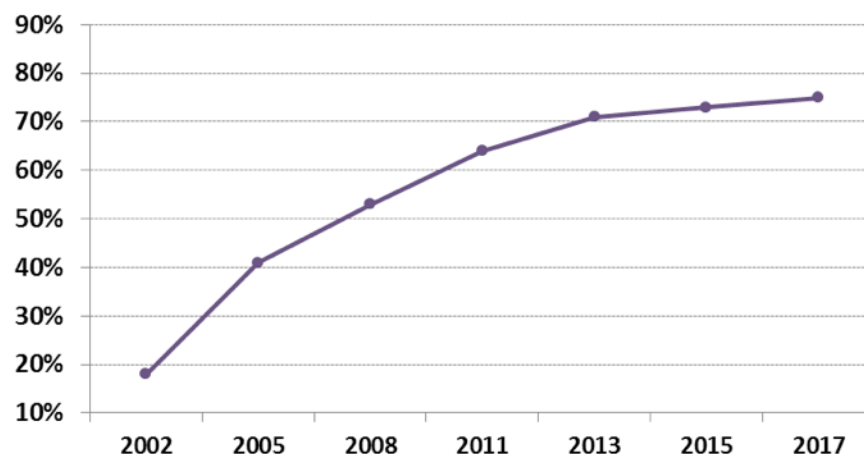
The Rise of ESG Disclosure and What It Means for You & Corporate Governance Explored

The Rise of ESG Disclosure and What It Means for You

December 2018

The Situation

Over the last fifteen years, growth in the amount of non-financial information reported by corporations has been exponential. This type of information covers a wide variety of topics including Environmental, Social, and Governance (ESG) data. ESG data measures a company's impact beyond profit through a wide range of figures, such as energy efficiency, water usage, human rights policies, waste output and workforce diversity. Corporate Social Responsibility (CSR) or sustainability reports are the most important source of a business' ESG data. As of 2017, 75% of major companies around the world produced some form of CSR report, up from 19% in 2002[i]. The industry-wide disclosure trend has been driven by pressure from regulators, investors and the public for corporations to improve transparency and performance on environmental and social matters.



Source: KPMG International Cooperative
*Based on sample of top 100 companies by revenue in each of the 49 countries

The Benefits

The increase in ESG disclosure presents a tremendous and underappreciated opportunity for investors, creating another source of valuable insight into a company's prospects. There is growing academic support for the notion that businesses with robust sustainability policies and practices demonstrate superior operational results and investment returns[ii]. Certain ESG metrics have shown strong links to equity outperformance.

Evidence suggests that companies with low levels of greenhouse gas emission intensity, relative to their industry peers, deliver higher returns on average[iii]. When excessive pollution is discharged into the environment, it may indicate that the company's resources have been used inefficiently, which would logically hurt profit margins.

Job satisfaction and workforce turnover are also valuable data points to consider. When a company is seen as a desirable place to work, it can be easier and cheaper to secure (and retain) top talent. A University of Pennsylvania study showed that a portfolio based on *Fortune* magazine's annual list of the "100 Best Companies to Work for in America" outperformed the benchmark by over 2% from 1984 to 2009[iv].

Additionally, sustainability innovation has the potential to be a major profit driver. A reputation for having a positive social or environmental impact can be a competitive advantage, helping a company gain new customers and retain existing ones[v]. Several businesses that have pivoted to develop new products or services to meet the demands of a low-carbon economy have seen strong growth. For example, Royal Philips, a leading healthcare technology company, earned €10.8 billion of revenue (60% of total) from selling environmentally friendly products in 2017[vi], up from €4 billion (15% of total) in 2006[vii].

The Challenges

While ESG reporting has come a long way, there is still much improvement required. ESG disclosures remain highly inconsistent. Even similar businesses in the same country may not divulge the same metrics, making performance comparisons difficult. In addition, non-financial data is not treated with the same scrutiny as financial data. Therefore, the reliability of the information may be questionable. It is encouraging, however, that there are several ongoing initiatives to further standardize ESG reporting, such as the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB).

Cidel's Approach

There is now a vast amount of ESG data available that, while interesting, may not be entirely relevant to forecasting equity performance. The key is to focus on the most pertinent information in a systematic way. One of Cidel's main input tools is Thomson Reuters Eikon, a financial information aggregator that reports up to 400 different numeric and binary ESG statistics for each publicly-traded company. To incorporate the benefits of ESG metrics into analytics, the Cidel team applies an evidence-based framework to bring together this external data and our own proprietary research. This allows us to focus on the most material metrics for each company, which can vary greatly among industries. We have found that *targeted* consideration of ESG data enables better-informed investment decisions, mitigating risk and driving higher returns over the long term.

*Cidel is an operating name of Cidel Asset Management Inc.

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[i] KPMG International Cooperative, "The KPMG Survey of Corporate Responsibility Reporting 2017", October 2017
[ii] University of Oxford & Arabesque Asset Management, "From the Stockholder to the Stakeholder", March 2015
[iii] The Goldman Sachs Group, "The PM's Guide to the ESG Revolution", April 2017
[iv] Alex Edmans, Journal of Financial Economics "Does the Stock Market Fully Value Intangibles?", September 2011
[v] Nielsen, "The Sustainability Imperative: New Insights on Consumer Expectations", October 2015
[vi] Royal Philips Annual Report 201
[vii] Royal Philips Sustainability Report 2006

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Why Investors Should Care About Corporate Governance

April 2018

Over the past two decades, a number of major corporate collapses, such as Enron and Lehman Brothers, have painfully exposed the dangers of weak corporate governance. Concerns about corporate governance are not new: Adam Smith questioned the ability of the corporation as an ownership structure to protect shareholder interests in his 1776 book "Wealth of Nations". In this article, we will explore corporate governance and its critical role in making investment decisions.

