Total Corporate Responsibility Funds
Maximizing Financial and Sustainability Performance

Frank Dixon
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Over the past 100 years, few companies (if any) have been able to maintain market-beating returns for more than fifteen years. In addition, from a systems perspective, no firm could be considered sustainable because global environmental and social conditions are declining in many ways (ie: increasing population and pollution, accelerating resource depletion, widening rich-poor gap, etc.).

The Total Corporate Responsibility (TCR) methodology was developed to address the systemic drivers of corporate decline and unsustainability in a practical, profit-enhancing manner. The approach can be used to develop investment products that provide superior financial and sustainability performance. It also can be used to implement advanced risk mitigation and corporate responsibility strategies. (TCR is being implemented by a subsidiary of one of the largest corporations in the world.)

Overview

Firms are part of a larger interconnected global system. When companies negatively impact environmental and social systems, feedback loops often hold them accountable. This feedback can take the form of lawsuits, market rejection, damaged reputation, loss of market share, reduced employee morale and productivity, increased regulatory scrutiny and reduced earnings. Ultimately the feedback can cause large investor losses. As economic activity increases in a finite global system, feedback loops are shortening.

Conventional business and economic theories and practices place firms at odds with larger systems because they view companies as independent entities (rather than as integrated components of larger systems) and fail to fully account for negative impacts. Failing to hold firms fully responsible for negative impacts compels them to act unsustainably and irresponsibly. (In a competitive market, if firms try to fully mitigate impacts, rising costs probably would put them out of business.) Systemic issues that compel firms to operate at odds with larger systems are the primary reason no firm is sustainable and no firm has been able to outperform the market over the long-term.

TCR is a practical, profit-enhancing method of addressing these highly complex issues. The purpose of TCR is to place firms in harmony with larger systems. By doing so, the approach provides for the first time the real possibility that a firm could become sustainable and achieve long-term market out-performance. In the short-term, TCR's systems-focused approach can enhance reputation, improve customer and other stakeholder relations, reduce risk and increase earnings.

TCR Fund Construction

Beyond corporate strategy, the TCR methodology can be used to enhance the financial and sustainability performance of many different types of investment funds (ie: hedge, enhanced-index, stock picking, etc.). Stocks are selected for TCR funds by using best-in-class TCR ratings in conjunction with conventional financial analysis. Leading asset managers would oversee fund construction, management and marketing.

TCR ratings are produced by Innovest Strategic Value Advisors, a global leader in analyzing corporate sustainability performance. Partly owned by State Street Global Advisors and ABP, the largest pension fund in Europe, Innovest research is used by many of the world's largest financial institutions. With offices in New York, London, Paris, Madrid and Toronto, Innovest's 40 analysts comprehensively analyze the environmental and social performance of more than 2,000 corporations around the world (see www.innovestgroup.com for more information).

Innovest research focuses on the financial impacts of environmental and social issues (ie: governance, product safety, human capital, developing country operations, supply chain, regulatory issues, customer and other stakeholder relations, etc.). Incorporating Innovest research into investment decisions helps investors increase returns because financially relevant issues, typically not addressed in conventional financial analysis, are taken into account.

TCR ratings are generated by adding system change analysis to Innovest's traditional environmental and social ratings. Corporate efforts to promote or block system change are analyzed. Assessment areas include campaign finance, lobbying, advertising and media campaigns. To produce TCR ratings, information from many sources is gathered and analyzed. Sources include government databases, Wall Street and NGO reports, periodical and Internet searches, corporate documents and websites, and comprehensive interviews with senior corporate executives. (A more detailed description of the TCR rationale and approach is available from the author.)

Asset managers can use TCR ratings to construct funds in many different ways. The degree to which TCR ratings influence investment decisions is determined by investor goals and risk preference. Risk-averse investors, for example, might choose an enhanced-index product based on a common index with a low tracking error. In this case, TCR leaders would be over-weighted and laggards under-weighted based on the investor's willingness to diverge from the benchmark index. Investor's seeking higher returns would allow greater over-weighting of TCR leaders.

Enhancing Financial Performance

TCR ratings enhance financial performance by providing more accurate indicators of management quality, undisclosed liabilities, scandal potential (ie: Enron screen) and systems integration.

Management Quality. Nearly all financial analysts would agree management quality is the primary driver of stock market returns. However, few have a good way of measuring it since the metric is intangible. Some say profitability and investment returns are good indicators of management quality. But these broad metrics include many factors over which management has little or no control. As a result, they are not good specific indicators of management quality. Also, using historical financial performance to predict stock market returns assumes the past will equal the future. This may not be a valid assumption in times of rapid change (such as these). Therefore, a more accurate indicator of management quality than historical financial performance is needed.

Probably the best way to gauge management quality is to assess performance in a highly complex area. If management excels here, it is implied they have the sophistication to excel in other parts of the business and thereby earn superior returns. Addressing environmental, social and other sustainability issues poses one of the most complex challenges facing management. There are high levels of market, technical and regulatory uncertainty as well as many different stakeholders and complex issues to address.

