

Tomorrow's investment rules

Global survey of institutional investors
on non-financial performance

The EY logo is positioned in the bottom left corner of the page. It consists of the letters 'EY' in a bold, white, sans-serif font. The background of the entire page is a low-angle photograph of a modern glass skyscraper, with a bright yellow diagonal graphic element cutting across the middle. The sky is clear and blue, and green trees are visible at the bottom of the frame.

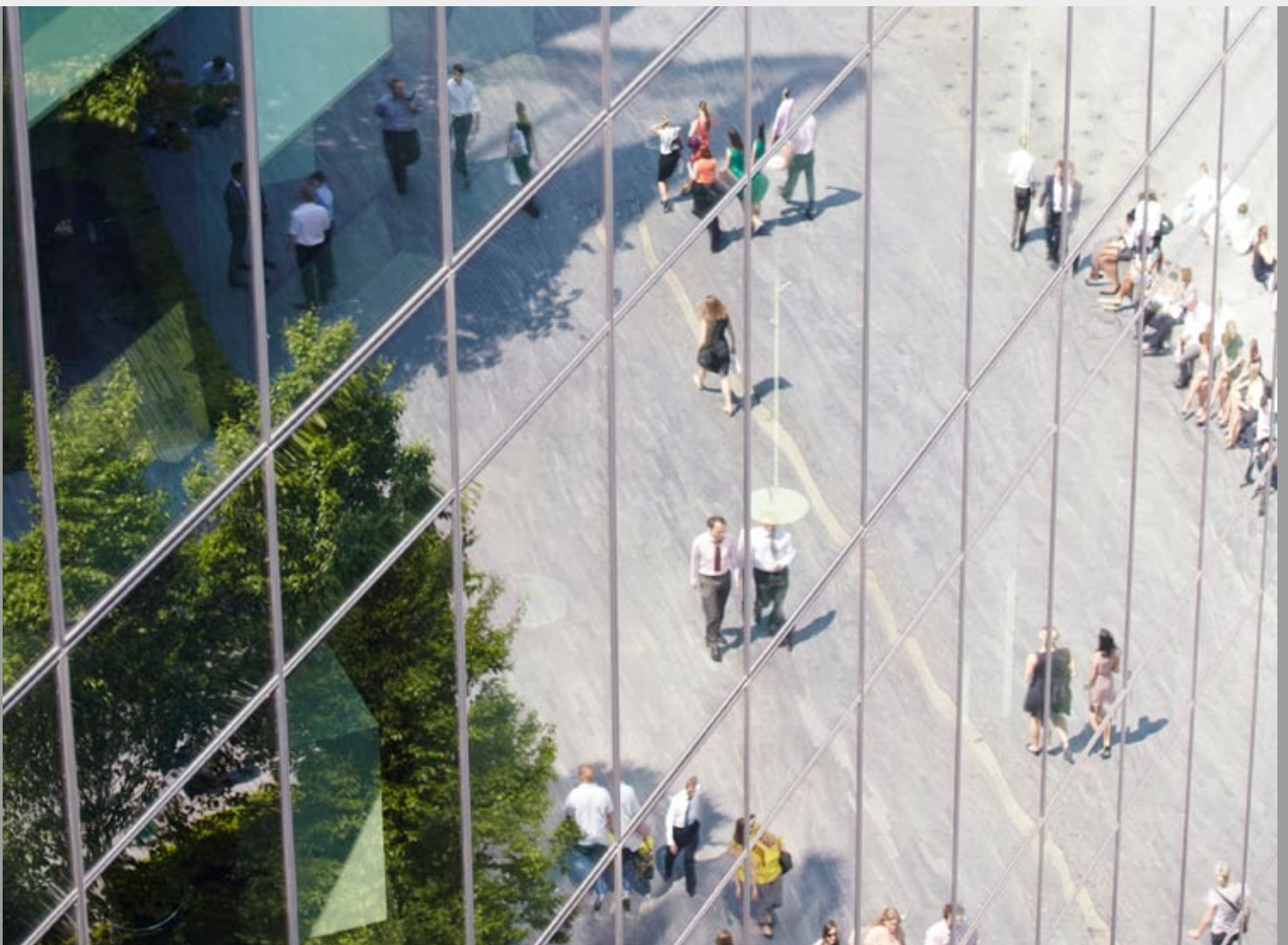
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Foreword

Over the past few years, corporations around the world have started to report more non-financial information, including data on their environmental, social and economic sustainability performance. Whether driven by regulation or a desire for market advantage, or to meet the needs and concerns of key stakeholders, this growing trend is changing business behaviors. How then are the providers of financial capital and, in particular, long-term investors to use this information to better inform their decision-making – if they can use it at all?

We surveyed a global sample of 163 institutional investors, including portfolio managers, equity analysts, chief investment officers and managing directors, to get their views on the availability and quality of corporate non-financial information, and on whether they valued and used this information during their decision-making on investments. We then interviewed a number of these investors to gain further insight into their answers. Over half of the participants in our survey are employed at organizations with equity assets under management of over US\$10b.

What is clear is that the majority of investors use this information when assessing investments and evaluating their current holdings. And they predominantly use information provided directly from the companies themselves, rather than relying on third parties, such as ratings agencies.

However, investors are struggling to find ways to meaningfully compare companies' data, to understand which issues are most material to their sustainable growth, and to draw quantifiable links between non-financial and financial performance. Differences also exist geographically, with a lower uptake of non-financial assessments across the United States than in the rest of the world. And there is a difference in the use of this information between developing and more-developed economies. We also noted that non-financial risks were more heavily weighted in decisions made in developing markets – which could lead to a greater proportion of such investments being either reconsidered or ruled out altogether.

We hope that the insights in this survey will help companies to develop their reporting to better satisfy their current and prospective investors' needs. Those needs will be best met by reports that provide an analysis of what is most material to value creation, that demonstrate the links between financial and non-financial performance, and that incorporate more standardized metrics to measure that performance.

Despite international developments on non-financial accounting standards, the emergence of integrated reporting and a widening appreciation of the risks and opportunities posed by externalities, there remains a significant opportunity for organizations that can better inform investors of the non-financial risks and opportunities that their businesses face. This kind of information could help companies to report transparently on how they are managing these opportunities and risks to ensure shareholder value creation over the long term.



Juan Costa Climent

Global Leader of Climate Change and Sustainability Services

Executive summary

In this survey, we identify what the key trends and drivers are in the uptake and use of corporate disclosures of non-financial information. The survey provides an interesting reflection on the different practices used to assess the value of environmental, social and governance (ESG) information.

EY engaged *Institutional Investor* to undertake an independent global survey of 163 investors, analysts, and portfolio managers to gain insight into their current practices and future needs.

In order to gain a deeper understanding of their practices, *Institutional Investor* also interviewed 12 respondents – who together form a cross-section of the survey group. For more on how we conducted this study, see Methodology, page 34.

The results of this survey were insightful in that they may help to shape the way companies and investors currently view non-financial information, and what aspects may be more useful to investors in future. One significant trend we uncovered was that non-financial information is increasingly being used to inform decision-making on investments. We found that a number of sources of information are being used to make these decisions, and that investors are using a mix of formal and informal methods to assess non-financial information. However, it was evident that investors still feel that reporting is often insufficient to meet their needs. Investors said they had a lack of information to understand what issues could materially impact returns for shareholders; that they often failed to be able to compare performance, even among peer organizations; and that they were often unable to draw the connections between non-financial and financial performance.

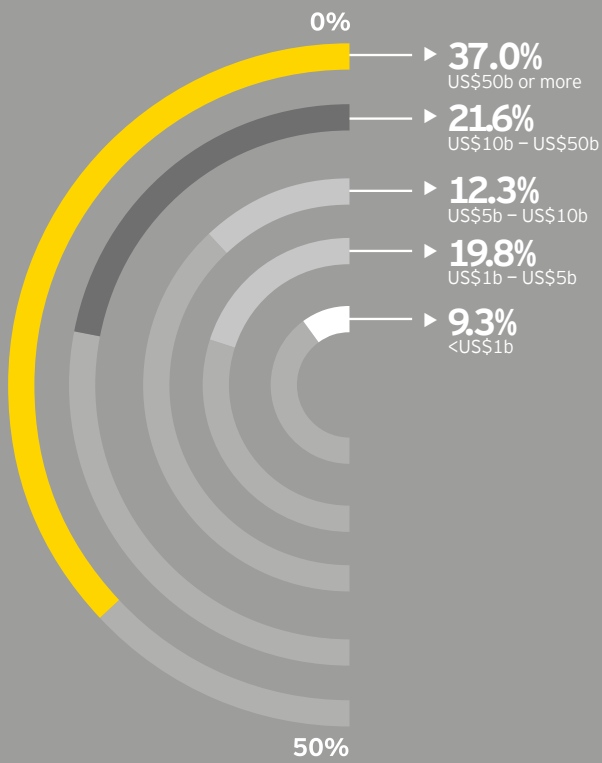
Survey key facts

- ▶ Broad representation from large institutional investors around the world
- ▶ Collaborative research program between Institutional Investor Custom Research Group and EY
- ▶ Fielded in September 2013
- ▶ Survey of more than 160 senior decision-makers at financial institutions

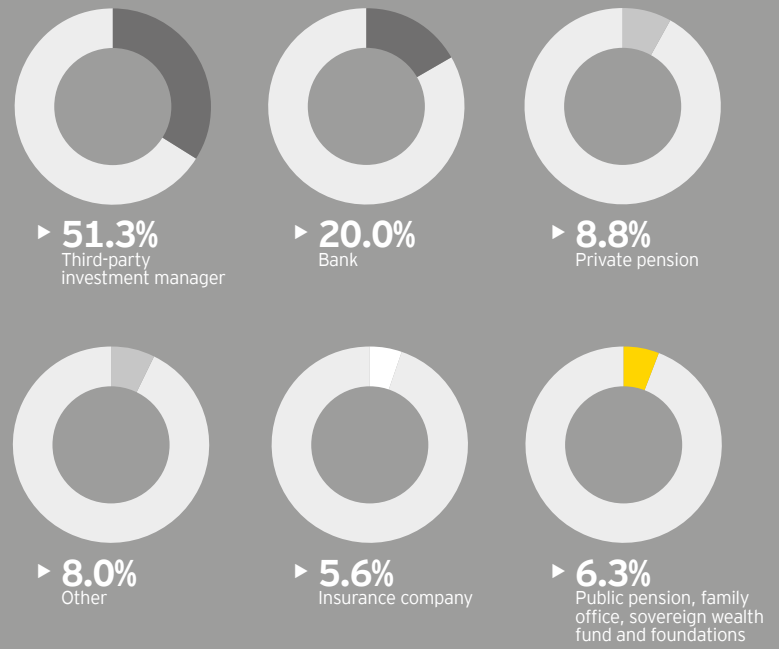
The key findings:

1. Two-thirds of investors use different techniques to evaluate non-financial disclosures. However, only half of this group use guidelines or a structured process to make their assessments. This means that two-thirds of investors either don't evaluate non-financial disclosures or rely on their own personal ideas about the data. This shows that a framework to aid investors is needed.
2. Materiality is a key concept that emerged from this survey. Investors were more likely to value information which came directly from the company itself rather than from third-party sources. In addition, among those that never consider ESG information in their decision-making process, the main reason for rejecting it was that they felt it was not material.
3. Investors said that, for the most part, they used non-financial performance as a good benchmark for risk. Some risks, such as history of poor governance or the absence of a strategy to create value in the long term, were held to be more important than others.
4. Investors said they felt that companies were disclosing their non-financial performance in order to help build a better corporate reputation. They also told us that those who report in a timely way had an advantage and a competitive edge.
5. Geographical location is an important factor: the responses were affected by where the investor is based in the world.

