

# Performance, Performance, Performance: The Power of Responsible Investment

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# UNEP FI Asset Management Working Group

## ■ A strategic alliance

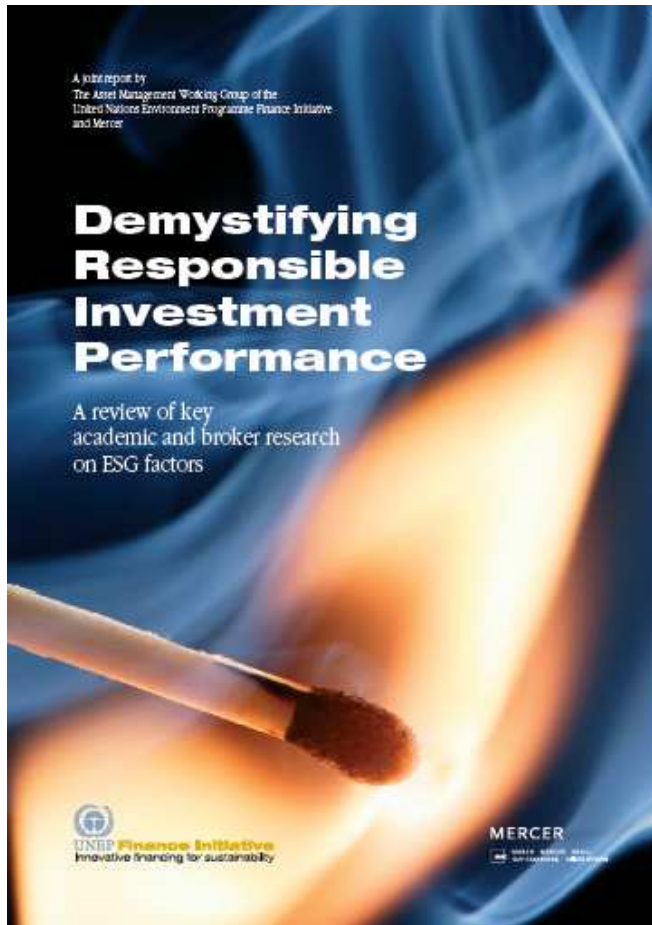
ABN AMRO Banco Real Brasil  
Acuity Investment Management  
AIG Investments  
BNP Paribas Asset Management  
Calvert Group (*Co-Chair*)  
ClearBridge Advisors  
Eurizon Capital  
Groupama Asset Management  
Henderson Global Investors

Hermes Pensions Management  
HSBC Investments (*Co-Chair*)  
Insight Investment  
Mitsubishi UFJ Trust & Banking Corp.  
Morley Fund Management  
Nikko Asset Management  
Pax World Management Corp.  
RCM (UK)

- **Mission** – advance the integration of environmental, social and governance (ESG) factors into the investment process



# UNEP FI Asset Management Working Group & Mercer



## ■ 20 academic studies

- Peer-reviewed, influential and award-winning studies
- Traditional finance theory applied to ESG factors
- Varied research methods, regions and approaches

## ■ 10 broker studies

- Qualitative and quantitative studies by renowned brokers
- Reflective of current state and direction of ESG research
- Varied research methods, themes, sectors regions and approaches



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# Overall findings

- Responsible investment leading only to underperformance is a misconception
- Various factors such as manager skill, investment style and time period are integral to investment performance
- Evidence suggests that there appears to be no performance penalty from taking ESG factors into account in the investment management process
- As a financial discipline, responsible investment can be successfully implemented in virtually any investment style
- Genuine ESG analysis needs to be clearly distinguished from simple automatic exclusions



# Overall findings

- More academic research is needed beyond screening, including the effect of engagement and integration in stock selection
- Systematic translation of ESG factors into quantitative inputs and financial ratios still needs to be developed in broker research
- Asset owner-asset manager collaboration is a key research driver



# Framework & methodology

## Narrative analysis

- Full academic reference
- Summary
- Test
- Results

## Tabular analysis

- Target audience
- Region
- Time period of study



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# Framework & methodology

## Tabular analysis

- Financial performance measure(s) – broad
- Financial performance measure(s) – specific
- E, S or G measure(s) – broad
- E, S or G measure(s) – specific
- Unit of measurement
- Number of units
- Source of ESG data
- Responsible investment approach
- Link to other articles



