

# Viewpoint: Can market based approaches drive changes to a more sustainable economy?

If so, what are the flaws in the current system?

## In our view

Capital markets currently allocate resources in a way that undermines sustainable development.

However, capital markets should be the main engine for promoting a global green economy via the way that they allocate capital and the way business owners behave.

Share owners should support increased corporate accountability by persuading companies to improve the disclosure of their performance in this area and, then factor this performance into their investment views.

Listing authorities should make corporate sustainability reporting a "comply or explain" requirement. They should also require an investors vote at company AGMs on this report.

A sustainable economy requires much more considered use of regulations, standards, fiscal measures and market mechanisms in order to ensure that the sustainable development externalities of corporations are integrated onto balance sheets.

A transformation to a sustainable economy requires sustainable performance incentives and sanctions for all key capital market players.

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The capital markets currently allocate capital in a way that undermines sustainable development. However, this need not be the case. In fact, capital markets should be the critical facilitator towards a global green economy. This article first sets out how the capital markets relate to sustainable development issues, then highlights what some of the key problems are and closes with some modest proposals for how to improve markets.

Electronic flows of money have no real impact on the physical environment. The impacts of capital arise when that capital is invested, for example in infrastructure investment projects by companies. The capital market's influence over corporate sustainability originates via two principal routes:

- **Economic influence:** The buying and selling of shares on the capital market influences the cost of capital for listed companies – this is the price the company has to pay to raise capital to finance its business. The more a company has to pay for capital, the less it can raise. This limits the extent of its activity. In addition, the economic value of the shares influences a director's remuneration and the degree to which the company is perceived as a candidate for takeover.
- **Investor advocacy influence:** Shareholders are the "principals" of the business and can exercise their rights of share ownership over their "agents", the company directors. They do this by sending explicit signals (referred to in much of the corporate-governance literature as "voice") regarding the management of the company. For example, at the end of a company director's term, the investor can vote for or against that director's re-election at the AGM.

The key problem is that neither the economic nor the investor advocacy sources of influence integrate sustainable development sufficiently broadly to ensure that we have a green economy. This is for two main related reasons: short termism and market failure.

The short termism argument rests on the capital market being too near-sighted in the way it evaluates companies. One root cause is that fund management organisations are evaluated by their clients – for example pension funds – based on criteria that they are themselves too short term. This, in turn, motivates fund management institutions to incentivise and evaluate their individual fund managers and analysts based on performance over time frames that are excessively short, and lead to too much attention on short-term financial performance. The behavioural problem with this is that when these individuals meet with company directors, the tenor of their questions and their consequent trading decisions leads

company directors who wish to enhance shareholder value to focus too much attention on the quarterly earning figures at the expense of investing in the long-term health of the company.

This maximisation of short-term results is a long-term problem for the economy as a whole: if the capital market does not sufficiently factor in long-term capital investment returns, then it undermines long-term investment decision making by company directors as a whole and leads them to allocate insufficient capital to investing in the long-term health of companies overall. While a lack of focus on the long-term financial health of a company is a general problem, as many sustainable development issues are inherently long-term, short termism is also a particular problem for sustainable development – it systematically erodes incentives for company directors to invest in a sustainable business.

The market failure argument is essentially an extension of this short termism problem. Markets are said to fail where, if left unchecked, they would lead to sub-optimal social welfare outcomes. Market failure is the guiding principle behind the need for government intervention. Examples of such market failures include abuse of monopolistic influence, preying upon a lack of customer understanding in order to miss-sell over priced products they may not need, and the social costs of environmental externalities caused by companies that can pollute without incurring the clean-up costs. The sustainable development capital market failure argument is that governments have failed to sufficiently internalise companies' environmental and social costs such that the consequent economic development is fully sustainable. As a result of government's failure to internalise these costs on company balance sheets, the capital market does not incorporate companies' full social and environmental costs. Indeed, until these market failures are corrected, it would be irrational for investors to incorporate companies' full social and environmental costs as they do not appear on the balance sheet and, therefore, do not affect companies' profitability or earnings per share over the investment time horizon. On a related point, even if significant costs accrue due to a sustainable development failure, then they can be negligible today because the market heavily discounts future cash flows.

Therefore, while financial markets are key in the pursuit of sustainable development, they currently do not need to understand or reward sustainable behaviour either because the market participants are paid to be too short term, or because market failure means that they do not need to worry about the very long-term costs which are outside of their investment time horizons.

