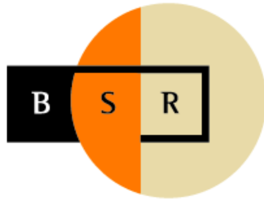

Business for Social Responsibility

Environmental, Social and Governance: Moving to Mainstream Investing?

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1. Introduction

The topic of incorporating environmental, social and governance (ESG) criteria as part of long-term company valuation by financial institutions has been entering mainstream debate in recent years. Although many mainstream financial institutions, such as ABN AMRO and Goldman Sachs, have begun considering the effects of including ESG criteria as part of their fundamental financial analysis, investors are waiting for vetted proof of long-term materiality before fully incorporating the criteria. If ESG criteria become part of mainstream investment analysis, it can have an important influence on how public companies manage these issues. It is therefore important to understand how these criteria are being incorporated by mainstream financial institutions, as well as the barriers that have currently prevented such integration from becoming universally practiced.

This report investigates the effectiveness of financial services companies at incorporating ESG criteria into mainstream investments. With regard to incorporating the ESG criteria, the report evaluates the challenges that have been faced and solutions that have been proposed industry-wide.

ESG criteria can include a range of different issues, depending on the regions and sectors. The following are examples of issues with a broad range of impacts on companies as identified by the Global Compact (GC) in the 2004 report entitled, *Who Cares Wins: Connecting Financial Markets to a Changing World* (GC, 2004).

Environmental issues:
- Climate change and related risks
- The need to reduce toxic releases and waste
- New regulation expanding the boundaries of environmental liability with regard to products and services
- Increasing pressure by civil society to improve performance, transparency and accountability, leading to reputational risks if not managed properly
- Emerging markets for environmental services and environment-friendly products

Social issues:
- Workplace health and safety
- Community relations
- Human rights issues at company and suppliers'/contractors' premises
- Government and community relations in the context of operations in developing countries
- Increasing pressure by civil society to improve performance, transparency and accountability, leading to reputational risks if not managed properly

Corporate governance issues:
- Board structure and accountability
- Accounting and disclosure practices
- Audit committee structure and independence of auditors
- Executive compensation
- Management of corruption and bribery issues

II. Statement of Problem

Historically ESG criteria have been synonymous with Socially Responsible Investment (SRI). SRI is defined as the integration of social and environmental criteria into the traditional investment decision-making process to allow large institutions and individuals to make investments that are consistent with both their social and financial goals.[1] In general, social investors use four basic strategies to maximize financial return and attempt to maximize social good: negative screening,[2] positive screening,[3] divesting[4] and shareholder activism.[5] These strategies were traditionally performed by specialist SRI firms such as Calvert Group, SRI research firms such as Innovest Strategic Value Advisors and KLD Research and Analytics, or in specific funds such as the Domini Social Equity Fund.

However, the rationale behind incorporating ESG criteria into the mainstream investment process as discussed in this report focuses solely on maximizing financial performance as per the fiduciary responsibility of mainstream financial institutions.[6] Organizations such as the United Nations Environment Programme Finance Initiative (UNEP FI) and Sustainability Asset Management (SAM), cite numerous academic and brokerage firm studies that qualitatively and quantitatively show a positive association between the inclusions of these criteria and enhanced financial performance.[7] However, many investors refute that substantial empirical data exists to draw the conclusion that ESG and shareholder value are intertwined. One investor points to the lack of long-term data to substantiate his belief that many of the claims of positive association are "hyped-up" and can only be proven with many more years of supporting data.[8] Due to the lack of long-term analysis of these criteria and their impact on returns, the present data is inconclusive.

There is no standardized approach to integrating ESG criteria into mainstream investing practices, which is demonstrated in the following ways. First, when observing mainstream financial institutions based on their publicly stated polices, there seems to be buy-in of the ESG concept, though this does not necessarily translate into routine integration of the criteria.

Second, there is no consensus on the effectiveness of the criteria. For example, on the issue of determining influence of the criteria on share price, some investors feel that variations in

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[1] Defined by Jantzi Research (http://www.jantziresearch.com/index.asp?section=11)
[2] Negative screening - excludes certain securities from investment consideration based on social and/or environmental criteria. For example, many socially responsible investors screen out tobacco company investments.
[3] Positive screening - making investments in activities and companies believed to have high and positive social impacts.
[4] Divesting - act of removing stocks from a portfolio based mainly on ethical, non-financial objections to certain business activities of a corporation.
[5] Shareholder activism - shareholder attempts to positively influence corporate behavior. These efforts include initiating conversations with corporate management on issues of concern, and submitting and voting on proxy resolutions.
[6] A November 2005 report from the law firm Freshfields Bruckhaus Deringer commissioned by the United Nations Environment Programme Finance Initiative (UNEP FI) established that fiduciary duty not only allows ESG considerations, it sometimes requires them.
[7] Based on conclusions drawn from UNEP FI's 2007 report entitled, *Demystifying Responsible Investment Performance* and SAM's report entitled, *The Sustainability Yearbook 2008*.
[8] Phone interview with Lloyd Kurtz of Nelson Capital (March 24, 2008)

stock prices are influenced by short-term investors (such as hedge funds) and that ESG criteria are not considered by these investors as part of their assessment practices. However, other investors are not discouraged by such claims, and feel that ESG criteria are good proxies for how a company is managed overall and therefore will help forecast how the company will perform in the long term. As such, the materiality of these criteria will primarily manifest themselves in long-term investments.[9]

Third, many investment professionals are not convinced that there is enough empirical evidence to say that consideration of ESG criteria will act as a better predictor of monetary success over time, but rather require several more years of history to make it a convincing case.

While these three points represent only a small sampling of the varied investor sentiments on the issue, they demonstrate the lack of standardization. As such, some financial investors believe that ESG factors have had a minimal effect on mainstream investment practice.

