

Tomorrow's Investment Rules 2.0

Emerging risk and stranded assets have investors looking for more from nonfinancial reporting



Building a better
working world



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Welcome from EY

Today more than ever, investors tell us that they're using companies' nonfinancial disclosures to inform and underpin their investment decisions. This is understandable, since we increasingly see cases where companies' intangible assets outvalue their tangible assets. Central to the discussion of value is data on environmental, social and economic sustainability performance. However, despite clear indicators of interest from the investor base, many organizations still fail to meet emerging investor expectations regarding their reporting in these areas.

Can responsible and resilient companies improve their disclosures to help attract capital? With the risk of environmentally stranded assets taking center stage for resource companies, in particular, can disclosures be improved in ways that increase market understanding and highlight purpose-led business practices?

For a second year, we commissioned Institutional Investor Research (IIR) to independently survey a global sample of more than 200 institutional investors, including portfolio managers, equity analysts, chief investment officers and managing directors. We explored their views on the availability and quality of corporate nonfinancial information, and on whether they used

this information when making investment decisions. A number of these investors were then interviewed for further insight into their responses.

This year's results send a powerful message, with significant increases in the number of investors embedding nonfinancial disclosures into their investment decision making. Plus, we see a much wider view on which industries and sectors are expected to be impacted by social, environmental and economic risks. As Paul Druckman, CEO of the International Integrated Reporting Committee (IIRC) sets out in his foreword, there exists both a deficit of practical information for investors, and a tremendous opportunity for companies to capitalize on integrated and value-driven reporting approaches that capture how and why their specific business models will create value over the longer term. That's important given the questions we asked regarding the risk of stranded assets and the fact a third of respondents cut holdings of a company in the last year due to that risk.

Leading companies globally are embracing purpose-led transformations of their businesses - focusing on more sustainable models likely to be increasingly attractive to providers of financial capital.



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What should issuers remember about nonfinancial reporting?

- ▶ **Stakeholders are key:** Understanding what a business's key stakeholders believe is important for its future success is fundamental to determining a strategy for nonfinancial reporting.
- ▶ **Materiality matters:** Undertaking an assessment to determine what environmental, social and economic sustainability risks and opportunities are most critical to a business's capacity to create value is important; investors expect a company to disclose these risks and to explain how it will manage them.
- ▶ **A future worth imagining:** As investors seek to understand how well-placed a business is for future growth, the business will need to consider large-scale trends and provide a narrative explaining how its business model is well-placed to succeed in light of them.
- ▶ **Connecting value:** With the advent of more integrated reporting, companies should articulate how their specific business models, strategies and governance are connected to financial performance.

Can responsible and resilient companies improve their disclosures to help attract capital?

Foreword

A message from Paul Druckman, CEO,
International Integrated Reporting Council

Given today's complex business models and operating environment, markets need clear, high-quality information in order to allocate capital efficiently and productively. Consequently, investors need information that goes beyond financial statements to commit to making both short-term and long-term investment decisions.

Improving the quality of information available to providers of financial capital, in order to enable a more efficient and productive allocation of funding, is a fundamental aim of integrated reporting. As chief executive of the International Integrated Reporting Council, I am keen to ensure that through integrated reporting, analysts can better understand how businesses are addressing their current and future challenges. This can help them not only to better understand all the resources and relationships being employed to create value but, ultimately, to make improved investment assessments.

There is a recognized need globally to back movements, such as integrated reporting, that promote financial stability and sustainable development. As we note in our publication *Creating Value—Value to investors*, "these trends create a magnetism that will pull all investors in a direction towards 'integrated investment' over time." Integrated reporting creates opportunities for a longer time horizon by filling information gaps that do not appear in traditional annual reports, enabling organizations to present this information in ways that help the market understand their business models, strategies and performance.

As the use of integrated reporting grows, this is becoming increasingly evident. Participants in our "<IR> Business Network" are reporting benefits from adopting integrated reporting such as a better understanding of business models, better long-term decision making and enhanced relations with investors.

I welcome this second survey from EY, involving more than 200 institutional investors around the world. Notably, the survey shows that more than half (59.1%) of respondents view reporting on broader areas of value creation as essential to investment decisions. This change clearly points to a growing interest in more relevant information and reporting on the part of both investors and preparers.

The survey also reveals that much has changed since the first study in 2014. It is particularly pleasing for the IIRC to see from this report that investors are enthusiastic about the benefits of integrated reporting, with 70.9% seeing integrated reports as essential or important.

We have always believed that for integrated reporting to become mainstream there must be strong support from the investor community, demonstrating that investors do want information about strategy, governance, performance and prospects. The 2015 EY survey clearly suggests that this support exists, which is why businesses need to be aware that investors will increasingly make investment decisions based on how all of a business's resources are creating value over time.

On the evidence of this survey, investors remain critical of the quality of information currently being provided. This offers an opportunity for companies to provide higher-quality information, so that investors have no excuse not to use this wider knowledge and strategic context in their investment decisions. Our experience also shows that companies that report this broader information are better placed to manage issues that arise more effectively, and, in turn, achieve significant financial savings.

Moving the dial from risk evaluation to understanding value is the way forward. A number of the findings in the survey highlight the fact that more information is needed for risk purposes, but investors should increasingly see this as a source of understanding value, too.

It is evident from this report that integrated reporting can help businesses meet investor needs. It gives them vital insight into business strategy, governance, performance and prospects. This report confirms an important, growing trend toward the adoption of a wider concept of value creation—supporting both better investment decisions and sustainable development.

Executive summary

For the second consecutive year, EY has commissioned a study on institutional investors' views regarding nonfinancial reporting by issuers (publicly traded companies). This follow-up study builds on our inaugural thought leadership report, published in early 2014, which established that investors were progressively incorporating environmental, social and governance (ESG) analysis, along with other nonfinancial elements, into their decision making. This year, we've seen even greater evidence of this reliance on nonfinancial information (see Figure E.1).

Based on the 2014 study, EY published *Tomorrow's Investment Rules*, which reported (1) that most investors do, indeed, factor ESG information into their decision making; (2) that only a minority, however, use structured, systematic methods to evaluate ESG; and (3) that many investors who do not use ESG information question whether companies' disclosures are adequate to determine if ESG is material to investment decisions. The report concluded that there is a need for companies to improve the nonfinancial information they report to meet the needs of investors.

This year's survey, involving more than 200 institutional investors around the world, asked two questions that weren't included in the original study:

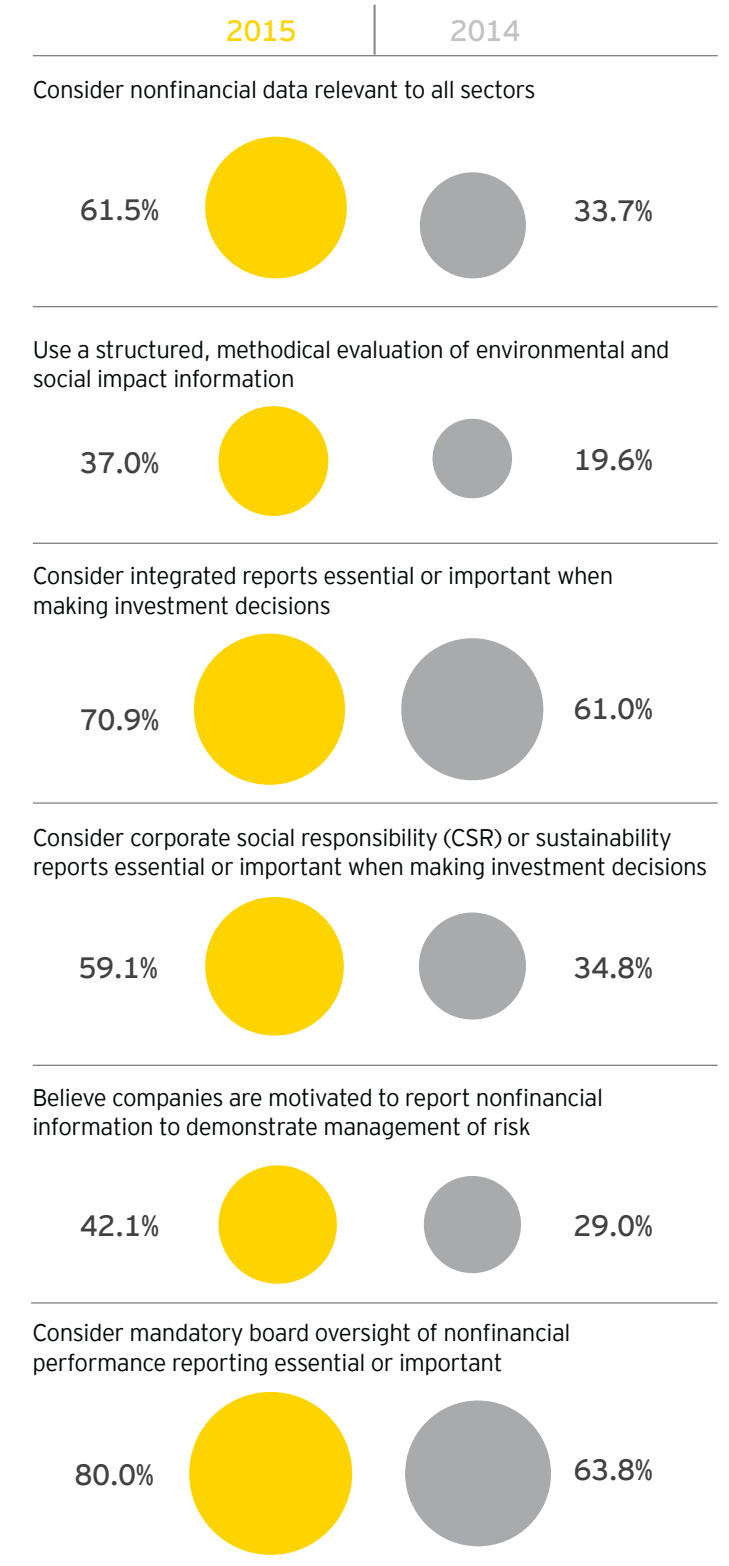
- ▶ In the last 12 months, has your fund decreased its holdings of a company's shares due to the risk of stranded assets?
- ▶ Do companies adequately disclose their environmental, social and governance risks that could affect their current business models?

The responses about stranded assets (i.e., those that lose their value prematurely due to environmental, social or other exogenous factors) reveal that investors' concern over this risk might be more widespread than many expect.

The responses about stranded assets reveal that investors' concern over this risk might be more widespread than many expect

Figure E.1.* Growing interest in nonfinancial reporting seen in significant shifts since 2014

Percentage of respondents who...



*Values in graphs throughout this report may not total to 100% due to rounding.

1 Recognizing a new value paradigm: a sharpened focus on stranded assets

Key 2015 findings

The key findings of the 2015 study are the following:

- ▶ A notable 62.4% of investors are concerned about the risk of stranded assets. More than one-third of respondents report cutting their holdings of a company in the last year due to this risk, while an additional quarter of respondents plans to monitor this risk closely in the future.
- ▶ With the impact of environmental and social changes on commercial enterprises accelerating – generally and in terms of stranded assets – 37.0% of investors today use a structured, methodical approach to analyzing nonfinancial information related to these risks as part of their investment decisions.
- ▶ However, this more structured approach may fall short of what investors need to forecast the impact of nonfinancial factors on investments. Investors are facing a deficit of the quality and type of nonfinancial information that they want. Nearly two-thirds of respondents say issuers do not adequately disclose ESG risks.
- ▶ As in the 2014 study, investors across sectors still find nonfinancial information most useful when it is based on standardized, industry-specific criteria, allowing comparisons between peers.

70.9%

see integrated reports as essential or important, ranking them second in usefulness behind only companies' annual reports

- ▶ Investors are enthusiastic about the benefits of integrated reporting; 70.9% see integrated reports as essential or important, ranking them second in usefulness behind only companies' annual reports.
- ▶ Similarly, a noteworthy 59.1% of respondents consider corporate social responsibility (CSR) reports to be essential or important to investment decisions.
- ▶ A majority of investors (61.5%) consider nonfinancial data to be relevant to all industrial sectors today.
- ▶ Nonetheless, more than one-quarter of respondents also report that nonfinancial information has not affected any of their investment decisions over the last year; they find it difficult to determine how material this information is to financial performance because it is often not verified or is difficult to compare across companies.
- ▶ One reason investors are not getting the nonfinancial information they want is because companies provide this information mainly to serve their customers and regulatory requirements. However, companies are beginning to provide useful information for investors; 42.1% of respondents say that companies report nonfinancial information to demonstrate risk management.
- ▶ The deficit of useful nonfinancial information available to investors has created a first-mover opportunity for issuers to provide the information that investors find most useful and, in doing so, establish a new investor strategy.

Key regional differences

Investors' use of nonfinancial information, along with its provision by issuers, varies substantially around the world. Some of the largest and most interesting regional differences revealed by this year's study are the following:

- ▶ Investors in Europe lead their peers elsewhere in integrating nonfinancial factors into their decision making. They are especially likely to use a structured approach to ESG analysis, to let their investment decisions be affected by nonfinancial information and to prefer integrated reporting that follows the IIRC Framework.
- ▶ Investors often group Europe and Australia together as ESG leaders. Some investors attribute Australian investors' interest in ESG to the fact that the country's superannuation funds often have investment committees that include employee representatives. It is true that a full 82.6% of investors in Australia – a larger portion than in any other region – consider nonfinancial factors to be relevant in investment decisions across all sectors, rather than just in specific ones.
- ▶ Investors in the US and Canada have made the most notable progress since 2014 in the integration of nonfinancial information into their decision making. This progress is reflected in various indicators of the importance of this information to investors, such as the value they place on board oversight of a company's nonfinancial disclosures. Over the same period, the portion of US and Canadian respondents who see integrated reporting as essential also rose.
- ▶ Asia-Pacific, excluding Australia, lags behind the rest of the world in its nonfinancial , according to investors. However, there are influences within the region pushing it toward a deeper awareness of the importance of nonfinancial information in investment decisions. Japan, for example, recently announced plans to improve the country's corporate governance.
- ▶ Latin America, whose investors and companies have previously shown less interest in nonfinancial reporting than have their peers in other regions, might be in the process of catching up. A larger portion of investors in Latin America, 57.1%, report reducing their holdings in the last year due to stranded asset risk than did so in any other region.

This study illustrates the significant gap between the nonfinancial reporting that investors want and that issuers offer them. But there is also an opportunity here. The results of this study can read like a road map for any issuer that would like to contribute to filling this gap. Offering the type of nonfinancial information that investors want in the form they want it can result in an issuer's gaining investor attention and, ultimately, winning an advantage over its peers in the capital markets.

According to an announcement by Hamburg Bulk Carriers (HBC) in February 2015, the company recently purchased a new cargo vessel that runs on a "significant low consumption" of fuel and outperforms the industry's Energy Efficiency Design Index for carbon dioxide emissions by more than 32%.

This announcement reveals how nonfinancial factors – including those pertaining to environmental, social and governance (ESG) concerns – influence business operations and investors' decisions. In the announcement, Jens von Husen, Managing Director of HBC, explains that in the years ahead he expects freight buyers to begin including emissions performance criteria in their purchasing policies, "some driven by fear of penalties, others driven by the wish for improvements or pressure from their own customers." As a result, von Husen believes, "Some ships will no longer be able to work profitably in some regions [and could become] stranded assets."

Von Husen's concern over stranded asset risk echoes a growing view of how ESG and other nonfinancial factors are likely to affect investor decision making in the years ahead. Stranded assets are those that prematurely or unexpectedly lose their value due to exogenous factors. The devaluation can be complete or partial; indeed, it can convert an asset into a liability.

