

CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: SYNCHRONIZED GLOBAL GROWTH

All major economies are currently on a path of healthy growth. With this comes synchronized profit growth for all major equity indices. 10 years of unprecedented expansionary monetary policies on a global scale finally are successful.

2020

BY THIS YEAR DYSON LTD. WILL BUILD AN ELECTRIC CAR

The new arms race is on for automakers. But how can money be made from this? Sometimes the sum of the parts is worth more than the whole. Therefore the suppliers of parts to the car builders is most likely the better approach.

1.5

BILLION \$ COMMISSION REVENUE DECLINE DUE TO MIFID II

Global equity research commission revenues will decline with the introduction of MIFID II in 2018. The rules oblige investors to directly pay for all research services delivered by investment banks.

4%

PERCENT OF STOCKS ACCOUNT FOR ALL OF THE NET MARKET RETURNS

Professor Bessembinder found that a mere 4 percent of the stocks in the entire market — headed by Exxon Mobil and followed by Apple, General Electric, Microsoft and IBM — accounted for all of the US market net returns from 1926 through 2015.

MONTHLY TOPIC: SUSTAINABLE QUALITY

An investment product with a CSR add-on has become a must-have in the product line-up of asset managers, particularly in Europe. And not only because the clients care about the environment or for reputational reasons, but primarily to manage portfolio risks and to hold companies with above-average financial conditions.

The majority of academic studies speak for the CSR - corporate performance relationship, indicating that there is a strong business case for CSR investing, as good quality of CSR goes hand in hand with above-average corporate financial performance.

Corporates concerned with good CSR practices not only enjoy increased trust from the investor's side, but also better-positioning in the long-run for lowering their operational costs, facilitating capital attraction, earning higher profits and higher valuations in the end.

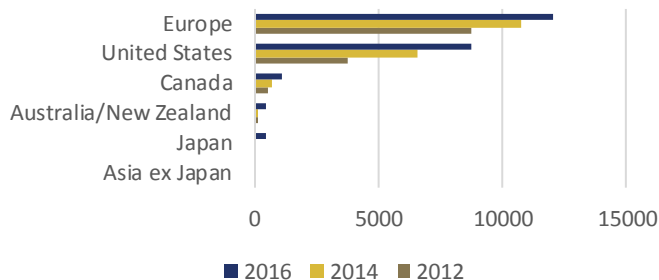
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QUALITY OF CSR GOES ALONG WITH CORPORATE EXCELLENCE

Why to Bother about CSR?

The trend towards socially responsible investments has been around for a relatively long time, however global growth in SRI assets has not weakened. Currently the amount of SRI assets accounts for more than a quarter of the world's total managed assets, with Europe leading the field (more than 50% SRI in proportion of total assets).



Source: HQAM, Global Sustainable Investment Alliance (GSIA) Global Sustainable Investment Review 2014; 2016

Figure 1: Growth of SRI Assets by Region 2012-2016, billion USD

While the trend towards sustainable investments can be attributed to a number of reasons, the primary one is that CSR evaluation is often perceived as an additional risk management tool, something that was admitted by the portfolio managers in CFA Institute ESG Issues survey¹.

Past cases also confirm that timely avoidance of companies with questionable sustainability 'climates' can decrease left-tail risk.

- One of the extreme cases is Transocean, which has a long history of poorest sustainability ranking among the deep-water drillers. After the Deepwater Horizon catastrophe in 2010 Transocean's share price halved in two months. Every subsequent accident involving the company was accompanied by severe share price decline. This led to extremely high beta of 1.67.
- Another company with poor CSR ranking, Valeant Pharmaceuticals, experienced its share price tumble by 80% between August 2015 and April 2016 after a drug price inflation scandal.

