The underlying thesis of the Social Awareness Investment discipline is that societal trends around globalization, cross-border investing, privatization, technology and natural resource management are increasingly taking on strategic importance to business. Consequently, how a company integrates these issues into its operations can impact its competitive opportunities and future growth possibilities—thereby affecting its risk/reward profile. Toward this end, we believe that the methods companies use to integrate these trends into their operations can impact their competitive positions and future growth possibilities.

The purpose of this white paper is to examine the potential implications of environmental trends on a company’s current and future investment outlook. It draws on our own research and analysis as well as our participation in a series of dialogues convened over the past several years by the Global Environmental Management Initiative, Global Reporting Initiative, the Coalition for Environmentally Responsible Economies and others.¹, ², ³

THE CONVERGENCE

Historically, most corporate and financial analysts have viewed the environment in the context of compliance costs and legal liabilities that detrimentally affect a company's bottom line. In fact, empirical data suggests that environmental factors have had a limited impact on investment decisions even in the natural resources and manufacturing sectors.⁴, ⁵
Recent events in the modern “global economy,” however, suggest that environmental issues are becoming more connected to economic development, trade, and worldwide demand for goods and services than ever before. Among the factors driving this change are:

- Increasing world population, growing prosperity and consumption among some segments of society, and the associated demand for goods and services.
- Expanding demands on a limited natural resource base, and the resulting pressure to improve resource productivity.
- Better and more widely available information on the environmental and social impact of development.
- The rapid growth of production and major advances in information technology.
- Increasing use of market mechanisms to supplement or replace command-and-control regulations.
- Escalating demand for closed-loop, zero-impact processes and technologies, as opposed to the use of end-of-pipe controls.
- Ever-increasing public concerns about the deterioration of air quality, water scarcity, and other quality-of-life factors being tackled by governments through increasingly tougher health-based standards.
- Growing political consensus that action is warranted to address the problem of global warming and climate change.

We believe these trends will affect virtually every aspect of local, regional, and global economies—and change forever how companies conduct business. Already, these trends are transforming environmental issues from relatively minor factors in corporate decision-making to those that are integral to remaining competitive in the 21st century. Failure to anticipate and integrate these trends in business planning and strategy could put a company’s entire economic model—and investment outlook—at risk.

We believe that incorporating an environmental overlay in our investment process enhances our fundamental analysis and improves our ability to identify those companies that are likely to derive and drive strategic value from their environmental “market intelligence.” A growing body of evidence in business literature appears to support our premise.

**RISK REDUCTION OPPORTUNITIES**

The initial step in our investment process is to determine a company’s investment risk, which is based on historical balance sheet data, earnings predictability, and stock price volatility. Understanding a company’s risk profile is a critical first step in the investment process, as it determines what we should expect as an appropriate return on our investment.

In some situations, particularly in the value sectors (e.g., autos, chemicals, energy, etc.) of the economy, a company’s approach to environmental factors can have a direct bearing on one or more of these risk factors, and either exacerbate or diminish its overall risk as an investment. Some of the specific ways this can occur are summarized below:

- How a company incorporates environmental, health and safety impacts associated with product use, misuse, and disposal into product design could affect its potential liability costs, which in turn could affect its creditworthiness and balance sheet.
- How thoroughly a company identifies and analyzes potential environmental liabilities associated with mergers &
acquisitions affects the uncertainty of future litigation as well as the level of capital expenditures and operating costs required to meet existing and anticipated laws which can affect the balance sheet.

◆ How successfully a company reduces business disruptions arising from accidents and spills not only affects its environmental, health and safety compliance costs, but also determines the sustainability of its operating license.

◆ How a company responds to emergency situations arising from product tampering or accidental chemical releases could affect its image, reputation and investor sentiment, which, in turn, could influence its stock price volatility. A subsidiary of one international oil company lost 40% of its retail market share virtually overnight in response to its proposed disposal of an oil storage facility.9

**THE VALUE CREATION POTENTIAL**

Research conducted in recent years10,11 suggests that integrating environmental considerations across a company’s business proposition can enhance its return potential through improvements to the bottom line and the top line.

Environmental initiatives—whether designed to lower energy consumption, reduce waste, or lower the rate of input use—can help drive process changes which improve efficiency, resulting in higher margins and return on investment. For example, one company has achieved considerable savings by converting to lighter-weight cans and bottles for their products.12 A major health care company was able to reduce energy use by approximately 18% between 1990 and 1997, despite an increase in production of 300% and a doubling of sales in the same period.13

Incorporating environmental factors into product design from the outset, in some situations, can lead to product and quality enhancements, which increase competitive advantage. Along these lines, a chemical manufacturer found that introducing a returnable and recyclable drum for one of its products resulted in a market share increase from 58% to 90%, higher customer inventory cycle time, increased customer loyalty, and significant annual cost savings for that division.14

A keen understanding of environmental megatrends—whether driven by shifting consumer attitudes, changing societal expectations, or new public policy directions—can help a company protect its competitive position, differentiate its products, and gain a first-mover advantage in new markets. Responding to growing consumer sensitivity to environmental issues, one manufacturer of white goods introduced a line of environmentally friendly products. Two years later, those products accounted for 16% of total sales based on volume and 24% of gross margins.15

**THE ENVIRONMENT/INVESTMENT INTEGRATION**

The degree to which environmental management strategies can affect risk, return potential, and ultimately financial performance has been a subject of considerable debate. It would be naive to suggest that environmental issues, in and of themselves, are a silver bullet for solving a company’s financial woes. However, incorporating these trends into our analysis, we believe, adds a new dimension to the valuation process that most investment advisors miss. Moreover, our experience suggests that our unique, integrated approach to financial analysis gives us a competitive edge when identifying top-quality corporate managements that are better positioned to create value in their companies and maintain leading positions in their industries. Our experience is consistent with the results of numerous academic studies indicating that companies with better environmental performance often have higher returns on investment compared to their competitors.16, 17
Some of the above endnotes reference studies or articles that reflect an author's perspective from a specific period and have been deemed relevant to the point that is being made in this white paper.