

# SUSTAINABILITY

## *on the* STREET: FIVE SIGNS THAT AN INVESTMENT WILL THRIVE



In the midst of these volatile markets, investors are witnessing the reversal of two financial management beliefs that have guided investment behavior for some time. The first is that following the combined wisdom of an apparently efficient market will lead to higher ground. The second is that investing in ethically sound and socially responsible equities must come at the sacrifice of returns.

Neither, it turns out, is true. And the market is learning that as it witnesses, on one side, the negative impact of market psychology overshadowing fundamental investment criteria and, on the other, the positive returns that have come in a range of ethically responsible investments. The key to coming out ahead is combining these insights to find balanced, sustainable companies that are undervalued, are maintaining strong capital reserves and are built to grow over the long term.

This is where ethical investing meets the mainstream. As more corporate leaders understand that maintaining and communicating sustainable business practices results in a solid foundation with greater appeal to investors, the distinctions between sound investing and today's definition of ethical investing will be erased. The Street will look to sustainability for its winners, and investors will beat the market with patience and an eye on ethics.

### *Open to ethics*

Ethical management drives long-term success, with core elements that are recognizable as fundamental investment criteria. Simply put, it is much less expensive to stay out of trouble than to get out of trouble in this accident-prone world. Managing cross currents of the global economy and an ever-shifting geo-political environment is difficult enough; courting liabilities only creates a competitive disadvantage.

This ethical foundation is not to be confused with campaigns for good corporate citizenship and social change. When it comes to investment criteria, there is a hard line in the sand between green initiatives and ethical management – a distinction that is frequently lost in marketing speak. While social agendas are critical contributions to a globally aware society, ethical management contributes directly to the sustainability of a company. Such strategy emanates from the top down and is reflected in five areas that drive long-term performance:

### *1. Long-term strategy based on disruption*

Perhaps the most important quality an enterprise can have today is a value proposition that speaks to forward-thinking trends and understands that great opportunity comes through disruption. Keeping sights set on long-term investments, there is enormous potential for meaningful monetary and social gains around new technology, innovative delivery mechanisms, and cutting edge research and application.

A look at three industries currently ripe for disruption highlights where future high performers could emerge:

- **Energy:** the oft-maligned oil market contributed largely to the volatility of 2008, and high energy costs are transforming industries rapidly. Though demand will likely decline in the face of high costs, many argue that oil supplies have peaked. Within that struggle, innovative energy players will rise to the surface: companies that produce alternative energy, improved energy efficiency, and changes in transmission and delivery are already moving to the front of the investment conversation.
- **Transportation:** the world's need for more efficient transportation has never been so clear. It has already put into motion a formidable race to market for hybrid and plug-in vehicle producers, new transportation infrastructure, and new building materials for cars and planes. Wider acceptance of climate change supports more immediate action as the cost of emissions is likely to rise across the globe.
- **Health care:** the United States has long struggled with its health care system, and stands on the brink of a potentially crippling period as the baby boomer demographic moves into its senior

years. The government has not yet brought a viable solution to the table, but forward thinking companies that focus on innovative business models, preventive care and low-cost services can offer a new way of providing affordable options for the next generation of retirees.

## *2. Low debt ratio*

Long an indicator of a strong balance sheet, carrying a low debt/asset ratio frees management to pursue initiatives it believes will benefit its stakeholders. A strong balance sheet affords well-managed companies flexibility to keep all options open and to grow market share in weaker market periods. For instance, cash on hand allows companies to buy in strategic assets while debt-burdened competitors must watch from the sidelines. In every environment, companies with stronger balance sheets can invest in long-term strategic advantages such as R&D – without the need to lever up assets. Alternatively, organizations that are over-leveraged are forced to forego initiatives, skip natural steps in their maturation, or short-change constituents in an effort to alleviate or serve the debt burden. Invariably, such maneuvers lead to negative issues and competitive disadvantage over time.

