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Commentary: Innovation as a keystone for the ESG conversation

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Asset owners, investment managers and corporate issuers all have been engaged in an ongoing discussion about environmental, social and governance considerations. While there are a variety of approaches to these issues, there is widening consensus among all these constituencies that they are important.

Even the Department of Labor has weighed in, clarifying ESG issues "may have a direct relationship to the economic value of the plan's investment" due to these factors' potential to influence risk and return, and stating unequivocally that ESG issues are "components of the fiduciary's primary analysis," not merely tie-breakers.

There is still a divide, however, over what should be done and what the proper role of boards, corporate management, investment managers and asset owners should be. Likely reasons for this divide include differences in investment time horizon and the economic impact of externalities, among others.

What's needed to move the ESG conversation forward is a path to common ground.

In our experience working for asset owners and engaging with corporate management and boards, we have gained a line of sight to ESG common ground. The topic of innovation, we have found time and again, creates crucial space for companies and asset owners and managers to engage. For companies in any industry, talking about innovation naturally can open the door to a cluster of topics — profits, sustainability, human capital — that in reality are far more closely related and better aligned than any party initially might think.

What is it about innovation that has the power to pull together historically divergent interests? In one of a number of our conversations about ESG engagement, Aeisha Mastagni, a corporate governance portfolio manager at the California State Teachers' Retirement System, West Sacramento, summed it up this way: "Innovation is something that corporations are naturally interested in as a driver of profits. Likewise, it also is important to advancing ESG factors and achieving related societal benefits. Like environmental, social and governance factors, innovation doesn't show up clearly in a single quarter's earnings results, but it does have material long-term implications for value. Innovation is something long-term investors and universal owners must emphasize in the face of market short-termism."

It's just this sort of confluence of interests around innovation that fostered productive action at a high technology company where Blue Harbour made a significant investment. Many investors, including Blue Harbour, had questions about the margin profile of the company, which was spending a lot on research and development. During our meetings with company management, we discussed a compensation plan that would appropriately match payoffs to these R&D investments, improving alignment. Over a longer horizon, however, the commitment to innovation through R&D has paid off, enabling the company to expand into new markets and leading it to an elevated growth rate. This payoff evolved over more than a year, requiring patience on investors' part and interim evidence by the company, but the improvement in governance in this investment helped all parties stay on the same page.

Underpinning the logic for innovation's useful role and the anecdotal evidence is plenty of hard data.

A report last year identified $12 trillion in business opportunities linked to the United Nation's 17 Sustainable Development Goals, with product innovation cited as one of the top two most important factors for realizing this benefit. Likewise, companies rate "industry, innovation and infrastructure" (SDG No. 9) among the top two sustainable development goals for relevancy to their businesses and where they can have the greatest impact. According to SDG No. 9, "Technological progress is also key to finding lasting solutions to both economic and environmental challenges, such as providing new jobs and promoting energy efficiency. Promoting sustainable industries, and investing in scientific research and innovation, are all important ways to facilitate sustainable development."

Engaging on the topic of innovation and reinforcing its importance to long-term managers and owners is particularly critical given that chief financial officers have acknowledged that "they have made real economic sacrifices to hit an earnings target," including postponing or eliminating "R&D ... or ... investments." There is even research indicating that increased analyst coverage reduces innovation, but that this dynamic "is mitigated when managers are protected by various 'pressure shields' such as larger equity holdings by institutional investors."

As investors and owners engage with companies on ESG issues, the topic of innovation has an important place in the mosaic because, similar to ESG factors, innovation can be analyzed from a policy or strategic perspective. Just as an owner might want to understand the human capital management strategy or environmental risk profile of a business, so too can they inquire about how innovation is managed and how it fits into a sustainable business strategy.

While innovation is important on its own as a topic, there is an added benefit in that boards, corporate management, investment managers and asset owners all instinctively can see that a discussion about innovation is a discussion about building value. This can be a good starting point for discussions about other ESG topics where the different constituencies may have a more varied perception of the impact on value.

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