Institutional Investor

OPINION

Where ESG Fails

Despite countless studies, there has never been conclusive evidence that socially responsible screens deliver alpha. A better model exists, argue Harvard Business School luminaries Michael Porter, George Serafeim, and Mark Kramer.

By Michael E. Porter & George Serafeim & Mark Kramer October 16, 2019

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We are entering a new stage of understanding of the linkage between investment performance and social impact. Previous approaches, such as socially responsible investing and environmental, social, and governance screening, have obscured the opportunities for higher growth, profitability, and competitive advantage that come from treating social and environmental issues as integral to a company's core strategic positioning. We term profit-driven social impact "shared value." Emerging evidence, although still limited and company-specific, suggests that companies that successfully implement strategies to create shared value can deliver superior shareholder returns. Capturing that value, however, will require very different practices on the part of both corporate leaders and investors.

Consider the companies, identified on *Fortune* magazine's annual Change the World list, that are delivering profit-driven social impact. Many of them do not achieve the top ESG rankings in their industries, nor do they have any significant presence of SRI funds in their share registry. Yet public companies on the *Fortune* list from 2015 through 2017 outperformed the MSCI World Stock Index by an average of 3.9 percent in the year following publication. Not only that, but sell-side analysts have repeatedly underestimated the profitability of these companies; three out of every four had one or more positive earnings surprises in the 12 months following publication.

Investors who seek alpha, as well as those who genuinely care about social issues, have clearly missed the boat by overlooking the significant drivers of economic value arising from the power of social impact that improves shareholder returns.

To realize this potential, we must revisit the relationship between economic and social performance. A currently popular idea holds that companies that score higher on rankings aggregating a myriad of ESG metrics, with little consideration of their financial materiality and its relation to the competitive strategy of a company, will deliver better shareholder returns. This is simply incorrect. Despite countless studies, there has never been conclusive evidence that socially responsible screens or company positions on lists such as the Dow Jones Sustainability Index deliver *alpha*. The reason is that these criteria have been developed without regard to the causal link between a company's social impact and its bottom line. Yet there is compelling evidence that superiority in identifying and harnessing selected social and environmental issues relevant to the business can, over time, have a substantial economic impact on companies and even entire industries. Few corporate leaders, and even fewer investors, understand this powerful economic-value proposition.

Most corporate leaders view their sustainability efforts primarily as a way to enhance their reputations and attract socially aware consumers, employees, and investors. Outside of SRI and impact investing funds, most investment analysts who consider ESG factors at all tend to treat them either as a way to attract socially responsible asset owners or as a tool to reduce the regulatory or reputational risks of their portfolio companies. The impact of social innovations on competition and economic-value creation are not fully understood or even considered. As a result, corporate executives, analysts, and investors alike are missing a powerful value driver.

And investors are not just missing an opportunity to improve returns by investing in companies that contribute profitably to social progress, they are also overlooking their most important purpose as investors. The purpose of investing is to create a virtuous cycle by allocating capital to those companies that create the greatest societal returns — both in business as usual and in improving the welfare of customers, employees, suppliers, and communities. This virtuous circle drives present returns as well as future growth and opportunity. When investors ignore their own social responsibility and fail to recognize the powerful connection between company strategy, social purpose, and economic value, they are eroding the impact and legitimacy of capitalism as a vehicle for advancing society. It is no wonder that so many citizens have lost faith in capitalism. At a time when economic inequality has increased and social needs are greater than ever, ignoring the synergy between corporate success and social progress emboldens critics and puts the future of capitalism at risk.

The concept of shared-value investing offers a fundamentally different approach than ESG rankings or SRI screens by directly tying social impact to competitive advantage. As *Fortune*'s Change the World list demonstrates, companies that create shared value can outperform their peers, delivering superior returns both to society and to their shareholders. Yet an understanding of how a shared-value approach differs from conventional corporate social responsibility thinking remains rare.

Evolving Investor Approaches to Social Impact

Investor thinking on social impact has evolved substantially over the past few decades. It began with an early focus on SRI funds, typically based on negative screens that reflected personal or institutional investor values, such as avoiding alcohol, tobacco, gambling, or fossil fuels. Although such industries surely carry social and environmental costs, these costs do not necessarily drive company performance or shareholder returns. Therefore the mainstream investment community concluded that any consideration of social factors must be driven by the personal values of an investor with a progressive agenda. There were also concerns that investment managers might be at risk of violating their fiduciary duty if they let their personal values influence investment decisions. Many investors even considered corporate social expenditures to be a waste of shareholder resources. Research by co-author George Serafeim and Ioannis Ioannou of London Business School shows that sell-side analysts were historically less likely to issue buy recommendations for companies that invested heavily in sustainability — or worse, discounted those companies' valuations. Only more recently has this discount disappeared.

