FROM THE STOCKHOLDER TO THE STAKEHOLDER

HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE

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“Momentum building.”

Paul Polman
Chief Executive Officer
Unilever

“I am delighted that this report shines a light on the importance of sustainability for shareholders; values in business matter for investors. At M&S we have put Plan A, our ethical and sustainability program, right at the heart of our business. It makes perfect business sense as well as being the right thing to do. Our relationship with our customers, employees, suppliers and society is built on 130 years of trust; it is a vital part of our brand. Furthermore the work we have done on sustainability provided a net financial benefit to the business of around £145 million last year through efficiencies in energy consumption, packaging, less waste etc.”

Robert Swannell
Chairman
Marks & Spencers

“This report adds to the increasing body of evidence that companies with sustainable business models deliver improved financial returns, and that investors taking sustainability into account can deliver improved investment performance. Investors and companies take note.”

Jessica Fries
Executive Chairman
The Prince’s Accounting for Sustainability Project

“A truly important study, showing how financial performance goes hand in hand with good governance, environmental stewardship and social responsibility.”

Georg Kell
Executive Director
UN Global Compact

"This report strips bare the misplaced myths around sustainable investment, clearly demonstrating that ESG can add significant value for companies and investors."

James Gifford
Founding Executive Director
Principles for Responsible Investment

"Increasing attention is being paid to extra financial statement factors in determining the value and the quality of companies. This report is what every person interested in the ESG field and every investor should have on their desk – it is clear, comprehensive (wonderful reference materials), free of jargon and above all persuasive as to the need to take into account the impact of ESG elements."

Robert A.G. Monks
Founder of ISS, Hermes Lens Focus Fund, Lens Fund
and GMI (formerly The Corporate Library, now part of MSCI ESG Research)

"I welcome and recommend this report as a supporting study for all Japanese investors and corporate executives who proactively address ESG issues and stakeholder dialogues following the recent introduction of the Japanese Stewardship Code."

Masaru Arai
Chair
Japan Sustainable Investment Forum

"This report shows the solid effect of corporate sustainability practices on companies' cost of capital, operating and stock performance. Such convincing findings may be ground-breaking in the sense that the study may contribute to ending the hesitations related to benefits of or at least reluctance to ESG issues."

Ibrahim Turhan
Chairman & CEO
Borsa Istanbul

"The report shows that shareholder engagement is an effective way to invest responsibly, and that it enhances long-term corporate performance, and ultimately shareholder value."

Rob Bauer
Professor of Finance
Maastricht University

"Thanks to the leadership of some companies we now have a wealth of evidence supporting the idea that corporate financial performance should not be at odds with the interests of other stakeholders."

George Serafeim
Associate Professor of Business Administration
Harvard Business School

"The integration of environmental, social and governance factors into corporate and investment decision making has been gathering momentum over the last decade. This well-researched report succinctly highlights one of the key drivers underpinning this shift: sustainability and financial performance are linked. This piece eloquently explores why, now more than ever, sustainability should be on the agenda of senior executives and investment professionals alike."

Michael Jantzi
CEO
Sustainalytics

"I welcome this report, which provides a good survey of research into the economic benefits of corporate sustainability. Importantly, it suggests that owners of the business are key to good corporate governance and that active ownership can contribute to financial and investment performance."

Colin Melvin
CEO
Hermes Equity Ownership Services

"From The Stockholder To The Stakeholder highlights the increasing global awareness of ESG issues among a broad range of stakeholders and emphasizes the business case for the integration of ESG into all aspects of business."

Philipp Aeby
CEO
RepRisk AG

The Smith School of Enterprise and the Environment is a leading international academic programme focused upon teaching, research, and engagement with enterprise on climate change and long-term environmental sustainability. It works with social enterprises, corporations, and governments; it seeks to encourage innovative solutions to the apparent challenges facing humanity over the coming decades; its strengths lie in environmental economics and policy, enterprise management, and financial markets and investment. The School has close ties with the physical and social sciences, including with the School of Geography and the Environment, the Environmental Change Institute, and the Saïd Business School.