# Overview of academic studies (1-5)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
1	Abramson, L. & Chung, D. (2000).	<b>Socially responsible investing: Viable for value investors?</b>	Sep 1990 - Mar 2000	ESG	Screening	positive
2	Barnett, M. & Salomon, R. (2006).	<b>Beyond dichotomy: The curvilinear relationship between social responsibility and financial performance.</b>	Jan 1972 - Dec 2000	E and S	Screening	neutral-positive
3	Bauer, R., Otten, R. & Rad, A. (2006).	<b>Ethical investing in Australia: Is there a financial penalty?</b>	Nov 1992 - Apr 2003	ESG	Screening	neutral
4	Bello, Z. (2005).	<b>Socially responsible investing and portfolio diversification.</b>	Jan 1994 - Mar 2001	Mainly S	Screening	neutral
5	Benson, K.L., Brailsford, T.J. & Humphrey, J.E. (2006).	<b>Do socially responsible fund managers really invest differently?</b>	Jan 1994 - Dec 2003	Mainly S	Screening	neutral



# Overview of academic studies (6-10)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
6	Brammer, S., Brooks, C. & Pavelin, S. (2006).	<b>Corporate social performance and stock returns: UK evidence from disaggregate measures.</b>	Jun 1997 - Jun 2002	E and S	Screening	neutral-negative
7	Chong, J., Her, M. & Phillips, G.M. (2006).	<b>To sin or not to sin? Now that's the question.</b>	Sep 2002 - Sep 2005	Mainly S	Screening	negative
8	Core, J., Guay, W. & Rusticus, T. (2006).	<b>Does weak governance cause weak stock returns? An examination of firm operating performance and investors' expectations.</b>	Sep 1990 - Dec1999	G	Activism	neutral
9	Derwall, J., Guenster, N., Bauer, R. & Koedijk, K. (2005).	<b>The eco-efficiency premium puzzle.</b>	Jul 1995 - Dec 2003	E	ESG integration	positive
10	Geczy, C., Stambaugh, R. & Levin, D. (2005).	<b>Investing in socially responsible mutual funds (working paper)</b>	Jul 1963 - Dec 2001	S	Screening	negative



# Overview of academic studies (11-15)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
11	Gompers, P., Ishii, J. & Metrick, A. (2003).	<b>Corporate governance and equity prices.</b>	Jan 1990 - Dec 1999	G	Activism	positive
12	Hong, H. & Kacperczyk, M. (2006).	<b>The price of sin: The effects of social norms on markets (working paper).</b>	Jan 1965 - Dec 2004	S	Screening	negative
13	Opler, T.C. & Sokobin, Jo. (1995).	<b>Does coordinated institutional activism work? An analysis of the activities of the Council of Institutional Investors.</b>	Jan 1991 - Dec 1993	G	Activism	positive
14	Orlitzky, M., Schmidt, F.L. & Rynes, S.L. (2003).	<b>Corporate social and financial performance: A meta-analysis.</b>	Jan 1972 - Dec 1997	S, and E to a lesser extent	Screening	positive
15	Schröder, M. (2004).	<b>The performance of socially responsible investments: Investment funds and indices.</b>	Varied start date: mid-1990s - Sep 2002	ESG	Screening	neutral-positive



# Overview of academic studies (16-20)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
16	Shank, T. M., Manullang, D.K. & Hill, R.P. (2005).	<b>Is it better to be naughty or nice?</b>	Dec 1993 - Dec 2003	ESG, with more S than E and G	Screening	positive
17	Smith, M.P. (1996).	<b>Shareholder activism by institutional investors: Evidence from CalPERS.</b>	Jan 1987 - Dec 1993	G	Activism	positive
18	Statman, M. (2000).	<b>Socially responsible mutual funds.</b>	May 1990 - Sep 1998	Mainly S	Screening	positive
19	Statman, M. (2006).	<b>Socially responsible indexes: Composition, performance, and tracking error.</b>	May 1990 - Apr 2004	Mainly S	Screening	positive
20	Van de Velde, E., Vermeir, W. & Corten, F. (2005).	<b>Corporate social responsibility and financial performance.</b>	Jan 2000 - Nov 2003	ESG	ESG integration/ Screening	positive



