PRI Principles for Responsible Investment

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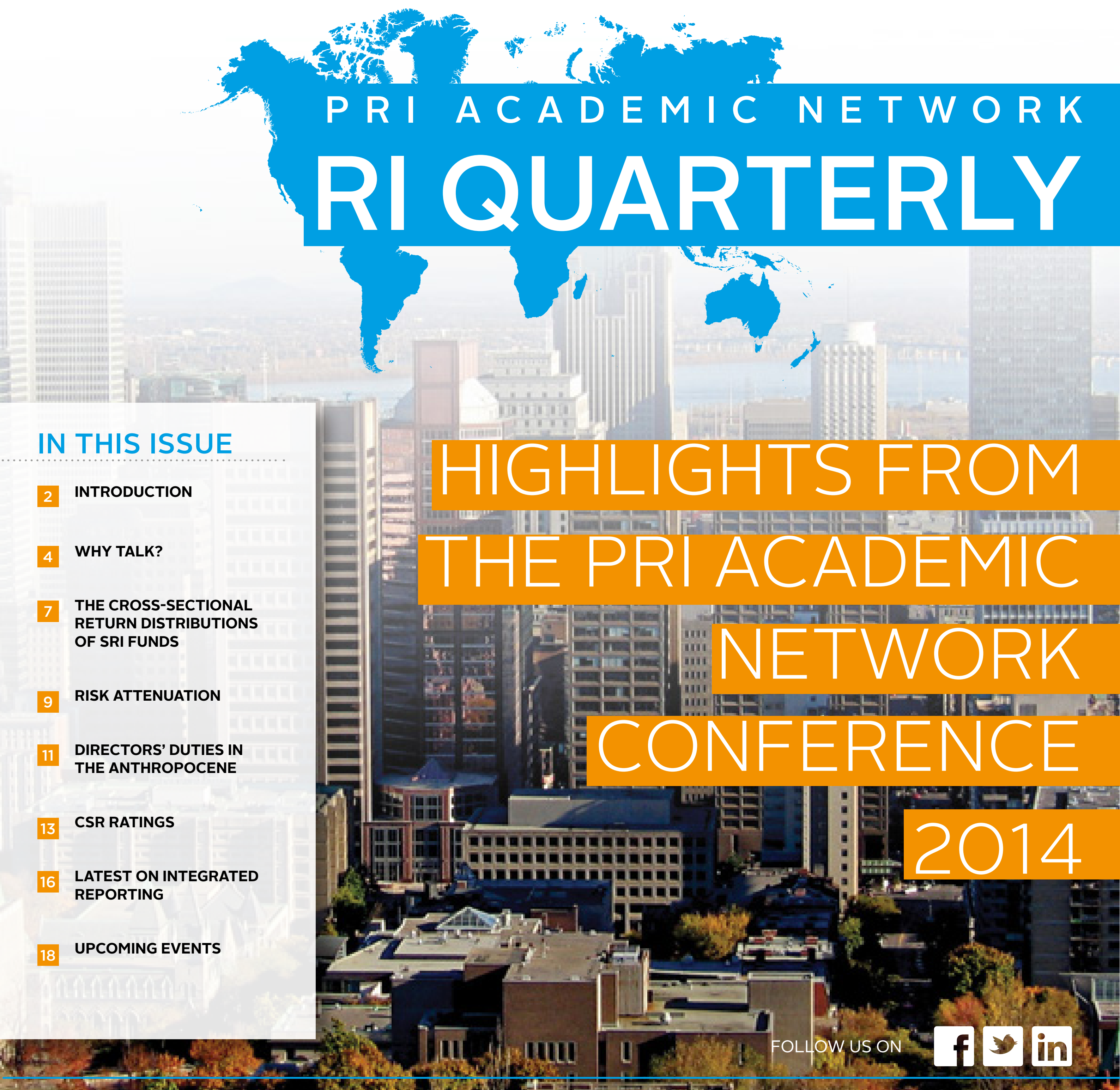

PRI ACADEMIC NETWORK

RI QUARTERLY

HIGHLIGHTS FROM THE PRI ACADEMIC NETWORK CONFERENCE 2014

IN THIS ISSUE

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The PRI Academic Network's goal is to bring academic research into practice and vice-versa. We bring academics and practitioners together, showcasing the best academic research to the investment industry, and encouraging academia to respond to the research needs of investors.

Contact: academic@unpri.org

The RI Quarterly is produced by the PRI Academic Network and aims to be the go-to publication for investment professionals and anyone needing the latest research on responsible investment, but without the time to read through the original papers. Every issue will focus on a number of academic papers around a theme selected by the PRI's Academic Network Steering Committee extracting the essentials of the argument and giving key findings in a clear and concise manner.

EDITOR: Sarah Cleveland is an independent investment consultant working on research, education and communication projects with companies in the institutional investment industry. Previously she consulted with a broad range of institutional investors as a senior consultant with Towers Watson Investment Services and Rogerscasey. She has been involved in economic research and financial services for over 20 years.

INTRODUCTION

BACK

Each year the PRI Academic Network Annual Conference grows in stature, and this year was no exception! Using a deliberate strategy to 'bridge the gap' between responsible investment academics and investors, our 7th annual conference exceeded its goals.

Competition for accepted papers following our call was fierce, resulting in world-class quantitative and qualitative research coming forward in Montréal. The themes included: ESG integration, shareholder engagement, short termism and structural market failure, social finance, and transparency and reporting.

