Sustainable Investing: What You Didn't Know Could Make You Money

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Don't you hate it when you're told, "You can't get what you want."
But when you listen for it, the world gives you this message just about every day when you're told you can't have it both ways. You can eat healthy food, or fast food – not both. You can drive a fast and fun car, or save money on gas - not both.

Somehow when issues are framed this way, we're more likely to accept that we can't get what we want. But tonight, I'm going to ask us to stretch ourselves so we can demand both this and that when it comes to our investments.

Earlier in my entire investment career I heard more than once "Karina...you can't get what you want."
"You can either make money on stocks, or save the planet, not both."
"People have been trying it for years, and it doesn't work."
"The returns are lousy."

Fast forward to today...My colleague David Powell and I manage money for a wide variety of institutions, families, and endowments. And by now we've learned enough to know that this idea, this notion of a tradeoff between planets and profit - it's just bad framing.

It's not about whether we're we might make less money by considering the environment. For me it's not about a trade-off whatsoever. It's about how we can make more money by finding situations where companies are being smart about the environment, in a way that helps them grow their revenue, reduce costs, and increase market share. In short: it's about figuring out how to have it both ways.

As a chemical engineering undergraduate student, I spent a summer at a recycled paper mill.
At this exact industrial site you see here, I worked on a water conservation project that involved collecting a lot of pulp and slurry samples from these giant pipes, vats and valves.

In a somewhat exhausted state from this work, I had a bit of a personal epiphany. I saw how much water we were saving, and with less water inputs we were creating less sludge, less waste. And the processes that we put in place to conserve water also helped to improve product quality. So there it was right in front of me: a business strategy that was good for the environment, good for customers, good for the bottom line, and good for shareholders.

Cool! I wanted to sort of jump on the bandwagon and help a lot of companies become cleaner and greener too! So for my first job out of college I worked as an environmental engineer helping companies – large industrials like this one – comply with air emissions regulations.

So that's not a terrible idea, right? I mean it's better to comply than to not comply and pollute too much, right? It was an eye opening experience for me. I was the last person the shift manager or any business leader wanted to see or spend time with. I was nothing but a cost sink. They just wanted me to measure their emissions, rubber stamp compliance with regulations, and get the heck out.
That was my introduction to the conventional wisdom that business strategies are disconnected from environmental factors. And yet…

The environment affects companies in so many different ways. There's pollution, and health effects, reputational damage, changing consumer preferences. You know, a lot of these issues weren't even on the radar screen for companies 10 years ago. Think about for example the organic food industry – that used to be niche but is it's really mainstream. Or fuel economy as a key driver for engine design…and customer choice. Because you wouldn't want a car company to lie to you about your car's fuel economy, would you? Right! So you care about these issues!

Environmental issues are fundamentally changing the game for business. Some companies will adapt and succeed, and others will fail. If you're an investor, you should be thinking hard about who those winners and losers will be. The best companies, they're not just going to survive in this rapidly changing environment, but they will find ways to thrive. They'll figure out what's going on with water scarcity, climate change, and they'll pivot their strategies accordingly well before it's too late. And they'll find ways to reduce their costs and risks on one hand, and smart ways to invest in corollary opportunities to innovate and grow on the other.

Now earlier we talked about this "bad framing" of profits versus the planet. Because of this false assumption, investors have been conditioned for years to turn away from critical environmental factors. So conditioned that, thanks to good work done by others in the investment community, the US Department of Labor decided to issue a clarification statement to pension funds around the country because many of them thought that they were PROHIBITED BY LAW from considering the environment and sustainability in their investments.

They thought it was illegal to do so! These very factors that so many view as counterproductive to making money - are driving real business results today. I speak from experience: It's at this intersection of performance, strong business performance, and sustainability, where we find some of the most compelling long-term investment opportunities.

