

*Journal of***APPLIED CORPORATE FINANCE****In This Issue: Investors and Sustainability**

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ESG Investing in Graham & Doddsville¹

by Dan Hanson, Jarislowsky Fraser USA

[T]aking shortcuts is not the pathway to achieving sustainable competitive advantage, nor is it an avenue toward satisfying customers. In times such as these, a company must invest in the key ingredients of profitability: its people, communities and the environment.

— Warren Buffett²

There are many different approaches to investing. My focus in this article will be on what is often referred to as “Graham & Dodd investing,” but what I will here call “intrinsic value business investing” or “business value investing” for short.³ Though the longer version is a mouthful, it has a couple of important messages that are worth noting at the start.

First, the use of “intrinsic value” is meant to reinforce the idea that our investment approach is predicated on making a meaningful estimate of the value of an equity stake in a business. This is notably different from the broadly labeled concept of “value investing,” which as practiced tends to be a largely statistical approach of identifying portfolios of stocks with price-earnings (P/E) or price-to-book ratios that are lower than those of the broad market.

In my experience, the popular use of the term “value investing” often reflects a failure to distinguish between the “value effect” on stock returns that is discussed in academic finance, and the role of fundamental analysis in producing above-market returns that is at the core of Graham & Dodd investing. For business value investors like me, the academic factor-betting and “value style-box” approaches to value investing are limited by their deliberate disregard of fundamentals such as balance sheet quality (P/E and P/B ratios reflect neither the risks nor costs of financial distress) and earnings quality (there is little distinction between high-quality, or sustainable, earnings and low-quality cyclical earnings). In practice, careful

analysis of balance sheets and earnings quality can play a critical role in producing above-market long-term equity returns.

Furthermore, business value investing is clearly distinguishable from today’s range of (generally more short-term and speculative) approaches in securities markets—everything from momentum “growth investing” to statistical and mean reversion approaches, from technical and quantitative investing (including style and factor betting and “black-box” algorithms) to fundamental indexation, arbitrage, and passive indexing (including dart-throwing for that matter). In contrast to these approaches, business value investors think of themselves as buying businesses, not stocks. Though business value investors are certainly subject to, and may benefit from, short-term fluctuations in the value of tradable securities, in the long run their returns (relative to those of the S&P 500 or other market benchmark) will be driven largely by the operating performance of the companies they invest in. As Benjamin Graham said, “In the short term, the market is a voting machine...but in the long run, the market is a weighing machine.”⁴

Intrinsic value business investors typically start by assessing the asset value and earnings power of businesses they deem to be well-run, and then seek to buy an interest in that business when the price becomes attractive—or, as Ben Graham put it, such investors try to buy at a discounted valuation that provides a “margin of safety.” Moreover, the intent is generally to hold the stock for a considerable period of time, typically three to five years or longer. This approach to investing, as famously chronicled in Warren Buffett’s article “The Superinvestors of Graham and Doddsville,” has proven to be very effective.

To assess the value of a business, one needs to have a reasonably complete picture of its assets and activities. For fundamental investors like us, “non-financial” issues such as governance, corporate culture, employee, customer, and supplier relations, and competitive position will normally be integral to our investment decisions. Assessing whether a company has a competitive advantage—and the extent and durability of that advantage—is a critical part of such investors’

1. This article draws on a presentation by the author at the June 2013 International Corporate Governance Network (ICGN) annual conference. The title refers to Warren Buffett’s 1984 article, “The Superinvestors of Graham-and-Doddsville,” which illustrates the extraordinary success of Graham’s value investing approach. Thanks to my colleagues at Jarislowsky Fraser for helpful comments, and thanks to Don Chew for invaluable editorial guidance.

2. Chairman of the Board, Berkshire Hathaway, endorsing subsidiary Johns Manville’s 2011 Sustainability Report.

3. As Buffett has noted, Graham & Dodd investing is the approach of “mentally, always buying the business, not buying the stock” by first determining “What is the business worth?” and then buying the stock only if priced at an attractive discount to that value.

4. As cited in 1993 Berkshire Hathaway Chairman’s Letter: <http://www.berkshirehathaway.com/letters/1993.html>

analysis in ascribing value to earnings power and intangibles. A company's competitive advantages will be key to driving long-run compounded business performance results.

When commenting on seemingly aggressive "growth" stock valuations in the 1950s, Ben Graham noted that companies with high profitability relative to tangible book value (as reflected in high operating returns on capital) warranted higher earnings multiples. And as the main source of value in companies has increasingly shifted from tangible to less tangible assets, many followers of Graham & Dodd have delivered exceptional investment results by taking an "earnings-power" approach to high-quality businesses, with enduring competitive advantages that are reflected in high profitability and elevated returns on capital. Such advantages are also clearly reflected in valuations that represent significant premiums to stated book values—premiums that effectively acknowledge the value of goodwill and intangibles.

In the pages that follow, I consider the role of "ESG" analysis in business value investing. An earnings-power approach, as opposed to the more conventional asset-based valuation approach, is inherently somewhat subjective—especially since it depends so heavily on sizing up the durability of a company's competitive advantage.⁵ For many business value investors, the use of an ESG or sustainability framework has long been, and will continue to be, an important and effective way of evaluating corporate assets and attributes whose values do not show up on the financial statements. Regardless of whether they use the labels "E," "S," and "G," investors who make judgments about earnings power and sustainable competitive advantage are in fact routinely incorporating ESG and sustainability considerations into their analysis and decision-making. As we shall see, there is no way to determine "what the business is worth" without getting some amount of ESG under your analytical nails.

Traditional Corporate Reporting

As outsiders, we are beholden to management to give us a fair picture of the business. We rely on relevant and meaningful corporate disclosure to help us in making informed investment decisions. Such disclosure is not limited to just the financial statements and SEC filings, but comprises the full set of information communicated to the outside world: the chairman's annual letter, general media/news reports, public relations and publicity, company websites, corporate social responsibility

reports, etc. In addition, traditional corporate financial reports in the U.S. already have important and insightful non-financial disclosures, including 10-K discussions of competition and risk factors, and proxy disclosure of management and board compensation and incentives. Thus, it should not come as a surprise that business value investors tend to view corporate non-financial reporting as a valuable, and increasingly expected, complement to corporate financial reporting.⁶

Nevertheless, in both kinds of reporting, it's important to recognize—as business value investors clearly do—that management has considerable leeway in how it applies the reporting rules and conventions. Just as management can choose to use aggressive (or conservative) accounting assumptions for financial reports, it can use aggressive practices in its non-financial communications. For example, many "hot" growth stocks have not only resorted to aggressive revenue recognition techniques in their financial accounting; they have also used press releases and other media events to promote inflated images of success and future growth. And much the same has happened in the case of corporate social responsibility reporting, where the practice of pairing a "pretty" CSR report with relatively little substance or authenticity has become sufficiently common to acquire the name of "greenwashing."

