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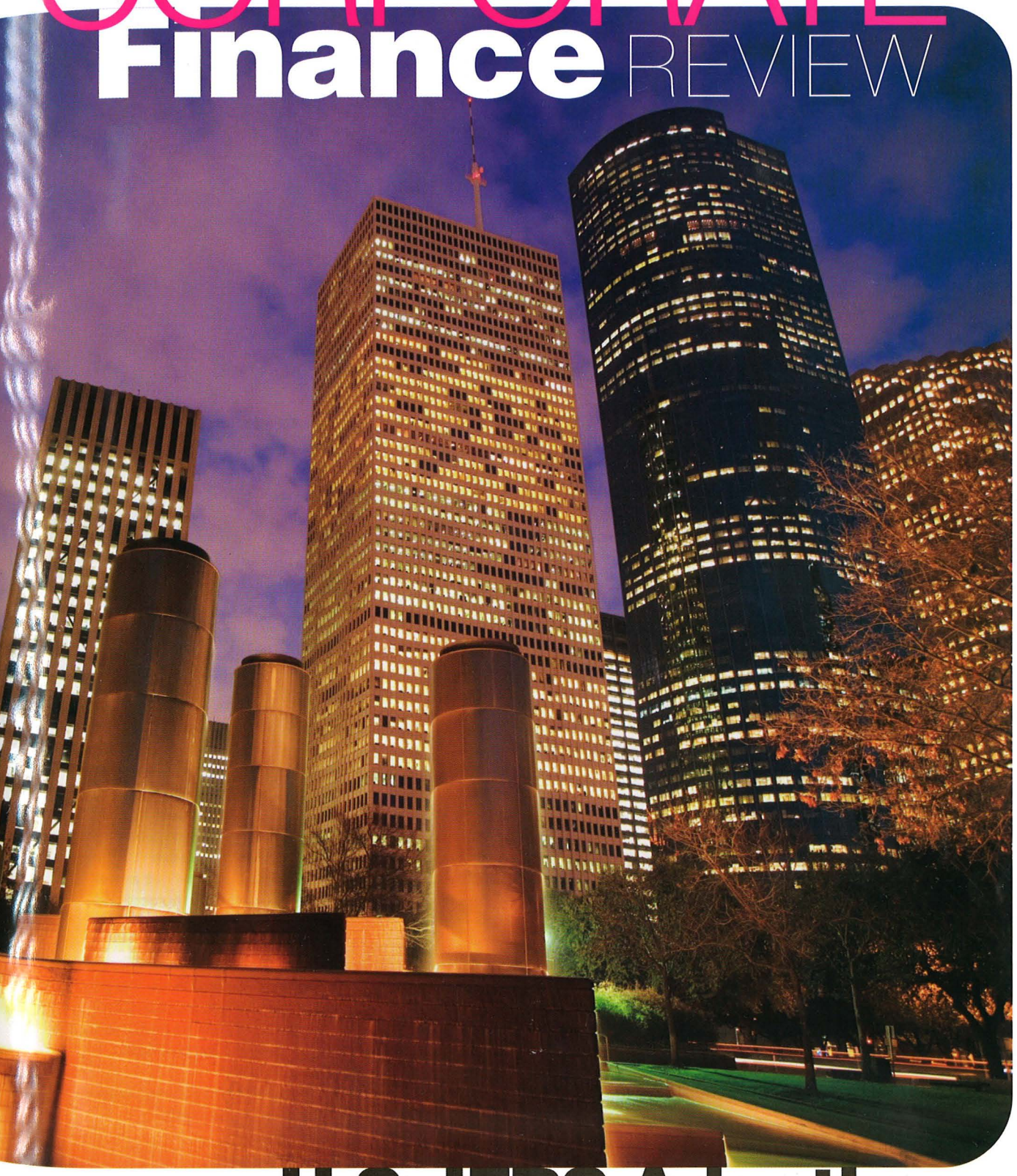

U.S. IFRS Adoption

A Matter of If, Not When

Global Collateral Requirements for Hedging

Boardroom Diversity

CORPORATE Finance REVIEW

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GAINING THE EDGE IN THE CAPITAL MARKETS: DOES A CORPORATE SUSTAINABILITY PROFILE HELP?

We've often heard the phrase "the market is the market," which represents the long-standing assumption of the efficient market hypothesis (EMH). This decades-old theory assumes rational behavior on the part of investors in their analyses of companies and corporate issuers in their disclosure practices, which should help to create an equity market that is efficient in terms of distribution of information, especially concerning risk factors.

