



Research Review

Responsible Investment: Outlook for 2009

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Provided by: Governance and Sustainable Investment team



Expect excellence

Responsible Investment: Outlook for 2009

F&C had predicted that 2008 would be a year of reckoning, as the credit crunch fed through into the real economy. But the scale of what happened took us, and the world, by surprise. Few predicted the mass bankruptcies, government bail-outs and precipitous lurch into recession that we have seen. The big question now is how much worse things will get, and whether government action will be enough to prevent recession turning into depression.

This transformation in economic circumstances also means a shift in the landscape for sustainable investment. Questions about corporate governance, previously seen as the preserve of the specialist, have moved centre stage as questions are asked about how the market's best and brightest bankers could preside over risk-taking that ultimately resulted in the biggest episode of wealth destruction since the Great Depression. Yet at the same time, there are risks that companies fighting for survival will see sustainability management as an unaffordable luxury. F&C will be watching closely to see how these forces play out – and reminding companies that good management of environmental, social and governance risks will make them more resilient to the ups and downs of the global economy.

Regulation not suffocation

The speed and scale at which the financial crisis took hold points to systemic failings at the heart of the financial regimes of the world's major economies. As the crisis laid bare weaknesses in public oversight mechanisms, there is an obvious temptation to intervene via new regulation. However, while a fresh look at failed policies is needed, F&C believes caution is essential to avoid an excessive swing of the pendulum that could hamper business – and provoke an equivalent counter-reaction once the crisis has eased.

Policymakers need to design regulatory regimes that will support long-term, sustainable growth in the financial sector, while more actively controlling systemic risk. That means making regulation smarter, not just tougher, and avoiding the temptation to make rushed, ill thought-out changes in response to public opinion or political pressure. We think that banking systems need integrated, rather than fragmented, oversight mechanisms, pointing to co-ordination between national regulators. We also believe that it is more important now than ever to promote greater transparency and disclosure, as investors struggle to make sense of banks' battered balance sheets – this will play out most obviously in the debate over mark-to-market accounting, where the presumption must be in favour of providing more information to explain why asset values have dropped, not masking the falls with new accounting rules.

- F&C will actively use its influence to engage with regulators, seeking to ensure that regulatory reform is supportive of investor rights and long-term value creation

States take a stake

The dramatic bailouts and recapitalisations of financial institutions throughout Europe and North America in 2008 reflected the urgency of ensuring liquidity and solvency in the midst of extraordinary market conditions. While the initial impact of this funding was to ensure greater near-term stability, it does raise questions about how the rights of minority shareholders will be respected after radical changes in ownership structures.

For banks that have gone the route of partial state ownership, questions will grow about how governments will use their influence as owners. Governments may be tempted to use their clout as shareholders to encourage banks to lend more freely and pass on interest rate cuts directly to borrowers to support broader economic recovery, whether or not this is commercially justified. Conversely, they may fall prey to fiscal pressure to raise funds through asset sales, and seek to drive up the short-term value of their bank stakes. A government's natural focus on its own domestic market and voters may also mean that banks' overseas strategies are neglected. But with state intervention only intended as a stopgap measure, banks must be governed on the basis of long-term enterprise value creation to ensure that there is future private sector appetite for investing in the financial sector.

We believe that governments will recognise this reality, and accept that it may take much longer than originally envisaged to get the banks back into a healthy enough shape to sell back their stakes to the private sector. The challenge for the banks' management is to continue to focus on long-term investor value, rather than being distracted by politics, and to demonstrate to their remaining private sector investors that their interests are being appropriately balanced.

- F&C will urge boards to be explicit about how they are balancing potentially competing interests, and protecting minority shareholder rights



Reforming the bonus culture

The crisis in the banking sector has highlighted the flawed 'bonus culture' that has seen rich rewards paid out over time frames that were not aligned to the period of value realisation for investors. F&C has long argued that remuneration should reflect the ups and downs of the value generation cycle, rather than allowing managers to collect their chips half-way through and leave shareholders to nurse their losses during the downturns. The challenge is now for banks to develop appropriate incentive structures in light of the painful lessons learned over the last year.

