

TOWARDS SUSTAINABLE CAPITALISM

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The signs are overwhelming: we are rapidly depleting earth's capacity to support life. The increasingly extreme effects of climate change, rising rates of pollution-related illnesses and rapidly diminishing natural resources are all signs that we have been running on environmental credit for too long. While we have been able to temporarily overspend our means, the sustenance of future generations requires an end to the cycle.

To be sure, humans have applied various innovations to local environmental challenges and 'tragedies of the commons' in the past. Think of overgrazing of public lands or the sanitation challenges of early urban development. However, the effects of human-related environmental degradation are now so widespread¹ that they require a radical shift in how we relate to earth's natural systems. For too long we humans have viewed ourselves as separate from the rest of the animal kingdom and nature generally. Our enlightened long-term self-interest impels us to redesign our relationship with the rest of nature. This kind of shift is not unprecedented: just as our moral understanding of owning fellow humans (i.e. slavery) went through a transformation in the early and mid-nineteenth century,² our understanding of our effect on the climate, and on the survival of other species – not to mention our own – is also changing.

Currently, the closest thing to a global consensus on our environmental and societal problems is the United Nations' ratification of the Sustainable Development Goals for 2030 (SDG). The September 2015 agreement, 'Transforming Our World: The 2030 Agenda for Sustainable Development', sets out an ambitious, well-defined and measurable agenda of 17 goals with 169 measurable targets.³

While SDG represents laudable global vision, goal setting and economic growth alone will not achieve the kind of changes we need to fully realise the SDGs. We need stronger global governance structures, such as binding climate treaties, as well as strong supporting mechanisms, such as education, health, clean water and waste treatment, that promote human wellbeing while also pursuing economic progress.⁴

In all respects, the global multinational corporation plays a key role. Corporations are created –and mandated – to 'maximise shareholder value'. Unfortunately, this has been the pursuit regardless of their impact on ecosystems or societies. Consumption of finite resources and production of waste is rarely considered in a corporation's net present value calculation.⁵ Today's multinational corporations (MNCs) dominate and influence the global economy – and earth's natural systems – through markets, employment and the supply chain, as well as directly or indirectly through communities and political systems. Any attempt to forge sustainable economic growth must involve the corporation.

An effective means to influence corporations' behaviour – and thus their impact on the environment – is by controlling their access to capital. Even the world's largest corporations struggle or thrive by their cost of accessing capital. All corporate activity, including innovation, product development, service delivery, productive investment, expansion, merger and acquisition, depends on capital.

The great majority of today's financial system allocates capital with little to no regard for the environment or for long-term benefits to society. An exception is the 'sustainable and responsible investment' (SRI) community. The SRI community has the power to collectively influence the financial system by decisively influencing corporations' access to capital towards enabling sustainable development goals. SRI is rapidly gaining critical mass, as witnessed by the growth of Principles for Responsible Investing (PRI) signatories, but the combined effect of the SRI investors is still small, and tools and technologies related to sustainable investing are still developing.

At Auriel Capital, we are dedicated to driving the growth of the sustainable and responsible investing community, and to magnifying our impact by doing it better to create a more sustainable financial system. This document describes Auriel's understanding of sustainable development, our intended work towards a sustainable financial system, and our role within that system. Our manifesto is laid out in four sections covering:

- a brief discussion of the state of the planet
- the role of the multinational corporation
- the three levers of change available to each of us
- Auriel's commitments as an agent of change

In assessing the state of the planet, we group our thinking into three areas: issues related to environmental externalities, excessive inequality and the transparency of information. These can, of course, be extended to other, more specific, areas such as gender and racial inequality, but we've chosen to leave these for another essay.

Environmental Degradation

Current forms of capitalism fail to tax corporations *for the negative externalities* they create. While we'd like to believe that all of us will make the right personal choices to bring about a sustainable world, most of us need a nudge, and the easiest nudge is for the relative prices of goods and services to reflect their true cost and not just the costs the manufacturer couldn't externalise. We believe that if we properly price climate change, biodiversity loss and the impacts on local communities, capitalism can solve, rather than create, many of the complex issues we are facing. A popular example is a carbon tax where the 'tax' to emit carbon is roughly the cost of offsetting all the (social) costs of emitting carbon. While the exact price is widely debated, we can be sure of one thing— zero is not the correct price! Pricing is no simple task, but it is not impossible. Indeed, to achieve approximately correct prices is better than being precisely wrong.