Going beyond the cliché "you do well by doing good," this report assumes that some ESG factors are risk factors that can have a material impact on investment performance when taken into account in conjunction with traditional financial assessment criteria. As such, this report answers the following questions:

1) How do companies and other players (research firms, shareholders, etc.) incorporate ESG criteria into mainstream investing culture?
2) How is the effect of ESG criteria incorporation being measured, and do these efforts have an impact?
3) What are the barriers to successfully incorporating these criteria into mainstream investing and what are possible solutions to those barriers?

III. Incorporating ESG Criteria into Mainstream Investing Culture

There is significant attention on including ESG criteria into mainstream investing culture. Numerous articles and discussions explore the efficacy of the criteria on shareholder value. However, it seems that most mainstream financial institutions approach with caution the integration of ESG criteria into their fundamental evaluation processes. Although many companies are establishing protocols for assessing ESG criteria, they are not fully integrated into their routine evaluation processes. Instead, mainstream investors are still waiting for proof of their long-term materiality.

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[9] Phone interview with Melissa Epperly of Goldman Sachs (April 3, 2008)

According to the *2007 Report on Socially Responsible Investing Trends in the United States,* "roughly 11 percent of assets under professional management in the U.S. – nearly one out of every nine dollars – are now involved in SRI" (Social Investment Forum, 2007). Although this figure may seem high, it includes all types of SRI, the majority of which are screened investments; as such, this does not speak directly to how ESG criteria as defined in this report are being incorporated into mainstream investing. This "11 percent" figure illustrates the vagueness of the information surrounding this issue.

However, the incorporation of ESG criteria has significantly increased in the past few years. One of the prime indicators that ESG factors are being incorporated into conventional investment practices is the inclusion of the topic as part of the 2008 CFA Institute Annual Conference.[10] As advertised by the conference, the intended audience includes portfolio managers, analysts, chief investment officers, chief executive officers, investment advisers, pension plan investment officers, relationship managers and consultants. Although the topic of ESG criteria is not the main focus of the conference, its inclusion demonstrates an acknowledgement that the criteria are moving out of the realm of isolated discussion amongst SRI professionals and are receiving mainstream attention.

Additionally, publications by thought leaders in the financial arena indicate a growing trend among financial institutions to incorporate ESG criteria into their routine investment practices in many industries, including: global energy, metals and mining, food and beverages, and pharmaceuticals. A highly publicized example of this incorporation is the recent announcement made by Citigroup, JP Morgan Chase, and Morgan Stanley. These three companies reported that they will require utilities seeking financing for coal-fired power plants to prove that the plants will be economically viable under potentially stringent caps on CO_2 emissions. "The banks say they don't want to be involved with debt that goes bad as a result of potential government emissions caps that require the power plants they finance to buy large numbers of extra pollution allowances" (Ball, 2008).

Despite these recent events, many investment professionals acknowledge that while these criteria are part of a growing trend, they are not convinced that they have yet reached mainstream consideration.

Summary

Based on publications from financial institutions, the results of the Principles of Responsible Investing (PRI) survey (summarized in Appendix C) and interviews with investment professionals, presently there is not a standardized approach to integrating ESG criteria into mainstream investing practices. It seems that companies are taking on varying levels of integration. The lack of standardization is revealed in two ways.

[10] The 2008 CFA Institute Conference agenda states the panel discussion, "Why Environmental, Social and Governance Issues Have Become Mainstream," will include: Bridge Barnet of Canada Pension Plan Investment Board, Matt Christensen of EUROSIF, Sarah Forrest of Goldman Sachs, and Michael Jantzi of Jantzi Research Inc. (http://www.cfainstitute.org/memresources/conferences/Event_1796/agenda.html)

First, financial institutions are developing different ways of evaluating ESG criteria. Many financial investment professionals are centering on the idea that *some* ESG factors will yield a positive return on investments, and *some* factors may yield a negative return. As such, they are looking to identify indicators of risk, corporate management, pending regulation and anything else that might affect the overall share price of a company.

Second, companies are differentiating themselves based on their methodology of integration. Variations include assessing ESG criteria with an industry focus, maintaining siloed ESG experts within the firm, fully integrated enhanced analysis for all investments, and development of specific ESG funds.

In this infant stage of ESG criteria development, it would seem that in order for financial institutions to stay competitive, their ESG integration methodology must constantly evolve as new data is available on the materiality of criteria and as various methodological differentiators prove to be successful.

IV. Impact of ESG Criteria

How is the effect of ESG criteria incorporation being measured, and do these efforts have an impact?

Most mainstream investors are still trying to assess the added value of including ESG criteria in the fundamental investment model. Although being able to precisely measure the impact of ESG criteria on overall returns would be ideal, in reality, there are several impediments to carrying this out. These include the lack of long-term data, inconsistent methodologies to incorporate ESG criteria, and innumerable variables that affect overall share prices.

An article in *The Banker* about the recently released “Banker/Innovest Top ESG Global Banks” listing concludes that banks that take ESG seriously (as identified by the study) have better stock market performance. The article highlighted data from the recent and ongoing subprime “debacle” (specifically analyzed from September 13, 2007, to January 1, 2008). The list “uniquely focuses on global banks, thus avoiding the tendency in rival lists for smaller microcredit or co-operative institutions to win prizes when their effect on the world is minor. The 22 global banks [analyzed and listed] are major institutions that shape the world in which we live.” The model used to rank the banks accounted for approximately 50 metrics, which were evaluated through the processes shown in Appendix D (the specific metrics were not revealed in the article).

Overall, the breakdown of how the model evaluates banks’ ESG performance is as follows: ESG risk exposure (30 percent); ESG due diligence (30 percent); strategic profit opportunities (15 percent); stakeholder capital (15 percent); and human capital (10 percent).

