

Uncovering alpha through understanding the “S” in ESG

In line with changing community expectations, the way firms manage their social capital is increasingly important to their financial performance. The relationship between community and business has evolved from one based largely on corporate philanthropy to a complex social contract involving staff, customers, suppliers and a range of external stakeholders. These new relationships mean that firms are in the public spotlight more than ever and those out of step with expectations can face a severe and sudden financial backlash.

Even amongst ‘experts’ in environmental, social and governance (ESG) analysis there has been more focus on environment and governance than social factors such as human capital management, workplace safety, and community relations. During the past decade, the environment has been considered widely from pricing carbon to calculating the cost of contaminated sites, and governance closely monitored from the Enron and AWB events to the global financial crisis. This suggests that there may be a misappreciation of company value in some social issue areas. For example, attracting and retaining skilled employees was of critical importance in the context of the labour constrained market. During the economic downturn, the hoarding of talent as an alternative to large scale redundancies highlights the expectation that this will return, and the importance of retaining talent to firm culture, performance and value.

Uncovering alpha (outperformance) in the “S”

When looking at the financial performance of companies considered the best employers, research shows that the best 100 employers in the US out-performed the market index in seven of the last eight years¹. In addition, those companies formerly but no longer considered best employers, outperformed the market index the year after they were removed from the best employers list, but failed to outperform the best employers. This intuitively makes sense as it reflects the declining ability of the company to manage people, but recognises that it is still likely to be ahead of the pack.

Finding the “S” that matters

For investors, what matters requires an understanding of the measures closely related to performance, and which investors can identify from outside the firm. For example, when examining human capital management for outperformance, there are a number of measures including career related training, and 360 degree manager feedback which fit these criteria, while others, such as staff turnover rates are often disclosed to investors but appear to have a lesser relationship with performance.

The way firms manage their human capital is increasingly important to their financial performance, but how well is this recognised by the market?

In an attempt to understand the different emphasis analysts place on different factors, the AMP Capital Investors Sustainable Alpha Team (SALT) conducted research looking at views held by ‘current company executives’ as opposed to ‘sell-side (stock-broking) analysts’. It is interesting to note that when considering what makes a good management team; sell-side analysts generally placed greater value on executives who focused on cost management and efficiency while the actual company executives thought the seemingly ‘soft’ issues of ‘people’ and ‘culture’ were far more important to long-term company performance. This research by SALT suggests a bias in the sell-side analyst community towards factors that are ‘measurable’ and easier to communicate as opposed to more intangible factors that may impact valuations.

Recognition of social trends is likely to require a redirection of research efforts and the development of a broader range of analytical skills in the financial community. Investors who move quickly to develop an understanding of social capital impacts are likely to generate enhanced returns. More specifically, investors’ long-term focus would benefit from:

- investing in non-traditional research tools – particularly those that focus on a company’s intangible assets such as branding, risk management, human resources, intellectual property and firm culture.
- adopting a diversity of skill sets. Just as company boards are often criticised for a lack of diversity, investment analysts (on both the sell and buy side) also lack diversity and hence often demonstrate a homogenous approach to valuation.
- developing processes that fully integrate insights gained in relation to intangible factors, such as environmental, social and governance performance into valuation methodologies.

¹ Edmans, A. (2009) Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices. Wharton School, University of Pennsylvania.



Good governance: avoiding short-termism

Risk and the global financial crisis

A key feature of asset-price bubbles is that markets become desensitised to risk, impacting multiple 'market participants' – including companies, boards, investors and their clients, and even governments. In 2001, investors overlooked the risk that transformational internet technology might not deliver on its promises for the many companies exposed to the technology bubble. It now appears that in 2007/08, risks associated with credit and counterparty risks were overlooked.

While 'bubbles' occur from time to time, they are not in society's long term interest. Excesses lead to a misallocation of capital, to unnecessarily painful fluctuations in economic growth and ultimately, to a lower standard of living for all. During a 'bubble', this risk manifests itself for investors as the market fails to factor in an appropriate risk premium.

Do shareholders contribute to 'bubbles'?