The ESG approach that has emerged over the past few decades is more connected to economic performance because a company's environmental footprint, labor conditions, and board oversight can influence financial results. Social sector leaders, however, have used this approach to pressure companies to advance a broad set of social issues across many different industries and their supply chains without regard to economic cost. This pressure has led to many improvements in social and environmental conditions, but has also further reinforced the conviction among investors that, apart from operational efficiencies owing to reduced use of energy and natural resources, other aspects of social performance can come at the expense of profitability.

As ESG assessments, sustainability reports, and reporting guidelines, such as those from the Global Reporting Initiative, have become more rigorous and detailed, companies have been held even more strictly accountable for many important social impacts. Companies, however, are judged on their overall aggregate performance across all indicators, equally weighted, rather than on the most salient issues for their particular businesses.

In many cases, ESG factors are not material to the performance of a particular business, nor do they highlight areas where the business has the greatest impact on society. The carbon footprint of a bank, for example, is not material to a bank's economic performance, nor would reducing its footprint materially affect global carbon emissions. In contrast, banks' issuance of subprime loans that customers were unable to repay had devastating social and financial consequences. Yet ESG reporting gave banks credit for the former and missed the latter altogether, in part because the voluntary and reputation-focused nature of sustainability reports tends to leave out bad news. Such broad and upbeat ESG reporting may make investors and consumers feel good by encouraging corporate window dressing, but it distracts from incentivizing and enabling companies to deliver greater social impact on the issues most central to their businesses.

The growing popularity of the sustainability movement has led many investors to consider ESG rankings, encouraged in part by the $80 trillion in investable assets that asset owners and managers have pledged will follow United Nations Principles of Responsible Investing. Research by Serafeim has shown that companies that today score better on the environmental and social dimensions of their business trade at a premium relative to their peers. However, without examining the actual link between social impact and profitability, there is little economic justification for this premium.

The Sustainability Accounting Standards Board has taken an important step in creating industry standards where the link between impact and economic performance is clear. The improved reliability and availability of ESG data, together with more research, have enabled SASB to work with industry representatives to identify the specific metrics that are *material* to a particular industry. Research by Aaron Yoon of Northwestern University, Mozaffar Khan of Causeway Capital, and Serafeim has demonstrated that, when companies focus their sustainability efforts primarily on material social and environmental factors, they significantly outperform the market, with alpha of 3 to 6 percent annually. They also outperform peer companies that concentrate sustainability efforts on nonmaterial factors. This approach is the first solid evidence that when social and environmental factors are considered from a business perspective, rather than a purely social perspective, they can influence shareholder returns.

Despite this research and the growing acceptance of ESG rankings in general, it is not clear that most investors meaningfully use ESG criteria in their investment selection process. The single ESG analyst at many large investment firms cannot possibly conduct a detailed analysis of the strategic value of the social performance of all companies under review. Many investors, therefore, select potential investments through a purely financial analysis that ignores social issues, then use a company's overall ESG performance as a final screen to reduce risk. After all, even the SRI-motivated decision to avoid fossil fuels and tobacco turned out to avoid hidden risks that emerged over decades. Investors therefore assume that better scores across all ESG indicators indicate more prudent and farsighted management. Their process, however, has no room for analyzing the specific social factors that affect industry structure, or that could confer a competitive advantage on an individual company.

Many other investors have moved away from fundamental company analysis altogether in favor of passive investing, less fundamental research, broad diversification, liquidity focus, and trading on short-term catalysts. Despite the widespread commitments to UNPRI, these investment approaches offer little reason to consider social impact. As a result, the economic benefit of shared-value strategies is generally reflected in stock prices only after long delays, once the shared-value investments have eventually translated into profits. Investors thereby send the signal to CEOs that there is no timely reward for targeted improvements in the social factors most central to their businesses. Investors are actually discouraging companies from pursuing shared value.

