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Socially Responsible Investment

Responsible investment: the evidence stacks up

Topic of the month November 2018

Sustainable investment is not only good for protecting the world for tomorrow's generations; it can also be a route to superior portfolio returns

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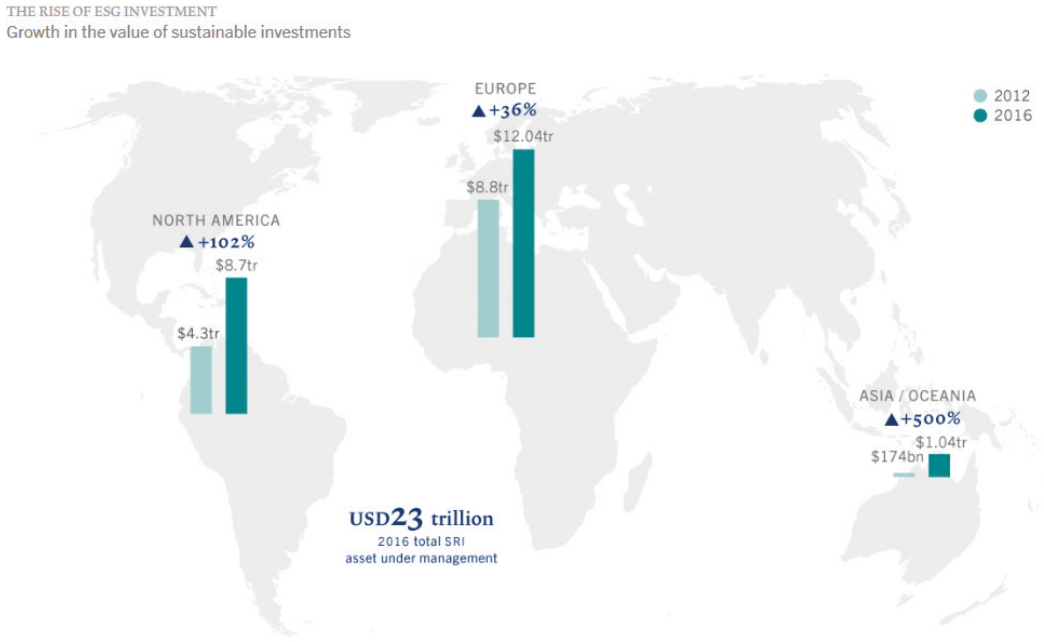
What constitutes a sound investment or business decision? Less than a decade ago, the answer to that question would have been framed exclusively in financial terms. No longer. Thanks to structural trends such as climate change and higher income inequality, a growing number of companies now put environmental, social and governance (ESG) considerations on a par with economic ones. That makes commercial sense, and for several reasons.

First, as governments around the world gear up to meet the Paris Accord targets on global warming, environmental regulation is likely to become a bigger risk to the bottom line. Second, the effects of the steady decline in the cost of renewable power and energy storage promise to be transformative, particularly for companies operating in energy-intensive industries such as energy, utilities and transport.



Source: Global Sustainable Investment Review 2016

The third incentive for businesses to embrace ESG is consumer power. In recent years, consumers have become increasingly aware of how corporations affect society and the environment. As a result, brand perception and customer loyalty – the non-tangible assets which make up a part of a company's market value – are increasingly linked with ESG credentials. That applies both to the long-term strategic development of the business, as well as to its day-to-day practices.

Neglecting ESG can inflict lasting reputational and financial damage. Shares in BP, for example, slumped in the aftermath of 2010 Deepwater Horizon oil spill. Volkswagen saw sales fall sharply after the emissions test cheating scandal. And, most recently, Transport for London refused to renew Uber's operating licence saying the firm's "approach and conduct demonstrate a lack of corporate responsibility".[1]

Healthier finances and better returns?

Our review of available academic research on ESG shows that companies that follow sustainability principles tend to exhibit better and more stable financial performance.