The foundation of this theory was set in place by economists in the 1960s and 1970s, and especially helped along by the work of Eugene Fama of the University of Chicago, who published his paper, "Efficient Capital Markets: A Review of Theory and Empirical Work" in May 1970. The foundational concept: A share price reflects all available information in the market. While investors or asset managers may temporarily "beat" the market, they cannot have a continuing edge over the longer term. The available information is used by tens of millions of investors to arrive at assumed future values of corporate shares. This follows the dictum, "a market in which prices always fully reflect available information is called efficient."[1]

But in recent years as the capital market mechanisms and behavior of corporate issuers became more complex and complicated, the efficient market theory has been steadily discounted and even debunked. And in the 2007–2009 financial debacle, a period during which many investors experienced significant losses, the capital market was not generally viewed as either "efficient" or "rational." Information was not always evenly distributed (see: insider trading and inadequate disclosure), and investors were not always rational (they typically ignored Wall Street wisdom, "buy on the bad news, sell on the good").

What about new analytical factors?

But what if there were clearly detectable and, of late, more reliable means of measuring select corporate issues for portfolios based on information not yet "leveraged" by the broader securities markets? We've been describing the rise in interest in certain types of market information in these pages, information that is often described as "extra financial," "nonfinancial," and "intangible" by mainstream market players. This is part of the information mix that is closely followed by a growing number of financial analysts, asset owners, and the managers they retain — the information embodies the perceived advantages of investing in public companies considered to be the leaders in corporate sustainability performance and demonstrating excellence in corporate responsibility.

Briefly stated, the emerging common wisdom is that company boards and managements that embrace strategies, programs, and initiatives, and implement significant changes in their enterprises that align with the expectations of investors that improved ESG performance (environmental, societal issue, and corporate governance performance factors) will make the company more sustainable over the long term.

These "more sustainable" companies, in general, should have lower operating

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costs, more efficient internal processes, fewer legal and regulatory challenges, and improved employee recruitment and retention, should exhibit improved product stewardship, and should engage with and enjoy non-confrontational relations with a widening range of stakeholders. And their shareholders should enjoy greater return on their investment.

For financial managers of companies considered to be the sustainability leaders, the cost of capital may be lower, and the company's sustainability profile may attract more patient, long-term investors such as public-sector employee retirement systems (e.g., New York State Common Fund and California Public Employees Retirement System) and large global investors such as the Norwegian Government Pension Fund (the leader in ESG investment among the world's Sovereign Wealth Funds).

Testing the sustainability hypothesis

How to put this "sustainability and responsibility" attraction hypothesis to the test? For one thing, we can look at the recent directions of investors' capital flow. Since the mid-1990s, as interest in "sustainable and responsible investment" (SRI) grew among asset owners and managers, the trade association for the SRI community — The Forum for Sustainable and Responsible Investment (US SIF) — has been issuing the results of surveys of asset managers.

In December, US SIF released its latest report: "Sustainable and Responsible Investing Trends in the U.S." The top-line findings of this every-other-year survey of capital market professionals include:

- At year-end 2011, U.S.-domiciled assets under management (AUM) held by 443 institutional investors, 272 money managers, and 1,043 community investment institutions that apply ESG criteria in analysis and portfolio management were determined to be $3.31 trillion.
- Putting this in perspective, that's roughly 11 percent of all AUM (the total U.S. market was $33.3 trillion) and an increase of 486 percent since the first survey back in 1995. The broader universe of AUM in the United States grew by less — 376 percent.
- Since the end of 2009 (the last survey), the overall total of SRI assets rose 22 percent.[2]

In the report, US SIF says:

> Today, more than one out of every nine dollars under professional management in the U.S.A. is invested according to strategies of sustainable and responsible investing (SRI). The individuals, institutions, investment companies, money managers, and financial institutions that practice SRI seek to achieve long-term competitive financial returns together with positive societal impact. SRI strategies can be applied across asset classes to promote stronger corporate social responsibility, build long-term value for companies and their stakeholders, generate jobs or introduce products that will yield community and environmental benefits.[3]

Looking at the S&P 500 Index® companies

At the beginning of 2012, a team of researchers at Governance & Accountability Institute began an analysis that considered this growth in SRI AUM and posed the questions: "Does corporate sustainability disclosure and structured reporting matter...and to whom?" The universes of companies analyzed included the S&P 500 Index® companies and the Fortune 500® companies. The S&P 500 Equal Weighted Index is regarded as the best single gauge of the large-cap U.S. equities market and includes 80 percent coverage of all U.S. equities. Almost $5 trillion in AUM are benchmarked against this widely used index. The Fortune 500® roster consists of the largest U.S. companies by revenues; all but a very few are publicly traded.