Consider ecosystem services, the processes by which the environment provides resources used by humans such as clean air, water, food and materials. Establishing the economic value of ecosystem services is laborious due to the large number of assumptions and estimates involved, to which the TEEB Valuation database provides a good starting point.⁶ While global estimates expressed in monetary terms do not signify commoditisation or privatisation, they do help highlight the magnitude and comparability of ecosystem services. For example, in 2011 Costanza⁷ estimated the total global value of ecosystem services to be \$125 trillion per year. More importantly, the authors estimated losses to ecosystem services at between \$4.3 and \$20.2 trillion a year from 1997 to 2011. This loss to our natural capital is a 'tragedy of the commons'.

Excessive Inequality

Income and wealth inequality are characteristic of market-based economies. The promise of enjoying the benefits from one's own efforts has always been a powerful incentive to invest in innovating new ideas, and to accept risk as part of any investment. Recently, Thomas Piketty painstakingly demonstrated⁸ how income and wealth gaps have widened since the 1970s. He further argued that if the rate of return on wealth continues to exceed the economic growth rate, wealth, and by extension income, will continue to become concentrated.

Growing income inequalities can undermine the foundations of market economies and political systems, and endanger the wellbeing of even the best-off,⁹ in part by creating unequal opportunities that decrease social mobility and weaken incentives to invest in knowledge. The result is a misallocation of skills and labour, and eventually wasted labour productivity through more unemployment. This process ultimately undermines the efficiency and growth potential of market-based economies and threatens social and political stability.

Figure 1 offers an excellent visualisation of the distribution of income within and across countries.

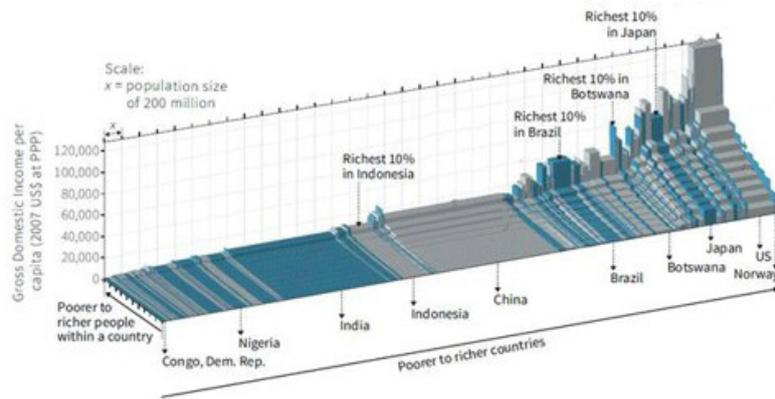


Figure 1. The distribution of income in the world. Height of the bars is the gross domestic income per capita (measured in purchasing power parity dollars) of the population decile indicated.

Source: Bob Sutcliffe designed the representation of global inequality in this figure and supplied the data. A first version was published in: Sutcliffe, B. 2001. *100 Ways of Seeing an Unequal World*. London: Zed Books.

To be sure, some degree of inequality may even be considered healthy due to its motivational effects. But current inequities are far from healthy, as illustrated in Figure 2. This chart depicts results of a survey asking United States citizens about the ideal and actual distribution of wealth in their country. Responses of those earning over \$100,000 a year and those earning under \$50,000 were reported separately. The actual distribution is shown for comparison.

