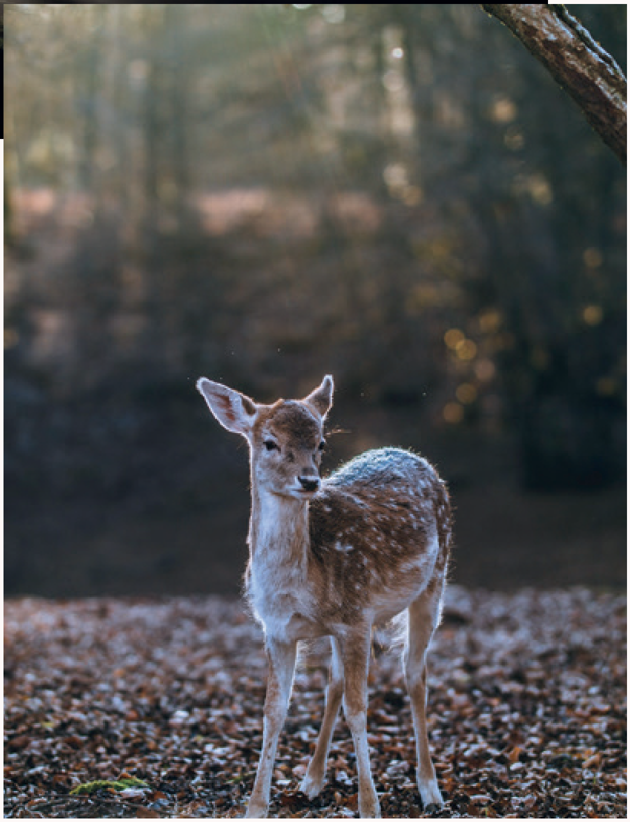
PLANET PAPERS

The economic ecosystem

How businesses, societies and investors can work together

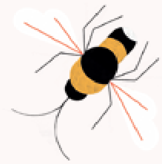
Rathbones
Look forward



Capitalism is a diverse ecosystem of businesses, the state and consumers

Cover illustration:
Michael Driver, Folio Art

Foreword



If you focus narrowly on the returns delivered to shareholders since the onslaught of COVID-19, you would have to say capitalism has navigated this extreme challenge successfully. But not in a sustainable way if the other stakeholders – employees, customers and the wider world – aren't sharing in the benefits or, worse, if they're paying a cost for delivering those returns.

Using an unlikely illustration from the history of the Prussian forest, we can address the myopic focus on short-term measures of profit growth in a surprisingly relevant way. We can set out some compelling reasons for every long-term investor to care about responsible capitalism – even if they don't necessarily care about the societal benefits. Just as our natural ecosystem relies on biodiversity, we mustn't make the mistake of thinking that company profits can be separated from the health of the entire economic 'ecosystem' in which those profits are made.

As we said in our 2019 report *Responsible capitalism*, where this parable was first published, we firmly believe that capitalism is the solution to the grave problems that threaten our future economic prosperity.

In fact, what we're calling 'responsible capitalism' is true capitalism, as it was originally conceived. It's a diverse ecosystem of businesses, the state and consumers, working together for the maximum long-term benefit of all.

Since first publishing this parable, we've continued exploring the 'whys, wheres and hows' of responsible investing, and working towards embedding principles of responsible capitalism into our investment processes.

We are fortunate in these efforts to have the support of our ethical, sustainable and impact investing specialist team at Rathbone Greenbank. At the end of this paper we also highlight some of the important work Greenbank has been doing in the area of biodiversity.

Edward Smith
Head of asset allocation research

A parable of the Prussian forest

How not to destroy the ecosystem in the pursuit of 'shareholder value'

It's the middle of the 18th century and you are standing in a forest in what we now call Germany. There are elm and beech and alder and spruce and a cornucopia of mosses, lichens, shrubs, flowers and ferns. A mixed choir of birds fills the canopy with tumbling descants, while rabbits, frogs, slowworms and innumerable invertebrates dance below. Two children gather mushrooms from the thick forest floor while their mother collects kindling for the bread oven; their two domestic pigs forage for roots.

The scene is blissfully sylvan, like something from the paintbrush of Caspar David Friedrich. To the Prussian state that owned it, the forest was, at the same time, a flourishing, profitable source of wood.

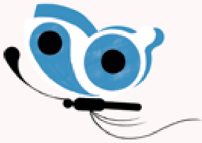
It's now the end of the 19th century, and you are standing in the same forest. Only you wouldn't know it. The elm and beech and alder are gone, as is the cornucopia of flora and most of the fauna. It's eerily silent. There are no mushrooms for the children to gather, the forest floor is patchy and the soil is thin and grey. The villagers no longer live symbiotically with the forest: they no longer have a stake in it. Only row after regimented row of Norway spruce stand before you. And many of them look rather sickly.