TCR takes the already difficult sustainability challenge and makes it orders of magnitude more difficult. The approach addresses larger systemic issues and seeks to drive system change. TCR represents the most difficult management challenge because no single company can change larger systems. Firms must work with peers and other stakeholders in a practical manner to achieve system change. Being the most difficult challenge facing management, TCR is probably the most accurate indicator of management quality and stock market potential available.

Undisclosed Liabilities. Over the years, firms have had many negative environmental and social impacts for which they were not held accountable. This occurred partly because impacts are often difficult to understand and quantify. As human knowledge and technology advances, the negative impacts of firms are becoming more obvious and the risk of being held accountable is growing rapidly. Companies continue to use and sell chemicals and products that degrade the environment and public health. Advertising, labor management and other corporate practices impose more intangible costs on society. These environmental and social issues place investors at substantial risk since there is always the chance firms will be held accountable (as illustrated by the asbestos and tobacco lawsuits). In spite of the large risk to investors, environmental and social issues are rarely addressed in traditional financial analysis (often because the issues are not quantified and financial analysts usually are not trained to address them).

Within sectors, there are often wide variations in environmental and social impacts. Firms with larger negative impacts pose greater risks to investors because the probability of being held accountable is much higher. Variations in environmental and social risk are rarely disclosed in financial reports, in part because reporting requirements have not kept pace with a rapidly changing world. TCR ratings provide one of the most accurate assessments of relative environmental and social risk and potential undisclosed liabilities available. Incorporating best-in-class TCR ratings into investment decisions enables investors to shift investments away from firms with potentially large undisclosed liabilities.

Enron Screen. Enron, WorldCom and other corporate scandals caused large investor losses. These scandals were driven mainly by unethical (and sometimes illegal) management behavior that was difficult to identify because it was internal. (In this case, ethical behavior refers to management teams that hold themselves to higher standards than peers and do “the right thing” even if there is a price to pay.) While stronger governance procedures resulting from the scandals provide some incentive to reduce unethical behavior, they certainly will not prevent it. Most importantly for investors, no reliable means of detecting internal unethical behavior has been developed. Since the systemic drivers of scandals (ie: quarterly earnings pressure, etc.) are still in place, it is highly likely that more scandals will occur. This will drive more large investor losses.

The key issue for investors is how to shift investments away from firms with a high likelihood of internal unethical (and possibly illegal) behavior. Measuring this behavior directly is difficult since it obviously is not disclosed. However, external behavior is a strong indicator of internal behavior. If a firm is acting less ethically than peers on a number of external, more measurable indicators (ie: environment, labor, product safety, governance, etc.), it is much more likely to be engaged in unethical internal behavior. The TCR methodology compares firms to peers on over 160 aspects of external management performance. Given the comprehensive nature of TCR assessment, the ratings provide one of the best indicators of internal unethical behavior (ie: best Enron Screen) available.

Systems Integration. As noted above, firms are part of an interconnected global system. As the scope of human activity increases in a finite system (ie: as the world effectively becomes smaller), the extent to which companies operate in harmony with larger systems becomes an increasingly important determinate of financial success. In other words, the extent to which firms meet customer and other stakeholder demands as well as mitigate negative environmental and social impacts will largely determine future success. TCR ratings provide the most accurate indicator available of how well companies integrate with larger systems.

Enhancing Sustainability Performance

The most important concern for individuals and humanity overall is survival. If this most basic need is not met, nothing else matters. Industrial society, with its high levels of pollution and inefficient use of resources, is rapidly degrading the Earth’s life support systems. Studies by the World Resources Institute and many others show that, with some regional exceptions, every life support system on the planet is in decline (ie: clean air, clean water, forests, topsoil, aquifers, fisheries, wetlands, biodiversity, etc.). In addition, social pressure and turmoil are increasing around the world, driven by population growth, a widening gap between rich and poor, and many other factors. Social distress is evident even in prosperous regions. Americans, for example, medicate themselves with food (two thirds are overweight, one third are obese), television (six hours per day on average), and anti-depressant drugs (rapidly growing use).

Declining environmental and social conditions show that humanity is grossly unsustainable. Without large-scale change, average global living conditions will continue to decline, probably in an accelerating manner. At one time, concerns such as these could be pushed off to future generations. However, as limits are approached and exceeded, environmental and social systems collapse. Current generations are being affected. Business and investors are being affected. Sustainability has become a pressing present issue, rather than one to be addressed later.

In response to sustainability concerns, large corporate responsibility (CR) and socially-responsible investing (SRI) movements have developed over the past thirty years. As environmental and social issues become increasingly financially-relevant to firms, investment funds that take these issues into account (positive-screened SRI funds, as opposed to ethically-screened SRI funds) are out-performing non-SRI funds more frequently. This is one of the main reasons SRI funds have grown nearly forty percent faster than all other assets under professional management in the US over the past ten years (to $2.2 trillion).