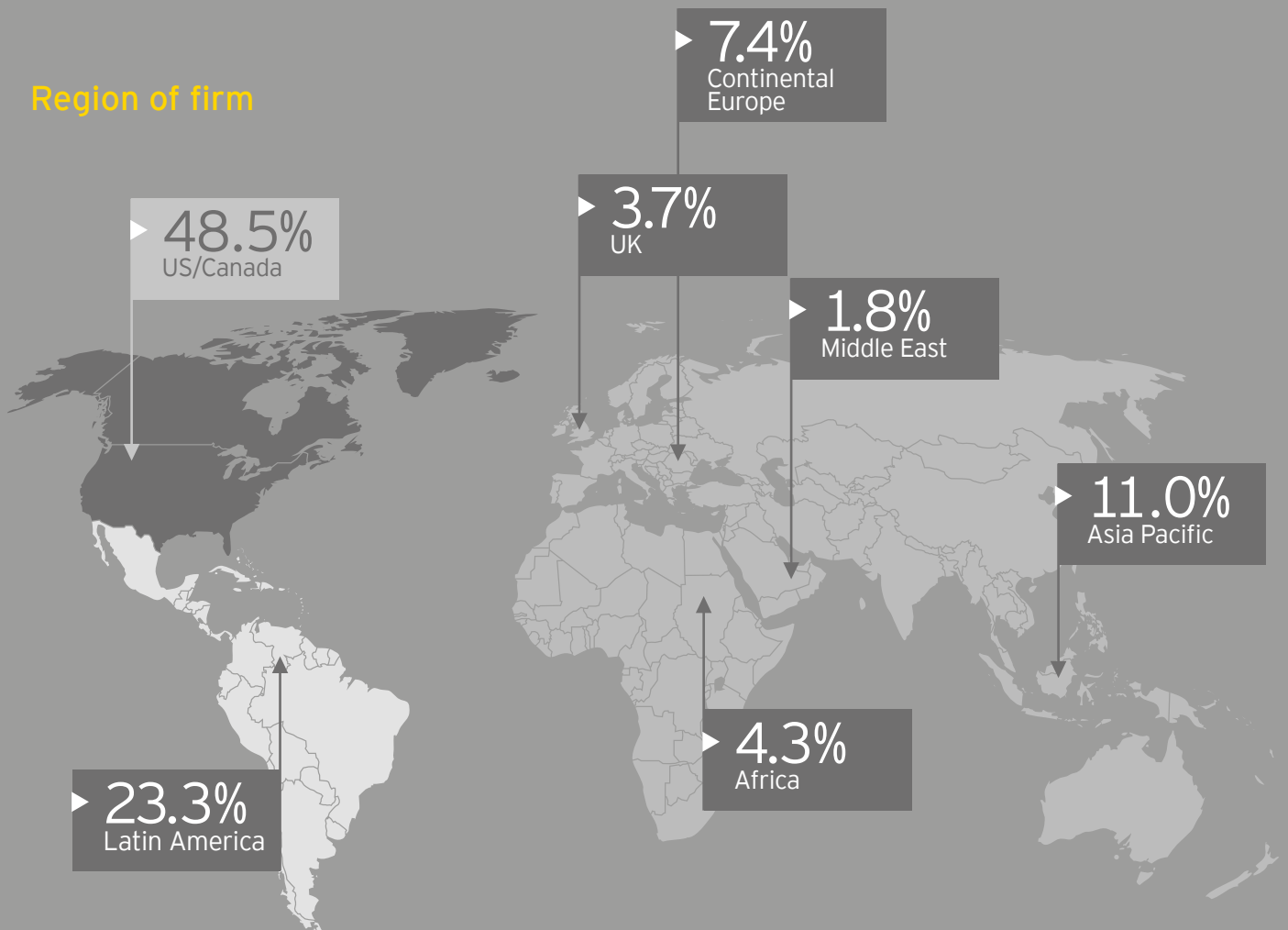
Assets under management



Type of institution



Region of firm



1

What value do investors place on non-financial performance information, and when do they use it?

One of the main findings of the survey is that investors are interested in corporate non-financial information on the environmental and social aspects of a company's performance. However, they differ in how they evaluate the information.

Almost two-thirds of the investors surveyed conduct some kind of evaluation of the non-financial information when making their investment decisions.

Around half of these investors use a structured evaluation or have processes in place (either internal or based on the UNPRI or other relevant guideline).

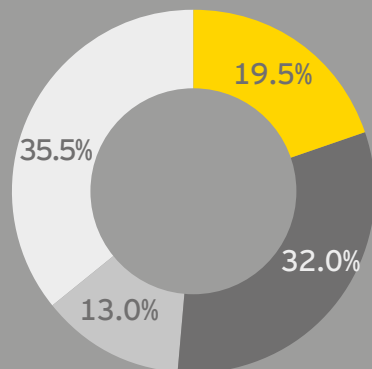
However, 32% of the respondents informed us that they relied on their own judgment of environmental and social data when determining the impact of such factors on value creation and risk.¹ In addition, over one-third said that they conducted little or no review of the non-financial disclosures from companies. This shows that, although some evaluation of this information is taking place, it is not being done by everyone or in a uniformly thorough way. This suggests that either the information is not of interest, not relevant for decision making, or it is not easy to compare between companies.

Some of those we interviewed said that they have teams dedicated to assessing non-financial aspects of performance. This non-financial assessment is then combined with the financial analysis and is incorporated into the risk and return view of the company, but such a capability does not appear to be widespread. More frequently, analysts consider non-financial matters informally, by applying their intimate knowledge of material risk factors at play in an industry, or their experience in dealings with a specific company. Others make use of a range of subject-matter experts to help inform and improve their standard processes.

One investor, from a South African third-party investment management firm with assets under management of US\$5b-US\$10b, told us that his firm does not separately evaluate environmental, social and governance factors. "We probably use it without actually meaning to, because ESG risks are interconnected to financial risks," he said. "We don't have any template we apply." This is both important and interesting, given that companies listed on the Johannesburg Stock Exchange now have an obligation to produce an integrated report covering both financial and non-financial performance as set out in the King III Code of Conduct.

Another Asia-Pacific-based equity analyst for a bank with assets over US\$50b under management echoed this view. "There's no hard and factual process we have here ... it is based on analysts' experiences and dealings with companies."

Q.1 Which of the following statements best describes how you and your investment team evaluate non-financial disclosures that relate to the environmental and social aspects of a company's performance?



- We usually conduct a structured, methodical evaluation of environmental and social impact statements and disclosures.
- We usually evaluate environmental and social impact statements informally.
- We usually rely on guidelines or information from third parties such as the UN Principles for Responsible Investment or other relevant guidelines
- We conduct little or no review

¹Only a total of 32.5% of investors conduct a structured evaluation, based on either their own internal policies or guidelines such as the UN Principles for Responsible Investment (Question 1)

However, 20% of investors take a more sophisticated approach to ESG evaluation. A Senior Vice President for a US-based third-party mutual fund investment manager with assets under management over US\$50b told us that his firm takes both a top-down and bottom-up approach to assessing ESG data. "From the top down, we're thinking about long-term ESG themes that impact economic growth over the next three to five years," he explained. "On a bottom-up basis, we are looking specifically at credit analysis – corporate credit but also emerging market sovereign credit – for example, integrating ESG risk factors into the individual companies and countries into which we are investing."

Among the top-down factors, he included wealth and inequality, stranded assets, the effect of carbon on the economy, demographics and geopolitical risks – all of which "could impact economic growth in some way."

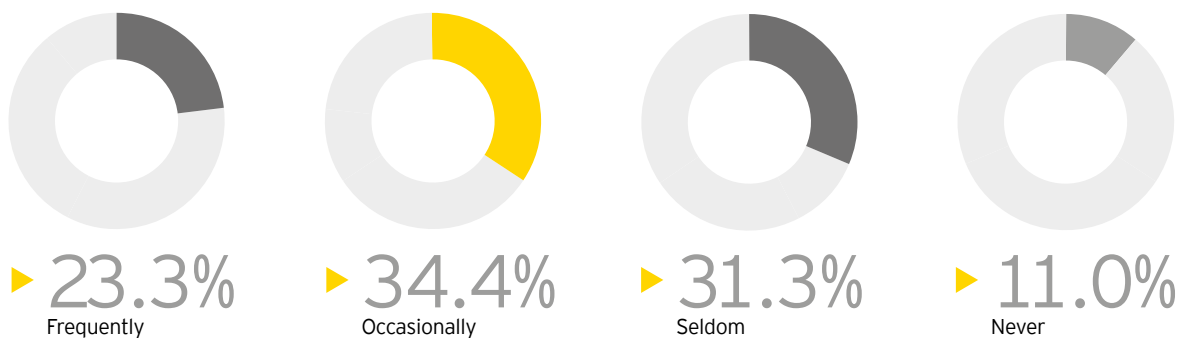
While the survey shows that there is an interest in ESG evaluation in the market, one US-based third-party investment portfolio manager with US\$10b-US\$50b under management suggested that it was held mainly by the younger generation of analysts and investors.

"There are people who are coming into the business today who are probably more focused on it than I am. And there is probably the generation older than me that still doesn't think about it at all ... it's not something you used to worry about 20 years ago."

Nine out of 10 investors have found that non-financial performance information played a pivotal role at least once in their decision-making in the last 12 months

A majority of investors told us that, in the last 12 months, assessing non-financial performance had played a pivotal role in their investment decision-making process. This demonstrates that the analysis of non-financial issues can no longer be dismissed as a niche approach to investment. Of the 11% who informed us that non-financial performance had not played a key role in the past 12 months, the principal reasons they gave were that it was unclear if the non-financial disclosures were material or had a financial impact (see Section 3 for more information).

Q.2 In the last 12 months, how frequently has a company's non-financial performance played a pivotal role in your investment decision-making?





Combining this information with that from the first question (which asked specifically about environmental and social aspects), we found that structured methodologies and guidelines or information from third parties are used more extensively by investors who frequently consider non-financial performance in their investment decision-making process. Not surprisingly, respondents who only occasionally or seldom include non-financial concerns in their investment decision-making process said they tend to do so through informal approaches.

For a US-based senior vice president of a third-party investment manager with assets under management of over \$50b, the benefits of considering non-financial data as part of their decision-making process were made apparent when they integrated ESG into all their processes.

“We don’t view ESG as a standalone process or initiative. And I think, for that reason – because our investment process is so institutionalized and ingrained – that this will be more slow-moving for us ... so for us to make this work, it has to be embedded in our investment process.”

“We don’t view ESG as a standalone process ... it has to be embedded in our investment process.”

Others, including an equity analyst for a pension fund in Latin America with assets under management of US\$5b-US\$10b, said that the value of ESG information came from new projects and innovation within a company.

“I think that, with evaluating investment projects – when a company has a project, the ESG can provide value because it will monetize the present value of the company.”

Overall, the survey and interviews both suggest that non-financial information is valued by investors. The question remains: how do investors use this information? Is it only relevant for risk assessment, or can it be used to quantify return?

2

How do investors use this information?

The survey revealed that, for investors, the most relevant source of information on the non-financial performance of a company was taken from the company itself – through annual or integrated reports – rather than from a third party. Investors told us that they are increasingly using the non-financial information from these company reports to assess risk. But they would like to be able to use this information to help their valuations. As was seen in the previous section, there is a split between those who have a formal evaluation for using ESG information, and those who use “gut feel” or have no review at all.

Investors also wanted to be comfortable that the information they received from a company was credible and reliable. There was no strong preference shown as to who provided the oversight, but it was clear that such oversight was an essential feature for investor confidence.

“The majority of investors felt that the integrated report was essential or important in decision-making.”