The Limits of Materiality

The SASB materiality analysis is an important first step in moving beyond broad-brush ESG scores to focus on specific social issues that carry meaningful economic effects in specific industries. Yet even this analysis falls well short of truly connecting social impact with competitive strategy and opportunities for superior profitability. After all, materiality originated as a legal concept largely oriented toward identifying risks that require disclosure, rather than highlighting future opportunities for competitive differentiation, growth, and profitability.

In addition, many of the operational factors highlighted by SASB as material are generic across an entire industry, not unique to a particular company's competitive positioning. The result is that incremental improvements in most material ESG factors converge over time into industrywide best practices, according to research by Ioannis Ioannou and Serafeim, and therefore do not confer any long-term competitive advantage on a single company within the industry. Greenhouse gas emissions, for example, are a material ESG factor for every logistics company because they correlate with the cost of fuel usage. All major logistics players — such as FedEx, DHL, and UPS — are implementing best practices to reduce their fuel consumption as a competitive necessity. This adaptation raises the bar for operational effectiveness across the industry and reduces carbon emissions, but is unlikely to mean a sustainable competitive advantage for any one competitor. Ignored in this entire approach is the integration of social factors into competitive strategy to differentiate products, expand markets, enhance human resources, or improve a company's local business environment. A materiality analysis of ESG metrics may help investors identify industry laggards or measure, analyze, and price risks that protect portfolio value. Yet this approach is insufficient to identify companies that are truly innovating by creating shared value through the use of social innovation to drive superior long-term economic results.

Material ESG factors can also be misleading to investors who fail to understand business model differences. One ESG scorecard that asked for the "volume of fossil fuels used" captured all of Walmart logistics fuel usage, but none of Amazon's outsourced delivery system (even though Amazon does report the carbon footprint of its third-party deliveries). According to one Bain study, the question of which delivery model is less carbon intensive ultimately depends on the number of items a shopper buys at once, which favors in-store shopping as consumers tend to purchase more items, often while on their way to some other destination, reducing the incremental carbon footprint per item.

In reality, Walmart has much more control over its total carbon footprint than Amazon. Walmart has aggressively innovated to reduce the carbon footprint of its distribution system, incorporating volume shipping to stores, redesigned packaging, and innovative fleet technology and management, delivering billions of dollars in cost savings. More importantly, 90 percent of the carbon footprint for consumer goods comes from manufacturing and usage rather than the method of purchase. Walmart has worked aggressively with over 1,000 suppliers to eliminate a gigaton of carbon emissions, often saving cost as well, while Amazon makes no effort to influence carbon footprint of its sellers.

Even when companies do improve on material social issues, they rarely report on the economic benefits that accrue. The idea that companies should focus their social impact on improving their reputations makes them eager to be seen as "doing the right thing," but, sadly, reluctant to acknowledge that they profit from it. In many cases, companies actually conceal the economic benefit from investors, which reinforces investor ignorance about the importance of social innovation as a source of economic value. Nestle, for example, has for more than a decade reported reductions in sugar, salt, and fat across its product portfolio. Only in 2018, for the first time, did Nestle publicly report that these healthier foods had faster growth rates and higher profit margins than traditional offerings. Nor is the economic value of social impact discussed in analyst calls. If there is any focus on social impact at all, it is usually to address a recent scandal that requires an apology.

Even the integrated reporting movement, which has encouraged companies to consolidate social and financial performance in a single annual report, has rarely zeroed in on those social factors that drive competitive advantage. SAP, a global provider of technology solutions, produces one of the market's most sophisticated integrated reports documenting the relationship between social impact and financial returns. The company has conducted a regression analysis to correlate ESG factors with profit-and-loss results. It reports that a 1 percent increase in employee health and engagement correlates with a 0.8 percent increase in operating profit, whereas a 1 percent decrease in carbon emissions correlates with a 6 percent increase in profit. These correlations, however, say nothing about how SAP's competitive strategy drives improvements in either factor in ways that competitors cannot match.

Even more recently, the movement to embrace a corporate purpose has drawn further welcome attention to social impact, but has also added to the confusion about its significance for competition. BlackRock CEO Larry Fink wrote in his most recent annual letter to corporate CEOs that investors should increasingly expect companies to have a social purpose. Yet purpose statements have usually been public relations exercises, disconnected from a business and its economic performance. A generic corporate "purpose" creates neither social nor shareholder value. When a company devises and articulates a purpose integral to its business, however, the result is often to create unique stakeholder value. A social purpose that is truly strategic must build on and reinforce the company's unique value proposition and competitive positioning. Companies whose employees recognize such clarity of purpose have been shown to deliver superior shareholder returns in research by Claudine Gartenberg of University of Pennsylvania, Andrea Prat of Columbia University, and Serafeim, whereas feel-good purpose statements have little impact.

