PRI Principles for Responsible Investment

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Responsible investment and investment performance

There is a growing body of evidence that investors, through a combination of ESG incorporation strategies and active ownership practices, can make a difference to investment performance, ESG outcomes and reporting by investee companies.

The materiality question – are ESG issues relevant to investors?

The answer to this question is an unambiguous yes. For evidence, it is only necessary to look at the financial impacts on BP from the Deepwater Horizon spill, to Barclays as a consequence of the Libor scandal, and to Lonmin as a result of the wages disputes, strikes and deaths at its South African mines in 2012.

While events such as these inevitably draw investor attention to the risks associated with ESG issues, there is a growing body of evidence that companies with better management of and performance on ESG issues are likely to make better investments over the longer-term. They are also likely to be regarded by investors as safer investments (using measures such as their cost of capital). In one of the most significant studies that has been published in this area, Eccles et al. (2011) conducted an empirical study of two matched sets of firms covering an 18-year period. They found that, over the long-term, corporations that voluntarily adopted environmental and social policies many years ago significantly outperformed those that had adopted almost none of these policies, both in terms of stock market and accounting performance.

The effectiveness of integrating ESG into investment decisions

The argument that ESG issues can be financially significant is now widely recognised and accepted. Moreover, there is a growing consensus that taking account of these issues is an integral part of investors' fiduciary duties. However, there is, as yet, no universal agreement on how best to integrate ESG issues into investment processes. This is reflected in investment practice: when we look across the investment industry, it is clear that there is no single way to integrate ESG issues into investment decisions. The approaches adopted have been top down (e.g. looking at macroeconomic factors, at thematic or structural changes, at sectoral dynamics and changes), bottom up (e.g. looking at individual companies' strategies, cashflows and profit

PRI Association
Registered office: Bath Place Business Centre, 2 Bath Place, Rivington Street EC2A 3DR London, UK Company no. 7207947
T: +44 (0) 20 7749 1940 W: www.unpri.org E: info@unpri.org

and loss statements, and asset valuations), and some combination of these. Furthermore, the data points that investors use, the specific ESG issues and performance measures that they consider, the weight that they assign to these issues and measures, and so forth vary markedly from investor to investor.

All of these factors mean that measuring the investment outcomes of integrating ESG issues into investment research and decision-making processes is very difficult. However, a number of studies have found positive results (see references below). For example:

- Deutsche Bank Climate Change Advisers (2012) recently conducted a comprehensive review of the literature[1] and found that company performance on ESG issues[2] is positively correlated with superior risk-adjusted returns at a securities level.
- The following studies have found that ESG integration strategies can lead to sizable abnormal returns (Alphas):
    - Corporate Governance (Bebchuk et al., 2009, Gompers et al., 2003)
    - ESG Engagement (Becht et al. 2009; Dimson et al. 2012)
    - Eco-efficiency (Derwall et al., 2005)
    - Employee Relations (Statman and Glushkov, 2009; Edmans, 2011)
    - Community Relations (Kempf and Osthoff, 2007, Statman and Glushkov, 2009)
    - Green Real Estate (Eichholtz, Kok and Quigley, 2010)
    - Best in class strategies (Kempf and Osthoff, 2007; Statman and Glushkov, 2009)
    - Over the long term (Eccles et al. 2012)
- A study has found that successful ESG investment requires specific skills (Gil-Bazo et al., 2009)
- Studies have found that financial institutions with more ESG appeal are found to:
    - Realise better competitive outcome in mortgage and deposit markets (Callado-Muñoz & Utrero-Gonzalez, 2011)
    - Have more loyal clients (Bollen, 2007)

Looking specifically at research focused on risk:

- Companies with high ESG scores are found to have less company specific risk (Bouslah et al., 2012; Boutin-Dufresne and Savaria, 2004; Lee and Faff, 2009; Bauer, Derwall and Hann, 2009; Oikonomou et al., 2012)
- Corporations with better ESG ratings are found to have lower cost of debt and higher credit ratings (Bauer et al., 2009; Bauer and Hann, 2011; Oikonomou et al. 2011).
- ESG criteria are found to provide an insurance like protection for firms in legitimacy crisis (Godfrey, Merrill and Hansen, 2009)
- ESG criteria can help to improve portfolio diversification and reduce worst case risk (Hoepner, 2010; Hoepner et al., 2013)

[1] Their review considered 100 academic studies, 56 research papers, 2 literature reviews and 4 meta-studies.
[2] They note that earlier studies use the term corporate social responsibility (CSR) whereas more recent studies use the term ESG.

Strengthening the Investment Case

The evidence base for the integration of ESG issues into investment research and decision-making processes remains relatively underdeveloped[3], although this is an area of significant research at present. This is a major area of focus for the PRI's Academic Network, which is encouraging investors to make their internal data (on ESG-related analysis and investment performance) available to researchers, to enable a fuller understanding to be gained of the relationship between ESG issues, corporate financial performance and investment performance at the stock (e.g. in terms of share price, cost of capital) and portfolio levels.

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