ACTIVE VIEWPOINT

MARTIN CURRIE
A Legg Mason Company

ENVIRONMENTAL, SOCIAL AND GOVERNANCE

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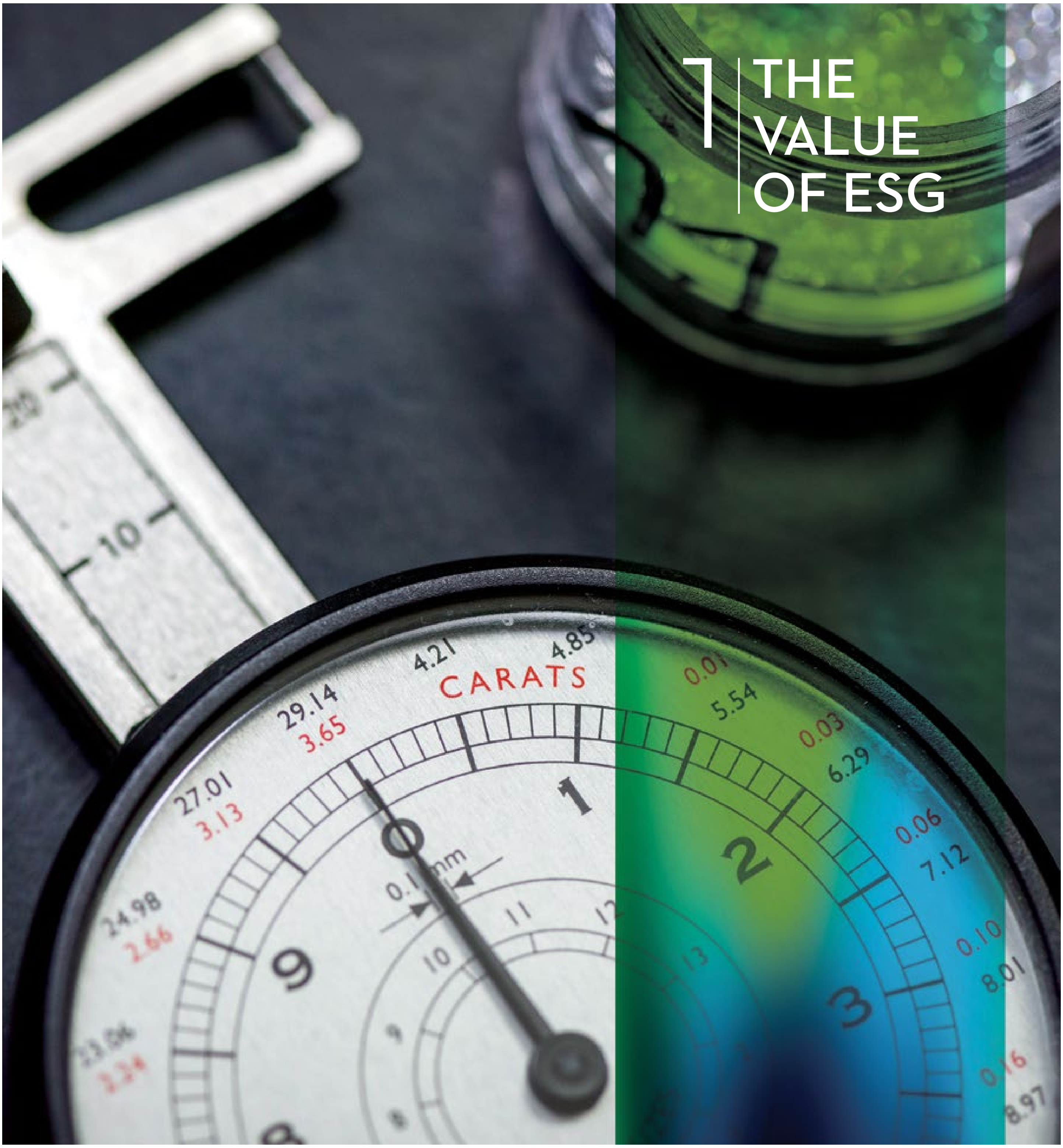


Effective stewardship of our clients' capital is at the heart of our client proposition. As such, we take a holistic view of investee companies, looking at all material information, whether quantitative or qualitative. Environmental, social and governance (ESG) analysis is fully embedded in this assessment, recognising that these factors, combined with active ownership, will influence a company's returns over the long term. In this paper we explain the rationale behind this approach, presenting the academic evidence which illustrates the value of corporate sustainability for businesses, investors and wider society.

