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Environmental, Social and Governance Factors…

Gaining Momentum in Mainstream Investing . . . or Not?

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A Market Incongruity?

There is a persistent disconnect between the long-term interests of investors and many companies and the short-term focus of a large number of investment professionals. Numerous initiatives have been formed recently to try to tackle this gap between long-term theory and short-term practice. European asset managers and analysts met in late August 2005 in Zurich and noted the "remarkable" and "phenomenal" growth in interest in the issue since it was first addressed at their June 2004 meeting. That gathering marked the release of the UN Global Compact-sponsored report *Who Cares Wins: Connecting Financial Markets to a Changing World* in which 20 financial firms strongly advocated the integration of environmental, social and governance (ESG) factors into mainstream investment analysis.

The discussions in 2004 noted how more investing is being carried out by individuals and institutions that rely on their investment decisions for their future financial security. These interests logically are more focused on the security of longer-term returns than on immediate market performance. This is especially so in the face of decreasing pension benefits and increasingly stressed national financial security institutions, such as the U.S. social security system.

Discussions also noted that the global business context is changing and that sustainability issues are becoming more important. The market has created a distance too great between interests that should be working in concert with each other but are, in fact, out of alignment. Participants both this year and last considered how risks and opportunities of including the ESG perspective should be re-evaluated to improve alignment between goals that are treated as if they are mutually exclusive.

Mixed Signals

"Investing for Long-Term Value," the latest meeting in which The Conference Board participated, was convened by the Swiss Federal Department of Foreign Affairs, the UN Global Compact and the International Finance Corporation. It focused on whether there had been progress in integrating "soft" factors to the analysis and actions of those within the financial industry in the intervening year. Nearly 90 invitation-only participants took part in a discussion held under Chatham House rules. Notable themes of discussion included:

- There has been a flowering of collaborative and complimentary initiatives during what was termed an "exceptional" year.
- While evaluation of ESG factors has been mainstreamed via the commitment of some individuals, this has not translated into institutionalization where they work.
- Despite the general acceptance of their importance, the extent to which ESG issues are considered material and not just important remains open to question.
- Analysts are uncertain whether they should be the initiators and are looking to client demand to spur interest in the research that is still needed.
- There remains a transatlantic gap in that there is much higher appreciation of these issues in Europe than in the United States. The majority of dedicated ESG research efforts from major investment houses are based in London.
- There is also a gap and challenge in how ESG issues can be adapted and used in emerging markets, where they are viewed with suspicion and mistrust. There, ESG is sometimes seen as another name for protectionism.
- The potential for ESG integration is at a critical point – its promise is as high as is uncertainty over its future.

This uncertainty was brought home further in the June 2005 report by The World Business Council for Sustainable Development (WBCSD) Young Managers Team (YMT) and the United Nations Environment Programme Finance Initiative (UNEP FI), *Perspectives – Generation lost: young financial analysts and environmental, social and governance issues:*

> Our work suggests that this anticipated "generational change" is not happening. Young analysts appear unconvinced over the materiality of most environmental, social, and governance issues to business; unable to consider them because of inadequate information, training, or tools; and unwilling to depart from business as usual because of conflicts with remuneration, career advancement, or culture.[1]

A Volatile Issue

Despite developments noted above, whether ESG factors can and should be factored into mainstream investment analysis remains a volatile issue. Advocates in the Socially Responsible Investment (SRI) community and many rating organizations, such as CORE Ratings and Innovest, argue strongly in the affirmative. At the same time, many in the mainstream community contend that ESG factors are often imprecise and difficult to measure with comparable specificity than are more traditional criteria, such as free cash flow. Thus, while funds managed under the SRI "banner" have increased dramatically in recent years, they still represent a tiny portion of the total money under management worldwide.

A major part of the challenge is related to the perceived dichotomy between *normative-ethical* investment rationales (frequently used as the basis for SRI investment decisions) and purely *financial* rationales. In

[1] *Generation lost: young financial analysts and environmental, social and governance issues,* World Business Council for Sustainable Development Young Managers Team and the United Nations Environment Programme Finance Initiative, 2005. http://www.wbcsd.org

normative-ethical reasoning, ESG factors may be the "right thing to do." Investment decisions are often screened on predetermined yes/no bases. Investment decisions may be "mission-based" or "activist" in nature, and companies may be rated for commitments and activities, often irrespective of measurable value impacts.