> The vast array of elements and relationships that the state had resolutely dismissed as a source of wood came back to haunt it.

What happened?

Forest management. Or mismanagement. The Prussian state and its managers looked through a vastly complex and poorly understood set of relations and processes that constituted the forest and, using a short-sighted fiscal lens, reduced the whole ecosystem to a single number: the annual revenue yield of timber. Everything that seemed unrelated to maximising yield from year to year was ignored (the birds or the fungi) and everything that was thought to impede production efficiency (domestic pasturage or the fertile underbrush) was eliminated.

But the vast array of elements and relationships that the state had resolutely dismissed as a source of wood came back to haunt it. Not seeing the forest for the trees – or the intricate environment that sustains a profitable resource – resulted in



Waldsterben. Forest death. It turned out that most of those fungi, insects, mammals, 'weeds' and even humans mattered. Soil building and nutrient uptake depended upon them. Programmatically or accidentally acting as though they didn't, while focusing single-mindedly on increasing the yields of monocultural grids of spruce, was a mistake. Uniformity and a lack of diversity also made them highly susceptible to disease.

The grave consequence wasn't seen until it was too late. The first rotation of conifers in stripped-down monocultural forests yielded spectacular results. But this tremendous growth was built on the nutrients engendered by the previous regime. By the second or third generation, production losses reached 20–30%. And that's not to mention the many other negative consequences: villagers' standards of living were affected by a loss of pasture, foraged food and charcoal, for example.[1]

Everything is connected

You may well be wondering why an investment manager would expend 500 words on Prussian forests. Or Prussian anything, for that matter! Well, we think it serves as something of a parable for present-day capitalism. Like most parables, it's rather blunt –

> We don't think the current regime has resulted in economic *Waldsterben*. But economic growth has fallen to worryingly low levels.

we don't think the current regime has resulted in economic *Waldsterben*. But economic growth, and productivity growth in particular, has fallen to worryingly low levels.

The incremental return on investment has plunged. In advanced economies, real wages have stagnated and inequality has risen (see our 2018 research report *Too poor to retire*). And that lowers economic growth further because the average worker has a higher propensity to spend additional income than the average wealthy capital owner (issues we addressed in our 2017 report *Under pressure*).[2] Altogether, this means lower interest rates and lower prospective returns on both equities and bonds, with investors lowering return targets or exposing themselves to a greater risk of loss as a result. Let's not make the same mistake as the 18th-century state and pretend that everything isn't connected. The whole ecosystem matters.

Unfortunately, we believe that executives, shareholders and investment managers *have* acted like

the Prussian state. At some point in the 20th century, the company and its *purpose* in society was resolved, like the forest, into a very narrow set of short-term profit metrics. And thereby the complex relations a firm has with society, the economy and the environment have been ignored or subordinated in the name of maximising profits from year to year. Like early-modern forest management, we believe that this reductionist strategy is short sighted. Alongside the many negative consequences for the broad socioeconomic ecosystem, it has jeopardised the opportunity for profit long into the future.

Acting in your own interest

We believe that executives and investors must consider a new approach, one that acknowledges that long-term profits depend on a diverse, thriving ecosystem. One that acknowledges that a healthy, well-paid, socially mobile workforce matters for market size and productivity;[3] that insurance losses from climate change-related events have increased fivefold in recent decades and that the environment and financial stability on which markets depend are connected;[4] and that companies are better off prioritising basic research and investment over financial engineering.[5]

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These are some of the issues we explored in our first *Planet Papers: A responsible recovery*, which made the case that we not only can, but must adopt a sustainable approach in the recovery from the pandemic.

This approach is not just a 'nice to have' or something for the altruistically motivated 'ethical' investment specialist. If you believe that the world works best when capital owners act in their own self-interest, this approach is still for you. The ecosystem matters for shareholder value over the long term. Societal problems and the prospective collapse of investment returns are one and the same. As we set out in our second *Planet Papers: Changing the planet*, the solutions for society and for investors in need of higher returns are one and the same.

Don't confuse strategy with result

Indeed, the rewards may come quicker than you think. There is a now-substantial body of evidence to suggest that businesses with the most sustainable practices are better performing than their peers.[6]

A 'metastudy' published in 2015 found more than 2,000 studies that look at the relationship between good environmental, social and governance (ESG) policies — or more broadly referred to as corporate social responsibility (CSR) — and financial market performance. A negative relationship was only observed in 10% of the studies, while about half of them found it to be positive.

Responsibly minded investments are better-performing investments. Most of the negative 10% were studies that simply looked at the relative performance of so-called ethical funds.[7] But guess what, it's not as easy as just screening out tobacco, guns and pornography. Our reading of the evidence suggests that a positive and negative screening approach, giving thought to what ESG factors are material to each industry, is likely to achieve the best results. We're working to incorporate the Sustainability Accounting Standards Board's (SASB) recent definitions of materiality into our research process.

