



The Link Between ESG and Financial Productivity

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In Focus

While it is widely recognised that environmental, social, and governance (ESG) issues can affect a company's valuation and financial performance, dedicated ESG strategies have not been shown to conclusively deliver superior outperformance versus traditional equity strategies over the long term. This has led some investors to believe that there is a trade-off between achieving their investment objectives and fulfilling their ESG goals.

Our research suggests that investors do not have to choose between their return objectives and their values if they focus on “compounders,” or companies that demonstrate the highest level of financial productivity. These companies have strong ESG characteristics and the ability to deliver superior investment returns over the long term.

Investors are increasingly prioritising ESG considerations when making capital allocation decisions. However, reconciling sustainability goals and investment return objectives could prove to be challenging, as a strong emphasis on one could undermine the outcome of the other. We believe that approaches focused on companies with high levels of financial productivity could potentially help investors to satisfy both of these important objectives.

Here, we assess the relationship between companies' financial productivity, their ESG characteristics, and their equity returns, by:

- Drawing on our previous research that identifies financial productivity as a key driver of equity returns
- Demonstrating the link between high financial productivity and strong environmental and governance rankings and exploring why this relationship exists
- Discussing some of the strengths and limitations of using third-party ESG ratings
- Explaining the merits of using financial productivity as a starting point for ESG investors

Financial Productivity Satisfies Return and Responsible Investment Objectives

We believe a company's financial productivity is strongly linked to the performance of its share price, as we demonstrate in Relative Value Investing. The wider investment community tends to undervalue companies with the highest levels of financial productivity because they assume, as per economic theory, that the high returns generated by these companies will attract competition, thereby eroding future returns. In reality, these companies have competitive advantages that enable them to retain their market-leading status and sustain their high levels of financial productivity for longer than widely anticipated, which often results in share price outperformance. When a disciplined valuation approach is also applied, returns may be further enhanced.

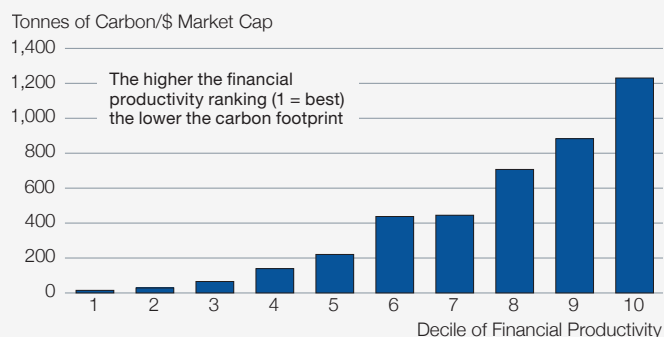
In addition to being positively correlated with equity returns, we also find a strong relationship between financial productivity and

environmental and governance ratings. To demonstrate the link between financial productivity and carbon intensity, we have grouped the active members of the MSCI AC World Index into deciles of reported financial productivity and then compared this with the average carbon footprint for each financial productivity decile, between 2015 and 2018. (Figure 1). The most financially productive companies (i.e., those that fall within the top decile of financial productivity) have the lowest carbon footprint.

We also found a similar relationship between firms' financial productivity and their MSCI governance ranking, as the most financially productive companies typically also have the strongest corporate governance practices (Figure 2).

Figure 1.

Financial Productivity and Carbon Intensity Are Closely Linked

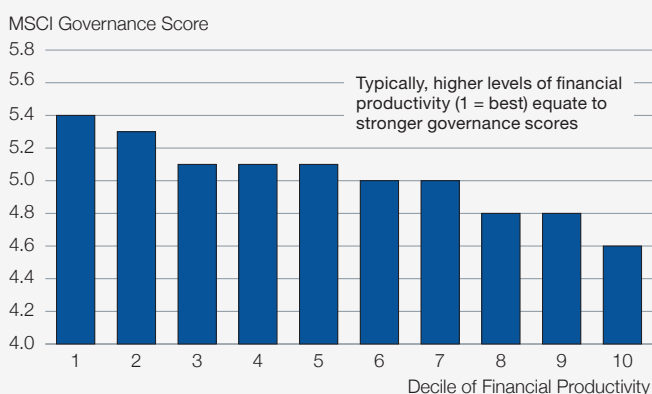


As at 25 May 2018. Source: Lazard, Credit Suisse, Trucost.