Arabesque Asset Management was established in June 2013 through a management buy-out from Barclays Bank PLC, which developed the technology from 2011 to 2013 in cooperation with professors from the universities of Stanford, Oxford, Cambridge and Maastricht. Arabesque and the Fraunhofer Society, a leading German semi-governmental think-tank and shareholder of Arabesque, entered into a strategic research partnership in 2014.

Arabesque offers a quantitative approach to sustainable investing. It combines state of the art systematic portfolio management technology with the values of the United Nations Global Compact, the United Nations Principles for Responsible Investments (UN PRI), and balance sheet and business activity screening. The integration of ESG research into a sophisticated portfolio management delivers a consistent outperformance.

Led by founder and CEO Omar Selim, Arabesque is headquartered in London and has a large research hub in Frankfurt, together with an Advisory Board of highly respected industry leaders and academics. Arabesque Asset Management Ltd is regulated by the UK Financial Conduct Authority (FCA). Arabesque (Deutschland) GmbH is based in Frankfurt with a focus on research, programming and advisory.

For further information on Arabesque's approach to sustainable investment management please contact Mr Andreas Feiner on +49 69 2474 77610 or andreas.feiner@arabesque.com

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CEO, ARABESQUE ASSET MANAGEMENT

We now live in a world where sustainability has entered mainstream. That much is evident from the fact that over 72% of S&P500 companies are reporting on sustainability, demonstrating a growing recognition of the strong interest expressed by investors.

This report, entitled [illegible], aims to give the interested practitioner an overview of the current research on ESG.

In this enhanced meta-study we categorize more than 200 different sources. Within it, we find a remarkable correlation between diligent sustainability business practices and economic performance. The first part of the report explores this thesis from a strategic management perspective, with remarkable results: 88% of reviewed sources find that companies with robust sustainability practices demonstrate better operational performance, which ultimately translates into cashflows. The second part of the report builds on this, where 80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance.

This report ultimately demonstrates that responsibility and profitability are not incompatible, but in fact wholly complementary. When investors and asset owners replace the question "how much return?" with "how much sustainable return?", then they have evolved from a stockholder to a stakeholder.

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Sustainability is one of the most significant trends in financial markets for decades. Whether in the form of investors' desire for sustainable responsible investing (SRI), or corporate management's focus on corporate social responsibility (CSR), the content, focusing on sustainability and ESG (environmental, social and governance) issues, is the same. The growth of the UN Global Compact,[1] the United Nations backed Principles for Responsible Investment (UN PRI),[2] the Global Reporting Initiative (GRI),[3] the Carbon Disclosure Project (CDP),[4] the Sustainability Accounting Standards Board (SASB),[5] the American [6] and European[7] SRI markets and the fact that more than 20% of global assets are now managed in a sustainable and responsible manner,[8] all bear strong testament to sustainability concerns. However from an investor's perspective, there exists a debate about the benefits of integrating sustainability criteria into the investment process, and the degree to which it results in a positive or negative return.[9]

This report investigates over 200 of the highest quality academic studies and sources on sustainability to assess the economic evidence on both sides for:

- a business case for corporate sustainability
- integrating sustainability into investment decisions
- implementing active ownership policies into investors' portfolios

This report aims to support decision makers by providing solid and transparent evidence regarding the impact of sustainable corporate management and investment practices. Our findings suggest:

- companies with strong sustainability scores show better operational performance and are less risky
- investment strategies that incorporate ESG issues outperform comparable non-ESG strategies
- active ownership creates value for companies and investors

Based on our results, we conclude that it is in the best economic interest for corporate managers and investors to incorporate sustainability considerations into decision-making processes.

We close the report with the suggestion that it is in the long-term self-interest of the general public, as beneficiaries of institutional investors (e.g. pension funds and insurance companies), to influence companies to produce goods and services in a responsible way. By doing so they not only generate better returns for their savings and pensions, but also contribute to preserving the world they live in for themselves and future generations.

