The NRTEE initiated scoping meetings to explore these issues. Leaders representing business, finance, government, and civil society groups attended day-long meetings in Ottawa, Calgary, Vancouver, Toronto, and Montreal. McCunn-Miller outlined six initial observations that arose from these discussions:

1. Capital markets will punish poor social and environment performance. But there is a lack of well-understood key performance indicators (KPI) that would allow better proactive, front-end analysis of sound CR commitments and performance. This is exacerbated by markets that are weighted toward quarterly results.

   The value of CR appears to lie more in risk avoidance than in the attainment of rewards. If a company sees value in implementing progressive environmental or social practices, it does not necessarily expect to be proportionately rewarded in the markets.

   Most business participants agreed that CR makes good business sense, McCunn-Miller noted, listing some of the perceived benefits. But this view of corporate value was not generally reflected in comments from the financial sector, other than in the overall context of good management.

CR is not yet “mainstream” in either the business or financial communities. This is partly because the benefits are intangible, related to concepts like reputation and brand that are difficult to quantify and more readily understood when their value has been negatively impacted. The CMS program is therefore looking at how to better articulate the link between CR performance and corporate value to support proactive investment assessment.

2. A key challenge may be a lack of common performance indicators that investors understand and can rely on.

   Participants encouraged the CMS program to explore a number of questions: What information does the market require to support decisions that will build sustainable value? To what extent is such information being sought? What information is being used in investment analysis?

   Participants said dissemination of the right information, using shared terminology, is critical. They also said that information is more likely to be used in capital markets if it is quantifiable. What is required is the right information, not an avalanche of information. Some participants suggested a register or clearinghouse for disclosure of CR information, but many advocated against more regulation.

3. There was broad consensus on the need for metrics to measure CR performance and further substantiate the business case for CR, focusing on measures that markets readily understand such as price to earnings (P/E) ratios, Market Value Added (MVA), and Economic Value Added (EVA).

   Many felt that CR performance is not adequately rewarded by capital markets because of the difficulty in comparing companies and assessing the financial implications of their performance. Boardroom culture does not readily accept non-quantitative methods of valuation.

   Many participants identified metrics as a key issue. Ideas included a scaled-down version of the Global Reporting Initiative, an international multi-stakeholder process with an independent governing body that develops global sustainability reporting guidelines.

4. The short-term focus of most capital markets is at odds with the long-term perspective of CR risks and opportunities.

   This critically detracts from the ability to assess and reward CR practices. This led to the suggestion that pension funds, which need to pay off over the longer term, would be a useful point of focus. They are large and influential capital players and they own shares in a broad suite of companies, so are interested in the overall health of the economy. McCunn-Miller noted that a major UK Pension Fund, the University Superannuation Scheme (USS), is trialing a 20-year hypothetical mandate for pension fund management contracts, rather than the current four-year time frame within which

such schemes normally operate. This shift would alter the make-up of issues that a board is required to consider, and would raise the question of the fiduciary obligation of trustees.

5. A recurring theme was that CR is tied to good corporate governance and vice versa.

   Expectations of what constitutes good corporate governance are changing. The expectation of transparency in financial disclosure is being broadened to include social, ethical, and environment issues as well. Some participants saw CR, governance, and quality of management as linked.

   Fiduciaries and the nature of their responsibilities was a focus of many sessions. The narrow traditional definition of fiduciary duty, which focuses on the best possible return for shareholders, may be a roadblock to incorporating CR into capital markets. Some see traditional definitions of the scope of fiduciary duty as outdated and out of touch with the expectations of investors.

   A further challenge lies in how to measure or disclose social and environment factors and include them in decisions. Participants felt that trustees are where the buck stops and are thus a key audience for the CMS program.

6. The message heard in a variety of fora was that leadership on this issue should not be prescriptive but voluntary.

   Arguments for regulation focused on disclosure to ensure transparency, which in turn would encourage incorporation of CR in investors' decisions. Arguments against regulation were varied. Some noted that moral suasion is as effective as regulation. One suggested soft approach was the development of a key list of "ten questions that boards should ask themselves," keeping things flexible enough to encourage new ways of thinking while providing sufficient due diligence to obviate the need for regulation. The UK has had some success with moderate disclosure requirements.

   Participants also suggested incentives such as tax credits, flow-through taxes, or accelerated depreciation to make CR more profitable.