The Banker/Innovest listing exemplifies the notion that developing a framework by which to assess the ESG incorporation is important in determining the validity of the ESG criteria.

However, as stated with the impediments to assessing impact, at this time, many investment professionals are skeptical as to whether it is possible to draw a conclusion such as the one in the Banker/Innovest report, which lacks significant historical trends data.

Summary

Many financial institutions have developed criteria and frameworks for assessing the impact of ESG incorporation on returns. The four frameworks listed below were selected for their open disclosure of criteria and/or methodology. Summaries and critiques of these frameworks are included in Appendix F.

- Smith Barney: *Sustainable Investment Themes*, July 1, 2005
- Goldman Sachs: *Introducing GS Sustain*, June 22, 2007
- Sustainability Asset Management (SAM): Questionnaire to design Dow Jones Sustainability Index (DJSI) 1999-2008
- Standard & Poor's: *S&P ESG India Index Fund Index Methodology*, January 2008

Based on these frameworks as well as interviews with investment professionals, several key themes emerged related to how the impact of ESG is measured and the challenges associated with such measurement. These findings are discussed below.

Outperformance as compared to a recognizable baseline is the most important indicator of ESG criteria materiality and impact. Overall, financial institutions need vetted proof of the financial returns for ESG to be credible. To this end, many mainstream investors look for long-term outperformance of investments as compared to some baseline when incorporating these criteria. Both the S&P ESG India Index (Index) and the GS Sustain Focus List have published the results of their stock picks as compared to internationally recognized baselines. The Index has a three-year historical performance comparison with the S&P CNX Nifty (the headline index on the National Stock Exchange of India). The GS Sustain Focus List has been compared for two years against the MSCI World and has outperformed it by 25 percent during that time.

One mainstream investor made the point that her company was not concerned with the specifics of the chosen criteria evaluated to achieve the outperformance, so long as there is outperformance and it is demonstrated for the long run. However, none of these frameworks have been observed long enough to conclusively show that they yield long-term outperformance. Thus, continuing to track these frameworks over time will help determine if these efforts are found to be impactful.

Most investment professionals look for at least a 10-year time horizon of data from vetted studies in order to claim materiality of investment criteria. Presently, it is difficult to do this type of analysis since data does not exist for that long, although it is important to note that some comprehensive data sets, including SAM's, are close to that threshold. To compensate for their inadequate historical sustainability data, some mainstream investment companies

rely on back-casting data. However, many professionals believe that back-casted data is not as valuable as data collected and analyzed for this purpose in real-time (back-tested) for many reasons, including:

- The ability to manipulate data toward a particular bias when interpreting outcomes
- The potential for decisions regarding fund maintenance having been handled differently if the stocks were initially picked to be in an ESG-focused fund, as opposed to a general fund, which may have lead to different outcomes

It is not possible to dissect the impact of ESG criteria on overall returns at this time. Current consensus is that there is no way to evaluate the impact that ESG criteria played in the returns of an investment, as opposed to the standard financial criteria. The challenge is with crediting causality to the specific criteria without any confounding factors. One investment professional stated, "If a company is rated very highly based on its ESG criteria and its share price has gone up, you can't be sure the company's share price went up because of the ESG criteria or some other reason. Perhaps by observing the company and similar investments for an extended period of time the relationship may become more obvious; but presently, it isn't possible to do."[11]

ESG criteria are only considered impactful (where impact is measured in returns) when considered in conjunction with fundamental financial analysis. All the professionals interviewed for this report are operating on the premise that the ESG criteria should only be considered as part of a highly integrated investment process. As such, the question of assessing impact of the ESG criteria alone becomes irrelevant, since they are only thought to add value when considered as part of an overall evaluation.

Lack of uniform data is an impediment to successfully measuring impact. The current lack of data — and more specifically uniform data — makes impact measurement very difficult. One SRI professional said, "With the data presently available globally, it would be very difficult to do such an analysis because the data is different across the board."[12] As such one can not make an "apples-to-apples" comparison about impact since each investment decision will be made on different available data.

There is no measurement of environmental or social impacts. Based on the research conducted for this report, it does not seem as though mainstream financial institutions are looking to measure environmental or social impacts of incorporating ESG criteria.

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[11] Phone interview with Alka Banerjee of Standard and Poor's (April 10, 2008)
[12] Kurtz, op.cit.

V. Barriers and Potential Solutions

There are several barriers to successfully incorporating ESG criteria into mainstream investing and achieving the intended impacts. These barriers include:

- The lack of long-term empirical evidence linking ESG criteria to financial returns
- The need to regulate reporting ESG factors so reliable comparisons can be made by financial services companies
- Short-termism vs. long-termism - shareholder demands for strong short-term financial performance compete with ESG investments that are longer term by nature
- Capacity - the shortage of investment professionals capable of assessing companies based on ESG criteria
- Philosophy - cynicism toward considering ESG criteria

This section discusses the barriers identified above and proposes solutions for fully integrating ESG criteria into mainstream investing.

1) More Research on ESG Criteria Impact Needed

Barrier:
Decades of research and observation support the claim of impact of fundamental financial criteria.[13] However, the same cannot be said of ESG criteria. In general, this newly integrated approach to investing is in its developmental stages, and before it can be fully accepted into mainstream practice, the relationship between data and returns needs to be more explicit. Investors are looking for better studies on the risk of not taking these factors into account, as well as demonstrated evidence of the financial benefits of taking these factors into account. (Appendix E describes current methodologies of evaluating the relationship between sustainability and financial performance.)

Investors are looking for long-term, vetted research to prove the materiality of ESG criteria (for which most require a minimum of 10 years of history). Evaluated on these standards, none of the frameworks presented in Section IV can be substantiated.