One of the most thorough studies suggests that investing in stocks that rank highly on material corporate responsibility factors can generate an astounding 3–5% annual excess return relative to those which rank poorly.[8] And that's after accounting for other factors, such as value or size.

It also finds significant benefits to accounting-based measures of success such as return on sales, not just share price returns. The paper is also one of the very few that deals adequately with the so-called endogeneity problem, by which we mean the difficulty of discerning whether good CSR leads to better financial performance or vice versa. It does this with some sophisticated statistical techniques but, moreover, it also uses the recent SASB definitions of ESG materiality that could not have been known to have been so important long before their publication. The evidence presented does indeed suggest that causation runs from good CSR to better performance.

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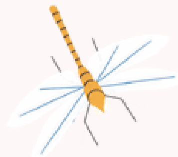


Particularly relevant today, there are several papers that have found good CSR to be associated with better immunity from a crisis, whether that was the financial crisis of 2008–09, or the fallout from the COVID pandemic in the first half of 2020. This holds even if you just isolate environmental policies. As such, as one set of authors puts it, managers cannot hide anymore behind market forces or the conventional wisdom that pursuing a climate-responsible agenda runs counter to the wishes of shareholders and would hurt shareholder value.[9]

In short, to our minds there is an overwhelming amount of evidence to prove that companies that behave more responsibly are associated with higher returns on capital, lower costs of capital, less risk of something 'blowing up', and, most importantly, higher share price returns.

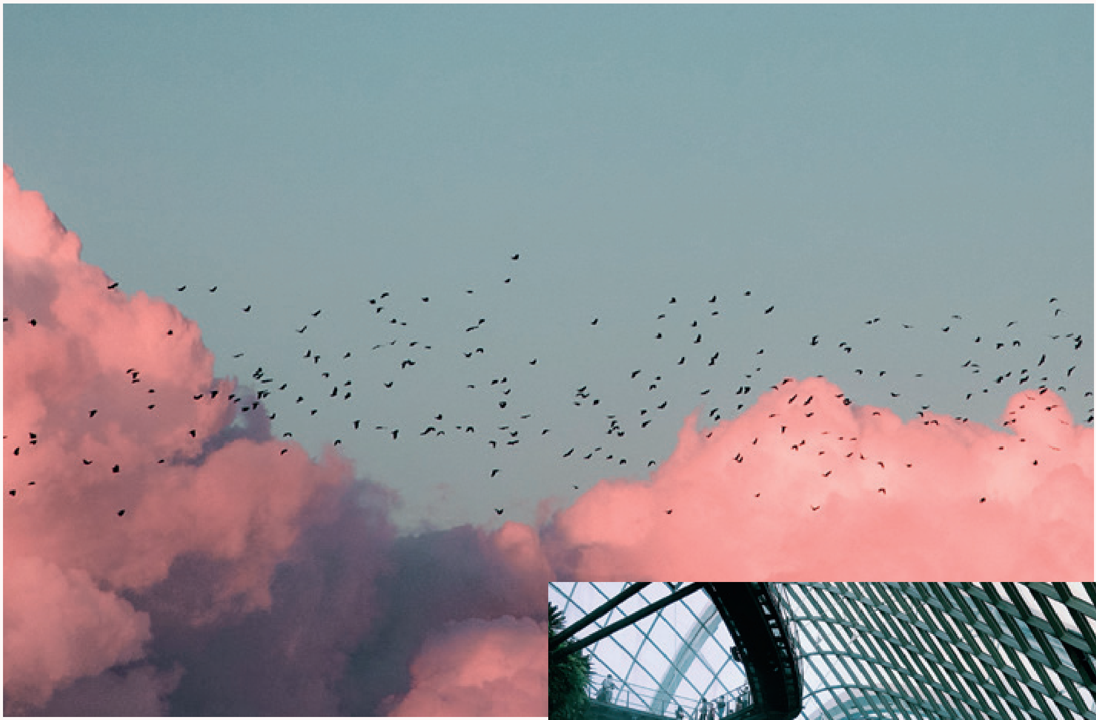
To our minds there is an overwhelming amount of evidence to prove that companies that behave more responsibly are associated with higher returns on capital, lower costs of capital, less risk of something "blowing up", and higher share price returns.

Most of our clients are long-term investors. Many are endowments with infinite time horizons. Others are motivated by intergenerational wealth creation for their families. Therefore, we must ensure that we do not diminish the investment returns of tomorrow, which are intimately linked to the investment decisions of today.

To be clear, we are not dismissing the notion of maximising shareholder value. But like Jack Welch, the idolised chief executive of General Electric in the 1980s and 1990s, who in hindsight famously called it the "dumbest idea in the world", we believe it should be the result not the strategy. And the only way to sustain those results is to ensure that public companies maintain vibrant, symbiotic relationships with employees, customers, suppliers and natural resources – with society at large.