# Key academic findings

- Breadth and depth of academic research has expanded over the years
- Findings on ESG factors: 10 positive, 7 neutral, 3 negative
- Varied results due to factors such as differing research methods and short sample periods
- There is some confusion within the academic community whether responsible investment should be a style of its own
- More research on ESG factors and portfolio performance foreseen as ESG becomes more widely adopted within academia



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# Overview of broker studies (1-5)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
1	Dell, B., McMahon, N., Goller, A., & Gruber, S. (2007), Berstein Research.	<b>Berstein energy: An energy or environmental problem? The impact of CO2 regulation on oil demand and alternative plays.</b>	Feb 2007	Mainly E	Thematic	neutral*
2	Bumm, P., Carballo, I., Halden, D., Lambert, P., Lamotte, C., Ocina, J.R., Patrick, D., Sikorsky, M. & Voisin, S. (2007), Cheuvreux.	<b>Biofuel challenges: A shift in leadership?</b>	1990-2005	E	Thematic	neutral*
3	Tyrrell, M. & Brown, M. (2006), Citigroup Global Markets.	<b>Sustainability compendium: Updating our sustainable investable themes.</b>	Feb 2006	ESG	Thematic/ ESG integration	neutral*
4	Forrest, S., Ling, A., Lanstone M. & Waghorn, J. (2006), Goldman Sachs.	<b>Enhanced energy ESG framework.</b>	2004-2006	ESG	ESG integration	positive
5	Fox, M., Forrest, S., Ling, A. & Lynch, M. (2007), Goldman Sachs.	<b>Global food &amp; beverages: Integrating ESG.</b>	1992-2006	ESG	ESG integration	neutral



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[1] Moskowitz Prize for Socially Responsible Investing, 2005 Winner

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# Overview of broker studies (6-10)

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
6	Ling, A., Forrest, S., Mallin-Jones, P. & Feilhauer, S. (2006), Goldman Sachs.	<b>Global mining and steel: Integrating ESG.</b>	2002-2005	ESG	ESG integration	positive
7	Llewellyn, J. (2007), Lehman Brothers.	<b>The business of climate change: Challenges and opportunities.</b>	Feb 2007	Mainly E	Thematic	neutral*
8	Palmier, H. & Desmartin, J.P. (2006), Oddo Securities.	<b>Nanotechnologies: There are still plenty of opportunities and uncertainties at the bottom.</b>	2004-2015	E and S	Thematic	neutral*
9	Hudson, J. & Knott, S. (2006), UBS Investment Research.	<b>Alternative alpha: Infrastructure - The long view.</b>	nov.06	ESG	Screening	neutral
10	Garz, H. & Volk, C. (2007), WestLB Extra-Financial Research.	<b>What really counts. The materiality of extra-financial factors.</b>	2000-2005	ESG	ESG integration	positive



# Key broker findings

- There is explicit recognition of the materiality of ESG factors
- Currently, most brokers are inclined to conduct thematic research
- Thematic studies (5) are generally positive on ESG factors explored
- Findings of (5) quantitative studies: 3 positive, 2 neutral
- It is still difficult to compare ESG criteria and traditional financial criteria, and identify distinct linkages
- More rigorous quantitative ESG research is necessary



