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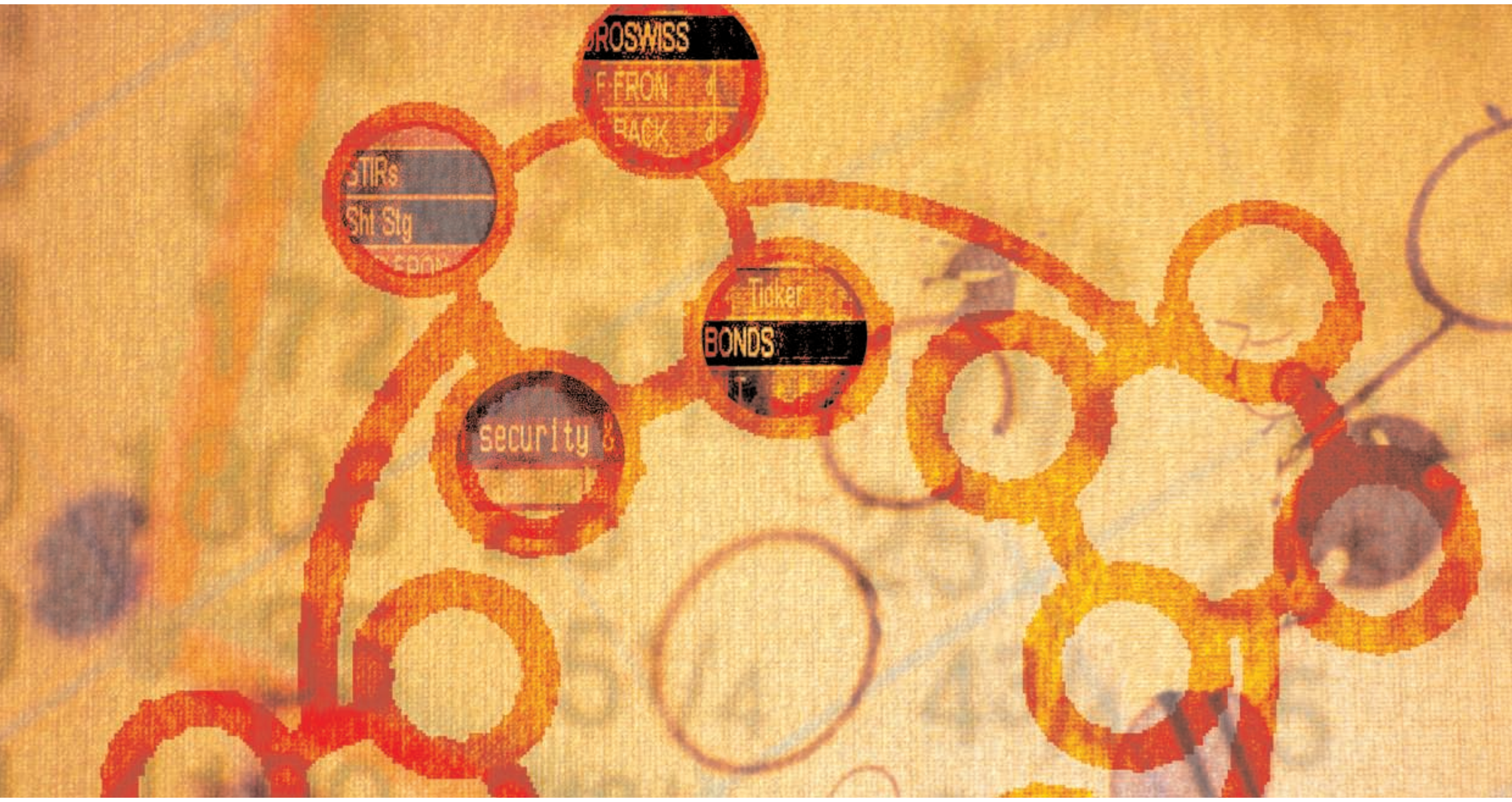
Perspectives EXECUTIVE SUMMARY



Generation lost: young financial analysts and environmental, social and governance issues

Young Managers Team 2004

World Business Council for Sustainable Development
Young Managers Team

UNEP Finance Initiative
Innovative financing for sustainability

Integration of environmental, social, and governance[1] issues in financial analysis would spur progress toward more sustainable business practices. To date, however, efforts to convince financial analysts to incorporate these issues have met with little success. The World Business Council for Sustainable Development (WBCSD) Young Managers Team (YMT) and the United Nations Environment Programme Finance Initiative (UNEP FI) joined forces to assess whether young analysts might be more amenable to integrating environmental, social, and governance issues than their older colleagues. If they are, we could expect the industry to gradually evolve to embrace environmental, social, and governance factors as new generations of analysts come on board.