McCunn-Miller concluded that despite the wide belief that CR is good for bottom lines, the financial community has yet to fully reflect this in its decision-making and investment allocations. There is much interest internationally in integrating environmental and social factors into investment analysis. Canada has an opportunity in the CMS program to develop solutions appropriate to the Canadian context.

At a time of heightened public concern over corporate conduct, it would be useful to explore the best way to link CR and capital markets. "It's all about integrity," she said

McCunn-Miller closed with a quote from the Dean of the Yale School of Business, Jeffrey Garten, who remarked that progress in the evolution of global CR has outstripped

the thinking and policies of business leaders, and that the "importance of the challenge is matched only by its difficulty."

Next steps for the CMS include designing the research and then holding large multi-stakeholder consultations. The NRTEE's recommendations are usually directed at government, but it is expected that many of the final recommendations may be directed at the private sector.

Peter Chapman

Executive Director of the Shareholder Association for Research and Education (SHARE)

Chapman said he would focus on rules relating to capital markets and corporate sustainability. He began by explaining that SHARE was created by the Canadian labour movement to serve the needs of pension trustees. Pension funds are significant investors, holding 17 per cent of equities on the Toronto Stock Exchange, 25 per cent in the US market and having a global value of $12 trillion.

How do pension trustees and other fiduciaries address long-term investment risks and opportunities within a framework that promotes sustainable investment? Some capital markets, like pension funds, have very long time horizons. So in many ways, pension fund trustees already have a viable framework for sustainable investment. But there are also competing short-term pressures. Regulators require pension funds to be funded adequately over the short term, investment managers are typically hired for the short term, and fund managers assess investments in individual companies on a quarterly basis.

As investment timeframes lengthen, the relative influence of environment and social factors increases. Chapman cited a UK example in which fund managers were urged to consider investment approaches that would take into account broad, long-term quality of life benefits for pension fund members. Fiduciaries face a challenge in how to interpret their duty in such cases. Pension law does not provide a clear sense of the scope of their legal obligations. Manitoba's Pension Commission has proposed changing pension laws to permit trustees to take non-financial criteria into account when setting investment policies. SHARE's research suggests that the debate is now moving beyond whether trustees may consider such factors to the question of how to do so.

The issue of climate change illustrates the dilemma: it presents many uncertainties and some investors are making adjustments to mitigate the risks. On another level, some investors are also realizing that their investment policies may be part of the bigger problem and its solution. This realization led institutional investors to launch the Investor Network on Climate Change in the US and to a similar European network. The organizations represented in these groups are household names in global capital markets, but Canadian institutional investors have been largely missing from these efforts.

Clarifying the relationship between fiduciary duty and sustainable investing is a key task for the CMS program. Another major issue is the challenge of metrics.

SHARE is undertaking a major study on links between corporate governance, corporate social and environmental performance, and financial performance. An early lesson from this study is related to the need for reasonably uniform disclosure to permit assessment of potential indicators or metrics.

Other key questions include defining what constitutes "material information" for disclosure requirements and what kind of regulatory system will provide investors with the information they need. "Our experience is that voluntary guidelines don't work," Chapman said. Elaborate rules are not required, but getting the disclosure mandate right is essential. Several countries, including the US, Australia, and Britain, now require pension funds and investment managers to disclose the extent to which they consider social, ethical, and environmental factors in investment decisions.

Some participants during the Round Table's scoping process argued that capital markets already identify and price material sustainability risks and opportunities. However several investment managers, including Loyalis, an investment management arm of Dutch pension giant ABP, has based its investment programme on the opposite premise. The pension plan has placed approximately 200 million Euros in an experimental fund to a three-year trial to test this, as well as offering the service to external clients. If successful, it will suggest that most investors fail to factor sustainability into their financial calculation.

So far, Canada has not been at the forefront of linking capital markets and sustainability, Chapman said, closing with three questions for the CMS program:

- What can Canada learn from best practices around the world?
- Where can Canada establish itself as a leader?
- How can Canada foster co-operation to advance the incorporation of sustainability in capital markets internationally?

Gordon Gibbons

Vice President, Leith Wheeler Investment Counsel

Gibbons explained his role as a portfolio manager, saying he would focus on the comments made at the scoping meetings by investment managers.

Of the questions that McCunn-Miller posed earlier, the most relevant for investment managers relate to whether there is a financial return to businesses that pursue CR policies. Questions asked by investment managers include: Is there a demand among the consumers of our products for this type of product? Can we increase returns by finding companies with high levels of CR?

