

A new era of sustainable investments

This year's oil spill in the Gulf of Mexico is yet another example of how social and environmental issues can have a very real impact on a firm's business strategy and financial performance. This awareness can matter for investors too.

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Sustainability is attracting ever-greater public attention. The topic already ranks highly on the legislative agendas of most governments, and media coverage of global sustainability challenges has proliferated through news channels around the world. But what impact – if any – do these trends have on the way companies are run and perform? And more specifically, does the increasing public awareness on sustainability issues have any relevance to the investment community?

To attempt to answer these questions, it is worth taking a look at how the global context of business is changing. We are currently in a period of history in which the economic landscape is changing faster than at any time in the past – especially with respect to the rapid economic development of emerging markets. For instance, while it took the UK almost 200 years to increase its GDP per capita from USD 1,000 to USD 2,000, it has taken China less than a decade. This surging growth in China, but also in other populous emerging markets like India, Indonesia and Brazil, has serious implications for the earth's ecological carrying capacity as well.

According to the World Wildlife Fund (WWF), a non-governmental organization (NGO) focusing on ecological sustainability, the acceleration of the industrialization process in emerging markets is significantly increasing the world's ecological footprint (i.e. the

amount of natural resources required to sustain nations (see Figure 1), especially since emerging markets account for around 80% of the world's population. The WWF estimates that our current consumption of natural resources already exceeds the planet's ability to replenish them by 25%. And if current consumption trends of natural resources continue, humans will likely need two earths by 2050, according to the WWF.

This analysis suggests that we are already being confronted with the limits of our ecological system. Furthermore, the expanding public discourse on these challenges is also changing the context in which companies do business. Today social and political expectations of business are higher than ever before, and the consequences for ignoring the demands of society are more severe. This trend is already reflected in the surge in regulatory policies as governments around the world try to limit the adverse impacts business operations may have on the environment. At the same time, Web-driven participatory media such as Twitter, Youtube and Facebook are enabling activists to mobilize public opinion, shape policy and steer corporate strategy to a greater extent than in the past.

Examples abound of how broad public sentiment can influence corporate strategy. In the pharmaceutical sector, for instance, public perceptions of excessive prices charged for HIV/AIDS drugs in developing countries have pushed global pharmaceutical firms to make these medications more accessible to the world's poor. Similarly, in the food sector, public concern about obesity (which afflicts 32% of Americans) is resulting in calls for further controls on the marketing of unhealthy foods. And the oil and tobacco industries represent further examples of how changing public perceptions of corporate behavior continue to reshape the ways companies do business.

Sustainability and shareholder value

Business leaders are increasingly recognizing that the creation of long-term shareholder value is inextricably linked to a company's ability to respond to the demands of society. It therefore comes as little surprise that investors are also seeking to incorporate concepts related to responsible corporate behavior into their assessments of a company's long-term value. But, up to now, investing in sustainability has largely been the domain of socially responsible investing. Yet socially responsible investing has always been an awkward science. Early approaches simplistically screened out investments in "sin sectors" such as alcohol, arms or tobacco. Returns typically underperformed the market due to the smaller opportunity set of investable stocks. As a result, the mainstream investment community received this approach with a good deal of reservation, since it seemed to force a trade-off between "doing good" and "performing well." This rather negative result, however, can be completely turned on its head. This is what the current generation of responsible investment strategies do. Instead of crudely excluding certain sec-



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tors, the emphasis is on identifying companies whose positive approach to stakeholder concerns over environmental and community issues can actually enhance medium-term shareholder value. For example, firms proactively managing issues around environmental stewardship, social engagement or the implementation of labor standards along their supply chains are likely to be better positioned to prosper in a world in which expectations of business are changing fast. At the same time, companies ignoring changing social and political expectations are increasingly exposing themselves to risks of potentially costly lawsuits, fines, backlashes from consumers and – if investor confidence is affected – increased costs of funding. In this context, responsible investment strategies seek to identify companies who actively manage their reputations by responding to the concerns of society early. Such companies are typically able to better attract top talent, improve the motivation of existing employees and enhance the relationships with key stakeholders such as governments, customers and NGOs – all of which are issues that can impact a company's long-term profitability.