1 For more information on the UN Global Compact, see: www.unglobalcompact.org.
2 Background information on the United Nations backed Principles for Responsible Investment (UN PRI), see: www.unpri.org.
3 See Global Reporting Initiative's website for further information: www.gri.org.
4 See www.cdp.net for more information on Carbon Disclosure Project.
5 For the SASB's mission statement, see www.sasb.org.
6 Forum for Sustainable and Responsible Investment (US SIF) (2014).
7 Eurosif (2014).
8 Global Sustainable Investment Alliance (GSIA) (2013).
9 See, for example, Milton Friedman's view on the social responsibilities of firms (Friedman, 1970) versus R. Edward Freeman's perspective on how firms can

In 2013, Accenture conducted a survey of 1,000 CEOs in 103 countries and 27 industries. They found that 80% of CEOs view sustainability as a means to gain competitive advantages relative to their peers.[10] Furthermore, the study found that “81% of CEOs believe that the sustainability reputation of their company is important in consumers’ purchasing decisions”.[11] On the contrary, they found that only 33% of all surveyed CEOs think “that business is making sufficient efforts to address global sustainability challenges”.[12]

One reason for this imbalance between acknowledging the importance of sustainability and acting on it is pressure from the financial markets’ focus on short-termism. [13]This clearly emerges from another survey conducted on behalf of McKinsey & Company and the Canada Pension Plan Investment Board (CPPIB), in which 79% of C-level executives and board members state that they personally feel “pressure to deliver financial results in two years or less”. [14]Tellingly, 86% of them note that this constraint is in contrast to their convictions, where they believe that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening longer-term financial returns and increasing innovation.[15]

There is however an increasing focus on longer-term thinking: a recent initiative, founded by the Canada Pension Plan Investment Board (CPPIB) and McKinsey, is bringing together business leaders from corporations, pension funds, and asset managers to promote longer-term corporate and investment management.[16] More broadly, numerous corporate leaders are taking decisive steps to implement a longer-term horizon within their companies. For example, under the leadership of its CEO, Paul Polman, Unilever has stopped giving earnings guidance and has moved away from quarterly profit reporting in order to transform the company’s culture and shift management’s thinking away from short-term results.[17]

Our research demonstrates that there is a strong business case for companies to implement sustainable management

10 Accenture (2013).
11 Accenture (2013: 36).
12 Accenture (2013: 15).
13 See Barton and Wiseman (2014).
14 Bailey, Bérubé, Godsall, and Kehoe (2014: 1).
15 See Bailey, Bérubé, Godsall, and Kehoe (2014: 7).
16 See Bailey, Bérubé, Godsall, and Kehoe (2014). More information can be found at www.FCLT.org

practices with regard to environmental, social, and governance (ESG) issues.[18] In other words, firms can 'do well while doing good'.[19] However, it is imperative that the inclusion of ESG into strategic corporate management is based on business performance.[20]

Sustainability is further important for the public image of a corporation, for serving shareholder interests, and for the pre-emptive insurance effect for adverse ESG events.[21] To put it another way: good ESG quality leads to competitive advantages,[22] which can be achieved through a broader orientation towards stakeholders (communities, suppliers, customers and employees) as well as shareholders.[23] Clearly management cannot meet all demands of all stakeholder groups at the same time. Rather, we suggest that by focusing on profit maximization over the medium to longer term, i.e., shareholder value maximization, and by taking into account the needs and demands of major stakeholders can a company create financial and societal value.[24]

In doing so, companies are required to appreciate the trade-offs that exist between financial and sustainability performance. Firms are required to implement sustainable management strategies that improve both performance measures (for instance through substantial product and process innovation).[25] To achieve this, companies are required first to identify the specific sustainability issues that are material to them. As recent research by Deloitte points out, "materiality of ESG data – like materiality for any input in investment decision-making – should be related to valuation impacts".[26] Table 1 shows a selection of ESG issues that, depending on the individual company in question, can have a material impact.

TABLE 1: SELECTION OF MATERIAL ESG FACTORS[27]

[illegible]	[illegible]	[illegible]
Biodiversity/land use	Community relations	Accountability
Carbon emissions	Controversial business	Anti-takeover measures
Climate change risks	Customer relations/product	Board structure/size
Energy usage	Diversity issues	Bribery and corruption
Raw material sourcing	Employee relations	CEO duality
Regulatory/legal risks	Health and safety	Executive compensation schemes
Supply chain management	Human capital management	Ownership structure
Waste and recycling	Human rights	Shareholder rights
Water management	Responsible marketing and R&D	Transparency
Weather events	Union relationships	Voting procedures

18 For business case arguments of corporate social responsibility and sustainability, see for example, Davis (1973), Hart (1995), Porter and Kramer (2002, 2006), Porter and van der Linde (1995a, 1995b).