Tying Social Impact to Corporate Strategy: Creating Shared Value

If we recognize the enormous power of capitalism as a driver of positive social impact, by far the most powerful way to integrate social innovation and economic value is through a company's strategy. Creating social impact through an innovative and profitable business model reshapes the nature of competition and makes social impact a part of capitalism itself. This requires going way beyond a checklist of material factors.

Consider Discovery, a South Africa–based life and health insurance company with the stated purpose of making people healthier. Although this could easily have been just a platitude, Discovery recognizes the fundamental impact of subscriber health on its business. The company translated its purpose into strategy and operations by integrating into its health insurance offering a powerful set of economic incentives for customers to engage in healthier behaviors. Customers are rewarded for reaching weekly exercise goals and receive rebates on the purchase of healthy foods through a sophisticated set of incentives developed by behavioral economists and monitored through apps and wearable fitness devices. Studies by Johns Hopkins University and the RAND Corporation have confirmed that Discovery's incentives affect behavior in ways that reduce health care costs and increase life expectancy.

As a result, Discovery is able to offer its insurance products at lower premiums while sustaining superior profitability tied directly to the social impact created by delivering on its purpose. The company's business model, operations, and data analytics are unique in the industry. With 40 million life-years of data correlating incentives with behavior change and health outcomes, Discovery's approach cannot be easily copied. Instead, the company has licensed its proprietary approach to many of the largest life insurance companies in the world, dramatically expanding its market reach. All employees at Discovery understand the centrality of Discovery's purpose to their jobs, which has meant continuing innovation to make this competitive advantage greater. The social impact Discovery creates — improving health — is central to its strategic positioning and creates shared value for both society and its shareholders.

As Discovery illustrates, shared-value creation is rooted in the fundamentals of corporate strategy: Companies can achieve superior economic performance only through a distinctive value proposition that either offers better value to target customers (differentiation) or achieves structural efficiencies that support lower cost versus competitors (cost savings). What has been overlooked historically in ESG thinking is that social innovation on key issues within every industry can profoundly affect strategic positioning in both differentiation and cost savings.

Shared value can affect strategy at three mutually reinforcing levels: (1) creating new products that address emerging social needs or open currently unserved customer segments; (2) enhancing productivity in the value chain, whether by finding new efficiencies or increasing the productivity of employees and suppliers; and (3) investing to improve the business environment or industry cluster in the regions where the company operates.

Consider some of the shared-value strategies represented on the Change the World lists. At the first level of shared value, MasterCard has created innovative new products and entered new markets through a growing number of profitable financial inclusion initiatives, such as its partnership with the South African government to distribute social benefits to 10 million people through debit cards. The company, with its focus on growth through financial inclusion, has staked out a different competitive position than others in its industry in a way that delivers greater social value and shareholder returns. Or take Xylem, a U.S. company that has found a new business niche in addressing the massive waste of the world's freshwater through sensor-driven software that can identify and reduce leakage in pipes and improve the efficiency of wastewater treatment. DSM has found a consistent pipeline of profitable innovations by focusing its R&D on solutions that advance the U.N.'s sustainable development goals.

Nike's Flyknit shoe offers another example: Driven by a commitment to reduce waste, Nike developed a running shoe unlike any other, with a top knit from a single strand of material. The shoe produced zero waste, and it was also less expensive to manufacture and lighter and more breathable than other shoes, delivering superior performance for customers and more than $1 billion in sales for Nike.

The second level of shared value is the value chain that defines a company's operating model. Suzano subsidiary Fibria, one of the world's leading suppliers of paper pulp, developed an innovative model of integrating small-holder farmers into its supply chain for eucalyptus wood through its Forest Savings Program. The program provides a new source of income for impoverished farmers, encourages biodiversity protection by integrating WWF recommendations, and also saved Fibria $30 million in 2016. CVS Health made a strategic move into health care delivery, opening thousands of in-store clinics and discontinuing the sale of cigarettes as part of a distinctly different competitive positioning than Walgreens Boots Alliance. SABMiller, now a subsidiary of ABInBev, provided consulting support to improve the retailing practices of the small family-owned retailers that sell its beverages, increasing the incomes of tens of thousands of families in Central America and generating 10 percent more sales for the company. Maersk has redesigned its transoceanic ships in proprietary ways to reduce fuel consumption. Starbucks' program to offer free college courses to all employees has become the single largest driver of the chain's recruiting success. Each of these companies reinvented an aspect of its operations in a distinctive way that created shared value, although most of these innovations would not necessarily improve the firms' ESG rankings based on existing methodologies.