Today, stranded assets are increasingly a risk in nearly every industry, but they have most often been associated with the energy and extraction industries, such as oil and gas, mining,

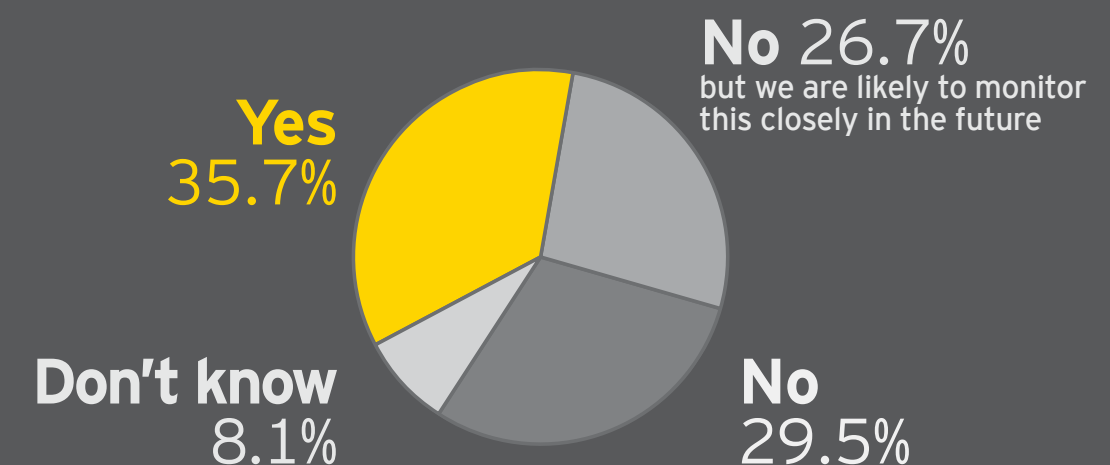
and utilities. A recent article in the *Economist* on the oil business featured the title "Yesterday's fuel" and argued that "two revolutions in technology will dampen the world's thirst for the black stuff." Specifically, "fracking" will turn gas into an abundant oil substitute, and advances in automotive design will not only continue to increase cars' fuel efficiency but will popularize electric cars and hybrids. As a result, oil companies, typically valued according to their petroleum reserves, face stranded asset risk tied to these shifts in technology and market dynamics. (See more on the causes of stranded assets on the following page.)

Against this backdrop, the data collected in this study reveals that investors are indeed concerned about the risk of stranded assets. In total, 62.4% of survey respondents – almost two-thirds – express concern over stranded asset risk. Nearly 36% report that their funds have decreased holdings of a company's shares in the last year due to this risk, while another 26.7% expect to monitor this risk closely in the future (see Figure 1.1).

Stranded assets are among the clearest pieces of evidence revealing that risks stemming from environmental and social factors are increasingly affecting companies' business performance. Consequently, investors increasingly seek to incorporate ESG and other nonfinancial performance information into their decision making. However, as we will see in the pages ahead, both investors and issuers (publicly traded companies) need to overcome formidable hurdles to realize the full value embedded in such information.

Figure 1.1. Nearly two-thirds of respondents are concerned about stranded assets

In the last 12 months, has your fund decreased its holdings of a company's shares due to the risk of stranded assets?



How assets become stranded

Assets usually have measurable life expectancies and risk-and-return profiles – both of which are principal components of their valuation. Assets become stranded when exogenous factors dramatically alter these components, resulting in their loss of value or liquidity. More often than not, these exogenous factors are tied to environmental or social change, such as the following:

- ▶ Increasing environmental risks (e.g., climate change)
- ▶ Evolving social attitudes (e.g., fossil fuel divestment movements)
- ▶ Government regulation (e.g., carbon pricing and air pollution regulations)
- ▶ Disruptive technology (e.g., fracking, wind-generated energy and electric vehicles)
- ▶ Geopolitical risk (e.g., government instability, war, investment restrictions and the repatriation of profits)

There are numerous ways in which ESG and other nonfinancial factors can cause assets to become stranded. Following are four explanations that feature very different underlying causes.

1. Regulation: One example of how asset devaluation might impact fossil fuels is known as the “unburnable carbon” argument. If governments were to implement stricter regulations on carbon dioxide emissions, the fossil fuel reserves held by oil and coal companies could exceed the quantity they would be allowed to sell as combustible fuel, turning their reserves into stranded or partially stranded assets. As a result, some investors now shift away from investments in companies with carbon-intensive assets. Indeed, to help them do so, investment indices that underweight fossil fuel stocks, including the closely watched MSCI Global Low Carbon Leaders Indexes, have recently been launched.

2. Social movements and activism: The effect of carbon emissions on climate change has been the topic of much public debate in recent years, and activist organizations now seek to alter both public attitudes and the behavior of investors. The advocacy group 350.org calls on institutional investors to divest their shares in oil, gas and coal companies whose reserves contain the highest potential carbon emissions. This activism, reminiscent of the Anti-Apartheid Movement of the 1980s and the anti-tobacco movement of the 1990s, may pose a risk of stranding carbon assets in the years ahead.

3. Geopolitics: Disruptive activities in foreign countries tied to regime change, sanctions and embargos, and international relations pose material stranded asset risk, say investors interviewed for this study. For example, tension between Russia and the West has affected one source’s holdings of a well-known American brand. This company “had issues in Russia where the government basically closed down a lot of their [operations] for a short period,” says a portfolio manager at an Australian asset management firm. “The Russian Government said it was due to health reasons, but really they just wanted to upset an American company.” Although the disruption affected only a small part of the company’s global operations, says the portfolio manager, “it made an impact that we have to be aware of.”

4. Environmental change: The link between climate change and stranded assets extends well beyond the companies that are closest to global warming. A June 2014 report from the Risky Business Project outlines three economically significant risks of climate change in the US: (1) damage to coastal property and infrastructure from rising sea levels and increased storm surge, threatening vast real estate and business operations; (2) climate-driven changes in energy demand and agriculture production, threatening the food industries; and (3) the impact of higher temperatures on labor productivity and public health. In short, climate change is likely to have a substantial impact across nearly all industries that could result in stranded assets.

Stranded assets are among the clearest pieces of evidence revealing that risks stemming from environmental and social factors can impact investor perceptions of business performance

2 Investors look to nonfinancial data for a more complete understanding of performance

How do investors evaluate nonfinancial information?

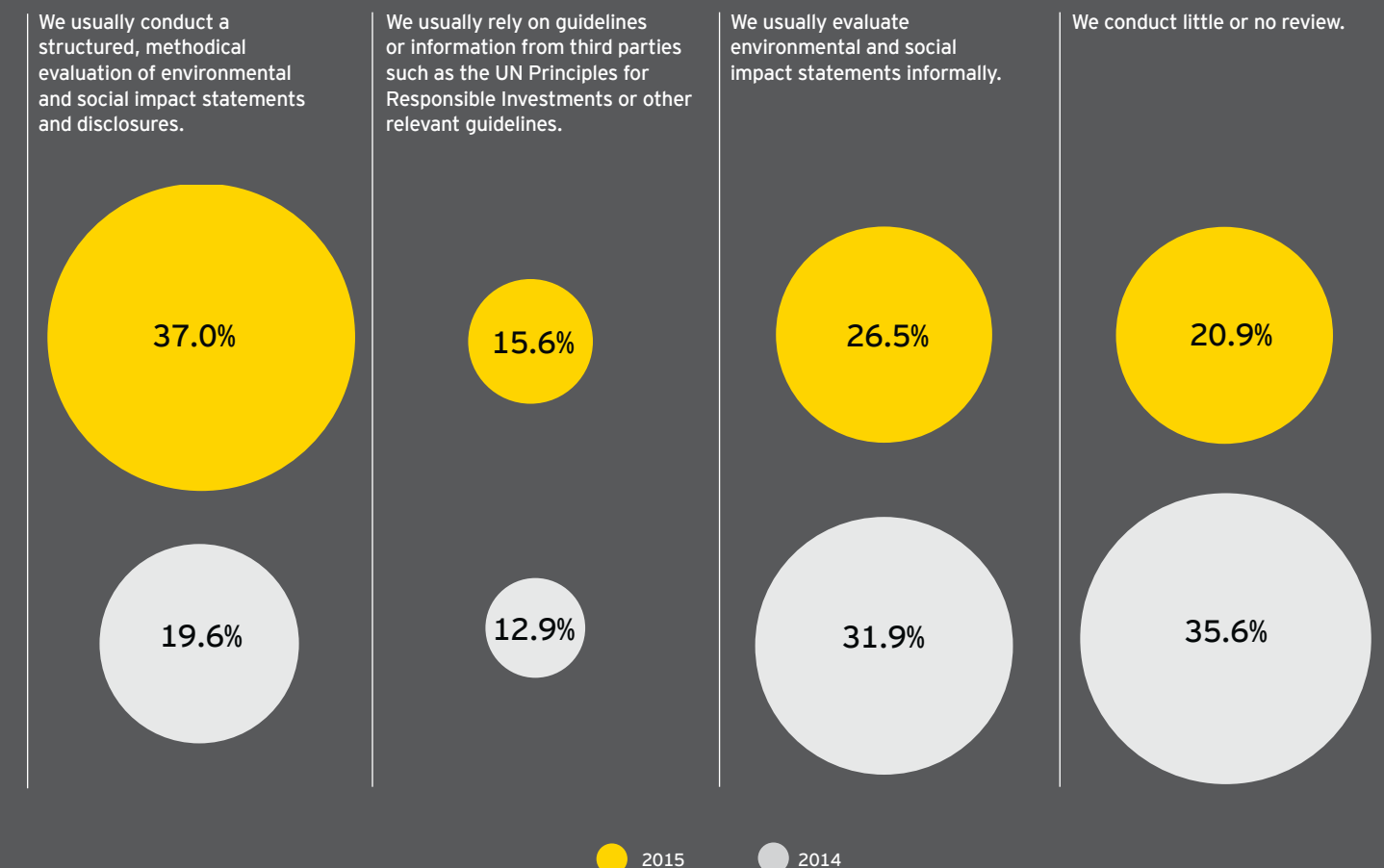
Amid growing concern about stranded assets and other effects of nonfinancial factors, investors report taking a more formal approach to evaluating nonfinancial information tied to social and environmental matters. In our 2014 study, only 19.6% of respondents said they typically conduct a structured, methodical evaluation of environmental and social impact statements and disclosures, while 37.0% report using such an approach in this year’s study (see Figure 2.1). Similarly, the proportion of respondents saying they conduct little or no review of ESG information has fallen substantially.

Still, the degree of structure used by institutional investors when evaluating nonfinancial factors currently varies widely. The evaluation can be basic, as is the informal approach used by a large Brazilian hedge fund, which trusts its analysts simply to use their common sense regarding the relevance of ESG information.



Figure 2.1. Investors bring structure to their evaluation of companies’ nonfinancial performance

How do you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company’s performance?



At the other end of the spectrum, what does a structured, methodical approach to evaluating nonfinancial information actually look like? Consider a Swiss private bank's structured approach to ESG consisting of an internally developed evaluation system that provides transparency and control, while allowing the firm to "counterbalance" information from issuers with data from third parties. According to one of the bank's financial analysts, "We have developed our own scoring system so that we don't have to rely on a black box. Basically, we have an engine that applies our ESG scores to all the companies in the MSCI World Index. We can run this filter easily and come up with the best scores in each sector, which then are eligible for our ESG portfolio."

Furthermore, the number of factors that investors evaluate is increasing as sources of value and risk under the umbrella of nonfinancial information is expanding. An analyst at a US asset management firm with over US\$400 billion in AUM describes the firm's adding tax avoidance to its nonfinancial screening. Last year, the firm began examining the risk of tax avoidance by multinational corporations and their practice of "shifting profits to lower tax jurisdictions where little of a company's business activity truly takes place." The analyst conducted extensive research on the topic in an effort to help his team understand where exactly the risks lie and which individual stocks in its various portfolios warranted the greatest concern. "This is definitely a governance and social issue, and it's an issue that falls through the cracks," said the analyst.

This same US-based analyst also offers a caveat regarding how investors should integrate nonfinancial screening into their investment decision making. In short, he advocates making it the responsibility of every analyst, rather than placing it in the hands of a separate specialized team. "I sense clients are concerned about the building up of large [but separated] ESG teams, because you run the risk of an analyst seeing an ESG issue and throwing it over the wall to that team. Instead, at my firm, we're saying,

"What we need is to have all 100-plus of our analysts and portfolio managers in equity and fixed income thinking about ESG and trying to integrate it into their work," said the analyst.

Ultimately, as the analysis of nonfinancial information plays an increasingly present and integrated role in investors' decision making, it may well assume a position similar to that of financial analysis – as a core skill and structured set of capabilities required by all investment professionals. In the long term, nonfinancial analysis may play a similarly prominent role in the operating and financial decisions at issuers, as well.

Furthermore, as investors and issuers progress in their use of nonfinancial information, the quality, timeliness and comparability of this information will need to rise. However, more and better information is only the start. As nonfinancial concerns continue to emerge as material to investment decisions, companies will likely be increasingly expected to provide this information alongside financial information in integrated reports.

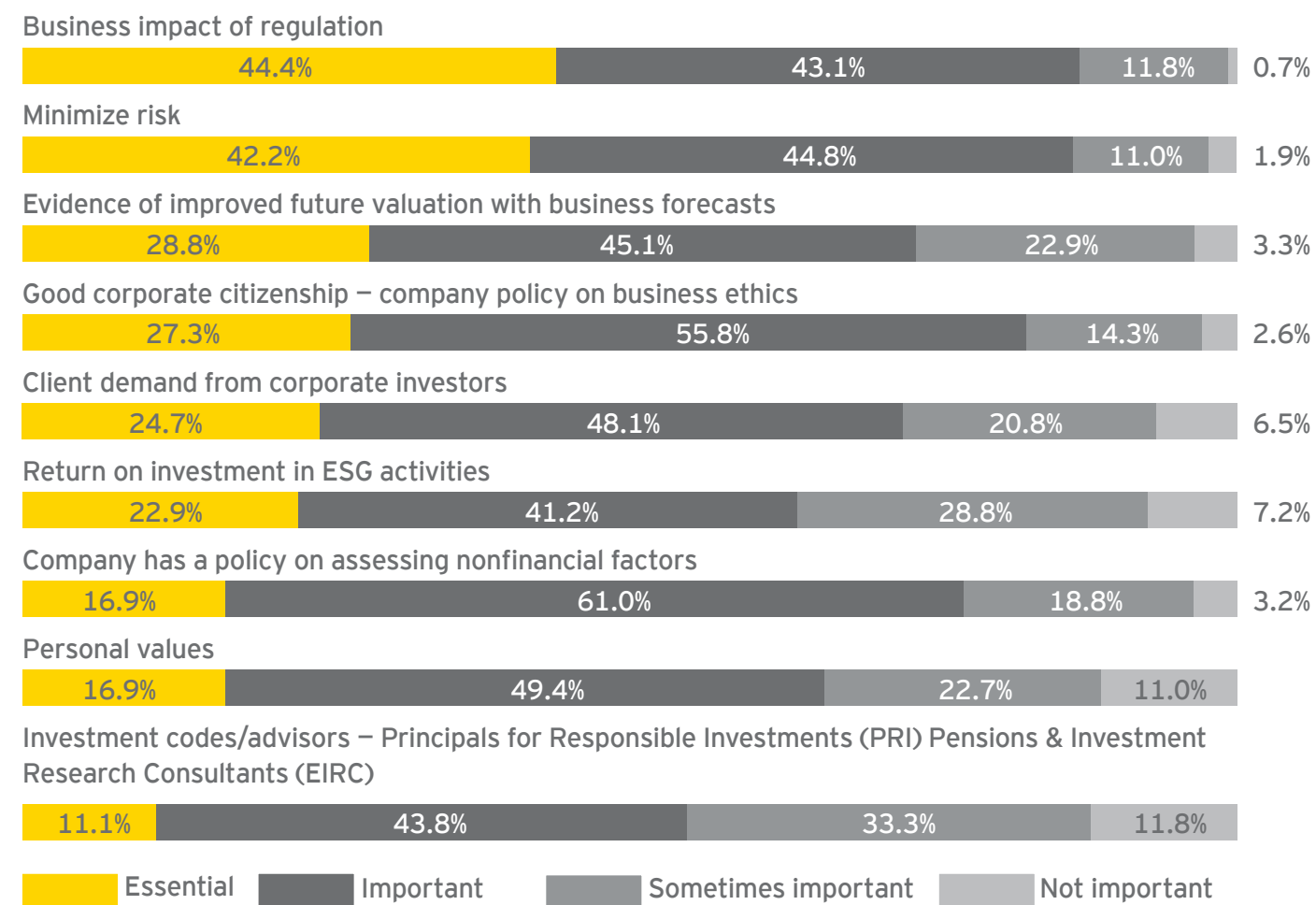
What do investors look for in nonfinancial information?

