Country-Level Governance is Key to Successful International "Responsible Investing"

While the origin of Responsible Investing dates as far back as the 1500's, it wasn't until the 1960's that the term Socially Responsible Investing (SRI) was adopted. Three decades later, SRI began to incorporate environmental and corporate governance factors, leading to a new acronym: ESG, or Environmental, Social and Governance factors.

The launch of the United Nation's Principles of Responsible Investing (PRI) in 2006 helped give rise to the overarching term "Responsible Investing," which describes the process by which risk and return investors use ESG factors. PRI has around 1,200 signatories and those signatories now represent about 15% of the world's investible assets[1].

Many improvements have been incorporated into Responsible Investing over time. Initially, so-called "ethical" portfolios tended to use negative screening (i.e., excluding companies). In 2012, Deutsche Bank[2] published a white paper focused on studies of performance based on negative screening. It was cited that only 42% of these studies showed that companies with high SRI scores exhibited outperformance. The whitepaper also found mixed results at the fund level.

Shift from negative to positive screening

Increasingly, there has been a shift from negative to positive screening (i.e., security selection and weighting based on adherence to a framework). The same DB whitepaper found overwhelming academic evidence that companies with high ESG scores have a lower cost of capital. It also documented meaningfully *better* performance from positive screening.

The "G" in ESG has received less attention than the "E" and the "S", yet it is more correlated with investment performance.

Within ESG ratings, the "G" (governance) had the strongest influence on performance[3]. Another study, from 2010, showed a strong positive relationship between corporate governance and company valuation[4]. Specifically, strong shareholder rights

[1] "From SRI to ESG: The Changing World of Responsible Investing", Caplan, Griswold, & Jarvis, Commonfund, 2013, page 3
[2] "Sustainable Investing: Establishing Long-Term Value and Performance", DB Climate Change Advisors of Deutsche Bank Group, June 2012, page 8
[3] Ibid, page 54
[4] "Corporate governance and firm value: International evidence", Ammann, Oesch, & Schmid, *Journal of Empirical Finance*, 2010

have been found to increase corporate valuations[5]; board and audit committee independence better protect shareholder rights and help increase corporate valuations[6].

Stronger emphasis on the "G"

By 2008 there were 11 providers of ESG ratings. A State Street Global Advisors study found little consistent predictive power from these ratings, though the predictive power did strengthen over time[7]. A subsequent article[8] explained some limitations in these ratings, including underdeveloped definitions, insufficient data, and untimely publishing.

The historical perception that Responsible Investing portfolios and/or products deliver subpar performance is diminishing. While there has been considerable progress, there is room for meaningful improvement. Further, given the demand for such products, there is significant room for product innovation to provide both better alignment with values and better prospects for attractive returns. In the not too distant future, Responsible Investing could become a proven source of alpha.

MSCI published an insightful study on the best practices in constructing Responsible Investing portfolios[9]. This study highlighted the need for a strong emphasis on corporate governance.

Countries can play a large role in improving corporate governance. This role includes strengthening the information reported by corporations, while also assuring common definitions. A report by the UNEP Finance Initiative[10] specifically identifies a stronger role for governments in requiring more ESG information be reported. Fundamentally, corporate governance is significantly impacted by the requirements of the countries under which they are regulated[11].

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[5] "Corporate governance and equity prices", Gompers, Ishii, & Metrick, *Quarterly Journal of Economics*, 2003
[6] "Do US firms have the best corporate governance? A cross-country examination of the relation between corporate governance and shareholder wealth", Aggarwal, Erel, Stulz, & Williamson, *National Bureau of Economic Research (NBER) Finance Working Paper*, 2007
[7] "A Comprehensive Analysis of the Relationship between ESG and Investment Returns", Kennedy, Whiteoak & Ye, State Street Global Advisors, 2008
[8] "The Future of ESG Investing" Ye, Taisheng, *SSga Capital Insights*, June 2012
[9] "Optimizing Environmental, Social, and Governance Factors in Portfolio Construction: An Analysis of Three ESG-tilted Strategies", Nagy, Cogan, & Sinnreich, MSCI Applied Research, 2013
[10] "The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing", The United Nations Environment Programme Finance Initiative (UNEP FI) Asset Management Working Group (AMWG), June 2004
[11] "Do US firms have the best corporate governance? A cross-country examination of the relation between corporate governance and shareholder wealth", Aggarwal, Erel, Stulz, & Williamson, National Bureau of Economic Research (NBER) Finance Working Paper, 2007