Peter Drucker, one of the founding fathers of management science, said in the 1950s that the purpose of a business is to create a customer. This is done through marketing and innovation, but it also requires a flourishing socioeconomic ecosystem that creates jobs. Businesses and their investors have a stake in that ecosystem, make no mistake.

This parable was first produced in our 2019 report Responsible capitalism.



Creating customers requires a flourishing socioeconomic ecosystem that creates jobs

Biodiversity matters

As with economic systems, when natural ecosystems break down due to a loss of biodiversity, it creates multiple risks for businesses and investors. Like the Prussian forest in our parable, our entire planet is suffering from biodiversity loss. This has several drivers[10] including land use change, pollution and climate change and they are having serious consequences for the vital ecosystem services that biodiversity provides.

These are the services that sustain life on land and life under water, and therefore our wider economy and society. Losses can refer to raw materials, disruption of the environment or a loss of resilience to climate change. Healthy societies, resilient economies and thriving businesses all rely on nature, yet the following statistics expose the state of nature around the globe, and a situation which urgently needs to change:

- almost 70% of global biodiversity has been lost since 1970[11]
- a million species are under threat of extinction, with risks to wider ecosystem services that support societies and economies
- in the US, $44 trillion of economic value is exposed to the loss of nature[12]

Biodiversity is one of the key areas of focus for our specialist ethical, sustainable and impact investing team at Greenbank, whose latest Investor Day in October 2020 was on the topic of 'business and biodiversity'. Greenbank was an early signatory to the Finance for Biodiversity Pledge and has recently become a member of the Partnership for Biodiversity Accounting Financials.

As senior ethical, sustainable and impact researcher at Greenbank, Sophie Lawrence, notes, "it is vital that we develop ways to comparably assess the impact and dependencies of our investments on biodiversity, so that we can both limit the damage to ecosystems and contribute to the protection and restoration of nature."

Given that most businesses depend on biodiversity either directly or through their supply chains, understanding these complex relationships isn't material only for ESG investors focusing on the societal benefits – getting it right will benefit all stakeholders.

You can read more about Greenbank's research and engagement work in this area on the *Knowledge and Insight* section of its website. The forthcoming Spring edition of the *Greenbank Review* will also be on the subject of biodiversity.

Footnotes

[1] This summary of the travails of Prussian forestry management is indebted to James C. Scott's *Seeing like a State*, a brilliant contribution to political science that contains many other examples of managerial processes of simplification and reductionism gone awry.

James C. Scott. *Seeing like a State: How Certain Schemes to Improve the Human Condition Have Failed*, London: Yale University Press, 1998

[2] See for example page 9 of '*Under pressure*' at www.rathbones.com/Inflation

[3] James Heckman and Stefano Mosso. '*The Economics of Human Development and Social Mobility*', NBER Working Paper Series, 2014

[4] Sarah Breeden, '*Avoiding the storm*', Bank of England, 2019

[5] Mariana Mazzucato, *The value of everything: making and taking in the global economy*, Allen Lane, 2018

[6] Robert Eccles, Ioannis Ioannou and George Serafeim, '*The Impact of Corporate Sustainability on Organizational Processes and Performance*', Management Science 60, no. 11 (2014): 2835-857; and Arabesque research.

[7] Friede, Gunnar, Busch, Timo, and Bassen, Alexander. "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies." Journal of Sustainable Finance & Investment 5, no. 4 (2015): 210-33.

[8] Khan, Mozaffar, Serafeim, George, and Yoon, Aaron. "Corporate Sustainability: First Evidence on Materiality." The Accounting Review 91, no. 6 (2016): 1697-724.

[9] Ding, W, R Levine, C Lin and W Xie. "Corporate Immunity to the COVID-19 Pandemic", NBER Working Paper No. 27055. (2020); Lins, K V, H Servaes and A Tamayo. "Social capital, trust, and firm performance: The value of corporate social responsibility during the financial crisis", The Journal of Finance 72(4) (2017): 1785-1824; Garel, A and A Petit-Romec "Investors rewards to environmental responsibility: Evidence from the COVID-19 crisis", Covid Economics: Vetted and Real-Time Papers 33. CEPR. (2020)

[10] The direct drivers of biodiversity loss are land use / sea use change, direct exploitation, climate change, pollution and alien invasive species.

[11] https://livingplanet.panda.org/en-gb/

[12] www.weforum.org/press/2020/01/half-of-world-s-gdp-moderately-or-highly-dependent-on-nature-says-new-report/

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This document and the information within it does not constitute investment research or a research recommendation.

The value of investments and the income generated by them can go down as well as up.

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@Rathbones1742

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