CSR Filter Contributes to Performance

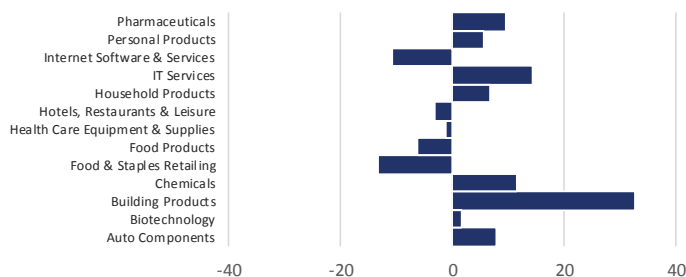
A look into historic data demonstrates that the consideration of sustainability and social responsibility issues when building a portfolio might eliminate extreme risks. Moreover, there exists a significant amount of statistical evidence confirming the ability of a CSR factor to generate alpha. Though the very first research pieces were speaking against the sustainability topic, recent studies prove the added value of sustainability analysis. The stereotype of underperforming "green" portfolios emerged from the negative screenings, which were applied to the portfolios in the beginning of the SRI trend: whole industries have been excluded making the portfolios totally undiversified, often biased towards small technology companies². Indeed, there are studies that show negative or neutral relationship between SRI factors and stock performance, but many more studies argue in favour of sustainability investing.

For instance, Morgan Stanley's³ examination of 10,228 open-end mutual funds and 2,874 Separately Managed Accounts concluded that there is a positive relationship between corporate investment in sustainability and operational performance - returns of sustainable investments often exceeded performance of the comparable traditional ones. Eccles, Ioannou, and Serafeim⁴ found that when relating sustainability scores to the stock market performance, a 'high-sustainability' portfolio outperforms a 'low sustainability' portfolio by 4.8% on an annual basis.

Good CSR Companies are also Good Companies Financially

Obviously the market values corporate investments in sustainability, which is also supported by the improved corporate financial performance. Friede, Busch and Bassen⁵ provide aggregated evidence from over 2000 studies on CSR-corporate performance relationship, saying that there is a strong business case for CSR investing as good quality of CSR goes hand in hand with above-average corporate financial performance. It often results in reduced cost of capital and increased capital profitability and Tobin's Q.

Average sustainability scores by industry groups of the Quality companies in majority of cases exceed sustainability score of the average benchmark company as shown in the chart below. Results of the analysis confirm that corporate financial health and CSR play on one side of the field, which is well-seen in case with building products, Chemicals, IT services, Pharmaceuticals.



Source: HQAM, MSCI, Sustainalytics

Figure 2: CEAMS Quality Global Equity vs MSCI World Index Industries ESG Score Difference (excluding industries in portfolio with only one company represented)

Therefore, the conclusion is rather straight-forward: corporates concerned with good CSR practices not only enjoy increased trust from the investor's side, but also better-positioning in the long-run for lowering their operational costs, facilitating capital attraction, earning higher profits and higher valuations in the end.

HQAM Approach to Sustainable Investing

The validation of the statement that financially healthy companies also have high ratings happens at HQAM on a constant basis. For instance, Geberit, Swiss sanitary products and systems producer, can boast exceptionally good financial conditions, while at the same time it enjoys the highest possible sustainability rating from Sustainalytics.

FINANCIAL CONDITIONS					EARNINGS QUALITY				
GEEN VIX	Balance Sheet	Income Statement	Cash Flows	Total FCC Index	Profitability	Business Efficiency	Capital Management	Earnings Structure	
31.12.2016	25	11	21	21	18	15	13	4	
31.12.2015	20	9	17	17	15	3	5	4	
31.12.2014	31	13	20	23	18	10	10	4	
31.12.2013	31	13	23	24	18	11	11	4	
31.12.2012	30	12	22	23	18	10	10	4	
31.12.2011	30	12	22	23	18	6	7	4	
31.12.2010	31	13	23	24	18	11	11	4	
31.12.2009	29	12	21	22	18	9	10	4	
31.12.2008	31	13	20	23	18	12	9	4	
31.12.2007	28	12	17	20	18	10	10	3	

Source: HQAM

Figure 3: Financial conditions of Geberit AG

Economic sustainability is the very core of HQAM Quality investment process. The process includes a specific SRI plausibility check to assess whether, from a risk perspective, ethical norms are being followed.

Sources:

- ESG Issues in Investing: Investors Debunk the Myths. (2015). CFA Institute, https://www.cfainstitute.org/ethics/Documents/Issues_esg_investing.pdf.
- Kelly, R. (2016). Sustainable Investing as Performance Investin. Thornburg Investment Management.
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- Friede, G., Busch T. & Bassen, A. (2015). ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233.