By holding the conference in the same venue and week as PRI in Person, investors participated in the research discussions and provided the academic community with deeper insight into the needs of the RI industry. For me, this year's conference highlights included our keynote presentations, such as George Serafeim's evidence on the importance of ESG reporting (page no. 16). With the 2013 PRI Academic Network Conference keynote speaker, Jean Tirole being awarded this year's Nobel Prize in economics, we may be on to a trend!

Another highlight was the Sustainalytics Prize for Excellence in Responsible Investment Research. Fabrizio Ferraro and Daniel Beunza's paper, *Why talk? A process of model of dialogue in shareholder engagement* (page no. 4) takes on a topic of deep interest both to academics and to the RI industry.

In this conference special you will find articles on the papers that received an honourable mention, an *Exploration of the cross-sectional return distributions of socially responsible investment funds* by Du et al (page no. 7); *Risk attenuation and the reporting of corporate social (health and safety) performance to investors* by O'Neill et al (page no. 9), and also the joint-winning student paper, *Directors' duties in the anthropocene: liability for corporate harm due to inaction on climate change* by Sarah Barker (page no. 11). We also feature another keynote speaker, Magali Delmas, and her work on *CSR Ratings: Does More Information Add More Value?* (page no. 13).

The videos and presentations from of all the plenary presentations are available now on the PRI Events page.

Dr. Tessa Hebb

It is with great pleasure I hand the chair of the PRI Academic Network Steering Committee to Daniel Beunza of the London School of Economics and look forward to our conference in London next year, where we will be combined with PRI in Person (8-10 September, ICC ExCeL). I hope you'll join us there.

Dr. Tessa Hebb
Conference Co-Chair and PRI Academic Network Steering Committee Chair, Carleton University, Ottawa, Canada.

Click here to access to the Academic Conference 2014 video sessions

We would like to thank Matthew Haley, David O'Brien Centre for Sustainable Enterprise, Concordia University for providing the pictures used in this issue.

BACK

"As the assistant professor of management at the London School of Economics, my research is focused on the sociology of financial markets. I have already met many of you over the years, and look forward to working with both the PRI, investors and academics as the Chair of the Academic Network Steering Committee. I do not need to remind researchers in this network that the world is at a turning point, not only in its geopolitical order but especially its environmental and social future. There is a pressing need for rigorous academic research on solutions and ways forward, and I expect to see these showcased in London next year. I welcome your ideas and suggestions and look forward to seeing you."

Daniel Beunza
d.beunza@lse.ac.uk

"I attended the conference as a sponsor of the Sustainalytics Prize for Excellence in Responsible Investment Research. Sustainalytics' decision to sponsor this prize for the past few years stems from our commitment to collaboration between academic and practitioners in enhancing responsible investment standards and approaches. The keynote on integrated reporting was a highlight, reflecting the opportunity for collaboration among academics and practitioners in identifying a narrower subset of ESG metrics, with the strongest correlation. Another key opportunity for collaboration is confronting the carbon challenge, one of the most critical risks facing us today."

Heather Lang, Sustainalytics

WHY TALK? A PROCESS MODEL OF DIALOGUE IN SHAREHOLDER ENGAGEMENT

BACK

- An iterative dialogue over time may lead to corporate change.
- Raising awareness, building coalitions and reframing issues are key parts of the process.
- Effective dialogue requires communication skills and commitment.
- This study may serve as a blueprint for effective shareholder dialogue.

Article summary written by Sarah Cleveland

AUTHORS

Fabrizio Ferraro

Daniel Beunza

Ferraro and Beunza analyse data on shareholder engagements from a faith-based coalition (ICCR, Interfaith Center for Corporate Responsibility) to develop a process model for dialogue. While shareholder engagement with corporate managers is recognised to have a positive impact, very little is understood about the mechanisms that make it happen. Ferraro and Beunza seek to answer the following research question: *how does stakeholder dialogue translate into organisational change?*

Shareholder engagement is characterised by filing shareholder resolutions to address social or environmental concerns, often accompanied by private dialogue. Success includes withdrawing the resolution and continuing dialogue.

Previous research has mainly addressed an activist approach to filing shareholder resolutions, focusing on reputational threats with the potential of endangering dialogue. Emerging literature acknowledges dialogue is growing in importance and takes expertise. Ferraro and Beunza observe a process model will help guide future engagements.

ANALYSIS

The researchers spent four years examining ICCR records dating back to 1993; conducting interviews with ICCR members, staff and corporates as well as witnessing ICCR members engage in dialogue with corporate managers. To build their theory, the authors selected six companies ICCR had engaged with for 10 years or more. In addition, the companies were diversified by industry and issue. Investors were instrumental in influencing change in three of the engagements (Wal-Mart, Merck, Ford) and ineffective in the other three engagements (ExxonMobil, Dillard's, Tyson).

The authors note the nature of engagement dialogue has changed

BACK

over time since the early 1970s when ICCR was founded. Early engagements rarely included dialogue, and this began to change in the 1990s when companies started to open negotiations. ICCR members recognised attempts to silence issues. Nevertheless, the existence of face-to-face meetings altered the conversation and set the stage for future effective dialogue.

The dialogue process is iterative over time and requires commitment. The authors use case studies to illustrate three elements that occur in all successful cases: raising awareness, building coalitions and reframing issues.

