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How to Build a Framework for Sustainability 2.0

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For companies to succeed during these times of change, they'll need to define and embrace a rigorous framework for sustainability -- something that goes beyond well-intended but overarching statements and builds a foundation that helps a firm achieve its sustainability and business goals.

The starting point for any measurement of the sustainability of companies should be the work of the Brundtland Commission of a generation ago, which in effect held that we need to find a way to meet the needs of the current generation without jeopardizing the ability of future generations to meet their needs. The commission's work came as the world was said to have passed the point of consuming an amount of resources per person that would ultimately be sustainable, so equity and fairness are also implied in the definition.

Ultimately, then, sustainability is a risk factor and an all-encompassing one at that. Some companies and their business practices, as well as many traditional investors, will likely have no chance of succeeding in this new reality without evolving, as we move to an inevitable situation of rectifying overconsumption on a global basis.

Further, before our eyes, during this current economic downturn, we have witnessed the coalescing of the meaning of sustainability as pertaining both to the outright survivability of companies (let alone those which will be most profitable) and to those that survive environmental, social, governance (ESG) scrutiny.

To measure true sustainability, therefore, a framework is required that also encompasses mainstream factors -- the usual ones that financial analysts use to measure profitability and valuation, such as return on capital, stock price to earnings, cash flow, etc. At the same time, this framework needs to judge companies looking to succeed in a changing world, while positioning themselves best from a risk standpoint with ESG factors in mind.

We suggest that companies need to be measured on a sliding scale of relative sustainability from an overall ideal score of 1 -- where 1 represents the most sustainable company in the world (and it is almost certain that no company is currently a 1) -- down to 0, which denotes companies that have no hope of surviving.

Key to this all-encompassing framework is that failure in any one factor is in and of itself disqualifying. Thusly, ESG and mainstream factors act in an independent, parallel fashion in this risk assessment, as opposed to being percentage factors in a score.

Any or all ESGFQ (environment, social, governance, financial, quality of management) factors can bring a company down to 0. It's assumed that many or most companies would score between .1 and .9, with a majority skewed between .1 and .5, and that this could become a coefficient for investment. Because failure on any one factor is disqualifying, there is no room for the sort of calculation that would enable a company to score 30 percent for its E factor, 40 percent for S and 30 percent for G to equal 100 percent or a similarly deceptive "strong" score. A company that fails on any one of these factors may well fail completely as a business, so why give any of these factors less than 100 percent weight. Furthermore, these are potentially disqualifying factors for companies that are looking to avoid risk as they evolve with the changing world, instead of embracing the concept that excellence can be achieved only by across-the-board out-performance.

This proposed method is therefore overarching and of equal relevance to mainstream and socially responsible investing. Investors and asset owners who ignore it would do so at their peril. Call it Sustainability 2.0

To break down these factors a bit further:

E - Environmental impacts, risks and opportunities. For example, Trucost impacts data showing companies with the largest environmental damage costs per dollar of profit or revenue, and HSBC climate change index, which looks at companies best attempting to find innovative environmental solutions.

S - Social risks and opportunities. Arguably, social metrics are the hardest to quantify, but firms like KLD take a stab at that, reviewing issues such as employee relations, human rights, diversity and product safety among many others. Any company failing to perform well on these issues runs the risk of not attracting or retaining the best and the brightest employees, nor retaining shareholders who focus on specific issues such as involvement in Sudan, and not retaining customers who focus on lifestyle choices and their consumer patterns accordingly. On the plus side, plans have been forwarded for establishing the likes of a Social Stock Exchange, as funded by Rockefeller, whereby companies would need to demonstrate best social attributes to retain exchange membership. This sort of "exchange plus" is already in place in Brazil and South Africa and has been successful. As investors, including union pension funds such as those administered by the likes of AFL-CIO, insist on minimum standards in investment, it would increase such risk and opportunity accordingly.

G - True governance risk, as performed best by the likes of The Corporate Library, which highlights situations of overcompensation, board composition and related conflicts of interest. For example, The Corporate Library had flagged Bear Stearns and Lehman Brothers as Ds and Fs in its scoring system, which if used in an overall true sustainability risk system, as proposed, would have protected investors accordingly. On the positive side, companies that reward all employees, shareholders and investors equally, and have full checks, balances and incentives, arguably represent an ideal which few firms achieve -- but those that come closest may well outperform. Private equity firms increasingly recognize that to best maximize their assets, they need to be top performers in these areas; there are increasingly creative and thoughtful short term investors who see that this is the way forward.

F - Traditional financial criteria. For one of too many examples these days, GM would have been an automatic 0 over the last few years, although owned widely by passive investors. If you hold a flat index that had GM as a constituent, that portion of your assets were doomed. Hence even for passive investors, sustainability risk is essential to consider. And it should go without saying that combining positive financial criteria (value plays from traditional Ben Graham/David Swensen approaches etc.) with sustainability risk should offer the best of all possible worlds.

Q - Quality of management is something that can be achieved only by direct interaction and investor judgment. Hence, sustainability inevitably needs human interaction, face-to-face dialogue and understanding that management is committed to full integration of sustainability -- walking the walk, not just talking the good talk.

Investing and measuring without such a framework in mind inevitably ignores some or all the risks that are critical to a company's success. Walmart's recently announced efforts, for example, fall short of what many investors require in a larger framework that includes judgments on management and other factors of direct relevance.

Ultimately, true sustainability may well be a holy grail -- something which is strived for, as opposed to something which can be pinned down completely. This is likely a good thing, as markets need winners and losers, and those who best get this right through sound judgment, creativity and innovation should win in the end.

Cary Krosinsky is vice president for Trucost, which has built the world's most extensive time series database of more than 700 emissions and pollutants as are generated by more than 4,500 public companies around the world. Cary is also co-editor of the recently released book "Sustainable Investing: The Art of Long Term Performance," with Nick Robins, HSBC's head of Climate Change.

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