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The evolution of investment

Modernizing Sustainability Reporting
How Baldwin Brothers Bridges the Gap Between Financial and Sustainability Disclosures
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Investors integrating environmental, social and corporate governance (ESG) analysis into investment decisions combat a lack of standardization among sustainability disclosures. The gap between financial and sustainability reporting further complicates this process. Whereas investors use financial reporting to underpin projections, sustainability disclosures are commonly-backward looking, reported on a delayed basis and disconnected from financial targets. Addressing this dichotomy is critical to helping investors recognize sustainability as an inherent driver of financial performance.

The root cause of this contrast is likely a result of internal divisions between core businesses and corporate sustainability units. The relatively recent advent of corporate social responsibility (CSR) reports explains the creation of these sustainability units. Many companies have yet to migrate sustainability-tasked professionals to standard reporting lines (i.e. a sustainability officer may report to an independent business unit rather than the chief financial officer). We argue investors are a driving force behind integrating sustainability into fundamental business practices.

Baldwin's enhanced research process helps us uncover companies that view sustainability as a critical aspect of their core business rather than a standalone issue. Such integration should foster better-run organizations that benefit from capitalizing on ESG-related opportunities and proactively managing associated risks.

Financial Guidance

Companies retain discretion over forward-looking guidance. Believing operating guidance should improve stock valuation and reduce price volatility, most corporations publicly disclose financial projections to help investors evaluate growth trajectories.[i] A lack of guidance-related regulatory requirements allows corporations flexibility with forward-facing metrics, reporting frequency and evaluation timelines.

Rules around guidance were not always so relaxed. For most of the twentieth century, the U.S. Securities and Exchange Commission (SEC) prohibited the publication of financial projections.[ii] During that time, financial regulations included stipulations for Management Discussion and Analysis (MD&A), commentary addressing the company's strategy and outlook, but regulators viewed quantitative forecasts as overly ambitious and often misleading.[iii] Shifting sentiment prompted the SEC to lift these restrictions in 1973, but company-issued earnings guidance did not become popular until decades later when regulators introduced legislation to protect companies that failed to meet their publicly disclosed forecasts. By 2004 half of publicly traded companies issued earnings guidance.[iv]

Corporations currently communicate plans, projections and outlooks through quarterly earnings calls, MD&A commentary or investor conferences. Although MD&A reporting is the only forward-facing requisite for publicly traded U.S. companies, firms overwhelmingly report additional forms of guidance. A 2016 survey of investor relations professionals found that of the 94% of firms offering guidance, most provided annual, while 29% and 20% of firms, respectively, issued quarterly and longer-term guidance.[v] Corporations therefore have a tendency to overemphasize the short-term when issuing such disclosures.

Sustainability Disclosures
Few regulatory requirements govern sustainability reporting. In the U.S., for example, the Dodd-Frank Act alone outlines some ESG-related requirements (namely, transparency around conflict mineral sourcing, health and safety protocols at mines and general comparisons of CEO with median worker pay).[vi] [vii] Filling this void, independent third parties report data intended to underpin materiality, comparability, timeliness and accuracy. Absent overarching standardization, however, their results are often disparate.

Burgeoning investor interest has likely driven the recent proliferation of CSR reports; 85% of S&P 500 constituents published such documents in 2017.[viii] Companies now typically publish an annual sustainability report in the months following a company's fiscal year end. Though most companies now follow Global Reporting Initiative (GRI) standards, disclosures and financial materiality still vary.

The inconsistent content found in sustainability reports exacerbates difficulties investors face incorporating ESG criteria into fundamental analysis. Initially focused on philanthropic activities and operational efficiencies (i.e. improvements to water, emissions and energy usage), early sustainability reports often failed to make a connection to financial materiality. Companies are just now beginning to pivot toward messaging sustainability as a means to reduce cost, increase revenue and limit risk.

The Dichotomy
Investors linking sustainability with financial materiality struggle to bridge the gap between ESG-related criteria and traditional measures of financial reporting, especially delayed data, lack of standardization and insufficiently conveyed influences on long-term business performance.

Timeliness. Regulators require U.S.-listed companies to publish quarterly earnings results within forty-five days of their fiscal quarter's end. Executive officers also typically host conference calls to comment on those results and answer investor questions. By contrast, sustainability reports are voluntary and have no publication deadlines. Instead, companies typically publish annual or biennial sustainability reports six to nine months after their calendar year end.