Conversely, if ESG risks and opportunities can be specifically identified, probabilities assigned and prospective financial value impacts estimated, the potential grows that such factors can be integrated into investment analysis. The challenge has been that this frequently is not easy to do — both because of the often uncertain nature of the outcomes for ESG risks and opportunities and the unclear time frame within which they may occur.

Companies Leading?

As demonstrated through the rapid, if eclectic, growth of non-financial reporting (EH&S, sustainability, citizenship, CSR, and the like), an increasing number of companies are aware of the potential significance of ESG issues and have sought to position themselves publicly on them. In the process, they are expending more and more resources on these issues, struggling, in many cases, to measure performance and results, and increasingly seeking to understand the value of these efforts to the business in both near and longer terms.

If and as ESG factors become more important to company valuation (as the trends hint), their most precise and accurate measurement and interpretation may come from companies rather than rating organizations or other outsiders. It would be ironic if factors that many companies have long considered peripheral to their primary "mission" are ultimately best defined, measured, and communicated to the financial community by the companies themselves. This is as it should be, perhaps, but the process certainly has not evolved in this way to date.

Emerging Signs

There are specific signs, however, that the situation may be changing and that momentum is gathering for greater integration of ESG factors into mainstream investment analysis. While the signs are relatively few in number and geographically dispersed around the world, there is a discernable trend underway. In addition to the recent discussion in Zurich, evidence of this trend includes, but certainly is not limited to:

- The World Economic Forum (WEF) published the January 2005 report *Mainstreaming Responsible Investment,* which presented in-depth the need for broader criteria for evaluating companies' long-term-value potential and the extensive institutional barriers to meeting this need.[2]
- The United Nations, through UNEP-FI and The Global Compact, has focused on this issue. As noted above, in June 2004, in partnership with 20 major financial institutions, the UN published *Who Cares Wins*. In the report, the mainstream investment community was strongly urged to incorporate ESG factors into its analysis and decision-making. The UNEP-FI – Global Partnership is also engaged in an ongoing project with a number of financial institutions and others to develop the Principles for Responsible Investing (PRI), which is expected to be complete in late 2005.
- A group of institutional investors (primarily in Europe) has created the Enhanced Analytics Initiative (EAI). EAI members reward firms that integrate ESG factors into their analyses with preferential business.

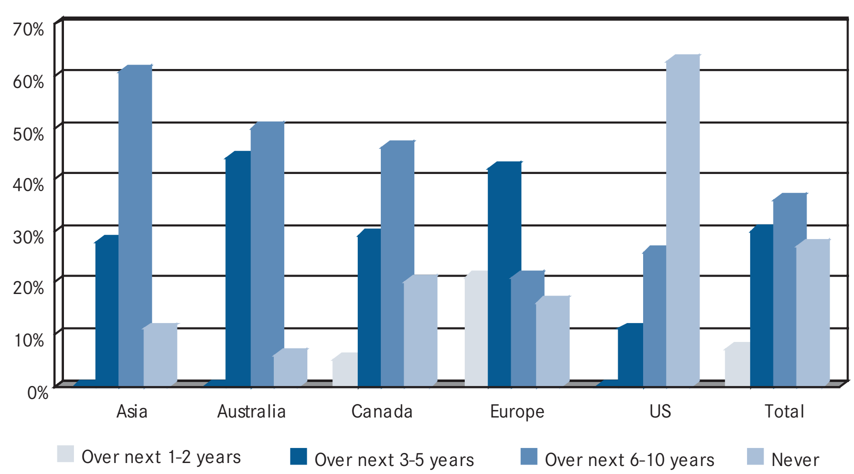
[2] Simon Zadek, Mira Merme and Richard Samans, *Mainstreaming Responsible Investment,* World Economic Forum and AccountAbility, January 2005.

- A number of investment firms, such as Goldman Sachs, Deutsche Bank and Morgan Stanley, have conducted and published research findings that integrate ESG factors (whether a broad range or single factors, such as climate change) into their analyses. SG Cross Asset Research recently engaged with CoreRatings to produce the April 2005 report *SRI Impact on Valuations* in which 200 European companies were rated.[3]
- In the United Kingdom, two factors have recently increased focus on the importance of ESG issues for investment value: the 2000 UK Pension Fund decision to include ESG performance as a part of the investment decision process and the recently adopted Operating and Financial Review (OFR) by which public companies of a certain size are required to report on the potential materiality of a broad range of issues to a diverse community of stakeholders beyond solely their shareholders.

