A FRAMEWORK FOR RESPONSIBLE INVESTING

RBC Global Asset Management (UK) Limited
Introduction

Over the last decade, the Environmental, Social, and Governance (ESG) activities of companies have garnered much attention. With growing concern over global warming, the increasing wage gap between the poor and the wealthy, and the continued issues with safety standards and product recalls, investors are looking to companies to accept some level of responsibility for mitigating these issues. The advent of social media has illustrated how detrimental a company’s misstep concerning ESG can be to shareholder value. Conversely, a company’s ESG activities can positively impact their financial results and long-term investment performance. Given the significant downside risks and potential for upside gain, investment managers are increasingly being called upon to consider ESG factors while conducting their fundamental analysis of companies. In some cases, ESG considerations are done by a separate or overlay team of professionals; however, the best case scenario is for this analysis to be embedded in the overall investment management and analysis process. While this is in fact broadening the skill sets of many investment professionals, it is inevitable that in the future, many more investment firms will be studying ESG factors to identify companies that can deliver sustainable long-term shareholder value.

In this paper we set out to illustrate how asset managers can integrate ESG factors into their investment process, the long-term benefits of doing so, and finally, why it matters.

### Approach

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<th>Responsible Investments</th>
<th>ESG Integration</th>
<th>ESG Analysis</th>
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<td>Defined as investments in those companies that:</td>
<td>Methods for incorporating ESG factors into the investment process vary by technique and degree:</td>
<td>Key sources for gathering information on corporate ESG practices include:</td>
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<td>• are committed to responsible business practices in terms of corporate governance, environmental considerations, and social externalities</td>
<td>• negative screens</td>
<td>• engagement with management teams</td>
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<tr>
<td>• promote a culture of excellence and &quot;best practices&quot;</td>
<td>• positive screens</td>
<td>• corporate financial statements</td>
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<td>• maintain a strong capital discipline and cash flow focus</td>
<td>• ESG themes</td>
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### Benefits

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<th>Higher Cash Returns</th>
<th>More Durable Returns</th>
<th>Stronger Earnings &amp; Performance</th>
<th>Lower Cost of Capital</th>
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<tr>
<td>• Stronger focus on ESG factors tends to correlate with higher cash returns and profitability</td>
<td>• High return companies tend to maintain those returns for longer when accompanied by higher quality management (ESG)</td>
<td>• Companies with higher and more durable returns often generate stronger earnings growth</td>
<td>• Companies with a strong ESG focus tend to have a lower perceived risk profile and consequently, a lower cost of capital</td>
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<td>• The most ESG-focused companies generate a 25% higher Cash Return on Cash Invested (&quot;CROCI&quot;) than their sector average</td>
<td>• Companies with high ESG scores sustain above-sector average CROCI for nearly twice as long as average</td>
<td>• Over the long term, stronger earnings growth can generate shareholder value and drive equity performance more than multiples</td>
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### Why It Matters

#### Growing Demand, Finite Supply

• Global GDP produced over the next 30 years will exceed that produced over the last 2000 years
• Exponential growth and finite supply of human capital, financial capital and natural resources must be addressed
• The environment’s questionable capacity to absorb the consequences of this growth is challenging many businesses

#### Profiting From Growth is Harder

• Benefits of demand growth are diminished given new pressures resulting from increased interest in ESG-related issues
• This growth is creating an unprecedented number of both opportunities and threats to companies across all industries
• Companies’ competitive positioning and management of ESG-related issues are more important now than growth exposure in isolation
How To Approach Responsible Investing

Defining Responsible Investments

Companies that have excelled in generating growth and returns over long periods of time have, by definition, developed sustainable business strategies. Companies with sustainable business strategies often exhibit competitive factors that increase the chances of a business to achieve higher returns. More often than not, these same companies are viewed as long-term leaders in their industries, are better managed and are best positioned to sustain leading return on capital and long-term growth as result.

Responsible Investments are defined as investments in companies that are committed to responsible business practices in terms of environmental, social, and corporate governance (ESG) considerations. There is increasing evidence that companies that take full account of these factors often foster a culture of excellence and a strong capital discipline which can lead to superior long-term performance. By the same token, a systematic incorporation of these ESG factors into a disciplined, fundamental investment process can lead to a more accurate assessment of long-term corporate value, potentially reducing investment risk and ultimately enhancing long-term investment returns.

