ESG INTEGRATION

Investors expect companies to integrate environmental, social and governance (ESG) topics into business decision making.

But why is this important and how can companies effectively develop their ESG approach to meet investor expectations?

In today's landscape, there is still active debate about (1) the link between ESG and corporate financial performance and (2) how institutional investors should integrate ESG factors into their investment decision-making. Accordingly, we identify action steps you can take to better position your company's ESG approach and disclosures.

Link between ESG and corporate financial performance

An increasing amount of academic research is signalling that attention to ESG factors can lead to better financial performance for both companies and investors[1]. ESG covers a wide range of factors, ranging from board structure and executive remuneration to environmental responsibility, corporate culture and employee well-being and satisfaction. Studies show that companies demonstrating strong management of these factors can reduce cost of capital, improve operational performance, increase shareholder returns and achieve long-term sustainability.

ENHANCED MANAGEMENT OF ESG ISSUES

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LOWERED COST OF CAPITAL	IMPROVEMENT OF OPERATIONAL PERFORMANCE	INCREASED SHAREHOLDER RETURNS

Performance of responsible investment and mainstream funds

AUSTRALIAN SHARE FUNDS	1 Year	3 Years	5 Years	10 Years
Average responsible investment fund (between 17 and 34 funds sampled depending on time period)	-1.24%	5.70%	6.43%	12.39%
Morningstar: Australia Fund Equity Large Blend	-5.49%	4.87%	4.42%	7.95%
S&P/ASX 300 Total Return	-3.06%	6.65%	5.60%	8.91%
INTERNATIONAL SHARE FUNDS	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Average responsible investment fund (between 7 and 38 funds sampled depending on time period)	-0.03%	11.18%	9.48%	9.50%
Morningstar: Equity World Large Blend	-0.68%	6.37%	8.42%	8.97%
MSCI World Ex Australia NR AUD	1.52%	7.49%	9.81%	9.57%
MULTI-SECTOR GROWTH FUNDS	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Average responsible investment fund (7 funds)	-1.13%	4.75%	5.65%	7.66%
Australia Fund Multisector Growth	-2.26%	4.39%	4.92%	7.02%

Source: Responsible Investment Association Australasia

Outperformed by the average RI fund

Underperformed by the average RI fund

1 *Clark, G., Feiner, A. and Viehs, M. (2014). From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance. SSRN Electronic Journal.*
This paper examined more than 200 sources including academic research, industry reports, newspaper articles and books – and concluded that:
1. 90% of the cost of capital studies show that sound ESG standards lower the cost of capital.
2. 88% of the studies show that solid ESG practices result in better operational performance.
3. 80% of the studies show that stock price performance is positively influenced by good sustainability practices.

As ESG casts such a wide net, not all variables can be studied at once to concretely conclude that all forms of ESG management demonstrably improve company performance. Ongoing research is still needed to identify the most relevant ESG factors that influence performance of individual companies in diverse industries. However, the economic relevance of ESG factors has been confirmed and is now building momentum among investors and companies alike.

What does ESG integration mean for investors?

Investors employ a variety of methods and strategies to integrate ESG in decision-making processes. Many variables are involved, and approaches differ between investment managers and even between teams. At a high level, we are seeing investors integrate ESG from the investment, voting and engagement fronts:

- A myriad of investment strategies such as positive and negative screening, impact investing, shared value investing, and low carbon investing seek to deliver long term competitive financial returns.

- Globally the quantity and level of investor support for ESG-related shareholder resolutions such as remuneration, human rights and climate change are increasing.

- Investors are increasingly seeking proactive, year-round engagement to secure commitments from senior management and the Board on ESG topics.

Institutional investors and investment managers typically employ multiple strategies either in combination or tailored to particular asset classes or products. This means that there is no clear benchmark for what ESG integration means in practice. ESG rating agencies typically use a universal ESG framework and research is primarily used by investors to understand at a high level, the ESG exposure of the overall portfolio. However, companies that score higher on rankings aggregating a universe of ESG metrics, do not necessarily deliver better shareholder returns if financial materiality and strategy are not considered. As a wide variety of sustainability information is available, investors are looking to determine what ESG information is financially relevant and how this may impact the company.

What should companies do?

To better position the company's ESG approach and disclosure, companies should consider the following:

1. Get the board of directors and senior management to buy into the benefits of integrating ESG factors into decision-making. Commitment from the top is an essential first step before bringing middle management into the conversation. All levels of management must be deeply involved in implementing material ESG policies.

2. Define the company's purpose – why it exists and the role that it plays in the world. Articulating their corporate purpose enables companies to understand and explain the broader stakeholder impacts of the business. This analysis in turn will underpin and guide the company's future ESG focus and activities.

3. As ESG transcends a single business division, set up a steering committee to ensure appropriate integration, accountability and responsibility for collective management and reporting. This steering committee should include representatives from the financial, investor relations, legal and compliance, human resources, CSR, culture and operations teams to ensure a balanced, company-wide perspective.

4. Engage with internal and external stakeholders (including investors) to assess the materiality of ESG topics to the company and wider supply chain.

5. Based on the outcomes of materiality analysis, invest in programs and resources to establish internal controls, manage the company's material ESG risks and opportunities and generate data for monitoring and reporting.

6. Design and embed processes to integrate ESG into senior management decision making, through controls, metrics, monitoring and reporting mechanisms. Incorporate ESG into executive remuneration and key performance indicators (KPIs).

7. Disclose the company's material ESG topics and related management activities. It will become increasingly clear for investors and other stakeholders the companies that are integrating ESG into their business and those that are not. The gap between those with only basic disclosure and those more advanced will continue to expand.

Companies should decide whether they want to be seen as leaders or laggards. While investors typically do not have a preference for a specific standard, the most widely used frameworks for sustainability reporting include Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and Task Force on Climate-related Financial Disclosures (TCFD) Recommendations.

8. Execute a separate ESG roadshow for current and prospective investors to demonstrate the company's commitment to ESG.

9. Integrate ESG into quarterly earnings calls and other IR communications activities.

Emily Lay and Maria Davis-Poynter,
Morrow Sodali,
Sydney, Australia

ABOUT MORROW SODALI

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CONTACTS

If you would to like assistance in drafting or refining your existing ESG disclosures, please get in touch with one of our experts.

US
+1 212 300 2470

EMEA and LATAM
+44 20 71006451

APAC
+61 2 8022 7940