July
August
2008

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CORPORATE Finance REVIEW

July/August 2008 Volume 13 Number 1

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONCERNS CONVERGING ON THE CORPORATE WORLD

The growing consensus among financial analysts and investment portfolio decision makers appears to be that share-price valuation and comprehensive financial analysis have been profoundly changing over this first decade of the twenty-first century. The reliance "only" on financial metrics and quantifiable corporate performance is diminishing, and now as much as one-third or even 40% of investment decision making is based on key investor perceptions, as the focus on the traditional metrics (financials and issuer financial performance) slides to a 60% factor. The ratio may change from expert to expert, but the fact remains that nonfinancial and intangible factors seem to be separating today's and tomorrow's capital markets winners from those issuers that are lagging or will lag in share price and other measurements of performance because of perception factors. And one of the most important perception factors is ESG.

Almost a year ago in this publication we introduced the emerging importance of companies' environmental, social, and governance (ESG) factors.[1] We wrote in introducing ESG to a wider audience of financial executives:

> The definitions of ESG include the key metrics of a firm's nonfinancial performance, the many important intangibles that help make up market valuation beyond traditional financials and other quantifiable information. A company's ESG profile will include a range of executive and workforce behaviors; the track record of corporate and product/brand reputation; nature of compliance with local and national laws and the growing list of industry and sector codes of accepted behavior; the manner in which the company is governed by its board and managers; responsiveness to stakeholders; disclosure and transparency; and other elements related to Environmental, Social and Governance factors important to investors.

Much has transpired since our first report; this is an update on the growing influence of ESG factors on investment behavior and preferences.

The status of ESG attitudes

What kind of nonfinancial or intangible factors now shape investor and advisor perceptions? Think of the questions investors and their advisors may be directly or indirectly asking about a company, or issues that may be raised by activists or journalists, such as the following: What is the reputation risk factor for this issuer? What are the spoken and demonstrated values of management, the board, and workforce? How are these values demonstrated in corporate functions? Is the company meeting stakeholder expectations? Does management acknowledge and then engage on critical societal issues—do they respond to "noise" in the environment—or do they ignore them and risk negative headlines that could seriously erode future valuation? The questions may vary, but the concerns about a company's ESG profile and performance are becoming more common among investors.

The noise about ESG concerns is being generated by a growing universe of stakeholders: shareholder activists (focused on both governance and a wide range of social issues), third-party ser-

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vice and information providers, employees, business partners, customers, and mainstream investors. Along with this are what we refer to as the Watchers, which includes traditional organizations such as Moody's and S&P, the global Mercer organization, ESG researchers such as KLD Research & Analytics and Ethical Investment Research Service (EIRIS); traditional-issue proxy advisors such as ISS/Risk-Metrics; and a growing list of major investment bankers. (Most important here from a perception-shaping perspective may be Goldman Sachs, which has now staked out ESG concerns as these affect large-cap issues around the world.[2])

Shaping perceptions

Capital market perceptions of publicly traded corporations are shaped by a variety of means:

- Expanded media coverage of business and investing, including both news reportage and the extraordinary expansion of commentary and opinion in both traditional and new media channels (there are new blogs added every two seconds now, with an astonishing number focused on corporate finance and investment);
- Technology is rapidly changing the media mix itself, with increasingly skeptical players creating Web-based publishing platforms for their views (at little cost or investment, unlike traditional media);
- Research analyst views and recommendations (from both sell- and buy-side) on critical ESG issues;
- The actions of institutional investors towards companies in their portfolios, including both activists and more mainstream institutions such as mutual funds;
- Increasingly, the actions of third parties involved in shareholder activism movements and coalitions (a host of third-party purveyors of corporate ratings, research results, profiles of ESG factors, and investment recommendations are retained by institutions to assist in their individual or collective advocacy and proxy activism).

The growing number of influencers has been building momentum in the EU and, now, in the United States, and they are shaping capital market behaviors through numerous public advocacy campaigns. The credit risk agencies have long influenced capital market behavior; more recently they have been factoring in governance and limited social factors in their ratings of issues. ("Values" can be important here; though this is clearly an intangible metric for a credit risk rater, think of the issue in investment terms as we watch the subprime credit disaster continue to unfold.)

CAPITAL MARKET PERCEPTIONS OF PUBLICLY TRADED CORPORATIONS ARE SHAPED BY A WIDE VARIETY OF MEANS.

ESG important to key players

Third-party rankers, risk and reputation raters, and capital market perception-shapers are influencing investor decision making. Citigroup recently announced it would direct $50 billion of investment over ten years in global climate-change strategies for both the Citi organization and the markets it serves.