From an asset-owner's perspective, it appears that habitual and institutionalised 'short-term' behaviours throughout financial markets are a root cause of 'bubbles' – especially as participants are increasingly subjected to short-term time-frames. As such, it is argued that the underlying problem can be addressed by the establishment of more sophisticated, better calibrated and longer-term incentives for all market participants, or 'alignment of interests', and to this end in recent years AMP Capital Investors (AMP

Capital) has supported only 60% of the incentive schemes proposed by companies.

Can everything be blamed on short-termism?

It may be too simplistic to blame 'short-termism' for all current woes. While the investment activities of fund managers may on the surface appear increasingly short-term, they can reflect an extremely long-term focus. For example, a common stock valuation tool used is 'discounted cash flow', often relying on predicted earnings over more than a thirty year period. In some instances a newly purchased share may, over the next month, very quickly move towards its long-term discounted cash flow valuation, causing it to be sold which appears short-term, but is also a rational and healthy response to market mispricing on the basis of a very long-term valuation.

Measuring the unmeasurable

The Sustainable Alpha team (SALT) at AMP Capital believes investors can avoid traps associated with short-termism and/or the tendency to overemphasise hard-and-fast financial data by spending at least as much time considering intangible and qualitative issues as they do considering tangible factors.

Valuing good governance

Understanding intangibles and how these impact asset valuations requires a longer-term perspective than is generally adopted, or indeed encouraged, by market

participants. One difficulty is that trends like 'climate change' or 'demography' play out over such long periods; while it is hard to establish governance mechanisms that properly measure management teams' initiatives.

Through long-term risk analysis of companies like Babcock and Brown and ABC Learning Centres, SALT was able to prevent material portfolio exposure to their businesses as they unwound. This occurred through an explicit 'factoring-in' of the long-term risks associated with governance and transparency – yet also meant some short-term performance had to be sacrificed when these companies were 'flavour of the month'.

Conclusion: allocate capital for long-term gain

The tension that exists between short and long-term performance is unlikely to dissipate in the near term. Rather, SALT anticipates it is likely to remain as both a perennial challenge and opportunity to fundamental investors concerned with long-term risk and return.

This is an edited account from Michael Murray, Senior Portfolio Manager of SALT, who as part of the International Corporate Governance Network Conference panel discussion on the Role and Responsibilities of Shareholders, addressed the issue in the context of the global financial crisis. The August 2009 AMP Capital Corporate Governance Report provides more detail on this issue from Michael (<http://www.ampcapital.com.au/institutions/governance.asp>).

profile



Angus Dennis

B Ec, LLB, F Fin

Senior Investment Specialist, Sustainable Alpha & Responsible Investment Leaders

Angus' involvement with Sustainable Funds at AMP Capital dates back to 2000 when as part of his then role as Head of Product Development, Angus worked on introducing a new sustainable capability into AMP Capital. Since that time in his role as investment specialist, Angus has been actively involved on building and profiling AMP Capital's Sustainable Alpha capability within the Australian market place. And in the last two years AMP Capital has emerged as the largest manager of responsible investments in Australia and NZ.

In 2004, Angus also developed the Responsible Investment Leaders (RIL) product range and he continues to have involvement with its management and focus on strong environmental, social and governance outcomes. Associated with this multi-manager responsible investment capability AMP Capital is now applying responsible investment strategies across shares, direct property, fixed interest and alternatives for the RIL Balanced Fund.

Angus chairs the RIL Ethics Committee and is a member of the RIAA (Responsible Investment Association of Australasia) Responsible Investment Academy Advisory Council and the Finsia Managed Funds and Superannuation Advisory Group. Angus was also involved in initiating and setting up RIAA's certification program.

Angus is married with 2 boys and enjoys surfing, tennis, bushwalking and community initiatives.



stock story

Infigen Energy

Research and engagement

Our sustainable investment process requires an understanding of both sustainability growth drivers at an industry level, and environmental, social and governance risks at the company level. The value proposition of the AMP Capital Investors Sustainable Alpha Team (SALT) derives from a fuller understanding of company value through our process which integrates tangible financial analysis with the more intangible extra-financial research. In delivering this value proposition during the past 6 months SALT has completed industry specific research on the healthcare and utilities sectors.

