CBSR

ES&G Forum 2014

Post-Forum Report

ES&G Forum 2014 Non-Financial Performance…*a missed opportunity?*

PRESENTED BY: encana

The 2014 ES&G Forum's purpose

- To provide a forum for business management, investment, and ES&G professionals to discuss emerging ES&G trends.
- To showcase new research and investment knowledge relevant to ES&G.
- To identify current ES&G trends and practices in local and global markets and the subsequent impacts on Canadian businesses, particularly main industries centred in Calgary.

GLOSSARY

CDP	Carbon Disclosure Project
ES&G	Environmental, Social and Governance
GHG	Greenhouse Gas
LTI	Long-Term Investments
Long-Termism	Having a Long-Term Mindset
IVM	Internal Value Modeling

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FORUM OVERVIEW

Canadian Business for Social Responsibility (CBSR) held its third annual ES&G Forum to highlight the new investor trends that seek to reshape organizational performance measures and assessments beyond traditional standards. These include non-financial performance assessments categorized in three areas: environmental, social and governance (ES&G). Building from the pre-Forum briefing document (see http://bit.ly/esg2014-preforum), this document provides an overview of the Forum's discussions and highlights significant emerging themes.

In the past, ES&G was regarded as an option with questionable positive returns. But it is now becoming a strong indicator of business value. Reviews of stock market performance for strategically oriented ES&G firms show strong financial gains. For institutional investors (who have been the leaders in using ES&G guidelines and checklists in their investment portfolios for a number of years), this just made good sense as ES&G aligns with the institutions' stated values. However, for mainstream investors the need to include ES&G has not been regarded as being vital.

The Forum's Advisory Committee challenged the speakers to respond to four questions:

1. What practical advice can you give to help companies link their non-financial (namely, ES&G) and financial performance and how can they best communicate their results?
2. How do public companies in the energy and/or extractive industries successfully implement responsible investment strategies?
3. Is there evidence of investors divesting their holdings in companies that do not measure up to their ES&G criteria?
4. What is the role of regulatory bodies (such as the SEC in the USA) in helping investors understand the relevancy of ESG information?

The discussions were kick-started with a keynote address from Jonathan Bailey, Engagement Manager at McKinsey. Three Panel discussions covered the topic of ES&G from the viewpoints of Investors, a panel of developers and/or users of ES&G investment guidelines and ratings, and a panel of investor relations executives. This report summarizes discussion topics and recommendations made by each of these panels.

What/who is a "responsible investor"?

"Anyone contributing to the Canada Pension Plan is a responsible investor."

Patti Dolan

Jonathan Bailey, Engagement Manager, McKinsey
Bailey discussed a recent collaboration between McKinsey and the Canada Pension Plan Investment Board (CPPIB) that investigated the value of long-term capital investment, the link between long-termism, sustainability, and strategic long-term indicators (beyond the next investment cycle). He explained that the phrase “long term” can vary depending on the industry and asset class. He cited the oil and gas industry as an example in that it takes several years to find a well to drill then build the infrastructure needed before the oil flows. As well, it took Proctor & Gamble, Coca Cola and Walmart between eight and eleven years to become profitable in China. Unilever, Puma, Natura and IBM have each established and published metrics that are driven by sustainability *as well as* financial performance.

A recent McKinsey Quarterly Survey of more than 1,000 C-suite executives and board members indicated 44% establish corporate strategies for three years or less. Other examples of the trend towards short-term investments include:

- Asset managers’ compensation packages still focus on cash incentives.
- Intrinsic investors that have a long-term view of corporate strategy and ES&G are losing influence.
- Savers change funds every 3–4 years, prompting asset managers to compete for assets.
- A year of poor short-term returns is more likely to result in downgraded ratings/values.