Last, at the third level of shared value, improving the external business environment, BHP has invested $50 million to improve the quality of local suppliers to its mines in Chile. This has created a local cluster of world-class mining suppliers that generated more than 5,000 jobs and, through improved performance, saved BHP more than $120 million in net present value. Or consider Humana's partnerships with nonprofits and government agencies to improve the social determinants of health in major U.S. cities where Humana provides health insurance. The effort has improved the health of its subscribers and reduced its medical costs, boosting shareholder returns.

When shared value is integrated at all three levels, breakthrough strategies can be the result. Medical device company Becton Dickinson has driven growth for decades through innovations that improved the safety of medical devices for caregivers and patients, beginning with the invention of a safety syringe to prevent the spread of HIV infection through accidental needle pricks. BD improved its business environment by working closely with governments and NGOs to promote public policies focused on hospital safety. The company has also expanded rapidly in emerging markets through public-private partnerships, including a decade-long arrangement with the Chinese government that has trained 700,000 nurses across China to use BD's safer intravenous catheter and partnerships with the Centers for Disease Control to improve the speed and quality of laboratory testing in emerging markets. The ability to invent products that better meet social needs, integrate public-private partnerships into the operating model, and influence government policy to heighten safety awareness has produced shareholder returns well in excess of those of BD's competitors.

As these examples suggest, creating shared value is fundamentally distinct from making incremental improvements in a long checklist of ESG factors that tend to converge over time in any given industry. Shared-value companies make a different set of choices than their competitors, building a distinctive social impact into their business models. As a result, they deliver different returns to their shareholders. Shared-value strategies such as these go far beyond traditional, siloed ESG thinking by tying social impact directly to competitive advantage and economic performance. This is by far the most powerful way for companies to help address the world's grave social challenges.

Shared value offers virtually every business important new opportunities to drive growth, profitability, and competitive advantage by improving social performance. This thinking has increasingly become accepted as an important dimension of business strategy. Unfortunately, however, it remains an entirely new frontier for investors. For example, it is notable that the Council of Institutional Investors was the strongest critic of the Business Roundtable's recent commitment to focus on social purpose and multiple stakeholders rather than just shareholder returns.

It is important to note that a shared-value strategy alone, without sound management and effective implementation, will not be sufficient to generate superior investment performance. Nor will every shared-value company on the *Fortune* list outperform its peers. As with any other competitive strategy, operational effectiveness is also essential to success. To be successful in delivering alpha, shared-value investment thinking must be combined with the conventional financial tools of security analysis.

Shifting Industry Structure: Shared Value and the Five Forces

Beyond improving the performance of individual companies, social and environmental factors can also change the nature of competition in entire industries, with profound effects on shareholder returns. The "Five Forces" developed by co-author Michael Porter offer a well-understood framework for determining profitability in any industry. What is less understood is the way in which social factors affect those forces.

Consider the power generation industry: Twenty years ago, government regulation set electricity prices and conferred regional monopolies. The cost of building new multibillion-dollar power plants created high barriers to entry. There were no substitute sources of energy, and customers had no choice of suppliers. A Five Forces analysis would have correctly predicted a stable and profitable power industry, and many investors bought utility stocks with the expectation of a predictable long-term yield. Now, however, many markets have been deregulated. European governments have imposed descending limits on use of the fossil fuels on which most major power plants depend. Solar and wind technologies have reached price parity, enabling distributed generation with very low barriers to entry. Most European utility companies and their investors missed these major shifts as they ignored changing societal factors in their investment analyses. The result was the destruction of €500 billion ($551 billion today) in economic value.

Utilities that have adopted a shared-value approach, such as €70 billion Italian energy company Enel, have uncovered major opportunities to profit from renewable energy, already the source of more than half of Enel's power and generating higher profit margins than older thermal-power plants. The company is also expanding innovation to drive new sources of revenue by providing high-speed internet connectivity, electric-vehicle fleets, and energy management software. By adapting to social and environmental pressures on industry structure, Enel has found new sources of revenue that many of its competitors have missed.