SALT has continued its constructive engagement as part of the investment process and as part of our value proposition to investors. Some engagement highlights with companies and industry were on the following topics:

Climate Change: Ian Woods presented at the Australian Financial Review Climate Change Conference. Ian presented at an insurance industry conference on Climate Change and Infrastructure. Ian presented to a Willoughby Council public meeting on Climate Change. Ian discussed the implications of the proposed Australian emissions trading scheme with Orica.

Corporate Responsibility: Nick Edgerton had discussions about ESG risks in the developing world supply chain with listed retailers Billabong, Pacific Brands Group, Premier Investments (Just Group) and David Jones. Nick and Ian Woods attended the UN PRI in Person conference. Nick presented to a CPA discussion group on corporate responsibility. Nick attended a site tour of Australia's latest 6 Green Star office building, GPT's Workplace6.

Reporting and disclosure: Ian Woods assessed about 75 sustainability reports as a judge in the ACCA Australia and New Zealand Awards for Sustainability Reporting. Ian provided feedback to Origin Energy and Boral about their corporate responsibility reports. Nick Edgerton met with Stockland and their sustainability assurance provider to input into the reporting process and provide feedback on the report. Nick met with JB Hi-Fi to discuss ESG risks and reporting and disclosure. Nick met with the Global Reporting Initiative Australian Focal Point to discuss the latest trends in corporate responsibility reporting.

Corporate Governance: Michael Murray, as part of the International Corporate Governance Network Conference panel discussion on the Role and Responsibilities of Shareholders, addressed the issue in the context of the global financial crisis. Karin Halliday and Ian Woods attended the International Corporate Governance Network Conference.

Human Capital Management: Nick Edgerton discussed staff agreements and union involvement with Cochlear. Nick met with the Aircraft Engineers Union to discuss workplace relations at Qantas, Jetstar and Virgin Blue. Nick discussed the importance of people and culture in the health care sector with Sonic Healthcare.

Occupational Health and Safety (OHS): Ian Woods discussed OHS with Rio Tinto, particularly in relation to fly-in, fly-out operations. Nick Edgerton discussed OHS and fatalities with Lend Lease.

Infigen Energy (IFN) has interests in a globally diverse portfolio of wind energy generation assets. Infigen's portfolio of assets includes wind farms in Europe, North America and the Asian Pacific and has a total capacity of approximately 2,246MW. The portfolio of wind farms comprises of interests in 41 wind farms diversified by geography, currency, equipment supplier, customer and regulatory regime.

In Australia, Infigen has wind farm developments in South Australia and Western Australia and is one of the largest owners of wind farms in Australia. With the recent passing of the Renewable Energy Target legislation, new opportunities are available to Infigen and it has over 1000MW of further wind farm development options in South Australia, Western Australia, NSW and Victoria. Currently its largest exposure is in the US.

In February 2008 Infigen reached agreement to sell its portfolio of Spanish wind energy assets to Formento de Construcciones y Contratas S.A. In November 2008, Infigen sold 50% of its interest in the Enersis portfolio of wind farms in Portugal to a consortium of investors led by Magnum Capital.

Infigen was previously called Babcock & Brown Wind and in 2009 changed its name to Infigen Energy reflecting the internalising of the management structure and the breaking of ties with Babcock & Brown. The Sustainable Share Fund believes this change has resulted in an improved governance structure for the company.

Note: AMP Capital Investors is not making any recommendation or warranty about the performance of shares in IFN.

performance

The AMP Capital Sustainable Share Fund (the "Fund") has outperformed its benchmark of the S&P/ASX200 Accumulation Index by an annualised rate of 0.43% since its inception in February 2001 to the end of August 2009. Over this period, the Fund has returned 8.50% pa compared to its benchmark return of 8.06% pa.

The start of March marked the bottom for the market. As optimism returned about the state of the economy and companies were able to recapitalise balance sheets, the fund benefited from some stock specific exposures to 'turn-around' stories. Three of the top contributors to the fund were overweight positions in Transfield Services Limited, Challenger Financial Services Group Limited and Goodman Group.

Over the past six months, defensive sectors which had performed relatively well during the downturn were left behind in the rally. The biggest detractors to performance were overweight positions in Healthcare and Telco companies.