"Anything we do can be quantified," Gibbons maintained. A substantial number of institutional investors are making decisions day to day, and a whole industry has been established to measure risk for investment managers. The feeling is that for the most part risk can be reduced to one or two numbers that convey volatility; decisions around the hiring and firing of investment managers thus boil down to two or three numbers.

Do companies with good CR records provide better returns? Gibbons said he sees more optimism today that they do. In the late 1990s, the flag bearers of the new economy were typically very aggressive companies built on very shaky foundations. The subsequent collapse of companies that engaged in poor practices and poor ethics have led people to value CR. Further, companies that maintain high standards of corporate governance have performed very well over the last four years. Gibbons said he expects there will be some regression the next time there is a bull market and people get carried way, but believes there have been genuine improvements that are here to stay:

"There is clear evidence of enhanced returns for shareholders who have focused on companies with superior standards of governance. Conversely, there may be a substantial discount applied to companies with poor governance records. In my view much of this re-pricing is here to stay and will become a permanent feature of security valuation."

Changes in regulations have had an impact, and investment managers have been agents for change. Many people in the industry are convinced of the need for good governance and good corporate practices

Investment managers are good at identifying contingent liabilities but they are not very good at rewarding companies that have sustainable practices, he continued. A key reason is that most decisions are made on very short-term performance, based on customer demand. In Canada, even pensions have a three-year horizon, he added.

Gibbons concluded by noting that he genuinely believes investment managers have been agents of change on corporate governance. But on sustainability, there is a long way to go, he acknowledged.

Helen Kearns

President, NASDAQ Canada

Kearns began by briefly reviewing her experience in capital markets in Canada. Her experience suggests that customers of Canada's capital markets want to compete and want to participate aggressively in the most liquid, competitive market in world—the US capital market.

Canada's place in global capital markets and its ability to compete must be weighed against the reality of US market forces that increasingly share the success of participants

in Canada's capital markets. Ignoring this reality risks marginalizing Canadian capital markets, but it does not mean that CR issues have no place in Canadian capital markets. It does mean that Canada cannot look to European trends as a definitive model because Canadian markets are inextricably linked to the US and capital markets are very quick to take advantage of competitive differences.

CR is a challenging topic for capital markets because this and related terms have not been uniformly defined. Kearns cited a definition of corporate sustainability, or responsibility as "strategies that add social and/or environment value to external stakeholders while increasing value for shareholders."

Senior management of corporations have a clear duty to maximize shareholder earnings. Large institutional investors in Canadian corporations, such as the Ontario Teachers Pension Plan (OTPP), have clearly stated social responsibility guidelines. These guidelines articulate non-financial goals, while making it clear that these should not take precedence over returns and risk factors. Companies are encouraged to adopt socially responsible policies to maximize long-term shareholder value. There is the balance between CR and capital markets, Kearns said.

Investors like the OTTP will assess companies on their business merits, and that will include factors that fall under CR. Valuing these intangible assets is an evolving force in financial analysis, she said, noting several methodologies for approaching this.

The question is whether markets receive enough information to accurately assess CR. Kearns said capital markets are sometimes inefficient at pricing intangibles. But they are by nature designed to price change. As long as issues make their way onto the list of shareholders' concerns, markets will attempt to put a price on them. But for issues that "lie beyond the gaze of financial analysis," it is incumbent upon the advocates of CR to clearly articulate what those issues are and why they deserve to be part of the financial analysis.

Striking a balance between capital markets and CR is a challenge that will continue to evolve as society evolves. Whatever course Canadian policies take, Kearns urged that they consider the environment in which Canadians are competing and want to compete.

Alan Willis

Project Director, Canadian Institute of Chartered Accountants (CICA)

Joking that the other panellists had left him with little to add, Willis shared his thoughts on how the CMS program can make a difference and add value.

A lot of work is happening elsewhere on linking factors like CR, environmental performance, and bottom lines, "so don't reinvent it," he said. The NRTEE has unique strengths as a multi-stakeholder forum, so it should focus on its own strengths in an area

that is already well ploughed.

In terms of what outputs the program can produce to make a difference, Willis commented on the NRTEE's ability to influence public policy and legislation and to convey messages to the Prime Minister's Office that are subtle but influential. His suggestions included providing practical guidelines for companies, making recommendations on disclosure standards and requirements, and educating the media and the public.