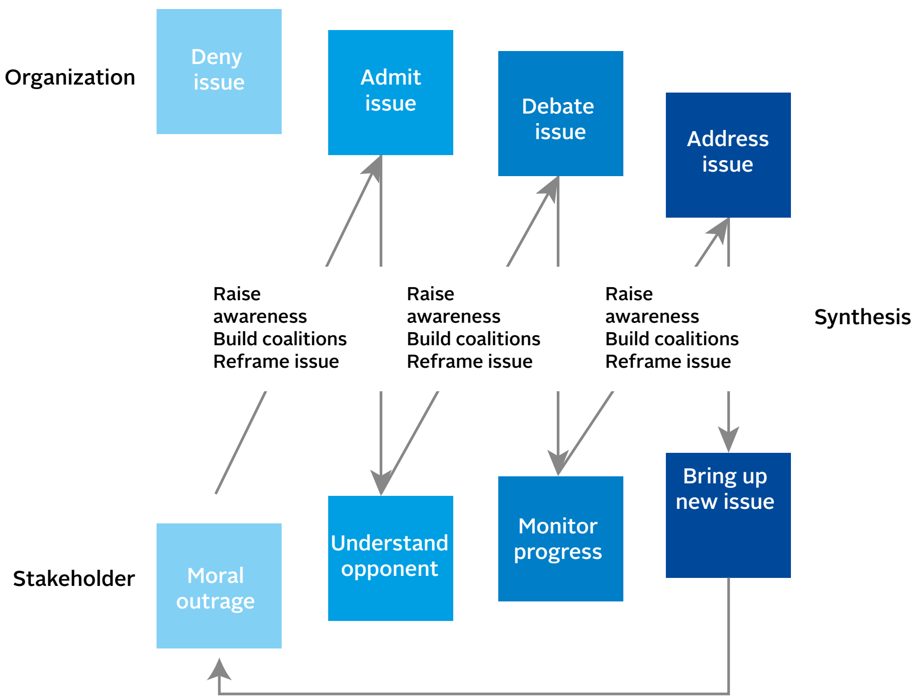
RAISING AWARENESS: WAL-MART CASE STUDY

ICCR engaged with Wal-Mart on equal opportunity employment rights from 1998 to 2007 resulting in modest changes. The process started with a resolution filed in 1998 that the company challenged at the US Securities and Exchange Commission (SEC), progressed to an initial contentious in person meeting followed by confidential and private dialogue, to result in Wal-Mart publishing its first Equal Employment Opportunities (EEO) report in 2006, disclosing a gender and ethnic breakdown of employees. Also in 2006, ICCR members withdrew a resolution and publicly commended the company.

Due to management changes, a shift in priorities and loss of a key ally, ICCR's dialogue with Wal-Mart slowed from 2007. In 2011 a Wal-Mart executive joined a conference call and began by 'apologizing and thanking ICCR "for your 20 years of patience and 20 years of persistence".'

Over time, ICCR members 'sensitized' company managers to employment issues. They created an emotional connection so managers could empathise how ICCR members felt. In addition, ICCR members did not expect immediate acceptance or try to change managers' thinking. This openness provided the opportunity for managers to consider the issues

THE DIALOGUE PROCESS



among themselves. The entire process requires skill honed through practice.

BUILDING COALITIONS AND REFRAMING ISSUES: MERCK CASE STUDY

ICCR's engagement with Merck occurred from 2001 to 2007 regarding HIV-AIDS and access to medicine in emerging markets. The engagement process started with a letter to the Board of Directors in 2001 requesting Merck to publish a CSR report and disclose policies on HIV-AIDS, filing a resolution in 2003, to Merck publishing its first CSR report in 2003 and agreeing to a conversation. In 2006 ICCR published a benchmarking study of pharmaceutical companies dealing with HIV-AIDS and organised the first 'Roundtable on Access to Medicine' in 2008 and another in 2010. Merck launched a new strategy on access to medicine in 2010 that had been developed internally but with feedback from ICCR members. These guiding principles were recognised within the industry and instrumental in Merck being ranked second among global pharmaceutical companies.

The authors identify three traits that distinguish Merck's dialogue:

- Efforts to meet in person with executives so a discussion within the organisation could be started.
- A non-confrontational and collaborative approach that built trust and comfort.
- Emphasis on general ideas rather than concrete policies in order to set a common ground rather than being prescriptive.

ICCR brought the 'right people' to the table, which had an impact on connecting different corporate units that are necessary to address issues that span across the organisation. A critical link is finding internal champions who will support the issue and help transform the company. Going outside the company and including industry peers is also an effective component of building coalitions.

By the nature of being a faith-based coalition, ICCR brings a moral voice.

However, it is ICCR members' status as shareholders that gives them clout to reframe the issues in a business context, which ultimately drives the organisations' change.

SYNTHESIS

Companies may voice their own response to issues during dialogue, and as part of the iterative process, bring the two sides (activist and company) closer together. This dance of opposing views can eventually be brought together. In the Merck case study, for example, Merck listened to ICCR then queried within the firm what to do with the feedback, and the right approach for the company.

INEFFECTIVE DIALOGUES

Dialogue will not be successful with all companies, however. The authors point to examples where ICCR could not build coalitions because there was no controversy within the company of alternative viewpoints. Groupthink crowds out different points of view, a necessary condition for internal debate. With highly contentious issues like climate change (ExxonMobil), there was no room for internal controversy.

CONCLUSIONS

The authors put forward seven propositions that encompass the empirical traits and observations made during the case analysis. The propositions address how contentiousness and dialogue relate to one another as shareholder tactics for:

1) shaping corporate practices on emerging issues
2) gaining access to corporate management
3) increasing managers' conviction the contested issue is relevant to their business
4) influencing internal (corporate) debate on the issue
5) influencing the strength of the relationship with the corporation
6) successful dialogue, and
7) the speed of corporate policy change.

