Executive Summary

In this report, we assess current trends around environmental, social, and governance (ESG) integration in mainstream investments and provide specific recommendations for companies to attract investors with long-term investment perspectives. Building on BSR's report *ESG in the Mainstream: The Role for Companies and Investors in Environmental, Social, and Governance Integration* published in September 2009, we reviewed more than 20 studies and research papers published between January 2010 and June 2012 to understand the current trends and context regarding ESG integration in mainstream investments and determine how companies can take advantage of the evolutions happening in this space.

ESG integration refers to the idea that all types of investors should examine companies' sustainability practices and performance because they can have a material impact on the financial performance of companies.

Findings revealed the following ESG investment trends:

» Despite the relentless short-termism pervasive in the current economy, there is a growing interest from mainstream investors in long-term investment opportunities and ESG integration.

» Asset owners including pension funds, insurance companies, and sovereign wealth funds, which have long-term liabilities and a fiduciary duty to their members, are leading the way by integrating ESG criteria across their entire portfolio.

» These investors are increasingly looking at the ESG performance of the companies they invest in as a way to improve the financial performance of their investment portfolio.

In light of these findings, we believe that:

» Listed companies have real opportunities to attract investors with long-term perspectives by enhancing and communicating about their ESG performance.

» To appeal to these investors, companies should: 1) foster greater sustainability and long-term value creation by avoiding short-termism and by further integrating ESG into their business model and strategy and 2) develop a proactive ESG communication strategy by communicating about ESG issues that matter to investors and by improving their ESG communication channels.
Introduction

Despite the relentless short-termism pervasive in the current economy, mainstream investors are increasingly interested in ESG integration. Asset owners see ESG integration as an opportunity to generate long-term performance while fulfilling their fiduciary duty, and investment managers see it as a way to improve the financial performance of their investment portfolio.

For listed companies, long-term investors constitute a more attractive investor base. First, compared to short-term investors, long-term investors generally invest over a period of time that is better aligned with companies’ business cycles and long-term sustainability strategy. Second, by holding shares over a greater period of time, long-term investors reduce share turnover, which is costly for companies. While short-term investors have exacerbated what Dominic Barton at McKinsey calls “quarterly capitalism,” long-term investors allow companies to reconnect their investment strategies with the real needs of their business.

This paper begins by demonstrating the rising interest for ESG integration among mainstream investors and identifying the key drivers. Then, it assesses the implications for public companies and recommends ways that companies can incorporate greater sustainability into their business model and improve their ESG communication with investors.
Trends in ESG Integration in Investments

Since the publication of BSR’s last ESG-focused report, ESG criteria have been integrated into mainstream investments more and more. The drivers of this trend are increasing demand from asset owners and growing awareness that ESG integration can improve long-term financial performance.

ESG Integration on the Rise Among Mainstream Investors

Analyses of the ESG market show a rising interest among mainstream investors in ESG integration. This interest is evidenced by the growing size of the market potential for responsible investment (RI), the greater availability and use of ESG data, and the effective rise of ESG integration into investment decisions.

A GROWING MARKET POTENTIAL FOR RIs

An increasing number of investors are showing interest in ESG integration and are adopting RI policies. Since 2005, the number of signatories to the UN Principles for Responsible Investment (UN PRI) has grown steadily and reached 1,085 in July 2012, including 258 asset owners and 651 investment managers. Collectively they represent US$32 trillion of assets—or about 25 percent of the world’s total financial assets. According to the UN PRI, about 94 percent of signatories have adopted RI policies.

However, because there are different ways to define “responsible investments,” there are also different ways, beyond the UN PRI, to evaluate the RI market. Some, like the European Sustainable Investment Forum (EuroSIF), include both ESG investments and SRI-focused funds under the RI umbrella while others focus solely on ESG investments. Some include all the assets under management (AUM) of a firm, while others only include assets in separate, dedicated ESG funds.