ESG Integration

Just as there are a sizeable number of ESG related issues, there also exist a number of techniques for incorporating these considerations into investment analyses. The range of possibilities goes from negative screening to full ESG integration. One of the simplest ways to incorporate ESG factors into the investment process is to employ straightforward negative screens that remove companies from a list of potential investments based on moral or ethical grounds; for example, screening a universe to exclude tobacco companies. At the opposite range of the spectrum is a more proactive integration of ESG analysis to support long-term bottom-up stock selection. While negative screening does have its benefits, fully integrating ESG factors into the security selection process is a perfect complement to investing based on business fundamentals.

Over longer term horizons, earnings growth tends to generate shareholder value and drive equity performance to a greater extent than multiple expansion. Companies with stronger ESG factors have delivered higher growth and higher cash returns for longer on average as we illustrate later in this report. This is possible because companies that take ESG factors into careful consideration tend to exhibit a proactive approach to mitigating risks and taking advantage of opportunities which in turn may allow them to sustain these superior cash returns for longer. Broadly speaking, the stronger and longer the track record of a business in terms of execution and profitability, the lower will be its perceived risk profile by investors and, consequently, its cost of capital, leading to operational and equity outperformance.

ESG Analysis

Within the investment decision making process, ESG issues should be considered in the same manner as traditional financial issues in terms of their capacity to affect long-term investment performance. ESG data can be an indicator of management’s approach to long-term industry leadership through factors such as transparency, appropriate risk controls and constructive engagement with stakeholders.

There are many tangible links between ESG factors and a company’s financial performance. For example, the revenues of a firm can be materially impacted by a negative ESG event that affects the reputation of a firm (i.e., child labor, sweatshops, pollution, etc). Purchasing decisions can also be influenced meaningfully by corporate reputations and communications, as can a company’s ability to recruit and retain talent. Companies that have a history of accidents or strikes may have problems attracting a high level of talent. On the other hand, innovative human capital management helps attract and retain talent, raise productivity, and improve operational performance in the long run. In analysing a firm’s financial statements, one will see that ESG issues are integrated, whether intentionally or not, into a company’s financial performance. Because of this, it is important to engage with companies’ management and conduct in-depth analyses of companies’ financial and sustainability reports to identify those that adopt:

Strong Corporate Governance Processes

Ask pointed questions, such as whether executives’ remuneration is linked to long-term corporate success. What is the level of corporate reporting and disclosure? How is the shareholder base structured and how do they vote? What is the track record of hiring
A Framework for Responsible Investing

Consider a company’s resource utilisation practices: waste reduction, regulatory fines, effective use of raw materials, etc. Responsible environmental considerations can be a win-win situation for the company, the shareholders and the environment.

Business Models that Generate Positive Social Externalities

Evaluate human capital management, labor issues and potential exposure to human rights issues. Accidents, protests and strikes can negatively impact productivity, invite litigation and damage a company’s reputation. Conversely, innovative human capital management helps attract and retain talent, raise productivity, and improve operational excellence.

A Culture of Excellence and ‘Best Practices’

Seek companies that have a strong focus on continuous improvement and innovative thinking, that establish high standards and have a strong measure of operational performance, that have a proven and long track record of fulfilling obligations to all stakeholders and the society, and that generate solid metrics such as economic value added, return on invested capital, and cash flow return on investment.

A Strong Capital Discipline and Focus on Cash Flows

Focus on businesses that have high cash flow return on investment and are disciplined at managing and deploying cash. Cash generating businesses tend to generate superior returns and performance. They are also better positioned to maintain their asset base and fund future growth. For example, a company’s return on invested capital should always be higher than its cost of capital and this condition should also be maintained at the individual project/capital deployment level.

In examining any potential investment, it is important to analyse a company’s history and current practices in terms of the above criteria and focus on those with the strongest track records.

