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## *Measuring the Impact of Sustainability Policies and Investments on Stock Price Framework & Methodology*

### Importance of Sustainability Initiatives

Most public companies have come to recognize that Sustainability performance, including environmental accountability, social responsibility and corporate governance (also referred to as ESG), is increasingly becoming an important criterion by which investors evaluate securities. The UN Principles for Responsible Investing reports that the Assets Under Management (AUM) of just its membership represents US\$18 trillion of assets from 36 countries. Overall, global investments using some kind of Sustainability evaluation may be as high as US\$27 trillion. These are serious numbers that are already having an impact on stock prices. The issue of Sustainability is not going away.

Leading companies have been trying to respond to the overall issue of investor interest in Sustainability but these responses have achieved mixed results, largely reflecting an inability to measure the full benefits (including stock price impacts) of specific Sustainability investments. As a result, corporations invest substantial sums of money on the basis of broad qualitative “good/bad” assumptions, without knowing if these investments are too much or too little, directed for maximum impact, or whether (and how) they create value for investors.

### Measuring the Full Economic Impact of Sustainability

Sustainability initiatives affect stocks in two ways. The obvious impact is on reported financial performance (the income statement, balance sheet, and cash flows). Corporate finance staffs are generally well positioned to analyze such conventional financial impacts. The less obvious, and yet potentially major, impact is through investor perceptions, where Sustainability-related buy and sell decisions directly affect the stock price. Companies whose negative Sustainability reputation and/or performance render them off-limits to a significant number of institutional investors risk lower stock prices due to diminished access to market capital. Conversely, companies that are attractive using such criteria regularly trade at a premium, reflecting enhanced demand among influential investor groups. Conventional financial metrics lack the ability to capture this important dynamic.

From a corporate perspective, understanding how Sustainability initiatives affect stock price is critical for making the right decisions. For example, overhauling an important production process to reduce energy consumption requires substantial investments with significant impacts on profits and cashflows. Such a project may appear unattractive or marginal when assessed using strictly conventional metrics (Net Present Value, Internal Rate of Return), but incorporating a substantial stock price boost can present a different (and more accurate) picture. Conversely, knowing when Sustainability performance won't affect the stock price gives management the ability to differentiate between value-creating initiatives that are shortchanged by conventional analysis vs. “feel good” projects that may sound appealing but ultimately detract from shareholder value.

## Research Background & Framework

The vast majority of published studies have failed to address the issue of how investors price Sustainability performance. Most published research focuses on decision rules for stock portfolios, and resulting aggregate returns. A few studies focus on the degree to which Sustainability ratings correlate with (or fail to correlate with) published financial performance. But these miss the key question: For any given company, what dollar impact does Sustainability performance have on the stock price?

A growing number of academic papers address the issue of investor preferences, cost of capital, and stock price. A statement by Eugene Fama and Kenneth French succinctly summarizes the issue as follows:

Like all prices, asset prices are determined by supply and demand. If some investors overweight the stocks of "socially responsible" firms, they push up prices and reduce expected returns. Similarly, they push down the prices and push up the expected returns of the socially irresponsible firms they underweight. Presumably that is their goal—to *reduce the cost of capital of firms they like* by reducing the "good" firms' expected stock returns and to *increase the cost of capital of firms they don't like* by increasing the "bad" firms' expected stock returns. - Fama/French Forum accessed online 7/30/2011- (Italics ours)

<http://www.dimensional.com/famafrench/2011/06/qa-expected-returns-and-socially-responsible-investing.html>

CharterMast/Ativo calculates the company-specific implicit discount rate to measure investor preferences and perceptions. The Ativo database contains detailed financial information and cost of capital (COC) estimates on approximately 40,000 companies globally. Comparing current market prices with financial performance (both reported and forecast) provides a mechanism to calculate company-specific COC. Our research effort to date combines these COC calculations with over 120 Sustainability policy and performance variables for approximately 2800 firms as reported by IW Financial. Statistical analysis of the combined data provides a mechanism to determine the relationship between Sustainability performance ratings and COC. Understanding these observed relationships between Sustainability rankings and COC provides the foundation for then calculating the dollar impact of Sustainability performance on stock price.

Ghoul and Guedhami (Does Corporate Social Responsibility Affect the Cost of Capital? SSRN-id1546755) used a similar methodology, and reached conclusions similar to ours. "Firms with better CSR scores exhibit cheaper equity financing. In particular, our findings suggest that investment in improving responsible employee relations, environmental policies, and product strategies contributes substantially to reducing firms' cost of equity."



## Sustainability Value Review – Company-Specific Methodology

For those firms that want to understand this research more completely, and to realize the full benefits of their Sustainability investments, CharterMast Partners provides the **Sustainability Value Review**. Specifically, the objective of this offering is to maximize payoff of company Sustainability efforts by quantifying impact on shareholder value and benchmarking efforts/results compared with key peers.