Carbon emissions data as at 31 January 2018. The active members of the MSCI AC World Index have been grouped into deciles of reported financial productivity and then compared with the average carbon footprint for each financial productivity decile between 2015 and 2018.

Figure 2.

Strong Governance May Enhance Financial Performance



As at 25 May 2018. Source: Lazard, Credit Suisse, MSCI.

Governance scores as at 31 January 2018. The active members of the MSCI AC World Index have been grouped into deciles of reported financial productivity and then compared with the average MSCI governance score for each financial productivity decile between 2015 and 2018.

The Power of Compounders

We believe that the strong relationship between a company's financial productivity and its carbon footprint can be explained by the company's asset intensity. Companies with the lowest levels of financial productivity tend to have higher levels of capital intensity (i.e., relatively more fixed assets on their balance sheet). The operation of these fixed assets, in particular plants and equipment, generally results in relatively high carbon emissions. Conversely, companies with the highest levels of financial productivity tend to have low capital intensity and this often means that they also have relatively clean environmental profiles.

Based on our investment criteria, we find few companies in asset-heavy sectors, such as oil, utilities, and infrastructure that

can sustain high levels of financial productivity either due to the commoditised nature of their products or services or due to regulations that are often designed to limit the allowable returns.

Asset-heavy businesses often have vertically integrated operations and a high level of physical assets on their balance sheet, so while they may have greater control over their supply chain and distribution, generating a strong return on assets could be challenging. This is because asset bases tend to be costly, resulting in a longer utilisation period to achieve returns on those assets. High upfront costs also mean these companies have greater difficulty in gaining scale.

Conversely, asset-light businesses tend to be more adaptable to changing market conditions and are usually easily scaled. In addition, they generally have lower operating costs and a stronger focus on innovation and brand building, resulting in relatively heavier investment in technology, research and development, and marketing. This creates sustainable competitive advantages, which is critical to a business, not only generating high levels of financial productivity, but also, sustaining it.

Additionally, companies with strong governance should create value for shareholders and investors over the long term as strong corporate governance tends to increase management's accountability and transparency and reduce excessive risk-taking. This can potentially drive more efficient use of capital and increase returns on assets over the long term. This is one reason why good governance should be a focus for all investors and helps explain the relationship between financial productivity and strong governance scores.

Financial Productivity: A Starting Point for ESG-Conscious Investors

Given the link between asset-intensive sectors (such as energy, materials, and utilities) and carbon intensity, a logical extension for investors seeking to improve their portfolio's environmental profile would be to screen out these sectors. While this would reduce the portfolio's carbon footprint the portfolio may still be exposed to carbon-intensive stocks in other sectors, such as consumer goods and food and beverage.

Equally, screening in companies with strong ESG characteristics (i.e., companies with low carbon emissions or high governance scores) could undermine investment returns. While our findings indicate that there is a strong positive relationship between the most financially productive companies and companies with the lowest carbon footprint and good governance practices, the opposite is not true. A portfolio of companies with the lowest carbon emissions and a portfolio of companies with the highest governance scores, would offer an investor the same level of financial productivity as simply investing in the MSCI AC World Index (Figure 3). As such, screening stocks in this way could have

