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BLENDED VALUE INVESTING:

INTEGRATING ENVIRONMENTAL RISKS AND
OPPORTUNITIES INTO SECURITIES VALUATION

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*Blended Value Investing: Integrating
Environmental Risks and Opportunities
into Securities Valuation*

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INTRODUCTION

Increasingly, investors are integrating environmental risk and opportunity into their financial valuations of public and private assets. This paper offers an overview of how environmental factors might be integrated into companies' financial valuation. More speculatively, it suggests ways in which a blended value investor could potentially attain equal or better financial returns than traditional investors agnostic to the environmental implications of their investments.

There are indications that financial markets are gradually integrating environmental considerations into securities valuations, emerging from a long period when such concerns had little if any influence on securities' prices. If this assertion is true, the tools and perspectives of blended value investing can help an investor identify and profit from the financial manifestation of previously unpriced environmental value. Using the terms of finance, blended value investing may be a way to generate 'alpha' – or returns above the risk-adjusted performance of the overall market, which are typically attributed to an investment manager's unique ability.

Public equities and debt operate in relatively liquid, efficient markets that combine information from many investors and market influences to reveal clear prices for securities. Nevertheless, markets do not 'explain' how they arrived at a given valuation. Thus, for example, it is difficult to know how much of an oil company's current share price reflects its commitment to alternative energy technology

or to a recently announced reorganization of its distribution network.

THREE VERSIONS OF THE EFFICIENT MARKETS HYPOTHESIS:

WEAK FORM:

- All past market data is reflected in price

SEMI-STRONG FORM:

- All publicly available information is reflected in price

STRONG FORM:

- All information (public and private) is reflected in price

In order to disentangle cause and effect, an investor or analyst must attempt to interpret the various pieces of information that contributed to the market's valuation. In the matter of environmental opportunity and risk, more mainstream market participants are examining how environmental considerations can have a direct impact on securities prices. Accordingly, the mid-2000s may be an excellent time to be a blended value investor. To deploy such an investing strategy effectively requires an understanding of the standard tools of valuation as well as the development and use of new blended value methods.

BLENDED VALUE AND 'MAINSTREAM' INVESTORS FACE THE SAME VALUATION CHALLENGES

Some assets are valuable for what they will be able to do continuously into the future. For example, a piece of land may be valuable because it can produce wheat or grapes into the foreseeable future. It is worth more than simply the value of one year's crop because a purchaser would believe that the land will produce future crop harvests. Nevertheless, it is worth less than the value of a hundred years' of harvests because there is risk that drought or plague could reduce future crops, and most investors prefer to receive money now instead of in the future. In finance terms, the value of a piece of productive agricultural land may be seen as the sum of discounted cash flows over some time horizon, with the discount rate reflecting an investor's alternative uses of capital and perception of risk.

The productivity of a given piece of land may be improved but will reach a ceiling according to available technology. In contrast, other assets, such as a profitable corporation, face fewer constraints. Traditional corporate valuation practice would assert that a company's profits may grow over time such that its productivity does not in fact face a ceiling. Thus, the current value of an asset is not only a reflection of current productivity, impatience and perception of risk – it is also a reflection of hope for the future. Financial valuation is thus an exercise with an extraordinary mixture of quantification of cash flows and qualitative – even emotional – judgments. Public markets that pool the judgments of many investors can help to add rationality to valuation.

Investors may use one or more different frameworks to guide them as they make investment decisions. Some are 'fundamental' investors and make decisions according to a careful analysis of cash flows, risk, and growth rates. They often see themselves as experts in business more than experts in financial markets. Other investors see investment as an exercise in mass psychology and simply attempt to predict how the market will value something, whether or not that valuation reflects core business dynamics. Some of these market participants engage in technical analysis of the market itself, looking for trends in collective behavior, not business fundamentals. Another set of investors subscribe to a random-walk theory that the markets are more-or-less efficient and that it is essentially impossible to consistently beat the market without insider information.

Billions of dollars are spent each year attempting to inform investment decisions. Thousands of economists and finance experts are employed by universities and market participants to understand how markets work and how information is aggregated to generate prices. Nevertheless, there is no fundamental consensus.