One economist gently criticized the practice of the SRI community to claim materiality of ESG issues without having extensive research to substantiate the claim. He states that sometimes there is a fine line to be drawn between research and advocacy, and many mainstream investors will be wary of claims such as the one made by the Banker/Innovest report (discussed in Section IV), which are analyzed over short time periods.

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[13] Fundamental financial criteria include revenues, expenses, assets, liabilities and other information found in financial statements.

Potential Solutions:
Based on its recently developed methodology that includes ESG criteria, Goldman Sachs has been able to pick stocks that outperform relative to the MSCI World in the short term. The GS Sustain report notes that "clearly, we do not yet have a long track record of performance in terms of our methodology, but we believe that the early signs are encouraging" (Goldman Sachs, 2007).

A robust two-part process by which to overcome the lack of long-term/vetted research is as follows:

- ***Long Time Horizon*** **–** A claim that a variable has been found that has an impact on share prices has to be accompanied with a minimum of 10 years of data to corroborate that claim. Thus current research and analysis must persist. Academics and investors need to continue tracking stocks and identifying new stocks using their ESG criteria and frameworks of assessment in order to recognize trends of returns over time.
- ***Adjustment for Known Market Effects*** **–** Using a well-recognized financial model such as the Four Factor Model, a.k.a. Carhart Model (valuation, size, data, momentum), to validate the ESG criteria will prove to be beneficial to get buy-in from mainstream investors.

Additionally, offering incentives to researchers to conduct this type of long-term analysis through initiatives such as the Enhanced Analytics Initiative (EAI) can help overcome this barrier. The EAI "seeks to address the absence of quality, long-term research that considers all extra-financial issues" assumed to be material. Overall, the Initiative incentivizes research providers to compile better and more detailed analysis of extra-financial issues within mainstream research, with the possibility of receiving a commission from the EAI for the best research. The impact of such an initiative depends mainly on being able to offer lucrative incentives to research providers to encourage them to conduct the type of research deemed most valuable by the initiative.

2) Insufficient Reporting of ESG Data

Barrier:
Lack of consistent data seems to be one of the greatest barriers to fully integrating ESG criteria into mainstream investing. Despite corporate social responsibility/sustainability reports published by many companies, there is no uniformity in the information being reported. In situations where no information is reported, the only way to evaluate the company would be to assess its public practices and policies even though these do not always equate to performance. In contrast to annual reports, which contain very specific and consistent data for all public companies, these reports are not required and there is no specific format or required data to be disclosed. Reporting standards such as the Global Reporting Initiative (GRI), which provide guidance on how organizations can disclose their sustainability performance, exist but are not used universally.

An investment professional noted that making investment decisions based on ESG criteria is difficult when a majority of companies do not provide the necessary information. The GS Sustain report identifies challenges such as inconsistent data and regional differences in policy focus, leading to insufficient quantifiable and comparable data to objectively measure several issues such as human rights and human capital management (Goldman Sachs, 2007).

Potential Solutions:
Available consistent data is crucial in order for investment professionals to make informed decisions. Unfortunately, reporting requirements — if they exist at all — vary drastically. There are two ways to overcome this barrier:

1) ***Regulatory Pressure*** – Require companies to report their ESG performance by introducing the possibility of regulatory consequences. Reporting standards such as the GRI already exist and compliance to one such standard could be made mandatory. Some countries, to varying degrees, have chosen to require sustainability reporting. "The Johannesburg Securities Exchange in South Africa mandates GRI reporting by listed companies, and governmental regulation in Australia, France and the UK explicitly require varying degrees of disclosure on social and environmental information" (Baue, 2004). However, it is important to note that some investors do not believe that the reporting standards of the GRI are robust enough for their assessments.

2) ***Investor Pressure*** - Incite companies to report their ESG performance by introducing the possibility of reputational and financial benefits. Companies such as SAM use detailed questionnaires as tools to gather the ESG data they seek and as such help to standardize reporting of this information. Unfortunately, without building more of a consensus on the materiality of individual criteria, each financial institution that uses a questionnaire may request slightly different information to conduct its assessment, placing a large burden on companies to provide that data. Uniformity of data will have to evolve in conjunction with the long-term research discussed earlier. Additionally, the inclusion of a company on indices such as the DJSI generates publicity and recognition, as well as access to capital for the company. As such, it may be an incentive to report on ESG factors. Eventually developing a reporting standard such as 10K reports will be the ideal solution.

3) Disparity Between Short-Term and Long-Term Investment Practices

Barrier:
Bain and Company calculated that in the 1980s the average holding period for a stock was approximately five years. Today it is less than one year. This can be observed by looking at the annual turnover on the NYSE, which is about 100 percent. This increasing trend toward short-term investing and the historical demand for quarterly reporting are both at odds with the theory that ESG criteria add long-term value. According to the 2004 UNEP FI report entitled *Generation Lost*, "Companies regularly sacrifice long-term economic value to meet earnings targets, with some studies suggesting that over half of business leaders would forego projects with positive net present value if they conflict with these targets. As projects

designed to boost a company's performance on environmental, social and governance issues typically involve quantifiable, short-term costs and speculative, long-term benefits, these would be among the likely sacrifices" (UNEP FI, YMT, 2004).

However, it is important to note that this trend toward short-termism is not prevalent across all asset classes. For example, within fixed income, investors that are focused on treasury markets tend to be very short-term focused, but bond analysts that look into 20-year corporate bonds may be interested in ESG research that could potentially affect the spread and rating of that bond.

Potential Solutions:
There are two ways to overcome this disparity in focus.