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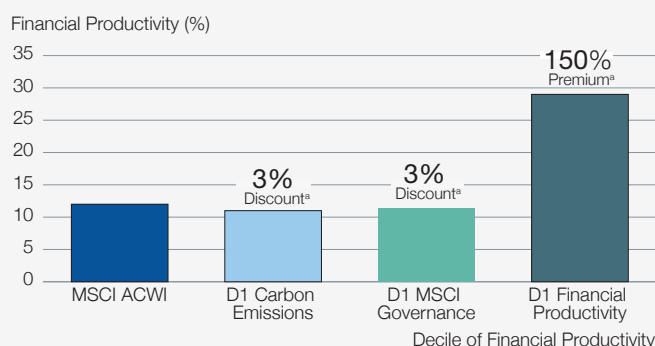
implications for investment returns over the long term, given the empirical evidence linking financial productivity and share price performance.

We believe that focusing on companies with the highest levels of financial productivity should substantially reduce a portfolio's funding of carbon emissions to bring it almost in line with a portfolio that invests solely in the least carbon-intensive companies in the index (Figure 4) while also offering significantly higher levels of financial productivity. A focus on companies with high financial productivity also results in an improved governance profile compared to the index (Figure 5).

We believe that by using financial productivity as a starting point in the stock selection process, the conditions for potentially outperforming global equity markets over the long term and meeting ESG objectives are simultaneously enhanced, as the investment characteristics of “compounders” allow for both of these investment objectives to co-exist.

Figure 3.

Leading with ESG Inputs Could Undermine Investment Returns



As at 25 May 2018. Source: Lazard, Credit Suisse, MSCI, Trucost.

a Financial productivity discount or premium to the MSCI AC World Index Governance scores and carbon emissions data as at 31 January 2018.

Shows the average financial productivity of companies in: the MSCI AC World Index, the top decile of carbon intensity (i.e., the least carbon-intensive companies), the top decile of financial productivity, and the top decile of MSCI governance (i.e., companies with the highest MSCI governance scores). Deciles are calculated across all active members of the MSCI AC World Index between 2015 and 2018.

The Strengths and Limitations of Ratings

While third-party ratings can offer useful insights, they do have some shortcomings. A broad-brush approach that uses third-party ratings to exclude certain stocks and sectors is suboptimal, in our view, as these approaches may fail to capture other companies with poor environmental, social, or governance practices. Simplistic exclusions could also unfairly screen out stocks based on naïve categorisations, rather than due to poor company fundamentals.

Corporate governance ratings are often based on assessments of board structure and leadership, remuneration and accounting practices, and issues relating to company ownership, to name a few. As an example of the flaws of third-party ratings, we highlight companies with a significant individual shareholder. External ratings providers tend to penalise these companies with a lower governance score, as the significant shareholder is perceived to have a disproportionate amount of influence on the board or in shareholder votes relative to other owners.

If a company has a low governance score due to its ownership structure, it may be screened out in an exclusion-based system. What is more important, in our view, is whether the interests of shareholders and management are closely aligned, and whether this aligns with the investment objectives of the investor. A family-owned company with a long-term strategy is likely to be more closely aligned with an investor with a long-term investment horizon compared to a company with a more diversified ownership structure focused on delivering strong quarterly results, possibly at the expense of its long-term success.

Measuring governance and environmental issues is a largely quantitative process, while measuring a company's social impact tends to be more qualitative. We believe that bottom-up, fundamental research could help to tackle the limitations of exclusion-based approaches and approaches that rely on third-party ratings. We analyse the ESG factors that we believe could influence a company's share price as part of broader fundamental analysis to determine how this will likely affect a company's future financial productivity and valuation.

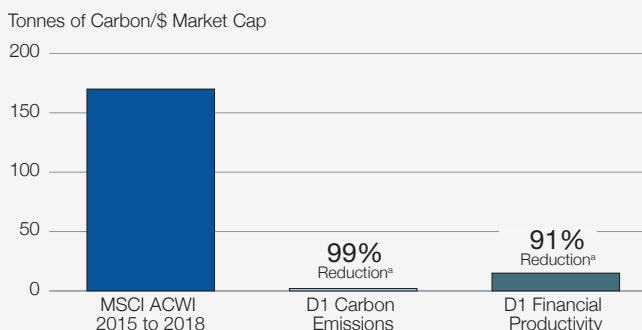
While there are shortcomings to screening an investment universe using third-party ESG ratings, these ratings can be useful tools when used as part of a thorough research process. Measures of ESG practices that are based on publicly available data also gives investors a means with which to track and compare different portfolios to ensure that an investment team's overall ESG approach is producing the type of portfolio that is in line with their expectations.