Such disingenuous reporting is likely to inflict as much harm on companies as their investors. While some investors—generally the least sophisticated—will be misled about the prospects for the business, inflated reporting is also likely to distort management's view and thereby limit its ability to manage its business in the most effective way—the one aimed at maximizing long-run efficiency and value. So, although business value investors do rely on management's judgments about relevance and materiality, the amount of confidence we put in such disclosures will vary based on the company's track record and our assessment of management's credibility.

Furthermore, we are wary of "false precision" in both financial and non-financial reporting. We understand that business is full of risks, and that even the most well-run and successful companies are going to experience volatility in cash flow. And we expect that volatility to show up in earnings variability. (When it doesn't, we begin to ask questions about the integrity of the firm's accounting.)⁷

So, for all these reasons, corporate reports and disclosures (including audited financials) from management should be

5. This earnings-power evolution of Graham & Dodd investing acknowledges the long-term power of compounding to dominate investment results, in cases where companies have sustained elevated returns on capital. As Buffett as said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." <http://www.berkshirehathaway.com/letters/1989.html>

This does represent a departure from the asset-based valuation approach practiced by Graham in the market environment of the 1930s-1950s. Asset-based value investing, also known as "cigar-butt" investing (buying an underpriced security and then selling it as it reaches fair value, akin to getting a free puff from a discarded cigar on the sidewalk), can deliver attractive short term returns. However, "cigar-butt" investing is based largely on exploiting temporary mispricings (rather than participating in the underlying fundamental performance of the business) and requires continually reinvesting capital, creating headwinds to long-term compounded returns.

6. Looking beyond the financial reports is certainly nothing new. In the 1950s, Ste-

phen Jarislowsky taught securities analysis using traditional financial reports and the classic Graham & Dodd *Securities Analysis*, but he also used general corporate history and media reports as part of the curriculum. See *The Investment Zoo: Taming the Bulls and Bears*, 2005, Stephen Jarislowsky.

7. See Dichev, Ilia D. and Graham, John R. and Harvey, Campbell R. and Rajgopal, Shivaram, "Earnings Quality: Evidence from the Field," (May 7, 2013). Available at SSRN: <http://ssrn.com/abstract=2103384> or <http://dx.doi.org/10.2139/ssrn.2103384>. This study indicates that distortions in reported earnings are widespread, and that compromising the quality of financial reports can compromise internal decision-making. The study's findings are concisely summarized in a quote from Robert Howell from the Tuck School of Business at Dartmouth: "The quality of earnings is inversely correlated with whether a company makes earnings estimates," as highlighted in "Earnings Wizardry," *Wall Street Journal*, October 1, 2012, <http://online.wsj.com/article/SB10000872396390444138104578030353195160818.html>

thought of as nothing more than a starting point for the real analysis. For business value investors looking to determine a company's earnings power, the main challenge, as already noted, is to size up its "sustainable competitive advantage." And this requires analysis based on concepts like customer franchise, and intangibles like brands and intellectual property, all of which are steadily becoming even more important determinants of future pricing power and profitability.

Substance over Form—and the Potential Role of ESG

To sum up, then, investors begin by viewing corporate reporting with skepticism. It is the substance of corporate behavior and practices that matters, and that will end up affecting the durability of a company's competitive advantage. Thus the aim of corporate communications and reporting should not be to impress investors with pretty pictures and glossy reports, or to project a false sense of precision and control. The aim should instead be to provide investors with information that will give them the clearest possible sense of the firm's policies and the practices used by management to ensure they get carried out. In other words, the message that top management sends to the investment community should not differ in important ways from the message it sends internally to its business heads and employees.

And, as already stated, ESG reporting and analysis, where relevant to the business, can and should play an important role in this process. Moreover, as we have just seen in the case of financial reporting, when evaluating ESG reports, business value investors look "between the lines."⁸ They attempt to see through platitudes and jargon to find evidence of genuine, cost-effective commitments of corporate resources to addressing environmental, social, and governance problems. In particular, they want to see goals that are linked to results. Such linkage can provide an important signal of accountability within a well-functioning corporate governance system. And an effective governance system, when combined with a compelling business strategy, can be critical in persuading investors of the durability and extent of a company's competitive advantage.

"E": The Environment, and Energy Intensity and Efficiency

The "E" in "ESG" refers to "environmental," but it could just as well refer to "efficiency" or "energy intensity." Financial analysts who are skeptical about the relevance of ESG are likely to assert that the environmental effects of business activities are "externalities," and hence the proper concern of lawmakers and regulators rather than corporate managers. Or if, as Milton Friedman argued, the social responsibility of business is to maximize its own profit and value, then managing the environmental impact of a business is

not management's job beyond the minimum threshold of complying with the law.

But even if one accepts Friedman's view, making a profit and being mindful of the environment are not mutually exclusive. To cite an obvious example, energy intensity is clearly not an externality, if only because energy use is a cost that is directly borne on the P&L. And a more efficient operational footprint can be a major source of competitive advantage. Efficiency directly impacts corporate profits and value. As Benjamin Franklin said, "a penny saved is a penny earned"—and, in that spirit, corporate productivity initiatives are typically introduced each year that look to take out a small portion of a company's cost base.

Energy savings are normally a focus of that effort. Finding ways to reduce energy intensity and streamline supply chain dynamics are integral to increasing the efficiency of business operations. And when managements communicate the targets and results of such efforts, both internally and externally, the use of specific metrics and key performance indicators (KPIs) can provide credibility for the initiatives. Ultimately, if a company is more productive, whether through energy efficiency, scale, or operational excellence, it has achieved a competitive advantage. Being the low-cost producer is a classic source of competitive advantage—one that not only can result in better value to customers, but can also provide the basis for building a further scale advantage without sacrificing profitability.

So efficiency gains are a fundamental source of increases in corporate profitability and value. And companies that are in the business of providing energy efficient solutions for others are able to demonstrate a positive return proposition to their customers, and thereby drive demand. Examples range from turbochargers for vehicle engines (as provided by companies like Borg-Warner and Honeywell), to low-power consumption chips and servers for IT infrastructure (AMD, Intel, Hewlett Packard), to next-generation aircraft (Boeing). In each of these cases, savings from reduced energy consumption has been a major driver of demand and the adoption of new technology.

Viewed in this light, then, many corporate investments in the environment—particularly those in energy efficiency—are likely to be integrally tied to the long-run profitability and viability of a business. But how do companies get investors to recognize the value of corporate investments whose payoffs don't show up in the bottom line this year?