The result of the analysis was a report published at year-end 2012: "Corporate ESG / Sustainability / Responsibility Reporting — Does It Matter."[4] The research team began with these questions:

- Regarding financial performance — Do companies that report on their ESG performance also perform better in the capital markets over the long term? Are there discernible

FOR FINANCIAL MANAGERS OF COMPANIES CONSIDERED TO BE THE SUSTAINABILITY LEADERS, THE COST OF CAPITAL MAY BE LOWER, AND THE COMPANY'S SUSTAINABILITY PROFILE MAY ATTRACT MORE PATIENT, LONG-TERM INVESTORS.

EXHIBIT 1 2007–2011 Top-Line Analysis

Time	F-500 GRI Reporters	S&P 500 GRI Reporters	S&P 500 EWI
One year	0.33%	1.06%	0.75%
Two year	8.45%	8.82%	10.37%
Three year	25.11%	22.37%	22.80%
Four year	2.94%	2.17%	2.20%
Five year	4.06%	3.87%	1.99%

share price advantages for corporate reporters?

- Equity indexes — Are companies that report on their sustainability performance more likely to be included in popular sustainability equity indexes such as the Dow Jones Sustainability indices?
- Key corporate reputational lists, awards, and recognitions — Are reporting companies selected more often for credible reputational lists such as *Newsweek's* Greenest U.S. Companies (list)?
- Key corporate ESG performance ratings and rankings — Are higher ratings/rankings achieved by reporting companies? (e.g., the closely followed Carbon Disclosure Project (CDP) performance scores)

The short answers determined in the analysis: *yes, yes, yes,* and *yes.*

The longer explanations are as follows.

An increasing number of large-cap corporate executives, managers, and boards are recognizing the many benefits that measuring, managing, and disclosing their strategies and performance on ESG factors can have for their companies — and both shareholders and stakeholders.

The percentage of S&P 500 companies that are publishing sustainability and related reports rose dramatically from 2010 to 2011 — from about 20 percent to 53 percent of all of the index companies. Similarly, the percentage of Fortune 500 companies rose from about 20 percent to 57 percent. Result: Companies that are not reporting on their sustainability efforts and progress are now in the minority of both universes of leading U.S. companies.

Companies that report on their sustainability strategies, initiatives, programs, and ESG performance appear to be more likely to be selected for key reputational lists, likely to be ranked higher by reputation raters and rankers, and are selected more often for inclusion in leading sustainability indices. These reputational "plusses" can translate to higher premiums in the capital market as investors place more importance on nonfinancial issues. Reputation often is an indicator of the quality of management, says Stephen T. McClellan, CFA, author of *Full of Bull*, and ranked in the All-American Research Team for 19 years by *Institutional Investor* magazine. He has told audiences that he considers the quality of management a very important part of his analysis of public companies, often accounting for more than half of the opinion.[5]

Overall, the framework of choice for structured disclosure and reporting on ESG is the Global Reporting Initiative (GRI), with the majority of companies in both the S&P 500 and Fortune 500 utilizing this comprehensive approach for their reporting.

Companies that measure and manage their ESG and sustainability issues appear to perform better over the longer term in the capital markets.

Analyzing financial performance

Focusing on financial results, the top-line analysis of five-year market returns comparing S&P 500® corporate sustainability reporters and Fortune 500® (U.S. largest companies) reporters versus the S&P 500® Equal Weighted Index, years 2007–2011 yielded the results in Exhibit 1.

In some periods, the corporate reporters as a group outperformed the benchmark. Of course, there are many factors that help to determine share price and return. Analyzing a larger group of companies over a longer period would provide more definitive results regarding the advantages of increased sustainability disclosure. There is more financial information in the report; the data for comparisons were provided by Investars, using the S&P 500 EWI as the benchmark, which is comprised of all S&P 500 Index companies in an Equal Weighted Index.

Reputational rankings, ratings, and listings

Analysis also indicated there were positive associations between companies reporting using the GRI framework and:

- higher Bloomberg ESG Disclosure Scores (these are published on the more than 325,000 Bloomberg market terminals installed worldwide);
- being included in the Dow Jones Sustainability Index for North America and the DJSI World Index;
- inclusion in the NASDAQ OMX CRD Global Sustainability Index;
- more favorable Glassdoor ratings (these are online opinions generated by employees of private sector companies);
- more favorable CSR Hub ratings;
- higher Carbon Disclosure Project (CDP) Disclosure scores;
- higher CDP Performance scores; and
- more favorable placement in Brandlogic's and CRD Analytics' "Corporate Sustainability IQ Matrix."