Orientation. While financial statements and earnings releases include past performance, investors rely on forward-looking guidance to estimate projections. These disclosures, in combination with management's qualitative commentary, help investors understand a company's outlook. By comparison, sustainability reporting primarily looks backward, typically detailing how a company has improved its ESG profile but disclosing little about how ESG awareness fits into a broader financial strategy.

Verification. Companies not only publish audited financial statements but also employ standardized financial metrics. Lacking such standardization, sustainability metrics vary widely. Independent verification of sustainability reporting is not mainstream, contributing to investor difficulties when comparing ESG criteria between companies. As a result, only 29% of investors appear confident in ESG-related reporting.[ix]

Time Frame. Though financial guidance is most often annual, management teams may also provide shorter term (i.e. quarterly) or longer term (i.e. three- to five-year) guidance. Sustainability reporting, if it includes any forward-looking commentary, necessitates a far longer horizon. A company might publish a goal to reduce its greenhouse gas emissions by 25% over the succeeding decade while disclosing financial guidance for just the upcoming year.

Financial Materiality. Regulators designed quarterly and annual reports to help investors develop a sense of a company's financial health. Despite strong demand for better links between sustainability reporting and financial materiality, including the launch of the Sustainability Accounting Standards Board (SASB) in 2011, corporate disclosures still lag investor expectations. Third-party sustainability reports seek to fill that information gap but those too may often fall short. The various discrepancies in reporting styles have dissatisfied investors. A 2016 PricewaterhouseCoopers (PwC) survey found that only 20% of investors are satisfied with sustainability reporting practices.[x]

The Cause

Capital markets cannot marry sustainability with traditional reporting practices without better recognition of their continued divergence. While differences in reporting requirements may bear partial blame, limited attention to ESG criteria may provide a better explanation.

The advent of socially responsible investing (SRI) may have separated sustainable from financial reporting. SRI employs negative screening as a means to exclude companies with certain business practices failing to meet an asset owner's subjective values. Companies that manufacture weapons, extract oil or sell tobacco are typical exclusions. More recently, investor focus shifted to financial materiality via best-in-class security selection or comprehensive ESG analysis, both inclusionary approaches. Unfortunately, this evolved approach may have further complicated reporting. Some investors now invest thematically, creating investment products centered on companies with high diversity measures or low carbon footprints, as examples, while others attempt to shift the paradigm entirely; the latter, viewing investment through the lens of the United Nations' Sustainable Development Goals, essentially asks corporations to fundamentally alter their reporting framework.

Socially responsible investors typically do not ponder how sustainability influences corporate financial health but rather how corporate sustainability reflects personal values. As a result, socially responsible investors tend to clamor for the widest array of information to determine if a company meets predetermined values. In response, companies developed distinct business units focused on values-influenced sustainability measures. Typically housed under the title, "Corporate Social Responsibility," professionals in these units strive primarily to publish sustainability reports in accordance with the Global Reporting Initiative (GRI), release relevant data through the Carbon Disclosure Project, field surveys for inclusion in sustainability indexes and provide feedback to research providers and investors.

This structure craves disruption. As they integrate ESG criteria into fundamental analysis, investors grow discontent with current reporting practices. A recent PwC study found that though 80% of surveyed companies follow GRI standards, only 21% of investors value these guidelines.[xi] Executives are equally frustrated. Just one-tenth of CEOs believe investor interest is reason enough to pursue a distinct sustainability strategy.[xii] Managements frequently argue that the SRI demand for catchall information does not justify associated reporting costs. Narrowing reporting to financially relevant sustainability measures should change this outlook.

The Solution

Investor interest in sustainability's financial materiality, rather than its perceived ability to uphold personal values, is key to combining sustainability and financial reporting. This convergence will help standardize measurement and reframe financial guidance. The latter is particularly critical to lengthening investment horizons.