Investors focus on nonfinancial factors that are tied most directly to measurable company performance and to client requirements, according to this year's data. Survey respondents are most likely to judge visible, measurable elements of nonfinancial performance – those that affect operating performance, risk and valuation – as essential or important (see Figure 2.2). Institutional policies and internal mandates are less likely to spur acute interest in nonfinancial information. Granted, very few respondents dismiss factors such as their own values, investment codes, external advice or company-level policies as unimportant. However, the survey data clearly indicates that investors care more about the nonfinancial factors that are linked most closely to the risk and return prospects of particular investments.

As nonfinancial concerns continue to emerge as material to investment decisions, companies will likely be increasingly expected to provide this information alongside financial information in integrated reports

Figure 2.2. Measurable effects on risk and performance are the most important nonfinancial consequences

How important are each of the following nonfinancial issues to you as an investor?



With investors' growing realization that ESG and other nonfinancial factors affect measurable aspects of companies' performance – that is, affect the risk and return of particular investments – it is not surprising that a number of investors are integrating a structured analysis of nonfinancial risk across their portfolios.

The head of responsible investing at a UK asset management firm with US\$425 billion in AUM explains, "We've been looking at how we can integrate ESG factors into our mainstream investment approach. We've recognized that these factors can and will have a material impact on corporate performance. As such, we should be considering an analysis of where these impacts might affect a company, from its value chains and supply chains to its operations and the demand for its products and services."

Under the ESG umbrella, it is often good governance that specifically receives investors' largest endorsement as valuable to companies' performance and as a useful criterion to include in

investment decisions. A portfolio manager at an Australian firm that invests US\$9 billion in AUM in global listed infrastructure explains how his firm analyzes the governance of every company in which it considers investing. "We look at," he says, "a couple of dozen different, visible measures in the area of governance, which we apply to every company. These measures include, for example, the explicit use of bribery and corruption policies; anti-corruption measures; whistle-blower programs; separation of the chair and CEO; separation of key parties within the company; diversity; audit committee independence; the amount of money spent on political lobbying; the disclosure of hacks, and remuneration."

More succinctly, and echoing many of the investors we interviewed, a portfolio manager at a German asset management firm says simply, "Governance is an area which often may be able to produce benefits for long-term performance. Call it just 'proper investing.'"

Investors are increasingly interested in nonfinancial performance, ranging from companies that are good environmental citizens to ones that are charitable donors

However, many investors still see ESG as a niche product, offered largely to satisfy the interests of specific clients. Various pension funds, for example, will not invest in companies that they see as harmful to society or individuals; others simply will not invest in “sin.” In other words, the issuers in their portfolios must pass certain negative screens. One global fixed income manager at a Malaysian pension fund with US\$200 billion in AUM reports that, among the red flags that would cause the fund to rule out an investment, “number one is the environment. If we are investing, for example, in an infrastructure project...we need to justify that there is no material adverse [environmental] impact to the society.”

Certain other institutional investors are interested in including in their portfolios companies that have passed positive screens – that is, companies that create value for individuals or society. A number of investors interviewed as part of this study offer examples of their making such investments in companies ranging from ones that are good environmental citizens to ones that are charitable donors.



One example comes from a consumer sector analyst at a Peruvian pension fund with more than US\$10 billion in AUM. He tells of recommending that the fund buy shares of a US grocery chain specializing in natural, healthy foods “as kind of a thematic investment, because we are trying to help solve certain effective problems in the world, including obesity. We are trying to improve the health awareness of people in terms of eating well. So, we invest in that company. That’s an affirmative way of using ESG screening to create value for society.”

Finally – while many investors build an analysis of ESG risk into all of their investment decisions and others reserve it for the creation of a niche product – investors continue to debate what the effect of ESG will be on the long-term returns offered by companies. Is it an added cost or a source of companies’ improved performance and, hence, returns?

The portfolio manager at the German asset management company says more generally, “I see ESG personally as an added cost layer. You basically pay for it if you want it; if performance is not necessarily your main concern because you have other standards and commitments.”

However, many investors believe that ESG can have a neutral or even positive effect on portfolio returns. “I think you can achieve an ESG objective without sacrificing returns,” says the head of equity portfolio management at a US asset management firm with US\$380 billion in AUM. “I think return, at the end of the day, is really what matters most to the fiduciary, right? I think these two objectives, ESG and returns, can be achieved at the same time; you just have to be very thoughtful in how you achieve these two goals.”

All in all, there are many reasons that investors are increasingly interested in the nonfinancial performance of the companies in which they consider investing. As the pension fund analyst from Peru enthusiastically explains, “Whether it’s for the high returns in the long term, for marketing purposes, or because you want to do good for society, nonfinancial considerations like ESG offer it.” However, for investors to find companies that can help them accomplish any of these goals, issuers need to report their nonfinancial information in ways that easily allow it to be incorporated into investors’ decision making.

How do investors react to different types of nonfinancial disclosures?

Echoing their views about the types of nonfinancial information they consider most important, survey respondents in 2015 indicate that their investment decisions are most likely to be affected by nonfinancial disclosures tied to visible, measurable risks to a company's performance (see Figure 2.3). Statements that, for example, demonstrate a lack of value-creation strategy, expose the risk of poor governance, or reveal risks that directly affect performance (such as risks to a company's supply chain, environmental performance or human rights record) are most likely to cause investors to rule out a potential investment or, at least, reconsider it.

On the other hand, nonfinancial risks that are less measurable, not directly linked to a company's business practices, or less pressing in the near term (e.g., those tied to climate change) are less likely to spur investors to abandon or reconsider an investment opportunity.

Viewed year-on-year, survey data reveals substantial consistency in investors' views regarding the impact of various disclosures. The absence of an adequate value creation strategy and concerns about governance top the list of disclosures that cause respondents to rule out a prospective investment in both 2015 and 2014, albeit they swap places in the two surveys. And while there are some other small shifts in the order of responses from last year to this year, the data remains quite consistent.



“I would like to get away from ESG being viewed as nonfinancial, because I think these are financial issues.”

Figure 2.3. Nonfinancial disclosures affecting risk and performance are most likely to stall an investment

How would the following disclosures about a prospective investment affect your investment decision?



The Australian asset management firm specializing in global listed infrastructure builds some of the specific nonfinancial risks that investors consider most serious directly into its decision making metrics. “When we’re putting together our financial models,” explains a senior analyst and portfolio manager at the firm, “we try to bring ESG into our cash flow forecasts, where possible. We consider costs to the revenue line that are impacted by social or environmental restrictions and feed this information into our expected return from a stock. On the risk side, our portfolio managers apply a risk factor to governance, in particular, since it’s the area that has the most impact on valuation. For governance, we typically use metrics that have to do with shareholder structure, board compensation, remuneration and the alignment between the company and investors.”

The types of ESG and other nonfinancial disclosures that most often cause investors to rule out an investment are those that ultimately have a financial impact on companies. The analyst at the US asset management firm with US\$425 billion in AUM summarizes it well: “ESG is not always nonfinancial. For an ESG factor to be interesting to a large portion of investors, it’s got to have some link to financial impact. Why does a mining

company release data on worker safety, for example? It’s because the company and its investors, obviously, realize it can impact production, which can impact sales, which impacts the value of the stock. I would like to get away from ESG being viewed as nonfinancial, because I think these are financial issues. They happen to have social or environmental or other important ramifications, but they’re also clearly financial.”

The issue becomes how investors can get the nonfinancial information that they consider most useful to their investment decision making – that is, information tied to companies’ visible, measurable performance. The IIRC is one organization helping investors and issuers achieve this goal. In 2013, it released the Integrated Reporting Framework, which helps companies produce integrated reports that link their ESG and other nonfinancial disclosures to their expected performance and plans for value creation. As companies and industries continue to adopt the guiding principles incorporated into this reporting framework, it could be a significant step toward investors’ getting the nonfinancial information they want.

In which sectors do investors consider nonfinancial information important?

Investors have broadened the range of sectors in which they consider nonfinancial information to be relevant. More than 60% of respondents in this year's study see such information as relevant across the full spectrum of industries, up from 33.7% in 2014 (see Figure 2.4).

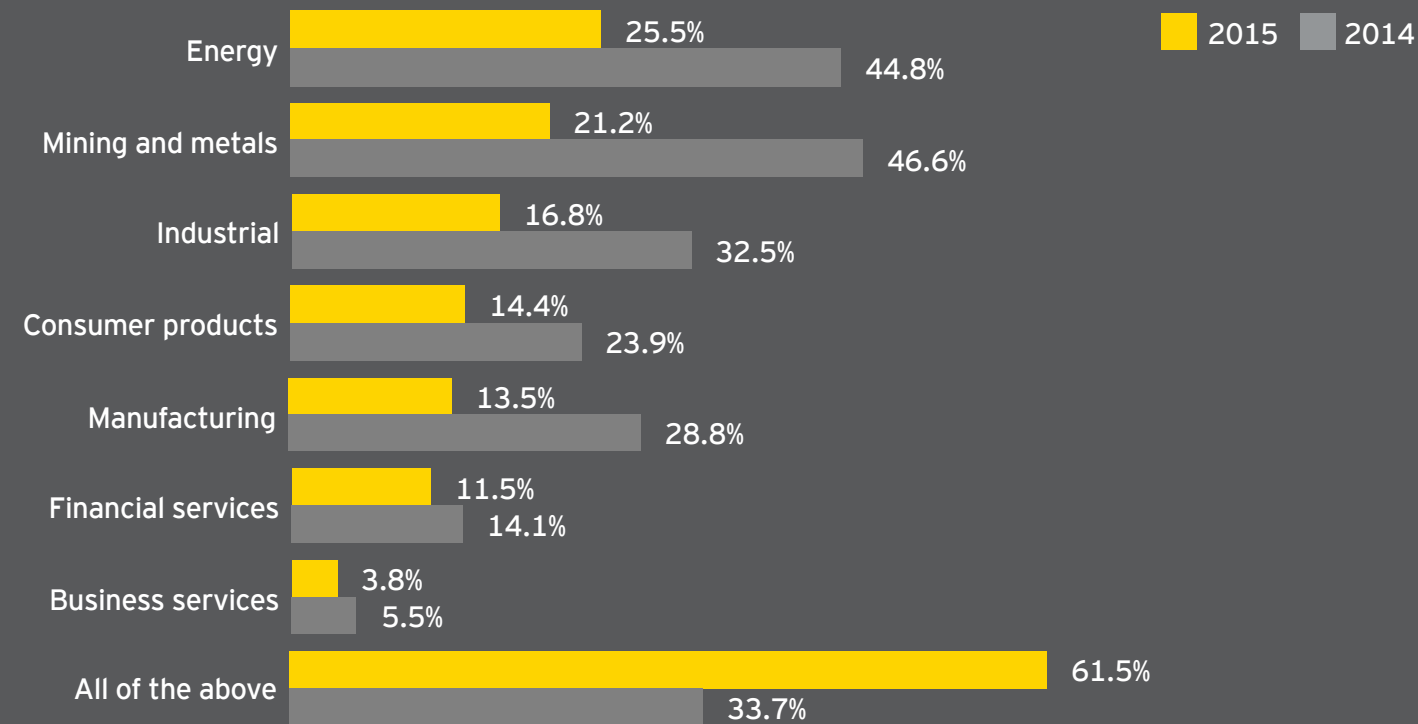
While a majority of investors consider nonfinancial factors relevant to all sectors, not all hold this view. As a result, more respondents consider nonfinancial data important to the energy sector than to any other sector. In addition to the 61.5% of respondents who say nonfinancial data is relevant to all sectors,

another 25.5% of respondents say it is relevant to the energy sector specifically, yielding 87.0% of respondents who consider it important to this sector. As the pension fund analyst in Peru puts it, "There are some industries that are more prone to ESG risk. These are energy, mining and probably the consumer sector – the last because of brand value in terms of customers and reputation issues."

Despite investors' expanded use of nonfinancial information across all industries, it is clear, as we will see in the next section, that they face a deficit of high-quality nonfinancial reporting. Issuers too often do not provide enough nonfinancial information in the form investors find useful when making investment decisions.

Figure 2.4. Investor interest in nonfinancial information spans all sectors

In which sectors are you more likely to consider nonfinancial data most relevant?



3 Investors seek consistent and comparable nonfinancial information

Survey respondents say they are looking at more nonfinancial information in more structured ways, but it appears that this additional effort has not yielded a broad shift in investment decisions. In the 2015 study, 23.7% of respondents say nonfinancial performance frequently played a pivotal role in their investment decisions over the previous year (see Figure 3.1); this is basically consistent with the 23.3% who said the same in 2014.

The most telling analysis may be this: Although a majority of investors pay some degree of attention to companies' nonfinancial performance, a relatively small proportion finds this criterion to be frequently pivotal to their investment decisions. One reason investors' decision making does not, at present, rely more heavily on companies' nonfinancial performance is that investors find they are not getting the most useful information about companies' nonfinancial performance. Investors say repeatedly that they do not receive enough accurate, standardized nonfinancial information relevant to companies' risk and performance assessment. Specifically, almost two-thirds of respondents say companies do not adequately disclose information about ESG risks, and nearly 40% call for companies to do so more fully in the future (See Figure 3.2).

Figure 3.1. Between 2015 and 2014, the proportion of investors finding nonfinancial information frequently pivotal to their decisions has remained at almost one-quarter

In the last 12 months, how frequently has a company's nonfinancial performance played a pivotal role in your investment decision making?

