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Investment Publications Highlights

A Revolution in Equity Investing: A Deeper Dive into Nonfinancial Data

Bruno Bertocci et al., UBS Global Asset Management, July 2015

A firm's intangible assets play an important role in determining its value, yet traditional security analysis that relies strictly on financial data may not fully capture the value added by those assets. The authors believe a comprehensive approach to security analysis that incorporates financial and nonfinancial data, including those linked to sustainability issues, can reveal insights that might otherwise be overlooked.

Multiple studies have found that nonfinancial risks, like environmental performance and social considerations (i.e., labor disputes), can threaten cash flows and stock prices.[1] As the authors note, poor water-management practices in California have led many to question the sustainability of some agriculture businesses in the state. Companies that measure nonfinancial risks are better positioned than rivals to mitigate those risks and capitalize on any opportunities.

Analogously, analysts reviewing a company as a potential investment could look at nonfinancial data to understand risks (and opportunities) a company may face. For example, external stakeholders (e.g., shareholders, customers, suppliers, communities) are often the driving force behind a company's decision to systematically consider sustainability issues. Some stakeholders seek to pressure large companies with negative media coverage, believing this tactic may compel management to change a particular behavior. As stock prices can respond negatively to unfavorable media coverage, this tactic can be effective. For an analyst, determining how susceptible a company might be to such coverage would be an additional factor in assessing investment potential.

Identifying and measuring nonfinancial factors in ways that enhance security analysis are key challenges. Nonfinancial indicators of success are not obvious and may be difficult to determine. Responding to this challenge, some in the industry are pushing to identify, measure, and standardize the reporting of nonfinancial data so that security analysts can more easily access a broader mosaic of data. Access to better data on nonfinancial factors may help security analysts identify investment risks and opportunities that were not otherwise apparent.

[1] The authors cite: Dinah A. Koehler and Eric J. Hespenheide, "Finding the Value in Environmental, Social and Governance Performance," *Deloitte Review*, Issue 12 (2013): 98–111; and Caroline Flammer, "Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors," *Academy of Management Journal*, vol. 56, no. 3 (2013): 758–781.

Corporate Sustainability: First Evidence on Materiality

Mozaffar Khan, George Serafeim, and Aaron Yoon, Working Paper 15-073, Harvard Business School, Harvard University, Boston, MA, 2015

The link between corporate investments in sustainability initiatives and financial performance has long been unclear. The authors suggest the reason behind the lack of clarity hinges on the difference between "material" and "immaterial" sustainability factors, determining that firms with good performance on material sustainability factors significantly outperform firms with poor performance.

Investor interest in sustainability has been increasing in recent years, and companies have responded. Sustainability reports issued by companies have grown to more than 7,000 in 2014 from less than 30 in the early 1990s. Policy organizations have also responded—the Sustainability Accounting Standards Board (SASB) began creating industry-specific guidance on sustainability accounting standards in 2011.

To evaluate the link between sustainability factors and financial performance, the authors created a new dataset based on SASB standards and the MSCI KLD's firm-level performance ratings for sustainability issues. The dataset mapped performance ratings—which address specific topics in seven broad areas—as either material or immaterial based on SASB standards. For example, because a health care firm's energy management practices are judged to be materially relevant to the success of the firm by SASB, its MSCI KLD rating in energy management would be labeled as material. Because SASB industry standards differ, the same rating for a financials firm would be labeled as immaterial. The authors then developed an overall firm score for materiality based on the various performance ratings labeled material and analyzed it against the firm's future stock market performance.

The authors find that firms with a high overall score for materiality, meaning the firm has performed well on relevant sustainability issues, have better future market returns than firms with low scores. However, firms that have a high overall score on immaterial sustainability issues do not generate superior returns to firms that have low scores. The best market returns are achieved by companies that score well on material sustainability issues but poorly on immaterial sustainability issues, leading the authors to conclude that investment in material sustainability initiatives does create value for companies and shareholders. ■

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