Viewpoints

Q&A

A change of thinking is right for the times

Sustainability in the investment world

Turbulent asset markets and economic outlooks make a change of thinking in order, says Roger Urwin. That change, he argues, is long-term sustainable investing — but he admits he might have a somewhat different definition of the term.

Roger Urwin
Global head of investment content

Sonja Lee
Head of marketing, Australia

Q Sonja: Roger, you missed the Queen's Jubilee by joining us for our Ideas Exchange Conference in Melbourne. With all the Eurozone uncertainty, will it be another *annus horribilis* for the UK economy and the rest of the world?

A Roger: You have to think very regionally at the moment — the Eurozone is in a grim state. Elsewhere in the world, while things may not be as bad, we can't honestly say that there are too many bright rays of sunshine out there. When things are really bad for one economy or a region, it isn't necessarily the case that they're bad for all markets; so it is possible to build a strategy around quality in equities, selectiveness in sovereign and corporate credits, and some diversity in alternative assets. When you travel a lot, you find the different regional emphases hit you between the eyes. There's no question that, in Australia, there is more optimism, but I think you may be missing some of the worst politics — many governments are making a pretty horrible mess of their policies. Our view is that most countries are finding it very difficult to transition at a time of potential inflection in a number of areas of world affairs.

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TOWERS WATSON

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Q You have been busy working for sovereign wealth funds: are you able to share some of what you've been doing?

A I have been helping various funds with organisational design and exploring how governance can be used as a tool to help them achieve their goals. The common feature of sovereign wealth funds is that they are single-purpose institutions trying to use their long time horizons to produce sustainable growth, underwritten by effective management of risk over time. This is a significant challenge and it calls for strong governance and strong thinking. Particularly with sovereign wealth funds, governance comes first and the thinking feeds off that. Big sovereign wealth funds often have specialised resources that enable them to drill deeper into investment complexity, but often that comes at the expense of being joined-up and under-exploiting the opportunities that exist across asset classes. They have a number of difficult challenges ahead to secure competitive advantage given their size. Size carries some advantages in terms of the resources that you can put to work, but it has many disadvantages in terms of the ability to act flexibly at a time of change.

Q Are there any learnings that you can share with us from the work that you've done?

A Yes, there are three things I'd like to share. Point 1: complexity is a surprisingly pervasive difficulty for everyone involved in the investment area, but particularly for bigger, more ambitious funds. Point 2: market opportunities to exploit long time horizons are often more theoretical than practical, because funds are susceptible to many shorter-term pressures. All long-term investors must also be short-term investors; most long-term investors are surprisingly short-term in their decision-making because of those pressures. Point 3: the so-called investment 'macro view' (or we might just use the more familiar term these days, 'world view') that people have, is going through a period of quite rapid change. It is reflecting change in economies, politics, society at large and issues around our 'natural capital', a term that covers energy, water and our climate. Sovereign wealth funds are out there trying to build a new world view relative to the one that they have had before.

Q You've also been researching sustainability and produced a report called 'Project Telos'. What does telos mean and how do you define sustainability?

A Telos is Greek for 'purpose.' We found that word helpful to define a project that involves finding a deeper purpose to investing and meeting both the requirements of current and future generations in a world of new challenges. Project Telos is about the pursuit of long-term investing that is both efficient — as in achieving the highest returns per year at risk — and inter-generationally equitable. In short, investing sustainably. You won't give up future return from your current return, future generations of stakeholders will do as well as current generations.

People have all sorts of hang-ups about the word sustainability. To us, it really involves the idea that what you do today affects what you can do tomorrow. Many investment strategies imply that current good performance could well be at the expense of bad performance in future. Sustainable investing is anticipating the transformational changes that are taking place in world markets, in world economies, in world politics, in society at large, and making sure that the portfolio is as weather-proof as possible to those sorts of changes.

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Q Why did you do this study?

A Towers Watson has been out there in sustainable investing for some time and we saw the opportunity to dive more deeply into the thought leadership of this area. The thinking on sustainability is far from complete, and one of the reasons why we think this is so is because there are many moving parts to the topic. Telos involved a very big team effort, collaborating with many outstanding researchers in their field; we engaged a number of experts, we engaged Oxford University. We engaged a large number of asset managers and also a panel of chief investment officers from a number of institutions that had an interest in the sustainability field. This was a team effort, no question about it. The product was more than the sum of the individual parts.

Q When the industry discusses sustainability, people often think it is a fuzzy term. Can you give me an example of a sustainable investment?

A Yes. Your comment is actually very interesting. Sustainable investing often attracts negative press. There are a number of people who come at it from an over-zealous point of view; and there's probably more who come at it from a rather prejudiced point of view, pre-judging the arguments to be about the green agenda.

