The added value of integrating extra-financial criteria in an investment process

Topic of the month November 2014

Investors, especially those in equities, are generally familiar with financial ratios such as earnings per share, dividend yield, etc. But what about extra-financial criteria? These are criteria which are not directly taken into account in companies' balance sheets and earnings statements. When they are reported, they are mostly in the appendices of the balance sheets, or even in a completely separate report, called the extra-financial report. This report is generally less known to equity investors, especially to analysts and portfolio managers. However, it is not less interesting. On the contrary, argues Ophélie Mortier, Petercam's dedicated SRI Coordinator.

Taking a holistic view of a company

Indeed, the financial community takes a global view of a company, meaning that it is embedded in a global context, which is relatively complex and strongly interlinked. The role of a company is not limited to producing profits, paying taxes, making risk and pension provisions and generating stock market returns. By its very activity, it plays a key role as regards its employees, clients, suppliers, regulators in a global environment. It is also subject to major challenges such as climate change, the demographic issue, and scarcity of resources including energy and agricultural resources.

Unfortunately, this role and impact are not easily measurable or quantifiable. How should we judge the acumen of a company's employees? By productivity? The aptitude of its manpower? The diversity of profiles and competences? How can we reduce the dependence on fossil energies? How can we assure sustainable quality relationships with suppliers? Extra-financial criteria are often quite intangible, hence the difficulty of measuring them in an objective way. Although financial analysis has been around for more than 100 years now and has evolved strongly, especially in terms of standards and norms, the extra-financial approach is much more recent and emerged just ten years ago.

Each sector has its own specificities and requires in-depth knowledge. For example, in terms of energy, it is of key importance to ensure that we are speaking about the same concepts, and that there is no confusion, for instance between primary and secondary energy. There is not always a guarantee that the methodologies used are perfectly comparable. The explanation is also linked to the limited number of findings and standards in this matter. Although ISO norms or similar norms are the first guidelines, the methodologies have not reached the levels of standardisation found in the purely financial analysis for which most concepts have been universally defined.

Concomitantly, control authorities, auditors, etc. have not yet acquired enough knowledge in these specific domains to validate and certify extra-financial accounts with the same guarantee of control and compliance which they would have used for balance sheets and profit and loss accounts. We also need time for training, knowledge and the development of norms and standards that can then be adopted. So it will take time, just as with financial reports. We would like to reiterate the difficulties in adopting consolidated accounts for multinationals, with some even claiming it would be very hard. Nowadays, it is unlikely for any multinational not to report its consolidated accounts.

Integrating extra-financial criteria into an investment process makes sense

But above all, why should one integrate extra-financial criteria into an investment process? Given the various hurdles, what real added value can this really provide?

First of all, the media are constantly reminding us that we live in a global and interconnected economy. Therefore, it is no longer possible to single out one specific element which would then be autonomous and independent of any other external influence. Putting a company in a global context makes sense in establishing a qualitative and fundamental analysis of its value and future potential. All economic stakeholders, no matter what level they are at, need to address macro-economic challenges such as demographics, climate change and resource scarcity. Each economic player is confronted with these challenges and will need to tackle them in order to survive. It is likely that those who are best prepared are best positioned to address them. In other words, the best prepared companies and the most proactive in that regard clearly have a competitive advantage over their more reactive peers. This competitive advantage will sooner or later manifest itself in companies' financial performance.

Materiality

The objective of integrating extra-financial criteria in an investment process is therefore linked to a competitive advantage resulting in superior financial performance. Because in the end, all investors will seek performance. That is why the integration of extra-financial criteria is primarily focused on material criteria, which are the most likely to have repercussions on the performance of a company in the mid- to long term.

'It's all about taking a holistic view of a company'

This aspect of materiality is also a challenge with regard to the integration of extra-financial criteria in an investment process. Indeed, often certain aspects linked to environmental, social or governance criteria do not have any impact – or no immediate one – on a company's stock price. There are many examples of allegations against certain companies, for example relating to anti-competitive practices or the respect of labour rights, etc. without the company's stock price budging. This is where the challenge of reconciling two timeframes comes in: investors' short-term quest for performance, and the materiality of ESG challenges which is more geared towards the mid to long term. An investor can be drawn to a quick profit which is unlikely to be sustainable. Other investors also need to face performance objectives which are too often short-term, and which entail unsustainable and harmful investment behaviour which detract from long-term investment performance. Indeed, there are still many investors around who are worried about their performance on the 31st of December of each year.

Today, a company's stock price can remain stable although the company is reneging on its commitments, for example to its employees. It is highly likely that the situation will change when investors continue to take their social role seriously as investors, and when regulators will become more strict and demanding on these various subjects.

In order to enhance the quality of the analysis of a company, the extra-financial criteria to be integrated into the investment process do not only need to be material, but should make it possible to discriminate between the several stakeholders. This is not a straightforward element of the analysis. One often hears the comment "but they all do it", while at the same time, given the difficulty of assessing certain aspects, which we mentioned at the beginning of the article, caution is warranted in comparing performances of competing companies.

Constraints and limitations

The integration of extra-financial criteria in an investment process therefore has its constraints. Primarily, the access to information. Although there are plenty of suppliers of extra-financial data, there is a strong bias towards larger market capitalisations. The latter are better placed to perform well in terms of extra-financial criteria than their smaller peers. Indeed, they tend to have more resources and will not hesitate to put in the means to show their better profile with regards to commitments to social, environmental and governance issues. In certain countries, such as France, companies of a certain size are legally obliged to report on extra-financial criteria. In addition, extra-financial information agencies are looking for information, and their questionnaires, which are lengthy and in-depth, require a time investment. Given the workload that this kind of information request may induce, it is not surprising to see that larger capitalisations stand out in terms of the quantity and the quality of the information provided. This lack of reporting on behalf of smaller companies can at first glance be considered as a lack of transparency and may thus be penalised by the rating agencies.

Finally, the reference indices in this domain also tend to allocate a higher weighting to larger capitalisations. That is primarily because they have more information at their disposal. For reputational matters, big companies also want to be part of this reference universe. It thus becomes a vicious circle, reinforcing the leaning towards larger capitalisations. Nonetheless, the number of indices on smaller capitalisations is on the rise. Their methodology and criteria are more adapted to their profile, means and resources. Once again, it is a matter of time before the smaller capitalisation spheres become as important as those of larger capitalisations.

Conclusion

In sum, although the challenges of integrating extra-financial criteria into an investment process are many, putting a company in a global context, with social, environmental and governance challenges, is not an easy thing either. This is justified and its added value will become increasingly visible over time.

Since 2000, financial markets have faced three major crises – one of corporations, one of financials and one of sovereign states – all being closely linked to governance crises. The integration of extra-financial criteria makes it possible to pick the leaders in terms of socio-environmental issues. Their volatility is much more controlled than that of companies which are less respectful of their social commitments.

Financial markets are still strongly dictated by investors' short-term approach, which stands in stark contrast to the challenges we are faced with tomorrow. Nonetheless, we may hope that the trend of making investments with longer time horizons will gain momentum. Not only investors, but all economic stakeholders, are currently in a transition phase during which the repercussions of the models developed so far are studied and questioned so as to build tomorrow's finance. The fundamentals of companies should be retaken into consideration, instead of limiting oneself to purely financial aspects. One should take a global view on a long-term horizon in order to guarantee the sustainability of this 'new finance', which will eventually be characterised by greater stability, not only on a micro level, but also on a macro-economic level.

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