GOVERNANCE

ESG investors go in search of the boardroom G spot

Governance appears set to dominate the corporate agenda this year as painful decisions around restructuring and headcount reinforce the ongoing debate around the impact of business on communities

Virginia Matthews

With sexy, big-hitter issues such as climate change and the living wage to propel them onto front pages, it's little wonder that environmental and social matters have dominated the ESG agenda to date.

Yet as the clamour for purpose beyond profit continues to build, governance is shrugging off its whiff of worthiness to make 2021 a pivotal year for the business world's all-important G spot.

As fashion retailer Boohoo discovered last summer, being on the wrong side of history over allegations as incendiary as modern day slavery poses a severe and immediate risk to a firm's share price, putting every aspect of its day-to-day governance squarely in the dock.

While boards could once claim immunity to the concerns of society as a whole, sitting on the fence is no longer possible. Yet with ESG asset managers keen to praise those managements willing to wrestle with complex issues such as gender and race inequality, and to call out those that are not, the dream of making money while also doing good has never looked so attainable.

Recent data from S&P indicates that its 500 ESG Index outperformed, suffered fewer losses and recovered faster than the S&P 500 during the pandemic, strongly suggesting what it terms "stakeholder capitalism" is a virtuous circle that rewards businesses and societies alike.

"Although it doesn't always get the attention it deserves, the pivotal role played by stewardship in both environmental governance and social governance underlies all the achievements made by ESG so far," says Peter Swabey, policy and research director at the Chartered Governance Institute.

"When you look at recent governance discussions, which have led to boardroom pay cuts and the suspension of dividends to ensure the financial pain of the pandemic is shared equally across organisations, you may agree with me that 'G' has become an extremely sexy topic."

Reassessing the value in values

Unilever's pledge to cut ties with suppliers that fail to pay the living wage by 2030 is an eye-catching example of how organisations can use their massive buying power to reflect the soul-searching of a nation. But are other managements prepared to follow its lead?

During the 2007-8 financial crash, client spending on ethical projects was swiftly and brutally cut, notes Gareth Thomas, who leads on anti-corruption and ESG at ethics consultancy GoodCorporation.

This time, the budgets allocated to supply chain and human rights risk assessment, for example, have been maintained, if not scaled up.

"I've never seen such enthusiasm for this sort of work before and it suggests that actively managing a complex set of governance-related risks requires a far broader set of capabilities and expertise than those associated simply with profit and loss," says Thomas.

"While 'G' was once routinely relegated to outside organisations, it is now seen as critical by any business leader looking to shape an organisation's thinking on key issues such as bribery, exploitation or human rights. In short, governance is fast becoming a proxy for good management."

If making money and providing employment were once seen as sufficient reasons for a business to exist, employees and investors are now looking for evidence of a far more profound purpose in the boardroom, he believes.

"Although the early days of corporate social responsibility were characterised by paper-thin pledges to do this or that, the demand among a whole range of stakeholders for independently verifiable governance procedures is rising fast, particularly among younger investors who can spot greenwashing a mile away," says Thomas.

What gets measured gets managed

Fund managers have access to a wide range of qualitative and quantitative data with which to assess the success of organisations at managing governance-related risks in their sector.

"There's a huge amount of ESG data out there," says Dominic Rowles, investment analyst at the savings and investment platform Hargreaves Lansdown, some of it providing "leader", "average" or "laggard" ratings, depending on a firm's exposure to a particular risk.

"The way companies manage critical incident risk will be a particular focus when analysing those involved in heavy industry, for example, while other sectors will be more vulnerable to legal and regulatory change," he explains.

With managers now having to make decisions based on still-emerging and unpredictable variables related to the coronavirus crisis, it is "more important than ever there is proper oversight of their decision-making," Rowles adds.

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Although the last major overhaul of the UK Corporate Governance Code dates back only to 2018, further regulation around financial disclosure is awaiting clarification. The Task Force on Climate-Related Financial Disclosures, which requires firms to disclose how climate change impacts their governance, strategy and risk management policies and to detail relevant metrics and targets, will be in force by 2025.

Well-governed companies win out

While the pandemic has claimed a number of high-profile corporate scalps on issues as varied as underweight corporate tax liabilities and even-skinnier school meal parcels, Rowles cites current city darling Next as a "well-governed company" that has responded well to the crisis.