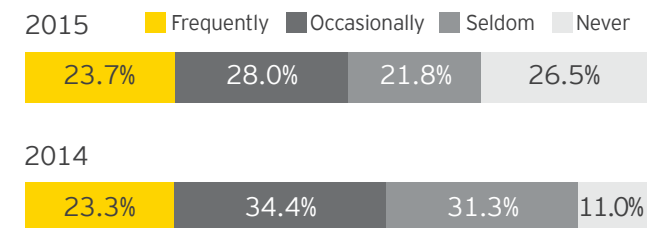
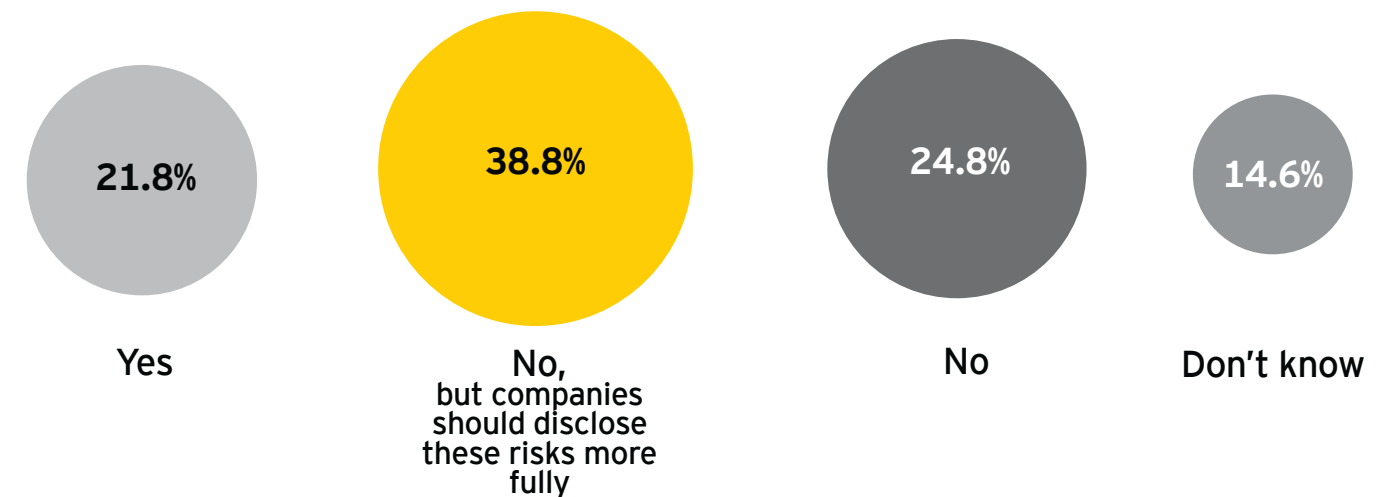


Figure 3.2. Investors say companies do not adequately disclose their ESG risks

Do companies adequately disclose their ESG risks that could affect their current business models?



There are many reasons for the poor and uneven reporting of ESG and other nonfinancial risks and benefits by issuers.

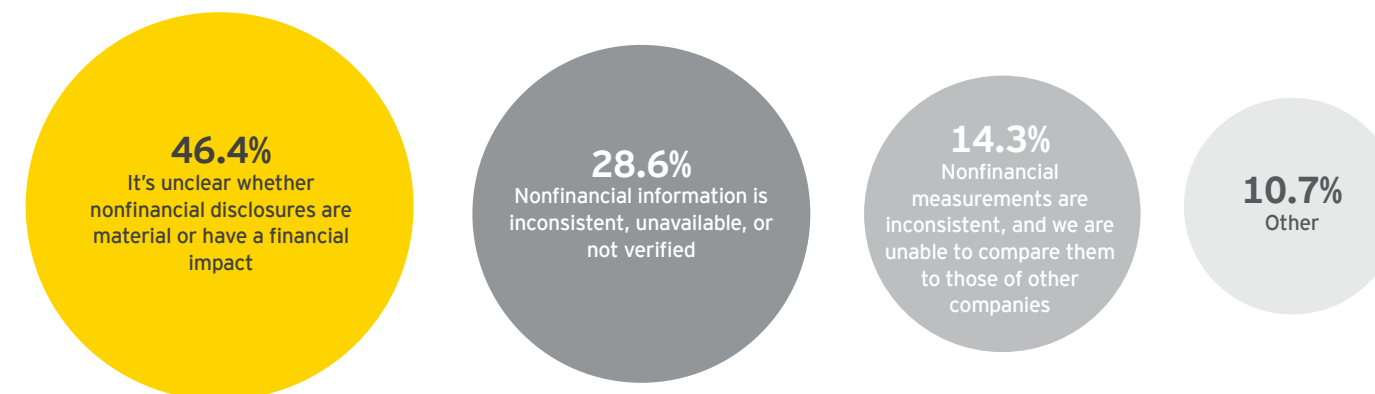
According to investors, these reasons are often tied to an issuer's size. Large cap companies are typically more forthcoming with nonfinancial information and often have more resources available to use in preparing nonfinancial reports for investors. The analyst at the Swiss private bank explains, "Most of the large cap companies nowadays have the means, ability and willingness to report on ESG issues, whereas small microcaps likely do not. So, when I screen the whole 2,500-plus companies in the world, I'd say around a third report on these issues. Among the large caps, almost 90% of the companies make ESG data available. I can see a clear correlation between the percentage of companies reporting and their market cap. I would suggest the smaller companies don't have the ability, rather than the willingness, to disclose to a decent level of scrutiny."

Consistent with this, other investors explain that issuers often cite cost – or perceived cost – directly as a reason for their inadequate disclosure of ESG and other nonfinancial information. Explains the head of sustainability research at a UK asset management firm, "The argument [from issuers] is that it's about cost. But the evidence shows that once you start producing nonfinancial reports, you start managing these issues more effectively, and you save a significant amount of money by better managing attitudes and resources, by addressing public safety issues, and so on. So, I think it's more than just cost. Cost is an excuse that's given. Some companies just don't think that this is information that investors should take an interest in, and so they aren't willing to invest in the reporting. There is an initial investment to be made in building the systems to report this information."

"The evidence shows that once you start producing nonfinancial reports, you start managing these issues more effectively, and you save a significant amount of money."

Figure 3.3. Investors who do not use nonfinancial information consider it immaterial or lacking quality

Which of the following statements best reflects your views on why you do not consider ESG issues in your decision making?



Giving a specific example, he continues, "We've engaged in the US with a very large electrical equipment company. It's been focused on [becoming] more resource efficient, and we coached them to do a sustainability report." The question, he explains, is why had this company not done a sustainability report sooner. "The argument that came to the surface is that it was about cost" despite the facts that "this company has a good ESG story" and that such reporting can result in savings.

Thus, echoing a number of investors interviewed for this study, this UK research head sees nonfinancial reporting as a potentially significant bottom line strategy based on its ultimate ability to save companies money.

Another explanation for issuers' poor disclosures regarding nonfinancial factors might lie in the emerging state of nonfinancial reporting. While investors now enjoy the results of hundreds of years of financial reporting, nonfinancial reporting is in its early stages – and is not yet based on standardized reporting conventions. The result is that the proper reporting of ESG and other nonfinancial information can seem not only expensive but also overly complex to companies.

At present, neither investors nor issuers are responsible for specifying how companies should report nonfinancial information.

However, a number of organizations involved in setting standards for company reporting offer remedies for the lack of consistency and company-to-company comparability in nonfinancial information. Three of the more influential of these organizations are the IIRC, the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI). (See related references on page 21.)

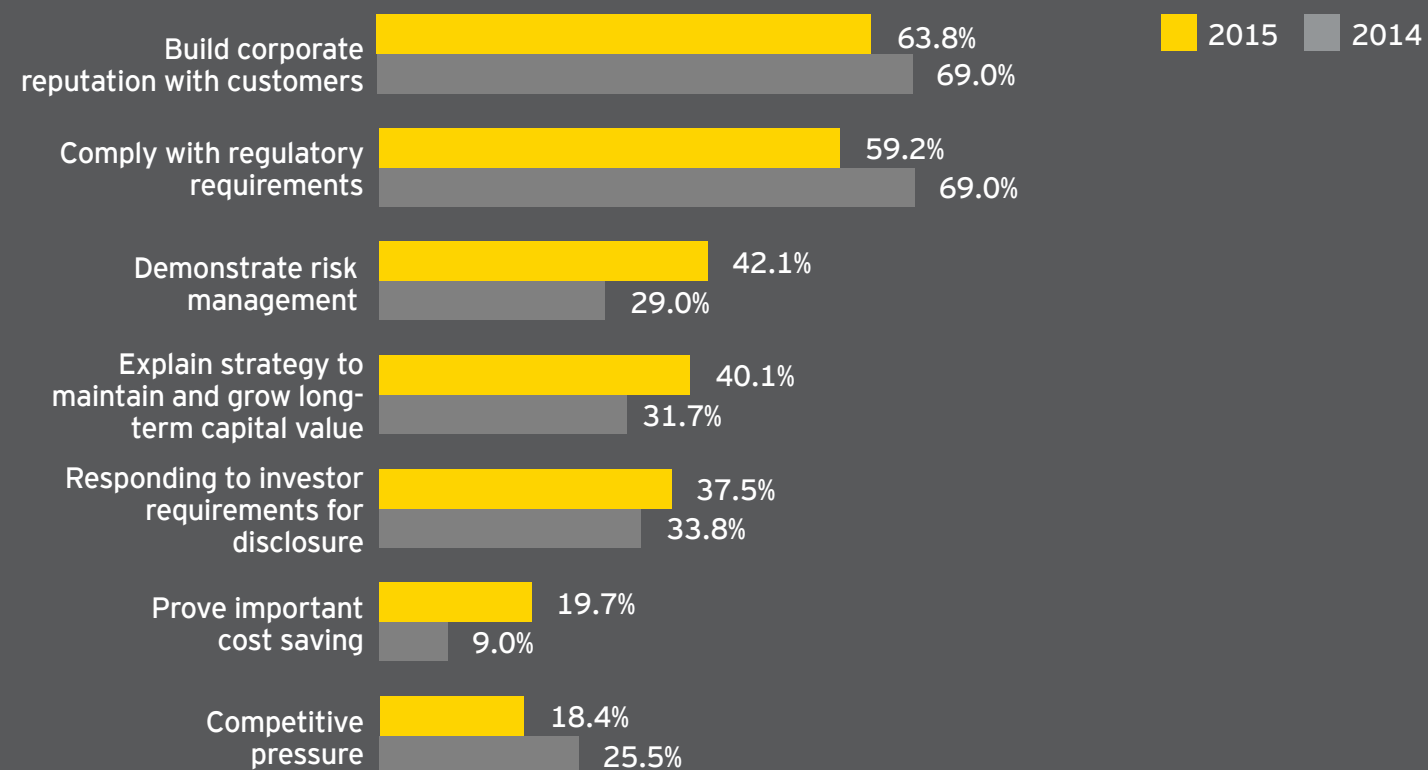
Against this current backdrop of uneven nonfinancial information from companies, it comes as little surprise that more than one-quarter of respondents report that companies' nonfinancial performance did not play a pivotal role in their investment decisions even once during the previous year (see Figure 3.1).

Among these investors for whom nonfinancial information never played a pivotal role, 46.4% explain that they do not consider nonfinancial disclosures in their decision making because they question the materiality or financial impact on the companies that they are evaluating (see Figure 3.3). Others believe that the nonfinancial information they receive is inconsistent, unusable in comparing one company to another, or unverifiable.

One probable reason for investors' dissatisfaction with nonfinancial information lies in the strategy behind companies' reporting – it is not currently created to serve the needs of investors

Figure 3.4. Companies provide nonfinancial information in an effort to serve customers and regulators, more so than to serve investors

What do you believe motivates a company to report its impact on nonfinancial issues?



One probable reason behind investors' dissatisfaction with ESG and other nonfinancial information lies in the rationale and strategy behind companies' reporting such information. A majority of investors say that issuers provide nonfinancial information in order to build their corporate reputations with customers or to comply with governmental regulatory requirements (see Figure 3.4), but not to serve the needs of investors themselves.

In the first case, regarding nonfinancial reporting that serves customers, issuers typically seek to put their best foot forward. "Certainly, the ESG leaders are the ones that want to broadcast their disclosures most loudly," notes the senior analyst in Australia quoted earlier.

Many companies, to appeal to customers, offer useful and transparent nonfinancial information. Unfortunately, there are also instances in which the information presented merely intends to put a positive spin on ESG issues.

In the second case, regarding nonfinancial reporting and regulatory compliance, certain companies focus on meeting the minimum regulatory requirement, rather than on telling investors a more complete story about the value and business impact of their ESG efforts. "Some companies may only do the bare minimum when it comes to reporting, saying, 'If there's no regulation that requires me to report this, I won't,'" explains the head of equity portfolio management at a US asset management firm with US\$380 billion in AUM. "I think that's probably the most common reason [for the lack of reporting]."

While investors might not be the intended primary audience of today's nonfinancial reports, survey data suggests that issuers may actually be providing more and better information for investors' use. Today, respondents are more likely to say companies disclose nonfinancial information in response to the concerns of investors than they did in the 2014 study. Forty-two percent of respondents in 2015 say that demonstrating a company's risk management motivates its nonfinancial reporting, up from 29.0% in 2014. Similarly, 40.1% say that explaining a company's long-term capital value strategy motivates a company's nonfinancial reporting, up from 31.7% in 2014.

At the same time, the proportion of respondents who believe that companies make nonfinancial disclosures to build their reputations with customers fell to 63.8% in 2015 from 69.0% in 2014. Similarly, the portion stating that companies make these disclosures to comply with regulatory requirements fell to 59.2% in 2015 from 69.0% in 2014. It appears that companies may be starting to move from nonfinancial disclosures as a means of brand building and regulatory compliance to a more investor-centric strategy.

“When I started in 2000, a very small proportion of the FTSE 100 had environmental policy statements, and that was it. Now, 15 years later, 80% or 90% have very comprehensive corporate responsibility reports.”

Consistent with this data, investors interviewed as part of this study note a marked improvement in ESG and other nonfinancial reporting in recent years, especially among large-cap companies. The UK head of responsible investing quoted earlier explains, "When I started in 2000, a very small proportion of the FTSE 100 had environmental policy statements, and that was it. Now, 15 years later, 80% or 90% have very comprehensive corporate responsibility reports." Speaking from Australia, a portfolio manager concurs, "ESG data is improving all the time, especially with larger-cap companies. They understand that this is a bigger issue, and they're reporting a lot of that data. They're almost putting a flag post in the sand [where the data] is today, and they're trying to improve on that year-on-year, which I think is a really positive thing. And with the companies being aware of [this data], I think when the board and management think strategically about what they're going to do with the company, they factor in ESG to a larger extent every year."

4 Standardized, sector-specific information is fundamental to investors' ESG assessments

Survey data indicates that investors are especially eager to measure a company's nonfinancial performance against that of its sector peers and to link a company's nonfinancial information to its expected performance. Specifically, almost three-quarters of respondents consider sector-specific reporting criteria and key performance indicators (KPIs) to be very or somewhat beneficial to their investment decision making, and more than 70% see metrics

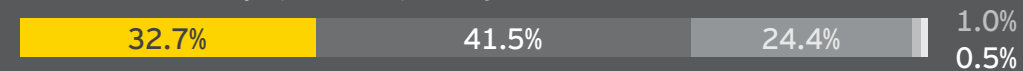
that link nonfinancial risks to expected performance as equally beneficial (see Figure 4.1). This enthusiasm for sector-specific disclosures is reinforced by respondents' comparatively low ranking of prescriptive accounting standards with fixed criteria, that would seek to apply a level of uniformity across all sectors.

Figure 4.1. Investors want to measure a company's nonfinancial performance against that of its sector peers using common performance criteria

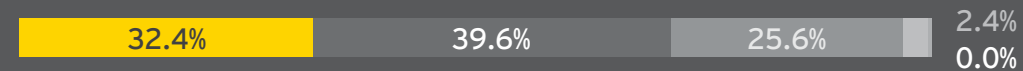
How beneficial would each of the following reports or disclosures be to your investment decision making?