Willis encouraged the NRTEE to clarify the fiduciary duties of directors and pension fund trustees, and to consider what it can do to add value.

Communication is key to engaging capital markets, he stressed, noting this is something of a "chicken and egg" situation. Information gaps exist where companies have not seen the strategic value of having the information; capital markets have not seen the relevance of the information so they have not asked for it.

"Avoid excessive further analysis of ground already covered," said Willis. The emphasis should be on insightful asking of key questions, such as how investors and analysts make decisions. Understanding this will help to identify what information is needed. Other questions include: Where do people get their information? and What information is already being provided? It is important to understand the nature of existing reporting media.

Companies often do not have the capacity to produce the required information to articulate CR polices and performance, he continued. How can Chief Financial Officers and Investment Relations Officers better communicate CR information and what information systems do companies need to produce the necessary information?

Capital markets have many subsets, Willis noted. On which should the CMS program focus?

He also noted opportunities presented by the stronger focus on corporate governance, fiduciary duty, and transparency in the wake of the Enron collapse. Take advantage of this and look at mechanisms that will convey information to those who need it, he advised.

Willis cited research from the UK on how to mobilize boardroom leadership, and urged the NRTEE to avoid reinventing corporate democracy and accountability.

Questions and Comments

A participant from Seattle who works on these issues said he expected to hear much more about banks. For most people banks are where the capital markets are so this needs more focus. He cited a recent example in Seattle where a bank offered a half-point discount on

its mortgage rates for clients buying sustainable properties. He urged Canadians to look at opportunities posed by the enormous construction and financing associated with the 2010 Winter Olympics.

He added that many companies that are trying to be socially responsible do not report what they do with the cash on their balance sheets. That cash represents significant investor power.

He also cited good opportunities for partnerships, such as a sustainable finance initiative for the Pacific Northwest, which could bring global resources and best practices in banking to the region.

In response, Nyberg noted the NRTEE’s work on urban sustainability. McCunn-Miller added that banks were identified as a key audience in the scoping sessions, and agreed on the need to focus on them. She also commented on the Equator Principles, which demonstrated that companies can voluntarily agree to a set of principles and can change their behaviours as a result.

Another participant urged that the CMS program look more at innovations in the financial services industry. She asked whether the panel expects most changes driving CR over the next five years to come from financial analysts or more from active shareholders.

Kearns replied that nothing drives change in capital markets like competition, and housing development is one of the most important economic drivers. If it is competitive to finance green communities, this will drive change. That is how capital markets work best, and it is already happening in forward thinking communities.

McCunn-Miller added that in her view shareholder advocacy in Canada is in its infancy. She expects to see growing activism and greater continuity as opposed to the current scattered approach. One of the more telling places where change has occurred is in climate change. When Canada was debating the ratification of the Kyoto Accord, it was clear that the investment community was not equipped to deal with this long-term issue. There was a realization of the need to come together and work with companies on how to deal with the issue.

A participant said a key challenge to moving forward is the lack of performance indicators. He referred to Kearns’ concerns about regulation and cited a similar situation in South Africa that did not result in capital flight. He added that investors like transparency, so it would be better if the stock exchange required businesses to report on these factors.

Kearns said that the Sarbanes Oxley Act passed in the US has changed the North American landscape tremendously. On key performance indicators, she noted that the OTPP looks at how much companies invest in being green as well as other factors, and this means more profit for the companies because they are managing their assets well. So

that is a key indicator: it reflects the co-existence of two objectives that are not diametrically opposed and that is what works well in the market.

McCunn-Miller said the CMS program has looked at key performance indicators but did not want to put the cart before the horse. Participants have urged against regulating markets or companies, but said that trustees should at least disclose the answers if they are asked the questions. The balance is, she said, that "we need to walk before we run but we do need to explore this further."

A participant asked the panel to comment on whether pension fund members understand what they can do to convince pension fund managers to invest more responsibly.

Chapman noted that an accountability structure exists among union members, leaders, and trustees. Trustees are not actually directed by plan members so the trustee does bear responsibility for decisions. But good communication between the trustee and members is very important. The link between trustee and members is a very important one although it is not always direct.

Gibbons added that despite all the efforts made to address good governance, when portfolio managers deal with pension fund trustees, the only important question is that of performance. The most important issue for trustees is returns and everything else is secondary.

Nyberg thanked the panellists and participants, noting that the discussion gave a good sense of the task ahead.