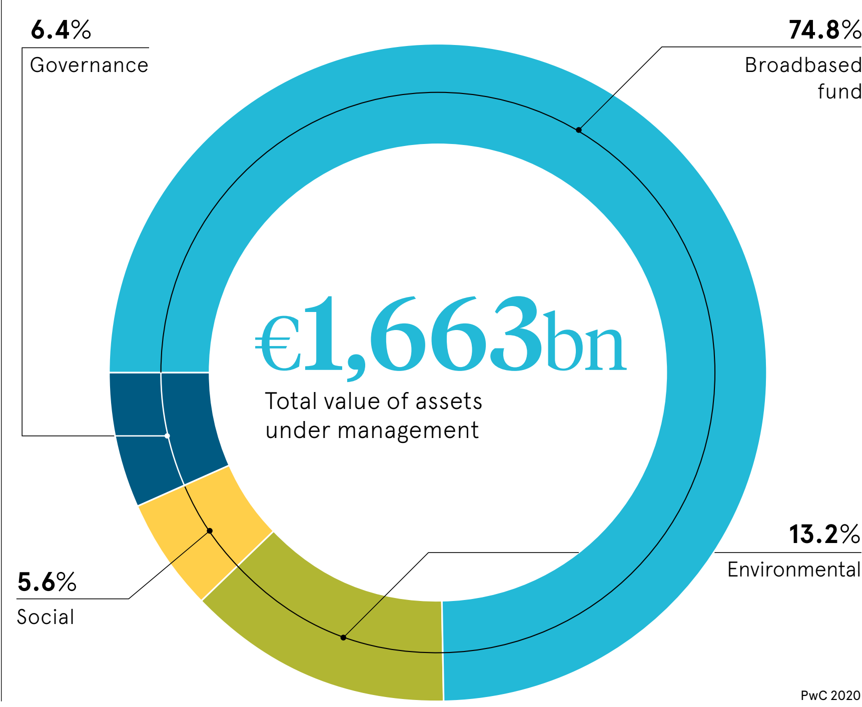
In March 2020, Next closed its UK warehouses and distribution networks to make them COVID-secure, while stores were repurposed to operate within social distancing guidelines. Boosted by brisk demand for online housewares and clothing, its share price climbed, while suspension of dividends and share buybacks helped reduce overall debt at a time when retail as a whole was suffering the biggest slump in its history.

All shares, along with corporate and personal reputations, can rise and fall over time, but for any business looking to sustain both growth and purpose for the long term, active, responsible and sensitive stewardship is the way forward, argues the Chartered Governance Institute's Swabey.

"At the end of the day, companies are run by fallible human beings and bad things can and do happen in boardrooms," he says. "It's the job of good governance, including the independent scrutiny of key decisions, to make it much harder for any individual with rogue intentions to have their way."

EVEN ESG FUNDS DO NOT PRIORITISE GOVERNANCE

Analysis of 9,700 European ESG-labelled funds by theme



PwC 2020

Commercial feature

Mandatory climate and ESG reporting can create new value

Companies that embrace the need for tougher climate and environmental, social and governance regulations will outperform their peers

While some asset managers are just getting to grips with integrating environmental, social and governance (ESG) practices into investment processes, tougher reporting regulations coming into effect mean they are under huge pressure to assess climate impact and business resilience in much greater detail.

However, far from being a big risk, this can be a strong source of value creation, as James Hilburn, director of financial services at Carbon Intelligence, explains.

"ESG factors are no longer just nice-to-have elements of compliance, but fundamental drivers of business value, and companies that understand and have embraced this are outperforming their peers," he says.

"This is a crucial area for asset managers. When allocating capital, they need sight of how companies are responding to ESG pressures, how their practices compare to their peers' and the key performance indicators. Here, ESG reporting disclosures have come to the fore by shining a light on those elements of a business that were previously rather unknown."

The two new mandatory reporting areas coming into effect this year include the Task Force on Climate-related Financial Disclosures (TCFD), with 2021 a reporting year for UK banks, insurers, large pension schemes, and premium listed companies, and the Sustainable Finance Disclosure Regulation (SFDR) for entities operating in the EU.

The TCFD, set up in 2015 as a business response to the Paris Agreement, manages climate risk by focusing on the impact of changing climate on the company.

"An asset manager needs to understand how a company has planned for different climate scenarios and the potential impact on its business," says Hilburn. "Do they have the right governance structures in terms of decision-making? Are they measuring the right metrics and reporting on those?

"With this insight into the stability of the business and its cash flows, asset managers can make better informed decisions, ultimately leading to better pricing of the assets."

> ESG factors are no longer just nice-to-have elements of compliance, but fundamental drivers of business value

The SFDR, also known as the anti-greenwashing regulation, is part of the European Union's sustainable finance package of legislation and is specifically aimed at financial firms and their performance across a broader range of ESG practices; the elements that effectively grant a company a licence to operate with its stakeholders.

"There are a growing number of 'green' or ESG-friendly financial products on offer currently," says Hilburn. "SFDR requires the firms selling these products to prove their green credentials by demonstrating what they do that has a positive impact and doesn't have a negative impact elsewhere.

"Transparent reporting on key metrics can demonstrate what you say you are doing and what you do are aligned. Firms that fail to do this effectively could see a significant customer and regulator backlash."

There are two levels to SFDR. The first is effective from March with the initial investment-manager and fund-level disclosures. From next year it is expected there will be the additional requirement to measure specific ESG performance of the underlying assets. This could be onerous for asset managers and investors as it will require disclosing granular detail, which the asset managers often don't have a great deal of insight into or control over.

Hilburn says: "For investment firms, there are multiple benefits from having companies within your portfolio that perform strongly in ESG. These include the improved ability to attract new capital for a sustainability and ESG focus, and the fact these companies tend to have a stronger brand, more loyal customers, better knowledge of and relationships with their supply chain, and their ability to use resources more efficiently and provide a better cost position. These levers will drive higher valuations and portfolio returns.

"The next decade will see a disruptive wave of climate and ESG scrutiny that will impact the asset management world. As Blackrock CEO Larry Fink recently said, 'We know that climate risk is investment risk, but we also believe the climate transition presents an historic investment opportunity'. The winners will be the ones that embrace that force, make climate-resilient ESG performance a board-level priority and harness it to create lasting value and competitive advantage."

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