Any reform must involve engagement that is carried out in a comprehensive and systematic manner with companies, investors and regulators; the aim is to devise rational systems that strike the right balance between attracting and retaining strong performers, while ensuring full alignment of interests between owners and managers. No company can be expected to adopt practices that place it at a competitive disadvantage in the market for talent, so we need new best-practice norms that are broadly accepted across the industry – while at the same time avoiding the temptation for excessive regulation. Shareholder scrutiny is vital in ensuring that reform sticks, and efforts to give shareholders in the US and elsewhere a "say on pay" must be redoubled to allow them to play this role.

- F&C will continue to encourage companies to give shareholders a vote on remuneration, and will seek opportunities to work with the new US Administration in making "say on pay" a regulatory requirement
- We will work with remuneration committees in investee companies as they seek to learn the lessons of the credit crunch and put in place more robust pay structures – and will use our vote to show our dissatisfaction with those who refuse to reform

Cutting costs, not corners

As the recession bites, companies looking to cut costs may see sustainability initiatives as an expensive optional extra. There is a risk that companies will put their programmes on ice, hoping that they can ride out the next couple of years without major incident, and return to the issues when economic circumstances are more benign.

The tensions may play out most obviously in the hard-hit retail sector. As retailers slash prices and see sales volumes drop, they may feel less able to ask suppliers to implement environmental and social improvements. Yet these improvements can provide opportunities for cost savings – through greater energy efficiency, for instance, or improvements in absenteeism rates. And neglect of these issues carries a severe downside risk: retailers operating on the margin of financial sustainability can ill afford the kind of reputational hit that a scandal over child labour or poor working conditions can cause.

Overall, we believe that the economic downturn is likely to see a shake-out in sustainability practice. Forward-looking companies who understand how to make sustainability a profitable part of their core business will continue to make progress. Other companies, which have taken a more superficial approach, may now neglect the issue and fall further behind.

- F&C will encourage companies to demonstrate how they have incorporated sustainability as a key value driver for their core business strategy, rather than approaching it as a reputation-enhancing add-on

Averting a climate crunch

While the current crisis demands urgent attention, it is equally critical not to lose sight of other longer-term risks that have the potential to inflict serious damage to the global economy. The most urgent of these is climate change. Whilst the focus now must rightly be on preserving a viable, functioning global economy, the massive fiscal injections that form the cornerstone of government responses around the globe present an unprecedented opportunity to tackle the deeper environmental challenges that lie ahead.

The parallels between the credit crunch and the pending climate crunch are striking: both involve a failure of the market to recognise and adjust for clear warning signs of danger ahead. Just as alarm bells were sounded and ignored about excessive liquidity and the poorly-understood risk of complex derivatives, scientific evidence about the urgent need to tackle mounting carbon dioxide emissions has also been consistently dismissed or minimised. And as painful as this financial crisis promises to be, the next climate crisis could be far worse if we don't learn the right lessons about the destructive potential of market failure.

The election of US President Barack Obama has generated hope that the US government will adopt a fresh attitude to tackling the climate challenge. It is very much our hope that the UN negotiations on a post-2012 regime, due to conclude in Copenhagen in December 2009, will introduce effective global mechanisms to tackle climate change.

- F&C will continue to work with other investors and companies to call on governments to agree a bold plan of global action at the UN negotiations
- We will urge companies to develop effective climate change strategies, and prepare themselves for more stringent greenhouse gas regulations in the future.



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Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

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WINNER



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- Liability Driven Investments (LDI)
- Private Equity Funds
- Emerging Market Debt
- Hedge Funds
- Global Tactical Asset Allocation (GTAA)

If you would like further information on our highly competitive range of investment strategies, simply contact the relevant F&C office below.

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