Bailey concludes:

- Companies that talk short-term tend to attract short-term investors, and vice versa for long-term. His advice is that when considering ESG strategies and investments, factors such as creativity, communication, and target market identification all can have a significant impact on a project’s and/or company’s success.
- Investors penalize long-term corporate investments by using discount rates that are 5% to 10% higher than what the risk and actual returns should justify.
- Pension funds are becoming less active in their investment portfolios.
- Companies that tend to react to short-term pressures are less likely to be able to respond to externalities. The result can be weaker long-term performance, exacerbated by higher operating costs, supply chain disruption and reputation damage that, in turn, can negatively impact operations, attempts at expansion, costs and supply chains.

Examples of Future Solutions
Asset owners and corporate boards are two groups with a disproportionate capacity to influence change within investment practices that can influence a general shift towards gaining a long-term investment mindset. Pension funds have led the way. The Ontario Teachers’ Pension Plan and the Canada Pension Plan Investment Board have both allocated capital assets to long-term investments. GIC, Singapore’s sovereign wealth fund, has a 20-year time horizon for its investment value creation targets and Berkshire Hathaway uses the rolling five-year average performance of the S&P 500 rather than annual returns to signal its longer-term focus. Another investment fund leader, bcIMC, was the first large pension plan to establish a thematic investing portfolio and then capitalized on it in 2013.

Advice for Companies
Bailey recommends the following for companies and their board members:

- Articulate a long-term value creation strategy that includes metrics that show value creation.
- Communicate what they are doing with their investors.
- Select board directors with proven experience and knowledge.
- Educate board directors on the long-term business strategy.
- Assign a director to liaise between management and investors with a focus on eliminating short-term pressures.
- Increase director compensation to align with the level of risk they take on.
- Align the span of long-term metrics with targets that meet investment expectations by identifying long-term market trends.
- Use internal value modeling as a tool to measure company value.

1,200 institutional investors have signed up to the UNPRI with a collective investment value of over $300bn.

INVESTOR PANEL

Three policy makers and implementers from leading investment management organizations were asked to share their insights on the value (or not) of using ES&G and to explain how including ES&G considerations has changed (or not) the way their organization operates. The following table summarizes their advice:

COMMENTS AND RECOMMENDATIONS FROM INVESTORS TO:

INVESTORS	COMPANIES	EVALUATORS/RATING ORGANIZATIONS
To incorporate ES&G into your investment strategy, review external proof points, e.g., use third-party reports from trusted organizations such as the UNPRI and Sustainalytics. Complement this with internal education and dialogue.	Integrated reports provide useful (benchmarkable) data, e.g., in the energy sector typical base indicators are LTI, energy consumption, GHG emissions, and water usage.	Investors use metrics (such as standard ratio analysis) to determine how investment decisions impact investees' financial performance. However, they need more ES&G indicators to predict stock performance.
Incorporate ES&G data into your investment decisions and work to get your people comfortable with using ES&G to assess performance.	Standardized performance metrics for public disclosure would help companies save time and reduce metric indicator redundancy for investors.	Review carbon intensity and evaluate which companies are performing well in the carbon sector.
There is a noted increase in client requests to invest in funds that are driven, or at least influenced, by ES&G factors. Internal education/knowledge sharing can help convince employees in investment firms of the benefits in using ES&G guidelines.	Pay attention to the internal governance structure – which is a leading indicator of good business practices.	A long-term perspective depends on the market. It is frustrating when investors are judged on quarterly performance while the investment outlook is long-term.
Divestment from fossil fuels is not the best approach. More efficient is to have a balanced mix of investments in a portfolio; placing limits on investments in carbon heavy companies.	Talk with investors about your corporate governance and stakeholder engagement practices. Be sure to discuss issues (perceived or real).	Beyond compliance, performance management systems tend to be punished by the market. ES&G portfolios do not typically outperform non-ES&G portfolios.
Proxy voting is great for investors to exercise when stock options are tied to long-term equity because the focus is on ROI rather than an increase in stock price.	Some companies proactively call the investor community, particularly to discuss governance issues. This is good practice.	Regulated reporting on the core ES&G data sets would be highly beneficial.
A good investment manager ignores debates such as on carbon and emissions. Instead, they use facts to educate clients and pay attention to investors' objectives and appetite for risk.	The majority of ES&G data is sourced directly from voluntarily disclosed data from companies. The lack of standardized reporting methods is a challenge for asset managers.	
Investors are increasingly tying their compensation and remuneration to longer-term objectives.	Companies are reaching out to investors more and more, especially about compensation issues.	
Clients like to know about their investment companies' ES&G issues and efforts, but they still favour attractive financial returns.		