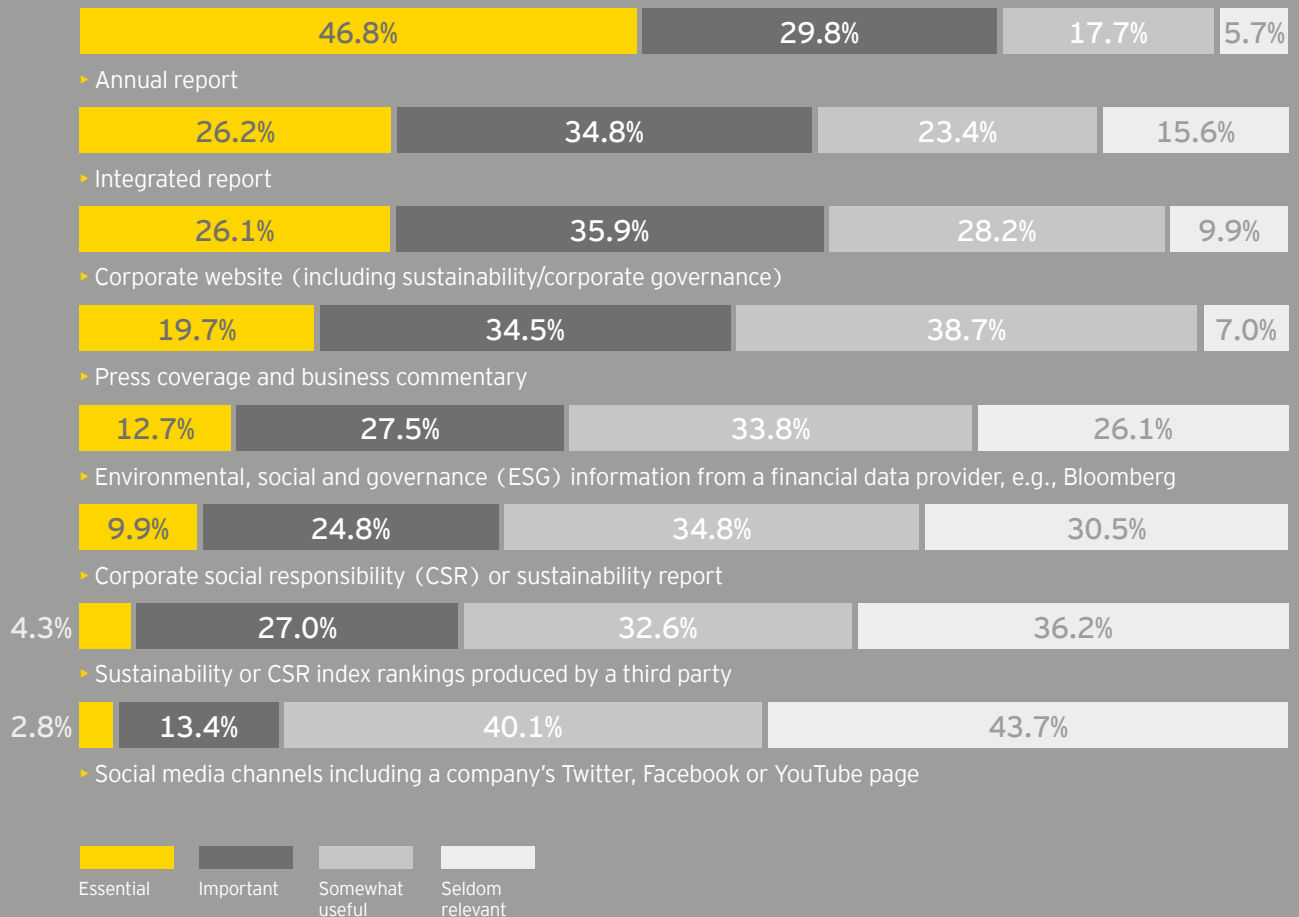
Investors want non-financial reports from companies themselves, not third parties

The top response from investors as to which type of non-financial information was either essential or important to their decision making was the annual report. The second and third most essential or important sources were the integrated report (26.2% and 34.8%, respectively) and from the company’s website (26.1% and 35.9%). In fact, the majority of investors felt that the integrated report was essential or important in decision-making (61%). This is particularly interesting, considering that the framework for integrated reporting from the IIRC had not yet been released at the time of the survey, and that only entities listed on the Johannesburg stock exchange are currently required to produce any form of integrated report.

Interestingly, information sourced from third parties, such as Bloomberg (which a total of 40.2% of respondents rated as either essential or important), index ratings (31.3%), and information from press or media coverage (54.1%), did not rank as highly as information sourced directly from the companies themselves.



Q.3 How useful do you find the following types of non-financial information when making an investment decision?



“The issue has been ... that the data is just so wide that it is hard to zero in on what is important and what is material.”

Investors had different preferences for how much information they wanted from companies and how detailed it should be. Some investors said they wanted less information but information that is more consistent and highlights the most material aspects. However, others were more interested in being able to evaluate the data themselves.

A senior vice president from a US-based third-party investment manager with assets under management of more than US\$50b thought that the data provided needed to be more comprehensible.

“Frankly, the issue has been – even with Bloomberg – that the data is just so wide that it is hard to zero in on what is important and what is material,” he said. “And, to date, that has really been the struggle in finding data sources.”

A portfolio manager from a South African third-party fund with assets under management of US\$5b- US\$10b told us that they ultimately needed a set of material issues to weigh up different companies.

“We have a tick box, a list of questions we apply ... it gives you a good feel straight away. For example, on environmental: Are they measuring environmental impact? Have they set targets? Is the environmental framework in place?”

On the other hand, a German senior portfolio manager at a third-party investment management fund with assets under management of more than US\$50b told us that raw data was better than processed data.

“I think, because we have a pretty big team, we are more interested in the raw data. The problem is the data provided by the companies, we would like some companies to provide more data – in any raw format whatsoever, disclose more information basically on an ESG basis. But processed data delivery I think would not be interesting to us.”

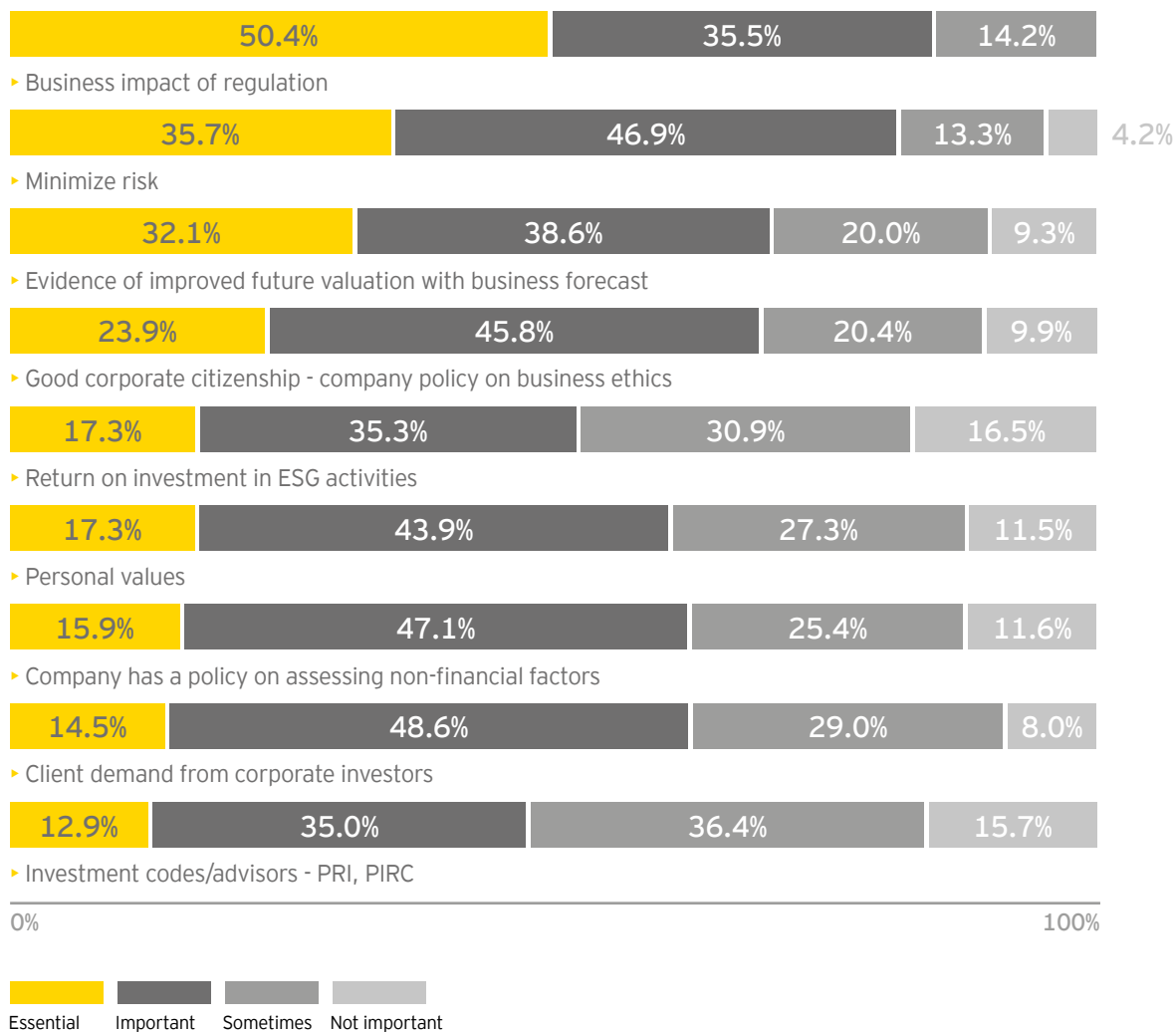
These different viewpoints suggest that companies need to provide a variety of information points to suit the needs of different investors. An integrated reporting framework, for example, could help to make this process easier. A company will report what is material to them, but would also provide further information and point to where an investor may find the raw or unabridged data that bigger investment teams could find useful.

Investors use non-financial information to help consider risks

For investors, one key motivation for considering ESG performance is risk. Investors told us that the two most important non-financial issues were the business impact of regulation and the ability to minimize risk.

While these top two concerns seem relatively unsurprising, the third and fourth highest responses – evidence of improved valuation (rated essential or important by 70.7%) and being a good corporate citizen (essential or important for 69.7%) – were unexpected. And they were rated much higher for this question than personal values or client demand from investors.

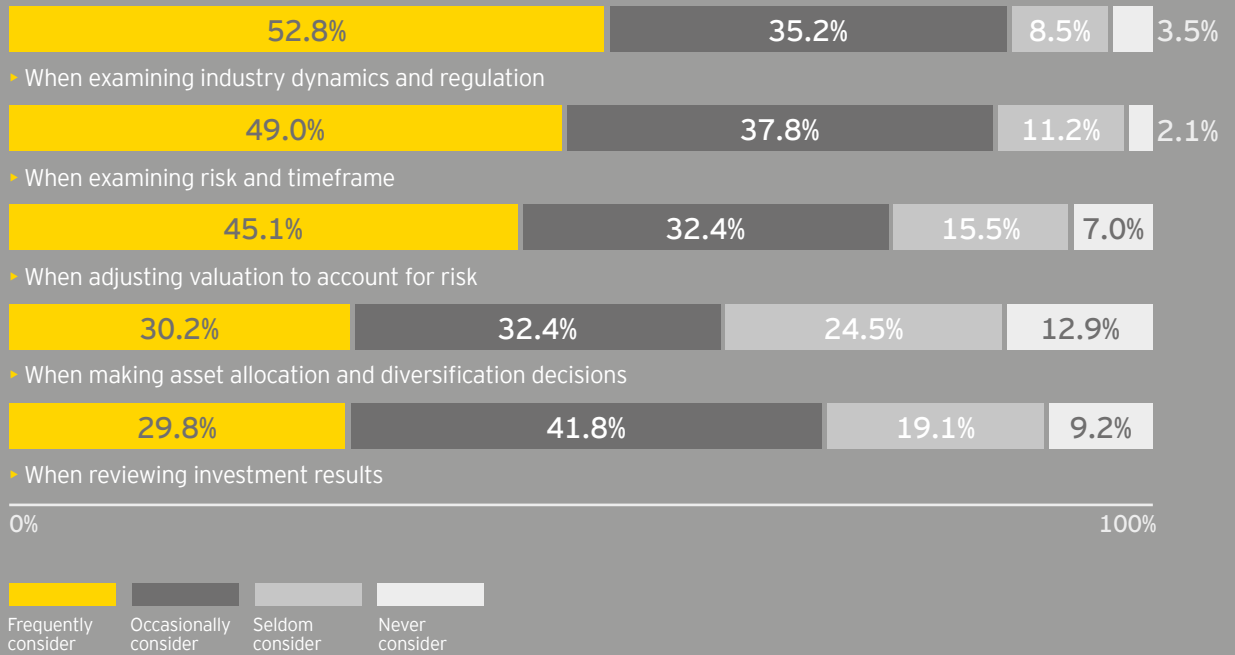
Q.4 How important are each of the following non-financial issues to you as an investor?