The CR movement also has grown rapidly. Nearly every large company has some type of formal or informal CR strategy. Many firms display sincere commitment to the issue of sustainability from the CEO down to the shop floor. Collectively, billions of dollars have been spent, often yielding substantial improvements in environmental and social performance. Yet, in spite of these efforts, no company is sustainable and humanity is heading in the wrong direction fast. This begs the questions, what's wrong with CR and SRI? Why is no company sustainable? What can be done?

The simple answer to this most complex problem is system change. (While the answer might be simple in concept, implementation is by far the most complex challenge facing humanity and business.) CR and SRI have focused mainly on the internal activities of firms (ie: making less pollution, taking care of workers, producing safe products, acting responsibly in developing countries, etc.). However, the unsustainability problem resides mostly at the system level, not at the firm level. Economic, political and social systems drive corporate behavior. As noted above, these systems do not hold firms fully responsible. As a result, firms cannot afford to fully mitigate impacts. It is not so much an issue of poor ethics or lack of CR commitment as it is of system constraints. Firms simply cannot act in a fully responsible, sustainable manner and remain in business. The two are mutually exclusive.

Traditional corporate-focused CR and SRI approaches will not achieve sustainability. A new type of system-focused CR is needed. Total Corporate Responsibility provides this. By focusing on the root driver of humanity's unsustaiability – system flaws, TCR provides the first CR approach that has the potential to actually achieve sustainability. TCR drives system change by rewarding firms that are more proactive than peers in seeking to promote, rather than block, system change. Firms working for system changes that hold all companies more responsible receive higher TCR ratings. As these ratings are incorporated into investment products, the stock price of firms receiving higher TCR ratings is bid up. This creates a self-reinforcing cycle of seeking to be held more responsible rather than less.

The TCR approach protects investors and society by addressing the most onerous activities of firms – activities that are often ignored or even implicitly condoned by mainstream (ie: non-SRI) investment advisors. These activities include lobbying to be held less responsible for negative impacts, giving money to politicians who support holding firms less responsible, using advertising that makes consumers feel empty and inadequate so they will buy products, and misleading the public about environmental and social issues through deceptive media campaigns. (These systemic problems are discussed in a more detailed TCR paper available from the author.)

Market Potential

Because TCR is an enhancement that can be applied to nearly all fund types, the market potential of TCR funds ranges into the trillions of dollars of assets under management. Communication is key to achieving this potential. When discussing TCR funds with most investors, the sustainability issue should not be raised until the financial case has been solidly made. As noted above, TCR ratings have the potential to substantially enhance financial performance. Probably all investment advisors would agree that management quality, undisclosed liabilities and scandal potential are financially relevant issues that should be taken into account when making investment decisions. However, these issues are difficult to quantify. As a result, they often are not adequately addressed when developing and managing investment funds.

TCR ratings, produced by a world leader in the SRI research field, provide a quantified means of incorporating these financially relevant issues into investment decisions. When combined with expert financial analysis done by a leading asset manager, TCR ratings provide substantial potential to increase returns. On the downside, a strong case can be made that, at worst, TCR ratings will be return neutral. This is especially true for risk-averse investors that dial down the TCR signal to a low level of influence over investment decisions.

Once the financial case is made, a strong case can be made that TCR funds will do more to drive sustainability than any other SRI approach. As noted above, this occurs because TCR shifts the focus from the firm to the system level. By focusing on the root driver of unsustainability (system flaws) and using the capital markets to drive system change, TCR provides the first investment strategy with the potential to achieve sustainability.

Many individual and institutional investors are interested in improving environmental and social conditions, such as high net worth individuals, endowments & foundations, and public and private pension funds. A small percentage of these investors are willing to accept lower returns in exchange for environmental and social improvement. However, most investors will not accept lower returns. TCR is designed for the very large number of investors who would chose an investment approach delivering superior sustainability benefits, provided that equal or better financial returns were likely. Investors interested only in financial returns can also benefit from TCR because of the approach's substantial potential to enhance traditional financial analysis and investment returns.

Frank Dixon *advises businesses, governments and other organizations on sustainability, system change and enhancing financial performance through increased corporate responsibility. For seven years, he was the Managing Director of Research for Innovest Strategic Value Advisors, the largest corporate sustainability research firm in the world. At Innovest, he developed financially-focused models and methods for assessing corporate environmental and social performance and helped institutional investors develop high-performing socially-responsible investing products. His work overseeing the sustainability analysis of more than 2,000 firms made it clear that systemic issues compel all firms to operate unsustainably by making full impact mitigation impossible. To engage business and investors in driving the system changes needed to achieve sustainability, he developed a new sustainability approach focused on system change, called Total Corporate Responsibility. He is advising Wal-Mart and other firms on sustainability. He has an MBA from the Harvard Business School. Frank Dixon can be contacted at fdixon@GlobalSystemChange.com.*