1) THE BUSINESS PERSPECTIVE

There is a growing body of evidence showing that companies which adopt effective sustainable business practices, specifically through a consideration of environmental, social and governance (ESG) factors, enhance their competitive advantage, increase their operational-cost effectiveness, and ultimately, improve their long-term financial performance. Many of these factors are not captured by traditional accounting practices, but can have a real impact on financial metrics and long-term value creation.

THE ESG EFFICIENCY ADVANTAGE

The view that corporations can realise meaningful cost and efficiency advantages through sustainability initiatives such as production innovation, resource efficiency and waste reduction is consistent with the findings of Eccles, Ioannou, and Serafeim (2011)[1]. They established that 'High Sustainability' companies significantly outperform their 'Low Sustainability' counterparts, in particular, through an ability and willingness to 'engage in more product and process innovations in order to be competitive under the constraints that the integration of social and environmental issues places on the organization'.

Companies with a strong ESG focus also tend to display efficient processes in terms of cost management. The number of corporate case studies in this area is ever-increasing. Notably, Serafeim (2014)[2] highlights the examples of Dow Chemicals, which reported savings of US$9.4 billion from energy efficiency improvements over a 16-year period, and General Motors, which claimed recycling and reuse initiatives saved the company more than US$2.5 billion. Likewise, Unilever has reported that its actions to achieve zero waste to landfill from its North American facilities (through initiatives such as improved inventory management, package recycling and generating biodiesel fuel) resulted in cost savings of more than US$1.9 million in 2013[3].

ESTABLISHING A LONG-TERM STRATEGIC BENEFIT

Importantly, the implementation of ESG practices in other aspects of company management can be equally impactful. For instance, Edmans (2011)[4] analysed the relationship between employee satisfaction and long-run equity prices – determining that those firms with higher levels of employee satisfaction generate superior long-term returns. Edmans concluded that the 'results are consistent with human relations theories which argue that employee satisfaction causes stronger corporate performance through improved recruitment, retention, and motivation, and existing studies of under-pricing of intangibles'. Likewise, Verwijmeren and Derwall (2010)[5] recognised that companies with leading track records in employee wellbeing not only significantly reduce the probability of bankruptcy by operating with lower debt ratios, but also enjoy better credit ratings.

The long-term strategic advantages of ESG have also been evidenced more holistically. In 2015, Friede, Busch and Bassen[6] aggregated more than 2,000 empirical studies relating to ESG and financial performance. The conclusion of their vast meta-study was that a positive relationship exists between ESG and corporate financial performance and that therefore the case for ESG investing is empirically very well founded. In particular, they noted that 'the orientation toward long-term responsible investing should be important for all kinds of rational investors in order to fulfil their fiduciary duties and may better align investors' interests with the broader objectives of society'.

What's more, longer-term competitive advantages are correspondingly evident for companies that align their operations towards a broad spectrum of stakeholders: employees, suppliers, communities and customers as well as shareholders. As we will talk about in the final section of this paper, with the market and wider society increasingly rewarding sustainable corporate behaviours, brand strength and public trust become significant determinants of long-term performance.

[1]'The Impact of Corporate Sustainability on Organizational Processes and Performance', Eccles R.G, Ioannou I., and Serafeim G. *Management Science, Volume 60, Issue 11 (2011).*

[2]'Turning a Profit While Doing Good: Aligning Sustainability with Corporate Performance', Serafeim G. *Centre for Effective Public Management at Brookings (2014).*

[3]Unilever press release: 03/17/2015.