Mercer, an advisor to institutional investors, is an example of ESG moving to the mainstream: Its managers are being encouraged to evaluate the extent to which fund managers are actively integrating ESG factors into the mainstream investment process. All financial managers in the Mercer database will now be asked (1) where and how managers are integrating ESG and (2) where they recommend further ESG research. "Demand for this type of integrated research spans traditional and alternative asset classes, and all regions," explained Tim Gardener, global chief investment strategist at Mercer.[3] Craig Metrick, head of Mercer's US responsible investment team noted, "For Mercer to take this step sends a clear signal to managers and owners alike. Not only do we believe that environmental, social and governance factors are important, but our clients, some of the largest asset owners in the world, do too."[4] (Mercer provides consulting, outsourcing, and investment services to clients; it is part of Marsh & McLennan Companies.)

The key ESG issues

Over the past decade two powerful forces in investment circles have been moving closer together in their effort to influence behavior, performance, and accountability in the corporate world: (1) those investors actively advocating specific corporate governance reforms and improvements in corporate practices and policies; and (2) institutional investors and social movement organizations advocating greater corporate responsibility on the part of corporations.

WHILE THE ESG CONCEPT MAY BE MORE IMPORTANT TO EU INSTITUTIONAL INVESTORS THAN TO THOSE IN THE UNITED STATES, ESG IS AND WILL CONTINUE TO BE AN IMPORTANT INVESTMENT FACTOR.

What kind of responsibility is of concern to investors? Think of these societal issues: diversity of the corporate workforce; global supply chain oversight (including use of child and slave labor offshore); lifecycle product stewardship; corporate relations with developing nation suppliers, including small farmers; concerns about product stewardship; US companies doing business with dictatorships and nondemocratic nations; consumer access to pharmaceutical products (and pricing for sensitive populations such as the elderly and those in developing nations); climate change; energy conservation; and many more issues.

As these combining forces directly or indirectly support each other's campaigns (especially in proxy voting, board elections, and support for shareholder-sponsored resolutions), there is now a clear, trackable influence of these players on mainstream institutional investors. This year, both governance and social investor advocates applied very public pressure *on* the leading mutual fund advisor groups—Fidelity, Vanguard, Capital Group—focusing on the funds' proxy-voting processes and advancing investors' agendas for specific ESG campaigns.

In our tracking of the ESG movement, we are seeing European Union investors and/or their advisors and research providers shaping the societal issues, creating the dialogue with other investors and companies, creating frameworks for ESG investment decision making, and moving toward more institutionalization of the ESG concept. But for those readers in the United States, be aware: While the ESG concept may be more important to EU institutional investors than to those in the United States, ESG is and will continue to be an important investment factor.

Recent developments underscoring ESG importance

A key global financial research and analysis organization, the European Federation *of* Financial Analyst Societies (EFFAS), is moving toward adoption of a set of thirty key performance indicators (KPIs) for ESG issues and long-term corporate viability to provide investors and corporate leaders with clear and comparable data. The KPIs were originally developed by DVFA—Germany's society of investment professionals—and adoption by the Europe-wide societies would mean that 14,000+ European investment professionals could put greater pressure on issuers to report (that is, more transparency) on corporate carbon emissions, energy use, global supply-chain management, and other ESG factors. EU corporations would have standardized systems to employ to report on their key metrics. If adopted in Europe, how long will this system take to migrate to the United States? As quickly as EU investors demand more ESG accountability? The answer is quite relevant for boards and management teams.

Socially responsible investment

In the US, the CFA Institute just released investor strategies for socially responsible investment (SRI); this is an important development insofar as "social investing" has not been a mainstream consideration for the majority of CFA members (typically financial analysts and portfolio managers). The CFA Institute is the global financial analyst member organization that issues CFA certifications (with almost 100,000 members worldwide in 133 countries); now, analysts and professional money managers are being encouraged to focus on ESG. As CFA Institute puts it,

> A growing number of people are extending their social consciousness beyond driving hybrid vehicles or drinking fair trade coffee to pursuing a socially responsible investment strategy that reflects their values and core beliefs.... Socially responsible investing (SRI)

> integrates financial objectives with social and environmental objectives. SRI assets are growing at a faster pace than the broader universe of all investment assets under professional management. . . .[5]

The CEO view of ESG

McKinsey & Company published a strategy paper last year, entitled "CEOs on strategy and social issues," that explored how chief executive officers around the world were dealing with the rising expectations of stockholders and stakeholders.[6] Though CEOs believe they have a strategic rationale for taking on ESG issues, the authors write that they also understand the challenges that must be overcome, including managing supply chains across countries with different regulations and norms for corporate social responsibility (CSR).

The authors surveyed CEOs of companies participating in the United Nations Global Compact, and 95% of the responding CEOs in the McKinsey study said they were doing more than they did five years ago to incorporate ESG issues into their core strategies. Pressure from employees, consumers, and other stakeholders played an important part in this trend, say the authors, but some CEOs see the new demands as opportunities to gain a competitive advantage and address global problems at the same time. Good for companies, good for investors, good for society.