1) ***Develop Complementary Partnerships*** - Initiatives such as the EAI and the Aspen Institute's Aspen Principles are trying to change the focus from a short-term to long-term focused investing culture. Initiatives with complementary goals should work together to influence their members to take on the mission of each individual initiative. For example, the PRI has many signatories (falling under the categories of Asset Owner, Investment Manager, and Professional Service Partner), all within the category of financial institution, and a mission to incorporate ESG criteria into the investment practices of its signatories. The mismatch between long-termism and short-termism is a barrier to that mission. The Aspen Principles have 24 signatories (falling within the categories of Business, Corporate Governance, Institutional Investor, Labor, and Professional Service), and are working on an initiative to get companies to commit to not provide quarterly guidance, but rather move toward more long-term value evaluation for the benefit of incorporating all extra-financial factors (including ESG). Presently three signatories overlap the two initiatives. It seems that cross-promoting these two initiatives would be mutually beneficial to both in meeting their goals and to overcoming this barrier.
2) ***Long-Term Value Creation*** - Promote the understanding that long-term assessments are not only important in incorporating ESG criteria, but are also necessary in creating long-term value.

There are several examples of successful investment houses with a focus on long-term investment. Dodge and Cox, one of the most successful mutual fund firms in the country, has an average holding period of approximately 10 years. However, the majority of investments are still short-term focused. Niche market players such as Generation Investment and SAM are trying to influence a shift to long-term focus from outside the mainstream investment houses. Their influence may be greater over time if they can prove consistent outperformance.

4) Lack of Capacity Among Investment Professionals

Barrier:
According to UNEP FI's 2004 report entitled *Generation Lost*, young analysts are "typically uninformed on many environmental, social and governance issues, and cynical about their materiality" (UNEP FI, YMT, 2004). In addition, conversations with investment professionals in niche sustainability financial institutions portray a similar picture of mainstream investors as being primarily trained to assess fundamental financial data and not fully equipped to analyze ESG criteria.

At Goldman Sachs, for example, the push to build capacity in this regard focuses on building the GS Sustain team, which serves as a centralized body that then works with and informs the various investment teams. Similarly, S&P noted that a specialized team was put together in order to perform the necessary analysis for building the ESG India Index. Both anecdotes describe scenarios in which the majority of investment professionals in these organizations are not equipped to conduct the necessary assessments on their own.

Potential Solutions:
There are three potential solutions to increasing capacity in mainstream investment organizations in order to more fully integrate ESG criteria.

1) ***Integrate ESG Issues into Institutionalized Educational Forums*** - The academic community could consider widening the core teachings and textbooks used for MBA, finance and investment degree programs such that the investment managers of the future are well versed in these issues. Additionally, inclusion of ESG criteria assessment in standardized testing such as the CFA exam will ensure that all future CFAs have basic knowledge of these criteria.
2) ***Train Investment Professionals and/or Hire Specialists*** - Several investment companies such as Citigroup and AIG Investments have engaged in training their investment professionals about potentially material ESG criteria. Additionally, some financial institutions, including Goldman Sachs and S&P (as mentioned above), hire specialists to work solely on these issues.
3) Purchase ESG Ratings Data - Some companies purchase ESG ratings data to assist with or compensate for lack of capacity. However, some firms believe that this must be done in-house in order to perform the level of analysis that they feel is necessary.

Again, the practices of the few companies interviewed for this report do not speak to all mainstream investment firms. A conversation with a professional at Innovest revealed that it has over 100 mainstream investment clients that purchase its ratings data (although he was not able to disclose the names of the clients).[14]

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[14] Phone interview with Peter Wilkes of Innovest (April 2, 2008)

5) Philosophy

Barrier:

Combating cynicism is a fundamental barrier for ESG criteria to gain mainstream acceptance. In order for investors to fully accept ESG criteria, all the previously stated barriers have to be overcome. In addition, investors will need a different mindset. According to Anthony Ling and Sarah Forrest in the *Working Capital Report*, “Pigeonholing ESG issues will kill them. They must be embraced as mainstream – that is how we can make a real and lasting difference” (UNEP FI, GC, 2007). However, in order to do this, investors will need to be open to the idea that the inclusion of ESG criteria may help lead to future value creation.

The *Generation Lost* report notes that many young analysts appear unconvinced of the potential materiality of most ESG issues to business: “unable to consider them because of inadequate information, training or tools; and unwilling to depart from business as usual because of conflicts with remuneration, career advancement or culture” (UNEP FI, YMT, 2004).

Potential Solutions:

There are many steps to overcoming this barrier, which include:

- ***Outperformance*** - The number one solution to this barrier, as cited by the investors interviewed for this report, is outperformance. Analysts are convinced by numbers and good data will help sway investor perspectives.
- ***Invite Open Discussion with Varied Stakeholders*** - Have open forums with investors of divergent views on the necessity to include ESG consideration. Within mainstream financial institutions, this will help disseminate the idea of ESG from CSR and sustainability specialists, into the minds of all investment professionals.
- ***Initiate Coverage in Mainstream Venues*** - Additionally, having the issue discussed in a mainstream forum like the CFA Institute Conference (as mentioned in Section III) helps to overcome this barrier by enabling a very general body of investment professionals to engage in the discussion.
- ***Reframe the Terminology*** - Avoid the term “non-financial” to describe the criteria. “Non-financial” has a negative connotation, creating an image of ESG criteria as being non-substantive and/or inconsequential. Terms such as “extra-financial” are better descriptors.
- ***Use Like-Minded Organizations to Spur Change -*** Organizations like the World Business Council for Sustainable Development (WBCSD), UNEP FI and other partnerships could develop prizes to entice their members to help move the discussion of ESG criteria into the mainstream.