Sustainability is now evolving into a core business practice. SASB is lobbying the SEC to require financially relevant ESG indicators in corporate filings. According to Morgan Stanley, 71% of surveyed investors believe companies exhibiting strong ESG practices will prove better long-term investments.[xiii] Ernst & Young likewise found 82% of surveyed investors believe understanding ESG-related issues sharpens the lens on business risks and growth opportunities.[xiv] Shareholder proposals further enhance demand for comprehensive sustainability information. Shareholders on average supported more than one-third of proposals requesting enhanced climate risk disclosure, for example, in 2017.[xv]

In addition to individual investors, institutions now increasingly promote sustainable investing. A landmark letter from BlackRock's Larry Fink argued that companies must make a positive societal impact to succeed over the long term.[xvi] State Street similarly started supporting shareholder proposals; in so doing, climate change-related votes increased nearly fourfold between 2015 and 2017.

Investor appetite for material ESG disclosures should also influence corporate behavior. In Europe, where sustainability awareness is more prevalent than in the U.S., sustainability disclosure requirements have tripled since 2006.

Furthermore, half of publicly traded European companies include ESG information in their investor communications compared to just one fifth domestically.[xvii] The U.S., however, is catching up. Investor interest in gender equality, for instance, spurred an increase in female board member representation at American companies from 15% in 2011 to 21% in 2017.[xviii] Research suggests diverse leadership improves financial performance.[xix]

A sophisticated understanding of sustainability can further influence corporate strategic timeframes. Four fifths of executives have admitted to cutting discretionary spending and two thirds to delaying projects in order to meet short-term guidance.[xx] Consequently, investors have successfully argued to end quarterly guidance practices, reducing the number of American companies that offer guidance from 75% in 2003 to 28% last year.[xxi] [xxii] In contrast, less than 1% of the largest European companies provide quarterly guidance.

We believe investor evaluation of ESG criteria will help public companies regard sustainability as a core business practice. Firms with meaningful sustainability oversight typically have lower costs of capital, higher long-term growth rates and reduced earnings variability. Those employing sustainability-led best practices may likewise generate financial outperformance.[xxiii] By focusing our research on ESG criteria that most likely influence financial outcomes, we typically uncover companies that have fully integrated sustainability into their corporate cultures.

Our Approach

Baldwin's investment process intends to reveal companies with sustainability advantages most investors do not yet appreciate. Our research views ESG criteria as a critical part of traditional fundamental analysis and manager due diligence. We believe many of our investments are similarly ahead-of-the curve in terms of merging sustainability with business strategy.

While all public companies could enhance the link between sustainability and financial materiality, the companies comprising our equity strategies may have best conceptualized sustainability as a core tenet. As part of that core, these companies arguably capitalize on related trends, such as improving resource efficiency, earlier than peers. Mindful resource utilization benefits operating margins and ultimately enhances profitability. It also incentivizes corporations to manage for the long-term, improving alignment with stakeholders.

As one example, First Republic Bank integrates sustainability into its long-term business model. The regional bank relies on its industry-leading customer service to drive outperformance. Clients not only conduct more of their own business with the bank but also refer new clients more frequently than at other financial institutions. This model generates higher revenue and reduces client attrition. Including low employee turnover, the bank's corporate culture fosters self-fulfilling growth. First Republic's recent decisions to publish a sustainability report, align executive compensation with investor expectations and expand business lines to meet low-income needs further support it as a compelling long-term leader.

Pioneer Natural Resources similarly demonstrates how thoughtful sustainability management translates into competitive advantages. Concentrated in the Permian Basin, Pioneer has a lower-cost asset base than most peers. As the company outlined in its 2016 inaugural sustainability report, its best-in-class assets and insulation from exploratory capital expenditures provide advantages in carbon-constrained environments.[xxiv] Furthermore, the company has improved its cost structure through vertical integration, developing in-house solutions for water recycling and emissions capture from well completions.[xxv] Early negotiations for pipeline capacity, which protect against rising costs, also exemplify Pioneer's proactive management style.

In our opinion, sustainability is inherent to good corporate leadership. Companies like First Republic and Pioneer benefit from aligning sustainability with corporate strategy. That alignment should inevitably yield earlier recognition of growth opportunities, heightened risk mitigation, engaged management teams and stronger relationships with stakeholders.

We believe capital markets will eventually recognize sustainability as a core principle behind corporate strategy. Until then, we will continue to utilize differentiated research to uncover enterprising companies aimed at solving today's global challenges. This thoughtful understanding of ESG criteria when conducting financial analysis should ultimately enhance our stewardship of your capital.

DISCLOSURES

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