19 A term used in the CSR context by David Vogel (2005: 19) and by Benabou and Tirole (2010: 9) to describe the 'win-win scenario' of CSR. Corporations adopt superior CSR standards to make the firm more profitable.

20 For a study on executives' perceptions of CSR and its business case, see Berger, Cunningham, and Drumwright (2007). See, for example, Davis (1973), Godfrey (2005), and Godfrey, Merrill, and Hansen (2009).

21 See, for example, Davis (1973), Godfrey (2005), and Godfrey, Merrill, and Hansen (2009).

22 Hart (1995), Hart (1997).

23 Kurucz, Colbert, and Wheeler (2009).

24 Jensen (2002), Porter and Kramer (2011). A similar statement has also been made by Smith (1994).

25 Eccles and Serafeim (2013).

26 Hespenheide and Koehler (2012: 5).

27 The data has been synthesized from several sources, including MSCI (2013), UBS (2013), Bonini and Goerner (2011), Sustainability Accounting Standards

The materiality of environmental, social and governance (ESG) issues differs substantially between industries. For instance, resource-intensive industries such as mining have a different exposure to environmental and social factors[28] than for example the commercial real-estate sector.[29] The Global Reporting Initiative (GRI) compiled a comprehensive overview about sector differences with regard to ESG issues. Over a period of ten years, the Global Reporting Initiative (GRI) has worked with a number of stakeholders to identify the most material ESG issues in different sectors[30] resulting in the G4 Sustainability Reporting Guidelines.[31]

Amongst others, there are three major ways how sustainability through the integration of environmental, social and governance (ESG) issues can lead to a competitive advantage: [32]

1. Risk:
   - *Company specific risks*
   - *External costs*
2. Performance:
   - *Process innovation*
   - *Product innovation*
3. Reputation:
   - *Human capital*
   - *Consumers*

Corporate managers should realize that the critical condition for translating superior ESG quality into competitive advantage is that sustainability has to be deeply rooted in the organization's culture and values. Companies must reframe their identity into organizations that are open to sustainability and encourage innovation to increase productivity. Only once this is done can a corporate culture be changed into a realm in which 'transformational change' can occur.[33]

A selection of case studies show that successful companies which build a competitive advantage from sustainability initiatives have a clear responsibility at the board level, clear sustainability goals that are measurable in quantity and time, have an incentive structure for employees to innovate and external auditors which review progress. Such companies are able to benefit from their sustainability programmes over the medium to longer-term.[34]

An analysis of corporate fines and settlements demonstrates the financial impact of neglecting sustainability and ESG issues. In Table 2, we show the ten largest fines and settlements in corporate history, which together amount to $45.5bn.[35] In the financial sector, banks have paid out $100bn in U.S. legal settlements alone since the start of the financial crisis,[36] and global pharmaceutical companies have paid $30.2bn in fines since 1991.[37]

28 See, Miranda, Burris, Bingcang, Shearman, Briones, La Vina, and Menard (2003).

29 World Green Building Council (2013). For an academic discussion of this issue, see also Eccles, Krzus, Rogers, and Serafeim (2012).

30 See Global Reporting Initiative (2013a).

31 Global Reporting Initiative (2013b).

32 Similar to the model developed by Kurucz, Colbert, and Wheeler (2009) and the United Nations Global Compact Value Driver Model (PRI-UN Global Compact, 2013).

33 Eccles, Miller Perkins, and Serafeim (2012).

34 See Loew, Clausen, Hall, Loft, & Braun (2009) for the collection of case studies on sustainability in firms from Germany and the USA.

35 Own research. The University of Oxford and Arabesque are running a database where a neglect of environmental, social and governance (ESG) issues led to payments in excess of USD 100mn through fines or settlements. The analysis of currently 136 cases shows that the sectors which have been most affected are financials, pharmaceuticals, energy, technology and automobiles which represent 90% of all fines and settlements.

36 McGregor and Stanley (2014).

FIGURE 1: BP'S SHARE PRICE COMPARED TO OTHER OIL MAJORS