SUSTAINABLE PERSPECTIVE
For the Mainstream Investor

Sustainable Insight
CAPITAL MANAGEMENT

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S is for social

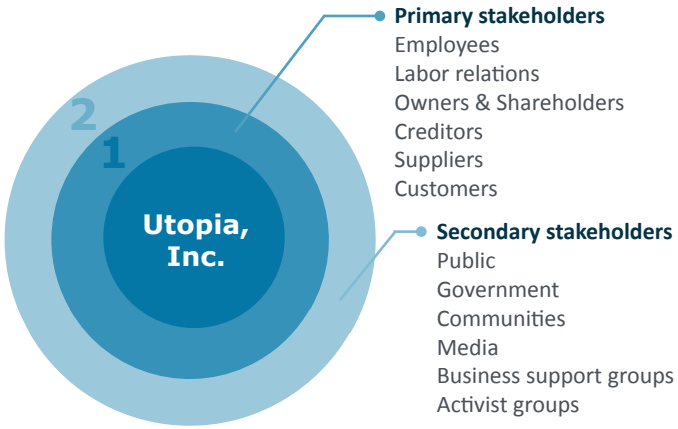
Does analysis of social data on companies – the 'S' in ESG – help investors make better decisions? Our research shows the answer is a qualified yes. In fact, the influence of social factors – such as employee welfare, supply chain relations and community impact – on investment performance seems to be increasing. 'Social', however, continues to lag the predictive power of the other two pillars of environmental, social and governance (ESG) investing. Moreover, our analysis indicates that particular care is needed when applying social factors to an investment process.

This paper explains the social pillar and discusses its strengths and limitations as a driver of investment performance. We then share our analysis of the predictive power of social ratings.

What is the social pillar?

The social pillar of ESG is all about a company's relationships: internally with staff and shareholders (primary stakeholders); and externally with the general public and communities (secondary stakeholders).

From an investment perspective, the basic idea is that social relationships matter as much to a company's financial health as they do to an individual's wellbeing[i]. Theoretically, therefore, analyzing social factors – such as data on a company's workforce, the impact of its products on society, and customer satisfaction – should help an investor identify which businesses are more likely to prosper.



1. Primary stakeholders include any group with direct economic exchange with the company (i.e. creditors, suppliers and customers)
2. Secondary stakeholders include groups with no direct economic exchange of business (i.e. public, communities, media)
Source: SICM

MEDIA CONTACT: CAROLYN ROOSE carolyn.roose@sicm.com

More research needed

Is there research to back up the theory? Academics say that studies into the link between the social pillar of ESG and the market value of equities are still "scarce and inconclusive"[ii]. As a recent paper by the Investor Responsibility Research Center Institute (**IRRCI**) notes, to date "the focus has largely been on environmental and governance matters."[iii]

Nevertheless, there's a fair-sized body of evidence that social factors matter. According to one study, companies that boast higher employee satisfaction are persistently more successful[iv]: a portfolio weighted using a list of the '100 Best Companies to Work for in America' would have outperformed the market by 3.5% a year between 1984 and 2009.

Encouragingly, academics point to a big opportunity for investors that can identify social factors that are predictive of stock performance. Studies have found that equity markets are slow to recognize the value of intangible assets such as employee satisfaction; in fact, share prices only start to move when the intangible asset results in a more easily measured outcome[v], like rising sales (see 'Getting the measure of the social pillar' below).

Since you asked...

We're often asked which ESG data providers we use at Sustainable Insight Capital Management. The answer: many of them. There are some managers who only use one provider. But to us this is too restrictive and is rather like using only one source for traditional investment research. We believe that deeper insights come from understanding the strengths and weaknesses of the output from multiple ESG providers (see **our paper** on the topic).

Getting the measure of the social pillar

A common criticism of the use of social factors in investing is that they are difficult to measure. While it is true that there is a lack of standardization in the way companies report on social issues, things are changing quickly. For example, industry-specific accounting standards are being developed in the U.S. that will enable companies to report on material ESG issues in a consistent way[vi]. Standards for over 80 industries in 10 sectors can be found on the website of the Sustainability Accounting Standards Board (**SASB**).

Thanks in part to advocacy by investor groups, social factor reporting has improved significantly in recent years. Another leap forward in data quality and consistency is likely in the near future.

