ROLE OF TRUST IN RESPONSIBLE INVESTING

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A core value that sustainable enterprises almost always emphasize is trust. Therefore, defining trust could be the best starting point for this article. Below is a quote from a book by Simon Sinek called "Start with Why".

"Trust does not simply emerge when a seller makes a rational case why the customer should buy a product or service. Trust is not a checklist. Fulfilling all your responsibilities does not create trust. Trust is a feeling, not a rational experience. We trust some people and companies even when things go wrong, and we don't trust others even though everything might have gone exactly as it should have.

With trust comes a sense of value - real value, not just value equated with money. Value, by definition is the transference of trust. You can't convince someone to trust you. You have to earn trust by communicating and demonstrating that you share same values and beliefs. You have to talk about WHY and prove it with WHAT you do. WHY is just a belief, HOWs are the actions we take to realize that belief, and WHATs are the results of those actions. When all three are in balance, trust is built and value is perceived." [i]

Trust also is the essence of good governance and the foundation of sustainable development. In today's world, institutions increasingly rely on the use of not only their own resources but also the resources of others. And to gain access to those resources of others, institutions need to create trustworthy relationships. [ii]

Consequently, earning the trust of various stakeholders is also the key to mobilizing resources toward a common vision. [iii]

In the past investors would mainly look at how managements were focused on ensuring there is proper accountability. Managements were expected to mitigate risk and then the expectation was that proper oversight and strong governance would ensure businesses could sustain for the long run.

Now corporates are having a bigger and bigger role in society. They are no longer just profit maximizing entities but they provide crucial daily services. As the impact on society becomes wider, the need to listen to multiple stakeholders increases to ensure that the business can operate and thrive in society in the long run.

The problem is that with so many players and so many voices it is becoming increasingly more difficult to reach consensus about how sustainability goals should be achieved.

United Nations for example created "UN Principles for Responsible Investment".[iv] Some governments initiated programs demanding change: China's "5 year social and environmental initiative", South Korea's "low carbon, green growth initiative", Japan's "socially responsible investing plan" just to name a few. Within the EU, the European Commission announced that it intends to come up with a legislative proposal by the end of this June to show asset managers their duty to consider sustainability.

Then there are global stock index providers and global stock exchanges that exercise influence. They compete with each other in the task of setting standards or creating indices specialized in responsible investing.

ESG index is one of them. This is an index consisting of companies, which observe environmental, social and governance (ESG) standards in their strategies.

Finally, the investment community is still extremely important. With global assets under management set to rise to $145tn by 2025, fiduciary investors surely have a role to play and a growing responsibility towards sustainability. [v]

Activist investors are also changing. In the past they used to be "corporate raiders" who bought stakes and then influenced the company to change to increase the stock's share price. Now there is a new trend of activist investors whose intentions are to drive broader change.

However there is a problem as pointed out before. ESG or responsible investing is in the eyes of the beholder. These days, everyone is trying to jump on the bandwagon and there is no hard and fast answer to which general ESG guidelines should be followed. Opinions, preferences, and expectations about how to achieve goals vary widely and it is close to impossible to bring everyone to a consensus.

The only conclusion to be drawn these days is a) the fact that more and more investors are launching funds attuned to these topics, and b) it shows that the market is becoming more conscious of the balance between returns and delivering it in a responsible manner.

As an example, BlackRock recently changed some investment rules in order to have an influence on a subject where anybody agrees that change needs to happen. As of their decision last April, firearm retailers and manufacturers will be excluded from BlackRock's broader socially responsible mutual and exchange traded funds.[vi]

BlackRock made also a public statement saying that the directors of these firms must from now on answer questions to BlackRock's satisfaction. To address the subject related to keeping schools safe from firearms is indeed an urgent matter. We were reminded of this one more time after sad events in South Texas last week.

The move is a reminder of claims by BlackRock that in their opinion "to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society".[vii]

But again the problem here is with clarity of consensus. For instance, while some people are strict only about guns and violence, others would put guns, tobacco and alcohol in the same category. How can BlackRock deal with differences in opinion to have a meaningful impact on these enterprises? And if one is unable to set standards even on a specific subject, how can it be possible to set guidelines for ESG in general?

Al Gore's Generation Fund, also distinguished in sustainable investing - and with quite successful returns - defines a sustainable company as one whose earnings do not borrow from future earnings. [viii] But is this not too vague a description?

Let's take mining as an example:

Some people think that you should mine without cutting forests, impacting local livelihoods (which often makes it impossible, as minerals are always found below trees in forests, and there will always be some ancient habitat around it). So should there be no mining?

Others would say sustainability is about the right balance between extraction and not causing too much pollution.

Still others will say that it is about responsible mining and rehabilitation of the area post-mining to restore the forest cover, disposing waste in an environmentally friendly manner.