Dialogue is most effective as a transformative, iterative process over a longer period of time. The authors intend this study to serve as a blueprint for effective dialogue.

Fabrizio Ferraro, IESE Business School and Daniel Beunza, London School of Economics

Why Talk? A Process Model of Dialogue in Shareholder Engagement

Available here.

EXPLORATION OF THE CROSS-SECTIONAL RETURN DISTRIBUTIONS OF SOCIALLY RESPONSIBLE INVESTMENT FUNDS

BACK

AUTHORS

Jianan Du

Brandon Thomas

Janis Zvingelis

- Average and median returns of SRI (socially responsible investment) and non-SRI funds are statistically indistinguishable from each other.
- SRI funds total and risk-adjusted returns are distributed more narrowly around their median than non-SRI funds, implying a tempered response to extreme events.
- SRI funds in the top half of the investment universe underperform non-SRI funds, yet SRI funds will outperform non-SRI funds when returns are in the bottom half, especially during bear markets.

Article summary written by Sarah Cleveland

The authors differentiate themselves from other work in the field by analysing how total and risk-adjusted returns are distributed, compared at various intervals away from the median (cross-sectional analysis). Previous research focuses on average performance. Their research shows return distributions are different for SRI and non-SRI funds, and this has implications for comparative performance and risk exposures.

Du et al used Morningstar Direct Open End mutual fund database as the source of performance returns and stock holdings for SRI and non-SRI domestic equity funds from January 1999 to June 2013. The study includes approximately 3,000 non-SRI and 100 SRI funds, which account for 50% of the SRI funds tracked in the database.

KEY RESULTS:

Average performance: The average performance of SRI and non-SRI funds are nearly identical at the mean, implying the socially conscious investor is just as likely to outperform or underperform as the conventional investor on average. In other words, there is no statistical evidence that the SRI funds will underperform the non-SRI fund.

Return distributions: The SRI funds total and risk-adjusted return distributions are more concentrated around their median and have narrower tails than the non-SRI funds. This may be interpreted as:

- A smaller difference in total return between the best and worst performing SRI fund, compared to the best and worst performing non-SRI funds.
- For funds that outperform their median, the risk-adjusted return is higher for non-SRI funds compared to SRI funds. However, for funds that underperform

their median, non-SRI funds have a lower risk-adjusted return compared to SRI funds. These differences in risk-adjusted return performance between SRI and non-SRI funds become more pronounced during bear markets.

- Narrower tails imply less extremes, meaning the total return of a top performing SRI fund will be lower than a top performing non-SRI fund, but the total return of the worst SRI fund will be higher than the worst non-SRI fund.

CONCLUSIONS

Investors considering implementation with active managers should view investing in SRI managers as a very competitive alternative to the non-SRI managers. First, the average performance of the SRI managers is statistically identical to that of non-SRI managers. More importantly, in case of underperformance an SRI manager will underperform by a considerably lower margin than a comparable non-SRI manager.

In practical terms, the study results suggest that more risk averse investors, who are particularly concerned about the potential size of underperformance should implement their equity allocations with SRI managers, because on average the SRI and non-SRI performance is virtually identical, but when SRI managers underperform, they do so by less than non-SRI managers.

Jianan Du, Brandon Thomas, and Janis Zvingelis, Envestnet Asset Management

Exploration of the Cross-Sectional Return Distributions of Socially Responsible Investment Funds

Available here.

RISK ATTENUATION AND THE REPORTING OF CORPORATE SOCIAL (HEALTH AND SAFETY) PERFORMANCE TO INVESTORS

BACK

- Voluntary disclosure of Occupational Health and Safety (OHS) performance is inadequate for corporate risk management and investor analysis.
- Corporate managers have wide discretion over what is reported and how it is measured, leading to conscious or unintentional omissions of critical OHS information.
- High hazard industries (mining, utilities, energy) tend to disclose more information, perhaps as a way to pre-empt investor demand.
- Quantity of performance measures did not reflect high quality of reporting.

Article summary written by Sarah Cleveland

AUTHORS

Sharron O'Neill

Jack Flanagan

Kevin Clarke

The authors evaluated corporate OHS performance data reported by Australia's 50 largest public firms from a range of industries. Data was collected from corporate annual reports between 1997 and 2009, and examined for trends to determine whether the quantity of voluntarily disclosed performance measures leads to comprehensive, high quality reporting. But do multiple measures tell investors what they need to know in order to assess the company's management of OHS risks? In efforts to distinguish differing reporting quality, O'Neill et al developed a disclosure index from quantitative data relating to OHS outcomes.

Prior research has shown corporations are not reporting comprehensively on corporate social responsibility issues, even though there is clear investor demand. Disasters due to OHS failures are not new, and the cost to investors has risen significantly over the last 30 years. For example, the 2010 Deep Horizon oil rig explosion in which 11 workers died reportedly cost BP $41 billion USD to date, and resulted in investors demanding for better OHS information.

ANALYSIS

The study adds to the growing research on voluntary OHS disclosure, and it highlights the complete discretion corporate managers have in reporting OHS data and selecting performance measures. The authors used two competing theoretical models to analyse the context for reporting decisions:

Capital markets model - focus on financial analysis: managers are driven to maximise shareholder value, at times at the expense of other stakeholders (employees). They seek to reassure investors the risk of significant failure is low because risk is managed effectively.