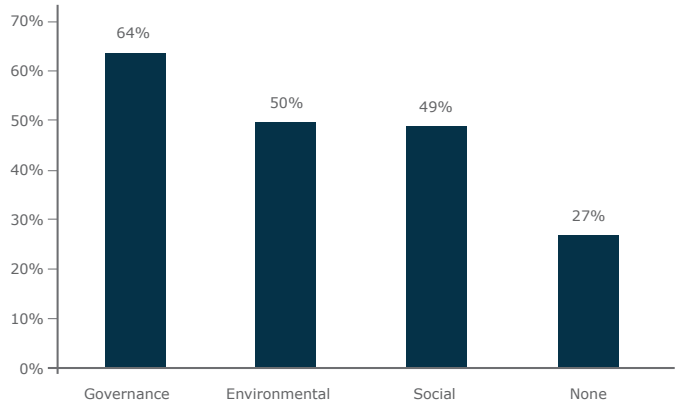


Figure 2: Which ESG factors do investors take into account?
Source: CFA Institute, 2015 survey of portfolio managers and investment analysts[vii]

MEDIA CONTACT: CAROLYN ROOSE carolyn.roose@sicm.com

Assume nothing

However, while it may seem intuitively reasonable that social factors have the potential to shape a company's fortunes, investors should not assume they can be used to predict future stock prices. After all, most people will be able to think of successful companies that have dire reputations, justified or not, for the way they treat staff, suppliers, and even customers. So how can investors identify which social factors will influence equity prices, and which are noise? The answer is to dig deep into the data.

ESG research and ratings

The primary repositories of corporate social data are the ESG research and ratings firms, such as MSCI ESG, Sustainalytics, RepRisk, ThomsonReuters and Bloomberg. They monitor and evaluate a broad range of factors. Though the precise data points each ESG provider collects varies, the major firms cover most, or all, of the main categories below. Specific factors that some providers track are also shown. Ratings vendors typically produce high-level social ratings on a company, as well as a breakdown by underlying factors.

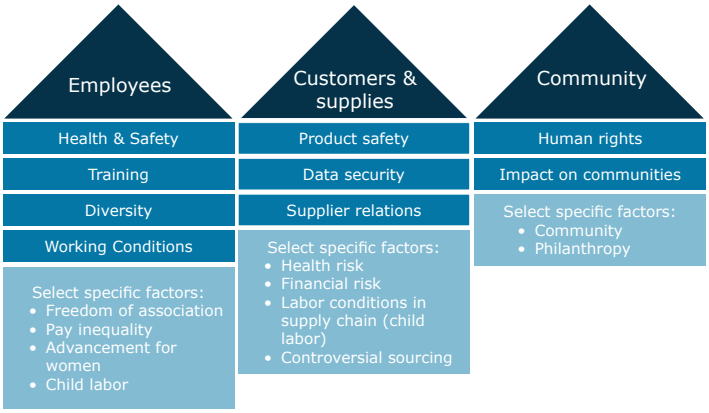


Figure 3: 'The components of 'S'
Source: SICM

Attitudes toward sugar turn sour

Alongside the research evidence, there are plenty of real-world examples of how social factors can shape a company's future. Consider the obesity epidemic, which is shortening lives and stretching healthcare systems to the breaking point. Back in 2005, The Economist ran an editorial[viii] arguing that businesses that ignore social factors like obesity are "turning a blind eye to impending forces that have the potential fundamentally to alter their strategic future."

The article was prescient. Over the subsequent decade, public authorities have made numerous attempts to curtail the activities of companies deemed to be contributing to obesity. For example, New York City's health department ran a subway ad campaign[ix] in 2009 urging citizens not to "drink yourself fat".

In 2014, Berkeley, CA became the first U.S. city to impose a soda tax[x]. The efforts appear to be working: soda sales in the U.S. have fallen for 10 years in a row[xi]. For soda makers, public opposition to their products remains a global challenge: a one-peso-per-liter tax on sugary drinks introduced in Mexico in 2013 resulted in a 6% decline in soda sales in the first year[xii]. The UK government is due to publish its strategy for tackling childhood obesity this summer. However, to the disappointment of campaigners it is unlikely to include a sugar tax.

Can social ratings and analysis help investors make better decisions?

ESG ratings provide a wealth of potentially useful information on a company's 'social' risks and performance. However, there are at least five reasons why investors should proceed with caution when using 'S' ratings to inform their investment decisions.

1 | Inconsistent data quality

The volume and quality of data that companies disclose on social-related issues varies widely. The UNPRI[xvi] notes that retailers, for example, are reluctant to disclose data about employee relations because they regard the information as commercially sensitive. The good news is that data quality is improving.