Beyond protecting a firm's reputation in an increasingly demanding business environment, the new generation of responsible investment strategies also maintains that a proactive approach to sustainability trends can directly affect a firm's profitability by reducing costs and even accessing new revenue streams. For instance, companies implementing policies directed at waste minimization and energy efficiency can reduce their operating expenditures, and as such enhance their earnings. At the same time, firms that develop new products and services related to sustainability trends, such as electric cars, solar panels and energy-efficient lightbulbs, can also benefit by tapping into new and potentially very lucrative revenue sources. Toyota's success with its Prius is a case that can largely be attributed to a growing interest in environmentally friendly products. Such examples suggest that a company's ability to actively manage the risks and the opportunities resulting from the evolving sustainability trends in our society can have a very real impact on its business success.

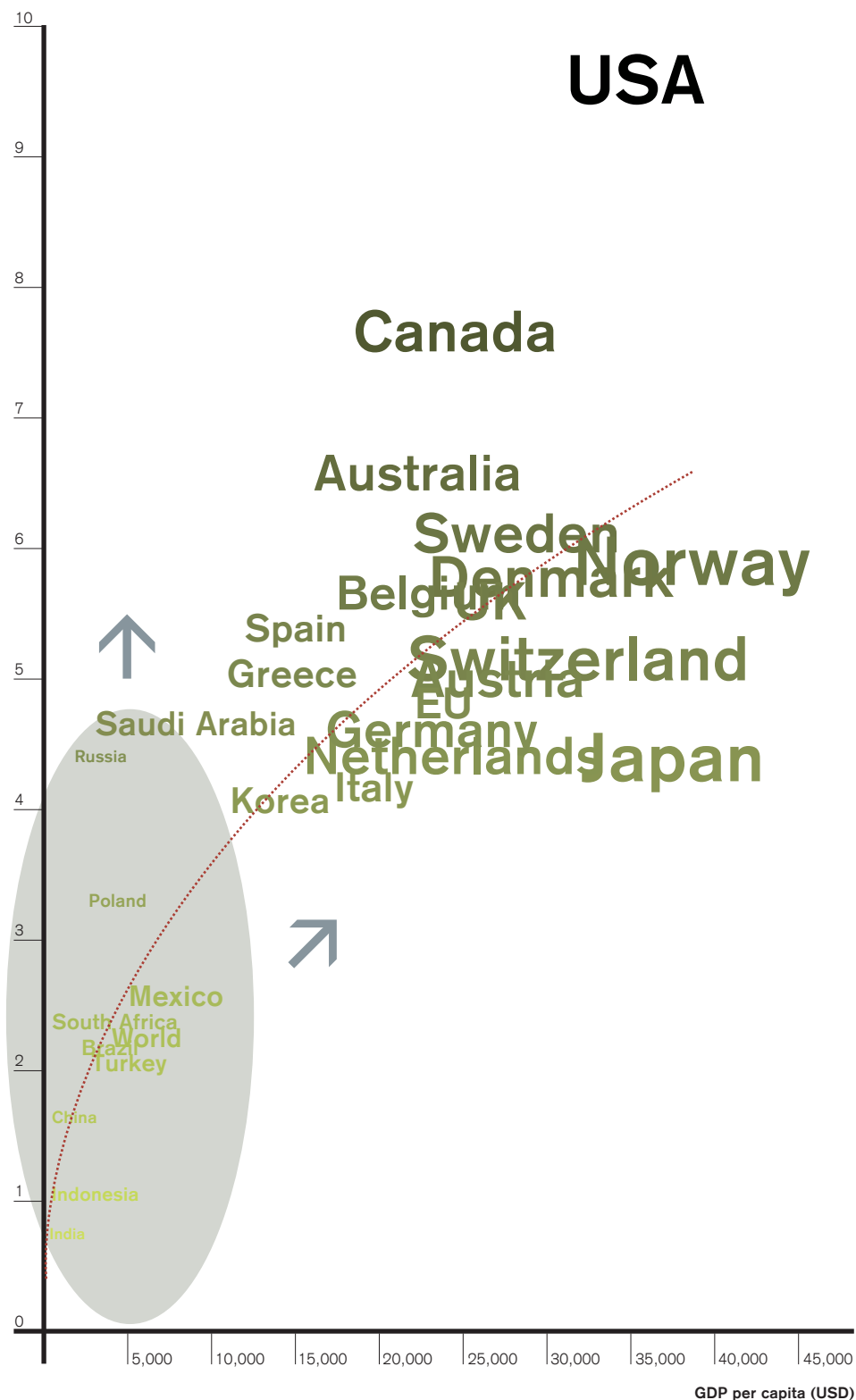
In fact, we at Credit Suisse believe that issues related to sustainability are likely to become one of the more critical drivers of industrial change and economic development over the next decade. Our responsible investment strategy is one way in which we try to recognize this trend by systematically in- >

01_Increasing the world's ecological footprint

If current consumption trends continue, humans will need two earths by 2050.