[4]'Does the stockmarket fully value intangibles? Employee satisfaction and equity prices', Edmans A. *Journal of Financial Economics (2011).*

[5]'Employee well-being, firm leverage and bankruptcy risk', Verwijmeren P. and Derwall J. *Journal of Banking and Finance (2010).*

[6]'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Friede G., Busch T. and Bassen A., *Journal of Sustainable Finance and Investment (2015).*

ESG AND REDUCED DEBT AND EQUITY COSTS

In terms of direct cost reduction, several academic studies have identified a tangible link between ESG factors and improvements in the costs of corporate financing. Bhojraj and Sengupta (2003)[7] showed that the default risk of a firm (via bond yields and ratings) is directly impacted by its corporate governance mechanisms. Specifically, their analysis showed that the positive perceptions of effective governance mechanisms could result in a reduction in firms' default risk and therefore its cost of debt capital. Additionally, Schauten and van Dijk (2011)[8] also determined that the influence of effective governance in terms of improved financial disclosure leads to lower credit spreads.

A company's credit rating, and therefore its credit spreads, are also enhanced by corporate social responsibility (CSR) factors. Attig, El Ghoul, Guedhami and Suh (2013)[9] noted that a company taking a strong focus on stakeholder interests including employee and community relations, conveys important non-financial messages to ratings agencies, thus indirectly lowering its financing costs.

Additionally, Bauer and Hann's (2010)[10] analysis of aggregate measures for the environmental strengths and concerns of firms (in relation to the yield spread of newly issued bonds, bond ratings, and long-term issuer ratings) demonstrated that pro-active environmental practices are associated with a lower cost of debt. Likewise, they proved that those companies which did not address the environmental risks and externalities of their operations pay a premium on the cost of their debt financing. Similarly, Chava (2014)[11] also assigned a relationship between the environmental profile of a firm and its cost of capital, concluding that investors take account of a company's environmental risks, which then leads to higher cost of equity and debt capital.

So from the perspective of running a business, it is clear that there are multiple incentives for considering ESG factors and implementing sustainable practices within a business model.

2) THE INVESTOR PERSPECTIVE

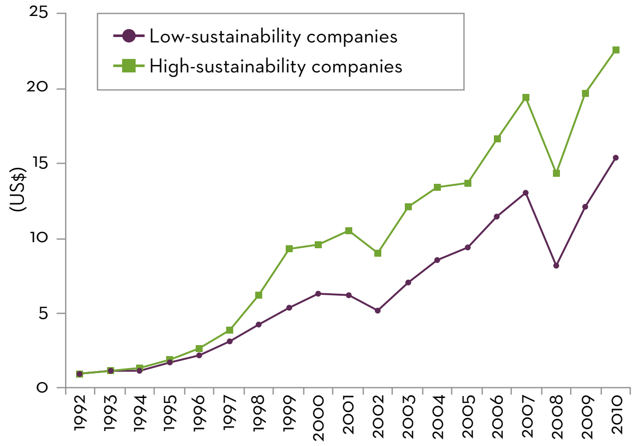
From the investor perspective, it follows logically that improved company-level performance relating to ESG factors should correspond with superior risk-adjusted, long-term equity returns. Again, academic evidence to substantiate this link is becoming increasingly well documented.

LONG-TERM VALUE CREATION

The positive transmission of corporate sustainability practices to share prices has been clearly evidenced by the work of Eccles et al. (2011). By analysing a sample of 180 companies between 1993 and 2009, their research showed that half of the sample companies (those which had implemented 'a substantial number of environmental and social policies adopted for a significant number of years'), fared significantly better than lower sustainability firms, both in business as well as stockmarket performance.