Risk attenuation model - focus on psychological and cultural drivers: Managers are more likely to manipulate OHS reporting so that serious risks are not brought to stakeholders' attention. Injury outcomes are 'smoothed' by aggregation.

Industry research indicates a strong inverse relationship between the effectiveness of managers risk management effort and the frequency and severity of the work-related injuries, i.e. the more lax the risk management, the more serious the injury. Tracking and reporting is complex due to different types of injuries and severities, therefore managers exercise judgment on what is reported. Non-financial measures of injuries can be broadly classified into three types:

Treatment measures: frequency rates, including classifications such as minor first aid, medical treatment and lost work time. Treatment measures are highly aggregated to rates of 'recordable injury' and 'all injury' rates.

Productivity measures: duration rates, i.e. how much time out of work.

Severity measures: measures that distinguish high consequence outcomes, e.g. Class 1 -permanent disability; Class 2 - long or short term temporary incapacity, and Class 3 - minor inconvenience.

RESULTS

Two-thirds of the firms reported quantitative OHS disclosures in at least one of the years of observation. Industries differed in disclosure rates, and performance measures in many cases were inconsistently reported and poorly defined.

- Disclosure by industry was significantly greater in high hazard (materials, energy, utilities) industries compared to the low-medium hazard (banking, finance, retail, etc.).
- Treatment classifications were highly aggregated and medium to low hazard industries were less likely to provide any injury frequency measures.
- Lost productivity was stated in only 22 reports overall, suggesting a low disclosure rate. Measures were typically 'total time lost per million hours worked.'
- Severity of injury and illness reporting was poor. Only two firms consistently reported fatality data in all sampled years. Only one firm included classifications of injuries as Class 1 or 2, indicating the reluctance to disclose non-fatal, high consequence injury data.

Research results did not indicate that the quantity of performance measures linked to quality of actual performance. In fact, the voluntary disclosure data showed that investors now have greater difficulty assessing managers' ability to prevent high consequence injuries. The quantity of data increased over time, but the breadth and scope narrowed, which may be due to the conscious choice of report preparers. Even though high hazard firms were more likely to report and include multiple measures of performance, data was 'incomplete, unstable and poorly defined.'

Investors are being presented unreliable information that is difficult to compare, for example, a sprained ankle and a broken neck were each reported as an injury, concealing important information needed for OHS risk management. The authors note that further empirical research is necessary to determine whether poor quality reporting is a result of managers' intention or stakeholders' weak demand.

CONCLUSIONS

The authors conclude the reported voluntary OHS performance measures were inadequate to assess an organisation's effectiveness in managing OHS risks. Three primary conclusions are noted:

Generally poor non-financial information. Firms used inconsistent terminology and reported incomplete data, making the data unreliable.

'Smoothed' reporting. OHS accounting methods tend to aggregate high severity (high consequence) and low severity (low consequence) injuries. Rigorous reporting needs to include both the frequency and severity of injury so that managers are held accountable for OHS risk management.

Potential for mandatory reporting. The study results infer potential mandatory reporting may be necessary to achieve comprehensive, high quality reporting of OHS performance measures.

Regardless of the study's limitations due to the small sample size and secondary data, the results confirm prior research that the volume of CSR disclosure is not a proxy for quality, demonstrating that increasing numbers of quantitative performance measures do not necessarily reflect a greater breadth of insight into performance.

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Sharron O'Neill, Macquarie University; Jack Flanagan and Kevin Clarke, University of New South Wales

Risk Attenuation and the Reporting of Corporate Social (Health and Safety) Performance to Investors

Available here.

DIRECTORS' DUTIES IN THE ANTHROPOCENE: LIABILITY FOR CORPORATE HARM DUE TO INACTION ON CLIMATE CHANGE

BACK

AUTHOR

Sarah
Barker

- Climate change presents material financial risks.
- The duty of care and diligence requires directors to be informed and engaged; ignorance and inaction are no defense.
- Directors may be liable for damage resulting from corporate inaction on climate change.
- Active governance of climate change risks and opportunities is increasingly required to satisfy directors' duties

Article summary written by Sarah Cleveland

This paper examines corporate directors' duties in the context of climate change as a material financial risk. The author builds the case that directors are increasingly at risk of being held liable if they do not actively govern the corporation around the material impacts of climate change. Barker addresses the question, *does 'business as usual' on climate change governance satisfy directors' (trustees') fiduciary duty of due care and diligence?* within Australian law.

CLIMATE CHANGE

Anthropogenic climate change refers to changes in the composition of Earth's atmosphere resulting directly or indirectly from human activity. Impacts of climate change are evident today with droughts, floods and other natural disasters causing human suffering and physical destruction. In response, the scientific and economic communities are asking that companies implement mitigation strategies to reduce the level of greenhouse gas (GHG) emissions, known to be the primary cause of climate change. In addition, if companies do not adapt to the observed, committed and potential impacts of climate change, they may be susceptible to significant financial impacts which may affect its relative competitiveness, if not viability.

The discipline of 'climate change law' is relatively new and, to date, has primarily focused on responsibility for emissions and costs of mitigation. The law on liability for the damage caused by climate change impacts is in its infancy, and there is even less law and scholarship on the specific question of directors' and trustees' liability for failures in the governance of climate risks.

DIRECTORS' DUTIES

The board of directors is responsible for overseeing the performance of the corporation as well as monitoring and supervising its regulatory compliance. Directors are governed by fiduciary, common law and statutory requirements with the underlying themes of loyalty (good faith, acting in the best interests of the firm) and competence (care and diligence).