The stages when investors are most likely to take ESG factors into account are: when examining industry dynamics and regulation (88% of investors frequently or occasionally consider ESG at this stage, which is most likely linked to investors' desire for material information) and when examining risk and timeframe to hold the investment (86.8% frequently or

occasionally). These findings provide further evidence that ESG information is most likely incorporated into the general risk-weighting assessment. This is further supported by the fact that a majority of investors frequently or occasionally adjust their valuations due to a risk identified from ESG performance (77.5%).

Q5. How frequently do you take non-financial information into account in the following stages of your investment decision-making?



The investors we spoke to echoed this sentiment about risk, but some are also trying to understand how their firm can move to the next level, which is to effectively value future performance, as well as risk.

A US-based senior VP from a third-party mutual fund with assets under management of more than US\$50b told us that ESG factors were a normal part of his firm's risk assessment process:

"We view ESG as an input into that ultimate decision, so that at our company, everything that we focus on, we call risk factors and obviously optimizing those risk factors for the highest risk-adjusted return to clients is what we think our major responsibility is."

However, he also said that it was difficult to isolate whether ESG or any other kind of risk were responsible for driving valuation.

"It's hard to isolate whether ESG was the driver, or whether, in addition, a confluence of other risk factors was really something that is driving valuation. That attribution is difficult, especially because it is hard to quantify what the ESG risk is. We haven't necessarily cracked that code nor have we seen a framework from others that have done it well."

Did he think that his firm would eventually develop a more material financial quantification of specific ESG risks?

"I think that's the destination, and we are in the very early stages," he said.

However, a senior portfolio manager for a German third-party investment manager with assets under management of over \$US50b said that positive impact is difficult to measure. He said that while it was clear ESG information was used to monitor risk, the positive performance of a company was the more difficult to prove.

"This is an interesting question; we've been doing research in the area ... I think [performance] is more under discussion and more difficult to show."

One of the main goals of integrated reporting is to plug this gap and to successfully demonstrate future performance to investors. Accountability and credibility are other key elements in making reports transparent, which is something highly desired by investors.

Investors want a high level of accountability over organizations' non-financial information

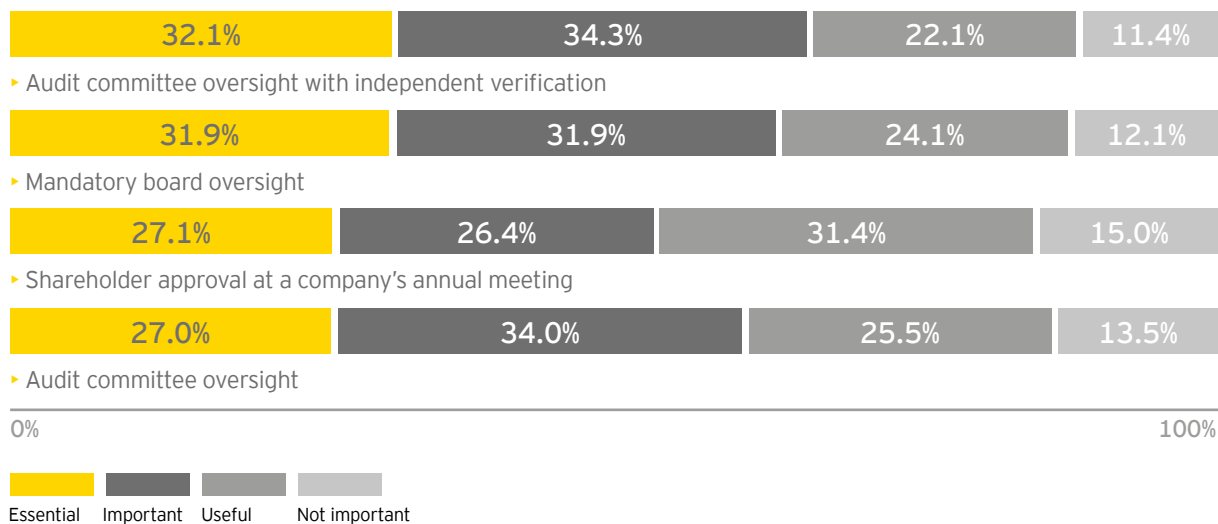
The increasing uptake of ESG analysis is seeing investors pay much greater attention to the quality and utility of the ESG information provided by companies.

Investors rated the audit committee with independent verification as the most desirable level of accountability for sustainability performance reporting, but only by a small margin.

However, what is most telling from these results is that a majority of investors felt that it was important or essential to have a level of accountability – whether in the form of audit committee oversight of sustainability data, oversight from the board or shareholder approval.

With sustainability report assurance remaining largely voluntary across the globe, the scope of assurance often remains limited to a number of key metrics. This data corroborates analysis undertaken by the ACCA that identified that 80% of investors felt that non-financial disclosures should be independently verified.²

Q6. How important are the following levels of accountability in sustainability performance reporting?



²What do investors expect from non-financial reporting?, ACCA and Eurosif, 2013

Companies should consider that assurance can be useful, not only for underpinning the disclosures and for providing adequate support to those using such information, but also for stopping third parties from estimating their impacts on the environment or society.

In our interviews, investors revealed that they wanted a high level of accountability for ESG. According to some, companies that take a high level of responsibility for their ESG data are those that can be trusted.

A South African portfolio manager for a third-party investment manager with assets under management between US\$5b-US\$10b said:

“If a company is applying ESG seriously, it tells you that they’re taking their risk analysis seriously. It really is a form of risk analysis.”

Another trend that investors have noticed is that the mandatory reporting of non-financial information is increasing globally. A US-based senior VP for a third-party mutual fund with assets under management of over US\$50b believes that consistency through standards would be helpful. The VP said, “We are familiar with [standard-setting] organizations that are looking to integrate ESG risk factors into accounting standards and reporting, and we think that’s positive.”

Just a year old, the Sustainability Accounting Standards Board (SASB) has received significant support. Indeed, Bloomberg has made a financial investment, with in-kind support from a range of market participants and reporting entities eager to help shape the indicators that may, one day, become required reporting disclosures.

Having now seen that investors do value non-financial performance information, that they use it to assess risk, and that they want both a wide spectrum of data and some material analysis carried out on it, one question remains: exactly what information is most important to investors?

“If a company is applying ESG seriously, it tells you that they’re taking their risk analysis seriously. It really is a form of risk analysis.”





3

What type of non-financial information do investors want?

Investors are most interested in the ESG information that is most material to the company's performance and they would rather this information came from the company itself than from third parties.

We also found that the majority of those who never used non-financial performance information in their investment decision-making process chose not to do so because the information wasn't material to the company. Not surprisingly, investors would be more likely to use non-financial information if it was successfully tied to financial performance, possibly through an integrated report or some kind of economic monetization or measurement.

More specifically, investors were likely to rule out or reconsider investments if the company lacked a clear strategy for creating value in the future or if the company had a history of poor governance. And finally, investors believe that companies are motivated to report their impact on ESG issues in order to comply with regulation but also to improve their corporate reputation.

Investors want the conventional information that they receive from companies to be specific and material to those companies

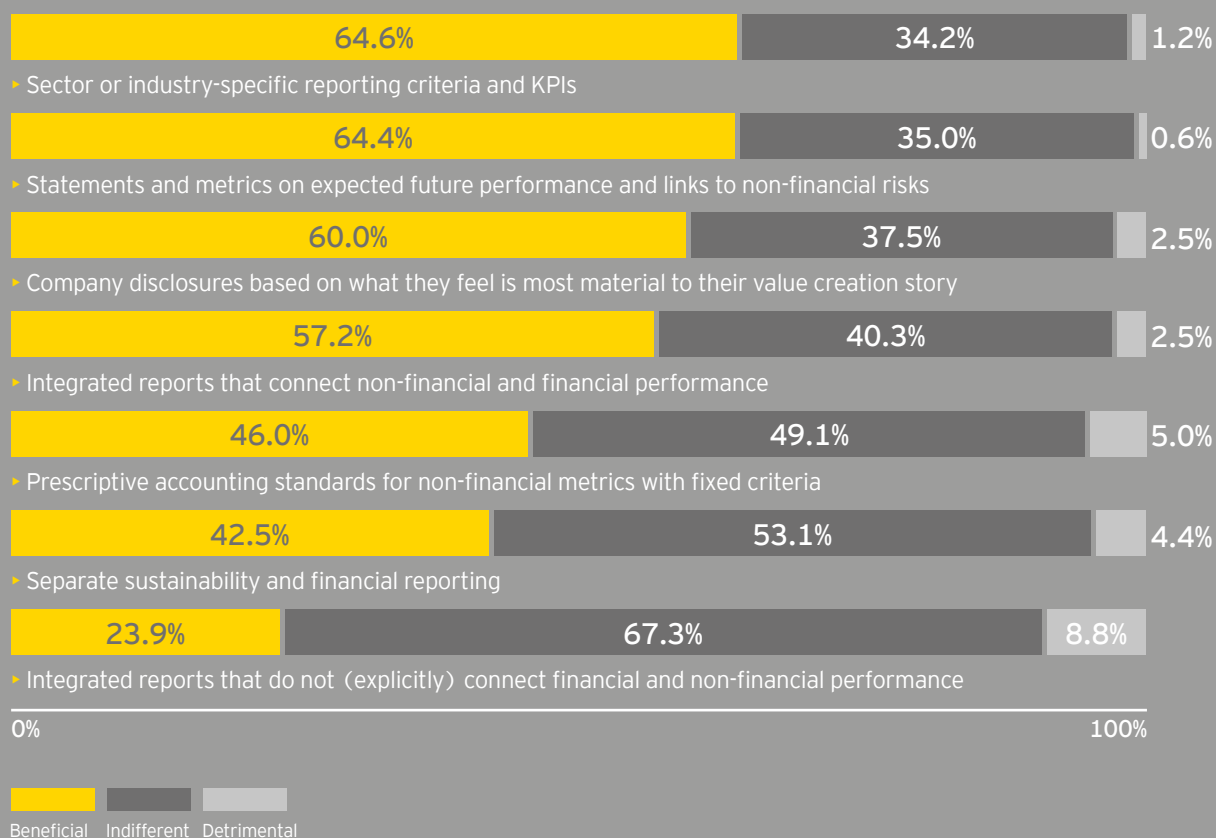
Almost two-thirds of investors think that it would be both beneficial to have sector-specific key performance indicators (KPIs) and metrics on expected future performance linked to non-financial risks. Sixty percent believe that companies should disclose what they feel is most material to their value creation story.