It will be, at least in part, a matter of focusing on the main concerns and communicating with the right language. For example, a CSR report that quantifies carbon footprint or emissions reductions—framing environmental impact but without business context—is likely to be of limited use to investors. On the other hand, investors are very interested in understanding whether a company has a competitive advan-

8. See L. Rittenhouse, *Investing Between the Lines* for a helpful discussion of how to interpret corporate management reports. Much of Rittenhouse's approach is equally applicable to non-financial and CSR reports, and we recommend this work including its

discussion of "fact-deficient obfuscating generalities or 'FOG'" in decoding CEO communications.

tage as a result of its “E” initiatives. And perhaps equally important, a company’s efficiency and cost savings (which will reduce its environmental footprint), or the fuel economy of its products or services (which benefits its customers), is likely to contribute to a reputation for general operational excellence—one that may well succeed in attracting the attention and interest of business value investors.

To see how the benefits to a company of energy efficiency and reduced environmental footprint can go well beyond reductions in direct energy costs, take the case of Wal-Mart when oil prices spiked after 2005. Throughout the 1990s and early 2000s, when oil was trading for less than \$20 a barrel, company after company built out sprawling global supply chains. Wal-Mart had long had a core competence in supply chain management—one dating back to its innovative use of direct satellite links and real-time data feeds to communicate end market demand to its suppliers. But if it was Wal-Mart’s expertise that pushed it to build sprawling global supply chains in the ’90s, it was the same core capabilities that ensured that, when oil prices shot up after 2005, Wal-Mart would take the lead among its competitors in *reducing* supply chain complexity and, as a result, achieve major cuts in energy use and costs.

In the past decade, Wal-Mart has also used its 800-pound-gorilla “buyer power” to play a leading role in driving consumer packaged goods companies to reduce packaging waste. Bulky packaging meant that trucks were transporting small products in large boxes. Smarter packaging was downsized in response to increases in transportation costs. Products such as “less-watered-down” concentrated liquid detergent became prevalent. The outcome was the same product quality for customers, and similar profit margins for retailers, but a significant reduction in the waste associated with larger containers and shipping costs. Likewise, reductions in excess packaging meant that Wal-Mart was able to ship more product on each truck.

In an even more recent development, Wal-Mart has joined other major retailers in driving a movement to increase the “local content” of the products it sells with the dual aim of managing their fuel price and general supply chain risks, and winning local political and popular support. This reflects a big change for a company that a decade or two ago was regularly the target of campaigns mounted to keep it from coming to town.

This is not to say that Wal-Mart is a poster-child for effective management of all ESG issues. On the contrary, Wal-Mart continues to be a target for “S” issues. In addition, the company has had significant governance issues in the past decade, including bribery scandals and disruptive management turnover. However, our point is that ESG is the lens

through which these issues can be readily identified. ESG provides a framework, not the answers (much as Michael Porter’s “five-forces” framework provides a helpful tool in thinking about a company’s strategic position). And so in that regard, Wal-Mart may well be a poster-child for the relevance of ESG issues in assessing competitive advantage.

Moreover, as this “buy-local” initiative suggests, companies are finding ways to use their core competencies to address environmental and social problems while also managing their own business risks. And such activities can be seen as critical parts of a comprehensive enterprise-wide risk management system (and attitude) that is designed to protect the firm’s franchise value. Many companies talk about risk management programs, but what matters in practice is a culture of effective firm-wide risk management.

For business value investors, an effective risk management program and culture are likely to be especially important indicators of a well-run company. Although the costs associated with such initiatives may reduce profit margins, at least in the near term, the resulting increase in investor confidence about the firm’s future earnings and sustainability or “staying power” is more than likely to increase the multiple of earnings and cash flow at which the stock trades.⁹ We will discuss communicating the business impact of ESG investments below, after reviewing the “S” and “G” areas.

“S”: Not Just Social, But Also Stakeholders, Safety, Social Contract, Symmetry, and Scuttlebutt

The “S” in ESG refers to “social,” a category that is broad and not easy to define. Practically speaking, “S” can be thought of as a barometer of how a company performs as a “corporate citizen,” as perceived by the general public and media, as well as by its business partners and counterparties. Stated in more concrete terms, “S” refers to a company’s social standing and interaction with a broad set of stakeholders: the communities in which the company operates, its supplier base, its customers, and its employees.

Of course, it is in any organization’s best interests to have good relations where it does business. This can be explicit, as in cases where a regulator’s approval is required to operate, whether it’s the corner bar that needs a liquor license, or a public utility seeking rate increases to pay for capital investments. But even relatively unregulated businesses need some implicit “license to operate.” Businesses that are not wanted in a neighborhood or community will face pushback from “NIMBY” protestors, zoning headaches, and other forms of resistance that end up reducing sales or increasing costs.¹⁰

But how can investors evaluate a company’s “S”? One approach is to start by asking other people who have dealings

9. A higher, more stable ROIC warrants a higher valuation.

10. Mining companies are a classic example where a “license to operate” will explicitly require good governmental and social relations (both of which will likely include some consideration to environmental impact). In a less extreme example, consumer companies

Nestle, Unilever, Coca-Cola, and Pepsi all have credible sustainability initiatives in their developing economy businesses, which have contributed to these companies being welcomed with a “license to operate” from local governments.

Employee Engagement as a Competitive Advantage: The Case of Costco

Costco actively manages ESG issues in a way that directly contributes to Costco's competitive advantage. Most notably, the company treats its employees well, providing better compensation and health benefits (<http://www.costco.com/benefits.html>) than its retailing competitors. In contrast to the significant labor-management problems experienced by most big-box retailers and grocers in the U.S., Costco's approach appears to have produced a highly engaged and productive workforce, which translates into a better shopping experience. Although other companies talk about "delighting the customer," Costco appears to have been notably successful in doing it.

Nevertheless, if you try to learn more about Costco's CSR program, you will note that its first and only CSR report was published in 2009. The sparseness of its communications is consistent with the company's emphasis on substance over form. Costco is investing in higher wages for its employees, in some cases against the wishes of short-term oriented shareholders. The result to date has been a long-

term competitively advantaged business mode. There is a consistency of message, whether in the annual report, in the CSR, or behind the member register, where the company's Mission Statement is posted.

Costco Mission Statement & Code of Ethics: Our Mission

To continually provide our members with quality goods and services at the lowest possible prices.

In order to achieve our mission we will conduct our business with the following Code of Ethics in mind:

Our Code of Ethics

1. Obey the law.
2. Take care of our members.
3. Take care of our employees.
4. Respect our suppliers.

If we do these four things throughout our organization, then we will achieve our ultimate goal, which is to:

5. Reward our shareholders.

with the company and are thus likely to know. In his classic book *Common Stocks and Uncommon Profits*, first published in 1958, the acclaimed investor and author Phil Fisher described an investing method that he called "scuttlebutt research."¹¹ Fisher's approach involved identifying a company's four most relevant competitors and then asking managers and employees at each company to evaluate the strengths and weaknesses of the other four. When done carefully, this approach is likely to produce a useful picture of all five companies. This approach benefits from a more objective cross-section of insights, as compared to directly probing a company's employee about its own operations.

