GOVERNANCE AND INVESTING

Why Firms Are Adopting ESG Principles

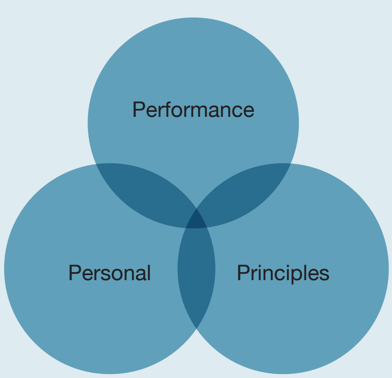
By Darby Hobbs and Alexandra Jostrom

In financial services, it's not just about investment performance any more. Personal choices and the principles of a firm are sharing the stage with performance as the three P's of sustainable and reputable management (figure 1).

This trend is being driven by shifting needs of our global community, which is impacted by decisions that corporations have made or are making that relate to environment, social, and governance (ESG) factors. These decisions directly impact value through the supply chain of goods and services for consumers (i.e., investors), employees, shareholders, and citizens. In business we think we are consumers first and citizens second, but at our firm we are seeing more citizens being proactive as consumers with the brands they engage, and the focus is on trust.

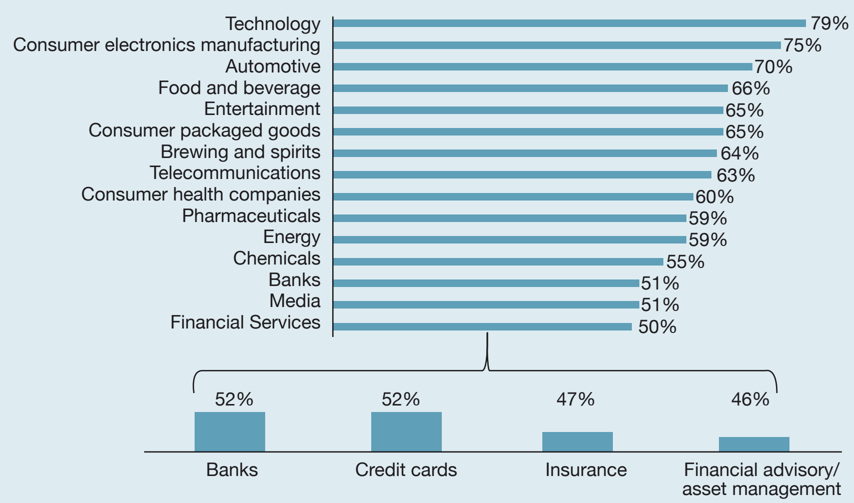
This is good news when you consider that the financial services industry is the least trusted industry in the world. Only 50 percent of those surveyed trust the financial services industry (figure 2). Diving deeper, only 46 percent trust financial advisory/asset management, making it the least-trusted of the financial services industry segments (Edelman Insights 2014).

Figure 1: SOCIAL3's Three P's



Source: SOCIAL3

Figure 2: Financial Services is the Least Trusted Industry Globally



Source: Source: Edelman Insights (2014)

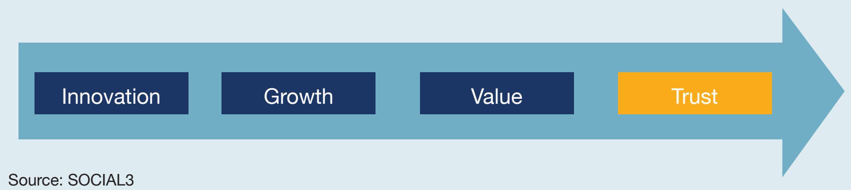
As consumers, we consciously or unconsciously lay the foundation for our own value drivers. What is important to us? What are we passionate about? What do we want to create? Whom do we trust? In essence, how do we develop our own consumer score for happiness and align ourselves with products, services, and organizations that embody what we hold in high value?

We can do this, building on discipline, direction, and faith that we can be true to ourselves and engage with the world through brand choices that support our value drivers. Companies that perform well, with an eye toward responsible, reputational management, corporate citizenship, and the development of sustainable programs, are the leaders in the long term.

Consumers are looking for transparency, creativity, engagement, and impact. Companies can deliver on these demands through what we call the "greater good value chain," which is accessible to companies that innovate (figure 3).

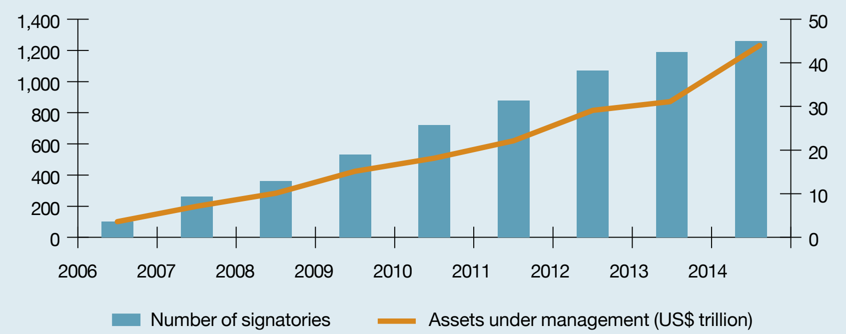
Innovation done right breeds growth; growth breeds value; value creates trust; trust engages the investor (i.e., the consumer) from a brand perspective. It's the delicate balance of a holistic communication system that aligns interests and passions of consumers (as citizens) with their daily lives and choices. All this momentum

Figure 3: SOCIAL3's Greater Good Value Chain



Source: SOCIAL3

Figure 4: Substantial Growth: Number of UN PRI Signatories and AUM



Source: UN Principles for Responsible Investing (PRI)

breeds development of a consumer's individual impact plan (IIP), driven by the three P's. Consumers who make brand choices that allow their money to work for them by promoting the greater good connect their IIPs more closely to their personal values. Hence the IIP, when rooted at the core of what defines a person, creates a symbiotic flow of passions, ideals, hopes, wishes, desires, and financial returns—a mosaic for success.

The socially responsible investing (SRI), ESG, and impact investing movement is gaining traction. Nearly three-quarters of companies included in the S&P 500 Index® (72 percent) have published sustainability or corporate responsibility reports, up from 20 percent in 2011 (Governance & Accountability Institute 2014). In other words, in 2013 only 27 percent of S&P 500 companies weren't publishing sustainability reports. This leads us to conclude that sustainability reporting is becoming the norm in the U.S. capital markets represented by the S&P 500, which is tied closely to the momentum of the U.S. economy.

Corporate responsibility reporting is becoming a mainstream business practice worldwide. Of the biggest companies in the world today, 250 report to the Global Reporting Initiative (GRI) (2014) about their economic, environmental, and social impacts. The European Parliament voted in April 2014 to approve a new law that will require that all public companies with more than 500 employees must address "policies, risks and results" in relation to "social, environmental and human rights impact, diversity and anti-corruption policies" in their annual financial reports. The 2,500 companies in Europe that today voluntarily produce sustainability reports will grow to nearly an estimated 7,000 by 2017, when the European Parliament law goes into effect.

ESG assets under management (AUM) were estimated in 2012 to be $13.6 trillion worldwide—equal to more than 20 percent of the 2012 global AUM (Global Sustainable Investment Alliance 2013; PricewaterhouseCoopers 2014a). As of April 2014, nearly 1,300 companies were signatories to the United Nations Principles for Responsible Investment (UN PRI), representing $45 trillion in AUM (figure 4). The number of signatories has grown at a nearly 40-percent annualized rate since the PRI was established in 2006, and assets have increased 600 percent in the same time period (UN PRI 2014).

Compelling reasons for asset managers to adopt ESG strategies include the following:

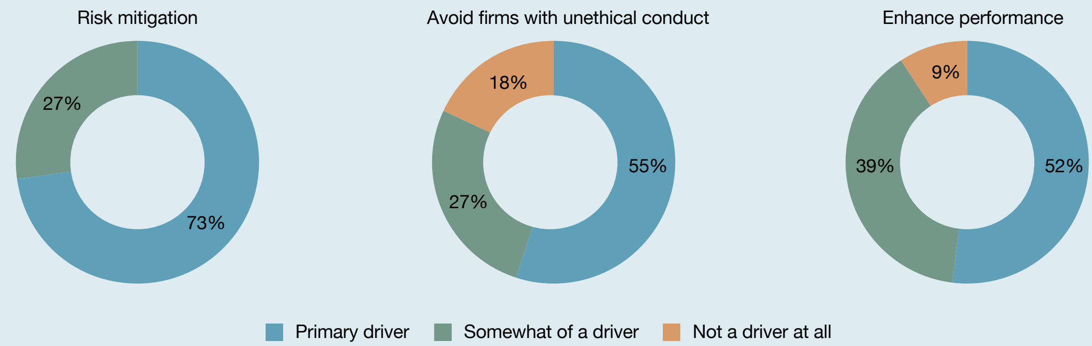
- risk management
- enhanced returns
- brand differentiation
- investor demand driven by the three P's and the need for IIPs

A recent study by PricewaterhouseCoopers (2014b) found that 73 percent of asset managers identify risk management as the driving reason for infusing sustainability metrics into their investment strategies (figure 5). The second and third most-popular reasons for employing ESG factors are to avoid firms with unethical behavior (55 percent) and enhance returns (52 percent).

These three reasons are tightly linked. Research indicates that firms that incorporate sustainability and corporate responsibility programs tend to outperform those that do not; in other words, "bringing a sustainability lens to business strategy can help to reduce risks, lower costs, drive revenues, and build intangible value, especially brand loyalty—all of which contribute to competitive advantage" (Etsy and Charnovitz 2011). Numerous studies from leading academic and financial institutions have demonstrated a positive correlation between an organization's strong ESG ratings and its returns. For instance, Deutsche Bank Group (2012) points out that "companies with high ratings for CSR and ESG factors have a lower cost of capital in terms of debt (loans and bonds) and equity. In effect, the market recognizes that these companies are lower risk than other companies and rewards them accordingly." Further, Koehler and Hespenheide (2013, 101) point out: "ESG disclosure is valuable because it helps a company demonstrate that it is managing its risks and has a track record of paying attention to its ESG performance. Those that disclose more ESG information are more likely to enjoy a lower cost of capital."

This does not prove that ESG strategies will outperform, but it does demonstrate that a

Figure 5: Why Asset Managers Are Considering Sustainability Issues



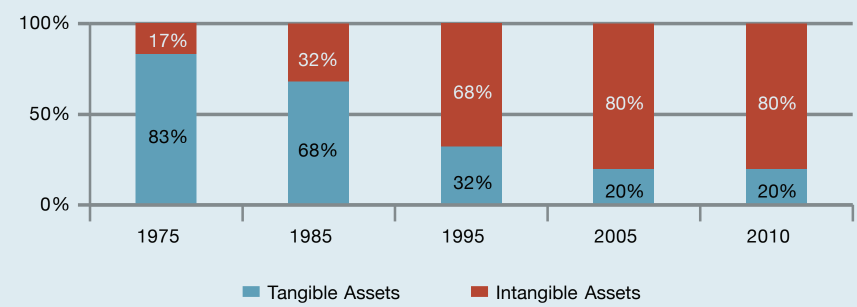
Source: PwC (2014)

business strategy that prioritizes risk management, prudent use of resources, and stakeholder engagement results in sound organizational practices that can yield better returns.

As asset managers increasingly adopt ESG strategies and as businesses continue to reap the value of defining sustainable strategies, more investors are seeing the benefits of ESG, leading to an oversubscription of the supply. A TIAA–CREF (2014) survey of retirement plan participants found that 64 percent of investors were interested in socially responsible investments. The interest, though most popular with younger investors, is widespread, and many baby boomers and women pay keen attention to integrating ESG strategies. According to IW Financial (2013), in the United States 85 percent of investment managers cite "client demand" as the main reason for integrating ESG into their investment decisions. This groundswell in ESG investing demand comes among a global shift in consumer mandates for increased transparency, shareholder activism, and movement toward conscious capitalism.

On the asset-manager side, ESG metrics are being viewed as important for producing a holistic assessment of a company's performance and its potential risks. Ocean Tomo (2011) found that between 1975 and 2010 intangible assets of S&P 500 companies increased from 17 percent of market value to 80 percent (figure 6). These intangibles, such as intellectual capital, risks, brand value, environmental exposures, etc., increasingly are competing with the physical assets of organizations.

Figure 6: Components of S&P Market Value



Source: Ocean Tomo (2011)

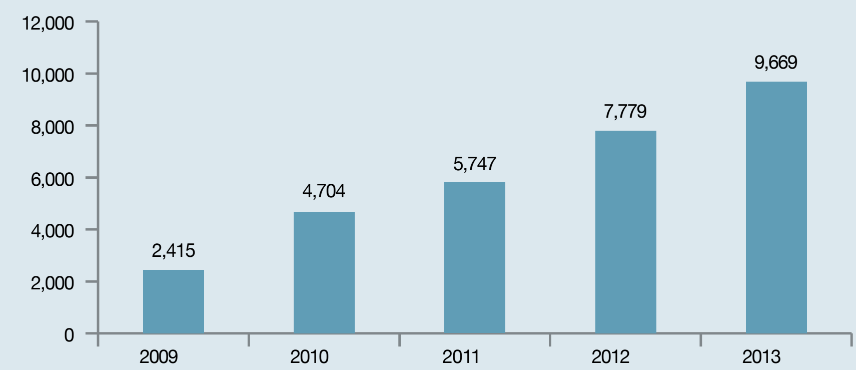
Over the same time period, as companies' asset compositions have shifted, the perspective of analysts who once dismissed ESG ratings and even viewed high ratings as a disadvantage to performance has evolved. Since the 1990s, analysts have begun to perceive corporate responsibility as a vital and integral metric to a company's overall picture of health, according to Ioannou and Serafeim (2014), who forecast that strong corporate responsibility performance likely may lead to an organization's outperformance in the long term, consequently yielding favorable investment outlooks.

Bloomberg (2014) reports that nearly 10,000 unique users used its ESG data in 2013, indicating an average annual increase in demand for ESG rating information of more than 41 percent since 2009 (figure 7).

Companies are realizing that ESG strategies create more than just goodwill; they also create economic benefits and shared value for their communities. Asset managers are using ESG to review how companies are holistically analyzed and engage clients with ties to their core principles.

For example, Johnson & Johnson (J&J), the second-best company on *Corporate Responsibility* (CR) *Magazine*'s 2014 100 Best Corporate Citizens list, has taken a broad-spectrum approach to its corporate sustainability and community impact. Some examples of J&J's initiatives include a commitment to remove potentially harmful chemicals from its products by 2015. By investing in employee wellness programs, J&J has saved $250 million in healthcare costs, with a return of more than $2.70 for every dollar invested in wellness from 2002–2008 as well as a more productive workforce (Porter and Kramer 2011). J&J committed to the United

Figure 7: Increase in Unique Users of Bloomberg's ESG Data



Source: Bloomberg (2014)

CORPORATE RESPONSIBILITY (CR) *MAGAZINE* BEST CORPORATE CITIZENS: TOP 25 RANKED COMPANIES

Rank	Company	Rank	Company
1	Bristol-Myers Squibb	14	Lockheed Martin Corp.
2	Johnson & Johnson	15	Accenture plc
3	Gap, Inc.	16	Cisco Systems, Inc.
4	Microsoft Corporation	17	Hess Corporation
5	Mattel, Inc.	18	International Business Machines Corp.
6	Weyerhaeuser Co.	19	Nike, Inc.
7	Ecolab, Inc.	20	McGraw Hill Financial, Inc.
8	Intel Corp.	21	E.I. DuPont De Nemours & Co
9	Coca-Cola Co	22	Hasbro, Inc.
10	Walt Disney Co.	23	Merck & Co., Inc.
11	Campbell Soup Co.	24	United Parcel Service, Inc.
12	Johnson Controls Inc.	25	Eaton Corporation plc
13	Kimberly-Clark Corp.		

Source: *CR Magazine* (2014)

Nations Millennium Development goals to improve health care for mothers and children and joined the United Nations Global Compact, two commitments among many other initiatives in the emerging and developing world to improve healthcare access (Johnson & Johnson 2013).

Gap Inc., the third-best company on CR's 2014 list, has taken a multi-pronged approach to corporate responsibility by expanding its sustainability reporting, raising the minimum wage in U.S. stores, and helping women in developing nations to learn life skills to advance their personal and working lives. Gap has pledged to cut its greenhouse gas emissions by 20 percent between 2008 and 2015; in 2012 the company began conducting green manufacturing workshops with key vendors based in Southeast Asia focusing on resource efficiently and environmental best practices (Gap Inc. 2011/2012).

In the financial services industry, we see TriLink Global bringing impact investing to the mainstream investor, and PaxWorld and Ellevate Asset Management joining together to help promote gender diversity on corporate boards and invest in companies that are advancing women through the Pax Ellevate Global Women's Index Fund. These efforts lead to investor engagement via the heart of issues that drive investor values. Large wirehouse firms such as Morgan Stanley, Merrill Lynch, UBS, and Prudential are offering ESG and SRI programs to their advisors, signaling that ESG is not a stand-alone activity or fad. These initiatives represent a holistic way of thinking about how businesses operate in today's global marketplace. They overlay sustainability principles on the operations of the business and engage investors, who see that they can invest for the greater good and get good returns, too.

Darby Hobbs is founder and chief executive officer of SOCIAL3, which fuses brand and sustainability principles through media production and presentation to cultivate ESG, impact investing, and CSR story lines and align clients' vision and strategy with market engagement. Contact her at darby.hobbs@social-3.net.

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