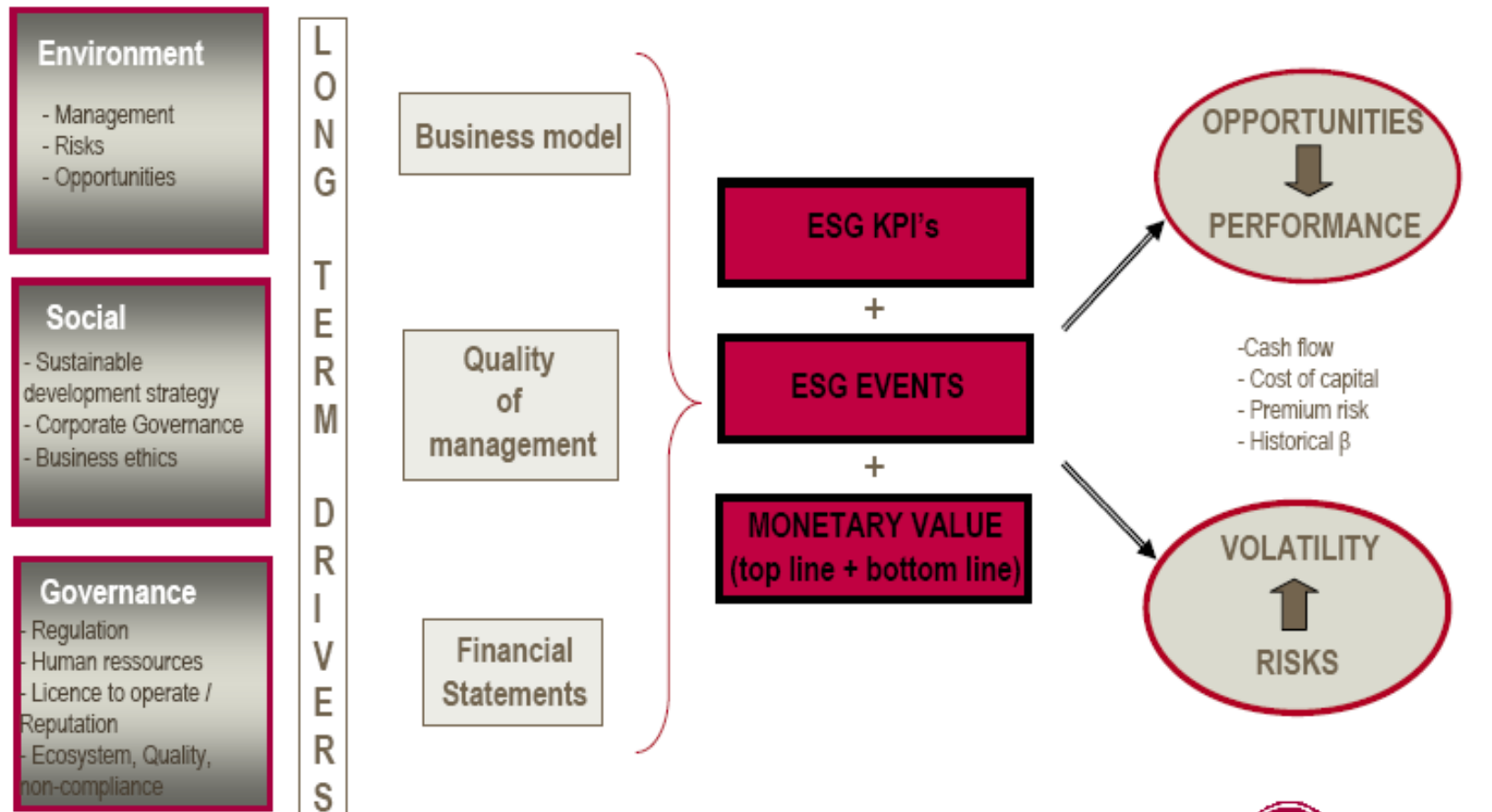
# Panel discussion



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# INTEGRATING ESG RESEARCH INTO VALUATION MODELS

ESG RESEARCH ➔ MATERIALITY ➔ MEASUREMENT ➔ VALUATION MODEL



# Current Status On Responsible Investment Performance

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## ① Key findings of Our ESG factor analysis

Responsible Investment can compete with other investment methods such economically, same with the report results.

## ② Supportable findings to “Fiduciary Duty”

Our conclusion from the study with Professor Morito under the Japanese Law System is that Fiduciary Duty does not prevent investors from taking ESG factors into account in the portfolio management process, if responsible investment (“RI”) can compete with other investment methods.

## ③ How to evaluate ESG factors? Is “RI” special?

Mainstream investors evaluate both quantitative and qualitative factors which are important for corporate earnings prospect.

It is important to evaluate material factors which could impact to corporate earnings/company value even in mainstream and “RI” along with continuous studies on “RI” contribution to performance.