The Advantages of Rigorous Fundamental Analysis

We believe our research on financial productivity, share price performance, and ESG profiles makes a compelling case for financial productivity as a starting point for security selection, even when ESG factors are a core consideration. The companies that we consider for inclusion in our portfolios have high or improving levels of financial productivity and strong ESG characteristics. Our relative value investment philosophy focuses on value creation through bottom-up stock selection, primarily by assessing individual securities based on the relationship between valuation and financial productivity. Our rigorous investment approach incorporates ESG analysis into the investment and risk management process to continually monitor and track ESG issues.

Figure 4.

Companies with High Financial Productivity Have Relatively Clean Environmental Profiles



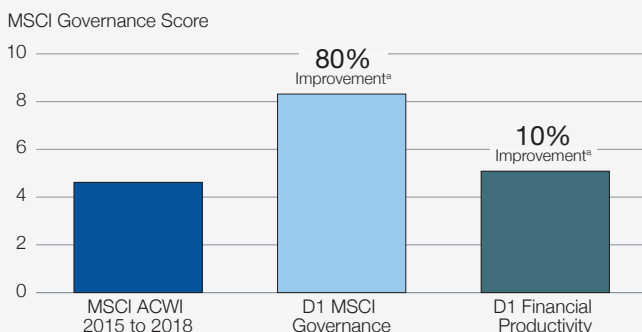
As at 25 May 2018. Source: Lazard, Credit Suisse, MSCI, Trucost.

a Reduction in carbon emissions versus the MSCI AC World Index. Carbon emissions data as at 31 January 2018.

Shows the average carbon footprint as at of companies in: the MSCI AC World Index, the top decile of carbon intensity (i.e., the least carbon-intensive companies), and the top decile of financial productivity. Deciles are calculated across all active members of the MSCI AC World Index between 2015 and 2018.

Figure 5.

Financial Productivity Can Also Enhance a Portfolio's Governance Profile versus the Market



As at 25 May 2018. Source: Lazard, Credit Suisse, MSCI.

a Improvement in average governance score versus the MSCI AC World Index. Governance scores as at 31 January 2018.

Shows the average governance score for companies in: the MSCI AC World Index, the top decile of MSCI governance (i.e., companies with the highest MSCI governance scores), and the top decile of financial productivity. Deciles are calculated across all active members of the MSCI AC World Index between 2015 and 2018.

We leverage Lazard's wider network of sector specialists who cover companies around the world and develop differentiated insights in an effort to determine the future direction of companies' financial productivity. This level of insight requires an understanding of each industry's drivers and firms' competitive positions within it, an appreciation of the incremental returns on capital that companies can achieve, an awareness of management's capital deployment decisions, and the potential impact of ESG issues on a company's financial performance. We believe our approach to fundamental analysis, which puts ESG analysis at its core, offers forward-looking insights that could potentially enhance long-term returns for investors.

Important Information

Notes

The teams measure financial productivity in different ways. For this paper, the authors concluded that the best approach was to use CFROI® (Cash Flow Return on Investment) for non-financial companies and RoE (Return on Equity) for financial companies. Note that CFROI® measures a company's ability to generate cash flow. It is an internal rate of return that equates the cash a business generates today with the cash (expressed in present value terms) that has been invested in the business. Essentially this means CFROI® is a better measure of "economic profit" than "accounting profit". It can thus be used to compare companies with differing leverage, across sectors and regions.

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