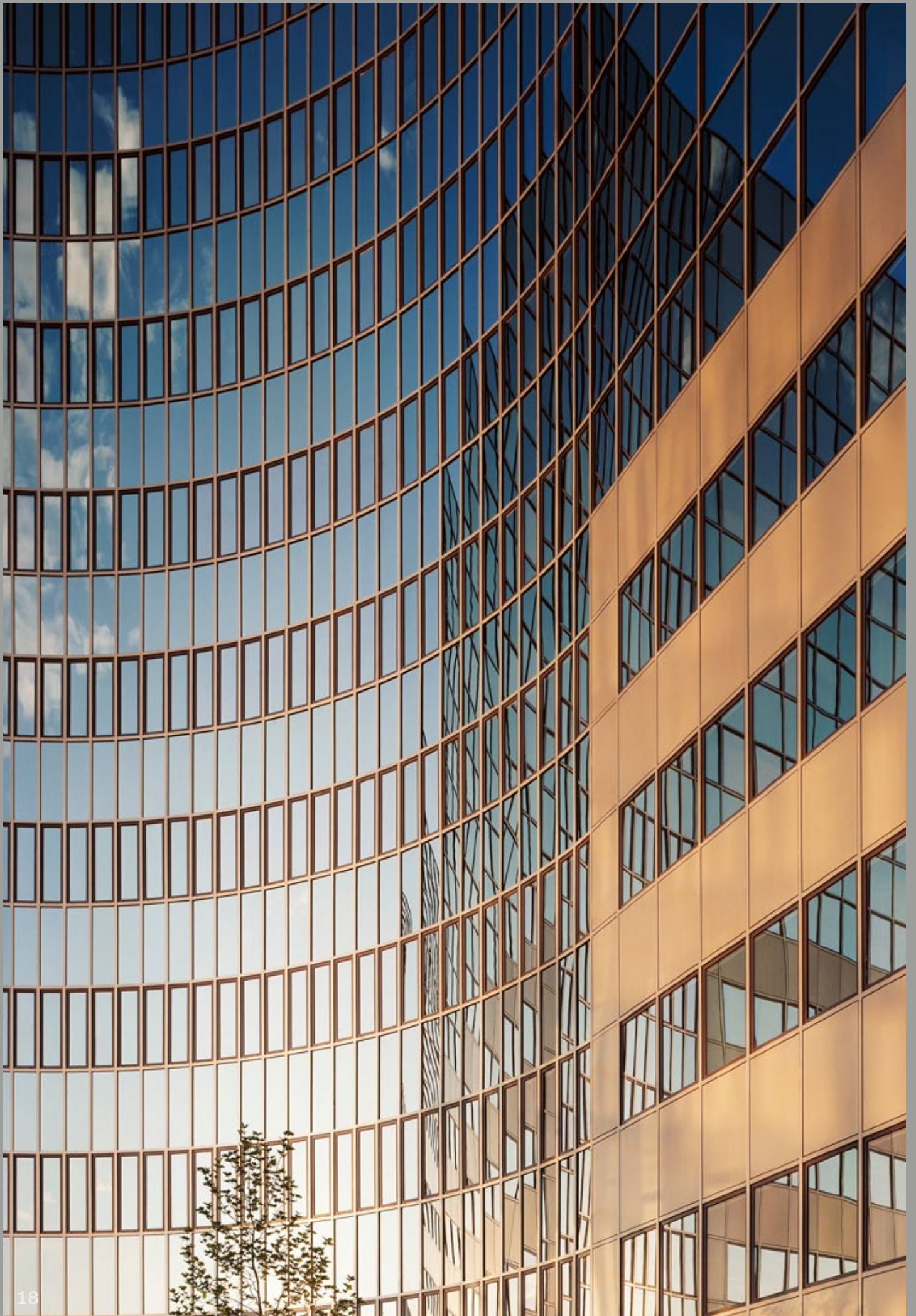
The second and fourth highest responses, though, are either connected with – or directly relate to – the advent of integrated reporting: a majority of investors believe that statements and metrics on expected future performance and their links to non-financial risks would be beneficial (64.6%) and that an integrated report connecting non-financial and financial information would be beneficial (57.2%).

Investors want information linked to financial performance

Besides wanting information that is material to the organization, investors also told us they would prefer the information to be explicitly linked to financial performance. While a majority of respondents said that an integrated report linking non-financial and financial performance would be beneficial, only 23.9% believe an integrated report would be beneficial without such links. And 8.8% said no linkage between financial and non-financial performance would be detrimental.

Q.7 How useful would each of the following reports or disclosures be to your investment decision-making?

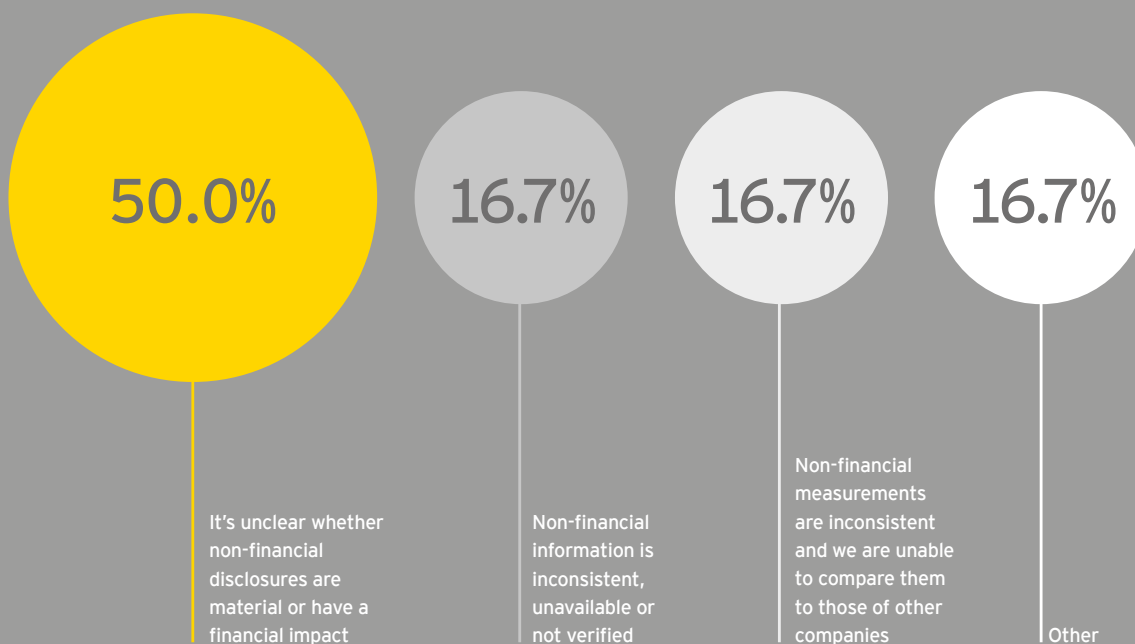




Materiality is the biggest issue for those who never consider non-financial performance

Over half of those who responded that they never use non-financial information explained that this is because it is unclear whether these disclosures are material or have a financial impact. Investors explained that they have difficulty in determining what aspects of non-financial information are material to the company they are assessing.

Q8. Which of the following statements best reflects your views on why you do not consider ESG issues in your decision-making?



There are a number of international bodies seeking to address this issue, such as the Global Reporting Initiative (GRI). The latest version of its sustainability reporting framework, G4 Guidelines, requires that those responsible for preparing non-financial reports list all the aspects determined to be material and specify where they are material. It also requires companies to describe the underlying process used to determine that materiality.

Both the GRI and the IIRC have discussed the importance of taking a more holistic view of corporate risk and opportunity that considers the material nature of such aspects for reporting. Materiality will be of vital importance to the implementation of integrated

reporting. Another body seeking to fill this void is SASB, which has produced the SASB³ Materiality Map that weighs the priority of sustainability issues by industry, across 10 sectors, aiming to assist decisions on asset allocation strategies and to aid companies to understand their exposure to certain kinds of ESG risk.

This growing focus on materiality will hopefully provide investors with a more relevant view of the risks and opportunities of issuers, and allow the investors to weigh portfolios according to sustainability risks. Investors will then be better equipped to compare peer performance on material ESG issues and to understand the relative positioning of companies with respect to future challenges.

³Determining materiality, Sustainability Accounting Standards Board, 2013, Accessed via <http://www.sasb.org/materiality/determining-materiality/>

Investors want to see a strategy to create value

When asked how different disclosures would affect their investment decisions, what was considered most likely to make investors either rule out or reconsider an investment was if the company did not have a clear strategy to create value in the short, medium and long term (93.8%), a core tenant of integrated reporting.

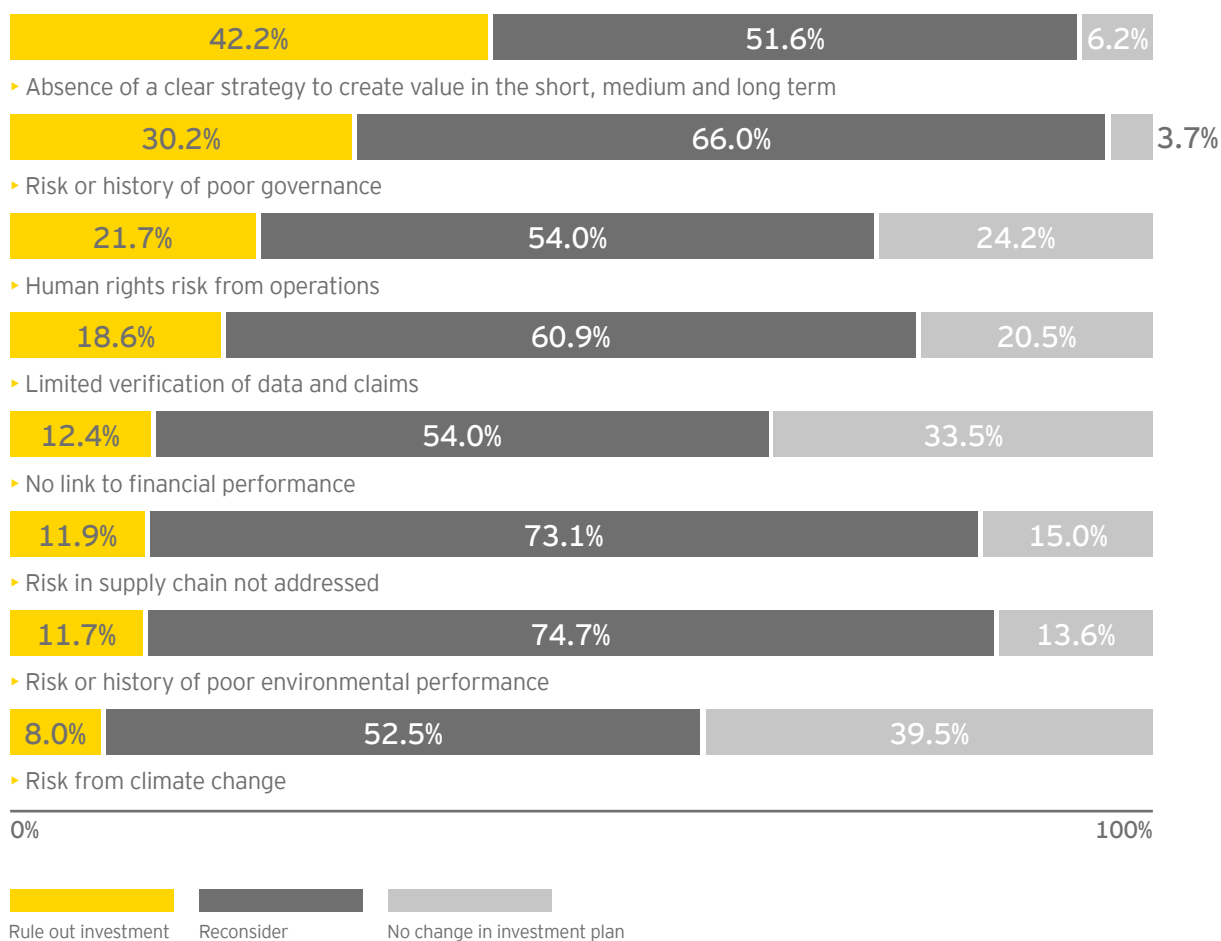
Within the current reporting model, many companies do not provide much – if any – information about the company's expected future performance and its plans for short- and long-term value creation. Instead, they concentrate on reporting past performance. This information gap is perhaps why most non-financial information produced today is used for risk minimization rather than value creation.

In December 2013, we saw the first Integrated Reporting Framework released by the IIRC, which will be integral in helping companies to produce an integrated report. The framework provides guiding principles and may provide clear support for those investors seeking to better understand a company's value creation story.

The disclosure second most likely to make an investor either rule out entirely or reconsider their investment was a history of poor governance (96.3%). One US-based portfolio strategist, working for an asset manager with US\$5b-US\$10b under management, explained that many aspects of a company's governance structure interested him:

"For example, a board of directors, peers, captive boards, and executive pay. One thing we're very interested in is the structure of executive pay: What's the right mix of ownership in stock and salary."

Q9. How would the following disclosures about a prospective investment affect your investment decision?