Investors need to take note too, particularly because sustainability leaders tend to deliver stronger risk adjusted returns on equities and debt.

For example, good resource management – from waste to energy consumption – doesn't just reduce a firm's pollution, but also its production costs. US companies which scored highly on climate change management within their industry have delivered higher returns on equity, reduced earnings volatility and shown stronger dividend growth compared to low-scoring peers.[2]

Social and governance credentials also have an impact on the bottom line. Companies with high employee satisfaction ratings have a track record of outperforming their industry benchmarks.[3]

In general, firms that focus on sustainability benefit from a lower cost of capital and higher credit ratings than their peers.[4] Those that have been ineffective in managing environmental risks have, on average, 20 per cent higher borrowing costs.[5] They also tend to have higher cost of equity.[6]

More broadly, a meta-analysis of more than 2,000 primary studies of company behaviour concluded that there is a positive relationship between corporate financial performance and sustainability credentials.[7] This is supported by two other major research papers, which independently showed that ESG-focused companies tend to outperform peers in terms of both share prices and financial results.[8]

What practical significance does this have for investors? According to one study, every USD1 invested in highly sustainable US companies in 1993 was worth USD22.6 by 2010, compared with USD15.4 for low-ESG peers.[9] Overall, our review of available research suggests that investing in ESG leaders carries no performance penalty and has the potential to boost returns.

Furthermore, there is some evidence that the better ESG rating a company has, the less volatile its share price trends to be, particularly in turbulent times. This, in turn, suggests that sustainable companies could offer significant diversification benefits to investors.

New horizons

No wonder, then, that the investment community's approach to ESG is also having to change. Historically, ESG-oriented portfolios have focused on excluding certain types of companies. But now the investor's role is broadening. Promoting sustainable business

practices through active ownership and engagement, as well assessing the impact of ESG factors on companies' valuations, returns and creditworthiness are an increasingly important part of investment activity.

That's not to say investors should focus exclusively on ESG leaders. Within moral and legal limits, there could still be a case for investing in well-priced sustainability laggards, as long as their future potential outweighs the risks.

As well as shaking up existing industries, the rise of ESG is opening up new opportunities for business and investment. For example, we forecast that the environmental products industry will grow by 6-7 per cent per year until 2020 – more than twice as fast as the global economy as a whole.

ESG analysis, therefore, can be a route to identifying companies with strong growth prospects, efficient cost management and the right attributes to win brand loyalty from an increasingly demanding public. Conversely, it can also help avoid falling foul of changes in economic trends, consumer preferences and government regulations.

1 Licensing decision on Uber London Limited", TFL, September 2017; Uber is appealing the decision

2 CDP S and P 500 Climate Change Report, 2014

3 "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices", Edmans A., Journal of Financial Economics, 2011

4 "Corporate Environmental Engagement and Credit Risk." Bauer R. and Hann D., Maastricht University ECCE Working Paper, 2010; "Corporate Social Responsibility and Credit Ratings." Attig, N. et al, Journal of Business Ethics, 2013

5 "Environmental Externalities and Cost of Capital, Working Paper," Chava S., Georgia Institute of Technology, 2011

6 "Corporate Environmental Responsibility and the Cost of Capital: International Evidence", El Ghoul S., Guedhami O., Kim H. and Park K., Journal of Business Ethics, 2016

7 "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies", Friede G., Busch T. and Bassen A., Journal of Sustainable Finance and Investment, 2015

8 "Sustainable Investing: Establishing Long-Term Value and Performance," Fulton, M., Kahn, B. and Sharples, C., Deutsche Bank's Climate Change Advisors Report, 2012; "From The Stockholder To The Stakeholder: How Sustainability Can Drive Financial Performance", Arabesque Partners and University of Oxford, 2015

9 "The Impact of Corporate Sustainability on Organizational Processes and Performance", Eccles R., Ioannou I. and Serefeim, G., Management Science, 2014

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