You would probably not be able to have enough investors who will ever agree about sustainability in mining or oil extraction – so should we stop this?

Another fund, Mobius Capital Partners, has just dedicated 1bn USD of assets to a fund specifically to invest in ESG observant companies and clarified that they would strive to seek representation on the boards of investee companies.

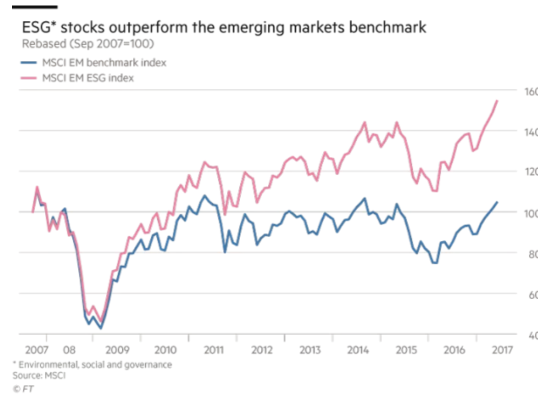
People are trying to grapple with which ESG or UN SDG factors directly impact long-term sustainability and which are marginal. There is not clear rule of thumb on this except that it matters.

Some stakeholders have a tendency to claim that if the community could create a standardized way of looking at ESG – just like the standards on how to look at financial statements – then problem would be solved. Then there would be an easy way of tracking companies that do not comply and those can be left out. However this is not possible for two reasons:

1) ESG is a very qualitative factor. It is simply not possible to define it in an investment quantitatively. 2) The problem with standards is that everybody will want to define it the way they want, as already explained above.

Can we measure the performance impact of responsible investing? The simple answer is no. Index providers like MSCI use their own specific methodologies. They have scorecards and they have created their own criteria to decide which companies will flow into ESG and which companies will be left out.

Together with these efforts, index providers have also achieved to highlight that ESG orientation has helped outperformance. There is indeed evidence that funds, which observe ESG standards tend to outperform the benchmark by a meaningful margin. One out of many examples is MSCI Emerging Markets Leaders index, which includes 417 companies that score highly on ESG. This Index did much better than the broad MSCI Emerging Markets since the 2008-09 financial crisis. [ix]



Therefore, as a proof statement for good performance, ESG has been a good indicator. But would everybody follow each and every one of the parameters, which MSCI or any other index provider may have used?

For all these difficulties, it may be very hard to attain a universal way of looking at sustainability goals.

Yet trust as a core value could still play a role and bring us one step forward in reaching common standards in sustainability.

Trust is the foundation of sustainable development. Again, as the world gets smaller and smaller, our mutual interdependence increases. Mobilizing others' resources can only be achieved through gaining their trust. [x]

During last week, there was a positive example of this when ten asset managers came together, joined forced and worked together on 8 questions that will help companies to be more responsible. These asset managers own altogether $8tn in assets and include Schroders, Hermes Investment Management and Axa Investment Management. The questions are qualitative in nature and they include asking bosses how they know if they are doing a good job, as well as the positive or negative effects of a company on society. [xi]

Now we go back to the definition of trust by author Simon Sinek.

Enterprises will not be able to convince their stakeholders on the long term unless they follow the right steps to drive change, especially if they are in a position of power to do so. Even if they continue providing great service, either suppliers or consumers may at some point leave if trust disappears, because:

"Trust is a feeling, not a rational experience."

Stakeholders have a duty as well – to understand that results of some investments by responsible executives may become clearer in light of a qualitative approach. And they may not even be quantified, put in numbers immediately. And that is fine because:

"***With trust comes a sense of value - real value, not just value equated with money."***

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i "Start with Why" by Simon Sinek - Page 84

ii Responsible Boards by Yılmaz Argüden—Action Plan for a Sustainable Future

http://www.argudenacademy.org/docs/IFC-PSO-36-022615.pdf

iii Responsible Boards by Yılmaz Argüden—Action Plan for a Sustainable Future http://www.argudenacademy.org/docs/IFC-PSO-36-022615.pdf

iv https://www.unpri.org/

v https://www.ft.com/content/f9953eb0-208b-11e8-9efc-0cd3483b8b80

vi https://www.ft.com/content/77e45bc8-3bdc-11e8-b9f9-de94fa33a81e

vii https://www.ft.com/content/f3f09b96-38e4-11e8-8b98-2f31af407cc8

viii https://www.ft.com/content/1757dc40-486f-11e8-8ee8-cae73aab7ccb

ix https://www.ft.com/content/9254dfd2-8e4e-11e7-a352-e46f43c5825d

x "Keys to Governance" by Yılmaz Argüden- Page 82

xi https://www.ft.com/content/bb5a7684-52b2-11e8-b3ee-41e0209208ec