

ESG data and management quality: lessons from the investment banks

The US investment banks that survived the credit crisis performed better on ESG issues than those that didn't. This perhaps surprising correlation suggests a strong indicator of management quality: managements able to assess and mitigate longer-term strategic risks to their business are also better equipped to cope with a crisis. By Christopher Greenwald



An increasing number of investors and financial professionals have come to recognise the usefulness of environmental, social and governance (ESG) data as a means for measuring the quality of a company's management. In the spring issue of *McKinsey Quarterly*, 80% of CFOs and CIOs responding to a McKinsey survey agreed with the claim that ESG data can serve as a proxy for management quality. Indeed, those companies that are able to manage and benchmark their ESG performance tend to be those that are able to manage all aspects of their business effectively.

While the central importance of management quality for long-term valuations has become all too apparent to investors during the financial crisis, it nonetheless remains one of the most difficult factors to determine on the basis of financial reporting alone. Investors have become increasingly aware of the usefulness of ESG performance data in providing a more concrete basis for assessing management quality that can aid traditional financial

analysis in determining the long-term valuations of companies.

The credit crisis: a window into management quality

While this recognition of the usefulness of ESG data has emerged, the details of the specific links between ESG data and management quality have not yet been fully explored. The credit crisis provides a unique opportunity to study this link in greater depth, given the stark differences between companies' risk management practices prior to the crisis that were revealed so starkly by the radically differing performances of companies once the crisis began.

The investment banking industry in the US represents the most dramatic example of such differences. Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns were all involved to differing degrees in the securitisation of mortgage financing, which was the epicentre of the financial crisis. The stark differences in the fates of Goldman

Sachs, Morgan Stanley and Merrill Lynch, which survived or were acquired during the crisis, and Lehman Brothers and Bear Stearns, which failed, provide a unique opportunity to examine what, if any, ESG variables differed among these companies. Which of these variables might have provided some signal of the quality of management decisions before the crisis began?

Any such study must focus on the reports of these companies for fiscal year 2006, which were published prior to the onset of the crisis. An examination of some of the key differences leads to two initial observations.

First, prior to the financial crisis, many of the most important financial indicators of these companies were very similar. The five-year average returns on equity as well as the credit ratings of the investment banks were virtually identical at the beginning of 2007. Moreover, any considerations of either sub-prime lending or mortgage-backed securities as risk factors were completely absent from the 2006 10-K filings by the investment banks. This was despite the increasing importance of these assets on their balance sheets, as well as the dominance of these topics in their 2007 10-K filings after the crisis began.

Second, while a number of the ESG variables for these companies were similar for fiscal year 2006, there were nonetheless several key and notable differences in the reporting of Morgan Stanley, Goldman Sachs and Merrill Lynch, on the one hand, and Lehman Brothers and Bear Stearns on the other. With the exception of two key indicators, the corporate governance data of the five investment banks were quite similar in 2006, both in terms of policies and actual performance measures such as committee independence and compensation ratios. Similarly, in the social area, many similarities existed among the investment banks' performance.

Environmental reporting reveals key differences

Surprisingly, the clearest differences between the banks that survived and those that failed were in the area of environmental data. Morgan Stanley, Goldman Sachs and Merrill Lynch all provided much better information on policies and initiatives to improve environmental efficiency and reduce emissions. Interestingly, and more specifically, in contrast to Lehman Brothers and Bear Stearns, these companies also reported on the importance of climate change as a risk to their future business performance, and they identified the overall strategic importance of extra-financial factors more generally.

The table shows the 10 factors for which the performance of Morgan Stanley, Goldman Sachs and Merrill Lynch was clearly better than Lehman Brothers and Bear Stearns for FY 2006.

While out-performance on these factors correlated with the investment banks that survived the financial crisis, it is important also to examine these factors and their relationship to the financial performance of other capital markets companies. By combining these 10 ESG criteria into a unique rating framework using the ASSET4 system, it is possible to examine the correlation of these factors with price performance over time. Doing so reveals quite interesting parallels.

Among all US capital markets and commercial banks, companies with relatively higher scores (greater than 50 percentile) on these 10 ESG factors out-performed those with lower scores between 2006 to 2008 by 14.4% on average. Consequently, the 10 ESG criteria that differed markedly among the five leading investment banks in 2006 may reveal important variables that can be used as a signal for measuring management quality across other companies in similar industries.

This conclusion may initially appear to be counter-intuitive, given that environmental factors do not have a significant material link to the financial performance of capital markets companies in the short term. However, these subtle differences in company reporting may nonetheless provide important signals concerning the seriousness with which ESG factors are taken by management. Specifically, the ability of management to foresee the impact of climate change on its business reflects its abil-

10 key extra-financial performance indicators

- Overall strategic policy on extra-financial indicators
- Commercial risks and opportunities due to climate change
- Emissions reduction policy
- Total reported carbon dioxide emissions
- Energy efficiency initiatives
- Environmental partnerships
- Environmental citizenship initiatives
- Environmental project financing
- Percentage of strictly independent board members
- Ratio of non-audit to audit fees

ity to understand its business activities in the light of longer-term and systematic risks.

Similarly, the ability of such companies to report and benchmark their environmental performance can serve as a strong reflection of the extent of effective measurement tools and management practices throughout these companies' activities.

In short, these variables provide a measurement of management's ability to adopt a long-term view of its business strategy. Those

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capital markets companies that are able to make short-term decisions in the light of such a longer-term view are much more likely to be cognisant of the systematic risks that they face. They are therefore better prepared to face the challenges that unforeseen circumstances such as the financial crisis may present.

Combining extra-financial and traditional analysis

ESG data does not hold a set of answers that can explain all or even most of the many complex factors that determined companies' radically differing financial performance during

the credit crisis. However, when combined with traditional financial analysis, ESG data can provide a useful means for measuring management quality and understanding the long-term orientation of companies more generally. Such assessments are most effective when grounded in objective ESG criteria that are filtered through sector- or industry-specific frameworks, given the differences in company reporting across industries as well as the various degrees of importance of ESG variables in different sectors.

As the provider of the world's largest database on objective, ESG data, ASSET4 is uniquely positioned to allow investors to explore the link between ESG data and management quality in greater detail. With 278 key performance indicators and over 900 individual data points as well as three to seven years of historical data on over 2,600 publicly traded companies, ASSET4's database allows investors to conduct in-depth qualitative or quantitative analyses on the impacts of specific ESG factors on performance at the level of the company, industry or sector.

ASSET4 is convinced that additional research in this area will reveal many new and important links between ESG data and the quality of a company's management. Doing so will help the larger financial community to understand better the significance of ESG data as providing a means to identify those companies which have a longer-term orientation toward managing extra-financial and financial risks that will be reflected in their valuations over time.

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