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IMPORTANCE OF INTANGIBLES REFLECTED IN ESG PERFORMANCE METRICS FOR A GROWING NUMBER OF INVESTORS

The public company's intangibles (or non-financials) are, for a growing number of investment institutions, directly tied to the tangibles (the traditional financials in corporate reporting).

Investopedia defines intangible assets as "not physical in nature," and they can include a wide range of issues, topics, and categories of assets that are not an integral part of the traditional financial reports. Consider a wide range of intellectual property, goodwill, and important brand recognitions — "while intangible assets don't have the obvious physical value of a factory or equipment, [they] can prove very valuable for a firm and critical to its long-term success or failure..."[1]

For more than a decade, we have been commenting on certain types of intangibles in the pages of this magazine. The intangibles in focus have been factors in determining corporate reputation, defining risk management practices, and influencing share valuation.

Our shared perspectives have included examination of developments in effective corporate governance policies and practices; companies' expanded disclosure regimes and structured reporting on sustainability and responsibility strategies, programs, and achievements; and the corporate and investment communities' views on environmental, social, and corporate governance (ESG) performance.

Capital market players are increasingly considering the company's ESG in their investment decision-making. (The approach is to consider a company's performance in environmental management, including energy issues, social or societal issues, and corporate governance practices and policies.)

We began our comments in these pages well beyond a decade ago as Sarbanes-Oxley legislation was being signed into law in summer 2002. The expanded considerations of governance for companies in portfolio (or for consideration) were accelerated and accompanied by a rapid adoption of ESG investment approaches. Progress was steady and then accelerated after the 2008 market crisis. Over the past decade, asset owners, their internal and external managers, and financial analysts have been expanding the body of work that affects corporate reputations and valuations, including opinions, rankings, scores, and ratings for public company performance.

We've provided numerous examples of this in prior commentaries in magazine issues back to March 2002. To demonstrate the breadth and depth of what is happening as the trend toward adoption of ESG investing approaches accelerates, we present the following scan of the sustainable investment landscape.

Putting the size of sustainable investing in context

To begin, some context and some important investing notes: In survey results just announced by the Global Sustainable Investment Alliance, professionally managed assets under management (AUM) that are defined as sustainable investments totaled $21.4 trillion at the start of 2014. This was said to be 30 percent of all professionally managed AUM world-

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wide. The volume is also an increase from the 21.5 percent determined in the first such survey (a year earlier). The Alliance is made up of the seven major regional sustainable investing trade associations plus Japan Social Investment Forum. The results reflect survey responses from North America, Europe, Australia, and Asia/Japan.[2]

In U.S. capital markets, survey results released in November 2014 determined that $1 in $6 of professionally managed AUM utilized sustainability approaches, totaling $6.57 trillion at the end of 2013 — that is 18 percent of total AUM in the U.S.[3]

The investment approaches are typically characterized as being sustainable and responsible investing, sustainable investing, ESG performance investing, impact investing, community investing, triple bottom line (people/planets/profits), and a few other terms. Often, the corporate response is characterized as corporate responsibility and the method of disclosure, publishing a sustainability report, or including sustainability information in the annual report.

Management organizations are shaping attitudes

The Conference Board is one of the world's largest training and information sharing organizations serving corporate managements. Senior management relies on the Conference Board for business research, coaching and training, and sharing of best practices and state-of-the-art strategy approaches.

As it describes itself, "...the board creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society."[4]

The Conference Board regularly issues a series of comprehensive reports on corporate governance and related matters worthy of close examination by corporate board members and senior managements (including financial officers). Looking at board diversity, the Conference Board researchers evaluated the case for diversity in light of recent competing research findings. In it, they found that the relationship between board diversity and financial performance has not been convincingly established. But there is a theoretical and empirical basis that when diversity is well-managed, it can improve decision-making and enhance a company's image by conveying commitments to equal opportunity and inclusion.[5]

The Conference Board recently launched the 2015 edition of Sustainability Practices Dashboard, a comprehensive database and online benchmarking tool for disclosure of a company's environmental and social practices. Issues and topics analyzed include 79 reporting practices such as atmospheric emissions, water consumption, biodiversity policies, labor standards, human rights practices, and charitable and political contributions.[6]

BlackRock and Vanguard Group: More assertive now

These issues are considered by asset owners and managers in increasing numbers, especially by activist investors such as those specializing in sustainable and responsible investing activities.

Generally in analyzing shareholders on the corporate roster, we find the passively managed institutions have been mostly absent in promoting the importance of corporate ESG performance and engaging with corporate managements to discuss ESG performance. This is changing. BlackRock, acknowledged to be the world's largest asset manager by total AUM ($4.65 trillion), along with Vanguard Group, the largest U.S. manager of passive investable indices, will each become more assertive in their dealings with companies in their portfolios.

