ESG – BUSTING THE MYTHS

SRI, ESG, CSR, UNPRI…the investment industry is notorious for its prolific use of acronyms, and the responsible investment industry is certainly no exception. In this paper we outline how Environmental, Social and Governance (ESG) analysis can lead to better investment outcomes, and we break down a few myths surrounding ESG.

WHAT IS ESG?

Some say ‘ethical investments’, others say ‘socially responsible investments’, while others will say ‘sustainable investments’ or ‘ESG integration’. Although there are similarities, there is often confusion about this terminology as the industry has evolved over time. So what’s the difference?

While both an ethical investment strategy and sustainable investment strategy might avoid investments in tobacco companies, they might have arrived at the conclusion for different reasons. An ethical investor might avoid tobacco stocks on moral grounds. However, with sustainable investment, or ESG integration, tobacco stocks might be avoided because of perceived poor long-term earnings fundamentals.

HELPING TO MAKE BETTER INFORMED INVESTMENT DECISIONS

In 2007, AMP Capital became a signatory to the UN Principles for Responsible Investments - or the UN PRI. These principles include a commitment to take into account ESG factors in our investment decision-making process.

In equity investments, the value of ESG analysis can be summarised into two key points:

- First, as a complement to traditional investment analysis, ESG can be a useful tool to discover investment risks before they ‘blow up’.
- Second, by integrating ESG analysis, investors can make better informed investment decisions. In turn, this can lead to better returns.

Let’s look at why this is the case.....

IN THIS PAPER WE DISCUSS...

- What ESG is, and why it’s not the same as ‘ethical investments’
- Why ESG analysis can help an investor make better informed investment decisions by understanding how companies manage their intangible drivers
- How ESG analysis covers more than environmental performance – an in-depth analysis of the ‘S’ and the ‘G’ can also help investors find mispriced securities
- Why responsible investments and strong financial returns do not need to be mutually exclusive
- Why engaging with companies on ESG issues can lead to better investment outcomes

ABOUT THE AUTHOR

Måns Carlsson-Sweeny joined AMP Capital in September 2010 as ESG Research Analyst. In this role, Måns is responsible for the analysis of ESG issues and sustainability drivers for a number of sectors, as well as regularly engaging with companies on ESG issues.

The starting point is to look at what actually drives a company’s value. Analysis shows that the majority of a company’s value is made up of so-called intangible drivers. These are not necessarily found in financial statements. Examples include a company’s culture, its occupational health and safety performance and its supply chain risk management. Importantly, our internal research shows that the percentage of intangible assets as a percentage of Australian companies’ market capitalisation has increased over time.

Given that intangibles increasingly make up the majority of a typical company’s value, by understanding how companies are managing their intangible drivers, investors can make better informed investment decisions. In addition, by understanding what is underpinning a company’s earnings, investors can assess the earnings sustainability of a company. If the business model relies on under-priced pollution, under-paid labour or weak regulation, the current earnings levels might not be sustainable. This is why ESG analysis might lead to the exclusion of tobacco stocks.
The majority of the value of the typical Australian company is made up of so-called ‘intangible drivers’.

Intangible drivers may include corporate culture, supplier relationships, environmental risk management...things you don’t necessarily find in a financial statement.

Understanding the importance of ‘intangible drivers’ can lead to better informed investment decisions and, ultimately, better returns.

IT’S NOT JUST ABOUT A COMPANY’S CO2 FOOTPRINT

ESG analysis refers to a wide range of non-financial drivers. In-depth analysis of these can identify mispriced securities and alpha for investors.

While the direct earnings impact of individual ESG issues might be small, another very important aspect of ESG analysis is the way a company deals with its ESG issues can also tell investors something about the quality of management.

ESG has often been closely associated with the ‘E’ of ESG and climate change. However, while environmental issues and companies’ environmental performance can certainly be key aspects in a wide range of sectors, such as the mining industry, in other sectors analysis of the ‘S’ or the ‘G’ in ESG can unlock relatively more important investment insights. For instance, while the transport sector has major environmental challenges in the long-term, the way a company deals with occupational health and safety and union relations, can have a direct earnings impact in the short-term.

Good ESG analysis tries to answer two questions:

> What is the earnings or share price impact?
> Is it already factored into the price?

WHAT IS THE EARNINGS IMPACT OF POOR OCCUPATIONAL HEALTH AND SAFETY PERFORMANCE?

The transport sector has the highest workplace serious accident incidence rate in Australia and it has one of the highest fatality rates. In addition to direct costs, i.e. workers compensation costs, investors also need to pay attention to a number of indirect costs, such as the impact of poor occupational health and safety performance on employee productivity, relationships with customers, regulators, unions and the wider community.