Report contents

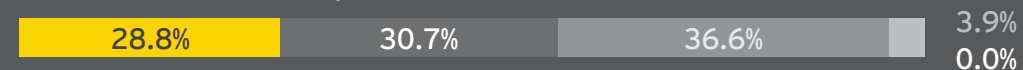
Sector or industry-specific reporting criteria and KPIs



Statements and metrics on expected future performance and links to nonfinancial risks



Company disclosures based on what they feel is most material to their value creation story

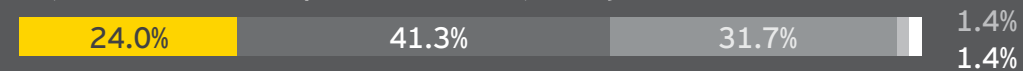


Prescriptive accounting standards for nonfinancial metrics with fixed criteria

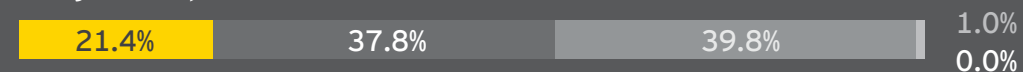


Report format

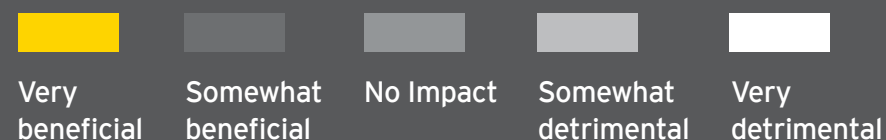
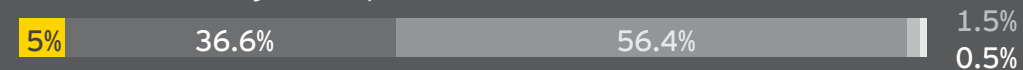
Separate sustainability and financial reporting



Integrated reports that follow the IIRC Framework



Self-declared integrated reports



Investors consistently affirm their desire for disclosures that allow the apples-to-apples comparison of companies, but lament the fact that conducting such comparisons is often difficult and time consuming. The UK head of responsible investing quoted earlier explains the current difficulty in doing cross-company ESG comparisons: "Even when companies provide information on ESG, the challenge is making it cross-comparable, because the companies obviously have different ways of collecting their data, and the indicators that they use are different. Where things are more regulated, there is better comparability and more data, but where there's less regulation, we have to go out there and seek to improve the disclosures by the companies that we own. Our ESG team fully engages with 120-plus companies per year; about 40% of those requests are for improved data disclosure."

Investors consistently affirm their desire for disclosures that allow the apples-to-apples comparison of companies, but lament the fact that conducting such comparisons is often difficult and time consuming

A senior analyst at an Australian asset manager adds that doing cross-company comparisons is complicated further because the process and standards are so sector specific: "The measures that we are interested in vary quite a lot across industries. While we might be interested in, say, the injury rates of companies that haul dangerous materials, the impacts we're interested in are quite different for hydro dams being built where communities must be shifted. The measures do vary quite a lot, which is why we do detailed, bottom-up research to understand the specific opportunities and risks for every company."

Attempting to solve the inconsistency and other problems with which nonfinancial reporting is faced at its current nascent stage are a number of standards organizations in the field of corporate reporting, including the IIRC, the SASB and the GRI. Their recommendations, some quite recent, are gaining international acceptance, and the companies that follow the guidelines of any one of these organizations are at a distinct advantage with investors.

Who stands for the standards?

A number of standards bodies are today attempting to fill the need for standardized, comparable, sector-specific nonfinancial information. The result is an array of recommended report types. Most, however, link ESG information to a company's predicted performance in an integrated report – that is, they integrate a company's financial and nonfinancial reporting into a single analysis. These links, along with other characteristics seen in many of these report models (such as sector-specific standards), are among the priorities that investors would like to see in nonfinancial reporting, according to this study.

Three of the most influential among these standards organizations are the following:

- ▶ The International Integrated Reporting Council (IIRC) has issued the Integrated Reporting Framework that allows companies to report material information about their strategy, governance, performance and prospects in the context of their external environment, using an integrated, concise format that makes cross-company comparisons easy.
- ▶ The Sustainability Accounting Standards Board (SASB) is an independent, US-based, not-for-profit organization whose mission is to develop and disseminate industry-specific sustainability accounting standards that help public corporations disclose material information useful to investor decision making within 80 industries.
- ▶ The Global Reporting Initiative (GRI) has pioneered a comprehensive Sustainability Reporting Framework that provides metrics and methods for measuring and reporting sustainability-related impacts and performance.

Despite the overall shortcomings of nonfinancial reporting in the eyes of investors, they value the quality disclosures that they do receive about the risks that matter to them. “Look at some of the industries that are typically associated with a high level of ESG risks – mainly the extractive industries such as oil and gas and mining,” points out an analyst at a large US asset management firm. “At the higher-quality companies (generally the non-small-cap companies that we consider for purchase), they’re quite good at releasing the information that you would want to see. For example, looking at the time-lost-to-injury rate for all of the firms, you can get that information, and you can compare it easily across companies. There are a lot of other industries where it’s harder to get that level of transparency, sometimes because the topics are a little harder to assess.”

Furthermore, investors’ views on the types of nonfinancial content in disclosures have remained fairly consistent recently. As in the 2014 study, respondents this year consider disclosures containing sector-specific reporting criteria and KPIs the most valuable when making investment decisions, and they consider disclosures reporting links between ESG risks and measurable projected performance to be the second most valuable. Notably, while these types of nonfinancial reports top investors’ wish lists in both years, their enthusiasm for each rose by eight or more percentage points from 2014 to 2015.

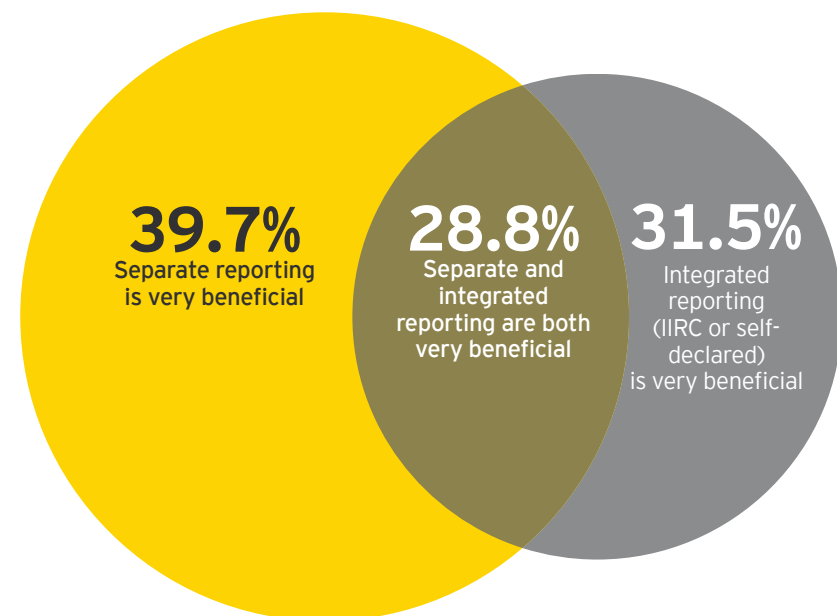
Regarding the various formats in which nonfinancial information can be reported – that is, separately or integrated with financial information – investors’ views initially seem to send mixed messages. On one hand, a solid majority of respondents, 59.2%, see integrated reports that follow the IIRC Framework as very or somewhat beneficial, and 41.6% see self-declared integrated reports as similarly useful. On the other hand, respondents also indicate a growing interest in separate sustainability and financial reporting; in the 2015 survey, 65.3% of respondents see separate sustainability and financial reporting as very or somewhat beneficial, up from 42.5% in 2014.

Looking at the data a bit more closely reveals that 34.6% of all respondents credit at least one type of reporting format as being very beneficial to their decision making. Of this group, 39.7% see only separate reporting as very beneficial, while 31.5% see only integrated reporting (whether it follows the International IR Framework or not) as very beneficial. And 28.8% of the group see both separate and integrated reporting as very beneficial (see Figure 4.2).

However, when asked to rank a wider range of format types used to communicate nonfinancial information, investors’ strong enthusiasm for integrated reporting is clear – and is on the rise. In this year’s study, 70.9% of respondents see integrated reports as essential or important, up from 61.0% in 2014 (see Figure 4.3). In fact, integrated reports ranked second only to companies’ annual reports (without specification as to whether they are integrated annual reports or not).

Figure 4.2. Investors see both integrated and separate nonfinancial reporting as very beneficial

How beneficial would each of the following reports or disclosures be to your investment decision making?



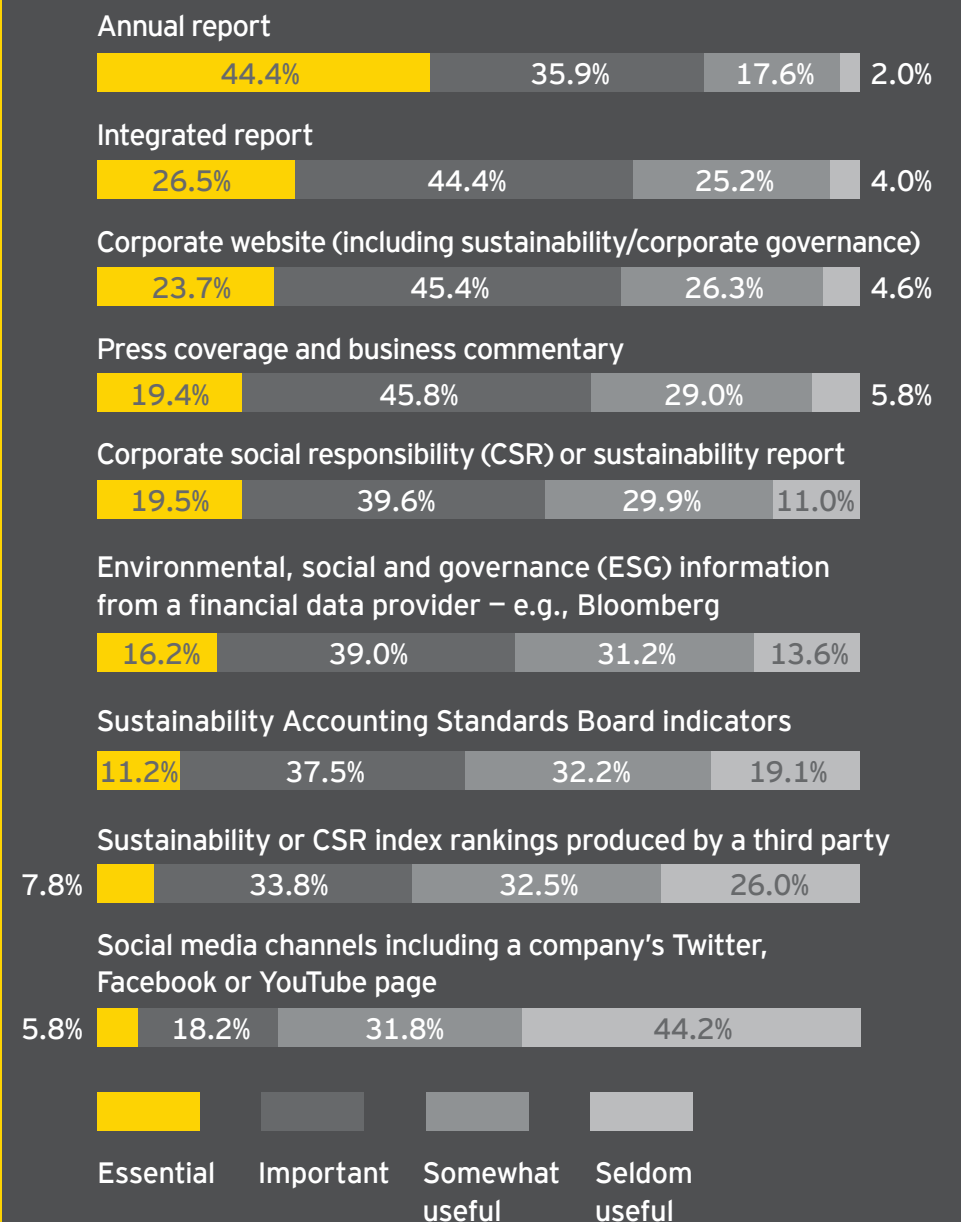
Investors’ strong enthusiasm for integrated reporting is clear – and is on the rise

Of course, this is not to say that separate reporting is not appreciated, as well. Indeed, any reporting of nonfinancial information is considered a good thing. In 2015, 59.1% of respondents see companies’ separate corporate social responsibility (CSR) or sustainability reports as essential or important, up from 34.8% in 2014.

In addition, investors largely seem to prefer that nonfinancial information comes directly from issuers than from third parties. Companies’ annual reports were endorsed as essential sources of this information by 44.4% of investors, and corporate websites were endorsed as essential by 23.7%. Information from third parties, such as press organizations or financial-data providers, received considerably smaller endorsements: 19.4% of investors consider press coverage of a company’s nonfinancial issues to be essential to their decision making, and only 7.8% consider sustainability or CSR index rankings produced by third parties to be essential.

Figure 4.3. Investors want nonfinancial information directly from issuers

How useful do you find the following types of nonfinancial information when making an investment decision?



Again, since 2014, investors have shown consistency regarding the sources from which they prefer getting their nonfinancial information. Companies' annual reports, considered essential by 44.4% of respondents in the 2015 study and by 46.8% in the 2014 study, rank first in both years. Integrated reports (without a specified source), seen as essential by about 26% of respondents in 2015 and 2014, rank second in both years.

Also, social media platforms (such as Twitter, Facebook and YouTube) gained popularity with investors since 2014. They were considered essential or important sources of nonfinancial information in 2014 by 16.2% of investors, while 24.0% elevated them to this level in 2015. (Still, social media endorsement in both years has been relatively small, perhaps for a number of reasons. Perhaps institutional investors have simply not yet joined the social media revolution, are suspicious of this still-new means of disseminating information, or see the overall source as less useful due to its broad and uneven role in disseminating company information.) Whether or not social media as a whole will continue to gain popularity with investors warrants watching.

In addition to preferring issuers themselves as the source of nonfinancial information, investors specifically value board-level accountability behind a company's nonfinancial information; 80.0% of respondents see mandatory oversight of a company's nonfinancial reporting by its board as either essential or important. Similarly, more than three-fourths of respondents consider oversight of such reporting by the board's audit committee – with or without independent verification – to be essential or important (see Figure 4.4).

The head of responsible investing at a UK asset management firm with US\$425 billion in AUM, quoted earlier, explains the accountability his firm seeks from companies regarding ESG and other nonfinancial information: "Board-level oversight is increasingly important. We're starting to think, 'What is the long-term strategy of these companies, and how are they taking into account these environmental limits to growth in their duty performance [as board members]?' The only area where you get that visibility is from the board itself. So, having board-level oversight is incredibly valuable."

Indeed, the value investors assign to the company accountability behind nonfinancial information has grown on all levels. The 80.0% of investors who consider mandatory board oversight important today has grown from 63.8% in 2014. Similarly, the proportions of investors who see oversight by a company's audit committee with and without independent verification have also grown since 2014.

Clearly, as investors have made nonfinancial information a more deliberate, structured part of their decision making process, they have grown more concerned about the accuracy and thoroughness of this information. In terms of the content of this information, investors value information that helps them compare companies within a sector and provides them with a forward-looking view into company performance and risk. In terms of the source of this information, investors value information directly from the companies about which they are making investment decisions. In terms of accountability for this information, investors want it to carry a seal of approval from the very top of the corporate ladder. (As we see later in this report, this wish list on the part of investors offers a recipe to issuers looking to win new investment.)

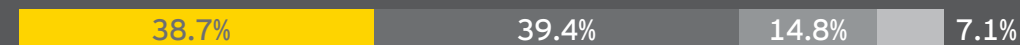
Figure 4.4. Investors value a company's top-level approval of its nonfinancial reporting

How important are the following levels of accountability in nonfinancial performance reporting?

Mandatory board oversight



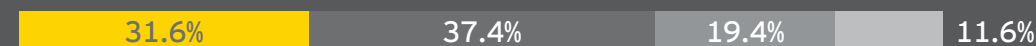
Audit committee oversight with independent verification



Audit committee oversight



Shareholder approval at a company's annual meeting



5 The regional view: Europe still leads, but ESG evaluations increasing globally

Nonfinancial information – its provision by issuers and its use by investors – varies substantially around the world, largely due to the maturity of the economies in which issuers and investors operate. Says the head of responsible investing at a UK asset management firm, "I think that in most of the emerging markets, the maturity of the economies, the political systems, and regulatory systems mean that levels of disclosure, in comparison to Western markets, tend to be a lot lower."