Our work suggests that this anticipated 'generational change' is not happening. Young analysts appear unconvinced over the materiality of most environmental, social, and governance 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. Based on the perspectives gained during this study, the WBCSD YMT and UNEP FI suggest that:

1 **Sustainability advocates could group environmental, social, and governance issues as intangibles along with reputation, strategic vision, brand equity, and other subjectively-valued, but undeniably material, intangibles. The term non-financial is best avoided, as are moral arguments. To overcome the widespread cynicism over materiality, it will be important to put forth credible, specific examples.**

2 **Financial institution executives could consider communicating internally their commitment to incorporate environmental, social, and governance issues, and clearly linking analysts' career progress and remuneration to analysis of environmental, social, and governance issues. It will be important to invest in education and the development of quantitative and qualitative tools for such analysis.**

3 **WBCSD, UNEP FI, and other partnerships could encourage our members to solicit and present environmental, social, and governance information at corporate results presentations, showcase good examples and institute an annual prize for incorporating environmental, social, and governance research.**

1 The Enhanced Analytics Initiative – a voluntary effort among financial institutions to commission research incorporating environmental, social, and governance issues – defines them as having one or more of the following characteristics:
- Are the focus of public concern (e.g. genetically modified organisms)
- Have a medium to long-term horizon (e.g. climate change)
- Are qualitative, and not readily quantifiable in monetary terms (e.g. corporate governance, intellectual capital)
- Reflect externalities not well captured by market mechanisms (e.g. environmental pollution)
- Are often the focus of a tightening policy and regulatory framework (e.g. greenhouse gas emissions)
- Arise throughout the company's supply chain (e.g. labour issues at supplier factories)

"Environmental, social, and governance issues influence the overall picture, but nothing more. The core of the analysis is based on medium-term financial data." **Sell-side equity analyst, research institution, France**

"I assume that the [market] price already reflects the value or impact of these issues." **Sell-side equity analyst, investment bank, Hong Kong**

"These issues don't crop up in quarterly conference calls." **Equity analyst, research institution, US**

Why financial analysts' views matter

Analysts' views on environmental, social and governance issues are critical to sustainability.

Securities analysts produce forecasts, valuations and opinions on the securities they track. This research is influential throughout the investment world, with investors, asset managers and rating agencies among the clients relying on this information. The extent to which analysts incorporate environmental, social, and governance issues into their assessments influences whether markets reward or penalise companies' performance in these areas.

Moreover, the companies being tracked also scrutinise analysts' statements and reports and react to their content. Companies' determination to meet analysts' earnings expectations is often blamed for creating a bias toward short-term planning. 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.

Why the time appears right for a broader and longer term view

A number of factors are currently in flux within the financial world, which together could help bring about a broader view of securities. Efforts to promote environmental, social, and governance integration have been bolstered by a steady stream of evidence linking environmental, social, and governance and long-term business value. A recent analysis by 21 of the world's leading investors and brokerage houses of the impact of environmental, social, and governance issues on securities pricing demonstrated the materiality of certain issues to long-term value[2].

Although difficult to quantify, the environmental, social, and governance-business value link is now broadly accepted in leading corporations, particularly among listed companies (which carry the greatest reporting burden and are subject to the most external scrutiny). GE's recently announced 'ecoimagination' initiative is a recent well-publicised example. In parallel, the concentration of share ownership in vehicles with long-term investment horizons (such as pension funds) is creating investor demand for broader and longer-term research that incorporates environmental, social, and governance issues.

Against this backdrop, the field of sell-side securities analysis is in turmoil. Following high-profile collapses such as Global Crossing and WorldCom, new regulations are in place to prevent conflicts of interest in full-service investment banks[3]. Under the 'global settlement' reached with 10 of the major banks, research teams are now more isolated internally, and can no longer be subsidised by more lucrative activities such as underwriting and corporate finance advice. In addition, analysts now fear litigation from investors, who allege that their losses stem from analysts' failure to spot operational failure or fraud. As a result, analysts are under intense pressure to prove their commercial worth.