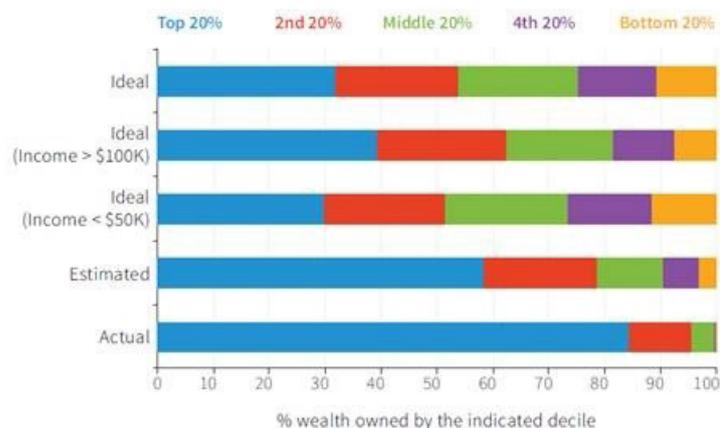


Figure 2. Americans' ideal, estimated and actual distribution of wealth.

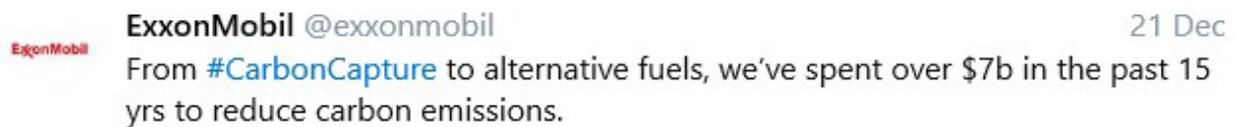
Source: Adapted from Figures 2 and 3 in Norton, M. I., and Ariely, D. 2011. *Building a better America—One wealth quintile at a time. Perspectives on Psychological Science, 6(1), pp. 9-12.*

Americans (both high and low income earners) are clear that they view some inequality as ideal, but they vastly underestimate the actual amount of inequality that exists.

Breakdown in Communication Standards

It is ironic that although access to information is *nearly* universal, the unequal distribution and presentation of information means that becoming well-informed is not at all easy. Too often, freely available, unbiased information is intertwined with biased news, advertising and entertainment – or worse, ‘alternative facts’ which mask or distort our understanding of the state of the planet.

Consider commercial players that push information to the consumer with no context provided to evaluate the relevance. The tweet below from ExxonMobil is a good example:



Source: Twitter, 21 Dec 2016.

At a glance, the fact of ExxonMobil spending \$7 billion on reducing carbon emissions sounds impressive, but it is paltry compared with the roughly \$320 billion that Exxon spent on total capital investment over the same period (and did not mention).

Global advertising spending hit half a trillion U.S. dollars in 2015 for the first time ever. This is comparable to the annual global investment in the electricity industry. The proliferation of the internet has brought the cost of news distribution effectively to zero, further enabling the 24/7 news cycle and creating an array of media outlets from which consumers can and do choose to support their world views. At the same time, ironically, media ownership is highly concentrated. In the U.S., for example, six corporations now control 90 per cent of the media, versus about fifty companies in 1983.¹⁰

Media owners depend on advertising for funding. Given the intense competition for audiences, private companies use psychological tools to manipulate public opinions to their commercial advantage.¹¹ An oft-cited study from Cardiff University found that over 60 per cent of local news stories in the quality national dailies came wholly or mainly from agency copy or public relations sources; a further 20 per cent had clear elements of wire copy and/or PR.¹²

It is increasingly difficult for any individual to distinguish between news, advertising and entertainment. This blur between advertising and unbiased information makes it more difficult to make educated and sustainable choices, whether it is at the voting booth as a citizen or at the shopping mall as a consumer. WikiLeaks, fake news sites and even the internationalisation of state-controlled media (Russia Today and China Central Television are examples) further complicate the picture.

The modern corporation, which allows many investors to pool capital and have their liability limited to their investment, took shape nearly 200 years ago and fuelled much of late nineteenth century growth. As the corporation gained power in legal status, the barriers to incorporation were loosened. In 1844, the U.S. Supreme Court gave the corporation explicit entitlement to pursue profit separate from social purpose. The U.K. followed in 1855 with the Limited Liability Act, which broadened the use of a corporate structure for conducting business. By 1889, there were only two British banks with unlimited liability. In the 1919 landmark case, *Dodge v. Ford*, the U.S. Supreme Court made it clear that the sole purpose of the corporation is to pursue profit for the shareholders.¹³

The large corporations that emerged between 1820 and 1920 in the U.S. and U.K. (Standard Oil, Rolls-Royce, JPMorgan) were the mascots of market capitalism, and the progenitors of today's large-scale corporations that practise international price arbitrage at every level of operation across the global economy. In his book *The Corporation*, Joel Bakan¹⁴ describes today's corporation as a psychopath – devoid of any moral compass, as it relentlessly pursues power and profits.

Multinational corporations (MNCs) today control enormous amounts of the global economy. About 1,500 global corporations control about 60 per cent of global revenues over cross shareholdings.¹⁵ Indeed, their financial power exceeds that of individual states. As an example, Fortune Global 500 companies generated \$27 trillion in revenue in 2016, which is more than twice the combined \$12 trillion in revenues collected by OECD countries.

Given their financial power, the world's largest corporations exert tremendous influence over global social and economic development. Consider these facts:

- Corporations are massive users of natural resources: about 3,000 corporations are accountable for a third of global environmental externalities.¹⁶
- Corporations influence political systems via donations and lobbying. In the U.S. alone in 2015, corporations reported spending \$2.6 billion on lobbying expenditures and comprise 95 of the 100 largest individual lobbyists.¹⁷
- The largest 500 corporations employ 67 million people globally. All corporations globally employ 600 million people.¹⁸

Corporate entities received 98 per cent of the patents in the U.S. in 2015, and around 90 per cent of the patents globally.¹⁹ It seems clear that MNCs are critical to any shift we make towards sustaining the planet. Consider the words of Ban Ki-Moon, United Nations Secretary-General from 2007 to 2016:

*Business is a vital partner in achieving the Sustainable Development Goals. Companies can contribute through their core activities, and we ask companies everywhere to assess their impact, set ambitious goals and communicate transparently about the results.*²⁰

THREE LEVERS OF CHANGE

We see three levers of change that can be applied to propel sustainable development. The levers are: individual choices, political choices and investment choices.

Individual Choices



Modern society lacks less the technical and scientific skills to build a sustainable capitalism, than the political will to act. For example, many current corporate sustainability initiatives are iterative improvements aimed at reducing unsustainable practices and implicitly promoting a business-as-usual approach albeit with a 'reduce, re-use and recycle' mantra tossed in. Although slowing the environmental destruction while we develop long-term sustainable solutions is laudable, we must eventually adopt a complete 'cradle to cradle' approach to industrial production.²¹

Achieving a change in political will is a slow and frustrating process. While we wait for the fruits of our labour for political change, we always have personal choice in how we shop, vote and invest our savings. For instance, if consumers stopped eating beef, Brazilian rainforest would cease being cut down to graze cattle and global warming would decelerate.²² This doesn't require political or corporate change. Nor does commuting by bicycle or using public transport.

Making decisive personal choices to align with a sustainable world can feel futile, as the impact of a single individual is so invisible even if it's entirely tangible and even measurable. This is why building community and networking with others committed to a future of flourishing on earth is so crucial. Collectively we have 100 per cent control through personal choice!

Political Choices

Governments must also guide corporate business practices towards sustainability, and 'we the people' must pressure our leaders to do so. We advance tax-driven regulatory options below, along with better regulation on advertising and political donations (in the USA).

Eliminating Harmful Subsidies and Taxing Externalities

Two industries that generate environmental havoc – fossil fuels and animal farming (though they are not alone) – currently enjoy generous subsidies in most industrialised countries. These subsidies effectively act a reverse tax on ecosystem-destroying activities.

A fossil fuel subsidy is any government action that lowers the cost of fossil fuel energy production, raises the price received by energy producers, or lowers the price paid by energy consumers. These include direct pre-tax subsidies such as direct funding and tax giveaways; and other activities, such as loans and guarantees to energy producers at favourable rates, and the provision of resources such as water and land to fossil fuel companies at below-market rates. So-called post-tax subsidies include environmental issues such as global warming and deaths from air pollution. These are just as real as pre-tax subsidies, though harder to measure, but since they have not been fully internalised, damages resulting from the use of fossil fuels are not borne by consumers; this constitutes a form of subsidy.

In 2014, Clements et al.²³ estimated global direct fossil fuel subsidies at \$492 billion. More recently, Coady et al.²⁴ estimated global direct and indirect (with social/environmental costs included) fossil fuel subsidies at \$5.3 trillion in 2015. This figure represents 6.5 per cent of global GDP. They further estimate that eliminating subsidies could have reduced global carbon emissions in 2013 by 21 per cent and fossil fuel air pollution deaths by 55 per cent, and could have grown revenues by 4 per cent while increasing social welfare by 2.2 per cent of global GDP.

As for animal husbandry, OECD countries together spend more than \$60 billion directly subsidising meat production. The agricultural subsidies have been justified to promote poor rural populations, yet less than 20% of current subsidies are used to benefit the rural poor inside the country. Meanwhile, the social costs of excessive meat consumption – potential to increase (childhood) obesity,²⁶ increased prevalence of cancer²⁷ and heart disease,²⁸ increased antibiotic resistance,²⁹ land degradation, carbon emissions, freshwater shortage and biodiversity loss³⁰ – are not considered in this total. To subsidise animal farming – particularly large-scale factory farming – is to subsidise harm.

Instead of subsidies, we can estimate externalities of all production processes and establish tax structures that capture the costs that private businesses (MNCs) pass to the rest of society. While not an exact science, taxing externalities is viable, and using the difficulty of establishing such a tax structure to hide behind a price of zero is unacceptable.

Tax the Use of Natural Capital

Some public choice economists argue that each individual in current and future generations deserves an equally proportionate share of ecosystem services.³¹ A tax on ecosystem services – or what public choice economists call ‘natural capital’ – would help realise this notion of social justice. A tax on natural capital is essentially a tax on the use of resources, for example, taxing carbon and other pollutants for diminishing our atmosphere, or taxing land and water use. A tax on the use of natural capital, if implemented, would help to redistribute global wealth, since the richest countries, which use a disproportionate share of the world’s resources, would have to compensate countries using less than their share of natural capital. Some proposed carbon credit schemes are based on this notion.

Such a tax system is commonly known as land value taxation (LVT), but the proposed tax structure includes not only the rental value of raw land, but the value of water use, pollution of the air, use of the sea's resources, and all other resources provided on the earth through no human effort (ecosystem services). LVT has a large amount of academic literature describing how such a tax system would operate.³² Essentially, the flow of ecosystem services gets auctioned off for tax revenue, and the stock of natural resources (if degraded) is taxed and invested to compensate future generations.

Economics Nobel laureate Joseph Stiglitz summarised his opinion of a natural capital tax like this: 'Would it be better if we had more taxation of land and natural resource, and more revenue from natural resource management (and I would include atmosphere and spectrum)? ... And I would say, "Yeah." And I think many economists would agree with that.'³³

Better Education and Regulation of Advertising

Two approaches can help improve communication standards: education and regulation. Our education system needs to teach both school children and public citizens about behavioural biases, and how marketing and advertising may manipulate their opinions to others' advantage. Public service announcements need to be broader in scope and much more pervasive and well-funded. For example, more 'Don't Drink and Drive' type television advertisements paid for by the taxpayer.

Regarding regulation, while it is difficult to know exactly where to draw the line, much more needs to be done. Endless and accelerating consumption of manufactured desire is harming humans and earth. As a specific case of failure, read how the U.S. Federal Trade Commission upheld the media's right to target sugary cereal ads aimed at small children on Saturday mornings, when they are likely to be alone in front of the television.³⁴

One starting point worth mentioning, given the United States' major role in the global economy, would be to overturn the *Citizens United v. Federal Election Commission* ruling, which effectively allows unlimited spending on political media by corporate entities without disclosure. A dissenting opinion by Justice Stevens argued that the Court's ruling 'threatens to undermine the integrity of elected institutions across the nation'.³⁵

Another important regulatory step is for corporate governance structures to require integrated sustainable corporate reporting, such as those advocated in the Global Reporting Initiative (GRI) and Sustainability Accounting Standards Board (SASB).³⁶ This would help investors, many of whom have signed onto the UN-sponsored Principles of Responsible Investing, make better-informed decisions when allocating capital.

Product labelling that includes environmental and resource-related information is another practical and potentially effective regulation that is similar to nutritional labelling on food. For instance, an Environmental Impact Unit could label products.³⁷

More Income/Wealth Redistribution

The social philosopher John Rawls³⁸ advocated choosing an amount of wealth redistribution to build into tax and spending policies behind ‘a veil of ignorance’. In other words, decision makers choose how much redistribution will occur in society without knowing exactly how the redistribution will affect the decision makers themselves. We need to strive for mechanisms where the decision makers for the level of wealth redistribution are not the currently wealthy. It seems clear, given human nature, that such political processes are going to under-redistribute.

A tax on wealth also forces the largest pools of capital to produce a material gain to remain large (i.e. to engage with economic decision making and productivity).³⁹ We recommend a wealth tax of around 1 per cent that is purely for redistribution from richer nations to poorer nations, in addition to taxing natural capital use and making the necessary transfers. (The SDGs recommend countries target 0.7 per cent of gross national income for development assistance.⁴⁰)

Investment Choices

Corporations’ cost of (and access to) capital determines the size and nature of their operations. The cost of capital is simply the expected return required by investors to provide capital for corporations. From the corporations’ point of view, it is the price of obtaining the funds to run their business. Creating shareholder value requires investing capital in a way that provides a return greater than the cost of capital. The lower the cost of capital, the more viable any project is for the corporation.

S&P Global capital surveys⁴¹ indicate that the largest 2,000 non-financial companies globally spend \$3 trillion annually to acquire or upgrade physical assets. These capital expenditures relate to companies’ operations, the kind of technologies they choose, where they build manufacturing capacity, when they replace existing capacity with new technologies, and their investment in research and development. The cost of capital impacts all of these decisions.

Investors play a key role in determining a company’s cost of capital. A quick analysis of a standard supply and demand curve shows that reduced demand (a downward shift in the demand curve) for a company’s shares will result in a lower share price. A lower share price implies that investors require a higher expected return from the company. The opposite is true for increased demand for a company’s shares: the demand curve moves upward and the price goes up, implying a lower expected return.

By allocating capital (buying and selling), responsible investors – indeed, all investors – have the power to shift companies’ cost of capital. By shifting the cost of raising capital, responsible investors can influence the direction of economic development by making it cheaper for sustainable companies to raise additional capital and more expensive for non-sustainable companies to do so.

The role of public equity markets in providing new risk capital is not limited to initial public offerings (IPOs). Listed companies raise additional equity through a so-called secondary public offering (SPO). Indeed, the amount of equity that OECD companies have raised through SPOs since 2009 was more than 14 times the amount they have raised through IPOs.⁴² This is one way companies fund the \$3.0 trillion each year on purchasing and upgrading physical assets.

Responsible investors have the power to influence the amount of capital firms can raise in their secondary offerings. To be sure, the effect on the cost of capital of any one investor may be miniscule, but we amplify the impact via our collective action. Momentum in sustainable investing is building, and we at Auriel Capital are proud to help lead the shift. Additionally, research from academia and industry peers, and practical and anecdotal examples from practitioners, decisively demonstrates that responsible investing can be done profitably.⁴³

At Auriel, we are committed to the collective goal of flourishing on earth by practising sustainable capitalism and responsible investment.

Our investment commitments:

- Using hedge fund techniques to decisively allocate capital from less sustainable to more sustainable companies.
- Dogmatically appreciating our fiduciary duty without compromising absolute returns.
- Pushing the industry forward with research and tools that promote responsible investing.
- Supporting the transition towards a sustainable financial system.
- Setting an example that the alternative investment (hedge fund) industry can be both sustainable and responsible by conducting our own operations as such.

Our political commitments:

- Supporting policies that promote income redistribution, elimination of harmful subsidies, taxing of externalities, natural resource use and responsible advertising.
- Supporting collective bodies that promote sustainable and responsible investment, such as PRI and Ceres.

Our personal commitments:

- Providing a work environment that allows for work-life balance.
- Reducing the footprint of our operations and offsetting the impact we cannot avoid.
- Encouraging sustainable commuting through economic incentives and flexible working hours.
- Encouraging plant-based diets for all employees through education and a policy of reimbursing only vegetarian meals during business travel.

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