

Investing in **sustainability**: An interview with Al Gore and David Blood

The former US vice president and his partner in an investment-management firm argue that sustainability investing is essential to creating long-term shareholder value.

**Lenny T. Mendonca and
Jeremy Oppenheim**

As McKinsey research indicates, executives around the world increasingly recognize that the creation of long-term shareholder value depends on a corporation's ability to understand and respond to increasingly intense demands from society.¹ No surprise, then, that the topic of socially responsible investing has been gaining ground as investors seek to incorporate concepts like sustainability and responsible corporate behavior into their assessments of a company's long-term value.

Yet socially responsible investing has always been an awkward science. Early approaches simplistically screened out "sin sectors" such as tobacco. Subsequent evolutions tilted toward rewarding good performers, largely in the extraction industries, on the basis of often fuzzy criteria promulgated by the corporate social-responsibility movement. These early approaches tended to force an unacceptable trade-off between social criteria and investment returns.

Three years ago, former US Vice President Al Gore and David Blood, previously the head of Goldman Sachs Asset Management, set out to put

¹The research, summarized in "The McKinsey Global Survey of Business Executives: Business and Society, January 2006" (*The McKinsey Quarterly*, Web exclusive, January 2006), indicates that 84 percent of executives think business has a broader contract with society.

Article at a glance

Three years ago, former US Vice President Al Gore joined with David Blood, the former head of Goldman Sachs Asset Management, to form an investment-management firm dedicated to investing for sustainability—that is, assessing the way social, economic, environmental, and ethical factors affect the strategy and valuation of businesses.

In this interview, the two men explore the underpinnings of their investment philosophy and discuss traditional approaches to socially responsible investing, as well as society's widening expectations of corporate responsibility.

Gore and Blood also delve into their thinking on how to gain superior returns for investors while integrating sustainability into an investment model. They touch on the effects of long-term investing versus the "short termism" of some investors, discuss the complexity of valuing companies across multiple dimensions of sustainability, and assess the activities of companies that pursue the opportunities sustainability creates.

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sustainability investing firmly in the mainstream of equity analysis. Their firm, Generation Investment Management, engages in primary research that integrates sustainability with fundamental equity analysis. Based in London and Washington, DC, Generation has 23 employees, 12 of them investment professionals, and a single portfolio invested, at any given time, in 30 to 50 publicly listed global companies.

The two partners recently sat down with McKinsey's Lenny Mendonca and Jeremy Oppenheim to discuss reconciling sustainability and socially responsible investing with the creation of long-term shareholder value.

The Quarterly: *What do you mean by the term "sustainability," and how does it influence your investment philosophy?*

David Blood: Sustainability investing is the explicit recognition that social, economic, environmental, and ethical factors directly affect business strategy—for example, how

companies attract and retain employees, how they manage the risks and create opportunities from climate change, a company's culture, corporate-governance standards, stakeholder-engagement strategies, philanthropy, reputation, and brand management. These factors are particularly important today given the widening of societal expectations of corporate responsibility.

Al Gore: When, several years ago, David and I were separately looking for ways to integrate sustainability into investing, mutual friends told each of us of the other's search. We discovered immediately that we had a common goal, and that led to a series of meetings and a friendship and, ultimately, to a decision to form a partnership. We researched the history of sustainable investing under its various names and decided to start a new partnership in order to design it, from the ground up, according to the architecture that we

believed was essential to address the challenges in the investment-management industry.

The Quarterly: *What did the history of sustainability investing teach you?*

David Blood: Sustainability investing has a long history, starting back with the first wave of negative-screening strategies, where investors excluded entire sectors based on a set of ethical criteria. This strategy remained niche; returns were lackluster due to the fact that your investment-opportunity set was limited. The next wave of sustainability investing was called the positive-screening, or best-in-class, approach. That's the philosophy of the Dow Jones Sustainability Indexes and the KLD Broad Market Social Index—these indexes replicate the underlying benchmarks but select only the best performers on environmental, social, and governance parameters.

However, the problem with this approach is that it's difficult to get a real sense of what's happening in those businesses, because it's basically a one-size-fits-all approach, often using questionnaires for decision making. In addition, often one team does the sustainability research and then hands it over to the investment team to do the financial research. That approach, we believe, has too much friction in it because it misses the explicit acknowledgment that sustainability issues are integral to business strategy. So in setting up Generation, we saw the need to fully understand sustainability issues alongside the fundamental financial analysis of a company.

Al Gore: We don't think it's acceptable to force a choice between investing according to our values or according to the ways most likely to get us the best return on investment. Our objective in innovating with this new model was to focus on the best return for our clients, full stop. But we wanted to do so in a way that fully integrates sustainability into the model.