Other factors that were rated as likely to adversely influence investors included risks in the supply chain (73.1%) and a risk or history of poor environmental performance (74.7%). A US-based senior VP for a third-party mutual fund manager with assets under management of US\$50b thought that the reason for this high response rate could be dependent on industry:

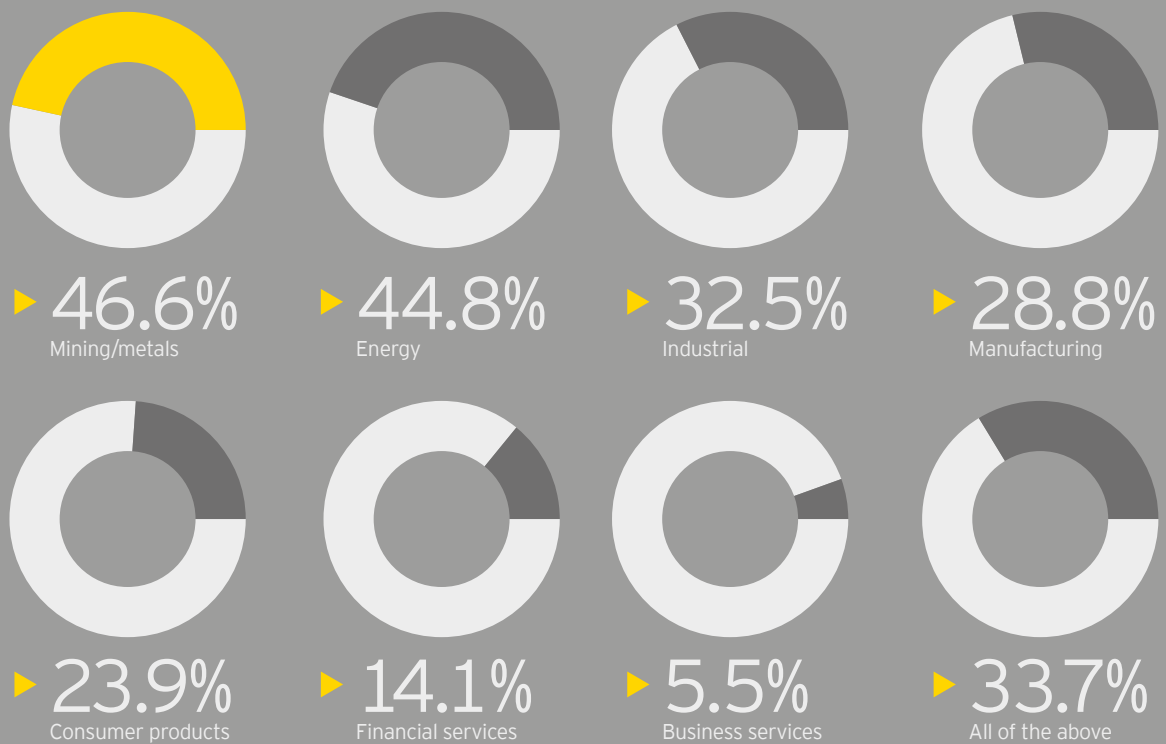
“What we are finding is there are some constant ESG factors applicable across industries, especially as it relates to things around governance. But the ‘E’ and the ‘S’ in particular tend to be more specific to the industry and so, therefore, coming up with what are the material risk factors to a particular industry that the analyst might be focused on, might differ across other industries that analysts are covering.”



When the investors were asked to name the sectors for which non-financial performance is most relevant, the most common answers were heavy industries: mining and metals, energy and industrial. However, over a third of investors believed that ESG information was relevant for all sectors. And their opinion is borne out by the fact that, although ESG was seen as least relevant to financial and business services, that was the sector seen as the most highly affected by a risk of poor governance.⁴

Q10. In which sectors are you more likely to consider non-financial data most relevant?

Respondents could select up to three responses.

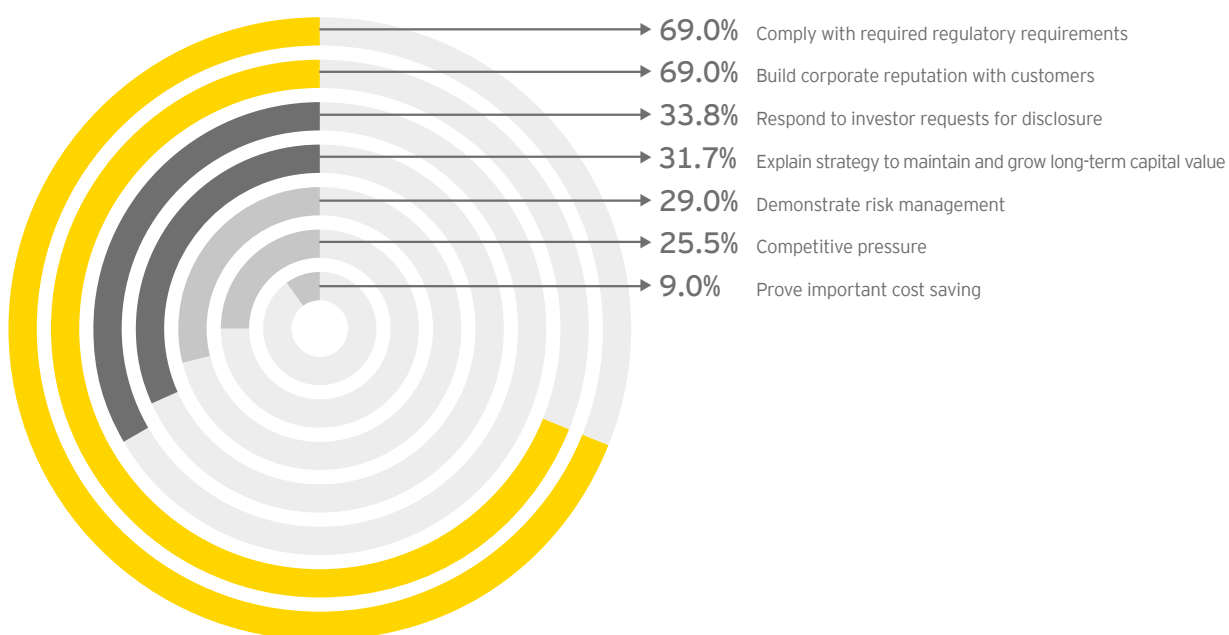


Overall, an integrated report may make these risks more obvious, but it may also allow the organization to effectively communicate its strategy, in the short, medium and long term, for mitigating the risks and to eventually create extended value for the organization.

⁴See Appendix

Q.11 What do you believe motivates a company to report its impact on non-financial, i.e., environmental, social and governance (ESG), issues?

Respondents could select up to three responses.



Investors believe that companies report their non-financial information to comply with regulations and to build their reputation

Investors believe that companies' biggest motivations for adopting sustainable practices are to build corporate reputation and to comply with regulations.

Over half the respondents frequently use non-financial information when assessing how regulation could impact an investment. Most believe that companies report on ESG issues either to be compliant with regulatory requirements or to build their corporate reputations with customers. This aligns with what investors most want to see from the data: the business impact of regulation ranked as the most essential issue for their investment decisions. This is largely due to the potential financial consequences that a breach may have on the business.

These two points were echoed in an interview with a US-based senior VP for a third-party mutual fund manager with assets under management of over US\$50b:

"We found that [sustainable activity] is aligned with companies who believe it will impact their competitive position or that have a consumer base that cares about these things. The other important component is the regulatory regime that is driving them to make these enhancements."

Most investors did not think that companies were motivated to implement ESG efforts to save costs (only 9% thought so). This is despite the fact that for some CFOs cost savings have been an important selling point for adopting ESG measures.⁵

Despite the low number of responses for competitive pressure (only 25.5% indicated it was a motivating factor for companies implementing ESG measures), many investors told us, in interviews, that they believed sustainability leaders were the ones deriving a competitive advantage within their own industry. While it is sometimes hard to quantify, investors are taking into consideration the positive effects that can contribute to alpha generation, a risk-adjusted measure of return.

While investors said that some companies implement sustainability strategies partly to gain a competitive advantage, a portfolio manager for a third-party investment manager based in the US with assets under management between US\$10b-US\$50b pointed out that having this kind of strategy can also affect investor perception and, at the end of the day, valuation:

“Simply put, it’s the same thing if the competitive threat for your product is higher, your valuation is going to be lower ... If I have environmental issues, or issues with my labor force that I’m not properly handling – it puts at risk my ability to deliver cash flow and profits – so I think it’s simply ... the cost of doing business.”

The overarching message from these results is that when investors are making an investment decision, they are looking for information from the company that shows that it is a market leader. And the feeling about ESG’s contribution to this? ESG most certainly can help carry this message.

Increasingly, international companies should be aware of investors outside their own countries. Investors based in emerging markets, for example, are even more concerned about ESG than their developed-market peers. In Section 4 we take a deeper look at the role geography plays.

⁵*Value of Sustainability Reporting*, EY and Boston College, 2013

4

How does location affect investors' feelings toward ESG?

This survey revealed that where investors are based has a big impact on their perceptions of non-financial reporting. There were clearly different approaches to analyzing data and different values placed on non-financial information depending on the investor's location. When it came to assessing the data splits between emerging markets and developed ones, the results were somewhat surprising. In particular, Latin American-based investors (23.3% of the sample) were the most interested and well-versed in ESG benefits.

Below, we outline trends from two of the most significant data splits: the US and Canada versus the rest of the world, and emerging versus developed markets.

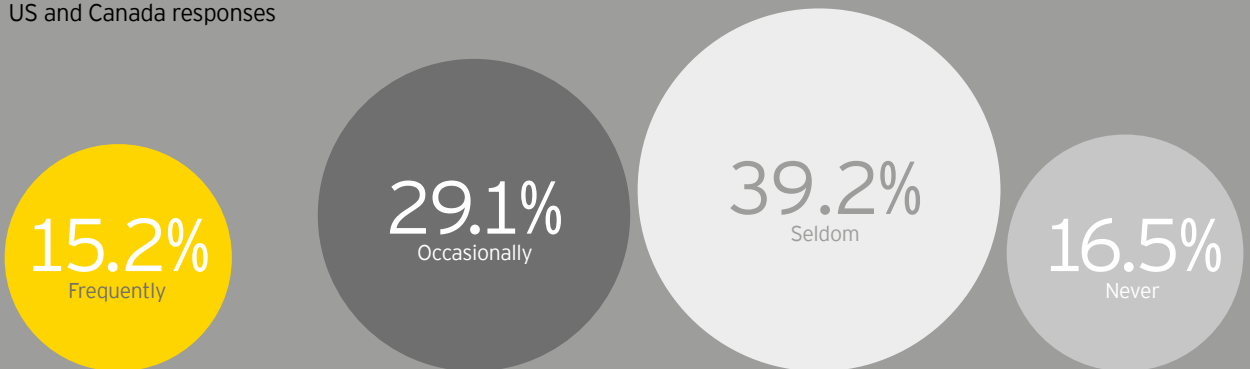
North America lags behind on ESG

Investors in the US and Canada are far less likely to use non-financial data in decision-making than investors based in the rest of the world

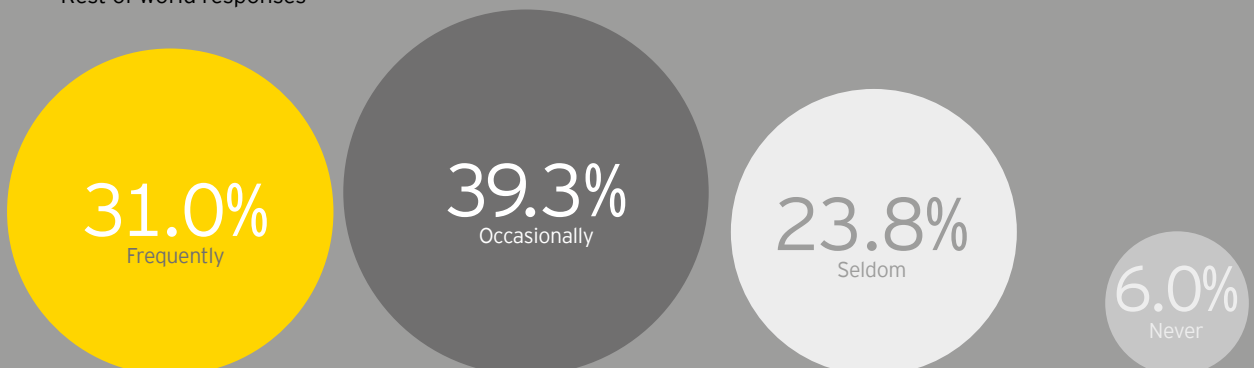
Just 15% of the North American investors we surveyed stated that a company's non-financial performance frequently played a pivotal role in their decision-making. This compares with a figure of twice that for the rest of the world (31%). Furthermore, 60% of respondents from outside North America frequently considered non-financial information when examining industry dynamics and regulations, compared with just 43% of respondents from the US and Canada.