Much, but certainly not all, of the activity in this area is focused in Europe and is much less prevalent in the United States, for example. Indeed, when Mercer Investment Consulting surveyed 195 investment managers around the world in late 2004, it identified major regional differences in perception of the current and future significance of environmental and social (ES) factors for investment analysis (there was no inquiry into governance).[4]

Clearly, investment managers in Asia, Australia, Europe and Canada see a more rapid growth of the incorporation of ES factors into investment analysis than do their counterparts in the United States (See chart below). However, there continues to be steady growth in reporting on ESG factors by U.S. companies, very likely reflecting the increasingly global nature of their operations and perhaps of their investors.

Anticipated timing for integrating environmental and social factors into mainstreat investment analysis



Source: 2005 Fearless Forecast Survey, Mercer Human Resource Consulting LLC and Mercer Investment Consulting, Inc., 2005.

[3] Patrick Legland et al., *SRI Impact on Valuations,* SG Cross Asset Research and CoreRatings, April 2005.

[4] *2005 Fearless Forecast,* Mercer Human Resource Consulting LLC and Mercer Investment Consulting, Inc., 2005.

Key Challenges: Materiality and Measurement

Investment analysis protocols and standards have evolved over many years and the fundamentals are well understood by analysts, even though there is flexibility in how such key concepts as "materiality" may be measured and assessed. While the U.S. standard for assessing materiality is closely governed (although still allowing for varying interpretations) by the Securities and Exchange Commission (SEC), elsewhere — especially in Europe — there is greater diversity and flexibility in interpretation and reporting standards.

When the diversity of ESG factors and their varying relevance for companies in different sectors is combined with effects that are frequently difficult to quantify and time, it is not surprising that mainstream financial analysts find it challenging (at best) to incorporate these into their analyses. Accurate measurement is essential for assessing potential impacts, and, as discussed in the recently published The Conference Board report, *The Measure of Success: Evaluating Corporate Citizenship Performance*, such measurement is often difficult to do.[5] Thus, it becomes even more problematic to assess the potential materiality of ESG factors and their impacts on businesses, leading many analysts to not even try to do so. This decision is reinforced by the perceived infrequency (with such periodic, dramatic exceptions as Bhopal, Exxon Valdez, and Enron) of significant, material impacts to companies.

Yet there is a steadily — if somewhat sporadically — growing sense of the importance of ESG factors as business becomes more global, the population continues to increase rapidly, greater stresses on earth resources and systems are seen, and global socioeconomic challenges expand (e.g., poverty, health and disease, access to education). Relating these types of issues to risks and opportunities for specific businesses is not easy, but it is increasingly being seen as both necessary and important for a full assessment of the potential sustainability — and value — of a business.

The Research Working Group to Integrate ESG Risk Factors in Financial Market Practice

In response to the need identified in *Who Cares Wins* for analytical approaches and tools to more effectively assess the importance of ESG factors in investment decision-making, The Conference Board's Corporate Citizenship program, in collaboration with onValues, a Swiss investment management firm, and the UN Global Compact Office, convened a Research Working Group in fall 2004 to develop a methodological framework to help analysts identify ESG factors relevant to 10 sectors and evaluate their potential significance for individual companies.[6]

The Working Group's goals were to:

- Assist financial analysts to more effectively integrate assessment of potential material impacts of ESG factors into their valuation of companies in 10 sectors, consistent with recommendations in *Who Cares Wins.*
- Develop a "framework" for analysis of such factors and provide summaries of the most important factors for the targeted sectors. The resulting framework is not prescriptive but is a conceptual discounted cash flow (DCF) approach that will encourage financial analysts to adapt, refine or alter it to meet their specific needs.

[5] Thomas E. Cavanagh, Anu Oza, and Charles J. Bennett, *The Measure of Success: Evaluating Corporate Citizenship Performance,* The Conference Board, R-1372-05-RR, 2005.