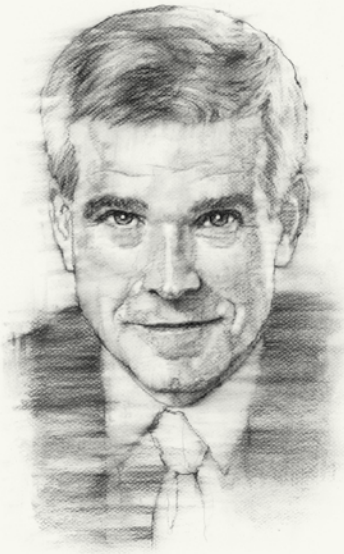
The Quarterly: *That suggests greater complexity.*

David Blood: Yes, sustainability research is complicated because it requires you to think long term and to think about the first- and second-order effects of an issue. We like to describe our approach to sustainability research as taking a systems view. What that means is, if you're thinking about climate change you first need to understand the physical, regulatory, and behavioral impacts on business. But you also need to understand what a changing climate means for disease migration and public health, what it means for poor populations in developing countries, what it means for water scarcity or demographic and urbanization trends. The most important and challenging

research is trying to determine how all these factors interact. Without that understanding, you can miss a significant part of the business implications.

The Quarterly: *What principles drive your approach?*

David Blood: The first principle, categorically, is that it is best practice to take a long-term approach to investing. We think that the focus on “short termism” in the marketplace is detrimental to economies, detrimental to value creation, detrimental to capital markets, and a bad investment strategy. It’s common corporate-finance knowledge that something on the order of 60 to 80 percent of the value of a business lies in its long-term cash flows. And if you’re investing with a short-term horizon you’re giving up the value creation of a business.



David Blood

Education

Graduated in 1981 with BA from Hamilton College, Clinton, New York

Earned MBA in 1985 from Harvard Business School

Career highlights

Generation Investment Management

(2004–present)

- Managing partner

Goldman Sachs (1985–2003)

- Co-CEO and CEO of Goldman Sachs Asset Management (1999–2003)
- CEO of Goldman Sachs Asset Management, Europe (1997–99)
- Served in various positions, including head of international operations, technology, and finance; treasurer of Goldman Sachs; head of global private capital markets; investment banker (1985–97)

Fast facts

Serves on board of trustees of Acumen (nonprofit global venture fund) and of SHINE (UK organization that funds educational-support projects for disadvantaged children and young people)

The second principle is that the context of business is clearly changing. We are now confronting the limits of our ecological system, and at the same time societal expectations of business are widening. On top of that, multinational businesses are oftentimes better positioned than governments to deal with some of the most complicated global challenges, such as climate change, HIV/AIDS, water scarcity, and poverty. Technology and communications have changed, and we've reached a point where civil society is now demanding a response from business.

The Quarterly: *What's your perspective on how that changes corporate strategy?*

David Blood: In effect what's happening, unbeknownst to many corporate leaders, is that the goalposts for their businesses' license to operate have



Al Gore

Education

Graduated in 1969 with BA in government from Harvard College
 Attended divinity school (1971–72) and law school (1974–76) at Vanderbilt University, Nashville, Tennessee

Career highlights

Generation Investment Management

(2004–present)

- Cofounder and chairman

Current TV (2005–present)

- Cofounder and chairman

US government (1977–2001)

- Vice president (1993–2001)
- Senator (1985–93)
- Member, House of Representatives (1977–84)
- Served in US Army in Vietnam War (1969–71) and worked as investigative reporter with *Tennessean* in Nashville

Fast facts

Author of several books, including *An Inconvenient Truth* (about the threat of and solutions to global warming); featured in the Academy Award–winning documentary film of the same name

Serves on board of directors of Apple and as senior adviser to Google

Visiting professor at Middle Tennessee State University

moved. There are higher expectations and more serious consequences, and the implications go way beyond protecting your reputation or managing costs. Rather, we see this changing context for business as an opportunity for companies to establish competitive positioning, grow revenues, and drive profitability. In the end, that's the holy grail of sustainability investing—to seize the opportunities, not just avoid the risks.

The Quarterly: *What has been the reception from pension funds and longer-term investors to this notion?*

David Blood: Very good. They recognize that they have long-term liabilities, and it is their fiduciary duty to match those liabilities with assets. The recent adoption of the UN's Principles for Responsible Investment by asset owners and managers representing over \$8 trillion is a good example of the institutional-investment community beginning to commit to a long-term time horizon and the explicit recognition that environmental, social, and governance factors drive value creation.