In the last 12 months, how frequently has a company's non-financial performance played a pivotal role in your investment decision-making?

US and Canada responses



Rest of world responses



In fact, some investment managers noted that, in determining the degree to which they would need to consider non-financial risk, the geography of their investor client base was of fundamental importance.

“It is also geographically different with Europe and Australian clients kind of leading the charge” said a portfolio manager for a third-party investment manager based in the US with assets under management between US\$5b and US\$10b.

“Those that do have a focus on consumer bases in places where they care about these things a lot – in Europe and elsewhere – tend to be more sensitive to it and then tend to respond with greater detail in this space.”

This demonstrates that not only are investors in North America less likely to incorporate non-financial risk into their decision making, but they are aware that their approach is less rigorous than that of their counterparts based elsewhere. Indeed, one US portfolio manager asked the interviewer whether “most answers [had been] similar? Are the Europeans a bit ahead of the rest?”

Certainly, it seems that the Europeans notice the global differences, too, as one senior portfolio manager from a German-based third-party investment management group with assets over US\$50b under management said: “I think there's a huge difference on a geographical basis. Different countries look at it in a very different way – the more northern European companies, there is a lot of awareness, and there is also a significant amount of knowledge and expertise on this topic.”

He added that in the emerging economies in Asia, there seemed to be less emphasis placed on ESG analysis, while in the US, there was an industry-specific and corporate governance focus.

The results on whether investors use a structured, informal or no review of ESG was highly skewed by the North American results

Nearly half of the respondents from the US said that they conduct little or no review of ESG information when making an investment decision (46%). This is in stark contrast to respondents outside the US, where only 26% conduct little or no review.

Brendan Le Blanc, an Executive Director in EY's US Climate Change and Sustainability team, said that some of the reasons for the underuse of ESG information in the US market were lack of comparability and materiality issues.

“The results of this survey echo many of the concerns we've heard from analysts who focus on responsible investment portfolios: that they're difficult to compare even between industry peers; they often lack rigor and assurance over key data sets; and the information they present is focused on recent examples of positive initiatives, rather than on the issues that are materially important to the sustainable growth of the company and its continued ability to deliver returns to shareholders.”

While 25% of respondents outside the US said that they conduct a structured process for evaluating ESG information, only 14% of respondents from the US do the same.

“What stood out for me was when we looked in more detail at the differences between how North American investors and those overseas evaluate environmental and social disclosures,” LeBlanc said. “While a quarter of all overseas responses said they had a formalized process, just 14% could say the same over here.”

Emerging markets push ahead

Investors based in emerging markets made up a significant portion of the respondents to the survey – 41%. In comparing their behaviors with those based in developed markets, we saw that they were more likely to place greater importance on ESG information, which they tend to use for assessing risk.

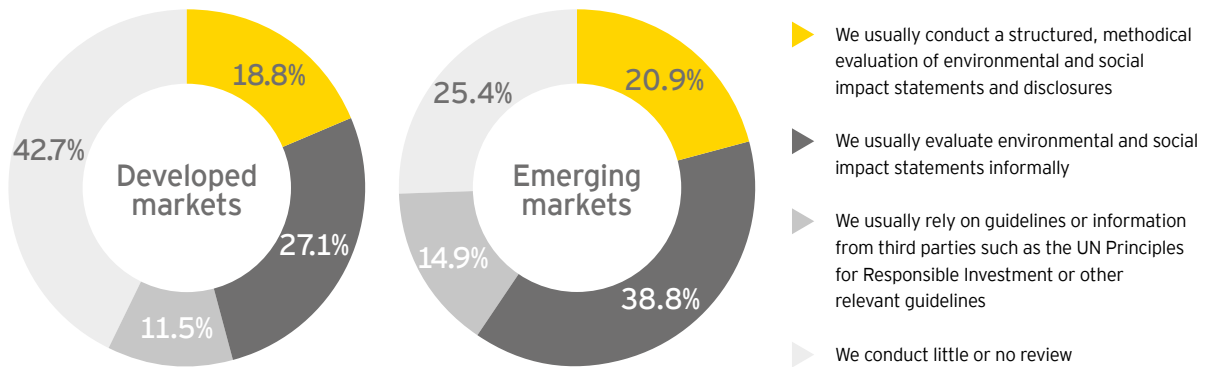
Evaluation techniques

Investors in emerging markets were more likely to have used non-financial performance information in the last

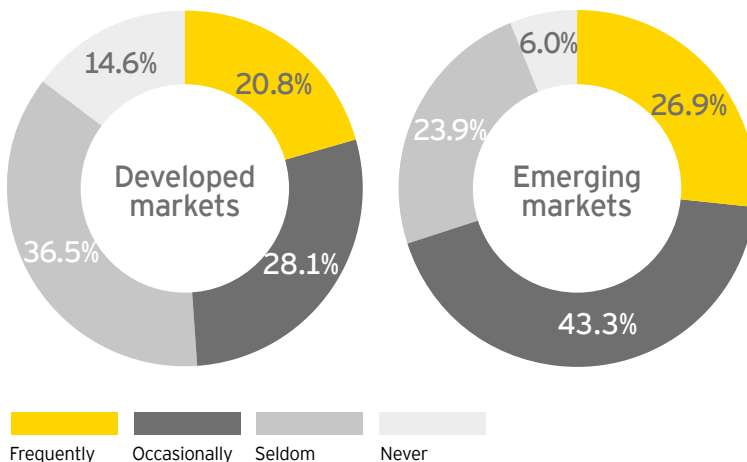
12 months when making an investment decision. Over 70% of the respondents based in emerging markets frequently or occasionally used this information, compared with only 48.9% of those in developed markets who did the same.

However, in emerging markets, investors are much more likely to have made an informal evaluation of the information: 38.8% told us that they relied on gut instinct, compared with 27.1% of those in developed markets. This shows that there is significant room for improvement in the way this analysis is being made.

Which of the following statements best describes how you and your investment team evaluate non-financial disclosures that relate to the environmental and social aspects of a company's performance?



In the last 12 months, how frequently has a company's non-financial performance played a pivotal role in your investment decision-making?

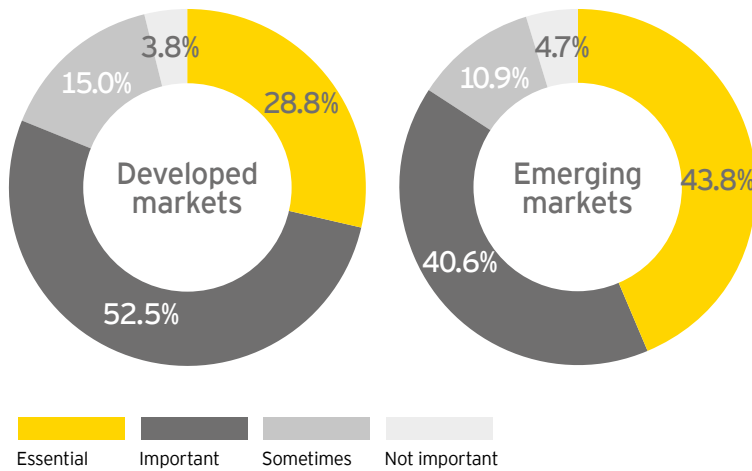


Minimizing risk

Investors in all markets were interested in minimizing their exposure to risk by successfully assessing ESG issues. However, 43% of the respondents from emerging markets said that non-financial information

was essential to minimize risk, compared with only 29% of those from developed markets. This shows that investors in emerging markets are, perhaps, more aware of the risks posed by ESG issues, or that these risks are more prevalent in emerging markets.

How important is minimizing risk to you as an investor?

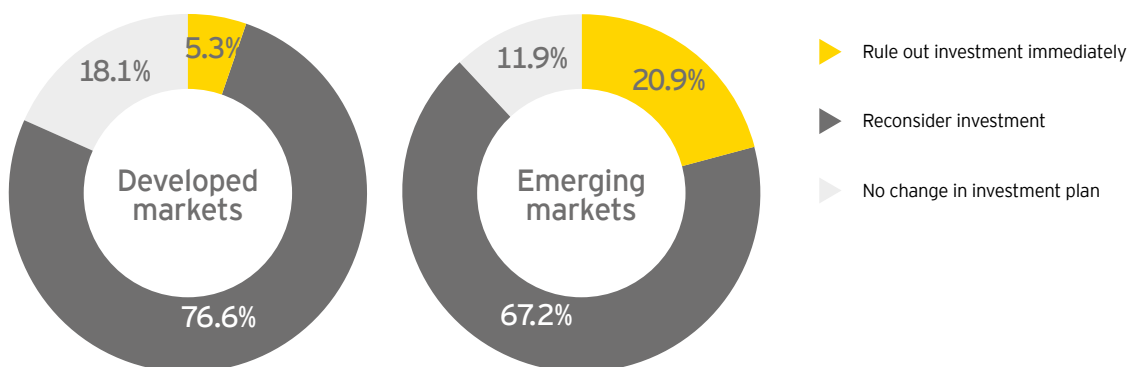


Risks in the supply chain

When considering a disclosure, if risks in the supply chain were not addressed, 21% of the respondents in emerging markets would rule out the investment completely. This is a significantly higher figure than the same one for respondents from developed

markets, where only 5% would rule out these investments completely. This shows that investors in the emerging markets are more aware of the implications that risks in an organization's supply chain may pose.

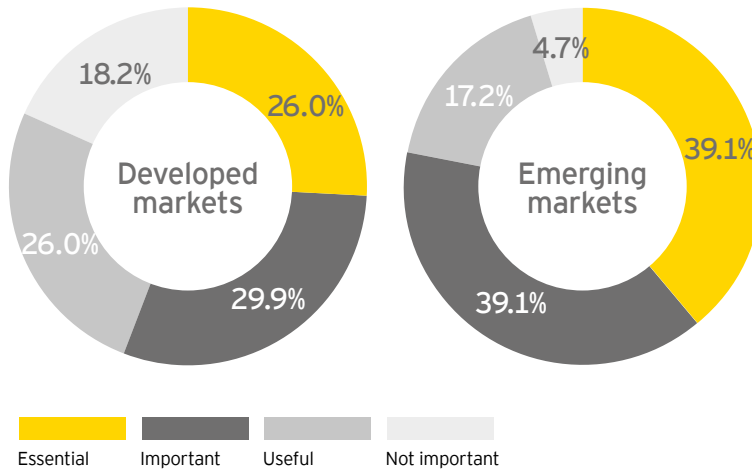
How would risks in the supply chain affect your investment decision?



Risks in the supply chain tend not to be managed at as high a level as other risks. And it seems that emerging market investors are more interested in a higher level of responsibility over ESG issues than developed markets investors.

Audit committee oversight with independent verification was the most desired level of responsibility for both groups; however, this level was seen as essential or important by 78.2% of those in emerging markets, and by only 55.9% in developed markets.

How important is audit committee oversight in sustainability performance reporting?

