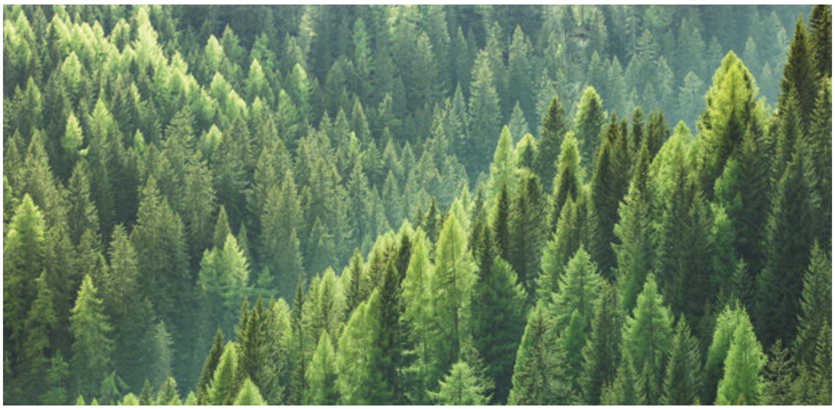
The ESG Factor

06 February 2019 by Gareth Thomas



Responsible investing has transformed from a United Nations Global Compact initiative into a mainstream investment trend

First mooted some 15 years ago, responsible investing is widely understood as the integration of environmental, social and governance (ESG) factors into investment processes and decision making at equity and debt funds. It covers a range of issues not traditionally part of financial analysis, but which may have financial relevance. This could include issues such as managing carbon emissions or water usage, how workers are treated, how accidents are prevented or whether there is a culture that fosters trust and innovation.

The idea was first put forward by Kofi Annan in January 2004, who invited over 50 CEOs of major financial institutions to participate in a UN Global Compact initiative, designed to integrate ESG into capital markets. This was followed a year later by a UN report entitled Who Cares Wins which made the case that embedding environmental, social and governance factors in capital markets was good business sense, leading to more sustainable markets and better outcomes for societies. The publication of Who Cares Wins was the springboard for the UN-supported Principles for Responsible Investment (PRI).

Despite these initiatives, however, institutional investors were slow to embrace the idea, arguing that their fiduciary duty was limited to the maximisation of shareholder value. Even the financial scandal of 2008 failed to provide the impetus needed to propel ESG investing into the mainstream.

Financial performance

While it has long been clear that a corporate scandal can decimate share value, and not just in the immediate aftermath as the gory details hit the headlines, investors needed more concrete evidence that embedding ESG factors produced strong financial performance.

In 2014, academics and investment bankers produced the first major meta study to show the link between good corporate ESG performance and financial performance. According to Georg Kell, founding executive director of the UN Global Compact, the study showed 'how financial performance goes hand in hand with good governance, environmental stewardship and social responsibility'.

The Chartered Governance Institute
Saffron House, 6-10 Kirby Street, London EC1N 8TS, United Kingdom

found wanting and are mired in scandal such as Volkswagen, Tesco,Toshiba and Rolls-Royce. As recently as summer 2018, the share price of all four companies was still 30-40 percentage points below their pre-crisis peak, underperforming the market in a period of general growth in equity markets (the FTSE for instance grew 15% between 1 Jan 2014 and 1 May 2018).

Future prospects

Clearly investing in companies with a material risk of unethical or illegal practices goes against the shareholders' fiduciary duty. Consequently, investors are increasingly looking for indicators of long-term sustainability that will ensure their capital investment is protected from the damaging impact of scandals. As such, investment analysis that focuses solely on financial performance has been in decline over the last ten years. Instead, we now see more and more investors analysing ESG-related goals alongside financial performance.

The London Stock Exchange states that ESG information has moved from a 'peripheral' to a 'core' part of investment analysis, estimating that 60% of assets managed for EU investors incorporate sustainable investment strategies. ESG performance is now routinely used to draw conclusions about management quality, exposure to business and ethical risk and the ability to gain a better understanding of companies' future prospects.

A recent survey by BNP Paribas found that 79% of institutional investors incorporate ESG into their decision-making, while Morgan Stanley reports that 84% of asset owners are pursuing, or actively considering, incorporating ESG into their investment process.