High-sustainability firms outperform over the long term

Evolution of US$1 invested in the stockmarket in value-weighted portfolios



Source: Eccles R.G, Ioannou I., and Serafeim G. *Management Science, Volume 60, Issue 11 (2011).*

The long period of time chosen for the data analysis is notable. The research deliberately allowed for the long-term organisational implications of ESG-orientated business practices to take place. This view mirrors the notion of ESG being a driver of long-term value creation for businesses (and by extension shareholders) as illustrated in the recent report from the Principles for Responsible Investment – PRI ('How ESG engagement creates value for investors and companies'). The report highlights the several areas in which ESG engagement by investors with companies can create long-term shareholder value and echoes the sentiment of Eccles et al. (2011), that 'high sustainability firms generate significantly higher stock returns, suggesting that indeed the integration of such issues into a company's business model and strategy may be a source of competitive advantage for a company in the long run.'

Please be aware that the information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable.

[7] 'Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors', Bhojraj S. and Sengupta P. *The Journal of Business, Vol. 76, No. 3 (2003).*

[8] 'Corporate Governance and the Cost of Debt of Large European Firms', Schauten M.J.B and van Dijk D. *Erasmus Research Institute of Management Report Series (2011).*

[9] 'Corporate Environmental Responsibility and the Cost of Capital: International Evidence', El Ghoul S., Guedhami O., Kim H. and Park K. *Journal of Business Ethics (2016).*

[10] 'Corporate Environmental Engagement and Credit Risk'. Bauer R. and Hann D. *Maastricht University ECCE Working Paper (2010).*

[11] 'Environmental Externalities and Cost of Capital, Working Paper', Chava S. *Georgia Institute of Technology (2011).*

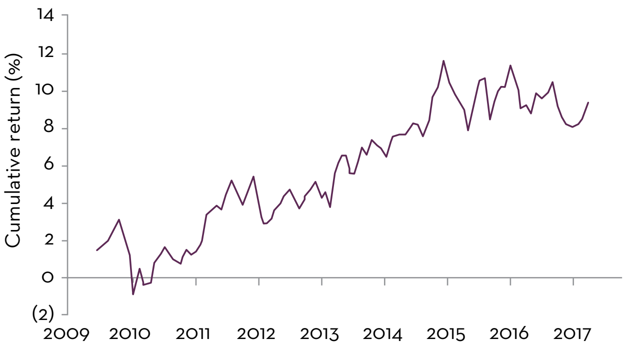
ESG AND THE POWER OF POSITIVE CHANGE

The link between ESG-focused businesses to long-term stockmarket outperformance is also supported by a recent study ('Foundations of ESG Investing'[12]) by MSCI, which examined how ESG information embedded within companies is transmitted to the equity markets. The research showed that 'high-rated' ESG companies (based on MSCI ESG Ratings data and financial variables) tended to demonstrate higher profitably, higher dividend payments and lower idiosyncratic tail risks. In addition, high-rated ESG firms also proved better at managing company-specific risk and as a result have a lower probability of experiencing incidents which could affect their share price. These companies also tend to have less exposure to systematic risk. Therefore, their expected cost of capital is lower, leading to higher valuations in a discounted cash flow (DCF) model framework.

More pertinently perhaps, the research also showed the transmission of change in companies' ESG profiles was linked to changes in financial indicators. Specifically, that higher rates of improvement in ESG characteristics ('momentum') were an important indicator of improved financial performance which led to increasing valuations.

Significant outperformance of the top ESG 'momentum' companies

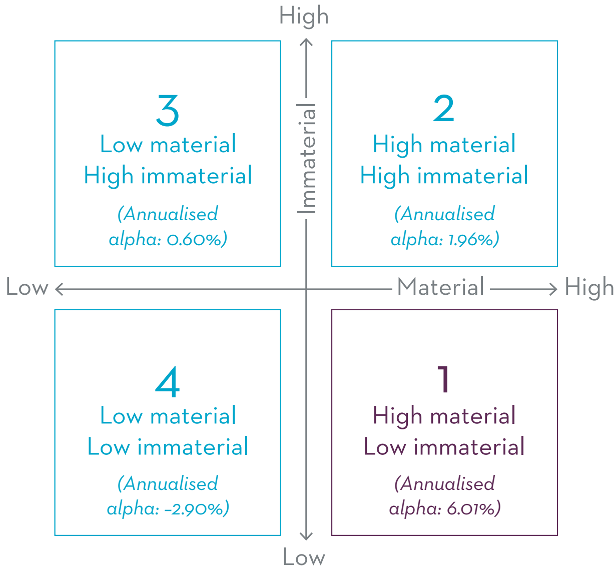
Cumulative performance differential of the top ESG momentum quintile versus the bottom ESG momentum quintile.



