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Pulling Back the Curtain: Demystifying Sustainability Analysis

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Investors are accustomed to complexity. Indeed, the financial world *thrives* on complexity – some of which involves quantitative analysis so mathematically intricate that at times it can be difficult even for financial professionals to understand it completely. (See *MIT Technology Review's* 2009 article "The Blow-Up" for an excellent summary.[1]) So, it often seems puzzling—or at least quaint—when financial professionals and the press lament that sustainability is too subjective[2], or confusing, and wish there were an easier way to know whether a company is sustainable or not.

That fact is, most financial professionals, and much of the business press, are simply not well acquainted with sustainability analysis. Though sustainable investing has been around for decades, for many years it was relegated to niche-status, and it has only recently received attention from the mainstream financial industry. As a result, many financial professionals lack a solid grasp of what sustainability factors are and how they are material to a company's performance.

This mirrors how many people outside the financial services sector often think about finance: without a good grasp of portfolio construction and valuation, many people find the whole thing confusing, or at least fiendishly complex.

It is high time that the world of finance gained a better understanding of sustainability. Rather than wishing for a simpler take on the multifaceted subject of sustainability, financial professionals would be better served by educating themselves on how sustainability affects financial performance.

KEY TAKEAWAYS

- Many financial professionals lack a solid grasp of what sustainability factors are and how they are material to a company's performance.
- "Is this a sustainable company?" is a complex question and measuring sustainability requires analyzing many aspects of corporate operation.
- Financial professionals should understand where sustainability rankings come from, and which capture the most relevant, useful and material information regarding future performance.

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[1] Urstadt, Bryan, "The Blow-Up," MIT Technology Review, October 15, 2007, https://www.technologyreview.com/s/408854/the-blow-up/

[2] Davidson, Alex, "What's a Sustainable Company? It's Hard to Define," The Wall Street Journal, April 3, 2016, http://www.wsj.com/articles/whats-a-sustainable-company-its-hard-to-define-1459735511

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Because, in fact, it does, and those who think of it only as a niche for tree-huggers will be left behind.

A Complex Question

People who truly understand finance and asset management are generally pretty smart, and well acquainted with the intricacies of portfolio analysis, asset pricing, and accounting, not to mention math. Yet when many of them approach sustainability, somehow the expectation is that it will be simple.

Nothing in finance works for more than a few minutes if it's so simple anyone can understand it. Moreover, asking "is this a sustainable company?" is kind of like asking "is this a good investment?" The vast majority of the time, the answer won't be a simple yes or no. That's why we have a wide variety of asset pricing models and measures of portfolio performance and value: there's no universally agreed-upon standard for what an undervalued company is, or the exact moment to invest in one. Financial analyst ratings on individual companies often range all the way from Buy to Hold to Sell, and all the in-between spaces. (For example, see the wide-ranging analyst ratings on Valeant Pharmaceuticals International Inc.[3] as reported in the Wall Street Journal.[4])

Measuring Sustainability

Sustainability is complex, and encompasses many aspects of corporate operation: environmental impact, treatment of the workforce, supply chain management, interaction with communities, and all the parameters of corporate governance. Many of those, by the way, are quantitative measures. While sustainability analysis doesn't have the luxury of having as many numbers as financial analysis does, it's important to remember the *reason* we have all those numbers in financial reporting: without them, companies can mislead, or at times even deceive, their investors into thinking things are better than they are.

As investors, we need facts to make decisions. The Securities and Exchange Commission makes this crystal clear on its "What We Do" webpage, noting that one of the worst economic episodes in our nation's history, the Great Depression, was initiated by a crisis of confidence in capital markets, and that the way to restore that confidence was with clear rules of honest dealing and more reliable information. So, thanks to a disaster, we now have financial reporting that gives financial analysts a boatload of numbers to work with. So many, in fact, that one of the most valuable arts in capital markets is figuring out how to extract insight from that thicket of numbers, and identify which ones are most important.

In short, the numbers alone don't tell the story: they are grist for the mills of analysts, and figuring out where value lies is not so much an exercise in looking up the proper number but a judgment call on which numbers to use, and how to turn insight into action.

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[3] As of 3/31/16, Valeant Pharmaceuticals International Inc. was not held by any Pax World Funds. Holdings are subject to change.

[4] "Valeant Pharmaceuticals International Inc.," The Wall Street Journal, http://quotes.wsj.com/VRX/research-ratings

Finding Value

Most financial analysts will tell you that there's no company whose financials are perfect, and even if there were, the chances of such a company going unrecognized and being undervalued are minuscule. Finding value means looking for the most significant areas of strength, and assessing whether the weaknesses are likely to overwhelm the strengths (or mediocrity). Sustainability analysis is the same.

Want an example? Let's look at climate change. There is a simple story on climate change: human emissions of greenhouse gases are causing average temperatures to rise. Beyond that, you have Pandora's box. Does climate change mean every place on earth will be two or four degrees warmer by some specified date? Of course not. A system as complex as a planet is going to have, literally, a world of variety under that simple average. Some places will be warmer, some cooler, some wetter, some drier. Even at the grass top issue level, there's complexity; some crops will grow better with more carbon dioxide, and some worse.[5]

Climate change will impact companies in myriad ways. For example, companies that have disproportionately large emissions of greenhouse gases may be subject to increasingly stringent regulatory risk, possibly even litigation, and probably reputational risk. Looking beyond emitters, nuclear power plants are especially vulnerable to climate change (read: heat waves) because they can only operate if the water they use for cooling is at or below a specified temperature. If the physical impacts of climate change aren't on your investment radar, you might miss those risks.

Ratings and Rankings

The fact that not all sustainability ratings agree does not mean that sustainability analysis is confusing or flawed. It means that different analysts see things differently, and the game is not so much about figuring out who is right or wrong but understanding where those rankings come from, and which of them captures the most relevant, useful and material information regarding future performance.

It's natural to wish that things would be simpler than they are, but it's silly to expect that, particularly as the world grows ever more complex. Sustainability is important. Most corporations intend to be around essentially forever, or at least for an unspecifiably long period, which means that operating in unsustainable ways is like continuing to smoke with the intention of stopping before the damage is done.

The wish for simplicity and consensus is understandable, but we're professionals here. Staying on top of what's happening means eternal vigilance, and sometimes that also means acquiring new knowledge and skills. (The CFA Institute is a great resource.[6])

The bottom line: it's time for finance to learn more about sustainability.

[5] Bawden, Tom, "Is Global Warming Good or Bad for Crops?" inews.co.uk, April 18, 2016, https://inews.co.uk/essentials/news/environment/global-warming-good-bad-crops/

[6] "Explore Environmental, Social, and Governance (ESG) Issues in Investing," CFA Institute, https://www.cfainstitute.org/learning/future/knowledge/pages/esg.aspx

Pax World Management LLC

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