AMP Capital Investors Limited
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ESG: How much value does it add?

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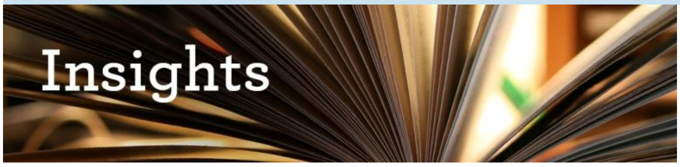


Environment, social and governance (ESG) are recognised as important tenets of investment. But just how much value does ESG actually add to returns? We undertook a study designed to quantify the value it contributes to investors.

Ian Woods

Head of Sustainable Funds

Assessing ESG issues

We consider companies from two ESG perspectives:

1. The Impact of Sustainability Issues on "what" the company does, and
2. The effectiveness of the management of material ESG issues by the company.

We see sustainability as shaping the market place in which companies are operating. For example, it is our view that climate change is clearly shaping the resource and energy sectors. Intergenerational equity and demographic changes are shaping the funds management industry, the aged care industry and healthcare. The desire to minimise, or limit, negative social externalities is impacting gambling and alcohol stocks. ESG trends on internationalisation, increased transparency, shifts in global growth and information technology are also impacting companies.

These forces vary between sectors and some companies are better positioned than others to take advantage, or at least be not as disadvantaged, than others. The various forces may not necessarily be coming from the same direction or operate within different time frames but all are considered. There is some overlap with areas covered by "traditional" investment analysis – that is to be expected if there is true integration of ESG issues.

The second aspect we consider is the effectiveness with which a company manages its material ESG issues. The majority of most company's value is made of intangible assets, here simply defined as market capitalisation, less tangible assets on balance sheet plus debt. These intangible assets are the systems, structures, relationships, skills, knowledge, culture and brand that are used to execute a company's strategy and manage risk to the company. They are aspects which the company can, by and large, control and are closely related to environmental, social and governance issues.

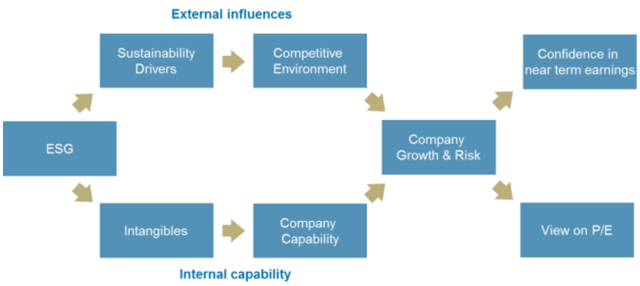
It is through obtaining a better understanding of the management of these intangible assets that ESG research aims to provide investment insights.

Answering the 'so what'?

All equity analysis requires an analyst to consider the growth in future earnings and the risk associated with those earnings when evaluating a company's share price, whether it is a detailed discounted cash flow analysis or one year earnings estimates and price/earnings multiples.

Analysts also need to consider catalysts which may be required for a certain value to be recognised by the market.

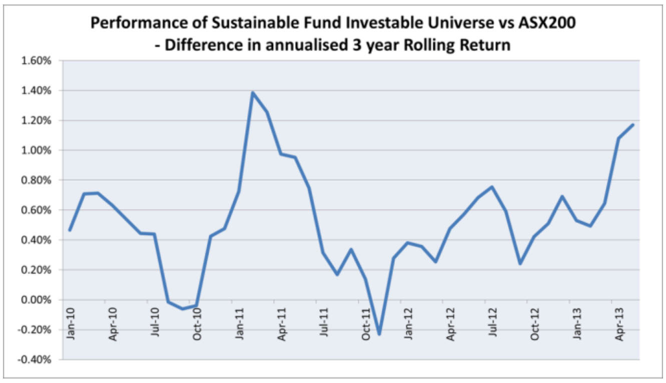
It is through the lenses of risk and growth, over various investment time frames, that our ESG analysis is made relevant to investment analysis. It may seem easy but it is the most difficult part of ESG integration and it is only through sitting with the investment analysts and portfolio managers that the real and timely benefit of ESG analysis is captured. The approach to ESG integration for fundamental equities is summarised in figure below.