Bringing a Shared-Value Approach Into Mainstream Investing

As we have discussed, the current siloed ESG approach, where analysis of societal impact is divorced from analysis of competitive strategy and growth, misses important sources of competitive advantage that come from some, but not all, improvements in corporate social performance. Until investors begin to consider shared value as core to investment analysis, they risk distorting corporate valuations, missing the true industry innovators and encouraging corporate managers to focus on checking ESG boxes that are not material to corporate performance or social progress. Taking social factors into account in investment decisions when they have a direct influence on a company's future economic performance does not violate fiduciary duty; indeed, as the EU policy has already noted, it is the failure to consider such factors that might create a risk of liability. Bringing the shared-value framework into security analysis will help both corporate leaders and investors grasp the opportunity to align social purpose with investing. It will also greatly expand the power of corporations and investors to contribute to a better world while improving shareholder returns.

Much of the investment community, however, still views social issues either as irrelevant to maximizing shareholder value or merely as a risk factor, not as an opportunity to drive alpha. Corporations will also have to implement substantial changes in practice to communicate more effectively the economic value of their social impact, and for investors to meaningfully integrate social factors into security analysis.

Regulators, NGOs, and sustainability-minded investors will, of course, continue to focus on overall ESG performance. Companies will need to continue to improve and report on their performance across the broader set of ESG factors, even though most will not confer any sustainable competitive advantage. However, the broader investment community will need much more targeted communication by companies to connect a highly selective set of social impacts with competitive advantage and economic value. This requires that companies communicate and rigorously measure the investment theses behind their shared-value strategies, using concrete quantitative metrics that directly link social factors with economic performance.

For example, when BD CEO Vince Forlenza presented the company's concrete and evidence-based long-term strategic plan at the 2017 CECP Strategic Investor Forum, he described how BD was building public-private partnership capabilities at every stage of its value chain to create shared value in emerging markets. He then quantified the impact for investors: From 2011 to 2015 steady double-digit annual increases in meeting health needs in these markets added $500 million to the company's growth. He then predicted that these partnerships would add another $500 million within two years as BD's shared-value initiatives continue to produce policy improvements and government partnerships that advance the delivery of health care in emerging markets. BD's competitors also participate in public-private partnerships, although most are purely philanthropic initiatives that are not integrated into strategic positioning and therefore do not drive quantifiable value to shareholders.

Investor communications must also include an explanation of how major societal trends are affecting industry structure and competition, and how a company's response will affect its future growth and profitability, just as Enel has described its changing business model in response to the pressures of climate change.

Last, investor briefings must look beyond the next quarter to describe a company's longer-term strategy. Shared value, like all true competitive strategies, is a long-term proposition. Continuity in strategy enables better alignment of activities across the value chain and improvements in economic performance. The longer a company pursues shared-value creation, the more it learns about meeting social needs in more effective and profitable ways, and the better it will be able to integrate positive social impact into every aspect of its operations. At the same time, long-term shared-value strategies do not excuse corporate leaders from continuing to deliver strong operating performance each and every quarter.

Such targeted, quantitative information from companies will matter only if investors are able to use the information effectively. Shared-value investors must start, rather than end, their analysis with a review of salient social issues that affect company prospects, such as climate change, the growing focus on nutrition, the emerging global middle class, the spread of non-communicable diseases, the low productivity of small-holder farmers, changing employee and customer demographics, and the effects of water scarcity. Understanding these social and environmental dynamics will help investors anticipate changes in industry structure and identify opportunities to create shared value.

Investors must also learn to distinguish real economic-value creation through social impact from corporate window dressing and the spin of reputation management. This means weeding out companies that operate with only a veneer of social responsibility or merely follow industrywide best practices. Shared-value companies will be doing things differently than their competitors in ways that connect social impact with shareholder value.

An investment firm cannot delegate consideration of environmental and social issues to a lone ESG analyst. The entire investment team must combine an understanding of social factors and impacts with financial and industry expertise. Consideration of social issues must shift from risk management to increasing alpha by recognizing their importance to long-term competitive advantage.