Campden Research, which considers ESG investments alone, estimates that the global market of RI AUM reached US$5 trillion in May 2011, with companies in the United States, U.K., and Switzerland managing most of these assets. According to the same study, the RI universe is predicted to grow annually at a rate of about 25 percent, with the market expected to total more than US$25 trillion by 2015. Regardless of how the market is evaluated, it is clear that this is a rising trend that will continue to grow among mainstream investors.

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5 Campden Research, Responsible Investment in Asia Research Report, 2011.
6 Ibid.
GREATER AVAILABILITY AND USE OF ESG INFORMATION

At the same time as the idea of RI has spread through the investment community, ESG information has become more mainstream as well. Two main drivers have led to a greater availability of ESG information:

- **Regulation:** An increasing number of regulations that require companies to disclose their ESG performance have been adopted globally, including in emerging markets (see sidebar).

- **Entrance of mainstream data providers:** The market demand for ESG information has led to the entrance of well-funded financial information providers on the market (including Bloomberg, MSCI, and Thomson Reuters) and to the consolidation of smaller and more segregated data providers.

The increasing amount of ESG data available on Bloomberg terminals is evidence of the growing availability of ESG information. The data provider reports that the number of publicly traded companies listed in its database and reporting on ESG indicators reached 5,217 in 2011, a 75 percent increase since 2008 when it launched its ESG platform. While there is still a need for more consistent and higher quality data, this source provides a useful platform for investors to analyze corporate performance. Bloomberg also reports a 50-percent increase in the number of ESG users in 2011 over 2010. However, it is worth noting that ESG data users still only represent about 1 percent of Bloomberg’s total user base—proof that investors have not yet figured out how to systematically integrate ESG information into their investment decision-making process.

On the other hand, an increasing number of financial institutions are forming their own ESG and sustainability research departments supported by regional sustainable investment networks. In the United States, the Sustainable Investment Research Analyst Network (SIRAN) now supports more than 260 sustainable investment research analysts from more than 50 investment firms, research providers, and affiliated investor groups. Similarly, EuroSIF today counts 75 member affiliates that support the development of sustainability through European financial markets.

**RISING ESG INTEGRATION IN INVESTMENT DECISIONS**

Most importantly investors increasingly integrate ESG information into their investment decisions. The UN PRI estimates that effective integration of ESG criteria into investment strategies reached seven percent of the total market of AUM in July 2011, which represented approximately US$10.7 trillion.

Additionally, research shows a clear trend toward developing models and tools for ESG integration across all asset classes, with a stronger penetration in the public equity space. Out of 5,175 ESG strategies analyzed by the consulting group Mercer, around 57 percent were in listed equities, 20 percent were in fixed income, and the remaining 23 percent were spread across alternatives.

While ESG integration is rising, not all ESG strategies achieve the same level of integration. In the public equity space, research identifies four main approaches:

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8 Ibid.
1. **Full ESG integration**: Investors tilt their entire portfolio to capture positive ESG stocks while minimizing their negative ESG exposures. This approach typically favors companies with stronger ESG ratings when other financial performances are equivalent.

2. **Screening approach**: Investors use issue-based screens when selecting stocks for their entire portfolio. This approach is typically implemented in addition to, or in place of, full ESG integration and also typically favors companies with stronger ESG ratings.

3. **RI-branded or ESG-branded investment**: Investors dedicate only a portion of their AUM to ESG investments. They use either a full ESG integration or a screening approach to develop RI-branded or ESG-branded products.

4. **Governance or active ownership approach**: Investors take an active approach by engaging with their portfolio companies that are subject to ESG risks. This approach lies outside the portfolio construction approach and might be applied regardless of the implemented investment strategy.

While full ESG integration is gaining traction, **active ownership remains the most prevalent RI activity**. In fact, the practice of monitoring corporate governance is typically considered to be a component of fiduciary duty within the mainstream financial community.\(^{16}\)

**Two Key Drivers**

We identify two factors driving mainstream investors’ expanding interest in ESG integration. First, asset owners’ demand for sustainable and RIIs is growing. Second, investors see ESG integration as a way to increase their long-term financial performance.

