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THE MAINSTREAM FINANCIAL COMMUNITY

BY JAY FALK

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We've all heard Milton Friedman's famous line "The business of business is business." By now, I hope someone has informed Mr. Friedman that today's leading businesses are thinking otherwise – and so is a growing group of mainstream asset managers, analysts and institutional investors.

Just twenty years ago social investors were characterized as "corporate gadflies" or "fringe investors," mere nuisances for most companies. Times have changed. Social investors have engaged publicly traded companies on a wide range of social, environmental, and corporate governance issues and have done so with increasingly sophisticated strategies and credibility. You can credit them for largely defining what is known today as corporate social responsibility.

Perhaps you are familiar with some of the names from the social-investment community — Calvert, Domini, Pax, Citizens, Interfaith Center on Corporate Responsibility, and CalPERS in the United States. Or F&C, Henderson, and the Universities Superannuation Scheme in the UK. In addition to a desire for competitive returns, these investors are motivated by broad set of "values" related to environmental and social issues.

Over the past several years, particularly the last year or so, a new class of investors is integrating environmental, social, and governance (ESG) issues in the investment process. Simply stated, they're mainstream, hard-nosed, business-case investors and analysts. And one more thing — they control trillions of dollars in the global equity markets.

These financial institutions include both buy-side (asset managers) and sell-side (brokerage firms). This "mainstreaming" trend has been growing and is starting to reach critical mass, with some of the most prominent names in the industry taking the lead, including UBS, Goldman Sachs, Citigroup, Smith Barney, and JP Morgan Chase.

It is worth noting these financial institutions are being driven by a "sustainability" approach to investing which is based on risk-management and value-creation factors associated with corporate sustainability performance. It is, therefore, distinctly different from the traditional SRI approach which is largely "values" driven.

With typical price-to-book ratios running between four and five, the intangible value of most companies is between 70 and 80 percent of total market value. Given this magnitude, it's not surprising that investors are increasingly interested in intangibles. Investors are beginning to ask: Does management recognize this value? How and to what extent are these intangibles being managed? And finally, does the company report its intangible value to investors and other stakeholders?

As a result, companies can expect a new level of sophistication from mainstream analysts. In short, their analytical methods will tend to be more objective and business case–oriented than traditional SRI analysis. They will be looking for key performance indicators that allow them to more fully understand the risks and opportunities associated with each investment.

Like traditional investment research, sustainability research methods will vary from one financial institution to another. Some investment firms will be using external research and rating agencies, while others will be using internal research teams. Their methodologies will range from mostly qualitative to highly quantitative. Some investment firms will take an integrated, top-down approach by training all of their analysts in sustainability issues, while some firms will take an industry-by-industry approach based on relative importance of sustainability issues to a particular industry.

About a year ago, a group of mainstream European institutional investors (including PGGM, USS, BNP Paribas Asset Management, Generation Investment Management, RCM, AGF, and Dresdnerbank Investment Management) launched the Enhanced Analytics Initiative. The purpose of this initiative is to encourage sell-side analysts to cover extra-financials, such as ESG factors, in their analysis by allocating 5 percent of their broker commissions solely for such research.

In yet another twist, nearly forty banks, including JP Morgan Chase, HSBC, Citigroup, Royal Bank of Canada, Bank of America, and Westpac, have adopted the Equator Principles. In doing so, these banks are making a commitment to assess and manage environmental and social risks in project finance in over one hundred countries.

A small number of insurance companies are also using ESG factors in underwriting policies. Swiss Re and Munich Re are two examples. While the industry is clearly behind the curve, things are starting to percolate. For example, over thirty insurance companies — including seven of the ten largest U.S. firms — recently attended an industry summit on climate risks and opportunities.

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Not convinced? Let's take a look at the investment-consulting arena. Most institutional investors use consultants to help them develop their investment policy statements. These consultants are also involved in the process of hiring and monitoring asset managers for their institutional customers. They are extremely influential and, for all intents and purposes, they are the gatekeepers of trillions of dollars in assets globally.

The investment consulting profession is widely seen as being very conservative — no trailblazers here. As such, consultants have been very reluctant to encourage or recommend anything that could be construed as being a "social investment" strategy. In fact, most institutional investors that have pursued a social investment strategy in the last twenty years have done so over the objections of their consultant.