2 | Comparisons are difficult

Social ratings are not always directly comparable between providers. ESG ratings vendors collect different social data, use different analytical methodologies, and apply different weighting schemes to social factors.

3 | The relevance of each social factor will vary

Nor are ratings necessarily comparable from company to company. Our analysis shows that the significance of a social data point depends on the industry sector, country and even company-specific factors. It is also likely to vary over time.

Two to watch: diversity and wage inequality

Studies show the number of U.S. investors who consider diversity has risen significantly in recent years. As a sign of the times, in February 2016 an Apple shareholder attempted (unsuccessfully) to get the company to mandate more racial diversity in senior management and on the board.

More investors are also paying attention to pay disparity. Over the past four decades the ratio of CEO pay to that of median workers has grown from 30:1 to 300:1. "We may be near a tipping point," says data provider MSCI[xiii]. "We expect investor and academic focus could shift to how intra company pay structures are linked to economic growth."

From 2017 onwards, public companies in the U.S. will be required to disclose CEO-to-median worker pay ratios[xiv]. This could impact sales: a study by the Harvard Business Review[xv] found that consumers' purchasing intentions change when they know how much a company pays top bosses relative to ordinary workers.

MEDIA CONTACT: CAROLYN ROOSE carolyn.roose@sicm.com

4 | Social factors change

The nature of a social factor can change surprisingly quickly. Until recently, for instance, diesel was regarded as a socially useful product: ownership of diesel cars was being encouraged by a number of governments[xvii] as a way to cut CO^2 emissions. Now the fuel has been re-cast as a public enemy amid escalating fears over air pollution (see 'Hero to zero to hero').

5 | Analysis can be subjective

How should the diversity of a company's workforce be assessed and scored? What weighting should be given to diversity versus other components of a company's overall social rating? There is no one answer. Investment analysis usually involves some subjective judgment, but social factor analysis arguably requires more than most.

6 | Take care

In our view, none of these concerns negate the value of 'social' analysis and ratings to investors. However, they do highlight the importance of understanding in detail how the ratings are generated and what their limitations are.

In the next section, we present our own research into the relationship between social ratings and financial performance.

Hero to zero to hero

Even if influential social factors can be correctly identified, they may have surprisingly short shelf-lives. Take Nike's sweatshop problem. As CEO Phil Knight admitted in 1998[xviii], the brand had become "synonymous with slave wages, forced overtime, and arbitrary abuse." Activists mobilized against the company and sales fell.

Yet these days few people remember the 'Just don't do it' campaign. As Business Insider notes, the company has "executed one of the greatest image turnarounds in recent decades." Investors that stuck around have been well rewarded.

Nike: Ticking Up

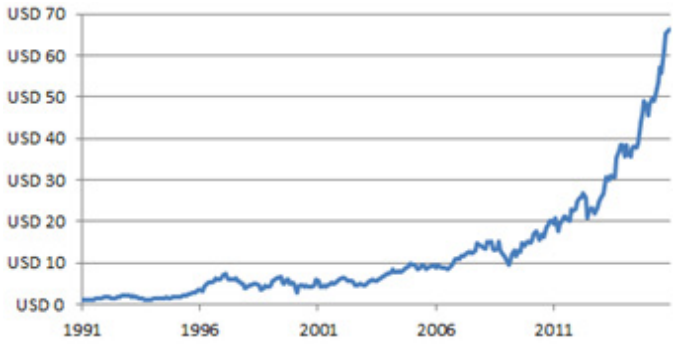


Figure 4: Nike share price since 1991, the year activists first published allegations about working conditions in the factories that supplied its products.

Source: Yahoo Finance

SICM Research: Exploring two key questions

SICM's own analysis highlights some of the complexities of using social ratings to inform investment decisions. (See Methodology on page 9 for more detail). We examined ratings from three major ESG data providers with the aim of answering two questions:

- What is the relationship between a social rating and equity returns?
- Can social factors be used to predict future equity performance?

Analysis #1: Social as a factor

First, we tested the relationship between the Social rating of the three vendors and returns of the MSCI World Index from July 2013 to December 2015. Using a multilinear regression model framework, we isolated the 'S' ratings as distinct factors (much as one might for other factors such as value, momentum or company size). This allowed us to strip out other influences and estimate the monthly return associated purely with the social factor.

We found that:

- Over the period, if a portfolio had a positive tilt to the 'S' factor, the component of return related to this tilt would have reduced the active return of the portfolio relative to the benchmark.
- The profiles of the returns from all three ratings are broadly similar. This suggests the three ratings vendors are fairly consistent in the effects they are measuring. See chart below.
- We also note the variation in the estimated 'S' factor returns over time. This could indicate that the social factor is behaving somewhat like a risk factor, ie capturing a component of the variation in stock prices and hence in portfolio returns.