What is the most critical aspect of ESG? Environmental issues, said the CEOs; increasing environmental concerns are the most important trend influencing public expectations of business, followed by the limited supply of natural resources (such as oil), and the emergence of China and India as powers in the global marketplace. The current "oil crisis" affecting all global markets could add significant momentum to "E" factors for investors.

Varying ESG standards a challenge for companies

The dilemma of varying standards country to country was also addressed in detailed terms in an essay by Bill Baue, author and long-time commentator on SRI, CSR, and ESG issues. The essay considers whether the glass is half-empty or half-full for the implementation of ESG standards. The standards for assessing and disclosing ESG are proliferating globally, he writes, a trend that brings applause — and skepticism. In late-2007 the International Finance Corporation, the private sector arm of the World Bank "shepherded 30 development finance institutions (DFIs) around the world into signing its Approach Statement on Corporate Governance."[7] Is this great news, or not?

Glass half-full view: Signing on by DFIs explicitly covers ESG issues in the emerging markets in due diligence. Glass half-empty view: "Folks charge that such standards amount to greenwash, using the socially responsible vernacular to paint a sheen on behavior that is in their opinion unsustainable."[8] Baue explored a wide range of US, EU and global ESG developments in the essay, which was widely distributed by Social Funds, a US-based publishing and research organization.

INCREASING ENVIRONMENTAL CONCERNS ARE THE MOST IMPORTANT TREND INFLUENCING PUBLIC EXPECTATIONS OF BUSINESS.

RiskMetrics Group's four pillars

A major influence on proxy voting trends is the advice offered on issues by RiskMetrics Group, including its Institutional Shareholder Services unit. Recently, the firm set out its "assessment model" for the "four pillars of sustainability"—climate change, environmental factors, labor and human rights, and ethics. Performance is measured using a governance-risk lens, the company explains, taking into consideration board oversight, management policy and execution, public disclosure, accounting methods, and strategic planning. "The extent to which large-cap global companies are regulating themselves with regard to these *factors in* the model varies significantly by nationality and industry sector," RiskMetrics says in its white paper entitled "Study Identifies Large Differences in Global Sustainability Governance."[9]

RiskMetrics conducted a year-long

pilot project assessing more than 1,700 companies on more than 200 policy and performance indicators. Outcome? Companies in the Morgan Stanley Europe, Australia, and Far East (EAFE) Index clearly outperform S&P 500 firms on both climate change and other environmental issues, but US firms have the edge on ethics issues. For labor and human rights, overall performance between EAFE and S&P 500 didn't differ substantially. Canadian companies lagged overall in the two indices but did best on labor and human rights. And though some individual companies stood out as clear leaders, overall average performance by sector and industry stood at less than 50% of the ideal defined in RiskMetrics's assessment model.

One could reasonably conclude that in ESG terms large-caps evidently have a long way to go to meet rising institutional investor behavior. Imagine the pressure to come on small- and mid-cap companies as their larger brethren "get it" in ESG terms and begin to pull ahead in meeting investor expectations.

Conclusion

In the past year, ESG has clearly grown in importance to investors. More companies are getting it. The issues within the E, S, and G categories are more clearly defined. The perception-shapers already in the game are being joined daily by more investors and advisors who are embracing ESG as an important means of assessing and evaluating and valuating corporate issuers. ESG factors are being linked directly to risk factors by those involved in advancing capital to the corporate sector.

For most of the decade this column has focused on more traditional corporate governance issues, particularly after the passage of the Sarbanes-Oxley Act in the United States in July 2002; we will be adding to this focus by analyzing ESG developments in our future work. Judging from the flow of ESG-related information, governance issues clearly have been added to by the environmental and social concerns of stakeholders and stockholders. •

NOTES

1 H. Boerner, "Your Company's ESG—Environment, Social, and Governance Factors Are Mattering More Now to Institutional Investors," *Corporate Finance Review* (Vol. 1 2, No. 2, September/October 2007): 40-43.

2 Ibid.

3 "Mercer manager research developed to consider environmental, social and governance factors" (May 21, 2008): available at www.mercer.com under Press Releases.

4 Ibid.

5 "Want to be a Socially Responsible Investor? CFA Institute Offers Investors 10 Tips to a Socially Responsible Investment Strategy" (June 17 2008): available at www.cfainstitute.com under Press Room/Press Releases.

6 D. Bielak, S.M.J. Bonini, and J.M. Oppenheim, "CEOs on strategy and social issues," *The McKinsey Quarterly* (October 2007): abstract available to nonsubscribers at www.mckinseyquarterly.com.

7 B. Baue, "Environmental, Social and Governance Standards: Glass Half-Empty or Half-Full?" (November 28, 2007): available at www.socialfunds.com under News.

8 Ibid.

9 H. Walsh, "Study Identifies Large Differences in Global Sustainability Governance" (November 15, 2007): available to subscribers at http://www.issproxy.com/knowledge/environmental_social_governance.html.