ANKURA CAPITAL

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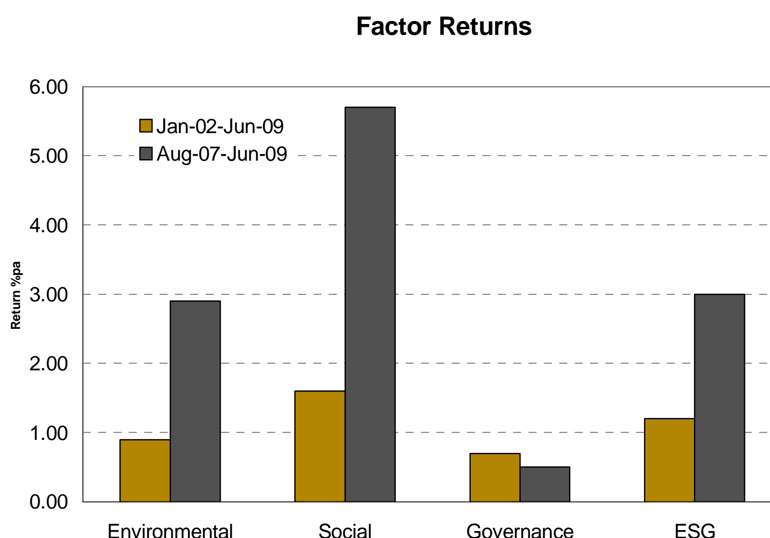
ESG: The case strengthens

The events of the Global Financial Crisis have drawn deserved scrutiny to the consequences of unfettered profit motives especially in the financial sector. This lends support to the long-argued case for Environmental, Social and Governance (ESG) investment considerations. Not surprisingly returns to ESG strategies have improved over the last two years. Evidence to date is consistent with the logical arguments for integrating ESG considerations in an investment process.

Does ESG boost performance?

Until recently the evidence that ESG ratings had a significant connection with stock returns was relatively weak. During the GFC that appears to have changed somewhat. We've based the analysis below on ESG ratings provided by Corporate Monitor, starting in January 2002. Returns to those ratings have been estimated in the context of a multi-factor model, which eliminates distortions from sector effects for example. Otherwise the fact that mining stocks have below average environmental ratings would cloud results. Below we contrast the pre-GFC period with the full period, by looking at factor returns to each of the component ratings and the composite.

Factor Returns



Source: Ankura Capital, Corporate Monitor

While these results look impressive, particularly since August 2007, they are generally not statistically significant given their volatility. Governance ratings appear to be the weakest component. The recent improved performance of the composite measure would need to persist for a number of years before the statistical case would be conclusive. As ESG is integrated more widely into investment processes some positive feedback can occur whereby a trend to adoption supports performance. Aside from the general connection with stock returns, it is important whether that is due to 'good' companies outperforming or 'bad' companies underperforming, or both. Here again the evidence is a little cloudy, but since the GFC it appears that the overall results are driven by 'good' companies outperforming, more so than 'bad' companies underperforming.

[1] A factor return can be thought of as the excess return to a portfolio biased strongly to that characteristic and neutral on other influences.

[1] These included Bond Corp, Qintex, Rothwells, and Westmex

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The long-term cost of poor governance

The corporate casualties of the past few years have in aggregate been small relative to the debacles of the late 1980's/early 1990's. The implosion of the Adelaide Steamship group and the loss sustained by Westpac in 1992 brought to a close a colorful era of failed corporate entrepreneurs. That period was essentially a confluence of fragile business models, loose accounting standards and finally a monetary policy eclipse. From 1989 to 1992 the cost in aggregate was circa 1%pa of index value. By contrast the losses over the last two years have tallied around 0.5%pa of index value. This estimate excludes the gearing debacle of the property trust and infrastructure sectors as that was at least transparent for investors. In the intervening 20 years there have been other isolated corporate failures including HIH and One.Tel. But more significantly there have been major write downs incurred by AMP (GIO, UK life assurance), National Australia Bank (Homeside, foreign exchange trading) and BHP (Magma Copper, Hot Briqetted Iron), as well as the James Hardie asbestos saga.

The damage associated with the above list averages around 1%pa of market performance over the last twenty years. The extended periods of perceived poor decision making at large companies over time have had a larger impact than the more sensational financial collapses which in some cases are generally avoided by institutional investors.

It's tempting to attribute corporate failures and significant losses to problems with corporate governance. Beyond board configuration, and committee structures, poor decisions could be indicative of weak governance. However they could equally arise from deficient business acumen. As well sometimes bad outcomes are simply due to bad luck. Particularly given the relatively small sample, it is difficult to connect objective governance criteria (ie CEO/Chairman separation, board and committee structures, rotation of directors etc) to much of this cost. Academics Frank Clarke and Graeme Dean in their book Indecent Disclosure argue that simple cosmetic governance criteria have often failed to avoid corporate failures in the past, and create a false sense of security. The weak results for governance in the above analysis support this skepticism. Their thesis is that compulsory compliance with rule-based accounting standards is often as much the problem as the solution and financial deception can be achieved, without mischief, by simply following the rules. The accounting framework itself is flawed.

An old concept

The earliest reference we've found to ESG investment dates to 1948. A common element of a World War and a Global Financial Crisis is the acknowledged role for government intervention. The thinking back then was that enterprises considered contrary to the public interest would likely be discouraged and while those that promoted it would be encouraged. There is an underlying political reality to environmental and social issues, separate to moral argument. Post-GFC the political climate globally has evolved very much in the direction of active intervention and has increased the risk of government regulation for badly behaved companies.

An example of this argument is the impact of government restrictions on tobacco advertising and health warnings on the tobacco business. More recently indoor smoking bans have been effective in crimping poker machines in clubs and pubs, on top of restrictions on the number of machines. A topical case is the fate of coal-based industries which will ultimately be impacted by policies designed to address climate change. Related to the GFC is the APRA review of remuneration in financial institutions.

Conclusion

One way to incorporate ESG criteria in portfolio management is to simply restrict exposure to 'bad' stocks. Our investigations indicate the characteristics of broad capitalisation diversified portfolios are not materially changed by so doing. While the statistical evidence may not yet be conclusive, there is compelling logic to justify integrating ESG considerations in some way. Governments will be compelled to act against industries that are against the interests of the environment or society. When they do the cost to companies in those industries can be significant. If poor governance is interpreted more broadly, historically it has been very destructive to shareholder value, with an outside estimate of 1%pa over the past twenty years. Avoiding even a fraction of that impost is well worthwhile.

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[1] Although not always. Adelaide Steamship and One.Tel both had prominent institutional investors on their registers.

[1] Pegler, J.B.H *The Actuarial Principles of Investment*, Journal of the Institute of Actuaries, Vol 74.

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