Some investors do indeed beat the market consistently, but ample evidence shows such performance is relatively rare. Thus, investors must either accept this fact and simply try to reach a risk-adjusted market rate of return, or they must seek information and analyses that give them insight beyond the average investor; that is, they must seek alpha. Blended value investment strategies may offer one such approach.

BLENDED VALUE INVESTING IS ENTERING THE FINANCIAL INVESTING MAINSTREAM

¹ Friedman, M (1962), *Capitalism and Freedom*, Chicago: University of Chicago Press.

² *2003 Report on Socially Responsible Investing Trends in the United States*, SIF Industry Research Program (December 2003).

³ See www.kpcb.com/greentech/ and www.clintonglobalinitiative.org

In 1962 economist Milton Friedman made his famous claim that the social responsibility of corporate managers is to make money for investors, and that pursuing any other goals – beyond following the law and basic morality – would betray their fiduciary duty.¹ Since then, many authors have corroborated that idea, others have attempted to modulate Friedman's unqualified stance and still others have directly challenged Friedman's approach – both on economic and ethical bases.

Nevertheless, it is not clear how blended value investment strategies will influence financial returns. Ample evidence (cited throughout this paper) suggests that some investments do offer both a financial return and substantive social and environmental returns. Less clear, however, is whether or not blended value investment strategies can consistently achieve financial returns that are the same as, or better than, traditional strategies.

One component of this question has to do with the goals of an individual investor. As with all investors, blended value investors vary in their

risk profiles – but they also vary in the social and environmental returns they seek. Their investment strategies range from simple negative screens (eg no investment in tobacco companies) to highly proactive investments in transformative technologies for which there may not yet be a market (eg investments in carbon sequestration technologies). Thus, even when an investor aims to create blended value, there is no single, monolithic blended value investing strategy.

Investors continue to increase their commitments to blended value investment strategies. In 2003, a total of \$2.16 trillion was invested with some sort of socially responsible investment strategy – though all but \$200bn of that was in negatively screened funds.² Altogether, this pool of capital accounts for about 11% of all invested assets in the United States. High-profile actions such as the \$100m Kleiner Perkins Greentech initiative and Richard Branson's pledge to reinvest about \$3bn in clean energy technologies have brought increased attention and legitimacy to blended value investment strategies.³

THE ENVIRONMENT AND SECURITIES PRICES: A SUMMARY OF THE EMPIRICAL EVIDENCE

Some evidence suggests that comprehensive blended value strategies can generate investment returns that are comparable to or better than investment strategies aiming only for risk-adjusted market rate financial returns. For example, socially responsible mutual funds have been more likely to receive the highest rankings (four or five stars from Morningstar and an 'A' or 'B' ranking from Lipper) than the average mutual fund.⁴

Nevertheless, the many academic studies of socially responsible investing have not definitively proven that the environmental practices of a given firm have clear effects on its securities' prices. Several researchers have found correlations, but their research has been countered by others claiming no connection or a negative relationship between proactive environmental action and financial value creation. One literature review in the 1980s found eight papers presenting a positive correlation, four with no statistically significant relationship, and two with a negative correlation.⁵ Other literature reviews have found similarly contradictory evidence.⁶ Over time, researchers have developed more sophisticated statistical techniques and have had access to better data. Many recent studies show a positive relationship between financial and social performance. For

example, one study by investment advisory firm Innovest found that oil companies (including BP, Royal Dutch/Shell and Suncor) with high environmental ratings outperformed their dirtier colleagues (including ChevronTexaco, Conoco and Occidental) by 17.3% between 1997 and 2002. These cleaner companies also outperformed by 44% on operating profit per share, by 33% on price-to-book ratio, and by 49% on price-to-cash-flow.⁷ Other recent studies have also found better financial results among stronger environmental performers.⁸

This dynamic evidence suggests that by 2006 environmental considerations were inconsistently reflected in securities prices. While the markets inefficiently manage environmental information, there are opportunities for astute investors to achieve outsize returns by deploying their specific insight into environmental opportunities and risks. Thus, now may be a particularly good time to be a blended value investor: investors have access to an increasing amount of information; regulators are learning how to use market mechanisms to reach environmental goals; an increasing number of consumers seek ethically defensible products; and environmental considerations are beginning to manifest in pricing.