In addition to the "anecdotal" insights that come out of this approach, the "common wisdom" of popular perception can be helpful. Reading *Fortune's* "Best Places to Work" surveys, or the likes of Glassdoor.com employee satisfaction surveys, can also be helpful in understanding a company's culture and competitive position.

"Symmetry," or "reciprocity," of behavior is also part of the "S." Is a company's business model based on taking advantage of customers, or giving them a good deal? This is not

always so easy to assess categorically. For example, Wal-Mart has delivered massive benefits to consumers through its "EDLP" (everyday-low-price) policy of merchandising—a policy that stands in sharp contrast to that of, say, Sears or Sears's discount store Kmart in recent years. (But, again, Wal-Mart's standing with customers is by no means perfect, despite the undeniable success and social value of EDLP.)

Safety performance is also an important, widely tracked, and potentially revealing (for investors) proxy for operational excellence. Under Paul O'Neil's leadership, for example, Alcoa became best in class.¹² And Exxon, in part as a response to the Valdez accident, became best in class among the oil majors.¹³ Safety is routinely targeted in materials and heavy industry as a top management and employee goal. For example, the conspicuous public posting at plant entrances of the number of accidents in a given year to date—with targets, for many businesses, of zero—is commonplace today. A safe work environment, while reflecting operational excellence, is itself positive for employee morale and productivity and regulatory relationships. And the fact that safety lends itself to being tracked, reported, and managed using relatively objective

11. This research approach has motives that are different from and should not be confused with those of the so-called "expert network" approach of trying to get an "edge" by speaking to company insiders or knowledgeable industry people. Rather, Fisher's approach is a common sense approach to gaining insights into a company's corporate culture and competitive position.

12. See *The Price of Loyalty*, Ron Suskind, 2004.

13. See *Private Empire: ExxonMobil and American Power*, Steve Coll, 2012.

14. As discussed, by virtue of being a simple metric, safety is particularly practical as an indicator. But equally important is whether behind the safety metrics is a true underlying

culture of risk management, risk mitigation, and accountability—relevant for complex processes—as opposed to a "lip-service" approach of selective reporting on simple processes. The "broken windows theory" of social norms suggests that a zero-tolerance approach can in fact be effective at driving behavior. Consider Exxon, which by all accounts had exceptional operational discipline, as reflected in a "zero-tolerance" attitude on safety in the decades since the Valdez accident. By contrast, it has been argued that BP focused intensely on simple metrics after its 2005 Texas City refinery accident, but not enough on complex processes, during the years leading up to the 2010 Macondo blowout disaster.

metrics makes it an especially practical indicator.¹⁴

Also widely used today are measures of employee engagement, which, as Bob Eccles and George Serafeim point out in the previous article, have been shown to be positively correlated with higher productivity. When employee engagement is high, attrition or turnover will likely be low. Conversely, if the workforce is unengaged, a company will pay a price in reduced productivity and increased turnover (and “shrink” or employee pilferage for that matter), which in turn results in the costly burden of rehiring and training replacement workers. In the retail industry, leaders in employee engagement like Costco and Starbucks have long volunteered to pay higher wages and offer more benefits than their competitors. As a result, such companies have productive workforces that contribute to a positive customer experience, which in turn boosts the top line.¹⁵

And business investors understand the importance of a productive and motivated workforce. As Phil Fisher proposed (and practiced) years ago, we talk to a company’s suppliers, competitors, and customers to get an “insider’s” view of the culture. We look at employee feedback websites and third-party surveys to confirm these findings. We view diversity as a reliable sign of a meritocracy—diversity not only in the rank and file, but also in senior management and on the board of directors. Investors like Fisher want to know, “Does the company have outstanding labor and personnel relations?” For as Fisher pointed out over 50 years ago, “Good relations lead to higher productivity and, as a result, better company output and performance.”

In fact, business value investors like us take what might be described as a “checklist” approach that asks questions like the following: Is this a good franchise? Do I want to invest in the business as a part owner? Do we want to associate with these people? In short, we think like potential industrial owners in the process of framing long-term investment decisions.

The “G”: Governance (Or, Is Management Working for the Shareholder? And Does It Take a Long-run View of the Company?)

From the perspective of securities analysts and investors, the issue of corporate governance boils down to the question, “Is management good for the shareholder?” That is to say, is management really acting in shareholders’ interests, and is it being held accountable by its board for doing so?

The desire to have a management team that views

shareholders as partners and owners of the business reflects a basic practical limitation that confronts outside investors: If management is not committed to acting in the interest of its shareholders, then no matter how strong the legal protections and formal mechanisms for accountability, including the formal governance checks through the board of directors, shareholders will be at a disadvantage.

At any given moment, top management has at least the potential to know significantly more than outside investors about the firm’s prospects, especially its near-term prospects. But that is not investors’ only important handicap. Even when investors are fully informed, if managements pursue a course of action that runs counter to their interests—say, a diversifying acquisition that seems likely to destroy value—investors also know that their ability to exert control over management has clear limits. Investor efforts to rein in management are generally associated with large costs, such as the cost of mounting a proxy fight or, more extreme, a hostile takeover.

In sum, outside investors and would-be shareholders are at a disadvantage to management and other insiders in terms of both information and control. And when shareholders sense their disadvantages—or are less than confident that management will refrain from exploiting them—they will view the company as a higher-risk investment and, as finance theory suggests, demand higher rates of return for holding the shares.¹⁶

As we saw in the analysis of “E” and “S” issues, assessing a company on “G” inevitably involves a considerable amount of subjective judgment—and in that sense, much of the process of identifying or verifying good governance can be summed up in the statement, “I know it when I see it.”¹⁷ At the same time, however, while the social and competitive context for analyzing corporate “E” and “S” issues has changed dramatically within the past decades, the fundamental “G” issues have remain essentially unchanged from those identified almost 80 years ago by Graham & Dodd—and by Phil Fisher too. In fact, five of “Fisher’s 15 Points” relate directly to governance:¹⁸

- Does the company have a management of unquestionable integrity?
- Does the company have outstanding executive relations?¹⁹
- Does the company have depth to its management?
- Does the company have a short-range or long-range outlook with regard to profits?