Source: 'Foundations of ESG Investing', Giese G., Lee L-E., Melas D., Nagy Z., Nishikawa L. *MSCI (2017).*

Also of note here, is the work carried out by Kahn, Serafeim and Yoon (2015)[13] on the importance of materiality in an investment case. Their findings point to a difference in the investment outcomes relating to those firms which focus on material rather than immaterial sustainability issues in their business case. They concluded that, 'firms with good performance on material sustainability issues significantly outperform firms with poor performance on these issues, suggesting that investments in sustainability issues are shareholder-value enhancing.'

Over a 20-year period, the research demonstrated investing in companies involving 'high performance' on material factors and 'low performance' on immaterial factors produced greater alpha than all other investments, including those scoring highly on both material and immaterial issues, as illustrated in the matrix below.



The chart demonstrates the estimated coefficients of a five-factor model for value-weighted portfolios. It illustrates that the estimated alpha for the portfolio of 'Material' investment firms is larger in magnitude and statistically different from zero. Source: 'Corporate Sustainability: First Evidence on Materiality', Khan M., Serafeim G. and Yoon A. *The Accounting Review, Vol. 91, No. 6 (2015).*

AVOIDING VALUE DESTRUCTION

Perhaps the most obvious link between a company's ESG credentials, its financial performance, and consequently its shareholder value comes from the negative effects of ESG-related shocks. Unsurprisingly, evidence in this area is most pertinently drawn from real-life examples, and there is certainly no shortage of instances of companies where ESG shortcomings have caused major financial damage and destroyed shareholder value.

From an investor perspective, it is easy to claim 'wisdom in hindsight' from reviewing such events, but these examples often demonstrate the value of effective ESG management purely from its catastrophic absence in a business model.

Take the oil spill at BP's Deepwater Horizon drilling rig in 2010, for example. Governance and cultural failures featured heavily in the route to the disaster, as overzealous cost-cutting, combined with poor controls and a general lack of transparency materially raised risks, not just for the employees who lost their lives and the communities affected, but for shareholders.

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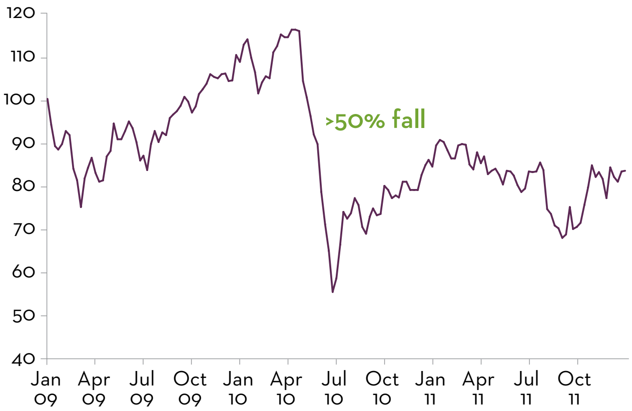
[12] 'Foundations of ESG Investing', Giese G., Lee L-E., Melas D., Nagy Z., Nishikawa L. *MSCI (2017).*

[13] 'Corporate Sustainability: 'First Evidence on Materiality', Khan M., Serafeim G. and Yoon A. *The Accounting Review, Vol. 91, No. 6 (2015).*

The financial implications were astronomical, with eye-watering costs for BP estimated at over US$60 billion and a halving in its stockmarket valuation in the immediate aftermath of this event.