In contrast, when we see sustainability, the environmental aspect is one of a number of elements and not necessarily the most important. Probably the best example of sustainable investing is the idea that, in setting up normal equity mandates with normal benchmarks (as in world index capitalisation-weighted) and monitoring year by year, we virtually set ourselves up to fail in terms of poor sustainability, because we dial in portfolios that do not have longer term adaptability built into them. Therefore, mandates that are described differently are deliberately conditioned to have a long-term orientation, by taking away the reliance on the benchmark and putting an absolute return in place as a target. This is an outcome-oriented target as opposed to a target relative to a benchmark index.

We build parameters that are more sustainable, come at lower cost and that ultimately appear to have the potential to perform better. So the arguments about sustainability are not about giving up value for values; genuinely the arguments about sustainability are what I term 'solid granite finance'. They all start with finance.

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Q Are there any funds around the world that are doing sustainability well?

A The subtitle to the research is 'we are going to need a bigger boat', playing on one of the great lines from the Jaws movie. We don't yet have the right vehicles and tools to do this properly.

That said, in my travels, I have seen a handful of funds that are closing in on methods that are promising. But it is definitely early days, and we should not expect this change of investment methodology to take place over a short period of time.

Q What are the key learnings of Project Telos?

A First of all, sustainable investing is best approached from a finance point of view; all our work has been premised on that basis. Second, approaching it from this point of view does not preclude seeing and measuring wider benefits. You know the sort of thing I'm referring to — supporting enterprises that produce benefits, not costs to society. The third learning is that this approach requires more flexible and expansive thinking on the changes that are taking place in the world: changes that many people are getting over-run by. Now, in the past we've been OK adapting as those changes have occurred but in the future that won't work nearly as well. The changes are too big and pervasive. We are promoting the idea that a much better strategy is to think ahead, use the methods of development of investment beliefs and as much as possible to build sensible and informed views of these big changes — and embed these beliefs in current strategy.

There are three changes that we emphasise in our work. The first is the idea that developed markets are going through a period of half-sized growth, low levels by historical standards, consistent with the difficulties of excessive indebtedness of a number of nation states, and enforced de-leveraging — which we know will carry a cost.

The second area of change is related to demography. We know that workforce change is significant in a number of developed markets — even China, where the workforce will start to decline from the year 2015 — so this is going to affect the prices of labour, the prices of equity and debt in due course, in ways that are partly predictable.

The third area of change is to do with natural capital. Natural capital obviously starts with things as essential as water and climate and extends to many sources of energy and the degree to which these become scarce and challenged. Deteriorating supply chains in the coming years will be a defining feature of many activities and affect many regional interests. I haven't mentioned global warming in that, but obviously the effect of carbon pricing on investments has to be taken into account at the same time — a subject that is pretty resonant in Australia, as you move that way.

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Q What would your advice be to institutional funds on sustainability?

A As with most difficult subjects you have to approach it systematically. You have to approach it from the point of view of managing change. There is a method that we have evolved that has been road-tested — we call it simply the sustainability ‘roadmap.’ It involves checking through a number of stages in thinking to get the diagnosis sorted and then move to design with associated actions to arrive at a sustainable strategy. We advocate that as a generalised change management approach to the problem. In the past the subject has been a hotchpotch.

Q What would your advice be to fund managers on the sustainability front?

A Fund managers were a very key part of the project team on Telos, giving their time and perspectives in terms of how they have been doing their work and how they could do their work in future. There are some quick wins, there are some slow wins. Give it some exposure in your organisation. Spend time on the beliefs agenda. One obvious point: more asset managers should be pursuing these longer term mandates.

Q A common concern I hear in the superannuation and investment world is that trustees and investment teams should only focus on generating the best possible investment outcome and should not have to regard sustainability, because this involves making a value or ethical judgement. What is your reaction to that?

A I think it is based on flawed logic. They’re following a different definition of sustainable investing to the one we’re following. There is no value given up for values if you do this right, quite the reverse. The stance that we are taking on sustainable investing is to measure its success through one lens only, which is improved long-term performance.

Q A few years back you gave a speech at ASFA and devised several six word memoirs on world economies and investment impacts. What would it be on Project Telos and sustainability?

A That talk worried about the world of ‘investing shorter, people living longer, poorer’. Sustainability at its six word core is ‘investing longer, deeper, fairer and classier’ and is the antidote to that.

Roger Urwin visited Australia in June 2012 for the Towers Watson Ideas Exchange conference.

Further information

For further information please contact your Towers Watson consultant.

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