What is corporate governance?

Corporate governance is the system of principles and procedures by which a company is directed and managed: essentially, it is how an organization polices itself. Typically, public corporations have separate shareholders and management; because of this division, managers may be tempted to maximize their own wealth at the expense of shareholders by paying themselves excessive salaries, for example. Corporate governance aims to align the interests of management with that of the company's shareholders (majority and minority) and other stakeholders including employees, customers, creditors and the community.

Shareholders elect a Board of Directors to act on their behalf. The Board plays a central role in setting and implementing a company's corporate governance policies. Board responsibilities include setting the company's long-term strategic goals, selecting executive management and reporting results to shareholders.

The Board is led by a Chairperson and is typically comprised of inside and outside Directors. Inside Directors are senior executives of the company, such as the CEO. Outside (or independent) Directors have no connection to the company other than their seat on the board. They are selected for their relevant experience or expertise and are seen as more objective as they can challenge management without fear of losing their jobs.

What are the elements of good corporate governance?

Through incentives and control mechanisms, good governance ensures that management and Directors act ethically and lawfully and in the best interest of shareholders. While there is no one perfect model for governance, the universal qualities of an effective framework are transparency, accountability and fairness. When assessing the quality of a company's governance, Cidel Asset Management looks for a number of positive indicators, including:

- An independent and diverse board: A Board that contains a majority of outside Directors is less likely to make decisions that unfairly benefit the interests of management over those of shareholders. The independence of a Board's audit and compensation committees is of utmost importance as these committees oversee financial reporting and employee compensation structure respectively. Additionally, a Board with gender diversity and a range of skill sets and backgrounds has the potential to diminish harmful groupthink.

- Separate CEO and chairperson roles: If the CEO holds the Chair position, they are essentially responsible for managing the company while simultaneously monitoring their own performance, creating the opportunity for abuse of power. Also, the ability and willingness of other Directors to exercise independent judgment may be diminished when the CEO is the Chair.

- Aligned long-term incentives: Management's compensation should depend primarily on the company's long-term performance. Unsurprisingly, short-term incentives lead to short-term thinking, which can cause managers to take excessive risks or underinvest for future growth. Also, compensation incentives should be fully transparent and established by an independent compensation committee comprised of a majority of independent Directors.

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Why Investors Should Care About Corporate Governance Cont'd

April 2018

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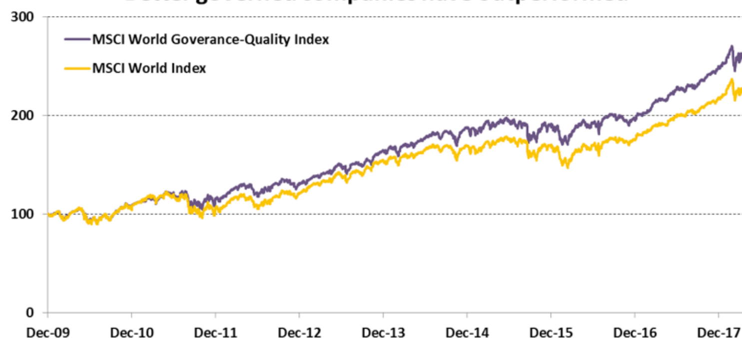
• Significant insider ownership: Management and Directors with significant ownership stakes are especially motivated to act in the best interest of shareholders. It also indicates that those who know the company best, the management and Directors, believe in its future prospects and are invested alongside their shareholders.

• Equal voting rights: Some companies have multiple classes of shares with either no voting power or disproportionate voting power. Without an equitable "one-share, one vote" structure, underperforming management teams may be able to maintain control without the majority support of the shareholder base. One of the best ways to enhance the accountability of a corporation is to ensure that all shareholders can express their views equally through voting.

Why is corporate governance important?

Weak corporate governance exposes investors to several risks that can damage a company's reputation and share price, such as fraud, unethical behaviour and accounting irregularities. One of the many issues that brought down Enron was that the independence of the Board of Directors was compromised. Consequently, the Board willingly suspended Enron's code of ethics to allow the company's CFO to create private partnerships where he was able to profit personally and conceal billions of dollars of Enron's debts and liabilities.

Beyond simply avoiding financial disasters, effective governance can enhance operational performance by encouraging the more efficient use of corporate assets and improving decision making through increased oversight. Furthermore, investors are more willing to lend to companies with shareholder-friendly policies. This allows companies to raise capital more cheaply, potentially boosting growth. Academic evidence shows a positive link between good corporate governance and investment performance . As seen in the chart below, stocks with better governance ratings have historically earned higher returns with lower volatility than the overall market[ii].



While good governance does not guarantee good returns, poor governance does increase the likelihood of scandals that may hurt shareholders. The longer an investor's time horizon, the more important governance considerations should be to them. At Cidel, an in-depth analysis of corporate governance is a key part of our approach to maximize long-term risk-adjusted returns for our clients.

i Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," Quarterly Journal of Economics, January 2009

ii Linda- Eling Lee, "Raising Minimum Governance Standards: Selecting Quality Companies for the Long Term", MSCI Research, December 2015

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