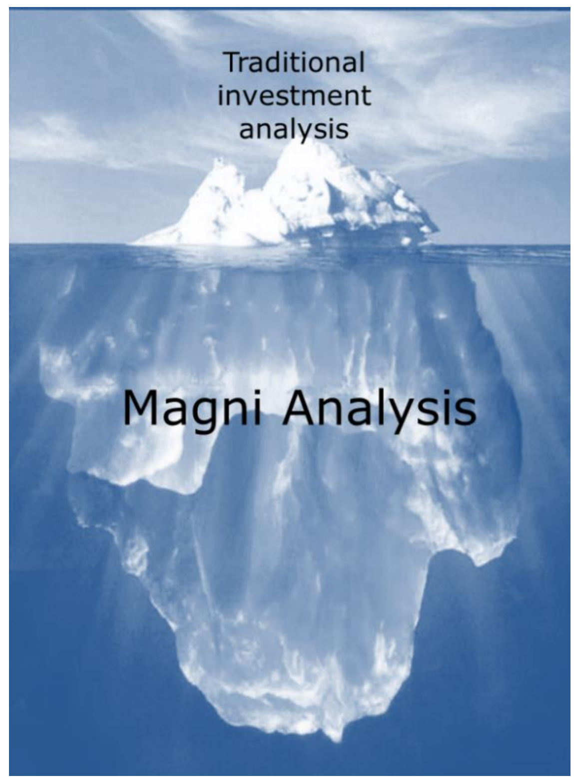
Country research: the next major improvement to Responsible Investing?

If two companies in different countries receive the same ESG score, **the country can be the deciding factor** regarding which company is a better investment. The company in the country with the better reporting requirements and where Responsible Investing is more important is more likely to further improve its ESG score. Incorporating country selection into investing can help identify where the greatest improvement is most likely. Country research may be the next major improvement to Responsible Investing.

Open, honest, transparent behavior must be evident

Are the country's corporate governance laws being applied adequately? Are companies adhering to regulations, and implementing policies and practices to be in full compliance?

The good news is that companies do tend to follow the legal, regulatory, and reporting requirements of the country where they are listed. Therefore, governance can and should be measured at a country level. A prior whitepaper by Magni Global Asset Management documents the current status of country research for investment purposes. Researching country-level information has traditionally encountered significant challenges. The available information is mostly not standardized and is inherently qualitative, using reported company data such as EPS, revenue, and free cash flow, but ignoring the impact of differences between countries. Essentially, the legal, regulatory, and economic infrastructure of countries is usually unseen by traditional investment analysis, and similar to an iceberg, the crucial investment information is formed below the surface.



While non-governmental organizations perform substantial research on countries, including economic performance and progress on social welfare, this research does not address the investment analysts' need for frameworks containing available facts that yield clear overall pictures where countries can be compared on an "apples to apples" basis. This is not easily accomplished; if it were easy, analysts would already access such information.

Magni has developed a process for researching and assessing the legal, regulatory, and economic infrastructures of countries. The process uses Magni's Sustainable Wealth Creation (SWC) principles which are based on widely accepted economic concepts.

Countries that receive high scores according to the SWC are required to have more than strong intent and/or rules; there must be evidence that the companies within the country adopt the intended behavior. For example:

- Do financial statements accurately reflect a company's position?
- Do shareholders have protections and adequate controls?
- Can company leadership make decisions confidently?

To convert principles into an objective, repeatable process, SWC is divided into twelve Economic Standards. The Economic Standards are further divided into 280 Qualitative Sovereign Factors. Countries are scored based on their declared intentions ***plus their actual level of adherence***.

Country scores are a Responsible Investing measure and have also demonstrated a correlation to investment performance. Decisions about Responsible Investing can be enriched through the incorporation of country scores.

The "G" in ESG has received less attention than the "E" and the "S", yet it is more correlated with investment performance. While the existing ESG measures have room for improvement, a better "G" can be used now. Including the impact of countries on corporate governance strengthens the measurement of "G", incorporates best practices, and positions portfolios for potential outperformance.

About Magni

Magni Global Asset Management LLC is the leader in country-level research on corporate governance. Magni developed the Sustainable Wealth Creation principles, based on widely accepted economic concepts, by researching the accounting, legal, regulatory, adjudicative, and economic infrastructures of countries. Its extensive database goes back 15 years and contains analysis on countries across 280 qualitative factors. The Minnesota-based research and asset management firm believes Countries Matter™ when investing internationally; Magni scores and ranks investible countries on their ability to provide an environment conducive to effective corporate governance.

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