One caveat that needs to be made is that a company’s country of domicile and the industry in which it operates will impact its ability to deliver on key ESG-related attributes within a Responsible Investments framework. While most investors would not invest in a company that has a track record of value destruction and a complete lack of strategy in terms of corporate sustainability, investors must also be aware of the importance of making relative judgments to limit company and/or portfolio risk. One way to do this is to invest in companies that stand out in terms of value creation and ESG strategy within their industries and countries of operation. For example, one of the biggest issues in corporate governance in China concerns the multifaceted role of the state, which can help but can also significantly hinder the development of good corporate governance practices, capital discipline, cash flows and returns. On the positive side of the equation, state owned entities are working hard to improve board practices and the levels of transparency and disclosure within these organizations.

**EXHIBIT 2**
Summary of Practices adopted by ESG-Focused Businesses

<table>
<thead>
<tr>
<th>Strong Corporate Governance Processes</th>
<th>Actively Responsible Environmental Practices</th>
<th>Positive Social Externalities</th>
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<tbody>
<tr>
<td>Ownership structure</td>
<td>Environmental policy and targets</td>
<td>Leadership and reporting on sustainability</td>
</tr>
<tr>
<td>Management structure</td>
<td>Resource utilization practices</td>
<td>Employees and human capital management</td>
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<tr>
<td>Executive compensation</td>
<td>Climate change initiatives</td>
<td>Consumer protection</td>
</tr>
<tr>
<td>Protection of minority shareholders</td>
<td>Sustainability</td>
<td>Human rights</td>
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<tr>
<td>Transparency</td>
<td></td>
<td>Stakeholder engagement</td>
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Benefits of ESG Investing

Higher and More Durable Cash Return on Cash Invested

ESG analysis can contribute to identifying long-term industry leaders and potentially reduce investment risk by providing greater insight into how companies operate. As the strength of companies’ competitive positions and management of ESG risks and opportunities become more important, rather than growth exposure in isolation, the inclusion of these factors into an investment process becomes crucial.

As illustrated in Exhibit 3 below, analysis conducted by Goldman Sachs shows that companies with stronger ESG scores have delivered higher cash returns on average. In addition, there is compelling evidence that these returns tend to be sustained.

**EXHIBIT 3**

**Stronger ESG Scores Correlate into Higher Returns...**

![Bar chart showing average CROCI by Management Quality (ESG) Quartile]

**...and to more Durable Return Leadership**

![Bar chart showing years of sustainable above sector average by Management Quality (ESG) Quartile]

Source: GS SUSTAIN, The Goldman Sachs Group, Inc., as of 7.5.12

Stronger Earnings Growth and Equity Returns

Equity returns comprise changes in earnings, valuations, currency, and the dividend yield. Throughout history, equity returns have been largely dominated by growth in earnings, with the other components contributing comparatively little.

Companies that score highly in terms of their approach to ESG factors tend to deliver higher cash returns on their investments than their sector peers, which constitutes a powerful and persistent source of alpha over the long term. This is because the higher the cash return of a company, the higher the earnings growth is of that company (for as long as that company has profitable re-investment opportunities in its business at the same rate of return the cash profits were generated in the first place). From a longer term perspective, the ability to deliver sustained earnings growth, and not multiples rerating, is the key driver of equity market performance.

**EXHIBIT 4**

**Earning Growth Dispersion Much Higher than Multiple Change Dispersion**

![Line chart showing changes in market-related PE and forecast earnings vs. market over holding periods]

**Change in Earnings Explains Most of the Equity Performance Over Longer Holding Periods**

![Line chart showing coefficients in explaining changes in return over holding periods]

Source: GS SUSTAIN, The Goldman Sachs Group, Inc., as of 7.5.12
Firms that are in top quartile in terms of ESG metrics deliver higher cash return on cash invested and these returns also tend to be sustained for longer. The importance of sustained high cash returns, strong cash generation, and the ability to profitably invest it in growth is evident in the growth rates of high and low return companies over the last decade. As Exhibit 5 illustrates, those companies with the highest cash returns, such as those firms in the top ESG quartile, delivered growth approximately 40% faster than the averages of their industries over that period. Most market participants tend to underestimate the effect that a high level of sustainable cash returns can have on long-term growth.