"It is becoming clear that sustainable development will be one of the major drivers of industrial change over the next fifty years and that there is a growing demand from both companies and institutional investors to understand its financial impacts. It follows therefore that the successful brokers will be those that anticipate this demand, respond to it with robust financially-relevant research and thereby differentiate themselves in an increasingly crowded marketplace." Colin Monks, Head of European Equity Research, HSBC

With companies convinced of the business case, investors calling for broader research, and the sell-side securities research industry desperate to regain credibility and justify its commissions, environmental, social, and governance analysis could

2 UNEP Finance Initiative: The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing www.unepfi.org/materiality

3 The 2002 investigation into Merrill Lynch, conducted by New York Attorney General Eliot Spitzer, uncovered the use of bullish research notes to attract and retain business for the investment banking division.

potentially represent a promising new direction. However, apart from changes underway at a few banks, few players in the industry have taken this view. If anything, the current crisis is leading to a bunker or herd mentality – less innovation, less risk-taking, and a greater tendency to cluster around the same conclusions.

Spotlighting young financial analysts

What then might make a difference? For the past six months, the WBCSD Young Managers Team and UNEP FI have joined forces to survey the views and practices of financial analysts under the age of 35. Young professionals across industries have been catalysts in raising the profile of environmental, social, and governance issues within their own companies, and financial analysts could arguably play the same role. Young professionals often hold strong (although often latent) personal convictions on the need for more environmentally and socially sensitive corporate practice, and lack faith in the ability of regulators and civil society to achieve this in isolation. With less time invested in business as usual, young analysts are logical candidates to accept a broader view.

Project methodology

Through 18 in-depth interviews with analysts across a range of sectors in continental Europe, the UK, Hong Kong, and the US, the project team explored:

- Analysts' understanding of environmental, social, and governance issues
- Views on the materiality of such issues to fundamental analysis and company valuation
- Current practice in integrating environmental, social, and governance issues
- Traditional and non-traditional information used in analysis
- Perceived drivers and barriers to greater integration of environmental, social, and governance in analysis.

In selecting the sample, we prioritised sell-side financial services sector professionals publishing regular research on publicly traded securities. Interviewees were mainly from mainstream investment banks and dedicated research houses, but also included representatives from large institutional investors, private banking for high net worth individuals, and specialist SRI research houses. Sectors covered by these analysts included traditional environmental, social, and governance hotspots (e.g. aerospace and defence, extractive industries, pharmaceuticals), new economy (e.g. telecoms, media, technology), and financial services. Analysts covered both large and small companies.

The interview format was designed to be exploratory and open, as we sought to engage and draw out analysts to speak freely. All interviewees were promised anonymity. Once the interviews were complete, we conducted an expert roundtable workshop in New York to discuss and debate the findings.

Project findings

Our work suggests that the anticipated generational change is not taking place in the financial sector. The analysts we interviewed are typically uninformed on many environmental, social, and governance issues, and cynical about their materiality. Many are unconvinced that their clients would value environmental, social, and governance-focused research, and doubtful that their companies would reward them sufficiently for doing it. Most are unsure how environmental, social, and governance integration could practically be achieved.

In Figure 1, we summarise the main project findings in the form of a decision tree. The tree features a series of questions an analyst would likely ask before factoring environmental, social, and governance into research. As we show, perceived barriers exist at each decision point. Overcoming these barriers will be vital if environmental, social, and governance issues are to have any hope of being part of mainstream financial analysis.

"The consideration of material social and environmental issues should be part of every financial analyst's normal work." Thomas Albrecht, Director of Research at Credit Suisse Asset Management

"Sustainability is a long-term issue, whereas valuation models tend only to be built [bottom-up] for five-year forecasts with simple extrapolations thereafter." **Junior portfolio manager, pension fund, Netherlands**

"Why not use government, rather than trying to cajole business to do something that runs counter to its own interests?" **Former sell-side equity analyst, investment bank, US**

There are sound reasons for believing that change is possible, particularly if all actors work together to dispel the notion that the financial impact of environmental, social, and governance issues cannot be quantified. For example, specialist analysts – and a small but increasing number of mainstream analysts – quantify environmental, social, and governance issues, and insurance underwriters quantify environmental, social, and governance risk. Corporate financiers manage to fit 'soft synergies' arising from intangible issues (e.g. brand enhancement) into the rigid frameworks of pro forma merger models. And, finally, it is important to remember that orthodox financial analysis is not necessarily the 'hard science' it sometimes claims to be[4].