From Generation's perspective, we're pleased with this awakening. If you go back to when we founded this firm, we thought that sustainability investing would eventually be mainstream, but we never would have guessed that the reception and focus on sustainability would be as loud and as urgent as it is today versus three years ago.

The Quarterly: *Why do you think that is?*

David Blood: It's because people realize that there are reputation issues related to sustainability, but they also recognize that, in the end, this is about driving profitability and competitive position. Asset owners are beginning to get this and they are looking to invest in the companies that understand it.

Al Gore: The market is long on short, and short on long. There's a widespread recognition within the industry that what has emerged over time doesn't really make any sense. They know that it needs to change and they are ready for change.

We are in a period of history, right now, when the contextual changes are larger than the ones we've been used to in the past. Changes that we've associated with very long cycles are now foreshortened and are occurring much more rapidly. Positioning a company to ride out these changes and profit from them often means making stretch investments to change the

infrastructure, change the energy source, change the physical plant, and adapt to the new realities. And if there is the tyranny of a three-month cycle, then companies won't make those investments. So focusing only on the quarter can blind you to the most important factors of all.

The Quarterly: *How many executives really understand the complexity and interconnection of the trends you describe?*

AI Gore: It's a rapidly growing number. I recently spoke at a conference, in Copenhagen, focused on carbon trading, with thousands of companies represented. As part of an internal survey, attendees were asked how many of them had internalized their "carbon budget" and begun to drive down their internal emissions.

A year ago it was 15 percent. This year it was 65 percent. That would correspond with what we've found in multiple other areas—a kind of tipping point that we are at right now. For example, I had a chance to visit Wal-Mart in Bentonville, Arkansas, around the time they launched their commitment to "green" their supply chain. And David and I spent time with [GE CEO] Jeff Immelt, and we could give you lots of other examples of CEOs who, a few years ago, might not have talked this way and yet are now not only knowledgeable but highly sophisticated. They may have started with concerns about brand protection and reputation and the like. But once they got into it, it was as if a whole new world of opportunity and new markets opened up.

The Quarterly: *What do those executives and companies that are doing this well see differently?*

David Blood: The first is that they understand their long-term strategy. Secondly, they understand the drivers of their business—both financial and nonfinancial. The leading CEOs are the ones who explicitly recognize that sustainability factors drive business strategy.

In our minds, the best businesses have always understood the importance of culture and employees and ethics. And they get it in their soul. But what's now becoming true—particularly for the industrials, the retailers, the pharmaceuticals, the utilities, and a broader array of industries—is that managers are realizing that there are broader factors affecting how they operate. They can recognize that over the next 25 years their strategy will depend on leveraging new opportunities and must operate within the changing context of business.

The Quarterly: *Can you give us an example?*

AI Gore: In Denmark, Novo Nordisk clearly gets this. They take a holistic view and a long-term view. They look at the whole system. Take their presence in China. They went into China at a very early stage with genuine concern for what they could do to help forestall the diabetes epidemic there, which is growing at a faster rate than it is in the rest of the world due to the transition to a Western diet and lifestyle.

Novo Nordisk has 60 percent of the Chinese market for insulin and they're focusing their business plan on trying to cure and prevent diabetes. If they succeed then presumably sales of insulin will not increase at the current rate, but they think the problem is large enough that it is more important to address the root cause of the problem. This commitment comes out of the phenomena that David was just describing to you.

The Quarterly: *Is this approach possible in all sectors? Clearly, the pharmaceutical industry is an interesting case. Can you get there in tobacco? Fast food? Or are these just sectors that are fundamentally, somehow, no-go territory?*

David Blood: There are material sustainability challenges in all industries. In the fast-food or food-manufacturing industry, there's a very strong move toward healthy living and eating, organic food, and the implications for sustainable agriculture. And how do food companies deal with the upstream challenges of these trends, challenges such as water use? While we don't invest in it, the tobacco sector faces a whole host of issues which are very much sustainability driven—not just the health impact of the product. But, again, sustainable agriculture is a big story, as is litigation risk. In another sector, like financial services, the key sustainability issue is how a company manages its human capital. In the energy sector, climate change is one of the most significant issues. In the health care sector, we look at ethical marketing practices between companies and doctors. Even in industries like luxury goods there are issues around excessive materialism, authenticity, and consumption.

What I'm describing here is what we call a materiality-based approach to investing. Rather than looking at 50 different tick-box sustainability criteria, we think you need to tackle the three or four long-term issues that will really affect corporate profitability.