**Lower Cost of Capital**

In addition to the positive effect on profitability and earnings growth, taking ESG issues successfully into consideration can lower the cost of capital for companies. Academic studies cited below have shown that companies with high ESG ratings often experience higher credit ratings and lower cost of capital, which often leads to higher profitability and shareholder value. This is because these firms are likely to have superior management equating to lower reputational risk and a longer track record of higher operational performance and cash returns. As brand and reputation are increasingly considered to be a company’s most important assets, investors are becoming more sensitive to how ESG issues can impact a company’s perceived investment risk.

For example, any type of incident caused by poor behavior or a breach in ESG guidelines can damage the trust and the loyalty of stakeholders towards a company. However, if a company operates in a responsible manner, investors perceive a lower risk of incidents and are more likely to invest, especially in the long run. Said in another way, investors are likely to view high ESG performance companies as having a low level of risk related to future litigation and/or obligations to make future abatement expenditures.

As a result of lower perceived risk and cost of capital, the value from high ESG performance is also reflected in the valuation of a firm. The basic argument is that a lower risk factor is related to a lower cost of capital or return required by shareholders. Given this, companies can increase market value by a lower rate of return or discount rate that investors apply to their expected future earnings.

One of the most recent studies on the topic comes from the UN PRI (United Nations Principles for Responsible Investment), which conducted an extensive review of all the academic literature analysing the effect of ESG on cost of capital, while also dissecting the impact of each individual aspect of environmental, social and governance concerns on the cost capital. Some highlights of this analysis are shared on the next page.
Environment
The UN PRI reviewed a study of bonds issued by 582 public US corporations between 1995 and 2006 (Bauer, R. and Hann, D., 2011. ‘Corporate Environmental Management and Credit Risk’, Working Paper, Maastricht University) which found that firms with poor corporate environmental management have a higher cost of debt, lower bond ratings and lower issuer ratings, mainly due to regulatory and climate change issues. In the study, Bauer and Hann estimate that the cost of debt for firms with environmental concerns could be up to 64 basis points higher per year. Environmental practices affect the solvency of borrowing firms by determining their exposure to potentially costly legal, reputational, and regulatory risks. Lenders charge on average 20% higher interest rates to companies which manage environmental risks poorly compared to those where environmental concerns are offset with environmental strengths.

Social
According to a study of 2,265 bonds issued by 568 firms between 1995 and 2006 (Bauer, R., Derwall, J., and Hann, D. 2010. ‘Employee Relations and Credit Risk,’ Working Paper, Maastricht University), firms with stronger employee relations have a statistically and economically lower cost of debt financing. According to the study, the quality of employee relations at the companies sampled explained 22–42% of the annual median interest rate spread US Treasuries paid by those companies. The study also finds that firms where employees quit, perform poorly, or take action against the firm see reduced or more volatile cash flows, posing a source of risk to bondholders.

Governance
Holding a firm’s financial condition and industrial sector constant, there is a positive relationship between anti-takeover mechanisms and credit ratings for investment grade firms, and a negative one for speculative-grade firms, according to a study of 775 companies between 2002 and 2007 (Bradley, M., Chen, D., Dallas, G.S., and Snyderwine, E., 2010. ‘The Effects of Corporate Governance Attributes on Credit Ratings and Bond Yields’, Working Paper, Duke University). This suggests that board stability and direction, rather than anti-takeover devices themselves, may be the greater determinant of credit quality and bond spreads. As anti-takeover mechanisms serve to strengthen incumbent management teams, the bondholders of a well-managed investment grade company are more likely to benefit from increased management protections. Likewise, affording such protections to speculative-grade organizations would inhibit what are more likely to be positive takeover opportunities.
ESG: Why It Increasingly Matters

Growing Demand, Finite Supply

Population growth, a rising middle class, rapid urbanisation, and economic growth are all fuelling an increased demand for food, water, energy, land, and other resources. In the last decade, emerging markets saw an 80% increase in per capita income, which is resulting in an increase in consumption (Exhibit 6). By 2030, another three billion middle class consumers are expected to drive up resource demand even further. Early projections show an 80% increase in energy use and 60% increase in water use.\(^1\) Based on the Organization for Economic Cooperation and Development (OECD) forecasts, global GDP produced over the next three decades will exceed that generated up to this point in time.