Vanguard (with $3 trillion AUM) is urging boards to be "substantially independent of management," and not stand by on important corporate governance issues. (Vanguard CEO F. William McNabb III sent letters to several hundred public companies in early March 2015.) The letter included language that while the funds have a passive management style, corporate managements need to understand the rise of shareholder

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activism has helped encourage expansion of the internal corporate governance team. And that team is holding hundreds of meetings each year with corporate management. In many cases, Vanguard holdings are easily 5 percent or more of the shareholder base.[7]

BlackRock, in recently updated proxy voting guidelines, will for the first time oppose directors standing for election over such issues as lengthy tenures, poor attendance, or if the board is not sufficiently diverse. The firm has long had a strong focus on corporate governance and in recent years expanded the focus to include "E" (environmental management) and "S" (societal) issues, appointing dedicated staff members to focus on ESG issues.

THE FOCUS ON BOARDROOM DIVERSITY IS RAPIDLY WIDENING IN INVESTMENT CIRCLES: A COALITION OF INSTITUTIONAL INVESTORS HAS BEEN PUSHING FOR INCREASED GENDER DIVERSITY IN BOARDROOMS.

Boardroom diversity in focus

The focus on boardroom diversity is rapidly widening in investment circles: A coalition of institutional investors has been pushing for increased gender diversity in boardrooms. This is the Thirty Percent Coalition, which has targeted 160 public companies in the S&P 500 Index and Russell 1000 with no women on their boards. A letter writing campaign began in the fall of 2014 with institutional signatories claiming $3 trillion-plus AUM in portfolios.[8]

Companies in focus included CF Industries, City National, Monster Beverages, Navistar, Patterson UTI Energy, and Superior Energy Services. Success is measured by the 17 companies (in the 160) who have now added women to the board. To date, 25 board diversity resolutions have been filed for the 2015 shareholder meetings. The coalition asks for adoption of a policy, which could include changing committee charters to enhance board diversity beyond current levels to "ensure that a wide range of female and minority candidates are included in the pool of candidates nominated."[9]

The coalition's argument is that "inclusive language in governance signals a commitment to board diversity" and many companies have institutionalized a commitment in response to shareholder engagements.[10]

Proxy lead sponsors include State of New York Common Retirement Fund, State of Connecticut, CalSTRS, City of New York Pension Funds, City of Philadelphia, PAX World, Walden Asset Management, Trillium Asset Management, Calvert Asset Management, Mercy Investment Services, United Methodist Church Foundation, Portico Benefits, and Episcopal Church Pension Funds.[11]

Human rights, women's rights, and corporate risk

Women's rights can be included in the investor and NGO focus on human rights. Sixty-plus investors from North America, Europe, and Australia with combined $3.9 trillion AUM are urging companies to use new guidance to help boards and management "know and show" their knowledge and management of human rights risks. The guidance is published through the "UN Guiding Principles Reporting Network."[12]

The goal is to "incentivize better corporate governance management and reporting of human rights risks," which are integral elements of ESG performance. Investors involved in crafting the guidelines include BNP Paribas Investment Partners, APG, Aviva Investors, Church of Sweden, Wespath, and Boston Common Asset Management.[13]

The intangibles translated into tangibles by the sponsors were articulated as "companies that do not proactively assess and manage human rights issues face potential legal, reputational, and other financial risks...while those meeting the corporate responsibility to respect human rights gain competitive advantage...."[14]

Boston Common Asset Management has been the lead asset manager in development of the tool. Lauren Compere, managing director, explained, "Ultimately, investors want to protect value by knowing human rights risks are being monitored and managed by companies they invest in..."[15]

Governance is still key — Expanded to include "S" and "E"

As we've explained over recent years in these pages, while "G" (governance) has been the main driver for several decades in investor–shareholder engagements, the "E" and "S" have been steadily added to the governance portfolio by a rising number of asset managers. Professor N. Craig Smith has been studying the efforts of this. In a recent white paper, he stated that "creating a sustainable future takes more than good intention....boards have an obligation to help drive a strategic approach to corporate sustainability."[16]

In "Sustainability: From the Back Room to the Board Room," the INSEAD academic observed that while ESG issues are becoming mainstream for companies and the public, more has to be achieved. Corporate leaders understand that addressing sustainability is about managing risks and opportunities for growth and developing solutions that respond to future demands (of customers, stakeholders, needs of the planet).

What is not so well-recognized is his view that ESG issues need to be considered at all levels of the enterprise. Boards have become more involved. An essential board role, for example, is the allocation of major capital investment. For extraction companies like Barrick Gold, sustainability is front and center in investment decisions. Utility companies need to address sustainability when making power generation decisions. And human factors in the supply chain (an intangible, perhaps for some) need to be considered in the content of supply chain sustainability.

The professor advised corporate managers to rethink key performance indicators in relation to executive compensation and the relationship to the corporation's sustainability efforts (or lack of). In his view, "corporate sustainability equates to corporate excellence."[17]

The CFO, corporate ESG, and sustainability

Finally, there's ESG and sustainability in the context of the chief financial officer. *CFO* magazine published a February 2015 online commentary by Richard T. Bliss, professor of finance at Babson College. The author explains that many companies struggle to integrate corporate social responsibility (CSR) efforts into their core mission, strategy, business model, and products and services. He proposes three categories for CSR activities:

1. focus on cost saving;
2. revenue growth; and
3. risk reduction.