[6] Participating companies include Goldman Sachs International, UBS Ltd., Calvert Group, BNP Paribas Asset Management, Mitsui Sumitomo Insurance Co. Ltd., Morgan Stanley & Co. International Ltd. and ABN-AMRO Bank N.V.

An indirect goal of the project was to communicate with The Conference Board member companies and beyond — in alignment with other initiatives underway through the UNEP-FI/Global Compact, the ongoing reworking of the Global Reporting Initiative's (GRI) guidelines for reporting, as well as increasing investment research underway — how this emerging trend may potentially affect them and their reporting needs.

To achieve these goals, the Working Group:

- compiled key global trends and their potential impacts for business and derived "generic ESG factors" (see table on p.7);
- conducted an analysis of 10 major business sectors and compiled the 10 most significant ESG factors for each sector;
- developed and documented a DCF modeling procedure as a framework to illustrate how these factors could be systematically evaluated;
- applied the conceptual approach to the energy sector to illustrate how it works; and
- suggested "scaled back" approaches to using the framework to address its potential complexity and illustrate how it could be flexibly applied, depending on different analysts' preferences and interests.

The framework is presented in the context of some of the relevant broader issues and trends summarized in the table on p.7.

The resulting report, *Expanding the Investment Frontier: Factoring Environmental, Social and Governance Criteria into Investment Analysis,* will be of interest and use to varied audiences.[7] It is most directly targeted to financial analysts and the framework (the "meat" of the report) was developed for them. For businesses, the overview of general trends in financial analysis of ESG factors and interpretations of materiality will be useful, especially for general managers not so closely involved in their companies' relationships with the investment community. The framework will also be useful because it provides a systematic approach for evaluating key global trends and their potential relevance to businesses in different sectors. Thus, it can become a helpful tool for assessing the adequacy and planning for potential effects of ESG risks and opportunities by individual companies.

A Gathering Force?

The Conference Board's work indicates that — however inconsistently and hesitantly —the evaluation of ESG factors in mainstream investment analysis is gaining traction, if not yet true momentum. For some companies, especially those that are investing considerable resources in managing for ESG risks and opportunities, this may be good news because they could receive increased "credit" in the markets. For others, this increasing momentum may be a wake-up call for more comprehensive analysis of and management for such factors. We are by no means there yet, nor is the pace consistent. But it appears increasingly clear that the trajectory toward the increasing importance of ESG factors in mainstream investment analysis is set, and companies need to be aware and respond appropriately.

[7] Charles J. Bennett, Ivo Knoepfel and David J. Vidal, *Expanding the Investment Frontier: Factoring Environmental, Social and Governance Criteria into Investment Analysis,* The Conference Board, R-1378-05-RR, 2005.

Generic ESG issues

Global trend	Environmental issues	Social issues	Corporate governance issues
Changing demographics and the emergence of new consumer and labor markets	• New markets for environment-friendly and energy-efficient products in emerging economies	• New markets for emerging consumer needs in emerging economies • Workplace health and safety* • Labor standards* • Human rights issues*	• Complying with local laws, while upholding global corporate governance and responsibility standards
Boosting innovation for efficiency and reduced impact on environmental and climate systems	• Carbon constraints (climate change) • Environmental liabilities • Pollution prevention • Reducing emissions and resource use • New markets for environment-friendly and energy-efficient products		
Preserving the natural resource base	• Product stewardship • Waste and toxic release management • Accidents and spills management • Efforts to incorporate external costs in planning and accounting		
Doing business in a globalized, interconnected economy		• HR management (including compensation, training, etc.) • Attracting and retaining employees • Workforce diversity and equal opportunities	
Earning the license to operate	• Environmental governance and management systems • Accidents and spills management	• Community and NGO relations • Government relations • Investor relations • Management of crisis situations*	• Board structure and accountability • Accounting and disclosure practices • Audit committee structure and independence of auditors • Executive compensation • Management of corruption and bribery instances • Business ethics policies • Corporate citizenship engagement
Changing geopolitical risk landscapes		• Human rights, community and government relations in politically unstable countries/conflict zones*	• Policies and systems to manage risk in politically unstable countries/conflict zones

* Always includes suppliers and contractors, especially for sectors heavily sourcing/producing in developing countries

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Expanding the Investment Frontier: Factoring Environmental, Social and Governance Criteria into Investment Analysis (R-1378-05-RR)

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