Sustainable Returns--Investor Impact

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover the topic of sustainable returns and investor impact, focusing on a CEO's fiduciary responsibilities to its shareholders and whether these responsibilities should extend beyond merely financial returns and include social responsibility. We will also discuss the ways that economists view the issue of sustainability and its challenges.

Our discussion breaks down as follows:

1. Fiduciary Duty
2. Investor Considerations
    a. Socially Responsible Investing (SRI)
3. A CEO's Dilemma
4. Investor Impact
    a. CEO Compensation
    b. Sustainable Returns
5. Economists' Views on Sustainable Returns

1. Fiduciary Duty

Let's begin by thinking like an investor for a moment.

If you were looking to invest in a company, what is your top priority?

Well, you would want to make a decent return on your money, correct? Otherwise there is no point in investing.

However, is there anything else that you might consider? Would you care what the company is producing or *how* the company produces?

Keep these questions in mind as we go through this tutorial.

Fiduciary duty is the idea that any company has certain duties or responsibilities to its investors.

First of all, that duty is to get them the highest return possible, but also do so with care, loyalty, and disclosure.

Generally, the focus has been on generating strong investment returns, which are reported in quarterly earnings performance.

However, this could also imply that companies have*social* responsibilities.

2. Investor Considerations

Now, what do investors consider when they are seeking companies?

Well, most investors seek companies with successful management teams. They look to leaders of the company to drive profits and make wise decisions for the company.

However, some investors, especially more so today, are also concerned with investing in socially responsible firms, or SRI, Socially Responsible Investing.

Some funds contain an index of only companies who follow high environmental, social, and governance standards.

2a. Socially Responsible Investing (SRI)

Socially Responsible Investing, or SRI, combines the goals of financial return and social good.

There are people who want to make money but they want to do it with companies that are doing something that is good, or at least not harming the environment, for instance.

Socially Responsible Investing encourages practices that promote environmental protection, consumer protection, human rights, and diversity.

Some even go as far as to avoid any companies involved in alcohol, tobacco, gambling, pornography, weapons, or military. It varies from index to index.

Some surveys point to increasing concern for companies to either disclose their climate risk and/or take on sustainability initiatives.

Currently, the evidence is inconsistent as to how much people actually want companies to do those two things.

3. A CEO's Dilemma

Let's explore an example involving a CEO of a company.

Suppose an environmentally concerned CEO wants to adopt practices that take into consideration climate change for his company.

This will cost money and may initially bring profit levels down.

In order to do this, he needs support from his investors, the Board of Directors, and any other corporate stakeholders.

Without this support, the CEO can easily be replaced.

This presents a dilemma, then, for leaders of companies. You can see why, perhaps, leaders of companies are not taking these initiatives, because what exactly *is* the CEO's fiduciary responsibility?

With more investors perhaps concerned about sustainability and climate change risk, does this now become a priority?

Clearly, returns are still the top priority for most investors. In a sense, there are two different areas of focus: returns, which is top priority, versus climate change and sustainability, which may be becoming a top priority.

Unfortunately, because returns are still the top priority, this can easily keep leaders from implementing policies that may adversely impact earnings performance, especially in the short-term.

Executives are forced to think short-term, in terms of quarterly performance, more than long-run, regarding issues like sustainability and climate change.

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4. Investor Impact

Now let's look at the impact that investors have had on public companies' decisions.

4a. CEO Compensation

Recently, the public, especially shareholders, has had something to say about CEO compensation.

A weak economy coupled with poor corporate performance led to many people questioning how much CEOs are making.

The outcome of the public outcry was something called "Say on Pay," where executive pay needed to be disclosed.

People wanted to know how much these leaders are making and wanted their pay to be tied to the company's performance and ability to manage risk.

Evidence suggests now that investors have had a significant impact in this regard. In fact, among 51 major CEOs, by the end of fiscal year 2012, half of their compensation was tied to their company's performance.

This highlights the role that investors can play in public companies' decisions.

4b. Sustainable Returns

So, if investors can have such an influence on CEO salaries, isn't this evidence enough to show that perhaps they can put pressure on companies to address the environment and climate change?

Awareness has increased enough for the SEC to address it as an issue, but unfortunately, short-run concerns keep the focus mainly on quarterly performance and returns.

5. Economists' Views on Sustainable Returns

So, how are economists viewing this? After all, this is an economics course.

Well, environmental groups such as Nature Conservancy are currently working on climate advocacy programs.

They are working with economists because they want to incorporate the ideas of profitability *and* returns that are sustainable.

Some believe that a long-term solution might be adopted, but only if it is universally adopted by all countries, and if it includes a list of what risks need to be addressed and mitigated.

HINT

Mitigated refers to changing how we do things.

Also, risk management needs to be specifically developed and implemented sector by sector. It is going to be different for each industry and each company.

Most people now recognize the importance of involving investors, seeing the impact that they have had--like on CEO compensation, for example.

If anything constructive is going to happen, companies realize that they need to get investors involved in developing and implementing changes in the way that executives make decisions for the company.

Economists are looking to the government to get involved, to set standards and provide a universal mandate.

Right now, there are no universal regulations in place in the United States when it comes to climate change. There was a treaty to reduce greenhouse gas emissions, the Kyoto Protocol, but the United States did not sign it.

As it turns out, investors in the United States are much less interested in climate change than investors in European countries--which is why economists are looking to the government to get involved in the U.S.

SUMMARY

Today we learned that CEOs have a **fiduciary duty** to their investors. We discussed **investor considerations** and how some people believe this responsibility of CEOs should extend beyond simply high returns and instead consider socially responsible behavior, such as **socially responsible investing (SRI)**. We explored an example of **a CEO's dilemma**, noting that there are obstacles preventing CEOs from committing to sustainability. However, we learned that investors can certainly play a role in public companies' decisions, noting **investor impact** on **CEO compensation** and **sustainable returns**. Lastly, we discussed **economists' views on sustainable returns**, learning that investors, environmental groups, and the government may be able to have an influence in the future.

Source: Adapted from Sophia instructor Kate Eskra.