FIGURE 1: FINANCIAL ANALYSTS' VIEWS OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES

		Survey Findings	Leverage Opportunities
Are environmental, social, and governance issues important for companies? Do I understand them well enough to assess them?	NO	Many analysts have a **limited grasp of sustainability**, stress governmental responsibility and regulation, not voluntary business leadership.	Re-brand environmental, social, and governance; use standard financial language (e.g. intangibles, rather than non-financial).
YES			
Are environmental, social, and governance issues material to financial performance?	NO	Analysts show **scepticism about the materiality** of environmental and social issues; exclusive focus on downside risk, rather than upside opportunity.	Communicate on issue-specific, proven, quantifiable, material links to business value; avoid moral arguments.
YES			
Are my clients interested and willing to pay for environmental, social, and governance research?	NO	Analysts cite **lack of client interest**, incompatible time scales (e.g. erosion of 'buy and hold' view of value creation); unlike the governance question with environmental and social issues there has been no crises and resulting regulations.	Promote Enhanced Analytics Initiative and similar efforts.
YES			
Would my company support me?	NO	Environmental, social, and governance issues are **seen as low priority** with no top-down mandate or concrete plans; no incentives for analysts.	Incorporate into remuneration and career advancement strategies; institute prizes and other rewards.
YES			
Can environmental, social, and governance issues readily be incorporated into mainstream company analysis?	NO	**Environmental, social, and governance are rarely integrated** into bottom-up modelling; some analysts use a top-down approach to quantifying such issues; most common use is as overlay to valuation.	Develop quantitative and qualitative methodologies that incorporate environmental, social, and governance; encourage cross-fertilisation between mainstream and environmental, social, and governance specialists.
YES			
Do I have the necessary knowledge, tools and credible data? Am I motivated to get it?	NO	**Comparable and credible data is scarce**; analysts lack specific knowledge or tools; personal innovation on environmental, social, and governance is perceived as high risk/low return activity; "bunker mentality" creates resistance to change.	Include environmental, social, and governance analysis in financial education, professional qualifications, and regulatory accreditations; build analyst interest by showing links to competitive advantage.

Key Terms

SELL-SIDE ANALYSTS work for a brokerage or firm that manages individual accounts and makes recommendations to the clients of the firm to help them make decisions to buy, sell, or hold stocks. **BUY-SIDE ANALYSTS** usually work for a pension fund or mutual fund company. Their recommendations are made exclusively for the company that employs them.

FUNDAMENTAL ANALYSIS is used to predict future trends of a share price by studying a company's fundamental financial figures (e.g. cash flow, recent dividends, and projection of future dividends).

VALUATION is the process to estimate the value of an asset. The principal valuation methodology used by interviewees is discounted free cash flow (DCF). One way that perceived ESG downside risk is factored into the Capital Asset Pricing Model is through higher betas (company-specific risk) or higher risk-free rates and market equity premiums (market-wide risks). In such cases, a higher cost of capital=higher discount rate=lower valuation.

4 Discounted cash flow valuation is built on an edifice of assumptions and estimates. Multiples-based valuations rely greatly on the analyst's feeling for which companies ought to trade at a discount or premium.

About the WBCSD

The World Business Council for Sustainable Development (WBCSD) is a coalition of 170 international companies united by a shared commitment to sustainable development via the three pillars of economic growth, ecological balance and social progress. Our members are drawn from more than 35 countries and 20 major industrial sectors. We also benefit from a global network of 50 national and regional business councils and partner organizations involving some 1,000 business leaders.

Our mission

To provide business leadership as a catalyst for change toward sustainable development, and to promote the role of eco-efficiency, innovation and corporate social responsibility.

Our aims

Our objectives and strategic directions, based on this dedication, include:

Business leadership

> to be the leading business advocate on issues connected with sustainable development

Policy development

> to participate in policy development in order to create a framework that allows business to contribute effectively to sustainable development

Best practice

> to demonstrate business progress in environmental and resource management and corporate social responsibility and to share leading-edge practices among our members

Global outreach

> to contribute to a sustainable future for developing nations and nations in transition

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About UNEP Finance Initiative

The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership between the United Nations Environment Programme and the private financial sector. UNEP FI works closely with the 200 financial institutions that are signatories to the UNEP FI Statements, and a range of partner organisations, to develop and promote linkages between the environment, sustainability and financial performance. Through regional activities, a comprehensive work programme, training programmes and research, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

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