Let's take a look at that intersection. For the sake of conversation I'm going to use this very simple chart with business on one axis, and the environment on the other.
When it comes to assessing business fundamentals, there's a lot that goes into figuring what makes for a great company within a good to great industry. Things like management's track record of execution, returns on capital, the competitive dynamics – there's a whole host of qualitative and quantitative information goes into that analysis

On the environmental axis the relevant research is: what are environmental strategies that make these great, fundamentally strong companies, even better. And that's what we call Environmental Business Advantages™, or EBA™. And when we find great companies with identifiable EBA, we know we have a good candidate for long-term investment *especially* because the rest of the market isn't paying as much attention to these drivers of competitive advantage as we are.

Let me give you an example: Cummins and Navistar. They compete in the heavy duty truck engine market.

Navistar took a contrarian view when faced with new pollution regulations that really required brand new emissions control technologies. They bet that their old engine platform was somehow going to meet these new emission regulations, and they were wrong.

They were *really* wrong. 2010 rolls around and they begin to get fined for every engine they were selling that was non-compliant, too polluting. And it gets worse. By 2012 they had to abandon their entire engine platform. The company as a whole became unprofitable and has been ever since. And for their own trucks that Navistar manufactured, they had to start buying engines from ... Cummins, their competitor.

Cummins on the other hand was a technological leader. They invested early, since the early 2000's, in R&D and emission controls technologies to create a clear path to make engines that were cost-effective and that exceeded these new requirements. Because of their technological lead the stricter the regulation, the better it is for Cummins. This Environmental Business Advantage has helped Cummins trounce the competition. On a global basis, they have 2 to 4 times the market share of their closest competitor.

Let me give you another example. Yum! Brands may need no introduction. They own KFC, Taco Bell, Pizza Hut ... and their entire reputation was hit hard in 2012 when a 3rd party agency disclosed that they had detected 18 different antibiotics and chemicals, many of which had been banned in China, that were used to fatten up their chickens quickly. Then in 2014 their stock price took another hit when an investigative reporter in China disclosed that one of their major meat suppliers had been falsifying expiration dates.

Now Yum competes in a fast food but slow-growing industry. Competition is intense, margins are generally thin. They duke it out for market share. Food quality is a critical factor for success. In such a competitive environment, how are you going to gain an edge?

You can gain an edge *because* of the environment, and you can use Middleby. Now Middleby may be a company you've never heard of, but they are definitely a part of your diet if you have ever eaten a toasty sandwich at Subway, enjoyed a warm pastry at Starbucks, or ever ordered a pizza that came out of a conveyor oven.

Middleby is a global leader in energy efficient cooking equipment. Many of their ovens operate at less than half the energy use of competing models. And their view on sustainability goes well beyond energy efficiency. For example they have innovated a new waterless food steaming technology that is actually pretty important for some restaurants around the world where water scarcity is acute.

So Middleby is about saving energy, saving water. It's also about food quality because of the controls they can put in place in kitchens. For their customers this isn't just about sustainability, it's about growing your top line and cutting costs. Two compelling customer value propositions that never go out of style. Because of this Environmental Business Advantage, Middleby has been able to far outgrow the pace of the broad fast food industry and they're growing at twice the rate of any competitor.

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So if you come at this with strategies that assume a trade-off: quality food versus fast food - you're going to assume away the very possibility of having it both ways. Some of the best innovations blow past these false dichotomies. You don't need to ask "Do you want a small computer, or do you want a really useful computer?" You can have a smartphone. And you can participate in that success through ARMHoldings.

In this audience there are hundreds, probably over a thousand ARM-designed chips in your purses and your pockets right now. And that's because about 30 years ago the company that became ARM made a decision that some thought was foolish: to design their processors around low-power and energy efficiency, while Intel and the rest of the industry was designing around computational power and speed. Because chip functionality has increased dramatically, you're pretty happy with the features of your smartphone (in general) and it's in part because they're energy efficient; we can deal with those small batteries. And ARM has essentially enabled your mobile lifestyle. By now, ARM has 100% market share in smartphones, and they're going after Intel's bread-and-butter in the larger form factors of computer servers too.