This in-depth analysis, over a 6-8 week period, includes the following stages:

1. Series of interviews with client's Sustainability, operating, and financial executives to assess internal perceptions and current strategies
2. Detailed review of company documents and comparison with external Sustainability, financial, and stock price data
3. Statistical analysis relating shareholder value results to both externally reported Sustainability data and internal perceptions of Sustainability performance (including peers where possible)
4. Identify performance vs. peers, including estimated financial impact of Sustainability improvements
5. Provide best practices guidance regarding Sustainability & materiality disclosures
6. (Optional) – Assessment of Investor Relations and Communications policies with respect to Sustainability

The key project deliverable is an onsite presentation of research results, with particular attention to how Sustainability performance is impacting the stock price of your company and selected peers, as well as the potential impact of major Sustainability initiatives currently under consideration or in process. The analysis shows how executive management (and Board) Sustainability decisions affect the corporate stock price and provides impactful insights to senior management so they can better apply limited resources across alternative initiatives to get the “most bang for your Sustainability buck.”

The key benefits of this review are to:

1. Determine the degree to which current Sustainability performance is helping or hurting stock price and shareholder value
2. Identify where Sustainability dollars/efforts should be directed for maximum shareholder value impact
3. Develop recommendations regarding specific Sustainability initiatives/strategies to enhance/support current company position (Sustainability strategy, investor relations, materiality and reporting, communications strategies)



### **Biographies of Key Sustainability Staff**

**Dennis N. Aust, Managing Partner, CharterMast Partners LLC**, has spent over 30 years developing and implementing value creation strategies, frameworks, and tools for Fortune 500 and mid-cap firms in a variety of industries, helping senior executives and boards understand/address key strategic and operational issues that are critical for delivering superior results for shareholders. Mr. Aust's articles covering strategic analysis, consulting, financial management, and innovation have appeared in the *Journal of Private Equity* and *Director's Monthly* (NACD). He has contributed chapters to "The Valuation Handbook: Valuation Techniques From Today's Top Practitioners" (Wiley, 2009), "Managing Innovation in the New Millennium" (ICFAI Press, 2002), and "Stock Options – An Introduction" (ICFAI Press, 2005). He was featured speaker at the 2010 National Conference of the Association for Strategic Planning, and has also spoken at the National Association of Accountants Annual Conference, the American Management Association, and the Chicago Booth Finance Roundtable. He holds an undergraduate degree in business and an MBA in management science from the University of Chicago. Contact Dennis directly at (312) 224-8509 or [dennis.aust@chartermast.com](mailto:dennis.aust@chartermast.com).

**Nick Andrews, Associate Director – Sustainability Practice, CharterMast Partners LLC**, supports clients in drawing a direct link between their Sustainability programs and shareholder value, through a focus on policies, materiality, reporting, and cost of capital. His past experience has centered on Transparency and Disclosure for public companies through the creation of non-financial reporting using the Global Reporting Initiative Reporting Guidelines. Mr. Andrews has supported clients in developing Key Performance Indicators (KPIs) and triple bottom line reports detailing their progress towards Sustainability.

Mr. Andrews holds a Masters Degree in International Business, with a specialization in Corporate Social Responsibility and Sustainability Reporting using the GRI Framework & Guidelines. He is also working towards attaining his Responsible Investment certification, issued through the Responsible Investment Association of Australia. Contact Nick at (630)-351-8555 or [nick.andrews@chartermast.com](mailto:nick.andrews@chartermast.com).

**Daniel T. Allen, Director – Sustainability Initiatives, Ativo Research LLC**, is actively involved in Environmental, Social and Governance Investing and runs the Sustainability Investing group on LinkedIn (One of the largest forums on the topic in the world.) He frequently writes about Environmental, Social and Governance (Sustainability) Investing, has been quoted in such national publications as *USA Today*, and is a regular public speaker on the topic. Mr. Allen's 2010 speaking engagements included the *NASDAQ SmartView Roundtable on Sustainable Investing: "What's at Stake for Investors & Public Companies"* in May and the *Sustainability Strategies for the Sustainable Investor Conference* in Brussels in October. Mr. Allen is a graduate of the J. Mack Robinson College of Business, Georgia State University and a former U.S. Military officer. Contact Daniel directly at (312) 263-7600 or [dallen@ativogroup.com](mailto:dallen@ativogroup.com).



**CharterMast Partners LLC** provides public and privately held companies the insights and tools to link specific management decisions and actions to share prices, to understand exactly how reported corporate performance does and does not reflect real economic performance, and how real economic performance creates value for shareholders. CharterMast's key expertise is in understanding what drives your company's stock price, identifying what is needed to change it, and putting in place the strategies and operating plans/processes to make it happen. CharterMast clients include Fortune 500, mid-cap, and privately-held firms in a variety of industries. For further information about CharterMast Partners, please visit: [www.chartermast.com](http://www.chartermast.com).

**Ativo Research LLC** is one of the industry pioneers in the practical application of quantitative finance theory (Chicago School) to real-world analysis of securities with a pedigree that dates from 1971. Today Ativo's research covers the world as their research universe provides recommendations on almost 17,000 securities, or 98% of global investable capital. Ativo Research is currently developing Q-Sustainability™, a proprietary quantitative methodology for the integration of environmental, social and governance (Sustainability) risk management factors into financial research and the investment process. For further information about Ativo Research, please visit the company web site: <http://www.ativoresearch.com/>.