⁴ Cf. note 2.

⁵ Ullmann, AA (July 1985), "Data in Search of a Theory: A Critical Examination of the Relationships among Social Performance, Social Disclosure, and Economic Performance of US Firms", *The Academy of Management Review*, Vol 10, No 3.

⁶ For example (among others), Richardson, AJ, Welker, M, and Hutchinson, IR (March 1999), "Managing capital market reactions to corporate social responsibility", *International Journal of Market Research*, Oxford; Blackwell Publishers; and Mathews, MR (1997), "Twenty-five years of social and environmental accounting research: Is there a silver jubilee to celebrate?", *Accounting, Auditing & Accountability Journal*, Vol 10, No 4.

⁷ *The Integrated Oil & Gas Industry: Uncovering Hidden Value Potential for Strategic Investors*, Innovest (2002) See also Baue, W (25 July 2002), *Oil and Gas Company Environmental Risk Should Concern Investors*. www.socialfunds.com

⁸ For example, see Baue, W (11 May 2005), "Institutional Investors Call on SEC, Wall Street, and Companies to Address Climate Risk", *Financial Analyst Journal*.

BLENDED VALUE INVESTMENT HYPOTHESES

As investors work to understand how environmental considerations will be priced into securities' market valuations, they should consider several characteristics of the markets and how they manage new information. The following hypotheses about how markets receive and absorb environmental considerations could help guide blended value investors as they deploy capital in markets that do not reliably price environmental opportunities and risks.

HYPOTHESIS 1:
ENVIRONMENTAL CONSIDERATIONS DIRECTLY AND INDIRECTLY INFLUENCE FINANCIAL VALUE.

Environmental risks can influence valuation through short-term hits to companies' bottom-lines, but they may also destabilize companies' strategies over a longer time horizon. Short-term risks include boycotts, spikes in commodity prices and inadvertent pollution releases. Strategic risks include unfavorable regulatory changes,

reputational damage, tort liability and the long-term introduction of unanticipated risk. Similarly, opportunities arise. Toyota's Prius and Ben & Jerry's ice cream are famous examples of the economic benefits that rise from a favorable consumer demand-side reaction to products that are more environmentally benign.

Many regulations create both winners and losers. For example, relatively efficient industrial carbon emitters in the European carbon markets not only benefit directly from the sale of surplus carbon credits but may benefit from destabilization of competitors that face additional costs and managerial challenges.

Some issues will affect an entire industry, and others will alter the valuation of individual players. For example, controversy over tobacco control would have an impact on valuations for all tobacco companies – but climate change will carry different implications for individual energy companies better able to adopt clean fuel technologies than for competitors dependent on traditional fossil fuels.

ENVIRONMENTAL FACTORS CAN IMPACT THE FINANCIAL BOTTOM LINE

REVENUE	INCREASE VALUE	DECREASE VALUE
DIRECT	Green products and services that appeal to consumers	Boycotts or decreased demand because of perception of negative environmental qualities
INDIRECT	Potential for regulatory advantage versus competitors Improvement in employee morale and productivity	Potential for regulatory disadvantage versus competitors
COSTS		
DIRECT	Reduction in waste-disposal costs	Commodity price variation
INDIRECT	Decrease in staff turnover costs	Higher insurance premiums Legal fees PR costs Increase in costs due to long-term environmental change (eg climate)

**HYPOTHESIS 2:
PRICE ADJUSTMENT LAGS BEHIND THE
EMERGENCE OF NEW INFORMATION ABOUT
AN ENVIRONMENTAL ISSUE.**

Generally, markets efficiently aggregate the opinions of many different investors. Given the complexity of environmental systems and a still-incomplete understanding of how certain environmental factors will interact with companies' economics, intelligent market participants can have different opinions about how environmental information will affect specific companies. Initially, the magnitude of a new risk or opportunity will make its way into the market in fits and starts. For example, as studies about the science of climate change are published, the market will not immediately process the economic implications for companies in different industries. Similarly, complex or contradictory research may emerge that brings additional uncertainty to public understanding of an issue.