VI. Conclusion

Overall, this report explores the present trends in incorporating ESG criteria into mainstream investment practice by answering the three questions initially posed:

1) How do companies and other players (research firms, shareholders, etc.) incorporate ESG criteria into mainstream investing culture?
2) How is the effect of ESG criteria incorporation being measured, and do these efforts have an impact?
3) What are the barriers to successfully incorporating these criteria into mainstream investing and what are possible solutions to those barriers?

Answering the first question revealed one main point: *Presently there is not a standardized approach to integrating ESG criteria into mainstream investing practices*. This point is exemplified in two ways. First, it seems that financial institutions are developing different ways of evaluating ESG criteria, including looking to identify indicators of risk, corporate management, pending regulation and anything else that might affect the overall share price of a company. Second, companies are differentiating themselves based on their methodologies of integration, and only time will reveal which methodologies are the most successful.

Based on the research conducted for the second question, five key themes emerged related to how the impact of ESG is measured and the challenges associated with such measurement. First, it was determined that outperformance as compared to a recognizable baseline is the most important indicator of ESG criteria materiality and impact. Second, the consensus is that there is no way to evaluate the impact that ESG criteria played in the returns of an investment, as opposed to the standard financial criteria. Third, ESG criteria are only considered impactful (where impact is measured in returns) when considered in conjunction with fundamental financial analysis. Fourth, the current lack of data — and more specifically uniform data — makes impact measurement very difficult. Finally, based on the research conducted for this report, it does not seem as though mainstream financial institutions are looking to measure environmental or social impacts of incorporating ESG criteria.

The five main barriers to integration include:

- The lack of long-term empirical evidence linking ESG criteria to financial returns
- The need to regulate reporting ESG factors so comparisons can be made by financial services companies
- Shareholder demands for strong short-term financial performance compete with ESG investments, which are longer term by nature
- The shortage of investment professionals capable of assessing companies based on ESG criteria
- Cynicism toward considering ESG criteria

In this nascent stage of ESG criteria development, it would seem that in order to stay competitive, the ESG integration methodology for financial intuitions must constantly evolve as:

- New data is available from company reporting
- New research on the materiality of the criteria emerge
- Various methodological differentiators prove to be successful

Overall, the materiality of these criteria and their successful integration into mainstream financial institutions will only be determined by time.

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Appendix

Appendix A: Index of Acronyms

The following acronyms appear in the body of this report:

CSR – corporate social responsibility
DJSI – Dow Jones Sustainability Index
EAI – Enhanced Analytics Initiative
EP – Equator Principles
ESG – environmental, social and governance
GC – Global Compact
GRI – Global Reporting Initiative
MSCI – Morgan Stanley Capital International
NYSE – New York Stock Exchange
PRI – Principles of Responsible Investing
S&P – Standard and Poor's
SAM – Sustainability Asset Management
SRI – socially responsible investment
UNEP FI – United Nations Environment Programme Finance Initiative
WBCSD – World Business Council for Sustainable Development

Appendix B: List of Organizations Interviewed

Individuals from the following organizations were interviewed during research and preparation of this report:

- Generation Investment: Lila Preston, Associate – March 7, 2008
- Goldman Sachs: Melissa Epperly, Equity Research Analyst – April 3, 2008
- Haas School of Business: Michael Pearce, Haas Socially Responsible Investment Fund Manager – April 1, 2008
- Innovest: Peter Wilkes, Managing Director – April 2, 2008
- Nelson Capital: Lloyd Kurtz, Senior Portfolio Manager – March 24, 2008
- Santa Clara University: Meir Statman, Glenn Klimek Professor of Finance – April 2, 2008

- Standard & Poor's: Alka Banerjee, Vice President Global Equities – April 10, 2008; and David Blitzer, Managing Director & Chairman of the Index Committee – March 26, 2008
- Sustainability Asset Management: Christophe Churet, Equity Analyst – April 14, 2008 and April 17, 2008
- Wells Fargo: Paul Brumbaum, Senior Vice President – March 14, 2008

Appendix C: PRI Report on Progress 2007 Findings (UNEP FI, GC, 2007)

The Principles of Responsible Investing (PRI) provide a framework for incorporating ESG issues into the investment philosophies and ownership practices of asset owners. The PRI was formally launched by Kofi Annan on April 27, 2006, at the New York Stock Exchange. Currently, at least 50 institutional investors with more than $4 trillion in assets have signed the PRI. Over 30 investment managers with greater than $3 trillion in assets under management have also signed the Principles.

The PRI *Report on Progress 2007* represents a broad sample set. It gives an overview of how investors are integrating ESG issues within investment decision making and ownership practices. A questionnaire was sent to 73 asset owners and 64 investment managers and completed by 62 asset owners and 44 investment managers. This represents an overall response rate of 77 percent.

The questionnaire was structured around the following six Principles:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress toward implementing the Principles.

Table 1 below summarizes the major findings of the PRI *Report on Progress*:

Table 1

ESG Incorporation Criteria	*Companies*
Train Investment Professionals	21% of investment managers and 9% of asset owners train internal non-ESG-specialist investment management staff "to a large extent"; 50% and 26%, respectively, train "to a small extent" (p. 7)
Specialist Dedicated to ESG Issue Analysis	79% of investment managers and 39% of asset owners (p. 5)
Integration by Asset Class: Equity	38% of investment managers and 30% of asset owners - "to a large extent" (p. 3)
Fixed Income	24% of investment managers and 12% of asset owners - "to a large extent" (p. 3)
Real Estate	6% of investment managers and 10% of asset owners - "to a large extent" (p. 3)
Private Equity	3% of investment managers and 7% of asset owners - "to a large extent" (p. 3)
Engagement Opportunities to Clients	18% of investment managers - "to a large extent" (p. 16)
Signatory of PRI	100%

The questionnaire allowed all signatories, regardless of the degree to which they had implemented the PRI, to report on progress. However, it is important to note that the companies included in this study represent a skewed sample set, since the questionnaire was only sent to signatories of the PRI. In addition, the companies that self-selected to respond to the questionnaire may have caused a selection bias in the results.