The pursuit of financial interests requires the board to oversee risk and strategy, which directors are required to perform with due care and diligence. Barker cites interpretations of the standard of conduct required to discharge the 'duty of care and diligence' as a 'reasonable director in the circumstances' or as 'a prudent superannuation trustee (i.e., professional trustee) would exercise...' As courts are hesitant to second-

guess corporate commercial business decisions, Australia instituted the 'Business Judgment Rule' to provide a 'safe harbor' against personal liability when decisions are honest, informed and rational. However, incompetence is not a defense.

The standard of the 'reasonable director' is increasingly being raised due to the growing complexity of business and markets. Directors are expected to become informed and understand the business of the corporation, and the economic context in which it operates, in order to oversee corporate risk management and strategy with due care and diligence. Risk management and strategy are linked to value creation of the firm, instrumental in company culture and fostering an environment for growth and innovation.

The science of anthropogenic climate change poses unprecedented ecological risks as well as new opportunities for well-positioned companies. Seen in this context, environmental risks are a material determinant of corporate wealth creation, and squarely within the purview of corporate 'best interests' and directors' duty of care and diligence.

Nevertheless, directors are generally not proactive on climate change issues. The author outlines several reasons for governance inaction around climate change - reasons that are increasingly inadequate to satisfy directors' (and trustees') duty of due care and diligence:

- Denial - a climate denier or sceptic
- Honest ignorance - oblivious to the risks of climate change
- Uncertainty paralysis - uncertainty in the speed, scope and scale of climate change impacts
- Conscious cost/benefit - intentional, rational, informed decision to maintain 'business as usual'
- Standards-based - default to regulatory requirements or industry standards/norms.

CONCLUSION

Barker concludes that, increasingly, an inactive, passive or reactive corporate governance approach to climate change may be inadequate to satisfy directors' duty of care and diligence. Courts are clear that directors are expected to be proactive and engaged when carrying out their statutory duties.

There are several implications on governance and how climate change is viewed within corporate social responsibility (CSR): Active governance of climate change as a material financial risk is increasingly required to satisfy directors' duties. Fund trustees may be expected to have standards of prudence and diligence at least as high as corporate directors. Moreover, procedural diligence by directors, rather than the substantive outcomes of their judgments, is the focus of regulators and the courts in applying the duty of care. Climate change should no longer be framed as an 'E' (environment) within 'ESG'. At a minimum, it should be considered as a 'G' (governance) issue.

At its extension, the evolution of climate change into a material financial risk may mean that orthodox theories of CSR, which posit climate change as a non-financial environmental externality, are now redundant in their application to this issue.

Sarah Barker, University of Melbourne

Directors' Duties in the Anthropocene: Liability for Corporate Harm due to Inaction on Climate Change

Available here.

CSR RATINGS: DOES MORE INFORMATION ADD MORE VALUE?

BACK

- A firm may be rewarded by the market for how it manages potential environmental outcomes rather than its actual environmental impact.
- Disclosure raises issues since a firm may have good internal processes, such as reporting yet produce significant amounts of pollution.
- The relationship between a firm's environmental and financial performance may vary over time. Proactive environmental strategies may be rewarded only over longer term horizons, and in the short term incur a cost.
- Data quality and availability are poor; researchers prefer data required by regulatory mandate that is transparent and standardised.

Article summary written by Sarah Cleveland

AUTHORS

Magali A. Delmas

Magali Delmas' keynote presentation was based on two recent academic studies[1] conducted with Dror Etzion and Nicholas Nairn-Birch, which questioned whether more Corporate Social Responsibility (CSR) information adds value. Researchers have identified 50 distinct rating approaches, and a third of them have emerged since 2005. The interest and demand for CSR data comes from responsible investors as well as the complexity of defining what social and environmental corporate performance is. Without a universally agreed approach, each provider uses its own proprietary assessment. Yet, does all of this additional information help investors make better decisions?

As a proxy for CSR, Delmas et al. use corporate environmental performance ratings since data are more available and quantifiable.

Their research questions include:

- What do CSR ratings actually measure? Research result: Internal processes, i.e. management systems and

external outcomes, such as impact on the environment

- What aspect of CSR does the market respond to? Research result: Internal processes
- When do CSR investments pay? Research result: Over the long term

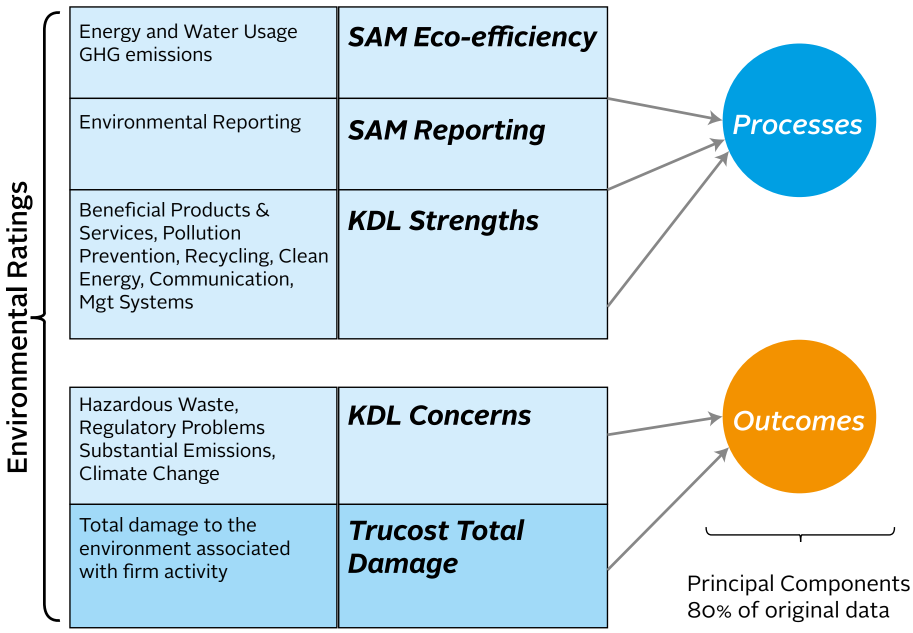
WHAT DO CSR RATINGS ACTUALLY MEASURE?