Effect of Deep Water Horizon on BP share price



Source: FactSet and Martin Currie.

3) THE SOCIETY PERSPECTIVE

In today's globalised, information-rich world, the number of stakeholders in a business are vast and well informed. As such, there is a far greater visibility, accountability and immediacy of a company's actions than at any point in history. This means that real (or even perceived) infringements of stakeholders' interests can have significant consequences for a company's reputation and ability to do business. More and more, companies therefore need to be aware of the implicit 'social contract' that they hold with their stakeholders.

Major international undertakings, such as the PRI and UN Sustainable Development Goals (SDGs), also reflect a broad consensus that a greater premium should be placed on sustainability than has historically been the case. As a result, the intangible assets which make up part of a company's book value, such as brand perception and customer loyalty, are increasingly linked with their ESG credibility. Lubin and Esty (2010)[14] even go so far as describing the heightened 'sustainability imperative' that now exists in society as a 'megatrend' which ultimately will 'force fundamental and persistent shifts in how companies compete'. Similarly, Clark, Feiner and Viehs (2014)[15] describe sustainability as one of the 'most significant trends in financial markets in decades'.

Other commentators acknowledge the magnitude of this societal trend as evidenced by demographically changing values. Winograd and Hais (2014)[16] in particular, point to the generationally driven shift in sustainable business practices demanded by Millennials, predicting that those 'companies that dedicate their future to changing the world for the better and find ways to make it happen, will be rewarded with the loyalty of Millennials as customers, workers and investors for decades to come. Those that choose to hang on to outdated cultures and misplaced priorities are likely to lose the loyalties of the Millennial generation and with it their economic relevance'.

Businesses that therefore consider ESG factors and embed sustainability within their operations are therefore strategically better placed to manage stakeholders' expectations and maintain their unwritten licence to operate. In addition, a positive reputation in regard to ESG matters can also prove to be a differentiator for company performance.

CONCLUSION: THE IMPORTANCE OF ACTIVE OWNERSHIP

This paper has demonstrated evidence of the increasing value of corporate sustainability for businesses, investors and wider society. In our view, we are witnessing a fundamental shift in ideology with regards to the role of corporate behaviour in society. The neoclassical economic view of a company's objective (most famously espoused by Milton Friedman) as being solely engaged in 'activities designed to increase its profits[17]' now seems increasingly anachronistic. By contrast, the concept of a company 'doing well by doing good' has now entered the mainstream as a valid determinate of long-term business performance.

As such, we believe that ESG issues can materially impact the performance of our clients' investment portfolios. From our perspective, fully integrating ESG in the investment process is therefore inherently consistent with our fiduciary responsibilities to act in the long-term interests of our clients. We place a significant emphasis on stewardship and active ownership as a key element of this by building strong relationships with companies and engaging with them in a constructive manner. Our focus will always be on issues that are most material to long-term shareholder value, such as strategy, capital structure, governance and wider sustainability matters. This allows us to improve our understanding of investee companies and their governance structures, it builds conviction in the investments made on behalf of our clients and, where we identify particular issues, we work with companies towards better practice.

In the next paper in this series, we look in more detail at how fully integrating ESG analysis through active ownership forms an integral part of our fundamental analysis on investee companies and helps identify both risks and opportunities.

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[14] 'The Sustainability Imperative', Lubin D.A. and Esty D.C. *Harvard Business Review, May (2010).*

[15] 'From the stockholder to the stakeholder. How sustainability can drive financial outperformance', Clark G.L., Feiner A. and Viehs M. *SSEE Research Report sponsored by Arabesque Asset Management (2014).*

[16] 'How Millennials Could Upend Wall Street and Corporate America', Winograd M. and Hais M. *Governance Studies at Brookings (2014).*

[17] 'The Social Responsibility of Business is to Increase its Profits', Friedman M. *The New York Times Magazine (1970).*

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IMPORTANT INFORMATION

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