14. “Costco CEO Craig Jelinek Leads the Cheapest, Happiest Company in the World”, BloombergBusinessweek, June 6, 2013 <http://www.businessweek.com/articles/2013-06-06/costco-ceo-craig-jelinek-leads-the-cheapest-happiest-company-in-the-world>

15. This tension and governance challenge has been characterized by Marty Whitman as the predicament facing outside passive minority investors, or OPMIs, in publicly traded corporations. See *The Aggressive Conservative Investor*, 2006. For an account of how investors can respond to this predicament by actively engaging to protect minority shareholder rights, including an accounting of the founding of the Canadian Coalition for Good Governance in 2002, see:

National Post, “‘I just want a fair deal,’ Stephen Jarislowsky has been defending minority shareholders’ rights for 40 years,” March 2004 <http://investorvoice.ca/PI/769.htm>.

17. Justice Potter Stewart famously made the point that norms (“local community standards”) matter; likewise a judgment as to whether corporate governance is “good” can be nuanced will depend on the context and situation.

18. Fisher, *Common Stocks and Uncommon Profits*.

19. Fisher is referring to a meritocratic environment in terms of advancement and compensation.

- Does the management talk freely to investors about its affairs when things are going well but “clam up” when troubles and disappointments occur?

Academic studies, using a variety of indicators of effective corporate governance, have provided persuasive evidence that companies with stronger shareholder rights and management accountability have delivered stronger fundamental performance over time.²⁰ Based on such findings, and on the idea that “engaged” stock ownership is a reliable way to drive above-market investment returns, “activist” public equity investing in the U.S. has reached record-high levels of assets under management—and even a perhaps surprising measure of public acceptance—in recent years. Investment partnerships have attracted media attention with their activist campaigns in many large-capitalization blue chip companies, including Cadbury, Canadian Pacific, Heinz, Hewlett-Packard, Microsoft, and Proctor & Gamble (to name just a few).²⁰ For example, as reported in a recent *New York Times* article, a new study of hedge fund activism by Lucien Bebchuk and two colleagues has provided compelling evidence that companies targeted by activist hedge funds tend to experience significant average increases in value while owned by such funds—and, perhaps even more surprising to some, that the average holding periods of such activist investors are considerably longer than the holding periods of the average U.S. institutional investor.²²

But, again, the root cause of such increases in value—and the reason for the existence of such activist hedge funds—can be traced to the information and control challenges faced by investors noted earlier and, equally important, to the unwillingness or inability of most shareholders to address such problems by taking an active role in governance. The activists are filling this void.

In terms of lack of will, many institutional investors have both a short time horizon (less than one year) and pursue strategies (momentum, “black-box”, etc.) that make no use of fundamentals. So while they may have the resources to engage with management, such shareholders as a matter of investment philosophy simply don’t take the view that owning the stock is owning the business, and they largely abdicate their ownership rights (in some cases literally, through stock-lending programs—an extreme version of maximizing short term shareholder income at the expense of a long-term view).

In terms of lack of ability, there are limits to investors’ ability to know what’s going on inside large publicly traded

companies and, when problems arise, to force management to do their will. And for interested passive and engaged “activist” investors alike, this means that having a clear understanding of the limits of one’s information and control, and the role of governance in overcoming them, is bound to be critical when evaluating a business.

That’s why the framing of “G” as an input to business value investing is woven into the approaches of Graham & Dodd and their modern-day followers. As already stated, such understanding must penetrate well below the level of mere compliance with the legal formalities of governance, shareholder rights, and the theoretical role of the board of directors. In practice, shareholders—particularly business value investors intent on making three-to-five year investments—need to understand the fundamental motivation and behavior of management. And they also want to feel confident about the ability and determination of boards to hold management’s feet to the fire should things not go according to plan.²³

Graham & Dodd, in the original edition of their classic *Security Analysis*,²⁴ raised the fundamental question and challenge of governance by emphasizing potential conflicts of interests between stockholders and corporate management. Because all of the areas of potential conflict highlighted in their 1934 text remain relevant today, we reproduce the complete list of issues here:

- 1) *Compensation to officers—Comprising salaries, bonuses, options to buy stock*
- 2) *Expansion of the business—Involving the right to larger salaries and the acquisition of more power and prestige by the officers*
- 3) *Payment of dividends—Should the money earned remain under the control of management or pass into the hands of the stockholders?*
- 4) *Continuance of the stockholders’ investment in the company—Should the business continue as before, although unprofitable, or should part of the capital be withdrawn, or should it be wound up completely?*
- 5) *Information to stockholders—Should those in control be able to benefit through having information not given to stockholders generally?*

In elaborating on this list, Graham & Dodd go on to observe that “boards of directors:”

20. “Corporate Governance and Equity Prices,” P. Gompers, J. Ishii, A. Metrick, *Quarterly Journal of Economics*, Vol. 118, No. 1, February 2003.

21. Notably, in the cases mentioned, the activist funds involved have taken a long-term business value approach, with a focus on driving multi-year operational improvement. The multi-year investment horizon is typically reflected in fee structures that likewise encourage fund investors to commit capital on a multi-year basis. These investment partnerships are in numerous cases long-only or long-biased, yet they are still generally referred to as “hedge funds” due to the carried interest fee structure. Within the broad-brush “hedge fund” category of investors, there is a subset that very much practices a long-term business value investment approach.

22. See Stephen Davidoff, “A Label for Activist Investors That No Longer Fits,” *New York Times*, July 9, 2013. In that article, Davidoff cites the Harvard Business School

working paper by Lucien Bebchuk, Alon Brav, and Wei Jiang, “The Long-term Effects of Hedge Fund Activism.” A specific example of engaged ownership driving shareholder value is the CalPERS focus list program: <http://www.calpers-governance.org/focuslist/focuslist>

23. For a practical discussion of how corporation leaders can break from “short-termism” and take a long term approach, see: “Visionary Board Leadership—Stewardship for the Long Term,” Matthew Orsagh, CFA Institute, June 2012 <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n3.1>

24. Chapter 44, “Implications of Liquidating Value. Stockholder-Management Relationships.”

Shared Value as Strategy: The Case of Nestle

The Swiss company Nestle has made active management of ESG issues through a program called Creating Shared Value (“CSV”) a key strategic initiative. Nestle invests in nutrition, water, and rural development programs in a way that supports communities where it operates, providing for more robust supply chains and responsible sourcing. Clearly, Nestle could increase short-term cash flow and profitability by reducing its CSV investment program, and pulling working capital out

of its supply chain. But management has made a strategic long-term decision to invest in the development of a more resilient supply chain and more sustainable sourcing. This investment is also justified as supporting the development of emerging economies that, in time, will grow to be significant customers. Such a long-term investment approach builds a more resilient operating capability, mitigates downside risk, and contributes to Nestle’s competitively advantaged global scale and brand value.

