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Why Investors Should Focus On 'Non-Financial Issues'

Mike Scott | Jan. 17, 2014

Once a niche corner of the market, analysis of environmental, social and governance (ESG) trends is increasingly taking centre stage, as illustrated by the recent news that the US energy group FirstEnergy FE -0.67% has agreed to calculate its carbon emissions, with a view to reducing them, after investors including the pension funds of New York and Connecticut asked it to become more sustainable.

"FirstEnergy is taking important steps today for shareholder value and the environment by looking holistically at how climate change is affecting the company over the long term," New York Comptroller Thomas P. DiNapoli said. "Companies are enhancing long-term shareholder value when they prepare for future regulations that reduce greenhouse gas emissions."

Amelia Timbers, energy programme manager at As You Sow, which along with the two states had filed a shareholder resolution that was withdrawn after the company agreed to take action, added: "The withdrawal of this proposal demonstrates that companies are starting to realise that investors are serious about climate change and want to see progress towards major greenhouse gas reductions. We have observed that companies that aggressively pursue climate solutions are some of the most profitable and admired in the sector."

FirstEnergy's move chimes with the issues raised in a new report, ESG Trends to Watch, in which the information provider MSCI has identified a number of ESG trends to look out for in 2014. The first issue it identifies is – to divest or not to divest? Momentum is building. The 350.org campaign garnered a high profile in 2013 but its successes were mainly restricted to university investors. However, Scandinavian investor Storebrand and Dutch bank Rabobank also announced they planned to sell their fossil fuel shares and now the UN's climate chief Christina Figueres has called on other institutions to follow suit. "The pensions, life insurances and nest eggs of billions of ordinary people depend on the long-term security and stability of institutional investment funds," she told an investment conference in Doha. "Climate change increasingly poses one of the biggest long-term threats to those investments and the wealth of the global economy."

For most investors, outright divestment seems drastic to say the least, says Linda Eling-Lee, global head of ESG research at MSCI. "Yet, from a financial perspective, even the outside chance that some reserves could become 'stranded assets' if a red line is breached should prompt a hard look at the assumptions underlying the valuation of fossil fuel producers." The firm expects investors to address the issue in a variety of ways, ranging from fully excluding holders of carbon reserves to increasing exposure to clean technology, as well as by engaging more with companies as New York, Connecticut and As You Sow did.

The next trend on MSCI's agenda is the challenges facing emerging markets, where previously stellar growth rates in countries ranging from Turkey to South Africa to Brazil have been marred by social protests and strikes, reflecting the fact that rapid growth has masked the lack of progress in improving the lot of the poor. For investors, the question is whether limited progress in converting economic prosperity into an expanded pool of economically productive people could portend future limits to growth, says Eling-Lee.

While income disparities and human development indicators do not feature heavily in country credit ratings, "the long term ability of countries to sustain economic growth depends also on its ability to harness its natural resources and develop its human capital base", she adds.

This is where ESG analysis can play a crucial role in making sure investors have the full picture when it comes to risk factors. "For example, of the 91 countries we analyzed in 2007, five out of the eight countries that had the largest discrepancies between their ESG rating and their credit rating received a credit rating downgrade sometime in the next four years. The five countries were Egypt, Italy, Portugal, Spain, and Tunisia."

Using access to basic sanitation as a measure of a country's progress in improving the lot of the very poor, MSCI notes that Nigeria, Russia and Romania "experienced either no progress or deteriorating access rates, despite a large gap with Developed Market Standards" while Brazil, South Africa and Turkey all made minimal progress. Such a lack of progress signals not only potential limits to the economy's skill base but also weak government effectiveness in addressing pressing social and economic needs, which should give investors pause for thought.

More positively, the group highlights the growth of green bonds, where the money is allocated to environment-friendly activities, in 2013 and says the market "is likely to take off" in 2014. With many of the first green bonds issued by the multilateral development banks such as the World Bank and European Investment Bank, investors have been confident in the integrity of the environmental claims as well as the likelihood of earning the advertised return. But as more commercial players enter the market, there will be a need for standards such as those proposed by the Climate Bonds Initiative, to ensure the transparency and credibility of green bonds.

Investors will need to be cautious, or at least aware of the risks, of investing in green bonds from "dirty" issuers – for example if an oil company issues a green bond and then experiences a major oil spill, it could lead to reputational risk for any investors in that green bond.

The report also highlights the continuing shift in ESG investing from an approach based on excluding certain sectors to a best-in-class approach "as investors embrace integration of ESG assessments into their investment processes."

However, Eling-Lee adds: "While a best-in-class approach may help reduce exposure to ESG risks within a sector, it typically is not designed to address differences in the environmental and social sustainability of different sectors – differences that are driving rapid depletion of the global stock of key resources." But now some investors are looking at the resource intensity of different sectors as a risk factor. This may push increased investment towards sectors with lower resource dependency, such as financials, technology and healthcare, and away from energy, materials and consumer staples companies. If this trend becomes entrenched, the more resource-dependent sectors could see their cost of capital rise significantly.

Another challenge for companies will be the continuing controversy around the tax they pay and where. While the issue has garnered a great deal of media attention and consequent reputational damage for companies such asStarbucks SBUX -0.69%, Amazon, Google GOOG -0.63% and Apple AAPL +0.88%, policymakers have been slower to take action. MSCI believes that 2014 will the year when they catch up, in the wake of plans to increase tax transparency last year from the OECD, the G20, the G8 and the EU. "Increasingly, major accounting firms are telling their corporate clients to re-examine their tax strategies with a view to mitigating reputational risk and to anticipating greater disclosure requirements on where taxes are paid," the report says.

There are two key areas of vulnerability investors need to be aware of – first, those companies that pay far less tax than the average rate of corporation tax in the countries where they operate, even if this is perfectly legal. Such companies make easy targets for the media, politicians and activists. Second, companies with subsidiaries in tax havens are likely to face some tough questions and calls to justify their presence in those locations. Some 21.4% of the 1,595 companies in the MSCI World Index paid tax rates substantially below the weighted average tax rate of the countries in which they generate revenues – these 213 companies paid an average of 19.3% tax while the rest of the index was paying around 34%. That is some $70 billion a year in tax lost to governments and leaves these companies with some tough questions to answer, as well as threatening their licence to operate and leaving them vulnerable to pressure from governments to “pay their fair share”.

The issues highlighted above don’t feature in most investors’ analysis of potential investments – but they are great examples of why they should.

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