Our internal research indicates that the indirect costs of poor safety performance are increasing. Quantifying these costs can be difficult - but as a rule of thumb, the indirect costs are typically at least as high as the direct costs.

IS THIS FACTORED INTO THE PRICE?

If companies’ disclosure was perfect, perhaps it would be. However, as we highlighted in our report 'Transport and ESG – watch out for bumps along the road' in 2013, which covered listed transport companies in Australia and New Zealand, investors need to have a comprehensive understanding and see beyond what companies are reporting.

While lost time injury frequency rates (LTIFR) have generally improved over time, they do not say much about the severity of injuries. In most cases, they do not include contractors and in some cases, they can even mask issues with a high number of fatalities. In many cases executive remuneration is only linked to the LTIFR performance, which means a risk of under-reporting. In addition, it can cause friction with unions if the actual safety performance is poor. Investors using alternative information sources to company reporting can find valuable insights and detect earnings risks before it is too late.

Another example of potentially conflicting information is staff engagement. This is an area where public disclosure is typically poor. In our analysis of transport companies, there was one particular case where significant discrepancies were found between one company’s reported staff engagement and an external survey.

What is the potential earnings impact here? The score of higher staff engagement reported by the company might mask the risk of industrial action. This, historically, has had a big impact on transport companies’ earnings. In addition, it might have a major impact on productivity.

Our research shows a strong link between staff engagement on the one hand and customer satisfaction on the other. In turn, customer satisfaction can be a major driver for market share growth in markets characterised by commoditised products and services and intense competition. Is it in the price? Going the extra mile and researching how companies are managing their intangible drivers through alternative information sources can enable investors to find mispriced securities – both over the long-term and short-term.

Other examples of sector-specific reports on ESG integration and how ESG can be used for stock-picking and portfolio positioning include ESG and the media sector: staying clear of the value traps, Commercial services sector – struggling with new dynamics and Retailers: why their ESG is important to investors.

AS CO-FOUNDER OF THE INVESTOR GROUP ON CLIMATE CHANGE IN AUSTRALIA AND NEW ZEALAND, AMP CAPITAL HAS BEEN HEAVILY INVOLVED IN ENGAGEMENTS ON CLIMATE CHANGE. WE HAVE ISSUED A NUMBER OF RESEARCH REPORTS ON THE TOPIC – FOR INSTANCE, ‘ASSESSING CLIMATE CHANGE RISK IN THE S&P/ASX 200 INDEX AND EQUITY PORTFOLIOS’.
ESG AND STRONG FINANCIAL RETURNS DO NOT HAVE TO BE MUTUALLY EXCLUSIVE

As discussed above, ESG analysis can help make better informed investment decisions, which may lead to better investment outcomes. Despite various academic studies on the topic, the myth that investors need to forfeit good returns to invest responsibly appears to stay alive. However, rather than commenting on other people’s research, we have our own story to tell.

Since 2007, AMP Capital’s in-house ESG research team has measured the performance of an investible universe of investment grade and non-investment grade stocks based on their ESG profiles against the ASX 200 index.

The graph below shows that the investible universe of ESG stocks has consistently outperformed the ASX200 index on a rolling 3-year period and has outperformed the index 55% of the months since inception. As of August 2014, it had outperformed the ASX200 index by approximately 900 basis points.

Are ESG and strong financial returns mutually exclusive? Our example shows compelling evidence that ESG analysis can at least create a better pool of stocks to choose from.

How ESG investing can lead to better investment returns

![Graph showing outperformance of ESG stocks against ASX200]

<table>
<thead>
<tr>
<th>Period</th>
<th>Total Accumulated Outperformance</th>
<th>Annualised Outperformance</th>
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<tbody>
<tr>
<td>6 months</td>
<td>0.0%</td>
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<tr>
<td>Since beginning of ’07</td>
<td>900 basis points</td>
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Source: AMP Capital. Shows return of ESG investible universe versus the ASX 200 index. Accumulated outperformance is the relative total shareholder return of customised index versus the benchmark (ASX200). Data as of August 2014. Past performance is not a reliable indicator of future performance.

ENGAGEMENT ON ESG ISSUES CAN LEAD TO BETTER INVESTMENT OUTCOMES

By engaging with companies they invest in, investors can improve their understanding of the companies’ management of ESG issues. By influencing companies, investors can safeguard their invested capital. However, investors can also broaden their investible universe by engaging with companies not in their portfolio and sometimes reduce systemic investment risk. In short, engaging with companies’ management of intangible drivers can lead to better investment outcomes. For a summary of some of the themes AMP Capital has engaged with investors on, please see Appendix.