As long as there are skeptics about blended value investing, securities' market prices will lag behind the expected valuation ascribed by blended value investing disciples. Blended value investing could be an investing strategy that wins (on strictly financial terms) in some markets and loses in others. In a sense, blended value investors are really 'value investors' who have insight into new dimensions of financial value creation and destruction.

As the economics of an industry become more closely aligned with a social or environmental concern – either through consumer or regulatory pressure – the market may begin to develop a more precise evaluation of a risk or opportunity. There is a danger (or opportunity) that the market will over-react. For example, some claim that the markets (venture financing in particular) are currently overly enthusiastic about certain parts of the renewable energy value chain and that fundamental analysis could yield lower valuations. Understanding the extra-financial aspects of these investments (scientific, political, and regulatory) may help blended value investors take advantage of price movement, up or down.

Several factors help explain imperfect market reactions to new environmental risks or opportunities. Each presents a chance for investors to capture value with thoughtful research and prediction. The lag may be explained in part by how certainly the newly revealed information will have a financial impact on a particular company. Another slowing factor is the extraordinary liquidity of public markets. Thus, investors may believe the risk of climate change will in fact lower the value of relatively dirty industries; nevertheless, knowing they can eventually sell quickly, the investors hold their securities until the market begins pricing – in that environmental risk.

The valuation impact of environmental information can also vary across political geography. For example, some investors cite the 'Kyoto Effect' by which energy companies face different valuations depending on whether or not their home country has ratified the Kyoto Protocol. Further integration of the global economy will depress these kinds of variations, but they are not likely to disappear.

**CATEGORIES OF REGULATORY INNOVATION
THAT WOULD IMPACT VALUATIONS**

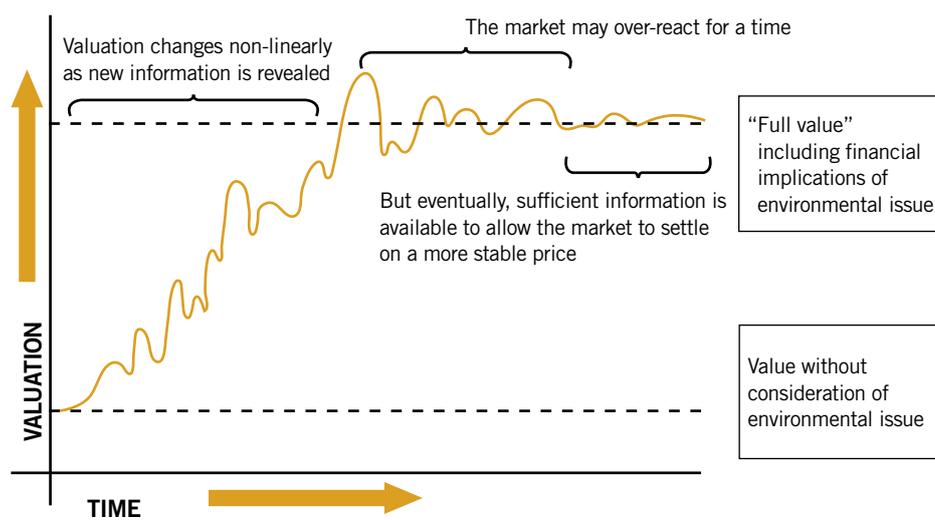
INNOVATIONS THAT CHANGE INTRINSIC VALUE

- Regulations that force companies to internalize externalities (eg carbon markets or carbon taxes)
- Tort law that implies corporate liability for environmental damage

INNOVATIONS THAT CHANGE INVESTOR BEHAVIOR

- Changes that reduce market turnover or increase investment horizons
- Accounting changes that force inclusion of environmental risks in financial statements

HYPOTHETICAL MODEL OF THE INCLUSION OF FINANCIALLY-RELEVANT SOCIAL INFORMATION IN A VALUATION



This chart shows how the market begins to price the impact of an emerging social or environmental issue into the valuations of securities affected by the issue. This chart could, for example, represent the price of renewable energy equities over the time period (1980-2005) when emerging information about climate change science began to diffuse into the markets.