In the fisrt study, Delmas et al. examine data from 475 US companies over a four year time period from 2004 to 2007. The environmental performance data are provided by three organisations: Trucost, KLD Analytics[2], and Sustainable Asset Management (SAM).

Results show the various environmental performance variables map into two components that explain 80% of the variance in the data. This implies the two components that CSR ratings actually measure are:

Processes: The process oriented component measures internal management activities that are intended to improve environmental outcomes.

Outcomes: The outcome oriented component measures the actual corporate environmental impact.



WHAT ASPECT OF CSR DOES THE MARKET RESPOND TO?

Next, Delmas et al. assess the relationship of processes and outcomes to financial performance. Only process based measures indicate a positive link, implying the market rewards a firm for efforts but not necessarily results. Cynically, this could mean firms could set up detailed policies and environmental management systems but not focus on how successful they are at mitigating pollution or improving water and energy utilisation.

In addition, when the rating components were evaluated individually (e.g., SAM Eco-efficiency, SAM Reporting, etc.), only one element had a significant link to performance. This could imply there is just too much 'noise' in the data - **more information does not add more value**.

Implications of the research include:

- Process based information may be preferred because it is easier to communicate and evaluate than outcome based information, which is difficult to collect, assess and rank.
- Data quality and the time lag of outcomes based measures may be an issue. Data on environmental impacts may be several years old, for example, toxic release information from 2012 just became available.
- Ratings methodologies may be incorporating more process based measures because of accessibility, with the effect of process based measures influencing market valuation.
- **Disclosure on its own is not a panacea**. Companies may stand out because of governance, reporting and environmental management systems, but produce a significant amount of pollution.
- Analysis of social data is expected to yield similar results, i.e. data will aggregate into processes and outcomes and process based measures will link to financial performance. This result may be even greater with social data compared to environmental data, due to the complexity of

quantifying social performance results - the mere existence of policies to protect workers does not prevent abuses.

Delmas et al. acknowledge that more research needs to be carried out on what information investors use, how they use it and how investors respond to different types of CSR data

WHEN DO CSR INVESTMENTS PAY?

The relationship between a firm's environmental and financial performance may vary over time. In the second study, environmental performance and practices of 900 firms were analysed over a five year period from 2004 to 2008. Leading providers supplied data on environmental practices, environmental performance, and financial returns, respectively. Results showed a negative relationship between environmental and financial performance in the short-term, whereas the long-term horizon yielded a positive impact. This results suggests that CSR investments will pay off in the long term.

Delmas et al. suggest a short-term oriented corporate manager will forego long-term benefits in order to save money today. On the other hand, a more forward-looking corporate manager may have an incentive to invest in necessary resources and skills now, in order to gain a competitive advantage in the future.

Knowledge surrounding how asset managers react to ESG data within their investment processes and what information is being valued is limited. Delmas suggests field experiments and simulations to better understand investors' behaviors.

1 Triangulating Environmental Performance: What do Corporate Social Responsibility Ratings Really Capture? Magali A. Delmas (UCLA, Los Angeles), Dror Etzion (McGill University), and Nicholas Nairn-Birch (UCLA, Los Angeles), 2013, and Temporal Dynamics of Environmental and Financial Performance: The Case of Greenhouse Gas Emissions, Magali A. Delmas (UCLA, Los Angeles), Dror Etzion (McGill University), and Nicholas Nairn-Birch (UCLA, Los Angeles), Draft 2014.

2 KLD Analytics was purchased by MSCI in 2010 and is now part of MSCI ESG Manager, Inc.

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Professor Magali A. Delmas, University of California, Los Angeles

CSR Ratings: Does More Information Add More Value?

Corporate Knights Magazine; Winter 2014, Vol. 13 Issue 1, p56

LATEST ON INTEGRATED REPORTING - WHAT BENEFITS DOES THE RESEARCH ILLUSTRATE TO DATE?

BACK

AUTHOR

George Serafeim

- More firms are undertaking elements of Integrated Reporting (IR) but may not call it IR.
- Firms practicing IR tend to have dedicated, long-term oriented shareholders.
- Carrying out IR may lead to more long-term investors holding shares of the firm, but having long-term shareholders does not lead to firms practicing IR.
- An activist shareholder base of dedicated investors may lead to more IR.

Article summary written by Sarah Cleveland

'A myopic view of driving shareholder wealth at the expense of everything else will not create a company that is built to last. You need to attract a shareholder base that supports your strategy - not the other way around. We actively seek one that is aligned with our longer-term strategy.'