"However, even in the emerging markets," continues this investor, "there's a lot more concern about governance because their corporate governance standards seem to be lower than in the European or North American markets." Investors worldwide acknowledge that among nonfinancial factors and specifically ESG, it is corporate governance that most often influences the potential value that can be captured by investors.

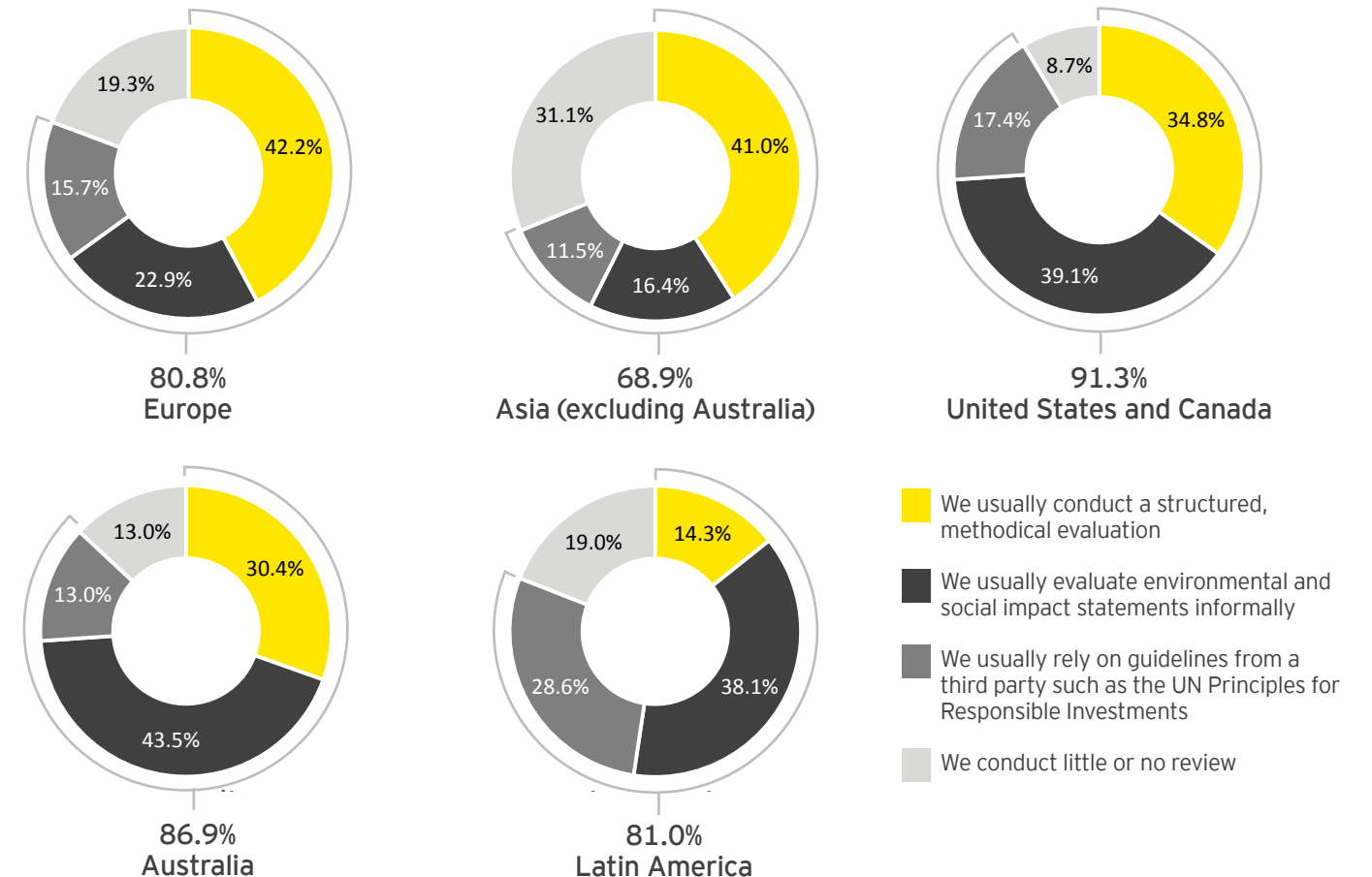
Europe and Australia

It seems clear that investors in the developed markets of Europe lead their peers elsewhere in more formally integrating ESG into their decision making. In Europe, 42.2% of respondents – more than any other region – report conducting a structured, methodical evaluation of companies' environmental and social impact statements (see Figure 5.1).



Figure 5.1. Solid majorities in all regions surveyed evaluate ESG information using structured methods, informal evaluation or third-party guidelines

What approach is typically taken in reviews of ESG information?



Similarly, 30.1% of respondents in Europe – again, more than in other region – report that companies’ nonfinancial information has frequently played a pivotal role in their investment decisions over the last year (see Figure 5.2).

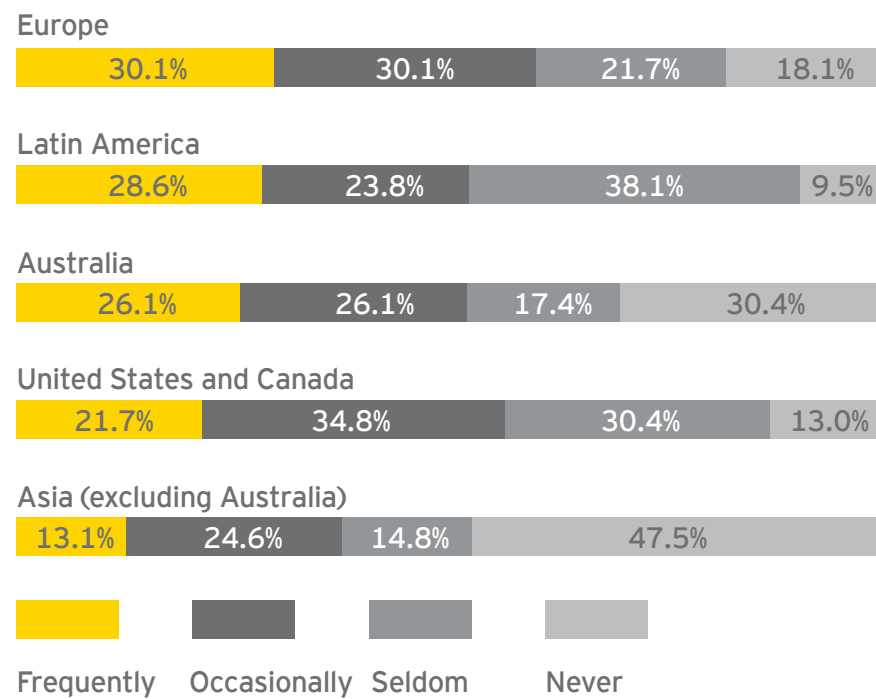
European investors are also currently more convinced of the utility of integrated reporting, relative to their peers elsewhere; 69.6% of European respondents see integrated reports that follow the IIRC Framework as very or somewhat beneficial (see Figure 5.3).

However, disclosures from companies throughout Europe are not uniformly to investors’ liking. Says the head of responsible investing at a large UK asset manager, “If you look within Europe, the companies there have much better, more informative levels of disclosure, but then there are different regional levels; it does vary.”

Investors and sell-side analysts often group Australia together with Europe, specifically as an ESG leader. One such US equity analyst says, “Very clearly, Australia and Europe are on the leading edge as it relates to understanding environmental, social and governance issues and wanting to see these topics integrated into an investment decision making process.” He attributes Australian investors’ acute interest in ESG in part to the influence of the nation’s retirement system. “Australia has these superannuation funds, which generally have employees on their investment committees or boards,” he explains. “That, I think, has really driven a sincere interest in ESG topics because you’re more likely to see an employee saying, ‘Hey, these are things that are important to me and other employees. Let’s make sure that our investment side is capturing that.’”

Figure 5.2. Nonfinancial information has affected investment decision making most often in Europe in the last year

In the last 12 months, how frequently has a company’s nonfinancial performance played a pivotal role in your investment decision making?



The survey findings tell a more nuanced story regarding Australia as a leader in nonfinancial reporting generally. On one hand, it falls, for example, near the middle of the pack in terms of the effect that nonfinancial performance has had as a criterion in investors’ decision making over the last year. On the other hand, however, a notable 82.6% of investors in Australia, a larger proportion than in any other region, consider nonfinancial data to be germane in investment decisions across all sectors, as opposed to just certain sectors (see Figure 5.4).



Figure 5.3. At present, European investors are more likely to see the advantages of integrated reporting that follows the IIRC’s Integrated Reporting Framework

How beneficial would integrated reports that follow the Integrated Reporting Framework be to your investment decision making?

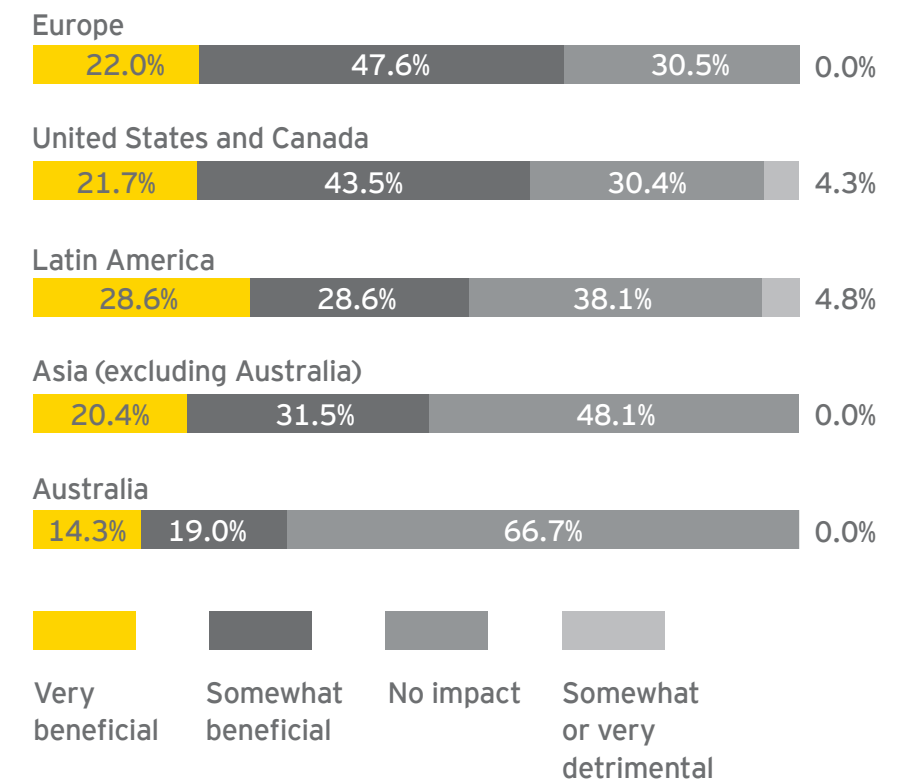
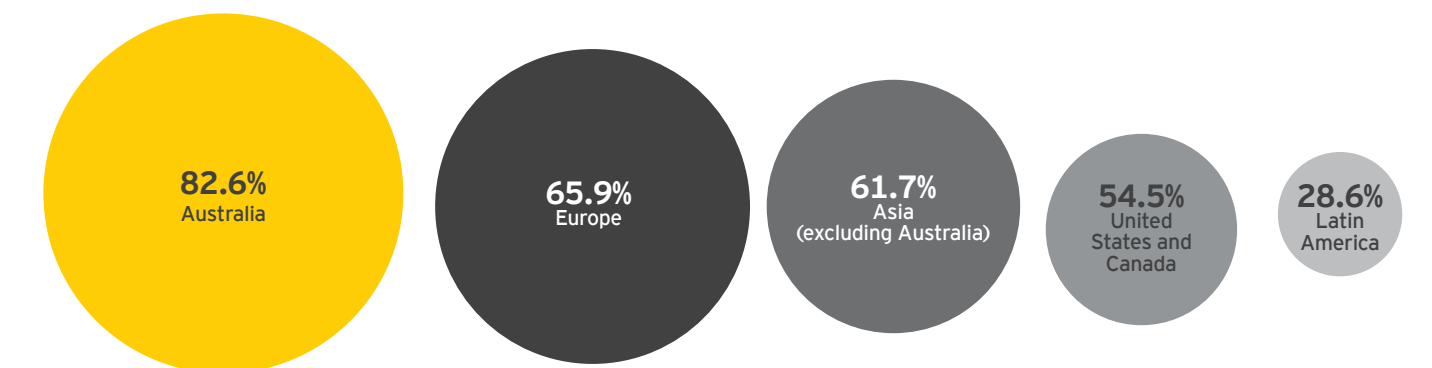


Figure 5.4. Investors in Australia are the most likely to see nonfinancial data as relevant across all industry sectors

In which sectors are you more likely to consider nonfinancial data most relevant? (Percentage of respondents choosing “All” rather than individual industry sectors.)



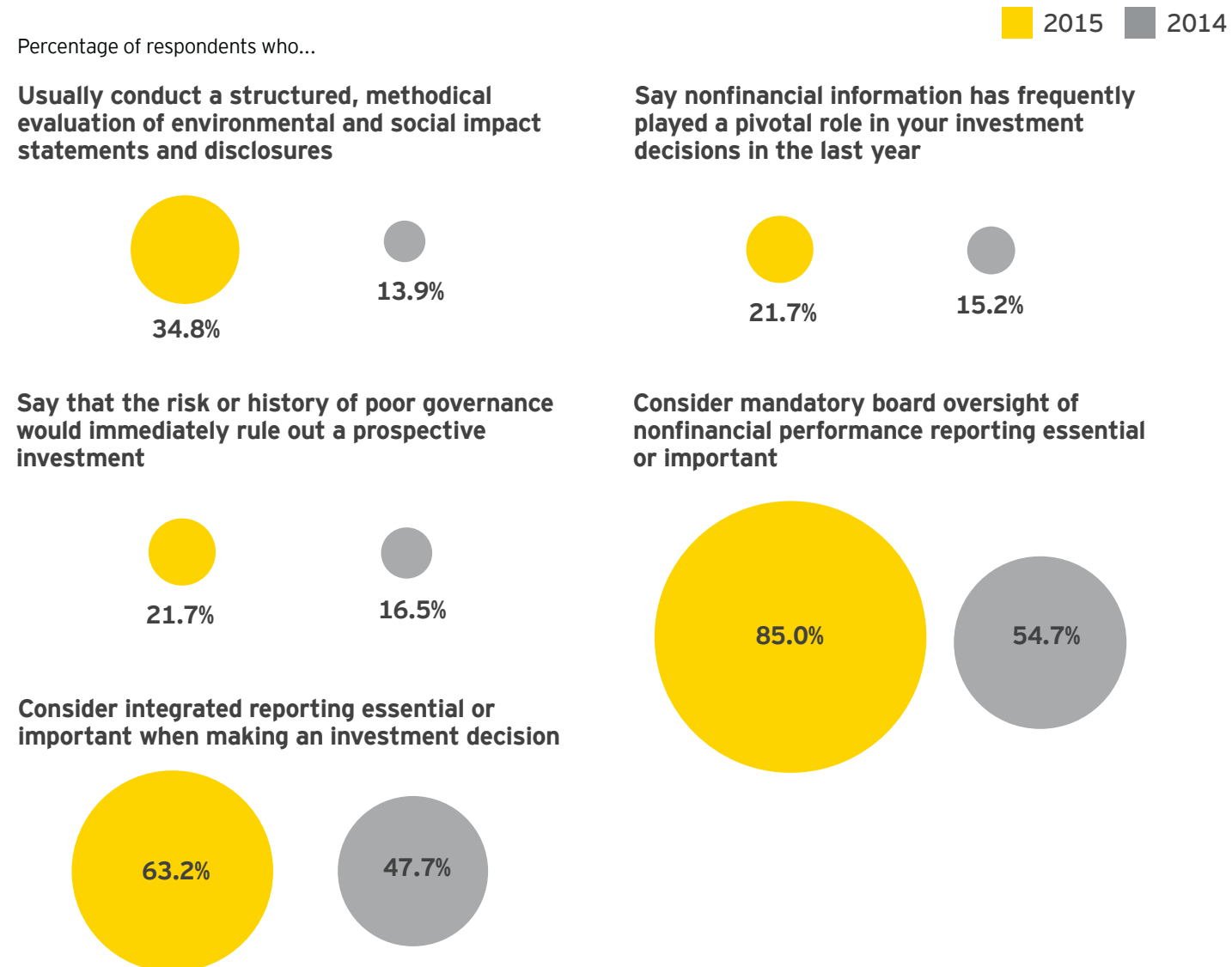
United States and Canada

The 2014 study suggested that investors in the US and Canada lagged behind their peers elsewhere regarding the use of nonfinancial information in their decision making. However, according to this year's study, investors in North America have taken notable steps forward in integrating nonfinancial factors into their investment decisions.