The challenge is to manage CSR issues and create shareholder value at the same time.[18]

There is not a single CSR goal, Professor Bliss writes. Companies are addressing a wide range of corporate decisions and activities, including conducting campaigns to reduce employee obesity, not operating in countries with poor human rights records, reducing carbon footprints, and producing quality products. Each of these in turn can help in management's primary goal: increasing shareholder value.[19]

Conclusions

While the company's intangibles (or the non-financials) have been secondary to investor decision-making based on the traditional financials, the practice of evaluating the corporate issuer's ESG strategies, performance, and achievements has become more mainstream among large asset owners, such as public employee pension systems and asset management firms.

The volume of professionally managed AUM using ESG approaches for portfolio decision-making has been growing and now is estimated to be $21.4 trillion or 30 percent of all AUM in the global capital markets in developed countries.

Corporate boards and senior executives are becoming more aware of the importance of the enterprise's ESG strategies, performance, and progress to investors and stakeholders. The issues and topics in focus are expanding in the "S" (social) and "E" (environmental and energy), and are related to the traditional "G" (corporate governance).

There are challenges to be met, though, such as aligning traditional missions (creating shareholder value) with what long has been non-financial considerations. ■

CORPORATE LEADERS UNDERSTAND THAT ADDRESSING SUSTAINABILITY IS ABOUT MANAGING RISKS AND OPPORTUNITIES FOR GROWTH AND DEVELOPING SOLUTIONS THAT RESPOND TO FUTURE DEMANDS.

NOTES

[1] "Intangible asset," Investopedia (2015). Available at: http://www.investopedia.com/terms/i/intangible-asset.asp.

[2] "Global sustainable investment review 2014," Global Sustainable Investment Alliance (Feb 25, 2015). Available at http://www.gsi-alliance.org/. Members of the Alliance are: Association for Sustainable & Responsible Investment in Asia, Eurosif, Responsible Investment Association of Australia, RIA of Canada, UK Sustainable Investment and Finance Association, US SIF — The Forum for S&R Investment, VBDO in the Netherlands, and Japan Social Investment Forum.

[3] "Report on sustainable, responsible, and impact investing trends," US SIF (Nov 2014). Available at: http://www.ussif.org/trends.

[4] The Conference Board is a not-for-profit organization based in New York City with corporate members in North America, Asia-Pacific, Europe/North Africa, and South Asia. The Conference Board Governance Center brings together a distinguished group of senior corporate executives from leading world-class companies and influential investors in a collaborative setting. Matteo Tonello is the managing director of the governance efforts; see the website for information on the various research efforts.

[5] Rhode, D. and Packel, A.K., Diversity on corporate boards: How much difference does difference make?, *Delaware Journal of Corporate Law* 39, no. 2 (2014): 377–426.

[6] "Sustainability practices 2015 dashboard," The Conference Board (Feb 2015). Available at: http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2909.

[7] Grind, K. and Lubin, J.S., Vanguard and BlackRock plan to get more assertive with their investments, *The Wall Street Journal* (March 4, 2015). Available at: http://www.wsj.com/articles/vanguard-and-blackrock-plan-to-get-more-assertive-with-their-investments-1425445200. The giant asset managers aim to push harder on the companies in which their index funds invest.

[8] "Institutional investors working with Thirty Percent Coalition continue to push for increased gender diversity in the boardroom," The Thirty Percent Coalition (Feb 18, 2015). Available at: http://www.30percentcoalition.org/news/105-institutional-investors-working-with-thirty-percent-coalition-continue-to-push-for-increased-gender-diversity-in-the-boardroom. The group started in late 2011 and includes business executives, women's organizations, institutional investors, corporate governance experts, and members of corporate boards.

[9] *Ibid.*

[10] *Op. cit.* note 8.

[11] *Ibid.*

[12] "Reporting framework," and "Framework & guidance," UN Guiding Principles Reporting Framework (Feb 2015). Available at: www.ungpreporting.org/consult-the-reporting-framework/download-the-reporting-framework.

[13] *Ibid.*

[14] *Op. cit.* note 12.

[15] *Ibid.*

[16] Smith, N.C., "Sustainability: From the back room to the board room," INSEAD (Feb 19, 2015). Available at: http://knowledge.insead.edu/corporate-governance/sustainability-from-the-back-room-to-the-board-room-3852.

[17] *Ibid.*

[18] Bliss, R.T., Shareholder value and CSR: Friends or foes?, *CFO* (Feb 9, 2015). Available at: http://ww2.cfo.com/risk-management/2015/02/shareholder-value-csr-friends-foes/. The article is based on ongoing research conducted as part of Project ROI, a partnership between Verizon, Campbell's Soup Company, Babson College, and IO Sustainability.

[19] *Ibid.*