## *3. Consistent increases in dividend returns*

Management that gives back to its investors consistently and with regular dividend increases demonstrates a key ethical value: the company's leadership is in for the long haul, and wants its investors to remain as committed as they are. While less devoted leaders may hold back dividends to increase their personal shares, those that place the importance of shareholder returns on par with their own compensation send a message of inclusivity. That fosters trust, participation, and a strong long-term position.

It was perhaps phrased best in Benjamin Graham's and David Dodd's classic investment book, *Security Analysis*, which states that "For the vast majority of stocks, the dividend record and prospects have always been the most important factors controlling investment quality and value."

## *4. Investment in social change that furthers corporate goals*

"Green" is quickly becoming the word of the decade, but not all social change is justification for investment. A constant flow of news briefs report on initiatives taken up in the name of the environment, but social change that supports management or a business model is where the market should be looking.

Opposing case studies best illustrate the difference:

- General Motors is being taken to task by the environmentally conscious community for its recent tendency to project a green image that is not supported by its business philosophy. GM launched an aggressive ad campaign about its Gas Friendly, Gas Free approach to its new fleet of cars and trucks, yet behind the scenes has done little to put alternative energy in use on the road. In addition, the company poured millions into lobbying against increases to Corporate Average Fuel Economy (CAFE) standards, arguing that its green approach was proof that standards did not need to be raised.

The result of GM's activity is more than just a skeptical audience of environmentalists. Instead of devoting resources to bolstering the company's competitive position through channels like intensive R&D, manufacturing improvements, and partnerships, it chose to initiate a misleading campaign and lobby Capitol Hill. Their initiatives did nothing to enhance the bottom line, strengthen their balance sheet, or put them in a position of market leadership.

- French food producer Groupe Danone must always keep its pulse on world markets and suppliers. It went well beyond that in 2005, however, by teaming with Grameen Group to establish low-cost, environmentally friendly manufacturing facilities built and run by residents in economically stagnant areas.

In 2007, the partnership's first factory opened north of Bangladesh and, according to a recent Business Week article, now produces more than 10,000 containers of yogurt per day and is expected to break even within two years. The goal of the venture was not to turn an immediate profit, but to establish new centers of manufacturing and consumer populations. The initiative not only strengthens the brand as socially aware and innovative, but creates a model that can potentially be rolled out in emerging countries across the world.

As part of a larger strategy, this contributed to Groupe Danone's shareholder success to the tune of a near 100% increase in stock price over the last five years.

## *5. Sustainability disclosure*

The previously noted elements are indications that a company is establishing itself as a productive investment, but transparency is the piece that embodies an honest commitment. This line of thinking has already been made evident in financial disclosure, as companies cultivate a sense of trust in the wake of the early 2000's widely publicized corporate accounting scandals (Enron, WorldComm, etc.).

Sustainability disclosure similarly provides stakeholders with a window into the company's ethical priorities and management. While still a nascent practice, this kind of reporting is gaining traction worldwide. CFO Magazine reports that from 2002 to 2005, "the percentage of companies producing sustainability reports increased sharply, except in the U.S." Reporters in Japan jumped nearly 10 percent, and in the U.K., Canada, France, Italy and Spain more than 20 percent. Going even further, a recent study by German bank WestLB showed that 44 percent of the 1,800 companies listed on the DJ STOXX Global 1,800 index issued sustainability reports.

The trend extends to developing regions as well. Another study by KLD Research & Analytics focused on emerging markets and showed that a staggering 87 percent of firms in the seven countries study offer some level of sustainability reporting. This is irrefutable evidence that companies understand the benefit of keeping stakeholders abreast of their strategy.

### *Finding future upside*

With these issues at the fore, companies distinguish themselves through fundamental strengths that create significant competitive advantage. Corporate leaders can make their own market by being progressive in their quest for opportunity, diligent about avoiding liability, and steadfast in setting a course for growth over the long term.

As the masses have a tendency to push valuations to extremes – both on the upside and the downside – great value can be tapped in companies that capture momentum at a distance from popular trends. Astute investors can join in their success by prioritizing the balance sheet, transparency and forward thinking over market psychology.