The findings aligned with some of the US SIF survey results. In the organization's 2012 survey, the broad outlines of ESG issues being considered by asset managers are focused on environmental, social criteria, governance, and product-specific criteria.

- Governance issues are incorporated by a total of 346 investment vehicles with $623 billion AUM.
- Environmental factors are incorporated in management of 551 investment vehicles with $240 billion in AUM.
- Social criteria (including Sudan-avoidance policies) are the most prominent in asset-weighted terms, incorporated in the management of $1.2 trillion across 622 investment vehicles.
- Product-specific criteria (such as restrictions on certain investments) are included in the management of 390 investment vehicles with $290 billion AUM.[6]

One of the key takeaways from the G&A Institute analysis is that for the first time, 53 percent (a majority) of S&P 500 Index companies and 57 percent of the companies in the Fortune 500 rankings are now disclosing and reporting on their sustainability/ESG performance. Nonreporters are now in the minority. The lesson for corporate boards and managers is that if their company is not reporting, it is almost certain that their industry and investment peers *are* reporting. The task of catching up to the leaders becomes more difficult as time passes. Those companies already reporting are innovating in their disclosure and structured reporting practices (such as publishing "tailored" reports that an investor or stakeholder can build their own customized report online).

And as the benefits of long-term sustainability reporting become clear and impacts more measurable, investors will expect — or demand — that companies in their portfolio begin to report, or, for existing reporters, will expand and deepen their disclosures. The intangible factors are becoming more tangible now to a growing universe of investors. ■

FOR THE FIRST TIME, 53 PERCENT (A MAJORITY) OF S&P 500 INDEX COMPANIES AND 57 PERCENT OF THE COMPANIES IN THE FORTUNE 500 RANKINGS ARE NOW DISCLOSING AND REPORTING ON THEIR SUSTAINABILITY/ ESG PERFORMANCE.

NOTES

[1] Fama, E.F., Efficient capital markets: A review of theory and empirical work, *Journal of Finance* (May 1970). This was professor Fama's thesis paper. Basic concept: A stock price reflects all available information in the capital market, so investors or

asset managers may temporarily "beat" market but cannot have an edge over the longer-term. The market was said to be "rational." This theory was cited by tens of millions of investors over the years as the means to arrive at rational future value of the available shares. Professor Fama's paper is available at http://www.jstor.org/discover/10.2307/2325486?uid=3739832&uid=2&uid=4&uid=3739256&sid=21101600163187; see also www.seekingalpha.com/article/339761-just-how-efficient-is-the-market for more on the efficient market hypothesis; see also http://en.wikipedia.org/wiki/Efficient-market_hypothesis

[2] *Ibid.*

[3] The Forum for Sustainable and Responsible Investment (US SIF), Report on Sustainable and Responsible Investment Trends in the United States, 2012 (Washington, D.C., December 2012). Sponsors included Bloomberg LP, TIAA-CREF, BlackRock, Breckinridge, Christian Brothers Investment Services, Legg Mason, Trillium Asset Management, Walden Asset Management, and other financial services organizations. Information: http://ussif.org/resources/research/documents/USSIFTrends2012ES.pdf

[4] Clark, L. and Master, D., 2012 Corporate ESG / Sustainability / Responsibility Reporting —— Does it Matter? An Analysis of S&P 500® Companies' ESG Reporting Trends & Capital Markets Response, and Possible Association with Desired Rankings & Ratings. Coppola, L.D. (Ed.) (New York: Governance & Accountability Institute, 2012). Information at http://www.ga-institute.com/. Researchers Lindsey Clark and David Master, working under the supervision of Louis Coppola, MBA, analyzed the corporate reporting trends, capital market response, and possible associations with desired reputational rankings and ratings. Collaborating organizations and professionals included Bloomberg, LLP (Rina Levy); SAM Group, managers of the DJSI; CRD Analytics (Michael Muyot) and Brandlogic (James Cerruti); CSR Hub (Bahar Gidwani); Investars and the GetAYou team; and the Global Reporting Initiative's Focal Point U.S.A. team (Mike Wallace and Marjella Alan).

[5] McClellan, S.T., *Full of bull* (New Jersey: FT Press/Financial Times, 2008). McCellan is a prominent Wall Street investment researcher.

[6] *Op. cit.* note 3.