Four indicators of the importance that investors place on nonfinancial performance and reporting – (1) investors' use of a structured approach in evaluating nonfinancial information; (2) the frequency with which such information is pivotal to their investment decisions; (3) the impact that the risk of poor corporate governance has on their decisions; and (4) the importance they place on board oversight of nonfinancial information – shed light on this advance by investors in North America. Each of these indicators saw a substantial rise among the region's investors from 2014 to 2015 (see Figure 5.5).

At the same time, the portion of respondents in the US and Canada who find integrated reports essential when making an investment decision also rose substantially, to 63.2% in 2015 from 47.7% in 2014.

Figure 5.5. Investors in the United States and Canada have become more focused on nonfinancial performance in the last two years



This growing enthusiasm for disciplined analysis of companies' nonfinancial performance may well be tied to a sustained shift in thinking in North America. Says one portfolio manager, "Institutional investors have been concerned about ESG for a long time, but that's really increased now in the US and Asia, as well, and there's a greater recognition that many of the drivers that people traditionally saw within areas of risk and opportunity actually fall under the ESG banner." Echoing this view, a US analyst adds, "We're starting to see, here in North America, recognition that [ESG] topics are impacting stocks and securities more often, so we should spend some time on them. We're certainly trying to drive that dialogue here, because we agree. We think ESG integration is just a natural part of any active, long-term investment process. I should say, 'any good, active, long-term investment process.'"

This shift has been a long time coming in the US. A head of sustainability research in the UK says, "There's certainly confusion around what ESG means for a lot of investors. When [US] investors were looking at these issues 10 years ago, it was really done on a moral basis. An ethical class emerged that was selecting companies within sectors partly on the basis of their performance on labor standards or environmental or regulatory performance." Such investors made decisions, he says, on "a moral basis rather than on recognition that these issues have a bearing on commercial performance. There is a sort of baggage associated with that history, where people still see this as being the core agenda."

There's certainly confusion around what ESG means for a lot of investors.

But in the US, while many companies now acknowledge the performance value added by managing ESG factors, this acknowledgement has not yet made ESG a mainstream portfolio strategy. An analyst at a large US asset management firm explains, "Some of the staples or branded packaged goods companies in the US have very intricate sustainability programs, and they talk about how these programs really add value, help them manage water risk and so on." "However," he continues, "when we say to the investment committee at most of these companies, 'You should consider ESG in your investment process for your 401(k) plan,' the investment officer says, 'No, no, no, we don't do that.'"

We think ESG integration is just a natural part of any active, long-term investment process. I should say, 'any good, active, long-term investment process.'





Asia-Pacific

Investors say, on one hand, that Asia (excluding Australia) lags behind the rest of the world in its reporting of ESG information. “There is a multitude of poor reporters in Asia, particularly in China and Malaysia,” says the head of responsible investing at a UK asset manager. But, on the other hand, there seems to be ready evidence that advances are underway. “Japan,” he continues, “just announced plans for its new stewardship code, which is going to improve corporate governance there.” One US analyst, suggesting that this new effort to improve corporate governance in Japan could be contagious, says, “Japan, traditionally a country where governance has fallen behind other developed market standards, is now trying to change that. You might start to see a shift throughout Asia if that occurs.”

The survey data also reveals other signs of growing interest in nonfinancial reporting in Asia (excluding Australia). Of the region’s respondents, 41.0% have a structured, methodical approach to evaluating ESG factors when making investment decisions, second only to Europe’s 42.2% (see Figure 5.1).

However, it seems that this interest in nonfinancial performance on the part of investors in Asia (excluding Australia) has not yet particularly affected their investment behavior relative to those of investors in other regions. Of respondents in Asia (excluding Australia), 47.5% report that companies’ nonfinancial performance never played a pivotal role in their investment decisions over the last year – in other words, nonfinancial information more often plays a pivotal role in investment decision in all other regions (see Figure 5.2).

Similarly, Asian companies lag their peers elsewhere in their disclosure of ESG risks, according to some investors. The head of responsible investing at a large UK asset management firm points out that he and his team devote much time and effort to chasing down ESG information in the region. “A lot of our requests with Asia (excluding Australia) companies are to get them to provide [ESG] data.”

Latin America

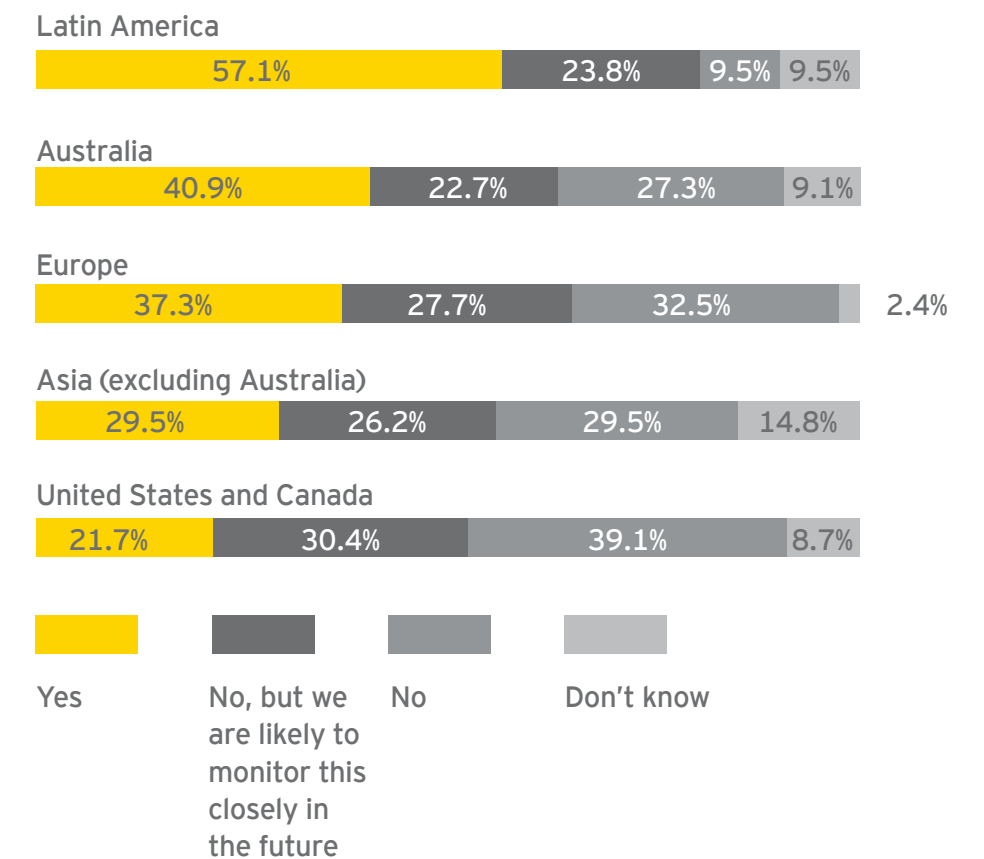
“In Latin America, the level of disclosure is lower than I have seen on US companies’ 10-Ks,” says an analyst at a Peruvian pension fund. “[In Latin America,] it’s not regulated. Companies issue things they have in their favor. Pertaining to risks, they just report what they feel like.” He goes on to explain that most Latin American investors also do not push companies for any more ESG disclosure than they offer. “I went on a field trip in the chemicals sector. The person in the investor relations department asked directly if the investors that were there, including me, cared about all the ESG factors, and they said, ‘Absolutely not.’ That is one perspective, but then, for example, because we are a pension fund and want to have an ESG policy, we do care, and we push companies to disclose that or improve their governance processes.”

That said, there seems to be the growing realization among Latin American investors that they need to protect their portfolios from the downside of ESG and other nonfinancial factors – at least in the form of stranded assets. More investors in Latin America, 57.1%, report reducing holdings in the last year due to stranded asset risk than did so in Europe, Asia or the US and Canada (see Figure 5.6).

Given the recent reallocations by investors in Latin America to avoid stranded asset risk, an uptick in screening for ESG and other nonfinancial risks during their initial investment decisions is likely not far behind.

Figure 5.6. Stranded asset risk is more pressing among Latin American investors

In the last 12 months, has your fund decreased its holdings of a company’s shares due to the risk of stranded assets (e.g., due to changes in regulation, social expectations, disruptive technology or environmental conditions)?



6 Actions for issuers and investors: nonfinancial reporting opportunities

In the face of growing concern over stranded assets and other risks, institutional investors around the world say they are increasing their integration of companies' ESG and other nonfinancial information into their investment decision making. They are considering more information, from more sources, in more structured ways, with a focus on issuer-supplied disclosures that shed light on expected business performance.

The good news for issuers is this: investors want higher-quality, more transparent disclosure of nonfinancial issues that affect companies' risk, performance, and valuation. Thus, investors are demonstrating a willingness – indeed, an eagerness – to gauge issuers' potential returns using expanded criteria, beyond the customary fundamental and technical inputs. Companies seeking new investors may view this as welcome news, since it offers them another basis on which to compete for investor dollars. The issuers that are able to provide the type of nonfinancial information that investors seek may enjoy greater investor attention and, ultimately, may attract and retain investor's capital.

Next steps for issuers

Investors have clear priorities regarding the type and quality of nonfinancial information they want. Accordingly, an issuer that discloses this information in the way investors find most useful improves the chances its story will attract attention.

In addition, issuers that excel at getting nonfinancial data to the market have a first-mover opportunity to help set the standard and tone for nonfinancial reporting within their sectors. In other words, they can shape, rather than react to, the reporting standards that investors seek.

For these reasons, issuers stand to be rewarded by offering investors their nonfinancial information – whether via separate sustainability reports, integrated reports that follow the IIRC Framework, or other means – as effective communication that is relevant to the needs of the investors they are trying to attract.

And what type of nonfinancial information do investors consider relevant? According to the survey data, investors most value ESG information that:

- ▶ Comes directly from issuers, rather than from third parties
- ▶ Focuses on measurable performance factors, such as regulation, cost and risk
- ▶ Relies on standard, industry-specific criteria that allow comparisons between companies in the same sector
- ▶ Clearly explains the links between nonfinancial risks and expected performance
- ▶ Has a company's top-level approval by, for example, its board or audit committee

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But knowing investors' priorities regarding nonfinancial reporting is not enough. An issuer must be able to put this knowledge into action that results in effective nonfinancial reporting of the company's performance. There are various paths that companies can take to this goal; many of them share some or all of these practical strategies:

- ▶ Invest in nonfinancial reporting: As this study shows, investors believe the majority of companies today do not adequately disclose nonfinancial information. Despite improvements – especially among large-cap companies – widespread and transparent disclosure does not yet exist. Companies that fall short should keep in mind, as is also revealed in the survey, that investors are progressively bringing a more integrated and structured analysis to the nonfinancial factors affecting companies. There is much to be gained from an issuer's transparency and enhanced nonfinancial messaging.
- ▶ Focus nonfinancial disclosures on information that is material to business performance: Investors are interested in companies' long-term value creation, and, therefore, in the nonfinancial information that affects it. One of the top-level findings of this study is that investors want to know how a company's nonfinancial information links to measurable influences on expected performance, such as regulation, cost and risk.
- ▶ Consider incorporating domestic and international leading practices into ESG and other nonfinancial reporting: With guidelines – such as the IIRC's Integrated Reporting Framework, SASB's nonfinancial accounting standards and GRI's Sustainability Reporting Framework – evolving rapidly, the bar for nonfinancial reporting is rising at a fast pace. Companies that model their nonfinancial reporting after the leading practices encouraged by any of these organizations have a competitive reporting advantage in the eyes of investors, while those that ignore these leading practices are progressively at risk.
- ▶ Act now: Investors are seeking the right nonfinancial information right now. Many, especially larger investors, contact companies directly to request the nonfinancial data missing from annual reports, websites and other publications. And, if investors cannot find the nonfinancial information they want, they may increasingly see it as a negative when making investment decisions.

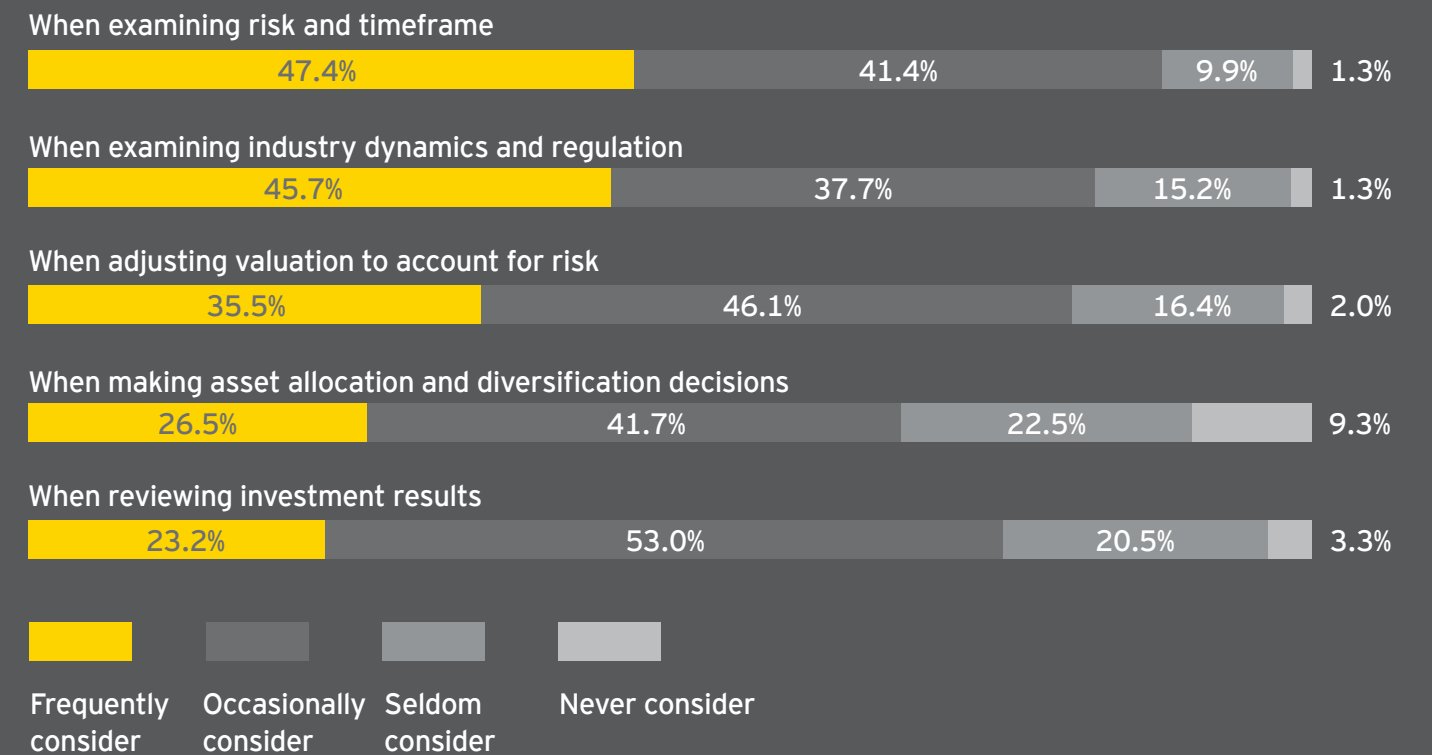
- ▶ Benefit from good governance: Respondents in this study report that, in their investment decisions, they particularly examine, often in a structured way, a potential investment's governance (often even more so than they examine the environmental and social issues or other nonfinancial factors affecting a company). Furthermore, a vast majority of respondents want governance procedures in place that give a company's board or audit committee accountability for its nonfinancial reporting.