The Quarterly: *What examples come to mind of companies that have thought beyond managing sustainability risks and moved on to creating revenue opportunities?*

David Blood: A company like Johnson Controls, for example, is interesting because of its focus on demand-side energy efficiency. About 50 percent of its business is batteries for hybrid cars and products to run buildings efficiently, the other 50 percent is automotive interiors and controls. We think it's the former that's going to be growing and driving that company. They understand that their products will help reduce their clients' environmental footprint. This strategy is completely revenue driven. GE's Ecomagination is another example. If you think about how GE's stock price is going to trade, it's going to trade primarily on growth. Jeffrey Immelt knows this. He's betting his reputation and his company on the notion that the businesses related to the environment will enable GE to grow faster than GDP. In Mexico we cover two Mexican home builders that are linked to demographic trends and to the very strong demand and need for affordable housing in Mexico.

These are just some examples of how companies can see sustainability trends as growth opportunities or as new niches for existing products and services.

The Quarterly: *One of the important interfaces between the investing world and management is the board. What role do boards of directors play in trying to ensure that this kind of mind-set is embedded in corporate activity and communicated to investors?*

Al Gore: I think that the board of directors has a growing responsibility to address these very topics. As stewards of shareholder interests, boards should be focused on the long-term sustainability of the firm rather than on the market noise. If I were on the board of a company doing business primarily in the European Union, I would ask questions about how long it will be before my fiduciary responsibility required attention to the aggressive management of carbon. Because even though natural resources are not depreciated and even though pollution is treated as an externality and a reputation risk, where regulations and laws are involved, pollution now has an economic cost. And that cost is increasing.

The Quarterly: *Do you assess how the board compensates the chief executive?*

David Blood: Remuneration is a very specific area that we look at. In line with all the things we've already talked about, perverse short-term incentives in the financial system obviously are manifested at a corporate level by remuneration structures.

The Quarterly: *What must CEOs do more of?*

David Blood: Some are taking on a host of issues and seeing the interlinkages, but there's an enormous segment that is still single-issue focused. I think managing and understanding climate risk is the first wedge into that. You would hope that people then start to look at the second-order effects of climate change. I think one of the biggest things that CEOs can do is explain their longer-term story to the capital markets more forcefully. Increasingly, the research community is interested in the environmental, social, and governance factors that drive company strategy and is integrating these factors into mainstream research.

The Quarterly: *Can we explore climate change a bit more deeply? How do you think about that from an investing standpoint and what do you think that business should be doing that would help not just with climate change but with investment returns?*

Al Gore: There is a big story and opportunity around the supply side of cleaner energy. We would look for companies to recognize that carbon constraints will be more aggressive in the future. So we would expect to see opportunity in businesses that are involved with lower-carbon energy, including renewable-energy provision, such as wind, solar, and cellulosic ethanol² production. Or in businesses that are involved in cleaning up traditional fossil energy, which we see as a very big trend. Or in companies that are involved in technologies like carbon capture and storage (CCS) and sequestration-ready power plants.³

The demand side, we also think, is an underappreciated opportunity. The efficiency of buildings—insulation, specifically—is low-hanging fruit in terms of economic opportunity. The technology has existed for some time; it just needs to be deployed and implemented more effectively. There are also demand-side opportunities around sustainable mobility and transportation—for example, growth in hybrid vehicles or lightweight materials in vehicles.

The Quarterly: *What other indicators do you look for in gauging a company's approach to addressing a sustainability issue such as climate change?*

² Cellulosic ethanol is produced using enzymes to break down vegetation into cellulose (the primary structural component of plants), which is then converted into fuel.

³ Carbon capture and storage (CCS) is an approach to eliminating carbon dioxide emissions from sources such as power plants by capturing the carbon dioxide and then storing it underground in deep geologic formations instead of releasing it into the atmosphere. Sequestration-ready power plants have the appropriate technology equipment and locations to perform CCS.

David Blood: In addition to helping us assess the quality of a business model, a company's response to the climate challenge can tell us an enormous amount about a management team. We use its response and engagement in the issue as sort of a litmus test or a lens into the quality of the team. A company's lobbying practices are also an interesting line of inquiry around climate change. Auto companies are telling people that they're wonderfully green all of a sudden, but it's important to evaluate if they are concurrently lobbying against emissions reductions, for example. That gets you to the heart of what is the real truth in a company's culture. If they're lobbying for something different than what they're telling everybody, you've got a problem.

The Quarterly: *Any final thoughts for executives trying to understand this trend toward sustainability investing?*

Al Gore: Be part of the solution and not part of the problem. Your employees, your colleagues, your board, your investors, your customers are all soon going to place a much higher value—and the markets will soon place a much higher value—on an assessment of how much you are a part of the solution to these issues. *Q*

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