Appendix D: Evaluation Process Employed by The Banker/Innovest Study (2008)

An article in *The Banker* about the recently released "Banker/Innovest Top ESG Global Banks" listing concludes that banks that take ESG seriously (as identified by the study) have better stock market performance. The article highlighted data from the recent and ongoing subprime "debacle" (specifically analyzed from September 13, 2007, to January 1, 2008).

The model used to rank the banks accounted for approximately 50 metrics, which were evaluated through the processes shown here (the specific metrics were not revealed in the article):

- Passing through Innovest's Capital Allocation Benchmarking Analysis (CABA) model, which examines the ESG performance of the companies, sectors and countries that banks have financed

- Identifying where ESG due diligence was housed in each bank: “Because being ‘green’ is so popular, when group risk is not in charge banks prioritize ESG risks based on their broadcastability rather than their financial relevance”
- Examining “whether a bank has struck the right combination of top-down enforcement and bottom-up consensus building to integrate ESG due diligence fully into the capital commitment process”
- Determining whether “senior management understands why ESG risk is significant and if they are realistic about what it takes to manage it effectively”
- Determining which banks are investing more, and with better returns, in new sustainability markets such as clean tech, renewable energy and microfinance
- Identifying which banks build partnerships that enhance their ability to forecast and price new-generation ESG risks
- Evaluating staff satisfaction surveys, inflows/outflows of executive traffic and staff turnover (*The Banker*, 2008)

Appendix E: Research Methodologies

There appear to be three different methodologies employed to investigate the relationship between sustainability and financial performance:

Event Studies – “Explore the immediate impact of social and environmental reporting on short-term stock price volatility. They provide us credible evidence suggesting that the relationship between a stock price decline following negative corporate sustainability performance (CSP) reporting is considerably stronger and more instantaneous than a stock price increase resulting from positive CSP reporting.”[15]

Historical Performance of Stock Performance – “Provide a statistically based comparison of the performance of a chosen or self-constructed sustainability portfolio against that of a chosen benchmark. Similar to event studies, these studies also suffer from a number of methodological difficulties that limit their ability to accurately depict the relationship between CSP and corporate financial performance (CFP).”[16]

Multi-Factor Econometric Models – “Enable the testing of a hypothesis simultaneously for the impact of all variables included in the model. This is the most robust way to investigate the relationship between sustainability and financial performance because it controls for external factors that may confound the relationship under investigation, e.g. size, region, sector, etc.”[17]

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[15] SAM. Unpublished paper, Chapter 3.
[16] Ibid.
[17] Phone interview with Christophe Churet (April 17, 2008)

Appendix F: Summary and Critiques of Frameworks Analyzed for Section IV

1) Smith Barney, Equity Research Europe – Sustainable Investment Themes 2005 (Smith Barney, 2005)

Citigroup subsidiary Smith Barney issued a report in 2005 that assessed sustainability issues across 28 sectors listed below:

- Autos & Parts
- Beverages
- Business Services
- Chemicals
- Construction: Building Products
- Engineering/Capital Goods
- Financials – Banks
- Financials – Insurance
- Financials – Life Assurance
- Food & Drug Retailers
- Food Producers & Processors
- General Retailers
- Household and Personal Care
- Leisure, Entertainment & Hotels
- Media
- Mining
- Oil & Gas
- Pharmaceuticals & Biotechnology
- Property (UK)
- Pulp & Paper
- Steel & Other Metals
- Technology – IT Hardware
- Technology – Software & Computer Services
- Telecommunication Services
- Tobacco
- Transport: Aviation, Ports & Shipping
- Utilities: Electricity and Gas
- Utilities: Water

The report "outlines the principal sustainability issues, as identified by Smith Barney, facing each sector in a way that relates their potential financial impact, their environmental and social significance, and the degree to which further analysis will be best rewarded."

In determining which issues should be considered as priority areas of focus, the following criteria were used:

- *Financial materiality:* The potential financial materiality of a given sustainability issue in order to determine how much attention the issue warrants
- *Environmental or social significance:* Issues of high social or environmental importance give rise to intervention by customers, regulators or employees, which could in turn have impacts on a business and potentially on its share price
- *Where attention will be rewarded:* Analytical attention given to determining the financial and environmental and social materiality of issues in this area will be rewarded
- *Forward-looking:* Priority given to emerging issues over issues that have already been reviewed by other commentators

- *Upside and opportunity:* Identify instances where sustainable development brings new upside opportunities

Although this framework does not specifically measure the impact of including ESG criteria into mainstream investing, it takes an early step in identifying ESG factors that Smith Barney considers to be of material consequence to companies in any of the 28 sectors.

2) Goldman Sachs, *Introducing GS Sustain* 2007 (Goldman Sachs, 2007)

Goldman Sachs launched its "GS Sustain focus list" of companies it believes will be the top corporate performers over the coming decades as determined primarily by how well they integrate ESG criteria into their businesses. GS Sustain Focus List members have to score well on a combination of ESG score and industry positioning, as evaluated by Goldman Sachs. By incorporating its proprietary ESG framework into "long-term industrial analysis and returns-based analysis of the sectors covered to date (energy, mining, steel, food, beverages, and media), it has been able to select top picks that have outperformed the MSCI by 25 percent since August 2005. Of these, 72 percent have outperformed their peers over the same period." The overall ESG framework incorporates corporate governance, social issues with regard to leadership, employees and wider stakeholders, and environmental management. The following list includes the general "objective and quantifiable" indicators listed by category for each sector (there is variability within sectors):