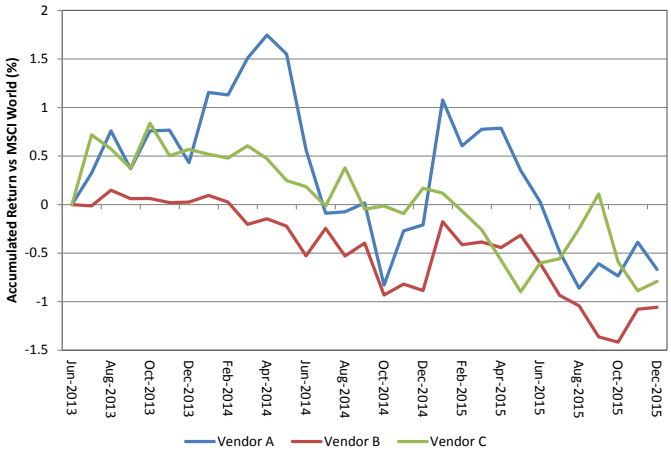


Figure 5: Pure factor return – Social
Source: SICM

Analysis #2: predictive power

The second way we tested the significance of social factors as a predictor of stock returns was to use quintile analysis. Using the North American utilities sector as an example, we ranked companies by their social score. We then grouped the top 20% (those with the highest score) into quintile one, the second 20% into quintile two and so on. Those with the lowest (poorest) social score were put in quintile five. All quintiles were based on market weightings.

We monitored the performance of each quintile over a month. At the end of the month, we adjusted the composition of the quintiles if any company's social score had changed. We then monitored the share price performance over the following month, and so on. The purpose of this analysis was to allow us to assess whether social scores have any forecasting power in relation to share price performance, while reflecting the dynamic nature of the ratings.

In the chart below we show the results of the quintile analysis, with performance measured against the S&P 500. We found that:

- There is a statistically significant relationship between the worst-ranked utilities (quintile five) and the underperformance of the S&P 500
- There is no meaningful relationship between the highest (best) scoring utilities and the share price outperformance or underperformance of the benchmark. Although there was a marked uptick in outperformance in the second half of 2015, the time period is too short to determine its significance.

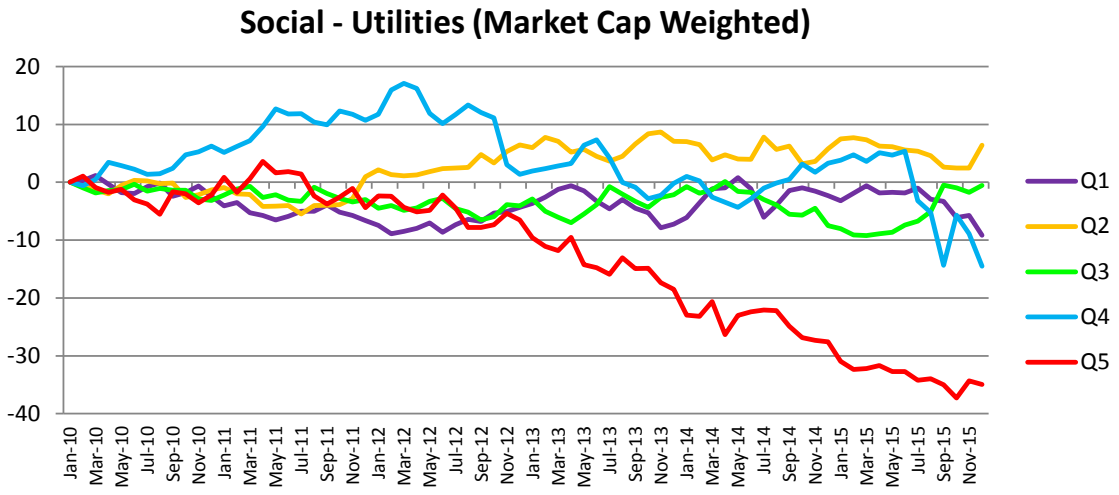


Figure 6: Quintile analysis - Social (Utilities sector)
Source: SICM

Conclusion: pay close attention

Our analysis suggests that social factors could be valuable to investors in two ways in particular:

- From the factor estimation results the social factor does capture some component of variation is stock prices. The mean return of the factor, in all three examples shown, was close to zero. From a risk modeling perspective there might be some merit in including the factor alongside other factors like momentum and size.
- At the sector level, as a possible performance differentiator amongst stocks.