Within this context, it is especially noteworthy that Mercer Investment Consulting recently embraced the concept of sustainability investing. Mercer, one of the world's largest investment-consulting firms, announced that it had analyzed and rated a group of investment managers on their ability to vote on proxies

and engage companies on ESG issues. This initial group included thirty investment managers with $12 trillion in assets under management. Mercer plans to expand this service by covering one hundred managers during the first quarter of 2006.

Mercer's move in this direction is particularly striking for two reasons. First, they were responding to the demand for this service from their customers. Second, and more importantly, these customers are mainstream institutional investors — not traditional "social" investors, as one might expect. It will be interesting to see if other consulting firms follow suit. Stay tuned.

In a related development, the United Nations Environment Program Financial Initiative recently commissioned a report on fiduciary issues. I know what you are thinking — another UN report? After you stop yawning, you might want to check out this report. It's titled "A legal framework for the integration of environmental, social, and governance issues into institutional investment."

This report is significant for two reasons. First, it turns conventional wisdom on fiduciary duty and sustainability issues completely upside down. Second, London-based Freshfields Bruckhaus Deringer, the third largest law firm in the world, authored the report. Needless to say, a heavy hitter like Freshfields brings much clout to this issue.

The Freshfields report primarily addresses fiduciary standards as they apply to public and private pension funds — the highest standard of care. This report concludes that not only is it permissible to consider ESG factors, but fiduciary duty requires that they be considered for material financial impact

This report is also significant because it could signal a fundamental shift in the way fiduciaries – the people who oversee trillions in assets globally – think about ESG issues as they relate to the management of their investment portfolios.

To summarize, on the investor side we have a number of large, mainstream financial institutions implementing sustainability investing strategies, a leading investment consulting firm that includes ESG factors in its consulting services, and a green light on the inclusion of ESG factors from a fiduciary perspective. That's a powerful combination by itself, but there's more.

On the corporate side, there is much evidence that shows leading companies are taking ESG issues more seriously. Although there are many indicators, the proliferation of annual CSR and sustainability reports is an important sign of corporate buy-in. After all, reporting comes toward the end of the sustainability chain, after policy/strategy development, program development/implementation, and measurement.

Corporate sustainability reporting has grown nearly tenfold in the last decade to almost two thousand reports annually. What started out in the early '90s with a handful of annual environmental, health, and safety reports has evolved into much broader and more comprehensive CSR and sustainability reports. The Global Reporting Initiative (GRI) has played a leading role in taking sustainability reporting to the next level. Despite its critics, the GRI guidelines are the closest thing we have to a standard framework for sustainability reporting. The third generation of GRI reporting guidelines will be completed sometime in the second half of 2006 and portends to be a significant step forward.

Sustainability reporting may become even more mainstream under the umbrella of "nonfinancial" reporting through initiatives such as the Enhanced Business Reporting Consortium. This business-led, nonprofit organization recently released a draft framework for non-financial business reporting.

In its current form, this framework includes four main reporting categories: **1**_ Business landscape, **2**_ Strategy, **3**_ Competencies, and **4**_ Resources and performance.

The strategy section includes ESG issues. Several other related issues such as shareholder relations, supply chain, and product life cycle are also included the framework.

The integration of ESG issues within the Enhanced Business Reporting Consortium framework is especially notable given the organization's list of strategic partners, which includes the National Investor Relations Institute, Business Roundtable, National Association of Corporate Directors, American Institute of Certified Public Accountants, NASDAQ, and others. The fact that the business community is leading this initiative indicates that communicating nonfinancial information, including ESG factors, to the financial community is becoming a standard business function.

SUSTAINABILITY REPORTING MAY BECOME EVEN MORE MAINSTREAM UNDER THE UMBRELLA OF "NONFINANCIAL" REPORTING

In summary, as more mainstream asset managers, brokerage firms, investment consultants, banks, and insurance companies analyze companies using ESG factors, companies can expect additional external demand for ESG data that are accurate, timely, and complete. Companies can also expect mainstream research to be more risk- and value-oriented — and considerably better funded than in the past.

In connection with reporting to the financial community, there will also be greater pressure within companies to identify and manage key risks and value-creation opportunities related to ESG issues. This is a win-win scenario for both management and investors.

As a bonus, many sustainability investors have been promoting themselves as "long-term" investors. They understand that most ESG issues have long-term implications; as such they are generally looking to evaluate companies well beyond the current quarter. This should be welcome news to most CEOs, CFOs, and IR professionals, as they have been battling with investors who seemingly have the attention span of a toddler. ■