Fossil-Free Portfolios?

Institutional investors are expressing interest in fossil-free products and carbon-light portfolios. There are investment models set up that exclude the fossil sector, e.g. a fossil-free index was launched in April 2014. However, so far they have not had a significant or negative impact on the oil and gas industry. In Canada, it is a challenge to segregate carbon-light and fossil-free securities from a portfolio, while globally, it *is* possible.

ES&G EXPERT PANEL

This panel comprised expert developers and/or users of ES&G investment guidelines and ratings that use ES&G research and guidelines to evaluate and rate investments. Their insights into the value and challenges of ES&G are summarized in the following table.

COMMENTS AND RECOMMENDATIONS FROM ES&G EXPERTS TO:

INVESTORS	COMPANIES – INVESTOR RELATIONS	EVALUATORS/RATING ORGANIZATIONS
Anticipate that it may take time to realize positive results from companies' ES&G efforts.	Companies should align their operations to address human rights (HR) considerations, particularly as they relate to managing relations with Aboriginal groups.	GISR stimulates growth in the investment market and drives continuous improvement by using standardized ES&G indices based on Centre for Ratings Excellence (CORE) principles.
Understand the UNPRI.	Align with the UNPRI, particularly on HR – a vital consideration in supply chains and for joint ventures.	Evaluators such as MSCI establish indicators for risk factors that already (or potentially) have a material impact on companies.
The next frontier for ES&G research is to focus on ratings and data.	Companies have a responsibility to report, conduct due diligence and to commit to land remediation.	Significant risks and best practices can be identified by reviewing health and safety data.
Investors are increasingly curious about international standards.	Not every company can or will choose to use the UNPRI principles. It is easier for national companies than multinational companies to implement the principles.	Raters should help companies establish the most relevant data to benchmark and track.

GISR'S GUIDE TO MOVING PAST MARKET BARRIERS TO ACHIEVE BREAKTHROUGHS USING MEASUREMENT:

MARKET ELEMENT	FROM BARRIERS…	TO BREAKTHROUGHS…
Materiality	Values	Value
Metrics/KPIs	Qualitative	Quantitative
ESG Research Coverage	Niche	Critical Mass
ESG Measurement	Policy and Procedures	Performance and Context
Benchmarking	Index-based/Universal	Sector-based
Investors	Exclude "externalities"	ESG "integration"
Asset Owners	Ignore	Engage
Sustainability Initiatives	Complexity and Competition	Clarity and Collaboration
Frameworks and Standards	Proliferation	Harmonization
Companies	Transparency	Transformation
Leadership @ Scale =	**Disclosure**	**Measurement**

INVESTOR RELATIONS PANEL

The panel of investor relations officers represented the oil and gas, waste management, engineering, and banking sectors in Canada. They shared insights into how they use (or not) ES&G guidelines and the results. The following table summarizes their advice:

COMMENTS AND RECOMMENDATIONS FROM INVESTOR RELATIONS EXPERTS TO:

INVESTORS	COMPANIES – INVESTOR RELATIONS	EVALUATORS/RATING ORGANIZATIONS
Market trends indicate investors are scrutinizing companies' environmental and social factors.	Investor relations professionals must understand the issues and impacts surrounding safety, industry, community and environmental practices. This includes determining which company actions are material, i.e., sufficiently significant to have to be publicly reported, including a company's external impact on people.	There is substantial evidence that investors are reading evaluators'/raters' reports.
Companies' performance reporting is evolving. They establish targets and meaningful key performance indicators (KPIs) that benefit investors so they are now given serious internal attention.	Manage your time and effort dedicated to sustainability matters – it usually fluctuates: increasing before AGMs and releasing public reports. Usually less than 10% of your time may be spent on sustainability matters (30% to 40% if governance is part of your job).	More questions are coming from European Union investors than North American investors and are usually focused on water, e.g., assessing the amount of revenue that is derived from water.
Investors use proxies mostly for governance issues and sometimes to address environmental concerns.	The evolution of reporting to include both qualitative and quantitative data is challenging IR specialists who are more used to reporting just quantitative data. Sustainability reports cover leadership, carbon emissions and a more collective approach for reporting that demands effective communications strategies.	The Sustainability Accounting Standards Board (SASB) materiality standards in the USA are currently being reviewed by Canada's Certified Professional Accountants Association (CPA).
Investors do not usually ask with which indices a company is aligned. But it is still helpful to be part of an index.	Activist investors are paying close attention to how companies manage their governance. All their questions should be immediately addressed and tracked.	Regulators tend to focus on short-term results, so investor relations review and report quarterly.

Today's Investor Relations role is multidisciplinary – covering marketing, communications and shareholder relations.

Advice for Investor Relations Officers

- Figure out who is your target audience, i.e., to whom you are writing the report.
- Conduct a Materiality Assessment to identify what is important to both your internal and external stakeholders and use the results to establish benchmarks.
- Externally, engage with analysts such as MSCI.
- Internally, engage the entire organization, especially your leadership team, to determine what really matters for the business and establish a multidisciplinary group comprising legal, strategy, IR, marketing, sustainability professionals.
- Be sure that data submitted to regulators are consistent with data sent to other stakeholders, including the media.
- Look at what other companies are doing and use an established framework such as the Global Reporting Initiative (GRI).

Where to Start

- Determine the value in reporting your company's sustainability efforts because it varies by industry, i.e., determine what risks there may be if not producing a report.
- Be proactive – start by agreeing internally what data should be collected and the process before preparing reports.
- Find out which data you already have and ensure it aligns with the business strategy.
- Start collecting as much data as possible, then narrow your focus down to tracking and measuring 1) data that will respond to external stakeholders' questions and expectations, and 2) data that will provide insight into internal functions, achievements, gaps and challenges.
- Climate change must be part of the Board and senior management's team considerations; it should also be considered throughout the supply chain.
- Look to your industry associations for guidance.
- Review your company's long-term projections to anticipate ES&G reporting needs.
- Engage a team of external advisors to provide advice and to critique internal efforts.
- Consider third-party verification to address transparency challenges.

Barriers to ES&G

During the Forum, challenges were mentioned as being real or potential barriers to the integration of ES&G principles into investment management. The first was terminology, where terms and acronyms (such as ES&G) are not yet embedded into standard business language and strategies (including budget considerations and the alignment of ES&G metrics with executive compensation).

Technical workers are thought to be paying the least attention to how their work impacts, or may impact, their employer's Social License to Operate (SLO).

The absence of a standardized set of metrics for tracking and reporting ES&G practices means investment analysts tend to request data that is not readily accessible. Internal practices and processes may not yet include ES&G or CSR considerations.

Business education now includes CSR. However, senior executives may have graduated before this transition as there were a number of discussions on the need for structured guidance and leadership on the integration of ES&G into business.

CONCLUSION

ES&G needs to be embedded/integrated into the business strategy and managed at the same level as all other business decisions. There was a general consensus at the Forum that the best way is to work with senior executives (decision-makers), starting with those who already value CSR issues, and work with them to align business strategies with ES&G targets. There is also a need for accounting and finance professionals to better understand, and be able to implement, systems that can track and measure CSR strategies (focusing on identifying the value of sustainability, such as reduction and efficiencies) according to business goals.

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