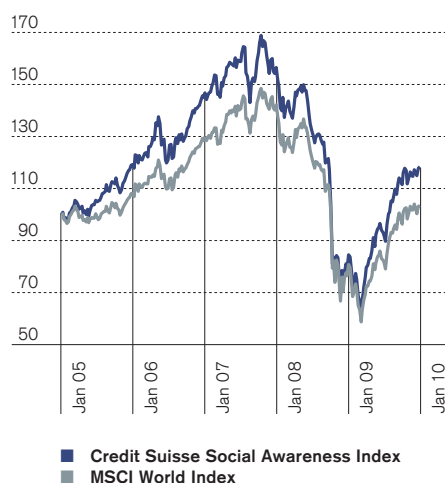
Source: World Resources Institute, IMF, Credit Suisse

Per capita ecological footprint (ha/person)



02 Performing well by doing good

The Credit Suisse Social Awareness Index has consistently led the MSCI World Index. Source: Bloomberg, Credit Suisse



Integrating an analysis of a company's management of sustainability issues into our existing fundamental investment process. In this context, we view a company's management of sustainability issues as an increasingly powerful determinant of its future ability to navigate change, to position itself competitively and ultimately to generate long-term financial returns.

At Credit Suisse, we define responsible investment as the explicit recognition that environmental, social and governance challenges can impact a company's capacity to generate long-term financial returns. As such, the responsible investment strategy is based on three premises. First, the approach is driven by a clear financial imperative, which seeks to identify companies likely to outperform the market in the medium to long term. Second, we view a company's handling of sustainability issues as a powerful forward-looking proxy for a company's overall management ability to respond to a changing business environment. And finally, the third premise of responsible investment is a long-term investment horizon, which implies investing in firms with an enduring ability to create value and sustain a competitive advantage within a given sector.

Asking the difficult questions

Our research methodology for responsible investment begins with an analysis of the sustainability risks and opportunities that can materially impact a company's ability to sustain profitability. To this end, we rely on a rating system that measures 120 environmental and social criteria most likely to contribute to a particular company's financial outperformance relative to peers – criteria such as labor relations, health and safety standards, employee motivation, corporate governance standards, stakeholder engagement strategies and environmental risk management systems. The output of the model is a rating matrix expressed on a relative scale, similar to those used by credit-rating agencies. In a second step, we refine the investment process by integrating the rigorous bottom-up fundamental financial analysis of our sector analysts, and, in a final step, we adjust our portfolio according to market-specific factors such as country preference, sector, currencies and other similar factors.

Our Credit Suisse Social Awareness Index is constructed in a similar way. The index measures company sustainability performance relative to the UN Global Compact and its explicit reference to international standards

in the areas of human rights, labor standards, the environment and anticorruption issues. The idea is that companies without robust policies in place to manage these issues are exposed to greater potential social and environmental problems and in turn expose investors to greater risk. Once a universe of socially aware companies is defined, we use the HOLT database to rank the stocks in terms of corporate performance and its valuation framework. The top 60 stocks are selected as the constituents of the index, with the index being rebalanced semiannually.

A key question for many investors is whether the integration of sustainability issues into the investment process can deliver acceptable returns over time. At least theoretically, additional information about the long-term economic drivers of a firm should lead to better investment decisions and better performance. For instance, anyone investing in European cement companies with a three-year horizon today would likely want to take account of the potential impact of the evolving carbon emissions trading platform in Europe. Academic studies also increasingly support the view that additional information on long-term economic drivers can enhance company performance relative to the market. And, if one looks at the historic performance of our Credit Suisse Social Awareness Index (see **Figure 2**), one can see that it has consistently outperformed the MSCI World Index, with the outperformance being particularly pronounced in bull markets. The results suggest that combining "sustainability overlays" with a robust underlying fundamental investment process can indeed generate incremental performance gains.

In the final analysis, we at Credit Suisse view the responsible investment process as a powerful tool to drive investment performance. In this context, we believe the interests of shareholders, over time, will best be served by companies that maximize their financial performance by strategically managing their performance on sustainability issues. So "doing good" and "performing well" may not be at odds after all. –