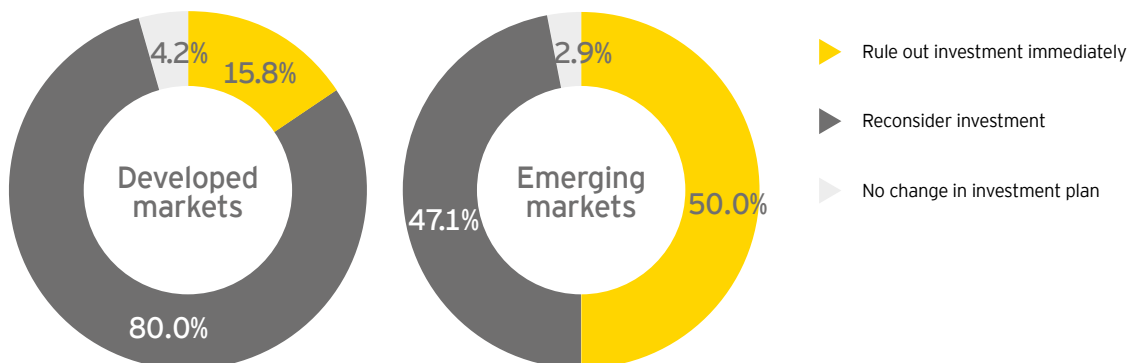


Risks from poor governance

Interestingly, those based in emerging markets would be much quicker to judge those companies that they feel have a history of poor governance:

50% of emerging market investors would rule out the investment immediately, in contrast with only 15.8% in developed markets who would do the same.

How would a history of poor governance affect your investment decision?



Importance of emerging markets

Mathew Nelson, EY's managing partner for Cleantech and Sustainability Services in Asia Pacific, noted that understanding the views of the emerging markets was now more important than ever.

"The traditional paradigm suggests that sustainability issues are higher on the agenda for the developed world compared with developing economies. However, what we have seen in places like China and South East Asia is that sustainability concepts are as important, if not more so, to the way they operate, and how quickly they adapt to a shifting landscape. As a result, it is not surprising that more respondents from emerging markets said non-financial information was essential to minimize risk compared with developed markets. With the global economic shift and the increasing globalization of capital flows, we can no longer ignore the views of the emerging markets."



Summing up:

The results in context for reporters

For reporters, this survey not only shows that their investors care about their non-financial performance. It also indicates why, how and when they use this information.

The findings show:

- ▶ Investors are already factoring in ESG information when making investment decisions, but want that information to be relevant and material.
- ▶ When making an investment decision, only a minority of investors currently conduct systematic assessments of non-financial information.
- ▶ There is a real need to improve non-financial information, to make sure that it is:
 - relevant
 - consistent
 - comparable
 - balanced
 - linked to the organization's financial performance
 - reliable and potentially verified by a third-party

We have seen that investors prefer getting their information on non-financial performance from the company itself, whether that is through its annual report, its integrated report or the company website. Other sources, such as the sustainability report and indexes, are much less useful, because they do not link financial and non-financial information. Investors are clearly making a distinction between what they expect from an integrated report and what they are currently getting from sustainability and corporate social responsibility reporting.

Most investors told us that they use non-financial information in their assessments of risk. However, a number of investors also informed us that they use this same information to identify additional value – or, as a Senior Vice President of a US-based third-party investment manager of a mutual fund with more than US\$50b of assets under management put it, “opportunistic responsibility.” This is a developing area, but, once it is understood, analysts and investors could add a premium to those companies to reflect this value – either through reducing the discount rate of their value or through scoring them higher against peers when screening multiple options.

Investors view the lack of a consistent framework for comparing non-financial information as an important problem. This may be addressed by the advent of integrated reporting, but there has been much confusion as to what it is. This study suggests that investors believe that an integrated report is just an annual report with non-financial information incorporated into it. But if the IIRC's framework is an indication of what such a report is, then the reality is that it should be a document that draws together all the material aspects of reporting. That provides an overview on how the company – through its business model – can create value in the short, medium and (most critically) long term.

Some of the key recommendations that reporters can draw from these results include:

1. Invest in reporting	The widespread use of non-financial data and information in all of the markets we surveyed indicates that companies can derive significant value from being more transparent on environmental, social and governance disclosures. But widespread reporting on sustainability performance has yet to occur, despite the significant growth in reporting of “top tier” organizations globally. This survey demonstrates that investors and analysts are often using their own judgment to determine whether your company is meeting its expectations.
2. Report on – and highlight – what’s truly material to your business performance	Investors just can’t tell whether most of the information currently available is important to longer-term value creation. Learning what key stakeholders believe is fundamental to your company’s sustainable business development will be critical in determining what to measure, manage and report.
3. Keep abreast of international developments	With both the GRI’s G4 Guidelines and the IIRC’s Integrated Reporting Framework now released, and with further developments such as SASB’s non-financial accounting standards, this area of reporting is evolving rapidly. Understanding these areas can be key for gaining a competitive advantage and staying abreast of potential new developments.
4. Act now, or be penalized	It is no good saying that investors aren’t asking you for this sort of non-financial information. They’re finding ways to get data and they are assessing you on it.
5. Get your governance right	The majority of investors said that they think that a company’s non-financial performance should have audit committee oversight and should be verified. Consider how best to establish governance processes to monitor and manage non-financial performance. And consider the benefits of engaging subject-matter experts and auditors to add rigor and validity to the process.



Methodology

Institutional Investor's Custom Research Group was commissioned by EY to examine investors' views on using non-financial information in investment decision-making. The Custom Research Group composed a questionnaire with EY and in September 2013 and gathered 163 responses from senior investment decision makers around the world through an online survey. In addition, further qualitative interviews were sought with investors who completed the survey. Twelve of these interviews were undertaken by *Institutional Investor* researchers.

Survey respondents represent large financial institutions such as third-party investment managers, banks, pension funds, foundations, endowments, sovereign wealth funds, insurance companies and family offices. Fifty-nine percent of respondents work for institutions with more than \$10 billion in assets under management. *Institutional Investor* provided a copy of the research results to those who participated in the study.

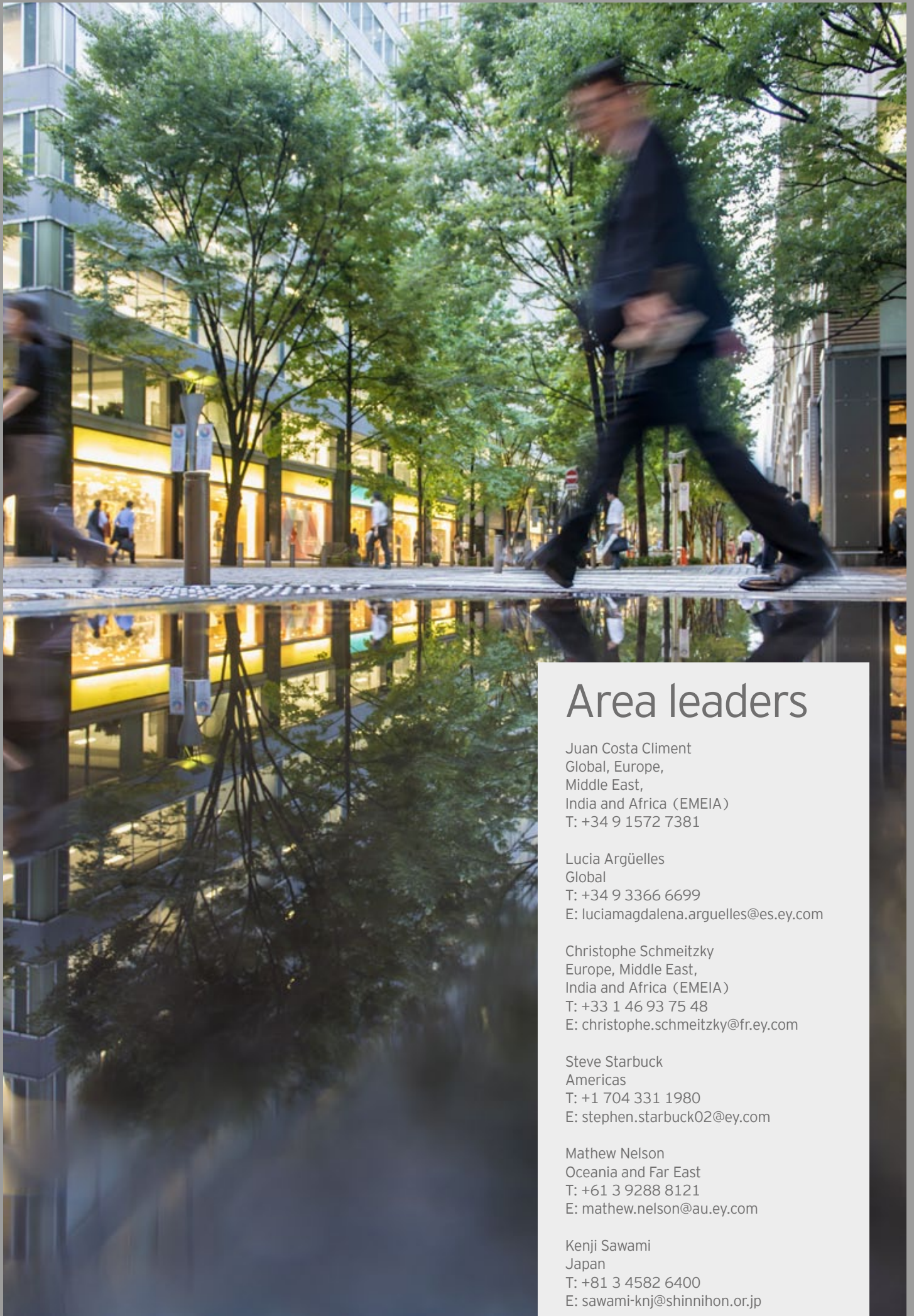


Appendix

Investors' response to non-financial disclosure varies according to their investment focus.

	Financial services	Industrial	Mining & metals	Business services	Manufacturing	Consumer products	Energy	All of the above
Absence of a clear strategy to create value in the short, medium and long term								
Rule out investment immediately	39%	43%	41%	56%	38%	47%	41%	45%
Reconsider investment	57%	45%	50%	33%	47%	47%	51%	55%
No change in investment plan	4%	11%	9%	11%	15%	5%	8%	0%
Risk or history of poor governance								
Rule out investment immediately	26%	33%	29%	33%	33%	41%	31%	36%
Reconsider investment	74%	65%	70%	67%	65%	56%	68%	60%
No change in investment plan	0%	2%	1%	0%	2%	3%	1%	4%
Human rights risk from operations								
Rule out investment immediately	17%	15%	22%	0%	26%	18%	22%	29%
Reconsider investment	61%	58%	51%	89%	49%	69%	52%	56%
No change in investment plan	22%	26%	26%	11%	26%	13%	26%	15%
Limited verification of data and claims								
Rule out investment immediately	13%	15%	18%	11%	15%	24%	19%	27%
Reconsider investment	61%	57%	51%	78%	54%	66%	51%	67%
No change in investment plan	26%	28%	30%	11%	31%	11%	30%	5%
Risk or history of poor environmental performance								
Rule out investment immediately	17%	9%	12%	11%	8%	15%	12%	15%
Reconsider investment	70%	78%	79%	78%	81%	74%	80%	75%
No change in investment plan	13%	13%	9%	11%	10%	10%	8%	11%
No link to financial performance								
Rule out investment immediately	14%	11%	12%	11%	8%	15%	9%	15%
Reconsider investment	59%	50%	47%	67%	54%	59%	50%	67%
No change in investment plan	27%	39%	42%	22%	38%	26%	41%	18%
Risks in supply chain not addressed								
Rule out investment immediately	9%	11%	9%	0%	9%	8%	10%	20%
Reconsider investment	74%	76%	71%	78%	77%	82%	70%	76%
No change in investment plan	17%	13%	20%	22%	15%	10%	21%	4%
Risk from climate change								
Rule out investment immediately	17%	4%	5%	11%	4%	10%	5%	13%
Reconsider investment	61%	52%	47%	67%	50%	59%	49%	64%
No change in investment plan	22%	44%	48%	22%	46%	31%	46%	24%

 Yellow highlights indicate the top two responses in each category.



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