## So, what needs to change?

Most simply, as short termism is partly a consequence of fund management contracts and their evaluation process, then these contracts and the evaluation process needs to change. In the words of United Nations Secretary-General Ban Ki-moon: 'It is time to create market incentives that reward long-term investment...' (May 2009). The UNEP Finance Initiative's Asset Management Working Group (AMWG) has recently called for actions that they believe will magnify the extent to which responsible investment is demanded by the capital markets. They proposed that:

*"Global capital market policymakers should make it clear that advisors to institutional investors have a duty to proactively raise ESG [environmental, social and corporate governance] issues within the advice that they provide, and that a responsible investment option should be the default position. Furthermore, policymakers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues."* [UNEP, 2009].

The report also proposes clauses on responsible investment that should be written into fund management contracts and that fund managers' performance should be based on an evaluation of their long-term ability to beat benchmarks. Moreover, as a result of the potential for unsustainable development to harm the absolute value of long-term investment portfolios, the report also proposes that investment consultant and fund manager clients should be able to sue for negligence if these issues are not properly considered.

Another key reason for short termism is the inadequate information on which many investment decisions are being made. Markets are driven by information – if the information they receive is short term and thin – then these characteristics will define our markets. If companies do not provide an assessment of the wider sustainable development risks and opportunities associated with those numbers, then how can the market assess the sustainability of that growth?

Conventions like the United Nations Global Compact are now routinely taken up by leading companies around the world. These companies understand that long-term shareholder value is enhanced by operating in a sustainable way and with integrity. Such companies now integrate these concepts into their own business policies, governance structure, strategy, incentive structures and this can be seen through their disclosure to the market.

However, there are major regional variations and significant differences in the quality and comparability of corporate disclosure in this area. Even for large companies where data does exist, much of the information reported is not material, not assured, not comparable and provides favourable, rather than balanced reporting. There is also particularly poor reporting on performance measures and objectives. It is also sometimes hard to track one company's performance through time.

One of the most effective ways of promoting enhanced corporate responsibility disclosure is for investors to use their vote on the annual report and accounts at company annual general meetings to promote better disclosure. Aviva Investors has been doing this since 2001 and, as a measure of effectiveness, companies respond to disclosure requests at the next annual general meeting roughly half the time. While this is a reasonable record of success, it is likely to be far more effective if this practice were conducted market wide. For this to happen, the support of listing authorities is required. Listing authorities need to both make corporate responsibility reporting a "comply or explain" requirement, as well as then require this report or explanation to be put to the vote at the annual general meeting (AGM). For example, stock market listing authorities could make it a listing requirement that companies must:

(i) consider how responsible and sustainable their business model is, and (ii) put a forward looking sustainability strategy to the vote at their AGM. This should help to create the right kind of discussions within companies at the board level and then between them and their investors.

Regarding the market failure argument, policy makers should use regulations, standards, fiscal measures and market mechanisms much more extensively in order to ensure that the sustainable development externalities of corporations are integrated onto balance sheets. In many countries, policy makers often defer to the market when formulating policy. This is wrong. The market discounts the future in a way that policy makers should not. If the short-term financial consequences of government interventions are expensive, then this alone is not reason to stop. Government policy should be set on the basis of a full and non-discounted long-term cost-benefit analysis.

In summary, a transformation to a sustainable economy has to involve a focus on the incentives of all key players within the capital market such that they are sanctioned and incentivised on their sustainability performance. We also need much better market information, which almost certainly will require a change to global listing rules that mandates the disclosure of strategic sustainability reports, and provides the owners of companies the opportunity to vote at the company's AGM on the report. We also need capital market policy makers to have greater regard for future generations when setting policy, and defer to the market less often. For the health of the economy, policy makers should integrate sustainable development issues into capital market policymaking, and internalise corporate externalities onto company accounts via, for example, increased use of fiscal measures, standards and market mechanisms. Investors have a role in promoting and supporting such interventions by regulators, and then allocating capital to more sustainable businesses. In this way, investors will then be better able to sustain their wealth creation role and play their fundamental role in the creation of a more sustainable global economy. We need an economy that invests in real and inclusive long-term green growth, genuine prosperity and job creation.

## References:

UNEP Asset Management Working Group, Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment, UNEP, 2009.

### Important information

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