Paul Polman, CEO, Unilever

In another well-received keynote presentation, George Serafeim discussed the evolution of Integrated Reporting (IR), as well as recent research on how IR identifies value creation within the firm and attracts long-term investors. Approximately 7,000 companies are issuing sustainability reports, although nearly all are issued separately from financial reports, and typically lag behind financial reporting by six to nine months. With no standardised construct, the relevance, reliability and timeliness of sustainability data reporting are a problem. To overcome many of these challenges IR has emerged as an innovative approach that combines sustainability and financial reporting into one framework.

Approximately 600 companies are issuing self-labelled integrated reports, whereas 100 are using the International Integrated Reporting Council's (IIRC's) framework that identifies six forms of capital instrumental in creating value within a firm: financial, manufactured, intellectual, human, social and relationship, and natural. Further research has shown a link between reporting capital-specific information and having a long-term oriented shareholder base.

Serafeim's discussion draws from his recent paper, Integrated Reporting and Investor Clientele, which looks at the relationship between firms that practice Integrated Reporting (IR) and their investor base. Firms practising IR hold the underlying belief a company's environmental, social and corporate governance performance provides better insight into future results than financial data since financial data are 'backward looking.' Prior research has shown the type of investors owning shares can impact management decisions - the more long-term

oriented the investor, the less likely to encourage corporate managers' short-term behavior, which is known to block business transition to sustainability.

ANALYSIS

Serafeim uses IR scores created by Thompson Reuters ASSET4 for a sample of over 1,000 US firms from 2002 to 2010, as well as an alternate IR score provided by Sustainable Asset Management (SAM) to test the robustness of the ASSET4 IR score. ASSET4's IR score is a composite index of disclosure scores.

Serafeim first tests the strength of the relationship between firms practicing IR and the long-term shareholder base. He then controls for other factors that are known to be associated with investor base, such as firm size, leverage, earnings yield, equity beta, etc. A further test is conducted to determine the causal effects – whether practicing IR leads to more long-term investors.

RESULTS

The influence on the level of association of IR and the investor base appears to be much stronger for:

- Firms with growth opportunities. Information about long-term business prospects becomes more critical.
- Firms that are not family controlled. Family-owned firms have a long-term orientation therefore IR is less likely to be a signal.
- "Sin" industries, e.g. alcohol, tobacco, firearms etc. The potential penalties and regulation are disruptive to the business model.

The level of influence appears to be weaker for firms whose past RI practice is erratic because of the lack of commitment to consistent disclosure, which pushes away long-term investors.

CONCLUSIONS

Long-term investors are attracted to firms that practice IR and they tend to be more loyal. The IIRC's IR Framework is relatively new, and more work needs to be done to identify which parts of the Framework are attracting long-term investors in particular. Serafeims' study does not evaluate whether IR helps investors make better investment decisions. The question remains whether, and how, investors are making capital allocations as a result of IR.

Professor George Serafeim, Associate Professor of Business Administration, Harvard Business School

Latest on Integrated Reporting - What Benefits Does the Research Illustrate to date?

Panel presentation available here.

UPCOMING EVENTS

BACK

I am pleased to highlight the upcoming events and call for cases detailed below. I look forward to meeting many of you in Geneva.

For information, please contact:

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SECOND GENEVA SUMMIT ON SUSTAINABLE FINANCE

THE GENEVA SUMMIT ON SUSTAINABLE FINANCE

27 November 2014
University of Geneva

The summit is a research conference organised by the University of Geneva. This full day event will be held at the International Conference Centre in Geneva (CICG), Switzerland.

The Summit is a collaborative effort between the University's Finance Research Institute (GFRI), the University's Institute for Environmental Sciences (ISE) and Sustainable Finance Geneva (SFG), an association of Geneva based investment professionals. The event will feature presentations by leading academics and institutions and the keynote presentation will be by Yngve Slyngstad, CEO of Norges Bank Investment Management and responsible for managing Norway's Sovereign Wealth Fund.

Please visit the conference website to register and for further information.

Please visit the PRI Academic Network web page to find our previous issues of the RI Quarterly

oikos

OIKOS CASE WRITING COMPETITION

Call for Cases 2015

The oikos case writing competition promotes high quality teaching cases on sustainability issues. Since 2013 the competition features a track dedicated to sustainable finance.

Oikos is an international student-driven organisation for sustainable economics and management. Founded in 1987, oikos' programmes embed environmental and social perspectives in faculties for economics and management. PRI cooperates with Oikos in the area of finance and supports the Young Scholars Finance Academy, which provides a unique platform to develop emerging researchers.

Submissions are welcomed from around the world. Submitted case studies should be suitable for use in management, entrepreneurship and finance education. The three track themes are:

- corporate sustainability
- social entrepreneurship
- sustainable finance.

The first prize is CHF 5000, the second prize is CHF 2000 and the third prize CHF 1000.

Winning cases, as well as the runners-up will be available in the oikos Online Case Collection. The collection currently consists of over 30 excellent peer-reviewed cases on sustainability in management and entrepreneurship. The deadline is 8 December 2014.

Please visit the oikos website for more information or contact case@oikos-international.org

The Principles for Responsible Investment (PRI) Initiative

The PRI Initiative is a UN-supported international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing the Principles, signatories contribute to the development of a more sustainable global financial system.

The Principles are voluntary and aspirational. They offer a menu of possible actions for incorporating ESG issues into investment practices across asset classes. Responsible investment is a process that must be tailored to fit each organisation's investment strategy, approach and resources. The Principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework.

The PRI Initiative has quickly become the leading global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, 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.

More information: www.unepfi.org

UNEP Finance Initiative
Changing finance, financing change

UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact