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EDITORIAL

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Chief Investment Officer

The climate has changed

A huge step has just been taken in the fight against global warming. Ahead of the G20 meeting on September 4 and 5, the US and China ratified the global climate agreement negotiated at last year's COP 21 summit in Paris. Before the agreement comes into force, it must be ratified by a minimum of 55 countries representing 55% of global greenhouse gas emissions. News from Washington and Beijing means 26 countries representing 40% of emissions have now ratified the agreement. The US and China alone represent close to 38% of these emissions.

This strong signal was accompanied by a call from insurance companies representing more than US 1,200bn in assets for G20 countries to scrap fossil fuel subsidies by 2020. The urgency of the situation was also underpinned in a report from the World Wildlife Fund (WWF) released on September 1st which showed that global energy transition was underway and irreversible.

Such good news on climate change should not, however, overshadow challenges facing water supplies, one of our research team's top environmental priorities. This month's riots in Bangalore in India over access to the Cauvery River are just one example.

Lastly, concerning the much-publicised question of executive compensation in large groups, academic research uses simple common sense to remind us that shareholder involvement can influence pay packages for top executives.

Sustainable Finance and Responsible Investment Chair

Edmond de Rothschild Asset Management is a co-sponsor of the Sustainable Finance and Responsible Investment Chair which is co-managed by Ecole Polytechnique and the Toulouse School of Economics, under the aegis of the Association Française de la Gestion financière (AFG).

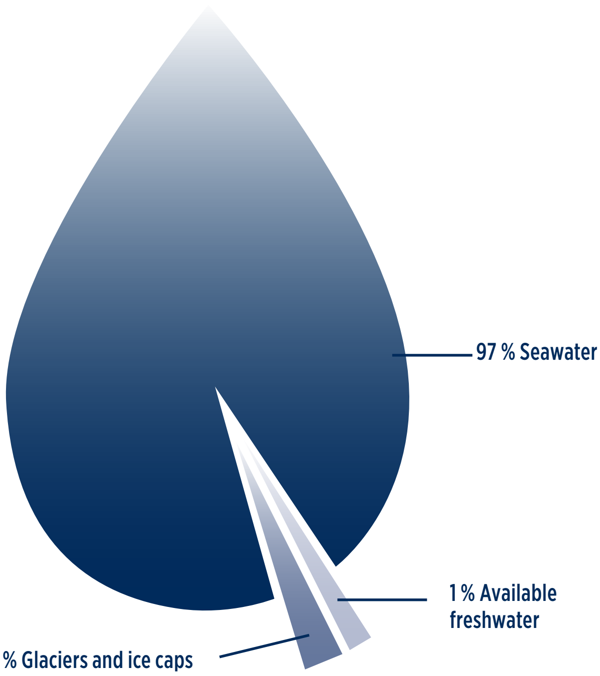
NEWS

WATER IS MORE ESSENTIAL THAN OIL

In 2016, California and Southern Africa suffered record droughts while more than 600 million people had no access to drinking water[1]. Water is increasingly sought after and needs to be protected. Blue gold is facing such significant challenges that the World Economic Forum has described water shortage as the biggest risk facing the planet[2].

Water is a rare resource. It is estimated that only 1% of the water on the earth is usable. According to the USGS[3], salt water represents 97% of total reserves while 2% of freshwater is frozen in ice caps and glaciers. Liquid freshwater reserves, meanwhile, are unequally spread between countries with large supplies and an increasing number of countries which are suffering from water stress[4].

More than **600 million people** had **no access to drinking water**



Source: USGS and Edmond de Rothschild Asset Management

At the same time, global warming, along with population growth and rising per capita water footprints[5] are putting increasing pressure on resources and exacerbating competition between water users and usage.

Water is central to most of our activities, whether agriculture, industry, and domestic and even recreational needs. People talk about the "virtual water" needed to make a product or deliver a service. For example, an estimated 10,000 litres of water on average are used to make a kilo of cotton while a kilo of beef requires close to 15,000[6]. This means 2,500 litres of water are used to irrigate the cotton needed for just one T-shirt and 3,500-4,500 to put a steak on our plates.

At the OECD Forum in 2012, Peter Brabeck-Letmathe, who was then chairman of Nestlé, said: "We are going to run out of water much faster than oil». This underlines the growing value of water even if some still view it as a commodity. However, unlike oil, water is a renewable source. Technological progress is opening up a significant array of potential solutions like using big data to model rainfall for more intelligent watering of crops or biochemical advances which make sea water desalination by reverse osmosis more accessible[7]. If we are to preserve blue gold, we will have to change our consumption habits and production methods.

1. UN Water, 2016 United Nations report on Water, p.21 (http://www.unwater.org/publications/publications-detail/en/c/396246/).
2. World Economic Forum, Global Risks 2015 10th Edition, p17 (http://www3.weforum.org/docs/WEF_Global_Risks_2015_Report15.pdf).
3. United States Geological Survey (http://water.usgs.gov/edu/earthwherewater.html).
4. Severe water shortage due to demand outstripping available resources.
5. An indicator used to assess and compare consumption patterns.
6. Source: Water Footprint Network, product gallery (http://waterfootprint.org/en/resources/interactive-tools/product-gallery/).
7. Water purification using a micro filter which only lets water molecules through.

FROM AN ACADEMIC POINT OF VIEW

THE SHAREHOLDERS' INVOLVEMENT AFFECTS EXECUTIVE COMPENSATION

The policy of CEOs compensation depends on the ownership structure of the company. In particular, the level and structure of remuneration differ according to the degree of involvement and the investment horizon of the controlling shareholders. The so-called passive or diversified shareholders, little involved in the control, pay the highest compensation levels, other things being equal. Shareholders whose investment horizon is relatively short pay bonus ratios that are higher and more sensitive to annual performance. The assessment of remuneration policies must take into account the type of control carried by the shareholders.

The executives' compensation has increased substantially since the 1980s in the United States. In other industrialized countries, and particularly in France, the evolution over a long period is difficult to establish because of the lack of transparency on the subject before the 2000s. However, changes in revenues of the 1% richest, including executives of large companies, show that their rise has also accelerated since the late 1990s[1]. The purpose of the paper presented here[2] is to better understand what determines large listed French companies' executives' compensation and, in particular, to assess the effect of major shareholders' control's nature and strategy on compensation policy.

The 2001 NRE law, improved by the 2005 Breton law, imposed to disclose executives' compensation in French listed companies. Based on information published in annual reports, we have built a database on compensations and ownership structure for the SBF 120 companies between 2005 and 2012.

A SINGULAR TYPOLOGY OF CONTROL

In order to differentiate the ownership structure, we propose a typology based on two main criteria: (i) the degree of involvement in the control of the company and (ii) the investment horizon of controlling shareholders.
The controlling shareholder is defined as the main shareholder of a company, provided her/she holds over 10% of the capital and is represented on the board of directors (or supervisory board).
The objective is to assess whether these criteria are relevant to highlight separate compensation practices, both for the compensation level (fixed salary and total compensation[3]) and for the compensation structure (bonus ratio and equity-based compensation).
The typology comprises eight categories. The first four, presented in the table below, concern a patrimonial type of shareholding. In the event that the CEO is not a member of the controlling family (hired CEO), the typology distinguishes between active and passive family shareholders according to an original criterion of experience in the company management. A shareholder family of which no current member on the board has operational experience in the company management is assumed passive and exercising low effective control on the CEO's activity (low degree of involvement).
The diversified nature of the shareholder (the family conglomerate, attached to the passive family, or investment firms) also contributes to assume that the degree of effective control is moderate. The investment time horizon is supposed long for patrimonial or State ownership. The horizon of control is also assumed relatively long when the control is exercised by another company in the same sector, anxious to implement an operational strategic policy (synergies ...)[4]. The horizon shortens however when the strategy is more financial and seeks a yield or capital's gain at medium term (investment firm) or short term (diffuse ownership).

Lionel Almeida

Lionel Almeida is a lecturer at the CNAM and teaches corporate finance. He graduated from ESCP Europe and served several years in the auditing and consulting sector, before starting a doctoral thesis in Economics at the University Paris Nanterre. He is interested in the economics of inequality and high income, corporate governance and especially in executive compensation policies and the ownership structure of large listed companies.

OWNERSHIP TYPOLOGY			
TYPE	MAIN CHARACTERISTICS	DEGREE OF INVOLVEMENT	TIME HORIZON
INDIVIDUAL OR FAMILY OWNERSHIP:			
(1) CEO-CONTROLLED	The CEO is also the controlling shareholder.	N/A*	Long-term
(2) HEIR FAMILY	The CEO is a member of the controlling family.		
(3) ACTIVE FAMILY, NON-EXECUTIVE	Founder of the controlled firm, or heir of a former top manager. Hired CEO.	High	
(4) PASSIVE FAMILY, NON-EXECUTIVE	Heirs without management experience in the controlled company, or family conglomerates. Hired CEO.	Low	
INSTITUTIONAL OWNERSHIP :			
(5) PUBLIC SECTOR	The controlling shareholder is the State or a State agency (i.e. Strategic Investment Fund).	High	Long-term
(6) PARENT COMPANY	Parent company from the same or complementary industry.	High	Medium/Long-term
(7) INVESTMENT FIRM	Portfolio companies (mainly private equity firms) or family conglomerates.	Medium	Short/Medium-term
(8) NO BLOCKHOLDER (DIFFUSE OWNERSHIP)	No shareholder holds more than 10% of the shares. Minority shareholders.	Low	Short-term

*: Not applicable Degree of involvement, no separation between controlling shareholder and CEO.

NATURE OF CONTROL AND COMPENSATION POLICY

The econometric study of the shareholding impact on compensation policy leads to establish several conclusions. First, the shareholding structures considered passive and/or diversified (passive family, investment firm) and diffuse ownership offer their executives, other things being equal, the higher compensation levels. In contrast, the controlling shareholders whose involvement in the control is strategic (public sector, parent company) or experienced (active family) offer their executives significantly lower compensation levels.

The compensation structure also differs from one control category to another. Shareholders whose strategy is seen as financial and with short-term investment horizon (investment firm, diffuse ownership) define compensation packages with a higher bonus ratio, unlike shareholders whose participation is strategic (State) or patrimonial (families) with a long-term investment horizon. The bonus sensitivity to annual performance criteria (ROA, Tobin's ratio...) is stronger for the former than for the latter.

Finally, regarding equity-based pay, their share in total compensation differs little from one type of ownership to another, but their sensitivity to annual performance is more pronounced for the diffuse ownership.

The differences in compensation between shareholder groups are found to be significant in terms of statistics but also of monetary value. Take a median CEO in our panel who receives a total compensation of 1.93 million euros. According to econometric estimates, this same CEO will receive approximately 50% and 20% less if his controlling shareholder is, respectively, the State or a parent company, and about 20%, 25% and 90% more if his ownership is, respectively, an investment firm, a diffused one or a passive family.

CONCLUSION

The evaluation of listed companies' compensation policy must take into account the type of control exercised by the major shareholders. When control is high, the level of pay is substantially lower in line with lower operational responsibility of the CEO and the lesser delegation of control. These low relative levels should therefore not give the opportunity to the executive officer to negotiate upwards his compensation on the only argument of comparing to peers.

Finally, high ratios of variable remuneration sensitive to performance are not always a sign of good governance because they can be associated with short term shareholding strategies. Conversely, apparently less incentivizing compensation structures can be associated with committed shareholders and long horizon, that have the capacity to effectively monitor the implementation of performance targets, bypassing incentive tools. The observer can then focus on evaluating the financial and non-financial targets' quality and take a more critical look at standardized and annual performance criteria that carry the risk of giving short-termist and strictly financial incentives to the CEO.

1. See the papers of Camille Landais (2007) and Olivier Godechot (2011).

2. Almeida L., The level and structure of CEO compensation: Does ownership matter?, Revue d'Économie Politique, 2014/4.

3. Total compensation is the sum of cash remuneration (fixed salary and bonus) and remuneration in securities (stock options, free shares or performance shares).

4. A financial company that controls another financial company is included in this category. Unlike a widespread idea, at comparable size and shareholder's structure, financial and nonfinancial companies have a similar behavior in terms of remuneration policy for their manager in our panel.

MEET THE COMPANIES

BONDUELLE

Founded in 1853 by Louis Bonduelle, the Bonduelle Group specialises in processed canned, frozen and fresh-cut vegetables. Vegetables are grown over 128,000 hectares and sold in a hundred different countries using various distribution circuits.

© Bonduelle.

We recently visited the Estrées Mons factory in the Somme department. The site is the world's largest vegetable processing factory for canned and frozen foods. The accent is on local suppliers as the factory processes vegetables grown within 100km. We saw how peas were picked and sorted before being frozen or canned. They are canned or placed in cold storage less than 4 hours after being picked.

Farmers are covered by the group's suppliers' charter which has more specific requirements with local variations. The group's target is to foster ecologically intensive agriculture based on sustainable farming and unconventional farming methods. Relations with farmers are stable with less than 5% in supplier turnover.

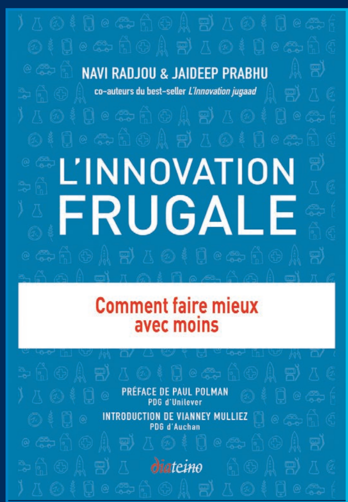
Bonduelle's VegeGo! Programme[1] aims to make the group a world leader in healthy vegetarian eating. This strong accent on health is underpinned by the group's products which have improved their nutritional profile. In the last 10 years, for example, Bonduelle has reduced salt content in its products by 40%.

1. In 2012, Bonduelle started a new phase of development by officially launching VegeGo! This company project defines Bonduelle's future for 2025 and was co-founded by employees, general management and shareholders.

RECOMMENDED READING:

Frugal innovation is a revolutionary strategy. But it is much more than that as it illustrates a new mindset that treats limited resources as an opportunity rather than a handicap. As resources become rare, this ground-breaking growth strategy depends on five major trends: collaborative consumption, the circular economy, the makers community, sustainable development and digital technology.

Frugal innovation seeks to use fewer resources while better meeting consumer needs. The movement has extended the horizons of many industries. The two authors are keen to stress that frugal innovation is not the same as low cost; rather it embraces notions of quality, simplicity and sustainability. Numerous examples of pioneering companies make this book a fascinating read.



FRUGAL INNOVATION

Doing better with less

Navi Radjou, Jaideep Prabhu

Les Editions Diateino*, *2015 *(300 pages, €24)*

THE SRI TEAM IN ACTION

JEAN-PHILIPPE DESMARTIN APPOINTED HEAD OF THE RESPONSIBLE INVESTMENT TEAM

Jean-Philippe Desmartin has joined Edmond de Rothschild Asset Management as Head of the Responsible Investment team. He will be based in Paris and report to Philippe Uzan, Chief Investment Officer.

Jean-Philippe Desmartin took up his position as Head of our Responsible Investment team on September 12 2016. He is a graduate of the Paris University II (business law and management) as well as the IEP in Paris (finance and economics). He started his career in 1993 in the financial engineering department at Crédit Du Nord. From 1997 to 1999, he was a project manager at the Alpha Group before moving to the extra-financial agency ARESE as Head of Development. In 2003, he was a director at Innovest and then in 2004 founded his own consultancy business, Desmartin Conseil. From 2005, he was Head of ESG (Environment, Social and Governance) research at Oddo Securities.

A member of several working groups and international committees seeking to further ESG issues (the European Federation of Financial Analysts Societies - EFFAS, the International Corporate Governance Network - ICGN, Principles for Responsible Investment - PRI, World Intellectual Capital Initiative - WICI), Jean-Philippe Desmartin also chairs the research commission at the French Forum pour l'Investissement Responsable. He has co-written three books on Responsible Investments, L'Investissement Socialement Responsable (2005), ISR et Finance Responsable (2014) and The Routledge Handbook of Responsible Investment (2015). His practice was the object of a business case conducted by the Harvard Business School (HBS) in 2011. Last year, his work was recognised as innovative by an international jury of academics and institutional investors at the Investment Innovation Benchmark (IIB).

Publication director: Philippe Uzan – Photo credit: Istock by Getty images.

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