The challenge for an individual investor is to determine where the market is at a given point in this reevaluation process – which would determine a buy/sell/hold strategy.

HYPOTHESIS 3: EXTERNAL STAKEHOLDERS CAN INDIRECTLY INFLUENCE VALUATIONS.

With the retreat of government oversight from corporations in many parts of the world, civil society organizations have moved to fill the vacuum. In essence, there has been a partial privatization of regulation, in which non-governmental organizations have taken responsibility for holding corporations accountable to public concerns.

The divestment of companies operating in South Africa during apartheid is perhaps the most prominent example of investors' non-market concerns changing corporate strategies. Similarly, efforts in the late 1990s to pressure apparel manufacturers to improve labor conditions led to increasingly sophisticated activism as organizations examined the structures of global supply chains and connected companies' positive public images (eg Nike and The Gap) with an uglier private reality (sweatshops) down the supply chain. In these examples, activists have invoked non-market action (boycotts, protests, etc) in order to initiate market actions (changes in business practices).

In recent years, investors have invoked a similar kind of activism, using capital market actions (buying and selling securities, and engaging in shareholder activism) to influence companies' non-market actions (such as reducing pollution). For example, the Boston-based group Ceres has engaged the financial community in the US. Ceres helped form the Investor Network on Climate Risk, a coalition of investors representing \$3 trillion in managed assets. Such activism assumes that if polluting companies face a higher cost of capital because of their poor environmental records, they will improve their practices. It also assumes that companies with positive records should be rewarded with a lower cost of capital.

Civil society strategies have, over time, increased in sophistication and effectiveness. For example, consider the efforts to decrease logging pressure on old-growth forests led by ForestEthics and Rainforest Action Network. As pressure on leading paper-producer Boise Cascade faltered, these organizations began targeting Boise's customers, most prominently in successfully encouraging Kinko's to cancel its contract.

These sophisticated efforts go beyond mere public relations, they target the core business propositions of multinational corporations – especially those selling products with low switching costs. Facing such external accountability, many companies have made cosmetic changes in practice while others (including Boise Cascade) have substantively altered their operations. There is relatively little evidence that these kinds of consumer campaigns have a direct bottom-line impact on poor performers – but concerns about reputational damage make these civil society actors very effective.

Civil society organizations are generally not attempting to alter the valuation of their targets – which could, in fact, be considered racketeering by financial regulators – but instead they aim simply to change practices. However, the existence of these now-powerful external actors is an likely implicit factor in market valuations.

HYPOTHESIS 4:
ENVIRONMENTAL INFORMATION RELEVANT TO PRICE IS OFTEN COMPLEX AND/OR UNAVAILABLE – BUT IS BECOMING INCREASINGLY ACCESSIBLE TO INVESTORS.

Financial markets thrive on information. Valuations can be based on complex economic models or whispered rumors – but in each case they are based on information. Emerging issues are often complex, and both industry-wide and company-specific implications can be unclear. Investors seeking relevant information may be forced to make their way through obscure or even contradictory scientific and economic research to understand an issue. It can also be very difficult to gauge the timing and degree of regulatory and civil society response to an emerging issue.

Increasingly, multinational corporations are publishing sustainability reports that provide data allowing benchmarking of specific aspects of environmental performance. These reports have been notoriously thin, unreliable, and inconsistent, but they have improved significantly, allowing investors to differentiate among companies in a given industry. Publicly available sustainability data is also being compiled through

financial market indices such as FTSE4Good in Europe and Bovespa in Brazil.

Importantly, financial services institutions increasingly provide analysis to aid investors in understanding the valuation impacts of environmental issues. New analytic shops such as Innovest, KLD Research & Analytics and Ethical Investment Research Service (EIRIS) provide comprehensive reports and issue-specific information. Perhaps more importantly, mainstream investment banks have begun issuing reports and recommendations on environmental issues.

Blended value investors who see themselves as value investors are likely to believe Hypothesis 4 holds true. As environmental information becomes more available to investors, the markets will begin to ‘catch up’ to the previously unpriced extra-financial value. That perspective also suggests the next hypothesis.

