



The Next Phase of Integrating Environmental, Social and Governance (ESG) Information into Mainstream Investing

While socially responsible investors have for many years used ESG – environmental, social and corporate governance – information to screen their investments for extra-financial risks, the integration of this information into traditional financial analysis has been viewed by many as the next phase in the maturation of responsible investment.

ESG ‘integration’ refers to the use of ESG data in determining company valuations and requires making a link between extra-financial information and financial performance. Many academic and financial research studies have attempted to make this connection by examining the relative stock market performance of companies based on ESG screening or criteria. These studies have provided very mixed results, however, for two reasons: they have generally involved the examination of the relative performance of SRI funds, or they have examined a company’s stock market performance based on ESG ratings independently of financial factors. The first approach suffers from being a reflection of the relative performance of fund managers rather than the role of ESG data, and the second suffers from studying ESG data in isolation from financial information and analysis.

To understand integration as a strategy, it is necessary first to develop models that use ESG data not independently of financial analysis, but as a means of enhancing financial analysis directly. Only on the basis of such models can integration truly be pursued by mainstream investors and consequently studied in terms of its implications for stock market returns.

Fortunately, there are some very encouraging signs that such sophisticated models for integrating ESG information are emerging, and several important factors are driving these developments. First, the credit crisis has caused mainstream investors to become increasingly aware of ESG as an important information source of insight into the long-term viability of companies. Specifically, mainstream investors have come to recognise the usefulness of ESG performance data as a proxy for evaluating the quality of a company’s management. While management quality is one of the most difficult factors to determine on the basis of financial factors alone, it is perhaps the most important factor in a company’s long-term valuation.

As more companies report their ESG data, tools are becoming available that enable investors to analyse the impact of these factors on a company’s financial performance.

ESG data provides a qualitative window into management practices that underlie top-line financial results, and investors are recognising that those companies that effectively manage their relations with customers, employees, the environment and shareholders tend to be effectively managed in all aspects of their business.

Second, more sophisticated models of integrating ESG data into the investment screening process have been developed by several of the leading sell-side research firms in the area. Société Générale and Goldman Sachs, for example, have both developed innovative approaches to incorporating ESG into financial analysis by combining a screening of financial performance or risk profiles with an assessment of management quality based on ESG data. Far from cutting these research efforts during the credit crisis, both firms have responded to an increased demand for such analysis by investors after the credit crisis by promoting and further enhancing their ESG research frameworks.

Third and most importantly, investors for the first time are becoming able to pursue a more fundamental integration of ESG data into financial analysis, given the greater availability of materially relevant ESG data at the key performance indicator (KPI) level. The availability of data has followed the dramatic increase in ESG reporting by public companies over the past 15 years. While only 50 companies were issuing reports on their environmental and social performance in 1993, over 3,000 companies issued reports on environmental and social performance for fiscal year 2007.

Investors have experienced a fundamental and permanent change in the way companies report information to the public, and a substantial portion of this information is materially relevant in evaluating financial performance. The development of the Global Reporting Initiative over the past decade, combined with the growing interest from investors has also fostered an increase in the availability and quality of quantitative ESG data that is necessary to benchmark company performance objectively.

One example of a particular ESG data point that companies have increasingly disclosed in recent years is the turnover of employees, or the percentage of the company's workforce that is replaced on an annual basis. For many years management consultants have recognised the importance of the employee turnover rate as not only an important measure of employee satisfaction, but also as a critical cost factor for companies. Replacing experienced employees requires not only the direct costs of hiring and training new employees but also the often hidden indirect costs of lost productivity and increased workload in order to compensate for the loss of knowledge and skills from experienced employees.

To measure the financial impact of employee churn rates more concretely, ASSET4 examined the results of 15 studies on the estimated costs of replacing employees to determine a factor that can be combined with the average employee and benefit packages across sectors. By multiplying the resulting values with the actual reported turnover rates of companies and then analysing the

resulting values in relation to company earnings before interest, taxes, depreciation and amortisation (EBITDA), it becomes possible to realise the bottom-line impact of the employee turnover rate on company performance in different sectors.

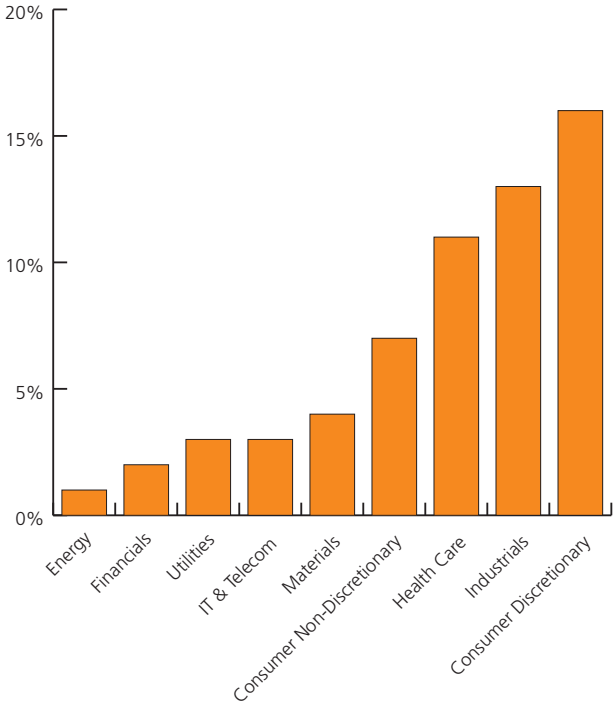
The resulting values in Figure 1 clearly indicate a very significant average impact of a single ESG variable on a company's financial performance for certain sectors. The impact of employee turnover rates can be as high as 16% for the consumer discretionary sector, 13% for industrials and 11% for health care.

While most traditional financial analyses have not included such materially important ESG factors, this has not been the result of negligence on the part of the financial community. Rather, until recently most financial analysts have not had systematic access to such information, either as a result of a failure by companies to disclose the information or due to a lack of tools to access this data across large numbers of companies. To develop models that integrate ESG data into traditional financial analysis, mainstream investors require easy and transparent access to the ESG data that companies are now reporting as well as the tools necessary to understand their potential impacts.

As the leading data provider of ESG information on over 2,900 companies globally, ASSET4's primary mission is to collect such materially relevant ESG data, to ensure its consistency and reliability, and to provide investors with a series of tools to benchmark relative performance and thereby integrate the data into their financial valuation models. In providing this, ASSET4 allows investors to understand the impacts that particular ESG variables can have on the financial bottom line and thereby to create screening and analysis frameworks that truly integrate financial and extra-financial information in determining long-term valuations and risks.

The integration of environmental, social and governance information by mainstream investors is clearly under way, and ASSET4 hopes to promote this movement by providing the necessary information and tools that mainstream investors require and thereby lead responsible investment into the next stage of its maturation and development.

Figure 1. Value of employee turnover rates/EBITDA



Source: ASSET4



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