One of the champions of ESG investing is Larry Fink, chairman of BlackRock, who writes an annual letter to chief executives reminding them not only of their responsibilities as business stewards but of the demands being placed on them by their owners, namely the institutional investors. Last year, as BlackRock approached its 30th anniversary, Fink's letter focussed on the need for businesses to engage with improving long-term value, demonstrating sustainable growth and articulating a clear purpose.

> *"Fund managers are not investing in building ESG teams to tick boxes or review paper"*

This chimed with other demands being placed on executive management and boards. Sir Win Bischoff, chairman of the Financial Reporting Council has long been urging companies to abandon quarterly reporting in favour of 'viability statements' introduced by the FRC in 2014 to strengthen boards' attention to the longer term, sustainable value creation. Such statements, he argues, should provide shareholders with an improved picture of the state of the business, its prospects and its contribution to the public good.

Speaking ahead of the FRC's consultation on the UK Corporate Governance Code, Sir Winn Bischoff stated that 'Values, behaviours and corporate culture are central to the way an organisation achieves its objectives and embeds an effective governance structure. By weaving these attributes into a business model, companies are not just contributing to the overall success of their business but creating an environment on which stakeholders can depend. And in that way, they create sustained growth for the long term.'

Smart algorithms

So, how is ESG information being collated and what should businesses be doing? Speaking recently at GoodCorporation's Business Ethics Debate at the House of Lords, Georg Kell highlighted how technology and the drive for transparency have contributed to and will sustain the growth in ESG analysis.

Gathering and processing data is becoming easier and cheaper. Smart algorithms will increasingly enable better interpretation of non-traditional financial information.

their ESG performance in order to access this rapidly expanding source of debt and equity funding. Investors increasingly require genuine commitment to ESG values and will become ever more demanding of the quality and veracity of reporting ESG performance. Independent verification attracts a stronger weighting in ESG performance collected by indices and this is a sign of things to come.

This can be a challenge for companies. Some businesses are starting to put plans in place to assess, measure and manage ESG issues with a view to obtaining ESG investment. The European Federation of Financial Analysts Societies has defined topical areas for the reporting of ESG issues and has developed Key Performance Indicators for use in financial analysis of corporate performance, identifying nine topical areas that apply to all sectors and industries.

These are:

- Energy efficiency
- Greenhouse gas (GHG) emissions
- Staff turnover
- Training & qualification
- Maturity of workforce
- Absenteeism rate
- Litigation risks
- Corruption
- Revenues from new products

Established reporting on environmental and governance issues make the 'E' and the 'G' relatively easy to measure and manage, however the 'S' can prove problematic. What is socially responsible to one investor may not be to another. Social indicators and impacts will also vary from company to company, sector to sector and from time to time, as social mores change.

Social responsibility

Measures to consider in order to demonstrate social responsibility include employment terms and conditions; health and safety records; mitigation of human rights and modern slavery risks; diversity and non-discrimination; anti-corruption procedures; freedom of association; impact on the local community as well as safety and security issues.

Recognised standards for ESG performance are only just starting to emerge. Some are using the Global Reporting Initiative standards or the PRI ESG Integration framework as a starting point.

An increasing number of businesses, however, are taking this seriously developing a pro-active approach to ESG in order to provide tangible evidence of their commitment to sustainability, integrity and good governance as well as strong financial performance. GoodCorporation is working with companies which are looking to review their performance against ESG indicators.

In some cases, we have used a bespoke ESG assessment framework to identify strengths and weaknesses and point to potential solutions or mitigation. Investors are not just interested in companies with good ESG scores. They also want to invest in businesses that are working hard to improve themselves: improving companies want to do the right thing and this will pay off further down the line.

In the companies where such assessments have taken place, the response from various stakeholders including employees, customers and suppliers has been overwhelmingly positive, with noticeable benefits in terms of staff motivation and productivity, better customer engagement and improved relationships with suppliers.

It is early days, there will be those that feel threatened, or who feel ESG can be superficially addressed or manipulated with a little bit of 'greenwashing.' But despite these reserves, the evidence from capital markets is that when it comes to investment, financial performance plus ESG performance is here to stay.

Have your say