*usually consist largely of executive officers and their friends. The officers are naturally desirous of retaining as much cash as possible... they are also inclined to expand the business persistently for the sake of personal aggrandizement and to secure higher salaries.*²⁵

Embedded in this brief statement are several important sources of conflict between management and shareholders. The most obvious has to do with *how much* management gets paid, particularly in the form of salaries and perks. But the *level* of salary and perks is not in itself likely to be the biggest concern. In fact, excessive levels of pay are likely to be troubling mainly insofar as they reveal more serious and costly problems, such as excessive retention of cash and the related tendency, noted by Graham & Dodd above, toward corporate empire building. As Michael Jensen and Kevin Murphy put it in the title of their much cited 1992 *Harvard Business Review* article, “It’s Not How Much You Pay, But How.”²⁶ And the basic insight is pretty straightforward: Highly compensated CEOs whose pay comes mainly in the form of stock appreciation are much less likely to embark on ill-advised acquisitions or capital spending binges than CEOs whose compensation takes the form primarily of salary and perks.

But this kind of corporate “overinvestment” is not the only management tendency that investors and boards must

guard against. Equally important, and in some ways even more destructive, is the problem of corporate *underinvestment*—the tendency of management to focus excessively on near-term earnings and the failure to take a longer-run view.²⁷

This underinvestment problem is especially important to business value investors like us because, as noted earlier, the average duration of our holdings, typically three to five years or longer, is well above the less than one-year average for U.S. investors.²⁸ Therefore, in making investments, we are effectively making a decision to associate with the company for a considerable period of time. And when so doing, we want to ensure that top management is devoting as much thought and capital to the long-run future of the business as to meeting near- and intermediate-term performance targets. And this is where ESG considerations can play an important role. Business value investors want to know that management is continuing to make investments in all of the company’s important stakeholders—all the groups whose participation (or refusal to do so) can affect the efficiency and value of the business. And this means significant ongoing investments of corporate time and capital not only in employees and customers and suppliers, but also in the environment and local communities, in a way that underscores a credible management commitment. The cases of Nestle²⁹ and Apache,³⁰ which appear in box insets, illustrate how ESG

25. In a chapter of *Security Analysis* called “The Dividend Factor in Common-stock Analysis,” Graham & Dodd identify the key governance issues and conflicts in public corporations. And precisely because of such conflicts, the reputation of boards may well be an important consideration for business value investors. For example, such investors may have a view about who are “great” directors, and who are “problematic,” as in the case of one large U.S. institutional investor that reportedly has a “no fly list” of directors they deem unacceptable—and categorically vote against—based on their track records. Such investors are also likely to pay close attention to how management responds to shareholder engagements. Besides a failure of management to engage with shareholders, another classic “red flag” (and incidentally an idea generator for shortsellers) is a board that is clearly a rubber stamp for management.

26. Michael Jensen and Kevin Murphy, “It’s Not How Much You Pay, But How,” *Harvard Business Review*, 1992.

27. Apple circa 2013 highlights what G&D highlighted as “arbitrary and sometimes selfishly determined” dividend policies, analogous to what Michael Jensen calls the “agency costs of free cash flow”—where the company generates and accumulates more cash than it has profitable investment opportunities. While this “agency cost” of exces-

sive corporate cash balances is a valid dilemma (it could be called a “high class problem”), a business investor needs to not just identify problems, but make judgments about whether those problems are being effectively managed. More generally, the nature of a company’s response to shareholder engagement can be a very telling signal of governance and management quality. When Apple faced a shareholder proposal in 2013 to distribute cash via financial engineering—even though the specific proposal was flawed (distributing excess cash via adding unnecessary complexity to the capital structure would be at best two steps forward, one step backward)—the company did not deny the issues raised were valid. Management and the board acknowledged and discussed the issues raised in the shareholder proposal, and subsequently significantly improved cash distribution policies.

28. U.S. annual stock market turnover has exceeded 100% every year since 1997, with a peak of 404% (equivalent to a 3 month holding period) in 2008. <http://data.worldbank.org/indicator/CM.MKT.TRNR/countries/1W-US?display=default>

29. See <http://www.nestle.com/csv/case-studies> for case studies illustrating Nestle’s approach to nutrition, water, and rural development.

30. <http://www.apachecorp.com/Sustainability/index.aspx>

ESG-Aware Fracking: The Case of Apache

Over the past decade, Apache has been among the most proactive among energy E&P companies in communicating its ESG approach, including ESG briefings made directly to the buy-side. Such briefings are open, direct, unscripted question and answer sessions with senior management that address the relevance of ESG issues to business operations. Apache began what has become an annual communication cycle in response to shareholder engagement by Steven Heim of Boston Common Asset Management. Realizing that Heim's engagement reflected interests shared by a number of shareholders, Apache has continued and expanded the practice over the years.

Examples include discussions of:

- *Hydraulic fracturing chemicals*: Apache acknowledges that fracking is an area of controversy, and has publicly supported and adhered to a standard of environmental safety that is stricter than specified by the letter of the law. The company's internal chemical science expertise has enabled it to "self-source" fracking chemicals, which limits environmental risks and significantly reduces costs (as compared to outsourcing a proprietary undisclosed

chemical blend from an oil services company).

- *North American shale footprint*: Apache prefers to operate in mature oil and gas regions, like the Haynesville in Texas, where there is a very experienced regulator and well-established standards of practice, which in turn serve to better define and thereby reduce operator risk. At the same time, the company has chosen not to operate in the Marcellus in Pennsylvania, which owing to a lack of a history of development has heightened regulatory and social risks as well as less infrastructure, all of which reduce the attractiveness of investment.

- *Water Management*: water is treated as a scarce and costly resource. Apache operates in areas where water scarcity has long been an issue, e.g. near ranching land. And so fracking project cost efficiencies include an emphasis on capturing and reusing local water, with the aim of preserving fresh water resources, thereby minimizing both expense and environmental impact. In other words, the quantity and quality of the local water supply, far from being viewed as "externalities," are seen as critical to project management.

issues can be proactively managed in a way that contributes to a company's competitive advantage.

In the past decade, there has been an explosion in the issuance of corporate social responsibility (CSR) reports and, within such reports, in the use and role of non-financial "key performance indicators" (KPIs) in communicating corporate commitments to and progress in meeting ESG goals.³¹ Clearly the idea that "if you can't measure it, you can't manage it" has taken hold, and with improved measurement should come improved accountability.³² The challenge for managers and investors alike is to cut through the noise of what has been called "disclosure overload." And for issuers, the costs of incremental reporting need to be weighed against the perceived benefits.

Like financial results, KPIs become meaningful to managers and investors only when management provides context and business relevance. KPIs can be used to provide quantitative indicators of the extent to which a company is both investing in and delivering results for stakeholders while also addressing a business problem. To cite just one example, in the case of companies like Coca Cola and Nestle, management has made

it a priority to report on its efforts to preserve the volume and purity of local water supplies—which is a critical input for the companies' products as well as a general social good.