But above all, our research highlights that it is crucial to understand the strengths and limitations of the underlying data, as well as the sectors and time horizons in which each factor is likely to have predictive power. This requires considerable effort, but the academic evidence suggests the potential rewards are significant. Markets are slow to recognize the value of intangible assets such as healthy labor relations, which indicates a valuable opportunity for active investors who can correctly interpret social data.

Even more encouragingly, social data could become increasingly powerful in the future. Thanks to the efforts of organizations such as the **World Bank**, the **UNPRI**, and the Sustainable Accounting Standards Board (**SASB**), the quality, quantity, and comparability of social data is improving all the time.

Until now, investors' primary focus has been on environmental and governance issues. But given the pressure on companies to improve transparency around social factors, the social pillar should merit increasing attention in the future.

Key Points

- The social pillar of ESG is all about a company's relationships: with staff, union workers, suppliers, customers and communities.
- Studies indicate that these relationships can have a bearing on a company's financial health.
- A number of data providers offer ratings based on corporate social factors, ranging from labor relations to data privacy to human rights issues.
- However, investors need to understand the strengths and limitations of the data.
- Presently, social ratings provide a weaker forecasting tool for share prices when compared to environmental and governance ratings.
- The quality of corporate social data continues to improve.

CONTACT

Bruce Kahn
bruce.kahn@sicm.com

Carolyn Roose
carolyn.roose@sicm.com

Paul Spence
paul.spence@sicm.com

John Willis
john.willis@sicm.com

Methodology & Comments

We examine the relevance of ESG factors on two levels. Firstly, we isolate each of the three main components of 'E', 'S' and 'G' and examine each one as a single factor. In this instance, we use the social scores provided by three major ESG data providers. By using a multilinear regression model framework that removes other effects such as sectors and investment styles we are able to estimate monthly returns associated with the social factor and determine the accumulated residual return associated with it. The performance of the social factor is compared against the MSCI World Index from July 2013 to December 2015.

Figure 5 on page 6 shows us that, by using the social ratings of these three data providers, the portfolio with a unit exposure to the factor would have initially underperformed the MSCI World Index, and not fully recovered these losses until January 2015. However, since July 2015, the portfolios of all three ESG data providers have produced positive returns against the benchmark. Note the broad similarity of the profile of the returns across the three vendors. This indicates that the vendors are measuring similar effects within the social category. This could suggest an improving significance of social ratings on share price performance, although a longer period of outperformance would provide a higher level of confidence. The consistency of the returns across all three data providers is notable. Also noteworthy is the variation in these factor returns. This could indicate that the Social factor is behaving somewhat like a risk factor, capturing a component of the variation in the underlying stock returns.

MEDIA CONTACT: CAROLYN ROOSE carolyn.roose@sicm.com

Endnotes

i. PLOS Medicine, July 2010: 'Social Relationships and Mortality Risk: A Meta-analytic Review'

ii. Marsat and Williams, January 2014: 'Does the market value the social pillar?'

iii. IRRC Institute, April 2015: 'The Materiality Of Human Capital To Corporate Financial Performance'

iv. Edmans, January 2010: 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices'

v. Edmans, January 2010: 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices'

vi. See www.sasb.org for more information

vii. CFA Institute, October 2015: 'Environmental, social and governance issues in investing

viii. The Economist, May 26, 2005: 'The Biggest Contract'

ix. New York Times, August 31, 2009: 'New Targets in the Fat Fight: Soda and Juice'

x. Time, November 5, 2014: 'Nation's First Soda Tax Passed in California City'

xi. Fortune, March 26, 2015: 'U.S. soda sales dropped for 10th straight year in 2014'

xii. Wired, July 13, 2015: 'Mexico's soda tax is working. The US should learn from it'

xiiii. MSCI, January 2016: '2016 ESG Trends to Watch'

xiv. SICM, August 2015: 'Insights 105'

xv. Harvard Business Review, May 2015: "Paying Up for Fair Pay: Consumers Prefer Firms with Lower CEO-to-Worker Pay Ratios"

xvi. UNPRI, December 2015: 'Quick reference guide: Engaging retailers on employee relations'

xvii. The Independent, January 25, 2015: 'Labour's drive towards diesel cars causing 'massive public health problem,' admits shadow Environment Minister'

xviii. Business Insider, May 9, 2013: 'How Nike Solved Its Sweatshop Problem'

Other SICM Research:

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