How much value does it add?

Like all factors impacting a company's share price, the importance of ESG issues for a particular stock can vary over time. We developed and tracked the performance, since 2007, of a proprietary ESG Index, utilising the ESG research process outlined above. Over this period, the AMP Capital ESG Index typically contained approximately 130-135 stocks representing typically 80-85% of the ASX200 market capitalisation.

Our ESG index has outperformed the ASX200 on 55% of months over this 78 month period to the June 2013 and has provided competitive outperformance over the ASX200 on a three-year rolling basis.[1]



Source: AMP Capital as at 30 June 2013.
Past performance is nota reliable indicator of future performance.

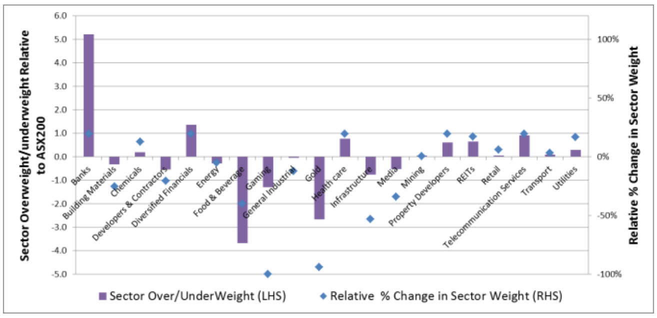
This has been a volatile time for the ASX200, impacted by: the run-up to the global financial crisis (GFC), the height and tailing off of the resources boom and more recently the search for yield. ASX200 annualised returns were near 20% initially to close to negative 40% during the height of the GFC to rebound by much the same 12 months later.[1]

What drove outperformance?

The performance of the ESG Index relative to the ASX200 can be attributed to both sector or size position but also company positions within each sector or size bucket.

Over the past three years relative sector positions has contributed more than 75% of relative performance and better companies within a sector the remainder.

In one respect this split is not surprising given there are a number of sectors, e.g. banking, healthcare and gaming, in which all companies are in or out of the ESG Index.



Source: AMP Capital as at 30 June 2013.

Interestingly, from a size perspective, it was the ESG investible companies within each size bucket, as opposed to the relative weight of the size bucket itself, that contributed the majority of relative performance.

In summary, the relative performance of the ESG Index has been driven by the overweight position in more sustainable sector, eg. financials and healthcare, underweight less sustainable sector, such as gold, and the relative performance of large verses small cap miners.

ESG adds….

The focus of our ESG research on both how sustainability is shaping the markets in which companies operate and how a company manages the key intangible assets gives insights into the evaluation of the growth and risk profiles of companies over a range of timeframes. This has enabled us to integrate our ESG research to a variety of fundamental investing styles.

It is our view that the focus of long-term investment drivers, through analysis of sustainable market drivers and focus on a company's management of intangible assets, has added to investment returns even through the volatile equity market environment of the last six years.

Since its inception in January 2007, the AMP Capital ESG Index has outperformed the ASX200 on a rolling three year average by typically 0.5%.[1]

This outperformance suggests that a low turnover active ESG fund may provide an interesting long-term investment opportunity for equity investors.

AMP Capital has had an internal ESG research team since the beginning of 2001. Consistent with AMP Capital's commitment to the UN Principles of Responsible Investment, we are also utilising the insights from integrating ESG research into equities and applying them to our Global Resources, Listed Infrastructure and REIT equity funds, our corporate bond funds and assessing the ESG performance of our external equity managers.

[1] Source: AMP Capital and Bloomberg market data as at 30 June 2013.
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Contact us

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