In addition to developing their own customized and self-reported KPIs, companies intent on evaluating and communicating their own ESG aspirations and achievements will also want to make use of third-party surveys and rankings. The "Fortune Best Companies to Work For" rankings, the Interbrand global brand survey,³³ the Booz global innovation study,³⁴ and other reports such as industry-specific ("trade rag") surveys have long been used by companies both for internal diagnostic purposes as well as communicating their achievements to the investment community and general public. And communication with investors, the subject we now turn to, is in some cases viewed as a challenge faced by companies when designing and carrying their ESG initiatives.

Communicating ESG to the Market

Communicating "ESG" to the market should be treated no differently than communicating business strategy and finan-

31. As detailed in the previous article by Eccles and Serafeim, KPI and CSR issuance has ramped dramatically.

32. The measurement maxim is widely attributed to Peter Drucker, but apparently he never said it. "Work implies not only that somebody is supposed to do the job, but also accountability, a deadline and, finally, the measurement of results—that is, feedback from results on the work and on the planning process itself," Drucker wrote in *Manage-*

ment: Tasks, Responsibilities, Practices. <http://thedx.druckerinstitute.com/2013/07/measurement-myopia/>

33. <http://www.interbrand.com/en/best-global-brands/2012/Best-Global-Brands-2012.aspx>

34. <http://www.booz.com/global/home/what-we-think/global-innovation-1000>

cial performance to the market. If ESG initiatives are relevant to business operations and prospects, then management should “open the kimono” and provide disclosure to shareholders. But, as in the case of good financial communications, ESG reporting should not be done in a way that is either sensational or excessively self-promoting (e.g., glossy color pictures of cupped hands holding a seedling) or obfuscating (with a barrage of metrics, but little context, that produces information overload).³⁵

Corporate communications to the investment community should generally aim to provide a window into management’s thinking—and, by so doing, they should aim to speak to business value investors, to people who think of themselves as owners, potential partners in the business. With that end in mind, a company’s financials, supplemented by the disclosure of selected KPIs,³⁶ should be used to give investors the best possible sense of how management thinks about the business and runs the company, both on a near-term and a longer-term basis. As stated earlier, management should attempt to communicate to outside investors what it sees on the corporate dashboard, the internal metrics that it uses to evaluate the progress and performance of the company. In this sense, management should run public companies as if they were private.

For an instructive example of the effective communication of ESG relevance to the business, I would point to Coca-Cola’s most recent letter to shareholders from its CEO. Here, in the company’s annual report, the CEO provides a summary of initiatives in water replenishment, packaging and recycling, developing country community investments, and nutrition and obesity.³⁷ The company’s CSR provides much more detail on these and other initiatives, but the CEO makes clear—to investors and employees, and to all the company’s important stakeholders, including the general public—that these initiatives are a priority by highlighting them in his letter. With similar effectiveness, Target’s most recent CEO letter expresses “confidence in the talent and passion of our 361,000 team members,” and backs up this statement by citing the company’s high ranking among *Fortune’s* “World’s Most Admired Companies” and *Forbes’s* “America’s Most Reputable Companies.” In both of these cases, those of Coca Cola and Target, such ESG initiatives are effectively given credibility—and, indeed, recognition as a

top management priority—through such prominent mention in the annual report.

As already noted, most of the details of ESG initiatives are provided in CSR reports. But when such initiatives play an important role in a company’s business strategy and operations, such reports can serve to complement its financial reporting. For example, Target’s 2011 CSR report provides a nice illustration of how a company’s articulation of its specific ESG goals and accomplishments can be linked to its operating performance and shareholder value. In a discussion of transportation efficiency, Target provides specific metrics for both objectives and achievements.³⁸ Likewise, with regard to water use, Target’s CSR reported gallons of water used on an absolute and relative (per square foot) basis, and both in terms of objectives and improvements.

Another example of effective and credible reporting of ESG initiatives is the case of Wal-Mart. In this instance, however, instead of treating ESG as a distinct area in a CSR, the initiatives discussed above (in the “E” and “S” sections of this article) have all been communicated in the course of financial analyst briefings. This practice reinforces the argument that ESG initiatives (and analysis) should not be thought of as a separate corporate undertaking, but rather as part and parcel of a company’s business strategy. In its communications, Wal-Mart has repeatedly chosen to open its internal decision-making process to the investment community. Where ESG issues do come to the fore, and are particularly central to strategy and competitive position (as in the Wal-Mart examples above circa 2006), management should communicate that in a manner that is integrated with financial and business strategy communications.

Costco provides another good example of ESG initiatives that have been effectively integrated into the firm’s financial reporting. While the company did issue a detailed CSR report in 2009, with granular insights into various sustainability initiatives, the company has since incorporated ESG issues into its annual report and 10-Ks. This kind of integrated approach, by reinforcing the direct link between ESG investment and shareholder value, confers credibility on a company’s ESG investments—and, in the case of Costco (and Wal-Mart), it makes clear to investors that management is focused on the economic substance of such investments rather than just the form.

35. Effective communication of ESG programs has little or nothing to do with the kinds of promotions of company stock that were practiced by U.S. conglomerates in 1960s, and by technology, media, and telecommunications companies in the years before the bursting of the dot.com bubble. Moreover, as a general rule, companies should avoid elaborate investor relations programs designed to attract short-term investors. Investor relations should communicate, not promote.

36. In recent years, the Sustainability Accounting Standards Board has developed a framework and industry-specific KPIs to guide companies when reporting to investors on their “sustainability impacts” and initiatives. Just as the FASB was established in 1973 as a non-governmental standard setting organization, the SASB was established to facilitate the development of standards and best practices for KPIs. SASB supports the development, by private sector industry working group participants, of KPIs that are standardized and comparable across companies. As for financial accounting, standards

allow for better comparability and benchmarking of performance, and can drive the promulgation of best practices. An industry-specific materiality approach acknowledges that context and relevance does matter; in some cases less is more; only particular indicators will have business relevance, and it is within management’s purview to determine what metrics to disclose. See the article in this issue by Jean Rogers, the founder and executive director of the SASB, and Bob Herz, former chairman of the FASB.

37. Coca-Cola’s CEO shareholder letter includes specific metrics such as achievements in water replenishment, which was 52% of water used in 2012, halfway to a 2020 target of water neutrality.

38. Target’s 2011 CSR reported improvements of distribution center inbound transportation efficiency of 29% to 1.43 cartons per mile, and improvements of outbound transportation efficiency of 22% to 12.17 cartons per mile, and indicated they were on track to achieve 2015 goals of 15% inbound and 20% outbound improvement.