Looking ahead, the Fund will continue to apply the Sustainable Alpha Process to search for investments that are offering superior return and risk characteristics that provide a sustainable growth outlook consistent with the Fund's style.

(Wholesale Units) AMP Capital Sustainable Share Fund, before tax and after fees (cum dist price) as at 31 August 2009

	3 mths	1 yr	2 yrs %pa	3 yrs %pa	4 yrs %pa	5 yrs %pa	7 yrs %pa	Inception
Fund	20.65%	-10.32%	-13.01%	-1.15%	5.09%	9.20%	10.54%	8.50%
Benchmark	18.94%	-8.06%	-11.20%	0.07%	4.77%	9.48%	10.04%	8.06%
Difference	1.71%	-2.26%	-1.80%	-1.22%	0.32%	-0.28%	0.50%	0.43%

*Important Note: AMP Capital Investors Limited (ABN 59 001 777 591, AFSL 232 497) ("AMP Capital"). The above returns were available only to wholesale investors from the Fund inception on 20 March 2001 to 31 August 2009 and are before tax, after fees and costs and assume income is reinvested. Past performance is not a reliable indicator of future performance. A new class of retail units was issued in the Fund on 30 March 2007 pursuant to Product Disclosure Statement ("PDS") with higher fees and charges than those attached to the wholesale units.

To invest in the AMP Capital Sustainable Share Fund ("Fund") investors need to obtain the Fund's current PDS from AMP Capital. The PDS contains important information about investing in the Fund and it is important investors read the PDS before making any decision whether to acquire, or continue to hold, units in the Fund. AMP Capital is the responsible entity of the Fund. Neither AMP Capital, nor any other company in the AMP Group guarantees the repayment of capital or the performance of any product or any particular rate of return referred to in this newsletter.

news

The global response to address climate change for the post Kyoto period (2013–2020) will be determined in December 2009 with the Conference of Parties meeting in Copenhagen. This article takes a look at news from key jurisdictions in the lead up to this influential event.

According to Yvo de Boer, executive secretary of the United Nations Framework Convention on Climate Change, the four questions when calling for an international agreement in Copenhagen are:

1. How much are the industrialised countries willing to reduce their emissions of greenhouse gases?
2. How much are major developing countries such as China and India willing to do to limit the growth of their emissions?
3. How is the help needed by developing countries to engage in reducing their emissions and adapting to the impacts of climate change going to be financed?
4. How is that money going to be managed?

So what news from key players in the lead-up to negotiations.

USA: In June, The Waxman-Markey Bill passed the US House of Representatives and must go through the Senate in late September. This draft legislation in the US is committing to a national cap-and-trade scheme targeting emissions reduction by about 5% in 2020 from 1990.

Australia: The Government's emissions trading scheme legislation was passed by the House of Representatives but was rejected in the Senate. It is expected to be reintroduced into Parliament later this year.

China: Chinese Bureaucrats issued a statement in late August committing to no additional growth in emissions post 2050. China has already committed to generating at least 15% of its energy capacity from wind, solar and other renewable energy sources by 2020.

Japan: New leadership in late August signalled a deepening of emissions reduction targets for an 8% to a 25% cut in the country's greenhouse gas emissions in 2020 from 1990 levels.

EU: Following almost 5 years of operating the largest multi-country, multi-sector Greenhouse Gas Emission Trading System, the EU remains committed to cut emissions by 20% from 1990 levels by 2020.

AMP Capital Sustainable Share Fund

The AMP Capital Sustainable Share Fund is available to Australian investors. The overall objective of the Fund is to deliver superior returns to our clients by investing in companies that contribute to, benefit from and best adapt to the shift to an environmentally sustainable and socially responsible global economy.

Further information can be found on our website:

www.ampcapital.com.au/sustainable

Important note: Investors should consider the product disclosure statement available from AMP Capital Investors Limited (ABN 59 001 777 591) for the Sustainable Share Fund before making any decision regarding the Fund. Neither AMP Capital Investors, nor any other company in the AMP Group guarantees the repayment of capital or the performance of any product or any particular rate of return referred to in this document. Past performance is not a reliable indicator of future performance. While every care has been taken in the preparation of this document, AMP Capital Investors makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.