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COMMENTARY

For People and Planet

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Capitalism and sustainability are deeply and increasingly interrelated. After all, our economic activity is based on the use of natural and human resources. Not until we more broadly "price in" the external costs of investment decisions across all sectors will we have a sustainable economy and society.

John Maynard Keynes

The industrial revolution brought enormous prosperity, but it also introduced unsustainable business practices. Our current system for accounting was principally established in the 1930s by Lord Keynes and the creation of "national accounts" (the backbone of today's gross domestic product). While this system was precise in its ability to account for capital goods, it was imprecise in its ability to account for natural and human resources because it assumed them to be limitless. This, in part, explains why our current model of economic development is hard-wired to externalize as many costs as possible.

Externalities are costs created by industry but paid for by society. For example, pollution is an externality which is sometimes taxed by government in order to make the entity responsible "internalize" the full costs of production. Over the past century, companies have been rewarded financially for maximizing externalities in order to minimize costs.

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Today, the global context for business is clearly changing. "Capitalism is at a crossroads," says Stuart Hart, professor of management at Cornell University. We agree, and we think the financial markets have a significant opportunity to chart the way forward. In fact, we believe that sustainable development will be the primary driver of industrial and economic change over the next 50 years.

The interests of shareholders, over time, will be best served by companies that maximize their financial performance by strategically managing their economic, social, environmental and ethical performance. This is increasingly true as we confront the limits of our ecological system to hold up under current patterns of use. "License to operate" can no longer be taken for granted by business as challenges such as climate change, HIV/AIDS, water scarcity and poverty have reached a point where civil society is demanding a response from business and government. The "polluter pays" principle is just one example of how companies can be held accountable for the full costs of doing business. Now, more than ever, factors beyond the scope of Keynes's national accounts are directly affecting a company's ability to generate revenues, manage risks, and sustain competitive advantage. There are many examples of the growing acceptance of this view.

In the corporate sector, companies like General Electric are designing products to enable their clients to compete in a carbon-constrained world. Novo Nordisk is taking a holistic view of combating diabetes not only through treatment but also through prevention. And Whole Foods and others are addressing the demand for quality food by sourcing local and organic produce. Importantly, the business response is about making money for shareholders, not altruism.

In the nongovernmental sector, organizations such as World Resources Institute, Transparency International, the Coalition for Environmentally Responsible Economies (Ceres) and AccountAbility are helping companies explore how best to align corporate responsibility with business strategy.

Over the past five years we have seen markets begin to incorporate the external cost of carbon dioxide emissions. This is happening through pricing mechanisms (price per ton of carbon dioxide) and government-supported trading platforms such as the European Union Emissions Trading Scheme in Europe. Even without a regulatory framework in the U.S., voluntary markets are emerging, such as the Chicago Climate Exchange and state-level initiatives such as the Regional Greenhouse Gas Initiative. These market mechanisms increasingly enable companies to calculate project returns and capital expenditures decisions with the price of carbon dioxide fully integrated.

The investment community has also started to respond. For example, the Enhanced Analytics Initiative, an international collaboration between asset owners and managers, encourages investment research that considers the impact of extra-financial issues on long-term company performance. The Equator Principles, designed to help financial institutions manage environmental and social risk in project financing, have now been adopted by 40 banks which arrange over 75% of the world's project loans. In addition, the rise in shareholder activism and the growing debate on fiduciary responsibility, governance legislation and reporting requirements (such as the Global Reporting Initiative and the EU Business Review) indicate the mainstream incorporation of sustainability concerns.

While we are seeing evidence of leading public companies adopting sustainable business practices in developed markets, there is still a long way to go to make sustainability fully integrated and therefore truly mainstream. A short-term focus still pervades both corporate and investment communities, which hinders long-term value creation.

As some have said, "We are operating the Earth like it's a business in liquidation." More mechanisms to incorporate environmental and social externalities will be needed to enable capital markets to achieve their intended purpose -- to consistently allocate capital to its highest and best use for the good of the people and the planet.

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