As these last two examples are meant to suggest, “ESG” disclosure and interpretation should not be viewed as a “new” form of analysis. It should instead be viewed as providing a lens through which business leaders can manage and communicate increasingly relevant aspects of its business. Business value investors are focused on making judgments about underlying business performance, and the guiding principle for reporting to shareholders on ESG initiatives should be materiality and business relevance.

But if this integrated approach of Wal-Mart and Costco has worked for them, it is not likely to be appropriate for all companies. And thus, for corporate reporting generally, there is no “silver bullet,” no magical prescription. Rather each company should report in a way that is authentic, substantive, and provides outside shareholders with an informed view on the company. In sum, ESG communication should be like financial communication; it should be credible, long-term, operational, and strategic, but not promotional.

And that brings us to one last question on communication: what is the role of earnings guidance in this process? As academic research has shown³⁹—and as Tim Koller of McKinsey argues in the article that follows this one—the main effect of providing earnings guidance is to attract disproportionate numbers of short-term “momentum” investors (the studies refer to them as “transients”). And one of the most notable effects of having a disproportionate share of “transients” holding the company’s stock is to increase the volatility of the stock price. But the research has also detected another, more serious consequence of ownership by transients: The managements of such companies, when faced with the prospect of missing an earnings target, are significantly more likely than the managers of companies with more long-term shareholders to cut R&D spending to hit their targets. This reactive approach is precisely the kind of management thinking and behavior that business value investors are seeking to avoid. Transient owners beget transient managers.

The lesson for corporate managers is equally applicable with regard to ESG communication: beware of a short-term or promotional approach to communication. Having said that, in some cases, guidance—especially annual guidance and the disclosure of longer-term targets—may be an effective way of communicating consistent and meaningful performance expectations both inside and outside the firm. IBM and Target are both examples of companies that have articulated five-year business plans with explicit financial objectives as a way of providing transparency and accountability to

investors as well as framing internal management goals. Such a multi-year “roadmap” approach provides a strategic framework for management, a very different exercise than short-term quarterly guidance. But in any event, the decision to provide guidance should come from management, and not be dictated by the perceived “demands” of the Street.

Corporate attempts to communicate their ESG policies should focus on the extent of investment and expected payoffs. What companies should want to avoid in their ESG communications is any suggestion of overstatement, or what is now widely recognized and referred to as “greenwashing.”⁴⁰ As in the case of financial reporting, the goal is to achieve credibility and convey an accurate picture of the business to investors who could become not just shareholders, but long-term partners. It’s not a campaign speech but more like a State of the Union address—a candid and realistic assessment designed to enable shareholders to make informed decisions.

Conclusion: In Search of “Quality”

As noted above, Warren Buffett has said that “It’s far better to buy a wonderful company at a fair price than a fair company at a wonderful price.” A major benefit of this kind of high quality approach is the tax-deferred compounding underpinned by organic growth. This is the essence of business value investing as practiced by Graham & Dodd and their many modern-day disciples, including Buffett himself.

But how do investors identify “wonderful companies?” It’s fairly easy to recognize the external characteristics, the symptoms if you will. Repeat appearances on *Fortune*’s Most Admired List offer one promising sign. And the combination of relatively high and consistent ROEs and ROICs with fairly modest ongoing investment requirements will produce the steady stream of “free cash flow” that attracts investors like Buffett. But in competitive markets, how long can companies continue to produce such high returns and stable cash flow? And are such companies really investing sufficient amounts of capital and management attention in their future?⁴¹

To answer these questions, investors need to understand the underlying causes of and risks to the firm’s current profitability. What are the core capabilities, and what is management’s plan to maintain and increase them? What role do intangibles such as brands, know-how, and intellectual property play in the firm’s success?

As we have argued in these pages, one of the indicators that management is thinking about the future of the business are well-thought-out and effectively communicated

39. See Brian Bushee, “Identifying and Attracting the ‘Right’ Investors,” *Journal of Applied Corporate Finance*, Vol. 16 No. 4 (Fall 2004). For another account of how providing inflated earnings forecasts can distort corporate decision-making and increase the odds of failure, see “Playing Favorites: How Firms Prevent the Revelation of Bad News,” Lauren Cohen, Dong Lou, Christopher Malloy, NBER Working Paper No. 19429, Issued in September 2013 <http://nber.org/papers/w19429>.

40. The contrast between “talking the talk” and “walking the walk” is nicely illustrated by BP vs. ExxonMobil. BP’s “Beyond Petroleum” advertising campaign launched

in 2000 ultimately served to diminish credibility, as it presented a positive “CSR” image but arguably distorted picture of the company’s activities (in contrast with BP’s dominant oil operations, and numerous operational disasters). ExxonMobil, by contrast, is not shy about the fact that it is an oil company, and Exxon has through its results earned a reputation for operational excellence.

41. Jim Collins’s *Good to Great* and William N. Thorndike’s *The Outsiders* both provide useful accounts of the value of home-grown management talent, a deep bench, and independent thinking.

ESG policies. Investors in search of great companies want to know, first of all, whether the company has a sustainable competitive advantage. And they want to know whether the company has an organizational and governance structure that will help management maintain and enhance that competitive advantage, a structure that provides management with both accountability and strong incentives to add value.

But they are also looking for reliable evidence that management is thinking about the company's future, about what organization will look like 25 years from now.⁴² It's not enough to have confidence in the current top management team. Today's business value investors—and it's important for corporate managements to recognize that they are “out there”—are also looking for signs of a deep “institutionalized” bench and a high-quality management culture. And when viewed in this light, and communicated in a credible way to the investment community, a company's ESG policies and investments are likely to be a helpful framework in assessing the durability of a company's competitive advantage.

To skeptics who would question the relevance of ESG issues to investment analysis, we submit that while the “ESG framework” may be new, there is nothing new in the underlying issues being addressed. On the contrary, ESG is just a lens through which to gauge the age-old issue of quality.

Nonetheless, broader acceptance by the investment community will take time. Despite the rapid uptake and evolution of ESG analysis and “integrated reporting,” this area of corporate analysis remains far removed from the finance curriculum, just as the financial statement fundamentals were largely absent from Modern Portfolio Theory 40 years ago. And much as the availability of Compustat eventually drove finance academics to incorporate fundamentals (as opposed to just stock price technicals) into their research, we believe that over time ESG and other non-financial data (that are already included in business analysis), including KPIs, will be acknowledged as “table stakes” considerations for investment decision making.

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42. As Stephen Jarislowsky has argued, in assessing a corporation's quality of management, it is important to have a view of both current *and future* management. See *The Investment Zoo: Taming the Bulls and Bears*, 2005, Stephen Jarislowsky.

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