Now let me give you some common **sense** context as to why companies land on this chart the way they do.

Intel is actually in this [lower right] quadrant with a wonderful representation along environmental strategies. They're really good at managing their operations, squeezing out efficiencies and reducing waste. They have a true commitment to sustainability. They've won awards for this. It's just not Environmental Business Advantage. In this case, it hasn't created competitive advantage to the extent that ARM has been able to build, and to have persist, for decades.

Navistar is in the lower left quadrant because they ignored, much less managed their environmental risks and opportunities and are still paying the price with lack of profitability
And YUM is down there too for lack of food quality and unsustainable practices that frankly could harm human health as well as animal welfare.

Now this is a curious bunch and I'm sure you're wondering if there are any companies up there in the blank upper left quadrant, and there are. I'm going to just say something quickly about those companies. Even if a company is making outsized profits today, if a company is not managing their environmental risks and opportunities well, I believe they are in danger of falling into that very, very risky quadrant in the lower left – because environmental factors are not disconnected from company fundamentals, from the business.

Meanwhile in the Environmental Business Advantage quadrant we have:
- Cummins - profitable with leading global market share
- Middleby – growing fast and taking share
- ARM – 100% market share

These are great business strategies in enormous markets. These are great environmental strategies. It's having it both ways.

If building Environmental Business Advantages were easy, everyone would be doing it and you would have heard of EBA before tonight, right? Well a common thread in the examples I just mentioned is that it takes years of investment and strategic intent to build EBA, to build competitive advantage - and that's never easy.

But some of the smartest companies, the best investments, are committed to building EBA – they may not call it that yet but they're doing it not just because customers are demanding good corporate citizens, or just because of regulation, or because Greenpeace or other organizations are demanding greater action for the greater good. It's actually about greater greed - which gives us an opportunity as investors to think about where a company's greater greed intersects with our greater good.

Now notice I'm not talking about solar, wind, compostable toilets or growing honeycombs in every back yard. Individual actions are essential, yes. But there are trillions of dollars available today – many of these dollars are yours - and this enormous amount of capital may be stuck with a mentality that sustainability is an obstacle to making money.

But let me ask you to imagine, if you will, a realistic, more sustainable future. It's not Utopia - I'm not asking you to imagine yourself growing all of your own food or dismantling and recycling your car. You may want to do that and that's fine, but whether you care about sustainability or not you're likely to want – in this future you envision – rising standards of living for yourself, for our kids, and for their grand kids.

And so will the billions of people around the world expected to enter the middle class over the next decade who will demand creature comforts like vehicles, fast food, and smartphones. This future does not have to pit profits versus the planet. It's not a dichotomy because there are companies who are building this world today.

If you envision vehicles in this future or yours, there are companies who will meet your demand with cars that are fast *and* fun to drive, and less polluting *and* more fuel efficient than they are today. *And* if you prefer to share rather than own your car, companies will help you do that too.

As we speak, some of the smartest companies are making investments today for their own long term sustainability, in their own economic self-interest, so they can compete for your loyalty and your dollars tomorrow.

Hopefully I've convince you to believe in the *and*, not the "or." *And* you want it both ways, let's move this forward:

> Talk to your employers and employees. Encourage them to be thoughtful about the future, rattle the cage in your industry and come up with smart, money-making environmental strategies. Go build the companies I want to invest in ten years from now! I promise you that if your company doesn't innovate, your competitors will.
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> Talk to your schools, and the nonprofits you support. Urge them to raise the bar on what we can expect from those endowments.
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> Tell your neighbors as too as you swap investment stories. Tell them they don't need to settle.

It's time we eradicate this notion of a tradeoff. There is no tradeoff. You can have it both ways.