For example, London-based Generation Investment Management was ranked by Mercer Analytics in 2018 as the highest-performing fund out of 169 long-only global investment funds over its 12-year history. A key tenet of Generation's strategy is "The impact on society is the driver of value creation." The firm uses a "road map" to a sustainable, low-carbon future to determine which industries will contribute to and benefit from that trajectory. Rather than separate sustainability analysis from fundamental valuation criteria, Generation includes experts in environmental issues on the investment team and searches for companies with distinctive competitive strategies based on their environmental impact. It has an external advisory board of global thought leaders on sustainability, and it holds invitation-only conferences on emerging sustainability trends to keep abreast of issues that can change industry structures. In addition, Generation emphasizes a long-term perspective, with an incentive compensation structure based on a three-year rolling average of returns. At the same time, it pays close attention to traditional factors in security analysis, such as the quality of management, free cash flow, P/E ratios, and barriers to entry. Generation is no less rigorous in its financial analysis and price discipline merely because it also considers environmental factors.

Summa Equity, a Scandinavian private equity fund, also begins its analysis with themes drawn from the SDGs to identify areas of investment opportunity. Within these broad themes investment teams then examine specific companies and industries in terms of both social and financial performance. The firm has developed its own framework for sourcing, investing in, and exiting companies in which the leadership of each portfolio company is responsible for measuring, managing, and reporting on a company's social impact. This framework, Via Summa, holds management accountable for taking a hard look at the company's competitive advantage and how it can be leveraged to create social impact through the core products and services of the company. This clarifies the firm's strategy internally to new hires and is integral to raising new capital and sourcing new deals.

Generation and Summa Equity look for positive social impact that reinforces exemplary financial performance by combining a deep understanding of social issues with traditional security analysis. Yet such an integrated analysis remains rare. For far too long the vast majority of conventional investors have ignored social impact, and most SRI and ESG investors have overlooked the tools of rigorous security valuation, such as free cash flow, P/E ratios, and barriers to entry. Merely investing in the most highly rated ESG companies is no assurance of superior returns. It is the integration of social factors with the conventional economics of highly disciplined security analysis, as well as attention to both long-term competitive advantage and short-term results, that leads to superior investment performance.

The Social Purpose of Investing

Companies in every industry are moving toward adopting social purpose as part of their competitive strategies. As we have noted, however, the investment community has lagged behind. Yet investing, like every other commercial endeavor, carries the opportunity to integrate social purpose into strategy. We believe that the most fundamental purpose of investors is to allocate capital to those businesses that can use it well in meeting society's most important needs at a profit. Without the effective investment of capital in the real economy, society cannot prosper. But we live in a world today where investors are profiting while much of society is struggling. This disconnect is a threat not only to the legitimacy of capital markets, but also to the future of capitalism itself.

Investors can choose to make money in ways that contribute to a healthier, more prosperous, and sustainable community — or they can choose to extract rents in socially destructive ways. The obligations of social responsibility have so far been imposed on companies, not shareholders. Yet investors themselves have a social responsibility. When they pressure management to pursue short-term profits in ways that harm the environment, put customers at risk, or exploit employees, investors must be held accountable. The law may limit their liability as shareholders, but public opinion and political pressure are not so easily circumvented.

How do we bring investors and society together again? Investing in companies that contribute profitably to social progress, and withdrawing capital from those that do not, will create a virtuous cycle in which the improving welfare of customers, employees, and communities generates future growth and expanded opportunities for more citizens. Shared-value investing, which seeks out companies that achieve excellent economic performance by innovating to meet important societal needs, will help restore the inherent power of capitalism to make things better while creating powerful incentives for companies to innovate. When a social need can be tackled with a profitable business model, the magic of capitalism is unleashed. Answers to the many deeply rooted societal problems we face become self-sustaining and scalable. Actual solutions to society's problems are in reach.

A serious problem is that many in the investment community have moved away from fundamental investing and its powerful social purpose, seeing algorithm-driven strategies and trading on market movements as ends in themselves. In the process the connection between capital investment and improvement of society is lost. Understanding deeper insights into economic-value creation, and deepening conventional investment analysis by adding shared-value thinking, will unlock growth, accelerate innovation, drive productivity, and improve shareholder returns. Moving in this direction would restore investing as a true profession, with a higher purpose — generating greater profit by expanding opportunity for all, instead of extracting short-term profit for the few at society's long-term expense.

Note: *The authors have served as consultants to and investors in some of the companies mentioned in this article.*