A further lesson for issuers is this: investors are more likely to consider nonfinancial information in the early stages of their decision making – that is, when they are considering whether to take a position in a company. More than 45% of respondents say they frequently consider ESG information when determining the risk and holding period of prospective investments, when evaluating industry dynamics, and when examining the regulatory environment (see Figure 6.1). Nonfinancial information plays a lesser role, say investors, when reviewing investment results. This means that investors are most likely to analyze nonfinancial data when they make initial investment decisions. Therefore, issuers hoping to make it onto investors' short list are well advised to provide the types of nonfinancial disclosures that analytical investors increasingly seek.

Finally, nonfinancial reporting should be a priority for companies seeking long-term investors, often coveted by issuers. Such investors are particularly interested in ESG and other nonfinancial matters. As the head of sustainability research at a UK asset manager with US\$770 million in AUM points out, "If you are only investing over a few months, then doing an awful lot of work and spending time and resources understanding the ESG profile of a business may not be worth it. But if you are or ought to be a longer-term investor, then these issues become much more relevant to the way that you think about the value of businesses."

Figure 6.1. Investors use nonfinancial information in the early stages of decision making

How frequently do you take nonfinancial information into account in the following stages of your investment decision making?



Failure to make nonfinancial disclosures even for reasons of limited resources, other priorities or timing may be interpreted negatively by investors

The price of not reporting nonfinancial data

A company that makes little effort regarding nonfinancial disclosures runs the risk of being dropped from consideration by investors incorporating nonfinancial screening into their decision making. This is an increasing risk with portfolios generally, as we have seen, and is an especially high risk with ESG-sensitive portfolios. Of course, the risk is all the greater if the company's peers within its sector provide nonfinancial information readily and transparently.

In explaining his firm's posture across all of its portfolios toward missing nonfinancial information, the head of responsible investing at a UK asset management firm with US\$425 billion in AUM reports, "Typically, if a company isn't providing data, it is potentially not managing or recognizing these risks or opportunities to its business, and we would not feel confident that its management has a strategy to deal with this. That would be how we'd perceive the lack of disclosure." He continues, "It often turns out that, actually, a company has been collecting this information for quite a long time, and it's just a matter of giving it a nudge to provide the data."

So, even though a company's reticence in nonfinancial reporting may not be an indicator of poor managerial analysis or stewardship, it may be perceived that way. Failure to make nonfinancial disclosures even for reasons of limited resources, other priorities or timing may be interpreted negatively by investors.

Furthermore, the consequences for a company that has subpar ESG-reporting practices relative to its sector peers can be serious in terms of ESG-dedicated investment portfolios. A lack of disclosure often means exclusion from such funds. One financial analyst at a Swiss asset management firm with US\$13 billion in AUM explains, "When we have no information on ESG from a company itself via Bloomberg, we assign it an internal rating meaning 'no data available,' which is neutral; it's not negative or positive." However, since his firm uses a "best-in-class" scoring standard to determine which issuers to include in its ESG portfolio, "such a company would screen lower than the best and would most likely fall off the cliff," he says.

Next steps for investors

As we've seen, more investors are stepping up their internal process for nonfinancial analysis with more structured, disciplined and consistent approaches. Investors are likely to continue building these structured evaluation processes and integrating them into their investment decision making because, without them, they would miss the increasing risks and opportunities posed by ESG and other nonfinancial factors to both their holdings and potential holdings.

Furthermore, there are a number of steps that investors themselves can – and do – take to increase the quantity and quality of the nonfinancial reporting that they receive. In particular, many survey respondents report that their firms, as part of their investment decision making, spend a significant amount of time and effort engaging companies that have not made available adequate nonfinancial information. As ESG and other nonfinancial information is seen as progressively more important to investment decisions, this investor practice will likely increase.

The head of responsible investing at a UK asset manager explains that "a very big part of what we do is being a good steward of the companies in which we invest, asking them to provide us with the data demonstrating that they're managing these risks. In the European marketplace, we're quite a big holder in many of the companies in which we invest. The size of our shareholding means that our ESG team has quite a good ability to get data and influence management." Not all investors have the influence over companies that this US\$425 billion asset management firm has.

Indeed, some investors even take steps beyond engaging company management about inadequate nonfinancial disclosures. An analyst at a Peruvian pension fund with US\$10 billion in AUM explains that, if the fund is not satisfied with the ESG disclosures or path being taken by a company in which it has more than 5% ownership, "as a last stage we would even call a shareholder meeting to discuss these issues."

Furthermore, certain investors are attempting to improve disclosure through legislation and collaboration with public action organizations. A US asset management firm with US\$380 billion in AUM has "a process in place where, through shareholder initiatives or statutory initiatives, we encourage companies to report," according to its head of equity portfolio management. And the head of responsible investing in the UK adds, "We also collaborate with others through initiatives such as the Carbon Disclosure Project and a sub-project of that called the Carbon Action Initiative, which is specifically focused on getting high-emitting companies to set themselves carbon targets and, going forward, absolute reduction targets."

As we see, a growing number of investors not only want higher-quality ESG and other nonfinancial disclosures but are also working to ensure they get them. In response, forward-looking issuers could effectively seize the opportunity to fill this information deficit and, in the process, create a more effective investor strategy for themselves.



About this research

This 2015 study, commissioned by EY and conducted by the Custom Research Group at Institutional Investor Research (IIR), examines investors' views about the use of nonfinancial information in investment decision making. It is a follow-up study to one on the same topic, also commissioned by EY and conducted by IIR, that was published in 2014.

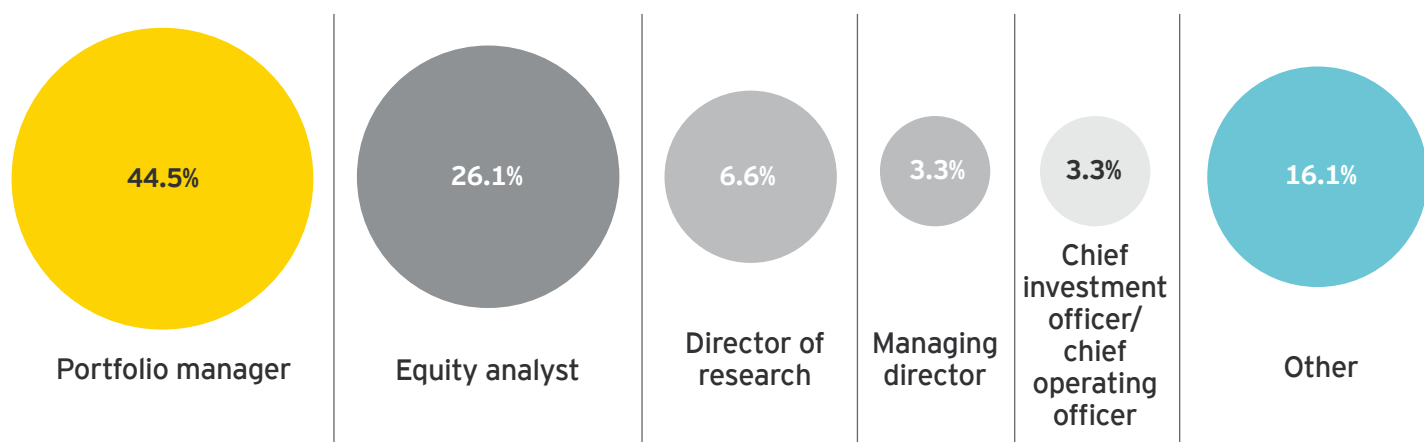
For use in the 2015 study, IIR, in collaboration with EY, composed a questionnaire on the study topic, which it kept largely consistent with the questionnaire used in the 2014 study so that historical comparisons could be made. In January and February 2015, IIR collected a total of 211 responses from senior decision makers at

institutional investors in the Americas, Europe and Asia-Pacific. In addition, in-depth interviews were conducted with 11 investors in order to obtain context and further details regarding the data collected.

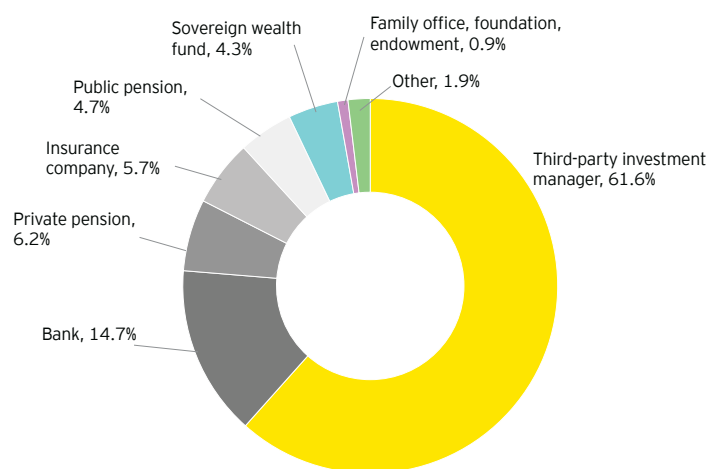
Survey respondents represent high-level investment decision makers; indeed, almost half are portfolio managers. Of all respondents, 61.6% work for third-party investment managers. Notably, almost three-quarters of respondents work for institutions with US\$10 billion or more in AUM (see Figure A.1).

Figure A.1. Survey respondents represent high-level decision makers at large institutional investors

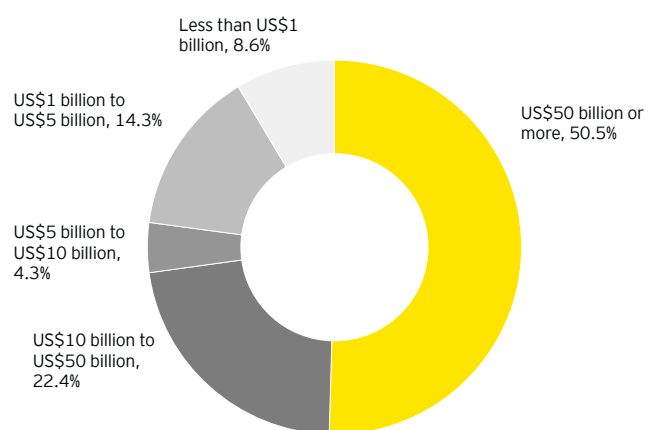
What is your title?



What type of institution do you work for?



What are your institution's assets under management?



Survey respondents are located in the Americas, Europe and Asia-Pacific (see Figure A.2). This year's study includes a much higher proportion of respondents from Asia-Pacific than did the 2014 study; the region's participation rose to 39.8% from 11.0%.

Together, survey respondents report being responsible for investment decisions in every sector. While more than half say that they invest across all sectors, the next largest groups of respondents say they invest most heavily in the financial services and the industrial sectors (see Figure A.3).

Figure A.2. Survey respondents are located in the Americas, Europe, and Asia-Pacific

Where is your position located?

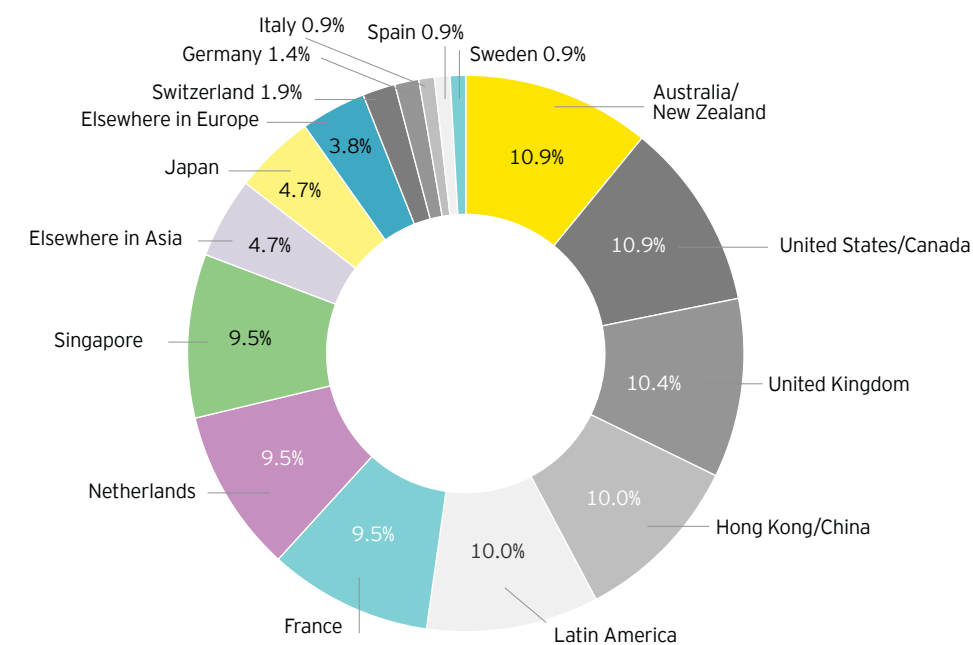
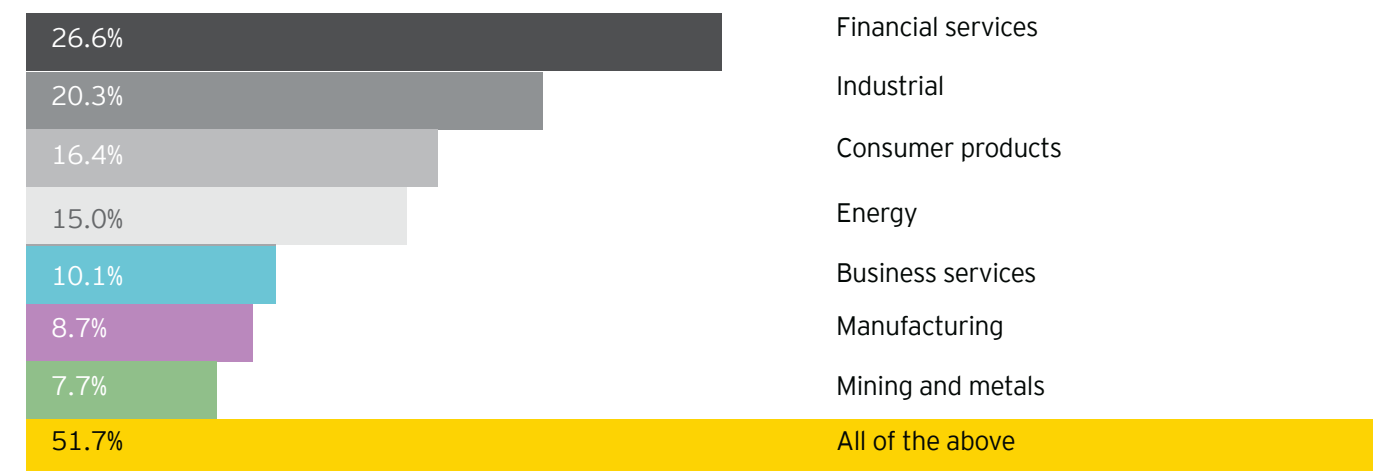


Figure A.3. More than half of respondents are responsible for investment decisions in all sectors

In which of the following sectors do you invest most heavily?



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