FINAL THOUGHTS

The responsible investment industry has evolved significantly over time from ‘ethical investments’ to integration of environmental, social and governance analysis. The latter is increasingly important as the proportion of a typical company’s market capitalisation that is derived from so-called intangible drivers has increased over time. While many sustainability issues may be known to the market, the implications for investments can be complex. As discussed in this paper, in-depth ESG analysis successfully integrated with financial analysis can provide investors with significant benefits, including:

> Better informed investment decisions;
> Identification of investment risks before they ‘blow up’;
> Identification of mispriced securities; and
> Higher investment returns — both in the short and long term.

In addition, active engagement with companies on ESG issues can lead to better investment insights and better investment outcomes through preservation of invested capital and/or expansion of the investible universe.

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.

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Over the years, AMP Capital has engaged with companies in a wide range of ways. While our good corporate access at management level enables discussions on ESG issues in an integrated way – not as a stand-alone issue – better corporate access at board level in recent years, driven by better communication between investors and directors due to the first-strike rule, has enabled deeper engagement. We also engage on many ESG issues at an industry level.

While we undertake numerous engagements with companies on an individual basis each year, we currently focus on a number of other key engagement themes such as supply chain management / human rights, climate change, improved ESG disclosure, coal seam gas and corporate governance and remuneration.

Corporate governance and remuneration are two long-standing engagement areas for AMP Capital. The way a company has structured its executive remuneration can tell investors something about the general governance of a company, including who and what it values and how open a company is with its shareholders. Understanding pay and engaging with companies on this can help ensure shareholders’ funds are used wisely and contribute to better and more informed investment decisions. The main engagement objective is to reduce systemic and company-specific investment risk.

AMP Capital’s voting on resolutions

While there are still areas where we have concerns for a significant number of companies, the ‘Two Strikes Rule’, which resulted in increased focus on remuneration structures, along with engagement, have led to improvements in the structure and communication of remuneration reports. AMP Capital’s corporate governance reports include more detail on voting statistics and our views on corporate governance.

Many other engagement themes have been long and continuous journeys. For instance, engagement on supply chain management was a result of a trip to Asia in 2011 where we visited factories and met with companies throughout the supply chain. Our main concern at the time was how manufacturing was gradually moving to countries with very poor labour standards, most notably Bangladesh. While minimum wage in Bangladesh was significantly below China’s, we questioned the sustainability of that gap and highlighted the potentially poor financial risk / reward ratio. In short, retailers were chasing minor cost benefits for significant additional brand and operational risk.

As a result, in 2011, AMP Capital began to engage broadly with retailers about their supply chain risk management and because this is a systemic risk, we also engaged at an industry level, particularly about the risks in Bangladesh, e.g. through publication of research, including How sustainable are Australian retailers’ new sourcing strategies in 2012.

In April 2013, the Rana Plaza building collapse took place in Dhaka, Bangladesh killing 1,138 garment workers. Since then, AMP Capital has urged retailers to sign the Bangladesh Accord on Fire and Building Risk – a multi-stakeholder framework involving retailers, unions and NGOs to minimise the risk of further disasters. We have engaged with Australian retailers about the Accord and became Australia’s second signatory of the Investor Statement on Bangladesh, which urges retailers worldwide to sign the Bangladesh Accord. Currently, approximately 200 retailers have signed the Bangladesh Accord, including most of the listed Australian retailers with material exposure to Bangladesh.
In 2014, AMP Capital joined a small group of investors from the US and Europe on a fact finding trip to Bangladesh, visiting garment factories, and meeting with retailers and key organisations. Afterwards, we published our *The ready-made garment sector at cross roads* report, highlighting key insights, investment risks and opportunities from the trip. While we are pleased to see an increased number of retailers have signed the Bangladesh Accord, we are now turning our focus to underlying issues in the supply chain, such as the ‘living wage’ issue and lack of freedom of association, which are issues that can impact the sustainability of supply chains as well as brand risk. To date, engagement activities have focused on urging retailers to adopt best practice employed by leading retailers that we met with in Bangladesh.

Unfortunately, it can take a major disaster such as the Rana Plaza building collapse for change to happen and we continue to see emerging risks elsewhere, such as in Cambodia and Burma. However, as an investor, you aim to stay one step ahead, by engaging with companies and detecting risks before they become an issue. ESG analysis can be a very useful tool in doing so.

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