EXHIBIT 6
More Economic Output in the Next 30 Years Than in the Last Two Millenia

Source: OECD (Maddison), UN Population Division, The Goldman Sachs Group, Inc.

EXHIBIT 7
Share of Global GDP by Region

Source: GS SUSTAIN, The Goldman Sachs Group, Inc., as of 7.5.12

ESG factors are relevant in all regions, but they are particularly crucial in emerging markets. This is because of the growing demographic and resource challenges that these countries are facing as a result of their rapid economic growth. The disparity between growing demand for and limited supply of resources such as capital, labor and natural resources will inevitably manifest itself to businesses in the form of higher costs and heightened operational risks. However, it will also provide firms with new opportunities for growth and unique sources of competitive advantage. It will be up to each individual company to decide how to overcome these new obstacles and take advantage of the opportunities that present themselves.

\(^1\)OECD, Working Paper 285, 2010
Profiting from Global Growth is Getting Harder

Profiting from global growth has become increasingly more difficult. While exposure to growing markets and sectors is still important, market and sector related growth have lost importance in determining a company’s profits. As individual companies’ growth has become less correlated to that of their industries, each company’s strategy, including how they deal with ESG issues, has become more important in determining long-term success and superior operating performance.

For example, globalisation brings opportunities but also significant ESG-related challenges for companies that have a network of offices with distribution centers and supply chains in several countries. The inherent complexity of managing a large and dispersed supply chain is heightened by making sure that social expectations pertaining to the ethical sourcing of products are met. Negative publicity related to sourcing products from suppliers that, for example, employ child labor, can have devastating consequences and be extremely difficult to overcome. By the same token, companies based in emerging markets could lose important contracts and opportunities to partner with large international corporations if the latter believe that these companies do not meet their ESG requirements.

Society has become increasingly aware of the existing grey area between profits and ethics. Occurrences of breaches in corporate ethics are more frequent than expected. Consider the news stories surrounding Martha Stewart, Tyco, Enron, and WorldCom; most of these instances involved prison sentences for senior executives. As a result, failing to meet key ESG considerations could cause significant reputational risk to companies. An association with a company not perceived to be ESG conscious is likely to have a direct negative impact on a company via loss of customers, market share and profits. On the flip side, companies that address the wider social and environmental impacts of their operations “can do well while also doing good.” These companies will be better placed as they will likely have built a stronger franchise and will comply with more stringent regulations ahead of its competitors - both important sources of competitive advantages.

Increased Investor Interest

The field of ESG investment has grown nearly tenfold over the last decade as financial markets have come to realise that integrating the environmental, social, and governance concerns of a population in investment decisions makes good business sense. Similarly, in the last decade, societal concerns about topics such as climate change and pollution have led to many new government policies relevant to business. It is also common sense that better corporate governance, which provides managers with fewer means of advancing themselves over their investors, tends to be beneficial to shareholders. Given these factors, the strong growth of ESG investing is no surprise.

As ESG related assets under management continue to grow, investors are showing that they recognise the advantages and want companies to recognise them, too. It is no surprise therefore, that ESG as a strategic investment process is increasingly and broadly being implemented for some of the largest holders of assets in the country, including public and corporate pension plans.

EXHIBIT 8

Correlation Between Sector and Average Company Growth

Source: GS SUSTAIN, The Goldman Sachs Group, Inc., as of 7.5.12
Conclusion

As we have discussed here, ESG factors can have a material positive or negative impact on corporate performance. While including these factors in traditional securities analysis is gaining traction, it is by no means mainstream. Because many professional finance degree programs do not sufficiently cover ESG datasets at this time, information on a company’s ESG activities is rarely considered by the average analyst or investment manager. This has created an attractive investment opportunity according to Grossmann and Stiglitz’ view that market (in)efficiency is a cyclical process in which those investors perform best who find profitable information sets that are barely known to their competitors. However, as the relationship between ESG factors and long-term corporate profits becomes more apparent, investors will seek out asset managers who understand the ESG advantage and can leverage the information arbitrage that exists. Responsible Investing can pay dividends, but it does require managers to internalize this information into their investment process and create appropriate strategies to help capture the upside that undoubtedly exists in this approach.


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