- *Corporate Governance* - Independence of board and leadership, transparency of audit and stock options, CEO compensation, minority shareholders' rights
- *Social Leadership* - Leadership responsibility for and compensation links to environmental and social performance, environmental and social reporting, and assurance
- *Social Employees* - Compensation, productivity, health and safety, gender diversity
- *Social Stakeholders* - Consumers, suppliers, communities, governments and regulators, investors
- *Environment* - Energy use and carbon emissions; management of water, waste, recycling; suppliers and sourcing; biodiversity and land use
- *Industry Themes and Company Valuation* - Sector-specific industry drivers of competitive advantage
- *Cash Return Spreads*

3) SAM, Questionnaire 1999 to 2008 (SAM, 2008) [18]

Sustainability Asset Management's (SAM) assessment process is based on the premise that consideration of extra-financial factors[19] adds to the overall financial evaluation of a company. The process is informed by a questionnaire (publicly available on the SAM website) that was developed in 1999 and has been updated in subsequent years. The questionnaire provides the research that is the basis for the Dow Jones Sustainability Index (DJSI) construction as well as SAM's investment products. The questionnaires specific to each of the 57 DJSI sectors (listed below) are distributed to the CEOs and heads of investor relations of the largest 2,500 companies in the world. Due to the comprehensive nature of the questionnaire, the overall response rate is between 25 percent and 35 percent from self-selecting respondents.

"The questionnaire is designed to ensure objectivity by limiting qualitative answers through predefined multiple-choice questions." The completed company questionnaire, signed by a senior company representative, is the most important source of information for the assessment. The overall score for each company determined during the assessment process is made up of general criteria and industry-specific criteria. They are each valued approximately equally in determining the score. The DJSI includes the top 20 percent of companies (market cap weighted).

- Aerospace & Defense
- Airlines
- Aluminum
- Automobiles
- Auto Parts & Tires
- Banks
- Beverages
- Biotechnology
- Building Materials & Fixtures
- Chemicals
- Clothing, Accessories & Footwear
- Communication Technology
- Computer Hardware & Electronic Office Equipment
- Computer Services & Internet
- Healthcare Providers
- Heavy Construction
- Home Construction
- Hotels, Restaurants, Bars & Recreational Services
- Industrial Engineering
- Industrial Transportation
- Insurance
- Leisure Goods
- Media
- Medical Products
- Mining
- Mobile Telecommunications
- Non-Durable Household Products
- Oil Equipment & Services

[18] Phone interview with Christophe Churet (April 17, 2008)
[19] Extra Financial Factors - factors that have the potential to have at least a long-term effect on financial performance but lie outside the usual span of variables that get integrated into investment decisions, irrespective of whether they are part of the research process. They include ESG factors and also traditional financial factors that are often ignored or under-utilized, at least in terms of the alignment of investments with the interests of beneficiaries. (As defined by the UNEP FI in the report entitled *Demystifying Responsible Investment Performance*)

- Containers & Packaging
- Diversified Industrials
- Durable Household Products
- Electric Components & Equipment
- Electricity
- Electronic Equipment
- Financial Services
- Fixed-Line Communications
- Food & Drug Retailers
- Food Producers
- Forestry & Paper
- Furnishing
- Gambling
- Gas Distribution
- General Retailers
- Oil & Gas Producers
- Personal Products
- Pharmaceuticals
- Pipelines
- Real Estate
- Semiconductors
- Software
- Specialized Consumer Services
- Steel
- Support Services
- Tobacco
- Travel & Tourism
- Waste & Disposal Services
- Water

SAM undertakes both external collaborations with leading universities worldwide as well as in-house empirical research, while prioritizing the former. The research indicates that "sustainability considerations are an integral part of corporate financial performance. As such, the integration of these factors into traditional financial valuation can help investors gain insights that facilitate the selection of stocks with an attractive long-term return potential."

The results of the questionnaire as well as the research have informed the creation of two broad families of investment products:

1) *Core sustainability products* that invest in companies identified as sustainability leaders based on the results of the annual sustainability analysis
2) *Thematic products* that invest in companies directly contributing to solving a particular issue related to sustainable development (ex. water scarcity)

4) S&P ESG India Index 2008 (S&P, 2008)

The Standard & Poor's (S&P) ESG India Index (Index) launched in January 2008 is, according to S&P, "the first investable index of companies whose business strategies and performance demonstrate a high level of commitment to meeting ESG standards." The Index was designed to raise the profile of companies that perform well along the three parameters of ESG responsibility when compared to their market peers. "Linking stock market performance to ESG is, perhaps, the most effective way to highlight the concept of ESG," since as an Index it replicates the existing market that incorporates ESG criteria. In addition, the Index provides investors with an instrument to incorporate sustainability

measures into their investment decisions. The top 50 companies that were included in the Index were selected from the top 500 Indian companies by total market capitalization that are listed on the National Stock Exchange of India Ltd. The creation of the index involved a two-step process:

1) A multi-layered approach to determine an ESG score for each company
2) Weighting of the Index by score

The companies were evaluated on their transparency in disclosing information on any of the indicators that are part of the ESG screening system. The weight for each Index constituent is set in the following manner:

- *Quantitative Score* - Each company is assigned a quantitative ranking based on three factors: transparency and disclosure on corporate governance, environment and social governance as per the company's published information
- *Qualitative Score* - The top 150 companies with the highest quantitative scores are selected for qualitative scoring on the basis of independent sources of information such as news stories, web sites and corporate social responsibility (CSR) filings
- *Composite Score* - A composite score is calculated for each company by summing the qualitative and the quantitative scores

"To ensure investability, liquidity is used as a secondary threshold in the selection of Index constituents: stocks with the highest scores are selected provided they have traded a minimum of Rs. 20 billion in the last 12 months. A company with a perfect ESG score but no liquidity in the market can become an impediment to the success of an Index."