**RISING DEMAND FROM ASSET OWNERS**

Growing demand from asset owners is the primary driver of ESG integration. In the United States, 85 percent of investors cite “client demand” as the main reason for integrating ESG into their investment decisions.\(^{17}\) In Europe, 81 percent of institutional investors believe that ESG integration is in the interest of fiduciary duty.\(^{18}\)

Globally, asset owners, including pension funds and insurance companies are leading the way by adopting ESG integration strategies for their entire portfolios. In particular, an increasing number of pension funds are putting ESG integration at the top of their agenda. For example, CalPERS, the US$230 billion Californian pension fund, approved the adoption of a total fund approach for integrating ESG issues as a strategic priority in 2011. Because of their extended fiduciary duty, pension funds face a greater risk of being sued if they fail to manage ESG risks in their portfolio. Pension funds, insurance companies, and mutual funds worldwide hold US$65 trillion,\(^{19}\) or about 35 percent, of the world’s financial assets.

On the other hand, investment management firms increasingly see sustainable investment as an opportunity to grow their practices by staying ahead of the curve, differentiating themselves from their competitors, and most importantly, better meeting the needs of their clients.\(^{20}\)

**ESG INDICATORS SEEN AS INCREASINGLY MATERIAL**

Another reason ESG integration is gaining traction is its growing importance in assessing a company’s performance. According to the International Integrated Reporting Council (IIRC), an increasing percentage of an entity’s market value can be attributed to intangible

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Between 1975 and 2010 intangible assets increased from 17 percent of market value to 80 percent for S&P 500 companies.\(^{21}\)

**Components of S&P Market Value**

<table>
<thead>
<tr>
<th>Year</th>
<th>Tangible Assets</th>
<th>Intangible Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>83%</td>
<td>17%</td>
</tr>
<tr>
<td>1985</td>
<td>68%</td>
<td>32%</td>
</tr>
<tr>
<td>1995</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>2005</td>
<td>20%</td>
<td>80%</td>
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<td>2010</td>
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<td>80%</td>
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</tbody>
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Source: Ocean Tomo

Between 1975 and 2010 intangible assets increased from 17 percent of market value to 80 percent for S&P 500 companies.\(^{21}\)

ESG indicators provide ways to measure the performance of these intangible assets. Research shows that investors perceive strong ESG indicators as a gauge for good risk management and strategic planning. Companies with strong ESG performance have a higher capacity to adapt to change, lower their capital constraints, and lower their cost of capital.\(^{22}\)

Most importantly, an increasing number of studies suggest a neutral to positive relationship between strong ESG indicators and long-term financial performance.\(^{23}\) Pooling results from 36 studies, Mercer showed that 30 studies evidenced a neutral to positive relationship between ESG factors and financial performance.\(^{24}\)

On that same note, a study led by RCM\(^{25}\) showed that investors could have added 1.6 percent a year to their investment returns over slightly less than five years by allocating to portfolios that invest in companies with above-average ESG ratings.\(^{26}\) Robert Eccles at Harvard Business School shows that, in general, the outperformance is stronger in sectors where companies compete on the basis of brands and reputation and in sectors where companies’ products depend heavily upon extracting large amounts of natural resources.\(^{27}\)

To sum up, an increasing number of mainstream investors are embracing the idea of RI and more and more often considering ESG information when making investment decisions. In particular, an increasing number of investors with long-term perspectives, including pension funds and insurance companies, see ESG integration as an opportunity to enhance their financial performance.

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\(^{25}\) RCM is a company of the preeminent global asset management group, Allianz Global Investors.


Implications for Companies

In light of these findings, there are real opportunities for listed companies to attract investors with long-term perspectives by enhancing and communicating about their ESG performance. What follows are key reasons long-term investors are important to companies and four recommendations for companies to overcome systematic barriers to ESG integration and ultimately appeal to these long-term investors.