HYPOTHESIS 5:
BLENDED VALUE INVESTING OPPORTUNITIES ARE CHANGING AS THE CORE ECONOMICS OF BUSINESSES BECOME MORE ALIGNED WITH ENVIRONMENTAL VALUES.

The fundamental economics of capitalism are not always well-aligned with environmental good. The famous ‘tragedy of the commons’ demonstrates how members of a community may draw from a resource in ways that are individually beneficial but collectively unsustainable. The structures of modern corporations geographically, politically, and legally separate investors from the consequences of their investment. The globalization of capital can exacerbate this problem.

Many of the efforts cited in this paper are part of broader efforts to ‘internalize’ externalities into the economics of individual businesses and investors. Increased transparency and public pressure may close the gap between market price and the ‘intrinsic’ values that include the costs and opportunities of environmental problems. Similarly, market-based regulations such as the Kyoto Protocol directly align the economics of businesses with the environmental goals (or, at times, lack thereof) of policymakers.

Thus, a number of converging forces are bringing financial value and environmental value into alignment – certainly a good thing for the planet. Over time, this development will remove inefficiencies in the market on which blended value investors are well-positioned to capitalize. It is unclear how long this process will take, but it is fair to assume that it will vary by sector, will continue for many years and will remain incomplete.

HYPOTHESIS 6:

EMERGING MARKETS MAY OFFER THE MOST APPEALING OPPORTUNITIES FOR BLENDED VALUE INVESTORS – BUT THEY PRESENT SIGNIFICANT ADDITIONAL CHALLENGES.

In recent years, major emerging market economies have grown more quickly than developed world economies. China has had consistent growth rates of 8-10% and India has seen rates of 6-8% compared with the US at 4-5% and Europe at 3-4%. Many of the most appealing financial opportunities in coming years will be found in the Global South.

These markets tend to have less-developed financial and environmental regulatory structures. Some have strong environmental laws which are simply left unenforced (Russia and India, for example). Others see a large part of their gross domestic products generated through informal, often illegal, channels (pirated CDs, illegal drugs and government corruption for example). Their consumer markets are as yet less responsive to environmental concerns: there are no whole foods markets in Indonesia. Nevertheless, the central financial institutions of these countries are increasingly providing investors with access to environmental information (eg the Bovespa market in Brazil) and pressuring managers to reform environmental practices (eg substantive activities by the Confederation of Indian Industry and other industrial groups in India).

The Global South also faces a number of looming environmental challenges – many of which have political and economic implications. Recent mass unrest in the Chinese countryside can in large part be traced to the economic impacts of environmental degradation.

In short, many of the same dynamics that make markets in the Global North ripe for blended value investors are at play in the Global South. Investors face significant challenges, given relatively underdeveloped financial infrastructure, high transaction cost and weaker available information. It can be more difficult to untangle valuations in the Global South than in the developed world, but exactly that sort of uncertainty provides opportunities for blended value investors.

CONCLUSIONS

Integrating environmental opportunities and risks into securities valuation generates a host of challenges. Many have been suggested in the previous pages: disentangling the various components of price, measuring environmental value, predicting changes in the external context and so forth.

A key question cutting across these difficulties is: what is the investor's time horizon? A short-term investor or manager can often consider environmental value as an externality. For example, two investors may both believe that all of an American oil company's operations will eventually abide by restrictions on greenhouse gas emissions, though the US will be slow to implement such constraints domestically. The investor with the shorter time horizon may not consider the financial consequences of the company's emissions, as they will have sold the

stock long before its valuation reflects the cost of managing carbon emissions. The longer-term investor will include the costs and opportunities of carbon constraints and will integrate them into their valuation of the company. As suggested elsewhere in this paper, the various time horizons of market participants complicate the manifestation of environmental value in a company's stock price. Any changes in the market or non-market environments that push investors to have longer time horizons and/or companies to internalize externalities will remove some of that complexity.

Some say that every environmental discussion is a discussion about balancing the concerns of the grandparent and the grandchild. Let us hope that blended value investment offers an opportunity to align financial inheritance with ecological inheritance.

RESOURCES FOR FURTHER READING

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