# How to consider ESG factors into the portfolio management process

## < A case of Financial Approach >

- ① Macro Analysis  
the rate of economic growth, financial status, the movement of population, etc.
- ② Sector Analysis  
the rate of industry growth, price trend, competition, technical trend, etc.
- ③ Company Analysis  
the rate of sales growth, profitability, B/S analysis, etc.

+

Quality of Management, Strategy, Policy, Organization, etc



Evaluate both quantitative/qualitative factors which are important for future corporate earnings prospect

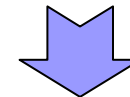
## < A case of Extra financial Approach >

- ① Macro Analysis  
climate change, the movement of population, globalization, etc.
- ② Sector Analysis  
industrial regulation, industrial characteristic, etc.
- ③ Company Analysis  
technical strength, CSR policy, etc.

=

+

CSR Strategy, Contribution to ESG issue, etc.



It is important to pay attention to ESG factors which important to corporate earnings, same with financial approach.

# ESG valuation methodology



36380	DJ MARKET TALK:		
36300	DJ INTERBANK FOR		
INDU	-135.14	UCLU	1.13
INDP	9646.26	UNOL	288.7
UTIL	+1.90	DUOL	823.7
TRAN	-84.40	TRIN	1.16

There is no doubt investors are aware of the effect of Corporate Governance on equity price: Enron, Worldcom, Tyco, Parmalat, Vivendi

Yet, it is difficult to evaluate in numbers the future impact such issues might cause

There are several workshops on how to quantify ESG with a valuation methodology

While it is generally accepted that ESG issues have a material impact on companies valuations, there does not seem to be yet a unique way to determine the value of such impact

Companies find it difficult to put in perspective the efforts of today for the benefits of tomorrow

Nonetheless, the evidence brought by several cases on the 'reputation effect' makes the pursued calculation ideally close to that of the Brand Value

# Potentially similar methodologies... brand valuation (\*)



$$\text{Brand Value} = PD/r(*) \times LD \times ED$$

The Hirose method evaluates the brand on the basis of 3 main drivers:

- **Prestige driver (PD):** based on the *premium price* coming from the comparison between the ratio "revenues/cost of sales" of the branded company and of the unbranded company.
- **Loyalty driver (LD):** estimates the most stable part of the profits arising from the brand
- **Expansion driver (ED):** estimates the growth perspectives of the profits arising from the brand.

(\*)  $r$  is the capitalization rate of the profits directly due to the brand prestige

$$PD = \frac{1}{5} \sum_{i=-4}^0 \left\{ \left( \frac{S_i}{C_i} - \frac{S_i^*}{C_i^*} \right) \times \frac{A_i}{OE_i} \right\} \times C_0$$

- $S_i$  = Revenues of the *branded* company (in the period "i")
- $C_i$  = Cost of sales of the *branded* company (including variable costs and direct fixed costs but excluding commercial costs, general and administrative expenses and depreciation)
- $S_i^*$  = Revenues of the *unbranded* company (benchmark)
- $C_i^*$  = Cost of sales of the *unbranded* company (benchmark)
- $A_i/OE_i$  = Impact of the advertising costs to support the brand on the operating costs (difference between revenues and EBIT)

$$LD = \frac{\mu_C - \sigma_C}{\mu_C}$$

$\mu_C$  = average of the cost of sales of the *branded* company in the last 5 fiscal years

$\sigma_C$  = standard deviation of the cost of sales of the *branded* company in the last 5 fiscal years

(\*) Japanese Committee on Brand Valuation  
Yoshikuni Hirose, Chairman



# An example of a new methodology... using the Beta (\*)



Measuring the impact of SRI risk on fair value using a lower Beta for SRI compliant companies

Using a DDM (Dividend Discount Model)

$FV = \frac{D}{i - g}$	$FV' = \frac{D}{i' - g}$
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D = dividends  
 i = required rate of return  
 g = dividend growth  
 i' = risk free rate + adjusted Beta \* mkt risk premium  
 FV = Fair Value  
 FV' = Fair Value Beta Adjusted

$FV' = \frac{D'}{i' - g}$	$\rightarrow$	$FV' = FV * \frac{i - g}{i' - g}$
$FV = \frac{D}{i - g}$		

$FV' = FV * \frac{i - g}{i' - g}$
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(\*) Société Générale: "SRI Impact on Valuations"  
 April 2005