The Value-Add of Long-Term Investors

For listed companies, long-term investors constitute a more attractive investor base because they allow companies to:

» Establish a foundation for sustainability. While mainstream investors generally analyze financial performance on a quarterly basis, it takes more than a quarter (and typically more than a year) for companies to harvest the benefits of their sustainability efforts. The business benefits of a successful sustainability strategy include enhancing reputation, building future markets, and preparing for future resource constraints. This strategy requires near-term costs that can only be adequately assessed with a long-term perspective.

» Align investment and business cycles. Similarly, the benefits of research and development (R&D), capital investment programs, and even advertising necessitate a horizon longer than a quarter. As IBM’s former CEO Sam Palmisano once told McKinsey’s Barton: “I can easily make my numbers by cutting SG&A [selling, general, and administration] or R&D, but then we wouldn’t get the innovations we need.”

» Reduce costly share turnover. By holding shares over a longer period of time, long-term investors reduce share turnover, which is costly for companies.

While short-termism has made the public equity market more volatile and widened the gap between corporations’ market price and their actual value, long-term investors offer companies the opportunity to realign their strategies with the real needs of their business.

Four Recommendations to Attract Long-Term Investors

To attract long-term investors, companies must not only integrate ESG into their business model and strategy but also proactively communicate about these issues to investors. In this last section, we give two sets of recommendations for companies to build greater sustainability into their business models and improve how they communicate their ESG efforts to investors.

MOVING TOWARD SUSTAINABLE CAPITALISM

In response to the growing concern over short-termism, an increasing number of business leaders and institutional investors are calling for a new approach to capitalism that fosters long-term economic creation: sustainable capitalism or long-term capitalism. Building on this trend, we recommend that companies foster greater sustainability and long-term value creation to attract investors with long-term perspectives. What follows are two recommendations for companies to avoid short-termism and to integrate ESG into their business model.

1. Avoid the quarterly capitalism culture. Research shows that firms focusing on the short-term have a short-term-oriented investor base, higher stock price volatility, and as a result higher cost of capital. Companies that avoid sending short-term messages have a better chance of attracting investors with long-term perspectives. There are two ways to achieve this goal:

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29 Ibid.
Avoid the default practice of quarterly earnings guidance. To a large degree, companies are setting the tone by favoring short-termism in their communication to shareholders.\(^{33}\) Pressured by financial markets, companies commonly issue quarterly earnings guidance—a default practice that diverts their attention from long-term strategies. After observing such distortions, Unilever CEO Paul Polman announced in November 2010 that his company would stop giving quarterly earnings guidance so that they could focus on the development of a new and more sustainable business model. By doing so, the company signaled to the market the types of investors it wants to own its shares. Coca-Cola and Ford have adopted similar policies.

Align compensation structures with long-term sustainable performance. Presently, most compensation structures disproportionately emphasize short-term performance and fail to hold managers accountable for the long-term impacts of their actions.\(^{34}\) Too often, top executive compensation is structured to reward a leader for having made it to the top and not for what he or she has actually done for the company.\(^{35}\) To foster greater alignment between executives’ concerns and long-term performance, companies should anchor compensation structures to the fundamental drivers of long-term value creation. For example, at Danone executives’ bonuses are based on economic, societal, and managerial objectives. While economic and managerial criteria are similar to other organizations, societal objectives consist of two parts: On the environmental front, executives are evaluated on how much they reduce the carbon footprint of the activity they are responsible for; on the social front, they are evaluated based on the rate of work injuries as well as the number of training hours and the development of talents.\(^{36}\)

2. Integrate ESG into the business model. Companies’ ability to generate the sustainable growth long-term investors look for depends on their ability to think about ESG as an integral part of their business model and strategy. They can integrate ESG in two ways:

- **Integrate sustainability into corporate strategy with C-level and board support.** For many companies corporate and sustainability strategies are independent. Integrating them requires developing a strategic vision for delivering sustainable value to all stakeholders. Because such strategic redefinition will impact a company’s core business model, it requires involvement from top management. Clear governance and accountability structures are also necessary. Royal Dutch Shell and HP are among many companies that have dedicated board committees to manage sustainability issues. These committees often play an important role in ensuring that each business builds sustainability into its operating process and consistently applies it at the corporate level.\(^{37}\)

- **Integrate ESG into core products and services.** Increasingly, a company’s ability to build new modes of collaboration and new ways of thinking into the development and delivery of products and services determines its long-term value creation. Nike, through its Considered Design approach, aims to reduce its environmental footprint by designing products that are fully closed loop. These products are developed using the fewest possible materials and designed for easy disassembly; they can be recycled into new products or safely returned to nature at the end of their life.\(^{38}\)

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A PROACTIVE ESG COMMUNICATION STRATEGY

Research shows that companies can capitalize on their sustainability efforts by communicating about the connection between ESG and financial performance in a more proactive manner. To appeal to investors with long-term perspectives, we recommend that companies develop a proactive ESG communication strategy. Companies should communicate about ESG issues that matter to investors and improve their communication channels.

3. Identify issues that are material to investors. While an increasing number of companies produce CSR reports, they usually fail to effectively communicate to mainstream investors about the issues that have the greatest potential impact on their business. To address this failure, companies can:

   » **Implement a materiality assessment process.** One way companies can demonstrate the quality of their management and risk systems and articulate a broader understanding about the global context in which they operate is to identify and communicate their most material ESG risks. Companies should understand which ESG issues have the most material impact on their business and be able to communicate to investors how those issues will impact their long-term financial performance.

   » **Focus the discussion on issues that matter to investors.** Companies should also recognize that different investors have different priorities. They should understand which issues their investors care most about and tailor their communications accordingly. For example, when talking to pension funds, RI officers should explain their company’s governance performance and articulate how strong governance allows the company to nurture long-term value creation.

4. Improve ESG communication channels. One challenge for many companies is explaining the benefits of their sustainable business strategies to shareholders. On the one hand, while investors constitute a single audience, most companies use separate channels to communicate about their financial data and ESG performance. On the other hand, most investors rely on third-party rating agencies to analyze companies’ ESG disclosures and do not necessarily ask companies for ESG information. By directly communicating about ESG, companies can explain to their investors how their sustainability strategies translate into long-term improved financial performances. Here are a few suggested communication methods:

   » **Incorporate ESG into the RI team mandate.** To foster better ESG communication, companies should encourage their RI team to gather knowledge about the company’s most material ESG issues and learn how they are being addressed. CSR teams should also look for ways to join RI teams in ESG conversations with investors. For example, Intel organizes an annual SRI/ESG road trip to foster greater RI and ESG conversation. RI teams should also be encouraged to actively court long-term investors in addition to answering current investors’ inquiries.

   » **Adopt integrated reporting.** Integrated reporting links a company’s financial and nonfinancial performances into a single, comprehensive report. It also provides a framework for companies to consider sustainability as an integral part of their business strategy.

   » **Monitor the quality of ESG information supplied to investors.** Since most investors rely on third-party rating agencies to analyze companies’ ESG disclosures, companies should also evaluate the amount and quality of information they supply to third-party data providers.
Conclusion

While financial markets globally have undergone substantial stress and change, an increasing number of mainstream investors see ESG integration as a way to improve their long-term financial performance and to respond to the increasing client demand for sustainable investments. This trend offers companies opportunities to attract long-term investors while, at the same time, reducing their shareholder turnover, aligning their investment strategy with the real needs of their business, and laying down the foundation for a sustainable future.

We have outlined four recommendations for listed companies to enhance and communicate their ESG performance. Concurrently, we continue to look for opportunities to advance ESG dialogue and to shrink the barriers that still exist between ESG integration and mainstream investments.

About This Report

This report was written by Hélène Roy with support from Laura Gitman, Managing Director, Advisory Services, BSR. For more information, or to get involved in future initiatives, please contact Laura Gitman at lgitman@bsr.org.